BANCA IMI

Macroeconomic Outlook

Research Department
December 2013

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INTESA SANPAOLO

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Index

December 2013

Quarterly

Intesa Sanpaolo
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Based on information available up to 10 December 2013

Please read carefully the important disclosures at the end of this publication

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Will the Fed ruin the party?

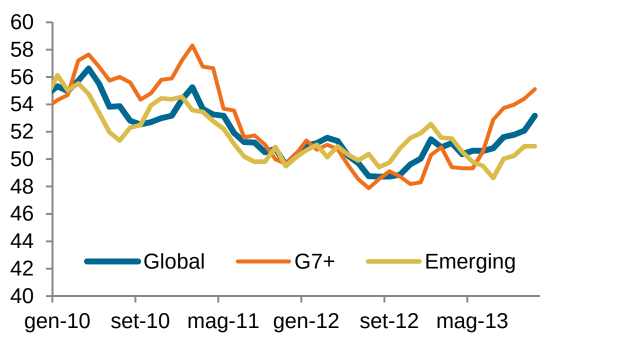
Luca Mezzomo

2013 leaves a cautiously optimistic legacy for next year. The mix of economic policies, improvements in financial stability in Europe and the absence of tensions on the commodities markets create the ideal conditions for another period of moderate growth without inflationary pressure. The main risk could come from the markets' reaction to the U-turn in monetary policy in the USA. However, the threats appear significant especially for the emerging countries that are most dependent on foreign investors, and even there a disaster is not warranted.

2013 draws to a close with signs of an upturn in global growth

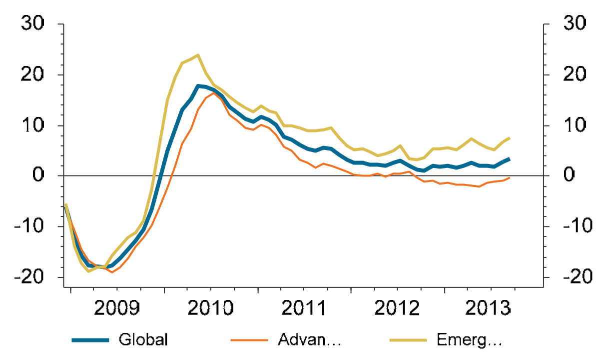
2013 is drawing to a close with encouraging signs that global economic activity is picking up, and with industrial output growth figures at last in line with a normal expansionary phase. The economic indicators in November show that the production component of the manufacturing PMIs of the largest advanced economies are driving the global average, which is being curbed by a somewhat modest performance by the large emerging countries. The albeit weak recovery in the Euro zone is already helping the central and eastern European countries, which are showing an improvement in their economic situation. The trend seen in the summer gradually became more pronounced in the autumn.

Manufacturing PMI by category of countries



N.B.: G7+ = USA, Euro zone, Japan, UK, Canada; Emerging = Brazil, China, India, Russia, South Africa, Poland, Mexico, Turkey. GDP-weighted average of Manufacturing PMIs Source: chart based on Markit data

Global trade (yoy)



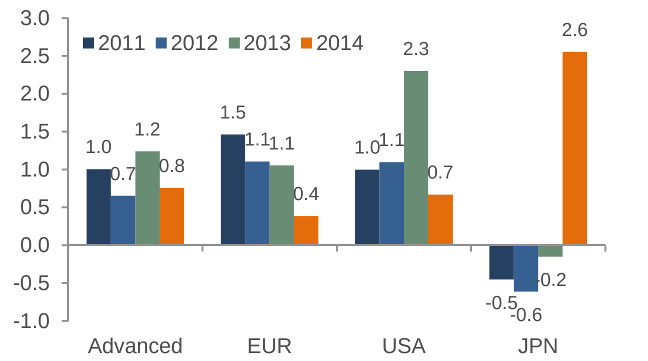
Source: chart based on CPB data

The outlook for next year seems cautiously promising, considering the predominant bias of the economic policies and the easing of financial pressure, especially in Europe. The conditions are in place for a year of moderate but widespread economic growth, without inflationary pressure.

In 2014, economic policies will not all have the same bias but, generally speaking, moderately restrictive fiscal policies and expansionary monetary policies will be the order of the day

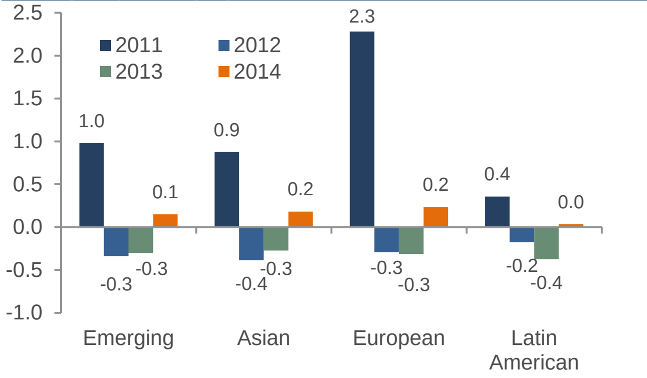
Fiscal policy is neutral in the emerging countries and only slightly restrictive in the advanced economies. However, the fiscal impetus will not be distributed evenly. At one tail of the distribution, the reduction in the cyclically-adjusted primary balance will be marginal for many Euro zone countries (including Germany and Italy). Conversely, the expected consumption tax rises in Japan could trigger a correction of more than 2.5 points in GDP, although this will almost certainly be softened through temporary expansionary fiscal measures. Moreover, other Euro zone countries will also be involved in fast fiscal consolidation processes (Portugal, Greece, Ireland). There is still some political risk in the USA, where fresh negotiations will be necessary to avoid a further shutdown of the federal government, but we think it unlikely that the events of last October will be repeated.

Fiscal policy: advanced economies



Changes in the cyclically-adjusted primary balance . Positive values relate to restrictive fiscal policy.
Source: IMF, *Fiscal Monitor,* October 2013

Fiscal policy: emerging countries



Changes in the cyclically-adjusted primary balance . Positive values relate to restrictive fiscal policy.
Source: IMF, *Fiscal Monitor,* October 2013

The monetary policies of central banks in advanced economies remain very accommodative: rates close to zero, a commitment not to raise them for a long time and generous liquidity supply. However, monetary conditions will not be more favourable than in 2013 in all countries. The stimulus will effectively be aggressive in Japan, where the central bank's securities purchases programme will continue without let-up. In the Euro zone we cannot rule out the possibility that new stimulus measures may be adopted if the economic recovery strengthens, but the baseline is that the money base will shrink and that rates will stay unchanged. However, the extension of full allocation to mid-2015 at least ensures that the banking system is not rationed in its demand for the monetary base, and there are no limitations on new measures should the financial and economic situation deteriorate.

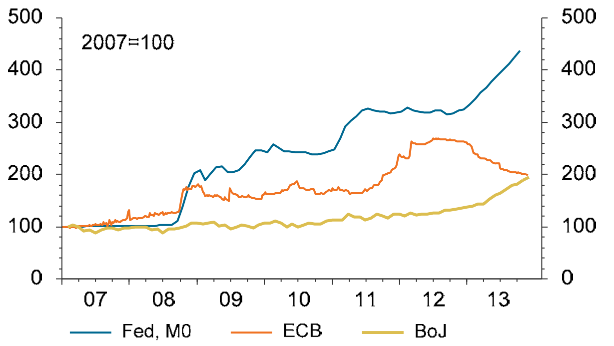
The strength of the reaction to the U-turn in US monetary policy is an unknown factor, especially for emerging countries

Conversely, the Federal Reserve is set to gradually taper its securities purchases to zero during 2014, although it will the supply of base money in excess of banking system’s needs. These development will certainly trigger a further rise in medium- and long-term yields on the dollar curves, which will be reflected in other markets, and the strength of investors' reactions after so many years in thrall to the monetary stimulus is a major uncertainty. Whereas in the Euro zone and Japan, the impulse will be partially cushioned by interest rate spreads, on emerging markets the changes could be magnified by portfolio reallocations and currency movements, as happened in the summer of 2013. The normal impact on growth rates of a 50-bps increase in ten-year dollar rates would be limited to -0.1% in the Euro zone and -0.2 to -0.3% in the emerging countries, assuming that risk premia for emerging sovereign issuers were to increase by 100 bps. However, the risks are plausibly greater for countries with high foreign debt servicing costs, a current account deficit in the balance of payments and low currency reserves ratios, because they are more sensitive to the drying up of capital flows and currency crises.

However, financial conditions will remain accommodative, and the tapering of quantitative easing will not be followed by a rapid rise in official rates

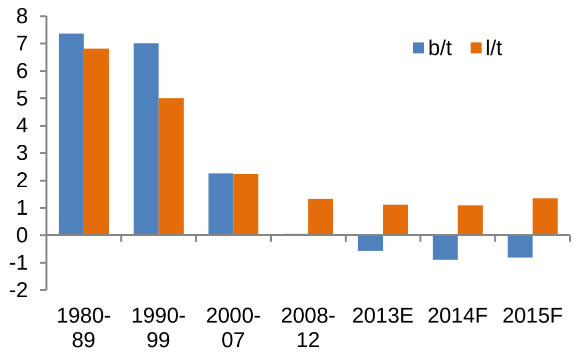
Various considerations lead us to believe that the US monetary policy U-turn, though representing a delicate transition stage, will not prove to be a fatal threat to the recovery. First, the level of the real short-term interest rates in OECD countries will remain in negative territory, while long-term rates will continue to be modest compared with the trend over the last 30 years; much will depend on the Fed's ability to control long-term expectations about official rates, and, in this regard, we think that the FOMC will counterbalance the reduction in quantitative easing with a strengthening of the *forward guidance*. This also applies to any repercussions for emerging countries: even the sell-off in summer 2013 seems to be explained more by the upward revision of rate expectations than by expectations regarding QE3 *per se*[1]. Second, in some countries, the potential positive repercussions on the value of the dollar abroad may offset the restrictive effect of higher long-term rates. Third, the consequences of a U-turn in US monetary policy for the global economy will also be offset by a more sound financial system. The cyclical conditions combined with fewer worries about the system's stability should lead, in 2014, to an easing in lending conditions and an increase in the money multipliers in various areas, including the US and the Euro zone. Finally, last summer, investors reduced their exposure to emerging countries, to a similar degree to that undertaken in 2011, which could have neutralised the risk to the emerging markets.

Size of central banks' balance sheets



N.B.: Total assets of central banks excluding the Fed (M0).
Source: Thomson Reuters

Real interest rates in OECD countries



Source: chart by Intesa Sanpaolo - Research Department

The Euro zone debt crisis would appear to be over. But for many countries the thorny issue of sustainability has not yet been resolved

The completion of the support programmes for Ireland, Spain and Portugal (in the latter case, supported at least by a precautionary credit line) will be another step forwards in resolving the debt crisis in Europe. In addition, the low interest rates guaranteed by the ECB will assist the restructuring processes. The biggest remaining areas of concern relate to the conclusion of the Portuguese programme, which is challenging due to the uncertainty over the implementation of corrective measures for next year, and the method chosen for alleviating Greek official debt. Over the longer-term, though, the issue of debt sustainability will remain unresolved for many countries, including some outside the Euro zone. In the IMF's illustrative exercise, the correction to the cyclically-adjusted primary balance necessary to steer the debt/GDP ratio towards 60% by 2030 will be more than 5% of GDP for the USA, UK, Spain, Ireland, and, of course, Japan. In Italy, it would be equal to 2.1% of GDP, to which should be added an improvement in the fiscal position of 2.3 points due to the return to growth the latter assuming that the favourable impact on the accounts from the recovery does not wane. Euro-zone countries cannot rely on the direct support of the central bank, unlike other regions where the central banks are playing an active role in ensuring that their countries' debt is financed at low cost through huge purchase programmes. For these countries, it will be even more important to be able to count on a relatively long expansionary phase with accommodative financial conditions.

[1] This is also the point made by Robin Koepke of the IIF in the note *Quantifying the Fed's Impact on Capital Flows to EMs*, dated 4 December 2013. The author argues that neither *tapering* nor official rate hikes should necessarily serve to overturn capital flows", but all steps towards normalisation could potentially cause a change in rate expectations and hence negative reactions by the market.

Economic growth by geographical region	2005	2006	2007	2008	2009
United States	2.5	1.8	2.8	1.8	2.9
Japan	4.7	-0.4	1.4	1.7	1.7
Euro zone	1.9	1.6	-0.6	-0.4	1.0
Eastern Europe	3.6	3.9	2.8	1.5	2.8
Latin America	5.7	4.1	2.9	3.4	2.9
OPEC	4.4	3.9	5.4	3.1	4.4
East Asia	9.2	7.0	5.5	5.5	5.7
Africa	4.3	3.4	3.2	3.5	3.9
World growth	5.2	3.9	3.2	2.8	3.6

Source: Intesa Sanpaolo calculations

In conclusion, the features of next year's macroeconomic scenario will be a narrower spread of GDP growth rates around a higher average than in 2013. The Japanese slowdown will partly offset the uptick in the USA and Europe. Moreover, growth will continue to be too low to initiate sustainable upward trends in industrial commodities and oil, and will slowly reabsorb the excess production capacity created after the financial crisis. We therefore expect that inflationary pressure will continue to have little effect on the behaviour of monetary policy.

The prerequisites for another period of moderate global economic expansion with no inflationary pressure are in place

Commodity price forecasts	2005	2006	2007	2008	2009
Oil (Brent, USD/barrel)	79.5	111.3	111.5	112.0	108.3
	+29.2	+40.0	+0.2	+0.4	-3.3
Commodities, excl. fuel (1990=100)	161.2	190.0	171.1	168.9	164.6
	+26.5	+17.8	-10.0	-1.3	-2.6
Metals (1990=100)	202.3	229.7	191.0	182.8	171.0
	+48.2	+13.5	-16.8	-4.3	-6.5
Agricultural commodities (1990=100)	125.1	153.5	134.0	134.1	122.5
	+33.2	+22.7	-12.7	+0.1	-8.7

N.B.: annual average levels and changes
Source: Intesa Sanpaolo – Research Department

Overview by region

On the monetary policy front, 2014 will be the year in which the QE3 programme comes to an end. The Fed is committed to maintaining an exceptionally accommodative monetary policy, even after the end of the purchases programme: it will also remain in place after the unemployment rate has fallen to 6.5% and the recovery has picked up steam. The FOMC will shift the relative weight of the monetary stimulus from purchases to forward guidance, and will make efforts to control the rise in yields that could accompany the tapering of purchases. As the recovery continues, however, there is a risk that the market will anticipate rate rises compared with the Fed's projections, leading to volatility and price corrections of financial assets. Controlling rate policy expectations will be a difficult challenge for the Fed, under Janet Yellen's leadership.

United States: 2014 will see the end of QE, but monetary policy will remain accommodative. The conditions are in place for more robust growth than in 2013

As regards fiscal policy, following agreement with the Budget Conference Committee, a budget for the current fiscal year, along with indications for the following year, is likely to be approved in January 2014. The automatic spending cuts of the Budget Control Act for fiscal years 2014 and 2015 are likely to be frozen and partly replaced with other less arbitrary measures. The effect on the deficit is likely to be a smaller reduction of one to two-tenths of a percentage point. If the budget is passed in January, it will be the first since 2009 to add financial stability to fiscal policy forecasts. However, a degree of uncertainty still surrounds the implementation of the December agreements, which do not have the force of law behind them.

2013 is set to close with 1.8% growth, while 2014 should achieve a growth rate of just under 3% (2.9%), with satisfactory consumer spending (2.4%), an upturn in capital investment by corporates (5.8%), and another double-digit growth figure for housing starts (12.7%). Support factors will be the restructuring of household finances, a now-consolidated real-estate sector, appreciably more moderate fiscal restriction than in 2013 and the continuing extremely accommodative monetary policy.

Euro zone: 2014 will be a year of moderate economic recovery, boosted by less fiscal restriction and accommodative monetary conditions

In the Euro zone, the return to GDP growth began in spring 2013 (+0.3% yoy in Q2), followed by a more modest rise in the summer quarter (+0.1% yoy). The recovery phase will be completed when the upturn also starts to affect the lending cycle and labour market, which will likely be at the end of 2013 or start of 2014. After two years of contraction, therefore, Euro zone GDP will resume growth in 2014 at a rate of around 1%. Domestic demand, after declining for the last two years, is expected to start growing again, driven mainly by corporate investment in machinery and equipment; growth in other investment will be more anaemic, however, due more or less solely to the appreciable recovery in the German construction sector. Fiscal restriction will continue but at a lower pace than in 2013. 2014 will also be a year in which imbalances - between domestic and foreign demand and between the growth rates of central and peripheral countries - will be reduced.

Inflation will stay closer to 1.0% than 2.0% in the next two years, but we still think that the deflation risk for the Euro zone average will be low. The output gap will continue to be wide but should start to narrow from mid-2014, while labour costs, damped down by peripheral countries, could accelerate in the central countries, especially Germany. Moreover, we expect that the effective exchange rate will depreciate by around 3% in the next 12 months, limiting downside pressure on consumer prices.

Monetary policy will remain accommodative in 2014, and new expansionary measures cannot be ruled out. Should the figures indicate downside risks to the scenario, the ECB could limit the refi rate to zero and bring the deposit rate into slightly negative territory (-0.1%), develop the *forward guidance* or launch new long-term refinancing operations, perhaps linked to the supply of credit to the private sector. We think that the ECB would consider a quantitative stimulus only in the event of a serious deflation risk for the entire Euro zone.

Japan: the BoJ will continue with its monetary stimulus but the economy will have to reckon with consumption tax rises. Growth will be more volatile. Inflation is likely to rise more markedly

In Japan, the BoJ is continuing with its strategy of qualitative and quantitative monetary stimulus, which up to now has produced satisfying results: these include, most importantly, an end to deflation and a considerable depreciation in the currency. Its projections of an achieved inflation rate of 2%, net of increases in indirect taxes, are probably too optimistic, and are not endorsed by all members of the Board. The central bank is still, however, committed to stepping up the stimulus if growth slows more than envisaged after the rise in consumption tax. We forecast that it will be possible, in mid-2014, to expand the securities purchases programme, by buying more long JGBs and high-risk assets.

The other main ingredient of the Japanese economic situation in 2014 will be fiscal policy. The hike in consumption tax will be the lynchpin of the intervention to bring the deficit/GDP ratio down by nearly three percentage points per annum in 2014-15. The fiscal clampdown (circa JPY 5.3Trn, 1.1% of GDP) will be offset by temporary expansionary measures on the public spending side amounting to around JPY 5Trn (1% of GDP).

The recovery should therefore continue in 2014 at similar levels to 2013 (1.8%), although with considerable quarterly volatility due to the budget intervention. Inflation net of indirect tax rises is likely to end 2014 in the vicinity of 1% yoy and continue along an upward trend.

China: growth levelling off at slower rates. Risks to financial stability linger, and are hard to assess

October and November data point to a slowdown in year-on-year GDP growth in 4Q 2013, which would not change our forecast for year-on-year growth of 7.6% in 2013, with risks slightly skewed to the upside tied to a stronger performance of private consumption than we had expected. The progressive slowing of credit aggregates in the coming quarters will weigh negatively, especially on investments, and will reap stronger effects on the growth trend in 2014, which we continue to forecast at 7.3%. Good labour market conditions, which for the time being continue to support spending, will inevitably feel the economic slowdown expected in the next two years. Their deterioration will prevent a strong acceleration in private consumption, helping keep inflation contained at around 3%. We expect broadly stable growth at 7.2% in 2015. The expansion of forms of financing alternative to the banking channel, the increase in problem loans, higher local government borrowing, and the risk of an inversion of the trend of real estate prices, remain reasons for concern for both the authorities and the rating agencies.

India: slight re-acceleration expected in 2014. The exchange rate will remain vulnerable to tensions

GDP grew by 4.8% y/y in 3Q 2013, beating expectations and accelerating from a low of 4.4% in 2Q. However, the recovery will remain shy, negatively impacted by deteriorating business confidence and by high debt in the corporate sector. The foreign channel should continue to contribute positively. We have revised slightly upwards our growth forecast for 2013, from 4.6% to 4.8%, while confirming a moderate acceleration scenario for growth in 2014. A stronger recovery is only expected as of 2015, with private consumption and investments making a stronger contribution. Despite the expected drop, consumer price inflation will remain high (9% in 2014). We expect the RBI (Reserve Bank of India) to hike rates again by 25bps at the turn of the year. An easing of monetary policy will only be possible starting in 2Q 2014, once the inflation trend improves tangibly. Therefore, the exchange rate will stay under pressure in the months ahead.

Commodities: prices expected to stabilise

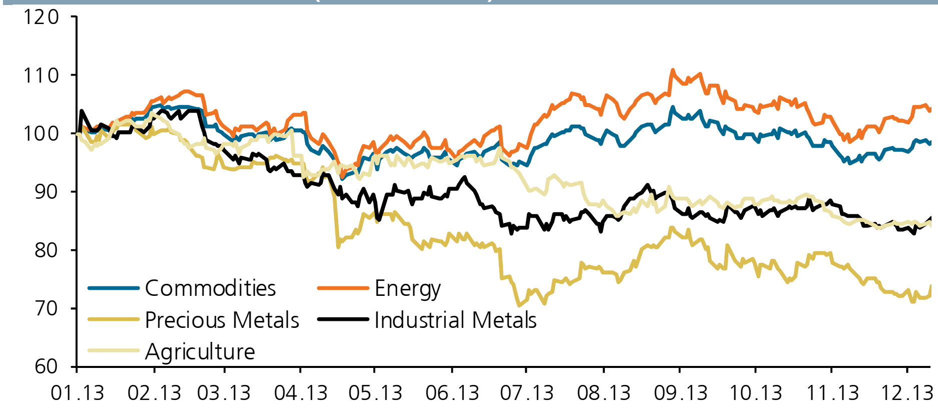
Daniela Corsini
Elena Galimberti

Performance driven by fundamentals

In 2013, the various segments of the commodity universe have posted mixed performances, but overall they have underperformed the other asset classes (e.g. the equity markets in developed countries) by a clear margin. For all the main commodities, the key drivers have been supply and demand fundamentals. In particular, geopolitical risks have impacted energy prices, especially oil, and precious metals, given gold's role as a safe haven.

The best year-to-date cumulative performance came from the energy segment, which benefited from the increase in the risk premium on the oil markets caused by geopolitical tensions and related concerns over supply in the Middle East. The worst performance was recorded by precious metals, which were dragged down by the collapse in investment demand for gold. Industrial metals suffered because of fears of a slowdown in China and plentiful supply on the main exchanges. Agricultural products also lost ground, with prices depressed across the board by abundant harvests and good weather.

S&P GSCI Total Return Indices (100 = 31.12.2012)



Source: Intesa Sanpaolo chart from Bloomberg data

We also expect commodity prices to be largely driven by supply and demand fundamentals in 2014. As a result, this asset class could again offer investors good diversification opportunities for investment strategies based on traditional portfolios. For short-term tactical allocations, it will be very important to take into account the release dates for macroeconomic data and policymaker announcements, as these events will continue to have a strong impact on market sentiment towards commodity investments, fuelling short-term volatility and generating speculative movements.

Overall, we expect the prices of most of the main commodities to stabilise next year, within a broad trading range. Moreover, we do not think that the upward pressure on prices from the improving global economy and ensuing rise in demand for energy and industrial commodities will be sufficient to alleviate the concerns that have weighed on the sector in 2013: namely physical markets characterised by rising supply, fears of a excessive slowdown in China and uncertainty over the next move in US monetary policy.

In particular, market sentiment toward commodities could deteriorate temporarily once the Fed announces it will start tapering its asset purchase programme. Nonetheless, we think any downward pressure caused by that announcement will be short-lived, since the expected change in policy will be accompanied by clear signals of a stronger US economy, and interest rates should remain at very low levels for some time to come. Our baseline scenario forecasts that, over the next year, less expansive monetary policies will be accompanied by a moderate appreciation of the US dollar. However, we note that a significantly stronger greenback than is factored into our estimates would be a major downside risk for the sector.

Our forecasts for the commodity *universe*

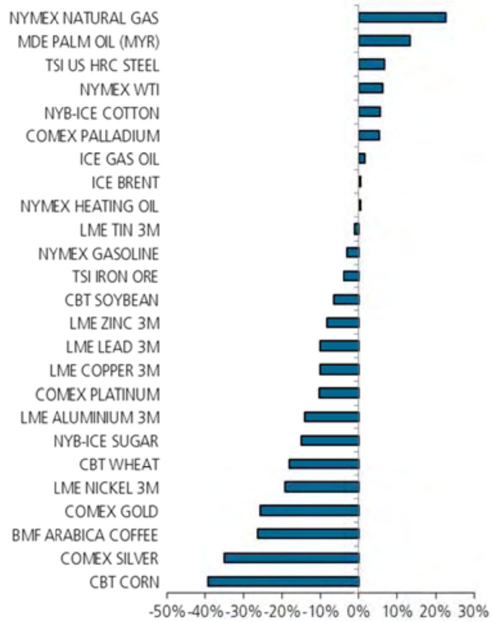
We have slightly reduced the risk premium incorporated into our oil estimates. A fresh escalation of geopolitical tensions looks unlikely over the next few months, thanks to the international agreements reached with Syria and Iran. In the short term, we see Libya as the main risk for the markets, given the complexity of the political situation there and the consequent difficulties of forecasting its oil output. However, we still think that Saudi Arabia will continue to play a key role in balancing the physical markets by, as necessary, increasing its own production to compensate for any unexpected interruptions or cutting it to offset any long-term increases in output by other countries. Consequently, we put our average price for the year at USD 109 per barrel for Brent and USD 99 per barrel for WTI. In the second half of 2014, prices should stabilise at around USD 110 per barrel for Brent and USD 100 per barrel for WTI. We foresee a wider spread between Brent and WTI than estimated in our previous quarterly scenario, owing to the quicker-than-expected reduction in imports to the US Gulf Coast caused by the surge in US production.

With regard to precious metals, we maintain our estimate of a persistent weakness in gold and silver, due to the structural reduction in investment demand and the difficulties in the Indian economy, as well as a stronger relative performance by platinum and palladium in the segment, thanks to these metals' exposure to industrial demand and vehicle sales.

With regards to industrial metals, prices should remain overall stable. Indeed, upward pressures from the recovery of the global economic cycle and the improvement in the demand in advanced economies should be slowed down by concerns regarding reduced consumption in emerging countries and weak fundamentals. For the majority of metals, the supply is abundant and global inventories are high. However, downward pressures from weak fundamentals and the risk of disappointing Chinese or US macroeconomic data should be once again mitigated by the support provided by the high marginal production costs (with the exception of copper, exchanged at prices well above the cost curve).

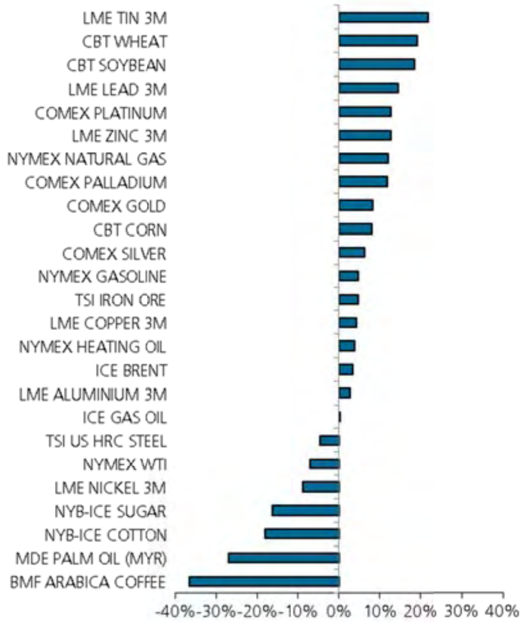
For agricultural commodities, the main market drivers remain the estimates of global production and consumption, which are vulnerable to climate risks. At present, the expectation of favourable weather conditions for cereal harvests in the next few months should keep prices for this segment at levels well below the peaks recorded in the last two years.

