Caboto

Macroeconomic Outlook

Research Department

September 2005

Banca Intesa

Research Department – www.bancaintesa.it – www.caboto.it

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Changes to our forecasts

- We have sharply revised up our commodity price forecasts. Specifically, the annual average oil price is expected to increase from USD 55.80 in 2005 to USD 61.30 in 2006.
- **Eurozone:** we have marginally revised our growth estimate to 1.8% for 2006, compared with 1.9% in June. Our scenario is essentially unchanged. We forecast an average annual inflation rate of 2.0% for Europe, compared with our estimate of 2.2% in 2005. The ECB is still waiting for confirmation that domestic demand is in recovery, and is likely to begin raising official interest rates in mid-2006.
- **United States**: we have raised our inflation estimates. The average for 2006 is expected to settle at 2.5%, compared with 3.3% in 2005. We have slightly downgraded our growth estimates for 3Q05 and 4Q05, due to the impact of the hurricanes. Our interest rate forecasts are unchanged, but we think that they may be subject to predominantly upside risks.
- **Japan**: 1.5% growth for 2005 was forecast in June. Based on the recently published revised figures, we have upgraded our estimate to GDP growth of 2.2%.
- **China**: we have revised upward our growth estimate for 2005 to 9.1% on the back of an exceptional first-quarter economic performance.

	Banca Intesa				Consensus Forecasts			
	GDP		Inflation		GDP		Inflation	
	2005	2006	2005	2006	2005	2006	2005	2006
USA	3.5	3.1	3.3	2.5	3.5	3.3	3.2	2.8
Eurozone	1.3	1.8	2.2	2.0	1.3	1.7	2.1	1.8

Source: Banca Intesa and Consensus Forecasts – September 2005.

Growth continues, in spite of everything

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The world economy turned the page on the slowdown mentioned in our June Macroeconomic Scenario as early as the beginning of the summer, as all PMIs pointed to an upturn in May. However, the rebound immediately came up against newly-rising energy and industrial commodity prices. The Economist's metal index rose 6.3% between May and August, an increase that was dwarfed by the 35% jump of oil prices in the same period. Most of all, the record-breaking highs reached by oil seem to have shaken consumer confidence in the G7 nations. This negative global situation was compounded by two adverse events that took place in the United States: first, car sales – typically a fluctuating market – entered one of their downturns, with negative repercussions on economic performance. Second, in late August and early September Hurricane Katrina caused southern Louisiana to be evacuated, local business activity to grind to a halt, and oil and gas extraction and fuel refining to drop substantially. This will further drag down demand and production, at least in September. The consequences will also be felt outside the United States.

The negative impact of higher energy prices, including natural gas, will reverberate also in 4Q05 and 1Q06. However, fears that prices might continue to climb in the next few months may be overdone. A downward correction at the end of the year, after the hurricane season in the Gulf of Mexico is over, cannot be ruled out. But this is not the only reason why the risk of a deeper and more persistent slump is limited right now. First of all, economic policy is not tight enough. Financial conditions appear still favourable overall: higher official interest rates in the US do not seem to have extended to the rest of the yield curve, which is becoming increasingly flat, while monetary policy remains loose in the eurozone and Japan. Fiscal policy is taking on an expansionary stance: in the United States because of the funds appropriated to repair the damage caused by Katrina, and in Europe because of recent or upcoming elections in Germany, France and Italy. Only Japan seems to have adopted a mild tightening stance. In addition, there seem to be no weaknesses in the inventory cycle or in the financial stability of the emerging economies. For these reasons, the fading effects of the latest increase in oil prices and the rebound of the US economy due to the post-Katrina reconstruction effort should add some steam to the global economic cycle.

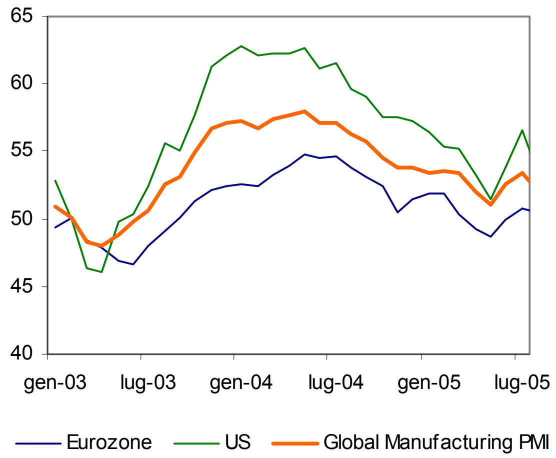
The scenario outlined in this report is consistent with continuing monetary tightening in the United States and an additional period of stability for interest rates in the eurozone, where it will be some time before domestic demand firms up. The widening interest rate spread between the United States and the eurozone should put a lid on the upward pressures experienced by the EUR/USD exchange rate as a result of the growing US trade deficit. Conversely, we expect the yen to strengthen owing to the much better condition of the Japanese economy and the likely change in the BoJ's stance.

GDP growth

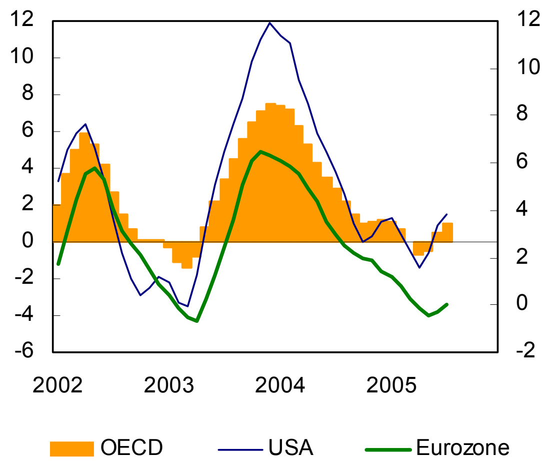
	2002	2003	2004	2005	2006	2007
USA	1,6	2,7	4,2	3,5	3,0	2,5
Japan	-0,3	1,4	2,6	2,2	1,5	1,3
Eurozone	0,9	0,7	1,8	1,3	1,8	2,0
Eastern Europe	4,0	6,1	6,6	4,7	4,8	4,5
Latin America	-0,7	1,7	5,8	4,1	3,7	3,6
OPEC	1,3	1,9	7,2	6,2	4,7	5,5
East Asia	5,7	6,1	7,2	6,4	6,5	6,9
Africa	3,0	3,1	3,8	4,4	4,2	4,2
World growth	2,8	3,7	5,2	4,4	4,3	4,4

Average percentage changes over year ahead.

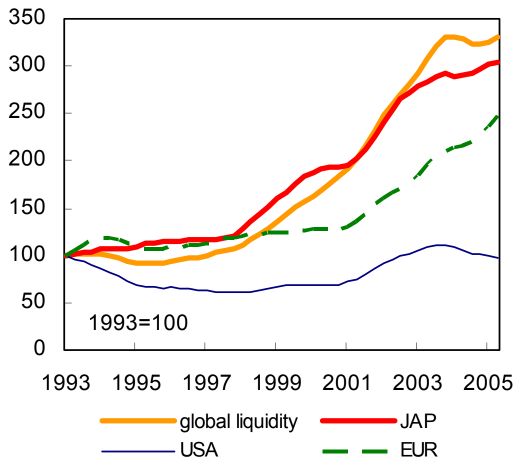
Manufacturing PMIs



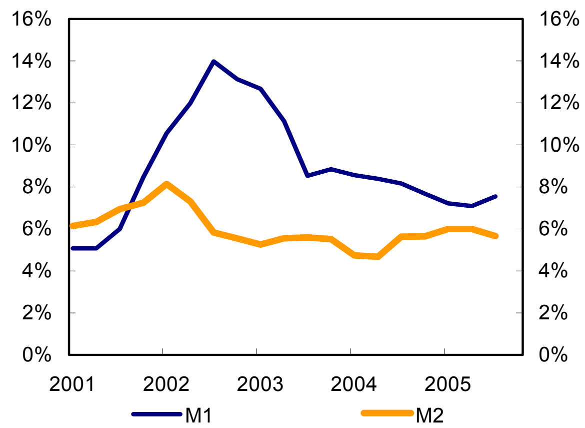
OECD Leading Indicators



Global Liquidity Index



OECD Money growth, y/y

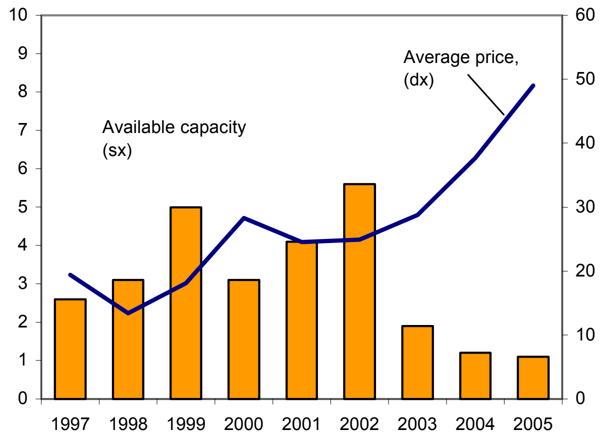


Commodity Prices

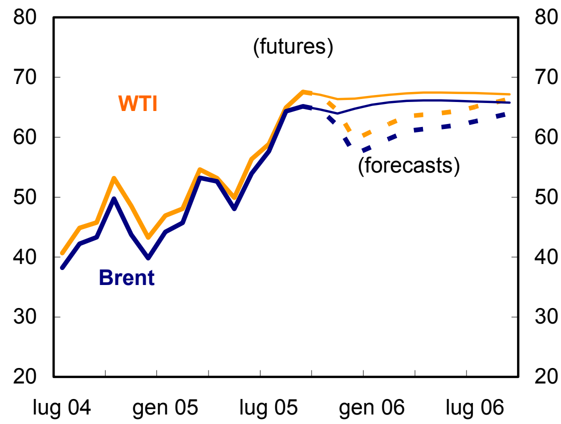
	2002	2003	2004	2005	2006	2007
Oil price; Brent crude spot$	25,0	28,9	38,3	55,8	61,3	62,3
	+2,4	+15,4	+32,7	+45,7	+9,9	+1,6
Non-fuel commodities price index	96,7	103,5	122,8	125,9	123,7	117,8
	+0,9	+7,1	+18,6	+2,5	-1,8	-4,8
World price of metals	87,7	98,4	134,0	159,1	152,1	130,6
	-2,7	+12,2	+36,1	+18,7	-4,4	-14,2
Agricultural raw materials w	96,7	100,4	105,9	107,5	106,2	108,8
	+1,7	+3,8	+5,5	+1,5	-1,2	+2,5

Levels and average annual rate of change.

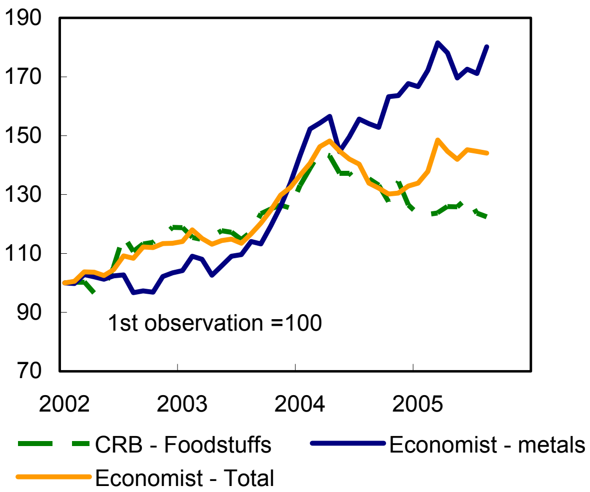
Crude oil – price & available capacity



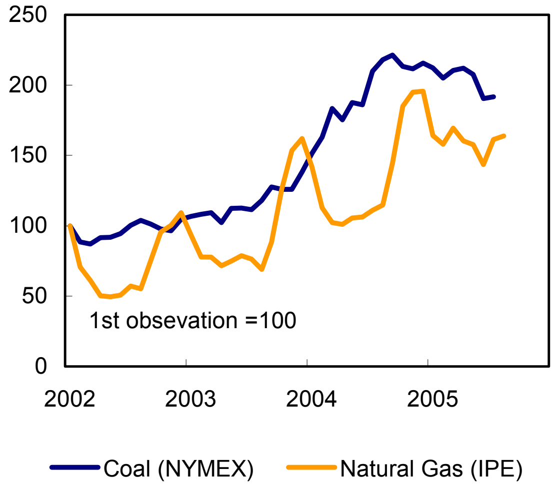
Crude oil price – futures and forecasts (US$)



Commodity price indexes (US$)



Natural Gas and coal prices (US$)



Oil supply is expanding, but will it be enough to cool the market?

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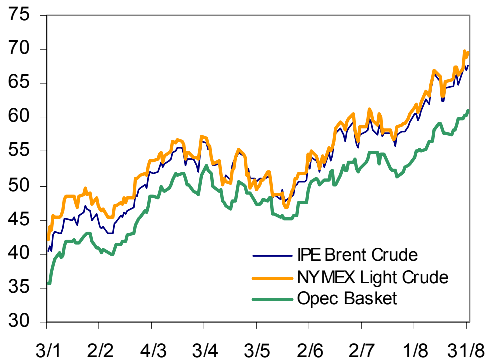
The spike in oil prices that has accompanied hurricane Katrina's rampage through the Gulf of Mexico is no surprise, following the announced closure of drilling rigs, refineries and unloading terminals. Last year another hurricane caused major damage, which impaired production and refining in the area for weeks. More surprising, if assessed on the basis of the available figures regarding the trend in stocks, are the previous highs recorded by the oil market in August. In the United States crude oil stocks have risen by 5m barrels at a time when they usually shrink, a phenomenon that at other times would not have failed to trigger a sharp downward correction. This is the result of a structural market situation that tends to fuel expectations of future scarcity and, therefore, "speculation" in the true sense of the term. The problem is that in the short term demand is unresponsive to the price and, therefore, restoring a balance requires the intervention of other factors (slowdown in economic growth, energy saving measures, temporary increase in supply); in the long term, however, we should expect increases in production capacity and a reduction in oil intensity in consumer countries, which might reverse the trend.

Fig. 1 – Oil prices

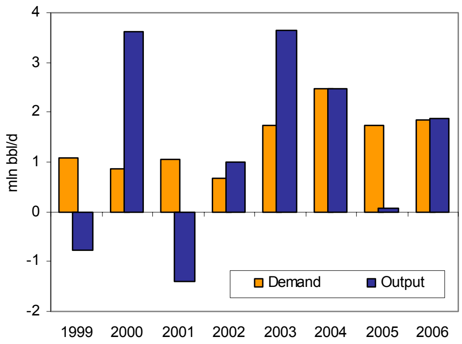


Source: EcoWin

Structural factors supporting oil prices

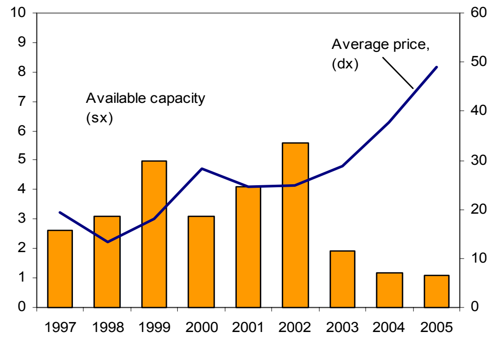
The first point to be made is that growth in world demand picked up in 2002, and has since remained above the average in the last 20 years (fig. 2). Responsible for this step change in pace is first and foremost China's economic boom, still under way. 78% of the growth in demand in the last two years is due to non-OECD countries. Thus, unlike the oil crises of the 1970s, the current crisis is driven by demand and not by a rationing of supply.

Fig. 2 – Crude oil annual growth



Source: BP, OEF, Banca Intesa

Fig. 3 – Crude oil, available production capacity

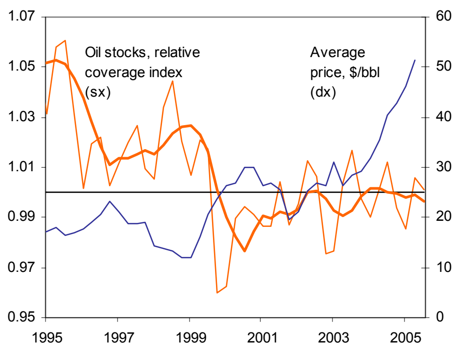


Source: EIA and EcoWin

Production has managed to keep pace with demand, but at the cost of eroding the available capacity margin. According to EIA estimates, following the high in 2002 this margin fell to its lowest level for 30 years (fig. 3). The scant available production capacity means that, in contrast to the past, the market might not easily absorb persistent downturns in exports by one or more major global producers. From this viewpoint, the hot spots are numerous (Venezuela, Nigeria, Iraq, Iran and Angola are the most important). In addition, the spare production capacity that OPEC can mobilise in the short term is concentrated in just one country, namely Saudi Arabia: this factor accentuates the fragility of the supply system and the sensitivity of market expectations to local geopolitical events.

