

# Macroeconomic Outlook

**Research Department**  
March 2009

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27 March 2009

### Quarterly

**Intesa Sanpaolo  
Research Department**

**Macroeconomic and  
Fixed Income Research**

**Luca Mezzomo**  
Economist

**Giovanna Mossetti**  
Economist - USA and Japan

**Paolo Mameli**  
Economist – Euro Area

**Asmara Jamaleh**  
Economist – Forex Market

**Enrico Bernini**  
Commodities

### International Economics

**Silvia Guizzo**  
Economist - Asia ex Japan

Priced on 27 March 2009

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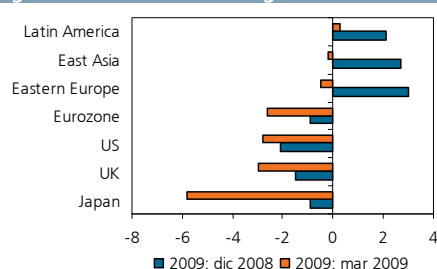
## Signs of stabilisation still weak

The global recession has proved much deeper than expected and has hit large exporting countries hard in the last few months. We have yet to see any convincing signs of a turnaround, although various indicators point to a slowdown in the speed of contraction, and are compatible with stabilisation in the second half of the year.

Luca Mezzomo

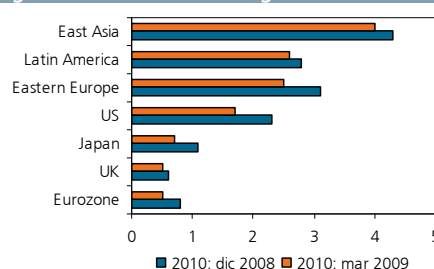
The decline in the economic outlook at the end of 2008 and the beginning of 2009 exceeded all expectations. This is evidenced by the huge cuts made to estimates on the average annual change in 2009 GDP by the panel of forecasters surveyed by Consensus Economics. The most substantial revisions concern the exporting countries of Western Europe and Asia, as well as emerging countries marked by serious balance of payment deficits or dependence on European and US demand. The most worrying aspect is the contraction we have seen in trade flows, unprecedented in the last fifty years and probably partly due to the fragmentation of production processes in the wake of globalisation: -40/45% for Japan, -25% for China, the eurozone and the main countries of Eastern Europe, and -16% for the US. The violent drop in production levels is being exacerbated by reductions in inventories of production inputs and finished products, in turn a consequence first of an overvaluation of demand and then (after Lehman) of pessimism regarding the timing of the recovery and a scaling back of investment plans.

Fig. 1 – Consensus on GDP growth - 2009



Average annual change. Source: Consensus Economics

Fig. 2 - Consensus on GDP growth – 2010

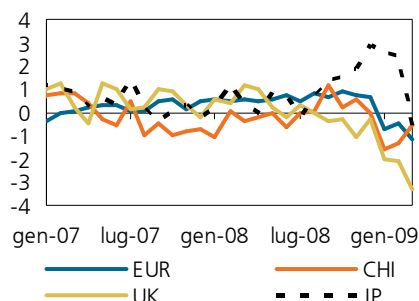


Average annual change. Source: Consensus Economics

Inventory indicators suggest that the period of contraction is unlikely to end any time soon. Some progress is evident, but not strong enough to herald a stabilisation of the economy in the second quarter:

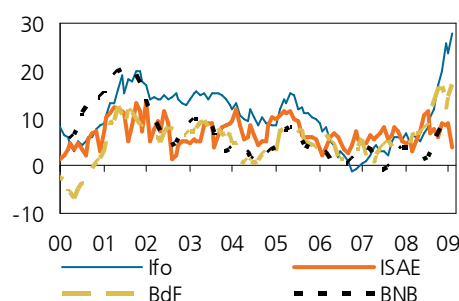
1. while in the autumn quarter, companies destocked production inputs but continued to register unwanted increases in finished product inventories, at the beginning of 2009, production cuts were sufficient to also reduce product inventories (with the sole exception of Japan, see Fig. 3). However, confidence surveys still suggest that inventory levels remain excessive (fig. 4) and, therefore, that further cuts in production are likely.
2. PMIs showed moderate signs of an upturn in 1Q, but this does not alter the fact that indicator levels remain consistent with a severe contraction in industrial output and GDP.
3. Signs coming from commodities could point to a near-term recovery in economic activity. The Baltic Dry index on freight has more than doubled compared to the lows of end-2008, and oil prices have recently risen back above USD 50 despite the fact that OPEC did not cut production at its meeting in March. However, these markets may be influenced by incidental factors (for example, abnormal concentrations of demand for the transport of ferrous minerals in China, the greater than expected implementation of OPEC cuts) which have little to do with the cycle of international demand, and must be interpreted cautiously.

Fig. 3 - PMI inventories of finished products



Standard deviations from the historic average.

Fig. 4 - Judgement on product inventories



Diffusion index: higher values indicate excessive inventories.  
Source: Thomson Reuters

- Business confidence surveys also provide positive indications on the future, albeit negative for the shorter term outlook. At the beginning of 2009, the judgement on the current situation continued to worsen, while that on the future registered a significant improvement. This is a clear trend in the German IFO, for example, and is consistent with economic stabilisation in the second half of the year.
- Finally, manufacturing showed signs of an upturn in February in China (PMI, electricity indicators, imports).

There are various reasons to believe that production activity will at least stabilise by the end of 2009: in particular, these relate to the end of the destocking phase, the full effects of discretionary fiscal stimuli and automatic fiscal stabilisers. The IMF has estimated that automatic stabilisers will have an impact of 1.6% of GDP in economically-advanced countries and 0.7% in emerging countries (up 1.2% and 0.7% respectively compared to 2008), and have effects that are expected to grow as unemployment increases and income subject to higher taxes falls. IMF estimates of discretionary measures total 1.5% of GDP for 2009 and 1.1% for 2010, with significant differences between countries (see Tab. 1). Again in this case, the measures approved have not yet been fully implemented: the Obama plan, for example, will only have an effect from the middle of the second quarter, while the incentives to scrap old cars introduced in Europe have only just started to filter through to orders.

The recession has taken hold so quickly that discretionary support measures will have little impact on the depth of the contraction, but perhaps more on when the economy stabilises. The monetary stimulus implemented by reducing official rates to near zero and the increase in the monetary base will also be more effective once economic growth has stabilised, apart from the immediate benefits on the cost of public debt and on servicing debt indexed to short-term rates.

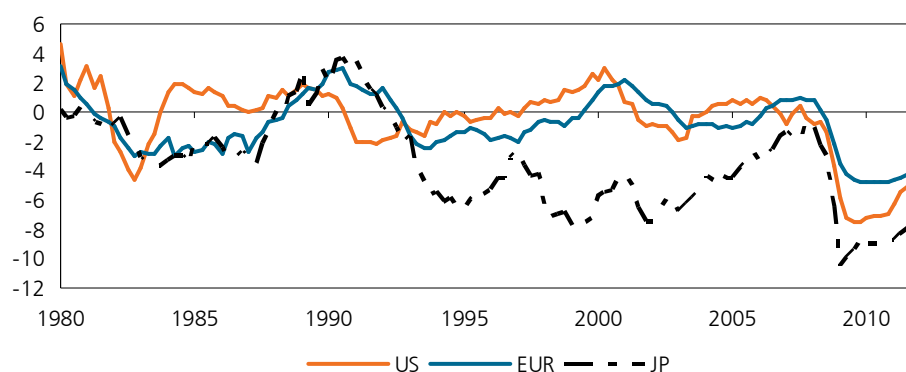
Tab. 1 – Estimated cost of discretionary fiscal measures according to the IMF (% of GDP)

	2008	2009	2010
Canada	0.0	1.5	1.3
China	0.4	2.0	2.0
France	0.0	0.7	0.7
Germany	0.0	1.5	2.0
India	0.0	0.5	nd
Italy	0.0	0.2	0.1
Japan	0.4	1.4	0.4
Spain	1.9	2.3	nd
UK	0.2	1.4	-0.1
US	1.1	2.0	1.8

Source: IMF, *The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, 6 March 2009.

Although the recession has yet to run its course, markets are showing greater sensitivity to the long-term implications of anti-crisis strategies. It is becoming increasingly clear that unusually high public debt is set to accumulate over the next two years. We should not forget that as well as the cyclical problem, there is an ever more pressing structural issue regarding the imbalance of accounts owing to the ageing population, as highlighted recently by both the ECB and the IMF<sup>1</sup>. With high deficits, higher levels of debt and growing structural imbalances, governments will have to rapidly consolidate their accounts as soon as the economy shows convincing signs of recovery. Bringing deficits back to more sustainable levels may in part be achieved through measures with little or no impact on growth (for example, reducing financial stabilisation measures), but in other ways (relating to the easing of real stimulus measures) is likely to have an effect on economic growth. It is critical that this period of fiscal consolidation takes place once the financial system has stabilised if a Japan-style scenario of brief and frequent relapses into recession is to be avoided. On the other hand, a delay in this process of consolidation could have repercussions on the cost of debt: investors are beginning to seem more cautious regarding the outlook for long-term bonds, incorporating the probability that the easing of stimulus policies will not be quick enough to prevent a rise in inflation.

Fig. 5 – Projections on the aggregate margin of available capacity consistent with our central scenario



In % of potential GDP Source: Intesa Sanpaolo chart through Oxford Economics' World Model.

The issue of the exit strategy for central banks (some of which are helping their governments by buying treasury bonds) should in theory be easier to manage. The ECB is injecting liquidity into the system through repo transactions, and draining excess liquidity should not pose any particular problems. For the Bank of England, which has begun to buy government bonds through a large-scale programme that also includes long-term issues, reversing the process will pose greater difficulties. The sale of bonds in its portfolio would create other distortions on the gilts market; the idea of early redemption by the Treasury (without passing through the market) would increase debt refinancing needs. A more simple solution - as has been proposed in the US, which will be faced with a similar problem in the next few years - is for the Treasury to issue bonds for the central bank to sell to banks, draining liquidity from the system.

While there are reasonable technical measures that can be used to drain off liquidity, doubts remain regarding the timing of the operation, given the negative experience of the excessive monetary accommodation of 2003-05. The need to withdraw quantitative stimulus measures will be evident when monetary and credit multipliers increase, indicating a fall in precautionary

<sup>1</sup> IMF, "The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis", March 2009; ECB, "Fiscal Sustainability and policy implications for the euro area", WP 994, January 2009.

demand for liquidity from the banking system. But what would happen if at that point, central banks maintained excessively accommodative liquidity conditions (by mistake, owing to rational cost-opportunity assessments or because they were obliged to)? Given the global economy's ample unused capacity (fig. 5), excess money supply is unlikely to turn into inflation in 2010. It seems more likely that the safety valve would initially be speculative bubbles on the financial markets, i.e. that excess liquidity would be channelled towards the financial segments, which, when appetite for risk recovers, offer the best prospective returns.

Tab. 2 – Economic growth by region

	2006	2007	2008	2009	2010
US	2.8	2.0	1.1	-3.3	1.6
Japan	2.1	2.4	-0.7	-5.6	0.4
Eurozone	3.0	2.6	0.7	-3.3	0.4
Eastern Europe	7.3	7.3	5.9	-1.1	-0.3
Latin America	5.4	5.5	4.1	-1.3	2.7
OPEC	5.9	6.0	6.0	2.1	4.2
East Asia	8.7	8.9	6.2	1.6	6.6
Africa	5.7	6.2	5.8	2.9	4.1
World growth	5.0	4.8	3.3	-1.1	2.7

Source: Intesa Sanpaolo chart

### Overview by region

In the United States GDP is expected to contract by 3.3% in 2009, stabilising in the middle of the year before returning to growth towards the end of 2009. Aggregate demand will initially be supported by public intervention, first through reducing household tax burdens and subsequently through direct intervention on spending and through state transfers. In 2010 growth is expected to return to 1.7%. In 2009 the greatest correction will be in the corporate sector, with a significant contraction expected in fixed investments and inventories. As regards consumption, the worst is over and growth, albeit modest, is likely to be seen from the start of the 2<sup>nd</sup> quarter. Households, facing an unprecedented fall in their net wealth, have now entered a structural phase involving an increase in the savings rate, which will remain above 6.5% in 2010. This structural change in behaviour will lead to restrained consumption over the next five years and GDP growth of between 2 and 2.5%. The collapse of foreign trade is also causing a reduction in the budget deficit and the current account: the public deficit will be financed more by private savings than from abroad.

The aggressive reaction of the authorities in facing the financial crisis will mean that a second great depression will be avoided. However, the inheritance of this intervention will make itself felt in the years following 2010, when monetary policy will face difficulties reducing monetary stimulus, and fiscal policy will need to become more restrictive. This will be necessary in order to bring back under control deficits and debt that will have increased dramatically in the two-year period 2009-10. The consequences will reveal themselves in cyclical fluctuations that will have more in common with the 1970s and 1980s than with the great moderation of the 1990s.

We are revising strongly downwards, to -3.3% from -0.7% in December, our forecast for annual GDP change in 2009. The 2.6% revision from three months ago can be explained mainly by the disastrous trend over the last two quarters. The worst-hit country will be Germany - the components of demand that will sink GDP are investments and exports (for each of these we forecast a fall of around 10%). As regards 2010, we do not share the view that the negative trend will continue, given that the structural factors that will impact the cycle next year (monetary and fiscal policies, disinflation) have recently all been evolving in a positive direction. In summary, we maintain our forecast of marginally positive growth for 2010 (0.4%).

On the basis of the revision of the outlook for oil, the figures for CPI being lower than expected at the start of 2009, and the prospect of a further weakening of core inflation pressures given the widening of the output gap, we review strongly to the downside our inflation prediction for

### United States

### Euro area

2009. Our new forecast is 0.4%, down from the 1.4% forecast in the last quarterly report and down from an average 3.3% for 2008. In our central scenario, CPI will turn negative in June and will continue negative until September. According to this model, core inflation (ex energy and non-processed food) will slow to 1.1% in 2009, down from 2.4% in 2008.

We believe that the BCE could bring the refi rate down to 1%, where it will remain until at least the middle of 2010. In the short term the BCE could also decide to lengthen the maximum duration of the auctions through which it supplies liquidity to the banking system (at a fixed rate and for any requested amount), from the current six months to 12-24 months. Finally, there is also some possibility that the BCE could launch (although probably not in the immediate future) a programme to buy private debt securities on the secondary market. However, a programme to buy government bonds seems rather less likely.

The **Japanese economy**, that until recently had been receiving a positive contribution from foreign channels, is expected to experience a GDP contraction of -5.5% in 2009. This has been caused first by the collapse in exports recorded since November and subsequently by the fall in industrial output and inventories. The reduction in demand at the end of 2008 has set into motion a downward adjustment in fixed investments, inventories, employment and consumption. This trend will invert only gradually through the stabilising of trade flows and support from public demand, with a return to growth in 2010 (forecast: 0.4%). The economy will remain in deflation for the whole of 2009, despite the stimulus policies of the central bank and the government. Economic policy has responded relatively quickly to the worsening of the situation, with a return to quantitative easing and central bank rates (almost) at zero, and the approval by the government of fiscal stimulus measures, equivalent to around 2% of GDP (half of this is planned for 2009). Even though the contraction in GDP at the end of 2008 and the start of 2009 has no precedent in the period since the Second World War, the Japanese economic situation is not as bad as that of the 'lost decade', and growth should return to around 1.5% from 2011 onwards.

#### Asia: Japan and China

In **China** foreign trade continues to suffer and economic indicators from major trading partners continue to point to a contraction of trade in the months to come. Positive signals coming from industrial output and the trend for credit are not totally consistent and, even though total fixed investments have held up, the slowdown in the real estate sector continues. Retail sales have also started to show the first signs of deceleration. Despite the stimulus measures deriving from monetary and fiscal policies, we continue to believe that the growth objective of 8%, confirmed by the government during the presentation of the 2009 budget, will not be reached.

Tab. 3 – Projected commodity prices

	2006	2007	2008	2009	2010
Oil (Brent, \$/barile)	65.4	72.7	97.7	48.2	58.5
	+20.1	+11.2	+34.3	-50.7	+21.5
Commodities excl. fuel (1990=100)	154.8	176.6	199.1	144.9	158.1
	+23.3	+14.1	+12.8	-27.2	+9.1
Metals (1990=100)	249.1	292.4	338.2	325.8	272.5
	+56.2	+17.4	+15.7	-3.7	-16.4
Agricultural commodities (1990=100)	110.4	115.9	114.9	107.4	111.0
	+8.8	+5.0	-0.9	-6.5	+3.4

NB: annual average levels and changes

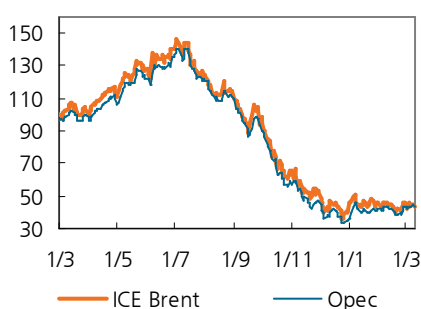
Source: Intesa Sanpaolo chart

**BOX 1 - Oil: supply cuts are starting to balance drop in demand**

Luca Mezzomo

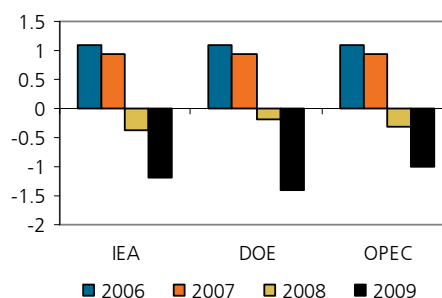
The sudden fall in economic activity has also shaken demand for oil: for the second year running, oil prices are now expected to register a significant drop (-1.2% y/y) after falling 0.4% y/y in 2008. OPEC forecasts a fall of one million b/d. This is the first time that demand for oil has dropped for two consecutive years since the collapse that occurred between 1980 and 1983 following the second oil shock. Oil consumption is only expected to grow in Latin America, the Middle East and Africa, but the deterioration in the economic outlook in these areas could lead to further cuts in estimates.

**Trend in oil prices**



Dollars per barrel Source: Reuters EcoWin

**Change in demand for oil, y/y**

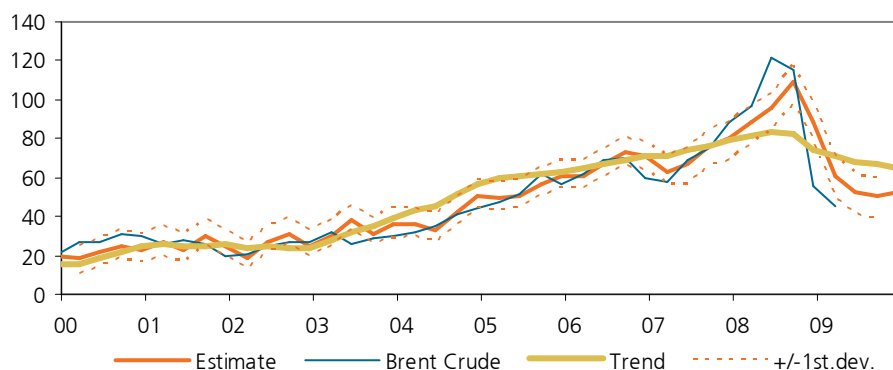


Source: IEA, OPEC and DOE-EIA.

The downside implications of this trend in demand have been offset in the last few months by OPEC supply cuts, following control measures decided in October and December 2008. Cartel production fell in January to 28.71 million b/d (-0.96 versus the previous month and -2.78 under the 3Q08 average). Until December, however, this did not stop OECD oil stocks from remaining above the historical average, at 52 days' worth of demand. The recovery of prices in the last few weeks from the lows of USD 32-35 seems to have eased pressure for further production cuts, as also evidenced by the statements of the OPEC 'hawks', such as Iran. A few days ago, OPEC officially expressed its irritation regarding the IEA's call to support the drop in oil prices, as it believes they need to be high enough to ensure investment in further production capacity is remunerative. Nevertheless, the temptation to guide prices towards more comfortable levels for producers has probably been shelved until demand picks up. However, Iran (in the past one of the most vociferous countries in calling for supply reductions) has been the least diligent in implementing production cuts, with an excess estimated at 460,000 b/d over the target. Partly in light of the hawks' lack of credibility, it does not seem that the cartel wishes to force prices to significantly higher levels than they currently are during this devastating global crisis, but if the trend in stocks show demand falling by more than expected, it is plausible that production could also fall. Among non-OPEC countries, production is expected to rise slightly: the increases due to Brazil, Azerbaijan and the US will be largely offset by the drops expected in Mexico, Russia and the North Sea.

With the unused capacity margin greater than the historical average (IEA estimates put this at 4.4 million b/d for conventional OPEC production, and this is expected to increase), the market's sensitivity to negative supply shocks, and probably also the potential for price rises, should be limited. We believe that to bring prices back to levels considered favourable in the past (over USD 60), OPEC will have to prevent consumers from stockpiling by not fully responding to the upturn in demand expected in 2010. The violent global recession has resulted in a trend reversal in oil prices likely to continue for the whole of the next two-year period. Conversely, the unfavourable market conditions could cause expansion projects announced in the last few years to be shelved, with negative long-term repercussions on the capacity of supply to meet future growth in demand. The IEA believes that these problems could start to emerge in 2013.

**Brent Crude – quarterly forecast model**



Source: Intesa Sanpaolo chart on Reuters EcoWin, IEA, EIA and Oxford Economics data

For the next few months, the futures market are factoring in a rise in prices of USD 4.90 over the next six months, USD 6.50 by December 2009 and USD 12 by December 2010. Contango is more limited compared to the peaks of February, but remains significantly higher than the historical average. However, there does not seem to be any great conviction that the market can register significant rises in the next few months: speculative positions are balanced and the price rises of the last few weeks have been accompanied by the prompt liquidation of long positions. Furthermore, the existence of stocks in transit estimated on the market at 80 million barrels (and favoured by both the strong contango situation and the drop in freight due to the decline in exports) could make it more difficult for the rises implicit in futures to be realised.

Without any surprise cuts from OPEC therefore, it is not yet certain whether oil prices will remain above USD 50 for the whole of the second quarter. We reduce our estimate for the average 2009 price to USD 48 (-50% compared to 2008), and forecast USD 55 for the end of 2009, and a jump to USD 58 in 2010 (+22% versus 2009). The recovery in 2010 is related to both forecasts that growth in the global economy will recover, as will therefore demand for oil, and the expectation that OPEC will not fully respond to the increase in demand, causing stocks to fall.

**BOX 2 – Precious metals and industrial metals**

Precious metals prices have been and remain heavily influenced by the degree of aversion to risk. The first quarter of 2009 apparently saw the end of the high level of uncertainty felt at the beginning of the year. Prices on exchanges saw very wide daily fluctuations, with a downward trend, until the beginning of March, whereupon the trend became markedly positive. At first, fears over the economic cycle were based on the International Monetary Fund's forecasts for world growth, revised downwards to between -1% and -0.5%, and on concerns about further credit problems in the financial sector. Only in March did the approval of the US Treasury's plan gain the confidence of investors and trigger a vigorous upturn in international markets.

Such a contraction in the economy has not been seen since 1945. The severe fall in total spending in industrialised countries explains investors' increased aversion to risk indicated by prices of financial assets. When total spending falls, households and businesses prefer not to draw on their assets because their value is falling and the returns are not attractive. It is the positive correlation – which is unfavourable from the point of view of the value of the portfolio – between the growth in spending and return on capital which establishes the premium on risk capital<sup>2</sup>.

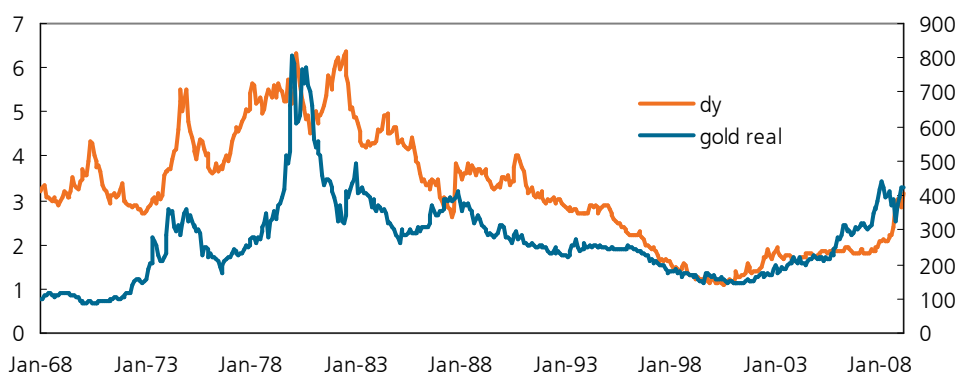
Enrico Bernini

<sup>2</sup> For a more up-to-date theoretical analysis of asset pricing see the latest Skiadas (2009), for an empirical analysis see Singleton (2006), and for a summary see Cochrane (2005).

For this reason, severe, prolonged exposure to systematic risk has progressively increased, in recent quarters, the concentration of substantial investments in safe havens: government bonds and other dollar-denominated investments, but also precious metals. Share prices hit new lows, and in March the S & P 500 index reached a new trough of 676.53 points, with a dividend-to-price ratio of 3% - a figure not seen since 1991. Reflecting the macroeconomic picture, aversion to risk in the last quarter accelerated the process of price adjustment relative to dividends in the main international share index. It is reasonable to expect that dividend-to-price ratios will remain stable at their present levels for some time. This is because the dividend-to-price ratio is now consistently higher than the real interest rate offered by long-term government bonds. It is likely to last because the economic growth expected from 2010 supports positive forecasts for company profits and the future growth of dividends. Figure 1 shows a comparison between the dividend-to-price ratio of the S & P 500 index with the real price of gold (gold bullion contract) denominated in US dollars, and therefore correct for the seasonally-adjusted domestic consumer price index. Both these indicators are real, and the figure shows that: 1) the present process of risk capital adjustment has origins that predate the present economic and financial crisis because since 2000 dividends have grown compared to the index (in 2000 the dividend-to-price index was at a low of 1.2%); 2) the same preference for liquidity has similarly affected the price of gold which, as a safe haven, had progressively fallen in the long period of share price growth, 1980–2000, and then appreciated (again, in real terms) over the last decade<sup>3</sup>.

With the increased probability of a return to growth in 2010, precious metals should suffer from the shift in capital to asset classes that can offer a share of the expected profits. In our view, those who retain long positions in precious metals face a growing risk of capital loss.

Fig. 1 – Share prices vs gold



Source: Intesa Sanpaolo

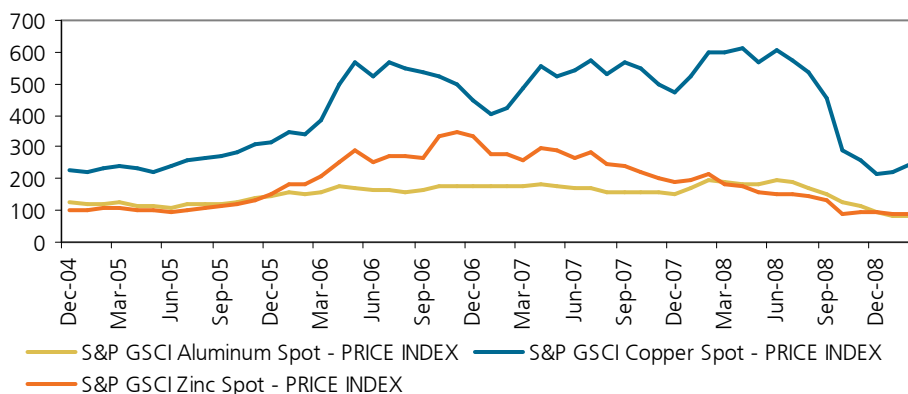
### Industrial metals

The outlook for industrial metals instead is different, for they have a positive correlation with the economic cycle and are already benefiting from the stabilisation of prices negotiated at the trade exchanges of London and Shanghai during the first quarter of 2009. Aluminium and copper prices had more than halved within only the second quarter of 2008, while zinc had foreshadowed the downturn from as early as late 2006. (Figure 2) Between 2005 and the summer of 2008 base metals had seen gradual, consistent price rises, and the increased

<sup>3</sup> On the dynamics of the dividend-price ratio see Bernini E. (2009) The Changing Value of Stocks: Risk, Taxes and Inflation. (forthcoming on Collana Ricerche – Intesa Sanpaolo)

correlation between their prices and that of oil confirmed their close dependence on energy costs.