Year-to-date performance (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

Performance in 2012 (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

Oil remains within its trading range

With regards to oil, supply and demand fundamentals remain weak due to the expectation of a plentiful US production which enables non-OPEC supply to grow faster than global demand. However, we expect that international tensions will continue to keep global oil supply below its potential for another few months, and our estimates incorporate a persistent risk premium, albeit revised slightly downwards.

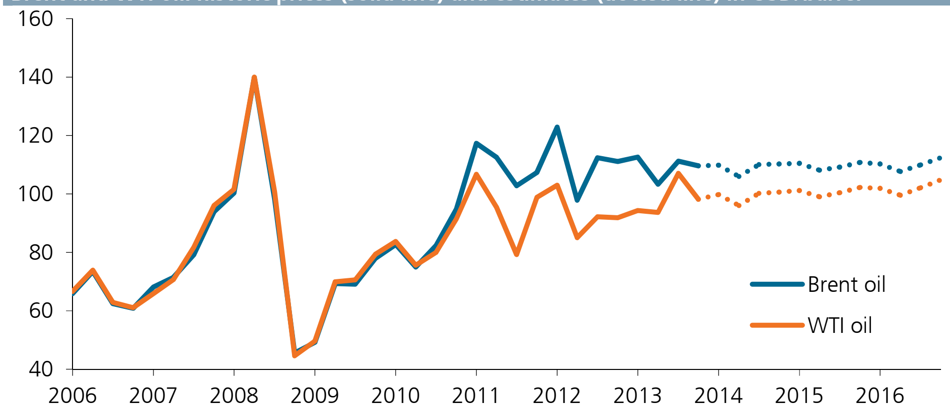
Compared with our previous scenario, outlined in September 2013, we have reduced the risk premium in our oil price estimates for 2014, and have therefore revised down our forecasts slightly. We do not currently expect a severe escalation of geopolitical tensions in the first few months of the year, thanks to the international agreements signed with Syria and Iran. In particular, the tensions over Iran's nuclear program should remain under control for the duration of the agreement signed at the end of November between Iran and the P5+1 world powers (US, Russia, China, UK, France and Germany). It is still very difficult to know what will happen when the six-month term of the agreement ends, but we think a breakdown in negotiations would not be in the interests of any of the parties concerned: the Iranian economy is under severe strain from the international sanctions, and the US mid-term elections due in November 2014 would make a worsening of geopolitical tensions undesirable. Furthermore, these elections will limit the time available for the Obama administration to reach a definitive agreement with Iran to bring an end to the sanctions. At the moment, the most likely outcome looks to be a renewal of the agreement for a further six months, or the launch of a new round of diplomatic talks. We have therefore factored into our forecasts a broadly stable risk premium for 2014.

In the short term, we think that Libya represents the greatest geopolitical risk, given the complexity of the country's political situation. We are more concerned by the possible impact of Libya's domestic tensions on the fragile equilibrium in the Middle East than by a further fall in the country's oil output, since Saudi Arabia will likely continue using its spare capacity to balance the physical market.

We have revised down our estimates for Brent oil to an average price of USD 109 per barrel for 2014, stabilising at around USD 110 in the second half of the year. We are keeping our resistance level at USD 120 per barrel, due to the risks still weighing on the macroeconomic scenario. Our support level remains at USD 100 per barrel, given the high fiscal spending in important producing countries and the high budget breakeven oil price needed to balance the fiscal budget. In the worst case scenario, even if there were a serious escalation of geopolitical tensions, we would not expect prices to remain above USD 135 per barrel for long since such level would not be consistent with the current strength of the global economy.

We have also revised down our estimates for WTI oil to an average price of USD 99 per barrel in 2014, stabilising at around USD 100 in the second half of the year. We project a wider spread between Brent and WTI than previously, owing to the faster-than-expected reduction in imports to the Gulf Coast. This spread will remain volatile, and could contract again if the US economy turns out much more robust than expected. However, even in the event of a particularly spectacular recovery, the energy saving processes under way will continue to rein in growth in domestic energy demand. Over our forecast horizon, we do not expect the spread to disappear completely, given current regulations prohibiting US oil exports and the high transportation costs of shale oil.

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



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart from Bloomberg data

Price estimates for Brent

At 06.12.13	1Q14	2Q14	3Q14	4Q14	1Q15	2014	2015	2016
Estimate	109.8	106.0	110.0	110.2	110.5	109.0	109.6	110.0
Bloomberg median	105.0	103.0	104.5	102.0	100.5	105.0	102.0	102.0
Forwards	110.8	109.9	108.4	106.9	105.5	109.0	103.2	97.8

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

At 06.12.13	1Q14	2Q14	3Q14	4Q14	1Q15	2014	2015	2016
Estimate	99.8	96.0	100.2	100.6	101.2	99.2	100.7	102.1
Bloomberg median	98.0	96.0	97.0	95.0	95.0	98.9	95.0	95.0
Forwards	97.8	96.4	94.3	92.2	90.2	95.1	88.1	84.0

Source: Intesa Sanpaolo chart from Bloomberg data

Supply and demand fundamentals

The supply and demand fundamentals for oil are broadly unchanged from our previous quarterly scenario, and remain weak overall: the International Energy Agency (IEA), OPEC and EIA estimate that non-OPEC supply will outpace global demand in 2014, thanks to the rapid rise in North American output. To balance the markets, OPEC needs to reduce its total production in both years, providing the markets with a lower quantity of oil than the current production target of 30 million barrels per day (Mb/d).

According to estimates by the US Energy Information Administration (EIA), spare capacity, which is currently almost entirely concentrated in Saudi Arabia, should gradually increase to 2.5 Mb/g in the fourth quarter of 2013 and to 4.0 Mb/g in the fourth quarter of 2014 (compared with the average of 1.7 Mb/g in the third quarter of 2013). The commercial reserves of OECD countries remain abundant and, for 2013 as a whole, should be broadly in line with the 2012 level of 2.65 Mb (equivalent to around 58 days of consumption): EIA estimates put the commercial reserves of OECD countries at 2.59 Mb by end-2013, rising to 2.61 Mb by end-2014.

As a result, our analysis of supply and demand fundamentals indicates that if the current geopolitical tensions and limits on supply decreased, prices would fall towards USD 100 per barrel for Brent, in line with our base macroeconomic scenario. Conversely, in the event of a particularly disappointing global recovery, prices would settle at around USD 90 per barrel.

Supply and demand for 2013 as estimated by OPEC, IEA and EIA

Estimates in November 2013, millions of barrels	Demand Total	Supply Non-OPEC	OPEC supply of LNG	"Call on OPEC Crude"
OPEC	89.8	54.1	5.8	29.9
vs. 2012	+0.9	+1.2	+0.2	-0.6
IEA	91.0	54.7	6.4	30.0
vs. 2012	+1.04	+1.3	+0.12	-0.38
EIA	90.3	54.2	5.8	30.1
vs. 2012	+1.08	+1.55	+0.08	-0.84

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

Supply and demand for 2014 as estimated by OPEC, IEA and EIA

Estimates in November 2013, millions of barrels	Demand Total	Supply Non-OPEC	OPEC supply of LNG	"Call on OPEC Crude"
OPEC	90.8	55.3	5.9	29.6
vs. 2013	+1.0	+1.2	+0.1	-0.3
IEA	92.1	56.5	6.6	29.1
vs. 2013	+1.1	+1.8	+0.21	-0.91
EIA	91.4	55.7	6.1	29.7
vs. 2013	+1.14	+1.48	+0.29	-0.33

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

United States – Free to grow to 3%

Giovanna Mossetti

- Growth should finally approach 3% in 2014, as a result of improvements in the household finances and in the newly consolidated real-estate sector, an appreciable loosening of the fiscal restriction compared with 2013, and a continuation of the exceptionally accommodative monetary policy.
- 2013 is set to close with 1.8% growth, while 2014 should achieve a growth rate of just under 3% (2.9%), with satisfactory consumer spending (2.4%), an upturn in capital investment by corporates (5.8%), and another double-digit growth figure for residential building (12.7%).
- The main risks to the 2014 scenario come from economic policy. As regards fiscal policy, a budget for the current fiscal year, along with indications for the following year, is likely to be approved in January 2014. The automatic spending cuts of the Budget Control Act for fiscal years 2014 and 2015 are likely to be frozen and partly replaced by other, less arbitrary, measures and a more modest reduction in the deficit of around one- to two-tenths of GDP. If the budget is passed in January, it will be the first since 2009 to provide financial stability to fiscal policy for at least 12 months. However, a degree of uncertainty still surrounds implementation of the December agreements, which relate to a broad raft of measures.
- On the monetary policy front, 2014 will be the year in which the QE3 programme comes to an end. The Fed is committed to maintaining an exceptionally accommodative monetary policy, even after the end of the purchases programme: it will also remain in place after the unemployment rate has fallen to 6.5% and the recovery has picked up steam. The FOMC will shift the relative weight of the monetary stimulus from purchases to forward guidance, and will make efforts to control the rise in yields that could accompany the reduction in purchases. As the recovery continues, however, there is a risk that the market will anticipate rate rises compared with the Fed's projections, leading to volatility and price corrections of financial assets. Controlling rate policy expectations will be a difficult challenge for the Fed, under Janet Yellen's leadership.

USA – Forecast table

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (1996 US$,y/y)	2.8	1.8	2.9	1.3	1.6	1.8	2.4	2.8	2.9	2.8	3.1
q/q annual rate				1.1	2.5	3.6	2.2	2.8	3.0	3.4	3.4
Private consumption	2.2	1.8	2.4	2.3	1.8	1.4	2.0	2.6	2.8	3.0	3.0
Fixed investment - nonresid.	7.3	2.5	5.8	-4.6	4.7	3.5	5.5	6.5	6.5	6.8	6.2
Fixed investment - residential	12.9	13.8	12.7	12.5	14.2	13.0	9.5	11.8	13.9	15.2	15.6
Government consumption	-1.0	-2.0	-0.3	-4.2	-0.4	0.4	-0.8	-0.4	-0.3	0.0	0.1
Export	3.5	2.4	4.9	-1.3	8.0	3.7	4.5	4.5	5.0	5.5	5.5
Import	2.2	1.6	4.1	0.6	6.9	2.7	3.6	4.0	4.3	4.4	4.7
Stockbuilding (% contrib. to GDP)	0.2	0.2	0.2	0.2	0.1	0.4	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	-2.7	-2.3	-1.9	-2.6	-2.4	-2.1	-2.1	-2.0	-1.9	-1.9	-1.9
Federal Deficit (% of GDP)	-7.5	-5.2	-4.7								
Gov. Debt (% of GDP)	122.6	123.5	123.9								
CPI (y/y)	2.1	1.5	1.6	1.7	1.4	1.6	1.3	1.2	1.7	1.6	1.8
Industrial production	3.6	2.5	4.2	4.2	0.9	2.4	5.7	4.0	4.4	5.0	5.2
Unemployment (%)	8.1	7.4	6.9	7.7	7.6	7.3	7.2	7.1	7.0	6.9	6.8
Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Effective exch.rate (1990=100)	70.9	73.5	76.0	72.9	74.0	74.0	73.2	74.9	76.6	76.7	75.9

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

Will growth finally be close to 3% in 2014?

In 2014, the US macroeconomic scenario is likely to see average quarterly growth of close to 3% qoq ann., as a result of improvements in the household finances and in the now-consolidated real estate sector, an appreciable loosening of the fiscal restriction compared with 2013, and a continuation of the exceptionally accommodative monetary policy.

2013 is set to close with 1.8% growth, while 2014 should achieve a growth rate of just under 3% (2.9%), with satisfactory consumer spending (2.4%), an upturn in capital investment by corporates (5.8%), and another double-digit growth figure for residential building (12.7%). Foreign trade should be virtually neutral. The contribution of public spending will remain negative but less than in 2013, thanks to the expansion of central and local government balance sheets and a correction that we forecast will be lower at federal level.

The risks to our 2014 forecasts are neutral overall, given that the forces are likely to pull in opposite directions. In terms of the private-sector recovery, there could also be upside risks for growth. On the other hand, economic policy will still be affected by uncertainty and potential volatility. As regards fiscal policy, an agreement on the 2014 budget is likely to be reached by the end of 2013, which will head off a further government shutdown and new clashes on the debt ceiling. A compromise is likely to have been defined by December, which will freeze the automatic spending cuts for two years and partly replace them with less arbitrary measures, as well as again temporarily extending other measures expiring on 1 January 2014. With this scenario in place, fiscal policy is not likely to create further obstacles to growth before the *mid-term* elections in November, but implementing the agreements could re-open conflicts and generate uncertainty.

As regards monetary policy, the information published in October-November could lead the Fed to start tapering purchases as early as December. If the FOMC were to decide to use the press conference following the next meeting to implement the U-turn, we think the forward guidance would be broadened in order to anchor the yield curve close to its current levels. At the moment, the probabilities of a tapering of the purchase programme starting in December or in January are much the same. The market is prepared for an imminent U-turn, but the FOMC's message is old news: futures are now factoring in stable rates until the end of 2Q15.

Private demand: growth consolidates at around 3%

In 2013, private demand was hampered by fiscal tightening and uncertainty. A combination of the January tax hike, the Budget Control Act spending cuts in the second quarter and the fiscal crisis in September-October put the brakes on growth, with restrictive effects on consumer spending and investment. In 2014, barring any new fiscal restraints, private demand will follow a more "normal" cyclical course, with consumer spending expanding by around 2.5% and non-residential investment growing by 5.8%.

The acceleration in consumer spending - from the 1.8% forecast for 2013 to an expected 2.4% in 2014 - is the result of improvements in consumers' finances and the labour market. Net wealth keeps increasing, thanks to the reversal in house prices, the positive performance of the financial markets (see Figures 3 and 4) and the fall in mortgages. The savings rate was 4.8% in November 2013, in line with the average from 1995 onwards, and well above the lows of the housing bubble (2% in July 2005). With the process of improving finances and building up savings complete and increasing fiscal and credit tightening at an end, household spending will normalise in 2014, in response to an improving labour market and the appreciable increase in wealth. In 2Q13, total wealth increased by 9.5% yoy and real-estate wealth by 12% yoy. The employment trend will provide some confirmation of the rise in income from work, despite the severe salaries moderation. We forecast that the number of people in employment will grow by around 180,000-200,000 a month in 2014, with an unemployment rate of 6.7% at the end of the year (with downside risks to this forecast).

Non-residential fixed investment slowed in 2013, in the wake of demand hampered by fiscal tightening and uncertainty. The signs at the end of 2013 are for a recovery in the manufacturing sector, no longer driven solely by automotive and energy sectors but others too. The sector indicators have remained strong, despite the government shutdown in October, with signs that order books and capital spending are picking up. We forecast growth of 5.8% in non-residential capital investment in 2014, up from the expected 2.5% in 2013, with a widespread upturn in both machinery and software, and in structures.

The residential housing sector is still growing: residential investment is likely to rise by 12.7% in 2014, after the 13.8% growth forecast for 2013. In the central part of this year, the sharp price rises and hike in interest rates brought new building and sales to a sudden halt, but following the removal of fiscal uncertainty and the improvement in the labour market, the rate of expansion is already picking up at end-2013.

Foreign trade should provide a modest positive contribution, thanks to the energy sector (fewer imports and more exports) and the pick-up in international growth.

Fig. 1 - Growth picks up following the end of fiscal tightening

Source: Compiled by Intesa Sanpaolo using Thomson Reuters Datastream data For the demand components, contributions to annualised quarterly growth; for GDP, q/q ann. changes

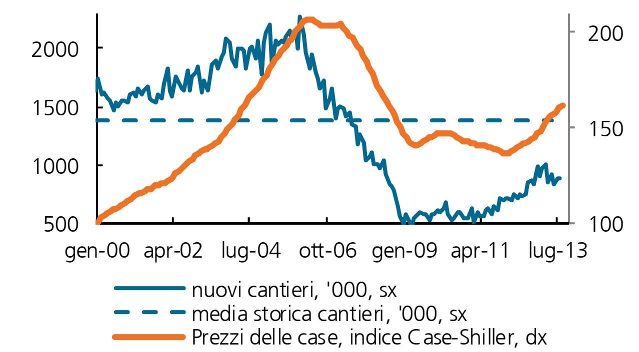
Fig. 2 – Manufacturing sector: sustained growth

Source: Thomson Reuters Datastream

Fig. 3 – Improved household finances

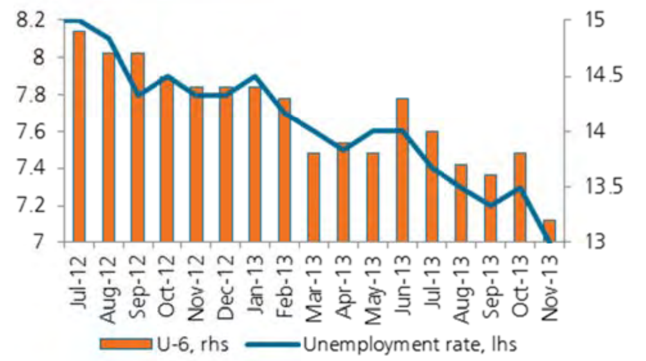
Source: Thomson Reuters Datastream

Fig. 4 – Residential housing sector: still positive



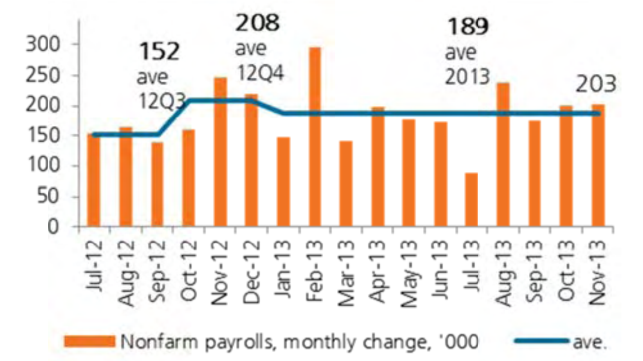
Source: Thomson Reuters – Datastream. House prices index =100 in January 2000.

Fig.5 – Unemployment rate falling steadily …



Source: Thomson Reuters – Datastream. U6 Unemployment rate, calculated including disaffected workers, workers marginally attached to the labour force, and workers in part-time employment for economic reasons

Fig. 6 – Numbers in employment by between 180,000 and 200,000 a month



Source: Thomson Reuters – Datastream. Figures in thousands.

Fiscal policy: pre-election truce

Fiscal policy has been a constant thorn in the side of recovery in 2013: the fiscal cliff at the beginning of the year, the implementation of automatic spending cuts after March, the fiscal crisis and the government shutdown in September-October have all curbed growth. The outlook for 2014 is considerably better. An agreement has at last been reached on the budget, ahead of the 13 December deadline. By January 15th, Congress should approve the first budget since 2009, incorporating compromises on most thorny issues on the table (budget and automatic spending cuts), eliminating the risk of another government shutdown.

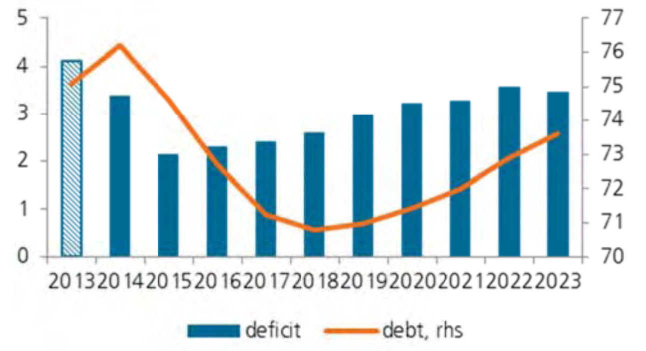
The agreement relates to the plans for the automatic spending cuts imposed under the Budget Control Act (which would be operational from 15 January), as well as to other measures expiring on 1 January. The Budget Control Act (BCA) now imposes a ceiling of USD 967Bn for discretionary spending in the fiscal year 2014 and USD 995Bn in the fiscal year 2015; spending on military operations abroad and emergency intervention must also be added to this, bringing expenditure that is not affected by the BCA to a total of around USD 150Bn a year. Total discretionary spending planned under the current legislation is therefore USD 1.11Trn in 2014 and USD 1.15Trn in 2015, from USD 1.15Trn in 2013. The BCC agreement is likely to bring the discretionary spending ceilings to at least USD 1.01Trn, with spending of USD 518Bn for defence (up from the USD 498Bn forecast) and USD 494Bn spending excluding defence (up from the USD 469Bn forecast). Total spending would therefore be USD 1.15Trn in 2014. This would be roughly halfway between the proposals of the Democrats, who envisage ceilings of USD 1.058Trn, and the Republicans, who propose maintaining the statutory ceilings unchanged, i.e. at USD 967Bn in 2014. The agreement is also likely to adjust the ceilings for discretionary spending in the 2015 tax year. The budget compromise extends temporarily the expiring farm bill and the freeze on Medicare doctors' fees. To partially make up for the planned scaling back of spending cuts, there will be higher airline fees and a reduction in health and/or social security spending for federal employees. The result is higher discretionary spending of 62 Bn over the period 2014-2023, with 48 Bn concentrated in the years 2014-15. Overall the agreement reduces the 10-year cumulated deficit by 85 Bn dollars.

Public spending should prove broadly neutral in 2014, with a stabilisation in the federal sector, and growth at the state and local levels. The agreement will have two positive effects. First of all, the risk of conflicts breaking out in 2014 is dramatically reduced, removing the uncertainty that has been a constant feature over the past two years, with the ever-present risk of a fiscal crisis. Secondly, the period of harsh fiscal tightening is now over, freeing the growth of private domestic demand.

An agreement along these lines would have two important consequences. First of all, primary public spending could rise in 2014-15, including the positive contribution of the central and local government budgets. Secondly, the clashes and uncertainty surrounding fiscal policy would be put to bed for a long period of time, eliminating volatility and curbs on household and corporate spending. In this scenario, the federal deficit in the 2014 tax year could be between 3.5% and 3.6% of GDP instead of 3.4% of GDP as projected by the CBO, from 4.1% in 2013.

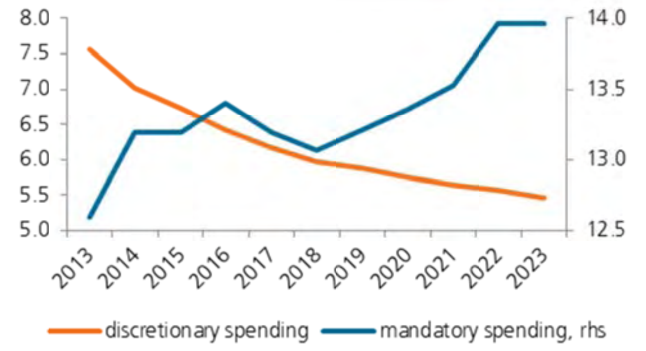
However, the agreement on the budget reached in Congress is not ambitious: it will leave unresolved the issue of the long-term unsustainability of the spending path, which will continue to increase as a percentage of GDP while revenues are projected to remain stable at 19% of GDP. Both the deficit and the debt are set to explode over a horizon going beyond 2030. The composition of Congress following the midterm election will be the determining factor in any structural reforms of the federal accounts. For now, however, the truce anticipated in 2014 is a positive outcome, if we compare it with the scenario of the last few years. Markets, households, corporate and monetary authorities will unanimously see this as a positive factor for growth.

Fig. 7 – The federal accounts are under control until 2018



Source: Congressional Budget Office Figures as a % of GDP

Fig. 8 – Existing legislation compresses discretionary spending to unsustainable levels, while health spending will grow steadily after 2018



Source: Congressional Budget Office Figures as a % of GDP

Monetary policy - 2014: a shift is coming

In 2014, there will be big changes on several fronts at the Fed.

In 2014, monetary policy still ultra-accommodative, with a new chairman...

On 1 February, there will be a change of chairmanship, when Ben Bernanke passes the baton to Janet Yellen: in the interests of continuity, this will be a gentle transition and is not likely to significantly change the management of monetary policy. In the last few years, Dr Yellen has presided over what was then the bulk of the changes in the Fed's communications, and under her chairmanship, the Fed should continue on the path of transparency. In terms of management style, Yellen's leadership, like that of Bernanke, will be "democratic", with considerable internal debate and decisions taken by a majority vote, marked by likely explicit dissent from the more extreme fringes of the Committee. Yellen's position in terms of monetary policy bias and reaction function are well known: Her bias is towards maintaining an expansive policy for longer than would have been expected by traditional rules (e.g. the Taylor rule), to strengthen the recovery and make it sustainable. This involves low interest rates for a very long time, probably until at least mid-2015, at which time there will be very slow initial rises, followed by an acceleration in the rate of fiscal restriction from the end of 2016 onwards.

…a small Board..

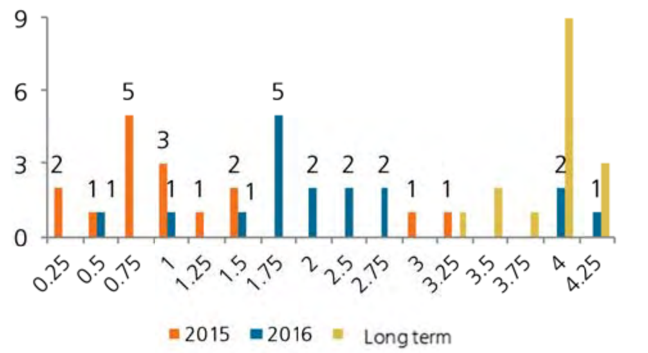
Another significant event in 2014 will be the change in the composition of the Board and the voting members of the FOMC. In 2014, the Board's relative influence in the FOMC will be drastically reduced. Specifically, at the end of August, Elizabeth Duke resigned, reducing the number of Board members from seven to six. In addition, Sarah Bloom Raskin, who was nominated as US deputy Treasury secretary in July and is currently awaiting confirmation of her new appointment, will step down shortly. The number of members will thus fall from six to five. At the end of January, Ben Bernanke and Jerome H. Powell will leave, bringing the number of governors to three. By May, Stein, whose position at Harvard was put on hold, is also likely to resign, leaving the Board with only two members: Ms Yellen and Daniel Tarullo. The process to replace the outgoing members will, of course, be initiated, but the times required for selecting and subsequently approving members of the Board are often protracted, and will be particularly complicated during periods of heightened conflict in Congress and in the run-up to elections.

There will be two problems with such a reduced Board: first of all, the huge workload will be almost unsustainable for the two remaining members, and it will become difficult to manage monetary policy due to the lack of governors with specialist knowledge in the Fed's various areas of expertise. Moreover, **the Board's influence in monetary policy decisions will be drastically reduced**. There are 12 voting members in the FOMC, seven Board members, the President of the NY Fed and four rotating members from among the Presidents of the other eleven Reserve Banks. Typically, the Board and the President of the NY Fed represent the "centre" of the Committee, which sticks closely to the Chairman. A centre composed of two or three members, with a new Chairman, will struggle more than usual to build a consensus. In 2014, the usual annual rotation will lead to four new voting members, including two super-hawks (Charles Plosser and Richard Fisher), compared with only one hawk this year (Esther George), and to uncertainty regarding the replacement of Sandra Pianalto (Cleveland), who has announced that she will resign in early 2014.

