BANCA IMI

Macroeconomic Outlook

Research Department

March 2013

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INTESA SANPAOLO

BANCA IMI

Macroeconomic Outlook

Index

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Quarterly

Intesa Sanpaolo
Research Department

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Based on information available up to 21 March 2013

Slow ahead

The world economy is moving along the tracks of a moderate expansion, led by the U.S. and emerging markets, with no sign of global inflationary pressures. The most worrying risk scenarios have so far been defused, although the situation remains far from quiet. Monetary policy remains very accommodative, but in the U.S. the most effective transmission to the real economy could allow a gradual winding down of quantitative easing.

Luca Mezzomo

Investor optimism concerning ongoing recovery proved to be correct

The positive orientation expressed by the financial markets in the second half of 2012 was confirmed by economic indicators. Confidence surveys and PMIs have provided signs of a widespread improvement in economic activity, although with different degrees by area (less contraction in the Euro Zone, actual acceleration of growth in the US and BRICs). These indications have begun to find comfort even in hard data, such as industrial production.

The strengthening of economic activity was also aided by the benign evolution of economic policies and developments on the main sources of the crisis, as well as the orderly evolution of prices on energy commodities. The monetary policies were very accommodating; the only significant development was the expansion announced by the Bank of Japan, although having effect from 2014. In addition, the risk of excessive fiscal tightening in the USA has not materialized. Finally, three European countries in crisis (Ireland, Portugal, and Spain) have seen a marked improvement of access to markets, while a fourth (Italy), for now has not been penalized as feared because of negative election results for governability prospects. Even the nasty Cyprus crisis failed to create big market movements.

Economic growth by geographical area

	2010	2011	2012	2013	2014
United States	2.4	1.8	2.2	1.8	3.1
Japan	4.7	-0.5	2.0	0.8	2.2
Euro Zone	2.0	1.5	-0.5	-0.5	0.9
Eastern Europe	3.6	3.7	2.8	1.9	3.5
Latin America	5.8	4.1	2.6	3.1	4.3
OPEC	3.8	4.8	4.0	4.1	4.7
Eastern Asia	9.1	7.0	6.2	6.1	7.1
Africa	3.8	3.4	2.7	4.0	4.9
World	5.1	3.9	3.2	3.3	4.1

Source: calculations Intesa Sanpaolo – Research Department

In developed countries, expansive monetary policies will continue to be accompanied by restrictive fiscal policies

The expected scenario for the economic policies has not substantially changed in recent months. The fiscal policy stance, as measured by the change in the cyclically-adjusted primary balance, will remain restrictive in developed countries, in particular the Euro zone and the United States, and neutral for emerging countries. The monetary policy stance will remain highly expansive: the level of monetary policy rates will remain zero for several quarters, and quantitative easing measures will continue to be in force in Japan (where they will be upgraded between April and January 2014) and the United States (where, on the contrary, the strengthening of economic activity should lead to a gradual winding down of the current program). The reduction in the budget of the European Central Bank, which will continue in the coming months, has reflected the return of idle cash, and has no significant impact on the level of monetary rates or credit conditions. With regard to the transmission of the monetary policy, it is expected that the US credit conditions will reflect more monetary stimulus, by improving the balance sheets of banks, companies and households. In the Euro Zone the situation is and will remain very different, given the ongoing level of fragmentation in financial markets and the lack of pressure homogeneity on local credit conditions. In addition, several European countries are characterized by processes of financial deleveraging affecting the household and business sectors, which reduce the transmission of monetary policy impulses to the demand components that are sensitive to interest rates; loan demand is further reduced by the presence of excess production capacity and uncertainty over future demand, which discourage investment in production.

Outlook on commodity prices

	2010	2011	2012	2013	2014
Oil (Brent, $/barrel)	79.5	111.3	112.0	108.9	113.6
	+29.1	+40.1	+0.6	-2.8	+4.4
Raw Material excl. fossil fuels (1990=100)	160.9	189.5	170.9	174.6	180.9
	+26.4	+17.8	-9.8	+2.2	+3.6
Metals (1990=100)	202.3	229.7	191.0	200.9	209.8
	+48.2	+13.5	-16.8	+5.2	+4.4
Agricultural (1990=100)	125.1	153.5	134.1	127.1	125.2
	+33.2	+22.7	-12.6	-5.2	-1.5

Note: average annual levels and changes
Source: Intesa Sanpaolo – Research Department

Few reviews on growth forecasts; GDP growth will be moderate in developed countries

Forecasts on GDP changes have been subject to very modest revisions compared to three months ago. At a marginal upward review for the United States (from 1.7% to 1.8%) it contrasts with an equally marginal downward revision for the Euro zone (from -0.4% to -0.5% y/y) and for India; estimates for China have not changed. Growth in developed countries will remain moderate, with uneven trends: acceleration in the United States, mild recession followed by a modest recovery in the Euro zone, slowing after a more positive start in Japan, where fiscal policy (accommodating this year, restrictive from 2014) and the exchange rate make economic performance volatile.

No risk of inflationary pressures

The price trend continues to be hampered by high unemployment and unused production capacity that characterize many developed economies. In addition, the upward pressure on energy prices appears calmer and less likely to generate pressure on final prices.

Overview by Area

United States: the economy continues to strengthen
Towards a slow exit from quantitative easing
Risks remain on the fiscal front

In the United States, growth is accelerating after stalling in Q4 2012. The increase in monetary stimulus in place since September, the turning point in house prices and the normalization of household balance sheets, more than offset the brake exerted by restrictive and uncertain fiscal policy of the Federal Government. The growth forecast is +1.8% in 2013 (with upside risks) and +3.1% in 2014. Private demand should keep growing, supported by all components: consumption, business fixed investment, residential investment. The contribution of monetary stimulus is massive and will support growth also in 2014-15. The cyclical recovery, plus two positive structural factors, will drive aggregate demand upwards in coming years: relocalization of the manufacturing sector and the energy boom. The latter will have a direct effect, as determined by increases in production, investment and employment in the sector, and indirectly through a massive reduction of oil imports in the next five years. Instead, fiscal policy is an on-going drag on growth. The agreement on the fiscal cliff, automatic cuts that came into force in March and the cap on spending for the rest of 2013 will reduce GDP by about 0.5-1 pp. Further conflicts are expected in Congress on the 2014 budget (April) and the debt limit (August). Monetary policy will remain highly accommodative for a long time: rates steady until mid-2015, gradual reduction in asset purchases in the second half of 2013 but still positive, balance sheet over three trillion dollars for a “considerable period” even after the recovery strengthens.

Euro zone
Another year of recession, especially for peripheral countries
There are still risks associated with the debt crisis

2013 will be another year of recession in the Eurozone, similar to 2012 with regard to the decline in GDP on average over the year (-0.5%). Demand should be similar, with a positive contribution of foreign trade and a negative contribution from domestic demand and inventory. The low point of the cycle could be right in the first quarter of 2013; however, only the second half of the year will see a gradual and modest recovery in economic activity. The economy in the Euro zone could return to modest grow in 2014, but not even next year a positive contribution can be expected from peripheral countries, still in the grip of economic policies and tight financing conditions, as well as, in some cases, long-term deleveraging processes in the private sector.

Inflation in the Euro zone is expected to decline from 2.5% in 2012 to 1.7% in 2013 and 1.8% in 2014. The contribution of energy is expected to decrease until the Autumn, when we expect oil prices in Euro will return to rise. Core inflation is expected to fall to 1.4% from 1.8% in 2012. The annual trend will be affected by increases in administered prices and indirect taxes, which have already occurred (and weighing on the 2013 average) or that are planned for 2013.

With regard to the ECB monetary policy, the reduction in the growth forecast for the current biennium leaves the door open to a review of refinancing in the coming months. However, we think that the probability of a cut in refinancing remains relatively small, and even more unlikely to have a negative level of the deposit rate, now at zero. Nor do we expect a new expansion of unconventional measures.

As in the past, the outlined scenario requires that the debt crisis in the Euro zone is not subject to extreme changes. On the other hand, not all 'extreme' events would have the same potential to divert the scenario from the baseline projections. We do not consider Cyprus a serious threat to the stability of the Eurozone; as in 2012, the critical point of the crisis is represented by Italy and Spain. However, if in 2012 Spain created the most concern, currently the most significant risk is created by the Italian political crisis, as the effectiveness of the support mechanisms depends on the availability of government structures able to negotiate and approve the conditions accompanying the programs.

Japan

In Japan, the change of government in autumn 2012 had an immediate effect on financial variables, with weakening of the exchange rate and rising inflation expectations even before new stimulus measures were announced. Growth in 2013 is expected to be 0.8%, accelerating to 2.2% in 2014. The path of growth and inflation in 2014-15 will be strongly influenced by the effects of the doubling consumption tax in two steps (April 2014, October 2015). After the volatility due to the change of the tax is over, inflation should be around 1.5% in 2017. The strategy of the new government acts on two fronts: 1) expansionary fiscal policy in 2013, moving to restriction later in the year to stabilize the debt/GDP ratio; 2) aggressively accommodative monetary policy, aimed at defeating deflation and achieving an inflation rate of 2% as soon as possible, with the goal of reducing real interest rates and reaching positive nominal growth. If the tax measures announced will actually be implemented, the deficit/GDP ratio is expected to fall to 4% in 2015 and stabilize around that level. The debt/GDP ratio is expected to reach a maximum of 217% in 2014 and gradually decline in the following years. Monetary policy is the key towards positive inflation. A credible inflation target of 2% and a much more aggressive monetary policy strategy has had an immediate and lasting effect on the exchange rate and inflation expectations, generating a significant increase in monetary stimulus.

China

The Chinese economy ended 2012 with an annual growth of 7.8% y/y, a significant slowdown from 9.3% in 2011. We maintain our steady growth forecasts at 7.9% in 2013, with a minimum acceleration of 8.2% in 2014. The risk scenario remains bearish for the negative impacts that could have a new slowdown in the housing market both on the finances of local governments and the performance of the banking sector. Inflation is expected to return to around 2.4% in March and then gradually rise again throughout the year. Expectations concerning an increase, albeit content, in inflation and credit reacceleration in 2012, through non-bank credit and investment in real estate will cause the PBOC to maintain a hold and at least in the first half of the year postponing any cuts later in the year.

India

Growth in the Indian economy has dropped to 5.0% in 2012 from 7.5% in 2011 due to a marked slowdown in consumer spending, particularly private ones (4.5% y/y vs. 7.3% in 2011) and investment (+0.7% y/y vs. 6.2% in 2011) to which was added a negative contribution of the foreign channel. We maintain a forecast of moderate growth acceleration in 2013, although we review downwards its previous forecast from 5.7% to 5.4%, and a recovery to 6.9% in 2014. We believe that the risks on growth will continue to be bearish in the short and medium-term and will arise from multiple fronts. On the domestic front, progress in the field of structural and fiscal reforms is still too shy to promote a strong recovery in the business environment. Added to this is the risk of a decline in inflation, slower than expected with a dampening impact on consumption. On the external front a further increase in the European crisis could accompany the weakness of international recovery. Both factors will continue to weigh on the export performance of India and the already high current account balance exacerbating the financing risks. The upside risks to inflation and the presence of high twin deficits severely limit the scope for further easing of monetary policy, although there are downside risks to growth. We therefore believe that the RBI (Reserve Bank of India) will make two more rate cuts of 25bp each at most in the year.

Commodities: fundamentals are still weak

Daniela Corsini

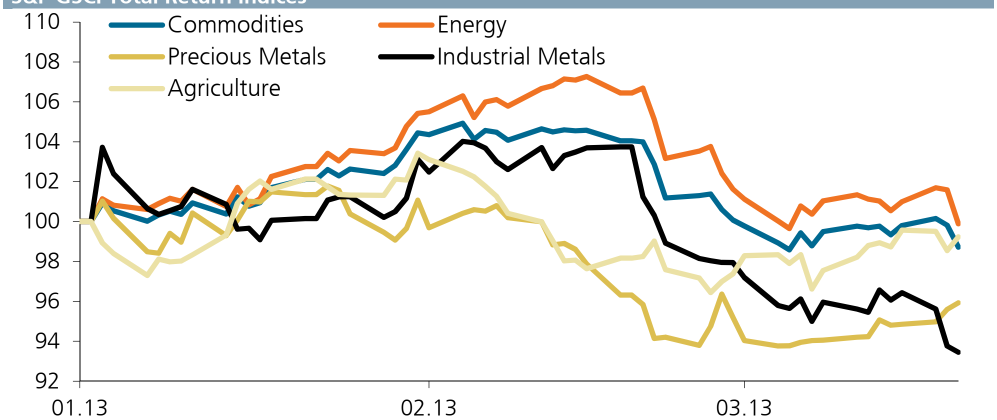
Our forecasts for the commodity universe in 2013 incorporate our expectations of persistent weakness in the global economy, which is burdened by some major downside risks. These mainly relate to uncertainty about political decisions in Europe (due to difficulties in peripheral countries), the United States (due to issues about fiscal budget and debt ceiling) and China (due to tightening measures on the property market and the expected restructuring of major industrial sectors). Based on our analysis of macroeconomic scenario and supply and demand fundamentals, we expect commodity prices to maintain historically high levels during the year. However, the markets will remain nervous, leaving ample room for speculative movements not justified by fundamentals.

A difficult start to the year

In the first few months of 2013, prices of the main commodities swung sharply. Until mid-February, prices of energy products and industrial metals were boosted by two factors: investor optimism, fuelled by the removal of major uncertainties such as the fiscal cliff in the United States, and tighter physical markets affected by a seasonal acceleration in demand from China prior to its Lunar New Year and by temporary supply reductions in a number of commodities. For example, markets faced difficulties in iron ore shipments due to poor weather conditions in Australia and reduced oil production in Saudi Arabia.

Since mid-February, however, commodities have lost ground due to a deterioration in the global macroeconomic scenario caused by stalled negotiations between Democrats and Republicans in the United States, triggering the Budget Control Act's automatic spending cuts, and due to the resurgence of downside risks in the European crisis. These risks have been accentuated by the outcome of the Italian elections and by the debate over the severe conditions imposed on the Cyprus bailout.

S&P GSCI Total Return Indices



Source: Intesa Sanpaolo elaboration on Bloomberg data

Precious metals have been suffering since the start of January from growing expectations that the Federal Reserve (Fed) could end its program of quantitative easing (QE). The main concern is that less expansive monetary policy in the US could weaken demand for gold as an investment due both to a reduction in available liquidity and to the risk of a consequently stronger US dollar. Note, however, that the end of QE would not immediately drain cash out of the system. In fact, although our central scenario contains a reduction in the monthly amount of securities purchased in the second half of 2013 and a cessation in the securities purchase program in early 2014, rates are unlikely to increase until mid-2015. However, gold prices already incorporate reduced attractiveness compared with other asset classes, which is partly due to the very high price in real terms reached by the precious metal in Western countries. A crucial role in the future evolution of gold prices will be played by Asian demand for physical gold. The markets are particularly concerned at the moment by the fragility of the Indian economy and the limited room for manoeuvre of the Reserve Bank of India, which is hampered by major current account and budget deficits.

Macroeconomic scenario still burdened by major uncertainties

Our forecasts for the commodity universe in 2013 incorporate our expectations of persistent weakness in the global economy, which is burdened by some major downside risks. These mainly relate to uncertainty about political decisions in Europe (due to difficulties in peripheral countries) and in the United States (due to issues about fiscal budget and debt ceiling).

Global growth will continue to be driven by emerging nations and in particular China, where the political transition at the head of the Communist Party should ensure continuity in existing monetary and fiscal policy. The stated priorities of the new government include urbanization, investment in infrastructure and a pledge to reduce the divide in living conditions between rural and urban populations. In the short term, the key significance of urbanization and government investment in infrastructure is highly positive for commodity demand, principally for industrial metals. In the medium term, these policies and the transition from an investment-based to a predominantly consumption-based growth model will reduce the potential growth rate, but will provide for more balanced and sustainable economic growth in the long term, thereby reducing future risks of a hard landing.

In China, too, we see political decisions as the principal downside risk, as these could lead to an excessive cooling of the property market (with extremely negative implications for industrial metals' demand estimates) and to far-reaching restructuring in major industrial sectors, for example in the steel industry and the aluminium sector.

Our forecasts for the commodity universe

Based on our analysis of the macroeconomic cycle and supply and demand fundamentals, we are expecting commodity prices to maintain their historically high levels during the year. However, due to significant downside risks still threatening the recovery of the global economy, the markets will remain nervous, leaving ample room for speculative movements not justified by fundamentals.

Monetary policy dynamics and US dollar strengthening will both be critical themes for all commodities, but above all for precious metals. In particular, gold could be hit by falling investment demand due to subdued inflation expectations and the greater attractiveness of other asset classes more exposed to strengthening of the global economy. In contrast, demand for physical gold from central banks and Asian investors should remain robust. In Europe, and above all in Mediterranean countries, intensifying risk aversion could boost demand for gold as a safe haven, since gold could be perceived as a more secure alternative to bank deposits. In light of these conflicting pressures, we expect gold prices to stabilize below USD 1,700/ounce in 2013 and 2014, while we are more positive about the medium- to long-term outlook for platinum and palladium, given their exposure to industrial demand and auto sales and thanks to endemic problems in South African mining output.

We anticipate a modest increase in industrial metal prices, driven by Chinese demand and risks of unexpected supply interruptions. However, sharp price hikes will be limited by high global inventories, many of which are tied up in inventory financing deals, and by substitution risks. In terms of levels, we expect prices in 2013 to be slightly higher on average than in 2012. The main risk is from government interventions in the sector, which could significantly alter the outlook for future available supply in the market in the medium and long term.

As regards agricultural commodities, returns will be very mixed, due to different supply and demand fundamentals and to different exposure to unique risk factors and single drivers. The market will scrutinize estimates for output and global consumption for each specific commodity. The principal exogenous factors with potential to shake up the balance in individual markets are political and climate risks, since extreme weather events are set to become more frequent as global warming intensifies.

In terms of oil, we think prices will moderate due to the anticipated improvement in the market balance in 2013. However, geopolitical tensions will remain to the fore, helping keep the markets in a state of tension.

Oil

We expect oil to remain in its trading range for some months to come, caught in a precarious balance between upward pressure from geopolitical tension and downward pressure from weak fundamentals, given that supply of non-OPEC oil should grow faster than global demand due to the rapid increase in North American output.

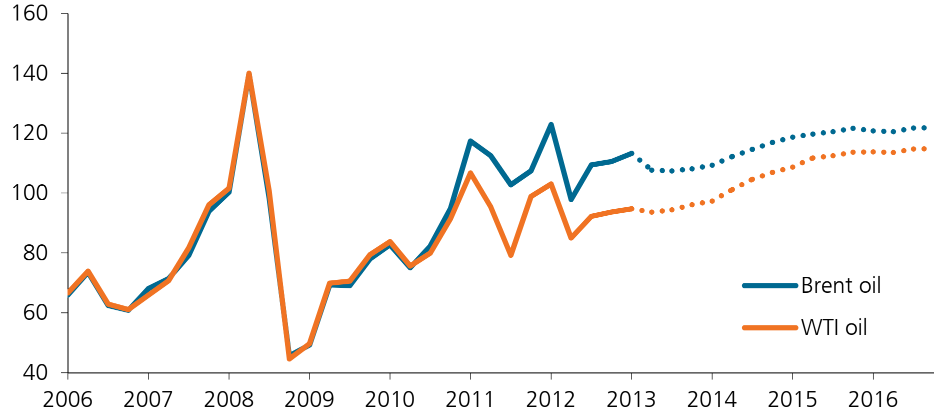
With regard to our previous scenario, which we outlined in December 2012, we have slightly revised upwards the estimated oil price due to the growing significance of geopolitical tension and the expectation of a gradual strengthening in global economic growth in the second half of the year.

However, we are expecting supply and demand fundamentals to remain weak and oil to stay in its trading range for some months to come. We have raised the support level to USD 100 for Brent due to high geopolitical risks and instability in the MENA countries. The factors impeding excessive price drops are: high levels of fiscal spending in major producing countries, high production costs for unconventional extraction methods and technical problems with fields and infrastructure, which will keep supply below its potential. In addition, prolonged price falls should be contained by substantial cuts in OPEC production, thanks to flexibility in Saudi Arabian output. In fact, statements by various OPEC member representatives clearly show the desire (and, in some cases, the need) to defend historically high oil prices, repeatedly stressing that prices of between USD 100 and USD 110 would be fair for both producers and consumers.

The resistance level, which we are maintaining at USD 120 for Brent, is based on the weak global recovery, estimates of plentiful production in North America and the risk that emergency reserves will be released.

In our central scenario, we estimate an average price for Brent of USD 109.1 in 2013 and USD 113.2 in 2014. Our average price estimate for WTI is USD 94.7 in 2013 and USD 102.5 in 2014. We think the spread between Brent and WTI will remain wide, given plentiful US production and technical limitations in transport networks and infrastructures. The spread should gradually narrow in the coming years, although we do not envisage it closing completely over our forecast horizon due to the growing relevance to total US production of shale oil extracted through unconventional methods, which entails structurally higher transport costs.

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



Source: Intesa Sanpaolo elaboration on Bloomberg data

Price estimates for Brent at 20.03.13	2012	1Q13	2Q13	3Q13	4Q13	1Q14	2013	2014	2015	2016
Estimate	111.7	113.2	107.6	107.4	108.1	109.3	109.1	113.2	120.1	121.2
Bloomberg Median	-	111.0	110.0	112.0	112.0	110.5	110.0	110.0	112.0	113.0
Forward Curves	-	112.8	108.8	104.6	103.5	102.3	105.9	100.8	97.3	94.8

Source: Intesa Sanpaolo elaboration on Bloomberg data

Supply and demand fundamentals

For 2013, the analysis of fundamentals suggests that non-OPEC supply will grow faster than global oil demand, due to the rapid increase in North American output. To balance the markets, therefore, OPEC would have to reduce its output close to its target of 30 million barrels a day.

Spare capacity is currently concentrated almost entirely in Saudi Arabia. The US Energy Information Administration (EIA) estimates that over the year, spare capacity will average 2.9 Mb/d, which is significantly higher than the 2012 figure of 2.1 Mb/d.

The commercial stocks in OECD countries are abundant, but this year these are likely to contract from the 2012 year-end figure of 2.69 Mb (equivalent to 58.4 days of consumption). The EIA estimates that by end-2013, commercial reserves of OECD countries will be 2.63 Mb (56.7 days of consumption), rising to 2.66 Mb (57.7 days) by end-2014.

Supply and demand as estimated by OPEC, IEA and EIA, updated to March 2013

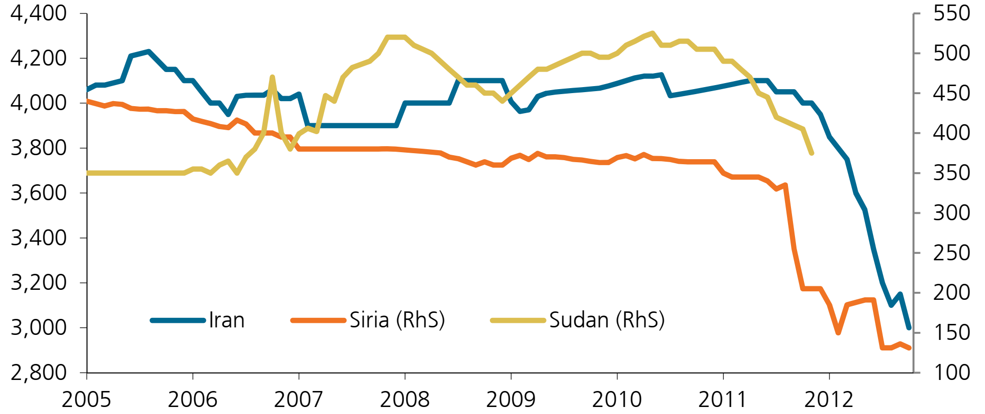
Estimates, Million Barrels	Total Demand	Non-OPEC Supply	LNG OPEC Supply	Call on OPEC Crude	Global GDP growth
OPEC	89.7	54.0	6.0	29.7	3.20%
vs. 2012	+0.8	+1.0	+0.2	-0.4	
IEA	90.6	54.5	6.4	29.7	3.50%
vs. 2012	+0.8	+1.1	+0.2	-0.6	
EIA	90.1	53.8	5.8	30.3	-
vs. 2012	+1.0	+1.2	+0.2	-0.6	

Source: Intesa Sanpaolo elaboration on data published from Organization of the Petroleum Exporting Countries (OPEC), International Energy Agency (IEA), U.S. Energy Information Administration (EIA).

Geopolitical risks

Currently, the main upside risks for oil prices are unplanned supply disruptions, principally triggered by geopolitical tension. The most vulnerable countries are: Syria (where output has fallen by 0.23 Mb/d since the start of the Arab Spring), Sudan and Southern Sudan (since independence was proclaimed in July 2011, output has been almost entirely frozen, but it could gradually restart at the end of March if the two states would comply with the cooperation agreement signed), Nigeria (whose potential capacity has been structurally reduced by sabotage and thefts in the Niger Delta region) and Iran (due to tensions over its nuclear program). Iran's supply is currently limited by severe international sanctions imposed on the energy, banking and insurance sectors. Iranian output is estimated to have fallen by 1 Mb/d since the end of 2011.

Output in Iran, Syria and Sudan (both on the right hand axis)



Source: Intesa Sanpaolo elaboration on data from the U.S. Department of Energy (DOE)

In February, negotiations restarted between the P5+1 group (comprising the U.S., the U.K., France, Germany, China and Russia) and Iran. Both sides have described this fresh round of talks as "constructive" and have agreed to meet again on 18 March for technical discussions in Istanbul and on 5 April for political discussions in Kazakhstan. The P5+1 group is understood to have offered to relax a number of sanctions if Iran suspends production of 20%-enriched uranium. That level of uranium enrichment would be consistent with the production of nuclear weapons (as suspected by the United Nations), but it would be excessive for civilian use, like electricity generation and medical research (the only objectives that the Iranians government officially admits to pursuing). Given that Iranian presidential elections are scheduled for June 2013, internal political divisions and the extreme economic hardship suffered by the country could move the Iranian negotiators to harden their line. Moreover, tension could intensify when the United States periodically evaluate the renewal of temporary exemptions from international sanctions conceded to a number of countries (Japan in March, China, India, Malaysia, South Korea, Taiwan, Singapore, Sri Lanka, South Africa and Turkey in June).

The American position, reiterated several times by President Obama, is that there is still room for diplomacy and political pressure before resorting to stronger measures. In any case, the US has made assurances that it will uphold its "unbreakable commitment" to defend the security of Israel, which would be under threat if Iran were to develop nuclear weapons. Obama believes it would take Iran at least one year to develop its nuclear program to such a level, whereas Israel fears that Iran could reach this threshold in the next few months.

Given the complexity of the situation and the devastating consequences that an escalation of these tensions could trigger throughout the Middle East, the oil markets will be deeply sensitive to the outcome of the forthcoming negotiations and the Iranian presidential elections.

In our central scenario we incorporate a persistent risk premium to our price estimates to cover ongoing international tension. However, we have excluded any assumption of military attacks (multilaterally by a coalition, or unilaterally by Israel) or temporary blockades of the Strait of Hormuz by Iran, and we are expecting international negotiations to continue in the coming months. If military intervention occurs in the area, Brent could rocket above USD 130, although this would be for a limited period, given that emergency reserves would be released and demand would be rationed.

Another country that could compromise the fragile balance in the oil markets is Venezuela, which holds the world's largest oil reserves. The presidential elections to choose the successor to President Chavez, who died on 5 March, will take place in April. Assuming (in all probability) that Nicolas Maduro, Vice-President and member of the majority PSUV party, wins, oil production is unlikely to be compromised in the short term, but there are severe doubts as to its long-term sustainability. This is principally due to the on-going lack of investments in development of oil fields and maintenance of oil refineries. Venezuela's domestic oil industry would need capital and technology, which would be easier to access if the country were more open to investment from foreign and multinational companies. If, however, the PSUV is confirmed as the winner of the forthcoming elections, economic policies and international relations would be highly unlikely to undergo deep-reaching change, given the desire to uphold the political legacy of Chavez.

In the coming months, the main problems the PSUV will have to face are: the risks of internal divisions within the party; the complexity of moving from a model where power was concentrated in the hands of a single person (or of a very limited circle of people) to a model with greater sharing of tasks and responsibility; the economic difficulties caused by the rapid growth in inflation and public debt, the scarcity of a number of basic goods, and the sustainability of generous social programs. The deterioration in domestic refining capacity could trigger a further increase in imports of refined products from the US and a consequent deterioration in public finances, which are already suffering from generous subsidies on oil consumer products and from sub-potential revenue from crude output, given that international prices are around the budget break-even level necessary for Venezuela to reach the fiscal balance and given the impact on total exports of oil deliveries to repay oil-backed loans stipulated with other countries, primarily China. This difficult economic environment could become unsustainable in the long term, generating political instability and stoking tension in the oil markets.

United States – The economy has finally recovered: towards 3% in 2014

Giovanna Mossetti

- The US economy, as expected, is accelerating after the stagnation in Q4 2012. The increase in monetary stimulus since September with the new QE3 program, the definitive turnaround in house prices (and therefore housing wealth) and the normalization of household balance sheets more than offsets the drag exerted by the restrictive and uncertain fiscal policy of the federal government. **The growth forecast is 1.8% in 2013 (with upside risks) and +3.1% in 2014**
- **Private demand should be supported by all its components:** consumption, business fixed investment, residential investments. The contribution of the **monetary stimulus** is enormous and will support growth also in 2014-15. Besides the cyclical recovery there are two **positive structural factors** that will increasingly drive the aggregate demand over the coming years: **relocalization of the manufacturing sector** and **energy boom**. The latter will have direct effects, determined by production increases, investment and employment in the sector, and indirectly through a significant reduction in oil imports over the next five years.
- **Fiscal policy** is now the main drag on growth. The agreement regarding the fiscal cliff, the automatic cuts that came into force in March and spending authorizations for the rest of 2013 will act as a brake on the GDP altogether amounting to between 0.5 and 1 percentage points. There still remains a large degree of uncertainty. In addition to the details of the agreement on automatic cuts and expenditure authorizations, the 2014 budget has yet to be defined, and should include the path of fiscal variables up to 2023. In August the debt limit will also again be binding. We expect last-minute agreements, with structural adjustments close to 2 trillion dollars over 10 years.
- **The aggressively expansionary monetary policy** more than offsets the fiscal restriction and the effects of uncertainty arising from the conflicts in Congress. For now, **the monetary stimulus continues to increase,** with +85 billion dollars of purchases per month. The pace of securities purchases is the new policy variable and will be adjusted in response to the changing scenario. Monetary policy will remain broadly accommodating for a considerable period even after the end of the purchase program.

USA – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (1996 US$,y/y)	2.2	1.8	3.1	2.1	2.6	1.6	1.7	1.6	1.6	2.4	2.6
q/q annual rate				1.3	3.1	0.1	2.2	1.1	3.0	3.4	3.2
Private consumption	1.9	2.0	2.6	1.5	1.6	2.1	2.2	1.5	2.5	2.8	2.7
Fixed investment - nonresid.	7.7	4.7	6.8	3.6	-1.8	9.7	3.2	5.8	5.0	6.5	6.4
Fixed investment - residential	12.1	14.1	14.4	8.4	13.6	17.4	12.0	13.5	15.5	18.0	13.5
Government consumption	-1.7	-2.3	-0.2	-0.7	3.9	-6.9	-0.1	-6.8	0.1	-0.9	0.6
Export	3.3	2.9	7.3	5.2	1.9	-3.9	3.4	5.1	6.6	8.0	7.7
Import	2.4	1.9	5.8	2.8	-0.6	-4.5	4.2	3.3	5.6	5.8	5.6
Stockbuilding (% contrib. to GDP)	0.1	-0.1	0.1	-0.1	0.1	-0.4	0.1	0.1	0.1	0.1	0.0
Current account (% of GDP)	-3.0	-2.7	-2.6	-3.1	-2.8	-2.8	-2.9	-2.8	-2.7	-2.7	-2.6
Federal Deficit (% of GDP)	-7.5	-6.0	-5.2								
Gov. Debt (% of GDP)	106.3	109.6	110.3								
CPI (y/y)	2.1	1.6	1.8	1.9	1.7	1.9	1.5	1.6	1.7	1.6	1.8
Industrial production	3.8	1.8	4.4	2.4	0.3	2.6	3.0	-0.3	1.7	4.1	5.3
Unemployment (%)	8.1	8.0	7.7	8.2	8.0	7.8	7.8	8.1	8.2	8.1	8.0
Fed Funds	0.25	0.25	0.27	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-year yield	1.78	2.27	2.76	1.81	1.62	1.69	1.93	2.17	2.38	2.62	2.75
Effective exch.rate (1990=100)	73.5	75.2	75.4	73.9	74.0	73.1	74.8	75.4	75.4	75.2	74.9

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: Thomson Reuters-EcoWin, Intesa Sanpaolo

Private demand running at full throttle, with the help of the Fed

The U.S. economy is growing again after stalling at the end of 2012. Our forecast is that growth from now on will be more like that of a normal recovery than it has been since the end of the recession (June 2009): Our forecasts are 1.8% in 2013 (with upside risks) and 3.1% in 2014. The slowing factors of the recent years due to the crisis (household debt, residential investment, employment market, state and local public finance) have turned around and now contribute positively to growth, reinforcing each other. In addition, there are positive structural factors that will increasingly drive expansion: 1) the relocation of the manufacturing sector, thanks to the comparative advantages of the United States and 2) the boom in the energy sector, which will drive growth directly (through investment and employment) and indirectly (through a significant reduction in imports and a possible increase in exports). In essence, we expect U.S. growth to be ready to return to a range close to 3% in the short term, which should also generate a more sustained employment trend, from 150-200 thousand in 2010-2012, to 200-250 thousand. The evolution of private demand remains influenced by the opposing effects of the economic policies: super-expansionary monetary policy, restrictive and highly uncertain fiscal policy. However, the balance is still largely positive: the monetary stimulus prevails widely, and will contribute to the acceleration of the recovery for a long time.

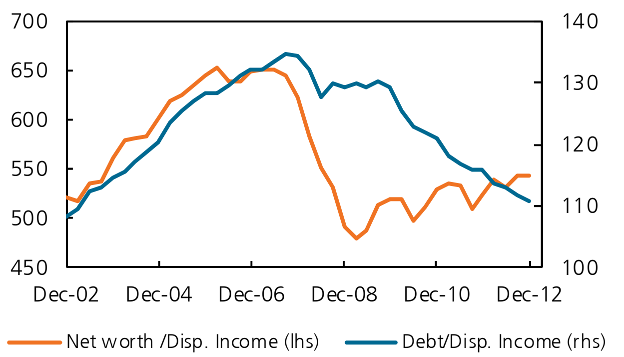
1. The revival of private demand. In 2013, the various components of private demand will return growth and reinforce each other, as in a normal recovery, allowing growth to exceed the threshold of almost stall, close to 2% seen from 2009 onwards.