Fig. 2 - Base Metals, price indexes



Source: Intesa Sanpaolo

From a financial perspective, the consistency of price rises led to structural change, attracting a growing number of investors seeking protection from inflation, which was unexpectedly high in 2008 – largely as a result of rising commodity prices. This was a result of the shortage of financial assets on the supply side, especially those denominated in real terms<sup>4</sup>.

The stability of the oil price and the various international policy measures aimed at business and at the efficient use of production resources between them give a picture where the prices of industrial raw materials will rise moderately. Confidence in the effectiveness of government intervention in the world's main economies was borne out by the recent approval of the expected US plan (23 March) which – through various ups and downs – had been a concern of international operators during the last quarter. The spot price for WTI crude, at levels approaching USD 53 per barrel, is above the levels seen at the end of 2008. Futures prices are in contango, with a spread remaining consistently around USD 20 per barrel, confirming expectations of price increases in real terms through to 2013.

The present world recession explains the congestion being seen in trade exchanges. This is true of the London Metal Exchange, where inventories have reached levels that preclude the buildup of new stocks at the start of 2009. The probable stabilisation of economic activity in the second half of 2009, and the ensuing recovery, are the reason for the present price rises. Aluminium, copper, and zinc futures prices were still in contango as at 26 March. However, aluminium futures prices do not suggest a marked increase, and zinc contracts, and especially copper contracts, reflect reduced price growth margins over the next five years.

In short, the scarcity of real financial activity on the supply side has favoured excessive, or speculative, valuations compatible with economic equilibrium. Capital and base metals markets offer opportunities for portfolio coverage and stocking up supplies for industrial use respectively. Spot gold contracts, at present close to nominal maxima, present risks if international economic conditions improve. Commodity prices will continue to be affected by fluctuations in the value of the dollar and uncertainty over how long the international financial system will take to recover.

<sup>4</sup> Bernini E. (2007). Investimenti reali e attività finanziarie: un progetto per la liquidità e la stabilità ("Real investments and financial activity: a plan for stability and liquidity").

## United States – “Back to the future”

- Growth is expected to contract by 3.3% in 2009, stabilising in the middle of the year and returning to positive territory towards the end. Aggregate demand will be supported initially by public intervention, first through the tax cuts for households and then through direct expenditure and transfers to state accounts. Growth should accelerate to 1.7% in 2010.
- In 2009 the largest correction will come on the corporate side, with a sharp contraction expected in non residential fixed investments (structures, equipment and software) throughout the year. The plunge in turnover also produces a reduction in inventories which will hamper the growth outlook in the first half of the year.
- As for private consumption, the worst is now over, and positive - though modest - growth should be seen as of the second quarter. Faced with an unprecedented plunge in net wealth, households are setting money aside and driving up the saving rate, which we expect to rise to over 6.5% in 2010. This structural change in consumer behaviour will result in a sluggish consumption dynamic over the next five years and in GDP growth of 2-2.5%.
- The aggressive reaction by the authorities to the financial crisis will avert another Great Depression. However, the legacy of the actions implemented will be felt in the years following 2010, when monetary policy will struggle to reduce the monetary stimulus and fiscal policy will have to become restrictive in order to restore discipline to the deficit and debt after the massive expansion in 2009-10. The consequences will be broad cyclical fluctuations, resembling more the 1970s and 1980s than the Great Moderation of the 1990s.

Giovanna Mossetti

Forecast Table	2008	2009	2010	2008				2009			2010	
				2	3	4	1	2	3	4	1	
GDP (1996 US\$,y/y)	1.1	-3.3	1.7	2.1	0.7	-0.8	-2.8	-4.1	-4.1	-2.0	0.3	
q/q annual rate				2.8	-0.5	-6.3	-6.8	-2.8	-0.2	1.8	2.4	
Private consumption	0.2	-1.3	0.9	1.2	-3.8	-4.3	-0.3	-0.6	0.8	1.0	1.0	
Fixed investment - nonresid.	1.6	-16.5	-1.0	2.5	-1.7	-21.7	-28.3	-18.6	-8.4	-2.5	1.7	
Fixed investment - residential	-20.8	-19.8	3.2	-13.3	-16.1	-22.7	-23.7	-20.7	-17.1	-9.3	13.5	
Government consumption	2.9	2.9	4.3	3.9	5.8	1.3	-0.5	5.2	4.3	4.6	4.4	
Export	6.2	-7.5	3.1	12.3	3.0	-23.6	-10.3	-4.7	-3.1	3.0	4.4	
Import	-3.5	-6.0	5.8	-7.3	-3.5	-17.5	-7.4	-1.8	1.2	8.7	6.0	
Stockbuilding (% contrib. to GDP)	-0.2	-0.5	0.6	-0.3	0.2	0.1	-0.5	-0.1	-0.1	0.3	0.2	
Current account (% of GDP)	-4.6	-3.1	-3.6	-5.1	-4.9	-3.4	-2.9	-3.0	-3.2	-3.4	-3.5	
Federal Deficit (% of GDP)	-4.2	-11.4	-10.1									
Gov. Debt (% of GDP)	68.2	83.1	96.6									
CPI (y/y)	3.8	-0.6	2.0	4.3	5.2	1.5	0.0	-1.0	-1.8	0.6	1.7	
Industrial production	-1.8	-8.7	4.8	-3.5	-8.8	-12.2	-15.6	-5.3	-1.5	3.0	7.3	
Unemployment (%)	5.8	9.2	9.6	5.4	6.1	6.9	8.0	9.2	9.7	9.9	10.0	
Fed Funds	1.93	0.25	0.25	2.09	1.94	0.51	0.25	0.25	0.25	0.25	0.25	
Effective exch.rate (1990=100)	74.4	83.4	80.8	70.9	73.5	81.3	82.0	83.5	84.5	83.5	81.8	

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

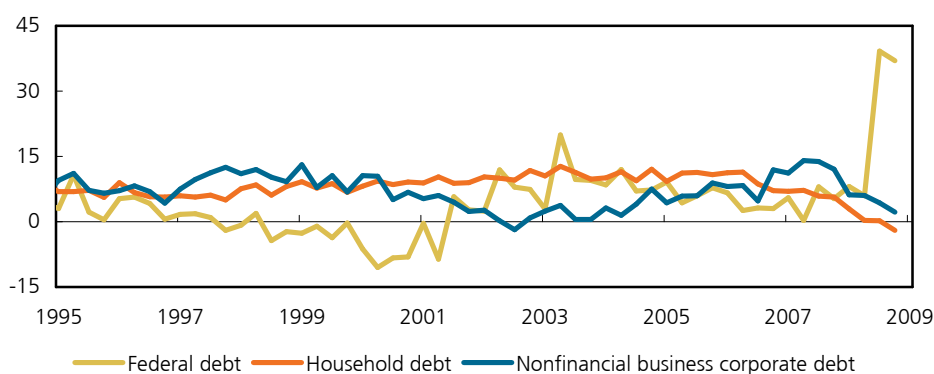
## United States: more private saving, to finance more public dissaving

The US macroeconomic outlook is revised down once again: any projected improvement depends on public measures and should not materialise before 2H09. The fiscal stimulus will drive growth into positive territory in the latter stages of 2009 and notably in 2010. Looking beyond the short-term trends, the crisis will leave a lasting legacy in the structure of the economy over the coming years. In the next five years the economy will be subject to large corrections and will resemble the 1970-80s more than the situation in the second half of the 1990s. The US economy will have two salient features: 1) the disappearance of the great driving force of the last decade, namely the US consumer; 2) a reduction in the external imbalance and an explosion in the public debt: the domestic debt will not shrink in the coming years, but will change issuer and will be financed more by household savings than by foreign flows.

The prospects for the US economy remain bleak, although the coming into effect of the fiscal stimulus package should stabilise GDP, with growth becoming slightly positive in the latter stages of the year, followed by a moderate upturn in 2010. The key point in the outlook is that the financial crisis has set in train **a process of not just economic but structural adjustment**, which will radically alter the US economic landscape for the foreseeable future. The "Great Moderation" is well and truly over and the next ten years will more closely resemble the 1970s, with large fluctuations caused by massive adjustments in economic policy. The economy will have two less favourable features than was the case in the 1970-80s, which will curb **average growth during the recovery**. 1) The large federal deficits built up between 2009 and 2011 will have to be reduced, producing tightening effects. 2) The combined effect of declining household wealth and credit tightening will trigger a further rise in the saving rate, which will put a persistent brake on the consumption dynamic. The second point will also affect the economic prospects for the next two years, while the effects of a reduction in the federal deficit will be pushed back until the recovery stabilises and are not expected to be seen until at least end-2011.

The end-2008 figures on fund flows bear eloquent testimony to the economic revolution to be expected in the next ten years: the trends in the debt and balance sheets of leading economic agents have been subjected to unprecedented corrections and have altered the situation and tendencies that have been in place since 1945. Generally speaking, the US debt has continued to expand at a similar rate to previous years, but the main borrower is now the federal government, whereas households are going back to saving.

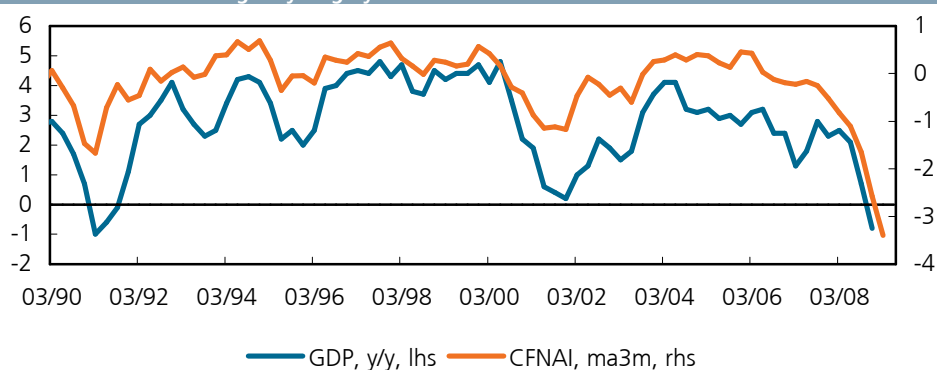
### Growth in non-financial domestic debt



Source: EcoWin, Flow of Funds data

This characteristic is not temporary. The collapse in the net wealth of households is without precedent since World War II and will lead to a further steep rise in the saving rate. In terms of economic balance, moreover, household saving is “necessary” in order to finance the negative saving in the public sector, as capital inflows into the USA from abroad dry up on the back of the rapid closing of the external deficit. This rotation of debt issuers, from households to federal government, describes not just the medium-term outlook but also the short-term picture. Through the coming quarters and in 2010, public sector debt will finance the modest trend in aggregate demand, while consumption will expand at a very slow pace in both the short and the medium term.

The contraction has a long way to go yet



Source: EcoWin

Turning to the forecasting figures, **a contraction of 3.3% is expected in 2009, followed by a recovery of 1.7% in 2010.** In both years the positive factor is public spending. In 2009, the chief feature is the switch in the correction from households to businesses. The slump in consumption in 2H08 is diminishing, aided by the cooling of inflation. The main feature of the contraction in demand in 2009 will be firms, which will slash investments on both capital spending and inventories. Like 2009, 2010 will be bolstered by the effects of the fiscal stimulus package and by moderate growth in consumption and investments. Starting in 2011 there might be semi-stagnation, due to the need to rein in the huge fiscal and monetary stimulus measures implemented in 2008-2010, in the context of a still very wide output gap. Global growth will no longer be driven by the United States, but will once more be driven by the major emerging economies.

The correction in **consumption** recorded in 2008 is without precedent and the size of the plunge was exacerbated by the loss of purchasing power caused by rising inflation. Consumption expanded by 0.2% in 2008, thanks to average growth of 1% in 1H08, followed by a contraction of 4% in 2H08. In 2009, the negative drag-on effect from end-2008 keeps the dynamic negative, albeit only slightly, in the first half of the year, followed by a recovery towards average growth rates of 1.3% in the second half. The forecast for 2010 is for consumption to grow by 0.9%, bolstered by fiscal policy and the stabilisation of the labour market in the middle of the year.

The decline in wealth will be the crucial determinant of the consumption dynamic, and will have a more lasting effect than the itself sizeable decline in the labour market (which should persist until mid-2010 at least). The wealth effect estimates<sup>5</sup> show relatively broad ranges. On average,

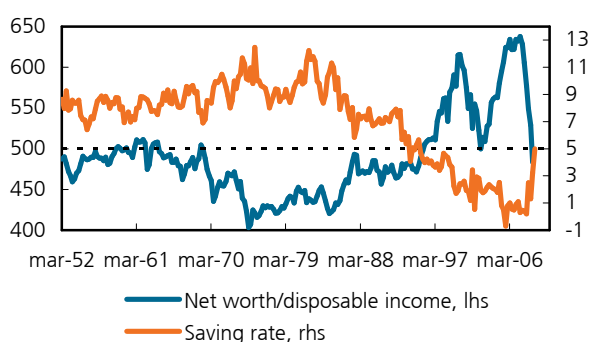
**Consumption: the worse is behind us, but the future is grim**

<sup>5</sup> A comparative analysis of the results of various estimates and models is contained in Congressional Budget Office, Housing Wealth and Consumer Spending, Background Paper, January 2007. For a breakdown by income bracket, see D. Maki, M. Palumbo, Disentangling the Wealth Effect: a cohort analysis of household saving in the 1990s, Fed Discussion Papers 2001-21, April 2001.

the effect on consumption of a change in real estate wealth is around 0.04 per Dollar. The CBO estimates that a 10% fall in house prices would drive up the saving rate by between 0.5 and 1.9 points and drive down consumption by between USD 55Bn and USD 190Bn per annum. If over-optimistic price expectations are included, saving's response to an actual reduction in house prices is between +1 and +3 points.

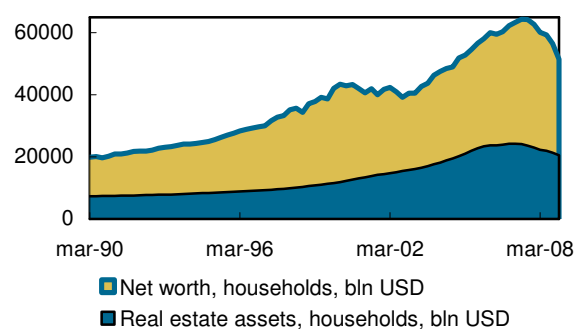
House prices fell by an average of 4.7% in 2007 and by 15.9% in 2008 according to the Case-Shiller index; the OFHEO index shows a movement of +1.5% in 2007 and 5.6% in 2008. The trend movement in real estate wealth in the flow of funds data was positive through to 3Q07; in 2008, the movement averaged -9.3%. The growth in the saving rate in 2008 was impressive (see chart below) and close to the top end of the above-indicated range of estimates. The saving rate rose from 0.2% in 1Q08 to 3.2% in 4Q08, followed by a further jump to 5% in January 2009. In addition to the fall in real estate wealth, the latter part of 2008 also saw a reduction in equity wealth and pension fund reserves. The forecasts for 2009 point to a further fall of 10% in the index Case-Shiller and 2.6% for the OFHEO index.

After two bubbles it's back to the past



Source: EcoWin

Net wealth and real estate wealth

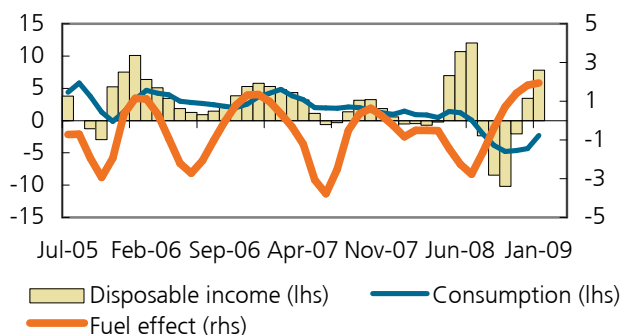


Source: EcoWin

In our outlook we assume further growth in the **saving rate**, albeit more sluggish and modest than has been the case to date, taking it to **6.5% avg. in 2010**, after which it stabilises at these levels in 2011-12. This will put a brake on consumption even when the labour market has stabilised, probably in the middle of 2010. Consumption should shrink by 1.3% in 2009, followed by a modest recovery in 2010 (+1%).

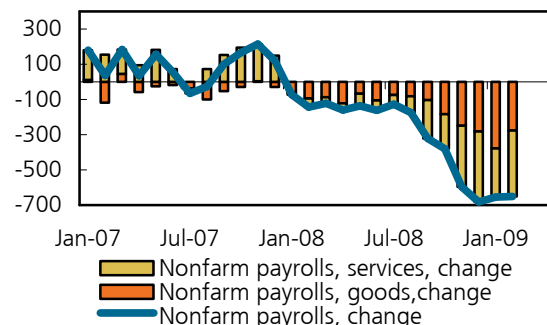
On a shorter time horizon, the figures signal some stabilisation in household spending, probably supported by the upturn in real income growth. The trend in real disposable income turned positive in December 2008, after four consecutive months of contraction, showing an increase of 7.8% yoy in January, in the wake of falling inflation, the indexing of social security transfers to the CPI in August 2008 and the increase in welfare transfers (unemployment benefits), despite the fall in labour income. Consumption should show a modest contraction in 1Q09 (-0.3% qoq ann.), and remain slightly negative in 2Q09 too (-0.6% qoq ann.) owing to the decline in labour income. Starting in 3Q09 the effects of the fiscal package should result in what we expect to be relatively modest consumption growth (+0.9% avg. in 2H09) on account of the expected rise in the saving rate.

Growth in real disposable income turns positive



Source: EcoWin

But labour income is impacted by the contraction in payrolls



Source: EcoWin

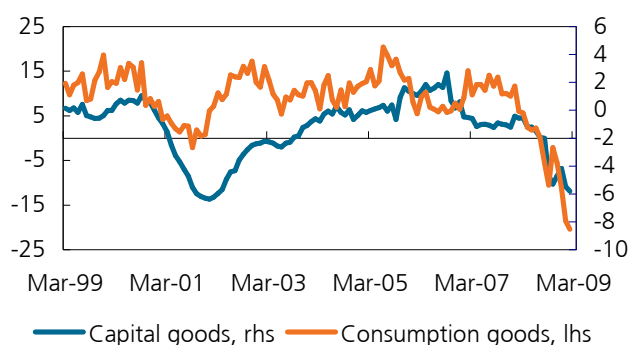
The labour market has continued to deteriorate and for now there has been no slowing in the rate of job-shedding vs. October 2008 (-646k). The employment component of the manufacturing sector surveys continues to fall (26.1 on the ISM in February, with similar indications for the March regional surveys). New jobless claims are at their highest since 1982, while since the end of January existing claims have risen to all-time series highs (series inception 1967), climbing to 5.317M in the week ended 28 February. Some modest signs of an improvement are however beginning to emerge. Among small businesses and in services **the rate of contraction signalled by the surveys is easing**: on the non-manufacturing ISM, employment rose to 37.3 in February from a low of 31.3 in December, while in the NFIB survey hiring intentions rose to -3 in February from a low of -6 in December-January. In terms of expectations six months forward, manufacturing firms are also starting to see an improvement in employment prospects: employment six months forward in the March Empire survey rose to -20.4 from -29.3 in February, while hours worked climbed to -5.6 from -13.8. A similar indication was given by the Philly Fed in February, showing employment rising to -16.9 from a low of -29.3 in January, and hours worked rising to -4 from -13 in January. The fall in payrolls in 2009 should amount to 3.3%, even envisaging a smaller contraction in payrolls as of the next quarter. **The unemployment rate should continue to rise throughout 2009 and reach a high of 9.8% in 1Q10**, before falling very gradually to 8.8% at year-end 2010 and remaining well above the equilibrium rate (estimated by the CBO at 4.8%) even in 2013.

The 2008 recession was driven by households, as consumption and residential building crashed. 2009 sees the **contraction shifting to businesses**. Industrial production, orders and exports have all been in free-fall, as in the rest of the global economy, since autumn 2008. Industrial production fell by 11.2% yoy in February and the contraction was not due solely to the auto sector. Car production was down 38.5% yoy, but manufacturing output ex auto shrank by 11.5% yoy. The only non-negative indication is the fact that the contraction in output is diminishing vs. end-2008. The smaller contraction in output recorded in the production component of the ISM was confirmed in the February data, when manufacturing production contracted by just 0.7% mom (thanks to an upturn in the auto sector) after three months of average contractions of 2.6% per month. The steep decline in output is accompanied by a substantial **contraction in inventories**, although these cannot keep up with the fall in aggregate sales: the total inventories/turnover ratio rose from 1.23 in June 2008 to 1.43 in February 2009, its highest level since September 2001. The only sector to report an improvement in the inventories/turnover ratio is retail, thanks to the upturn in sales in January and February. The contraction in inventories and output will continue, not least because the indications on the orders front remain negative, although they do at least signal some stabilisation in the rate of decline. Orders on the manufacturing ISM have been stuck at 33.1 for two months (from a low

**Investment will collapse in 2009**

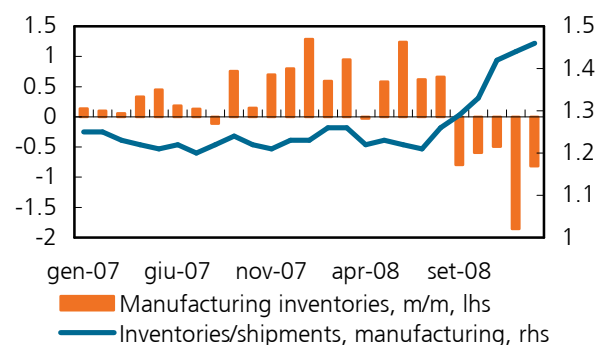
of 23.1 in December 2008), while export orders stabilised at 37.5 (from a low of 35.5 in December). Capital goods orders ex defence and aircraft fell 34.4% qoq in January and by 20% yoy. In the Philadelphia Fed survey expected investment spending six months forward stood at -17.8 in February, and in March the Empire included a deterioration in investment spending to -19 from an average of -11 in the previous three months.

**Industrial production (yoy): dire outlook for investments**



Source: Thomson Reuters - Datastream

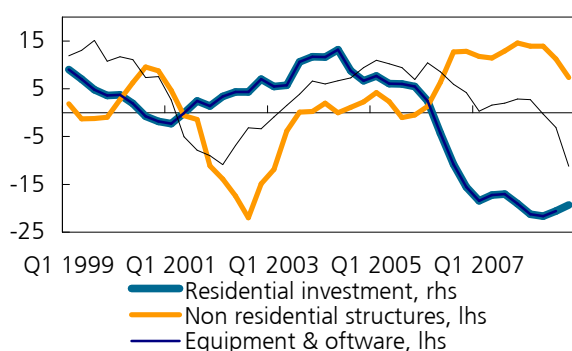
**Cuts in inventories and production cannot keep up with the contraction in turnover**



Source: EcoWin

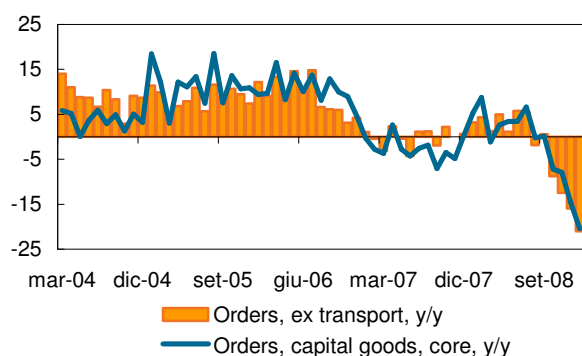
Our forecasts are for a **contraction in investments of 16.4% in 2009**, with the rate of decline accelerating to -28% qoq ann. in 1Q09, after -21% qoq ann. in 4Q08. The rate of decline should moderate as of 2Q09, although we still expect the second quarter to show a fall of 18% qoq. The collapse in fixed corporate investments in 2009 will hit both **commercial building** forecast: -11%) and **equipment** (-19.4%).

**Not one component of investments will be positive in 2009**



Source: Thomson Reuters - Datastream

**Orders: very negative indications for investments**



Source: EcoWin

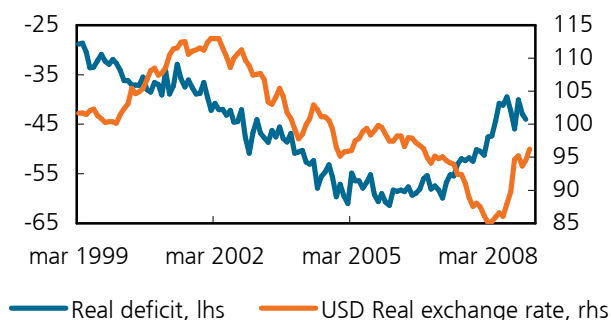
With regard to **residential building**, the forecast of an improvement in 2009 was over-optimistic. The new forecast pushes back real estate sector stabilisation by another year, while the rate of contraction expected this year should be similar to 2008 (-20%). The fall in housing starts is continuing to its lowest level since series inception. New starts in February showed their first positive movement since June 2008, but it is too early for this to indicate a reversal, in light of the other information from the sector and the stock of unsold existing homes (equivalent to nine months of sales). The massive purchases of Treasuries and agency-backed securities announced at the Fed's March meeting will have the effect of reducing mortgage rates, but general

macroeconomic conditions will at most merely reduce the rate of contraction in this area of investments.

The **trade balance** is rapidly narrowing. The **current account deficit** in 4Q08 closed sharply, falling from USD 181.3Bn in 3Q08 to USD 132.8Bn in 4Q08, and eased from 5% to 3.7% of GDP. The narrowing of the deficit was largely due to the narrowing of the trade balance (down USD 40Bn to USD 140Bn), showing a reduction in goods liabilities of USD 42.2Bn and a reduction in the services surplus of USD 1.7Bn. The incomes-related balance rose to USD 36.5Bn from USD 29.6Bn in 3Q08. Imports should continue to shrink in 2009, contracting by an estimated 5.7%. Expectations of an upturn in growth at the end of the year results in a projected trend reversal in 4Q09. On exports, the 2009 outlook is for a decline of 7.6% and a small rebound in 2010. In terms of contribution to growth, net exports will be broadly neutral, barring a negative contribution expected in 4Q09 when imports should diverge sharply from the persistent weakness of exports.

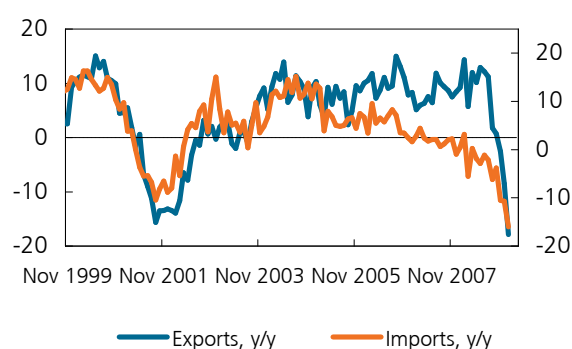
**Net exports basically neutral for most of 2009**

Plunging growth resolve the external imbalance issues



Source: Thomson Reuters – Datastream

No trend reversal in external trade at least until end-2009



Source: Thomson Reuters – Datastream

**Inflation** should come to -0.6% in 2009, showing negative trend changes in the two central quarters of the year (-0.9% in 2Q09 and -1.8% in 3Q09) and a return to positive territory in 4Q09 (0.6% yoy avg.). The base effect with 2H08 will dominate the trend dynamic. In 2010, inflation will return to 2% avg. A gradual downtrend will typify the core CPI as of 2Q09. The forecast is for a core CPI averaging 1.1% in 2009 and 1% in 2010. The core CPI should fall below 1% (0.6% avg.) at end-2009. The rapidly widening output gap will be behind the reduction in the core rate below the Fed's target level and will be the main justification for keeping official interest rates on hold until year-end 2010 at least, even when the central bank starts withdrawing some of the additional money supply introduced since mid-2008. The CBO estimates that the output gap without fiscal stimulus would be 7.4% at year-end 2009; with the measures the output gap would be 6.5-7% in the best-case scenario. In the CBO forecasts the output gap does not narrow until year-end 2013.