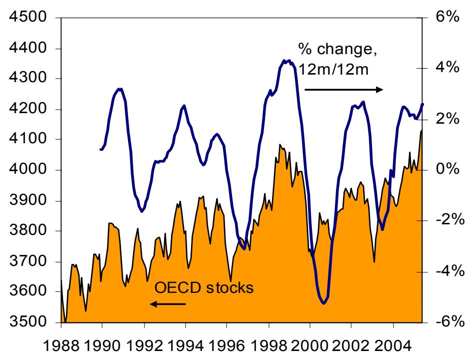
The system's resilience to the shocks may be enhanced by the presence of an adequate level of oil stocks. On this front, developments have been more favourable. Stocks have been growing in absolute terms (fig. 5), reaching levels well in excess of the seasonal norm in the United States. On a longer time horizon, commercial stocks in OECD countries, which provided 50-51 days of coverage at end-2004 (and just 49 at start- 2003), now cover 53-54 days of demand. The current level of coverage seems in line with the recent past (fig. 4) and is not at present a critical factor.

Fig. 4 – Global oil stocks, relative trend



Source: OEF, Banca Intesa. Ratio of current coverage (in days of demand) to its 5yr average, moving average and quarterly value.

Fig. 5 –OECD oil stocks, million barrels



Source: IEA, EIA-DOE. Figures up to June 2005.

Another element of weakness is the bottleneck downstream, with global refining capacity now firmly above 90%, making it susceptible to negative events (accidents, weather events, etc.). Recently, pressures on refining products have frequently fed through to crude oil, inverting the normal causal chain. Expansion projects are mainly concentrated in the producer nations or emerging consumer countries, like China, whereas there are no major projects in a huge importing country like the United States[1].

Short-term outlook

Over the next 1-3 months the market will be conditioned by expectations regarding the demand/supply balance in the winter months, which in turn depends on the impact of the hurricanes expected in the Gulf of Mexico between now and October, and on the forecasts regarding winter temperatures. This is the period which will presumably record annual highs in oil prices, at between $70 and $80.

Between November and December, if there are no unforeseen events that further undermine the market's ability to cover fuel demand, and if the winter is not exceptionally rigid, we expect to see a sharp correction, with lows below $60. The unwinding of positions by funds should extend this movement. One potential downward factor, that might even come into play before November, is potentially greater than the expected growth in supply: Russian production is in fact bouncing back, reaching a high of 9.5m bbl/d (vs. 9.37m in August 2004), production in Africa is increasing and there is the chance that Saudi Arabia will soon increase its supply of crude oil by 0.5m bbl/d, drawing on its residual capacity. The increased availability of crude oil might bolster the level of reserves and diminish the risk of an excess of winter demand materialising.

Medium and long-term outlook

On a longer time horizon, our GDP growth estimates imply demand-side growth equal to or just above that estimated by EIA-DOE (1.8m bbl/d in 2006), which assumes a slowdown in the United States to 2.8% y/y. The cumulative growth in 2005-06 would be 3.5m bbl/d (3.4 according to IEA), of which 0.6m in the United States and 1.0m in China. Higher price estimates might imply more modest growth in demand of around -0.1/0.2% for every 10% increase in the price vs. the baseline scenario.

As indicated by the IEA in its monthly report, the impact of the additional demand will however be mitigated by a more robust increase in production capacity than any seen in the recent past. Saudi Arabia has announced an expansion of production capacity to 12.5m bbl/d by 2009[2]. The oil pipeline from Baku to Ceyhan should come on stream in December this year, boosting oil exports from the Caspian Sea. In addition, various projects being implemented in South America and Africa should start producing[3]. Even considering a fall in production from existing fields, past investments should more than offset the growth in

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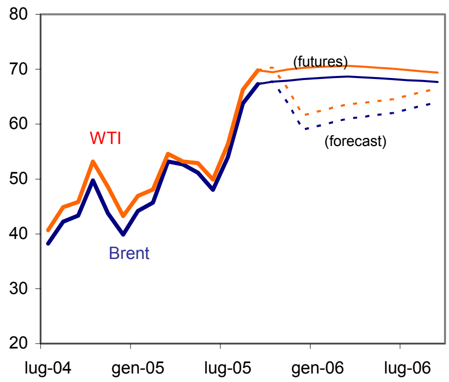
1 *Banca Intesa, Industry monitor: Energy, August 2005.*

2 *The plans envisage additional capacity of 2.3-2.4m bbl/d between 2005 and 2009, vs. a decline of 0.8m bbl/d in production by pre-existing installations and investments estimated at $15bn. However, half of the additional capacity will only be available in 2010.*

3 *In Nigeria projects delivering 280k bbl/d will be completed this year, and equivalent additional capacity should be available by end-2006. In the medium term, Iran's projects might prove just sufficient to replace the natural decline in production, despite the stated aim of expanding production to 5.5m bbl/d by 2010. Brazil should add 1.6m bbl/d of gross capacity by end-2007 and the United States 0.7m bbl/d by end-2006.*

demand, probably allowing the available capacity margin to be expanded from 1.2 to 1.6m bbl/d (with the uncertainty relating to the assessment of actual current capacity, our figures for which are based on EIA-DOE calculations). In addition, the expansion of capacity as inferred from the development projects reported in the press amounts to around 2.5m bbl/d in 2006 and 2007, and falls to 1.5m in 2008. This easing of the pressure on the supply side might thus extend out to 2007 and therefore justify a cooling of oil price tensions. However, the margin would remain very low in historical terms and would rule out an actual reversal of the trend in prices (fig. 3 and 6).

Fig. 6 – Oil price, monthly average, projections



In the longer term, it is legitimate to doubt whether the sector, which also has to counter the decline in existing wells, can for long maintain the production growth rates we are seeing. Looking beyond the coming years, the only factor that may force prices back down to the levels of two years ago is a significant cooling of demand, as happened after the oil shocks of the 1970s. On this front, the risk that the US economy may slow sharply in the coming years (for reasons only partly due to the hike in energy prices) is not insignificant, but for now it is not our central forecast. Equally, China and India are unlikely to fall into a recession purely on the back of the energy cost. By contrast, however, the high cost of fuel might foster progress on the energy efficiency front, reducing the elasticity of oil demand to GDP growth. In this case, however, there is a chance that OPEC would cut production in order to halt a slide in prices. For this reason, we do not think oil prices are likely to return to the prevailing levels seen just one year ago.

United States: forecasting complicated after the hurricane

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We revise our US macro scenario at a time of great uncertainty. Two weeks after hurricane Katrina lashed the south-eastern coasts of the United States, it is still hard to assess the macroeconomic implications of this event.

The early data for a period following the disaster send very negative signals for matters relating to employment, industrial output, consumer confidence and inflation expectations. The only positive development is the decrease of regular rack price to pre-hurricane levels. Our forecast is founded on the assumption that oil prices will not rise from current levels and that the relief efforts implemented by the Bush administration will bolster national income and spending. However, the amount earmarked (over USD 60bn already approved, but some estimates raise that figure to as much as USD 200bn) and the uncertainty over the time lag necessary for these funds to filter through to spending make the forecasting exercise unusually complicated, suggesting that extra caution is needed when assessing projections for 2006.

In our opinion, the net effect on GDP growth will be negligible and much lower than early estimates. The downgrade of consensus expectations (Bloomberg Survey of 14 September) for GDP growth in 3Q/4Q05—by 0.5% q/q and 0.4% q/q (ann.) respectively—is partly a reaction to data coming in lower than market expectations and has little to do with Katrina. Compared with our previous scenario, we have deducted on average one-tenth of one percentage point from the quarterly growth of the last two 2005 quarters.

While the net effect on growth is likely to be negligible, the near-term impact on manufacturing, employment and inflation will be highly significant. The closure of rigs and refineries over a number of days shaved 0.3% m/m off industrial output, according to the Fed. Considering that, after 20 days, the situation is still far from normal, the impact on September data will be much greater. The return to full operating capacity for some refineries will take longer than expected. Output will therefore be affected, as working plants are already operating at full capacity. The effect on the labour market is likely to be even more pronounced and persistent. The number of unemployed workers applying for unemployment benefits could increase to over half a million, and push up the national unemployment rate.

Turning to inflation, Katrina’s early effects are already visible in the surge of the indices of prices paid, as reported in the manufacturing surveys of the New York and Philadelphia Fed and indicated by rising inflation expectations. According to the University of Michigan survey, **year-ahead inflation expectations increased from 3.1% y/y to 4.6% y/y in September, while long-term (5-10 years) expectations went from 2.8% y/y to 3.1% y/y**. The increase in long-term expectations is particular worrying because this increases the risk of an inflationary spiral being triggered which would be very costly to bring to a halt.

Households will squeeze the last drops of equity from their home

Consumer spending should continue rising during the current quarter: the +3.4% q/q (ann.) forecast for 3Q05 is in line with the trend seen in the first half. However, the combination of a fresh rise in energy prices (as magnified by the Katrina effect) and wage moderation have caused the savings rate to fall further. Considering the level already reached in July (down 0.6%, a record low for this series), the savings rate is likely to hit a new low in September. After a modest recovery in August, the decline of disposable income brought about by Katrina, either directly or indirectly, will have negative repercussions on the savings rate.

The employment recovery in 4Q05 and the stabilisation of oil prices should make way for a rebound from its record low during the quarter. However, consumer spending would have to slow for the savings rate to begin rising again, and it could slow down more markedly if property prices were to finally reach the end of their long climb. Our forecast for 2006 assumes a 3.3% increase in (real) personal income on the back of a 1.4% rise in the employment rate (an average of 175,000 new non-farm jobs a month) and a 3.8% advance in hourly pay rates (up on the 2.8% increase projected for 2005). Given a 3.0% (real) increase in consumer spending and a 2.1% deflator, the savings rate should stabilise on average at around 0.2%.

Residential construction spending continues to grow at a fast pace, thanks to low interest rates and the expectation of rising property prices. While the post-Katrina reconstruction effort will boost housing investment in the flooded areas in 4Q05 and in 2006, the outlook for this expenditure item is negative at national level. In fact, the price surge of new homes slowed down significantly in the second quarter and the latest surveys show that the trend has continued into this quarter. The affordability index for first-time homebuyers is also down, compared with early 2004, and is now at its lowest level since 1988.

Property price trends have a major influence on the scenario for 2006, both directly and indirectly, due to the resulting wealth effect on household assets. The extraction of cash as a result of higher property values via mortgage refinancing has bolstered household income over the past few years. This important theme was addressed once again by Alan Greenspan during his latest conference at Jackson Hall. Our 2006 forecast assumes a slowdown in the rate of property price increases, to 7% y/y from the 13.5% y/y reported by OFHEO in 2Q05. This assumption is supported by several factors. First of all, the relationship between the prices of new homes and of existing housing stock suggests that a drop in the former will affect sooner or later the latter. Rising interest rates and more stringent risk control in mortgage lending will limit mortgage refinancing activities and the use of certain financial instruments considered risky by the supervisory authorities. Lastly, in the medium term the contribution of demographic variables should be negative, since the age group for which housing demand is usually highest is decreasing as a proportion of the total population. The specific features of the real estate market - significant price inertia - and the moderate increase in interest rates rule out the possibility of a crash similar to those that take place in financial markets. That said, the slowdown in house prices, to a rate more in line with the long-term average (6.5% over the past 10 years), should gradually remove the wealth effect and have a visible impact on the 2006 macro scenario.

Manufacturing investment

We infer from the deliveries of capital goods that in the current quarter manufacturing investment is slowing down. The monthly volatility of orders and deliveries suggests that sudden drops in orders should not be projected into the future, as these often turn out to be temporary. The order recovery in the next few months should instead confirm the positive growth outlook for corporate spending on machinery and software. Investment in non residential structures is a different story, as these have been unable to return to the levels recorded prior to the 2001 recession. The stagnation of this type of investment—while machinery and software expenditure have posted double-digit growth rates—demonstrates the extent to which investment in new structures had become excessive. Given the lower rate of depreciation for this type of asset, it is hard to imagine that spending in this area will pick up substantially any time soon. Overall, the slowdown in final demand and corporate earnings is likely to affect capital investment, causing it to slow down to 7.1% in 2006, from 8.3% in 2005.

Exports

The closing of the trade gap between March and July is the combined effect of strong export growth and a decrease in imports. July imports were down 2.3% compared with February, while exports were up by 5.9%. The time lag of trade balance statistics does not make it possible to assess the most recent development in foreign trade. Our forecast for the current quarter includes a 4.7% q/q (ann.) recovery for imports and a decline in the export growth rate to 5.7% q/q (ann.). Falling domestic demand should be the real catalyst of a closing trade gap. The import decline should more than offset the small decrease in the pace of export growth. In spite of the stabilisation of the trade deficit (as a % of GDP), the current account deficit cannot follow suit because of the net payment of interest and dividends. The accumulation of dollar-denominated assets by foreigners ate into what was a net positive balance until 1Q 2005, despite a high level of foreign debt. The current account deficit is forecast to increase to 6.6% of GDP in 2006.

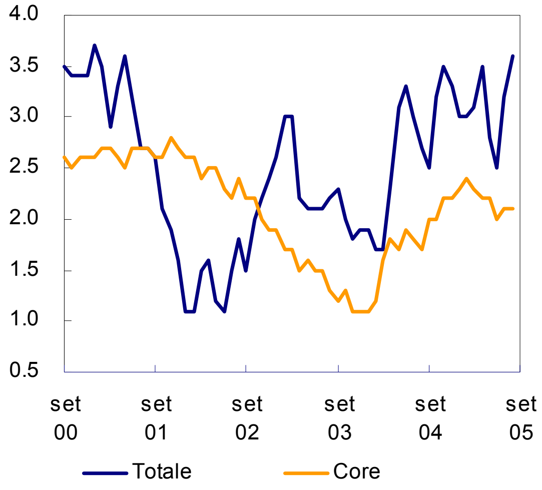
Inflation

The exceptional stability of the last few months notwithstanding, our model points up a higher rate of inflation for the next few months. Forecasts at 6 and 12 months ahead for the y/y figure imply a moderate acceleration in m/m core inflation. For the remainder of 2005, the monthly increases should hover around a trend of 0.2% m/m, while during 2006 this should rise to an average of 0.25% m/m. **Thus, the core inflation rate should be 2.1% y/y at end-2005, and 2.8% y/y in December 2006**.

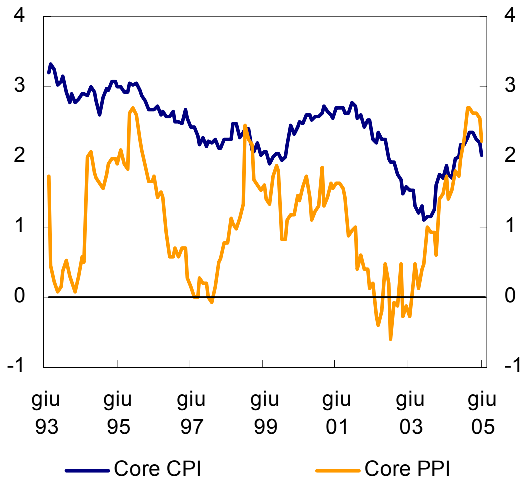
The key points underlying our forecast are set out below.

1. The increase in **unit labour costs** should continue in the next few quarters, eroding corporate profit margins and putting pressure on companies to pass higher costs on to consumers. The closing of the output gap will boost the pricing power of firms while heightened inflation expectations should fuel hourly pay rates.
2. The effect of the **depreciation of the dollar** has so far been limited but there are signs that foreign manufacturers are becoming more sensitive to changes in exchange rates, and this sensitivity could increase if Asian currencies were to strengthen. Looking ahead, the depreciation of the dollar will continue to exercise upward pressures on prices.
3. The upsurge of **the energy component**, which will be somewhat violent in the August-September period, should subside to a degree between October and November. We assume that it will be more or less neutral in 2006. This means that the CPI will hit a high by the end of this quarter, and fall back after that.