Consumption. The financial situation of households has turned around: household debt resumed growth in the 4th quarter of 2012, after 15 consecutive quarters of contraction (from Q12009) Although mortgages are still falling, the pace is ever more contained and the negative flows are now more than offset by the increase in consumer credit. The increases in wealth and net wealth, +7.4% y/y +9% y/y respectively, are an important factor in explaining the resilience of consumption even in the face of the rising taxes at the start of 2013. The value of housing wealth is in uninterrupted expansion since June 2011: house prices have definitely turned the corner and are expected to increase at 2-digit rates in 2013-14. The debt/disposable income, at 110% at the end of 2012, has returned to the levels of 10 years ago (108.3% in Q42002). The debt/ disposable income service, at 10.4% at the end of 2012, is at its lowest since the series (Q11980) exists and continues to decline. The "Household Income" factor is the necessary condition, even if it is not sufficient for a normal recovery: this is now a clear victory for monetary policy. The combination of net wealth growth and the improvement in employment lead predict an acceleration in consumption despite rising taxes (2% in 2013, 2.6% in 2014).

Growth, investment, employment. Several transient factors have slowed business in the 2nd half of 2012: Hurricane Sandy, fears of the fiscal cliff, slowing of the global economy. 2013 starts with a higher gear: surveys and economic data point to a significant acceleration in manufacturing (in response to excessive reduction of inventories in Q42012) and a solid expansion in services. The orders and expectations of companies signal that the phenomenon is not confined to the first quarter, but has all the characteristics of a lasting trend. The forecasts of faster growth in demand, towards 3%, are accompanied by the expected changes in employment with more than 200 thousand new jobs a month. Therefore we forecast solid growth for business fixed investment in 2013-14 (4.7% and 6.8%, respectively). The positive scenario is reinforced by the relocalization of production from developing countries back to the U.S., which has now become competitive for productivity and employment costs, and production of oil and natural gas, that will greatly reduce imports, generating demand for domestic production of energy (see Fig. 6). The EIA projections for demand and production of oil and distillates foresee the contribution of total net consumption imports, down from 45% today to 34% in 2019. The import of crude oil in 2012 was equal to 2.6% of GDP. A drop of one third in six years would lead to imports of crude oil down by approximately 30%. With very conservative assumptions, this path would lead to a positive contribution to growth of 0.2pp per year from net exports alone.

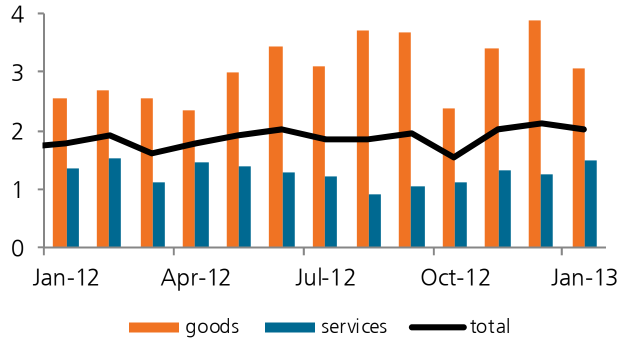
Residential construction: it's a boom! The residential building sector contributed positively to overall growth in 2012. All indicators are uniformly positive in signalling further expansion of the sector, in light of the low stock of unsold homes and the increase in demand linked to the positive trend in prices, the improvement of the employment market and the favourable credit conditions. **We expect growth of 14.1% in 2013** and 14.4% in 2014, with positive effects on GDP and employment (see fig. 5).

Fig. 1 - Return from the peak of the debt and the lows of net wealth: household balance sheets returning to normal



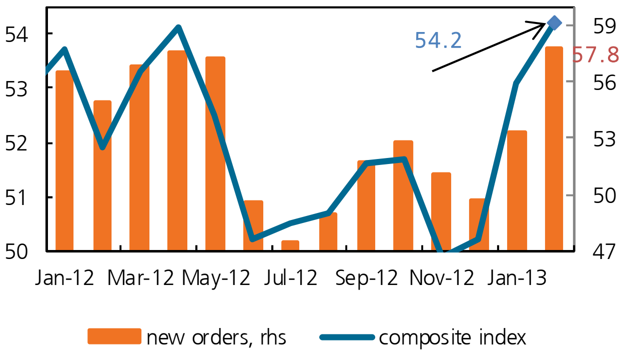
Source: Flow of Funds, Federal Reserve Board

Fig. 2 – Consumption driven by goods (especially cars), but services are also starting to reaccelerate



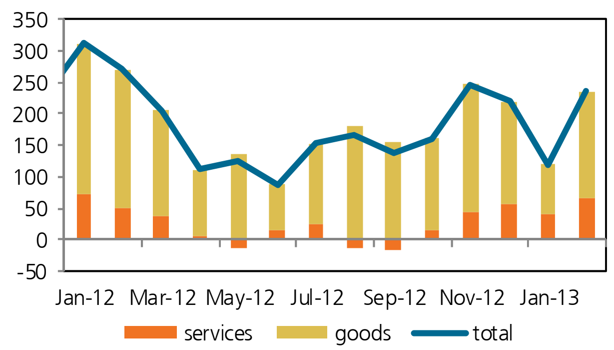
Source: Thomson Reuters-Datastream. Yoy chg.

Fig. 3 - ISM: composite index and orders component



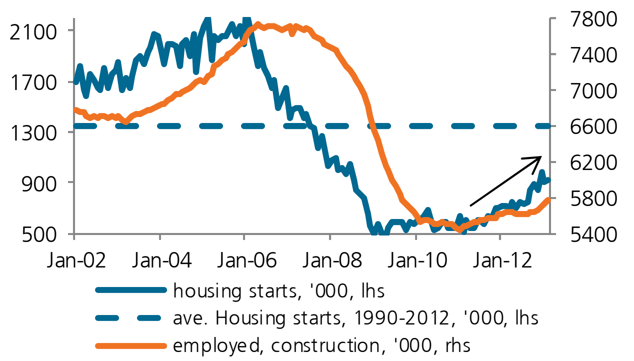
Source: Thomson Reuters-Datastream

Fig. 4 - Change in employment moving to a more solid pace



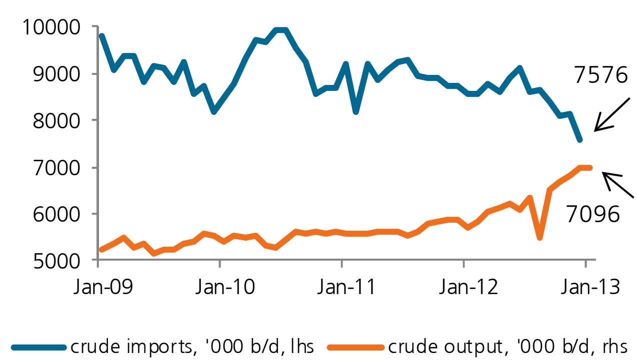
Source: Thomson Reuters-Datastream. Monthly changes in thousands.

Fig. 5 - The residential construction sector still has a long way to go: positive effects on demand and employment



Source: Thomson Reuters-Datastream

Fig. 6 - Oil production will reduce the burden of the energy bill on the trade deficit



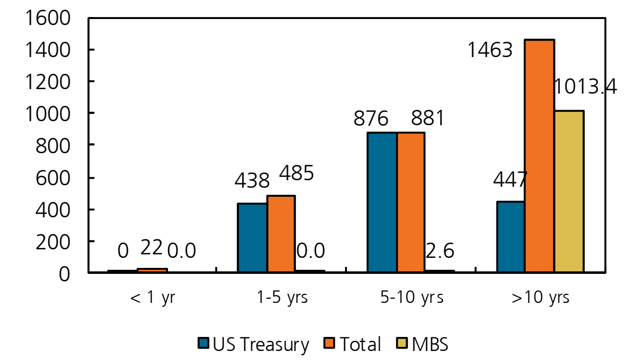
Source: Department of Energy

2. Fiscal policy: running from one hurdle to another. The conduct of the fiscal policy remains fraught with obstacles, generated by a divided Congress with very different positions on the medium-term strategy. At the beginning of the year the fiscal cliff was avoided by a last-minute agreement that led to a rise in taxes on high incomes and returned the payroll tax to pre-2011 levels (at 6.2% from 4.2% of the last 2 years). On March 1, the automatic cuts of the Budget Control Act entered into force (see box below). The next obstacles are the extension of the provisional budget for the current fiscal year (the current law expires March 27th), the approval of a **budget for 2014** (by April 15th to avoid freezing the MPs salaries), and the rise in the **debt limit** that should again be binding in August. Congress voted to extend the continuing resolution to fund the Treasury through the end of the current fiscal year, including some changes to improve the implementation of the Budget Control Act (BCA) automatic cutes. The restrictive effect on growth due to the BCA should be limited, in the range of approximately 0.2-0.3 percentage points in 2013.

The thorniest issues remain the **budget and the debt limit.** The House has already passed a Republican budget with spending cuts of 4.6 tln dollars over 10 years to attain a balanced budget at the end of the period. Spending as a percentage of GDP would fall to 19.1%, from the current 22.2% and the 21% average of the last 30 years. The plan includes a tax reform with only two rates (10% and 25%) from the current 7, with the returns unchanged due to a limit on the deductions. The corporate tax would be reduced to 25% from the current 35%. On the expenditure side, the average growth rate is limited to 3.4% from the 5% of the trend expected by current legislation. The plan includes a reform of Medicare (a health care spending program for the elderly), which plans to offer subsidies for the purchase of private insurance and large cuts in Medicaid (health care for low-income individuals), and various other assistance programs, while action concerning defence is limited and subject, however, to significant reductions. The plan approved by the Democrats in the House is widely different. It includes corrective measures for 1.875 tln dollars over 10 years divided equally between expenditure and revenue. For the latter an overall increase over 10 years of 975 billion dollars is planned, in stark contrast to the Republican plan. Of 975 billion in spending cuts, 240 billion would concern defence (the Republicans reduce defence spending by 500 billion), 493 billion domestic programs (including 275 billion savings on Medicare and Medicaid); 242 billion come from saving on interest. Neither of these plans will become law: negotiations are currently underway and will continue in the first half of April. We maintain the forecast that **fiscal policy is moderately restrictive in the coming years, with a brake on growth of around 0.5pp per year,** more than offset by strong developments in private demand and by fiscal stimulus.

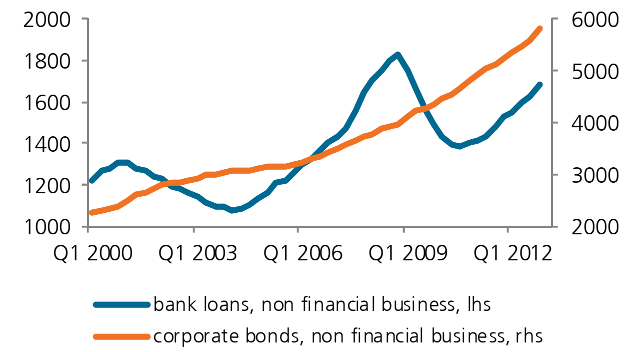
3. Monetary policy: Helicopter Ben still flying high. Monetary policy will remain super-expansionary for a long time. The Fed is striving to communicate rules to guide the market in anticipation of possible turnarounds on the balance sheet and rate policies. As for the **policy rate**, the guidance of the FOMC is now defined by thresholds of unemployment and inflation: the fed funds rate should remain at zero at least until the unemployment rate is above 6.5%, provided that the inflation rate in the medium term remains below 2.5% and inflation expectations are anchored. With the current forecast of the FOMC, this means stable rates until at least mid-2015. With regards to the **balance sheet**, there are two dimensions: the QE3 program and the level of the balance sheet. The securities purchase program underway now plans purchases for 85 billion dollars a month (40 billion of MBS and 45 billion long-term Treasuries) until there is "a substantial improvement in the outlook for the employment market": the FOMC will study a set of indicators in addition to the unemployment rate (see box) to make this assessment. In light of current information, we expect that after June the FOMC will begin to signal the arrival of a gradual downsizing of purchases (between the 3rd and 4th quarter) in order to progressively reduce the increase of monetary stimulus. Around the end of 2013 we should see the end of QE3. However, the retention of the balance sheet at the level of end-2013 will amount to maintaining the stimulus unchanged. If, as we expect, growth will be around 3%, in the middle of 2014 the FOMC may decide to stop the reinvestment of maturities of securities. We expect the Fed to choose to avoid selling securities and entrust downsizing of the balance sheet to maturities: since the life of the securities in the Fed's portfolio is focused on the extra-long maturities, the reduction of the stimulus will be extremely slow, with the maintenance of ultra-expansionary financial conditions for years. The markets will benefit from support to riskier activities and growth of aggregate demand. In the general framework of large unused resources, there is no risk of inflation, which is expected to remain below 2% until at least 2015.

Fig.7 - Securities in the Fed's portfolio by maturity (6 March 2013)



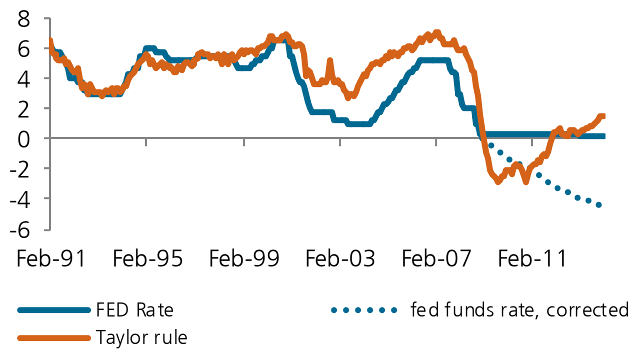
Note: Billion dollars. Source: Federal Reserve Board

Fig. 8 - Monetary policy drives credit upwards



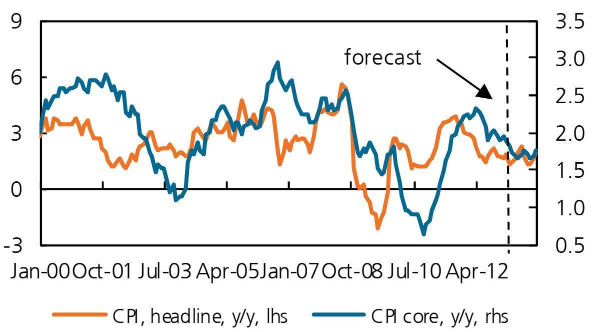
Note: Billion dollars. Source: Federal Reserve Board

Figure 9 - Stimulus in excess in respect to that foreseen by the Taylor rule



Source: Intesa Sanpaolo elaborations on Bloomberg data. The corrected fed funds include the estimated effects of the purchase programs on federal funds. Yellen said (Dec 2012) that it is optimal to follow a more accommodating rule first and more restrictive afterwards

Fig. 10 - All is quiet on the inflation front



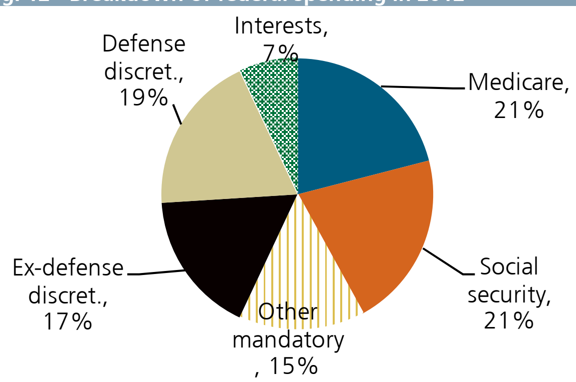
Source: Congressional Budget Office

Fig. 11 - The automatic cuts in fiscal year 2013

	2013 cuts	% reductions
Defence	-42.7	-7.9
Ex-defence	-42.7	-4.6
- Programmed expenditure		
Of which: Medicare	-9.9	-2.0
Other	-4.0	-5.8
Program. Expenditure subtotal	-13.9	
- Discretionary expenditure	-28.7	-5.3
Total	-85	

Source: Congressional Budget Office. Bn dollars

Fig. 12 - Breakdown of federal spending in 2012



Source: Congressional Budget Office

Focus I: The sequester - a rough mechanism for cutting spending

On 1 March 2013 the automatic cuts set by the Budget Control Act (BCA) of 2011 entered into force. The BCA provides for a reduction of total expenditure between 2013 and 2021 of 1176 billion dollars, through a correction of 490 billion (divided equally between defence and ex-defence) on aggregate, net of interest, and savings of 216 billion dollars in interest costs. The annual intervention is estimated at 109.3 billion per year, of which 54.7 billion for defence and 54.7 billion for ex-defence items.

The spending reductions should have come into effect on the 1st of January 2013, but the fiscal cliff agreement has moved the implementation to March 1st, and reduced the amount of cuts to 85 billion for the fiscal year in progress (until October 1).

The reductions are applied on the expenditure authorizations and are determined in a linear fashion on all programs and activities, apart from a subset of exempt programs. The multi-period programs (health, social security, most of the assistance, student loans) are almost entirely eliminated, Medicare (health program for the elderly) and Veterans Affairs cuts may not exceed 2%.

The Congressional Budget Office expects that in 2013 the actual spending cuts will be less than the total amount specified by law, and will be around 42 billion dollars (0.25% of GDP). This is due to the fact that the reduction on authorizations can lead to an effect of less cash for the current year. In addition, the cuts related to personnel need time to be implemented: the request for unpaid leave for federal employees must be notified one month in advance. Therefore, the total reduction in spending is not particularly large, and was already included in the growth forecasts for 2013. We expect the effect of reduced growth to be around 0.3pp of the GDP.

The implementation of the cuts is difficult because the planned linear reduction of all programs prevents a rational definition of the items to be cut. In areas of high labor intensity, the only tool available in the short term is the temporary (unpaid) leave of federal employees: this requires a notice of one month. Once the workforce of many agencies is reduced, there will be a large amount of inconveniences in the daily life of the country if the mechanism for implementing the cuts is not changed.

In Congress there have been no serious negotiations to avoid the automatic cuts: both the parties have acted on other fronts in the past month, implicitly indicating that they would not open discussions to avoid cuts. The open issues for March and April are the extension of the temporary budget, expiring on March 27th, and the 2014 budget, to be approved by April 15th to avoid freezing the salaries of MPs.

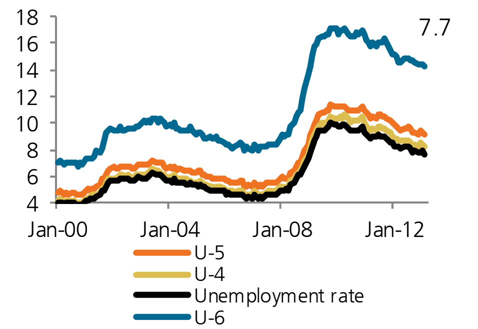
On March 21st the House approved a plan to extend the continuing resolution until the end of the current fiscal year and includes the cuts provided for by the Budget Control Act (85 Bn dollars), but changes the implementation rules for some departments. The law is expected to include exceptions to linear cuts for the Departments of Defense, the Veterans Affairs and several other agencies, so as to avoid particularly negative impacts on the operations of many federal agencies. Therefore, as expected, the cuts will remain in place in terms of quantity, but the manner of implementation will be changed.

The approval of the continuing resolution and the changes to the BCA’s implementation are a rare show of bipartisan agreement in Congress. This may give some hope for the coming negotiations on the budget and the debt limit.

Focus II: the Fed's dashboard

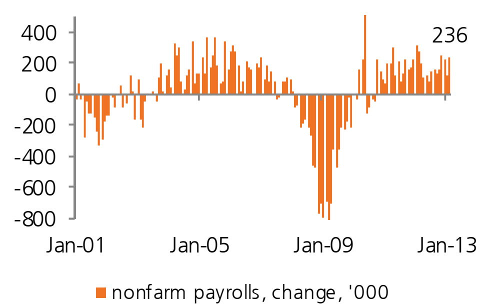
This "framework" shows the indicators that the Fed will follow to assess the "substantial improvement in the outlook for the employment market." At the moment, none of the four groups of indicators has shown a significant and sustained improvement since the end of the recession. In the light of recent data, we expect that at the next meeting (May 1) the most positive indicators will be consumption, GDP and employment growth, with further improvements at the June meeting.

Fig. 1 – Unemployment measures



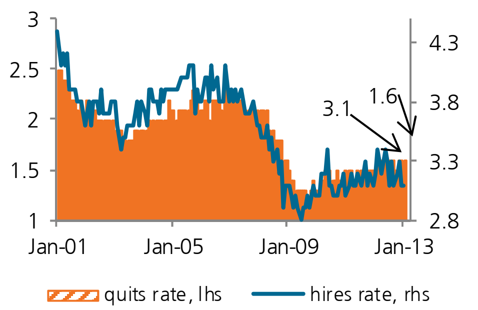
Source: Bureau of Labor Statistics. For the definitions of variables see the notes below

Fig. 2 – Changes in non-farm payrolls



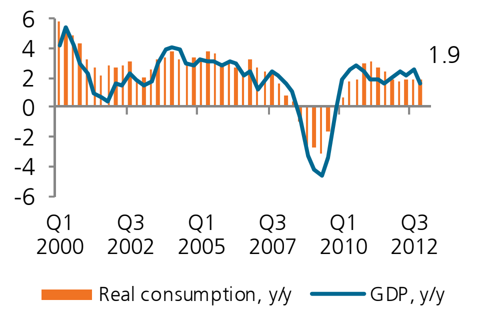
Source: Bureau of Labor Statistics. For the definitions of variables see the notes below

Fig.3 - Gross job flows



Source: Bureau of Labor Statistics, JOLTS

Fig. 4 - Growth of real demand: consumption and GDP



Source: Thomson Reuters-Datastream

Note Figure 1: U-4: total unemployed + discouraged workers as a percentage of the labor force plus more discouraged workers. U-50=total unemployed + all individuals marginally attached to the labor force as a percentage of the labor force plus people marginally attached to the labor force. U-6=U-5 more part-time workers for economic reasons as a percentage of the labor force plus all individuals marginally attached to the labor force. Individuals marginally attached to the labor force are not part of the workforce, they want a job, they would be willing to work and have sought work in the last 12 months.

Note Figure 3: Hires rate = hires in percentage of total employment. Quit rate = voluntary quits as a percentage of total separations (resignations, dismissals, redundancies from mergers, etc.).

Euro Area – Is the storm over?

Anna Grimaldi
Paolo Mameli

- 2013 will be another year of recession in the Euro zone, similar to 2012 with regard to the decline in average GDP over the year (-0.5%). Demand should also be similar, with a positive contribution from foreign trade and a negative contribution from domestic demand and inventories. This scenario does not incorporate "tail" risks concerning the development of the debt crisis. If these risks are overcome, the Euro zone economy could return to growth in 2014. However, a positive contribution is not expected next year from the peripheral countries, which are still in the grip of restrictive economic policies and tight financial conditions.
- We forecast Euro zone **inflation to fall from 2.5% in 2012 to 1.7% in 2013, and to 1.8% in 2014.** In our view, inflation risks are more to the downside than the upside. As usual, there is a risk of abrupt and unexpected spikes in commodity prices over the forecasting horizon. However, aside from that, we think the core inflation might slow more than we have penciled in. **Excess supply in the labor market will limit upward pressures on salaries, costs and domestic prices.**
- **Do not expect much more from Frankfurt.** The ECB pledged to keep monetary policy accommodative and to maintain the full allotment mechanism for an extended period. But beyond this, the ECB will not introduce new measures to restore the transmission of monetary policy stimulus in peripheral countries any time soon.

Euro Area – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	-0.5	-0.5	0.9	-0.5	-0.6	-0.9	-0.9	-0.8	-0.6	0.2	0.5
- q/q change				-0.2	-0.1	-0.6	-0.1	0.0	0.1	0.2	0.2
Private consumption	-1.2	-0.7	0.6	-0.5	-0.1	-0.4	-0.4	0.0	0.1	0.2	0.1
Fixed investment	-3.9	-2.3	1.9	-1.7	-0.8	-1.1	-0.7	-0.2	0.2	0.6	0.5
Government consumption	-0.1	-0.3	0.4	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.1	0.1
Export	2.9	2.6	4.8	1.6	1.0	-0.9	0.7	1.1	1.0	1.1	1.5
Import	-0.9	1.2	4.5	0.6	0.1	-0.9	0.3	0.8	0.8	1.4	1.3
Stockbuilding (% contrib. to GDP)	-0.7	-0.3	-0.3	0.0	-0.3	-0.1	0.1	-0.2	-0.1	0.0	-0.2
Current account (% of GDP)	1.2	1.8	1.8	1.1	1.3	1.6	2.8	1.8	1.4	1.4	2.7
Deficit (% of GDP)	-3.5	-2.9	-2.7								
Debt (% of GDP)	93.1	95.2	95.3								
CPI (y/y)	2.5	1.7	1.8	2.5	2.5	2.3	1.8	1.8	1.6	1.7	1.7
Industrial production (y/y)	-2.3	1.4	1.8	-0.5	0.1	-2.1	0.5	1.8	1.8	1.1	0.0
Unemployment (%)	11.4	12.3	11.9	11.3	11.5	11.8	12.0	12.2	12.4	12.4	12.3
3-month Euribor	0.57	0.20	0.47	0.70	0.36	0.20	0.18	0.20	0.20	0.20	0.20
10-year yield	4.02	3.22	3.52	4.27	3.99	3.41	3.03	3.17	3.25	3.42	3.61
EUR/USD	1.29	1.31	1.28	1.28	1.25	1.30	1.32	1.32	1.31	1.29	1.28

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

The economic situation: new clouds on the horizon

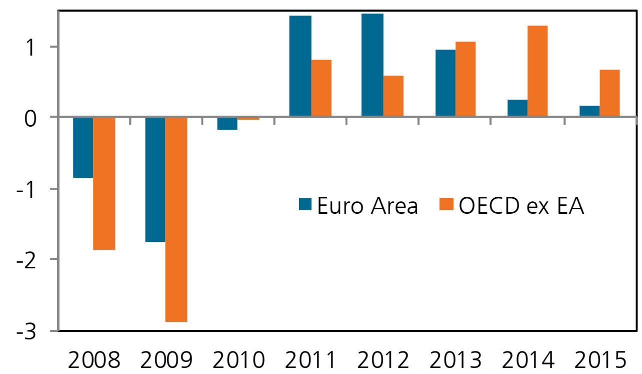
Paolo Mameli

2013 will be a year of transition for the Euro zone, similar to 2012 with regard to the decline in average GDP over the year (-0.5%). Demand should also be similar, with a positive contribution from foreign trade and a negative contribution from domestic demand and inventories. This scenario does not incorporate "extreme" risks concerning the development of the debt crisis. If these risks are overcome, the Euro zone economy could return to growth in 2014. However, a positive contribution is not expected next year from the peripheral countries, which are still in the grip of restrictive economic policies and tight financial conditions.

An "anomalous" cycle

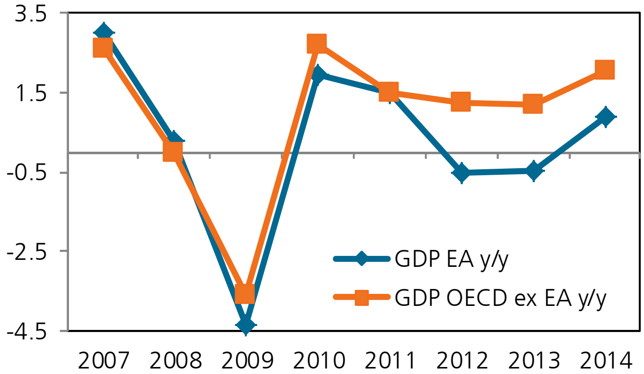
The cycle in progress in the Euro zone appears anomalous in many ways. In fact, after only two years of (modest) recovery after the "global" recession in 2009 (when GDP fell by 4.3%), the Euro zone returned to recession in 2012 albeit against a backdrop of an expansive global cycle. This came as a result of a very specific reason, the debt crisis in the peripheral countries, which led to a very restrictive fiscal policy as early as 2011 (with a squeeze of nearly four GDP points in the period 2011-2013). In other words, **fiscal policy, after moving anti-cyclically until 2010, started becoming pro-cyclical as early as 2011, causing the 2012 recession (which will most likely continue in the current year).** The comparison with the rest of the world (restricting the analysis to developed countries only) shows that fiscal policy elsewhere, as well as being more expansive in 2008-2009, was far less restrictive in 2011-2012. The tightening in the rest of the world could in any case worsen as early as this year and especially in 2014. **Should the tightening in fiscal policy (more likely in 2015 than in 2014) be accompanied by a monetary policy adjustment as well (now ultra-expansive everywhere), and result in a new global recession, the Euro zone, given its orientation (which was accentuated recently) to exports, would unlikely be immune.** Thus, the risk of having tightened probably too soon fiscal policy was causing a divergence with respect to the global cycle, which could have negative repercussions if the global cycle were inverted.

Fiscal policy in the Euro zone was not as expansive as in the rest of the world during the 2008-2009 recession and far more restrictive as early as 2011…



Note: changes in the primary balance adjusted for the cycle. Source: OECD and Intesa Sanpaolo calculations

…causing a divergent cycle if compared to the rest of the world in the years 2012-2013



Source: Intesa Sanpaolo charts and forecasts from OECD data

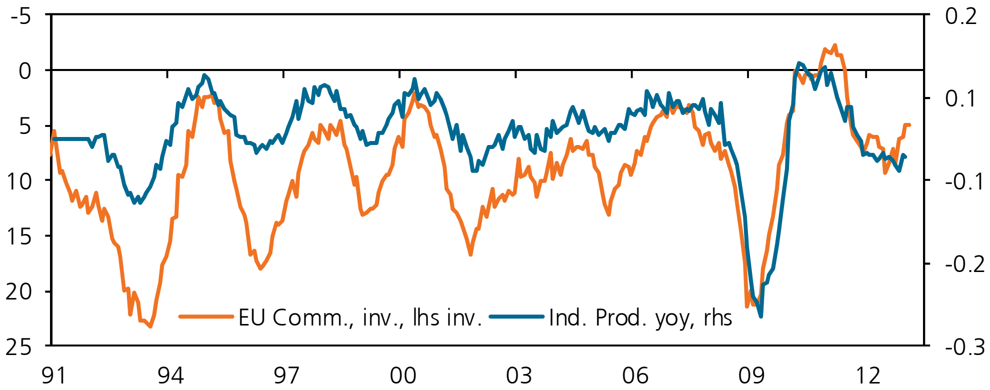
When will there be a turning point in the cycle?

Where will the low point of the cycle be, i.e. when will there be a U-turn? To this end, we update the **cycle dating** exercise carried out in the September 2011 issue of this publication[1], i.e. an analysis of the turning points in terms of: a) industrial production (we choose to consider the level of industrial production excluding construction) b) inventory levels (firms' assessments of inventory levels according to the EU Commission industrial companies' survey). Historical analysis

[1] Intesa Sanpaolo, "Macroeconomic Outlook September 2011", pages 25-26.

shows, first and foremost, that inventories are very highly correlated with production (often with a lead). In fact, the turning point of inventories seems to anticipate that of industrial production (especially at the peak rather than trough of the cycle) by an average of 5 months. Note also that the duration of cycles measured using inventory levels is higher (by an average of 5 months) than the duration of the cycles measured using real industrial production data. In any event, **all the turning points of the inventories cycle have been reflected in turning points for production** (in this regard there have been no "false signals"). An analysis of the historical evidence available shows that the average duration of the "negative" inventory/production cycles is 15 and 10 months respectively (with a peak, reached during the severe 2008-2009 recession, of 24 and 14 months respectively). According to this "datation", if the current cycle were "standard", the turning point for both inventory and production should have been mid-2012. This duration seems to have been exceeded, and therefore the current cycle has already proven to be longer than the historical average. If the duration of the cycle were the maximum recorded in the recent past (i.e.in 2008-2009), the turning point would be between October 2012 and March 2013. So far, a provisional trough for production was reached in November 2012 (and a peak for inventories in July 2012), but it is not necessarily true that it cannot be exceeded. This analysis, however, as already pointed out a year and a half ago[2], shows that **the trough of the cycle could be in the first quarter of 2013; in any event, in our scenario a recovery in production activity (albeit gradual and modest) can only be expected in the second half of the year.**

The turning points of the inventory cycle follow (and in many cases anticipate) the turning points for industrial production



Source: Intesa Sanpaolo charts based on European Commission and Eurostat data.

[2] Intesa Sanpaolo, "Macroeconomic Outlook September 2011", pages 25-26: "the next turning point could take place in the best case scenario at end-2012/early-2013"; "the economic trend will remain very weak at least until the end of 2012/beginning of 2013, and we may only witness an appreciable upturn in production in late 2013."

Duration of "recessive" cycles (based on inventories and industrial production) in recent past experience

				Duration (months)
Min inventories	Feb 95	Max inventories	May 96	15
Max production	May 95	Min production	Apr 96	11
Min inventories	Jun 98	Max inventories	Jan 99	7
Max production	Jul 98	Min production	Dec 98	5
Min inventories	May 00	Max inventories	Oct 01	17
Max production	Dec 00	Min production	Nov 01	11
Min inventories	May 04	Max inventories	May 05	12
Max production	Jul 04	Min production	May 05	10
Min inventories	Dec 06	Max inventories	Dec 08	24
Max production	Feb 08	Min production	Apr 09	14
Average cycle duration:				
Inventories: 15 (max 24)				
Production: 10 (max 14)				
Min inventories	Mar 11	Max inventory:		(Jul 12?)
		-assumption: average cycle duration (15 m)	Jun 12	
		- assumption: max cycle duration (24 m)	Mar 13	
Max production	Ago 11	Min prod:		(Nov 12?)
		-assumption: average cycle duration (10 m)	Jun 12	
		-assumption: max cycle duration (14 m)	Oct 12	

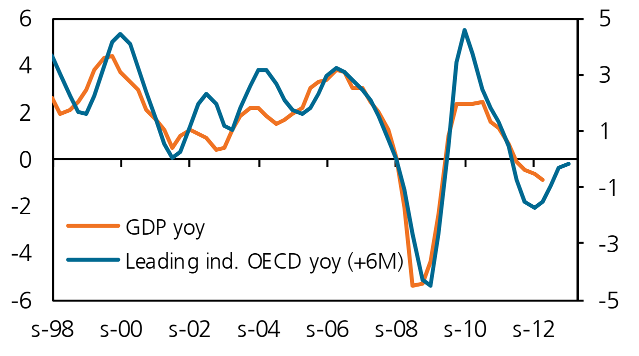
Source: Intesa Sanpaolo charts based on European Commission and Eurostat data

Another way to forecast the development of the cycle (over a period beyond 3-6 months) is to consider the stance of **economic policies** (which in the end are the fundamental determinants of cycle):

- FISCAL POLICY. If the above analysis is correct, that is if the debt crisis and its consequences in terms of tighter fiscal policy and financial conditions are more or less the single cause of the current recession, we must consider how it will develop in order to understand when a turning point can occur. As highlighted in the previous section, **the fiscal correction will only become insignificant in 2014** (in the order of a few tenths of a percentage point of GDP). This year the adjustment, if it is less than in the two previous years, will still be significant (about one percentage point of GDP after the one and a half percentage points on average in 2011-2012), and therefore not consistent with a GDP recovery on average for the year.
- MONETARY POLICY. It is more difficult to assess the effects of monetary policy, since it is true that official interest rates are nearly zero (as in most other developed countries) and real interest rates are negative, however: a) the situation is highly differentiated by country, as according to the Taylor rule, monetary policy is very accommodative in some countries (Germany), broadly neutral in others (France) and even **restrictive in all peripheral countries;** the difference is even more significant if one considers the growth rate of domestic demand compared with the level of short term interest rates in real terms; b) liquidity is ample (and is determined endogenously by the banks based on the full allotment mechanism), yet it is not transmitted to the broader monetary and credit aggregates. An indicator that captures the impact of monetary policy on the cycle is real M1, recognised by the ECB[3] itself as an indicator of the turning points of the cycle (it captures liquidity, not stopping at the level of interest rates or the monetary base, though not reaching the broad monetary aggregate M3) with a lead of about one year. Note, rather, that since the 80s, all the turning points of M1 were associated with turning points (with an average delay of one year, between three and six quarters) of GDP (although not all the GDP turning points were anticipated by M1 turning points). The correlation is between 66% and 94%. In the current cycle, the analysis of **real M1 is giving a signal of a turning point in the annual change in GDP as early as the beginning of 2013** (in our scenario GDP yoy will actually reach a low of -0.9% in the first quarter of 2013 and then begin a slight trend reversal in the spring quarter at -0.8%).