**Economic policies increasingly vital for the 2009 outlook: intensive care with potentially life-threatening future side effects.**

The forecast of a modest upturn in growth in 4Q09 depends entirely on the expected effects of the **fiscal package and the stabilisation of the financial markets**. According to the CBO, from a total package of USD 787Bn approved in February, the measures relating to 2009 amount to USD 184Bn (1.3% of GDP) in fiscal year 2009, to USD 399Bn (2.8% of GDP) in fiscal year 2010 and to USD 134Bn in fiscal year 2011. Our estimate is that the effect of the measures on GDP will be less than the amount approved since several parts of the package should be ineffectual in stimulating growth (e.g. USD 70Bn for the AMT adjustment; tax cuts for businesses); the

**Super-expansionary economic policies will start to gradually affect growth as of the end of Q2**

reduction in taxes on households will have a significant effect only at the lower end of the income scale, and will have only a very modest effect on income classes that have a positive saving rate and want to increase it. With regard to public expenditure, infrastructure spending will be almost entirely concentrated at state level and is unlikely to be introduced before 4Q09. Conservatively, we assume the effectiveness of the package will amount to around 0.6% of GDP in 2009 and close to 1% in 2010. The CBO assumes that the effect of the measures on GDP 2009 will be between 1.4% and 3.8%, and between 1.1% and 3.4% in 2010. The US Administration has equally bullish estimates. The size of the effect of the economic policies, including the expansion of the Fed's balance sheet, will depend on the stabilisation of the financial markets.

The CBO has published an updated **fiscal outlook**, which includes the estimated effects of the measures adopted by Congress in February and implies a marked deterioration in the deficit in fiscal years 2009 and 2010 vs. the outlook published just two months ago. The federal deficit should explode **to USD 1.7Trn in fiscal year 2009, or 11.9% of GDP** (from USD 1.2Trn estimated in January), and fall to **USD 1.1Trn, 7.9% of GDP, in fiscal year 2010** (previous estimate, USD 703Bn). Using this new "baseline", the CBO estimates the fiscal outlook that should ensue from the implementation of the budget proposed by the Administration one month ago: the result is a deficit path that worsens every year vs. the baseline scenario – **USD 1.8Trn in 2009**, USD 1.4Trn in 2010 – and would not fall below 4% at any time over the period considered (2009-2019). Note that in the CBO outlook, like that of the OMB, the underlying economic assumptions are very optimistic from 2010. Apart from a realistic -3% projected for 2009, the CBO assumes growth of 2.9 % in 2010 and 4% avg. in the period 2011-2013, before falling only very gradually towards trend growth (estimated at 2.2% in the period 2009-2013, and 2.3% in the period 2013-2019).

**Federal deficit close to 12% of GDP in 2009**

The USD 1.7Trn deficit projected for 2009 in the CBO's baseline scenario is derived from a fall in **tax receipts** to 15.5% of GDP (from 17.7% in 2008), partly due to the fiscal package approved in the American Recovery and Relief Act (ARRA) totalling USD -65Bn, and the remainder to lower revenues on account of the economic downturn. On the **outgoings** side, the deterioration in 2009 takes the total to 27.4% of GDP, from a previous estimate of 24.9% of GDP (and from 21% of GDP for 2008). Expenditure is impacted to the tune of USD 120Bn by the effects of the ARRA and also by around USD 150Bn worth of additional TARP-related outgoings. The reduction in the deficit from 2010 is driven by a rapid fall in expenditure accompanied by an upturn in revenues, leading to the deficit stabilising around USD 300Bn as of 2012.

The projected **financing requirement is around USD 2.3Trn** for the current and next fiscal years, even though the deficit as defined by the Administration and the CBO will be smaller since the agency support measures and TARP funds are not booked at their nominal value but at their risk-adjusted expected value. Specifically, the USD 700Bn allocated to the TARP programme has an impact on the budget of USD 180Bn, while the agency support measures count for USD 240Bn. The deficit as reported in the national accounting figures should amount to around USD 1.8Trn. One factor that adds uncertainty to the deficit forecasts relates to the outcome of the stress tests to which banks are now being subjected and which might point up the need for fresh injections of funds relatively soon and further increase the federal government's requirement. The Fed's purchasing of up to USD 300Bn worth of Treasuries in six months, as announced on 18 March will help ease the pressures stemming from the explosion in the borrowing requirement.

**Monetary policy** has reached the end of the line: at the 18 March meeting the FOMC brought into play "all available tools" in order to support sustainable growth and price stability. The separation of monetary policy and fiscal policy has narrowed in both form and substance, with Treasury/central bank relations resembling the way they were after the second world war

**The central bank has become a subsidiary of the Treasury**

The March FOMC meeting The Fed decided to more than double outright public bond purchases, this time including **Treasury notes**. The statement reveals greatly increased concern at the situation and the **economic prospects**, indicating that no area of private demand is in a position to make a positive contribution to growth. Consumption is being squeezed by job losses, shrinking wealth and credit tightening. Company investments are falling on the back of weak sales and credit tightening. Exports are in free-fall because the global recession. The statement says that expansionary economic policies will contribute to a “gradual resumption of sustainable economic growth”, but avoids giving a time horizon for this forecast. The previous statement claimed the recovery would arrive “later this year”. Inflation might remain below the desired level for some time.

In the context of this deterioration, the **rates strategy** remains that adopted in recent months, but the timing changes: the statement now says that rates will likely remain exceptionally low “for an extended period”, whereas in January the wording was “for some time”. With regard to **balance sheet strategy**, in order to beef up support for mortgages and the real estate market, the Fed has announced a further expansion of its balance sheet via the purchase of another USD 750Bn worth of agency-backed securities, taking total purchases in this segment to USD 1250Bn. In addition, outright purchases of agency-issued assets are increased by a further USD 100Bn, taking the total to USD 200Bn. In order to improve conditions on the credit markets, the Fed has announced the purchase of up to USD 300Bn worth of “longer-term” Treasuries over the next six months. The Treasury purchases will focus on the 2-10Y segments, and will also include TIPS. On average, the purchases will be made twice or three times a week via competitive auctions with primary dealers. It has also been announced that the TALF programme now being rolled out will be extended by widening the range of assets accepted as collateral.

The Fed thus responds with all guns blazing to three negative conditions that have formed this last month. 1) The **economic indications** continue to deteriorate, showing a sharp downturn in the economic prospects for FY09. 2) The central bank balance sheet expansion strategy has slowed owing to the scaling back of several programmes and the dilatory start-up of the TALF: the voluntary nature of the main schemes has reduced **the Fed’s control over the size of the balance sheet**. 3) The **tensions in Congress** over the use of the funds given to AIG and the bonuses handed out by the banks “rescued” by TARP have engendered a climate hostile to further fiscal action to help the financial system: the operation may be politically incorrect, but in the end it is to the benefit of all the parties involved. In light of yesterday’s decisions, **the Fed’s balance sheet**, which at end-2007 stood at around USD 870Bn, should expand to at least USD 3,000Bn, and **could reach USD 4,000Bn** (one quarter of GDP) if the TALF programme is put into full effect.

By its decision to purchase Treasuries and the signal that the central bank’s balance sheet will continue to expand to around one-third of GDP, purchasing structured agency assets and allocating credit to businesses and sectors, the Fed has overstepped all the markers that protected its independence from political influence and its ability to react flexibly to economic fluctuations. Such is the institutional importance of these developments that it resulted in a joint statement from the Fed and the Treasury intended to reassure the markets regarding the future institutional monetary policy set-up.

The joint statement issued 23 March and entitled “The Role of the Federal Reserve in Preserving Financial and Monetary Stability” stresses that the Fed has **sole responsibility** for preserving monetary stability and it confirms that the Treasury and central bank are in agreement in identifying the elements vital to preserving monetary and financial stability. The programmes implemented to date by the Fed have breached most of the basic principles of responsible, prudent and independent monetary policy: this breach is justified under the Federal Reserve Act by “unusual and exigent circumstances”. However, in normal circumstances monetary policy

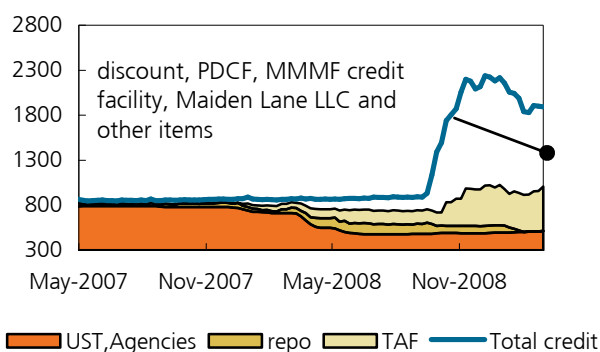
**In the short term, this solves the problem of financing new rescue packages for the economy and the banking system...**

**... in the medium term the blurred boundaries of the Fed’s independence may seriously complicate the central bank’s exit strategy from the current monetary stimulus**

must not “allocate credit to narrowly-defined sectors or classes of borrowers”: these decisions are the preserve of fiscal policy. In addition, the actions now being taken in response to the emergency “must not constrain the exercise of monetary policy as needed to foster maximum sustainable employment and price stability”. The statement stresses that the Treasury may use an exceptional funding mechanism, called the “Supplementary Financing Program”, to manage the central bank’s balance sheet. In addition, the statement indicates that the Treasury and the Fed are outlining legislative action that will provide additional tools with which the Fed can neutralise the effects of its lending and purchasing on the supply of bank reserves. Lastly, the statement says the authorities are working with Congress on a regime that will allow the authorities to intervene in response to the risk of failure of any systemically critical financial institution, assigning clear responsibilities and powers in advance, in order to avoid a repeat of disorderly failures such as those of Bear Stearns and Lehman. The Treasury will also seek to acquire the assets inherited from the failure of Bear Stearns, moving them from the Fed’s balance sheet to its own.

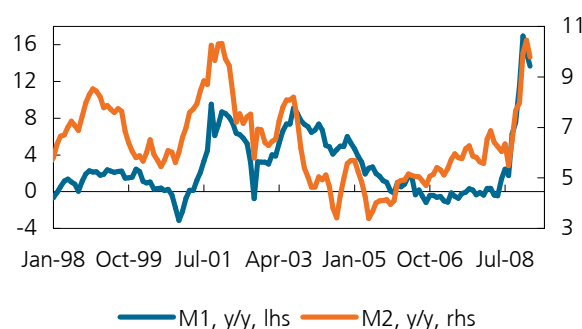
The fact that the authorities have issued this statement is indicative of just how fragile and dangerous is the state of the institutional structure on which economic policy is developed. As an WSJ editorial and an interview with John Taylor in the FT noted, the present economic policies are destroying the principles of Fed independence guaranteed since the early 1950s, following a deep rift between the Fed and the Truman Administration over the setting of interest rates. During the second world war the Fed kept rates at around zero, and this policy was maintained even after the war. Towards the end of the 1940s, monetary policy called for higher interest rates to control rising inflation, whereas the fiscal authorities wanted rates to be left where they were to finance the Korean War and public spending. The conflict was resolved in the 1951 agreement in which the foundations were laid for monetary policy independence from the fiscal authorities. The joint statement from the Fed and the Treasury also shows that the Administration is aware of the risks connected with a monetary policy that is not independent in normal circumstances and reduces the risk of political constraints on Fed activity when the situation has normalised. Nevertheless, the legacy of the measures implemented in recent quarters will be extremely difficult to eliminate as promptly as is needed. The one thing that is guaranteed with a budget amounting to 30% of GDP and hundreds of billions of dollars of state assets on the central bank’s balance sheet is that the next cycle will be characterised by very broad fluctuations, exacerbated by steps to correct the super-expansionary economic policies implemented by the Treasury and the central bank. In this respect “Back to the future” seems an adequate characterisation of the economic outlook for the next five years.

The Fed’s balance sheet could shoot up by another 2 Tn



Source: EcoWin

Monetary aggregates skyrocketing: risks for teh future?



Source: EcoWin

## FOCUS – Public-Private Investment Programme

The Treasury has made public more details of the financial stability plan announced in February, giving information on the operation of the public-private partnership investment programme (PPIP) for the acquisition of toxic assets and for the broadening of the TALF aimed at supporting banks' balance sheets. The public-private investment programme sets up the public-private investment funds (PPIFs) which will receive public money to buy legacy assets (which were, until yesterday, known as toxic assets), reviving lines of credit within the economy and improving the working of financial markets. As emphasised by the white paper that describes how the programme works ([http://www.treas.gov/press/releases/reports/ppip\\_whitepaper\\_032309.pdf](http://www.treas.gov/press/releases/reports/ppip_whitepaper_032309.pdf)) the FFIP complements the other programmes in the financial stability plan, namely the capital assistance program, the homeowner affordability and stability plan, and the consumer and business lending initiative.

The measures are based on the assumption that the banks' problems are, at least in part, due to excessive undervaluation of a broad swath of assets, especially those linked to the property sector. According to the Treasury, "the discounts currently embedded in some legacy asset prices are a significant strain on the economic capital of U.S. financial institutions" and have involved wide-scale deleveraging. The aim of the PPIP is to attract private capital for the acquisition of these assets thanks to the presence of public funds, and on attractive financing terms. The programme "should facilitate price discovery" and reduce the excessive discount embedded in these assets. The crucial issue of how to price the assets would be settled by the market. Setting the "long-term" price by the market would allow reduction of the embedded liquidity discount, without however making the Treasury (and therefore the taxpayer) pay more than such assets' long-term value. The programme applies to loans and structured securities. The Treasury will make available up to USD 100 billion (still remaining from the TARP funds) with the aim of buying troubled assets up to a value estimated at between USD 500 billion and USD 1,000 billion.

### 1) Loans

For these, the Treasury and the FDIC will implement the legacy loans programme (LLP). This aims to attract private capital to buy loans with FDIC debt guarantees and Treasury co-investment. The Treasury will offer 50% of the capital for the purchase, but management control will remain in private hands, though supervised by the FDIC. The banks will identify pools of loans that they wish to sell. The FDIC will analyse the pools of loans and determine the level of debt it is prepared to guarantee, with a debt-to-equity ratio limit of 6 to 1. Private investors will bid for 50% of the PPIF equity, and the capital offered, together with the debt-to-equity ratio fixed by the FDIC, will determine the price offered to the bank. If the transaction is completed, the fund will manage the assets, under strict supervision by the FDIC, until they are liquidated. For example, if there is a pool of loans with a face value of 100 and a debt-to-equity ratio of 6 to 1 set by the FDIC, assuming that bids reach 84, the portion of the capital to be split equally between the Treasury and private investors would be equal to 12. The remainder would be collected via the issue of debt to the value of 72, guaranteed by the FDIC and secured by the purchased assets.

### 2) Structured assets

The legacy securities programme (LSP) consists of two parts, one similar to the loans programme (consisting of public and private co-financing) and the other operated through the TALF programme with Treasury and Federal Reserve debt financing.

The LSP expands the TALF, creating a programme of non-recourse loans to offer to private investors who wish to acquire structured securities. These assets will include residential mortgage-backed securities (RMBS) which originally had an AAA rating, and CMBS (commercial mortgage-backed securities) and ABS with an AAA rating. The details of the loan conditions have yet to be determined and will be drawn up after suggestions have been sought from market participants. On the basis of what has been announced, the TALF will be able to offer loans up to USD 1 trillion.

As regards public-private funds, the Treasury plans to name about five fund managers whose task it will be to attract private capital for buying structured securities, receiving a capital contribution of 50% of the total investment. The funds will be able to be granted a loan of up to 50% of the total capital, which could be extended to 100% of the fund's capital. For example, a fund that raised capital worth 100 would receive 100 from the Treasury, a loan of up to 100 from the Treasury under certain conditions, and a further loan of 100 under certain other conditions. The fund could have available up to 400 (based on having attracted 100 in private capital) and could start its acquisitions programme, while keeping control of fund management. PIMCO and Blackrock have indicated an interest in taking part in this programme.

The plan for acquiring "legacy assets" gives more detail operating mechanisms, even though some areas have not yet been finalised. As regards the LSP (for structured securities) the conditions attached to Treasury loans have yet to be determined, and there are no guarantees limiting losses on assets. Therefore, for this part of the plan it may prove difficult to find a price that leads to acquisitions. As regards the LLP (for loans), the price offered may also be below the price at which banks are prepared to sell assets. If the programme led to the acquisition of at least USD 500 billion in loans, this would be the equivalent of freeing the banks' balance sheets of 10% of their mortgages. In previous recessions about 12% of assets were non-performing, with a recovery rate of about 30-40%. The plan suffers from being "voluntary" and depending on a process of "price discovery" which might not lead to the relieving of banks' balance sheets (or, alternatively, could lead to their insolvency).

## Eurozone pays a heavy price for the global crisis

Paolo Mameli

- The forecast for average eurozone GDP growth for 2009 has been revised heavily downwards, to -3.3% from -0.7% in December. The reduction of 2.6 percentage points from three months ago can be broken down thus: 0.7 points due to the poorer performance during the last quarter of 2008, per 1.5 points due to more pessimistic forecasts for the first quarter of 2009, and just 0.4 points due to a downgrade for the rest of the year. The worst-hit country will be Germany, and the components that will bring down GDP will be investment and exports (each of which is expected to fall by almost 10%).
- For 2010, we do not believe growth will remain negative, because structural factors that will impact on the cycle next year – monetary policy, fiscal policy, and reduced inflation – have all moved in a favourable direction of late. In essence, we continue to forecast modest growth in 2010 of 0.4%.
- On the basis of the new oil price situation, lower-than-expected CPI figures for the beginning of 2009, and the prospect of a further weakening of core inflationary pressures as a result of a deepening of the output gap, we revise our forecasts for inflation in 2009 firmly downwards to 0.4%, from the 1.4% forecast in our last quarterly report and from the 3.3% average for 2008. In our central scenario the CPI enters negative territory from June, remaining there until September. In this model, core inflation (excluding energy and non-processed food) slows to 1.1% in 2009 from 2.4% in 2008.
- We expect that the ECB may bring its refi rate down to 1% and leave it unchanged until at least halfway through 2010. In the short term the ECB should also decide to extend the longest duration of the auctions through which it supplies liquidity to the banking system (at a fixed rate and for any amount requested) from the present 6 months to 12-24 months. Finally, the ECB may decide (though probably not imminently) on a plan to buy private debt on the secondary market; by contrast, we think it unlikely that there will be a plan to acquire government bonds, chiefly because it is difficult to implement from a practical point of view.

Macro forecasts	2008	2009	2010	2008			2009			2010	
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.7	-3.3	0.4	1.5	0.6	-1.3	-3.7	-3.8	-3.7	-2.2	-0.2
- q/q change				-0.2	-0.2	-1.5	-1.8	-0.4	-0.1	0.1	0.2
Private consumption	0.6	-1.3	0.1	-0.1	0.1	-0.9	-0.3	-0.4	-0.2	-0.1	0.0
Fixed investment	0.6	-9.0	-0.8	-1.1	-0.6	-2.7	-4.1	-2.4	-1.2	-0.4	0.0
Government consumption	2.0	1.4	1.9	0.8	0.9	-0.6	0.5	0.5	0.5	0.4	0.4
Export	1.8	-10.8	1.6	-0.1	0.0	-7.3	-4.5	-1.1	-0.7	0.1	0.6
Import	1.8	-8.6	1.3	-0.3	1.4	-5.5	-3.5	-1.8	-0.7	0.1	0.5
Stockbuilding (% contrib. to GDP)	-0.1	0.2	0.0	-0.2	0.2	0.6	-0.4	-0.1	0.1	0.1	0.0
Current account (% of GDP)	-0.7	-0.5	-0.4	-0.3	-0.9	-1.2	-0.6	-0.7	-0.3	-0.3	-0.9
Deficit (% of GDP)	-1.7	-4.3	-4.9								
Debt (% of GDP)	68.6	72.7	75.7								
CPI (y/y)	3.3	0.3	1.3	3.6	3.8	2.3	1.0	0.2	-0.3	0.3	1.0
Industrial production (y/y)	-1.7	-11.9	0.8	-0.7	-3.2	-11.5	-14.0	-12.5	-10.9	-5.1	-1.2
Unemployment (%)	7.5	9.1	9.8	7.4	7.5	7.9	8.4	9.0	9.4	9.8	9.9
3-month Euribor	4.64	1.42	1.60	4.86	4.98	4.21	1.99	1.25	1.18	1.27	1.99
EUR/USD	1.47	1.31	1.37	1.56	1.50	1.32	1.31	1.31	1.31	1.33	1.34

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

## Growth will turn positive at best between end-2009 and start-2010

We are revising sharply down, to **-3.3%** from December's **-0.7%**, our forecast for Euro area GDP in 2009. **The revision of -2.6 pp from three months ago is due** to a downward revision on Q.4 2008 (-0.7 pp), to a bleaker assessment of first quarter 2009 (-1.5 pp) and **only marginally (-0.4 pp) to a downgrade of the other quarters of the year. The country hit hardest will be Germany** which, mainly on account of a disastrous first quarter (in all likelihood worse than the itself staggering -2.1% qoq recorded at year-end 2008), might see a contraction of over 5% in 2009 GDP. **The demand-side components doing the damage in 2009 will be investments and exports** (both expected to be down almost 10%), vs. a smaller fall in consumption (-1.3%) and public spending which will make a positive contribution. International trade should shave just over one percentage point off growth.

The revision to our 2009 GDP forecast is due mainly to a downgrade on Q.4 2008 e Q.1 2009

With regard to 2010, we do not share the view that growth will remain negative. The recent adverse trend in the economic indicators is not a good predictor of medium-term growth, whereas **more structural factors, which will impact on the cycle next year, have recently turned positive:**

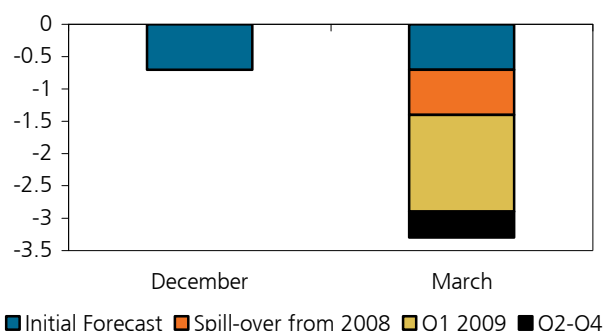
... but we retain our forecast of a return to slightly positive territory in 2010

**1) monetary policy** has become even more accommodating, with rates heading for 1% and the ECB even mulling additional tools to support lending; in addition, the fall in official interest rates is once again being reflected in market rates (the Euribor index is at its lowest since Euro inception), increasing the likelihood of the stimulus feeding through to the real economy;

**2) fiscal policy**, especially in Germany and Spain, is moving in a markedly counter-cyclical direction, and this will have a cumulative impact of around 0.5% on GDP in 2009-2010 (see below);

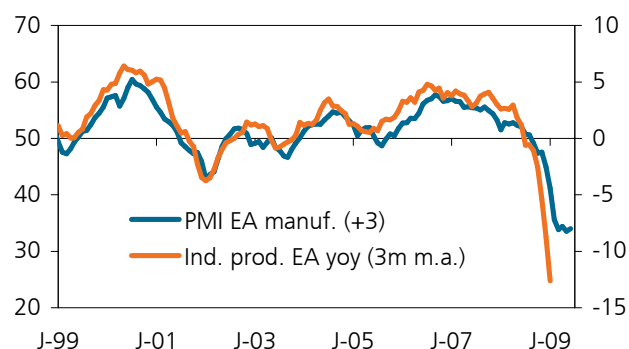
**3) inflation has continued to cool**, bolstering household spending power. In short, **we stand by our view of slightly positive growth in 2010 (0.4%)**. Half the bounce would be due to an upturn in exports and half to domestic demand (public spending and consumption, while investments might remain slightly negative).

The downward revision on 2009 GDP forecast is largely due to a bleaker assessment of Q.4 2008 and Q.1 2009



Source: Eurostat, Intesa Sanpaolo

The trend in the real data (notably in industry) has been even worse than the confidence indices



Source: Eurostat, Markit Economics, Intesa Sanpaolo calculations

With respect to three months ago, confidence indices showed some easing of the rate of decline, signalling that the downtrend might be over, **but the real data, notably industry-related, have continued to worsen sharply** at the start of 2009 after a disastrous end to last year. Industrial production has nosedived (especially in Germany), falling much further than the (already low) confidence indices suggested. The feeling is that signs of a possible rally are confined to the expectations indices, while the recovery proper is a long way from being

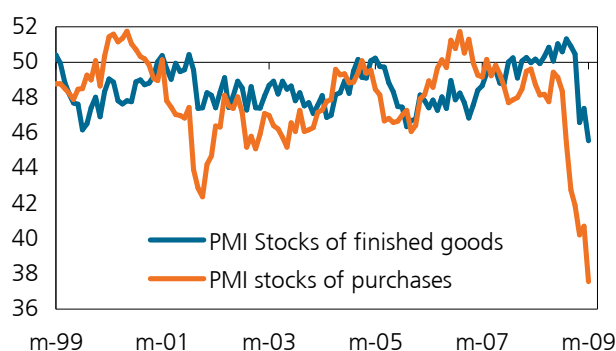
The fall in the real data in industry has been even greater than might have been expected from the confidence indices...

“tangible” for firms, which are still seeing their order-books shrink rapidly. On this front, it is worrying, vis-à-vis the prospects for corporate investments, that **capital goods have been hit particularly hard**. Assuming a further fall in February and a rally in March, we expect output to be down -6.5% qoq in 1Q09 (vs. -5.3% qoq before). The figure is consistent with a GDP contraction of -1.8% qoq in 1Q09.

**An analysis of the inventories cycle signals that the stabilisation of production is still a long way off.** The finished product inventories indices inferred from the PMI surveys, after recording an all-time high (51.3) in October (reflected in a bounce in national accounting inventories in 4Q08, contributing 0.6% qoq to GDP), plummeted thereafter, falling to a new all-time low in March (45.6). Even steeper was the fall in purchased goods inventories (37.6 in March). In other words, **a correction in inventories is under way, which accounts for the fact that production fell further than the confidence indices might have suggested** (in recessions such as the early 1990s event, the fall in inventories accounted for c.70% of the production cuts). However, what is worrying is that the level of inventories, **despite falling in absolute terms, has merely increased relative to the desired level** (i.e. in relation to what businesses estimate to be the prospective pace of sales), as can be inferred from the sub-index of the EU Commission business confidence survey (the national business confidence surveys give similar indications). Thus, we conclude from these considerations that the **correction in inventories is under way but far from being complete, and it will continue to weigh on production** in the coming months.

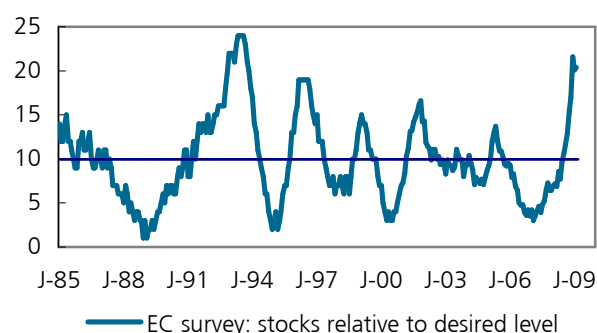
... owing to an incipient correction in inventories...

Firms have started to reduce inventories...



Source: Markit Economics

... but they are still well above the desired level

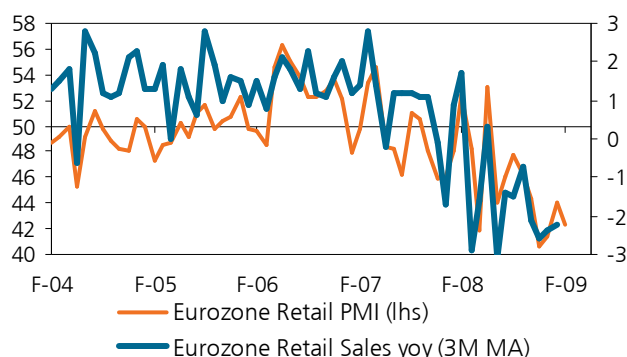


Source: EU Commission

In addition, the absorption of inventories might not be completed as long as sales continue to fall. In truth, at start 2009 **both consumer confidence and spending have held up after falling in 2H08, thanks to the rally in real incomes** stemming from the fact that nominal incomes have remained broadly steady while inflation has fallen sharply. However, the **most likely outlook is that this resilience will prove short-lived**: in the coming months the negative impact of rising unemployment might outweigh the positive impact from the rise in real incomes (which peaked in early 2009 and should dissipate during the year as nominal wages slow). The breakdown of the consumer sentiment surveys in several countries, which show growing concern over jobs and diminishing concern over prices, appears to bear out this view.