CPI: core inflation still moderate, despite oil pressures (% change y/y)



Core CPI and PPI (% change y/y)



United States: an estimate of the Katrina effect

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Weighing up the economic effects of the hurricane has been the principal concern for the financial markets. According to our analysis, Katrina should cut growth by -0.2% q/q in 3Q05 and by -0.1% q/q (ann.) in 4Q05. The limited scale of the impact is due to the allocation of a fiscal stimulus effect three times greater than that considered in the initial assessments.

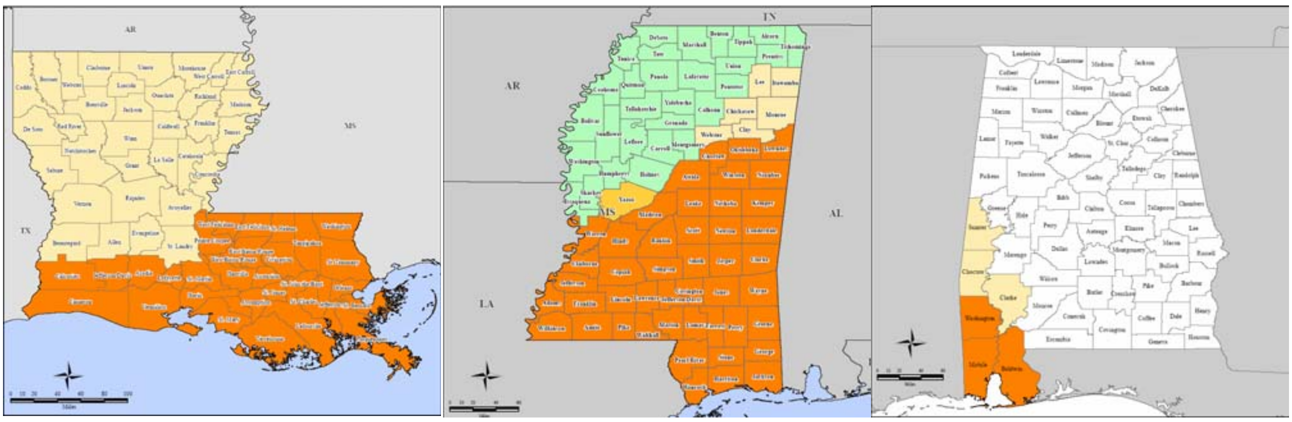
The balance of the disaster caused by hurricane Katrina in terms of human lives worsens by the day. A final count will not be possible for many weeks yet, but it is immediately clear that the human cost is enormous. In addressing this issue one's first thoughts go to all those who have lost their lives and their families.

The weighting of the economic effects of such a tragic event has been the focus of market attention. Never have forecasts been so affected by uncertainty as in this case. The uncertainty over the timing of the recovery is so great that not even the apparent precision of the calculations can mask the subjective nature of the estimates. Having said this, let's look at the numbers. The *Congressional Budget Office* (CBO) puts the impact at between –0.5% and -1.0% in the second half of 2005, with around 400k job losses by the end of the year. The calculation included federal spending of US$ 10.5bn for assistance and relief, a figure rendered obsolete by the additional US$ 51.8bn recently approved by Congress.. Considering a damage estimate of US$ 100bn, with around US$ 25-30bn covered by insurance, with this figure the Administration has set aside barely enough to even things up, purely in economic terms, with nature. In addition, the estimate of the total damage looks set to increase and there is already talk of a further US$ 50bn being needed to finance a rebuilding programme that will take years. The weight of this expenditure will impact mainly on the budget for 2006 and 2007, since the current fiscal year is virtually over.

In light of this fresh data, we have sought to quantify the impact on 2H05 GDP. We arrive at an estimate well below that of the CBO and many others circulating on the financial markets.

First, we have tried not to treat the three states hit by Katrina in the same way. Given their more extensive devastation, Louisiana and Mississippi are by far the worst hit, with 31 and 46 counties respectively, while Alabama has damage in just three counties.

Distribution of FEMA disaster declarations as at 9 September 2005



Source: Federal Emergency Management Agency

Secondly, even within the individual states we have sought to differentiate the damage to the main urban centres according to the counties involved. The criterion used is the distinction between the counties to which FEMA (Federal Emergency Management Agency) offers public assistance (lighter) or individual assistance (more substantial, shown in orange on the maps). With regard to Louisiana, the urban areas hit hardest are New Orleans-Metairie-Kenner and Houma-Bayou Cane-Thibodaux, while Lake Charles, Lafayette and Baton Rouge have also incurred extensive damage. In Mississippi the centres hit the hardest were Gulfport-Biloxi, Pascagoula and Hattiesburg. In Alabama the only city seriously affected is Mobile.

To arrive at an estimate of the impact on GDP we have used nonfarm payrolls as proxy. Using this variable also allows us to accommodate assumptions regarding the impact on the employment structure and to strip the distorting effect of the hurricane out of the national estimate for September. The news on the closure of production and refining sites and ports, the interruption to water, electricity and gas distribution, the wiping out of hotels and tourism and the flooding of many land communication routes suggest a higher estimated impact on employment in Mining, Construction, Manufacturing, Transportation, Trade, Utilities, Education and Hotels. Employment in Finance, the Professions and the Public Sector seems less affected. The labour growth assumptions for the coming months of 2005 envisage a more buoyant recovery in the sectors hit hardest by the hurricane, where inactivity has repercussions at the national level.

The implications in terms of the gross state product (GSP) of Louisiana, Mississippi and Alabama are alarming. For Louisiana the growth rate in 3Q05 and 4Q05 is -24.3% q/q and -30.5% q/q (ann.) respectively. For Mississippi the figures are -11.9% q/q and -14.8% q/q (ann.). For Alabama the fall in GSP is put at -2.2% q/q and -3.9% q/q (ann.). Considering the weight of the three states within national GDP (1.24% for Louisiana, 1.18% for Alabama and 0.64% for Mississippi), their contribution in terms of growth will be barely perceptible for Alabama, while Louisiana and Mississippi should together account for -0.4% q/q (ann.) in 3Q05 and -0.5% q/q (ann.) in 4Q05 in terms of national GDP growth.

Thus far we have looked at the direct effect of the devastation wrought by Katrina. There is another effect, this time indirect, which is manifested in the hike in the price of gasoline and other fuels. The definition of this impact is described in detail in another article in this issue of WEM. The impact on GDP growth directly attributable to Katrina via private consumption is quite substantial at -0.3% q/q in 3Q05 and -0.4% q/q (ann.) in 4Q05.

Lastly, we come to the stimulus effect of federal public spending for relief and reconstruction. We have assumed that of the US$ 62.3bn that the administration intends to spend, around one third will be used by the end of the year. Considering that the daily expenditure of FEMA has risen from US$ 0.5bn to US$ 2.0bn with the signing of the first emergency home building contracts, the assumption of $13bn being spent by end-December might look conservative. The impact on GDP should add around +0.5% q/q to 3Q05 and +0.8% q/q (ann.) to 4Q05.

Overall, the combined effect of these factors should cut growth by -0.2% q/q in 3Q05 and by -0.1% q/q (ann.) in 4Q05. The limited nature of the impact is due to the inclusion of a stimulus effect three times greater than that envisaged by the CBO: on the same expenditure assumption we find growth reduced by -0.5% q/q in 3Q05 and by -0.6% q/q (ann.) in 4Q05, values entirely consistent with the CBO estimate.

Despite an effect on growth that should ultimately prove modest, the loss of jobs has probably been devastating and in all probability will be so persistent that it will not be absorbed until well into 2006. In Louisiana alone we should see a fall of 400k jobs in the nonfarm sector, the less populated Mississippi should lose around 100k jobs, while Alabama should stem the loss to around 45k. Overall, the September national employment survey might include a net contribution from Louisiana, Mississippi and Alabama of around -545k jobs. The reconstruction activity that will follow when the areas hit have been cleaned up will lead to robust employment growth in some sectors, although the net effect in the short term will remain very negative when we consider that the number of people in work in December should still be 330k below the pre-hurricane level.

Fed funds: the rate hikes continue

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The outcome of the FOMC meeting on 20 September provides important information vis-à-vis the rates outlook, even before the minutes are read (due out 11 October). The fact that the Fed decided to raise rates notwithstanding the hurricane is in itself a very strong message and reflects in no uncertain terms the Fed's view on risks in the coming quarters**. The price risks are only balanced with appropriate monetary policy action which, according to the release, means continuing to remove monetary stimulus. The words are important**: although they have been reiterated for many months now, on this occasion they carry far greater weight**.**

In the context of the largest natural disaster in US history, the Fed has not changed its assessment of the economic situation, other than stating, obviously, that uncertainty in the short term is much greater. Thus, aside from the question of method, whereby monetary policy must not respond to temporary shocks, as is written in the text books and has been underscored in many bank officials' speeches, the **Fed continues to see more risks on the inflation side than on the growth front,** despite the "solomonic" formulation used for months now in the release.

The 20 September message remains unchanged: rates must rise

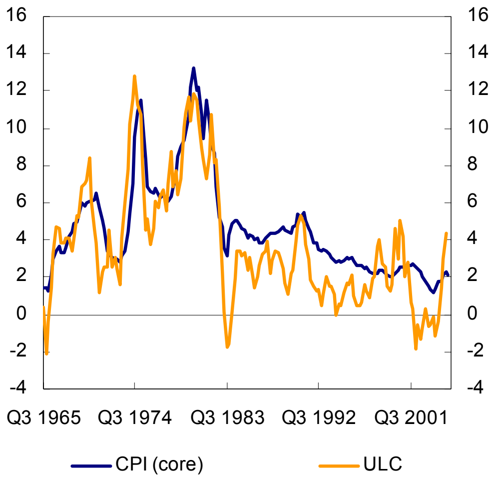
At the 20 September meeting, the Fed raised rates again and reiterated its concern over prices. The Fed's decision to raise Fed funds even after the hurricane is justified in the first paragraph of the release on two grounds:

1. First, according to the Fed, **growth was maintaining "*a good pace*" prior to the arrival of the hurricane**.
2. Secondly, "*it is the Committee's view*" that the **impact of Katrina,** though significant in terms of loss of output and an increase in prices and price volatility in the energy sector in the short term, **"*does not pose a more persistent threat*", other than increasing the uncertainty over the outlook for the coming months.** The assessment of the economic situation reiterates the points made in previous releases, stating that monetary stimulus and productivity growth continue to shore up the growth prospects, while on the inflation front the "*higher energy and other costs*" (perhaps the labour cost?) have "*the potential to add to inflation pressures*". In addition, the Fed admits that core inflation has remained moderate and that "*longer term inflation expectations remain well contained*", although in the past expectations were described as "well contained". **The Fed will certainly not have been indifferent to the sharp rise in inflation expectations registered by the University of Michigan survey**, which recorded an increase in inflation expectations one year forward from 3.1% to 4.6% (the highest level for over

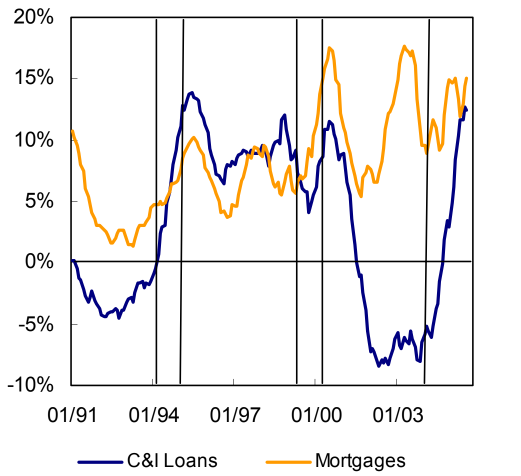
ten years) and an even more worrying increase, though more modest, in expectations five years forward, from 2.8% in August to 3.1% in September.

In its forward-looking section the statement is unchanged: monetary policy is still accommodative and the hikes will continue at a measured pace, while the risks remain balanced "with appropriate monetary policy action". **The Fed continues to signal that Fed funds have not yet reached neutrality** and that it prefers to risk a little more on the growth side in order not to lose the painstakingly achieved price stability based on stable inflation expectations.

Core CPI and ULC (% chg. y/y)



Credit continues to grow (mortgages and C&I loans, % chg. y/y)



Periods betw een lines indicate periods of rising fed funds rates

From the FOMC's viewpoint, **the September decision was certainly fraught**, as shown by the fact that for the first time in two years the decision **was not unanimous**, registering the dissent of Board member Mark Olson. In addition, the request to raise the discount rate did not come from all the regional Feds, but only from seven out of 12 districts. The districts that did not request the hike were Atlanta (hit by the hurricane), San Francisco, Cleveland, Dallas, and St Louis.

The outlook for the next meetings: the end is not yet in sight

The conclusion we can draw from the September FOMC statement and action is that the **Fed intends to raise rates several more times, and not just once as the market expects**. This is not surprising in light of the fact that, with the recent rise in inflation and with the growing inflationary pressures cited by the Fed (and perceived by households in both their short and medium-term expectations), **real rates are falling again.** In addition, the fiscal stimulus could more than offset the direct loss of income due to the hurricane.

The rates path is decided by the Fed on the basis of an evaluation of the costs and benefits of each move. On the risks front, although the Fed explicitly cites only the growth and inflation risks, it should not be forgotten that the central bank must also assess a more general risk too, relating to the potential instability of the financial markets. In the Federal Reserve Act, the Fed, in addition to its mandate to determine monetary policy so as to contribute to the maximum growth compatible with price stability, is also required to **maintain the stability of the financial markets**. On this front the references to "froth" on the property market made by many Fed members, first and foremost Greenspan, and to the historically low level of the risk premium on many assets confirm that the central bank cannot stop and run the risk of having to accelerate the pace of future hikes following an upturn in inflation.

Greenspan's Fed, in its role as manager of risks to the economy, is **keeping one eye on inflation and the other on asset prices and the cost-benefits trade-offs of a possible tactical error** in monetary policy. This fact will remain central to the forecast of the end-point for Fed funds, and for now the Fed does not want to show the market the end of the hikes.

In the coming weeks a host of **speeches** are scheduled, notably two by Greenspan. On these occasions the Fed will confirm its confidence in the resilience of the economy and its fears of a re-emergence of inflationary pressures, signalling that the state of the economy, despite the hurricane, calls for the further removal of monetary stimulus. A medium-term perspective will have to be kept firmly in mind when, in the coming months, the flow of data will be negative and might halt the upturn in rate expectations. **However, we stand by our view that the risks to the path in Fed funds lie mainly on the upside, and we may in due course revise up our estimates for the end-point in Fed funds.**

United States

	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (1996 US$,y/y)	**4,2**	3,5	3,0	**3,8**	**3,6**	**3,6**	3,4	3,3	3,2	3,1	2,9
q/q annual rate				**3,3**	**3,8**	**3,3**	3,4	2,9	3,3	2,9	2,4
Private consumption	**3,9**	3,5	3,0	**4,3**	**3,5**	**3,0**	3,4	2,3	3,1	3,1	3,1
Fixed investment - nonresid.	**9,4**	8,3	7,1	**10,4**	**5,7**	**8,4**	5,7	6,0	8,8	7,4	6,4
Fixed investment - residential	**10,3**	5,9	-1,5	**1,6**	**9,5**	**9,8**	2,2	-3,0	-3,1	-0,8	-4,3
Government consumption	**2,2**	2,2	1,5	**0,9**	**1,9**	**2,7**	3,7	4,1	1,6	-0,6	-0,9
Export	**8,4**	8,0	6,9	**7,1**	**7,5**	**13,2**	5,9	7,2	5,9	5,9	6,8
Import	**10,7**	6,6	5,9	**11,3**	**7,4**	**0,5**	4,8	7,8	5,8	6,1	6,4
Stockbuilding (% contrib. to GDP)	**0,4**	-0,3	0,2	**0,0**	**0,1**	**-0,5**	-0,1	0,1	0,1	0,1	0,1
Current account (% of GDP)	**-5,7**	-6,5	-6,6	**-6,4**	**-6,5**	**-6,4**	-6,6	-6,7	-6,6	-6,7	-6,8
Federal Deficit (% of GDP)	**-3,6**	-2,7	-2,9								
Gov. Debt (% of GDP)	**64,0**	65,5	66,7								
CPI (y/y)	**2,7**	3,3	2,5	**3,4**	**3,0**	**2,9**	3,7	3,4	3,2	2,7	2,1
Industrial production	**4,1**	3,0	2,3	**4,4**	**3,8**	**1,4**	2,4	1,6	3,1	3,1	1,7
Unemployment (%)	**5,5**	5,2	5,0	**5,4**	**5,3**	**5,1**	5,1	5,2	5,1	5,0	5,0
Fed Funds	**1,35**	3,16	4,34	**1,95**	**2,47**	**2,94**	3,48	3,75	3,95	4,34	4,61
10-year yield	**4,27**	4,31	5,21	**4,17**	**4,30**	**4,16**	4,29	4,49	4,79	5,11	5,42
Effective exch.rate (1990=100)	**85,4**	83,1	81,7	**81,8**	**81,3**	**83,5**	84,7	83,1	82,3	81,7	81,4

Percentage annualised growth rates over previous period, if not otherwise specified.