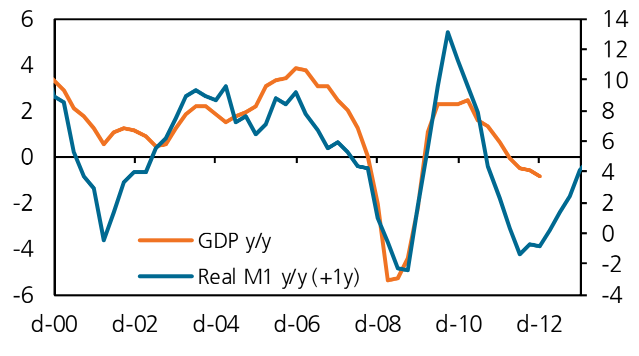
[3] "The informational content of real M1 growth for real GDP growth in the euro area", ECB monthly bulletin, October 2008

Leading indicators are signalling that the annual decline in GDP will lessen......



Source: Intesa Sanpaolo charts based on Eurostat and OECD data

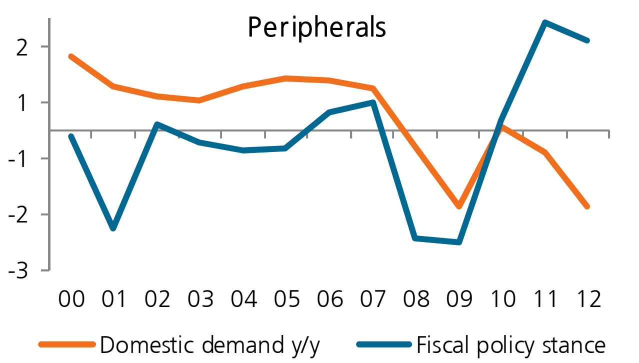
...as early as the first half of 2013



Source: Intesa Sanpaolo charts based on Eurostat and ECB data

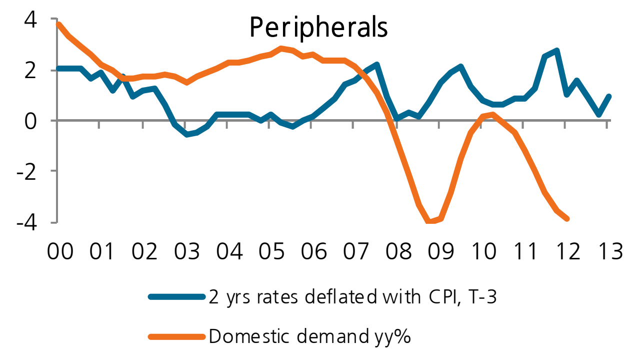
In short, the overall **economic policies will remain highly differentiated by country, and in peripheral countries they do not seem consistent with a significant recovery in production activity:** the fiscal policy is, as is well known, very restrictive (and will remain so in 2013) and monetary policy, when assessed in relation to the growth rate of domestic demand (excluding inventories), appears restrictive as well. It goes without saying that the financial conditions remain very tight, and the peripheral countries will not start contributing to overall Euro zone growth in 2014 either.

In peripheral countries not only fiscal policy ...



Note: fiscal policy stance= changes in cyclically-adjusted primary balance; periphery=weighted average of Italy, Spain, Portugal, Greece, Ireland. Source: Intesa Sanpaolo charts based on Thomson Reuters-DataStream data

...but also monetary policy is restrictive if domestic demand is considered



Note: periphery=weighted average of Italy, Spain, Portugal, Greece, Ireland. Source: Intesa Sanpaolo charts based on Thomson Reuters-DataStream data

Demand components

The demand composition pattern in 2013 will be similar to 2012, albeit with less marked changes. We expect a still positive contribution from net exports (0.7% after 1.6% in 2012), and a negative contribution from inventories (-0.3% after -0.7% in 2012) and especially from final domestic demand (which we expect to decline by 0.9% after -1.4% in 2012). The contribution of foreign trade will decline as, while export growth will be roughly unchanged, import will return above zero. The minor decrease in investments comes on the back of an easing recession in the construction industry, whereas investment in machinery and equipment will be curbed more than last year. For yet another year (the fifth in a row!) consumption will be affected by a decline in purchasing power in real terms (and real disposable income is not even expected to grow significantly in 2014). Finally, government spending will correct for the third consecutive year in the wake of fiscal adjustment.

Nominal and real disposable household income (chg. % year)	2007	2008	2009	2010	2011	2012	2013	2014
Disposable Income	4.3	3.4	-0.3	1.0	1.9	0.6	0.6	2.1
Inflation	2.1	3.3	0.3	1.6	2.7	2.5	1.7	1.8
Purchasing Power	**2.2**	**0.1**	**-0.6**	**-0.6**	**-0.8**	**-1.9**	**-1.1**	**0.3**

Source: Intesa Sanpaolo charts based on OEF data

In our central scenario (which rules out the occurrence of "extreme" risks such as the exit of any country from the Euro zone or the loss of access to the market for Italy or Spain), the European economy will start growing again in 2014, when, given a still-positive contribution from foreign trade and a negative contribution from inventories (albeit in both cases, of a smaller size than in previous years), domestic demand could return to positive territory. In summary, **after a 2013 very similar to 2012 (-0.5%), the Euro zone could return to growth** (by 0.9% in our estimates) **only from 2014.** Moreover, the recovery next year will once again be driven by the core countries, while the peripheral countries at best will make a zero contribution to GDP after curbing the cycle by more than half a percentage point in the period 2012-2013.

Risks

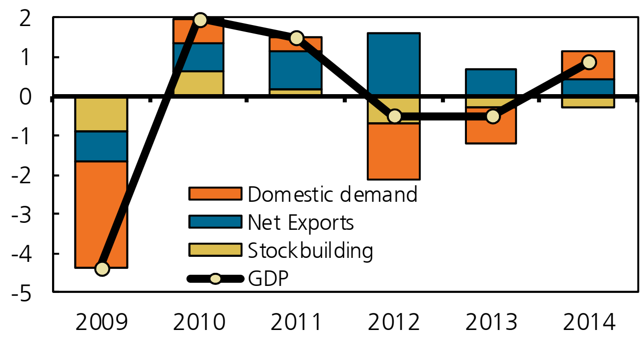
The risks to our central scenario remain undoubtedly on the downside. The risk of exports (which is currently the only "growth driver") being hampered by the exchange rate appreciation registered between July and January seems to have reduced recently, given the movement in the opposite direction on the euro seen in February and March. So, the most serious current threat to the economic situation remains **a possible resurgence of the debt crisis**, which could come from two trouble spots: 1) the impasse in negotiations and implementation of a rescue package for Cyprus; 2) the risk of ungovernability that emerged after the February elections in Italy. The review of the program on Greece and the challenges of macroeconomic rebalancing in Spain and Portugal are also factors that could potentially keep the tension high. However, there are important **factors that we believe could limit the contagion** (from Cyprus and Italy to other crisis-ridden countries):

1. first, investors are encouraged by signs that Spain's strategy of fiscal correction in 2012 worked much better than had been feared; the performance of the local market seems to be supported by foreign investment flows, as shown by the continuous and extensive reduction in the Bank of Spain's net liabilities, to the rest of the Euro system (308 billion at the end of February, 25 million less than in January, in contrast with what was recorded in the same month by the Bank of Italy);

2. the renegotiation of promissory notes used by Ireland to recapitalise its banks has reduced the financial needs of the Irish Treasury; also thanks to this Ireland has again started to place long-term bonds at yields lower than those paid by Italy;

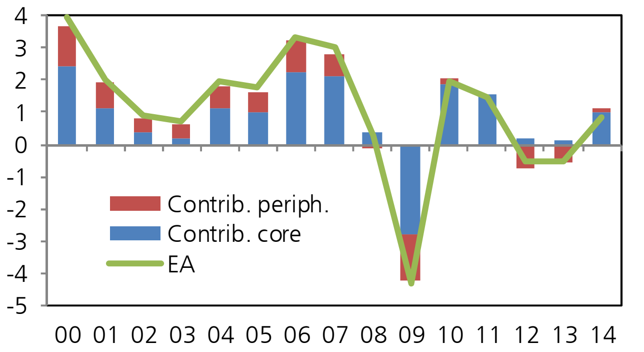
3. another factor that reduces the risk of the crisis continuing is the European Commission's higher flexibility with regard to the fiscal targets for Portugal: it seems likely that the country will be given an extra year to make the fiscal effort required in 2013-14 more credible and eliminate the risk of the program being held up now that 80% of the funds have already been disbursed.

Domestic demand at a halt, slight recovery possible in 2014



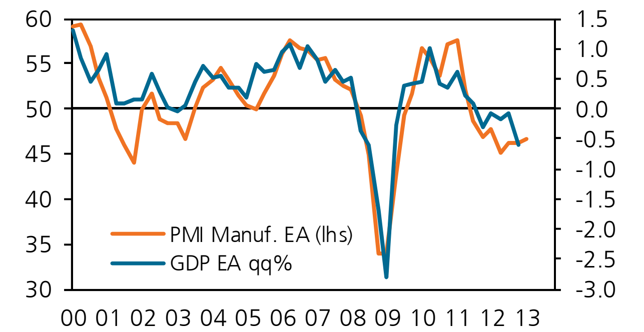
Source: Eurostat and forecasts by Intesa Sanpaolo

Peripheral countries will not even contribute to growth next year



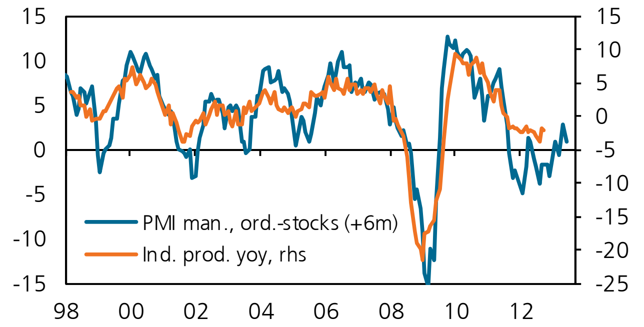
Source: Intesa Sanpaolo charts and forecasts from Eurostat and Markit data

Surveys indicate cycle will stabilise at low levels…



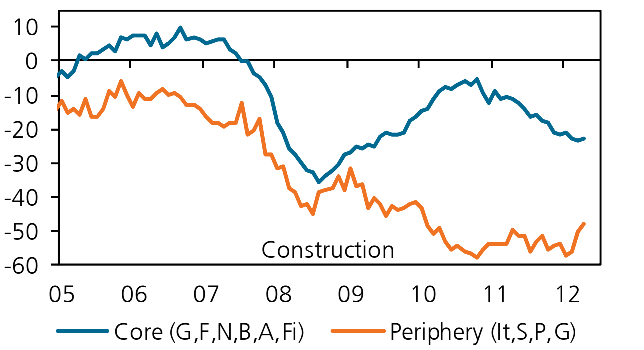
Source: Intesa Sanpaolo charts based on Eurostat and European Commission data

…but the worst may be over in the industry



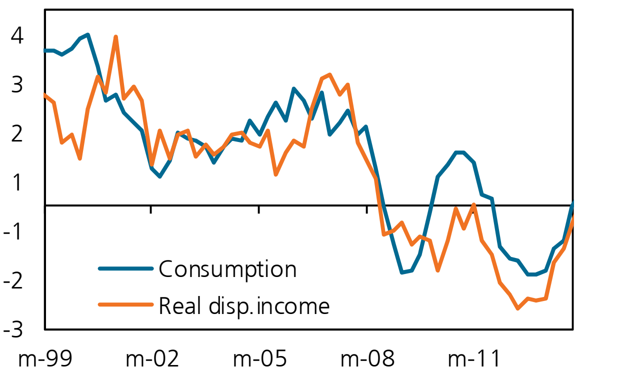
Source: Intesa Sanpaolo charts based on Eurostat and Markit data

Construction continues to be very weak, especially in the peripheral countries,



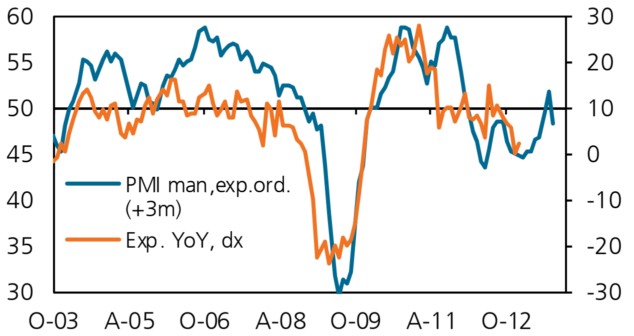
Source: Intesa Sanpaolo charts based on European Commission data

Consumption will remain negative throughout the year, held back by trends in purchasing power



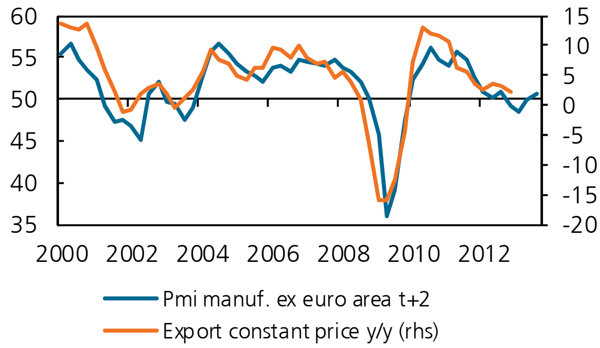
Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

Signs of recovery from manufacturing exports…



Source: Intesa Sanpaolo charts based on Eurostat and Markit data

…on the back of the rebound in global demand



Source: Intesa Sanpaolo charts based on Eurostat and Markit data

Euro zone inflation: below 2%, with risks to the downside

Anna Grimaldi

Inflation fell to 1.8% in February from 2.6% yoy at the end of summer. The slowdown was largely due to the moderation in commodity prices, with the contribution of energy falling to 0.4% yoy in February, from 0.9% yoy in September. The contribution of food to headline CPI was broadly unchanged from September at 0.4%. The increase in agricultural commodity prices observed in the summer months did not have meaningful effect on the CPI food, since the upside pressures exerted by fresh products were offset by the fall in other foodstuffs. Inflation, excluding energy and fresh foods (approximately 30% of the basket of goods in the harmonised price index), the ECB's preferred measure, fell to 1.4% from 1.6% last September, and from 2.0% at the end of 2011. Stripping out tobacco, administered prices and taxes, Euro zone inflation was 0.5% in February, down from 1.0% at the end of 2011.

Inflation fell to 1.8% in February from 2.6% at the end of summer

We expect inflation to fall further over the next few months to a minimum of 1.5% in September. Upward pressures have eased significantly since the end of the summer: the PMI price paid index fell in March to 46.8 from 54.7 in October, possibly on the back of the appreciation in the actual exchange rate observed between August and January. German imports prices, excluding energy, suggest a further moderation in consumer goods' prices over the coming months.

We forecast Euro zone inflation to fall from 2.5% in 2012 to 1.7% in 2013, and to 1.8% in 2014. The energy contribution should decline until the autumn, when we see the price of oil in euros rising back up. Our underlying assumption are for a EUR/USD exchange rate at 1.31 in 2013 and falling to 1.28 in 2014, which is considerably weaker than the exchange rate incorporated in our December estimates (1.35 in 2013). Oil is expected to fall from USD 112 in 2012 to USD 109 in 2013, and to then to rise to 113 in 2014.

Average inflation at 1.7% in 2013 and 1.8% in 2014, with core inflation at 1.4%

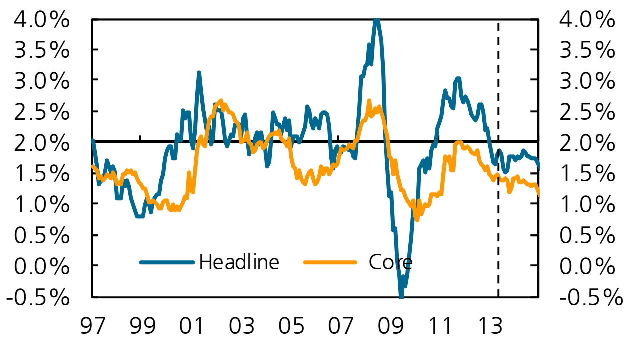
Core inflation is likely to fluctuate around 1.4% on average, from 1.8% in 2012. The annual trend will be impacted by increases in administered prices and indirect taxes, which have already occurred (and which weigh on the 2013 average) or are expected for 2013 (VAT rise expected in Italy for July 2013).

In our view, inflation risks are more to the downside than the upside. As usual, there is a risk of abrupt and unexpected spikes in commodity prices over the forecasting horizon. However, aside from that, we think the core inflation might slow more than we have penciled in. The output gap is expected to remain negative at -3.9%, broadly stable compared with 2012. Excess supply in the labor market will limit upward pressures on salaries, costs and domestic prices. Unemployment could continue to rise, from 11.9% in January to 12.4%. Labor costs have fallen from 2.2% at the end of 2011 to 1.3% at the end of 2012 and we do rule out significant rises in the next few months as we expect a cyclical upturn in productivity from spring 2013, which should keep unit labor costs under control. A more pronounced period of economic weakness than that incorporated in our estimates could drive underlying consumer price inflation net of energy, food and administered prices below 1.0% for the end of 2013.

Inflation expectations, as can be derived from inflation swaps, fell slightly in the last two months. Five-year inflation expectations, as can be derived from the ECB survey, show that the percentage of forecasters that see inflation at between 1.0% and 1.9% has increased, while the percentage of those who expect inflation to be above 1.9% has fallen. In the ECB's March press conference, President Mario Draghi stressed that inflation expectations are stable and that the cost of insurance against inflation but also against deflation fell in the past few months.

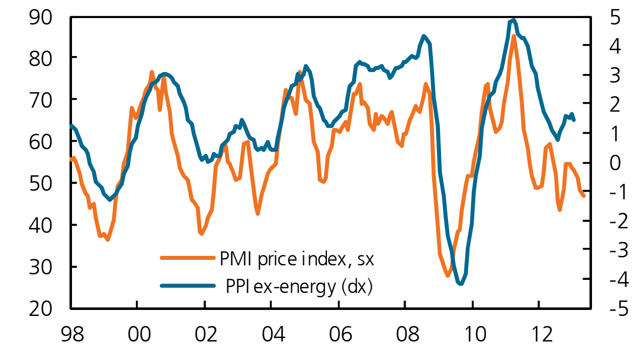
Survey-based inflation expectations point to more downside than upside risks

Inflation to fall until the autumn



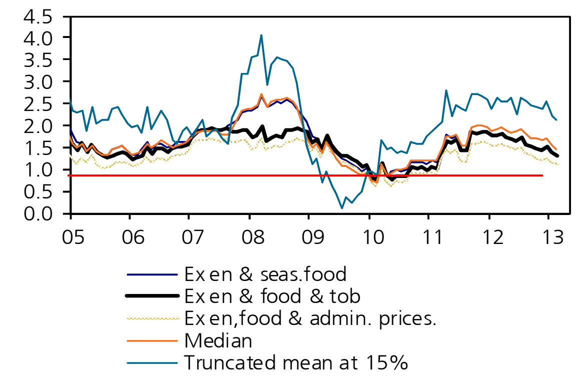
Source: Intesa Sanpaolo elaborations on Eurostat data

Upstream pressures are declining, partly due to the appreciation of the euro between August and January



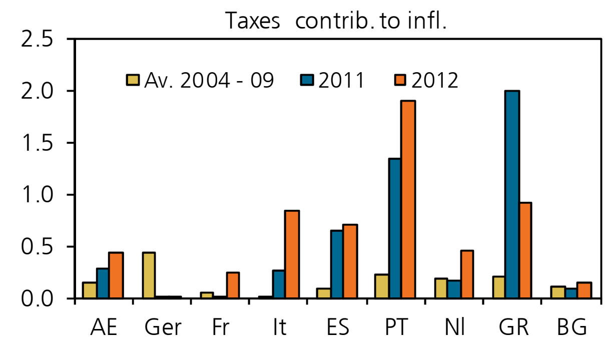
Source: Intesa Sanpaolo elaborations on Eurostat and Markit data

Core inflation has fallen across all measures in the last nine months, despite the rise .....



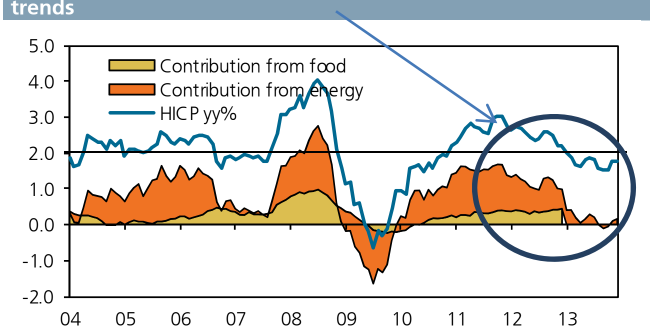
Source: Intesa Sanpaolo elaborations on Eurostat data

…in indirect taxation



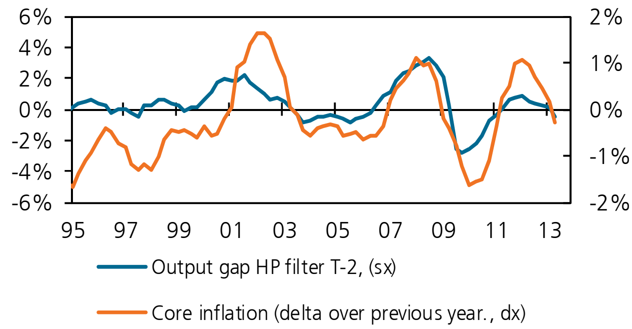
Source: Intesa Sanpaolo elaborations on Eurostat data

Inflation profile still dependent on energy and fresh food trends



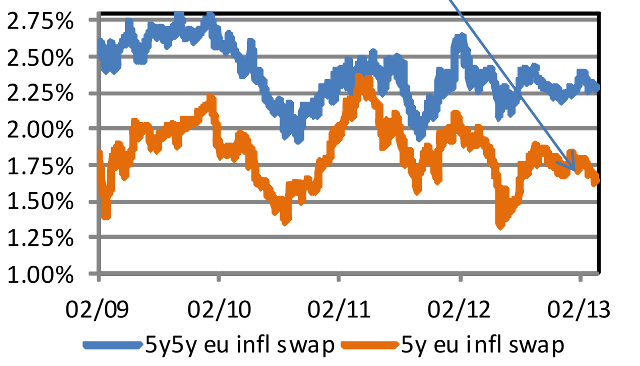
Source: Intesa Sanpaolo elaborations on Eurostat data

Risks to core inflation are to the downside



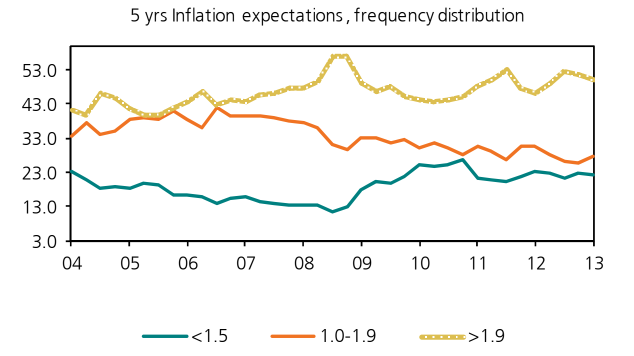
Source: Intesa Sanpaolo elaborations on Eurostat data

Market inflation expectations falling slightly



Source: Bloomberg and Intesa Sanpaolo

Percentage of forecasters who see five-year inflation below 2% is increasing



Source: Markit, Eurostat and Intesa Sanpaolo

ECB: don't expect much from Frankfurt

Anna Grimaldi

The ECB left interest rates unchanged in March but the downwards revisions to the growth outlook leave the door open for a cut to the refi rate in the coming months. Yet, we think that the probability of a refi rate cut remains very low, as it would have a limited impact on the real economy. During the latest European Parliament hearing, ECB President Mario Draghi indicated that the problem is not the monetary policy impulse but its transmission: "*What we need to do, and this is the ECB's number one challenge, is to ensure monetary policy transmission in the whole area*".

There could be a cut in the refi rate if money market rates rose sharply following the repayment of three-year funds, but this is not the central scenario

In deciding whether or not to cut the refi rate, we think that money market conditions will be more relevant than downside risks for the macroeconomic scenario, although these would provide an official justification for the decision. With the full allotment mechanism in place, the refi rate represents a limit for money market rates insofar as at significantly higher interest rates, it would be cheaper for banks to borrow money from the ECB. Up until 20 March, the amount of funds repaid from the two three-year auctions was EUR 231Bn and the amount of excess reserves was EUR 382Bn, still well above the threshold of EUR 200Bn, which the ECB considers an indicative threshold for money market rates to remain skewed to the bottom of the refi rate's corridor: the deposit rate.

A cut in the deposit rate is highly unlikely

The ECB stated in more than one occasion that it is technically prepared to cut the deposit rate, but we continue to believe that the probability of it taking such a step is very remote. A negative interest rate on deposits could distort the function of the repo market and penalise money market funds. Moreover, a cut could prove counter-productive for lending, as noted by ECB Vice-President Vitor Costancio on 14 February 2013: "*When, as in the current situation, demand for credit is not buoyant, this may lead banks to increase their loan rates to compensate for the costs of negative deposit rates. The ECB has looked at the experience of Denmark and Sweden, which applied negative deposit rates for a brief period, and concluded that the effect of such a policy measure is not clear-cut*".

What else can the ECB do to maintain an accommodative monetary policy?

Although it has left interest rates unchanged since March, the ECB is committed to maintaining monetary policy accommodative. We do not think however, that the ECB will announce new unconventional measures anytime soon, partly because of the Bundesbank's strong resistance to bolstering monetary stimulus through measures aimed at restoring monetary policy transmission to the periphery of the euro area. Draghi has reiterated many times that the failure to transmit the monetary policy stimulus is due to the fragmentation of the interbank market and that "*what we have to do is to wait until accommodative monetary policy is transmitted to the real economy"*. Draghi noted in March that the OMTs' announcement contributed to reduce fragmentation of the interbank market.

The main instrument used by Draghi to indicate that the ECB is prepared to maintain an accommodative monetary policy is the full allotment at refinancing auctions, which we think will be maintained at least until the end of 2014. The instrument is nothing new and while it may have prevented a balance of payments crisis, it has certainly not favoured the transmission of monetary policy stimulus to peripheral countries, where both fiscal and monetary policy are rather restrictive.

One way to assess the stance of monetary tightening is to look at the trend of real short-term interest rates with respect to that of domestic demand. As charts below show, real interest rates are lower in core countries but higher in peripheral countries. The difference in monetary policy stance is evident even in the rates on loans of below EUR 1Mn with the interest rate set for up to one year.

Is a change in the rules governing cross-border collateral on the way?

In his speech at the conference on financial integration on 19 March, Draghi said that the ECB is working to improve the possibilities for the cross-border use of collateral in credit operations "*which will increase efficiency*". Such declarations represent a new development, and might be interpreted as an acknowledgement that something must be done to limit interbank market fragmentation. The change in collateral rules could take the form of a revision of the guarantee margins applied to the debt instruments of other credit institutions.

We think the ECB has run out of ammunitions should the recent risk off environment triggered by Italian politics and the Cyprus crisis escalate into contagion fears.

LTRO auctions are not excluded in the event of increasing market tension but would offer limited relief

We cannot rule out the possibility that the ECB could announce other medium- to long-term auctions to limit the repercussions on the liquidity of banks in peripheral countries. However, we do not believe that other long-term auctions would solve the problem of credit risk and counterparty risk that continues to limit the circulation of capital from core to peripheral countries, albeit less so than a year ago.

OMTs are a backstop that can only be activated by governments

Purchases of government bonds on the secondary market is no longer an option. Since the SMP was officially discontinued in September, the ECB has remit to governments the activation of the OMTs as Mario Draghi noted ("*it is up to the governments to decide*"). Whilst the ECB ESM joint action plan in principle provide an unlimited backstop to speculation of a solvency crisis in the euro area the activation of the plan is not obvious and immediate. Indeed, the implementation risk is still there and in sofa we had no concrete test of the ability of European Institutions to react swiftly. Moreover, the use of this instrument is limited to those countries that have not lost access to the market, and is therefore not applicable to Cyprus.

ELA the sole emergency weapon

As the Cyprus crisis suggested the sole emergency weapon that the ECB has to counteract the escalation of markets' concerns on a country financial soundness is ELA. But even the provision of emergency liquidity is conditioned to the solvency of banks recurring to it.

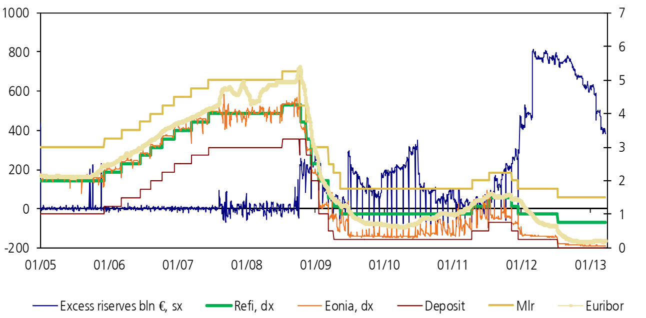
In conclusion, the ECB pledged to keep monetary policy accommodative and to maintain the full allotment mechanism for an extended period. But beyond this, the ECB will not introduce new measures to restore the transmission of monetary policy stimulus in peripheral countries any time soon.

Table 1 - The ECB lowers its growth and inflation estimates

		ECB		Consensus		Intesa Sanpaolo	
Forecast date	Year	HCPI	GDP	HCPI	GDP	HICP	GDP
Sep-12	2012	2.4/2.6 (2.5)	-0.6/-0.2 (-0.4)	2.3	-0,5	2.5	-0,4
Sep-12	2013	1.3/2.5 (1.9)	-0.4/1.4 (0,5)	1.7	0,5	2	0,3
Dec-12	2012	2.4/2.6 (2.5)	-0.5/-0.2 (-0.4)	2.5	-0,5	2.5	-0,4
Dec-12	2013	1.1/2.1 (1.6)	-0.9/0.3 (-0,3)	1.9	0.0	1.8	0.0
Dec-12	2014	0.6/2.2 (1.4)	+0.2/2.2 (1.2)	1.6*	1.4*	1.8	1.0
Mar-13	2013	1.2/2.0 (1.6)↑	-0.9/-0.1 (-0.5)↓	1.8	-0.2	1.7	-0.5
Mar-13	2014	0.6/2.2 (1.4)	+0.0/2.0 (1.2)↓	1.7	1.8	1.8	0.9

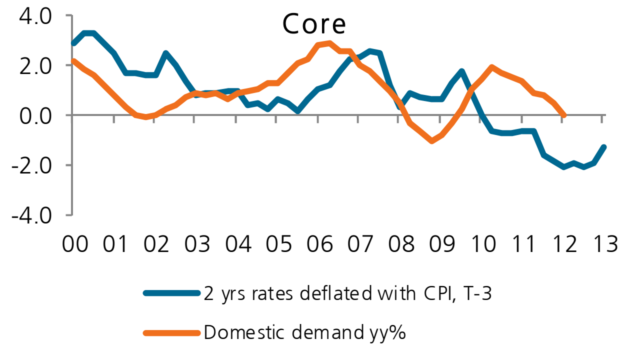
Note: (*) EU Commission estimates for November, when consensus estimates for 2014 were not available.
Source: ECB, Consensus Economics and Intesa Sanpaolo estimates

Full allotment will keep monetary policy accommodative for long but for the time being…



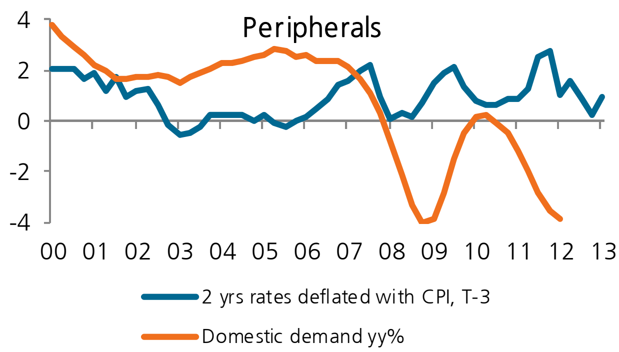
Source: Intesa Sanpaolo chart from ECB data

… monetary policy is only accommodative in core countries…



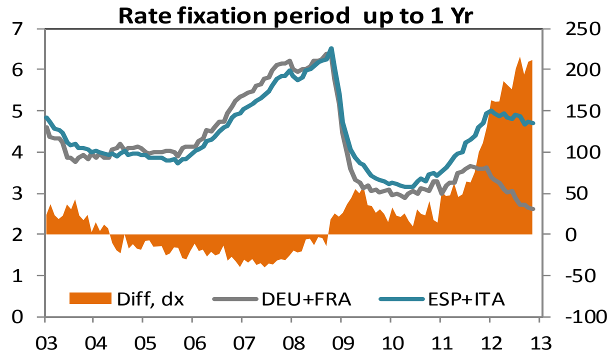
Source: Intesa Sanpaolo chart on Bloomberg and Eurostat data

… and very restrictive in peripherals



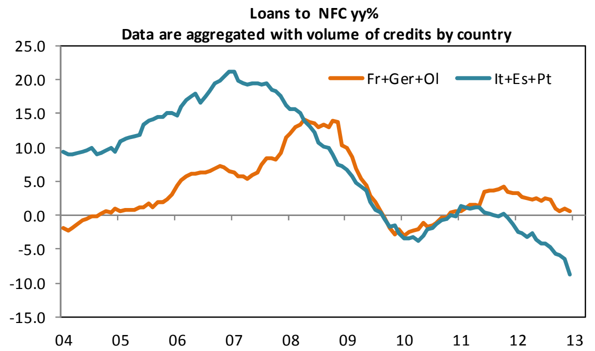
Source: Intesa Sanpaolo chart on Bloomberg and Eurostat data

Companies in peripheral countries pay approximately 200 bps more on loans than firms in core



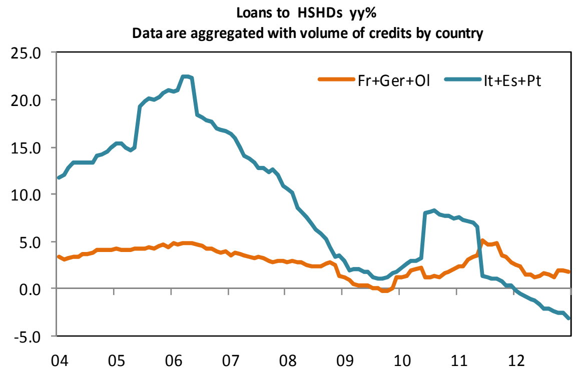
Source: Intesa Sanpaolo chart on ECB data

There are no signs of trend reversal in lending to companies or…



Source: Intesa Sanpaolo chart on ECB data

...households in peripheral countries



Source: Intesa Sanpaolo chart on ECB data

Germany: a weak start, but the worst should be behind us

Anna Grimaldi

We confirm our growth forecast for German GDP at 0.5% in 2013, vs. +0.7% last year. The estimate for this year is conditioned by the weak exit from 2012: -0.6% q/q. Confidence surveys, and in particular the expectations component of the IFO, point to a business cycle reversal already at the beginning of 2013, driven by the recovery in global demand. However, GDP growth will return only to modest positive territory in 1Q 2013, due to the weak dynamics of industrial order and production at the start of the year. Negative effects stemming from poor weather conditions cannot be ruled out, in the construction sector in particular. The economy's strong fundamentals, the sound competitive position and a resilient labour market, should allow GDP growth to accelerate from the spring. Expansive monetary conditions and income-supportive fiscal policy measures should aid a recovery in domestic demand. In 2014, there should no impediment to German GDP growth returning (1.8%) above trend (estimated at 1.3% by the Bundesbank and at 1.6%. by the OECD). Already in 2013, domestic demand should make a stronger contribution to GDP growth than the foreign channel, given the increasing import content of German exports. Germany should therefore contribute to the rebalancing process within the euro area, exporting growth. Risks to the 2013-2014 scenario are skewed to the downside, and are tied to negative developments in the euro area and to a slower recovery in global demand than we are currently forecasting, as well as to a weaker rise in domestic demand, and in particular of corporate spending.