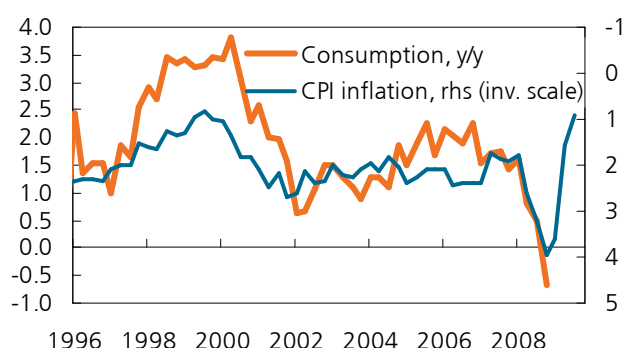
... which will not however be completed as long as consumption remains on a downtrend

Retail sales still on a downtrend...



Source: Eurostat, Bloomberg, Intesa Sanpaolo calculations

... despite an upturn in household purchasing power

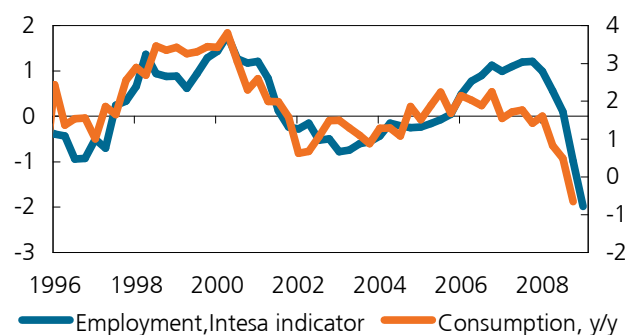


Source: Eurostat, Markit, EcoWin, Intesa Sanpaolo calculations

The medium-term resilience of private consumption will depend crucially on the labour market. Employment fell -0.3% qoq in 4Q08 after -0.1% qoq in 3Q08, showing a particularly steep downturn in Spain (-2.1% qoq) and resilience in Germany (+0.1% qoq). Year-on-year, payrolls have slowed to zero growth (from 0.6% yoy). The fall in the PMI employment index (to 41.4 in 1Q09 vs. 45.3 in 4Q08) is consistent with further slippage into negative territory. The Intesa Sanpaolo employment index (constructed as the weighted average of the employment component of the EU Commission confidence indices in industry, services, construction and retail) gives even more negative indications. **We project a 1.7% fall in employment this year (and 0.6% in 2010), and an unemployment rate rising gradually to just shy of 10% at end-2009/start 2010.** The slowdown in lending (though more modest) will also impact on consumption in 2009. **We expect consumption to shrink by -1.3% in 2009** (after +0.6% in 2008).

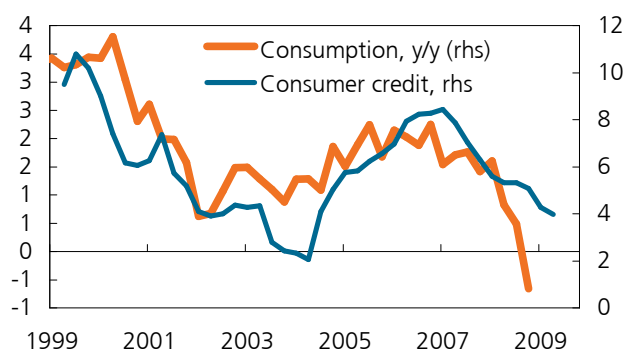
**Unemployment and reduced access to credit will dog consumption...**

Consumption will be dogged by falling employment...



Source: Eurostat, EU Commission, Intesa Sanpaolo

... and, to a lesser extent, by the slowdown in lending



Source: Eurostat, ECB, Intesa Sanpaolo calculations

The other risk to consumption is the negative wealth effect stemming from the fall in house prices. As shown by the ECB in its January bulletin<sup>6</sup>, the empirical surveys show a marginal propensity to consume vs. real estate wealth (long-term) of 6-10 cents per dollar in the United States, 9 cents per dollar in Canada, 4 pence per pound sterling in the United Kingdom and 1-2 cents per euro in Italy. The evidence for the Euro area is less consistent and relatively scant. The ECB concludes that, just as the real estate market boom seen in recent years does not seem to have significantly bolstered consumer spending in the Euro area, so the current slowdown should overall have a relatively limited impact over the Euro area as a whole. However, marked differences are found between countries. Based on indicators such as a high percentage weighting of owner-occupied

**...while the negative wealth-effects stemming from the fall in house prices should have a limited impact on consumption**

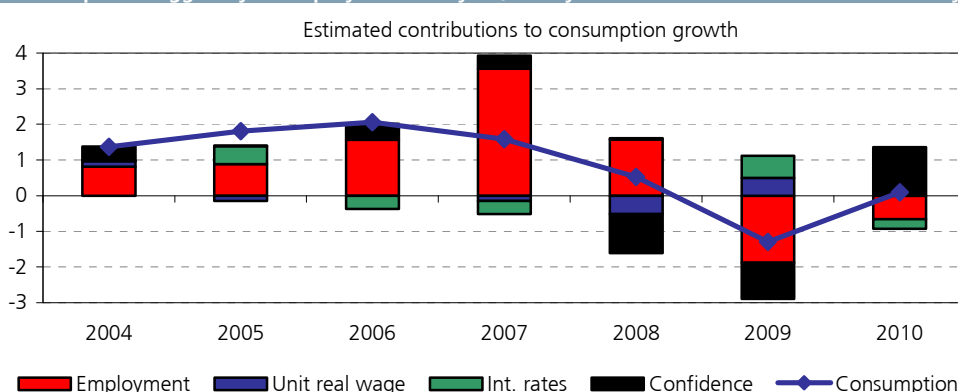
<sup>6</sup> "Housing wealth and private consumption in the euro area", ECB Monthly Bulletin January 2009.

homes, a high loans-to-house-value ratio and ample opportunity for early repayment (which may strengthen and speed up the transmission mechanism), the chief risks are found, in addition to Ireland and Spain, in the Netherlands and Portugal. While the risk of a major impact from the real estate correction on consumption is relatively modest in the Euro area as a whole, this same risk is far greater in these countries.

**Thus, in 2009-2010 consumption will be held back by falling employment, but at the same time it will benefit from falling inflation that should boost real pay (despite a slowdown in nominal wages) after the contraction in 2008. Which effect will prevail?** To this end we have constructed a model that explains private consumption in the Euro area by four factors - employment, real pay, interest rates and confidence (although a residual remains, it is statistically manageable). Based on the model's elasticity, and adopting assumptions consistent with our central forecast for the independent variables, it is possible to project the contributions of the various components to household spending. Naturally employment, after making a substantial contribution to consumption growth in recent years (peaking in 2007), will have the opposite effect in 2009-10, since we expect payrolls to fall by 1.7% in 2009 and by 0.6% in 2010. The contribution would thus be -1.9% this year and -0.7% next year. Real pay should be positive both in 2009 and 2010 (after falling in 2008), and should contribute 0.5% to consumption growth this year and 0.75% next year. The impact of interest rates peaks this year (+0.6%), but might fall into slightly negative territory next year as a consequence of a possible slight rise in yields from the current lows. We also assume that consumer confidence (according to the EU Commission index) will bottom out in 1Q09 and then rise gradually to its long-term average at year-end 2010. This would produce a negative impact of 1% in 2009 (as in 2008) and a positive impact of the same amount next year. **The model signals that this year the negative impact resulting from the fall in employment and confidence will be dominant, and according to the model the movement in consumption might be even more negative, at -1.8%** (signalling downside risks to our forecast of -1.3%). **Next year** (on the assumptions made), **the positive effect of the bounce in real pay and confidence would come out on top**, which might trigger a much larger bounce (just over one percentage point) vs. the broad stability (+0.1%) envisaged in our central forecast. But should confidence remain at the current levels, consumption would remain in negative territory (-0.2%) next year too.

This year consumption will be depressed by falling employment; next year confidence might pick up

**Consumption dogged by unemployment this year; next year the trend in confidence will be key**



Source: Datastream, Intesa Sanpaolo. Contributions are calculated using a model that explains Euro area consumption via employment, real wages, interest rates and consumer confidence

**Growth in exports to emerging countries becoming a risk rather than an opportunity**

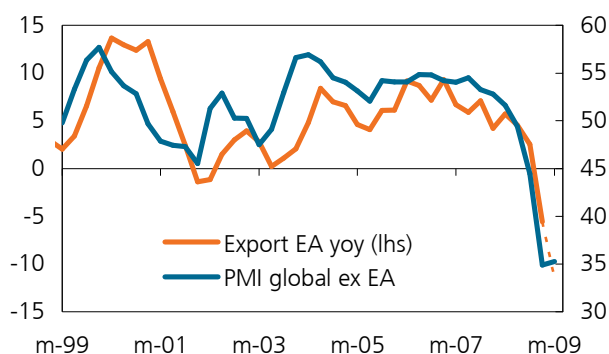
**The deepening global recession only exacerbates the outlook for a typically export-led economy like the Euro area.** The hardest hit country will be Germany, the world's biggest exporter, while countries with a larger domestic demand weighting like France will hold up better. **The Intesa Sanpaolo index, calculated as the average PMI of the world's major nations (weighted by the**

Risks are growing to typically export-led economies...

percentage of exports from the Euro area to each country), has continued to worsen in recent months, stabilising only in March. In addition, as mentioned in connection with the industrial production data, the figures on real exports could be even worse than may be inferred from the confidence indicators.

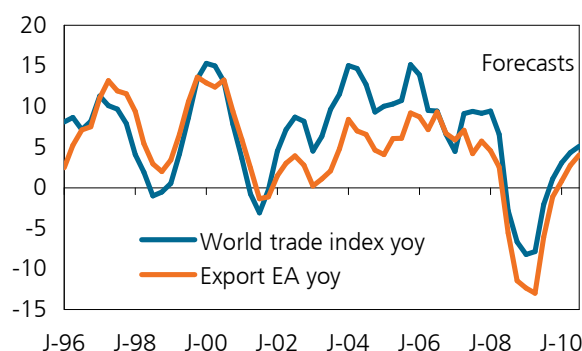
We have also constructed a global trade index defined as the weighted average imports of the various world economies (again using Euro area exports to each country). Based on our global macroeconomic forecasts, this index should **bottom out in 3Q9**, and then recover in 2010. Euro area exports, despite underperforming this index (especially in the short term), owing in part to a loss of competitiveness stemming from a historically strong exchange rate, should pick up **next year (though only by an estimated 1.6%)**.

No sign yet of a reversal in global demand from the confidence indices



Source: Eurostat, Markit, Intesa Sanpaolo calculations. Note: The RoW PMI is the weighted avg. of the existing manufacturing PMI indices, excluding the Euro area. The weights are Euro area export percentages to each of the countries included in the index

Exports expected to bottom out in 3Q09 and then to recover slightly



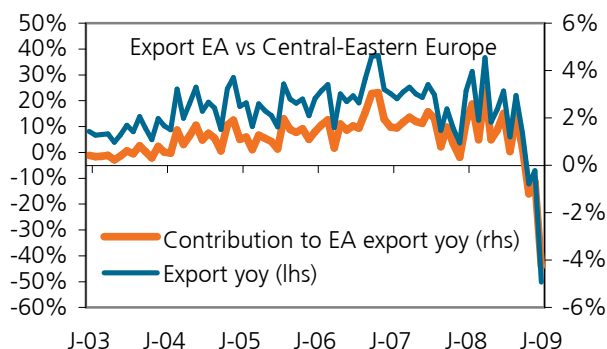
Source: Oxford Economic Forecasting, Eurostat, EcoWin, Intesa Sanpaolo calculations

It is worth noting that the outlook has deteriorated markedly in recent months for Central and Eastern Europe, which in past years has been a major driver for Euro area exports (notably Germany), and is now experiencing a worrying credit crunch accompanied by a deep industrial crisis. The contribution from these countries to export growth, after growing uninterrupted in the last five years, has collapsed since October, falling to -4.3% in January on a 50.1% slump in deliveries to the region (back in September annual growth was +22% yoy).

... and countries most exposed to Eastern Europe and Asia

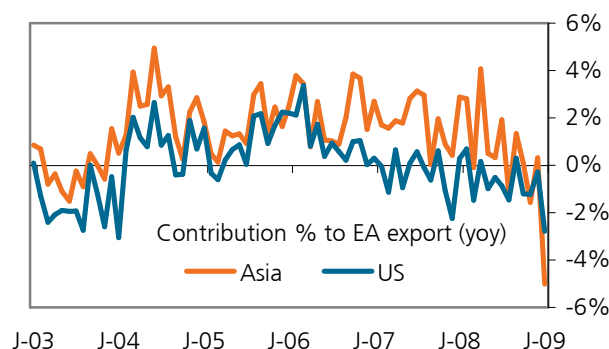
Also in free-fall are exports to Asia, which is making an even more negative contribution (-5% in January), owing to a -24.4% contraction in deliveries. In short, the worsening economic and financial situation in the emerging countries of Europe and Asia poses a greater threat to Euro area exports than the US slowdown, since the negative contribution from trade with each of these regions has outstripped deliveries to the USA (-22.1% yoy, contribution of -2.8% yoy). Growth in exports to emerging countries seems to have turned from an opportunity into a risk.

The contribution of CEE countries to Euro area exports has turned negative...



Source: Eurostat, Intesa Sanpaolo calculations. Note: the aggregate includes Albania, Bosnia-Herzegovina, Croatia, Macedonia, Czech Republic, Bulgaria, Estonia, Latvia, Lithuania, Poland, Romania, Russia, Ukraine

... as has the contribution of Asia, surpassing the negative impact from the United States



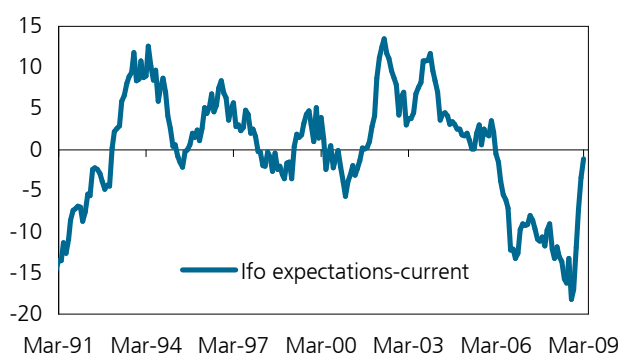
Source: Eurostat, Intesa Sanpaolo calculations

### Some indicators signal a possible return to positive growth in 2010

All the short-term confidence indicators, whilst showing some tentative stabilisation in the first months of 2009 (indicating that the downtrend might be over), remain close to all-time lows, signalling that near-term risks to growth remain on the downside. However, the indicators seen as more **forward-looking** (expectations index of ZEW and IFO, and balance of expectations and present situation in the IFO, back close to zero and at three-year highs) **seem to point to a possible recovery** (at least in terms of mitigating the most negative phase of the cycle) **on a six-month time horizon, i.e. between end-3Q09 and start-4Q09. This timescale looks reasonable. In our central forecast growth stabilises around zero at year-end 2009 and positive growth follows in 2010.**

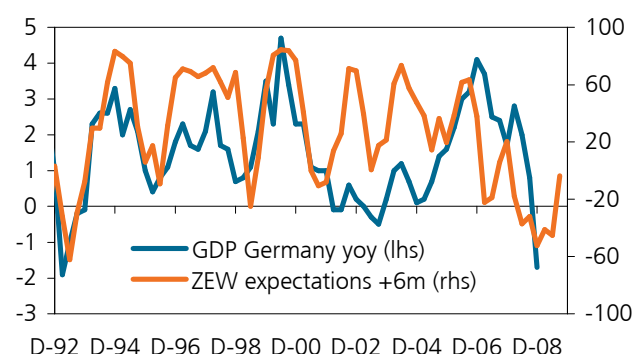
Expectations signal an improvement on a six-month time horizon

Balance of expectations and present situation on the IFO points to a recovery six months forward



Source: Ifo, EcoWin, Intesa Sanpaolo calculations

The ZEW index seems to have bottomed out, but has not always been a good predictor of GDP



Source: Eurostat, ZEW, Intesa Sanpaolo calculations

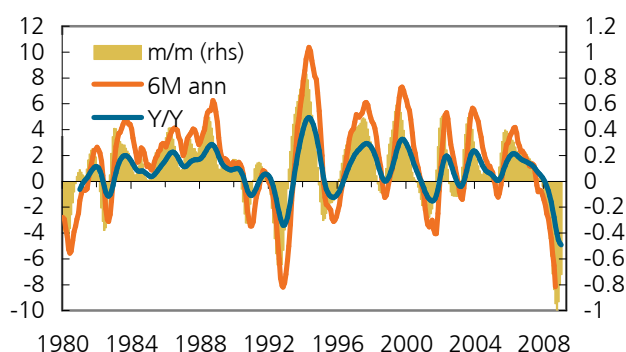
The more "structural" indicators such as the OECD leading indicator and M1 are sending out stronger signals now than three months ago, when we first noted them. The OECD leading indicator shows the most negative phase of the cycle easing from a October low of -1% mom to -0.7% mom in January. According to this indicator, the current negative cycle started in December 2007 and, now in its fifteenth month, has already passed the average historical cycle duration of 14.7. If we exclude the chain of recessions in the early 1990s, the longest recession (since series inception in the early 1980s) is the 17-month event from March '82 to August '83. The present recession will most likely outlast the early 1980s event. According to this indicator, **the cycle might bottom out around March, although a return to positive growth would be much further off.**

According to the OECD leading indicator, the cycle might bottom out between 1Q09 and 2Q09

**Real M1**, which we estimate at 5.6% in March (highest since year-end 2007), and which is a good cycle predictor on a one-year time horizon in the Euro area<sup>7</sup>, **is now sending out stronger signs of recovery**, thanks to the acceleration in the expansion of money supply and the cooling of inflation. **This indicator now clearly signals a return to firmly positive growth at start-2010. In our central forecast this will arrive later on**, probably in 2Q10. In any event, these indications point to a possible return to positive growth in 2010 (this forecast is currently at the top end of the consensus range and more bullish than the ECB's March estimate, for example).

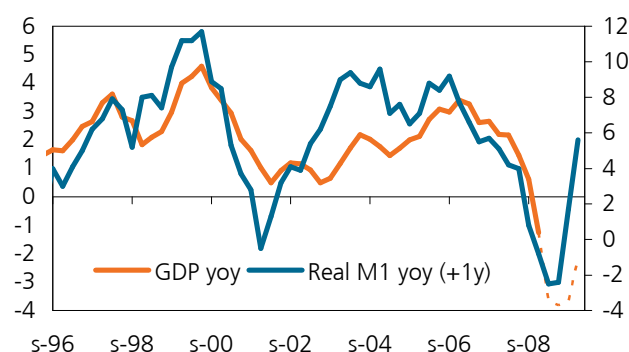
**Real M1 points to a possible return to positive annual growth at start-2010**

According to the OECD leading indicator, the cycle might bottom out in March 2009 in the case of an "average" recession



Source: OECD, Intesa Sanpaolo calculations

Real M1 growth signals a possible reversal in the cycle between year-end 2009 and start 2010



Source: ECB, Eurostat, Intesa Sanpaolo calculations and forecasts

### The introduction of incentives will have an impact on the auto sector

While the auto sector continued to show a sharp downturn in demand in February in Euro area average terms (810,293 registrations, -16% vs. February 2008), which also impacts on the first two months (1,556,838, -20.6% yoy), **the countries where trade-in incentives have been rolled out to stimulate the purchase of cleaner and safer vehicles recorded a more or less pronounced trend reversal in February (suggesting an even greater effect in March).**

**The prime example is Germany**, where the plan includes a contribution of EUR 2,500 for old cars over nine years old traded in for a Euro 4 or higher vehicle (even one-year old). The current plan guarantees support until the funds are finished and in any case not past year-end. In Germany the trade-in incentives, initiated in mid-January, triggered a **bounce in sales in February** after six months of falls, and was in fact the best February of the last ten years. Registrations totalled 277,740, up 21.5% on February 2008 (+36% vs. January). **Orders were also exceptionally strong: 480k (+61%), a volume not seen since 2001. The incentives seem also to have had an effect on the consumer confidence index. The impact of the incentives is estimated at around 400k additional vehicles** (source: Global Insight); bearing this in mind, at this rate the funds might be exhausted as early as April (carmakers are lobbying the government to extend the plan). The VDA expects over 3M registrations by year-end 2009.

**The biggest effect has been seen in Germany...**

**In France, the effects of the trade-in programme (EUR 1k) have yet to be felt.** In February registrations totalled 152,066 (-13.2% yoy) and January-February 301,438 (-10.6% yoy). Note that dealerships have a limited supply of vehicles eligible for purchase against a trade-in, i.e. with CO2 emissions below 160 g/km. The impact of the trade-in scheme (on top of the bonus-malus system) is estimated (source: Global Insight) at 220k additional registrations at year-end, although these projections currently look optimistic.

**... there is no evidence of an impact in France...**

<sup>7</sup> "The informational content of real M1 growth for real GDP growth in the euro area", ECB monthly bulletin, October 2008

Spain reported a further decline in registrations in February (62,107, -48.8% yoy); in January-February new license plates totalled 121,492 (-45.5% yoy). The scheme ("Plan Vive") offers only zero-interest on the first EUR 10k and with a maximum cost of EUR 30k for trade-ins of vehicles over ten years old and the purchase of vehicles with CO2 emissions below 140 g/km, and does not seem sufficient to trigger a trend reversal (the local associations are baying for a trade-in plan similar to those in place in the other major European markets). According to Global Insight, the contribution of the present Plan Vive will not exceed 100k additional registrations, although here too the estimate looks optimistic.

... the incentives plan looks insufficient in Spain...

In Italy, auto registrations continued to fall in February, plunging by 24.4% yoy to 165,289 (January-February 323,478 units, -28.5% yoy). The incentive scheme offers EUR 1500 for the scrapping of Euro 0.1 or 2 vehicles against the purchase of Euro 4 or 5 vehicles and gas, electric or hydrogen powered vehicles, in respect of purchase agreements drawn up after 7 February. However, a more detailed analysis of the February figure shows (source: Unione Nazionale Rappresentanti Autoveicoli Esteri) that **there was an impact, since the first half of the month was very negative, showing a contraction of around 40% yoy, while the second half showed a gradual improvement**, with the final week actually turning positive at 0.3% yoy. **These indications point to a rally in March, in view too of the growth in new orders (+220k, +4% yoy).** Intesa Sanpaolo, in partnership with Prometeia<sup>8</sup>, estimates an additional demand impact of **just over 100k vehicles** vs. the baseline assumption without incentives, with a market topping 1.9M vehicles in 2009, which is below the value seen in the last ten years and down over 11% vs. 2008. The measure should also boost production, which we expect to rise to just over 700k units, up over 6% vs. the particularly depressed value recorded in 2008.

... Italy recorded an impact as early as end-February

In conclusion, **the adoption of massive incentive programmes will impact on auto sales as of March** and, therefore, on national accounting durables consumption between end-1Q09 and start-2Q09. Although experience shows that this impact is temporary since it translates into the bringing-forward of purchases, it is nonetheless important to have bolstered sales at a critical time. We also expect a **positive impact on industrial production** as of March or April at the latest.

Impact of trade-in incentive schemes on registrations in 2009	
	Additional impact on 2009 sales
Germany	400k
France	220k
Italy	>100k
Spain	<100k
<b>Euro area (Total Big-4)</b>	<b>820k</b>

Source: Global Insight and Intesa Sanpaolo-Prometeia forecasts

#### The fiscal stimulus is now substantial, notably in Germany and Spain

On the fiscal front, the main piece of news at end-2009 (besides several "fine tuning" measures approved in a number of States) has been the approval of a **new fiscal package worth EUR 50Bn over two years, corresponding to 1% of GDP** (although it is not yet clear if this figure implies all new funds or whether the "core" package, i.e. considered in terms of impact on the public finances, is smaller, at around EUR 35Bn). This is the second stimulus plan after the one approved in November, which freed up resources totalling EUR 32Bn, but which impacted on the finances by EUR 12Bn or just 0.25% of GDP. This is Germany's biggest expansionary fiscal package since World War II. The package includes: 1) A vast programme (**EUR 17Bn**) of **public infrastructure**, which will involve various sectors (from education to telecoms) and which might

The main piece of news has been the approval of a second fiscal package in Germany

<sup>8</sup> Industrial Analysis Newsletter, March 2009.

be financed in part by the Laender; the plan will focus on infrastructure projects, most of which are already under way, suggesting that implementation times will not be unduly protracted; 2) A substantial package of **tax cuts, totalling EUR 18Bn**. Most of the proposals have been included (though many have been watered down): cut from 15.5% to 14.9% in mandatory healthcare contributions (paid 50:50 by worker and employer); an **extensive review of the income tax system**, including: a) raising the tax exemption threshold (from EUR 7,664 to EUR 8,004); b) cut from 15% to 14% in the lowest tax rate (the SPD's proposal for a concurrent increase in the highest tax rate was not accepted); c) a "flattening" of income bands from which low and mid-incomes should benefit. Overall, the income tax revenue shortfall should amount to around EUR 9Bn. Other measures include a one-off bonus of EUR 100 for households with new-born children and auto purchase incentives totalling EUR 1.5Bn (including trade-in incentives worth EUR 2,500 for any car more than nine years old). The plan also includes the creation of a EUR 100Bn **fund** which will provide guarantees to businesses having difficulty in securing credit; it is not clear whether the fund will also allow the government to acquire equity stakes.

As for the rest, there are no major additional measures with respect to the fiscal packages presented in our last Quarterly Report, apart from the introduction of relevant incentives for the durable goods and in particular the auto sector (see above). If we limit ourselves to genuine fiscal measures, **Germany and Spain take the lion's share**, having announced measures totalling around 1.5% of GDP (and in Germany a similar amount is expected in 2010), while France and Italy have remained below 1% of GDP (in Italy, the measures decided in early February, including the introduction of incentives in March and the extension of social benefits, partially adjusted the figure after the crisis-fighting decree last November showed a slight squeeze). **To this should be added all the not strictly fiscal actions, i.e. the earmarking of massive funds to support bank lending (guarantees and recapitalisation), which amount to 4.9% of GDP in Germany**, of which 0.9% was passed with the first fiscal package (incentives for green building and refurbishments, loans for infrastructure investments to municipalities in disadvantaged regions, additional lending for SMEs, additional loans for firms that invest in clean energy) and 3.8% with the second package (the above-mentioned guarantee fund); **2.6% in France** (loans to SMEs, loans for social housing, acceleration in tax rebates), **and 4.3% of GDP in Spain** (loans to businesses and households, restructuring of mortgage payments for struggling households, early payment of unemployment benefits, tax breaks for homes).

**The not strictly fiscal measures to boost lending are even more substantial**

Breakdown of fiscal plans for 2009 in major Euro area countries		
	EUR Bn	% GDP
<b>GERMANY</b>	<b>34</b>	<b>1.4</b>
Reduced revenues (+income support)	24	1.0
- Cuts in taxes and contributions for families and employment	20	
- Auto industry	2	
- Favourable accounting treatment for depreciation of investments	2	
Increased expenditure	10	0.4
- Infrastructures	10	
<b>FRANCE</b>	<b>17</b>	<b>0.9</b>
Increased expenditure	17	0.9
- Infrastructures	10	
- Unemployment benefits and employment support	4	
- Subsidies for housing and car purchase	2	
- Bonus for basic income households	1	
<b>SPAIN</b>	<b>16</b>	<b>1.5</b>
Reduced revenues (+income support)	2	0.2
- Tax cuts	2	
Increased expenditure	14	1.3
- Infrastructures	8	
- Expenditures to support innovation, car industry, environment, welfare	6	
<b>ITALY</b>	<b>11</b>	<b>0.7</b>
Reduced revenues (+income support)	-1	-0.1
- Revision of company book values	-3	
- Anti tax evasion measures	-2	
- Incentives on cars and other durable goods	2	
- Deductibility of regional tax from corporate income	1	
- Tax cuts for productivity enhancements	1	
Increased expenditure	12	0.8
- Unemployment benefits	8	
- Bonus for low income households	3	
- Other spending measures	1	

Source: national governments, Intesa Sanpaolo calculations

As for the impact on growth, we believe account should be taken primarily of the strictly fiscal measures (increased expenditure or reduced revenues) which, as noted above, in our calculations amount to around 1% of GDP this year and 0.7% next year (these estimates are roughly in line with those of the EU Commission<sup>9</sup> in January and the IMF<sup>10</sup> in February). Intesa Sanpaolo, based on the historical elasticities, estimates that the new measures implemented in the Euro area may have an impact on Euro area GDP of 0.6% this year and 0.4% in 2010. Basically, without the fiscal stimulus the GDP contraction in 2009 would be close to 4% (vs. -3.3% in the central forecast), and a return to positive growth in 2010 depends crucially on the fiscal stimulus (without which GDP would be stagnant rather than expanding by 0.4% as in our central forecast). Moreover, considering the entire fiscal stimulus, i.e. not just the discretionary measures announced by member states but also the stimulus measures decided at EU level (0.3% financed by the EIB), the extra-budget measures and automatic stabilisers, the size of the intervention comes to around 4% of GDP (cumulative) in the two years considered and the impact on growth is therefore greater.