…but most importantly a change in the relative weight of the stimulus, from purchases to forward guidance

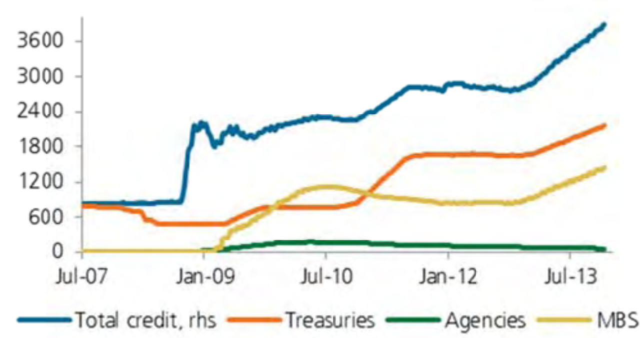
Lastly, and more importantly in terms of substance, 2014 will be the year of tapering. Monetary policy will continue to be exceptionally expansive, **with a gradual reduction in the securities purchases programme and a shift of the stimulus towards forward guidance**. The Fed has repeatedly said that reducing the purchases programme is not a restriction of the stimulus but an increase at a more modest pace. The central theme of the Fed's communication during this period of transition is the distinction between the purchases programme and the interest rate path. We think that the progressive, gradual reduction in purchases will be accompanied by clear indications of very long-term zero interest rates and very modest rises in 2016, in order to anchor both short-term rates and long-term expectations. Moreover, it will again be stressed that the thresholds stated as being necessary (although not sufficient) prerequisites for any U-turn on rates are in fact thresholds and not triggers: the FOMC, as will become apparent from projections of the rate forecasts, does not intend to raise interest rates even when the threshold is reached, but will do so later.

Fig. 9 – Expected Fed funds by number of FOMC participants: low rates for a very long time



Source: Federal Reserve Board, compiled by Intesa Sanpaolo The values on the vertical axis represent the number of participants at the FOMC, which forecasts the level of fed funds shown on the horizontal axis.

Fig. 10 – The Fed's balance sheet is likely to stabilise at close to USD 4.3Trn in 3Q14 (25.6% of GDP)



Source: Federal Reserve Board. Figures in USD Bn.

Euro Area - The Road to Exit the Crisis is Still a Long One

Scenario in a nutshell

Paolo Mameli
Anna Maria Grimaldi

- The slow process of exiting the "great crisis" is continuing for the Euro area, in line with expectations in terms of timing and scope. The easing of tensions on financial markets, which began in autumn 2012, was followed, at a lag of around six months, by a return to positive GDP growth in quarterly terms.
- After contracting for two years, Euro area GDP is to resume growing in 2014, at a pace of around 1%. The trend of domestic demand should turn positive again, mostly driven by investments in machinery and equipment. The growth in private consumption, on the other hand, should be significantly slower than GDP growth, and limited to core countries. Foreign trade is to continue to make a positive contribution to GDP, albeit less so than in recent years, against a background of recovering trade flows in both directions. Inflation should stay closer to 1.0% than to 2.0% in the next biennium, although for the Euro area as a whole the risk of deflation is contained.
- In 2014, monetary policy is unlikely to be able to do more than wait for events to pan out; should economic data outline the risk of a fall back into recession, however, the ECB could cut rates again, enhance forward guidance, or launch new LTROs (possibly on condition of banks using the funds to step up lending). Full-fledged QE would imply a serious risk of deflation. As regards fiscal policy, while 2014 should be the fourth consecutive year of fiscal consolidation in average Euro area terms, the size of the correction (therefore of the negative impact on the cycle: -0.2% based on our estimates) should be significantly smaller than in previous years.
- In addition to marking a modest recovery, 2014 should see a reduction of imbalances, in terms of the gap between domestic and foreign demand, and especially between core and peripheral countries. However, in peripherals the need for further deleveraging in the private sector is expected to continue slowing the cycle for years to come.
- The main risks to the scenario are a potential re-exacerbation of the financial crisis (less likely today than it was in the past, but not impossible), and the impact, via exports, of a less brilliant trend of demand from the rest of the world, and/or an appreciation of the exchange rate.

Forecast Table

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	-0.6	-0.4	1.0	-1.2	-0.6	-0.4	0.3	0.7	0.7	1.1	1.3
- q/q change				-0.2	0.3	0.1	0.2	0.2	0.3	0.4	0.4
Private consumption	-1.4	-0.5	0.5	-0.1	0.1	0.1	0.0	0.0	0.3	0.2	0.3
Fixed investment	-3.9	-3.2	1.6	-1.9	0.2	0.4	0.2	0.2	0.5	0.7	1.0
Government consumption	-0.6	0.3	0.5	0.3	0.0	0.2	0.1	0.1	0.1	0.1	0.1
Export	2.7	1.1	4.2	-1.0	2.1	0.2	0.7	1.3	1.1	1.1	1.1
Import	-0.8	0.1	4.1	-1.2	1.6	1.0	0.9	1.1	0.9	0.9	1.0
Stockbuilding (% contrib. to GDP)	-0.5	-0.1	0.1	0.1	-0.2	0.3	0.1	0.0	-0.1	0.0	0.0
Current account (% of GDP)	1.3	2.0	2.1	0.0	1.3	2.2	2.0	1.9	0.0	1.4	1.2
Deficit (% of GDP)	-3.7	-3.2	-2.8								
Debt (% of GDP)	92.6	95.9	97.1								
CPI (y/y)	2.5	1.4	1.2	1.9	1.4	1.3	0.8	0.9	1.3	1.1	1.1
Industrial production (y/y)	-2.4	-0.6	3.3	0.3	1.0	-0.2	0.3	0.8	1.7	1.5	0.7
Unemployment (%)	11.4	12.1	12.0	12.0	12.1	12.1	12.1	12.1	12.1	12.0	11.9
3-month Euribor	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2

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

The economic situation: the recovery is under way, but is modest and still subject to risks

Paolo Mameli

The slow process of exiting the "great crisis" is continuing for the Euro area, in line with expectations in terms of timing and scope. The easing of tensions on financial markets (the "dawn of the recovery"), which began in autumn 2012, was followed, on the back of easing pessimism among economic operators (and especially enterprises, in the manufacturing sector in particular), and at a lag of around six months, by a return to positive GDP growth in q/q terms (since Spring 2013: Euro area GDP growth of +0.3% qoq in 2Q, followed by a more modest increase the following quarter, of +0.1% qoq). This is the phase we are currently experiencing and that will presumably be followed, with a certain delay, by the completion of the recovery phase, once also expanded to the credit circuit and to the labour market.

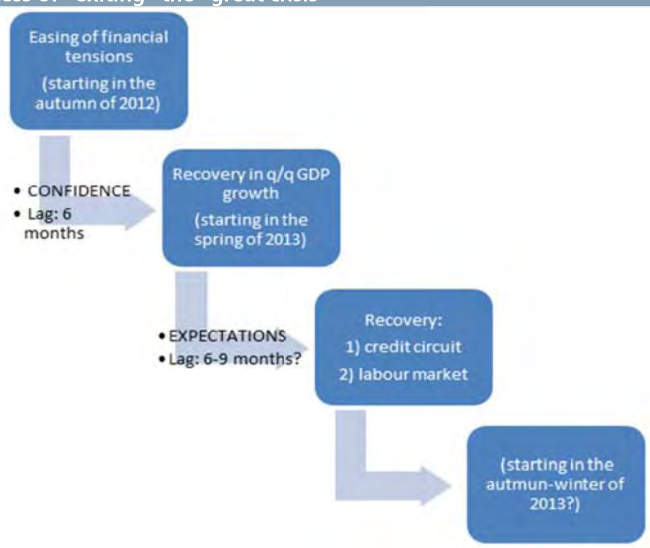
The slow exit from the crisis is proceeding as expected

Signals of this latter phase have already been detected, as the expectations of a recovery in economic activity among financial and non-financial companies are starting to translate into less tight credit conditions, and in a reversal of hiring intentions from the their recent lows. This view is supported by:

- The indications of the latest Bank Lending Survey point to a smaller net tightening of credit conditions applied to households and enterprises in the present quarter, and, for the first time since 2009, there is an expected easing of conditions in 4Q13 (at least on loans to enterprises and consumer credit). All the same, demand for loans remains moderate: as highlighted by the ECB in its latest monthly bulletin, the uncertain stabilisation of the rate of change over 12 months of loans to non-financial companies, and reallocation to shorter maturities, are compatible with the typical cycle of inventories in the early stages of a recovery: both trends reflect the stabilisation of credit conditions currently under way; a significant fact is that the reduced weighting of factors in the supply side, which contributed to the tightening of credit criteria, was accompanied in the last quarter by a marked decline in risk, tied to economic activity in general or to the prospects of individual enterprises or sectors of industry; in other terms, it only seems to be a matter of time before the easing of risks as perceived by financial institutions, and the resulting intention to slacken lending conditions, translates into a less depressed trend of real data on loans;

- The current attempt at a stabilisation of the labour market: not only do the hiring intentions of enterprises seem to have reversed (although they are still not back in expansive territory, at least according to the PMI survey), but the unemployment rate is attempting to stabilise, having generally stayed put at 12.1% in the past six months; the 12.2% level hit in September (then abandoned in October) may therefore prove to be the peak jobless rate.

The (slow) process of "exiting" the "great crisis"

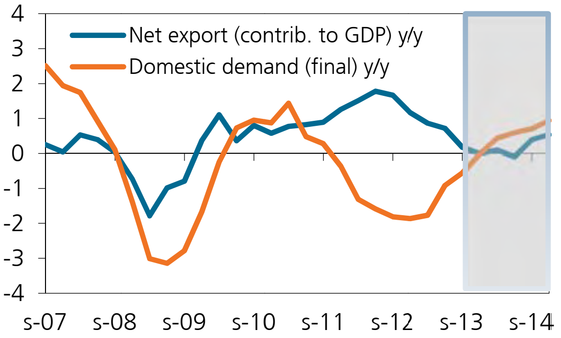


Source: Intesa Sanpaolo Research elaboration

As the recovery slowly takes hold, the imbalances which characterised the recent phase of the cycle are decreasing. First of all, the divergence between domestic demand and the contribution of foreign trade, while still present, is decreasing sharply (is closing and set to change sign around mid-2014). Net exports were the only GDP component to make a positive contribution throughout 2012-13. Starting already at end-2013, a reversal should materialise. The contribution made by foreign trade should drop close to zero, and vice versa, domestic demand (net of inventories) could resume growing in yoy terms. This trend should continue and strengthen during 2014. The fact that the recovery is mostly based on domestic demand, rather than on foreign demand, should make the cyclical recovery phase under way less fragile.

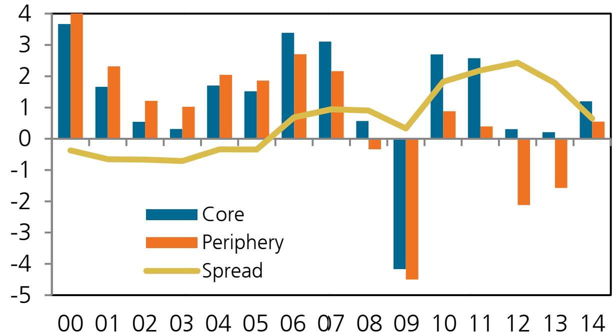
2014 should be the year in which imbalances are reduced, in terms of the gap between domestic and foreign demand...

The divergence between growth of domestic demand and contribution of foreign trade is decreasing (to change in 2014)



Source: Eurostat, Intesa Sanpaolo Research elaboration and forecasts

In 2014, peripheral Euro area countries to resume growth (albeit modestly), and the gap vs. core countries to narrow

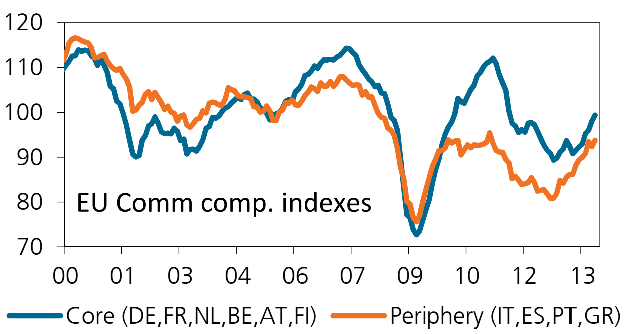


Note: Core = Belgium, France, Germany, Holland, Austria, Finland; Peripheral = Greece, Spain, Ireland, Italy, Portugal. Source: Eurostat, Intesa Sanpaolo Research elaboration and forecasts

The other fundamental imbalance that is being reduced is the one between core and peripheral Euro area countries (this is a more structural imbalance, the main reason behind the spiralling of the "great crisis"). As shown by the European Commission's sentiment indices, the gap is closing in particular in the manufacturing and services sectors, while remaining very wide in terms of confidence of households, and of retail sales and construction sectors. In any case, we believe that in 2014 growth in peripheral countries may also return into positive territory, for the first time since 2011, although its contribution to the Euro area aggregate should remain very contained, and the recovery, especially if assessed in terms of domestic demand, should continue to be driven by core countries (and Germany first among them).

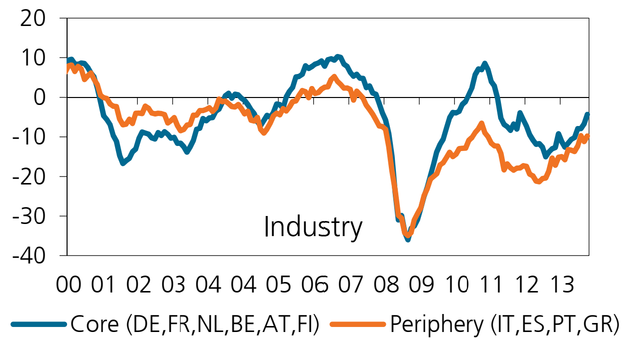
…and between core and peripheral countries...

Central vs peripheral countries: EU Commission national composite indices



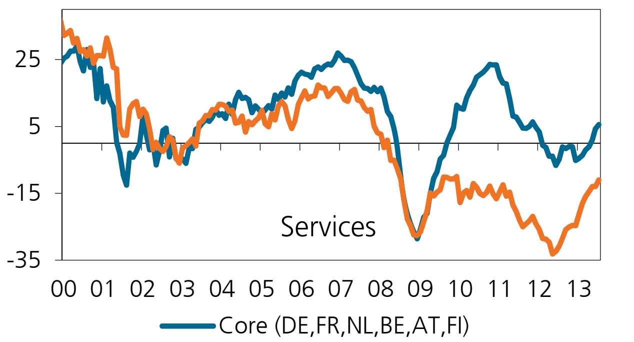
Source: Intesa Sanpaolo chart from European Commission data

Central vs peripheral countries: EU Commission national indices, manufacturing sector confidence



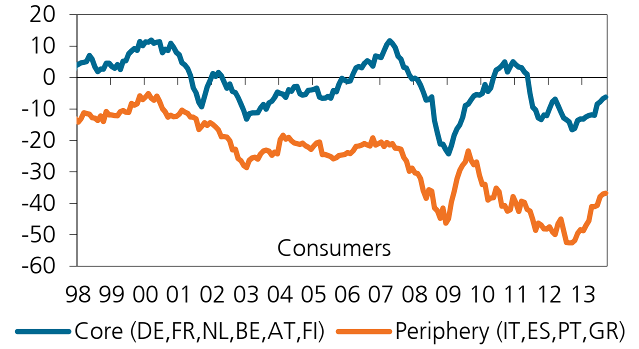
Source: Intesa Sanpaolo chart from Eurostat and European Commission data

Central vs peripheral countries: EU Commission national indices, services sector confidence



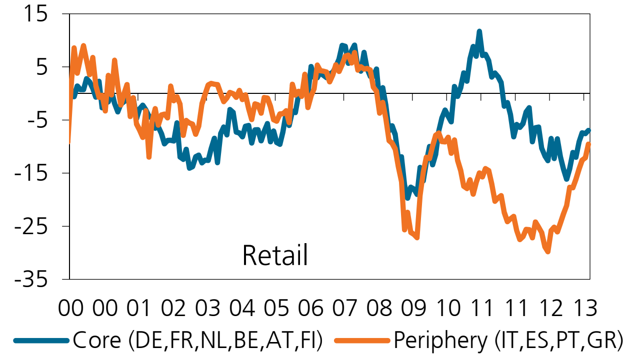
Source: Intesa Sanpaolo charts from European Commission data

Central vs peripheral countries: EU Commission national indices, consumer confidence



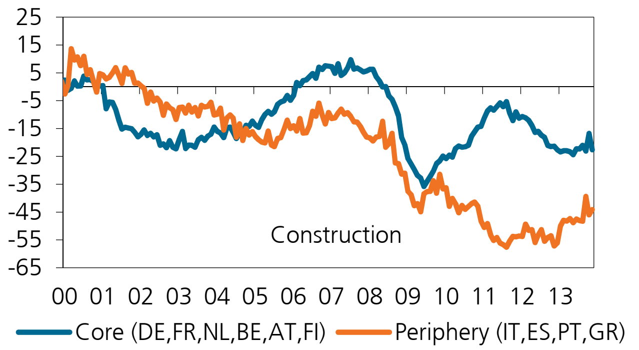
Source: Intesa Sanpaolo chart from Eurostat and European Commission data

Central vs peripheral countries: EU Commission national indices, retail sector confidence



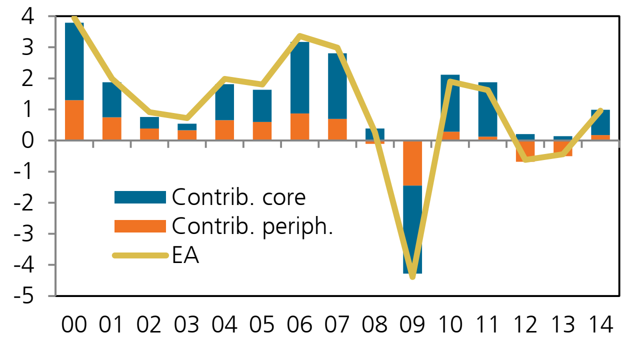
Source: Intesa Sanpaolo charts from European Commission data

Central vs peripheral countries: EU Commission national indices, construction sector confidence



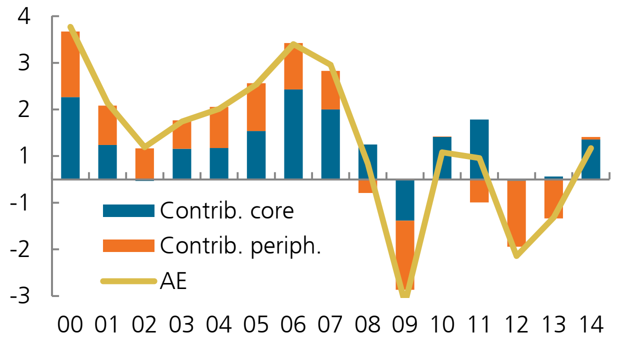
Source: Intesa Sanpaolo chart from Eurostat and European Commission data

Change in Euro-zone GDP: contributions from centre and periphery (Italy, Spain, Ireland, Portugal and Greece)



NB: Core = Belgium, France, Germany, Holland, Austria, Finland; Peripheral = Greece, Spain, Ireland, Italy, Portugal. Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

Change in Euro-zone final domestic demand: contributions from centre and periphery (Italy, Spain, Ireland, Portugal and Greece)

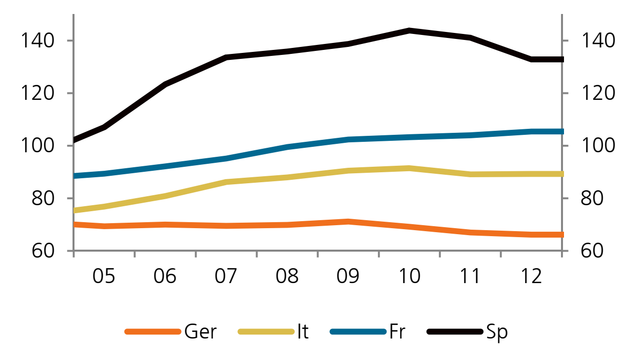


NB: Core = Belgium, France, Germany, Holland, Austria, Finland; Peripheral = Greece, Spain, Ireland, Italy, Portugal. Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

Note that the "great crisis", and the deep recession which resulted from it in peripheral countries in particular, has not led to past imbalances being cured in full. The deleveraging process in the private sector is far from complete. The latest data (at mid-2013) show that the only countries in which the debt of enterprises and households has decreased in relation to GDP are Spain and Ireland, albeit only marginally. During the crisis, private sector debt remained broadly unchanged in Greece, Portugal, and Italy (anyway, the level of debt is no reason for particular concern in Italy). As regards other main economies of the Euro area, debt has kept increasing in France, whereas paradoxically the only country that has managed a true deleveraging process is Germany. The fact that the correction of excessive debt in the private sector cannot be considered as completed in most peripheral countries is a structural factor, capable of slowing the cycle in those countries (as a result, in the entire Euro area) in the coming years.

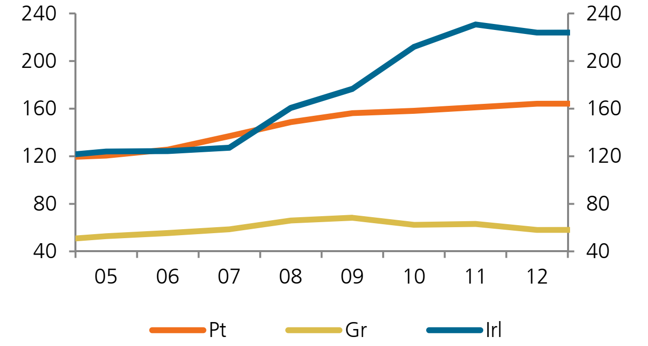
…although the structural correction in peripherals is not complete and is to continue to hold back the cycle for years to come

Debt of non-financial companies as a % of GDP in the main Euro zone countries



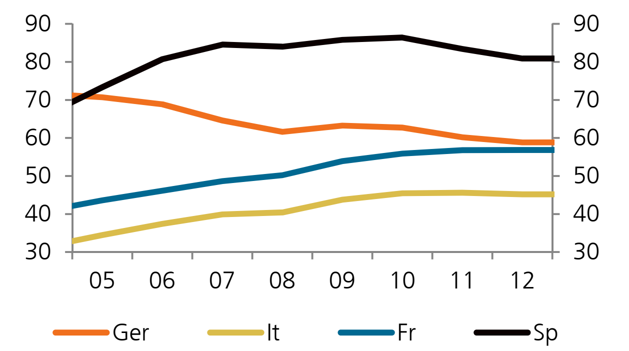
Source: National central banks and Intesa Sanpaolo charts

…and in the assisted countries



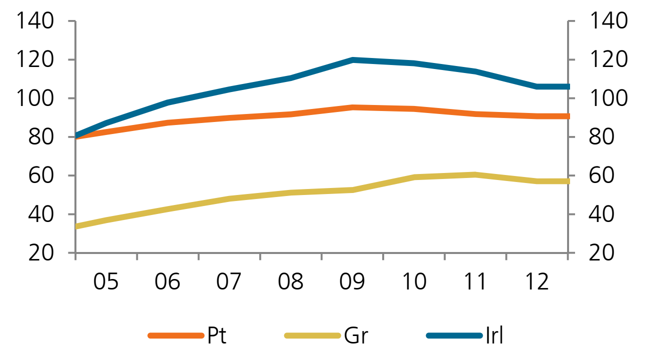
Source: National central banks and Intesa Sanpaolo charts

Household debt as a % of GDP in the main Euro zone countries



Source: National central banks and Intesa Sanpaolo charts

…and in the assisted countries

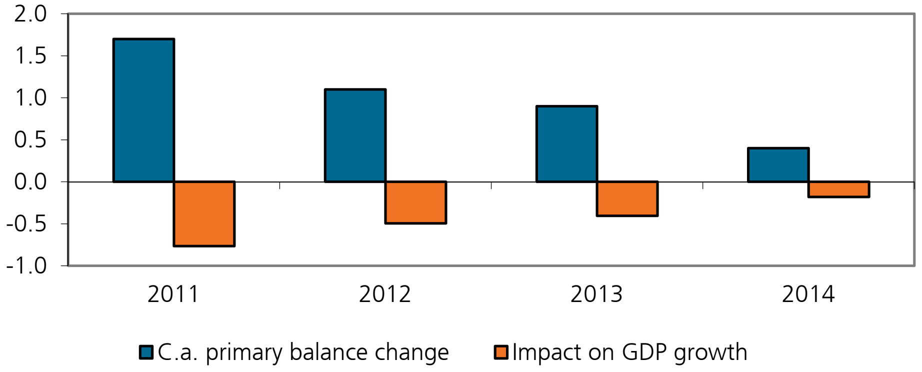


Source: National central banks and Intesa Sanpaolo charts

In our view, 2014 will be a year in which economic policies will offer limited support to growth. After the exceptional measures put in place in recent years, monetary policy, now virtually out of available ammunition (standard and non-standard measures), is unlikely to be able to do much more than wait for events to pan out, and a gradual exit from the financial and economic crisis to materialise. As regards fiscal policy, next year the degree of restriction (as measured by the cycle-adjusted change in the primary balance) should further attenuate (0.4% according to the EU Commission's autumn estimates, from 0.9% in 2013, 1.1% in 2012 and 1.7% in 2011). While 2014 should be the fourth consecutive year of fiscal consolidation in average Euro area terms, the size of the correction (therefore of the negative impact on the cycle: -0.2% based on our estimates) should be significantly smaller than in previous years.

The impact of economic policies in 2014 to be little more than negligible

The degree of restriction of fiscal policy (and consequently the negative impact on the cycle) will decrease further in 2014 compared with previous years



NB: the impact on growth is calculated using the multipliers of the OECD Interlink Model. Source: Intesa Sanpaolo chart from EU Commission data

Recovery still subject to risks

The main risks to the scenario are:

1. A potential re-exacerbation of the financial crisis risk, whose likeliness has decreased significantly in recent months, but which should not be entirely ruled out, and may be induced by a political impasse, or by more disappointing data than expected on the public accounts of peripheral countries (Italy, Spain, Greece, and Portugal). Political instability in Italy (with the possibility of early elections already in 2014, rather than in 2015 as in our base-case scenario) currently represents the most important risk in this sense;
2. External risks tied to the impact, via exports, of a less brilliant trend of demand from the rest of the world, and/or an appreciation of the exchange rate.

As regards the first point, risks could derive either from a weaker than expected global cycle, due to a failure of the US economy to accelerate, or to episodes of financial/currency crises in some emerging countries. As for emerging countries, given their rather limited weighting in Euro area exports (for instance, the weighting of countries such as India, China, Russia, or Latina America as a whole, is only limited to around 3% of the total for each), only a synchronised recession/financial crisis would have a significant impact on GDP growth in the Euro area. In the current phase, however, such a widespread crisis is hard to envisage (reasons for concern seem to stem from specific internal factors in some emerging economies).

With regards to the second point, our scenario prices in an average EUR/USD exchange rate of 1.29 in 2014, from 1.34 on average in 2013. Therefore, next year the exchange rate, compared to this year, would have a positive impact on GDP, quantifiable based on our estimates at +0.3%. The exchange rate could have an effect of the opposite sign only in the event of a significant appreciation from current values (should it stay at around its present value of 1.36, the effect on GDP would be negative by four-tenths compared to the benchmark scenario, and by just one-tenth in differential terms compared to this year).