Euro Area

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- The downward growth revisions for the eurozone at the beginning of the year leave our 2005 estimate at 1.3%, down from 1.4% in June.
- We have slightly revised our growth estimate for 2006 to 1.8%, from 1.9% in June. Our scenario is basically unchanged.
- High oil prices will weigh on growth between end-2005 and early 2006 but the impact should be offset by a more favourable exchange rate.
- Domestic demand is key in this faster growth phase.
- A more favourable employment outlook, together with tax cuts in Spain and probably in France, should boost disposable income and consumer spending.
- But the real good news could be the upturn of the German construction sector, which has been almost in freefall for about ten years.
- Higher earnings, increasing profitability and still-accommodative monetary conditions for much of 2006 should translate into a more sustained pace of investments.
- Looming elections in Italy, France and the Netherlands will boost public expenditure. The eurozone deficit will remain at 3.1% of GDP, public debt rising.
- High oil prices will continue to put pressure on consumer inflation until March 2006. Underlying pressures are still manageable. We think eurozone inflation will stand at an annual average of 2%, from an estimated 2.2% in 2005.
- The ECB is waiting for a confirmation of a domestic demand recovery, which we expect, and should start raising interest rates from mid-2006.

Growth will return to trend despite high oil prices

Our forecast is that, after the spring slowdown, growth in the eurozone will resume in line with trend, at 0.4% q/q, in the second half of the year. Risks to our estimates are still mainly to the downside: our scenario might seem bullish, given that the trend in oil prices over the past few months has led us to revise our Brent price estimates up by 20% for 2006. High oil prices will continue to weigh on growth in late 2005 and early 2006, but the impact should be offset by a more favourable exchange rate. We are therefore revising our growth estimate for 2006 down only slightly, to 1.8% (from 1.9% in June).

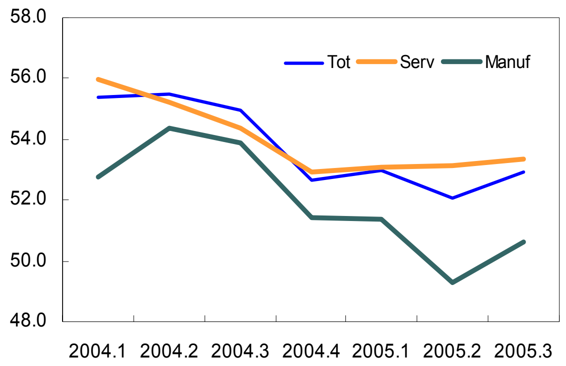
For the time being, the information available for July and August shows an improved economic climate. The composite PMI has in fact settled on average above its 2Q level, while the confidence indicator of the European Commission rose in August for the third consecutive month and is now 1.3 points above June's level.

A better exchange rate is providing relief to manufacturing

The depreciation of the euro and increasing global demand gave relief to the manufacturing sector in July and August, thus boosting output expectations. Companies are reporting increasing domestic and foreign orders. The manufacturing PMI jumped in July, and corrected only partially in August, remaining on average above the level of the second quarter. Real data shows moderate progress in industrial production in July, in the wake of strong recoveries in Germany and, to a lesser extent, in Italy. On the other hand, France's output was disappointing.

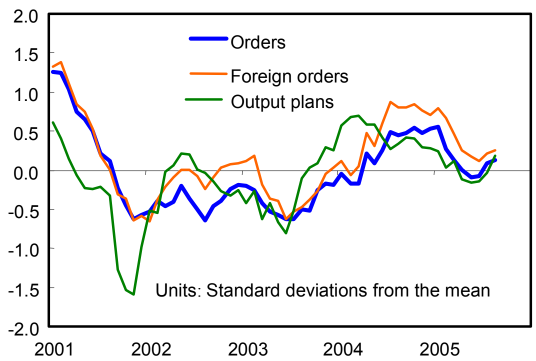
The improvement in the service sector was less pronounced, but the PMI is still above 50, which is consistent with flat output growth. Export data for July shows a slowdown in Germany, France and Italy.

Fig. 1 – Improved general economic climates



Source: NTC research and Banca Intesa

Fig. 2 – Rising output expectations and manufacturing orders



Source: EU Commission and Banca Intesa

However, the improvement of the manufacturing PMI excluding the eurozone bodes well for a recovery in August and September. On average, we expect European exports in 3Q to perform in line with the positive trend observed in 2Q05.

The main driver of this period of positive growth is domestic demand

However, in this phase of more sustained growth, domestic demand will be key both in the second half of this year and in 2006. In our opinion, domestic demand will rise on average by 1.2% until the end of the year and should further accelerate to 1.7% y/y in 2006.

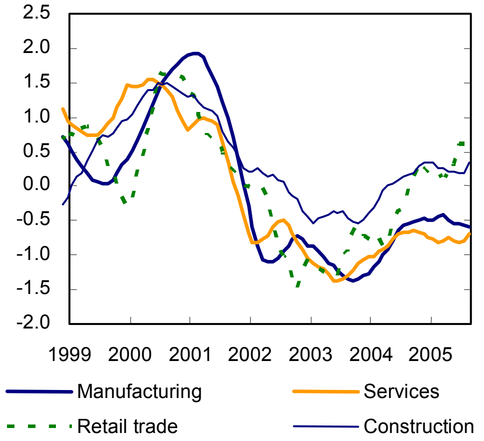
But why are we so confident about a revival of domestic demand in the eurozone?

Progress will be driven by consumption and investment. According to our estimates, as early as the third quarter of this year household consumption will increase by 0.4% q/q, after the spring lull. The push is likely to come from a recovery of consumer spending in France which, according to retail data, should rise by around 1.0% q/q. Spain will also do well, while consumer spending will slow down only slightly in Italy, given recent employment trends. German consumers cannot be counted on, however. Spending may slow down temporarily in late 2005 and early 2006: we do not rule out a correction in France and some volatility in Germany, especially if the proposed VAT increase is approved. Healthcare reform in the Netherlands is also likely to have an impact.

Increased employment and tax cuts will buoy up income and consumer spending

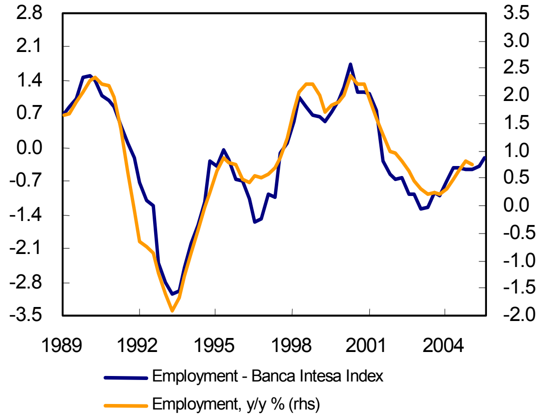
In 2006 we see a further acceleration of consumer spending in the eurozone, as disposable income rises. While real salaries are likely to remain fairly steady, we think the employment outlook may be improving (see chart 4). Banca Intesa's indicator points to an acceleration of y/y growth to around 1% as early as the third quarter. Further support to disposable income and consumption will come from the tax cuts approved in Spain and the Netherlands and those likely to be approved in France.

Fig. 3 – A better outlook for employment



Source: NTC research and Banca Intesa

Fig. 4 – An increased employment growth rate should bolster disposable income

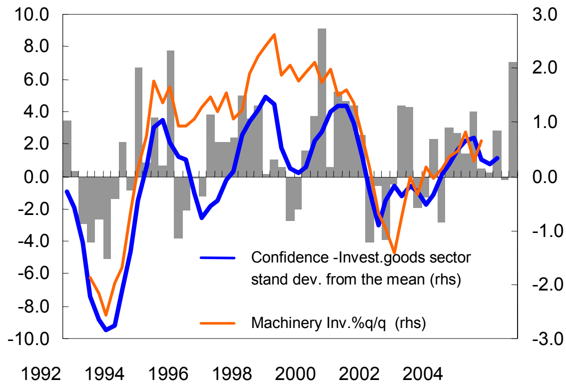


Source: EU Commission and Banca Intesa

Finally, capital expenditure picks up

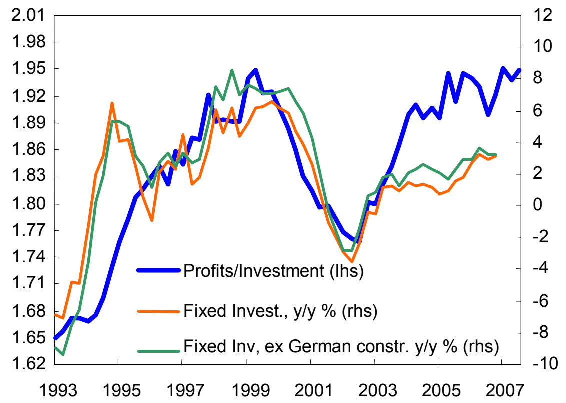
Domestic demand is also likely to be propelled by fixed asset investments. Although corporate earnings in the eurozone have been growing steadily over the past two years, investments have been falling. Historically, a rising profits-to-investment ratio went hand in hand with accelerating investments. However, a gap between these two variables has opened since the end of 2003. EU investments are affected to some extent by the re-investment of profits in emerging countries. However, we think at least some existing European production capacity will have to be replaced. It is probable that the uncertainty that has dominated over the past two years has prompted European companies to postpone spending decisions. However, the trend in orders for German manufactured goods – which have a one-quarter lead time over investments in machinery – is consistent with acceleration at the beginning of 2006. Further support to investment spending should come from financial conditions, which will remain largely accommodative for much of 2006: we anticipate the first interest rate increase as late as June of next year.

Fig. 5 – Trends in German manufacturing orders signal acceleration of EU investments



Source: Eurostat, Bundesbank and Banca Intesa

Fig. 6 – A rising earnings-to-investment ratio bodes well for a more positive investment cycle in the EU



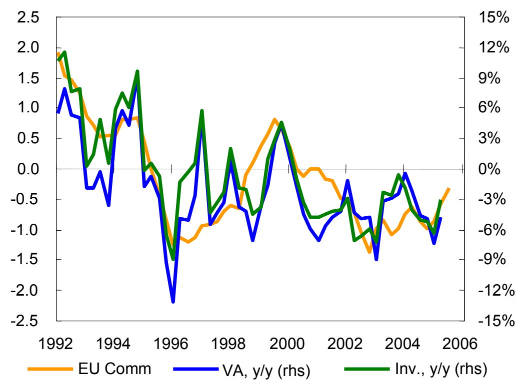
Source: Eurostat, Bundesbank and Banca Intesa

But the real good news is about the German construction sector

But the most important development, which to some extent justifies our most bullish growth scenario for 2006, is that the German construction sector is close to a rebound, and the sector might find solid standing ground after freefalling for about ten years. What at the beginning of the year appeared to be just an improved confidence climate is now translating into solid real data. The fundamentals seem to corroborate the notion that the sector is now back on track.

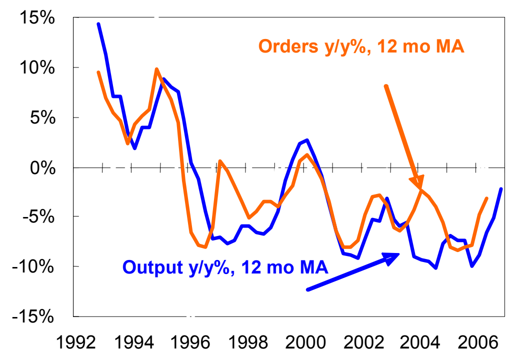
The overall confidence climate started improving at the end of 2002, and reached a four-year high in August. We tend to believe that the improvement is quite solid, given the streaming flow of orders and firms' intention to increase their headcount. National accounts data on both construction investments and value added showed signs of improvement for the sector in 2Q05: after the sharp falls of 3.3% q/q and 6.4% y/y in 1Q05, construction investments decreased by just 0.2% q/q and 4.7% y/y in the second quarter. Value added rose by 1.7% q/q after a drop of 3.4% q/q in the winter months. Orders data is consistent with a positive growth rate for output in 3Q05. We therefore think that the German construction industry hit the bottom at the beginning of the year and that, from the end of 2005, it could go from highly negative growth rates to stagnation or to slightly positive growth. A turnaround in the construction sector would impart a measure of vigour to growth in Germany and the eurozone, since over the last ten years, the construction sector has shaved an average of 0.5% off Germany's GDP growth.

Fig. 7 – In August, confidence in the German construction sector reached its highest level since 2001



Source: EU Commission, Bundesbank and Banca Intesa

Fig. 8 – The flow of new orders is consistent with a less negative growth rate in 3Q05



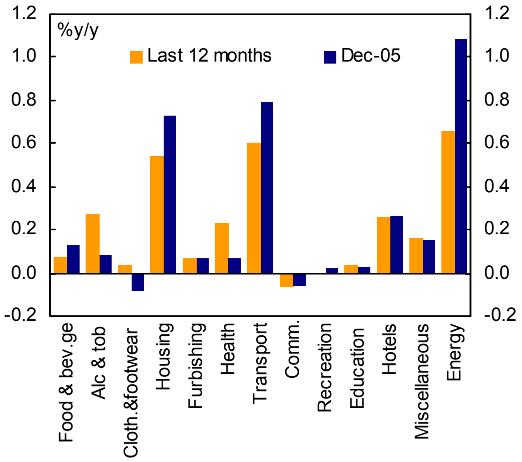
Source: Bundesbank and Banca Intesa

With public spending rising, the deficit will not improve in 2006 either

We should not underestimate the stimulus to growth coming from public spending in 2006, an election year in Italy and a pre-election period in France and the Netherlands. Overall, we see public spending rising by 1.7%, compared to the estimated 1.0% for 2005. The bad news is that the eurozone deficit will continue to rise, to 3.2% from 2.7% in 2004. The debt/GDP ratio will thus touch 72% by the end of 2006.

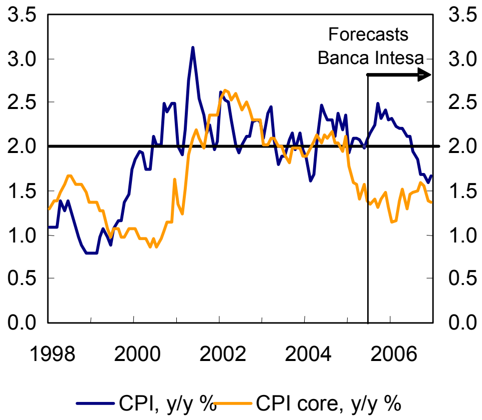
Moving on to inflation and monetary policy, energy will continue to put upward pressures on consumer prices until March 2006. But a gradual decrease in oil prices in 2006 should deflate inflation to below 2% in the second half of the year. On average for the year, we see inflation in the eurozone declining to 2.0%, from an estimated 2.2% in 2005. Underlying inflation pressures will remain in check for much of next year. The average yearly core inflation will settle at 1.4%, from an estimated 1.5% this year.