The impact on growth, considering only the strictly fiscal measures, is around 0.5% of GDP in 2009 and 2010

<sup>9</sup> European Commission, Interim Forecasts, January 2009, 19 January 2009

<sup>10</sup> "The Case for global fiscal stimulus", Freedman, Kumhof, Laxton and Lee, IMF Staff Position Note, 6 March 2009

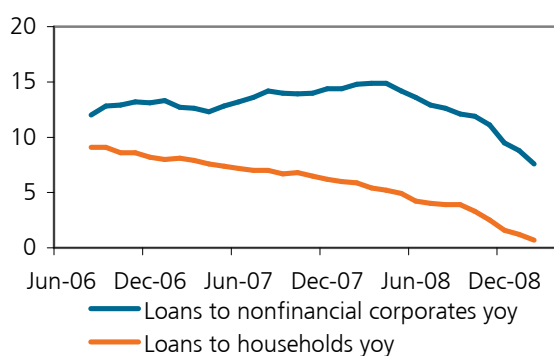
Fiscal plans in the Euro area: size of measures and impact on growth		
Size of fiscal measures (additional resources)	2009	2010
EU Commission (Jan-09)	1.0%	0.5%
IMF (Mar-09)	0.9%	0.8%
Intesa Sanpaolo (Mar-09)	1.0%	0.7%
Impact on GDP	2009	2010
EU Commission (Jan-09)	0.75%	0.5%
IMF (mar-09)	0.5%	0.3%
Intesa Sanpaolo (Mar-09)	0.6%	0.4%

Source: EU Commission , FMI, Intesa Sanpaolo

### First signs of a net contraction in credit: demand factors play a large part ...

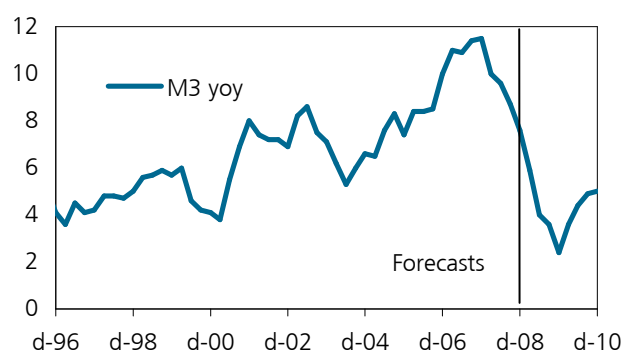
**M3** slowed markedly to 5.9% yoy in February (the lowest for more than four years). Loans to the private sector fell for the 14 month running, to 4.2% yoy in February – the lowest for 14 years. With growth now close to zero in loans to households (0.7% vs 1.2% yoy), loans to businesses continued to slow to 7.6% yoy in February from 8.8% yoy in January. M3 is rapidly approaching the ECB's official target (4.5% yoy) and an M3 model constructed on the fundamentals (cycle and interest rates) projects a further slowdown throughout 2009, to a low of 2.4% yoy in 4Q09.

#### Loans to households and business slow more rapidly



Source: ECB

#### An M3 model constructed on the cycle and interest rates projects a slowdown to the end of 2009, and recovery only in 2010



Source: ECB, OEF, and Intesa Sanpaolo calculations

The M3 figures show **the first signs of a decline in lending supply in the eurozone**: already in December loans to the private sector were down mom for the first time since series inception in 1998. In February the fall mom was EUR 10 bn (concentrated on loans to business for terms of up to a year). The fall was due to weak demand, but there are also signs of supply-side tightening connected with deleveraging.

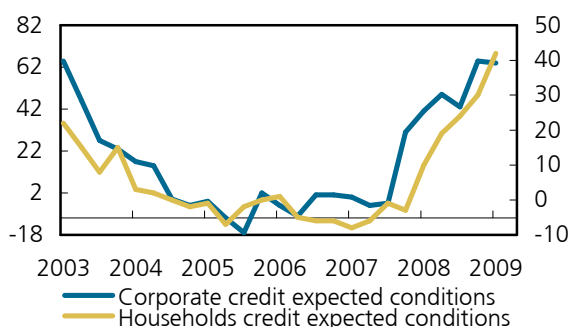
In short, the monetary aggregate figures show that: 1) for the first time since the eurozone came into being, there was a **contraction in the supply of loans to the private sector** between the end of 2008 and the beginning of 2009; 2) increasing strain on financial markets has impacted on specific items on FMI balance sheets and in particular on an ongoing **reduction in financial leverage** for residents outside the eurozone; 3) far from diminishing, the **preference for liquidity** for precautionary purposes is actually growing among banks and companies, which does not help money supply circulation and weakens the monetary policy transmission mechanism.

... as well as supply-side restriction signalled in the last *Bank Lending Survey (BLS)*

The last BLS, published on 6 February, showed a slight fall in 4Q08 (from 65% to 64%) of banks tightening lending standards for businesses, whereas the percentage of banks tightening credit to households rose again (from 36% to 41% for mortgages and from 30% to 42% for consumer credit). **Cyclical factors apparently outweigh financial factors in guiding the banks. Banks expect the tightening to ease across all categories in 1Q09.** They also reported a steep fall in lending demand from both companies and households.

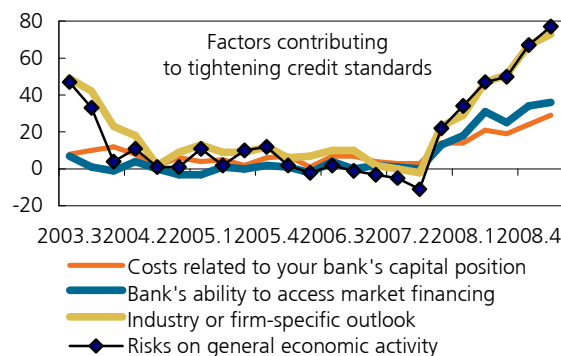
On the impact of the recent financial turbulence banks signalled that the recapitalisation support and state guarantees on bank bond issuance announced by the authorities seem already to have had a positive impact in 4Q08 on access to wholesale funding, and these should further improve in 4Q09. Despite this, banks have continued to have **serious problems in accessing the money markets** and securitisation, and even access to the bond markets has become more problematic following the financial market turmoil.

The *Bank Lending Survey* confirms the credit tightening for households and businesses



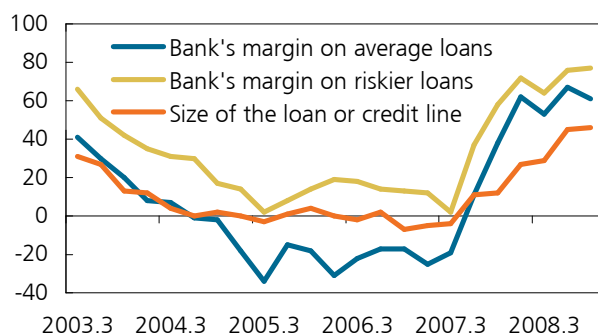
Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

The reasons given by banks for the credit tightening cite cyclical factors rather than the financial crisis



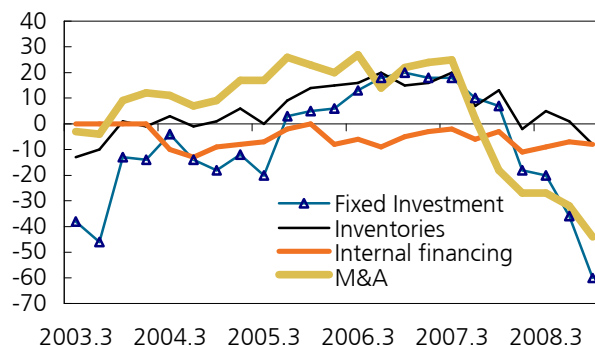
Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

Tightening both in the cost and the amount of credit lines to firms ...



Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

... which is being reflected in a contraction in net lending demand among businesses, particularly for investment

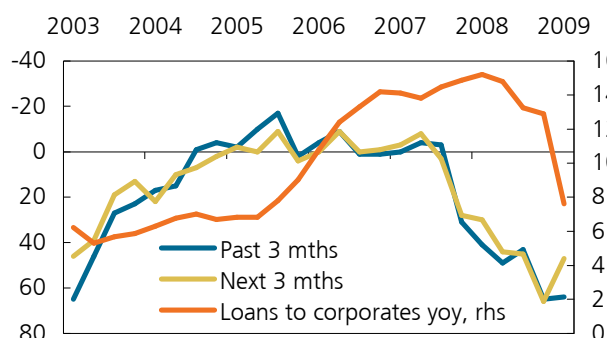


Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

The further increase in tension on financial markets seen in February – albeit diminished in March – signals that it is by no means certain that 1Q09 will see an end to credit tightening as indicated by the banks quoted in the survey. Even if it is not a case of a real, overall restriction on the supply side, nevertheless the tightening of conditions is leading both to an increase in the banks' margins on the riskiest loans and to a fall in the amounts of loans or credits; and the undeniable increase in selectiveness as regards loans and the cost of debt, especially to business

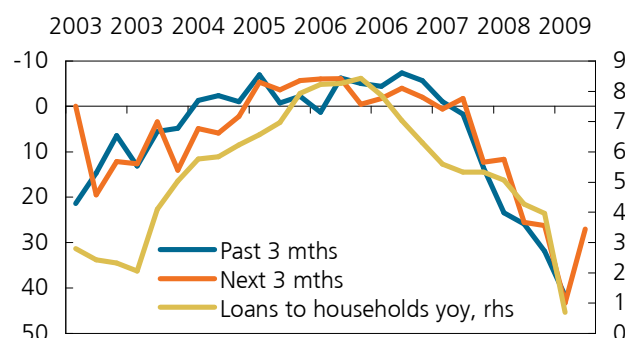
(given that, even though the risk-free rate has fallen, spreads on the riskiest products have continued to rise significantly) cannot but affect the demand for loans. Moreover, the banks cited in the survey have already flagged a fall in net demand for loans on the part of business, especially loans for financing investment in new fixed assets (for these demand fell to -60% from the previous -36%) and for extraordinary financing – whereas demand for debt restructuring funds is up.

The tightening of lending criteria reported by banks in the latest *Bank Lending Survey* will lead to a further slowdown in lending to companies...



Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

... while the risks of a further fall in lending to households appears to be smaller



Source: ECB Bank Lending Survey and Intesa Sanpaolo calculations

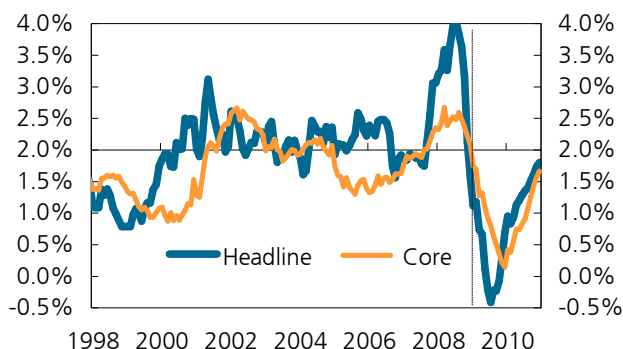
## A sub-zero summer for inflation

Based on the new oil price scenario – we now estimate that prices will be USD 48.1, down from USD 66.3 three months ago, or half the 2008 average of USD 98.1 – on lower-than-expected CPI figures at the beginning of 2009, and on the prospect of further weakening of core inflationary pressures because of the deepening output gap, we have revised our 2009 inflation forecast substantially downwards to 0.4% from the 1.4% in our last quarterly report, and well below the 2008 average of 3.3%. This figure is in line with the latest ECB forecast and below the consensus average for March of 0.6%. In our central scenario the CPI enters negative territory as early as June, and remains there until September. The low point of -0.3% yoy should be reached in June. This forecast is based on a short-term model of the situation that takes account of oil price and exchange rate shocks, and of the seasonal nature of core components. In this model core inflation (excluding energy and non-processed food) slows to 1.1% in 2009 from 2.4% in 2008.

An **alternative scenario** is one in which the oil price, instead of rising close to USD 52 a barrel as in our central scenario, falls gradually to USD 35. In that case, average annual inflation would be 0.2% in 2009, and the low point would also be reached in June (-0.5% yoy). Inflation would remain negative until October, and thereafter would rise more slowly (see graph).

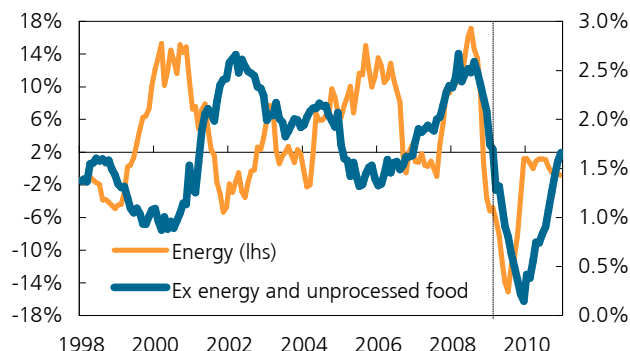
**We expect average inflation to be barely above zero in 2009...**

Inflation will fall below zero this summer...



Source: Eurostat and Intesa Sanpaolo calculations

... owing to a very negative contribution from energy

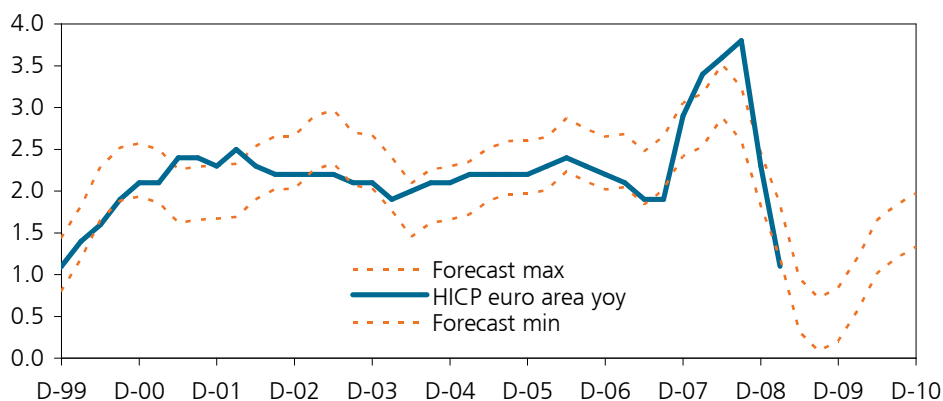


Source: Eurostat and Intesa Sanpaolo calculations

Conversely, in order to forecast inflation in 2010 we believe it is more useful to estimate the CPI on the basis of fundamentals. For this we have constructed an inflation model based on: 1) the Goldman Sachs raw materials index; 2) the cost of labour; 3) the EUR-USD exchange rate; and 4) the supply of M3. The model's fit is good ( $R^2$  0.76, standard error 0.32). The model shows that 2008 saw overshooting, whereas at the start of 2009 inflation was at the lower end of estimates (and indeed undershooting cannot be ruled out in the coming quarters). The model shows a low point for inflation in 3Q09, after which it could be on a rising trend until the end of 2010. It should be pointed out that, although it assumes a sharp fall in the cost of labour (from 3.5% in 2008 to 2.4% in 2009 and 0.7% in 2010), the model does not contain any forecast of deflation. On the basis of this model, we estimate that inflation will average 1.3% in 2010, higher than the last ECB forecast of 1% but lower than the March consensus figure of 1.5%.

... and little more than 1% in 2010

Results of a Euro area structural CPI model based on commodities, labour cost, exchange rate and money supply



Source: Eurostat, Intesa Sanpaolo

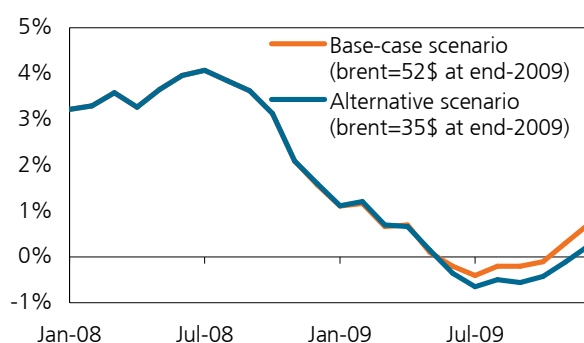
The incipient rise in unemployment will bring about a marked fall in the cost of labour, all the more since salary increases in 2008 were partly the result of one-off pay awards that will not feature this year. The wage moderation brought about by the rise in unemployment and the ending of one-off pay awards will be combined with the **drag-on effect (downwards) from the public sector** to the private sector. Indeed, the growing risks to public budgets are leading many states to cut payroll costs. Most striking is the case of Ireland, where a cut in public sector pay is expected to offset the risks of a ballooning deficit (the government has said it wants to bring the deficit – which without its intervention would rise to 13% of DGP – within the Maastricht limits by

Core inflation will continue to fall until the year end, pushed downwards by the fall in the cost of labour

2013, by saving a total of EUR 15 billion over five years). Any cut in public sector pay would be a return to the wage deflation last seen in the 1930s. As highlighted by the ECB in a recent study<sup>11</sup>, the fall in wages and/or public sector employment would have a profound effect on private sector pay, influencing the cost and likelihood of remaining unemployed and putting pressure on private wage settlements. The ECB estimates that a 1% cut in public sector pay would lead to a 0.1% cut in private sector wages, and a 1% reduction in public sector jobs would cause a 0.45% cut in private sector wages.

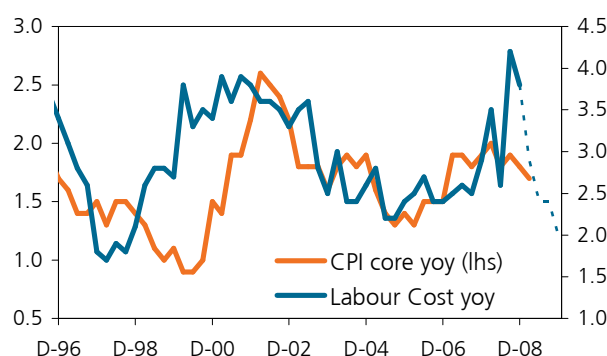
We expect an increase in labour costs across the eurozone of 2.4% this year, down from 3.5% in 2008. As a result, **while headline inflation should start rising again in the second half of the year, we expect a further fall in core inflation** (to 0.3% yoy at the end of 2009), as a result of wage settlement restraint and from oversupply as a result of the output gap.

Alternative scenario (Brent crude at USD 35 at the end of 2009)



Source: Eurostat, Intesa Sanpaolo calculations

Core inflation dragged down by the fall in the cost of labour



Source: Eurostat, Bloomberg, Intesa Sanpaolo forecasts

**We do not believe however that average inflation in 2009 can be negative, or that there is a real risk of deflation in the eurozone**, chiefly because, as shown by the large amount of literature<sup>12</sup>, less competition in the market for goods and great labour market rigidity in comparison to the UK and US (less flexibility, and the index-linking of salaries in certain countries) brings greater persistence of inflation.

**We do not believe, though, that there is a real risk of deflation**

According to a recent ECB study<sup>13</sup> analysing the cross-country evidence of real pay adjustments in manufacturing to the economic cycle, typically more open economies with greater union influence show less sensitivity in real wages (and employment). Contrary to what might be expected, this is not true of Germany which, together with France, is among the countries with the highest elasticity of real wages to the cycle (between 0.3 and 0.4). Conversely, other eurozone countries including Spain and Ireland have the most counter-cyclical real wages in the sample considered (the 12 main OECD countries). Midway between the two groups are Italy, Austria, Finland, Belgium, and the Netherlands. Accordingly, **the responsiveness of real wages to the cycle is extremely variegated across the eurozone and does not allow unequivocal implications to be deduced about a significant negative correlation.**

<sup>11</sup> "Interactions between private and public sector wages", António Afonso and Pedro Gomes, ECB Working Paper Series No 971, November 2008.

<sup>12</sup> See for example "Euro area inflation persistence in an estimated nonlinear DSGE model", Gianni Amicano and Oreste Tristani, ECB Working Paper Series No 754, May 2007.

<sup>13</sup> "Real Wages over the Business Cycle OECD Evidence from the Time and Frequency Domains", Julián Messina, Chiara Strozzi, Jarkko Turunen, ECB Working Paper Series No 1003 / February 2009.

An analysis in the February bulletin<sup>14</sup>, based on new data from a companies survey, shows not just that changes in pay are less frequent than price adjustments (60% of respondent firms change pay once a year and about 25% less frequently, while in respect of price variations the percentages are significantly lower, at 40% and 7.4% respectively), but that there is **microeconomic evidence of downward wage rigidity**, although the picture is highly diversified owing to massive differences between countries in respect of pay setting mechanisms, such as the degree of index-linking of wages. **The percentage of workers covered by a collective labour agreement is 83.3% of the total in eurozone countries** (well above the US and UK). In addition, in all eurozone countries (except Italy) there is a **form of inflation-related pay adjustment** in a significant percentage of firms, particularly in Belgium (98%) and Spain (70%), where automatic indexing prevails; note too that in most countries **adjustments are linked to past inflation** (only in Portugal is expected inflation more important in setting pay levels). **These factors explain the greater downward rigidity not so much of nominal wages as of real wages in eurozone countries** compared with the rest of the world: the percentage of firms with real wage rigidity is 20.3% in eurozone countries (with a high of 98.2% in Belgium and one of the lowest values, 1.7%, in Italy).

Wage rigidity in eurozone countries							
	% of workers covered by a collective contract	Automatic linking of wages to inflation		Informal linking of wages to inflation		Total	Downward real wage rigidity
		Past inflation	Expected inflation	Past inflation	Expected inflation		
Austria	94.5	9	1	9	3	22	9.8
Belgium	86.3	98	0	0	0	98	98.2
Czech Republic	50.2	7	5	28	24	59	11.7
Germany	NA	NA	NA	NA	NA	27	4.4
Estonia	8.7	3	2	35	21	54	54.8
Spain	96.8	38	16	11	5	70	9.6
France	67.1	9	2	21	8	33	20.0
Greece	91.0	15	5	12	10	43	11.2
Hungary	18.4	7	4	14	6	31	8.2
Ireland	29.4	6	3	19	10	30	1.7
Italy	92.2	1	0	3	1	6	10.8
Lithuania	15.6	7	4	24	13	48	NA
Poland	19.3	5	2	17	6	31	6.9
Portugal	90.0	3	6	13	29	52	9.0
Slovenia	NA	20	3	32	5	60	23.5
Total	63.4	13.2	3.9	12.7	6.9	35.3	16.8
<b>Eurozone countries</b>	<b>83.3</b>	<b>16.3</b>	<b>4.1</b>	<b>9.7</b>	<b>5.5</b>	<b>34.2</b>	<b>20.3</b>

Source: BCE (monthly bulletin, February)

This evidence signals that wages and prices<sup>15</sup> in the eurozone do respond to the economic cycle, though not enough to trigger wage deflation that would justify a fall into firmly negative territory not just for inflation but also for medium-term inflation expectations. **The existence of major pay rigidities (in the presence moreover of still historically low unemployment, despite its clear uptrend) signals that the chances of deflation in the eurozone are in our view rather limited.**

<sup>14</sup> "New survey evidence on wage setting in Europe", ECB Monthly Bulletin, February 2009.

<sup>15</sup> See also "Optimal sticky prices under rational inattention", Bartosz Maćkowiak, Mirko Wiederholt, ECB Working Paper Series no 1009 / FEBRUARY 2009.

## ECB tempted by quantitative easing

At its March meeting the ECB cut, as expected, the refi rate by half a percentage point, from 2% to 1.50%. At the same time it confirmed the current rates corridor (return on deposits 0.50% and marginal refinancing rate 2.50%). Trichet said the decision had been made with a broad consensus, reached after a “very, very in-depth debate”.

At its March meeting the ECB cut rates to 1.50%...

The new quarterly projections show a sharp cut (greater than might have been expected) in the estimates both for growth (now put at, looking at the central figure in the spread, at -2.7% vs -0.5% in 2009, and at zero vs 1% in 2010) and for inflation (0.4% vs 1.4% this year and 1% vs 1.8% next). The new projections are broadly in line with ours as regards 2009 (though we are more pessimistic than the ECB on growth), but would appear to risk underestimating both growth and inflation in 2010.

... sharply reduced macroeconomic projections...

ECB projections: zero growth and 1% inflation in 2010							
Macroeconomic projections		ECB		Consensus		Intesa Sanpaolo	
Date of projection	Year	IPCA	GDP	IPCA	GDP	IPCA	GDP
March 2008	2008	2.9	1.7	2.7	1.5	2.9	1.7
June 2008	2008	3.4	1.8	3.3	1.7	3.4	1.7
September 2008	2008	3.5	1.4	3.5	1.3	3.6	1.1
December 2008	2008	3.4	1.0	3.4	1.0	3.4	0.9
March 2008	2009	2.1	1.8	2.0	1.8	2.1	1.9
June 2008	2009	2.4	1.5	2.3	1.4	2.3	1.4
September 2008	2009	2.4	1.2	2.4	0.9	2.3	0.6
December 2008	2009	1.4	-0.5	1.4	-0.9	1.4	-0.7
March 2009	2009	0.4	-2.7	0.6	-2.6	0.4	-3.3
March 2009	2010	1.0	0.0	1.5	0.5	1.3	0.4

Source: ECB, Consensus Forecast, Intesa Sanpaolo

The projections are made both on the basis of “technical” assumptions, that is, taking the market’s expectations as regards interest rates, commodity prices, and exchange rates at the time the projection is made, and also taking into account all available information. According to Trichet, if all projections had been based solely on “technical” assumptions they would have included much higher levels of both growth and inflation.

It may be that the ECB went ahead with a deeper cut than expected in order to avoid a further, larger cut in the next report in June, so as to bring rates to 1% in April (or May at the latest) and then leave them unchanged in June. **The new projections, which include nominal GDP growth of 1% in 2010, certainly justify, whether according to Taylor’s or Fisher’s rule, rates at 1% when the monetary cycle reaches expansion.**

**The risks as regards growth (compared with the base scenario in the new projections) now appear “more balanced”** (whereas they were regarded as consistently low in previous months), reflecting the expensive effects of the fall in raw materials prices.

As for inflation, it is expected to be well below 2% in the two-year period in question; Trichet admitted for the first time that the CPI might enter negative territory around the midway point of the year. The risks compared to the central inflation scenario are seen to be “roughly balanced” as in previous months.

Trichet repeated that the risks of deflation in the eurozone are very slight because expectations of medium- and long-term inflation seem anchored to the ECB’s target (1.9% according to February’s *Survey of Professional Forecasters*, and also expectations of market inflation do not display deflationary risks). However, according to Trichet there is no guarantee that inflation expectations will always remain “anchored”.

Trichet announced, as expected, **an extension of the exceptional measures** expiring at the end of March (provision of liquidity via fixed-rate auctions on sub-six month maturities in any amount), which will be maintained for as long as necessary and in any case beyond the end of 2009. **This means that the eonia rate will remain below the refi rate.**

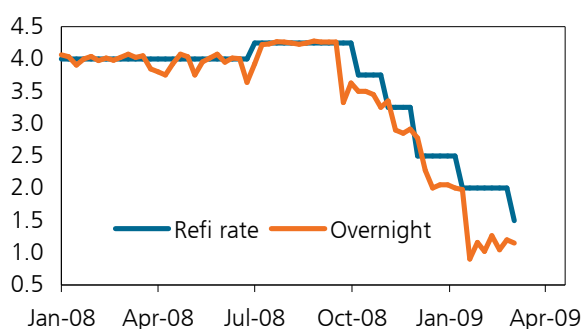
... and opened up to **"unconventional" monetary policy measures**

In response to whether the ECB had discussed purchasing commercial paper, Trichet said the bank was already adopting "non-standard" measures that were expanding the central bank's balance sheet to an exceptional degree. On the adoption of further unconventional measures (whose difference from today would lie mainly in foisting the credit risk on the ECB) Trichet ruled nothing out, suggesting that **the ECB was mulling both the need for new measures and the merits of the same**; such measures might be under consideration but will be announced only at the right time. According to Trichet, such new measures would be better described as "credit easing" rather than "quantitative easing". **The adoption of new measures would not be conditional on the freezing up of monetary policy transmission via the ordinary channels.**

As to future interest rates moves, Trichet said the ECB has not decided "ex-ante" that 1.50% is the low point, indeed, he was explicit that further cuts cannot be ruled out (this has been the formula used in recent months to indicate a move at the following meeting).