Breakdown of Euro zone exports as a proportion of the total

2013 (first 9 months)	Total
Intra EU-16	53.7
Extra EU-16	46.3
Intra EU-27	62.3
Extra EU-27	37.8
Other Europe	11.2
Nord Europe	13.3
OPEC	3.7
BRIC	7.8
NICS Asia	3.3
JP	1.2
India	2.9
China	3.5
Russia	2.6
US	6.3
UK	6.8
Total	100.0

Source: Intesa Sanpaolo chart from Eurostat data

The impact of exchange rates: shock analysis (% yoy deviation from baseline scenario)

	Shock	after 1y	after 2y
GDP	EUR/USD -5% temp	0,3	0,0
	EUR/USD -5% perm	0,4	0,3
	EUR/USD -10% temp	0,5	0,1
	EUR/USD -10% perm	0,8	0,6
Consumption	EUR/USD -5% temp	0,0	0,0
	EUR/USD -5% perm	0,0	0,1
	EUR/USD -10% temp	0,0	0,1
	EUR/USD -10% perm	-0,1	0,1
Investments	EUR/USD -5% temp	0,3	0,1
	EUR/USD -5% perm	0,3	0,4
	EUR/USD -10% temp	0,5	0,2
	EUR/USD -10% perm	0,7	0,8
Import	EUR/USD -5% temp	0,1	0,1
	EUR/USD -5% perm	0,2	0,3
	EUR/USD -10% temp	0,2	0,2
	EUR/USD -10% perm	0,3	0,6
Export	EUR/USD -5% temp	0,6	0,1
	EUR/USD -5% perm	0,9	0,6
	EUR/USD -10% temp	1,1	0,2
	EUR/USD -10% perm	1,8	1,3
Inflation	EUR/USD -5% temp	0,3	0,2
	EUR/USD -5% perm	0,5	0,5
	EUR/USD -10% temp	0,6	0,3
	EUR/USD -10% perm	1,0	1,0

Source: Intesa Sanpaolo table using Oxford Economics Forecasting model.

Components of demand

Based on our estimates, after contracting for two years, Euro area GDP should resume growing in 2014, at around 1%. The recovery should be even more lacklustre than the one recorded in the 2010-11 biennium (average growth of 1.8%).

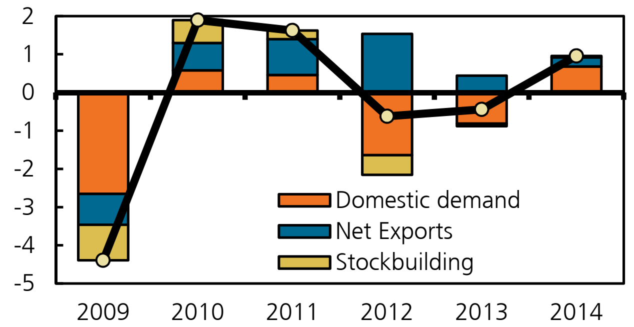
Domestic demand (net of inventories), after having decreased by a hefty 1.6% in 2012, and by 0.8% in 2013, is expected to pick up again next year, by 0.7% in our estimate. The recovery of domestic demand will be mainly driven by corporate investments in machinery and equipment (especially for replacement ends), the only component set to outpace GDP growth (by 2.1% based on our estimates); investment growth in the other segments, on the other hand, will be more sluggish (1.1%), and almost entirely driven by the appreciable recovery of the German construction sector (+2.7% based on our estimates), as opposed to generally stagnant constructions in the other countries (stagnant in France and Italy, still contracting in Spain).

Private and public spending alike will grow at a significantly slower pace than GDP, in our view. The former will be supported by a recovery in the purchasing power of households, which will in any case be modest: disposable income is estimated to increase by 1.5% in nominal terms (from 0.5% in 2013), and therefore by just three-tenths in real terms. Assuming a slight drop in the savings rate, we expect private consumption to grow by 0.5% in 2014. Consumption growth will be led by core countries (+1.5% in Germany), whereas households' spending, in the best of cases, will prove stagnant in the peripheral countries, including Italy and Spain.

Public spending is forecast to increase at an equally slow pace (0.5%), held back by the ongoing need to correct budget balances, and in particular by cuts to public sector employment and to the purchases of goods and services by the public administration.

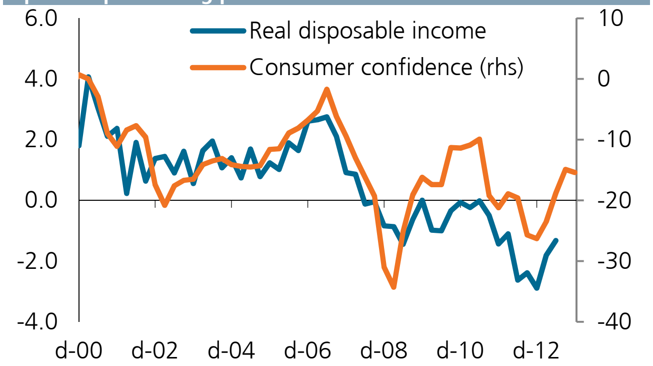
Lastly, foreign trade should continue to make a positive contribution to GDP on average in the year, but less so than in recent years: we estimate a contribution of +0.2%, from +0.4% this year, and +1.5% in 2012, against a background of recovering trade flows in both directions. We expect both imports and exports to grow at a very similar pace (of just over 4%). The recovery in exports should be supported by demand (the index of global demand for goods and services produced in the Euro area is forecast to accelerate to 5.5% in 2014, from 3.6% in 2013), in a context in which the exchange rate should not prove to be a significantly hindering factor (at least not in our base-case scenario).

Change in Euro zone GDP: main growth components



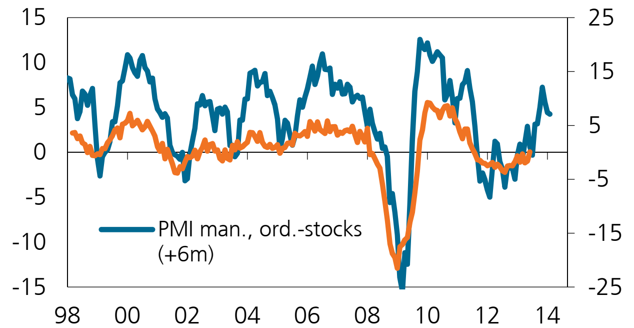
Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

The improvement in consumer confidence seems to reflect an uptick in purchasing power from its lows



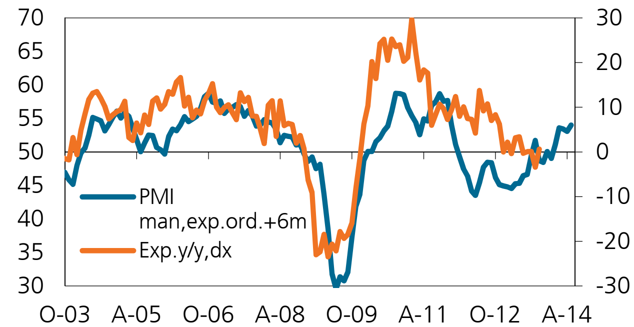
Source: Intesa Sanpaolo chart from Eurostat and European Commission data

The leading indicators show that economic recovery, particularly in manufacturing, will become more evident as early as the next few months.



Source: Intesa Sanpaolo chart from Eurostat and Markit data

For the time being, the recovery is still being driven by exports.



Source: Intesa Sanpaolo chart from Eurostat and Markit data

Inflation closer to 1% than 2% also in 2015, but deflation risks remain contained

Anna Maria Grimaldi

The sharper than expected slowdown in inflation in the past two months, together with an appreciation of the effective exchange rate, fuelled fears of deflation in the euro area. We estimate that inflation will stay at just above 1.0% in 2014-2015 as well, but consider the risk of deflation contained in terms of the euro area average. The output gap will remain wide, but should start to close in mid-2014; labour costs slowed in peripheral countries, but could accelerate in core countries. Also, we expect the effective exchange rate to depreciate by around 3% in the next 12 months, limiting downward pressures on consumer prices. Low inflation should be countered, as it could render the rebalancing process within the euro area more burdensome.

The decline in inflation in 2013 is explained by the volatile components, but core prices also played a role

Euro area inflation stood at 0.9% y/y in November falling an unexpected dip to 0.7% in October, from a previous 1.1%. Core inflation returned to 0.9% after 0,8% in October (a level hit before only in February 2010). The volatility of inflation dynamics is largely explained by the decline in October and the rebound in November of package holidays costs. Energy and food prices also contributed to the slowdown in consumer prices over the past few months. In 2013 as a whole, inflation should average 1.4%, from 2.5% in 2012. During the course of this year, consensus estimates have been progressively revised downwards (September 2012: 1.8%; June 2013: 1.5%; September 2013: 1.4%). Phases of sharp decline in inflation occurred before in the Monetary Union's history. In July 2009, inflation slowed to -0.7% from +4.1% one year earlier, although on that occasion the slowdown was almost entirely explained by the oil price shock, triggered by the global recession. Over the past year, the decline in inflation has been once again due largely to the energy component (55%), although the slowdown in core inflation contributed by a good 26%, compared to 5% in 2009. The trend of core inflation net of energy, food, and tobacco prices, has slowed in particular in the past six months (0.8% in October, from 1.3% last June). The underlying trend of consumer prices net of the contribution of administered prices and taxes, which is defined as cyclical inflation, fell, on our calculations, to 0.6% in October, from 0.8% a month earlier. Cyclical prices slowed more in the euro area periphery than in core countries, and the annual dynamics is in negative territory in Greece, Ireland, and Portugal. In Spain, cyclical inflation returned into positive territory on the back of an increase in administered prices in September, after staying negative for around a year.

Our forecasts for 2014 show inflation falling further in Spain to 0.7% (partly as the 2013 inflation was bloated by the VAT hikes of late 2012) but rising back in Greece, Portugal and Ireland. In Italy, inflation should hover at 1.4% from 1.3% this year as the VAT hike of last October should have a two tenths impact on 2014 price dynamics Table 1 shows that the decline in inflation is more pronounced in the periphery compared to core countries and thus should reflect at least in part the rebalancing process within the Euro area. However, it is not clear to what extent the drop in inflation in peripheral countries is due to a shock on the supply side, i.e. improved competitiveness through the reduction of costs and wages, and price moderation associated with deregulating in the product market. In Spain, the labour market reform introduced in February 2012 triggered a downtrend in the industrial sector wage trend over the past 12 months. In Portugal and Greece, wages have been declining for over two years. However, the slowdown in core prices is probably due principally to weak domestic demand, and in particular to weak private consumption.

Tab 1 - Intesa Sanpaolo inflation forecasts by country												
	Aus	Belg	Finl	Germ	Ita	Ola	Fran	EA	Port	Gre	Irl	Spa
2008	3.2	4.5	3.9	2.8	3.5	2.2	3.2	**3.3**	2.7	4.2	3.1	4.1
2009	0.4	0.0	1.6	0.2	0.8	1.0	0.1	**0.3**	-0.9	1.3	-1.7	-0.2
2010	1.7	2.3	1.7	1.2	1.6	0.9	1.7	**1.6**	1.4	4.7	-1.6	2.0
2011	3.6	3.4	3.3	2.5	2.9	2.5	2.3	**2.7**	3.6	3.1	1.2	3.1
2012	2.6	2.6	3.2	2.1	3.3	2.8	2.2	**2.5**	2.8	1.0	1.9	2.4
2013	2.0	1.2	2.2	1.6	1.3	2.6	1.0	**1.4**	0.4	-0.7	0.5	1.5
2014	1.8	1.5	1.9	1.5	1.4	1.5	1.1	**1.2**	1.2	-0.2	0.7	0.7
2015	1.9	1.6	1.8	1.6	1.6	1.7	1.3	**1.4**	1.2	0.1	0.9	1.0

Source: Eurostat and Intesa Sanpaolo estimates

Deflation fears seem excessive, although risks to the consumer price trend remain on the downside

The inflation surprise in October, together with the appreciation of the effective exchange rate between June and October (+1.3%), has triggered deflation fears in the euro area which we are only marginally claimed by the rebound in November figures. The ECB motivated its decision to cut the refi and marginal refinancing rates by 25 basis points with to the surprise in inflation results and due to the fact that the consumer price trend is expected to remain slow, significantly below the 2% mark, for and "extended" period of time. The ECB will shed light on exactly for how long it expects inflation to remain subdued with the publication its inflation estimates for 2015, due to be published next December.

We have revised our estimate of euro area inflation in 2014 downwards, to 1.2% from 1.5% (September 2013 estimate). The revision was mostly prompted by the mechanical effect of the October surprise reading, although we expect the trend of core prices to slow further, to 0.6%, between now and mid-2014. We expect inflation to stay closer to 1.0% (1.3%-1.4%) rather than to 2.0% in 2015 as well.

The assumptions on which our estimates are based point to only a slight increase in the price of oil in 2014, to USD 111 per barrel (from USD 109 in 2013), and to a depreciation of the EUR/USD exchange rate to 1.29 from an estimated average of 1.32 in 2013. In the course of 2015, the price of oil in euros is forecast broadly stable at its 2014 levels.

We stick to our view that risks to inflation remain more skewed to the downside than balanced, at least until the end of 2014. Yet, deflation fears seem excessive, at least for the euro area average.

What we do expect, is a depreciation of the effective exchange rate of around 3% in the next 12 months, with the FED starting tapering pressures on the euro should partly recede. The depreciation of the exchange rate should help limit downside pressures on the consumer price trend. ECB models suggest that the impact of a 5% depreciation/appreciation of the euro determines a 0.7% increase/fall in the CPI (see Table 2).

Tab. 2 – Effect of a 5% appreciation of the euro/dollar exchange rate			
One year after the shock	Germ	Fra	Ita
ECB*	-0.05	-0.07	-0.12
ECB**	-0.66	-0.6	-0.34
Oxford Econ. Forecasts. Policy response on	-0.2	-0.1	-0.4
Oxford Econ. Forecasts. Policy response off	-0.3	-0.3	-0.6

Source: *ECB Working Paper No. 1315, April 2011, and Oxford Economic Forecasts **Impact after four quarters of the shock, country blocs as per the ECB's multi-country model, see Working Papers No. 456 for France, No. 660 for per Italy, and No. 654 for Germany

Furthermore survey based price indicators suggest that downside pressures have receded in September / October. The PMI index of prices paid in the manufacturing sector rose in October to 51, from 48 in May. Price expectations derived from the EU Commission's survey also suggest that the slowdown of upstream prices should now be over.

Risks tied to the trend of core inflation

Based on our estimates of a limited increase in energy prices over the next two years, and barring surprises, the trend in inflation will be shaped by how much further core inflation may fall, in peripheral countries in particular. During the 2008-2009 recession, headline inflation hit a low in March 2009, whereas core inflation kept slowing until February 2010. This was due to the fact that the core inflation tends to respond with a lag to the slowdown of the cycle and the deterioration in unemployment. The link between the change in core inflation and the measures of economic slack remains rather controversial. The November 2013 ECB bulletin contains an interesting focus on the link between economic slack and the consumer price trend, or Phillips curve, for the euro area (see the ECB November Bulletin, Box 2 pp. 92-94). The article reasserts the conclusions presented in the January 2011 ECB bulletin, in which the response of euro area inflation to underutilised capacity in the economy is shown to be rather contained, barring large output gap changes. In the November 2013 focus, the ECB notes that the Phillips curve coefficient has actually dropped following the crisis. In general, the ECB observes that slack variables (output or deviation of unemployment from NAIRU, or measures based on monthly surveys, such as the degree of production capacity utilisation), only offer limited improvements, compared to a autoregressive model, in predicting the trend of wages and prices.

Among the possible explanations for the scarce response of euro area inflation to the output gap, the ECB points to the fact that more credible monetary policies, and a more or less explicit medium-term inflation target, have contributed to keeping the price trend under control, flattening the Phillips curve[2]. Despite acknowledging the effects of higher taxes and administered prices on the limited decline of inflation in response to the cycle, the ECB concludes that the bland response of prices is due to the nominal downward rigidities in wages and costs. This will prevent a further improvement in competitiveness within the euro area. The conclusions reached by the Focus paper contained in the November bulletin seem to suggest that the ECB considers downside risks to the inflation trend to be limited, and that further structural reforms will be necessary to determine a more significant adjustment of wages, and to allow competitiveness gains in peripheral countries.

We share the ECB's view that deflation risks remain contained in the euro area average. The deterioration of the labour market should mostly be over, and the output gap should start to close, in average terms, in the second half of this year, if GDP growth evolves in line with our latest forecasts (1.0% after -0.3% this year). Wages in core countries, and in Germany in particular, could resume growing at a pace of around 2.6%-2.8% starting in the second half of in 2014, as the unemployment rate in Germany is in line with the structural level. Therefore, downside pressures on the trend of core prices should progressively ease over the course of the next 12 to 18 months. However, we cannot rule out downside risks to the trend of consumer prices, as the response of cyclical inflation to the output gap could be broader than suggested by the models, in peripheral countries in particular. It should be said that in the history of the Monetary Union, the output gap has never been so wide, and for so long, as between 2010 and 2014. In peripheral countries, the output gap derived from the aggregation of OECD estimates for Portugal, Ireland, Spain, Greece, and Italy, has been negative since 2008, and may stay broadly unchanged in 2014 compared to this year. The hourly cost of labour slowed to 0.9% y/y in June 2013, from 1.8% in 2012 and 2.2% in 2011. It should also be considered that the reforms aimed at breaking the link between wages and inflation, introduced in recent years in Portugal, Spain, and Greece, will reap their effects on the wage trend at a time lag.

In conclusion, our view is that euro area inflation will stay closer to 1% than to 2% in the next two years as well, cooled buy the slowdown in the trend of core prices at least until mid-2014.

[2] A similar finding was advanced by the IMF in its April 2013 WEO.

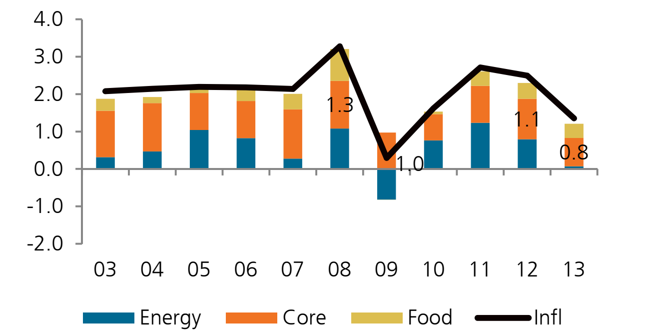
Deflation risks in terms of the euro area average remain contained. However, we cannot rule out that inflation may surprise on the downside in peripheral countries, given the size of the output gap, and the moderation of the cost of labour trend; for these countries, much will depend on the return to positive growth rates, not only in terms of GDP, but also of the trend of domestic demand.

Low inflation should in any case be countered, but are the ECB's actions enough?

Low inflation should in any case be countered, as it may make the internal rebalancing and deleveraging processes more burdensome, as also pointed out by Draghi in the November press conference. Low inflation is typically detrimental for both private and public debtors. With slower nominal growth, the debt/GDP ratio decreases less rapidly, unless interest rates drop more than proportionally compared to GDP. With low inflation, corporate profits tend to approach zero, with negative effects on investment decisions. The extension of full allotment until July 2015, more than the refi cut, helped impress a downward shift on the structure of money market rates and longer term bond yields. That said it is not clear whether the monetary policy impulse will be translated to the financing costs of enterprises and households. The ECB stated it is ready to use a full range of instruments in the event of new downside surprises. With the deposit rate at zero, the ECB will have to resort to non-standard measures to increase base money.

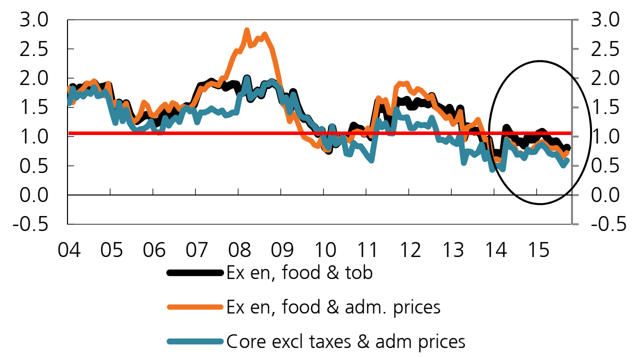
The Fed, and more recently the BoJ, only managed to significantly step up the monetary base, and inflation expectations, by purchasing assets outright. However, as we discuss in the following section, we know that an asset purchase programme on the secondary market would be very controversial, and it is unlikely to meet with an ample enough consensus within the Council.

The slowdown of inflation in the past year is explained by the energy component, but also by the trend of core prices



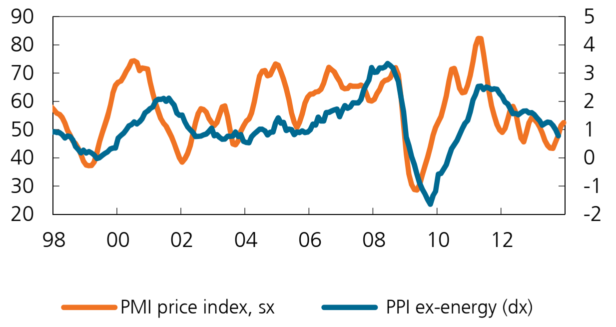
Source: Eurostat and Intesa Sanpaolo calculations

Core inflation net of the contribution of tax hikes and administered prices is dangerously approaching zero



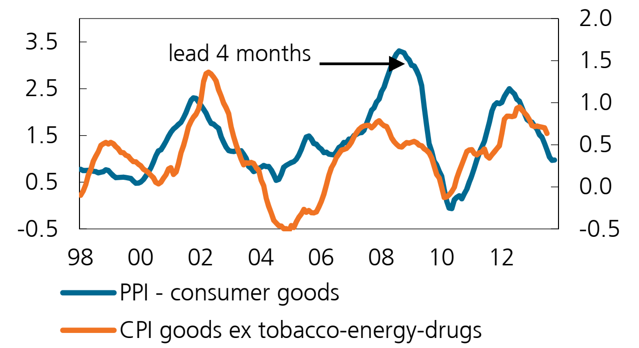
Source: Eurostat and Intesa Sanpaolo calculations

Downside pressures on prices upstream of the production chain have receded…



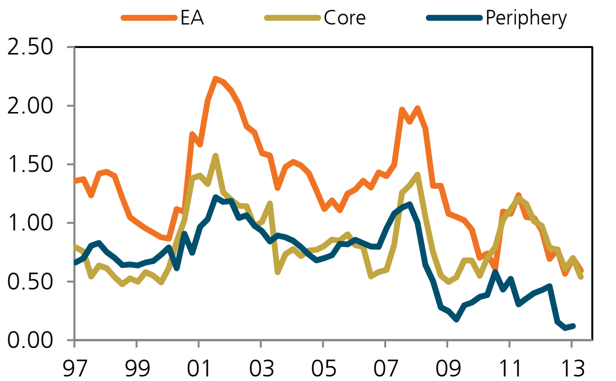
Source: Markit, Eurostat and Intesa Sanpaolo calculations

… although the drop in producer prices in the consumer goods segment still hasn't transferred fully to consumer prices



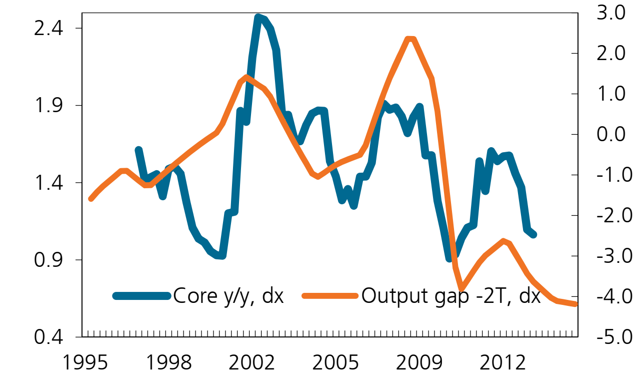
Source: Eurostat and Intesa Sanpaolo calculations

Prices ex food, energy administered prices & taxes slowed more in the Periphery than in Core



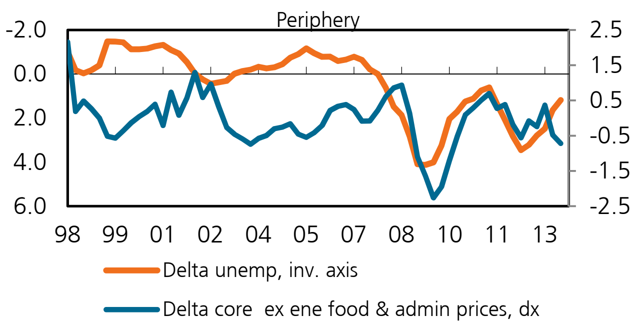
Note: The weight assigned to Core (Ger, Fra, Holland, Belgium) and Periphery (Ita, Spa. Port, Irl, Gr.) country weights are those used in euro area HICP. Source: Eurostat and Intesa Sanpaolo elaborations Source: Eurostat and Intesa Sanpaolo calculations

With a stabilization of the output gap in 2014, downward pressures on core prices should gradually ease on average in the EA



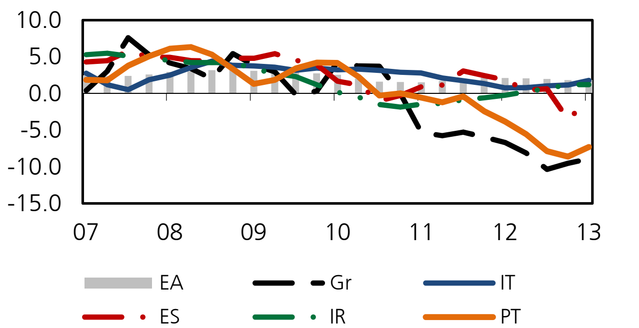
Source: Eurostat, OECD and Intesa Sanpaolo calculations

Yet, we cannot rule out risks of core inflation falling further in the Periphery as unemployment remains at all time high and…



Note: Periphery (Ita, Spa. Port, Irl, Gr.) country weights are derived from unemployment shares in the EA total unemployment. Source: Eurostat and Intesa Sanpaolo Source: Eurostat and Intesa Sanpaolo calculations

… labour costs are falling faster than in Core countries in particular in Spain, Portugal & Greece



Note: Periphery (Ita, Spa. Port, Irl, Gr.) country weights are derived from GDP weights. Source: Eurostat and Intesa Sanpaolo calculations

2014: will the ECB have to do more?

Anna Maria Grimaldi

Last December, we wrote that other than a rate cut "the ECB is unlikely to move pre-emptively, adding monetary stimulus aimed at restoring correct monetary transmission in peripheral euro area countries" (Macroeconomic Outlook, December 2012). During the course of this year, the ECB cut the refi rate by 50 bps rather than only 25 bps, as we had expected, leaving it at 0.25% in November, an all-time low since the euro take over. The ECB did not intensify the unconventional monetary stimulus in a targeted way but introduced "qualitative" forward guidance in July. Forward guidance is a particularly significant new development for a central bank like the ECB, renowned for its *mantra* "we never pre-commit" to a future path for interest rates.

Forward guidance has been the main new development in 2013

Forward guidance has helped to keep the money market rates and sovereign returns under control in recent months. However, it is hard to detangle the effect of the FED postponing the tapering and the introduction of an easing bias by the ECB. In November, the ECB indirectly strengthened its commitment to maintaining rates at "present or lower levels" by deciding to extend its full allotment regime by one year, until July 2015. It is unlikely that the ECB will raise rates before it ends these financing operations. In principle, the refi rate could also rise with full allotment, but in this auction regime, the ECB cannot steer the EONIA, as this is trades at the floor of the corridor, and the guidance rate is effectively the deposit rate. Thus an increase in the refi rate would push up the cost of funds taken at the ECB window. Broadly speaking, the ECB committed to keep interest rates unchanged until the second half of 2015, and is maintaining a downward bias.

What can we expect in 2014?

The question is whether, in 2014, the ECB will do more in terms of non-standard measures, given the risk of a prolonged period of low inflation. The ECB guidance arrived approximately seven months after the Fed, which in December 2012 had linked the path of interest rates to a quantitative unemployment threshold of 6.5% and two months after the Bank of England guidance. Could the ECB therefore surprise us in 2014, with a QE or a programme similar to a funding for lending scheme, faced with the prospect of inflation hovering around 1% until late 2015?