Fig. 9 – Energy will continue to weigh on consumer prices until March 2006



Source: Eurostat and Banca Intesa

Fig. 10 – Underlying inflation pressures will remain in check



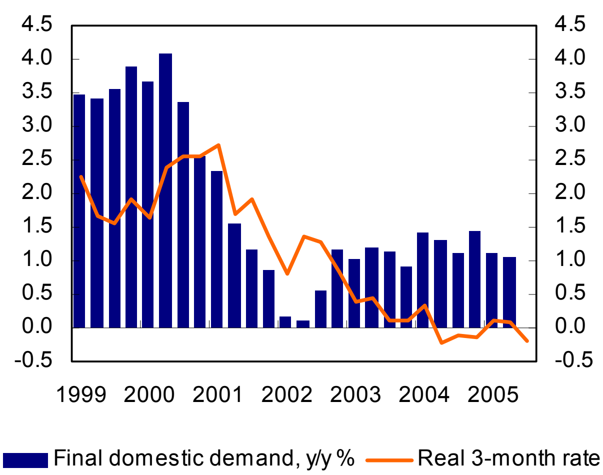
Source: Eurostat and Banca Intesa

Monetary policy: rates on hold until mid-2006

Current monetary policy will remain appropriate for several months yet

At the meeting on 6 October, the ECB will leave the refi rate unchanged at 2% for the 28th month in a row, and no changes are in sight in the coming months either. As the President Trichet has repeatedly said, rates are deemed appropriate and there is no need to change them in either direction in the short term. However, it is clear that the ECB's inclination is currently for a rate hike, which has not been implemented yet due to the fragility of domestic demand. **Based on the forecast of a steady but sustainable improvement in the domestic economy in the coming quarters, we expect the current ultra-accommodating monetary policy phase to end in the course of next year.**

Real rates at historical lows



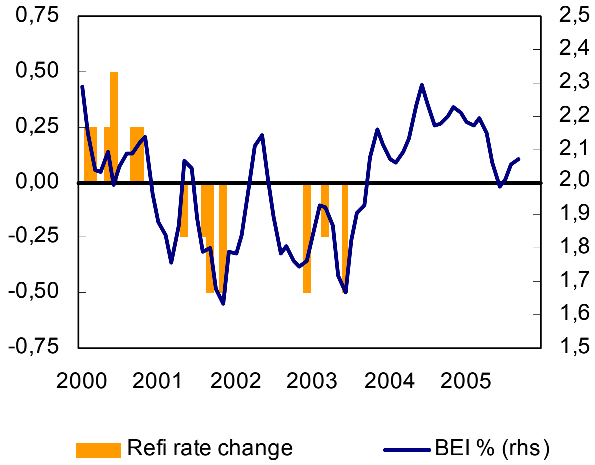
The accommodating stance is justified by the uncertainty surrounding domestic demand

The anomaly lies in a **negative level of real rates** (-0.3% according to our estimates in 4Q05), in the context of domestic demand that, in spite of everything, is proving quite resistant to the oil price shocks. The variability of confidence and the situation in Germany, where domestic demand is only now starting to show some signs of life, have persuaded the central bank to maintain an accommodating bias, allowing the **headline CPI to remain stubbornly above 2%** since, in the absence of pressures from demand and wages, the trend in the core CPI has proved contained and inflation expectations have regarded the energy price spikes as transitory.

This adds to the build-up of excess liquidity and the growth in property prices

The downside to such a policy is that it has created the conditions for a marked acceleration in credit demand, notably in the residential real estate sector. Excess liquidity coupled with overvalued property prices is the main cause for concern vis-à-vis price and financial system stability in the medium term. In addition, **the trend in inflation expectations has become less reassuring in recent months.** Breakeven inflation on linkers has started rising again in the last two months, interrupting a downtrend stretching back to June 2004. At the same time, **consumer expectations have been rising since end-2004 in tandem with the oil price spikes** and are now at their highest level since 2002. In light of the recent fresh spike in the price of Brent crude, the forecasts for this variable and the CPI in general, the trend in inflation expectations is unlikely to reverse in the coming months.

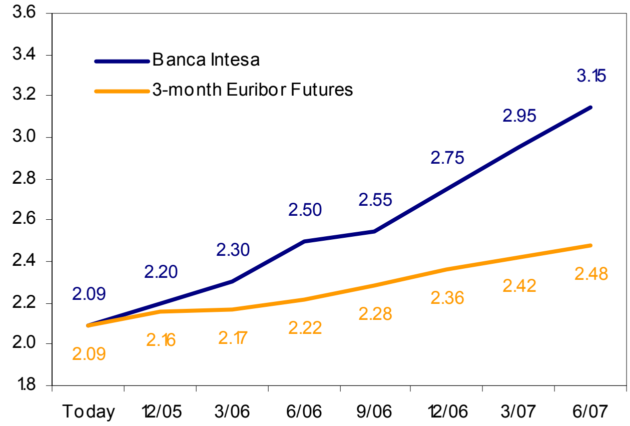
Inflation expectations rose during the summer



Normalisation should begin in 2006, but the markets do not believe it

In conclusion, the ECB seems set on maintaining the status quo for several months yet, in anticipation of more robust signs that domestic demand is growing. This would create the conditions for the central bank to respond to the rise in inflation expectations and start normalising the monetary policy stance in a bid to absorb some of the excess liquidity and check the growth in property prices. **The key variable in respect of the timing of the rate moves will therefore be growth in consumption and investments** which, according to our estimates, might near 2% in 1H06. **Our forecast is more aggressive than that envisaged by the Euribor futures market, which does not see any rate hikes until 2007 at the earliest.**

The market envisages no change in rates until 2007



German elections: waiting for the green light

As far as the financial markets are concerned, the results of Germany's elections on 18 September could not have been worse for the needs of Germany and Europe. However, **the situation is still fluid** and it is still not written that Germany ends up being ruled by a Grosse Koalition between CDU and SPD for the next four years. **The make-up of the new government will have an substantial impact on the financial markets, which will closely follow the talks between the parties.** The deadline for the election of the new Chancellor is 18 October: should there be no agreement, Germany would return to the ballot box. Undoubtedly, **the mood of uncertainty that will endure up until the formation of a government will weigh heavily on the morale of the markets, especially equities, which have already dragged down the Dax vs. other European bourses.**

Angela Merkel's CDU has the relative majority, but its advantage over the SPD is slight

From a practical standpoint, the vote gave a **relative majority to the CDU** of Angela Merkel, who should be the next Chancellor, **but the margin over Schroeder's SPD is just three seats (225 vs. 222)**. The liberal FDP party, an ally of the CDU, won 61 seats while the Greens, allies of the SPD, won 51, which are not enough to give the formations the majority in the Bundestag, which is at least 307 seats. The New Left, which stands to the left of the SPD, surprisingly won 54 seats, taking votes mainly from the two major parties, and in theory it could shift the balance of power to the left. However, the SPD has categorically ruled out working with the New Left party created by ex-members of the SPD itself. The possible solutions to the impasse are either a Grosse Koalition between CDU and SPD or a three-party solution, which would be new for Germany, following a coalition switch by either the Greens or the FDP. The latter have however said they are utterly opposed to any collaboration with the SPD, leaving just **two alternatives in play: the Grosse Koalition and the "Jamaika Koalition" between CDU, FDP and Greens.**

The talks between the parties will continue over the coming days. A wait-and-see phase is likely since the results will not be final until early October[4], and the

[4] *One district of Dresden votes on 2 October due to the sudden death of a candidate. The seats assigned should not affect the CDU's current relative majority. In 2002 all three seats were won by the CDU and the projections say that the CDU will win at least one seat this year.*

election of the new Chancellor would not be possible in any case. The initial skirmishes, characterised by intransigence on the part of the FDP and the Greens, could rapidly soften if the popularity of the *Jamaika Koalition* among German voters continues to grow, as happened in the immediate aftermath of the vote.

A CDU-FDP-Greens coalition could govern effectively

This latter solution might prove more workable than the Grosse Koalition in designing structural reforms in key areas such as the labour market and taxation, since the manifestos and electoral bases of the parties have more points of similarity. It would also be preferable because it would reduce the tensions stemming from a clash of personalities within a Grosse Koalition. The leadership of the CDU, and Merkel herself, would not be called into question, at least in the first half of the government's term, and if anything the two wings, FDP and Greens, might help mediate on some of the more controversial issues, such as the hike in VAT to which both are opposed.

The Jamaika Koalition might exploit the fundamental proximity of views between the three parties on the need to liberalise and make more flexible the labour and product markets, and to simplify the tax system by reducing rates and sorting out the tangle of exemptions, deductions and special treatments which in 2003 secured for Germany the accolade of least efficient tax system from the World Economic Forum. One **inevitable area of conflict would be energy policy**, with the Greens opposed to the CDU-FDP idea of extending the working life of the nuclear power plants, but this issue is not so urgent and crucial for the Christian-Liberals as to rule out any mediation. Another source of dispute relates to the method of healthcare system reform, but, given the shared awareness of the need to reduce its weight within the tax system and the labour cost, a compromise should be achievable.

The Grosse Koalition is the worst case scenario

By contrast, finding shared solutions between the parties in a Grosse Koalition would not be simple. The solutions proposed in their respective manifestos showed a marked divergence of positions, largely due to the shift towards a more social policy by the SPD, keen to recoup support among a grass roots dissatisfied with the initiatives taken under Agenda 2010. The main advantage of a CDU-SPD government would thus lie in a broad majority in both houses of parliament, but on the practical front German legislative activity would continue on the lines of the last two years, when in practice the country was led by a CDU-SPD coalition.

The Jamaika Koalition is the solution preferred by business

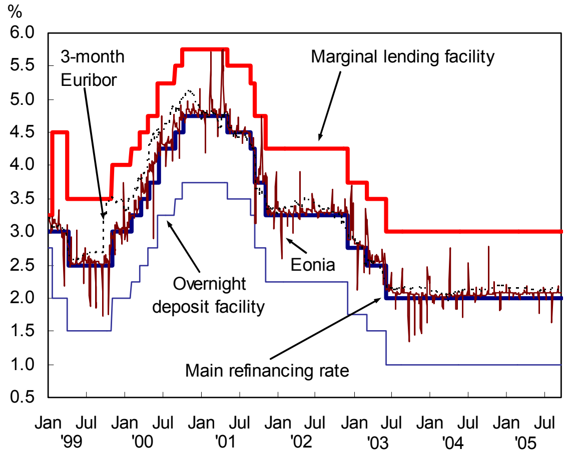
It is this which has spooked the markets, prompting them to penalise euro-denominated assets, and German assets in particular. But **if the *Grosse Koalition* is the worst case scenario, we see some reason for cautious optimism.** There would not be a marked deterioration in the political situation compared with the last few years, leaving the task of overhauling Germany's productive system to the reforming pressure arriving from below. Therefore, once the disappointment at a missed opportunity has been digested, we believe the reasons that led to the outperformance of the Dax vs. the other European indices from the launch of Agenda 2010 in March 2003 through to August 2005 will ultimately prevail. **If, on the other hand, the Jamaika Koalition were to be in power for the next four years, the implications both for the macroeconomic outlook and the financial markets would have to improve sharply if, as revealed in a survey by Financial Times Deutschland, firms consider it to be "*the best coalition possible*".**

Euro Area

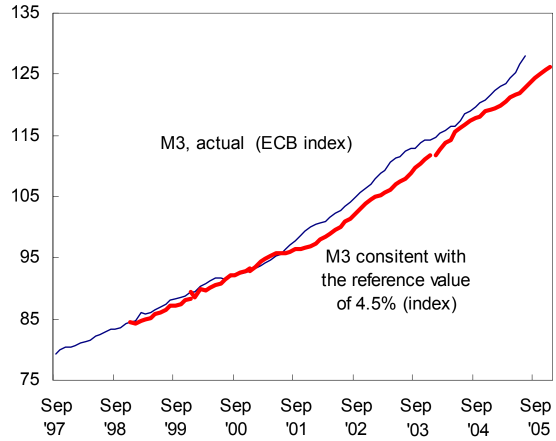
	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	**1,8**	1,3	1,8	**1,5**	**1,3**	**1,1**	1,3	1,6	1,5	1,8	1,8
- q/q change				**0,2**	**0,4**	**0,3**	0,4	0,4	0,3	0,6	0,4
Private consumption	**1,4**	1,2	1,3	**0,8**	**0,2**	**-0,1**	0,4	0,4	0,3	0,3	0,4
Fixed investment	**1,3**	1,3	3,0	**0,4**	**-0,2**	**0,2**	1,1	0,6	0,8	0,7	0,8
Government consumption	**1,1**	1,0	1,7	**-0,3**	**0,5**	**0,3**	0,2	0,3	0,8	0,1	0,4
Export	**6,0**	3,9	5,5	**0,5**	**-0,7**	**2,1**	1,8	1,5	1,2	1,1	0,9
Import	**6,1**	4,1	5,4	**1,4**	**-1,4**	**2,1**	1,3	1,4	1,2	1,2	1,2
Stockbuilding (% contrib. to GDP)	**0,4**	0,2	-0,1	**0,0**	**-0,1**	**0,2**	-0,3	-0,1	-0,2	0,2	0,1
Current account (% of GDP)	**0,6**	-0,1	-0,2	**0,4**	**0,2**	**0,0**	-0,2	-0,3	-0,3	-0,2	-0,2
Deficit (% of GDP)	**-2,7**	-3,1	-3,2								
Debt (% of GDP)	**70,6**	71,2	71,8								
CPI (y/y)	**2,1**	2,2	2,0	**2,3**	**2,0**	**2,0**	2,3	2,3	2,2	2,1	1,8
Industrial production (y/y)	**1,9**	0,9	1,3	**-0,2**	**0,1**	**0,4**	0,5	0,3	0,1	0,0	1,0
Unemployment (%)	**8,9**	8,7	8,4	**8,8**	**8,8**	**8,7**	8,6	8,6	8,5	8,5	8,4
3-month Euribor	**2,11**	2,13	2,42	**2,16**	**2,14**	**2,12**	2,13	2,11	2,12	2,25	2,55
10-year yield	**4,06**	3,33	3,41	**3,79**	**3,62**	**3,34**	3,19	3,16	3,27	3,30	3,43
EUR/USD	**1,24**	1,25	1,25	**1,30**	**1,31**	**1,26**	1,22	1,22	1,24	1,26	1,26

Percentage variations over previous period, if not otherwise specified.

Main short-term rates



Monetary aggregates dynamics



Germany

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The wide swings of Germany's quarterly GDP growth do not reflect the rather sluggish performance of the relevant indicators. Another example is likely in 3Q05, with an increase of 0.5% q/q, compared with 0% in 2Q05. However, the underlying performance of the economy is consistent with a moderate improvement that has been under way since the end of 2003. With the exception of retail sales, the most recent figures on demand components point to a sustainable recovery towards the end of 2005 and in 2006, despite skyrocketing oil prices. Domestic demand, however is picking up. The services PMI reverted to the levels seen at the end of 2000, confidence in the construction sector is at a four-year high, unemployment fears are at record lows since the end of 2002, and consumers' spending intentions at their highest since 2001. Furthermore, 300,000 new jobs have been created since the end of 2003, and the rate of unemployment, as defined by ILO, has returned to the level prevailing at that time. Lastly, German companies' earnings rose by a robust 3.5%, y/y in 1H05, compared with 5.5% for 2004 as a whole. All this is indicative of a resurgence in domestic demand which, along with exports, is likely to drive the recovery. This process might be limited by inventories, as after three years of (probably unintentional) positive contributions of around 0.5% on average per annum, the trend could reverse in 2006. Compared with June, we confirm our estimate of 1% for 2005 and raise that for 2006 from 1.3% to 1.4%.

Rising oil prices prevented the CPI from slowing down, after the effects of the tax measures in 2004 faded: we expect it to accelerate to 1.9% in 2005, up from 1.8% in 2004. Stripping out energy and government-set prices, the CPI has been rising at a rate of 1% since mid-2003: there are no inflationary pressures and Germany remains on the verge of excessive disinflation. We do not expect the situation to change in 2006.

There seems to be no improvement in the country's public finances, despite good results following the reform of unemployment benefits, as growth is still too weak and dependent on foreign demand. The estimated nominal growth for 2005/2006 is 0.8% on average, which is below the finance ministry's expectations. This makes it unlikely that the deficit/GDP ratio will fall below 3% before 2007. Without measures to curb spending, debt will increase to 73% of GDP by the end of the decade.

Germany

	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (1995 prices, y/y)	**1,1**	1,0	1,4	**0,5**	**0,8**	**0,6**	1,1	1,6	1,1	1,5	1,4
- q/q change				**-0,1**	**0,8**	**0,0**	0,5	0,3	0,3	0,5	0,4
Private consumption	**0,2**	-0,1	1,0	**0,8**	**-0,5**	**-0,3**	0,1	0,4	0,2	0,3	0,4
Fixed investment	**-1,5**	0,0	3,1	**-0,4**	**-1,2**	**0,2**	2,0	0,0	0,6	1,1	0,7
Government consumption	**-1,6**	-0,4	0,7	**-1,9**	**0,6**	**0,6**	-0,2	0,1	0,2	0,1	0,2
Export	**8,3**	5,7	6,0	**0,5**	**2,5**	**1,2**	1,6	1,9	1,6	1,2	1,0
Import	**6,1**	5,3	7,2	**0,5**	**-0,6**	**2,3**	2,6	2,8	1,4	0,0	1,8
Stockbuilding (% contrib. to GDP)	**0,5**	0,7	0,3	**-0,1**	**-0,1**	**0,4**	0,4	0,4	-0,2	-0,5	0,2
Current account (% of GDP)	**3,8**	3,8	3,4	**3,6**	**5,1**	**4,1**	2,8	3,2	3,8	3,6	3,0
Deficit (% of GDP)	**-3,7**	-3,6	-3,3								
Debt (% of GDP)	**66,1**	68,6	70,1								
CPI (y/y)	**1,8**	1,9	1,6	**2,1**	**1,7**	**1,6**	2,0	2,0	2,2	1,8	1,3
Industrial production (y/y)	**2,4**	2,1	1,6	**0,0**	**0,9**	**0,6**	0,9	-0,4	0,4	0,3	0,9
Unemployment (%)	**10,6**	11,6	11,0	**10,7**	**11,7**	**11,8**	11,6	11,4	11,3	11,1	10,9

Percentage variations over previous period, if not otherwise specified.