Germany – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (1995 prices, y/y)	0.9	0.5	1.8	1.0	0.9	0.4	0.0	0.2	0.4	1.5	1.9
- q/q change				0.3	0.2	-0.6	0.1	0.4	0.5	0.5	0.5
Private consumption	0.6	0.9	1.4	0.2	0.0	0.1	0.2	0.4	0.3	0.4	0.4
Fixed investment	-2.0	-1.0	4.0	-1.9	-0.5	-0.8	-0.6	0.3	0.9	1.0	1.2
Government consumption	1.4	1.4	1.5	-0.3	0.7	0.4	0.3	0.3	0.4	0.4	0.4
Export	4.3	2.8	5.4	3.3	1.5	-2.0	0.5	1.8	1.3	1.2	1.4
Import	2.2	3.4	5.9	2.3	0.6	-0.6	0.8	1.8	1.0	1.4	1.7
Stockbuilding (% contrib. to GDP)	-0.6	0.0	-0.2	-0.1	-0.3	0.2	0.1	0.0	-0.1	0.0	0.0
Current account (% of GDP)	6.4	6.4	5.7	6.5	7.0	5.9	6.3	6.6	6.6	6.2	6.0
Deficit (% of GDP)	-0.6	-0.2	0.0								
Debt (% of GDP)	80.6	78.6	76.5								
CPI (y/y)	2.1	1.7	1.5	2.1	2.1	2.0	1.7	1.8	1.8	1.6	1.6
Industrial production (y/y)	-0.4	0.9	4.0	0.1	0.4	-2.3	0.4	1.1	2.0	1.0	0.5
Unemployment (%)	6.8	7.2	7.0	6.8	6.8	6.9	6.9	7.1	7.3	7.3	7.2

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

Short-term outlook: German industrial production stagnated at the beginning of 2013, following a 0.6% m/m rise at the end of 2012. The data is in contrast with the recovery signals of the industrial sector from the IFO and ZEW surveys, but it is in line with the dynamics of the PMI manufacturing index observed between November and March. The data from January shows the production sector on track for a weak recovery in March 2013 +0.4% Q/Q. The data on retail sales signal a more sustainable trend of consumption spending after the + 0.2% Q/Q of the second half of 2012. Exports grew by 1.4% in nominal terms in January whilst imports expanded 3.3%m/m. Overall, GDP is expected to grow at best by 0.1% in Q1 2013 after the 0.6% Q/Q decline at end of 2012. The recovery should accelerate in the coming Spring months to +0.4% Q/Q.

Thanks to an acceleration of exports and...

We expect, exports to gain speed in 2013, as the Euro zone should return to positive growth. Roughly 40% of German exports go to Euro area countries. On average, we expect exports to increase by 2.8% in 2013 and by 5.4% in 2014. Imports are should grow more than exports both in 2013 (3.4%) and in 2014 (5.9%), given the high import content of German production and machinery investment. We therefore expect that net exports will offer, progressively, a less significant contribution to GDP growth with respect to the 2000's. Thus, we should witness a partial closing of the trade surplus, from the 6.5% of 2012.

...of domestic demand sustained by expansive policies

Domestic demand will continue to offer limited support to growth in the first part of this year given the still uncertain climate. Even so, consumption and investment should accelerate throughout the year sustained by expansionary economic policies.

The short term outlook for capex remains uncertain: capacity utilization increased only marginally and foreign orders fell at the beginning of 2013. Extremely favourable financial conditions and the need to substitute labour with capital should trigger a gradual acceleration in business investment. We expect capex to be limited to the substitution and rationalization of existing structures until the improvement in confidence consolidates. Investment to increase production capacity should resume only in the second half of the year. On average, machinery spending is expected to still be in negative area, -2.4% in 2013, given the weak start of 2012, but to recover to 4% in 2014. A more sustainable growth in machinery spending in Germany tends to have positive repercussions on production and exports in the rest of Euro zone given the intense import content of German business investment. Eurostat data on goods' trade revealed that in 2012, Germany imported 39% (117 billion Euros) of machinery goods from the rest of the Euro zone, despite the weight of imports from outside the Euro zone rose significantly in the past decade. The Netherlands and Italy still accounted for 9% and 6% of total machinery imports last year.

A pick up in machinery investment may have positive spill -overs on AE export growth

Construction investments should expand in the Spring after the weakness over the turn of the year. Yet, data on new orders and building permits for residential construction and commercial construction suggest the underlying trend could be less positive than in 2011 (+6.0%). On average, construction investments should grow 0.9% in 2013 (as an unfavourable base effect with respect to the first half of last year weighs on the annual trend) and 2.5% in 2014.

Consumption spending should prove only marginally stronger than in 2012 (+0.9% from +0.6%), in part due to a negative carry from the end of last year. We expect more sustainable growth of 1.4% in 2014. Household consumption should be supported not only by economic policies but also by wage dynamics on the forecast horizon. Negotiable salaries should grow more or less at the same pace as in 2012: (2.7% on average). In 2013, the wages of 12.5 million workers should be renewed, the Bundesbank expects the increases to be in line with those seen in 2012. Negotiable wages are expected to increase in 2014, thanks to the cyclical recovery.[4]. Negotiated wages should accelerate in 2014, as the cycle pick up. Compensation of employees should expand in line with negotiated wages in 2013, as it was the case in the past two years. The trend is due to the fact that the wage increases negotiated over the last two years are explained by permanent increases in the base salary. The more sustained wage dynamics in the 2008-2013 period, compared to the moderation of the 2004-2008 period, triggered by the Schroeder reforms of 2003, may induce a more expansive consumption cycle and favour a rebalancing of internal growth of the Euro zone. The wage share in GDP has risen from 2005 to 2012 while the profit share has started to decrease since 2009, the ongoing redistribution of wages should allow for Germany's export growth, contributing to the internal rebalancing process in the Euro zone. Yet, the precautionary motive which kept the dynamics of German consumption short of labour dynamics in the 2000s could once more become more relevant and keep consumption on a modest path.

[4] IG Metall has requested for 2013 (negotiations started in 21 March) wage increases of 5.5% versus the 6.5% asked in 2012, when it obtained an increase of 4.3% (however the most significant of the last 20 years and more than twice 2012 inflation). In the negotiations, increases of 6.6% were requested and civil servants claimed increases of 6.6%

Labour markets prospects are still positive, but unemployment could rise to 7.3% by the summer

The prospects for labour market dynamics remain favourable. Surveys indicate only a modest slowdown of the hiring intentions at the beginning of the year, the number of vacancies has marginally decreased in January and February and simultaneously there was a drop in registered unemployment at 18 thousand over the same period. The unemployment rate reached a new low in January at 6.8% to then marginally increase in February to 6.9%. We cannot rule a delayed effect of the economic slowdown on employment dynamics. Yet, we think the impact will be again more on the number of hours worked, due to the flexible arrangements at firm levels, rather than a sharp increase in layoffs,. The through for employment dynamics should be reached at the beginning of the summer, when we predict job growth to slow to 0.3% y/y from 0.6% y/y of last January. Unemployment could reach 7.3% this summer to then go down again in 2014. The increase in labour force could negatively impact the unemployment rate dynamics since the Bundesbank will increase the participation rate in 2013 given the migration of nearly 300,000 people. Unemployment dynamics could be negatively impact by an increase in the labour force. The Bundesbank is projecting the participation rate to rise in 2013-2014 due to migration flows of nearly 300 thousands.

Inflation should return to 1.7% in 2013, from 2.1% estimated for 2012. The lower pressures from the energy sector should counterbalance the increase of unit labour costs associated with wage increases and softer employment growth. In 2013, core inflation should move in line with the headline index, after the +1.5% y/y of this year. In 2014, inflation is expected to be stable around 1.6%.

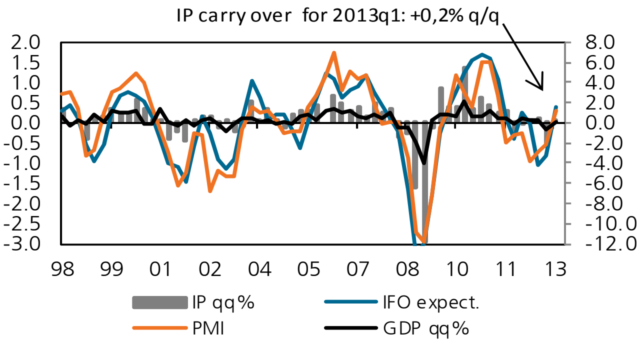
Focus I: Germany will respect the Fiscal Compact already in 2013

The budget balance closed with a small surplus in 2012: +0.1% of GDP, an improvement from -0.8% in 2011 and much better than the -0.9% printed in the SP (stability program) 2012. The better than expected result for 2012 is explained by an increase corporate profits tax revenues in in excess of business income[5] growth and by lower than expected rise in social expenditure; courtesy of a better than expected labour market performance. Falling interest rates had an impact of only 0.1% of GDP on interest rate expenditure. Last January, the Commission projected interest rate spending at 2.6% of GDP while Bundesbank February data showed interest spending at 2.5% of GDP. The structural deficit improved by 0.9% in 2012 to -0.5% of GDP; the result is in line with the SP projections of last April 2012. In 2012, the debt to GDO ratio should have closed at 81.7% of GDP from 80.5% in 2011 on the payment of contributions to the European facilities (29 billion for guarantees to allocate to the EFSF and 27 billion to the ESM), and the liquidation of the Western German state Bank. In 2013, the fiscal balance is expected to return to a deficit of -0.5% of GDP, since the cyclical slowdown of the second half of 2012 should wipe out the positive influence of the cycle. Furthermore, in view of the autumn elections, a series of income support measures (a reduction in social security contributions to 18.8% from 19.6%; the expansion of the tax base to apply the deduction of the physical person income tax rates; eliminating the taxation of tickets for medical visits to a specialist; the introduction of fiscal incentives for renovations) were introduced with the 2013 Budget and will be only partly funded through spending cuts. The main savings should derive from lower interest rate expenditure as financial conditions remain expansionary (the lower medium to long term yields typically transmit with a lag on interest spending) and from the expiration of state obligations sustaining financial institutions who offset the commitments for European support mechanisms. The multi-year budget plan presented by the Merkel cabinet on 14 March 2013 projects a continuing deficit in 2014 (6.4 billion Euro versus the 17.1 billion Euro predicted for 2013) and the return of a balanced deficit in 2015. The Budget Plan forecasts revenue growth of

[5] According to Bundesbank, the wide variation of income tax residuals - a decline in corporate taxation receipts in 2009 and a rebound in 2011 -12 in excess profits, dynamics- is explained by the corporate tax payments' schedule which is not fully reflected in the models.

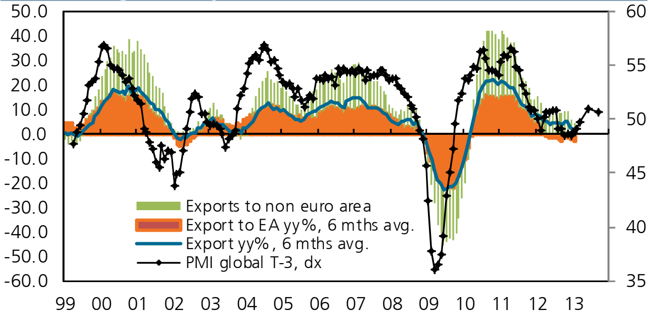
10% and expenditure declining 2% between 2014 and 2017, a seemingly realistic hypothesis since the EU Commission expects at 1.4% potential growth. The **structural fiscal balance** is expected to be nearly unchanged in 2013 and in balance already in 2014. Germany can boast of being in an overall solid position with respect to the other European partners, the deadline of compliance for the Fiscal Compact (structural balance not superior to -0.5%) is 2015. Moreover, already in 2013, the debit/GDP ratio could drop once again at the expiry of the liabilities related to sustaining the "*bad banks.*"

Production data suggest only a slight GDP recovery at the beginning of 2013, but the surveys are positive.



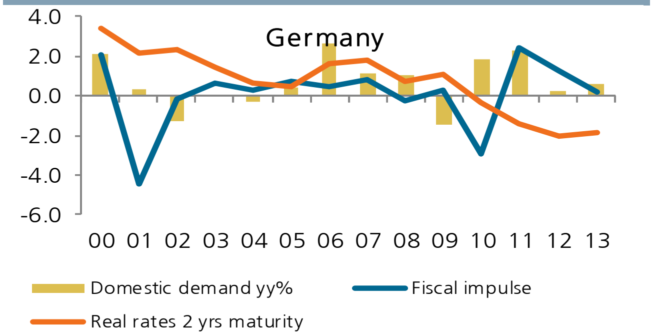
Note: IFO and PMI standard deviation from long-term average
Source: Markit, Deutsche Bundesbank and Intesa Sanpaolo elaborations

The increase in confidence reflects the recovery of global demand, signalled by the PMIs and trade indices



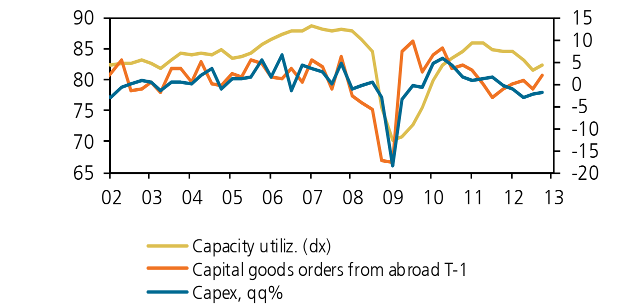
Source: Markit, Deutsche Bundesbank and Intesa Sanpaolo elaborations

Economic policies should support domestic demand dynamics



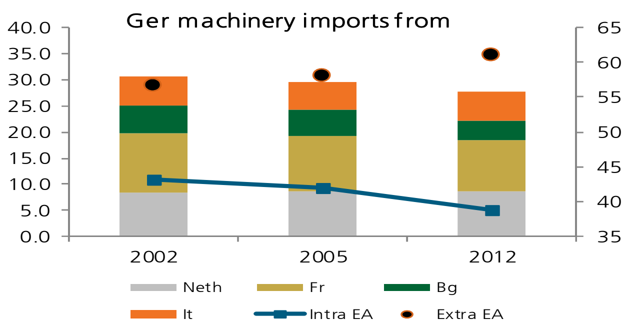
Source: Bloomberg, EU Commission, Deutsche Bundesbank and Intesa Sanpaolo elaborations

Investment prospects remain uncertain in the short term, yet spending to raise capacity should pick up in 2013H2



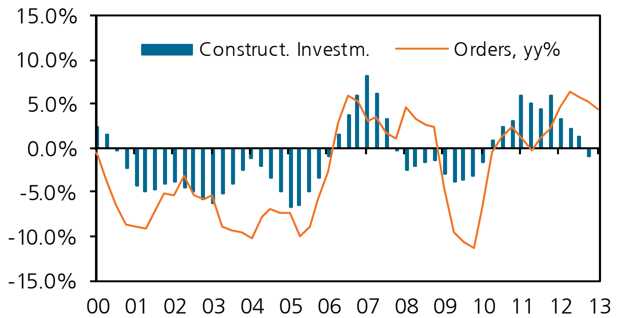
Source: FSO, Deutsche Bundesbank and Intesa Sanpaolo elaborations

The investment cycle may have positive spill overs on the rest of the area since Germany imports 39% of machinery from the Euro zone



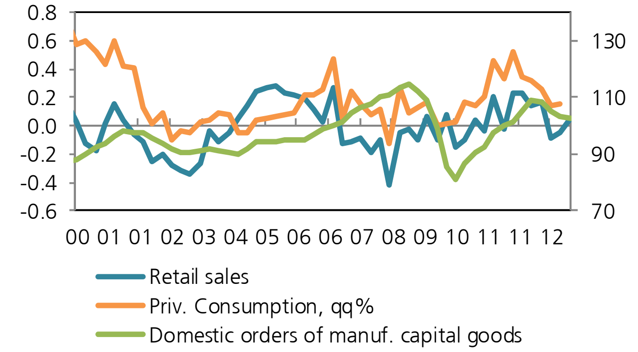
Source: Eurostat and Intesa Sanpaolo elaborations

Construction: expansion to continue but at a slower pace than in 2010-2011



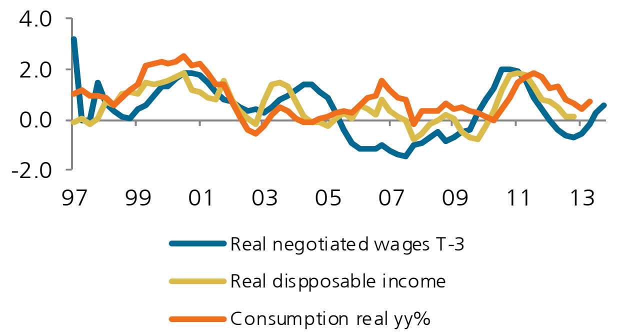
Source: FSO, Deutsche Bundesbank and Intesa Sanpaolo elaborations

Weak consumption until the Spring, but to then pick up …



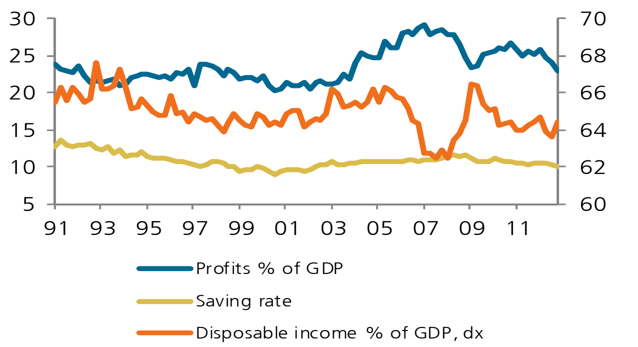
Source: FSO, Deutsche Bundesbank and Intesa Sanpaolo elaborations

…on the back of more sustained salaries and disposable income (thanks to supportive fiscal measures) growth



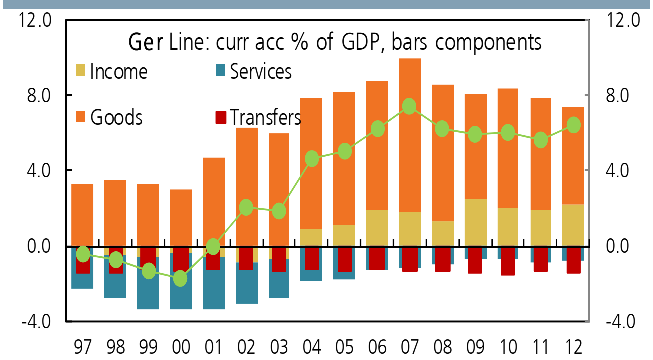
Source: FSO, Deutsche Bundesbank and Intesa Sanpaolo elaborations

Will Germany export growth? The share of profits in GDP is falling while that of consumption is rising



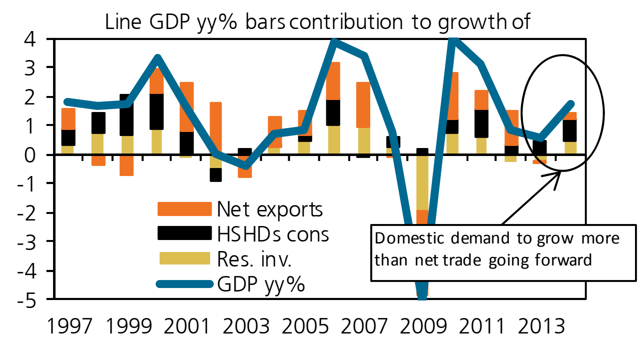
Source: Deutsche Bundesbank and Intesa Sanpaolo estimates

There is ample margin to balance the current account surplus



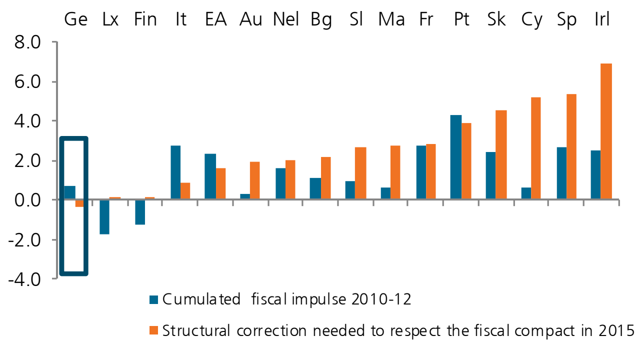
Source: Eurostat and Intesa Sanpaolo elaborations

From 2013, domestic demand should contribute more than exports to GDP growth



Source: Deutsche Bundesbank and Intesa Sanpaolo estimates

Germany will abide to the Fiscal Compact (structural balance at -0.5% of GDP) already in 2013



Source: FSO and Intesa Sanpaolo elaborations

Focus II: Ten years on: from "sick man" to "steam engine", but will it last?

In 2003, three years following the introduction of the euro, Germany was singled out as the "sick man of Europe". Today, it is hailed as an economic model to emulate. The country's subpar performance compared to the AE average between 1995 and 2005 is in part ascribable to the burdensome heritage of the reunification process. However, in 2003 Germany, at the time led by social democrat (SPD) Chancellor Schroeder, succeeded in initiating a deep transformation process, through an ambitious reforms' plan known as Agenda 2010. The reform package was aimed at "*modernising the social economy*", making the product market more flexible and encouraging the business of small and medium enterprises, which were, and still are, the bulk of the German industrial system. The core measures of Agenda 2010[6] were undoubtedly the laws known as Hartz I - IV (named after the ex-Volkswagen's manager who proposed them). The laws responded to the need to render the labour market more flexible (both at entry and exit) and to abate long-term unemployment.

The Hartz I and II Laws of 2002 introduced so-called "*mini-jobs*" and personal service agencies, two new instruments to counter undeclared work. Hartz Law III transformed the Federal Labour office into the Employment Agency, geared to improving the process of matching the demand and supply of labour. The Hartz IV reform united federal unemployment benefits and municipal subsidies (social benefits) creating a single welfare instrument that guaranteed a payment of 345 euros a month in West Germany and 331 euros a month in East Germany (the previous *Arbeitslosenhilfe* benefit scheme guaranteed 53% of the last net salary received). The reform placed a 12-month limit on payment of the unemployment benefit (18 months for workers over 55 years of age), with beneficiaries stripped of their right to receive it, if they refused a job offer. Vocational training schemes were also promoted, to help cut long-term unemployment. The Hartz IV reform introduced more flexible rules for dismissals largely through the possibility of excluding qualified workers, or workers considered as strategic, from the criteria governing layoffs[7].

Between 2004 and 2005, negotiations concerning work hours and retribution levels between individual companies and single workers became an increasingly widespread practice. Significant examples were the bonus systems tied to company performance negotiated by Volkswagen in 2004 and Opel in 2005. In 2005, it was introduced the possibility to adjust weekly working hours (between 36 and 40 hours) every 36 months and to cut wages by 10% to safeguard competitiveness and employment levels.

Effects of the reforms on employment and labour costs

1. Early in 2005, the number of unemployed workers exceeded the five million mark, and the average annual unemployment rate had risen to almost 12%. Seven years later, the situation has radically changed: unemployment is at its lowest post–reunification levels, under the three-million threshold and the unemployment rate is roughly in line with the OECD's estimates of structural unemployment (7.1% in 2012, 6.7-6.8% in the present two-year period) despite the recent crisis.
2. The trend of long-term unemployment has reversed, both as percentage of the overall workforce and as a percentage of total population.

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[6] For details on the measures passed, see the EU Commission website, and in particular the indicators on labour market reform: http://ec.europa.eu/economy_finance/indicators/economic_reforms/labref/result.cfm
[7] The measure introduced the option of the worker to choose between a severance indemnity (of half the retribution for every year of seniority) or a legal dispute (which, if won by the company, deprived the worker of the indemnity).

3. During the latest cycle, adjustment of the labour factor was achieved more through cutting work hours than through layoffs, as had been the case over previous cycles, and if in 2008-2009. The Kurzerbeirt had a considerable impact accounting for one-third of the reduction in work hours in 2008 but in 2012 the adjustment in hours responded to firms' need to retain qualified workers. The OECD estimates that, based on the long-term relation between GDP and employment, unemployment should have risen by at least three points over the latest cycle. However, it is also true that this time around the manufacturing sector was hit hardest by the crisis, whereas labour-intensive sectors such as construction remained immune.
4. Cost of labour in the industrial sector, net of the construction segment, has grown less than in the other main euro area countries.

In its Country Report on Germany, the OECD acknowledges that past reforms have helped improve the resilience of employment in the latest cycle, and to bring down long-term unemployment, singling Germany out as an example for other countries.

The costs of the reforms and the current political debate

The costs of the reform have by no means been negligible. Based on EU Commission data, social spending increased by 3.3% (8.6 billion euros) between 2003 and 2006, about three times in excess of primary spending (net of transfers).

Beyond a quantification of the costs for public finances, many claim that the Hartz reforms have triggered forceful decline in unemployment through the proliferation of part-time low paid jobs and at the expense of social equality. Indeed, a recent OECD paper[8], and the IV report on wealth and equality from German Labour Ministry both highlight an increase in social inequality in Germany.

The political debate is heating up ahead of the September elections, and the SPD, which pledged for the modernization of the social in 2003, has centred its political program on income redistribution and greater social justice. The SPD proposes the introduction of a national minimum wage of 8.5 euros per hour, restrictions to the application of part-time contracts, an increase in the top income tax rate (to 49% from 42% at present) and in capital gains tax (from 25% to 32%) and the introduction of a property tax. The SPD's reversal from the social liberalism pursued ten years ago is justified by the need to distance itself from the CDU's platform. Chancellor Merkel has taken full advantage of the German economic *renaissance* between 2005 and 2009, clinching two consecutive elections, in 2005 (when she led a CDU–SPD coalition), and in 2009 (in a coalition with the liberal FDP party), and she still retains a personal advantage to won a third mandate as Chancellor this September. Within the CDU, Social Affairs Minister Ursula Von der Leyen has spoken up in favour of the introduction of a minimum wage. The liberal FDP party, in the person of the Minister of the Economy Rosler, continues to oppose income-redistribution measures. Mrs Merkel is avoiding entering the social justice debate so that she can keep her options open to form a coalition government with either the SPD or the FDP.

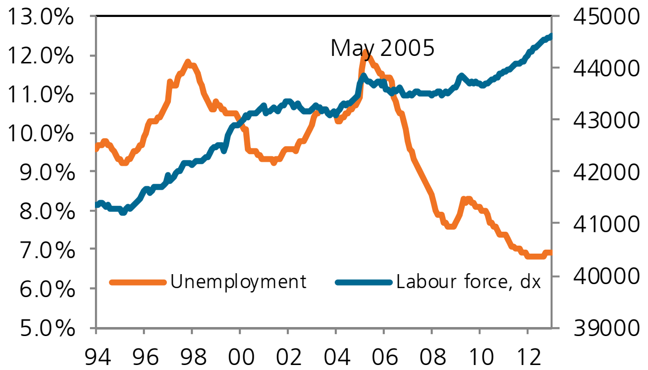
Calls for greater equality in Germany are in part justified. However, risks to the country's growth potential in the medium term should not be overlooked. Demographics data are rather alarming and show that the population is ageing rapidly, a trend which should be countered, notes the OECD, not only by fostering immigration flows, but also by encouraging full-time female participation in the labour market. Mr Schroeder himself, in a speech held on 24 April last year, said that the reform process in Germany cannot be halted, and should target greater social

[8] See: Income inequality in the European Union, April 2012 OECD report

inclusion in the labour market through a higher full time female participation and more pervasive integration of immigrants.

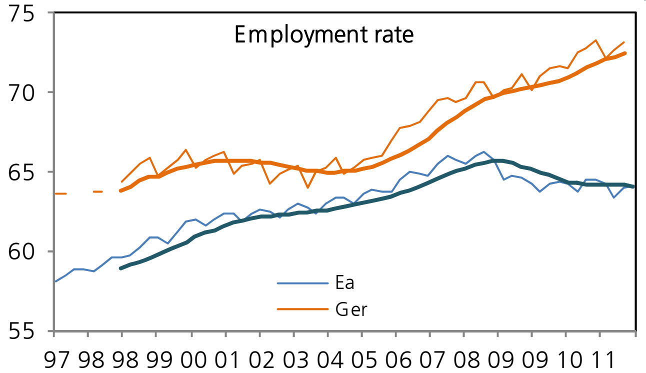
In our view, the German economy will retain the economic edge it won back over the past decade, provided it meets the right reform challenges.