Following November's decisions, more than on member of the ECB's board made very accommodative statements and did not rule out "more extreme" measures to ensure that the price stability mandate is complied with. Mario Draghi and Vitor Constancio indicated that the ECB was "technically ready" to cut the deposit rate to below zero. But the ECB members have even floated the idea of a securities purchase programme. On November 22, Peter Praet, chief economist at the ECB and a member of the ECB executive committee, clearly indicated, during an interview with the WSJ, that if the ECB's mandate were jeopardized, every possible tool would be used, including securities purchases. Mr Constancio, who is Vice-President of the ECB, also said that anything was possible, and that the ECB could consider extreme measures (27 November 2013), but also stated that no securities purchase programme had yet been discussed (19 November 2013).

The tone of the ECB's December statement and staff forecasts suggest…

At the December meeting, Mario Draghi surprised markets with a less accommodative stance than expected. The ECB President indicated that the Council had only briefly discussed a cut in the deposit rate, and that no specific interventions had been identified beyond this, from an "ample array of powerful tools". He also specified that, after a period of low inflation, the ECB believed that consumer prices would move gradually towards 2%, and that the insurance buffer against low inflation was adequate as there was evidence of a gradual upwards drift in core inflation. These statements were supported by the December staff projections, which, for the first time, introduced timely estimates for core inflation. There was an unexpected growth forecast revision to 1.1% for 2014 (two-tenths of a point above the consensus at the end of

November) and the ECB expects an acceleration to 1.5% in 2015. Inflation estimates, as we expected, are again closer to 1.0% than 2.0% for 2015 (1.3%, from 1.1% in 2014), but surprisingly the ECB projects that core inflation (stripping out food and energy) will be higher than headline inflation, rising to 1.3% in 2014 and 1.4% in 2015, although it expects labour costs to slow to 0.9%-1.0% in the next two years, from 1.4% in 2013. The ECB therefore appears to believe that inflation is curbed by energy and fresh foods, but not influenced by the cyclical position of the economy.

Table 1 – ECB provides core inflation and unemployment estimates for the first time

	ECB December 2013			Revision vs. September 2013	
Year-on-year % change	2013	2014	2015	2013	2014
GDP	-0.4	1.1	1.5	0	0.1
Headline inflation	1.4	1.1	1.3	-0.1	-0.2
Inflation net of energy and food	1.1	1.3	1.4	0	-0.1
Inflation net of energy, food and taxes	1.1	1.1	1.4	0	-0.1
Unemployment. (%)	12.1	12	11.8	-0.1	-0.2

Source: ECB, staff economic forecasts, December 2013

…that the most likely scenario will be one of unchanged rates until the second half of 2015 at least. Yet there is a good outside chance of a refi rate cut to 0.10% in Q1

Mr Draghi added that monetary policy takes longer to show its effects, especially at a time when the interbank market is fragmented and given that the banks, the private sector and national governments are working to put their finances back on track in some Euro zone countries.

Mario Draghi's less bearish tone and the staff forecasts of core inflation growth above headline inflation until 2015 suggest that the ECB believes that measures already implemented are enough to push consumer prices up gradually towards 2%, and that forward guidance is adequate as a tool for keeping short-term rates under control. We hope that, as tapering begins, the ECB is not proven being too optimistic about its ability to communicate to markets. **Our central scenario is, therefore, that the ECB will keep rates at their current levels until the second half of 2015.**

That said there is a good outside chance the ECB will have to do more in 2014: the deleveraging process within the euro area is still long and painful, and could affect growth more seriously than is widely assumed. If data were to signal material downside risk for the macroeconomic scenario, the ECB could:

In the case of an unexpected downward trend, the ECB could cut the rate on deposits and strengthen guidance

1) shave the refi rate to 0,10% by march 2014, in order to limit the EONIA volatility within a narrower corridor;

2) take the deposit rate to slightly less than zero (-0.1%)[3]. This measure has already been discussed in December, but it is not certain that such a move would find sufficiently broad support within the Board;

3) the ECB could also try strengthening forward guidance, but it seems unlikely that it will introduce quantitative thresholds;

4) Mario Draghi's statements during the press conference seem to make another LTRO less probable, but we don't rule out that the ECB will bring in a programme similar to the BoE's *funding for lending* scheme, to try to stimulate lending and prevent additional liquidity being used to exploit carry opportunities on the government bond curve, as in 2012. The

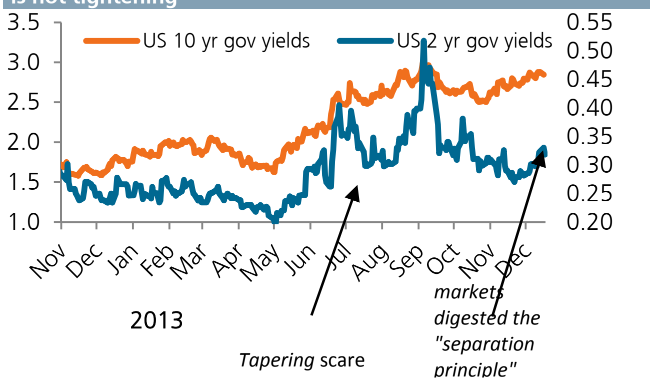
[3] Cutting the refi rate but not the rate on deposits is technically possible, but does not seem to us to be a reasonable decision as it would have no effect on the EONIA, so the most it could do is limit volatility. For an analysis of the costs and benefits of a cut in rates on deposits to less than zero, see the *Weekly Economic Monitor* of May 24.

day after December's meeting, Ewald Nowotny indicated that such a funding scheme must be considered, because special attention needed to be paid to those areas which the ECB's expansive monetary policy could not reach;

European QE is a remote event and will be considered only in case of serious inflation risk

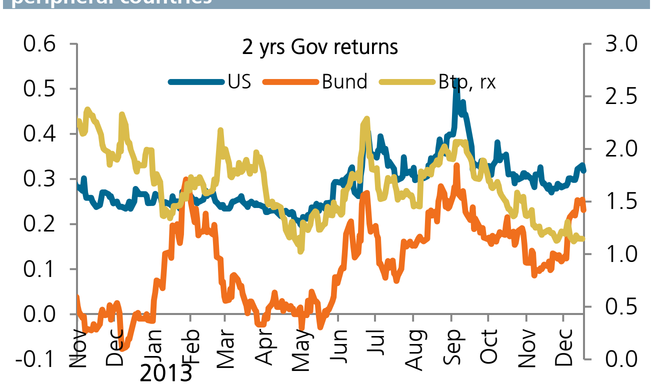
We think that the ECB would only consider quantitative easing in Europe if there was a serious risk of deflation for the entire Euro zone, and in this case, probably only after cutting the deposit rate and attempting to keep market rates under control with forward guidance. That said any quantitative stimulus would be the only substantial macroeconomic tool of those potentially now on the table. If the ECB decides to purchase, it could be deterred from the option of purchasing ABSs by differences in regulations governing these instruments within the region. A QE programme would probably therefore entail purchases of government securities on the secondary market. This option would not constitute a breach of the ban on financing the deficits of Member States (Article 123 TFEU) but the announcement of a QE programme would decidedly be controversial, given the well-known German opposition to purchases of government securities, including on the secondary market, and in view of the procedures planned for the OMT programme. Jens Weidmann has repeated his warnings against bond buying programmes, as this would mean a reversal of roles: "monetary policy stabilises real government debt while inflation is determined by the needs of fiscal policy". We believe that, as in the case of OMTs and the SMP, German opposition would not prevent the ECB from proceeding if the risk of deflation became real. There are also rumours that one way of overcoming German opposition would be to announce a programme to buy all Euro zone securities, including German ones, for a pre-established amount, proportionate to the shares of the individual Member States in the ECB's capital. A QE programme constructed in this way could involve fewer limitations, including on the duration of securities that can be purchased in OMTs, as it would not be aimed at individual States, but would counteract the risk of deflation in the Euro zone. By introducing full allotment in refinancing auctions, the ECB lost control of the monetary base, and a securities purchase programme would therefore not necessarily succeed in increasing excess liquidity in the system. However, the programme would reduce the term premium on government rates, although it might not necessarily reduce credit risk in the peripheral countries.

Fig. 1 – US tapering is just around the corner, but markets seems to have accepted "the separation principle" = tapering is not tightening



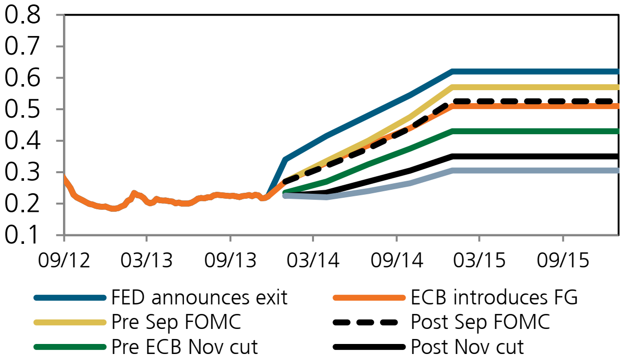
Source: Intesa Sanpaolo chart from Datastream data

Fig. 2 – European short-term interest rates are less closely correlated with US rates than in the summer, particularly in the peripheral countries



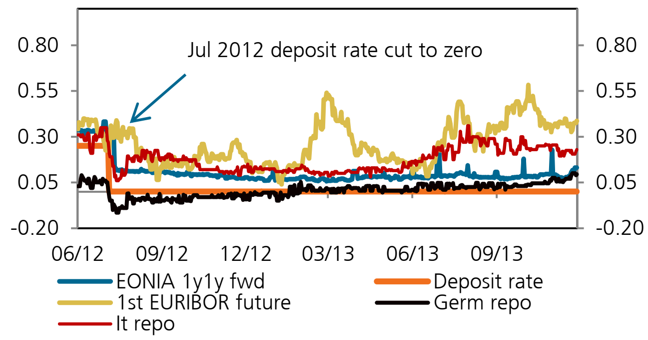
Source: Intesa Sanpaolo chart from Datastream data

Fig. 3 – With forward guidance, the ECB has been able to keep rate increase expectations under check



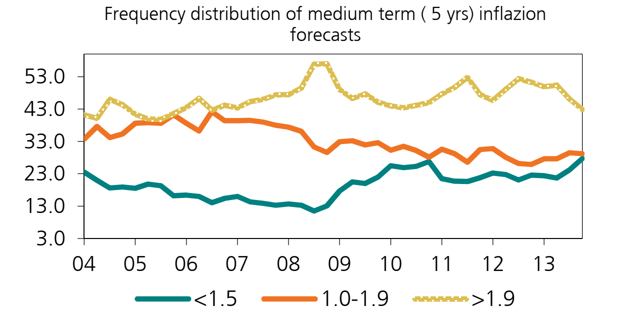
Source: Intesa Sanpaolo chart from Datastream data

Fig. 4 – A negative deposit rate could push the EONIA down to zero (-) and repos into negative territory



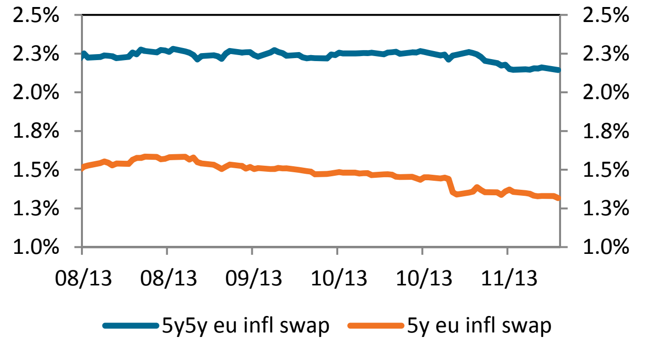
Source: Intesa Sanpaolo chart from Datastream data

Fig. 5 – The SPF 5-year ahead inflation forecast are firmly anchored at 1,9%, yet frequency distribution is shifting towards th than 1.5% has grown



Source: Intesa Sanpaolo chart from ECB data

Fig. 6– 2 & 5 yrs inflation forwards have been shifting downwards after the October surprise on inflation



Source: Datastream

Germany: to grow above trend for now

Anna Grimaldi

We continue to see the German economy expanding 1.7% in 2014, up from +0.4% estimated for the current year. Thus, Germany will return to above trend growth next year (1.4% in the Commission's latest forecasts). We expect growth to accelerate only marginally to 1.8% in 2015. Growth composition should continue to shift from net exports to domestic demand supported by: financial conditions that should remain expansionary over the forecasting horizon, the acceleration of real salaries and a slight improvement in the labour market. The current account surplus will close only marginally from 7% this year to 6.6% in 2014. The large German current account surplus is now considered a problem by the European Commission, which launched an in-depth review on November 18th in the occasion of the publication of the Alert Mechanism Report for 2013[4]. The German economy's performance, which has been substantially better than that of the rest of the Euro zone starting in 2005, is due to the reforms at the beginning of the 2000s. However, starting in 2014 we anticipate that the growth differential from the average will narrow at least partially (see Figure 14). Germany continues to have a large competitive advantage (see Figure 13), but it must be maintained with reforms aimed at increasing participation in the labour market and at countering the impact of adverse demographic pressures and the capital gap (especially in infrastructure) on potential growth as compared to the rest of the Euro zone (see Figure 15). The terms of the preliminary agreement between the SPD and CDU (a referendum vote of all members of the SPD is expected on 14 December) suggest that the new government's policies could have a moderately positive impact on domestic demand growth in the short term, but there are few indications concerning medium-term policies. Decisions on retirement age will certainly not alleviate Germany's high dependency ratio. In addition, the introduction of a minimum wage of EUR 8.5/hour starting in 2015 could also put the salary structure under pressure in the years ahead partially eroding Germany's competitive advantage if it is not offset by further recoveries in hourly labour productivity (for additional details on the agreement between the CDU and SPD, see Focus on p. 41).

The risks to the scenario are on the downside and stem mainly from less sustained growth in foreign demand and from consumption and machinery investment dynamics weaker than what fundamentals would suggest.

At year end, Germany will grow at least at the same pace as in summer months

Short-term outlook: in the summer months, German GDP rose by 0.3% qoq (0.6% yoy), at a slower pace than 2Q when growth was inflated due to statistical effects. GDP growth was driven by an acceleration in domestic demand, and especially construction that more than offset the slowdown in exports. Indications for the end of the year are for an increase in GDP of 0.3% in the best case scenario, and risks are on the downside. In fact, industrial output (-1.2% mom) enter Q4 on a weak footing (-1.2% qoq after 0.7% growth qoq in the summer). The decline output should only be temporary blip caused by the volatile trend in capital goods activity, and in particular in the aerospace industry. Between October and November, the IFO index averaged 108.7 up from 107.4 in the summer and from 105.3 in 2Q. The PMI composite rose to 54.3 in November from 50.4 in June. Prospect for the future are encouraging as hinted by the rise in the

[4] A current account surplus above 6% or below 4% is one of the criteria taken into consideration by the Commission to determine whether a country is affected by excessive macroeconomic imbalances. However, it is not this "imbalance" alone that has led to the initiation of a procedure; there are three other parameters that Germany does not meet: the effective exchange rate, the decline in market share and public debt. The Commission indicates that the primary surplus is expected to remain above 6% in 2014 as well (autumn forecasts put it at 6.6% compared to 7% projected for 2013), and thus, it could put the exchange rate under pressure. The Commission further notes that despite the fact that private debt is one of the lowest in the Euro zone, the process of deleveraging continued, and corporate investment resumed its decline last year.

IFO survey expectations index to the highest level since 2011. The net improvement in the orders/revenues ratio from the PMI survey suggests a further acceleration in industrial activity by year-end (see Figures 1 and 2), driven by stronger export growth. Export expectations and the PMI export orders index, together with the increase in global PMI suggest a fast rebound of German exports following the late summer slowdown (see Figures 3 and 4). The IFO and PMI services sector breakdown suggest conditions are also improving in the services and retail trade.

The outlook for the construction sector remains positive

Exports are expected to rise by 3.9% in 2014, up from +0.9% in 2013, but less than imports (+4.7% after the 0.9% increase in 2013). In 2014, the contribution of foreign trade to growth will be marginally negative as compared to a 1.7% increase in domestic demand. Domestic demand growth momentum should come, in particular, from construction investment and capex. It is possible that construction investment could weaken over the turn of the year, after the sharp growth seen in 2Q and 3Q. However, the outlook for the sector remains positive. Financial conditions continue to be quite favourable: the interest rate on new residential mortgages (with a rate-setting period of between five and ten years, the most representative category in Germany) remains at historically low levels (2.68% in August 2013, down 10 bps from a year earlier). The trend in orders and permits, particularly in residential construction, and the increase in production capacity suggest construction investment could expand 2.7% in 2014 after a decline of 0.6%.

Capex to pick up in the Spring

The capex cycle seemed to have turned the corner in the Spring, but then slowed down in the summer. We do not expect to see any significant acceleration in the next two quarters. Production capacity utilisation rose but remains below the long-term average. The decline in domestic orders for capital goods suggests that for now, firms still have a cautious approach to plant expansions. Going forward, the recovery in demand together with financial conditions that remain favourable (despite a likely uptick in the structure of short and longer term rates) and a rather solid budget situation should favour steadier growth starting in 2Q 2014. On average, we see corporate investment rising 3.8% in 2014 after the 1.0% drop in 2013. In reality, this will be a rather meagre recovery compared to previous cycles, but in recent years, German companies have continued to relocate abroad.

Consumption rising rapidly with solid fundamentals

Private consumption disappointed in the summer with growth of just 0.1% qoq after 0.6% qoq in the spring. For the September scenario, we still take a positive view of the trend in household consumption, which we expect to accelerate to +1.5% in 2014 from the +1.1% estimated for the current year in view of solid fundamentals. In our opinion, consumption will be supported by financial conditions that are still expansionary, by growth in real labour income of over 1.0% and by fiscal policy measures anticipated for this year and the next[5].

Meagre employment growth. There is still room for an increase in working hours in 2014.

The labour market: Between June and October there was nearly no growth in employment on a quarterly basis, and the unemployment rate rose by a tenth to 6.9% in September. PMI indices and confidence surveys suggest a slight increase in employment growth in the coming months. However, employment creation will still be limited since German companies adjusted working hours more than staff levels during the last recessionary phase. The number of hours worked in the summer rose, but is still below the pre-crisis level. Thus, it will take some time before staff levels resume their upward trend (see Figure 8). We estimate that employment could grow 0.7% on average in 2014, and that the unemployment rate will be broadly unchanged at 6.7%. Unless there is a significant increase in the labour force (which is unlikely, even assuming migration flows of about 300,000 p.a.), the unemployment rate will fall only modestly over the

[5] Note that the reduction in pension contributions from 19.6% to 18.9% was more significant in terms of its impact on the cycle.

forecasting horizon. Over the medium term it remains essential to push forward structural reforms targeting an increase in women full-time participation in the labour market to increase the labour force.

Real disposable income up by 1.0%, well above the Euro zone average

Salary growth similar to the one registered in 2013 (about 2.5%) and by stable inflation, together with mild expansionary fiscal policy should support disposable income dynamics over the forecasting period. The agreements signed between March and June entail salary increases lower than those agreed in the first part of the year, on average between 2% and 3% over 21 months. Salaries, including bonuses and ancillary benefits, slowed to 2.1% in June, from 3.0% in March, but rose by 2.4% in September. In our opinion, labour costs will increase by 2.5% this year and 2.6% next year, partly as a result of reduced social security contributions. Unit labour costs will likely be affected by limited productivity growth in both 2013 and 2014.

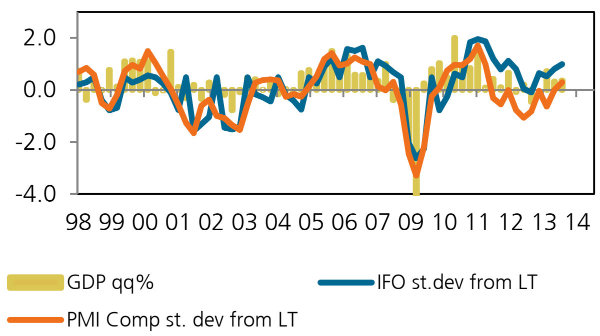
Inflation stable at 1.6%

Inflation fell from 1.9% last July to 1.3% yoy in November, mostly on falling contribution from the energy component. The trend in the CPI net of energy costs remained broadly stable between June and October (but details for November were not yet available as at the date of this report). Average annual inflation is expected to come in at 1.6% this year and next (2012: 2.1%). Underlying inflation could rise from 1.2% to 1.4% in 2014 as labour costs accelerate relatively to 2013.

The new government will not compromise Germany's fiscal virtue

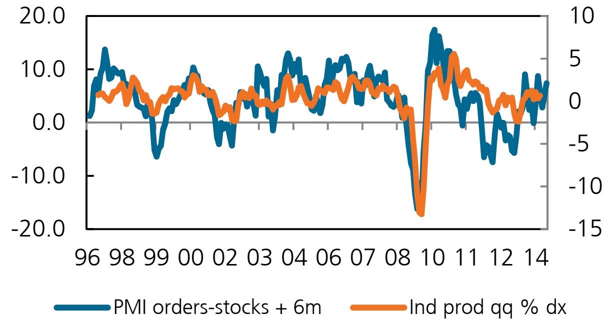
Public finances. The budget balance could break even or end up with a small surplus of +0.1% in 2013. In 2014, we anticipate a balanced budget or slight deficit since the positive impact of the cycle will be offset by a fiscal policy stance that is marginally more expansionary. Negotiations between the CDU and SPD have shown that an increase will be likely in pension spending and infrastructure spending, which should be partially offset by the stronger revenue growth and the introduction of a motorway toll for foreigners. It is possible that the structural balance could still improve to +0.4% of GDP in 2014 despite the increase in pension spending. Debt is expected to fall as early as next year to 78.6% of GDP for 2014 from 81.9% of GDP for 2012.

Fig. 1 - IFO and PMI indicate the recovery is well under way



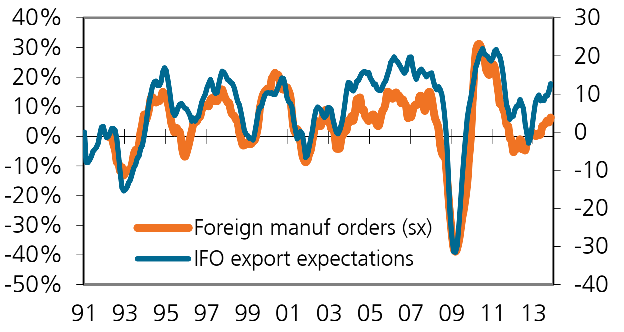
Source: IFO Institute, Markit and Intesa Sanpaolo calculations

Fig. 2 - Industrial activity should accelerate at the beginning of the new year



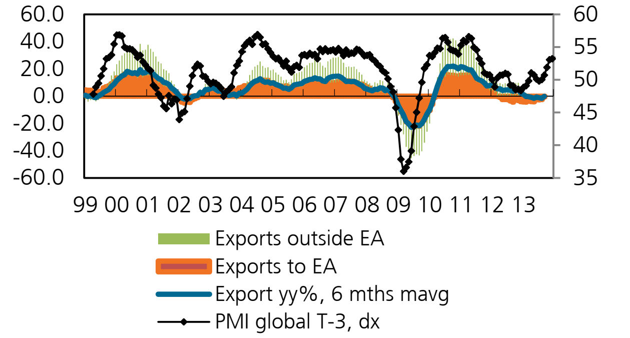
Source: FSO, Markit and Intesa Sanpaolo calculations

Fig 3 - Companies report a jump in orders from abroad



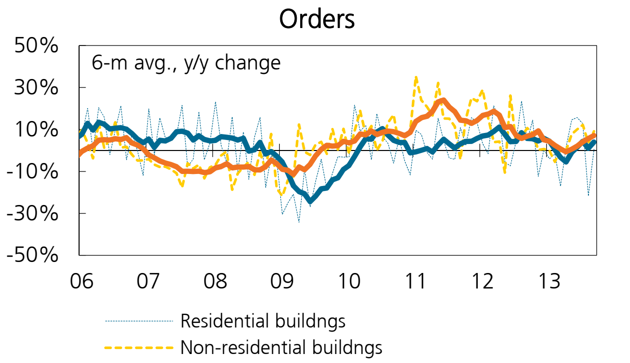
Source: IFO Institute and Intesa Sanpaolo calculations

Fig. 4 - Global demand should drive exports starting at the end of 2013



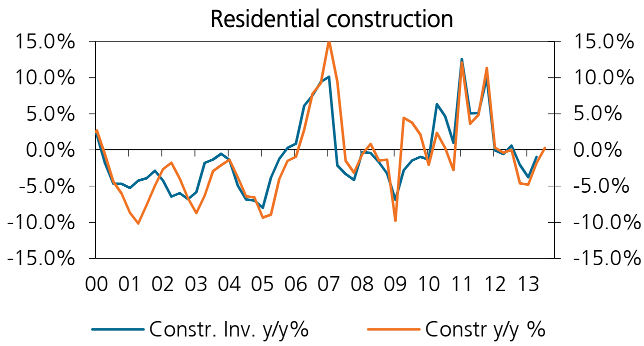
Source: Markit, FSO and Intesa Sanpaolo calculations

Fig. 5 – The trend in orders and ...