France

France should continue to stand out for its slightly above-average performance. We maintain our growth estimate for France at 1.6%, the same as in June. In 2006, the French economy should grow by 1.9%. This improved performance can be partly explained by the lower sensitivity of the French manufacturing and service sectors to the vagaries of the oil market, compared to Italy and Germany. This is shown by the input/output matrices for 2001 (see figures 1 and 2 on the next page).

Economic indicators also show that the economy is healthier in France than in the rest of the eurozone. Specifically, the French service sector seems to have entered a more sustained phase of development at the beginning of the summer. The services PMI has posted continuous improvement since April, except for a short pause in June. In August the activity index reached 54.6, well above the level consistent with zero growth and two points higher than the comparable reading for the eurozone. Progress in the manufacturing sector is less sustained, but still more pronounced than in the rest of the eurozone.

On the demand front, exports fell in July. However, the more favourable exchange rate and a recovery in the eurozone should bolster sales abroad.

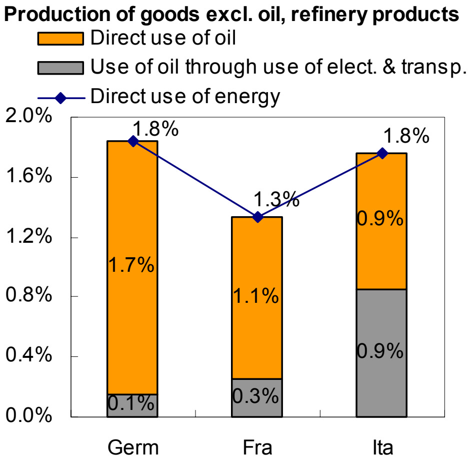
A shop-till-you-drop mania in the summer months set consumer spending en route for a 1.0% rebound, after the 0.3% q/q decrease in the spring. The newly-found spending enthusiasm of French consumers is partly explained by the generous end-of-season discount sales and partly by the fall in the savings rate. Consumer spending, especially in the home appliance segment, was indirectly driven by the buoyant real estate market. It is possible that consumer spending will correct at the end of 2005. In 2006, consumption should resume growth at a sustained pace, and the economic recovery alone should be enough to reduce unemployment. Furthermore, the measures adopted by Dominique de Villepin's government in June should assist employment growth in the medium term. In his mandate, the Prime Minister gave top priority to employment growth, and further measures could be introduced in the 2006 budget. However, this year's budget could see tax cuts to further boost consumer spending.

The partial recovery of productivity following the suspension of the 35-hour working week and particuarly advantageous financing conditions should prop up investments in the next few months. The latest quarterly investment survey by INSEE shows an upward revision of capital expenditure, compared with December. However, a marked rise in commodity prices might seriously jeopardise our estimate of 2.9% investment growth.

As announced in recent weeks, we expect a substantial package of fiscal measures in 2006, the pre-election year. The government has promised to increase expenditure on large infrastructure. The budget should confirm the extent of the fiscal package and the measures to be implemented to bring the budget deficit below 3% of GDP. According to our estimates, both the budget deficit and debt will continue to increase in 2006.

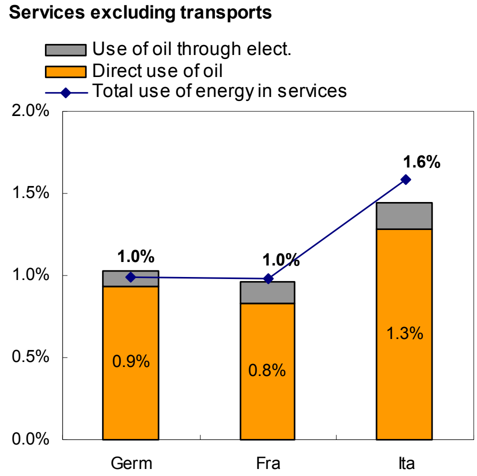
France should therefore continue to grow at slightly above the European average in 2005 and 2006, thanks to brisk investment spending and consumer resilience. However, in the medium term France will struggle to maintain its moderate outperformance compared to the European average unless it is prepared to overhaul its economic model, one of the most protectionist of workers' rights in the eurozone. We expect reforms to be foremost on the agenda of political debate next year.

French manufacturing and ...



Source: Eurostat and Banca Intesa research

... services use less oil than Italy and Germany



Source: Eurostat and Banca Intesa research

Main macroeconomic forecast 2005-2006

	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	2.0	1.6	1.8	2.1	1.9	1.3	1.7	1.4	1.5	1.9	1.8
- q/q change				0.7	0.4	0.1	0.5	0.4	0.5	0.6	0.4
Private consumption	2.3	2.3	2.5	1.2	0.8	-0.3	1.2	0.5	0.6	0.7	0.6
Fixed investment	2.1	2.9	3.1	1.2	1.5	-0.4	0.9	0.8	0.9	0.7	0.8
Government consumption	2.7	1.4	1.7	0.6	0.2	0.3	0.4	0.5	0.4	0.3	0.5
Export	2.0	1.6	2.5	0.8	-0.2	1.0	-0.2	0.9	0.4	0.5	0.9
Import	6.1	4.4	4.6	1.1	0.7	1.3	-0.7	1.3	2.4	1.3	0.2
Stockbuilding (% contrib. to GDP)	0.8	0.2	0.0	-0.3	-0.1	0.4	-0.6	0.0	0.4	0.2	-0.4
Current account (% of GDP)	-0.4	-1.3	-1.2	-0.8	-1.4	-1.5	-1.1	-1.2	-1.2	-1.4	-1.2
Deficit (% of GDP)	-3.7	-3.4	-3.5								
Debt (% of GDP)	65.6	66.0	66.4								
CPI (y/y)	2.3	2.0	2.0	2.3	1.9	1.9	2.0	2.1	2.2	2.1	1.9
Industrial production	1.8	0.7	1.6	1.0	0.0	-0.5	0.8	0.4	0.5	0.5	0.2
Unemployment (%)	10.0	10.1	9.9	10.0	10.1	10.2	10.1	10.0	10.0	9.9	9.9
Effective exch.rate (1990=100)	107.4	107.9	107.9	108.3	108.5	107.8	107.7	107.5	107.5	107.8	108.0

Percentage variations over previous period, if not otherwise specified.

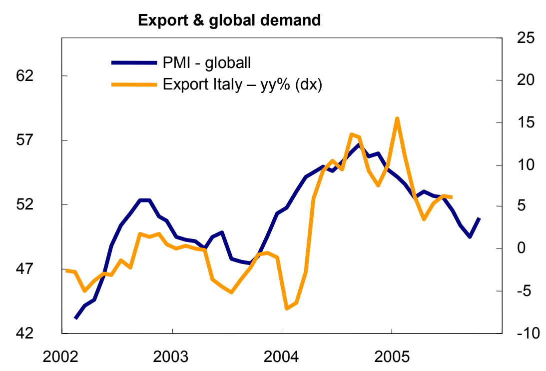
Italy: the worst is over

After the disastrous results of late 2004 and early 2005, the Italian economy staged a surprising performance in the spring months. GDP shot up 0.7% q/q in the second quarter, a jump the like of which we had not seen since the beginning of 2001. The economic recovery is partly explained with the significant rise of domestic demand, particularly household consumption. Exports posted a brilliant 5.5% q/q increase, aided by a favourable exchange rate and higher global demand. But this is history, and although history sometimes repeats itself, in light of the latest information available, we feel that growth in the second half of the year will not be as vigorous as in spring.

Certainly, current economic conditions are more favourable and still slightly better than in the spring months for the time being. On the domestic demand front, the only figures available for the third quarter are car registrations for July and August, which are consistent with higher car sales in the third quarter. Durable spending may still have shown resilience in the summer months, even though the ISAE survey points to deteriorating spending intentions. **Salary trends should translate into a level of consumer spending in line with that seen during the spring (+0.6% q/q)**. Business investment rebounded, rising 2.0% q/q compared to 1.9% q/q in the preceding period. Inventory data showed a recovery of domestic demand. Machinery investments may well continue to grow in the second half of the year. However, we think that, unless the present favourable economic conditions take a firmer hold, investments are unlikely to grow at the pace seen in the late 90s, and companies will not spend more than what is necessary to replace existing productive capacity.

Foreign trade continued to send positive signals. Indeed, the ISAE survey and the PMI show accelerating foreign demand.

Fig. 1 – Improving global demand



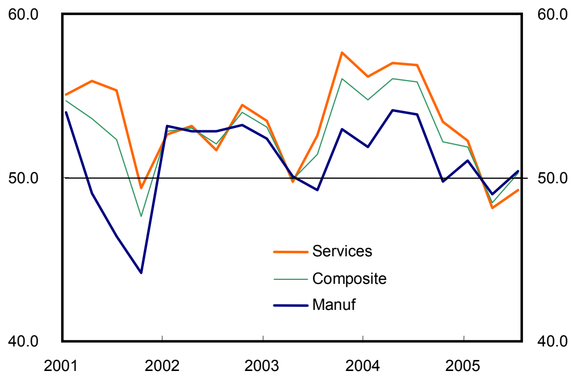
Source: NTC, Istat and Banca Intesa

Extra EU exports slowed down in July (+0.9% m/m after +3.2% m/m in June). However, a more favourable exchange rate should continue to provide support to exports and output. The trend in the PMIs in other industrialised countries suggest a moderate acceleration of global demand, which should benefit Italian exports.

On the supply side, the ISAE survey showed encouraging signals in July and August, gaining two and a half points. Italian firms reported an increasing order backlog and revised upward future output expectations. The PMI rose nearly four points between May and July, and at a level of 50.8 is consistent with slightly positive growth in manufacturing output. The more favourable economic conditions do not concern manufacturing alone, but services as well. The composite PMI jumped by nearly two points in July, partly correcting in August, and remained on average above the level achieved in 2Q05. On the other hand, improved confidence indices might not mean much for 3Q05 growth estimates. This is because over the past six months there has been little consistency between supply-side indicators, especially the ISAE surveys and the PMI, and manufacturing output and value added in services. Besides, the PMI composite is at a level consistent with near-zero economic growth.

The only real data available on the supply side is July's manufacturing output, which marked an entry into 3Q05 above average expectations. However, the q/q change was negative. Making predictions on August is always very difficult but, even assuming a slightly positive change until September, it is unlikely that manufacturing output will rise at the same rate as in the spring months (+0.7% q/q).

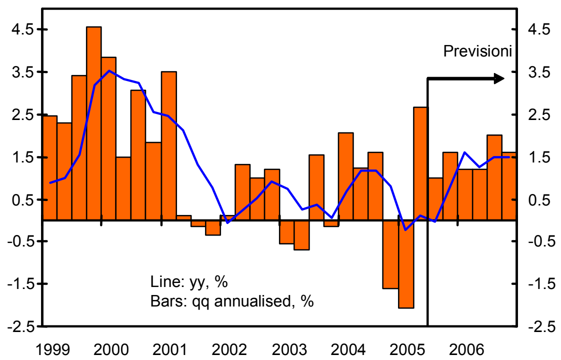
Fig. 2 – Improving confidence but at levels consistent with a slightly positive growth rate



Source: NTC, Istat and Banca Intesa

Barring a sharp boost from services, Italy's GDP may disappoint once again in the third quarter. Thus, the prudent thing to do is to assume a 0.3% q/q growth rate in the summer and a slight acceleration to 0.4% q/q by year-end. **Overall, GDP should end 2005 in positive territory, gaining 0.2%**.

Fig. 3 – GDP unlikely to repeat its spring performance



Source: Istat and Banca Intesa

Although the Italian recession is technically over, average growth for the first six months has been only slightly positive—which more accurately reflects Italy's actual state of health.

It is clear that manufacturing and the Italian economy are finding some relief in the depreciation of the exchange rate and in more favourable demand levels. However, we still think that the long-term crisis that has hit the Italian industrial sector over the past two years will not be solved merely by an upturn in the economic cycle. The loss of competitiveness on international markets reflects an increase in the cost of labour in excess of the European average. Structural reforms designed to restore price competitiveness in manufacturing and services are necessary. In the absence of any such measures, it is unlikely that Italy will achieve growth in line with the European average.

For 2006, we see Italy's growth accelerating to 1.4%, in line with trend. The revision of our growth estimates, compared with June, reflects a slightly higher entry point into the new year. We think that a more favourable exchange rate and still-brisk global demand should aid exports, though only moderately. Italian firms could then continue to replace existing productive capacity, as they did in the second quarter of this year. Overall, we see capital expenditure rising by 3.3% on average for the year, after a negative 0.3% estimate for the current year. The resilience of the labour market and a more favourable employment outlook, as indicated in business surveys, should cause employment to increase at least at the same rate as that in the first half of 2005: 0.6% y/y. Consequently, we expect consumer spending to step up to around 1.4%, after a positive 1.0% estimate for this year.

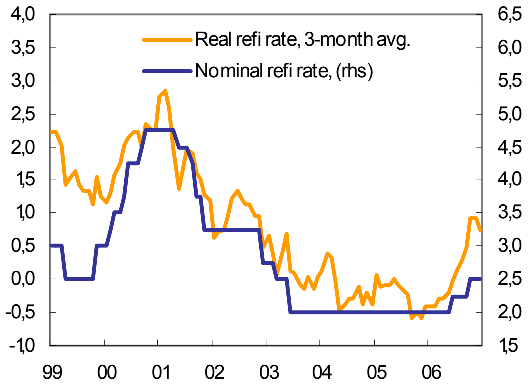
We do not think the government's proposals in view of the 2006 budget include effective measures to encourage growth and to keep the budget deficit under control. The recent replacement of the economy minister may also involve radical changes in the overall set-up. The information currently available indicates a EUR 20.5 billion budget. Of this, EUR 11.5 billion is to be used to reduce the deficit by an amount equivalent to 0.8% of GDP, while the remaining EUR 9 billion will be earmarked for growth. The government looks set to spend EUR 3 billion on investment and employment and another EUR 4.6 billion on a development fund. As of now there are no specific indications as to exactly how these funds will be used. In the absence of further details on the specific measures, the risk is that this budget will end up increasing spending without stimulating growth, thus jeopardising attempts to reduce the deficit.