Unemployment started to drop two years after the Hartz reforms kicked in and is now at its lowest since reunification



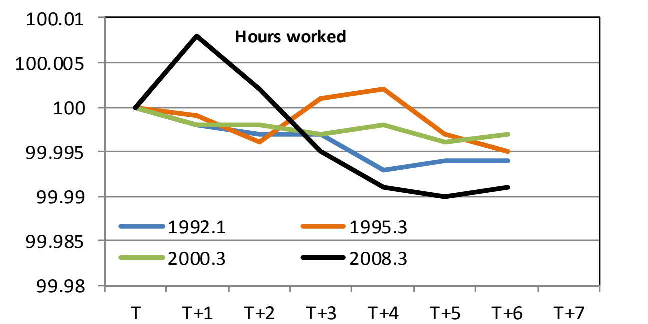
Source: FSO and Intesa Sanpaolo estimates

The employment rate reversed



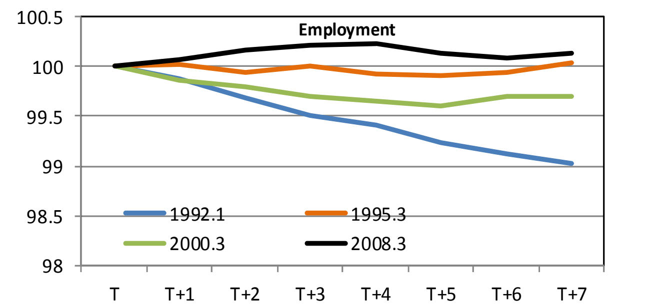
Source: Eurostat and Intesa Sanpaolo estimates

Work hours reacted much more than…



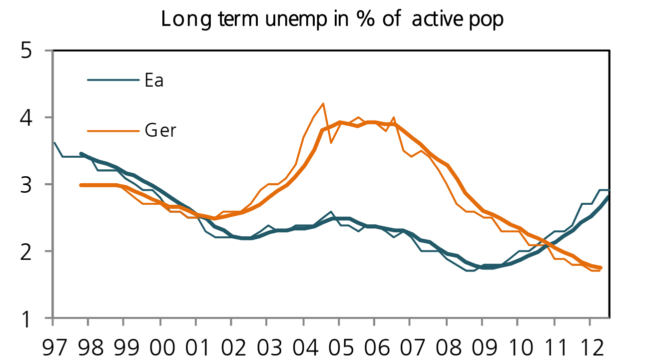
Source: Eurostat and Intesa Sanpaolo estimates

… employment during the latest cycle



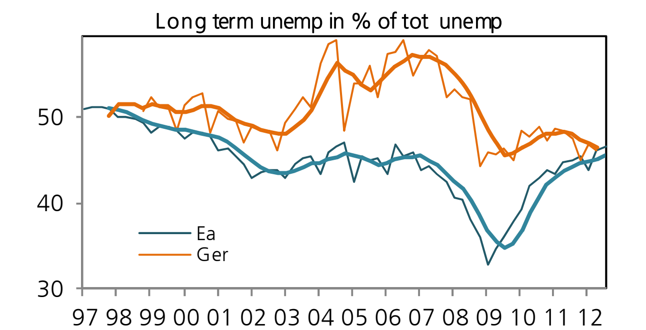
Source: Eurostat and Intesa Sanpaolo elaborations

There is no denying that long-term unemployment in Germany dropped, both as a percentage of the working population…



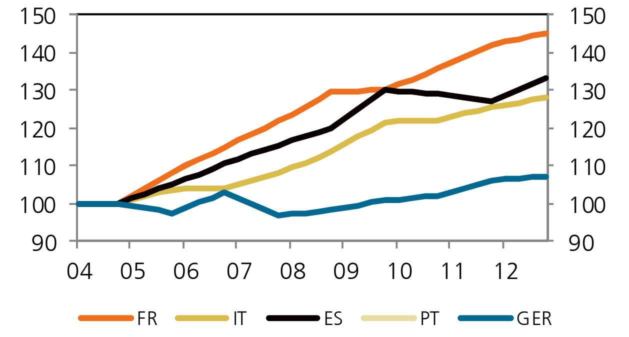
Source: Eurostat and Intesa Sanpaolo estimates

… and of overall unemployment, contrary to the trend observed in the rest of the euro area



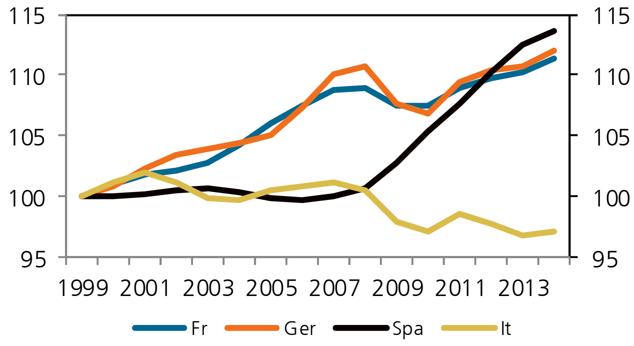
Source: Eurostat and Intesa Sanpaolo estimates

Labour cost in manufacturing has risen less than in the rest of the euro area since 2004



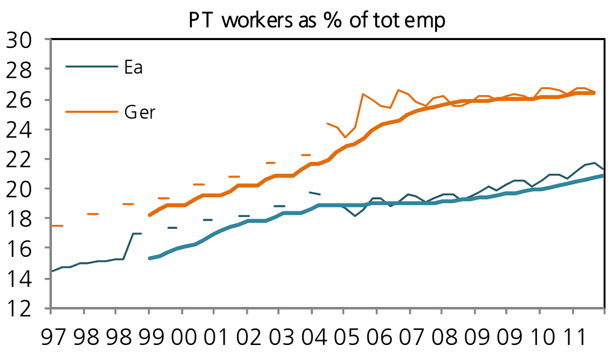
Source: Eurostat and Intesa Sanpaolo estimates

Productivity is growing in line with the French trend



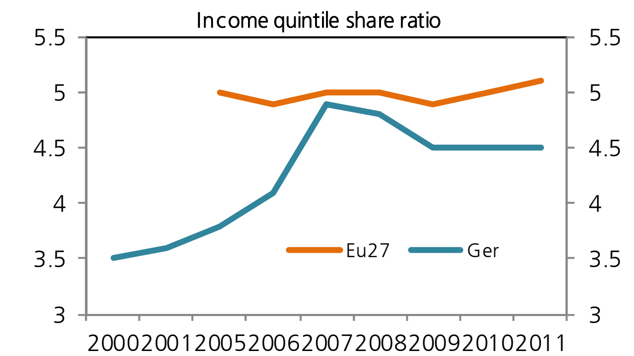
Source: OECD and Intesa Sanpaolo estimates

The rise in employment was achieved through the creation of part-time jobs



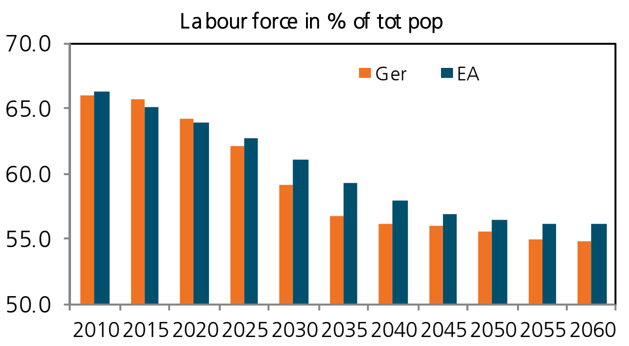
Source: Eurostat and Intesa Sanpaolo estimates

Many point to the reform as the culprit behind the increase in social inequality in Germany between 2005 and 2009



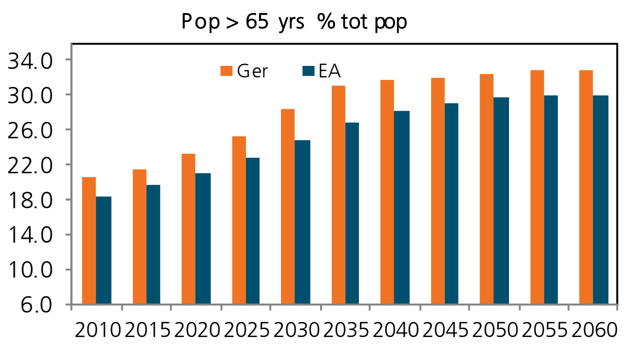
Source: Eurostat and Intesa Sanpaolo elaborations

The contraction in the workforce…



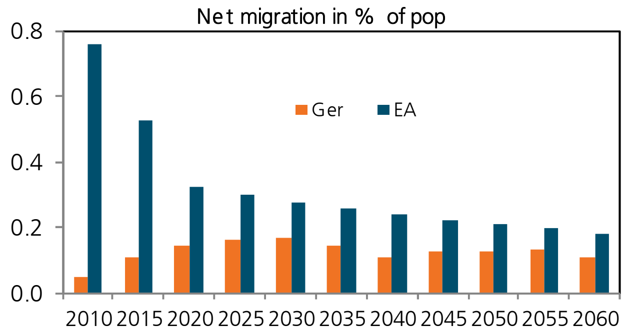
Source: EU Commission and Intesa Sanpaolo estimates

… associated with an ageing population, must be countered



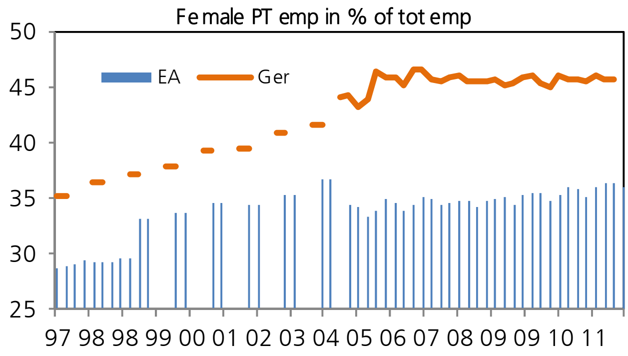
Source: EU Commission and Intesa Sanpaolo elaborations

Immigrant flows are not enough



Source: EU Commission and Intesa Sanpaolo estimates

Full time female participation must be encouraged



Source: Eurostat and Intesa Sanpaolo elaborations

France: stagnation for 2013

Guido Valerio Ceoloni

France closed 2012 with essentially zero growth against a backdrop of economic stagnation. Even the fourth quarter was negative, with growth of -0.3% qoq.

Estimates for this year continue to point to slight growth, of +0.1% yoy: the weakness at the end of 2012 is expected to drag on for the first half of 2013, before then giving way to a recovery in the second half, which is expected to then enable the country to close the year with only slightly positive growth. The French government, represented by Minister of Finance Pierre Moscovici, announced in February that growth estimates for 2013 will be revised downwards in part because of the difficult international environment. In December, the government had again confirmed its growth forecast for 2013 at +0.8% yoy.

Household consumption held up in the fourth quarter, even recording slight growth of 0.3% qoq compared to 0.2% qoq in the third quarter. This year's fiscal restrictions will affect spending decisions as early as the first quarter, as anticipated by the trend in consumer confidence. However, over the rest of the year, (moderate) growth is expected to return. In fact, domestic demand remains weak due to a reduction in available household income, in a labour market environment that will remain challenging this year. Disposable income is expected to undergo a trend reversal in 2014, when fiscal consolidation is also expected to ease.

Investment fell sharply in the last quarter of 2012, with a drop of 1.0% qoq, compared to -0.5% qoq in the third quarter. The figure is expected to remain negative in the first quarter of 2013, partly because of the higher taxes imposed on companies, before returning to positive territory only from the middle of the year. The outlook for capital spending is not positive, since the stagnation in 2012 and profit margins in the industrial sector, which have been falling constantly since 2011, have negatively affected businesses' expectations. In 2014, the gradual recovery in aggregate demand and confidence indices should stimulate the recovery.

In terms of the trade balance, exports in the last quarter of 2012 declined from the previous quarter (-0.6% qoq, from 0.7% qoq), while imports shrank by more than in the third quarter, from growth of -0.5% qoq to -0.8% qoq. Overall, the trade balance made a positive contribution to GDP of 0.1 points in the fourth quarter. We expect that in 2013 the trade balance will contribute to GDP growth, but only slightly because of the loss of international competitiveness and weak foreign demand. If we analyse the change in exports by year since 1997, we see that French exports have fallen by almost a quarter, with only Italy performing worse. German exports in the same period have risen by almost 20%.

Lastly, the contribution of inventory to GDP continued to trend downwards at the end of 2012, from -0.3% qoq to -0.4% qoq.

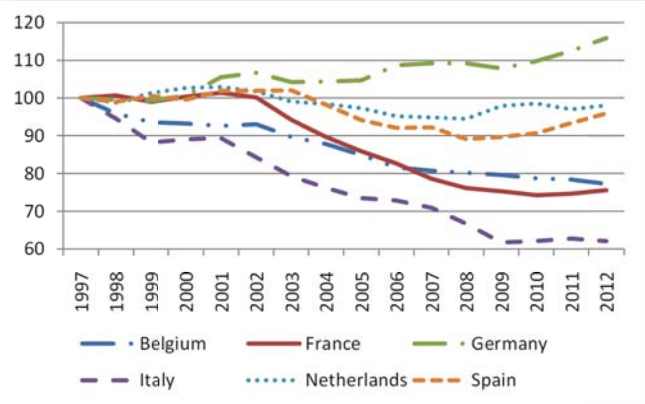
2012 closed with an unemployment rate of 10.3%. This figure is expected to gradually increase this year, rising to 10.6% at year-end.

In order to combat these two negative trends, in January the government passed a series of measures to boost employment and competitiveness. One of the main measures was the creation of a tax credit, CICE (Crédit d'impôt pour la compétitivité et l'emploi), which should generate a total of approximately EUR 20 billion between 2014 and 2016 on income declared from 2013 to 2015, by reducing the tax burden on contributions due from businesses, for the benefit of incomes up to EUR 90,000. This measure is expected to begin to have an effect from next year by improving companies' cash flows, slowing growth in labour costs and creating approximately 400,000 jobs in three years, even if the impact on employment is likely to remain modest.

These measures will mainly be financed through the VAT hikes, but only from 2014: the rate currently at 19.6% will be raised to 20% and the rate currently at 7% will be raised to 10%. In terms of price dynamics therefore, inflation, which ended 2012 at around 1.5% and continued to trend downwards throughout the first quarter of 2013, will undergo a trend reversal towards the beginning of summer, rising to around 1.6% by year-end.

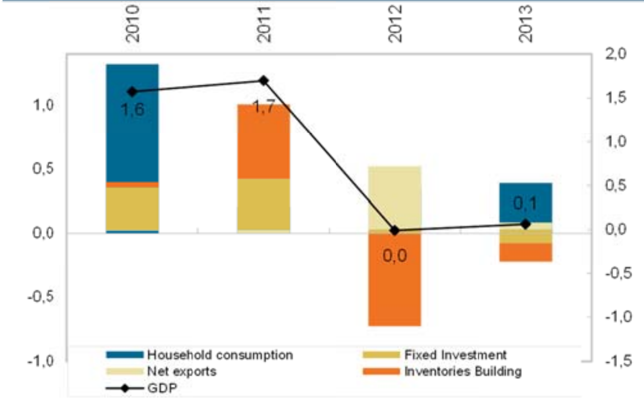
In the area of public finances, France is expected to reduce the deficit this year to 3.7% of GDP, compared to 4.6% in 2012, while public debt will increase by about three percentage points to 93.4% of GDP. The previous scenario, which envisaged the deficit falling to below 3% already this year, has thus definitively been discarded. The budget for this year will amount to around 3% of the GDP, with additional measures adding up to a further 1.5 points. The revised deficit target is attributable to the change in the macroeconomic scenario, given that growth of 0.8% would have been forecast for this year, bringing the structural deficit down from 3.3% in 2012 to 1.9% in 2013, while the cyclically-adjusted primary balance is expected to worsen from -0.6% in 2012 to around 1% this year.

Export performance for total goods and services: % changes from previous year



Source: Intesa Sanpaolo

GDP and its main components



Source: Intesa Sanpaolo

France – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.0	-0.1	1.2	0.1	0.0	-0.3	-0.4	-0.3	-0.1	0.6	1.1
- q/q change				-0.1	0.1	-0.3	-0.2	0.1	0.3	0.4	0.3
Private consumption	0.0	0.2	0.9	-0.2	0.3	0.2	-0.1	0.0	0.2	0.2	0.3
Fixed investment	0.0	-1.0	1.3	0.3	-0.5	-1.0	-0.2	0.0	0.1	0.3	0.4
Government consumption	1.4	1.5	1.5	0.4	0.4	0.4	0.4	0.3	0.2	0.3	0.5
Export	2.3	2.0	4.3	0.3	0.7	-0.6	0.6	1.0	0.9	1.0	1.1
Import	-0.3	1.2	4.1	1.4	-0.5	-0.8	0.5	0.4	0.8	2.0	1.0
Stockbuilding (% contrib. to GDP)	-1.1	-0.6	0.1	0.2	-0.3	-0.4	-0.2	-0.2	0.1	0.5	-0.1
Current account (% of GDP)	-2.4	-1.8	-1.6	-2.8	-2.4	-1.8	-1.8	-1.6	-1.7	-2.0	-1.9
Deficit (% of GDP)	-4.7	-5.8	-5.4								
Debt (% of GDP)	115.9	122.1	127.2								
CPI (y/y)	2.0	1.2	1.5	2.0	2.0	1.5	1.0	1.1	1.3	1.5	1.5
Industrial production	-2.6	-2.4	0.9	-0.9	0.2	-1.9	-0.7	0.0	-0.1	-0.4	0.3
Unemployment (%)	9.9	10.6	10.6	9.8	9.9	10.2	10.4	10.7	10.7	10.7	10.6

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

Italy: It's the politics, stupid!

Paolo Mameli

Although it started on a less negative note than at the end of 2012, 2013 will be another year of recession for the Italian economy (-1.5% in our estimates, after -2.4% in 2012), the longest in the past thirty years. The strongly recessive factors of 2012 will remain active for much of the year, and we may not see a recovery until the end of 2013. Partial relief will come from the Government plan to speed payment in arrears to companies. However, downside risks to the outlook remain, the main one of which results from the uncertainty surrounding the political situation. The country does not need an additional budget for the current year, but at the same time cannot afford to reduce fiscal adjustment.

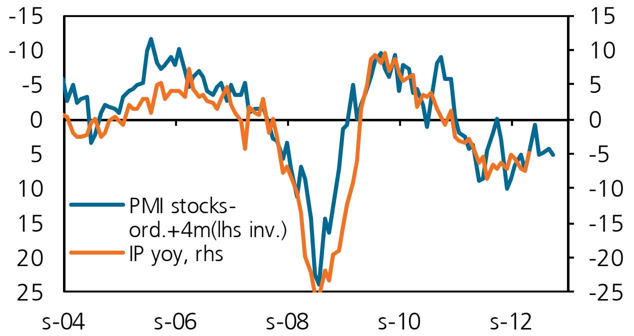
2013 opens on a less negative note than end-2012…

For the Italian economy, 2013 could start on a far less negative note than end-2012. On the basis of January's rebound in industrial production (and despite the still pessimistic tone of the surveys), industry may have contributed approximately zero to added value in the first quarter. Taking into account that added value is likely to have continued to decline in services (and construction), data are consistent with significantly less negative GDP (down by two/three-tenths of a percentage point) in early 2013, after the severe -0.9% qoq seen at the end of 2012.

…however recovery is still far-off

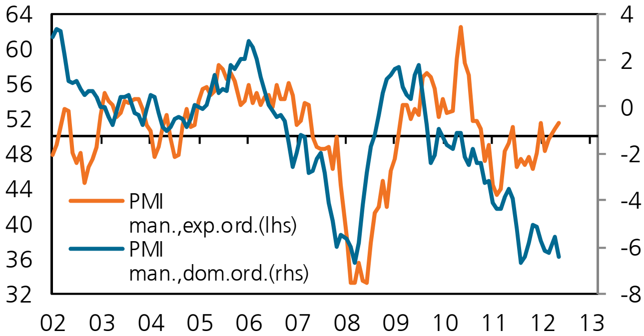
However, a return to qoq GDP growth is deferred until the end of the year: in the central quarters, GDP could remain negative (incidentally, the current recession is set to be the longest since quarterly data has been available, i.e. 1981: nine quarters, with six quarters since 1992-1993). In spring, investment could fall again, particularly in machinery and equipment after the improvement at the beginning of the year. However, a possible advance in purchases of durable goods related to the planned VAT increase (effective July 1st) could, on the other hand, support consumption; conversely, in the summer quarter there could be a recovery in investment and a decline in consumption. The contribution of foreign trade is expected to remain positive throughout the year given the trend in exports (since January) while imports could also be affected by some volatility induced by the VAT hike. Exports have held up well, as confirmed by recent indications from surveys, showing a recovery in export orders and a further decrease in orders from the domestic market.

Surveys show a less negative cycle in the industry…



Source: Intesa Sanpaolo charts based on Istat and Markit data

…thanks purely to exports, while domestic demand continues to suffer



Source: Intesa Sanpaolo charts based on Markit data

Economic policies and financial conditions are still tight

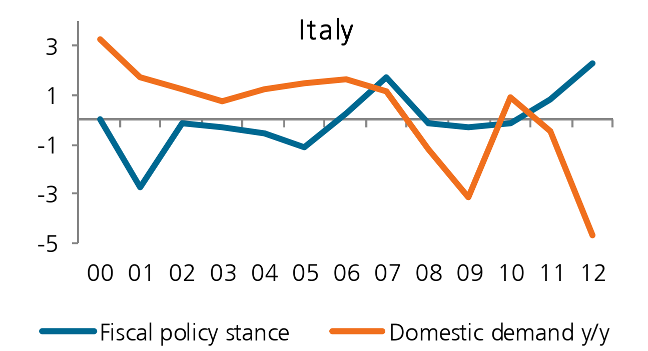
The profile described projects an annual decrease of GDP by one and a half percentage points in 2013, after 2.4% last year. Only in 2014 GDP rate of growth will return positive on the year, although certainly not brilliant (0.5% in our estimates). The point is that the recessionary factors that caused such a marked recession in 2012 (only two years after the previous one) will still be active in 2013, although presumably with less intensity. In fact, the debt crisis has led to a tightening of both fiscal policy and financial conditions:

1) FISCAL POLICY: according to no-policy-change projections made by the European Commission, the 2013 squeeze (measured by the change in the cyclically-adjusted primary balance) will be 0.9% of GDP for Italy, after 2.3% in 2012 (1.2% from 2.9% according to IMF estimates). Fiscal policy will only become neutral (or even slightly expansionary according to no-policy-change projections) in 2014;

2) FINANCIAL CONDITIONS: recent developments in the domestic political scenario (with the ungovernability risk following recent elections) and in the European context (with a new resurgence of the crisis in Cyprus as its epicentre) pose risks to our central scenario, which sees financial conditions still restrictive for the 2013 average, albeit less than in 2012 (the average recorded so far in 2013 from the summary indicator of country risk represented by the BTP-Bund spread on the ten-year maturity was less than 300 basis points versus 400 basis points for the 2012 average).

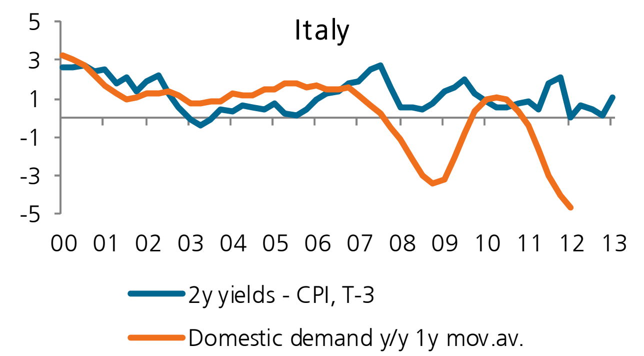
Admittedly, to offset these recessionary factors there is an accommodative MONETARY POLICY. However, it is necessary to add the following caveats: a) this year there will be no additional stimulus; b) expansion of the Central Bank's balance sheet has not been transmitted to the broader monetary aggregates and loan circuit; c) monetary policy appears to be in the grip of a "liquidity trap" because even with rates at zero it appears contractionary if one considers the growth fundamentals. This is evident from the graphs below, which show how in relation to very weak domestic demand, both fiscal policy and monetary policy can be considered restrictive for Italy at the moment.

Not only fiscal policy…



Note: fiscal policy stance=changes in the cyclically-adjusted primary balance; periphery=weighted average of Italy, Spain, Portugal, Greece, Ireland. Source: Intesa Sanpaolo charts based on Thomson Reuters-DataStream data

…but also monetary policy is restrictive if domestic demand is considered



Note: periphery=weighted average of Italy, Spain, Portugal, Greece, Ireland. Source: Intesa Sanpaolo charts based on Thomson Reuters-DataStream data

The scenario does not incorporate "tail" risks

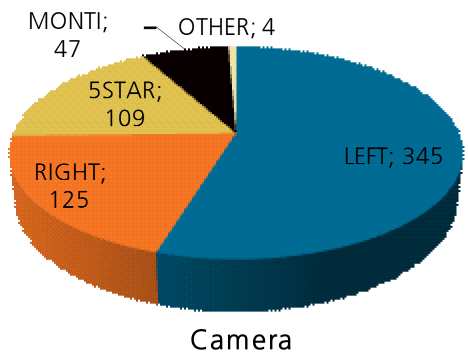
Note that the assumptions underlying our scenario are:

1) the maintenance of an expansionary cycle on a global scale, with a gradual consolidation of the signs of recovery seen in confidence surveys covering the first few months of the year, not only in the USA and China, but also in Germany (refer to IFO);

2) developments in the political crisis that enable the most "extreme" scenarios to be avoided (spike in spreads above the average levels of last year, the loss of market access, use of the ESM-ECB safety net).

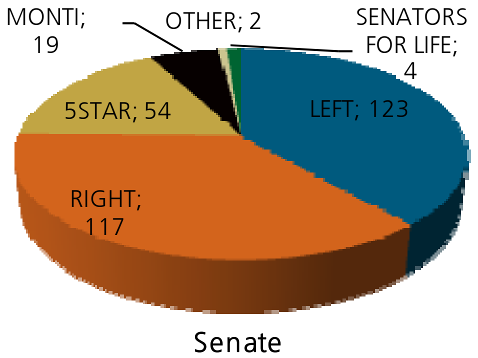
In summary, our base scenario does not incorporate the most "extreme" cases, although these cannot be completely ruled out, such as an early return to the polls or a new situation of governability or the success of forces declared to be contrary to European Treaties; or a crisis of confidence that would oblige the country to negotiate a preventative bailout package; such negotiations would be complicated as it would probably not involve an additional fiscal correction but would require a reform program agreed by the main political parties (at least in the absence of a new government). It is clear that if these risks materialise it would lead to a significant negative impact on the real economy through the usual channels of business confidence and credit conditions.

Breakdown of seats by coalitions in the Chamber of Deputies (required majority: 315)



Note: Left: coalition PD-SEL and others; Right: PDL+Lega Nord
Source: Italian Ministry of Interior, Intesa Sanpaolo charts

Breakdown of seats by coalitions in the Senate (required majority: 160)



Note: Left: coalition PD-SEL and others; Right: PDL+Lega Nord
Source: Italian Ministry of Interior, Intesa Sanpaolo charts

In any event, we believe that the current ungovernability can indeed be harmful (especially for growth prospects), however less than in the past with regard to Italy's vulnerability to a possible speculative attack on the financial markets. In particular, we believe there are important factors that make the current situation very different from that at the end of 2011, when the Monti Government was installed:

1) the fundamentals of public finance in Italy appear to be better: the country has already carried out most of the fiscal correction and an additional fiscal package is not required (this year Italy should leave the excessive deficit procedure, and the latest EU predictions indicate that the country will broadly reach the target of a balanced budget in structural terms);

2) the financing requirement for 2013 is much lower than last year: gross issues will drop to 418 billion from 481 in 2012, net issues to 36 from 53 last year; in particular the net supply of BTP will return close to pre-crisis levels (34 billion from 54 billion in 2012) and net issuance of Treasury bills will be negative; in addition, the first three months of the year have already seen massive prefunding with 52 billion net and 133 billion gross (32% of the total for the year) issues; in addition, the proportion of debt held abroad has dropped significantly compared to a year and a half ago (amounting to about 37% compared with a peak of 52%);

3) in Italy, as in other peripheral countries, a more general process of rebalancing vs the rest of the world is currently under way, which can be seen in the trend of closing the current account deficit of the balance of payments (and consequently in the "target 2" accounts), mainly driven by the return to positive territory of the trade balance, which reduces the need to attract foreign capital;

4) the European context seems very different for three reasons: a) the existence of a safety net consisting of the mechanism introduced by ECB and ESM, which significantly reduces risk in the event of loss of market access, b) fiscal fundamentals are also improving in other countries that are most affected by the sovereign debt crisis, c) in Europe there is a more flexible approach to the crisis, namely the granting of more time for the fiscal adjustment in countries where the recession is most severe.

In our view, these mitigating factors may limit the volatility in the markets and ensure that the main risk indicators do not return to the highs reached in late 2011.

Some hope from the release of PA payments

According to Bank of Italy data, in 2011 companies boasted receivables from the Public Administrations of **71 billion or 4.5% of GDP**. This percentage has probably increased further (it is estimated to have reached at least 80 billion last year). As the directive 2011/7/EU on dealing with late payment in commercial transactions obliges payment for goods and services provided within 30 calendar days or, in exceptional circumstances, within 60 days, the application of new contracts signed from 2 January means that the issue concerning the release of arrears is of great importance. After the substantial green light from the EU, the Government presented the plan with which it intends to inform Parliament to help accelerate the payment of the debts of the PA to its suppliers (with the related impact on growth and public finances) for the years 2013 and 2014. **The Government targets to pay 20 billion in the second half of 2013 and a further 20 billion in 2014.** The measures include: a) an exception for the 2013 expenses for the national joint funding of EU structural funds, b) debt of local authorities through: (1) easing of constraints for the domestic Stability Pact to allow the use of the available administration surpluses; (2) the exclusion of the Regions from the Stability Pact concerning payments made to local authorities on residual liabilities to which the residual assets of municipalities and provinces correspond; (3) the establishment of revolving funds to provide liquidity to local governments (regions and local authorities), to be paid back within a set, sustainable period; c) debt of the healthcare system, through the provision of cash advances for the payment of debts relating to transactions already accounted for in the previous financial years for the calculation of net debt, which will then be repaid according to a financially viable repayment plan; d) prior tax refunds borne by the State, through the use of cash stocks.

The sectors concerned are: a) CONSTRUCTION (19 billion), b) HEALTH/PHARMACEUTICAL (10 billion), c) SERVICE PROVIDERS with receivables due from the NHS (34 billion) d) HI-TECH (3 billion). The unfreeze of arrears payments may therefore have a **significant impact in sector terms**. It is more difficult to assess the **impact on the overall economic cycle**. The total debt of the PA to businesses that the Government agrees to pay in the 2013-2014 period is worth 2.5% of GDP. If the payment were similar to a tax rebate, the impact on the cycle would be (on the basis of the fiscal policy multiplier used in the OECD Interlink model) approximately 1.1% of GDP. However, the payment of receivables is not a tax cut as it does not affect a company's balance sheet, it simply improves liquidity. Thus it seems reasonable at least to apply those assumptions only to companies that suffer from a shortage of liquidity and therefore for which cash payment could amount to a tax cut (or a grant). Thus, applying this estimate to the percentage of companies that say they have liquidity problems related to late payments (70% of companies, according to data from the European payment index 2012), the impact would be 0.8% ("spread" over two years). However, this estimate is optimistic, because the share of companies claiming to suffer from late payments should be assessed not on the number of companies but turnover (which would likely involve a percentage of much less than 70%). Assuming this "optimistic" estimate, the impact on an annual basis would therefore be 0.4% of GDP.

Impact on the cycle of the unfreeze of arrears PA payments

	in million	in % GDP
Total PA payment delays (2011 data)	71	4.5
Amounts that the government will "unfreeze" in 2013-2014	40	2.5
Impact on GDP if payment is treated as tax relief	18	1.1
Impact applied to the % of companies affected by delayed payment	**13**	**0.8**

Source: Intesa Sanpaolo estimates based on Bank of Italy, MEF, OECD data

Public Finance Outlook

After closing at 3% in 2012, the government deficit trend is expected to fall further this year, estimated at 2.5% thanks to the implementation of additional adjustment measures under the provisions approved by the Berlusconi and Monti governments between 2010 and 2012. An additional half point of GDP must be added to deficit, as estimated by the Treasury Ministry, arising from the payment of PA trade payable arrears (which, for the portion of investment spending, would have an impact not only on debt but also on deficit). Thus, 2013 would close with a deficit of 3% of GDP, as in 2012. However, if the government target contained in the September DEF Update (-1.8%) is not reached, it would be due almost entirely to the worsening of the recession (the government has just revised the 2013 GDP estimate to -1.3%, from the previous -0.2%; we believe that the estimate is still optimistic). In other words, the (cyclically-adjusted) structural deficit, while not reaching zero as per the initial target, in our estimates will amount to 0.5% of GDP, i.e. it will comply with the letter of the new Fiscal Compact. The primary surplus, after the robust improvement to 2.5% of GDP in 2012, will continue to grow in 2013, and we estimate it will reach 3.3%. In other words, **the country does not need, as the European Commission also now recognise, an additional budget for 2013, although the risk remains that the improvements will stop after this year.** Moreover, the debt may peak at above 130% of GDP this year and then start to decline only in 2015. In short, given the still very delicate situation on the financial markets, we cannot yet lower our guard about the path of the main public finance variable.

Italy – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (2005 prices, yoy)	-2.4	-1.5	0.5	-2.6	-2.6	-2.8	-2.2	-1.6	-1.7	-0.6	-0.1
qoq				-0.7	-0.2	-0.9	-0.3	-0.1	-0.3	0.2	0.1
Household Consumption	-4.3	-2.1	0.3	-1.1	-1.1	-0.7	-0.7	0.1	-0.4	0.1	0.1
Government Spending	-2.9	-0.9	-0.4	-0.6	-0.1	-0.3	-0.3	-0.3	-0.3	-0.2	-0.1
Fixed Investments	-8.0	-3.6	0.6	-1.8	-1.2	-1.2	-1.0	-0.9	-0.4	0.5	0.1
Imports	-7.8	-2.8	2.1	-0.6	-1.7	-1.0	-1.2	0.2	-0.2	0.2	0.7
Exports	2.2	3.0	3.3	1.0	1.2	0.3	1.0	0.6	0.5	0.8	0.8
Chg. inventory (contrib., % GDP)	-0.6	-1.1	-0.2	-0.1	-0.1	-0.7	-0.3	-0.1	-0.2	-0.1	0.0
Current Account (% GDP)	-1.2	0.7	1.1								
PA Balance (% GDP)	-3.0	-3.0	-2.5								
Debt (% GDP)	127.0	130.3	130.3								
Consumer Prices (yoy)	3.0	1.8	2.1	3.3	3.2	2.5	1.9	1.5	1.7	2.1	2.2
Industrial Production	-6.4	-2.5	0.7	-1.9	-0.5	-2.3	0.0	-0.1	0.0	-0.1	0.0
Unemployment (%)	10.6	12.3	12.3	10.6	10.7	11.2	11.8	12.3	12.5	12.6	12.6

Note: Percentage change on previous period (unless otherwise indicated). Source: calculations and forecasts Intesa Sanpaolo

Spain: pending instructions from Brussels

Anna Grimaldi

Throughout 2012, there have been many positive developments in Spain: completion of the reform needed to manage the restructuring of the Spanish banking system (together with the formal aid request to the EFSF/ESM); regulatory reforms to set stricter budget targets to all government entities; establishment of an independent fiscal authority; payment of the PA debts towards suppliers for 30 billion euros (against a total of 65 billion); reform of the labour market. The measures taken in 2012 and the announcement of the ECB plan in the summer triggered a return of foreign capital in Spain, as it is evident from the improvement of TARGET II balances between September and February and the dynamics of financing needs from abroad, net of the Bank of Spain. The net financing with the rest of the world turned positive at the end of 2012 for the first time since the beginning of 2011. However, Spanish high net external debt position requires the deleveraging process to continue both for households and for the public sector. Thus we maintain a very cautious view on the country.

Despite the positive developments of 2012 on the outlook for the country is still poor

The recession that began in December 2011, just two years after the 2009 crisis, worsened towards the end of 2012 when GDP fell by 0.8% q/q due to the fiscal measures approved in last September and that had a strong impact on the end of 2012. In the early months of 2013 GDP is likely to shrink again by 0.6% q/q, since the fiscal tightening should continue to weigh on the domestic demand and in particular on consumer spending. We continue to expect a decline in GDP of -1.6% in 2013 after -1.4% in 2012. The country will start growing again only in 2014 (+0.4%), but the economic performance will remain below potential (1.1% from last OECD estimates) at least until 2015. Domestic demand is expected to shrink more than GDP in 2013: -4.7% and will remain negative also in 2014: -0.9%. Consumer spending is expected to fall 4% in 2013 and 0.4% in 2014 burdened by fiscal policy measures, the dynamics of disposable income, the process of deleveraging and the fall in wealth associated with the correction in property values. The correction in the construction sector will continue in 2013 (-7.5%) and 2014 (-1.7%), although at a less severe rate -7.5% compared to the previous four years (-11% on average). Investment in machinery is dampened by the weak domestic demand dynamics and a shortage of credit and will thus remain negative until the end of 2013. At the beginning of 2014 at least replacement investments should return to growth. Exports will remain the sole growth engine (+4.4% in 2013 and +5.0% in 2014) driven by the recovery in global demand and by the gains in competitiveness of the recent years. Imports will grow less than exports (-3.6% in 2013 and +2.7% in 2014) due to the decline in domestic demand. The closing of the current account deficit should therefore continue, thanks to the improvement in the trade balance which has been in surplus in 2011. In order to consolidate the improvement of the trade balance, it is essential that the internal devaluation of labour costs advances further.

Domestic demand will shrink more than the GDP

Exports only growth engine

Salary negotiations considerably slowed in 2012, following the reform at the beginning of 2012. The October data did not show an adjustment of wages to the increase in inflation seen in September (3.5% from a previous 2.7%) with the VAT hike. It is key that this trend is confirmed in the coming months. The large output gap should dampen inflation further, from 2.8% in February to 1.5% at the end of the summer, when the annual VAT increase will exit the annual comparison. Annual average inflation is expected at 2.2% in 2013 and 1.9% in 2014.

More moderate wage growth after the reform at the beginning of 2012

The outlook for the labour market is still worrying. Unemployment rose to 26.2% in January 2013, an all-time high since 1980. Surveys suggest labour dismissals will continue in the coming months even though at a slower pace than in 2012. We expect unemployment to continue rising to 26.8% by the end of summer, due to the 6-9-month lag with respect to the cycle. With a modest GDP growth even after 2014 unemployment is unlikely to return to pre-crisis levels.

Public finances: pending instructions from Brussels.

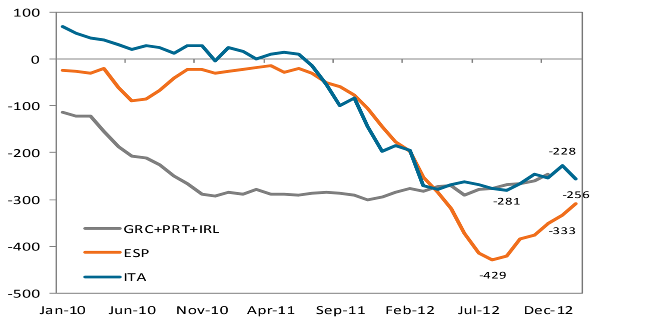
The budget balance closed with a deficit of 6.7% in 2012 from -8.9% in 2011. Measures to support the financial system accounted for 0.5% of GDP in 2011 and 3.3% in 2012. The result is only half a point above the target agreed with the EU Commission last July. The decline in the deficit is due to an improvement of 1.3 percent of the GDP of the central government budget, from -5.1% to -3.8% of GDP and a reduction of 1.6 points of the Regions' deficits 1.7% of GDP. Social Security, however, closed with a deficit of 1.0% from -0.07% in 2011. The result on the Regions is very positive and indicates that the internal stability pact, which was approved in early 2012, contributed to the achievement of budget targets. It should be noted that the Regions' expenditure is largely constituted by spending on health and education which are typically inertial.