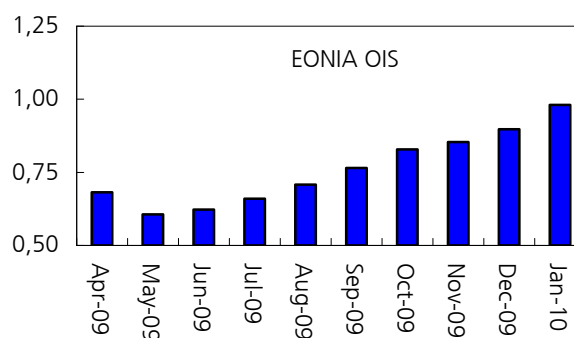
**The most interesting development seems to be the greater openness to "unconventional measures" in monetary policy**, already predicted even by "hawks" such as Weber. These might involve the purchase on the secondary market of bonds or commercial paper (which the ECB already accepts as security in refinancing operations). Less helpful, and difficult to implement given the breadth of supply in the eurozone, is a possible programme for acquiring government bonds, as decided by the UK. **However, the impact of such measures might prove less effective** than hoped in a system which, unlike that of the US, is far less focused on the market and much more on the banking system's mediating role.

Euro o/n rates are already lower than 1%



Source: BCE, Bloomberg

Eonia OIS – implied rates



Source: Reuters, Intesa Sanpaolo calculations

Based on recent remarks by various members of the Governing Council, the most likely monetary policy outlook in the short term is as follows:

**1) the refi rate will be cut to 1%** (a level justified by the Taylor Rule, as signalled in our last Quarterly Report), **and will be left on hold thereafter; this move will necessarily be accompanied by a reduction in the corridor** between the rate on marginal refinancing operations and the rate on deposits; indeed, the return on deposits may well be kept at 0.5% (or at most at 0.25%, but not at zero); **in our view a rise in interest rates** (which the market curves envisage by year-end) **will not materialise until the second half of 2010** (the reversal of rates will in any case be

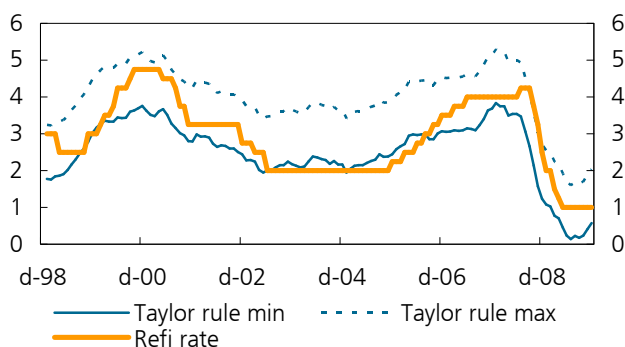
**We expect a refi rate of 1%, the extension of the duration of cash-injections auctions and, but not immediately, the purchase of private debt securities**

preceded by the withdrawal of the exceptional liquidity injections which, as noted, will be extended at least until year-end 2009);

2) as pre-announced by various members, **it is almost certain that the ECB will extend the maximum duration of the auctions used to provide the banking system with liquidity (fixed rate and for any amount required), from the current 6 to 12 (or, less probably, 24) months;** the decision would trigger a flattening of the Euribor and EONIA futures curves, which currently show a positive slope, indicating a rise in rates from the end of this year;

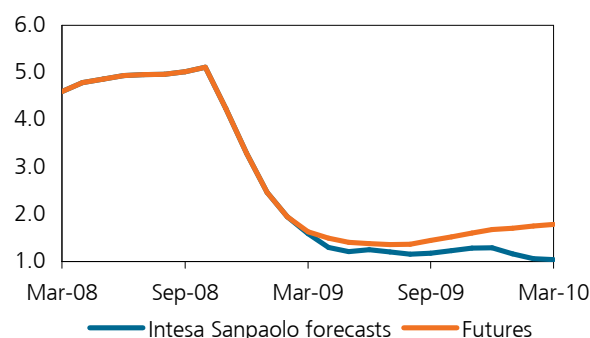
3) there is also the chance, signalled by various members including Papademos (26/3), that the ECB will introduce (yet, probably not in April) a programme for the **purchase of private debt securities on the secondary market** (commercial paper or private bonds, probably bank bonds), the sole restriction being the types of bonds accepted as collateral (BBB-rated); **a government bond purchasing scheme is unlikely, in our view** since, whilst theoretically possible, it would be hard to implement in practical terms since the purchases would be concentrated on several bonds, causing probable negative repercussions (on both the secondary and primary market) on the other bonds outstanding, as has been the case in the USA and, most especially, the UK; given the recent upsurge in peripheral country spreads, we think the ECB will be keen to avoid risks of this sort.

In our view the ECB will take the refi rate to 1%, leaving it unchanged probably until mid-2010



Source: ECB, Intesa Sanpaolo.

We do not share the market's view of a possible rise in short-term rates by year-end 2009/start-2010



Source: Bloomberg, Intesa Sanpaolo

## United Kingdom – Deep, but necessary recession.

Asmara Jamaleh

**The British economy too got off to a bad start in 2009.** Here, the impact of the global crisis has been exacerbated by the large role played by the financial services sector in the economy as a whole. After a meagre 0.7% growth chalked up in 2008 (less than 1/3 of the potential) forecasts for 2009 need to be revised downwards, as in the rest of the world. The forecast now is for a **deep recession** (-2.8% growth, a shrinkage of the economy more than **twice as severe as in either 1981 or 1991**). **Leaving aside public spending, this negative figure applies to all other components of GDP this year:** consumer spending, investment, exports, and imports. At least the expected fall in imports ought to more than compensate for the fall in exports, thus making a positive contribution to growth, though this will be of little help. **However, in so far as the fall in imports** – which could continue into 2010, unlike exports (which will be helped by the modest revival of global growth in 2010 combined with the fall in the value of the pound between 2008 and the first half of 2009) – **is symptomatic of a fall in consumer spending, it is reasonable to suppose that there is a switch to an increased tendency towards savings,** as it is expected to happen in the United States. This could be beneficial by reducing the extent to which consumers resort to running up excessive debts. In that event **the crisis** – beyond its immediate cost (which will be drawn out: at least a couple of years) – will have **brought about structural change that contains the elements not only for a more balanced distribution of the various elements of the UK economy but also for an at least partial solution to the structural imbalances on an international level which, thanks to globalisation, caused the serious crisis which began in the United States to spread to the entire world.** Given that (1) in the fourth quarter of 2008 much of the contraction (-1.5% quarter on quarter) is attributable to the running down of stocks, (2) the fiscal authorities had no qualms about spending (note the worrying figures for the government deficit and debt) as long as this helped consumers and business, and (3) the Bank of England cut rates by 300 basis points in the fourth quarter and a further 150 basis points in the first quarter of 2009, bringing the bank rate down to 0.50% (this has now reached rock bottom) and has gone down the avenue of quantitative easing (including a plan to buy gilts) **the first quarter of 2009 might be slightly less negative than the fourth of 2008,** seeing a contraction of around -1.0% quarter on quarter, rather than the -1.5% seen previously. **In the first and second quarters the most disappointing element is likely to be consumer spending** as evidenced by the welter of figures coming out (extremely poor retail sales in February, a very worrying CBI survey of the retail sector, consumer confidence remaining very low, unemployment up from 2.5% to 4.3% in the space of a year and forecast to exceed 6.0% in 2010, house prices falling further and faster in double figures: according to the Nationwide, -17.6% year on year in February, compared with 2.6% in February 2008 and 10.1% in February 2007). **However, the crisis in investment threatens to be more protracted,** chiefly because of the continuing difficulty of gaining access to credit. **As for the expected fall in inflation during the year, this should benefit consumer spending, also because the fall in earnings is mostly seen in the headline rate, whereas earnings net of bonuses have been much more resilient.**

Forecast Table	2008	2009	2010	2008			2009			2010	
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.7	-2.8	0.9	1.7	0.2	-1.9	-3.2	-3.6	-2.9	-1.6	-0.5
- q/q change				0.0	-0.7	-1.5	-1.0	-0.4	0.1	-0.2	0.1
Private consumption	1.6	-2.6	0.1	-0.2	-0.2	-0.7	-1.0	-0.8	-0.5	-0.3	0.2
Fixed investment	-4.3	-9.5	-1.5	-1.3	-3.6	-2.3	-2.7	-3.0	-1.5	-1.0	0.0
Government consumption	3.5	3.3	1.5	0.1	0.5	1.5	0.9	0.7	0.7	0.3	0.2
Export	-0.1	-4.5	0.5	-1.1	0.5	-5.5	-0.2	-0.1	-0.2	0.0	0.0
Import	-0.5	-6.2	-0.3	-1.1	0.3	-5.9	-0.5	-1.0	-0.7	-0.2	0.5
Stockbuilding (% contrib. to GDP)	-0.4	-0.9	0.4	0.2	-0.1	-1.3	-0.2	0.1	0.3	0.0	0.1
Current account (% of GDP)	-1.6	-1.5	-1.5	-1.8	-2.1	-1.6	-1.4	-1.5	-1.6	-1.5	-1.5
Deficit (% of GDP)	-4.6	-8.9	-8.7								
RPIX (y/y)	4.3	1.0	1.9	4.4	5.3	3.8	1.8	1.0	0.2	0.9	2.2
Industrial production	-2.7	-10.9	-0.8	-1.2	-1.7	-4.5	-5.0	-1.0	-1.5	-0.8	0.1
Unemployment (%)	2.8	5.2	6.3	2.6	2.8	3.3	4.3	4.8	5.5	6.2	6.4
3m GBP Libor	5.49	1.64	1.15	5.86	5.81	4.60	2.11	1.65	1.50	1.30	1.20
GBP/USD	1.85	1.42	1.54	1.97	1.89	1.57	1.44	1.38	1.40	1.46	1.49
Effective exch.rate (1990=100)	90.9	76.0	79.2	92.9	91.6	83.6	77.2	74.5	75.1	77.3	78.1

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

## Asia

### Japan

- Forecast growth for 2009 has been revised sharply downward, to -5.6%. The minimum for the cycle should be in the fourth quarter 2008 and first quarter 2009.
- The Japanese economy's dependence on exports is the main cause of its dramatically negative performance in 2009. In February 2009, exports dropped by 49% yoy, spread across all regions. During the fourth quarter of 2008, the negative contribution of foreign trade amounted to -3% qoq.
- The collapse of foreign demand had a rapid effect on production, orders, inventory and sales. Activity should stabilise in the second quarter. The sharp drop in imports should also reduce the negative impact of foreign trade.
- The economic policy response was relatively fast. The central bank resumed its quantitative easing policy, lowering interest rates almost to zero, supporting banks' assets and offering credit directly to businesses by buying commercial paper. The government announced measures worth approximately 2% of GDP, whose effects should start to be felt in the second half of the year.

Giovanna Mossetti

Forecast Table											
	2008	2009	2010	2008				2009			2010
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	<b>-0.7</b>	-5.6	0.4	<b>0.4</b>	<b>-0.1</b>	<b>-4.4</b>	-8.1	-6.1	-5.3	-2.7	0.9
q/q annual rate				<b>-4.5</b>	<b>-1.4</b>	<b>-12.1</b>	-13.6	3.8	2.2	-2.0	-0.4
Private consumption	<b>0.6</b>	-1.0	0.3	<b>-3.1</b>	<b>1.2</b>	<b>-1.8</b>	-2.4	0.2	1.5	-3.6	-0.4
FI - private nonresidential	<b>-3.9</b>	-13.8	-2.7	<b>-8.9</b>	<b>-12.8</b>	<b>-19.8</b>	-21.2	-9.3	-1.8	-4.8	-3.0
FI - private residential	<b>-7.2</b>	-0.7	-1.9	<b>-7.4</b>	<b>17.0</b>	<b>24.7</b>	-7.7	-13.2	-9.7	-5.8	1.8
Government investment	<b>-6.2</b>	4.0	4.0	<b>-3.1</b>	<b>4.7</b>	<b>0.4</b>	4.0	6.1	7.4	7.4	2.4
Government consumption	<b>0.9</b>	2.3	1.3	<b>-3.6</b>	<b>-0.6</b>	<b>5.6</b>	4.0	2.0	1.2	1.2	1.3
Export	<b>1.9</b>	-26.2	1.2	<b>-9.0</b>	<b>2.6</b>	<b>-44.9</b>	-59.3	15.5	7.4	1.0	-2.0
Import	<b>1.1</b>	-15.1	0.3	<b>-11.7</b>	<b>6.8</b>	<b>12.4</b>	-45.2	-12.8	-4.4	-6.9	2.0
Stockbuilding (% contrib. to GDP)	<b>-0.2</b>	-0.9	0.2	<b>-0.1</b>	<b>-0.1</b>	<b>0.1</b>	-1.2	0.4	0.0	-0.1	0.1
Current account (% of GDP)	<b>3.2</b>	2.3	1.9	<b>3.7</b>	<b>2.8</b>	<b>1.8</b>	1.5	2.4	2.6	2.6	2.4
Deficit (% of GDP)	<b>-7.3</b>	-9.5	-10.7								
Debt (% of GDP)	<b>166.9</b>	184.7	194.3								
CPI (y/y)	<b>1.4</b>	-0.4	-0.6	<b>1.4</b>	<b>2.2</b>	<b>1.0</b>	0.7	-0.2	-1.3	-0.8	-0.6
Industrial production	<b>-3.3</b>	-24.9	4.8	<b>-3.3</b>	<b>-5.0</b>	<b>-39.9</b>	-58.9	14.4	11.5	4.0	0.9
Unemployment (%)	<b>4.0</b>	4.8	5.8	<b>4.0</b>	<b>4.1</b>	<b>4.0</b>	4.3	4.6	4.9	5.3	5.6
3-month CD rate	<b>0.92</b>	0.23	0.03	<b>0.70</b>	<b>0.80</b>	<b>1.36</b>	0.46	0.23	0.20	0.02	0.02
JPY/USD	<b>103.4</b>	95.0	102.4	<b>104.7</b>	<b>107.6</b>	<b>96.1</b>	91.1	92.3	96.2	100.5	103.2
Effective exch.rate (1990=100)	<b>133.0</b>	154.0	137.9	<b>126.9</b>	<b>125.8</b>	<b>151.2</b>	161.9	159.1	151.4	143.8	138.5

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

### Japan is in free fall, but H2 2009 should be better

The global recession and implosion of foreign trade has had a deep impact on those countries that are most dependent on exports and have weaker domestic demand. Japan's economy, which benefited from a sizable positive foreign trade contribution until mid 2008, will now see 2009 growth contract to -5.6%, firstly due to the fall in exports registered from last November onward, and subsequently to a decrease in industrial production and inventory. Plummeting demand at the end of 2008 triggered a drop in fixed investments, inventory, employment and consumption. This process will reverse only gradually, through stabilisation of trade and public sector demand, which will lead to positive growth in 2010 (forecast at 0.4%).

Policy makers responded relatively quickly to deteriorating economic conditions, with the central bank resuming quantitative easing and lowering interest rates nearly to zero, and the government approving expansionary fiscal measures worth nearly 2% of GDP, half of which take effect in the 2009 calendar year. Although the extent of GDP shrinkage at the end of 2008 and beginning of 2009 is unprecedented in the post-war period, Japan's economic predicament is less dramatic than it was during the 'lost decade'. The economy has not entered the recession with such profound imbalances as those present during the 1990s: there was no bubble in Japanese assets, and financial institutions were not particularly exposed to either domestic or foreign toxic assets; the credit trend, which was experiencing relatively sustained growth, is evidence of the difference between the 1990s - when banks were paralysed by bad loans - and the current climate, in which banks have relatively healthy balance sheets. Japan's problem in the current crisis is its dependence on exports: a by-product of globalisation and imbalances between savings and consumption around the world. The scenario after 2010 sees more contained growth than in 2004-07 (which was at 2.2% on average). Average growth is forecast at around 1.5%, beginning in 2011, without the need for the kind of structural change that will be required in the United States to rebuild household savings and reduce the federal deficit.

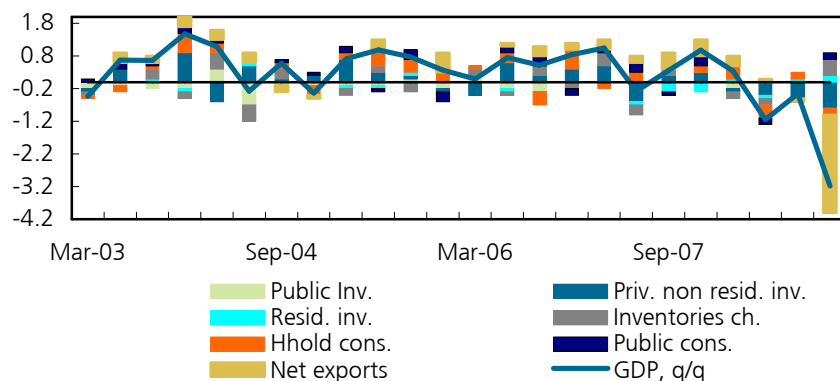
### 1. Economic Scenario: imploding exports trigger a violent correction

The Japanese economy is registering the worst performance among industrialised countries, with a collapse in GDP at the end of 2008 (-3.2% qoq, -3.6% yoy) induced by a steep fall in exports. Signs for the first part of 2009 are not comforting: exports are still falling, and the drop in production - aimed at reducing inventories - has not succeeded in stabilising the ratio of inventory to revenue. The first quarter should be even worse than the fourth quarter, with a forecast drop of 3.6% yoy. Even with growth expected to stabilise in the second quarter, **growth in 2009 will probably register a drop of 5.6%**. Fiscal measures approved thus far are likely to be increased further, and will begin to exert a positive effect on demand from the middle of the year. Monetary policy has already resorted to unconventional measures and, at least in the area of business finance, the programme to acquire commercial paper is contributing to interest rate reduction and increased availability of credit. These measures have improved the scenario for future quarters, but cannot limit the collapse of current growth.

The first quarter will continue to see exports in free fall, a drop in consumption, and a strong contraction of industrial production. Two factors will change with respect to the previous quarter, with contrasting effects on GDP trends: 1) the beginning of 2009 will see ongoing correction to inventory levels, which, however, will not prevent negative revenue trends; 2) falling imports will help to contain the negative effect of imploding exports.

**GDP** in the fourth quarter 2008 dropped by 3.2% qoq (-12.1% annualised qoq, -3.6% yoy). A large portion of the downturn is due to foreign trade: net exports contributed -3% to the overall fall in GDP. Nonetheless, figures for overall domestic demand are also marginally negative, in spite of a recovery in residential construction and public investment: domestic demand registered a drop of 0.1% qoq. Private demand dropped by 0.5% qoq. Consumption dropped by 0.4% qoq, with a contribution of -0.2%; non-residential investments dropped by 5.4% qoq (contribution: -0.8%). Positive factors included residential investment, up 5.7% qoq (0.2% contribution), public sector consumption (+1.4% qoq, 0.2% contribution), and inventories (contribution of 0.5%, which will impact the expected correction in the first quarter of 2009). Imports rose by 3% qoq, surprisingly, while exports collapsed 13.8% qoq. The GDP deflator increased by 1% yoy, but the rise in the consumption deflator was more contained.

GDP: The abyss of net exports



Source: EcoWin

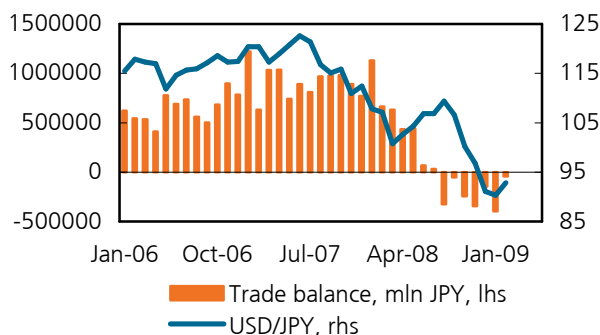
Figures currently available for the first quarter of 2009 do not show any improvement in exports, while industrial output and inventory levels indicate that the contraction has not slowed yet. The Reuters Tankan survey in March registered a new record of -78 for large manufacturing companies. However, expectations for the next three months are better, at -62, and the survey of the non-manufacturing sector posted an improvement to -39, compared with -37 in February. Among the negative data, there are some indicators of stabilisation over the coming months. The fall in orders began to slow, according to December data, and the February PMI survey showed some improvement, with orders, foreign orders and production all up, although employment continues to worsen.

The core contraction in fourth-quarter GDP was due to the **collapse of foreign trade**. January and February data registered a continuing, steep fall in exports, but also indicated a new development: a large drop in imports leading to a reduced trade deficit, especially in February. During the fourth quarter, total exports fell by 13.8% qoq. The balance of trade fell to JPY -395.4Bn in January, but improved to JPY -43.3Bn in February. A trade deficit was first registered in August 2008. Export values in February fell by 5.2% mom and 49% yoy. In real terms, exports fell by 45.5% yoy in February, and specifically by 55% yoy to the USA (accounting for 17.5% of total exports), by 45.6% yoy to the EU (14.1% of total) and by 40.6% yoy to Asia (46.8% of total). With respect to the US, exports were dragged down by the automotive sector, which registered a drop of 76.7% yoy. Asia registered an improvement from January to February, probably linked to the Chinese new year (Chinese exports account for 16% of total).

The only positive indicator of growth in foreign trade figures at the start of 2009 is the **collapse in imports**. The huge negative contribution of net exports to growth at the end of 2008 was due to the combination of a nosedive in exports while imports were still marginally rising in real terms. January figures show a 31.7% yoy fall in nominal import values (compared with -21.5% yoy in December), while February saw a drop of 12.3% mom and 43% yoy. In real terms, imports fell by 25.3% yoy in February. The drop in exports was evenly distributed between market regions (-24.4% yoy from the USA, -27.2% yoy from the EU, -30.8% yoy from Asia). Real import figures began to fall in December, after three months of sizable increases. A continuing downward trend would lead to a considerable decrease in the negative contribution of net exports to growth.

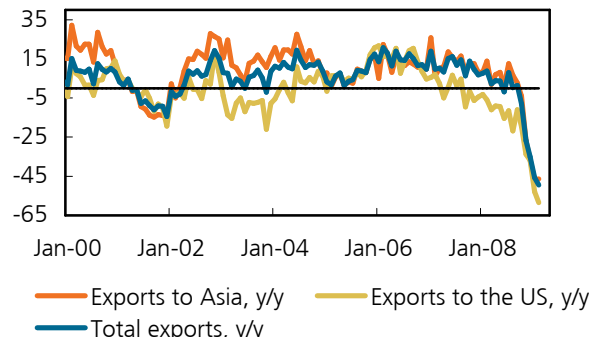
**Exports continue to decline, but imports also fell in the first quarter Net exports will lead to a smaller negative contribution in the first quarter**

Trade balance deeply in the red



Source: EcoWin

Exports collapse, not only in Asia

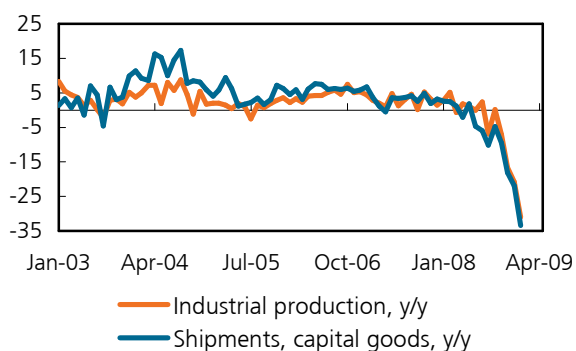


Source: EcoWin

Non-residential investments will fall by more than 10% in 2009, following a 3% drop in 2008.

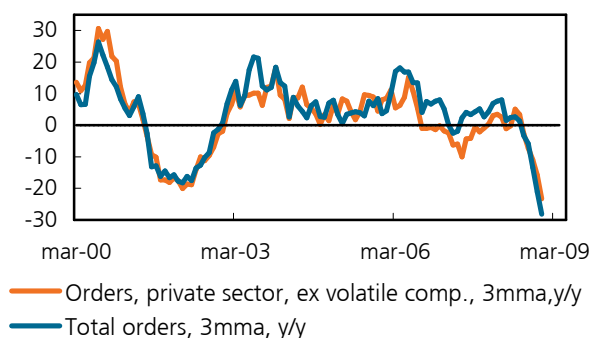
The drop in exports had an impressively rapid effect on industrial output and business orders. **Industrial production** registered a drop of 20.7% yoy and 12% qoq at the end of 2008. January data showed falls of 10% mom, 30.8% yoy and 18.7% qoq. Deliveries fell by 11.4% mom in January (-18.2% qoq, -31.6% yoy), confirming that the first quarter will also be extremely negative for non-residential investments. The METI forecast for February was revised downward to -8.3% mom, but the forecast for February includes a 2.8% rise mom. The adjustment in Japan's manufacturing sector is particularly large, thanks also to the weight of several sectors that were strongly hit by the economic crisis: the transport, electrical machinery, information and communication sectors represent 50% of industrial production in Japan, compared with 30% in the United States.

Production and deliveries in free fall



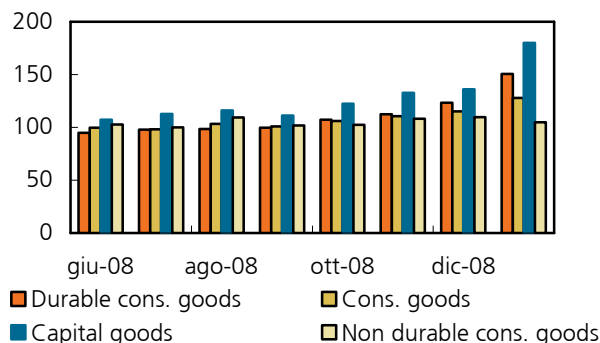
Source: EcoWin

Orders still falling sharply



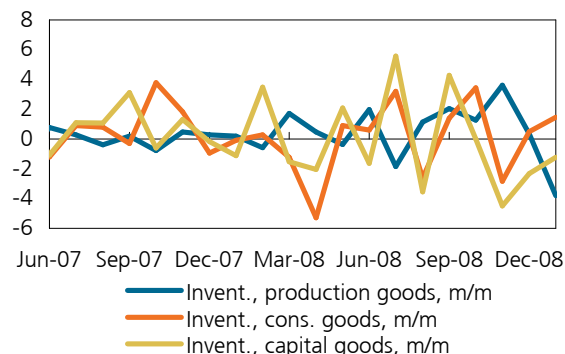
Source: EcoWin

Inventory-revenue ratio on the rise



Source: EcoWin

in spite of efforts to reduce stock



Source: EcoWin

Businesses reduced their inventories by 2% in January, after a 0.1% rise in December. Most sectors (11 out of 17) reduced stock in January, especially in transport (-17.3% mom), machinery (-12.8% mom), electronics (-21.8% mom), and steel (-17.1% mom). Nonetheless, the inventory-revenue ratio has continued to rise, indicating that in the current quarter production will continue to reduce inventories to more acceptable levels.

**Inventory corrections cannot keep pace with falling revenues**

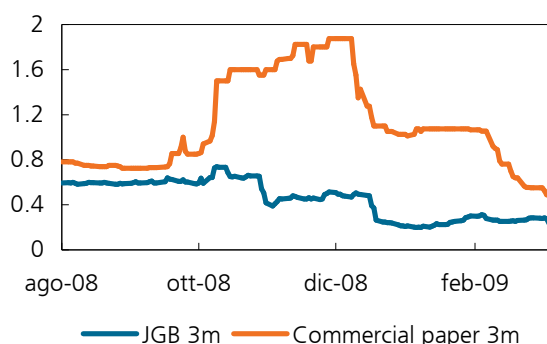
One sign of **possible stabilisation of business contraction rates comes from the PMI** in February, which rose by 2 points from 29.6 to 31.6, with an increase in orders as well (from 17.8 to 20.6), though it remains at extraordinarily low levels. The foreign orders and employment components have continued to drop. Figures from the first quarter will see a more contained negative contribution from net exports, but still larger than that of inventories and non-residential investments. **Non-residential investments** are forecast to drop by 13.8% in the year, and the quarterly contraction rate will only slow in the second half of the year. The residential construction sector will also begin to weigh on the scenario, after contributing positively until the end of 2008. Figures for construction sector orders and new building sites indicated that **residential investments** will register a drop starting in the first quarter and lasting all of 2009 (forecast: -7.2%), as a consequence of the cyclical downturn and drop in the availability of household credit.