Italy – Main macroeconomic forecasts

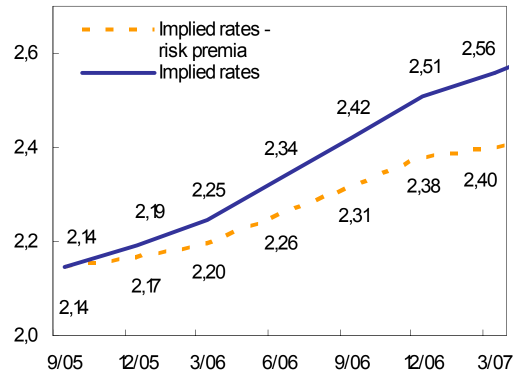
	2002	2003	2004	2005	2006	2005				2006	
						1	2	3	4	1	2
GDP (constant prices)	0.4	0.4	1.0	0.2	1.4	-0.2	0.1	0.0	0.7	1.6	1.2
- q/q change						-0.5	0.7	0.3	0.4	0.3	0.3
Private consumption	0.4	1.4	1.0	1.1	1.4	0.1	0.6	0.4	0.4	0.3	0.3
Government consumption	1.9	2.3	0.7	1.0	1.6	0.1	0.3	0.2	0.5	0.4	0.4
Fixed investment	1.3	-1.8	1.9	-0.6	3.3	-0.8	1.5	1.0	0.7	0.7	0.7
Export	-3.2	-1.9	3.2	-0.3	3.7	-4.7	5.5	0.5	2.0	-0.5	0.6
Import	-0.5	1.3	2.5	2.2	5.3	-2.9	4.8	0.5	1.0	1.5	1.0
Contrib to GDP%											
External trade	-0.8	-0.9	0.2	-0.7	-0.5	-0.5	0.2	0.0	0.3	-0.6	-0.1
Final domestic demand	0.8	0.9	1.1	0.7	1.8	-0.1	0.8	0.5	0.4	0.4	0.4
Stockbuilding (% of GDP)	0.4	0.4	-0.3	0.2	0.0	0.1	-0.3	-0.2	-0.4	0.5	0.0
Current account (% of GDP)	0.7	-0.5	-0.1	-0.8	-1.3	-2.0	-2.5	1.3	-1.8	-1.8	-2.1
Budget balance (% of GDP)	-2.7	-3.2	-3.2	-4.4	-4.6						
Debt (% of GDP)	108.3	106.8	106.6	108.3	108.3						
CPI (y/y)	2.5	2.7	2.2	2.0	2.1	1.9	1.8	2.2	2.2	2.2	2.3
Industrial production	-0.6	-0.6	-1.3	0.4	1.4	-2.3	-1.5	-1.4	0.2	1.4	-0.1
Unemployment (%)	8.7	8.4	8.0	7.8	0.0	8.2	8.0	7.9	8.0	7.9	7.7

The situation at a glance

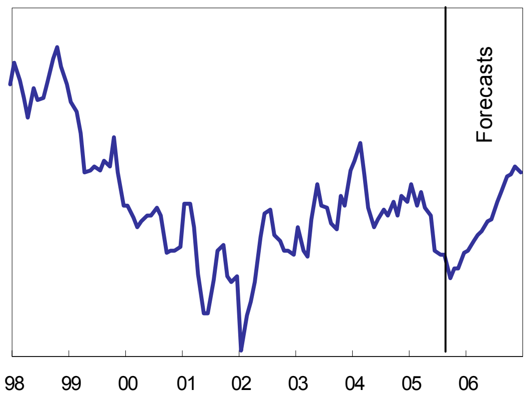
Nominal and real refi rate



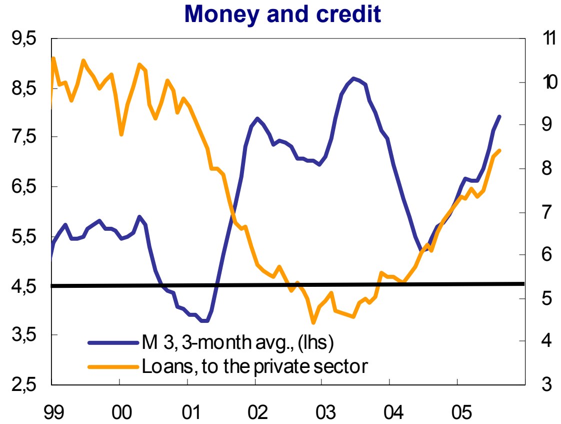
The 3-month Euribor Futures strip curve



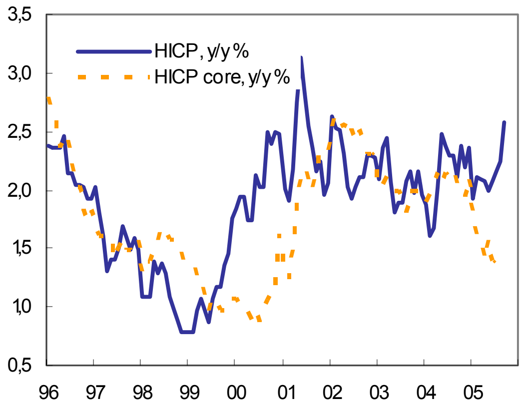
Banca Intesa Monetary Condition Index



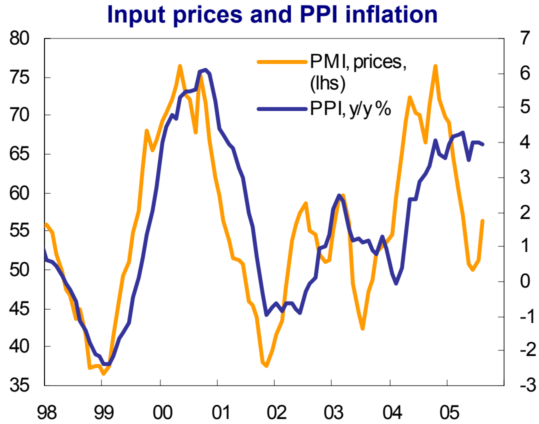
Money and credit



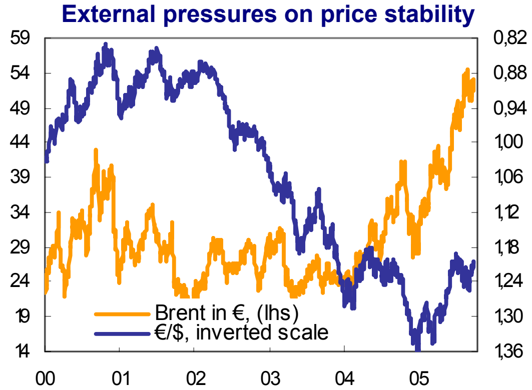
Headline and core inflation



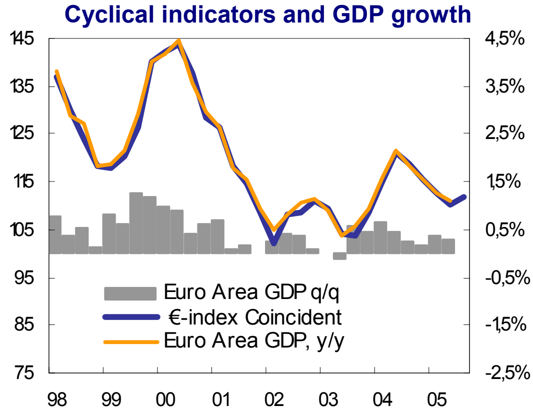
Input prices and PPI inflation



External pressures on price stability



Cyclical indicators and GDP growth



United Kingdom

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Growth estimates for the UK economy have been further revised downward, from 2.4% to 2.0%, falling for the first time since 2002 **slightly below potential**. **Consumer spending has played a key role**, having slowed considerably for the first time in ten years after the noticeable dampening effects on the property sector of the rising interest hikes implemented between 2003 and 2004. The risk in the current phase is a recovery in household spending that is slower and smaller than expectations, after the standstill in the first quarter. Unemployment, low though it may be (2.8%), has been constantly increasing since February, keeping earnings growth in check. Medium-term forecasts see inflation under control, which has had a curbing effect. Rising oil prices do not seem to be a cause for concern (aside from one or two blips), given the resilience of sterling and the high level of competitiveness that forces firms to absorb cost increases instead of passing them on to consumers.

Uncertainties over how and when consumer spending will resume, along with the virtual absence of inflation concerns, are again **fuelling speculation over another interest rate cut, after that in August** (from 4.75% to 4.50%). For the time being, the chances of any such event by the end of the year appear quite slim, but all depends on how consumer spending fares in the third quarter. Estimates point to further improvements on the second quarter, especially because of the low basis for comparison. However, even though they tend to magnify the perception of downturns, business and confidence surveys do not show any turning point yet. As for the other GDP components, the pace of investment is rather brisk, thanks to more favourable financial conditions and high foreign demand. In 2Q05 net exports provided a substantial contribution to growth (0.6%), nearly offset by inventory runoff (down 0.5%)—which, however, should get the third quarter off to a good start. All in all, **3Q05 should show growth of around 0.5% (at least)—the same rate as 2Q05.** A gradually declining exchange rate (the GBP is currently overvalued) will also bolster the manufacturing sector, which will come out of the recession seen in the first half, although the decline will not be enough for exports to keep up with the performance achieved in 2Q05. Lastly, public spending is stepping up, making it unlikely that the deficit/GDP ratio will return below 3% in 2005-2006.

United Kingdom

	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	3,2	2,0	2,5	2,7	2,1	1,8	2,0	2,0	2,2	2,4	2,6
- q/q change				0,6	0,4	0,5	0,5	0,6	0,6	0,6	0,7
Private consumption	3,7	1,7	2,5	0,6	0,1	0,2	0,5	0,6	0,6	0,7	0,7
Fixed investment	4,9	3,2	3,6	-0,2	0,3	1,5	1,0	0,9	0,7	0,8	0,8
Government consumption	3,1	2,1	2,7	0,4	0,7	0,4	1,0	0,7	0,6	0,6	0,6
Export	3,4	5,3	6,0	1,1	-0,9	5,6	0,5	1,3	1,3	1,3	1,3
Import	5,4	4,2	5,8	1,7	-1,2	3,0	0,8	1,5	1,4	1,3	1,4
Stockbuilding (% contrib. to GDP)	0,1	-0,3	-0,2	0,3	0,0	-0,7	0,0	0,0	0,0	0,0	0,0
Current account (% of GDP)	-2,0	-1,9	-2,4	-1,4	-2,0	-1,7	-1,9	-2,2	-2,3	-2,5	-2,5
Deficit (% of GDP)	-3,1	-3,5	-2,6								
Debt (% of GDP)	41,5	42,0	42,5								
RPIX (y/y)	2,2	2,4	3,0	2,3	2,2	2,2	2,6	2,5	2,6	3,0	3,1
Industrial production	0,7	-0,8	0,9	0,1	-0,8	0,0	0,1	0,6	0,7	-0,5	0,5
Unemployment (%)	2,7	2,7	2,8	2,6	2,6	2,7	2,8	2,8	2,8	2,8	2,8
3m GBP Libor	4,59	4,71	4,38	4,84	4,86	4,84	4,62	4,50	4,45	4,40	4,35
Long Gilt	4,87	4,41	4,30	4,65	4,66	4,44	4,29	4,25	4,31	4,31	4,28
GBP/USD	1,83	1,83	1,75	1,86	1,89	1,86	1,78	1,78	1,77	1,76	1,75
Effective exch.rate (1990=100)	104,1	102,2	97,3	102,4	102,9	103,3	101,7	100,9	99,6	98,0	96,7

Japan: positive surprises

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Economic data and the election results in Japan yielded positive surprises for the country's medium-term prospects, bearing out the bullish outlook of our June quarterly report. Domestic demand is now a credible support for growth. As noted repeatedly over the past months, the labour market and salary improvements will be the key drivers behind solid growth in consumer spending and the possible end of deflation.

There were two new developments in the last quarter. First, **the revision of national accounts data, which was significant for the second quarter and more limited for the first, has determined an upward revision of the growth outlook for the year**, lending credibility to a scenario of growth above potential in 2006. Second, the dissolution of parliament in July following Koizumi's parliamentary defeat on the privatisation of the postal service, which turned into an **unprecedented electoral victory as voters showed in no uncertain terms their support for the structural reform process launched by the government**.

Overall, the scenario is positive, with inflation expected to return into positive territory toward year-end and a normalisation of monetary policy seen for the next fiscal year. The fly in the ointment is the public finances, which will be cause for increasing concern as interest rates reach more normal levels. In the meantime, however, the message is to enjoy the honeymoon period of a normalised economy and the shrinking of the huge public sector in Japan, thanks partly to a positive growth scenario.

The election results are a clear mandate for Koizumi

September's elections gave an overwhelming mandate to the government to pursue the privatisation of the postal service. The vote also gave a significantly increased majority to the current coalition in the lower house, as shown in the table below.

Elections: a mandate for postal reform

	September 2005	Pre-election
LDP	296	212
DPJ	113	177
New Komeito	31	34
Japan Communist	9	9
SDP	7	5
People's New Party	4	4
Nippon Party	1	3
Independents*	13	30
Others	6	3
Total seats	**480**	**477**
*LDP members who voted against postal reform		
Government coalition		
LDP + Komeito	**327**	**246**

Source: Bloomberg

The relative majority party before the elections, the LDP, obtained an absolute majority in the lower house, with 61% of the seats, from 44% before the elections.

The party won 84 seats from the other coalition participants and the opposition parties. Out of the 30 LDP members of parliament who opposed the postal reform decree, triggering Koizumi's decision to dissolve the house, only 13 were re-elected while Komeito, LDP's ally, lost 3 seats. The democratic party lost 64 seats, going from 177 to 113, dealing a significant blow to the opposition, whose ranks fell from 198 to 134.

The immediate implication of the elections is the mandate to continue with the postal reform. This means that the government will again submit the decree that was rejected, even though it should be noted that the postal privatisation process will take years (see Macroeconomic Scenario, October 2004). Based on the government's own scenario, it will not be finished until 2017. The privatisation process requires many crucial steps in the next ten years, including the break-up of the postal service into four agencies, each dealing separately with insurance, financial services, postal services and savings. The decree that precipitated the elections was just one of the many steps along the road to privatisation. The government will have to overcome many hurdles, despite the brilliant September results. One of these will be a change in leadership, when Koizumi will step down, as he reiterated in the immediate aftermath of the elections.

Estimates revision and macroeconomic scenario

The revision of growth estimates for the second quarter was substantial, and was implied in the investment spending figures for the second quarter released a few days before the revised GDP data. Aggregate growth for 2Q was raised from 0.3% to 0.8% q/q, mostly due to the greater contribution of non-residential private investments.

Revised 2Q growth - q/q % change

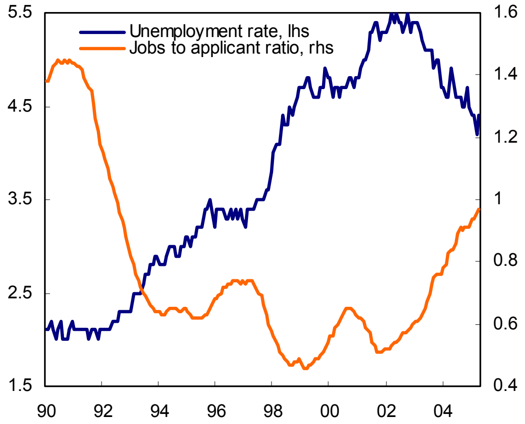
	Rev. 2Q	Prel. 2Q	Contribution
GDP	0.8	0.3	0.6
Domestic demand	0.6	0.1	0.7
Private demand	0.9	0.2	0.3
- Consumer spending	0.6	0.7	0.3
- Residential investment	-2.3	-2.3	-0.1
- Non-residential investment	3.6	2.2	0.6
- Inventories			-0.2
Public demand	-0.3	-0.4	-0.1
- Consumption	0.2	-0.2	0.0
- Investment	-2.6	-1.3	-0.1
Exports	2.9	2.8	0.4
Imports	1.5	1.6	-0.2

Growth in the second quarter was not as fast as that in the first, but was strong enough in terms of contribution to private domestic demand (up 0.7% q/q) to foreshadow another growth year above potential. In our June scenario, growth forecast for 2005 was 1.5%. Following the revised data just published, we have adjusted our GDP growth scenario to 2.2%.

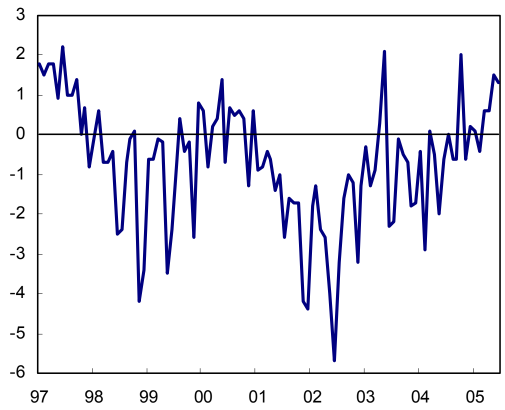
The main point of the forecast remains that of a relatively solid and stable path for household consumption, as underpinned by the structural improvement of the **labour market.** On that front there are no changes, as the charts below show.

The latest employment data confirms the pace of **job creation**, with the y/y figure for July at 0.5% and positive growth rates from the beginning of the year. Good news also for salaries, as the **aggregate figure** in July rose 1.7% y/y.