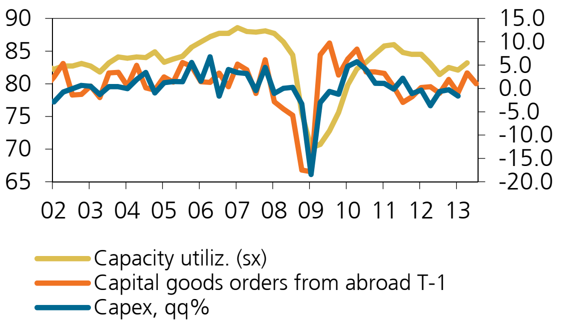
Source: IFO Institute and Intesa Sanpaolo calculations

Fig. 6 - ...production point to continued steady growth in construction investment



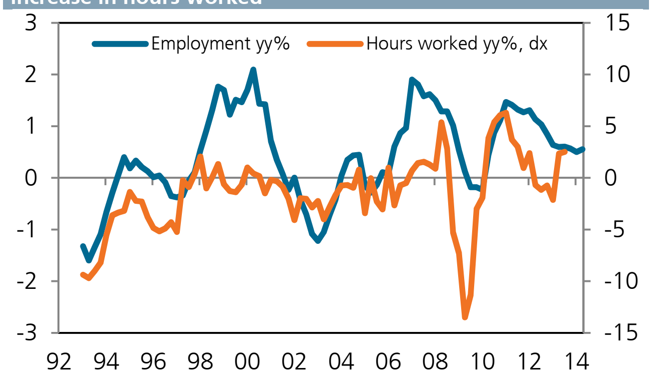
Source: Markit, FSO and Intesa Sanpaolo calculations

Fig. 7 - Corporate investments should see an increase in 2Q14



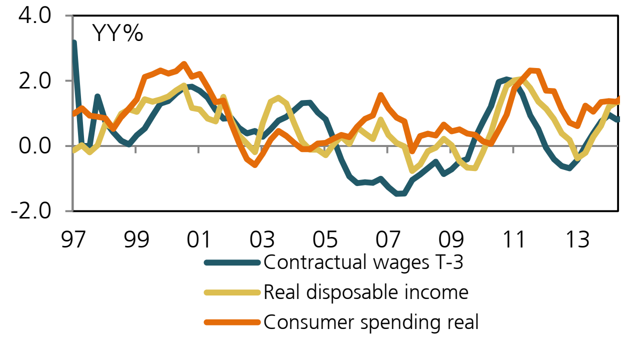
Source: Bundesbank, FSO and Intesa Sanpaolo calculations

Fig. 8 - Employment will remain stable with a significant increase in hours worked



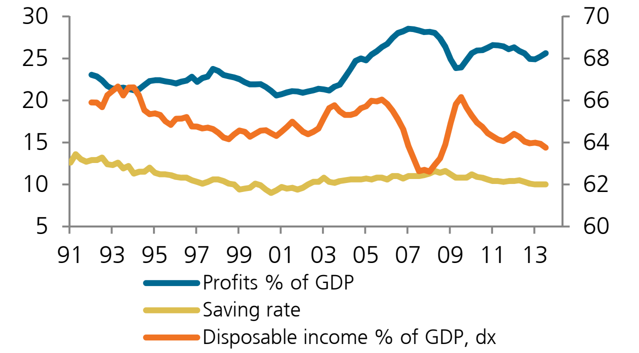
Source: Bundesbank, FSO and Intesa Sanpaolo calculations

Fig. 9 - Consumption sustained by salary growth



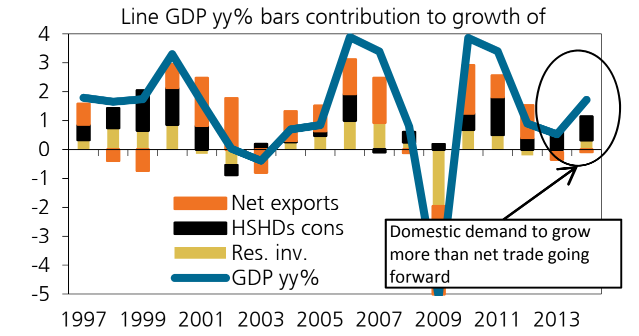
Source: FSO and Intesa Sanpaolo calculations

Fig. 10 - Profits as a % of GDP are again rising to the detriment of salaries



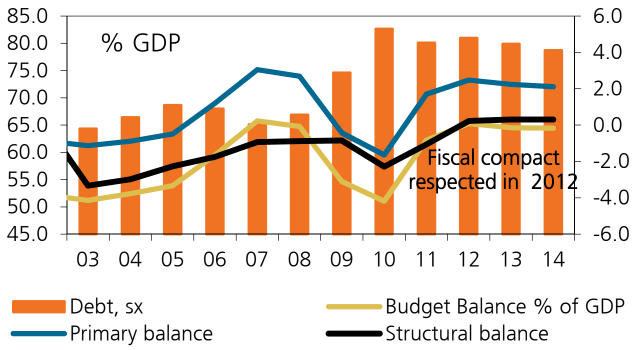
Source: FSO and Intesa Sanpaolo calculations

Fig. 11 - The composition of growth should continue to shift from net exports to domestic demand



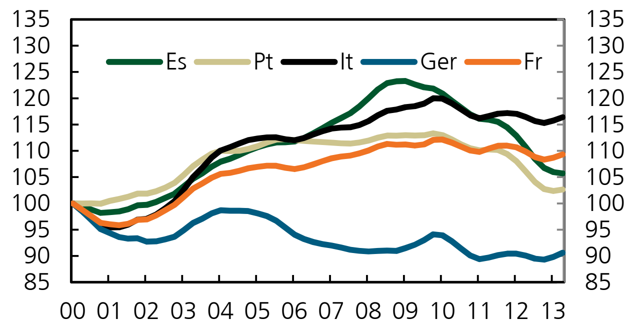
NB: percentage contributions to yoy GDP growth. Source: FSO, Intesa Sanpaolo estimates

Fig. 12 - Debt will start to decline as early as 2014



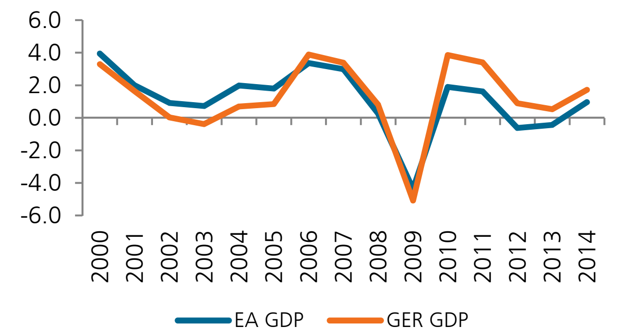
Source: FSO, AMECO and Intesa Sanpaolo calculations

Fig. 13 - Germany still has a significant advantage in terms of unit labour cost trends



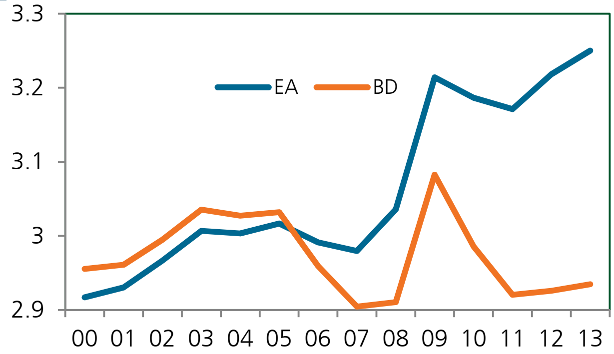
Source: AMECO, EU Commission and Intesa Sanpaolo calculations

Fig. 14 - The growth gap vis-a-vis the Euro zone average is narrowing



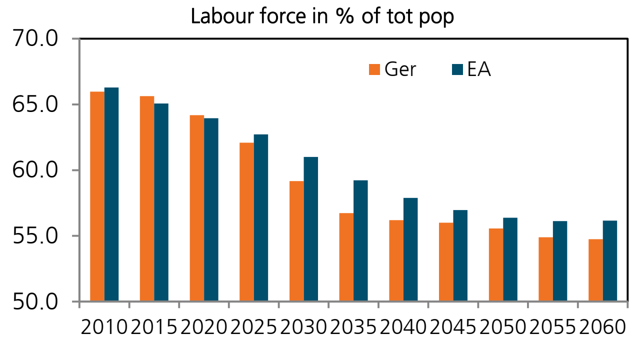
Source: Intesa Sanpaolo forecasts from Eurostat data

Fig. 15 - Capital stock as a percentage of GDP is significantly lower than Euro zone average



Source: AMECO, EU Commission and Intesa Sanpaolo calculations

Fig. 16 - Participation in labour force will be under the Euro zone average by 2025



Source: EU Commission and Intesa Sanpaolo forecasts

Forecast table

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (1995 prices, y/y)	0.9	0.5	1.7	-0.3	0.5	0.6	1.4	1.8	1.6	1.7	1.7
- q/q change				0.0	0.7	0.3	0.4	0.4	0.5	0.4	0.4
Private consumption	0.7	1.1	1.5	0.3	0.6	0.1	0.4	0.3	0.6	0.3	0.3
Fixed investment	-1.4	-0.8	3.2	-1.9	1.6	1.5	0.2	0.3	1.0	1.1	1.1
Government consumption	1.0	0.6	1.5	0.1	-0.2	0.5	0.6	0.4	0.4	0.2	0.5
Export	3.8	0.4	4.0	-1.0	2.4	0.1	1.0	0.8	1.0	1.4	1.3
Import	1.8	0.9	3.9	-0.6	1.9	0.8	0.4	0.9	1.1	0.9	1.9
Stockbuilding (% contrib. to GDP)	-0.6	0.2	-0.3	0.4	-0.3	0.2	-0.3	0.1	-0.1	-0.3	0.1
Current account (% of GDP)	7.0	6.6	6.3	6.9	7.3	7.1	7.1	7.0	7.2	7.3	7.0
Deficit (% of GDP)	0.1	0.1	-0.1								
Debt (% of GDP)	81.0	79.9	78.7								
CPI (y/y)	2.0	1.5	1.6	1.5	1.5	1.6	1.4	1.6	1.7	1.4	1.5
Industrial production (y/y)	-0.4	0.2	2.8	0.0	2.1	0.6	0.5	0.6	0.8	0.9	-0.1
Unemployment (%)	6.8	6.9	6.8	6.9	6.8	6.8	6.9	6.9	6.9	6.8	6.8

Note: Annualised percentage changes on the previous period – unless otherwise indicated. Fonte: Intesa Sanpaolo calculations on Thomson Reuters-Datastream data

Focus: What will the *Grosse Koalition* do?

Last 27 November, the CDU and SPD reached a preliminary agreement to form a *Grosse Koalition* after nearly a month and a half of negotiations. The SPD will hold a referendum on 14 December to approve the issues stipulated. The two parties will announce who will head the key ministries only after the final vote of the SPD. The two parties will have a very comfortable majority in the 18th German Bundestag holding 504 of 631 seats (CDU/CSU 311; SPD 193). Angela Merkel's election as chancellor could occur on 17 December 2013. The two parties have agreed to the following:

1) The introduction of a minimum salary of EUR 8.5/hour starting in 2015 as required by the SPD. This would be the highest minimum salary in the Euro zone after Belgium and the Netherlands. The reform could place upward pressure on the salary structure and cost of labour in Germany regardless of productivity trends, and thus, could have a negative impact on competitiveness in the medium term although it will provide a boost to income and consumer spending growth in the short term;

2) Income and property taxes will remain unchanged as required by the CDU during the electoral campaign;

3) There will be no compromises on debt mutualisation in the Euro zone;

4) Raise spending by EUR 5 billion to upgrade infrastructures and by EUR 2 billion for pensions. The increase in infrastructure spending seems rather limited to us in view of the accumulated gap vis-a-vis the Euro zone average;

5) Higher spending will not be funded with debt but should be covered by the future increase in revenues associated with steadier growth and the motorway toll for foreigners;

6) Reduction of retirement age from 67 to 63 for those who have worked more than 67 years as required by the SPD, and an increase in pensions for working mothers as required by the CDU;

7) In terms of spending on alternative energy, the percentage of renewable energy will be increased from 40% to 45% by 2025 (the current target is 35% by 2020 and 50% by 2030 for the supply of electricity based on the EEG) and from 55% to 60% by 2035 (the current target is 50% by 2030 and 65% by 2040 according to the EEG).

France: taxes up and growth postponed until 2014

Valerio Ceoloni

Following the surge in the summer due to temporary factors, the third quarter ended with another contraction of -0.1% qoq (0.2% yoy) and growth for 2013 remains at 0.1% yoy after the stagnation of 2012. While 2013 will not have been a year of complete stagnation, we do not expect performance to exceed 0.1%-0.2% qoq (0.4% yoy) in the fourth quarter, which will leave average GDP growth of 0.1% for the year. Confidence surveys in the manufacturing industry for recent months are still lower than the long-term average with less-than-invigorating prospects for orders from at home or abroad. Industrial output is likely to increase towards the end of the year only by 0.1%-0.2% qoq after the -1.4% qoq in GDP, and hence contributing little or nothing to GDP. Production capacity utilisation remained steady at around 80% in the second and third quarters, and we do not expect things to change substantially in the fourth quarter, as PMI indices have at no point during the year managed to reach the 50 mark that indicates business expansion. By way of contrast with the manifest difficulties faced by the industrial sector, the services sector, while weakened, is recovering as the year draws to a close. Confidence surveys show that morale is still lower than the long-term average. In the construction sector, despite signs of improvement, the level of activity remains well below (-40) the long-term average (-6) and we do not expect perceptible improvements before the end of the year, as new house-building has fallen by 4.0% mom in October, after a 2.2% mom drop in September. Growth in the last part of 2013 will therefore be driven by sustained domestic demand (0.3% qoq from 0.1% qoq) compensating for destocking (-0.2% qoq from 0.5% qoq), while net exports are set to stagnate again after contributing -0.7% in the third quarter, due to the appreciation of the euro.

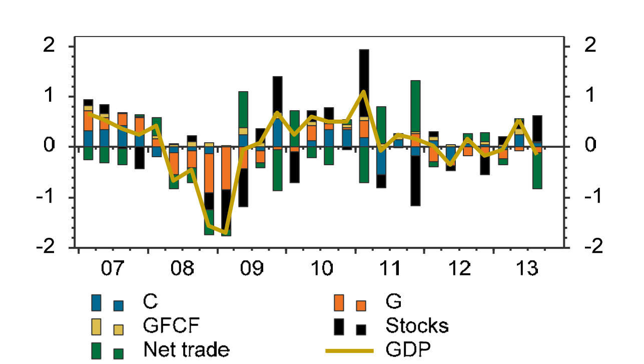
Growth, then, will have to wait until 2014, when we expect a 0.7% yoy rise in GDP. The entry into force on 1 January of the CICE (the French tax credit for competitiveness and employment) is likely to bring about a real improvement in competitiveness by raising the tax credit for companies from 4% to 6% and in turn reducing labour costs by 3% on average – to less than what they are in Germany for all employees on low to medium salaries. Set to cost a total of EUR 10Bn in 2014, CICE will be funded partly by an increase in VAT (raising EUR 6Bn) and partly by cutting public administration costs. There are also plans for a raft of reforms in the services sector, the real estate market, transport and energy to enhance competitiveness, competition and households' purchasing power. Investment in construction is expected to stabilise again after falling for two years, just as we expect the recovery in the sector to accelerate. Industrial output, too, is likely to improve its annual average next year by 1.0%, contributing around 0.2%-0.3% to GDP. Inflation risks are balanced; more vigorous recovery could follow the expected effects of the reforms that are being implemented, while a further slowdown in the private sector could compromise exports, investments and employment.

Total unemployment (including in the overseas territories) went up in the third quarter (to 10.9% from 10.8% in June) and we expect it to increase by another tenth of a point in the fourth quarter of the year (average for the year: 10.9%). In 2013, therefore, total unemployment rose by 0.7% from 2012's figure of 10.2%. We do not expect any reversal of this trend in 2014, so the numbers of those without work can be expected to rise, by another two-tenths of a point, on average, to 11.1%, with President Hollande's promise of a turnaround by the end of the year remaining unfulfilled. The risk to the forecast is to the upside, considering the announcements by the main car manufacturers a few weeks ago of their plans for further restructuring and of their expectation that headcount would fall by another 14,000 this year alone; they were, however, unwilling to make any forecasts for next year.

Price inflation continues to slow in response to reduced energy prices and weak domestic demand, with the core index largely at the same level as its general counterpart (+0.9% annual average, core index: +0.8%). The recovery in consumption will push prices up marginally this year, and we expect the current trend of low inflation to continue next year, when we forecast inflation to fall below 1% throughout the first six months and not to rise until the second, mainly in response to rising energy prices and an increase in VAT (annual average 0.9%, core index annual average 0.8%).

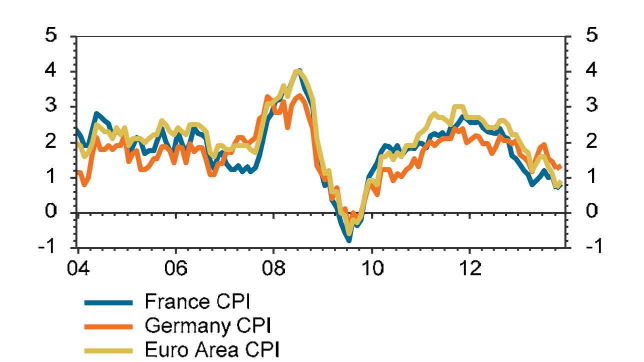
One of the urgent objectives the government has set itself in all this after the approval of the budget for 2014 and the consensus expressed at European level is to get the public accounts, which have steadily deteriorated over the last two years, back on track. The target, therefore, is still to bring the deficit below 3%. The deficit is expected to fall to 4.1% (4.8% in 2012) by the end of the year thanks to the measures implemented during it as a structural effort equal to 1.7% of GDP, while 2014 is likely to see a further improvement of three-tenths of a point taking the figure to 3.8% (with a structural effort equal to some 1.3% of GDP) thanks to the freezing of transfers to local authorities, the cutting of central structures' operating costs, and savings in health spending and in the inflation-linking of pensions. Broadly speaking, the higher taxes levied in 2012 and especially in 2013, will be used to meet costs from 2014 (when spending cuts will amount to 80% of the total effort). In 2014, public spending will fall by EUR 1.5Bn, EUR 8.5Bn less than its growth trend. Meanwhile, higher revenues in 2014 will amount to only 0.1% of GDP, compared with 1.5% this year. Fiscal pressure will stabilise next year at 46.0%, from 46.1% this year, and will remain stable throughout the 2015-2016 period. However, if growth falls short of its potential, this may negatively impact tax revenues and hence risks to the forecast for 2014 are to the upside for the deficit. Finally, public debt is forecast to rise again from 93.5% this year to 95.3% in 2014 and then to 96% in 2015, with interest costs amounting to EUR 46.7Bn next year.

Contributions to GDP



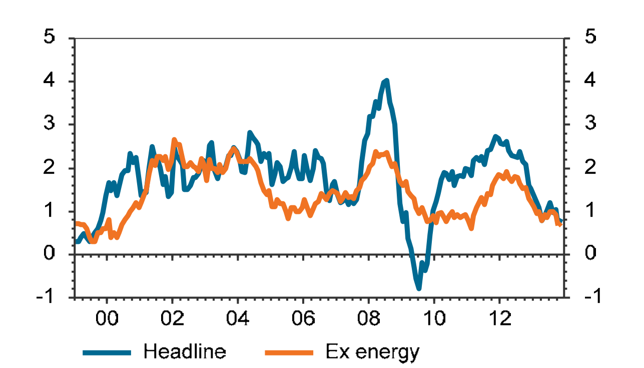
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



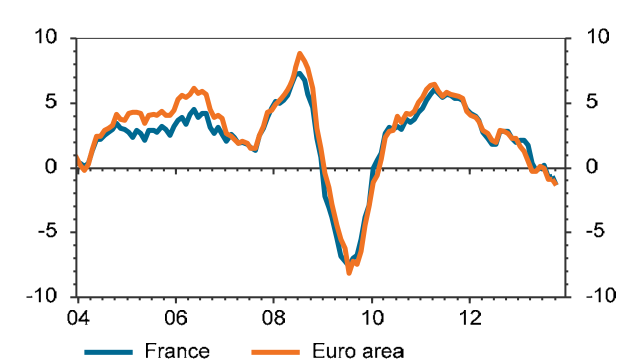
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI excluding energy: France



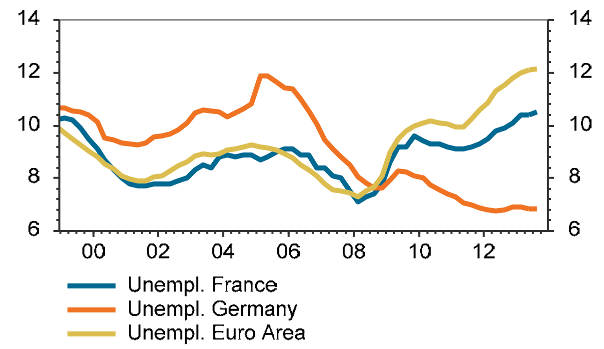
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

PPI



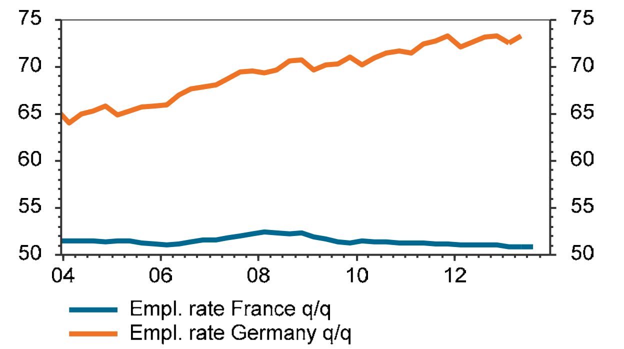
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



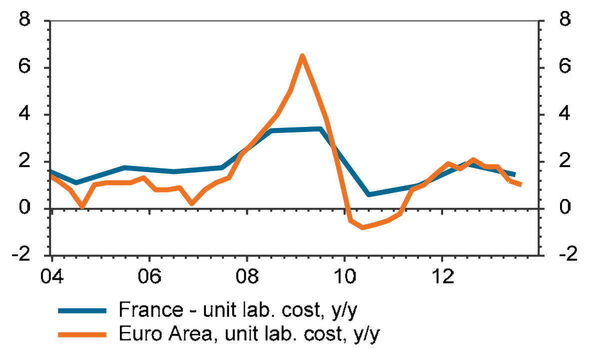
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Employment



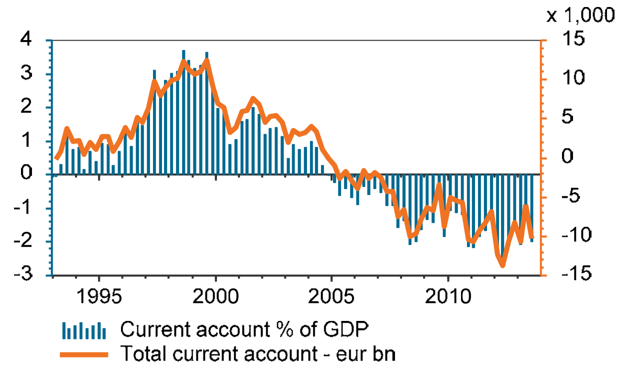
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unit labour cost



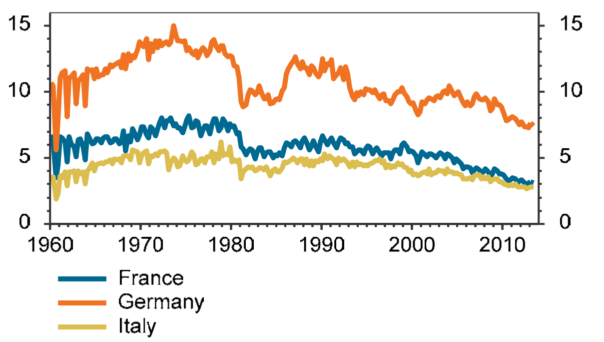
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



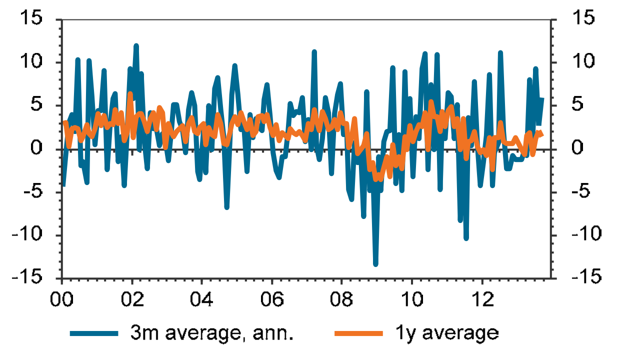
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Global export quota



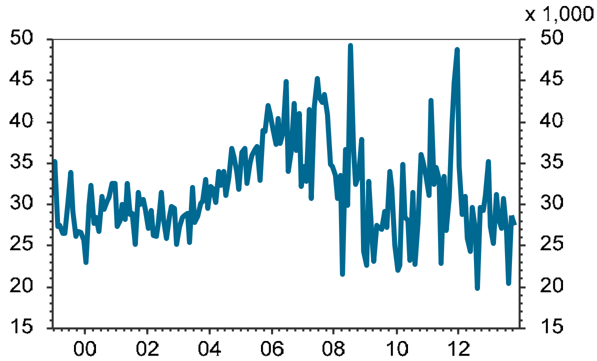
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Retail sales performance



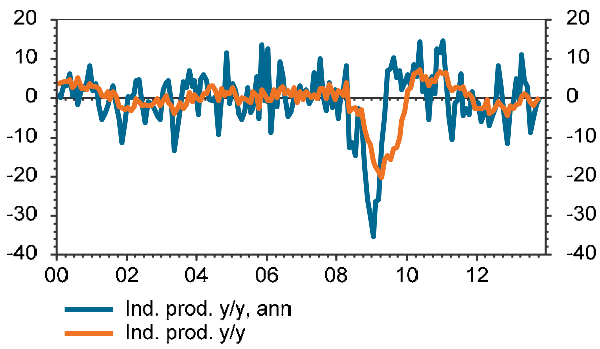
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Total new builds



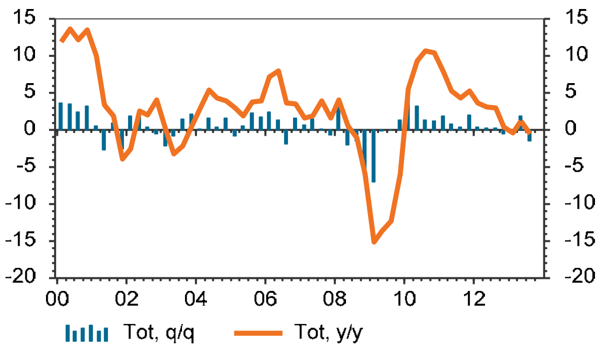
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Industrial output



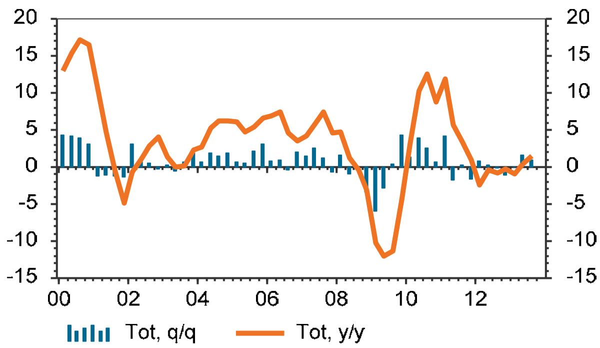
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Exports of goods and services



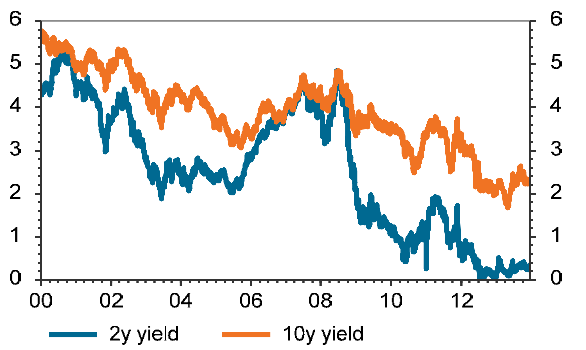
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Imports of goods and services



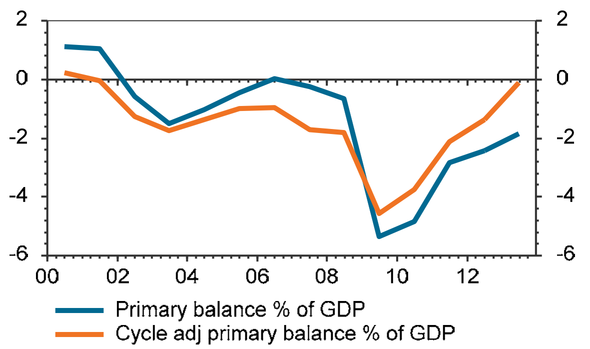
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

2-year and 10-year government bond yields



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Primary balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Italy: and yet it moves

Paolo Mameli

Despite the continuing deterioration in the labour market and credit data, **the recovery is also materialising in Italy**, although it is not as strong or as advanced as in the other main Euro zone countries. **2014 will be a year of transition**, from recession to a gradual "return to normality". **We confirm our forecast of 0.5% GDP growth, with some upside risk** arising from the global economic upturn and the repayment of the Public Administration's commercial arrears. However, **the main risk relates to the possibility of early elections** in 2014 instead of 2015, as in our central scenario, which could renew pressure on country risk as there is a strong possibility of another inconclusive result.

Overview of the scenario and basic assumptions

2014 will be a year of transition for the Italian economy. GDP has contracted cumulatively by 4.4% over the last two years, and while the recovery will take shape, it will certainly not be spectacular. In fact, growth will not even reach the rate seen during the previous "mini" recovery in the two-year period 2010-2011, when it was just over 1%. In all probability, we will have to wait until 2015-2016 before we see GDP growth of just over 1%. **After contracting this year by 1.8%, GDP will grow by 0.5% in 2014. Our estimate is rather more cautious than that of the main "official" forecasters** (the least optimistic of which is the OECD with +0.6%, while the Bank of Italy, Istat, the European Commission and the IMF are all in line at +0.7%; the Government's estimate is an "outlier" at 1.1%).