Despite the better than expected result in 2012 we think that public finances are far from the 2012-2015 PS targets negotiated with Brussels in July (see Table I). The government at the time expected a drop in GDP of only 0.5%. Recently Mr Rajoy announced the estimates will be revised downwards more in line with the February the Commission estimates of 1.4% decline in GDP. With lower growth some relaxation of the 4.5% target for this year should be ensured. Yet, the European Commissions was expectation a deficit of 6% this year in the February projection. The gap with the July target is only partially explained by lower growth (see Table II). The Commission projections are at current legislation namely they incorporate only the measures actually adopted for the year. We believe that many of the measures in force in 2012 (cut of the Xmas bonus for public employees, suppression of three days holiday, changes to business taxation) will be confirmed for 2013. Therefore we expect the deficit to close at 5.5% this year and rise again to 5.6% in 2014, when the effect of the wealth tax, in force in 2012 and 2013, wanes.

We think the achievement of the 3% limit will be moved forward to 2015. The Minister for the Budget Cristóbal Montoro, indicated that the revisions to targets should mainly affect the regions for which a decline in the deficit to 0.7% of GDP is expected. What concessions Spain will be able to check with Brussels is yet to be seen. Although the country has implemented a correction of structural balances of more than 3 percent of GDP in 2012, compliance with the new stability pact would require a cyclically-adjusted primary balance surplus of 3.2 percent of GDP in 2015, and our estimates are for a primary balance deficit of 0.8 points in 2014. The Commission even expects a cyclically-adjusted primary balance at - 2.5% of GDP. The bottom line is that the Commission estimates Spain should implement a structural consolidation effort of 5.7 points of GDP between 2013 and 2015 to comply with the new public finance rules. It is certain that a structural effort of 5.7% would leave the country in recession in 2014. At this stage the shape of the recovery is very much dependent on the amount of the fiscal correction the country will have to implement in the next couple of years. This why the position of the EU Commission is very relevant.

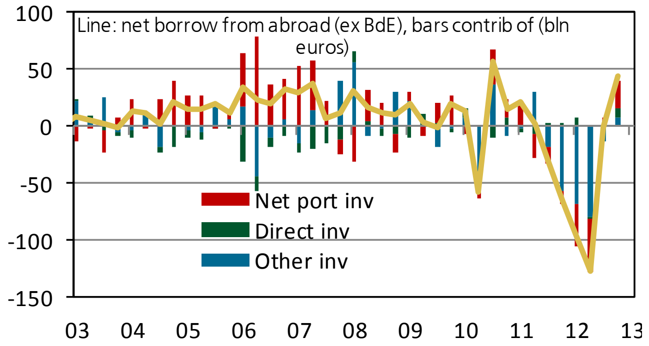
The debt rose to 84.1% of GDP from 68.5% in 2011, due to contributions to EA support mechanisms and the payments of debt to suppliers. The debt is expected to rise to 95.8% of GDP in 2014. Contribution to EU mechanism (7 billion euro in 2013 and 4.15 billion in 2014) and the payment of payables for 2.7 billion euro will weigh on the debt dynamics also this year. The State has established an FPP fund for the payment of debts to suppliers with a budget of 30 billion Euros (3.0% of GDP) compared to total debt of public administrations for 65 billion euros (6% of GDP). The fund was financed through issuance of government securities. So far funds have been used for 27 billion euros (9.3 billion euros for Local Authorities and 17.5 billion for the Regions). Payment of the PA debt should have an effect on the economy of 0.5% - 0.8% of GDP, according to the estimates of the Spanish Treasury.[9]

The improvement in the TARGET II balance suggests that confidence is returning



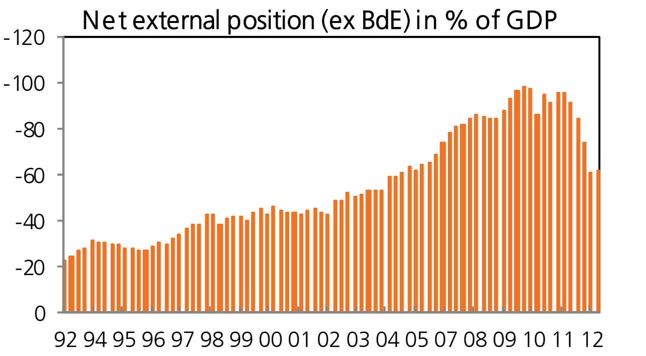
Source: Eurosistema data

Between September and December, the external funding turned positive for the first time since early 2011



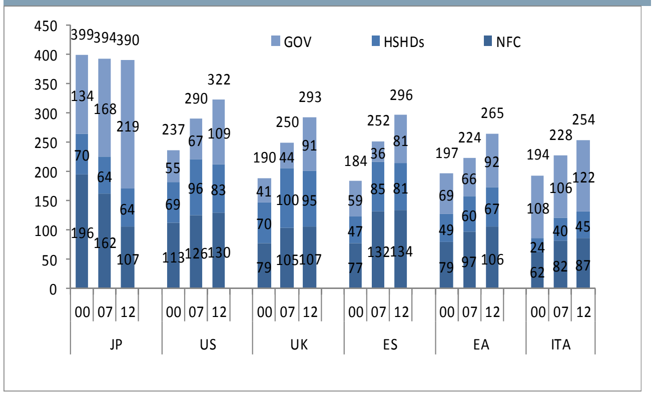
Source: Bank of Spain

However, the high external debt position makes the country still dependent on foreign capital



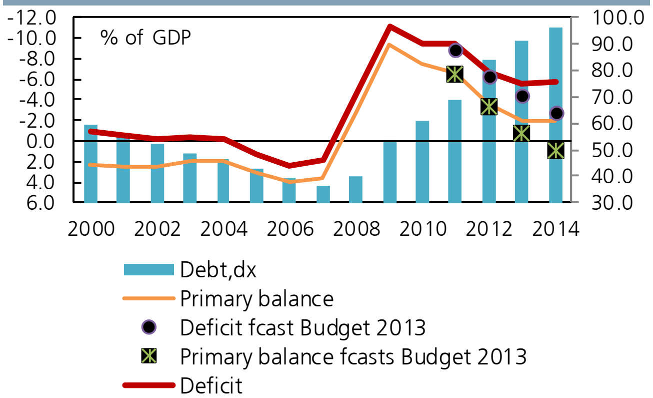
Source: Bank of Spain

The process of deleveraging in the private sector and…



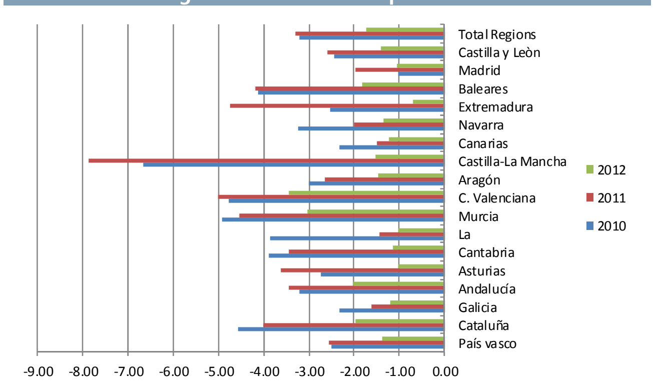
Source: National Central Banks and calculations Intesa Sanpaolo. Note: loans and debt securities. Public Debt EU Commission (EDP)

…Public sector must continue…



Source: Treasury and EU Commission

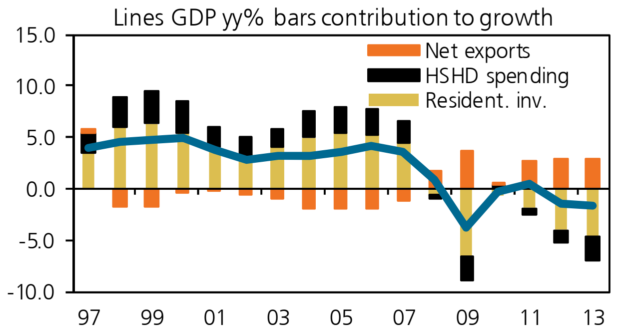
Control of the regions' deficits has improved



Source: Treasury and EU Commission

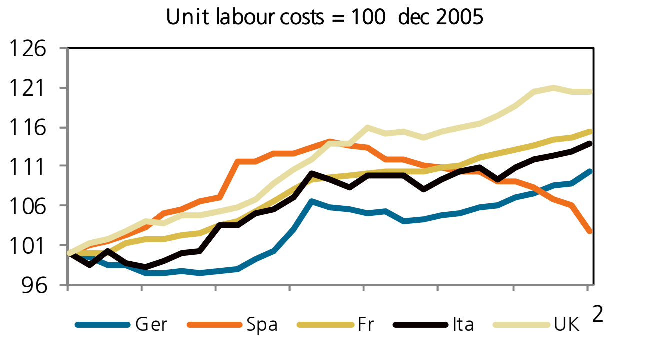
9 http://www.tesoro.es/doc/130301%20Presentation%20Kingdom%20of%20Spain2.pdf

Growth must come from abroad



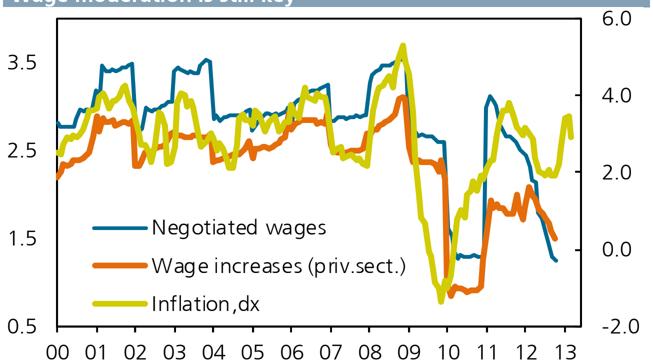
Source: Eurostat

Competitiveness improves



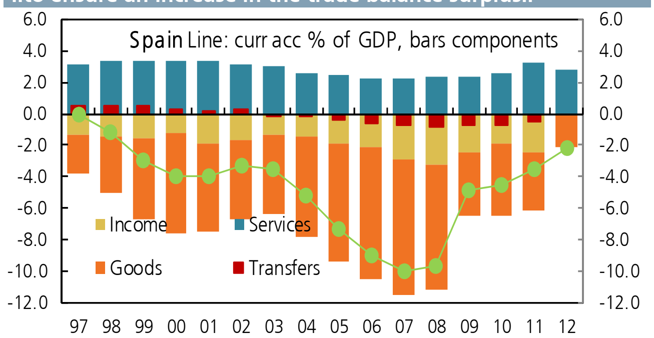
Source: Eurostat

Wage moderation is still key



Source: Eurostat

..to ensure an increase in the trade balance surplus..



Source: Eurostat

Table 1 – Last July budget targets are no longer credible

	2011 (PS 2011-14)	2011 consuntivo	2012	2012 consuntivo	2013	2014
State	-4.1	-5.0	-4.5	-3,8	-3.8	-2.7
Autonomous Communities	-1.3	-3.4	-1.5	-1,7	-0.7	-0.1
Local Authorities	-0.3	-0.4	-0.3	-0.2	0.0	0.0
Social Security	0.4	-0.2	0.0	-1.0	0.0	0.0
Administrations Pub	-6.0	-8.9 (-9.4)*	-6.3	-6.7(-9.9)*	-4.5	-2.8

* ()deficit adjusted for the effect of the aid to banks for 5.4 billion euro in 2011 and 34 billion euro in 2012
Source: MinHap and calculations Intesa Sanpaolo

Table 2 –Spain will have to enact an effort of 4% GDP to meet the new Stability Pact

% GDP	2011	2012	2013	2014
Deficit (estimate Intesa Sanpaolo)	-9.4	(-7.2*)-6.7	-5.5	-5.6
Deficit (estimate European Commission)*	-9.4	(-7.0*)-6.7	-6.7	-7.2
Primary balance	-6.5	-3.6	-1.9	-1.9
Primary balance(estimate European Commission)	-6.5	-4.0	-3.2	-3.6
Interest expenses(estimate Intesa Sanpaolo)	2.5	3.1	3.6	3.7
Interest expenses(estimate European Commission)	2.9	3.0	3.5	3.6
Cyclically-adjusted balance (estimate Intesa)	-7.4	-4.6	-3.7	-4.5
Cyclically-adjusted balance (estimate Commission)	-7.6	-4.6	-4.6	-6.1
Cyclically-adjusted primary balance (Intesa Sanpaolo)	-4.9	-1.5	-0.1	-0.8
Cyclically-adjusted primary balance (Commission)	4.7	-1.6	-1.1	-2.5
Adjusted primary balance in line with the new SP				3.2
Debt in % of GDP	68.5	84.0	91.2	95.8

Note:*Forecasts. Source: MinHap, calculations Intesa Sanpaolo and winter estimates of the EU Commission

United Kingdom – Less growth now, more sustainability in the future

Asmara Jamaleh

The UK economy's recovery is proving more arduous than anticipated, but in this case stagnation is a stage on the way to achieving the necessary **rebalancing** between domestic demand and net exports: less growth now can allow more sustainable growth in the future. The "continuing weakness" in the growth outlook was the cause of the UK's **downgrade** by Moody's (22 February) and loss of its triple A status. However, the structural basis remains robust (as Moody's also said), and the downgrade has had no dramatic impact on the markets as it was already partially priced in. Moreover, rather than signalling fresh critical issues, the downgrade confirmed the status quo and sounded more like a warning than what it purported to be. In fact, Moody's does not view the continued economic weakness as a problem in absolute terms, but rather as a risk to fiscal correction. But this risk has been neutralised in the **2013 Budget** (20 March), with George Osborne sticking to the austerity plan he outlined in his Autumn Statement (5 December). So the deficit reduction programme remains in place, with the government projecting a fall in the deficit/GDP ratio from 11.2% in 2009-10 to 7.4% this year and to 2.2% in 2017-18. The growth predictions provided by the Office for Budget Responsibility for the new budget have been revised down: from 1.2% to 0.6% in 2013 and from 2.0% to 1.8% in 2014. We are also **downgrading growth expectations for 2013 from 1.0% to 0.7%** after a poor +0.2% in 2012, and expect it to accelerate to 1.9% in 2014. The main factor supporting growth is the monetary stimulus. When presenting the 2013 Budget, Osborne announced **updates to the Bank of England's policy remit.** ***Inflation targeting*** **remains in place (2%±1%),** but new conditions **have been added,** including (a) providing **forward guidance** (as employed by the Fed) and (b) detailing the trade-offs made in deciding how long it will be before inflation returns to target. The BoE has to give an assessment of the new policy remit when it submits its inflation report in August, the first after Mark Carney replaces Mervyn King as governor on 1 July. Osborne also added that the Asset Purchase Facility will remain in place for the coming year and that the Treasury and the BoE are working on a plan to extend the **Funding for Lending Scheme.** However, interest rate hikes are not expected to start before the end of 2014. At the BoE's February meeting, three of the nine members voted to increase the Asset Purchase Facility. The split stayed at 3-6 in March, for fear that stimulus could compromise credibility of the inflation target, causing sterling to fall further. But now its policy remit has been changed, the BoE will have scope to take expansionary action, which would help stimulate recovery in demand and investment, while the recent depreciation in sterling will help neutralise the negative contribution of exports. Healthy growth in employment will offset high inflation and low wages growth. After contracting in Q4 (-0.3% qoq), growth should already be back in positive territory in the first quarter of 2013.

United Kingdom – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.2	0.7	1.9	-0.2	0.2	0.3	0.5	1.0	0.4	1.0	1.4
- q/q change				-0.4	1.0	-0.3	0.1	0.2	0.3	0.4	0.5
Private consumption	1.0	1.1	1.8	0.5	0.3	0.2	0.2	0.2	0.4	0.4	0.6
Fixed investment	1.4	2.2	5.7	2.0	-0.6	-0.4	0.5	0.7	1.5	1.8	1.1
Government consumption	2.6	-0.1	-1.6	-1.6	0.5	0.6	-0.1	-0.2	-0.3	-0.4	-0.4
Export	-0.3	2.7	5.4	-1.3	1.7	-1.5	0.8	1.5	1.7	1.8	1.3
Import	2.0	2.7	4.7	1.3	0.3	-1.2	0.9	1.4	1.6	1.5	1.3
Stockbuilding (% contrib. to GDP)	-0.2	-0.1	0.0	0.2	0.5	-0.4	0.0	0.0	-0.1	-0.2	0.1
Current account (% of GDP)	-3.6	-3.1	-2.8	-4.5	-3.4	-3.3	-3.3	-3.2	-3.0	-2.9	-3.0
Deficit (% of GDP)	-6.4	-6.2	-5.9								
CPI (y/y)	2.8	2.7	2.5	2.8	2.4	2.7	2.8	2.7	2.8	2.6	2.5
Industrial production	-2.3	0.1	1.8	-0.9	0.6	-2.1	0.8	0.5	0.4	1.0	0.2
Unemployment (%)	4.9	4.7	4.6	4.9	4.8	4.8	4.7	4.7	4.7	4.7	4.6
3m interbank rate	0.83	0.50	0.54	0.99	0.73	0.53	0.51	0.50	0.50	0.50	0.50
GBP/USD	1.58	1.57	1.64	1.58	1.58	1.61	1.55	1.53	1.59	1.62	1.63
Effective exch.rate (1990=100)	83.1	81.8	87.5	83.2	84.1	83.7	80.1	79.2	82.7	85.1	86.7

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

Asia

Japan: a radical shift in monetary policy to defeat deflation

Giovanna Mossetti

- The change of government in the fall of 2012 had immediate effects on financial indicators. Expectations of a reflationary policy impacted exchange rates and expected inflation even before new stimulus measures were announced. In 2013 growth should be 0.8% and step up to 2.2% in 2014. The growth path and inflation in 2014-15 will be strongly affected by the doubling of the consumption tax (April 2014, October 2015). Once the volatility related to the change in the tax is removed, inflation should be around 1.5% in 2017.

- The strategy of the new government acts on two fronts: 1) fiscal policy that is expansionary in 2013, and tight thereafter, to stabilise the debt/GDP ratio; 2) aggressively accommodating monetary policy, to defeat deflation and reach an inflation rate of 2% in the shortest possible time, with the goal of reducing real interest rates and achieving positive nominal growth (finally generating some seignorage from public debt).

- In terms of fiscal policy, additional stimulus measures were introduced for 2013, to fuel growth before the beginning of a long fiscal tightening path. The government is firm in its objective to double the consumption tax between 2014 and 2015 and to reduce to a significant extent the primary deficit over the next three years. If the measures announced are actually enacted, the deficit-to-GDP ratio should drop to 4% in 2015 and stabilise around that level. The debt-to-GDP ratio should rise to a record 217% in 2014 and decline gradually in the following years.

- Monetary policy is the main key to the turnaround toward positive inflation. The announcement of a credible inflation target of 2% and of a much more aggressive monetary policy in terms of both purchase program and communication had immediate effects on exchange rates, interest rates and inflation expectations. The result is an expected dollar/yen exchange rate of around 95-100 in 2013-2014, negative real interest rates along the entire yield curve and nominal interest rates anchored to the expectation of massive increases in JGB purchases, including long-dated bonds, until the 2% inflation target is reached.

Japan – Macroeconomic forecasts

	2012	2013	2014	2012			2013				2014
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	2.0	0.8	2.2	4.0	0.4	0.4	-0.5	-0.1	1.5	2.3	3.1
q/q annual rate				-0.9	-3.7	0.2	2.4	0.9	2.6	3.4	5.5
Private consumption	2.4	1.0	1.6	-0.1	-1.9	2.0	0.8	1.2	2.1	2.8	5.7
FI - private nonresidential	2.0	-0.5	4.3	-0.3	-12.5	-5.7	6.1	1.4	2.5	4.2	4.3
FI - private residential	2.9	1.0	0.7	9.1	6.8	14.9	-11.0	-0.8	0.1	1.0	0.8
Government investment	12.5	4.1	-3.9	27.1	10.7	7.2	-5.9	1.5	8.4	4.1	-7.8
Government consumption	2.7	0.8	1.3	1.7	1.6	2.7	-1.6	0.8	1.2	1.6	1.6
Export	-0.2	0.4	11.9	0.2	-19.0	-14.0	10.1	8.3	10.8	12.3	13.2
Import	5.3	2.6	8.0	6.8	-1.9	-9.0	8.2	5.0	5.6	9.6	9.4
Stockbuilding (% contrib. to GDP)	0.0	0.2	-0.1	-0.4	0.3	-0.1	0.5	-0.2	-0.1	0.0	0.2
Current account (% of GDP)	1.0	0.2	0.7	1.3	0.7	0.5	-0.1	0.2	0.3	0.4	0.5
Deficit (% of GDP)	-10.0	-10.2	-7.2								
Debt (% of GDP)	209.6	218.8	217.8								
CPI (y/y)	0.0	-0.2	2.0	0.2	-0.3	-0.2	-0.6	-0.5	0.1	0.3	0.5
Industrial production	-1.0	0.5	4.5	-7.7	-15.8	-7.2	14.3	4.5	1.7	3.9	4.9
Unemployment (%)	4.4	4.4	4.0	4.4	4.3	4.2	4.3	4.4	4.4	4.3	4.2
3-month CD rate	0.19	0.13	0.27	0.20	0.19	0.19	0.08	0.09	0.16	0.19	0.21
JPY/USD	79.8	94.6	98.6	80.1	78.6	81.2	92.1	93.9	95.8	96.8	97.7
Effective exch.rate (1990=100)	178.9	150.0	144.5	178.5	183.1	175.0	153.9	151.0	148.1	146.9	145.6

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

Reflation in times of unconventional monetary policy

The change of government in the fall of 2012 marked a watershed in Japanese economic policy. The commitment to reflation of the new Prime Minister, S. Abe, affected financial indicators as early as November, even before the announcement of a new fiscal stimulus, of the new policy course against deflation in January, and the implementation of monetary stimulus interventions (expected in April). The strategy of the Abe government acts on two fronts: 1) immediate fiscal stimulus to strengthen the economy in view of a tightening path which will culminate with the increase of the consumption tax (04/2014 and 10/2015), 2) pressure on the central bank for an aggressive stance against deflation. The government approved a budget for 2013 which includes measures for the last three months of financial year 2012 (i.e. the first quarter of 2013), involving an increase in infrastructure expenditure of 5.2 trillion yen, to be carried out in the central part of 2013, and an expected reduction of the overall primary deficit for financial year 2013. On the deflation front, the new policy developments caused the exchange rate to depreciate significantly since autumn and inflation expectations to rise (resulting in a drop in real yields, which were finally in negative territory along the entire yield curve).

Economic policies will be the key factors for Japan in 2013-2014. In light of domestic and international developments, positive growth is forecast for 2013-2014, with 0.8% in 2013 and 2.2% in 2014. The recovery will continue at a solid pace at least until the first quarter of 2014. The increase in consumption tax in April 2014 and October 2015 will determine volatility along the paths of growth and inflation. The outcome of the combination of tight fiscal policy and super-expansive monetary policy until 2016 should be a reduction of the deficit to around 3-4% of GDP, the stabilisation of the debt-to-GDP ratio around 217% (followed by a very gradual decline in the following years), a rate of inflation of around 1.5% y-o-y, and a rate of growth of about 1%. The Japanese economy will continue to be characterised by a growing trade deficit, caused by energy imports and a negative net contribution of exports, once the exchange rate is stabilised. In the medium term, the problem of a decreasing current account surplus might become a risk factor.

Monetary policy – Inflation target and new unconventional monetary policies. Prospects of a new approach by the BoJ impacted exchange rates and inflation expectations as early as November (see charts). The main developments took place in two stages.

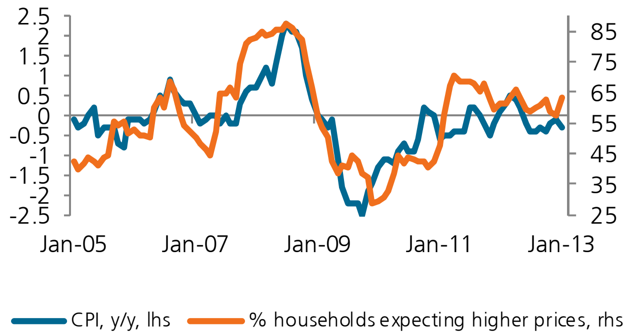
1. January saw the introduction of an official inflation target of 2%, to be reached in the shortest possible time, and a phase of explicit cooperation between government and BoJ on the fight against deflation began. In addition, an "open" (without a final date and with no limit on the quantities of JGB to be purchased) asset purchase program, similar to that carried out by the Fed, was announced. The program will be implemented in January 2014, when the existing programs are completed, and will continue to run until the inflation target is hit.

2. On 20 March, following expiration of their terms of office, the governor and the two deputy governors of the Bank of Japan stepped down. The officials that will replace them (Kuroda, Iwata, Nakaso) were selected on the basis of their views on anti-deflation policy.

The central bank will introduce new stimulus measures in April. As early as February, the bank had already discussed an expansion of the stimulus, with proposals that will probably be adopted in April. We expect the existing programs to be modified, stepping up purchases of JGBs and including longer-dated JGBs. The Committee might add the commitment to maintaining zero interest rates and the programs open indefinitely, until inflation reaches 2%, thus anchoring the entire yield curve even though inflation is expected to rise. The central bank should also eliminate the "banknote rule", a self-imposed ceiling that limits the amount of JGBs held in portfolio to the amount of banknotes outstanding. Other proposals already discussed include the reduction of the interest rate paid on excess reserves and the purchase of derivatives in the asset purchase program. The key tool, however, is the purchase of bonds and this will be the focus of the new Board. In light of the broad market expectations of aggressive interventions, the BoJ might launch multiple attacks simultaneously, to not disappoint the market, and to keep the goodwill earned in advance thanks to the "expectation effect". Thus, the new BoJ's action should be very similar to the Fed's in terms of both communication and the asset purchase program. The result should be a significant acceleration of the expansion of the central bank's balance sheet, with an increase in JGBs held and liquidity outstanding. The effect of this new approach should also impact financial conditions worldwide.

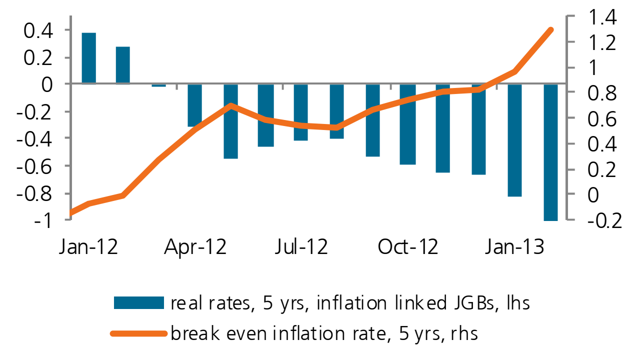
Inflation: it will get worse before it gets better. In January deflation rose, as the CPI fell by 0.3% y-o-y and core inflation decreased by 0.7% y-o-y, from 0.6% y-o-y. Price levels are signalling a likely deterioration of deflation in the next few months, but we expect the significant depreciation of the yen to prompt a modest correction of the negative trend in the second half. Confirmation of this is coming from the change in prices paid shown by business surveys. However, the key element is the increase in price expectations, which should accelerate consumption and reduce real interest rates, with positive effects on investments.

Fig. 1 – Inflation and percentage of households that expect rising prices



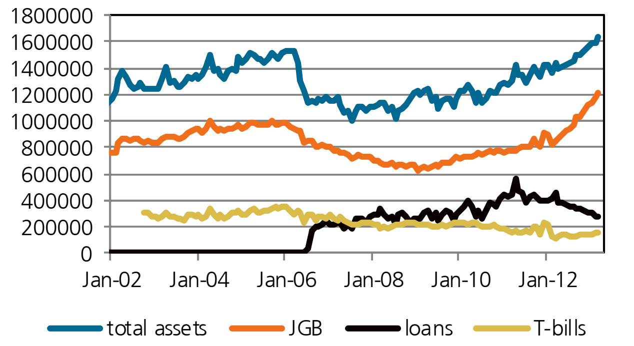
Source: Thomson Reuters-Datastream

Fig. 2 – Rising inflation expectations are driving real interest rates in negative territory



Source: Thomson Reuters-Datastream

Fig. 3 – The BoJ's balance sheet: step-up of asset purchase program expected



Source: Bloomberg

Fig. 4 – Public debt by type of bondholder

	September 2012		September 2011	
	tln yen	% of total	tln yen	% of total
Households	25.2	2.7	29.5	3.9
Banks	401.9	42.4	326.6	43.7
Insurance companies	183.0	19.3	155.3	20.8
Pension funds	28.9	3.0	29.0	3.9
Public pensions	66.6	7.0	70.3	9.4
BoJ	104.9	11.1	63.6	8.5
Fiscal loan fund	2.3	0.2	0.9	0.1
Governm. (ex pensions)	24.2	2.6	2.0	0.3
Other	25.2	2.7	23.5	3.1
Non-residents	85.9	9.1	47.4	6.3
Total	948.1		748.1	

Source: Ministry of Finance

Fiscal policy: temporary stimulus, before starting a long march towards public accounts consolidation. The budget submitted by the government in January covers 15 months, including fiscal year 2013 plus the last quarter of 2012. The budget calls for a reduction of the primary deficit in 2013, which is partly generated artificially by an increase in public expenditure in the last quarter of financial year 2012, but is also partly due also to a genuine correction. The total balance would go to -9.3% of GDP in financial year 2013, from -9.8% in financial year 2012. The primary balance would fall more sharply, to -4.75% of GDP in 2013, from -5.2% in 2012.

The correction is implemented in part through higher taxes on top income brackets, but mostly through a reduction of transfers to local authorities for retribution costs: public employee expenses would amount to 0.8% of GDP, reducing both headcount and salary and benefits. The 2013 budget shows an increase in interest expenditure of 297 million yen, to 4.6% of GDP from 4.5% in 2012, due to an increase in public debt, even though interest rates are locked in along the entire yield curve. True tightening will set in with the consumption tax increase in 2014-15. Based on the significant increase of tax revenue generated by the doubling of consumption tax, once its full effects take hold, the deficit-to-GDP ratio should go down to -3.7% at the end of 2015 and should stabilize around 4% in the following two-year period. Revenue as a share of GDP would go from 33% in 2013 to 37% in 2015, in the presence of a drop of expenditure as a share of GDP to 41%, from 43.1% in 2013, thanks also to the decline in interest expenditure. The picture for 2014-15 is very risky: for fiscal austerity not to be entirely counterproductive, nominal GDP must rise. That is why a reflationary monetary policy, with weak exchange rate and negative real interest rates, is a necessary (though not sufficient) condition for fiscal consolidation.

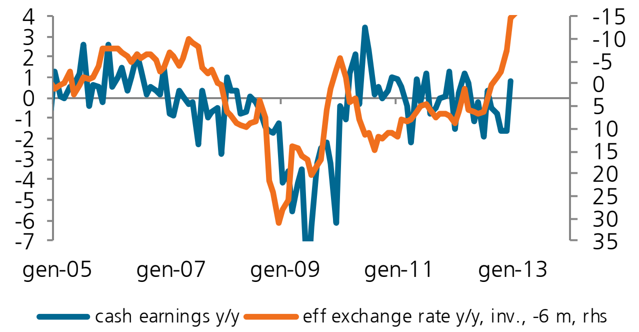
Private demand: support to consumption and investments provided by positive inflation expectations. Growth forecasts for 2013-14 are positive thanks to the combined effects of the fiscal stimulus in the central part of 2013, the increase in consumption preceding the consumption tax hike in April 2014 and the stimulus effect on exchange rates and real interest rates. GDP should grow by 0.8% in 2013 and 2.2% in 2014. The year 2013 is held back by the negative ending of 2012 (-0.5%, annual average), but the first quarter should trigger a positive quarterly growth that is expected to accelerate rapidly throughout the year, until the first quarter of 2014. The expected performance for 2013-2014 is not indicative of Japan's potential growth, which the BoJ expects to range from 0.5% to 1%. From 2015 on, growth should slow down to a significant extent, under the burden of fiscal tightening.

In 2013, higher inflation expectations, higher nominal salaries and the anticipated consumption level before the tax hike will support consumption. In 2012, household expenditure benefited from incentives to purchase durable goods, which resulted in a yearly growth rate of 2.4%. In 2013, average consumption growth is expected to amount to 1%, and to accelerate to 1.6% in 2014. This year, the quarterly growth rate should be, on average, close to 0.4% q-o-q, increasing by year-end to 0.7%, and accelerate again in the first quarter of 2014 (1.4% q-o-q) in view of the upcoming increase in consumption tax in April (from 5% to 8%).

Fixed investments by businesses are expected to rise sharply as early as the first quarter of this year, after 4 consecutive declining quarters. The impact on the exchange rate and on real interest rates, together with higher expected retail prices, should drive investments up by 1.5% q-o-q in the first quarter; for the rest of the year, this rate of increase should slow down, but still be positive and close, on average, to 1% q-o-q. The negative spill-over effects from the previous year weighs on the annual average, which should still be negative in 2013, at -0.5%, rise to 4.3% q-o-q in 2014 and to 5.1% in 2015.

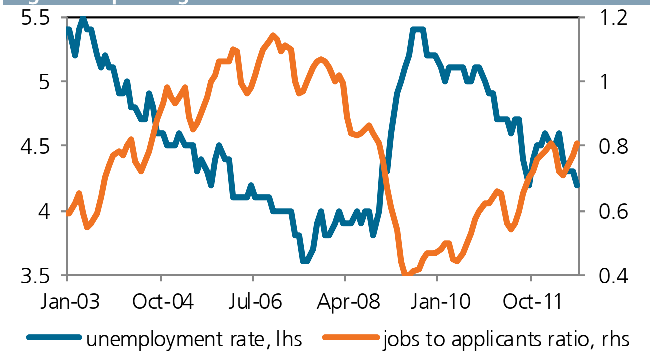
Exports are expected to achieve rapid acceleration, after 2 negative years (up 0.4% in 2013, up 11.9%, and up 9% in 2015), thanks to the exchange rate effect and the rise of foreign demand. Imports continue to be the Achilles' heel of the Japanese economy, after the earthquake in 2011: as the recovery gathers speed in 2013-14, imports will increase (up 2.6% in 2013, up 8% in 2014), with the resulting negative trade balance. The current account will continue to be positive thanks to the income balance. In addition, the closing of the public deficit gap will contribute to keep any risk of crisis of the balance of payments under control.