The last Lending Survey (22 January 2009) registered a strong increase in **borrowing demand** (a net 43% of businesses increased demand, against -5% in the previous survey), probably tied to difficulties in obtaining finance through other channels. The rise is particularly marked for large businesses. Household demand for credit has instead decreased markedly, and is expected to continue to fall in the next quarter. The survey results were also confirmed by lending figures, which show a persistent increase from the fourth quarter of 2008, especially in the business sector. Overall lending in February was up 3.8% yoy, with business lending up against almost zero growth last August. However, the Lending Survey indicates an expected fall in credit demand in the next three months (to 20 for businesses and -11 for households). Banking credit standards have become far more restrictive for small businesses and households, but are relatively stable for medium and large companies.

Lending growth could, however, be supported by **economic policy measures recently implemented by the government and central bank to boost credit**. Since October 2008, the government has offered loan guarantees to small firms totalling JPY 20Trn. A similar measure in 1998 had no effect on lending growth, because banks were acting to reduce total lending. In addition, banks have received support from the central bank for other assets (see below), which may help to contain credit restrictions. The contraction in domestic business is due not so much

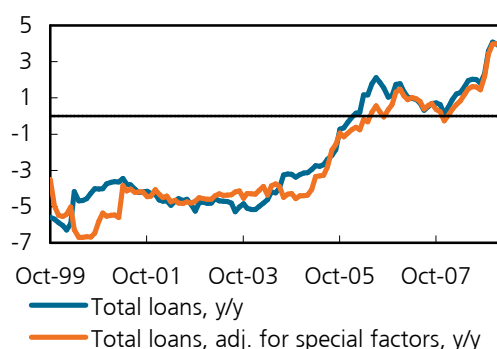
to the rationing of credit supply as to the collapse in orders, especially foreign ones. Besides bank loans, companies have access to the central bank's directly lending channels through its purchases of commercial paper. Following the launch of this programme, a reversal of the negative trend in demand will depend on the impact of the government's fiscal measures, and perhaps even more on the stabilisation of growth in the United States.

The BoJ's intervention affects commercial paper rates



Source: Bloomberg

Government loan guarantees to small firms support lending trends



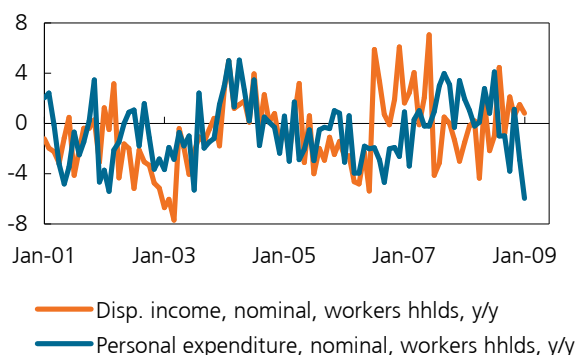
Source: EcoWin

Business is at the epicentre of Japan's economic downturn, while households experienced the collapse of demand late in the day. Until the end of 2008, the labour market was only in modest decline. Employment conditions have worsened, however, with a constant decline in full-time jobs since August 2008, becoming more marked at the end of 2008 for companies with more than 30 employees. Sector surveys (both the Tankan and PMI) indicate that employment is expected to worsen. The fall in employment did not have a strong impact on unemployment rates, which fell by two decimals in January, because it is accompanied by fall in the work force due largely to demographic conditions. Income from work is down by around 1% yoy, while disposable income is up in both nominal and real terms. However, household consumption has fallen markedly, with an increase in savings focussed on bank deposits. In household confidence surveys, labour market prospects are the most worrying element, while the fall in inflation has not yet been felt.

Consumption to fall by 1% in 2009

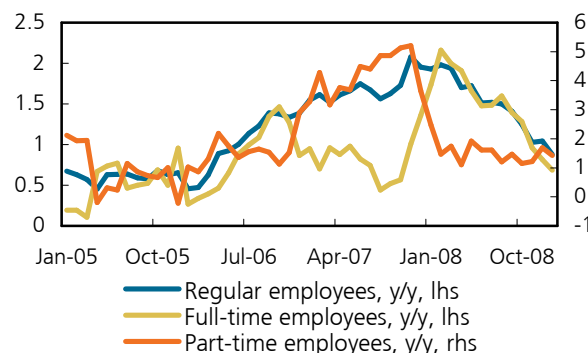
**Household confidence** finally stabilised at the beginning of 2009, after falling constantly since mid-2007, and even registered modest rises in both January and February, probably as a first reaction to falling inflation and government measures. **Household expectations for inflation** indicate a scenario of rising prices over the 12 months, out of line with actual inflation prospects and effective pressure on prices. Consumption is forecast to remain weak in the first half of 2009, with a modest recovery of growth in the second half, thanks to the expansive effects of economic policy and to falling inflation. Japanese households are in a decidedly rosier financial situation than American households, with a very prudent allocation of savings and contained exposure to debt. Consumption is forecast to fall by 1% in 2009, and to stabilise in the middle of the year as a result of fiscal policy.

Prudent saving among households



Source: EcoWin

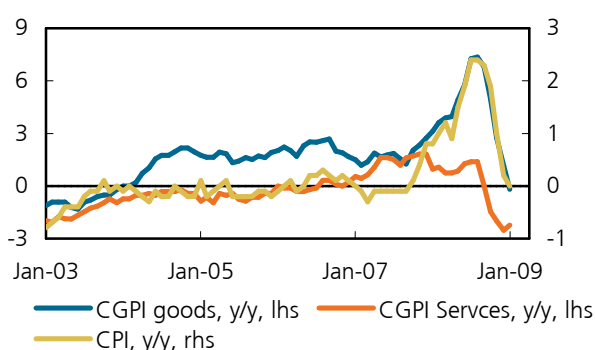
In the face of a deteriorating labour market



Source: EcoWin

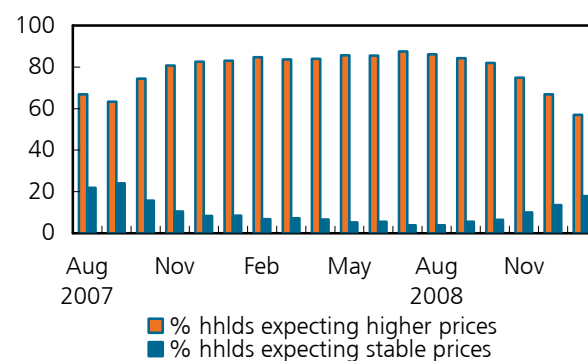
The expected weakness of demand, plus the growth in spare capacity (already signalled in the December Tankan) and the easing of commodity price pressures, points to negative inflation in 2009. The revision to the BoJ's macroeconomic forecasts announced in January puts inflation at -1.1% in fiscal year 2009 (in the range -1.2% to -0.9%) and still negative, at -0.4% (range -0.6% to 0%) in fiscal year 2010. Our inflation forecast is -1.2% in 2009 and -0.4% in 2010, with a more negative trend in the middle of this year. The price components of the surveys and the trend in producer prices confirm the easing of prices charged by firms, aided by the firming of JPY. The latest month-on-month changes show a rapid and steep fall in prices exposed to currency effects and relating to discretionary spending Consumer price inflation showed zero change in January, while the index ex food and energy was down -0.2%. The figures show steep increases in food prices (+3.3% mom) and tariffs (+2.3% mom for water, electricity and gas), plus steep falls in apparel (-0.8% mom), transportation (-6.3% mom, ) and leisure (-1.4% mom).

Inflation has turned violently...



Source: EcoWin

... but expectations are adjusting slowly



Source: Intesa Sanpaolo calculations on Cabinet Office data

2. Fiscal policy: fiscal measures totalling 2% of GDP, with estimated effects approaching 1% of GDP

Between August and December 2008 the Japanese government announced **exceptional measures totalling JPY 75Trn**, of which **JPY 12Trn (c.2% of GDP) in fiscal measures** and **JPY 63Trn (c.10% of GDP) in financial measures**, funding for firms and guarantees on debt issued by

**Fiscal measures announced totalling 2% of GDP will support growth in 2H09**

**companies and financial institutions.** A further package might be discussed by the end of next month. Of the fiscal measures approved, JPY 6.5Trn relates to increased transfers to local administrations, support for healthcare programmes for the elderly, building refurbishments, more unemployment benefits and various infrastructure projects at state and regional level. The remaining JPY 6Trn of fiscal measures will be part of the budget for fiscal year 2009.

Out of the total **fiscal measures** announced, around JPY 3-3.5Trn takes the form of tax breaks for **households** (tax cuts and rebates), JPY 2-2.5Trn in tax cuts for **businesses**, JPY 3Trn for **construction spending and infrastructure**, JPY 1.5Trn for increases in **public consumption**, JPY 1Trn as reserve and JPY 1Trn to cover the cost of loan guarantees. Thus, the funds that should help stimulate demand total around JPY 10Trn. In order to assess the effects of the measures, we assume a multiplier of close to 1 for the increase in public consumption spending and infrastructure (total JPY 4.5Trn), a multiplier of around 0.3 for the household tax cuts (JPY 3.5Trn, with an estimated effect of around JPY 1Trn), and a marginal effect for the business tax breaks, using a multiplier of 0.1. The combined effect would thus be an estimated JPY 5.8Trn or around 1% of GDP. The timing of the measures suggests that the actions should start to impact on demand as of the end of 2Q09.

Effect of fiscal measures estimated at 1% of GDP		
Tln Yen	Measures	Estimated effects
Higher <b>public spending</b>	4.5	4.5
<b>Household tax relief</b>	3.5	1.05
<b>Corporations tax relief</b>	2	0.25
<b>Total</b>	10	5.8

Source: Intesa Sanpaolo calculations on Ministry of Finance data

With regard to the financial measures, the government might extend the business lending provided by the Development Bank from the current cap of JPY 1Trn to JPY 1.5Trn. The Development Bank also has JPY 2Trn to buy commercial paper and short-term debt from companies (operations commenced in the last week of February). At the start of February, the government also proposed setting up an Industrial Innovation Corporation with annual funding of around JPY 200Bn p.a. to lend direct support to innovative firms operating in the ecology and environment sectors.

### 3. Monetary policy: *déjà vu*, with rates (almost) at zero and early “quantitative easing”

With the worsening crisis and the collapse in aggregate demand, the Bank of Japan has brushed off the emergency measures set aside only a few years ago, returning rates almost to zero and reintroducing programmes designed to expand its balance sheet.

The **overnight rate** was taken to 0.1% at the meeting on 19 December 2008, from 0.3% before. In December it was also decided to increase **outright JGB purchases** from JPY 14.4Trn p.a. (JPY 1.2Trn per month) to JPY 16.8Trn p.a. (JPY 1.4Trn per month). In addition, the range of assets accepted for purchase has been extended to include 30-year bonds, indexed securities and linkers. The direct financing of firms against commercial paper continue, with an increase in the size and frequency of the operations decided in November.

8 January saw the start of **refinancing operations against corporate debt** according to the directives announced on 2 December at an extraordinary meeting of the Policy Committee, which instituted the facility known as “Special Funds-Supplying Operations to Facilitate Corporate Financing”. Operations will be conducted on a regular basis and their original aim was to reduce financing tensions around the end of the fiscal year (end of March) in an unlimited amount at a rate equivalent to the overnight rate in force. Eligible bonds must have a

**The BoJ has already deployed a wide range of quantitative easing tools**

**In the coming months monetary policy will entail further expansion of the programmes now running**

BBB or higher rating. The initial end-date for the scheme (30 April 2009) was extended at the February meeting, taking it to September 2009, while the frequency of the operations was made weekly (from fortnightly); the duration of the loans has been extended to three months (from 1-3 months) for some dates. The BoJ also announced the **outright purchase of commercial paper and asset-backed commercial paper**. The central bank stressed that these measures increase the risk level of the assets on its own balance sheet and must be assessed as emergency measures to counter an exceptional situation; moreover, they must only be used if they are deemed "necessary to improve the situation in the light of the Bank's mission". To prevent the arbitrary allocation of funds with individual firms, the central bank will purchase securities via competitive auction from financial intermediaries who are BoJ counterparties and not directly from the issuing firms. The programme has a pre-set expiry date (the initial date of 31 March was extended to September 2009) and the size of the purchases will be limited (up to JPY 3Trn, with a limit of JPY 100Bn per issuer) so as not to undermine the existence of a private market for trading in the assets considered.

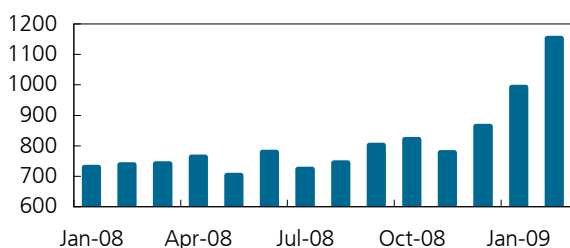
At the 21-22 January meeting, the BoJ went even further down the quantitative easing path. As indicated at the January meeting, the BoJ staff has prepared the guidelines for a new **programme involving the outright purchase of corporate bonds**. Eligible bonds must have an A or higher rating and residual maturity of up to one year from the end of the month in which the operation is conducted. Operations must have as counterparty financial institutions that are already central bank counterparties. The maximum amount of the purchases must not exceed JPY 1Trn and the ceiling for each issuer is JPY 50Bn. Purchases may be made up to 30 September 2009 and started on 4 March, with monthly frequency, subject to changes, with each operation amounting to around JPY 150Bn.

On 3 February the BoJ announced the reintroduction of the programme to **purchase shares** held by banks in order to stabilise the financial markets. The programme was introduced in 2002 and remained in effect until 2004, with purchases up to JPY 2Trn (limit JPY 3Trn). The original programme envisaged purchases of shares from banks whose share portfolio exceeded the Tier 1 capital; the sale of shares started in September 2007 and was suspended in October 2008. On that date the shares held on the BoJ's balance sheet amounted to JPY 1.27Trn. Under the reopened programme announced in February, the purchasing limit is JPY 1Trn and has a duration of around one year (through to end-April 2010). The shares eligible for purchase must have a BBB- or higher rating and must have been traded for at least 200 days on a stock market with transaction volumes totalling at least JPY 20Bn. The central bank will set a limit per issuer so as to diversify the portfolio of shares purchased. Banks eligible for the programme must have an account at the BoJ and must fulfil the following requirements: i) they must hold stocks whose value exceeds 50% of their Tier 1 capital; ii) they must have stocks worth over JPY 500Bn; 3) they must adopt the capital ratios as defined in international standards. The purchases may not exceed JPY 250Bn per bank. Under the scheme, the central bank may not sell shares purchased before the end of March 2012, and all shares must be sold by year-end 2017..

On 18 March, BoJ governor Masaaki Shirakawa said that the central bank will begin a new programme to acquire subordinated debt from the banks to limit the effects on banks' balance sheets of the persistently worsening financial conditions. According to the BoJ's press release, the deterioration of financial markets could lead banks to impose further restrictions on credit, while the cycle's negative effects are eroding banks' existing capital and could undermine the stability of Japan's financial system. The purchase of subordinated loans by the banks would lend support to the banks' capital and contribute to maintaining financial intermediation. Acquisitions would be for up to JPY 1Trn, with limits for individual institutions and at rates determined by the BoJ in line with market trends. The programme's operational details will be announced subsequently in a separate communication. The BoJ emphasised that the injection of "quasi-capital" into banks is an "extremely extraordinary" measure. According to Mr Shirakawa,

the measure aims to support the capital of the country's largest banks. The central bank's meeting ended with interest rates unchanged (overnight rate at 0.1%), but also by announcing an increase in the bank's acquisition of JGBs (from JPY 16.8Trn per year and 1.4Trn per month to JPY 21.6Trn per year and 1.8Trn per month). The aim of this intervention is to increase available liquidity, especially in tandem with the end of the financial year. In its economic assessment, the press release underlines the negative effects of the drop in export and its repercussions on business activity and profits. The BoJ indicated that its monetary policy will continue to act on three fronts: lowering interest rates, guaranteeing the stability of financial markets and facilitating business finance. The BoJ governor also said that the central bank will not make direct purchase of JGB in its move to finance the fiscal stimulus, because such a measure could be counterproductive. At present, the bank's consensus seems to indicate no scope for further intervention on interest rates, which are already practically nil (at 0.1%), although deputy governor Yutaka Yamaguchi said on 26 March that a further shaving of rates could not be ruled out.

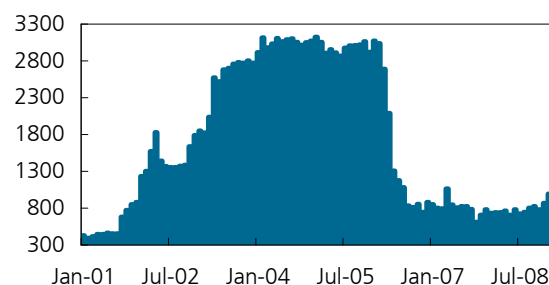
BoJ reserves rising again...



■ Current account balances, Bank of Japan, x10 bn Yen

Source: Bloomberg

... but are still well short of past records



■ Current account balances, BoJ, x10 bn Yen

Source: Bloomberg

In the space of two months the central bank has deployed all the tools that it had slowly put together during the crisis in the 1990s and **the room for manoeuvre it still has relates to the duration and size of the programmes under way.** The result of the quantitative easing measures is reflected in the central bank's balance sheet, with the assets side expanding from JPY 7.7Trn in August 2008 to JPY 11.5Trn in January 2009 and to JPY 12.7Trn at the start of March. The March level is still well short of the level seen at the start of the decade, when the reserves were around three times the current level.

## China: weak signs of a turnaround are not clear cut

- Foreign trade continues to suffer, and the activity indices of major commercial partners point to an ongoing contraction in trade in the coming months. Positive signals from industrial output and credit trends remain ambiguous, and the property sector is still in decline in spite of total fixed investment remaining stable. Retail sales figures indicate the first signs of slowdown.
- In spite of expansive monetary and fiscal policy measures, we continue to believe that the government's 8% growth target for 2009, confirmed when presenting the 2009 budget, will not be attainable.

Silvia Guizzo

Forecast Table	2005	2006	2007	2008	2009	2010
GDP (constant prices)	10.4	11.6	13.0	8.9	5.9	9.4
Consumer spending	7.9	9.6	10.2	8.4	10.9	11.7
Public spending	12.7	11.2	11.2	10.8	11.3	10.1
Capital investment	13.1	12.8	12.8	7.7	2.7	9
Exports	20.3	21.2	18	10.5	-8	3.4
Imports	7	11.8	13.6	9.2	-9.2	4.1
Industrial output	11.7	13	14.7	9.3	6.3	9.2
Inflation (CPI)	1.8	1.8	4.8	5.9	-0.7	1.5
Unemployment rate	4.2	4.1	4	4.1	4.6	4.2
Average salaries	12.4	13	17.7	10.3	6.6	10.8
1-year lending rate	5.6	5.9	6.9	6.9	4.2	4.8
USD/CNY exchange rate (avg)	8.2	8.0	7.6	7.0	6.8	6.3
Current account balance (CNY Bn)	1317.9	1992.3	2828.6	3057.0	2789.3	2477.8
Current account balance (% of GDP)	7.4	9.8	11.4	10.5	8.8	7.1
Fiscal balance (% of GDP)	-1.3	-0.8	0.7	0.8	-1.7	-2.8

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

Source: Oxford Economic Forecasting, Intesa Sanpaolo

## Export sector signals remain negative

February saw a fourth consecutive monthly drop in exports and imports, although imports registered a smaller drop than in December (-24,1% vs. -43.1%). Exports of ordinary goods continued to decline, while those of processing goods, although unfavourable, did not drop with respect to February levels, while exports in sectors tied to electronics and high-tech also remained stable. Exports improved slightly in the north-east regions (Inner Mongolia, Jilin and Heilongjiang provinces) which had been the first to register a drop in business in mid-2008. Since these regions produce cereals, fuel commodities and metals, falls in commodity prices had a strong impact, alongside restructuring of heavy industries and closures during the Olympic Games.

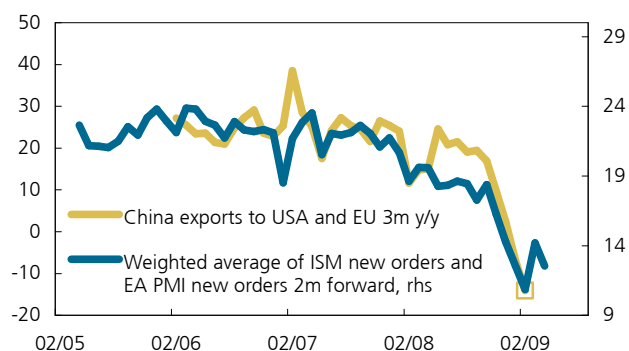
The quality of data for the first quarter is nonetheless very weak, due to the lunar new year, which occurred in the last week of January this year. If we adjust the data to account for effective working days, exports and imports both registered an even worse decline of around -40%. The foreign orders component of the PMI rose, compared with the low touched last November, but remains well under 50, indicating a fall in orders. Activity and retail sales indices in Europe and the USA, which are the key export markets, are also in decline. The outlook for exports thus remains weak, at least for the next two months.

Recovery in China's PMI in contrast with drop in ISM



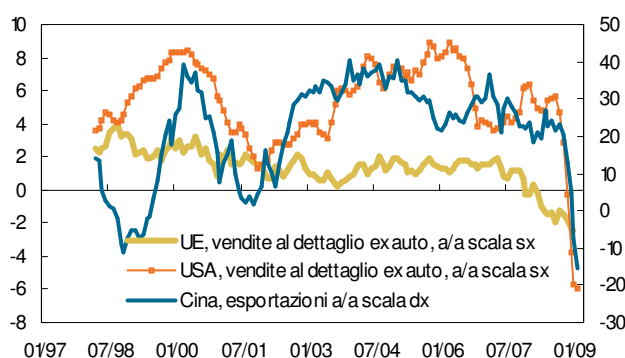
Source: Bloomberg

and with Euro area PMI



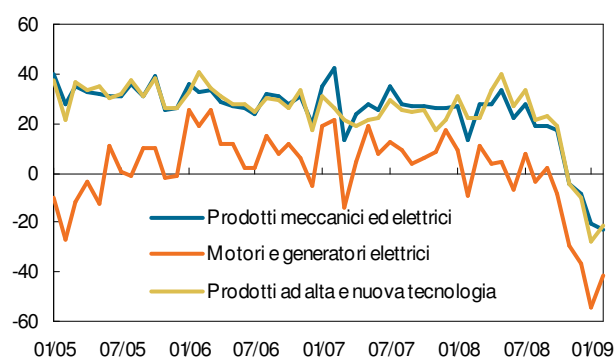
Source: Bloomberg and Intesa Sanpaolo elaborations, 3-month moving average

Fall in retail sales in industrialised countries does not support an inversion in export trends in the short term



Source: Bloomberg, 3-month moving averages

Exports (yoy)



Source: EcoWin, yoy variations

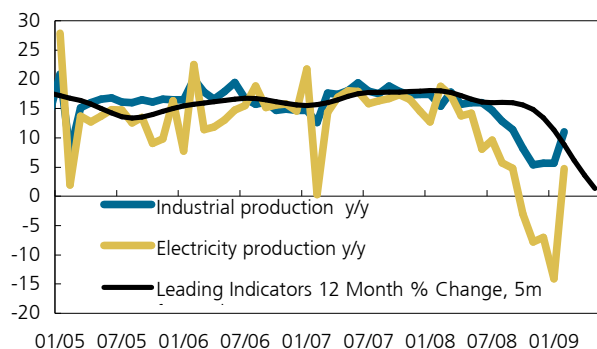
## Industrial production picks up, but consumption shows first signs of slowdown

Several positive signals have emerged from industrial output data, but these could be subject to the same adjustments as foreign trade data. Industrial output rose by 11% in February, in line with a rise in power generation, with positive changes in the production of steel, iron and iron alloys. Leading indicators continue to point to a slowdown, and PMI figures remain weak in spite of a recovery. The February increase in the input inventory component of the PMI (China Federation of Logistics) could be a timid sign of an inversion in the destocking trend of recent months, but this figure is difficult to interpret because the index is far more volatile than the PMI (CLSA), and remains very low. Furthermore, the figure could be largely related to heavy industries, which could benefit from an increase in demand, thanks both to lower commodity prices and to the launch of large infrastructure works such as the extension of the rail transport network. This hypothesis is consistent with the marked increase in fixed investment registered in the north-eastern and western provinces in January.

Automobile production rose by 26.9% in February, after four months of decreases, and vehicle sales rose by 24.7%, but retail sales are beginning to show signs of weakness. In nominal terms, retail sales growth (cumulative yoy) has fallen from 21.6% in December to 15.2% in February. In real terms, however, the rate remained virtually unchanged over the last six months of 2008 (average 17.7% yoy, non cumulative) in spite of a strong drop in inflation, but may have fallen by about 11% yoy (non cumulative) in February. Consumer confidence has continued to decline

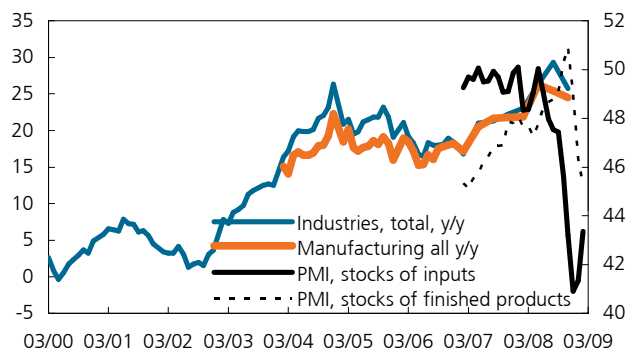
and is at its lowest level since 2004, with a critical labour market situation as indicated by slowing employment levels in all sectors, and outright drops in some sectors (textile and metalworking), as well by press reports.

#### Industrial output influenced by festivities



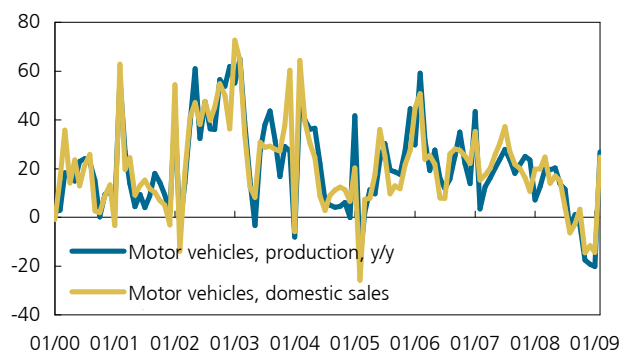
Source: Bloomberg

#### Company inventories: restocking?



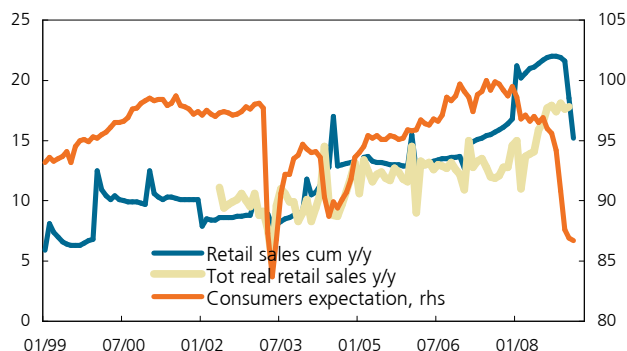
Source: EcoWin and Intesa Sanpaolo elaborations

#### Automobile production and sales jump



Source: EcoWin

#### Retail sales: first signs of slowdown

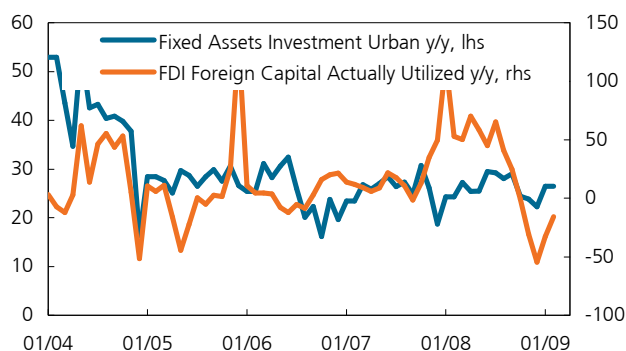


Source: Bloomberg

### Unclear signals from investment and credit

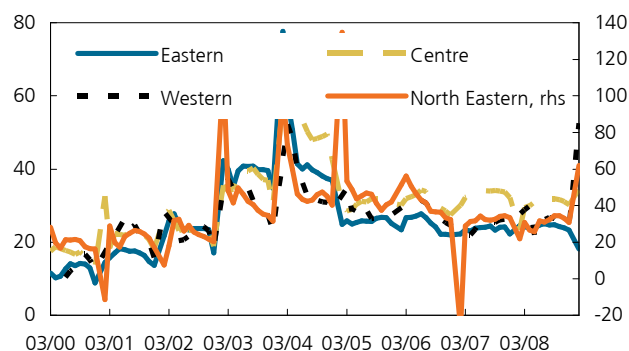
Urban fixed investment grew by 26.5% in cumulative terms in January, in line with growth rates registered in the final quarter of last year. Nonetheless, December data on residential investment and property development continue to indicate a slowdown in growth rates, compared with the peaks registered in mid-2008, consistent with a drop in sector business confidence and in sales of both residential and commercial building floor space.