The table on the next page gives a breakdown of the expected change in GDP in 2014, compared with 2012-2013. We have calculated, on a basis given by the cyclical trend in the previous year, the impact on GDP of "fundamental" factors. As can be seen, **the effects of economic policies and financial variables will be very modest. Growth will come from:**

1) **GLOBAL DEMAND**: In our central scenario, global growth (according to the measure of world GDP adopted by the IMF) is expected to rise from 2.9% in 2013 to 3.6%. However, the upturn in global demand for Italian goods (measured as the weighted average of growth rates of imports from all countries that trade with Italy, with each weighted according to its percentage of Italian exports) will be much greater. Our estimates show this rising to 5.2% from 2.7% this year (and from 1.4% in 2012), in particular due to the recovery in Germany and France (13% and 11% respectively of total Italian exports) and the uptick in the US (7% of Italian exports). Our estimates show the elasticity of Italian GDP (via exports) to growth in global demand at around 0.3%, which therefore results in a significant impact on 2014 GDP (over one percentage point);

2) **PAYMENT OF THE PUBLIC ADMINISTRATION'S ARREARS**: In our estimates, payment of the Public Administration's arrears totalling EUR 47Bn (which, according to the government, could be as high as EUR 50Bn by 2014) has a positive impact of around 1.1% on GDP (0.2% in 2013, 0.7% in 2014 and a further 0.2% in 2015). At the end of November, of the EUR 27Bn expected for the current year, funds granted or in the process of being granted to debtor organisations amounted to EUR 24Bn, of which over EUR 16Bn had already been paid to creditors. Based on the figures in a survey carried out by the Bank of Italy in conjunction with Il Sole 24 Ore, the majority of companies (over 40%) stated that the main use of the monies recovered will be the payment of suppliers and employees, followed in second place by the financing of working capital and the reduction of bank debt. Only a minority of companies said they would plough the funds back into new investment (4% of the whole industry and services segment; this percentage increases with the size of company to approx. 8% for companies with 500 or more employees). However, we suspect this percentage is markedly higher when calculated by turnover rather than number of employees. Moreover, we think that the portion of recovered arrears used for investment will increase over time. However, based on the above-mentioned survey, the payment of arrears by the Public Administration already seems to have improved the prospects of the companies that have received payment: whereas 33% of companies expect to achieve a solid increase in production rates in the next few months, this

rises to 38% if we consider only those companies that have recovered a significant portion of overdue receivables from the Public Administration;

3) the other factor that we expect to have a positive impact is a residual component, which we attribute to the **"risk premium/confidence" effect**. After the upsurge in country risk indicators at least partly caused the slump in household and corporate confidence in 2012, this is likely to have an opposite effect in 2014; indeed, as soon as in 2013 there has already been a clear recovery in confidence indicators (precisely as a result of the easing of financial tensions). This trend, and especially its impact on real economic activity, is likely to become more marked during 2014 once the recovery also starts to be felt in the labour market (which will have a positive impact on consumer confidence) and in the credit market (which will boost corporate confidence further).

Turning to the other factors considered, we note that:

1. **economic policies** will have little effect on GDP: monetary policy seems to have only a very limited effect on the cycle, at least until access to lending becomes easier (probably once the recovery is under way). And fiscal policy, although it will not be restrictive for the first time in years, cannot support the cycle either, given the limited room for manoeuvre on the 3% deficit target (in our estimates the trend for 2014 is already hovering around that threshold);

2. as regards the other **financial variables**, the fall in long-term rates, which seems to have played a role in alleviating the recession during 2013, will struggle to provide further support in 2014. Exchange rate effects appear rather low (-0.1%), taking into account not only the euro/dollar cross but also Italy's effective real exchange rate.

Breakdown of the change in GDP: Intesa Sanpaolo simulations

	2012	2013	2014
Previous year GDP (A)	0.6	-2.6	-1.8
Fiscal policy effect (B)	-3.1	-0.7	0.0
Monetary policy effect (C)	0.3	0.2	0.1
Long-term rates effect (D)	0.0	0.2	0.0
Exchange rate effect (E)	-0.1	0.2	-0.1
Repayment of the PA's outstanding debt (F)	0.0	0.2	0.7
Global demand (G)	0.4	0.8	1.4
Confidence (H)	-0.6	0.1	0.3
(A)+(B)+(C)+(D)+(E)+(F)+(G)+(H)	**-2.6**	**-1.8**	**0.5**

Note: the fiscal policy effect is obtained by applying augmented "Blanchard-style" multipliers (=1.1) to the changes in the cyclically adjusted primary balance; the effect of changes in the short- and long-term rates is calculated using simulations on the OEF model; the exchange rate and global demand effect is calculated using econometric regressions; the effect of the repayment of outstanding debt by the PA is calculated by applying a multiplier of 0.4 to the companies suffering liquidity problems due to the payment delays; the "confidence" effect is a "residual" variable. Source: Intesa Sanpaolo

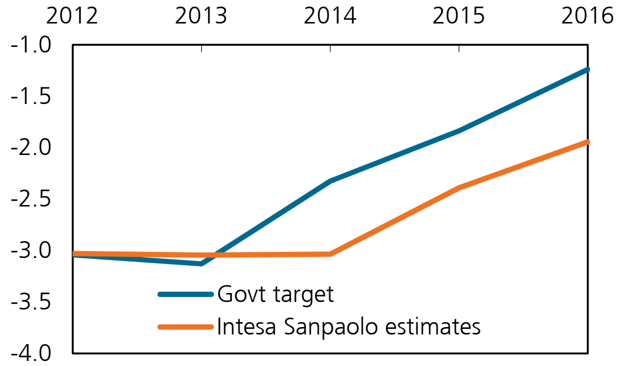
The main risk weighing on the scenario is political risk.

With regard to the above-mentioned factors, there appear to be upside risks to our cautious 0.5% GDP growth forecasts in 2014. **However, there are also significant downside risks, with the main one being possible renewed pressure on the country risk**, stemming from or relating to a deterioration in expectations about public finances (it is particularly important that the government manages to reduce the debt/GDP ratio). A political crisis may also cause pressure, especially if it triggers new elections, which could see the country spiralling into a situation of ungovernability.

In this regard, **our central scenario assumes that the government will remain in office for the whole of 2014**; we do not rule out that early elections could be held in 2015. In our view, the Constitutional Court's recent ruling that the majority premium (both in the House and the Senate) and the "blocked" lists in current electoral law are unconstitutional reduces the political risk as it de facto obliges the political powers to agree on a new voting system. If agreement is not reached, proportional representation in its purest form will be introduced – with an election threshold of 4% – and hence "grand coalitions" would be the only possible outcome for years to come (a scenario that nearly all the political parties seem to find undesirable). The government therefore seems to have emerged all the stronger from it. It would take several months at least to change electoral law, especially if undertaken as part of a broader reform of the institutions (e.g. the regional Senate). This in itself would make it unlikely that elections will be held in 2014, given also that Italian law prohibits national elections being held at the same time as European elections (which are on 22-25 May 2014), and that Italy's six-month presidency of the European Union starts on 1 July. Moreover, it is hoped that the new electoral law (and/or associated institutional reform) will enhance the future governability of Italy, which could translate into a fall in the risk premium on the financial markets.

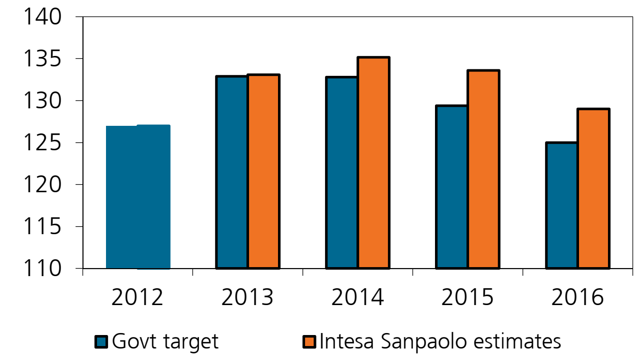
In the time available (12-18 months), the government would not, of course, limit itself to institutional reform, but would attempt to walk the difficult economic tightrope between the need to meet the 3% deficit target (which, in our view, is also at risk for 2014) and reduce debt, as well as attempt to support the burgeoning recovery through expansionary measures. However, there does not seem to be much room for manoeuvre in this regard given that, in our estimates, **the Stability Law has already exhausted all margins in achieving the 3% target.**

Deficit as a % of GDP: government targets and Intesa Sanpaolo estimates



Source: MEF and forecasts by Intesa Sanpaolo

Public debt as a % of GDP: government targets and Intesa Sanpaolo estimates



Source: MEF and forecasts by Intesa Sanpaolo

Is there a deflation risk?

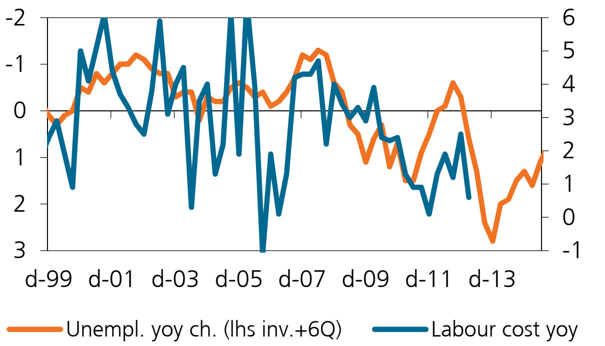
As regards the inflation scenario, **we think that 2014 will be very similar to 2013, i.e. a year of low inflation** (with CPI closer to 1% than to 2%), **but certainly not one of deflation**. There are at least two reasons why current economic scenario is incompatible with deflation:

1. **on the supply side**, the recent (and expected) trend in corporate costs, with reference to both external and domestic components, is disinflationary but not deflationary: neither commodities prices (especially energy) nor labour costs have fallen on an annualised basis in the last year (or are expected to fall in the coming year); rather, its rate of growth has, if anything, slowed: this is particularly so for labour costs, which, unlike in other European countries, have remained in positive territory both in nominal terms and expressed as unit labour costs;

2. **on the demand side**, the recovery currently taking shape will impact inflation too, albeit with a time lag; in other words, it is hardly surprising that inflation has fallen so drastically in the last few months, given that GDP has been growing at below potential for years and that the economy is still experiencing excess supply over demand (i.e. the output gap is extremely negative). While it is true that excess supply in the economy is set to remain considerable for the next few years, the ultimate outcome is likely to be a gradual - albeit slow - recovery.

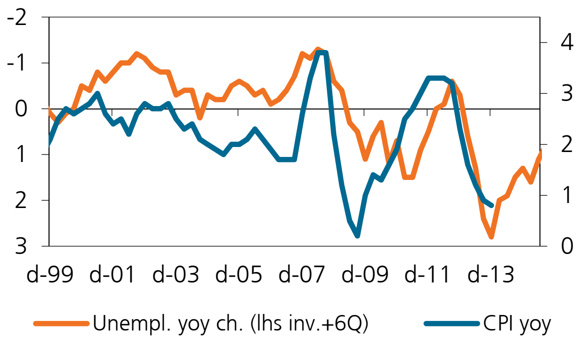
In other words, a deflationary risk would materialise only in the event of strong supply-side shocks (a marked fall in commodities prices, which is not included in our central scenario on commodities and which would therefore be *positive* for real activity), or if the embryonic recovery were aborted at birth. Our estimate is for average inflation of 1.3% in 2014 (from 1.2% national and 1.3% harmonised in 2013).

The current cyclical phase (even including the labour market, which is the weakest link in the chain) is not consistent with a deflationary scenario, either with regard to labour costs…



Source: Intesa Sanpaolo chart from Istat data

…or consumer prices



Source: Intesa Sanpaolo chart from Istat data

Main growth components

Next year, the biggest boost to the cycle will probably still come from foreign trade, although we estimate that its positive contribution to GDP could slow to 0.4% (after 0.7% in 2013, and after an annual average contribution of over 2% in the two-year period 2011-2012). This will happen against a backdrop of improving trade flows, which will be more marked for exports (+3.4%, given that the global demand indicator for Italian products is expected to rise to 5.2% yoy in 2014, after 2.7% in 2013) than imports (+2.3%, due to ongoing weak domestic demand).

Specifically, we think that the most lucrative key markets for Italian exports in 2014 could be: 1) the other Euro zone countries, especially Germany, which represents close to 13% of Italy's total exports and which is expected to grow by 1.7% in 2014. Germany will also be virtually the only major European country to show a recovery in the construction and private consumption sectors. Both these components could be important for driving Italian exports in both the machinery and consumer goods sectors. We might also see a sizable contribution from Eastern European countries that have close ties with Germany (of these, Poland is the country with the highest percentage of Italian exports); 2) the US, the largest outlet for Italian exports after Germany and France, whose GDP is accelerate by around one percentage point in 2014 compared with 2013; 3) the OPEC countries, which as a region contributed most to Italian export growth in 2013; 4) Russia and Turkey, whose percentage of Italian exports has increased significantly over the last few years (just under 3% on average for the first nine months of 2013 in both cases). Conversely, we think that the contribution of Asian countries and Latin America will be less marked.

Given that the contribution from foreign trade will remain positive, 2014 is set to be the year of an albeit modest recovery in domestic demand, which we estimate will grow (net of inventories) by two-tenths of a percentage point in 2014, after -2.4% in 2013 (and -4.6% in 2012). Indeed, it could be described more as a stabilization than a real recovery. Household consumption will remain stagnant, with a meagre one-tenth of a percentage point increase after three consecutive years of significant decline. 2014 will, in fact, be the first year that households' real disposable income rises after six consecutive years of decline (which started in 2008). However, the upturn, assisted by low inflation, will be modest at barely two-tenths of a percentage point (the forecast factors in a slight rise in savings rate). Moreover, unemployment (expected to continue to rise to 12.5% in 2014, up from an average of 12.2% this year) will not help the recovery in household spending.

After exports, the baton of the recovery will pass to **investments**, which are expected to grow by 0.7%, i.e. faster than GDP. This figure, however, obscures the large differences between investment in machinery & equipment and transport vehicles on the one hand, and construction investment on the other. The former will be boosted by the improvement in profit margins (due especially to foreign sales) and the need to replace capital assets after years of recession (but curbed by the fact that it is starting from a position of severe under-utilisation of plant and equipment, which limits investment to replacement projects rather than expansion of production capacity). In short, we expect investment in machinery to grow by 1.6%. Conversely, investment in construction will be stagnant after a good six years of decline: we will have to wait until 2015 for recovery to materialize in the sector.

Public spending, although it will manage to avoid the negative figure seen in the four-year period 2010-2013, will struggle to give a non-negligible contribution to GDP (we estimate public spending unchanged next year after a -0.2% decline this year); in fact, whilst 2014 will not be a year of tight fiscal policy, neither will it be a year of expansionary measures. And, in any case, it is unavoidable to balance the accounts by curbing expenditure.

In summary, 2014 will be a year of transition, from recession to a gradual "return to normality", **rather than one of a "genuine" recovery**, which in all probability will not occur until the two-year period 2015-16. We confirm our forecast for GDP growth of 0.5%, with some upside risks stemming from the global economic recovery and the payment of arrears by the Public Administration.

In summary, it will be a year of transition rather than real recovery

Macro forecasts - Italy

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (2005 prices, yoy)	-2.6	-1.8	0.5	-2.5	-2.2	-1.8	-0.8	0.0	0.5	0.8	1.0
qoq				-0.6	-0.3	0.0	0.1	0.2	0.2	0.3	0.3
Household Consumption	-4.2	-2.5	0.1	-0.5	-0.5	-0.2	0.0	0.1	0.2	0.2	0.3
Public Consumption	-2.6	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Investments	-8.4	-5.4	0.7	-2.9	0.0	-0.6	0.3	0.2	0.3	0.5	0.3
Imports	-7.5	-2.6	2.3	-0.5	-0.7	2.0	-0.2	0.7	0.4	0.7	1.0
Exports	1.9	0.1	3.4	-1.2	0.7	0.7	0.8	0.8	0.9	1.0	1.0
Chg. Inventories (contrib., % GDP)	-0.6	-0.2	-0.1	0.4	-0.4	0.5	-0.2	0.0	-0.1	-0.1	0.0
Current account (% GDP)	-0.6	0.5	1.0								
PA Balance (% GDP)	-3.0	-3.0	-3.0								
Debt (% GDP)	127.0	133.1	135.1								
Consumer Prices (yoy)	3.0	1.2	1.3	1.9	1.2	1.1	0.6	0.7	1.1	1.2	2.1
Industrial Production	-6.4	-3.1	1.3	0.1	-0.7	-0.7	0.8	0.3	0.7	0.6	0.2
Unemployment (%)	10.8	12.2	12.5	11.9	12.1	12.3	12.5	12.6	12.6	12.5	12.4

NB: Percentage change on the previous period - unless otherwise stated. Source: Intesa Sanpaolo calculations on Thomson Reuters-Datastream data.

Spain: andante moderato

Anna Maria Grimaldi

We continue to hold a slightly more positive view on the Spanish economy. The EUR 100 billion programme of financial assistance for banks under the European Stability Mechanism should be concluded by the end of the year without additional conditions and constitutes an important step forward in the process of strengthening the Spanish financial system and investor confidence, and accelerating the deleveraging of the private sector. The cycle turned in the spring. Exports slowed at the end of the summer, but are still growing strongly, boosted by the gains in competitiveness achieved in recent years. We expect the current account balance to show a surplus of around 0.5% of GDP at the end of 2013, improving to 1.4% in 2014. Corporate investment grew steadily in the second and third quarters, which suggests that firms are starting to replace at least some of their existing equipment, after years of reduced spending. Consumption unexpectedly grew in the summer months, after ten quarters of consecutive declines. Unemployment remains at record highs, but seems to have peaked in the spring, earlier than we had expected. Fiscal policy in 2014 should be less restrictive than in 2013. Lending conditions should ease during the year, as the return of confidence becomes consolidates. The more positive picture and return to growth led the three main rating agencies to revise their outlook for Spain from negative to stable. We maintain our estimate for GDP growth at 0.5% in 2014 (-1.3% in 2013), and do not expect growth to approach 1% until 2015.

The risks for our scenario are still to the downside: the rebalancing process of the country's imbalances will have to continue given that the external debt position remains ample and could have a greater impact on growth and domestic demand than generally assumed. Austerity should continue in 2015-2016, in order to bring the deficit below 3% and putting debt on a downward path. There is also the risk that global demand will be less buoyant than we assume and/or that imports will outpace exports again when there is a reversal in the domestic demand trend. The reform process should thus make further advances in order to consolidate gains in cost competitiveness, to achieve greater efficiency in the product market, to foster further downward wage adjustment, to boost the fall in unemployment from the record highs and improving the implementation of the budget alongside spending cuts at all government levels.

Short-term outlook In the third quarter of 2013, Spain's GDP returned to growth, albeit at the very modest rate of +0.1% qoq. This performance was driven, unexpectedly, by domestic demand (+0.3% qoq), while net exports made a negative contribution (-0.2% qoq), as imports rose faster than exports (+2.8% qoq versus +2.2% qoq). For the last quarter of the year we expect growth to be zero or slightly positive. The manufacturing and services PMIs are close to the 50 level. In October, industrial production fell by 0.4% mom by our estimates, which could herald a stagnant 4Q. On the other hand, we could see a recovery at the end of the year, as the export orders PMI points to an acceleration in exports (see figures 1 and 2). Growth in 2014-2015 should continue to be driven more by foreign trade than domestic demand. Exports are projected to grow by 5.8% in 2014, after a 2.1% rise in 2013. Imports could advance by 4.8%, driven by exports and the recovery of production activity. We should again see a positive contribution to growth from foreign trade, of 0.5%. Data for the third quarter and the information currently available on labour markets, orders and output indicate that domestic demand could return to growth in 2014, at the modest pace of +0.2%. In particular, improved confidence in the machinery sector suggests that corporate investment could continue to rise in the coming months, although at a slower pace than in the summer (+2.5% qoq). It looks as if firms have begun to replace existing equipment, at least to some degree, thanks to the recovery in exports. However, the large amount of unused production capacity along with lending conditions that remain restrictive lead us to think that this will only be fully realised once there is a more mature recovery in production activity (see figures 4 and 5). In 2014, we expect to see growth in corporate investment of 3.5%, up from -0.8% in 2013 (note that growth carried over from 2013 is 1.7%). As for construction investment, the worst should now be behind us. The share of residential construction in GDP is now below the European average, with house prices having fallen by 13.1% yoy in real terms, a slight improvement on the previous six months. In 2014, we expect the contraction in construction investment to be much less marked (-3.3%) than in 2013 (-10.2%). In the coming quarters, consumption should remain roughly flat, owing to the moderation of inflation and stabilisation on the labour market. We see consumer spending growing at an average of 0.3% in 2014. We expect more robust growth in consumption only in 2015, as the labour market gradually improves.

Labour market The unemployment rate fell to 25.9% over the summer, from a peak of 27.1% at the start of 2013. The number of unemployed has fallen by more than the workforce. The number of inactive people is broadly unchanged from the second quarter. Unemployment in Spain remains very high, at levels not seen since the 1970s, and represents one of the main challenges for the coming years and will likely fall only gradually, given the fragile nature of the recovery. In its last review of Spain, the IMF noted that the country has never managed to create employment with GDP growth below 1.5-2.0%, which we only expect to see after 2016. The economic surveys point to another year of negative job creation in 2014 (around -1.5%, from -3.8% in 2013), which is consistent with another slight fall in unemployment in the first half of the year, and stabilisation in the third and fourth quarters. In the summer months, redundancies were only seen in the public sector, while the private sector added 52,000 jobs, of which 39,000 in the services sector. The job indices from the EU Commission's economic sentiment survey suggest that the labour shedding should slow in the coming months also in the construction sector. Employment in the construction sector has dipped to just above the end of the 1980s level, and we think it is unlikely it will fall further. At best, we estimate that the unemployment rate will fall to 25.5% at the end of 2014.

Labour market reforms from 2012 are starting to have an impact, at least in terms of wage growth. In 2013 collective wage bargaining agreed for a 0.6% wage increase, down from 1.7% in 2012. Real salaries remain firmly in negative territory. Wage growth has been negative since the end of 2012 and fell again in June, by 0.3% qoq. Although this represented a smaller decrease than in previous quarters (-2.2% qoq on average between December and March), it was significantly below the Eurozone average of +0.9% qoq. In our view, wages will continue to fall throughout 2014, at the rate of -0.4%.

Inflation bottomed out in October, at -0.1% yoy on the national index, and at zero on the harmonised measure, before rising to 0.2% in November. The fall from 2.9% in November 2012 was due to the removal of the effect of the VAT rise of September 2012, as well as a slowdown in energy and food prices. Core inflation fell to 0.2% yoy in October, down from 2.3% a year earlier. Over the next few months, the considerable slack in the economy and the nominal wage trend could lead to core inflation falling to an average of 0.4% in 2014, from 1.5% in 2013. Headline inflation should stand at around 0.7%, down from 1.4% in 2013. A reduction in inflation and labour costs in peripheral Euro-zone countries will be necessary to accelerate the process of internal imbalances; note though, that these countries – including Spain – face a considerable deflation risk, given the size of their output gaps. The deflation risk will naturally recede as the recovery, especially in domestic demand, gain traction.

2014 set fair, but considerable uncertainties remain. It cannot be ruled out that the government will have to get a mini budget approved during the year

Public finances: the budget deficit is expected to reach 6.8% at the end of 2013, from 10.6% in 2012, only slightly above the target agreed with Brussels (6.5%). The measures to recapitalise the banks weighted by 3.8 percentage points of GDP in 2012, and by 0.3 percentage points in 2013. There is still a high degree of uncertainty about the 2013 balance, as receipts could be lower than in the last quarter of 2012 (when the VAT rise led to a substantial increase in tax revenue) and given that the end-October data seem to point to upside risks for spending in particular at the regional level. But let's look forward to 2014-2015. The deficit target is of

5.8%, with a structural improvement of 0.8%. The European Commission believes that this objective is achievable, owing to the extension of the measures on personal and corporate income tax[6] and the cut in the number of additional (previously allowed for personal reasons) days of holiday entitlement for public employees. Nonetheless, considerable uncertainties remain: first, the measures aimed at increasing the tax base through the fight against tax evasion could have disappointing results, falling short of the 0.1% of GDP forecast by the government; secondly, the local government reform could produce spending savings below the EUR 1.1 billion projected for 2014. According to the European Commission's opinion[7] on the 2014 Stability Law, the structural effort for 2014 is 1.3 percentage points of GDP, i.e. lower than the 1.8% indicated in the recommendations of last June, meaning that an improvement of 0.8% is required for the structural balance in 2014. The Commission's autumn forecasts point to a broadly unchanged structural deficit in 2014. But while 2014 looks ok, the Commission noted that Spain has not announced detailed enough measures to achieve the 2015 target in addition the structural effort is significantly lower than expected. Spain has adopted a reform of public administration and local government (last July), which should eventually (2019) lead to cost savings of EUR 8 billion. In addition, an independent fiscal council has been established. However, apart from these reforms, no significant structural measure has been announced. Furthermore, the Commission has underlined that Spain has not yet made progress on a systematic spending review, and even the tax reform seems some way off (an opinion from the independent commission is expected for February 2014). It cannot be ruled out that Spain will have to get a mini budget approved during the year in order to meet the targets agreed for 2014.

From 2015 Spain will have to implement a further reduction of at least 2% of GDP

For the coming years, the starting point, according to the European Commission, is a structural deficit in 2015 of 5.8% of GDP, slightly worse than the 2014 figure. The Spanish government, on the other hand, estimates the structural deficit at 2.0%, an improvement on the 3.3% estimated for next year, since it has included additional measures equivalent to 1.3% of GDP in its draft budgetary plan for 2014. Thus, looking at the 2014 estimates, there is quite a gap between the government and European Commission projections for the structural balance. As we stressed in our quarterly scenario in September 2013, the larger the structural deficit, the greater the austerity measures that will be required over the next few years. The discrepancy between the estimates can be attributed to the different calculation methods for the size of the output gap and therefore the cyclical impact on budget balances.[8] It was, in fact, Spain that raised the issue of the calculation method for the size of the output gap, but for the moment the Commission has not revised its estimate for the slack in the economy; the country will therefore need to make a significant fiscal effort from 2015 onwards, which will compromise its return to positive and more sustained growth than the 0.5% forecast for 2014. The public debt, meanwhile, is expected to rise to 100% of GDP in 2014, and only fall below that level from 2017.

[6] The deadline for deducting write-downs has also been extended to 2014-15, with an effect on tax receipts of 0.2% of GDP. Government legislation passed on 28 June excluded foreign losses from the tax base of companies. We estimate that this measure could account for 0.1%-0.2% of GDP.

[7] See SWD (2013) 603.

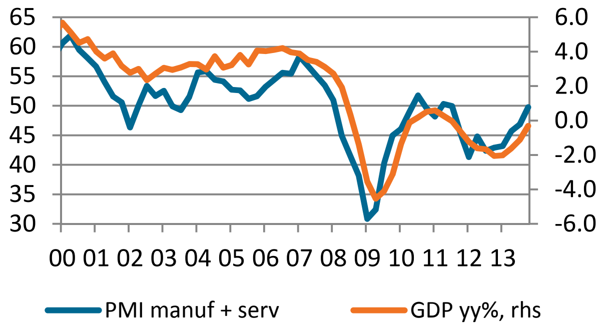
[8] The cyclical component of the deficit is given by the interaction of cyclical elasticity with the output gap. If the output gap is wider, the cyclical component is larger and vice versa.