Fig. 5 - Changes in exchange rates and salaries



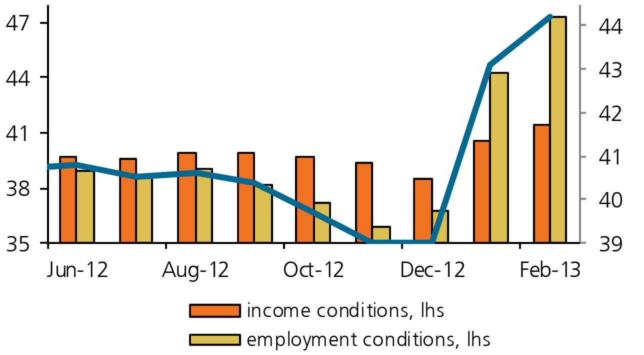
Source: Thomson Reuters-Datastream

Fig. 6 – Improving labour market



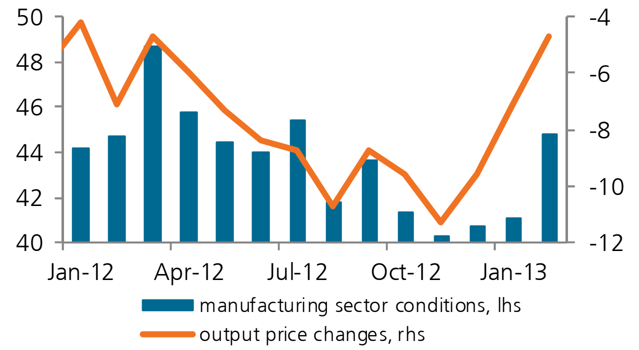
Source: Thomson Reuters-Datastream

Fig. 7 – Consumer confidence turned a corner



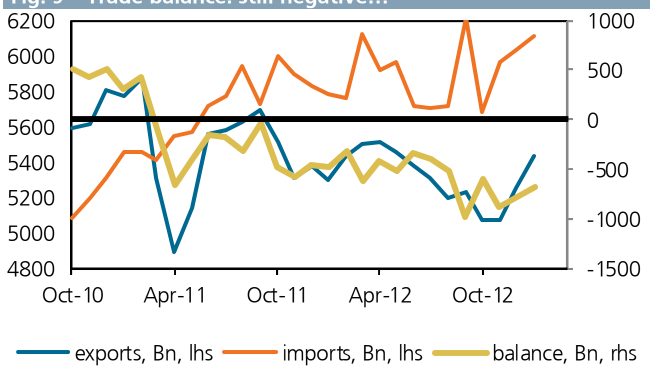
Source: Thomson Reuters-Datastream

Fig. 8 – Medium-small business survey (Shoko Chukin): credible reflation



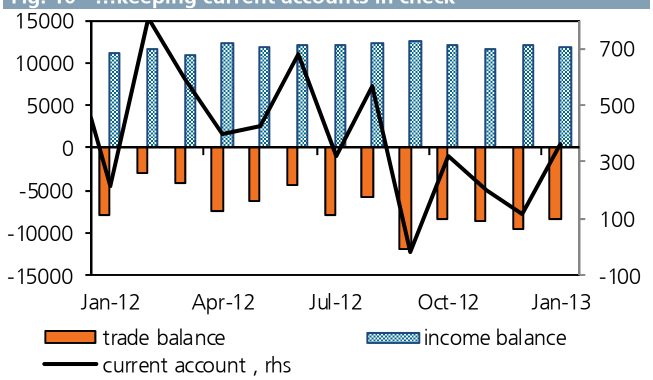
Source: Thomson Reuters-Datastream

Fig. 9 – Trade balance: still negative…



Source: Thomson Reuters-Datastream

Fig. 10 - …keeping current accounts in check



Source: Thomson Reuters-Datastream

China: investment and exports pick up in the first two months of the year

Silvia Guizzo

- The Chinese economy ended 2012 with an annual growth of 7.8% yoy, a significant slowdown from the 9.3% of 2011. Most likely, the upsurge in public spending offset the marked slowdown in investment and a slight fall in consumer spending, while the contribution from foreign trade is likely to have remained positive. The figures for the first two months of the year are, as always, difficult to interpret due to the varying date of Chinese New Year, moving as it does between January and February. In cumulative terms the first two months of the year showed a slowdown in retail sales and industrial production, while capital investment picked up (+21.2% yoy), driven by government investment and the residential housing sector, and also by a recovery in investment in equipment purchases. Investment in the manufacturing sector continued to slow, (17.0% cum yoy in February versus 22% cum yoy in December), offset by an upsurge in the agriculture and services sectors.
- Consumer confidence, while showing a certain volatility, has been improving since mid-2012. The total index and the expectations index reached new highs at the start of 2011 but a wide gap still persists between expectations and current levels. The survey of industrial companies for the first quarter of 2013 shows a much greater increase in business owners' confidence in the general economic conditions than in their own companies' situation, and a marginal increase in domestic orders alongside a fall in orders from abroad.
- The rise in consumer price inflation in February (+3.2% yoy from 2% yoy in January) is mainly due to the seasonal impact of the Chinese New Year, with price rises mainly concentrated in the food sector (+6% yoy from 2.9% yoy in January). Production prices continue to fall. Inflation looks set return to around 2.4% in March before rising gradually during the year. Expectations of a rise – albeit limited – in inflation, and an upturn in lending during 2012 through non-banking credit, as well as investment in real estate, will force the PBOC to maintain a wait-and-see stance, at least in the first part of the year, delaying any cuts until the end of the year.
- We maintain our growth forecast of 7.9% for 2013, with a slight acceleration to 8.2% in 2014. Risks for this scenario remain to the downside, internally given the potential negative impact of a possible slowdown in the property market, both on local government finances and on the performance of the banking sector. Externally, a further slowing of growth in the United States and the Euro zone, associated with the slowdown in the other Asian economies, will have a negative impact on Chinese exports.

China - Macroeconomic forecasts

	2008	2009	2010	2011	2012E	2013F	2014F
GDP (constant prices, at factor cost)	9.6	9.2	10.4	9.3	7.8	7.9	8.2
Consumer spending	9.5	11	11.4	8.5	8.4	8.6	8.9
Public spending	4.8	3.8	6.9	9.4	9.7	9.7	9.2
Capital investment	9.2	22.2	11.3	9.2	7.4	8	7.4
Exports	-1.1	-11.2	25.9	3.9	3	7.5	8.5
Imports	-6	5.2	18.4	2.7	4.2	8.1	8.1
Industrial output	9.9	9.9	12.3	10.3	8.1	8.7	7.7
Inflation (CPI)	5.9	-0.7	3.3	5.4	2.6	2.6	3.4
Unemployment	4.1	4.3	4.2	4.1	4.1	4.1	4.1
Average wages	16	10.6	12.8	14.9	14.8	14.4	13.8
1-year loan rate	4.3	1.7	2.7	5.3	4.6	4.2	4.2
USD/INR exchange rate (average)	6.95	6.83	6.77	6.46	6.31	6.18	6
Current account balance	2912.1	1661.6	1604.2	1298.6	1348.7	1834.3	2162.7
Current account balance (% of GDP)	5.7	3.2	3.1	2.5	3.0	3.3	3.5
Budget balance (% of GDP)	-0.2	-1.5	-1.3	-1.0	-3.0	-3.3	-2.9

NB: Percentage change on the previous period - unless otherwise stated. Figures refer to the calendar year
Source: Oxford Economics Forecasting and Intesa Sanpaolo

Real economy and inflation

The Chinese economy ended 2012 with annual growth of 7.8% yoy, a significant slowdown from the 9.3% of 2011. Most likely, the upsurge in public spending offset the marked slowdown in investment and a slight fall in consumer spending, while the contribution from foreign trade is likely to have remained positive.

We estimate that per capita household spending will have remained strong in real terms with growth of around 8.5% yoy in 2012, albeit lower than the 8.9% of 2011. Spending slowed during the year in line with a more muted trend for income, both in the cities and in the countryside. Retail sales slowed from 17.1% yoy in 2011 to 14.3% yoy in 2011. The fall in inflation is likely to have kept retail sales growth essentially stable in real terms at around 12%. The figures for the first two months of the year are, as always, difficult to interpret due to the varying date of Chinese New Year, moving as it does between January and February. In nominal and cumulative terms, retail sales grew by 12.3% yoy in February, less than the 14.3% yoy of December, but more marked in real terms given the rise in inflation during the first two months of the year.

Consumer confidence (National Bureau of Statistics), while showing a certain volatility, has been improving since mid-2012. The total index and the expectations index reached new highs at the start of 2011 but a wide gap still persists between expectations and current levels. The urban depositors survey, carried out quarterly by the PBOC, shows that in the first quarter of 2013 consumers became more confident regarding their current incomes and employment prospects, but slightly less confident as concerns their future income prospects that remain at end-2011 levels. The percentage of consumers planning to purchase a house or a car over the next three months also fell. The employment component of the PMI index has been falling during the last six months for the manufacturing sector in the National Bureau of Statistics survey, while it has, except for the first few months of 2013, been rising in the Markit survey. It has, however, been falling in both surveys for the services sector, although it remains at a higher level. For the second quarter of 2013 the Manpower survey reports stable and rising hiring intentions in all sectors. The outlook for consumer spending remains stable, supported by the expected fall in inflation and policies announced to provide support to the low incomes and to increase salaries in general.

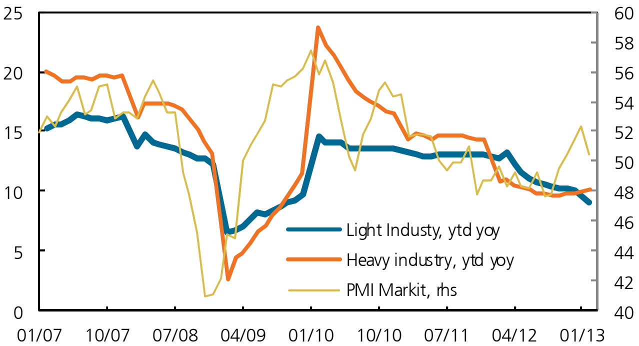
The rise in consumer price inflation in February (+3.2% yoy from 2% yoy in January) is mainly due to the seasonal impact of the Chinese New Year, with price rises mainly concentrated in the food sector (+6% yoy from 2.9% yoy in January). Production prices continue to fall. Inflation looks set to return to around 2.4% in March before rising gradually during the year.

Exports have bounced back markedly in recent months (+19.8% 3m yoy in February), much more than imports (5.3% 3m yoy) which are still weighed down by the fall in imports from the EU and, to a greater extent, those from Japan, as well as low import demand for ordinary goods for household use (-1.7% 3m yoy). Exports to the ASEAN area continue to grow quickly (+34.7% 3m yoy), while exports to the United States (+13.2% 3m yoy) and to the EU (+6.9% 3m yoy) are also improving. Those to Japan, however, continue to fall (-2.7% 3m yoy). The trend for the foreign orders component of the PMI, as well as that for the orders component for many Asian countries, does not point towards a sharp acceleration in exports in the short term.

Industrial production rose by 9.9% cum yoy in February compared to 10% yoy in December, with a slowdown in light industry. The PMI manufacturing index fell from January to February in both the total orders and the orders from abroad components. A preliminary estimate from Markit shows an increase in March, in particular for the orders component, which could take the quarterly average to just above that for the fourth quarter of 2012. However, the National Bureau of Statistics survey confirms the severe difficulties faced by small and medium-sized enterprises. The survey of industrial companies for the first quarter of 2013 shows a much greater increase in business owners' confidence in the general economic conditions than in their own companies' situation, and a marginal increase in domestic orders alongside a fall in orders from abroad. The assessment of banks' willingness to lend has improved, almost reaching levels last seen in 2009-10, during a period of monetary policy easing.

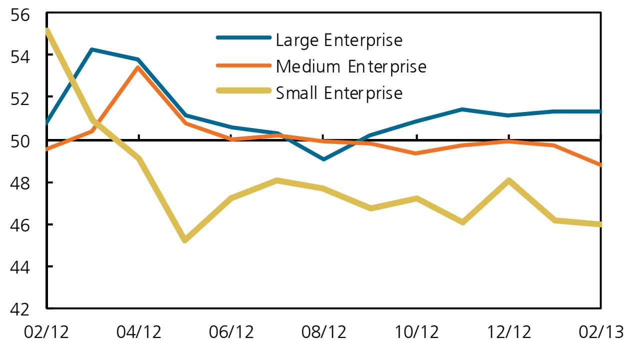
Capital investment increased by 21.2% cum yoy in February, compared to 20.6% cum yoy in December, driven not only by state and residential housing sector investment, but also by a recovery in investment in equipment purchases(+22.9% yoy) and in the transformation (+27.2%) and construction and installation (+26.2% yoy) of plant and equipment. Investment in the manufacturing sector, however, continued to slow (17.0% cum yoy in February versus 22% yoy in December), offset by an upsurge in the agriculture and services sectors. In particular, the upsurge in transport infrastructure investment (15.7% yoy vs 9.1% yoy in December)is continuing, supported by the recovery in rail and motorway investment. Geographically this upturn has been driven by the eastern coastal regions. Residential sales by surface area recorded a strong recovery in the first two months of the year (+49.5% cum yoy in February), accompanied by continued and accelerating property price increases. As a result, the government has re-emphasized the need to keep in place and, in some cases, toughen measures to combat speculation in the real estate market, introducing a tax of 20% on the proceeds from residential property sales in the secondary market. The rating agency Moody's recently changed its outlook from Negative to Stable for property development in China, given the improvement in sales, liquidity conditions and financing, as well as the prospect of continuing urbanization for the country. However, vacant floor space on the market has continued to increase rapidly (+42.9% cum yoy in February) as did construction companies' stocks of unsold buildings (+18.9% cum yoy in the first three quarters of 2012).

Industrial output: Light industry slows



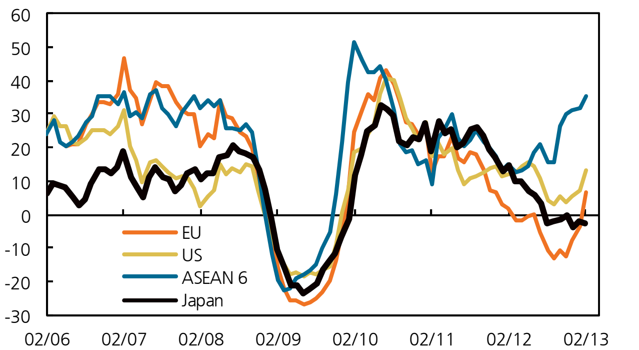
Source: CEIC, Markit

Small and medium enterprises are still struggling



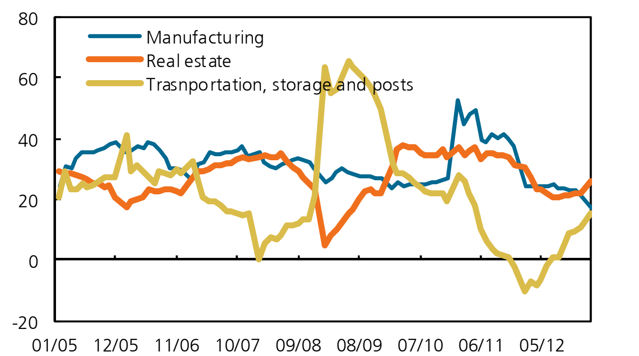
Source: CEIC

Exports to industrialized countries improve



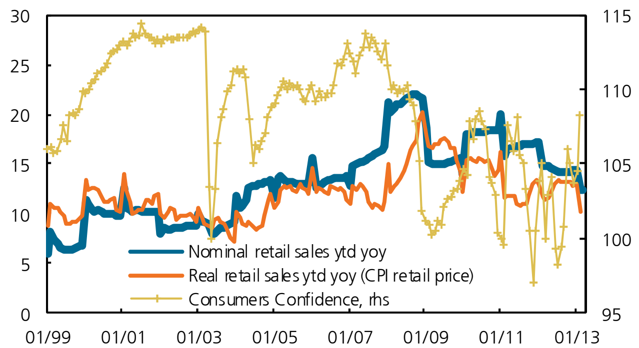
Note: 3m yoy change. Source: Bloomberg and Intesa Sanpaolo elaborations

Transport and real estate drive investment



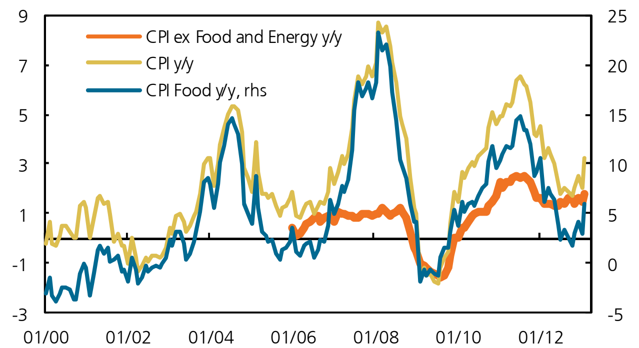
Note: nominal investment, yoy change. Source: Thomson Reuters-Datastream

Consumer confidence continues to improve



Source: Bloomberg, CEIC and Intesa Sanpaolo elaborations

Inflation rises again



Source: Bloomberg, CEIC

Monetary and fiscal policy

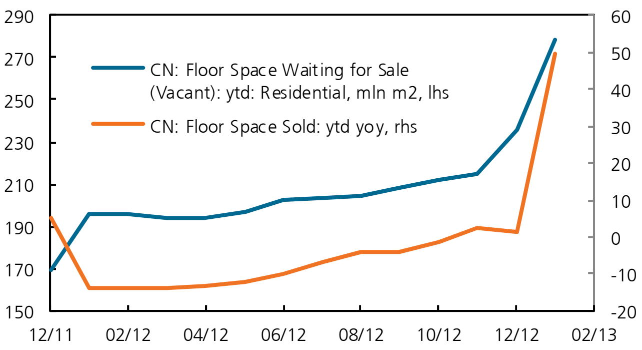
In the first two weeks of March, the People's Congress met in its first plenary session electing, as had been widely expected, Xi Jinping as president of the Republic and Li Keqiang as prime minister. In his speech to parliament the premier listed three main priorities for the new government: maintaining economic growth, improving the living standards of its citizens and safeguarding social justice. In light of this the government has targeted an annual average growth rate of 7.5% of GDP, which would lead to the doubling of the 2010 per capita GDP by 2020. The objective of expanding the network of social protection and increasing disposable income in both cities and the countryside remained in place. With the aim of improving the living standards of its citizens and thus supporting consumer spending, in January the State Council approved guidelines for the distribution of income that target an increase in minimum salaries of at least 40% of average current levels by 2015, the improvement of employment legislation as well as legislation concerning property rights. At the same time the guidelines stipulate that state-owned companies increase the percentage of profits they transfer to the central government by 5% by 2015, from their current 15%. A ceiling on manager salaries is also suggested. The government confirms its GDP growth target of 7.5% in 2013, lowering its inflation target to 3.5% from 4% in 2012, and that for M2 from 14% to 13%.

The government increased its spending budget for 2013 to CNY 1,200Bn from CNY 800Bn the previous year, forecasting a rise in the deficit/GDP ratio to 2% from the previous 1.5%, with higher spending in particular on health, pensions and education. The deficit for local government rose to CNY 350Bn from the previous CNY 200Bn, with the difference being financed by securities issued directly by the Ministry Finance. The measure was judged unfavorably by Moody's since, given the slowdown in tax receipts and the strong demand for infrastructure, it could encourage local government to continue to fund itself through specifically-created financing vehicles, known as Local Government Financing Vehicles (LGFV), which have, to date, contributed to an increase in local government debt. However, the China Banking Regulatory Commission recently advised banks to apply more stringent criteria when granting loans to LGFVs – particularly those with high debt levels.

Parliament also approved the reorganisation of some ministries and government agencies. Specifically, the State Food and Drug Administration was converted into a ministry, and the National Agency for Health and Family Planning was created by merging two other agencies. An agency to regulate the media was created in the same way. The Ministry of Railways was incorporated into the transport ministry, and the commercial operations of the railways were transferred to a new state-owned company, the China Railway Corporation. The National Energy Agency absorbed the agency responsible for electricity tariffs while the State Oceanic Administration was given the supervision of the coastguard, fishing and anti-contraband maritime units which had previously been assigned to three different offices. The guidelines are therefore aimed at simplifying and improving the efficiency of ministries and speeding up approval procedures for investment projects.

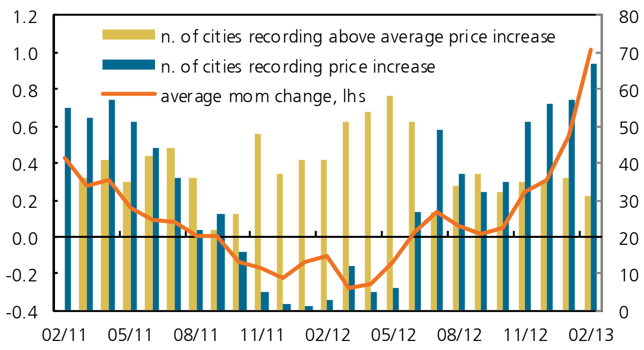
Bank lending stock is slowing moderately (+15.0% yoy in February from a peak of 16.3% yoy in September 2012). During 2012 the aggregate figure for "social finance" rose more (+22.9%) than bank lending (+9.8%), supported in particular by trust loans and corporate issues. The trend seems to be confirmed by the figures for new lending in the first two months of the year. In the second half of 2012 the PBOC progressively intensified its reverse repo operations in order to supply liquidity to the markets, although three-month rates rose steadily nonetheless. In January the central bank announced that it would also introduce a new short–term instrument, called Short Term Liquidity Operation, for open market operations. It will have a maturity of less than seven days and will be alternated with normal OMOs according to the need to stabilise liquidity and interbank rates. Expectations of a rise – albeit limited – in inflation, and an upturn in total lending, as well as investment in real estate, will force the PBOC to maintain a wait-and-see stance, at least in the first part of the year, delaying any cuts until the end of the year.

Residential property: Sales increase but so does stock of unsold properties



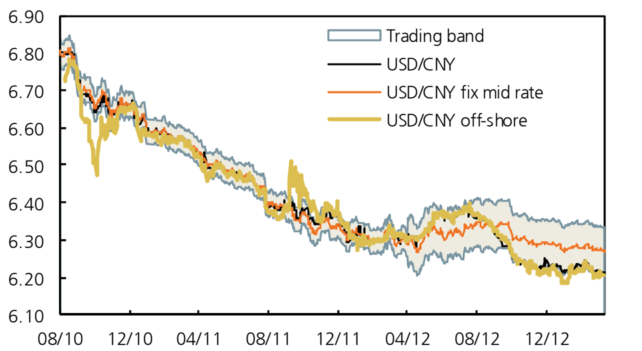
Source: CEIC, Bloomberg and Intesa Sanpaolo elaborations

Residential property prices continue to rise



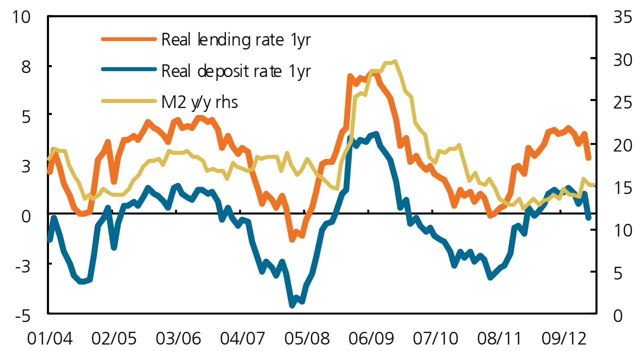
Source: CEIC and Intesa Sanpaolo elaborations

The exchange rate remains stable



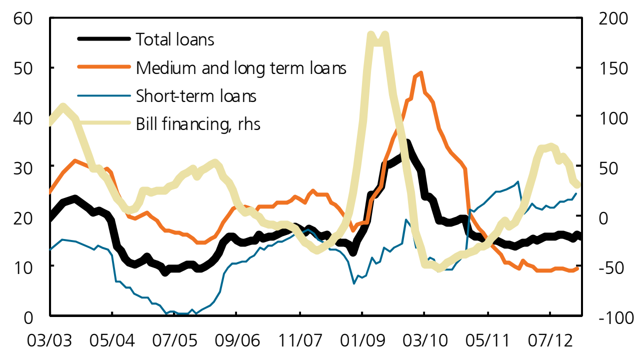
Source: Bloomberg and Intesa Sanpaolo elaborations

Real rates



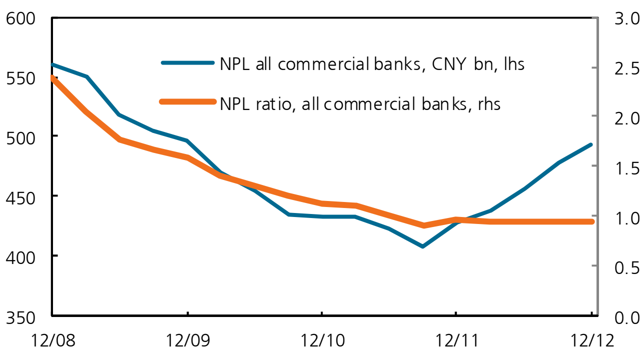
Source: Bloomberg and Intesa Sanpaolo elaborations

Lending growth remains stable



Note: yoy change. Source: CEIC, Monetary and Financial Institutions Survey

Non-performing loans continue to rise



Note: Commercial banks Non Performing Loans. Source: CEIC

India: a still missing recovery

Silvia Guizzo

- The yearly growth of the Indian economy fell to 5.0% in 2012 from 7.5% in 2011 due to a marked slowdown in consumption spending, particularly private spending (4.5% yoy vs. 7.3% in 2011), and investments (+0.7% yoy vs. 6.2% in 2011) to which was added a negative contribution of foreign origin. In 2012, the GDP dynamics, kept at just above 5% in the first three quarters, has gradually slowed down. The 4th quarter registered a growth of 4.5% despite a recovery of private consumption and fixed investments. The clear slowing down of public consumption and the negative contribution of net exports were instead still a drag on growth. Business confidence surveys show only a marginal improvement in economic conditions in the 4th quarter of 2012 and 1st quarter of 2013, although with mixed expectations on orders. The consumer confidence index has instead dropped further in the 4th quarter both in current assessment and expectations. Despite the fall in the core inflation of wholesale prices, consumer price inflation remains high and stable (10.9% YOY in February). Industrial production has given signs of a prudent improvement at the beginning of the year, even if the production of capital goods continues to fall. Investment dynamics, given the rise of stalled projects and the decrease of projects started in the 4th quarter, will still be weak at least during the first half of the year.
- The goal of reducing the deficit/GDP ratio from 5.2% in fiscal year (FY) 2012-13 to 4.8% in FY2013-14, though appreciable, appears optimistic and inserted in a typical pre-election budget that has basically avoided addressing key issues in depth, such as the financing of the current account deficit, revenue generation through the enlargement of an increased tax base and the rationalization of expenditure. Upward risks on inflation and the presence of twin deficits remarkably restrict the space for a further loosening of monetary policy, despite the downside risks on growth. We therefore believe that the RBI will continue to prefer open market operations to keep sufficient liquidity and will deliver at most two 25pb rate cuts during the year.
- We maintain a forecast of moderate growth acceleration in 2013, even if we review downwards the forecasts from the previous 5.7% to 5.4% and a recovery to 6.9% in 2014. We believe that growth risks continue to be on the downside in the short and medium term come from several fronts. Domestically the progress in structural reforms and fiscal policies are still too timid to promote a strong recovery of the business climate. Added to this is the risk of slower inflation expectations with a braking effect on consumption. On the external front the re-emergence of a European crisis could be complementary to the weakness of international recovery. Both factors will continue to weigh on the performance of Indian exports and on the already high current account balance maximalizing financing risks.

India - Macroeconomic forecasts

	2008	2009	2010	2011	2012E	2013F	2014F
GDP (constant prices, at factor cost)	8.1	6.5	9.7	7.5	5	5.4	6.9
Consumer spending	8.4	6.9	8.6	7.3	4.5	6.9	7.9
Public spending	18	9.2	8.1	7.8	6.2	3.6	5.7
Capital investment	9.4	-0.7	17.5	6.2	0.7	5.4	7.3
Exports	18	-7.7	15.4	18.3	5.8	8.2	11.1
Imports	32.6	-8.3	18.2	18.4	9.8	9.5	10.7
Industrial output	7.7	0.2	9.7	4.8	0.7	5.1	7.6
Inflation (CPI)	8.3	10.9	12	8.9	9.3	7.9	4.5
Unemployment	12.6	12.5	12.5	12.5	12.5	12.4	12.4
Average wages	15.2	9.1	21.4	16.3	9.2	11.2	10.3
1-year loan rate	9.9	5.6	6.3	9.5	9.5	8.4	7.9
USD/INR exchange rate (average)	43.5	48.36	45.74	46.69	53.48	53.78	52.4
Current account balance	-1394	-1247	-2396	-2958	-4640	-5421	-5327
Current account balance (% of GDP)	-2.5	-2.0	-3.2	-3.4	-4.8	-4.9	-4.3
Budget balance (% of GDP)	-4.8	-7.0	-3.8	-6.7	-5.5	-5.7	-4.8

NB: Percentage change on the previous period - unless otherwise stated. Figures refer to the calendar year. Source: Oxford Economics Forecasting and Intesa Sanpaolo.

The real economy and inflation

The yearly growth of the Indian economy fell to 5.0% in 2012 from 7.5% in 2011 due to a marked slowdown in consumption, particularly private (4.5% YOY vs. 7.3% in 2011), and investments (+0.7% YOY vs. 6.2% in 2011) to which was added a negative contribution of foreign origin. During 2012 the GDP dynamics, kept at just above 5% in the first three quarters, has gradually slowed down. The 4th quarter registered a growth of 4.5%, the lowest rate in the last 15 quarters, despite a recovery, even on m/m terms, of private consumption (+4.6% YOY) and of fixed investments (+6% YOY). The clear slowing down of public consumption and the negative contribution of net exports were instead still a drag on growth. Supply-side deceleration was driven by the weak dynamics of agriculture and manufacturing which has also been accompanied by a slowdown in services.

Trend-based imports are back on positive ground in the 4th quarter of 2012 with an increase of 7.1% YOY, supported by the strong rebound of oil imports (+26.1%). Ex-oil imports are still weak (-0.7% YOY) as well as those of capital goods with the exception of machine tools (+2.3% YOY). Exports have yet again recorded a decline (-3.6% YOY) although lower than that of the previous quarter (-11.4% YOY) and were likewise favourably influenced by exports of petroleum products. The most marked decline in exports compared to imports in 2012 has given rise to a new increase in the trade deficit from 161 billion in 2011 to 197 billion in 2012 (FOB-CIF; from 8.6% to 10.8% of GDP). The export orders component of the PMI index fell to 53.2 in February from 56.4 in December, but the quarterly average remains widely above 50 supporting moderate export recovery in the coming months.

Industrial production gave signs of a prudent improvement at the beginning of the year even if the production of capital goods continues to fall. Investment dynamics, given the rise of stalled projects and the decrease of those started in the 4th quarter[10], will still be weak at least in the first half of the year. The FDI liberalization measures taken in autumn and the speeding up of the approval of investment projects exceeding 10 billion rupees through the Investment Committee (*Cabinet Committee on Investments*), although positive, are proving difficult to implement particularly owing to problems related to land acquisition, environmental permissions, restrictions on mineral extraction and coal-fired consumer production (*coal linkage*). The recent adoption of the Law on land acquisition is definitely a positive step for investment medium-term outlook.

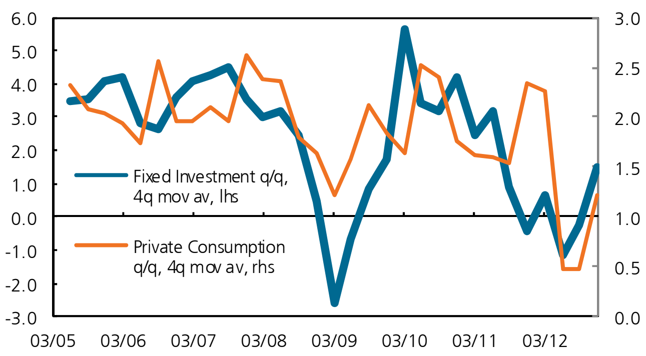
The business confidence surveys (*Industrial Outlook Survey, Dun & Bradstreet*) indicate only a marginal improvement in economic conditions in the 4th quarter of 2012 and in the 1st quarter of 2013, although with mixed expectations on orders, which have however climbed between January and February in PMI activities.The consumer confidence index fell again in the 4th quarter both in the current assessment and in expectations and the percentage of consumers intending to increase both current and future consumption has decreased. Domestic sales of automobiles are however still in sharp decline (-25.7% YOY in February) and mobile phone subscriptions also continue to decrease (-3.3% YOY in December) after the peak reached in June 2012 with 934 million subscriptions.

The wholesale price inflation rose marginally to 6.8% YOY in February from 6.6% in January while remaining in a slow deceleration trend from August 2012. Consumer price inflation continues to be high. It rose to 10.6% YOY in December and subsequently up to 10.9% in February. The exchange rate depreciation, the recently granted possibility to manufacturers to introduce gradual increases in fuel prices and rising price pressure in grains, point to an inflation profile only marginally declining in 2013, particularly for consumer prices, with risks remaining on the upside.

[10] See Ministry of Finance, Economic Survey 2012-13.