Slight increase in overall fixed investment



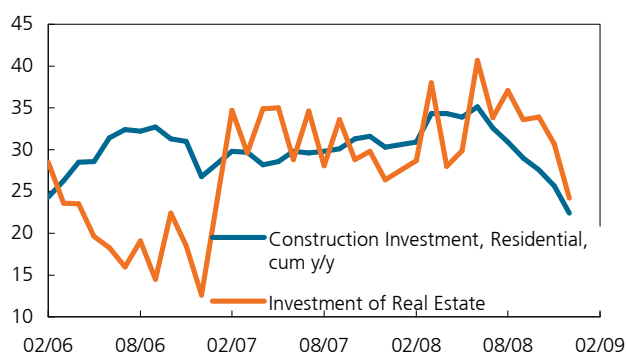
Source: Bloomberg

Especially in north-east regions



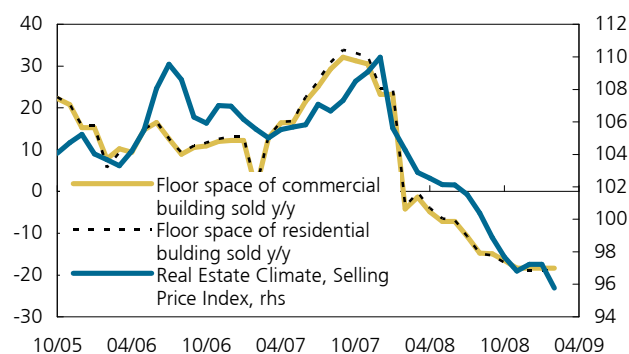
Source: Intesa Sanpaolo chart from EcoWin data

Construction investment in decline



Source: Bloomberg

In line with lack of market confidence

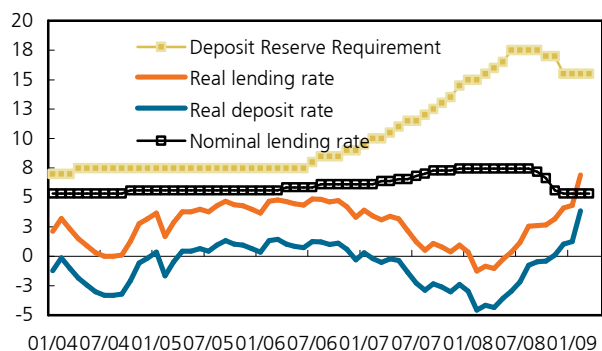


Source: Bloomberg

In December, the PBOC cut interest rates by a further 27bps, bringing the one-year lending rate from 5.58% to 5.31% and the one-year deposit rate from 2.52% to 2.25%. It also reduced the compulsory reserve ratio by a further 50bps for both large and small banks. The central bank then reduced its discount rate by 117bps, to 1.8%. As we have stated in the past, the measure's direct impact on investments is likely to be small, since investments are 76% financed by own funds and only 16% by bank loans (according to 2006 data from the statistics bureau). Furthermore, the solvency of state-owned companies and their connections with political circles makes them the preferred target customers for bank credit, to the detriment of the small and medium-sized enterprises which are the real engine of Chinese growth and employment. A more significant boost could come from an increase to the credit targets established in 2008.

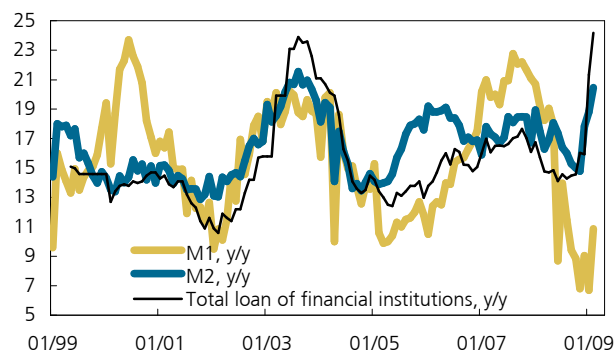
In the last six months, growth rates for M2 and bank credit grew considerably. In particular, growth in bank credit rose from 14.6% in October to 24.2% in February, led primarily, however, by very strong growth in bill financing. This type of finance reportedly accounted for 39% of new credit in January, according to press reports<sup>1</sup>, an anomaly which prompted the China Banking Regulatory Commission (CBRC) to launch a survey of the country's banks, which reportedly avoid giving long-term credit to businesses, preferring to focus on short-term instruments that are also more economical for businesses. For example, businesses can obtain six-month finance through invoice discounting, at a discount rate of 1.8%, compared to the six-month lending rate currently set at 4.86%. The January survey of monetary and financial institutions also indicates that long term credit growth is essentially stable, while loans to the trade and industry sectors have slowed.

Official interest rates: falling inflation boosts real rates



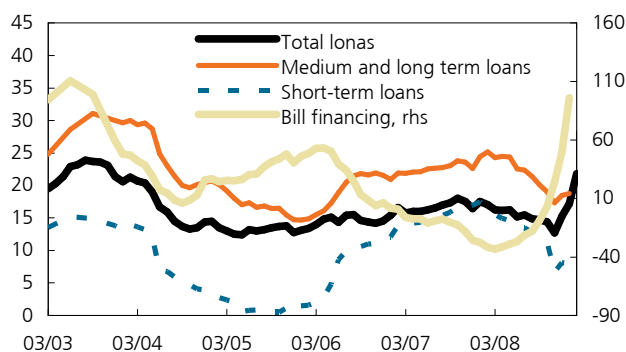
Source: Bloomberg

Money supply and banking credit on the rise



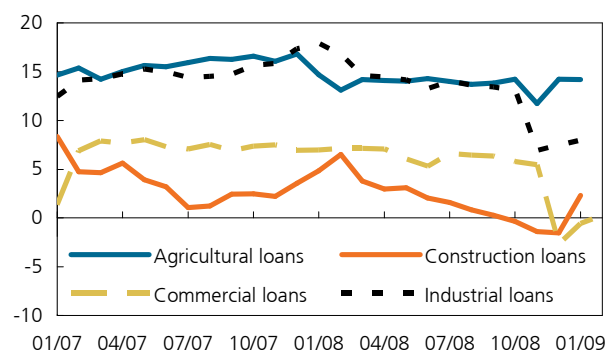
Source: Bloomberg, Monetary and Financial Institutions Survey

Credit growth led by bill finance



Source: EcoWin, Monetary and Financial Institutions Survey

Bank credit by sector



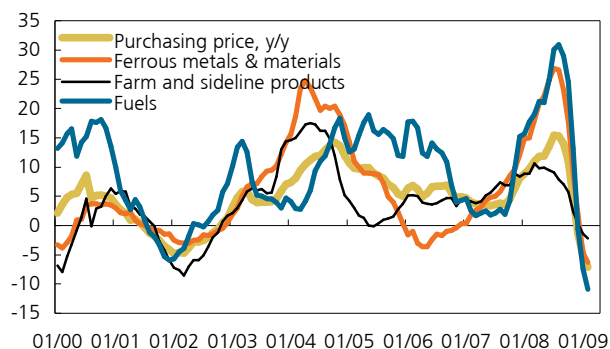
Source: EcoWin, Monetary and Financial Institutions Survey

## Falling inflation boosts real interest rates

Inflation fell by 1.6% in February, with falls concentrated in food prices. Marked drops in input prices, especially for metals, were mirrored by a fall in production prices, both for industrial goods (-5.7% in February) and consumer goods (-0.4% in February). This decline should reverse around mid-year, but will continue to affect consumer prices until then, leaving average inflation for 2009 in negative territory, at -0.7%.

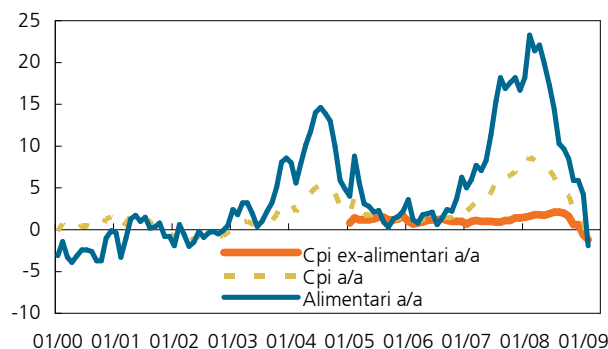
This faster decline in inflation has completely neutralised the interest rate cuts introduced last autumn, to the extent that real interest rates on both loans and deposits returned to positive territory. If macroeconomic data continues to worsen in the coming months, we do not rule out a PBOC decision to cut interest rates further and continue to impede a stronger exchange rate by acquiring Treasury securities. In spite of recent concerns expressed (and later denied) by members of government regarding the solidity of US debt, China has increased its purchases of Treasuries, which rose both in level (50% yoy in January) and as a proportion of reserves, in line with a halt in currency appreciation.

Input prices yoy



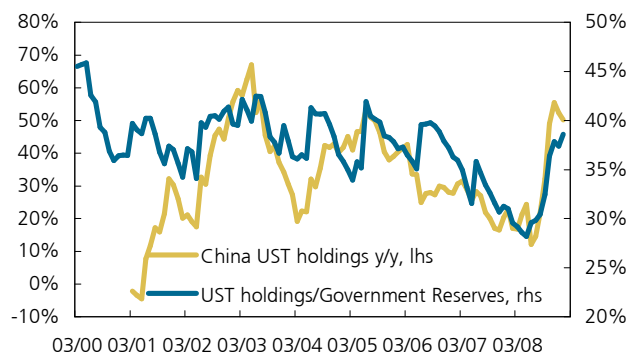
Source: Bloomberg

Consumer prices yoy



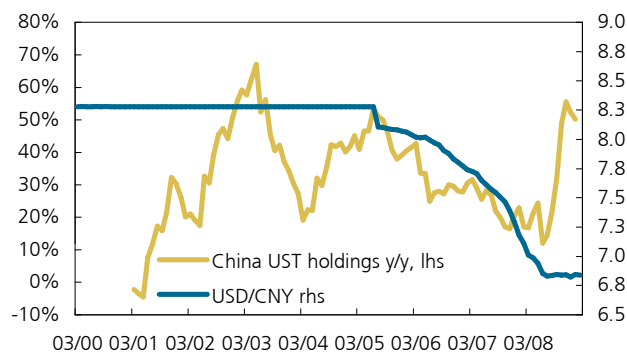
Source: Bloomberg

China continues to buy T-notes



Source: Bloomberg

And the exchange rate stops rising



Source: Bloomberg

Conclusion

The government presented a 2009 budget during annual session of the People's Congress, which is held at the beginning of March. The government reiterated its objectives to maintain growth 8%, promote social welfare measures and support consumption, but gave little detail on the implementation of such measures. The government forecasts an increase in the national deficit (which includes both national and local government budgets) from 0.3% in 2008 to 3% in 2009, with a deficit of CNY 950Bn financed by issuing debt, of which CNY 200Bn-worth will be from local authorities. The government also maintained its 2009 growth target at 8%, a level deemed necessary to increase employment.

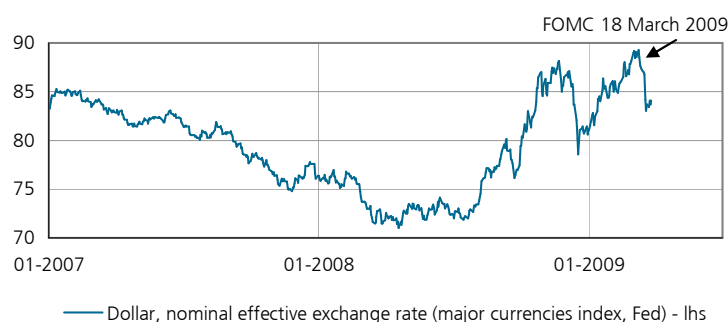
Considering the ongoing decline of indicators in the manufacturing sectors of industrialised nations and in global demand, as well as signs of weakness in China's labour market, the government's forecasts seem overly optimistic. In line with our lowered estimates for US and European GDP and private consumption, we have lowered our forecast for Chinese economic growth to 5.9%, against our December estimate of 6.7%, with a marked decline in the first two quarters of 2009. We expect some improvement in the second half of the year, due to the delayed effect of the looser credit policy for investments and a slight recovery in global demand. Growth in 2010 is forecast to be slightly above 9%, but there is risk of a downward revision.

## Forex markets – The dollar’s post-FOMC drop was a “false signal”

DOLLAR

Asmara Jamaleh

2008 was the year of the dollar’s “recovery”, which occurred just when the second phase of the financial crisis (see fig.) broke out in summer 2008 (the first dates back to summer 2007). 2009 saw the continuation of this (upward) trend from the second half of 2008. But in March, coinciding exactly with the FOMC meeting, the dollar fell sharply (see fig.), registering on the first day of decline the biggest daily drop in the nominal effective exchange rate since 1985.



Source: EcoWin

The question is if this was (1) a temporary blip or (2) a trend reversal set to last over time (at least for the whole of 2009), with the currency possibly hitting new lows under those registered in 2008. We lean towards the first theory: a temporary blip.

During the FOMC, the factor that triggered this violent and general correction was the Fed’s decision to bring forward the purchase of Treasuries, ahead of expectations. Previously it had only proposed this as an idea, without suggesting that it was in any hurry to launch this measure. Obviously, a quantitative increase in the dollar money supply reduces the currency’s value, so general depreciation is a normal reaction. It was probably amplified by the perception that the Fed did not wish to wait because the US economic and financial outlook has deteriorated further – despite the fact that the authorities have already launched numerous monetary and fiscal policy initiatives to combat the crisis. If this were the case, we believe that, as we maintained when the second crisis broke out in summer 2008, this time too, it cannot but also have a negative impact on the other major economies; in addition, none of these can allow a further and protracted appreciation compared to that (excessive even in absolute terms) registered after the FOMC.

Furthermore, the prospect of the Fed further purchasing Treasuries generates expectations of falling yields, which, if accompanied by other initiatives (see latest rescue plan for the financial system proposed by Treasury Secretary Timothy F. Geithner, attempts to resolve the AIG case, etc.) intended to restore confidence, may make Treasuries attractive again even in the eyes of foreign investors. The renewed and continued acquisition of US assets by institutional and non-institutional foreign investors is crucial for the dollar’s strength, and this is therefore a sensitive issue.

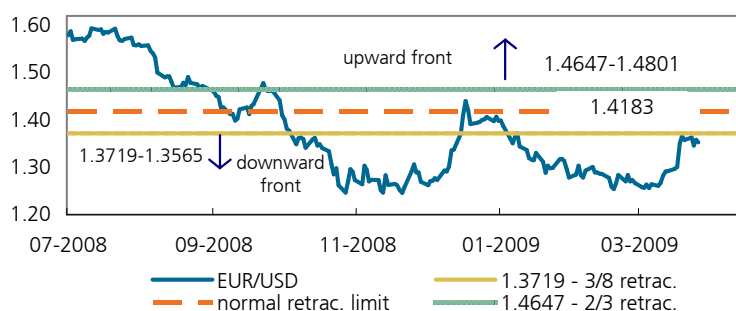
Furthermore, the dollar has lost the pre-eminence it enjoyed a few years ago, but this does not necessarily mean that its place has been taken by another currency; it may simply be that from now on, it will share the leading role with another or more than one currency, over which at least initially it will maintain relative supremacy. This theory is probably the most plausible in a transitional phase such as that which may be currently under way, which started at least three years ago when China abolished the bilateral peg with the dollar and anchored the yuan to a

basket of currencies (July 2005). If we accept both the theory of contagion in a globalised environment, and also the idea that the longer this specific crisis in the US goes on, the longer it will last in the other main economies, we can well believe that those that acted first to combat it and did so most effectively will also be the first to leave the worst behind. In this case, also in line with our forecasts of a recovery in US growth in 2010 after the contraction of this year (see “United States”), both in terms of numbers and quality (falling consumption and increased savings) **the first country to leave the worst behind it could be the US, a factor that could support the dollar** (just consider the further reduction in the current account deficit, associated with an increase in propensity to save, which has already eased significantly, partly because of the recession. This theme was at the centre of a debate that raged in 2002-2004, when some thought that the deficit could only be corrected by allowing the dollar to depreciate, a hypothesis that we did not agree with. In fact, the dollar was allowed to depreciate, and not only did the deficit get substantially worse, but other imbalances that could not be sustained indefinitely were also created, until we reached today’s crisis – it is by no means certain that this either can be resolved by the dollar’s “depreciation”). Furthermore, **it is possible that others will increasingly follow the US lead**, both those that have already begun to buy domestic government bonds (the BoJ and the Bank of England) and those that seem more reluctant (ECB), although various ECB members, including president Jean-Claude Trichet, have said recently that they are prepared to use unorthodox monetary policy instruments. **In this event, exchange rates would be rebalanced “automatically”, returning to pre-FOMC levels.**

**We therefore believe that the dollar’s recent post-FOMC decline is at most a precursor to a period of moderate vulnerability for the currency, and in any case a brief or very brief temporary blip, which will not see it return to its 2008 lows. It could rally as early as 2Q, before gradually returning below pre-FOMC highs in 3Q or 4Q, while on average remaining at higher levels than in 2008.**

## EURO

The euro began 2009 by replicating, albeit at a lower level, what happened in the three months between July and October 2008: then, it fell from its historic high of EUR/USD 1.6038 on 15 July to a low of 1.2328 on 28 October. Over a very slightly shorter period of time, it repeated this movement, falling from 1.4055 at the beginning of the year to a low of 1.2455 on 4 March 2009. Then, a period of moving sideways looked set to begin, when suddenly, **on the announcement of the last FOMC, the currency surged upwards, climbing from 1.2984 to 1.3517 against the dollar in just a day.** On the day after, the movement continued to 1.3737, and since then, the exchange rate has moved within the 1.34-1.37 range.



Source: EcoWin and Intesa Sanpaolo calculations

As explained in detail above in the section on the dollar, **this spike was exclusively due to the FOMC and the dollar’s sharp and general decline, rather than the inherent strength of the euro.**

In terms of technical analysis, the movement has however to date continued to follow the bearish trend enclosed within the 1.3565-1.3719 range. The threshold of 1.3719 was tested on several occasions but only on an intra-day level, and was not breached. In any case, the bullish reaction would seem justified technically up to 1.418, the “normal” retracement limit – without jeopardising the possibility of a subsequent return to 1.30 and below, possibly towards 1.25-1.23 (as happened in December, see fig.), unless the economic outlook changes. **Meanwhile, the real bullish front** – that which could re-open the way to the historic highs of last year of 1.50-1.60 – **remains distant, because it would begin only once the 1.4647-1.4801 range has truly been breached.**

Also from a fundamentals viewpoint, there should still be room for a return to at least the 1.30-1.25 band within a timeframe not expected to last beyond 1m-3m. This is because, while the first effects of the fiscal stimulus package should be felt from the second quarter, favouring growth, the process of monetary easing is still being finalised in the eurozone, and will undoubtedly include further rate cuts and probably also recourse to unorthodox monetary policy instruments: theoretically, it is possible that the ECB will also purchase government bonds, following the example set by the Fed, then the Bank of Japan and the Bank of England. Under this hypothesis, exchange rates between these currencies (euro and dollar in particular) would re-adjust almost mechanically. Within the same timeframe, probably more in the first half of the period considered, the economic outlook of the eurozone would not yet show any signs of improvement and recently rumours have begun to circulate that the 1Q results of European companies, to be published from April, could hold some nasty surprises. Not to mention the still unresolved question of banking system stability in Central and Eastern Europe, to which the banks of some eurozone countries seem exposed, and the significant decline in some countries’ public finances, particularly following the fiscal measures launched to combat the crisis. There is therefore a range of factors that would justify the euro falling to the levels mentioned above.

The exchange rate is only expected to recover in the second half of the year and going into 2010 towards 1.35-1.40, mainly because over a longer period of time, the issue is again expected to arise of how to finance the huge US public deficit – a gulf opened up by the fiscal stimulus packaged launched by the US administration. Over the year or a little longer (within two years), despite the serious US fiscal deficit, it is hard to imagine the euro returning to 1.60, because, according to our central scenario on Fed and ECB rates, growth is set to pick up considerably more in 2010 in the US than in the eurozone, following the hole in which both are expected to remain in 2009. Based on European and US short-term yields, as well as the manufacturing PMI and ISM indices as a proxy leading indicator for their respective growth rates, our model projects, at static fair value level and without using the dynamic adjustment component, exchange rates between 1.38 and 1.28 until the end of 2010. **While admitting the possibility of periods of overshooting of the exchange rate as has happened in the past, in the absence of “new” external shocks, the historic highs of the euro reached in summer 2008 would therefore seem to be behind us,** while precluding the return to the magnificence of certain periods in the past, the dollar will probably remain at higher levels in the near future than those of the last few years, without returning to the lows of 2008.

## STERLING

Like the euro, the pound also followed a bearish trend in 1Q09 – albeit a “flatter” one – from the highs of July 2008 at GBP/USD 2.00 to a low of 1.3498 on 23 January, almost replicated (1.3653) on 11 March. The decline was facilitated by the mix of expansionary economic policies launched to combat the crisis (see “United Kingdom”). These included a generous fiscal stimulus package, a monetary policy that cut rates by 450 bp between October and March, taking the bank rate to the historic low of 0.50% and the launch of *quantitative easing*, with the

introduction in March of the Bank of England's plan to purchase gilts over several months, which can be revised as required.

Initially, the Bank of England welcomed the decline in the exchange rate, as it believed that it favoured exports and would thereby reduce the size of the expected recession. Inflation figures published on 24 March however surprised on the upside, showing an increase in February from 3.0% to 3.2%, that is above the upper limit of the target band ( $2\% \pm 1\%$ ). This necessitated a letter of explanation from Governor Mervyn King to Chancellor Alistair Darling, in which he stated that this was a temporary situation and that inflation would follow a downward trend in the next few months. The governor said that the previous depreciation of the pound may have contributed to the unexpected rise in inflation. This could reduce its downside in general, but is unlikely to be sufficient to prevent that in the short term and in any case **by the end of the second quarter, the pound will again near its recent lows** between GBP/USD 1.40 and 1.35 (an incursion between 1.35 and 1.30 can not be ruled out in advance, but would be a brief spike) and towards EUR/GBP 0.95-0.98 (an incursion around parity can not be ruled out in advance, but this again would be a brief spike). **1Q and 2Q09 are expected to see the release of some extremely negative figures, and still represent the riskiest period both at macro level and in terms of 1Q company results, to be published from April onwards.**

**Subsequently, in the second half of the year, the pound could stage a gradual recovery,** particularly against the dollar (with Bank of England rates slightly higher than those of the Fed) and perhaps to a slightly lesser extent against the euro (given that the ECB is expected to keep rates higher than the Bank of England). **Broadly speaking, over the year and beyond (to the end of 2010), the recovery against the euro from current levels or any new short-term lows projected above should proceed** with a certain regularity also **because it is possible that the interest rates/growth combination expected in 2010 after the recession of 2009 should become more favourable to the UK than to the eurozone (see our central scenario forecasts outlined in "Eurozone" and "United Kingdom")**. Furthermore, it does not seem very likely in 2009 (aside from a brief foray at most) that new highs or lows will be explored compared to the relative and absolute records registered in 2008 (that is above GBP/USD 2.00 or above EUR/GBP 1.00).

## YEN

**After the wave of risk aversion that, triggered by the financial crisis, took the yen from the lows of 110 to highs not seen since 1995 (14 years ago!) of USD/JPY 87, 1Q09 was a period of "rightful return" to USD/JPY 100, heralding the direction for the next few months.** The bulk of the carry trades on the yen should now have been terminated, so only high rates or good fundamentals could allow the yen to appreciate further in the rest of the year. Interest rates, at 0.10%, are the lowest worldwide, even though they are closely followed by the US and Switzerland, both at 0.25%. Furthermore, the Japanese economy is again in recession/deflation, with the peculiarity however that the appreciation of the yen is largely responsible for the decline in growth: around two thirds of the contraction in 4Q08 is due to the negative contribution of exports. **After brushing USD/JPY 100 in early March, the exchange rate is expected to stabilise within a weaker band centred on the USD/JPY 100-105 range in 2Q and 3Q09,** both because the external conditions (flows related to the surge in risk aversion or the termination of carry trades) that can support it automatically are no longer in place and because the same domestic fundamentals, in absolute and relative terms compared to the other main economic areas, suggest that the exchange rate will weaken.

**It seems rather unlikely that the Bank of Japan will have to follow the example of the SNB (Swiss National Bank), which as well as cutting rates to almost Japanese levels (0.25%) recently intervened on the currency markets to weaken the Swiss franc.** Switzerland is in fact expected to go into recession this year, and given that it is a small economy whose exports are directed towards the eurozone, and that the franc has been "diverging" over the last month (i.e.

strengthening against the euro), the SNB's measure launched at EUR/CHF 1.47 to bring the exchange rate back to around EUR/CHF 1.55 may be considered appropriate. It is a different story for the yen, which in the same timeframe was already independently returning to less imbalanced (and weaker) levels until it reached USD/JPY 100. The BoJ should not therefore be forced to intervene directly on the currency markets by selling yen and buying dollars and possibly euro, as was feared a few months ago that it was ready to do if required – that is probably if the exchange rate had neared and/or exceeded (on the downside) USD/JPY 80.

**The possible risk to our central scenario is a new, very high wave of risk aversion following a round of 1Q09 results (out from April) possibly much worse than expected.** In this case, it is possible that the yen will strengthen again, while the Fed proceeds with buying Treasuries. But this should not lead to a change in our forecast profile, but possibly only a delay – probably not even very great, just a few weeks – of the acute phase of yen weakness (the transition through the USD/JPY 100-105 band). Subsequently, at the end of 2009 and the beginning of 2010, with the start of the global recovery, the yen should get back on its path of long-term equilibrium, which according to estimates based on rate/yield spreads, the main long-term driver of the yen exchange rate, would put it at around USD/JPY 95 over that time horizon.

Intesa Sanpaolo Research Department – Head of Research Gregorio De Felice		
Tel. +39 02 879+(6) – 02 8021 + (3)		
<b>Macroeconomic &amp; Fixed Income Research</b>		
Luca Mezzomo	62170	luca.mezzomo@intesasnpaolo.com
<b>Fixed Income Strategist</b>		
Sergio Capaldi	62036	sergio.capaldi@intesasnpaolo.com
Chiara Manenti	62107	chiara.manenti@intesasnpaolo.com
<b>Macroeconomics</b>		
Anna Maria Grimaldi	62118	anna.grimaldi@intesasnpaolo.com
Paolo Mameli	62128	paolo.mameli@intesasnpaolo.com
Giovanna Mossetti	62110	giovanna.mossetti@intesasnpaolo.com
Alessio Tiberi	32834	alessio.tiberi@intesasnpaolo.com
<b>Forex Markets</b>		
Asmara Jamaleh	62111	asmara.jamaleh@intesasnpaolo.com
<b>Commodities</b>		
Enrico Bernini	62057	enrico.bernini@intesasnpaolo.com
<b>Research Assistant</b>		
Serena Fumagalli	62118	serena.fumagalli@intesasnpaolo.com
Simonetta Melotto	62102	simonetta.melotto@intesasnpaolo.com
<b>International Economics</b>		
<b>Economist - Asia ex Japan</b>		
Silvia Guizzo	62109	silvia.guizzo@intesasnpaolo.com

## Appendix

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