The labour market fuels growth



Positive y/y nominal labor income growth



Source: Bloomberg

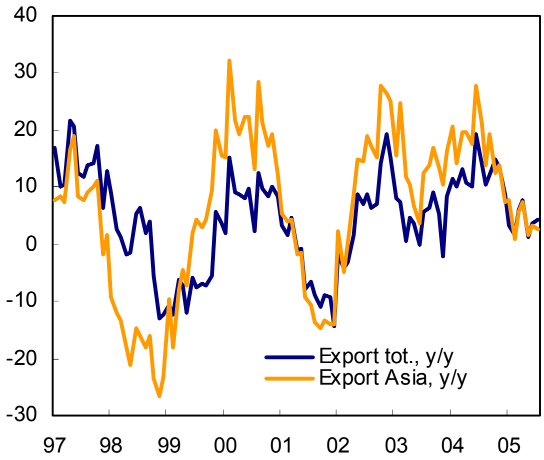
Consumption was positive and strong for two consecutive quarters, after the contraction in the three quarters from March to December 2004. The outlook for the next few quarters is good and the only uncertainty looming over household spending is the introduction of the consumption tax. Past experience shows that the introduction of a tax at the beginning of 2007 would cause consumption to step up in 2006 and then slow down in the following year. However, now it seems that the new government intends to postpone this measure once again, which should keep consumption stable next year, at a quarterly average of around 0.4%.

Household confidence surveys attest to a positive picture for consumer spending. Over the past three months, **consumer confidence** has risen above 48, a level not seen since 1991. The latest release available, for August 2005, indicates that the employment component of the survey went above 50 (50.4), and the indicator related to durable good purchases stayed above 50 for three months out of four, starting in May. The good news is that not only are the indicators high, but the improvements achieved this past year have stabilised. Consumer spending is fostered also by the growing perception by households that **deflation is over**. The survey shows that 44.6% of respondents expect prices to rise over the next 12 months as opposed to 6.4% who see a decline.

As to **investments**, the second quarter showed further acceleration, up 3.6% q/q, from the already sustained pace of the first (+2.3%), thanks partly to the significant increase in corporate earnings (up 12.9% y/y in 2Q05). The outlook remains positive, despite the slowdown of machinery orders, which fell to a single-digit growth rate (+5% in June) after an exceptional 2004. The loss of momentum in this area is due to waning foreign orders (-1% y/y in June). Good news came from domestic orders, which show a sustained growth rate (+10.9% y/y in June) accounting for nearly 60% of total orders.

The deterioration of **exports,** which shaved 0.2% off GDP growth in the second quarter, gives little cause for concern, considering the favourable outlook for domestic demand.

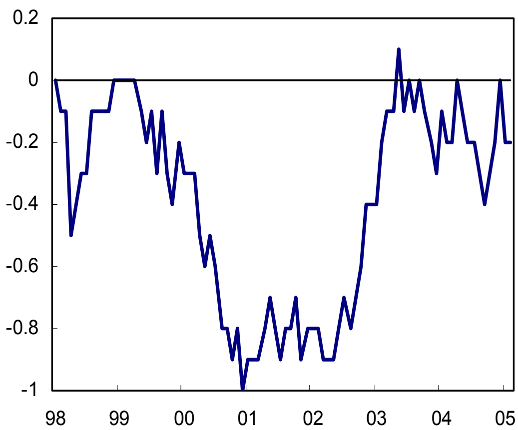
Exports are no longer an engine of growth



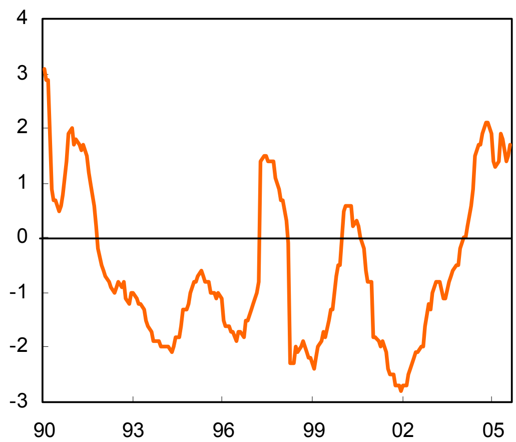
Source: Bloomberg

Inflation continues along its path to normality and the CPI is likely to post positive y/y rates of increase by year-end. The deflationary effect of tariff deregulation will not be considered in computing inflation in the next few months. As the BoJ said recently, the core CPI excluding these components is already stable and marginally positive.

Core CPI still affected by service deregulation



Producer prices affected by rising oil prices



Source: Bloomberg

Japan is very gradually preparing to alter its **monetary policy** stance. The votes cast during the latest monetary policy meetings at the BoJ still show a majority, with diverging opinions on maintaining the reserve target (7 to 2). In an address on 15 September, the deputy governor of the central bank Kazumasa Iwata said that some board members think that **core inflation will be either zero or positive from October**, while the economy is returning to a sustainable growth path, even in the absence of significant economic policy stimuli. BoJ governor Toshihiko Fukui is still very cautious in his remarks on possible changes in the monetary strategy, noting that before implementing change it is necessary to be very sure that growth is on a solid path.

The minutes of the latest meetings of the central bank show clearly that the discussion on the reserve target is open. This is the first step towards a more normal monetary policy. Two board members proposed a target reduction, Atsushi Mizuno to a range between JPY 25 and 35 trillion, and Toshikatsu Fukuma to JPY 27-32 trillion (from the current JPY 30-35 trillion). In a speech held after the minutes were published, Fukuma reiterated his position, indicating that the BoJ may lower the reserve target and maintain a zero interest rate. According to Fukuma, the reserve cut should not have negative effects on growth, whilst too high a target might encourage excessive risk-taking among investors; furthermore, maintaining an unaltered policy in the face of changes in economic conditions could be a mistake.

The macroeconomic scenario and the conflicting statements by members of the BoJ (particularly the diverging views between the governor and his deputies), suggest that policy will change at a very measured pace but also that there will be a regime change starting in the first quarter of 2006. Our forecast is that by the end of this fiscal year, particularly between January and March, the BoJ may remove the reserve target introduced two years ago and keep interest rates at zero for a quarter or two, **with rates becoming positive from the last quarter of 2006**. The removal of the reserve target will be a clear signal to markets on the future of interest rates and will reflect on monetary policy expectations quite rapidly. The consequences will show up in the cost of debt, which will be the new policy concern for the next few years.

Japan

	2004	2005	2006	2004	2005				2006		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	2,6	2,2	1,5	0,9	1,0	2,2	2,8	3,0	1,9	1,4	1,3
q/q annual rate				0,6	5,7	3,2	1,8	1,3	1,2	1,4	1,5
Private consumption	1,5	1,7	2,1	-1,2	5,0	2,4	1,5	1,3	2,4	3,2	1,6
FI - private nonresidential	5,8	7,9	3,4	0,8	13,0	15,2	6,1	3,1	1,6	2,0	2,5
FI - private residential	2,2	-1,9	2,4	2,3	-5,3	-8,9	-1,6	4,5	4,2	5,3	2,3
Government investment	-10,8	-9,0	-2,0	-0,7	-3,6	-10,0	-2,4	-2,5	-1,3	-1,0	-0,3
Government consumption	2,7	1,8	1,1	2,5	2,8	0,8	0,4	1,3	1,3	0,5	2,3
Export	14,5	5,5	5,9	6,3	-0,3	12,1	5,3	7,7	5,0	4,1	5,0
Import	8,9	6,9	9,9	8,9	2,7	6,1	9,2	9,7	11,3	11,9	8,4
Stockbuilding (% contrib. to GDP)	0,2	0,1	-0,1	0,2	0,3	-0,5	0,4	-0,1	-0,1	0,0	0,0
Current account (% of GDP)	3,7	3,4	3,0	3,6	3,5	3,4	3,4	3,3	3,2	3,0	2,9
Deficit (% of GDP)	-8,0	-7,6	-7,4								
Debt (% of GDP)	148,7	159,8	165,9								
CPI (y/y)	0,0	-0,1	0,1	0,5	-0,2	-0,1	0,0	-0,1	-0,2	-0,1	0,1
Industrial production	5,3	2,1	2,6	-3,7	7,3	-1,7	5,6	3,7	2,7	1,8	1,6
Unemployment (%)	4,7	4,2	3,8	4,6	4,6	4,3	4,0	3,9	3,9	3,9	3,8
3-month CD rate	0,04	0,09	0,18	0,03	0,05	0,04	0,21	0,07	0,01	0,12	0,23
10-year rate	1,52	1,34	1,49	1,43	1,32	1,17	1,40	1,48	1,56	1,50	1,44
JPY/USD	108,2	107,3	99,4	105,8	104,5	107,5	111,0	106,0	102,0	99,5	98,0
Effective exch.rate (1990=100)	135,1	135,4	146,4	135,5	136,5	134,8	132,2	138,0	143,2	146,3	148,2

Percentage annualised growth rate over previous period, if not otherwise specified.

China: exports start to race again

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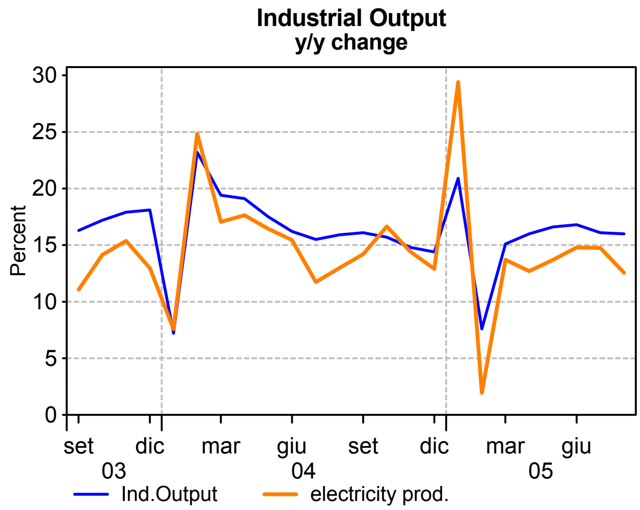
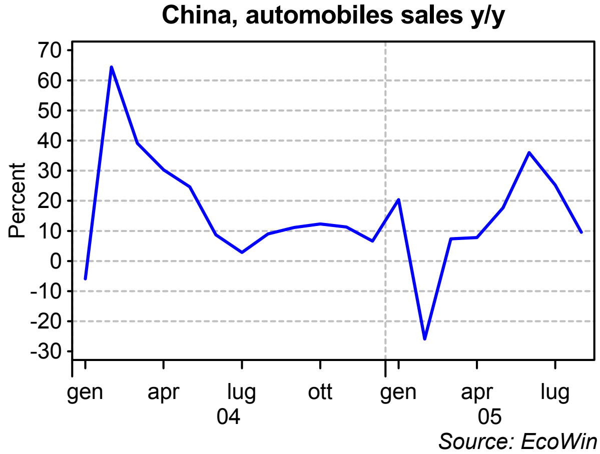
On July 22 China formally decoupled its currency from the US dollar. The Chinese currency is now being managed so as to "keep the exchange rate basically stable at an adaptable equilibrium level, so as to promote the fundamental equilibrium of the balance of payments and safeguard economic and financial stability". The government is pursuing this goal by pegging the exchange rate to a basket of currencies (the exact composition of which has not been revealed). The basket, which is used more for medium- to long-term guidance purposes than as a gauge of daily fluctuations, includes at a minimum USD, EUR, JPY, KRW, SGD, AUD, RUB, MYR, GBP and THB. The weights have not been disclosed, but we estimate that the dollar, euro and yen could account for 55%, 12% and 16% of the total respectively. On Friday July 22, the initial dollar parity was 8.11 RMB. Since then, the closing price on the local interbank market has set the opening exchange rate for the following business day. The central bank will allow fluctuations of 0.3% on either side of this parity (this range may be revised in the future). For the other currencies, the central bank will announce a specific fluctuation range, which should be broad enough to accommodate changes in cross-exchange rates. First indications are that the exchange rate is exceptionally stable vis-à-vis the dollar and excessively volatile vis-à-vis the yen and the euro. This is consistent with the assignment of a very large weight (well above 90%) to the US currency: the central bank is evidently actively engaged in stabilising the market. Thus, the macroeconomic implications of reform are totally negligible.



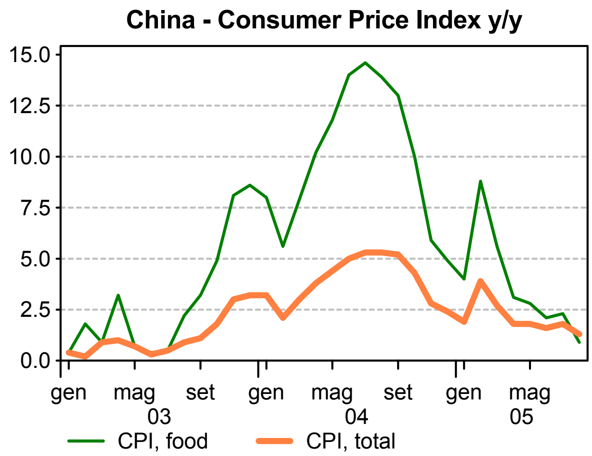
The slowdown expected in China also seems limited to a few areas of the economy: the slowdown caused by specific dampening measures in the housing, metal and cement sectors has been more than offset by the performance of the rest of the economy, which has not been significantly affected by rising energy prices. The y/y GDP growth rate estimated in the first half of 2005 was 9.5%, while manufacturing output expanded by more than 16% even in July, despite the decrease of the manufacturing PMI index to 50.6, a record low for the series.

The Chinese economy is enjoying both booming exports and an upturn in domestic demand, which is still being bolstered by foreign investment. Despite higher oil and coal prices, the balance of trade surplus hovered around USD 10 billion between May and August, a USD 30 billion improvement on the same period of 2004. This exceptional performance was due in some measure to a lower rate of imports growth, which was in turn caused partly by available domestic inventories and partly by import substitution manufacturing. Another temporary factor was the race to deliver textile products to markets such as Europe, where a protectionist backlash has been gathering steam following the expiry of the multifibre agreement.

On the domestic front, only construction investments have been reported down, by 11% y/y, but total capital spending rose again, by 23.5% y/y. This diverging pattern reflects the impact of specific measures, such as a drop in investment in infrastructure financed via bond issues, which fell from USD 14 billion to USD 10 billion, and other programmes which have created an uneven flow of capital investment.



Consumer spending, which is supported by the long-term phenomenon of rising per capita income, is still vibrant. The automobile market sprang back promptly, after the slowdown at the beginning of the year, and new car registrations rose by 25% on a y/y basis. Retail sales have been expanding by over 10% y/y for about a year.



Dampening down the economy is now no longer a priority due to the exceptionally moderate inflation trend. Thanks to subdued pressures on food (especially cereals), the consumer price index in August rose at a rate of just 1.3% on an annual basis. Under these circumstances, despite the significant liquidity injected into the economy as a result of the trade surplus, it seems unlikely that the authorities will decide to raise interest rates. Fiscal policy, which aims to achieve a deficit equivalent to 1.9% of GDP this year, has instead adopted a moderately tightening stance. Moreover, priorities are changing, as emphasis on infrastructure projects wanes and resources are shifted to support farmers and to limit the impact of industrial restructuring.

All in all, we will have to wait for a slowdown in the US economy and an easing back of foreign investment (which so far has only stabilised) before the Chinese economy settles at more moderate expansion levels. In the near term, growth will falter mainly because of falling exports towards the end of 2005.

China

		2002	2003	2004	2005	2006	2007
GDP (current prices)	CNY bn	10520.0	11740.0	13700.0	16338.0	17911.7	20022.6
	y/y	8.1	11.6	16.7	19.3	9.6	11.8
	USD bn	1270.0	1418.0	1653.0	1906.0	2196.0	2544.0
GDP (constant prices)	y/y	8.3	9.3	9.6	9.0	8.7	8.9
Consumer spending	y/y	6.2	6.3	8.6	10.3	10.8	11.1
Fixed Investment	y/y	16.3	24.7	19.5	18.5	11.3	14.9
Public consumption	y/y	7.6	5.2	6.5	5.0	5.0	4.4
Exports	y/y	24.5	33.8	22.8	20.7	14.2	11.8
(foreign demand index)	y/y	4.4	6.0	12.0	7.2	8.2	8.3
Imports	y/y	24.6	37.2	20.9	14.3	16.4	18.8
Industrial output	y/y	20.3	26.1	21.5	14.0	11.1	12.3
Unemployment rate	%	3.9	4.2	4.2	4.0	3.9	3.9
Inflation (CPI)	y/y	-1.1	1.4	3.7	2.1	2.6	3.6
Short-term interest rate	%	5.3	5.3	5.4	5.6	5.3	5.3
USD/CNY (average)		8.28	8.28	8.28	8.18	7.93	7.73
	y/y		0%	0%	-1%	-3%	-3%
USD/CNY (eop)		8.3	8.3	8.3	8.1	7.9	7.7
EUR/CNY (eop)		8.2	9.6	10.6	9.8	9.5	8.8

Source: Banca Intesa.

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