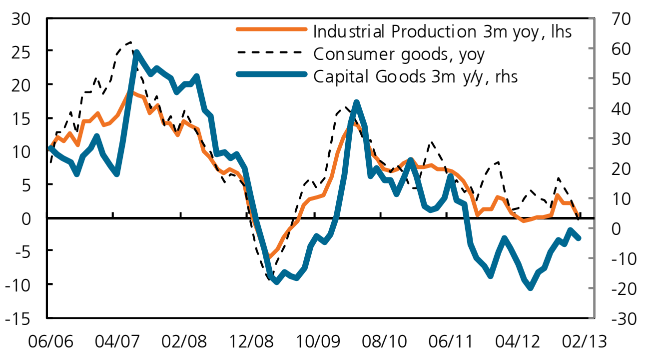
The real economy and inflation

Investment and consumption in marginal recovery



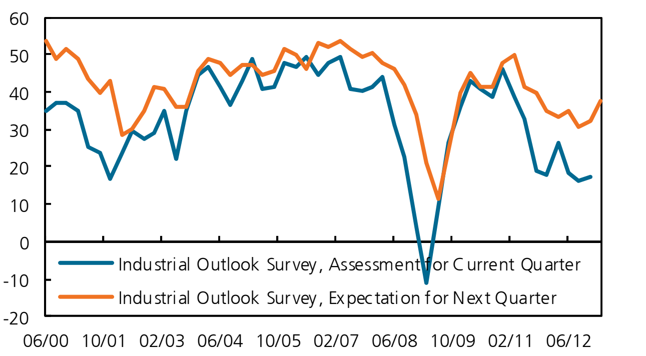
Source: CEIC and Intesa Sanpaolo elaborations

Industrial production is still weakened by capital goods



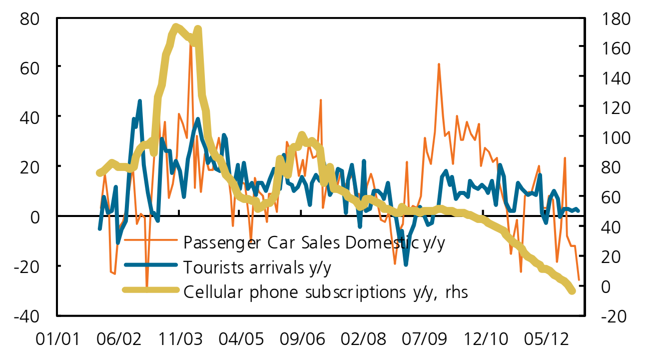
Source: CEIC and Intesa Sanpaolo elaborations

Business confidence indices: expectations improve



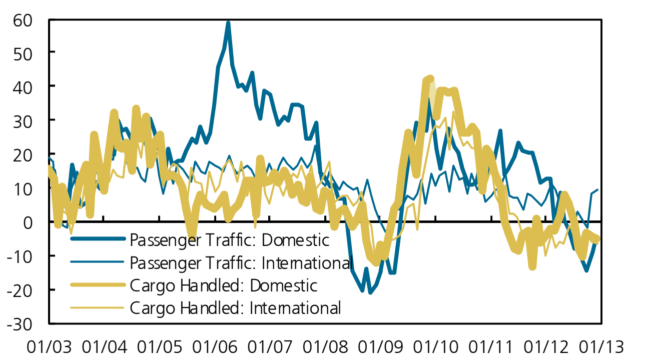
Source: CEIC

Slowing revenues from tourism, declining car sales



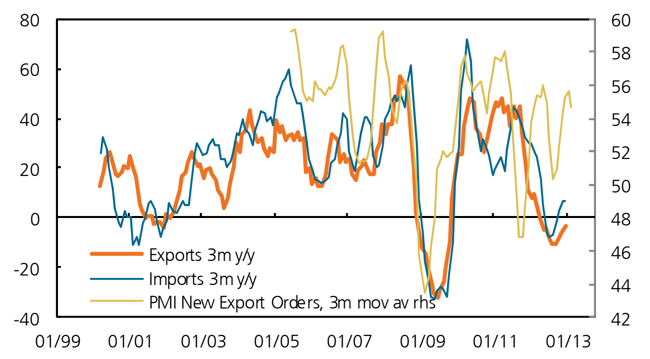
Source: Bloomberg, CEIC and Intesa Sanpaolo elaborations

Domestic and international traffic



Source: CEIC. yoy change

Foreign trade in moderate recovery



Source: Bloomberg, HSBC-Markit and Intesa Sanpaolo elaborations

Economic, fiscal, monetary policy

Government has submitted the draft Budget Law, which must then be approved in late March. The deficit for Fiscal Year (FY) 2012-13 is expected to be 5.2% of GDP, less than 5.8% for FY 2011-12 but in a slightly increasing compared to the first preliminary estimate of 5.1%. The upward revision is particularly due to lower proceeds from disinvestments of State holdings and the sales of telephone frequencies, and subsidies spending greater than expectations. Government estimates a GDP growth rate of 5% in FY 2012-13, expects an acceleration of growth ranging from 6.1% to 6.7% in FY 2013-14 and a decline in the deficit/GDP ratio to 4.8%.

A more equitably shared and sustainable growth remains the main objective of the Government implemented above all with an increase in appropriations in favour of minorities and rural development, in particular with spending increases in health care, education and water management. The goal of sustainable development is however inserted in a typical pre-election budget that has basically avoided addressing key issues in depth, such as the financing of the current account deficit, revenue generation through increased tax base enlargement and rationalization of expenditure. The goal of reducing the deficit/GDP ratio, though appreciable appears optimistic. It is based on a forecast of a nominal GDP growth of 13.5%, a significant increase in tax revenues (19%) besides a significant non-tax revenue from disinvestments (550 billion rupees) and from telephone frequency auctions (400 billion rupees), with these goals having already been proved difficult to reach in the past.

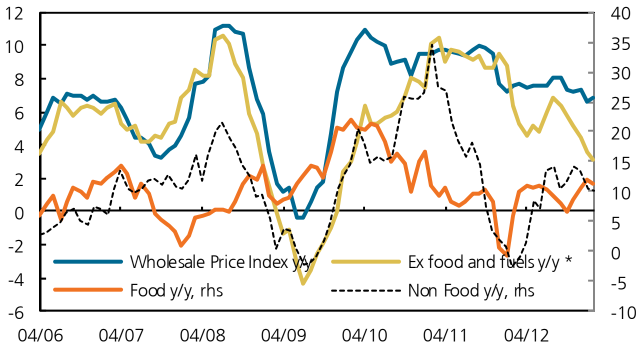
Some 89% of fiscal deficit will be covered by net emissions of domestic bonds amounting to 4840 billion rupees (about 69 billion euro), an increase of 3.6% from FY 2012-13. A provision of 20 billion is made to be realized through short *Treasury bills*. The intention has meanwhile been expressed to carry out buyback operations or swaps on 2014-15 and 2016-18 maturities.

Credit to the non-food commercial sector continued to decelerate in the second half of 2012 and rose by 15.8% YOY, getting back to end 2011 growth rates. M3 growth (+12.7% YOY in January) seems to have stabilized over the past three months but remains, along with credit growth below the forecast of RBI. The RBI in January revised down M3 forecast for the end of March 2013 from 14% to 13% leaving unchanged those on credit to the non-food sector at 16%. The slowdown in the growth rate of deposits, due to very low and to some extent negative real rates, has favoured the shift of savings into non-financial assets and particularly in gold buying and it remains a source of concern for the Central Bank for the implications both on banking activities and on the balance of payments.

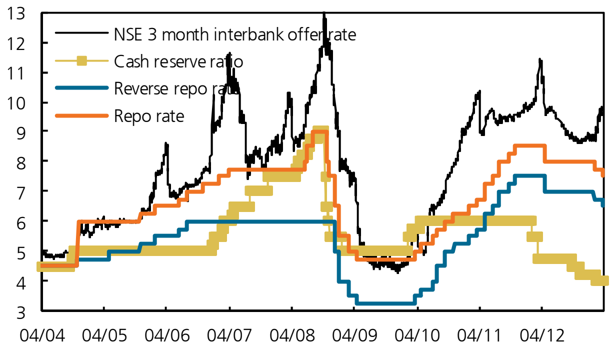
Liquidity conditions have been more restrictive since the end of November. Despite the open market operations (*Open Market Operations*, OMOs) between December and January, the amount requested by way of repurchase through the LAF (Liquidity Adjustment Facility) was on average 970 billion rupees, rising on average to 1134 in February, well beyond the level considered acceptable by the Central Bank. At its meeting in late January, the RBI cut the reference rates and the cash reserve ratio (CRR) by 25 bps and cut again the reference rates by 25pb during its March 19 meeting, bringing the repurchase rate to 7.5% and leaving the CRR at 4%. The Central Bank expects that, despite the recent slowdown in inflation of non-food wholesale prices, total inflation of wholesale prices remain around current levels in FY 2013-14. The dynamics of food prices and of administered prices maintain a strong gap between consumer prices and wholesale prices, with upward risks for inflation expectations. In addition there are risks of financing the current account balance which would be significant in case of sudden risk aversion on international markets. These two aspects remarkably restrict the space for a further loosening of monetary policy, despite the downside risks on growth. We therefore believe that the RBI will continue to prefer open market operations to keep sufficient liquidity and will deliver at most two 25pb rate cuts during the year.

Fiscal, monetary and exchange rates policy

The wholesale price inflation eases

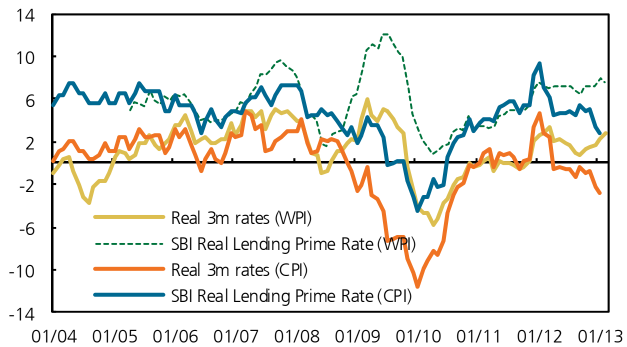


The RBI cuts rates



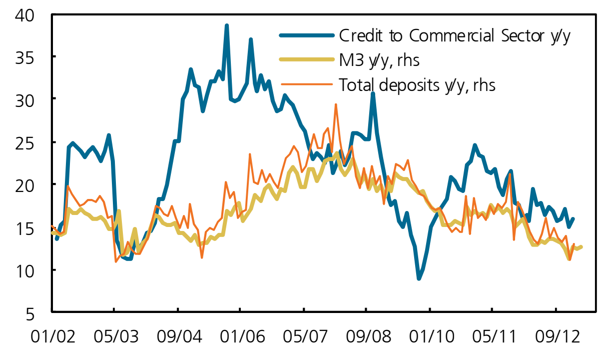
Source: CEIC and Intesa Sanpaolo elaborations

Real rates



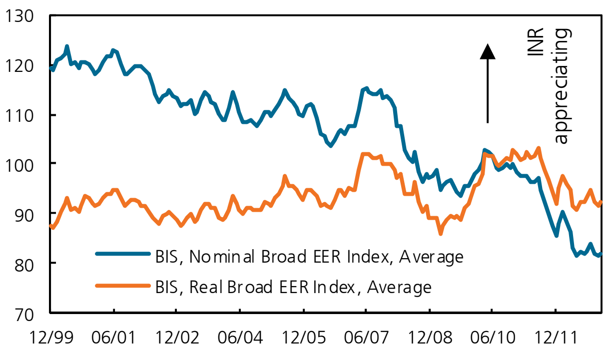
Source: Bloomberg and Intesa Sanpaolo elaborations

Credit does not accelerate



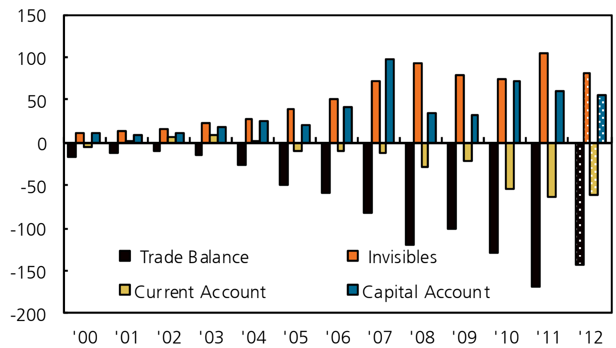
Source: CEIC, Bloomberg

Effective exchange rate in depreciation



Source: CEIC

The current account balance worsens (billions of dollars)



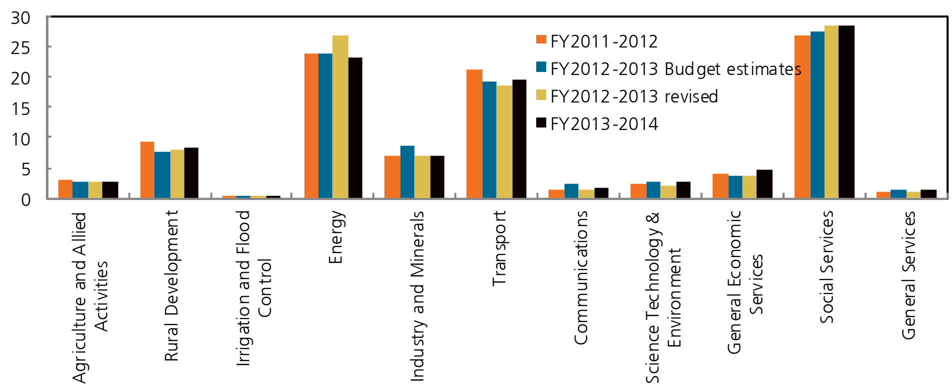
Note: first three quarters for 2012. Source: CEIC, Bloomberg

Focus: the budget for fiscal year 2013-14

The reduction of the deficit/GDP ratio to 4.8% for FY 2013-14 from 5.2% estimated for FY 2012-13 is expected through an increase in State revenue, both from fiscal and non-fiscal revenues. In particular, Government has raised the additional income tax rates for business companies with taxable income exceeding 100 million rupees (raised from 5% to 10% for domestic companies and from 2 to 5% for foreign ones paying the maximum rate) and on the personal income exceeding 10 million rupees (established at 10%). The tax on distributed dividends rose from 5% to 10% while a withholding tax of 20% was imposed on the distribution of profits of unlisted companies through the buyout of shares. The increase in non-tax revenue expected from major proceeds of disinvestment operations which have not been carried forward during the previous fiscal year and from the new auctions on telephone frequencies could yet again prove to be optimistic. In fiscal year 2011-12 Government was in fact bound to reduce the estimates on revenue deriving from these auctions from 400 billion rupees to 194 billion: the November and January auctions saw reduced participation by operators who felt discouraged by basic prices considered to be too high and by the cancellation of several 2008 assignments by the Supreme Court over charges of corruption and price manipulations.

Along with direct tax increases upward adjustments in indirect tax rates were added, in particular consumption levies (or duties) on cigarettes and luxury products (from cars to mobile phones). The main allotments will still be the allocations made to social services (28.4% of the total), followed by energy (23.3%, down from FY 2012-13) and transport (19.6% of the total, higher than those for FY 2012-13). An increase was made in allocations in the areas of Science, Technology and the Environment (from 2.2% to 2.6%) and those involving rural development (from 7.9% to 8.3%). The Bill however contains tax breaks both for the lowest-end income earners and the purchase of first homes, and for some investments in plant and equipment and confirms the long-term objective of bringing the deficit/GDP ratio to 3% for FY 2016-2017 AF. The subsidies, which in fiscal year 2012-13 increased by 35.6% when compared to the initial estimate, are expected to decrease from 2.6% to 2% of GDP in FY 2013-14, with an increase in food subsidies financed by cuts to energy and fertilizer subsidies.

Allocation of expenditure by sector (% of total)



Source: India Ministry of Finance and Intesa Sanpaolo elaborations

Government has reiterated its intention to introduce the Direct Tax Code, whose Bill has been in Parliament since August 2010 and will be reviewed as soon as possible, and Good and Service Tax (GST). The report of the Committee on the study of GST was presented at the end of January and is still being examined by Government, it being difficult to foresee its implementation before the start of the next fiscal year (March 2014). The entry into force of general regulations on tax evasion (*General Anti-Avoidance Rule*) was postponed to the 1st April 2016.

Forex Markets: Currency war - And the winner is… the dollar

US DOLLAR

Asmara Jamaleh

THE YEAR OF THE DOLLAR

2013 has begun with widespread euphoria (or at least a marked improvement in sentiment) among the various asset classes, **triggered by** a favourable combination of:

(a) positive signs of **growth** worldwide (mainly China, followed by the US), and;

(b) easing of **specific risk aversion** to the Euro zone (tail risks relating to the sovereign debt crisis almost at zero)

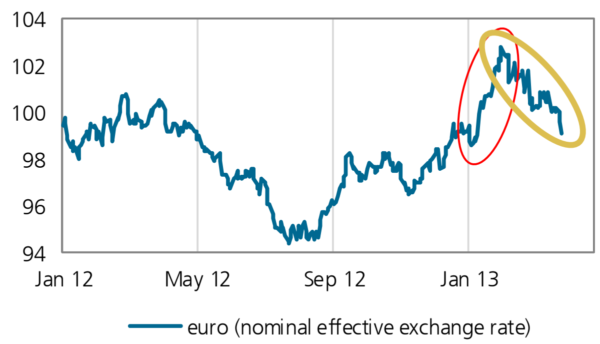
On the currency markets, **(1)** the "growth" factor has particularly favoured a **broad and sustained** strengthening of the US dollar (Fig. 1), whereas **(2)** the "easing of specific risk aversion" has fostered a **broad, but not lasting** strengthening of the euro (Fig. 2).

The bullish phase of the euro in fact related to January alone, while February and March were a period of correction.

Fig. 1 – Dollar: year starting on the rise

Source: Thomson Reuters-DataStream

Fig. 2 – Euro: rise and fall



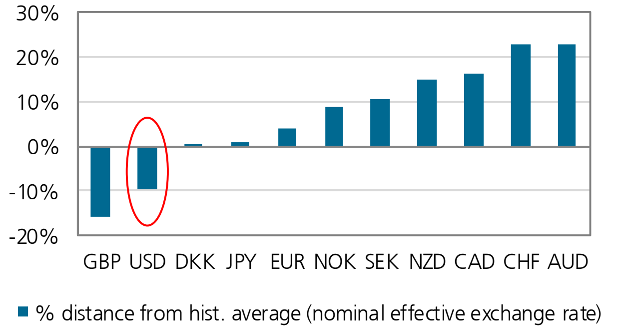
Source: Thomson Reuters-DataStream

Conversely, the dollar continued to rise also in February-March, thanks to the **current (US data) and future (Fed's commitment to growth) improvement in the US growth outlook.**

After such a performance, we may ask whether it is set to last or whether it was just a flash in the pan. **Our basic view is that the recent strengthening of the dollar is likely to continue** during the year, although not necessarily in a uniform manner.

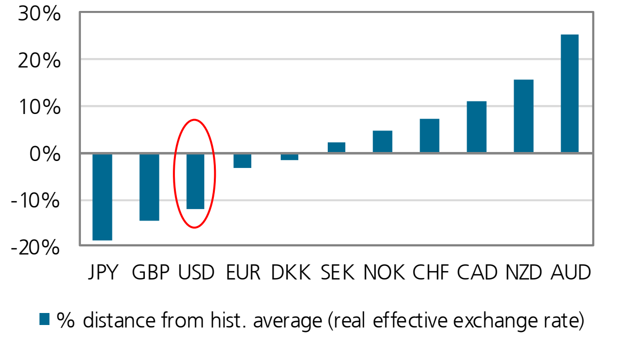
The Fed is increasingly trying to clarify which monetary policy measures-tools-conditions it intends to use to pursue the sustainable-virtuous-lasting-credible growth objective. Therefore, **the future reduction in quantitative easing should be a favourable development for the dollar, regardless of whether or not this is a prelude to a cycle of interest rate hikes.** In the first case (exit strategy as a prelude to a cycle of rate hikes), the rates/yields curve assuming a definite direction after a long period of zero interest rates would directly benefit the dollar against "all" currencies, both of advanced and emerging economies. In fact, the Fed practically zeroed interest rates in December 2008 (from 1.00% to 0.25%) and has not touched them since, while other central banks have in the meantime already raised rates again, but then stopped, or - not having zeroed them – have cut them further or are considering whether to make other cuts. In the second case (exit strategy followed by a more or less long period of zero-rates), making policy measures conditional upon achieving a "precise" growth (and/or employment) intermediate target would enable expectations for improved growth to be firmly maintained, thereby having a positive effect on the dollar. Of course, in this second case, it is possible that after the recent broad appreciation, the dollar may undergo a partial retracement, but this would be limited in scope and time, and would be followed by some recovery, resting on an underlying upward trend.

Fig. 3 – Dollar still at very low levels…



Source: Thomson Reuters-DataStreamNB: referred to the historical average calculated since 1999 on the nominal effective exchange rate (Source: BIS)

Fig. 4 – … even in real terms



Source: Thomson Reuters-DataStreamNB: referred to the historical average calculated since 1999 on the nominal effective exchange rate (Source: BIS)

Why should expectations of US growth alone be sufficient to support the dollar? Mainly for three reasons: (1) because at this stage, also outside the US, growth still represents a problem or uncertainty for many other economies, both advanced and emerging, and recent signs in the US have been positive; (2) because despite the excellent start to the year, the dollar still remains at very low levels, around 10% below its historical average in both nominal and real terms (Fig. 3 and Fig. 4), whereas almost all other currencies (G10) are broadly aligned with their averages or above (with the exception of sterling and, in real terms, the yen); (3) because US interest rates are the lowest in the world (after Japan, again within the G10), and thus the upside on rates/yields is higher.

The outcome of the last FOMC (20 March) offers in our view support to the prospect that the recent strengthening of the dollar has room to continue during the year. Fed Chairman Ben Bernanke has paved the way for the start of an exit strategy, which will, however, be carefully calibrated on current developments in US growth, because the Fed would like to be sure that the improvements will not be temporary, but sustainable and lasting. Therefore, it may take a long time between the full withdrawal of the current monetary stimulus and the start of the rate hikes cycle; however, this sounds as a pledge of growth, which in turn becomes the condition/prerequisite to raise interest rates. Thus, the value of the dollar may reflect not only (i) performance but also (ii) quality in growth and (iii) offer a return (rates/yields), which, starting from zero, can only go up.

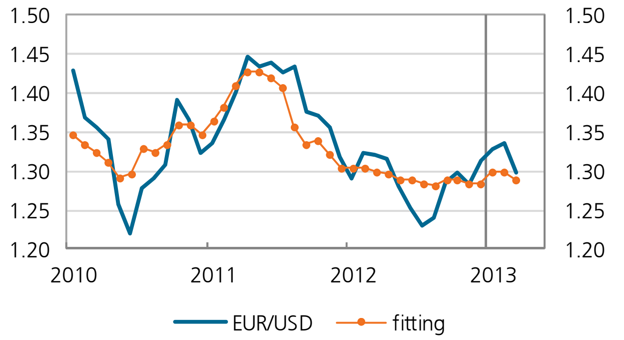
EURO

NO BULLISH CUES: DOWNSIDE BELOW 1.30 EUR/USD, BUT NOT BELOW 1.20

2013 has begun very well for the euro, which in less than a month has risen from 1.30 to 1.37 EUR/USD, a level last seen in November 2011. The easing of the so-called tail risks related to the sovereign debt crisis has led international investors to unload some of the positions on other currencies that had been used as a safe place to park in case of extreme events hitting the Euro zone. Confidence started to strengthen after the first meeting of the ECB (10 January), partly thanks to President Mario Draghi's speech, in which he hinted at the start of economic recovery in the Euro zone already this year (even if only towards the end of the year). A strengthening of the euro could therefore have been justified, but a stable rise above 1.35 would in our opinion have been excessive. In fact, according to our estimates based on the EUR/USD's relation with

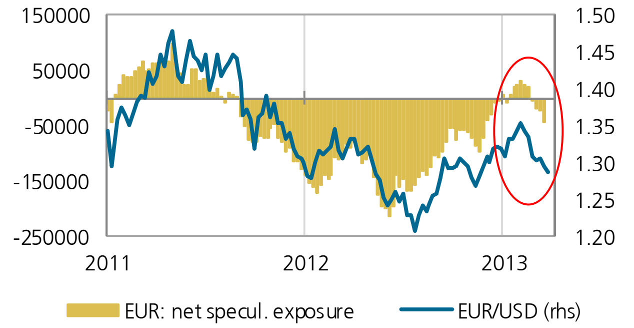
Euro and US short-term yields, the fair value for the EUR/USD exchange rate between January and March should have been on average between 1.29 and 1.30 EUR/USD (Fig. 5).

Fig. 5 – EUR/USD fair value estimated at 1.29-1.30 EUR/USD



Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 6 – Euro not yet sufficiently encouraging



Source: CME and Thomson Reuters-DataStream

The marked correction since the beginning of February (from 1.37 to 1.27 in just over a month) supports this view: data has provided evidence of economic improvement underway in the US, which is lacking in the Euro zone (in recession as much as last year), the ECB and the Fed have taken note (the ECB admitting the continued sluggish growth in Europe and the Fed starting to consider an exit strategy), and the exchange rate has reacted accordingly. The uncertainty generated by the outcome of the Italian elections and the Cyprus crisis has also accentuated the trend already in place. Speculative trades, repositioned long euro at the beginning of the quarter after a year and a half of a protracted short, recently returned short (Fig. 6). Exposure is however quite limited, which indicates a greater bias toward a further weakening of the euro rather than toward any long-lasting recovery. Recent developments and the outlook, at least in the short term, offer very few bullish triggers for the single currency. In the absence of favourable surprises from the Euro zone or particular disappointment from the US, the dollar seems preferable to the euro in the straight EUR-to-USD comparison.

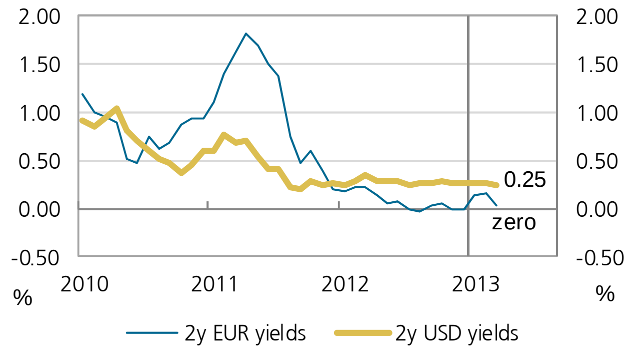
The range within which the euro appears most likely to move in the next few months is 1.25-1.35 EUR/USD, with greater preference for the medium/low end rather than the high end. If we take as our reference the model explaining the EUR/USD exchange rate as a function of the European and the US short-term yields (Fig. 7), we can see that the current combination (Fig. 8) of Euro Area-US yields is approximately 0-0.25%, a good gauge of the current combination of economic growth and inflation, and in line with these factors, the estimated fair value of the exchange rate is 1.28 EUR/USD (Fig. 7).

Fig. 7 – EUR/USD values consistent with various yield-pairs

		US short-term yields (%)			
		0.00	**0.25**	0.50	1.00
Euro Area short-term yields (%)	**0.00**	1.3045	**1.2859**	1.2676	1.2318
	0.25	1.3280	1.3091	1.2905	1.2540
	0.50	1.3520	1.3328	1.3138	1.2767
	1.00	1.4013	1.3814	1.3617	1.3232

Source: Thomson Reuters-DataStream and Intesa Sanpaolo elaborations

Fig. 8 – Euro zone vs. US short-term yields



Source: Thomson Reuters-DataStream

Until the Fed starts its exit strategy, it is unlikely that US short-term yields will rise above 0.25%, while European yields might begin to rise from the current level of near zero if data for the area started to show signs of improvement. With both Euro and US yields at 0.25%, the exchange rate would return to 1.3091 EUR/USD (Fig. 7), which is not so high. However, we can imagine that, notwithstanding the situation in the Euro zone, if the US continued to show signs of improvement, even in the absence of an actual increase in yields (still somehow "locked" by the Fed's current monetary policy), it would be as if US yields had risen to 0.50%, and at this level of US yields, the euro would drop to 1.2676 EUR/USD, provided euro yields stayed at zero (Fig. 7).

Similar conclusions would be reached thinking in terms of what may or not already be priced in to market prices. There are two main possible scenarios: (1) the worst case for the Euro zone (very negative data and/or a worsening of the situation in Cyprus or a re-emergence of problems in peripheral countries, etc.) and (2) the best case for the US (better than expected growth). We can easily find points of reference for scenario (1) by looking at 2012 exchange rates, when the risk of a break-up of the Eurozone weighed the heaviest. At the height of the crisis, the exchange rate plummeted to 1.20 EUR/USD, but never fell below this level. However, the most likely downside would be around 1.25 EUR/USD, because this is the level at which the recovery began after the ECB meeting that shifted sentiment towards the Euro zone (6 September 2012), when Mario Draghi said: "We will do whatever it takes… to preserve the euro". However, in the most unfavourable hypothesis, we cannot rule out a temporary break through below the 1.25 EUR/USD level, but it seems unlikely that it would go below 1.20. Conversely, scenario (2) has no basis for comparison in the near past because the state of "emergency" in the US has gone on for more than four years, ever since the Fed practically zeroed interest rates and then did not touch them again. This scenario, however, could be similar to a situation in which US yields could start to climb, reaching around 1.00%, a level which corresponds to an exchange rate estimated at 1.2318 or 1.2540, depending on whether euro yields are zero or 0.25% respectively (Fig. 7): the downside then would be "confirmed" at around 1.25 or slightly below, but above 1.20.

The main alternative risk scenario to the central one is that the US economy puts in a very disappointing performance, possibly owing to fiscal policy management. In this case, the euro would benefit, but to be able to remain steadily at 1.35-1.40 EUR/USD, the decline in the US would have to be particularly serious, a hypothesis due to a combination of 0.50%-0% Euro area-US yields (Euro at 1.3520 EUR/USD: Fig 7) or 1.00%-0% (Euro at 1.4013 EUR/USD: Fig 7). The likelihood of any such development is very low, especially in light of the Fed's strong commitment to growth, which has been extensively discussed above.

BRITISH POUND

REBOUND EXPECTED AFTER THE COLLAPSE: GROWTH REBALANCING NOT TO BE LEFT TO THE EXCHANGE RATE

It was a very bad beginning of the year for sterling: in slightly more than 2 months it lost 10% against the dollar (from GBP/USD 1.64 to 1.48) and 9% against the euro (from EUR/GBP 0.80 to 0.88). The reason for this collapse was not a sudden or serious deterioration of the UK economy, but an unfortunate combination of external and internal factors that all occurred together.

External Factors: (1) return of *risk aversion* against the Euro Zone with reduction of the positions on currencies that, during the 2012 crisis, were employed as alternative "safe havens" to the single currency: GBP was one of those currencies, (2) generalised strengthening of the US dollar; (3) deterioration of the outlook in the Euro Zone, the main destination of British exports.

Internal Factors: (1) absent signals of (current, not perspective) improvement of the economy; (2) the uncertainty created by the Bank of England at the February's meeting, when a serious MPC split emerged, with 3 out of 9 votes, including the Governor Mervyn King's one, in favour of an immediate increase of QE (such split remained at the March meeting); (3) the upward revision to the inflation projections in the February BoE's *inflation report*; (4) the subsequent deterioration of the problem for the BoE who felt uncomfortable implementing a more expansive monetary policy to help economic recovery with inflation still rising above its *target* since December 2009 (over 3 years); (5) expectations that the Chancellor would stick to the *austerity* plan on 20 March (presentation of the 2013 Budget), as in fact it happened, without any concession to help growth through fiscal policy measures; (6) uncertainty caused by Cameron's campaign in favour of a future referendum (which will be held after the first half of the next legislature should the Tories win a second term) for a possible exit of the United Kingdom from the European Union; (7) uncertainty caused by the change of leadership of the BoE, from Governor Mervyn King to the designated Mark Carney (currently, Governor of the Bank of Canada) which will occur on the 1st of July, because Carney has been showing a pro-growth monetary policy approach, generating fear of further rise in inflation (which is already high and above the target) in a context of nearly-zero growth; (8) Moody's *downgrade* with UK losing of triple-A rating.

Amongst the various aforementioned factors, the most critical one in structural terms is the nearly-zero economic growth coupled with inflation which is stubbornly high, mainly for non-endogenous causes which cannot be addressed by monetary policy. Despite all this, we expect sterling to rebound, both against the dollar and, especially, against the euro.

Even though we have revised our GDP growth forecast down from 1.0% to 0.7% in 2013, the review of the BoE's monetary policy framework announced by Osborne[11] together with the presentation of the 2013 Budget (20 March) will allow monetary policy to remain (or become more) accommodative in order to help economic recovery even against the backdrop of rising inflation. In fact the *inflation targeting* (*target* at 2% ±1%) was maintained, but some further conditions to be observed in the conduct of the monetary policy were added. These are the most relevant: (1) the implementation of a *forward guidance* (as Fed is already doing) and (2) the requirement for the BoE's governor to send a letter to the Chancellor (alongside the BoE minutes) when inflation is above the 2% *target* (currently the letter is to be sent only when inflation is above the upper limit of the target range, i.e. above 3%, or below the lower limit of 1%). In particular it is the introduction of the *guidance* that allows the BoE to implement further stimulative measures also in the presence of above-target inflation. Osborne has also announced that the BoE and Government are already working on a program for a possible expansion of the Funding for Lending Scheme.

In this way also the BoE, similarly to the Fed, has a kind of a commitment-to-growth, which, based on arguments similar to the ones mentioned above for the dollar, represents the main factor on which we base our expectations for GBP rebound (towards GBP/USD 1.58-1.60 and EUR/GBP 0.82-0.80) during the year. Also, even more than the USD, the GPB comes from historically very low levels in terms of nominal and real effective exchange rates, finding itself now 15% below its historical average (Fig. 3 and Fig. 4 of the US dollar's section). This suggests that – apart from extraordinary *shocks* or a further deterioration, instead of improvement, in the economic growth outlook – sterling has an upwards directional *bias*.

Among of the main objections that may arise against the "sterling rebound" view is that (1) depreciation may help growth through positive contribution from net exports, (2) this would be

[11] "Review of the monetary policy framework" (http://cdn.hm-treasury.gov.uk/ukecon_mon_policy_framework.pdf).

welcomed by the Bank of England. We reckon instead that (1) such depreciation would be helpful if the pound started from higher values and not from the current values which - as mentioned - are already very low in terms of historical comparison (this means that the depreciation that "had" to occur already occurred), while (2) as for the BoE, this has recently explained its position through Governor Mervyn King's statements (the BoE does not intend to adopt any kind of measure to weaken the currency) and, even more clearly through the latest BoE's minutes (the main reason for which the majority of the *Board* voted against the proposal of increasing APF was, explicitly, the fear that announcement of fresh monetary stimulus to help growth, against the backdrop of rising inflation, could undermine the BoE's credibility as *inflation fighter*, causing further depreciation of sterling).

We also add that further sterling's depreciation from recent lows would cause the double – unwelcome - effect of (i) sending inflation higher, and (ii) increasing the negative contribution from external trade, due to import costs rising more than export volumes (similarly to what happened in the United States in 2002-2004 when the Fed tried to reduce the C/A deficit by letting the dollar depreciate, but it had the opposite effect due to the low sensitivity of US exports to the exchange rate). Similarly to the US, rebalancing UK growth from domestic to external demand cannot be achieved, if not for a minimum part (option already implemented) through the exchange rate, but through a period of lower growth: we deem that a large part of this period has already passed, since average growth was -0.4% during the last 5 years against +3.1% during the previous 5-year period.

YEN

FINALLY BACK TO THE EQUILIBRIUM PATH

In the 1st quarter of the new year the yen carried on the path taken in November, it kept going down, depreciating even beyond expectations, from USD/JPY 85 at the end of 2012 to USD/JPY 96. The increasing likelihood that the new head of the BoJ will further loosen monetary policy, together with the deterioration of the trade balance and the generalised strengthening of the dollar led the exchange rate in the direction indicated by fundamentals based both on interest rate/yields spreads and inflation differentials. According to our estimates of both models (exchange rate-yield spreads and exchange rate-inflation differentials) the *fair value* of the yen would be around USD/JPY 90-95.

However, the Japanese currency might depreciate further, since the exchange rate adjustment started after years of divergence from the equilibrium path. This year's expected central range of the yen's movements should be USD/JPY 95-100, but a temporary breakout above 100 cannot be ruled out, especially should the US economy perform better than expected. The first leg of further weakening of the yen should occur when new monetary stimulus will be announced by the BoJ in April.

A risk that may occur, given the large deficit in both the trade balance and the fiscal balance (deficit and debt), is that depreciation gets out of hand (i.e. above the USD/JPY 110-115 range abandoned in 2007), leading to capital outflows (which would negatively affect the Japanese economy), but the Japanese authorities do not wish that. However, we deem that in the worst case scenario the BoJ and Government would intervene to stop what would risk becoming an undesired devaluation: Japan is the second biggest holder of foreign-exchange reserves in the world (10.8% of total) after China (30.2% of total). Also add that, in order to have large capital outflows, a very negative combination of credibility loss by the central bank (too negative an hypothesis) and a large risk of economic recession (not expected in our scenario) would be required.

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Appendix

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The financial analysts who prepared this report, and whose names and roles appear on the first page, certify that:

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