Table 1 - Public finance forecasts: a further corrections looms ahead how big is it?

	2012	2013	2014	2015
European Commission estimates, Nov 2013(May 2013 estimates)				
Balance target recommended in June 2013	-10.6	-6.5	-5.8	-4.2
Balance	-10.6	-6.8	-5.9 (-7,0)	-6.6
Interest	3.0	3.4	3.6	3.6
Cyclically-adjusted balance	-8.2	-4.3	-4.3 (-4.3)	-6.2
Cyclically-adjusted primary balance	-5.2	-0.9	-0.7	-2.6
Structural balance	-5.2	-4.1	-4.2 (-5.5)	-5.8
Structural balance - government estimates		-3.4	-3.3	-2.0
Structural effort recommended in June 2013		+1.1	+0.8	+0.8
Debt	86.0	94.8	99.9	104.3
Balance	-10.6	-6.8	-6.0	-6.1**
Interest	3	3.4	3.6	3.6
Cyclically-adjusted balance	-8.4	-4.2	-4.3	-5.2
Cyclically-adjusted primary balance	-5.4	-1.3	-0.8	-1.6
Structural balance	-5.2	-4.1	-4.2	-3.8
Debt	86.0	94.8	100	103

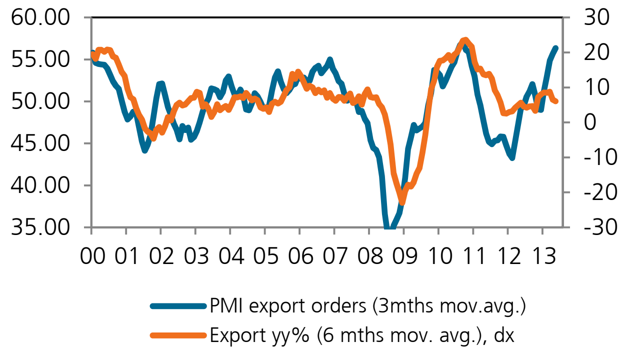
Source: European Commission autumn forecasts and Intesa Sanpaolo estimates **Estimates under the laws in force are based on the European Commission deficit estimate made in the autumn (-6.6%). These estimates take into account measures likely to be confirmed in 2015 and factor in projected growth of +0.9% for 2015, around one percentage point below the Commission's estimate.

Fig. 1 – PMI surveys suggest the worst is over



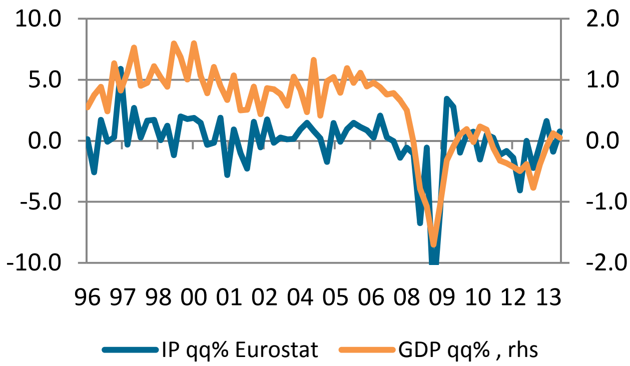
Source: INE. Intesa Sanpaolo charts based on Markit data

Fig. 2 – The export orders PMI points to an acceleration in exports over the next few months



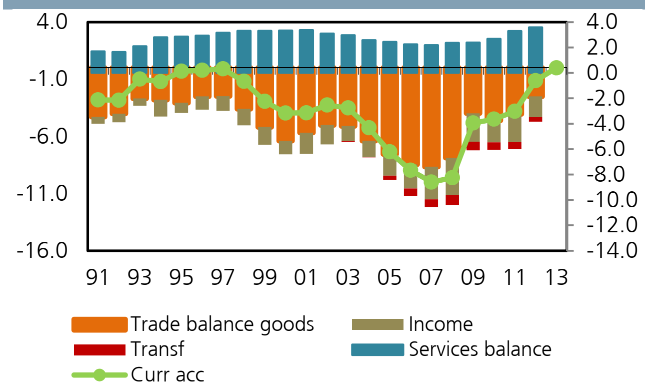
Source: INE. Intesa Sanpaolo charts based on Markit data

Fig. 3 – Industrial production in October points to more sluggish GDP growth (0.0% qoq) than in the summer



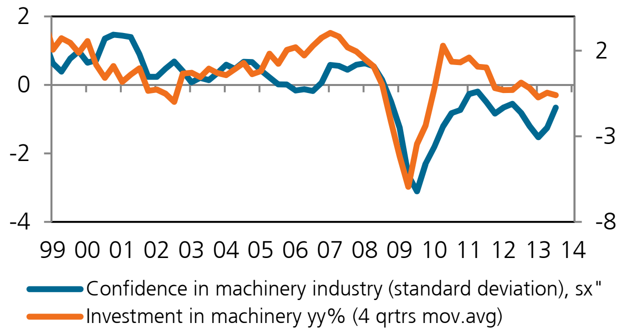
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 4 – Towards a current account surplus by the end of 2013



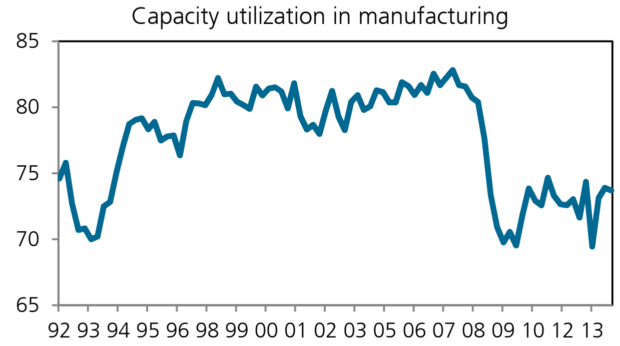
Source: Intesa Sanpaolo chart from INE data

Fig. 4 – Moderately positive signs for machinery spending, but we are unlikely to see a sustained cycle...



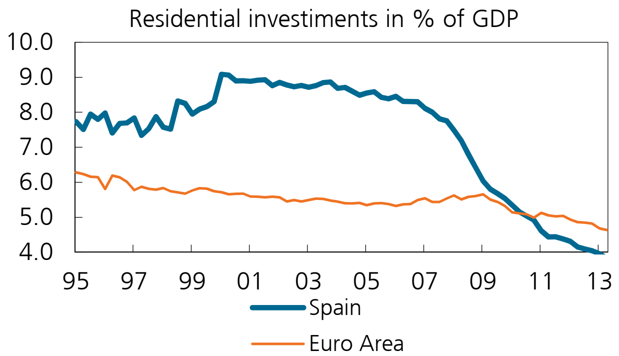
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 5 –...as there is still considerable unused capacity



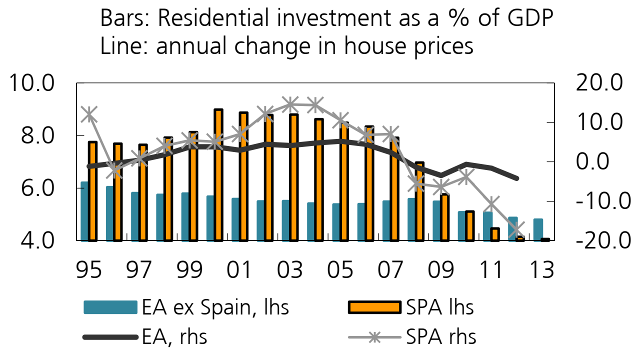
Source: Intesa Sanpaolo chart from INE data

Fig. 6 – Investment in residential construction as a % of GDP at its lowest level since 1976 and now below the Eurozone average



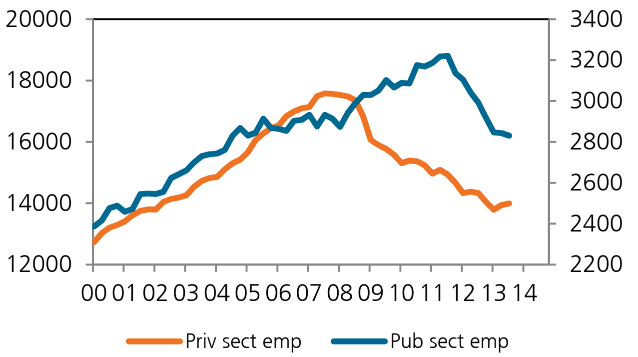
Source: AMECO and Intesa Sanpaolo calculations

Fig. 7 – House prices continue to fall, by 13% per year in real terms



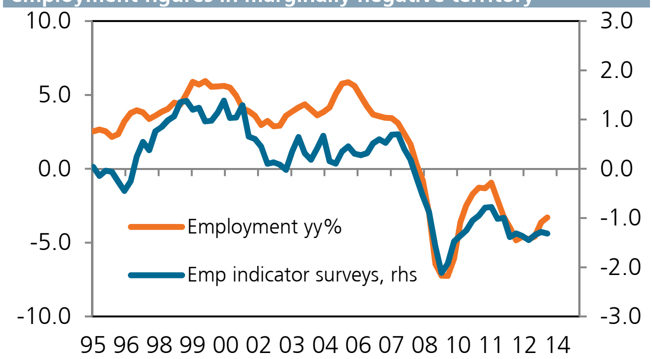
NB: Bars: resid. invest. as % of GDP. Lines: house prices yoy %, dx. Source: Intesa Sanpaolo chart based on AMECO, ECB and INE data

Fig. 8 – Private sector employment began to rise in the summer



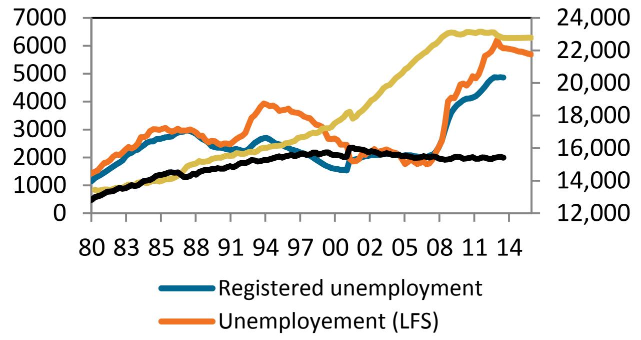
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – Confidence surveys point to a stabilisation of employment figures in marginally negative territory



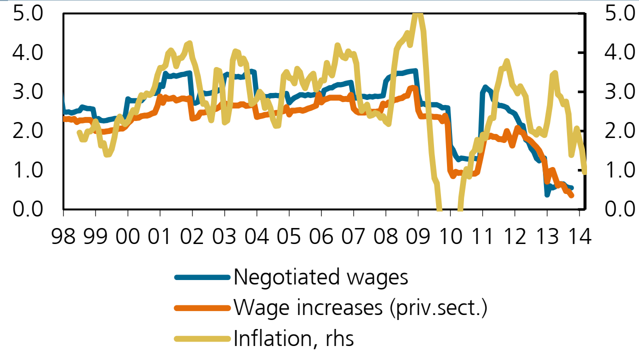
Source: Intesa Sanpaolo chart from European Commission and INE data

Fig. 10 – The number of unemployed has fallen by more than the active population



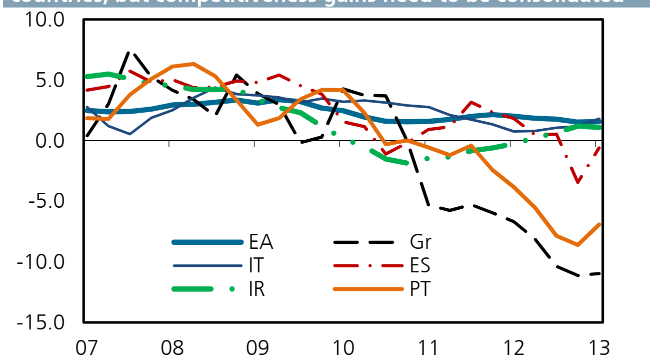
Source: Intesa Sanpaolo chart from INE data

Fig. 11 – Contractual wage growth slowed considerably



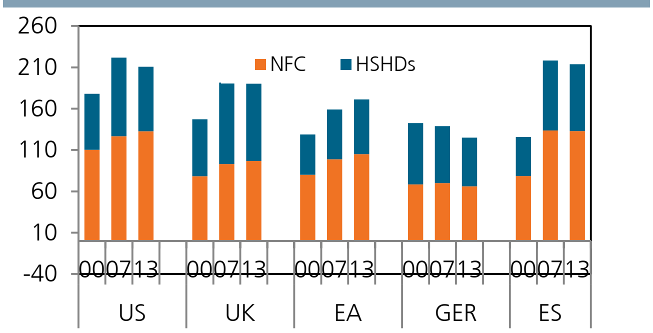
Source: Intesa Sanpaolo chart from European Commission and INE data

Fig. 12 – Labour costs have fallen by more than in other countries, but competitiveness gains need to be consolidated



Source: Intesa Sanpaolo chart from Eurostat data

Fig. 13 – Deleveraging of the private sector must continue



Source: Intesa Sanpaolo chart based on ECB, Fed and BoE data

Forecast table

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	-1.6	-1.3	0.5	-2.0	-1.6	-1.1	-0.3	0.2	0.6	0.6	0.7
- q/q change				-0.4	-0.1	0.1	0.1	0.1	0.2	0.2	0.1
Private consumption	-2.8	-2.5	0.3	-0.6	0.0	0.4	0.0	0.1	0.0	0.1	0.1
Fixed investment	-7.0	-5.7	0.1	-1.6	-2.0	0.2	0.9	-0.3	-0.1	0.1	0.3
Deficit (% of GDP)	-10.6	-6.7	-6.0								
Debt (% of GDP)	86.0	94.7	100.0								
CPI (y/y)	2.4	1.5	0.7	2.8	1.8	1.3	0.2	0.0	0.9	0.4	1.4
Unemployment (%)	26.1	26.0	25.7	26.5	26.4	25.9	26.0	25.9	25.8	25.8	25.7
10Y rate	5.86	4.55	4.23	5.06	4.50	4.53	4.09	4.06	4.31	4.24	4.32
'Effective exch.rate (1990=100)	100.6	102.4	101.9	102.0	102.2	102.5	102.7	102.3	102.0	101.7	101.5

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

Peripheral countries in crisis

Cyprus: second review completed

Valerio Ceoloni

The programme is going forwards in accordance with its route map, with the completion of the second review in November, and real progress is being made on the recapitalization of the country's financial sector. The restructuring plan[9] for the country's biggest bank, Bank of Cyprus, has been completed and will restore the group to profitability in the medium term, while its second major bank, Hellenic Bank[10], has already been recapitalized thanks to an injection of private sector capital. Even so, the shortage of liquidity in the banking system and the current restrictions on the movement of capital have adversely impacted lending by banks, and this state of affairs is not likely to change in the shorter term. It has, however, been confirmed that, from 2014 onwards, restrictions on the movement of capital will be significantly relaxed once depositors regain confidence and the banking sector becomes more stable.

The Eurogroup's confirmation that the second review has been completed will open the way to the release of the next tranche of aid, amounting to some EUR 200M by December, which will take the total aid already granted to around 5Bn out of the total 10Bn made available.

In terms of outlook, although the recession the country is experiencing is severe, it has eased since the initial estimates, and GDP is likely to contract by 7.7% yoy in 2013 (as compared with the 8.7% yoy initially estimated) thanks to the resilience of the tourism sector in particular. The decline in GDP is set to fall back to -4.8% yoy next year. The deficit for 2013 is likely to shift from 2012's figure of 6.3% to 8.3% before stabilizing at 8.4% the year after. Debt is forecast to increase considerably from 86% in 2012 to 116% this year and to 124% in 2014, largely as a result of the recapitalization of the banking sector and the lack of GDP growth.

Greece: a return to growth in 2014 still looks difficult

After completion of the third review in July, Greece now has to face the last year of the bail-out programme, which is expected to conclude in December 2014; during the year the reform has progressed to a slower beat, especially as regards the projected receipts from privatizations. Despite these difficulties, the recession is definitely starting to ease: there has been progression from -5.7% yoy in the last quarter of 2012 to -5.5% yoy in March, then to -3.7% yoy in June and to -2.9% yoy in September. No new improvement seems likely in the last quarter of the year (we expect -3.0% yoy) because of a series of tax deadlines and the end of the tourist season, which supported GDP in the two middle quarters of the year. Mid-year GDP, however, is set to improve from 2012's figure of -6.8% yoy to -3.8% yoy this year. We disagree with the European Commission, which sees a return to growth (averaging 0.6% yoy) as early as next year, and would argue that the high rate of unemployment, the depression in consumer spending and fiscal restraint will continue to weigh heavily and keep the country in recession into 2014 (-1.0% yoy). The main drivers of growth will be net exports and investments, while consumer spending will continue to be restrained by fiscal pressure that is not likely to ease next year, but rather to stabilize, given that the government has virtually ruled out new austerity measures. We also see unemployment – which has steadily increased since 2009 – falling next year only to 26% from this year's 27%, with downside risks being presented by the fragility of the government as a whole and the potential social instability, and the size of the fiscal gap, which could compel the government to introduce measures next year that will take further bites out of incomes and hence impact consumer spending. While the Greek government's estimates put the size of the "hole" at approximately EUR 500M, the Troika is more pessimistic and

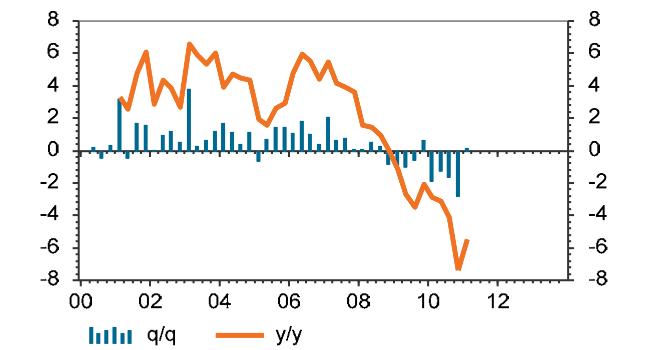
[9] The plan also included the sale of the Greek branch to Piraeus Bank, to which the third-largest Cypriot bank, Laiki (formerly Cyprus Popular Bank) had already been sold.
[10] Last March, Hellenic Bank also sold its Greek branch to Piraeus Bank.

estimates it at around EUR 2Bn; it is worth bearing in mind that the view from Athens is an optimistic one, based on the hope that the measures to combat tax evasion taken during the year will help to keep the fiscal gap within the parameters envisaged. Nevertheless, the downside risks are real. On the whole, though, market sentiment in Greece is definitely picking up, with the ten-year rate falling below 9% and the stock market hitting heights not seen for two years or more.

On the public accounts front, Athens is set to record the first primary surplus of around 0.4% of GDP this year, exceeding the original estimates of 0.2%. However, the deficit[11] is likely to peak this year at -13.5%, as compared with 2012's figure of -9.0%, and then fall drastically next year (-2.0%), mainly thanks to the conclusion of the banking sector recapitalization. Public debt, meanwhile, is projected to peak this year at 176% of GDP, after 157% in 2012, then to stabilize next year (175.9%) and start to fall from 2015 onwards (171%). The target is still to reduce debt to below the 125% level by 2020.

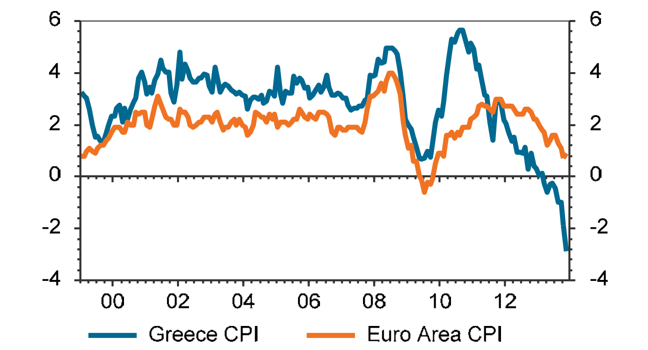
Finally, the issue that could hold up the progress of the programme is, as we said earlier, that of privatizations: to meet this year's deadlines, three transactions bringing in nearly EUR 2Bn would be due to complete. As things stand, following the completion in October of the sale of the state-controlled gambling firm (OPAP), the sale of the energy distribution network (DESFA)[12] is still to be finalized, while no buyer has yet been found for the national energy company (DEPA). Even if the DESFA transaction is completed within the year, at least one-third of the funds will certainly not be raised in 2013; as for the rest, note that stipulating too rigid a deadline can be counterproductive, as the risk is that the country's assets end up being sold off rather than going to the higher bidder. Ongoing pressure from the Troika with regard to deadlines may well, therefore, have a negative impact, as the present lack of buyers, reflecting low demand, results in prices lower than what might be expected[13].

GDP



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



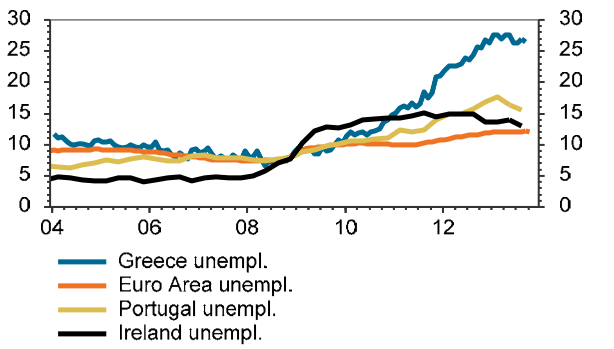
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

[11] In accordance with the ESA95 standards, calculation of the deficit takes into account, inter alia, the costs of recapitalising the banking system, which amount to some 10% of GDP

[12] In June, the Azeri company SOCAR won the tender launched by DESFA for a controlling stake (66%) in its capital. The deal is likely to bring in some EUR 400M for the Greek government.

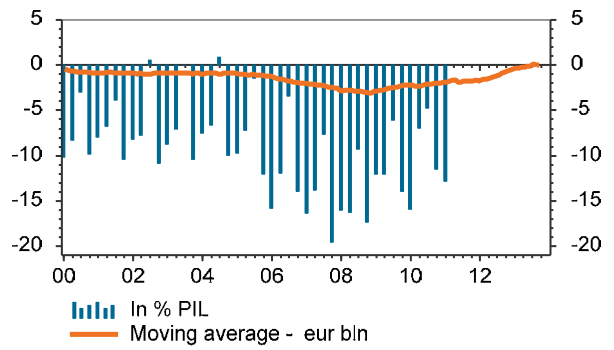
[13] The figure of EUR 2.5Bn in revenues initially forecast for 2013 has already been revised downwards to EUR 1.5Bn, of which, to date, around 600Mn has actually been received.

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Ireland: out of the tunnel

The bail-out programme launched in 2010 will officially end in December after paying out a total of EUR 85Bn. This will represent a complete return to sovereignty for Dublin, as the government has decided not to ask the ESM to activate a precautionary credit line and to rely entirely on the reserve of some EUR 25Bn accumulated so far to meet its requirements until the start of 2015 – a decision that will not prevent the government turning to the ESM later on if circumstances so require.

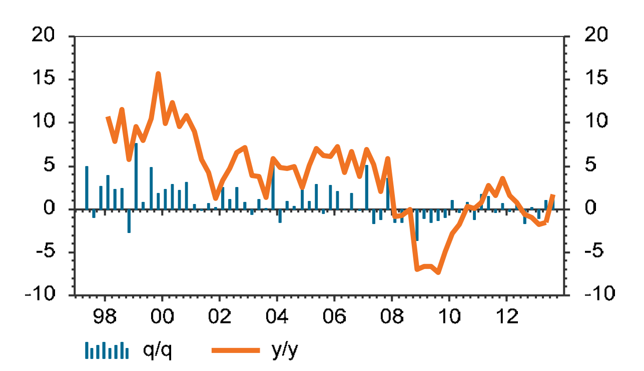
Although growth has not yet restabilized, this year is set to be the last in recession. Our view is that, by mid-year, GDP will have contracted by -0.5% yoy, following on from the +0.2% yoy in 2012; the two central quarters have indicated a return to growth (0.5% qoq and 0.15% qoq respectively), and, although we expect another positive figure (0.7% qoq) for the fourth quarter, the year will be a negative one in terms of the average. Renewed growth will therefore wait until next year, in which we expect a 1.4% yoy jump in GDP (against the European Commission's estimate of 1.7% yoy GDP growth in 2014, after the +0.3% seen this year). The main contributory factors in this are set to be capital investments and net exports, even though the volume of the latter – both in goods and services – has turned out to be lower than expected this year (+0.6% yoy) and the estimate for next year has been revised downwards from 4.0% to 3.0%. Meanwhile, domestic consumer spending is expected to remain low, as this year, but stabilising, largely in response to two factors, namely the downward trend in unemployment during the year (it was 12.6% in October, down from 14.5% at the same time in the previous year) and an appreciable easing of inflationary pressure on prices (inflation stood at 0.1% yoy in October, compared with 1.2% in on the national index the previous year), thus enhancing households' purchasing power.

There have been further improved inflows in the banking sector, with deposits remaining stable despite falling interest rates, while the national bank has had less recourse to loans from the ECB, which totalled 41Bn in October (compared with around 78Bn a year ago). Nevertheless, the deleveraging process is not yet complete. The trend in private sector lending remains weak and rates are still higher than the Euro zone average. On the other hand, there is a continuing increase in non-performing mortgages, which reached 12.4% of total mortgages at the end of the second quarter, compared with 11.7% in the first.

On the public accounts front, the budget for next year has turned out to be less weighty than expected, going no further than to provide for a total of EUR 2.5Bn compared with the EUR 3.1Bn originally envisaged. About a third of this amount will be new revenues with the remainder achieved through spending cuts. The austerity measures put into effect by the government from 2008 to the present have accounted for a total of EUR 31Bn, or around 20% of current GDP. This year's **deficit** is expected to fall to **7.4% of GDP** from 2012's figure of 8.2%, and **further to 5% in 2014**, compared with an initial target of 4.3%, in view of the forecast downturn in GDP and the impact on next year of lower tax revenues compared with this year's forecasts. The deficit is set to fall below the 3% threshold in 2015 on condition that the government implements additional measures worth some EUR 2Bn (1.1% of GDP). Lastly, **public sector debt** is expected to peak this year **at 124.4%,** up from 117.4% in 2012, but to fall next year to 120.8%, partly thanks to the planned reduction in the present precautionary reserves which amount to around 13% of GDP and enabled the country to avoid making use of its precautionary credit line. Debt is likely to stabilise around 119.5% in 2015.

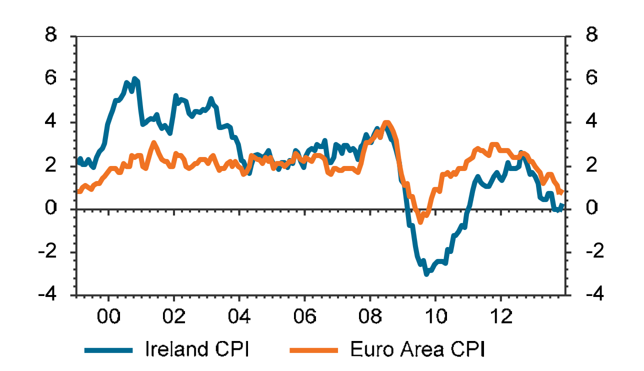
The downside risks to the scenario remain ever-present, in view of the weakness of domestic demand and the difficulties SMEs face in accessing credit, not to mention the vulnerability of a banking system that has not yet fully recovered. However, with regard to foreign demand, the new business partnerships, which should support net exports, will only become fully operational next year. Upside risks could come from the labour market, which may well see unemployment fall more rapidly than expected, partly in view of the slowdown in the creation of new part-time jobs in favour of full-time positions, which will push up disposable income. Overall, though, the completion of the bail-out programme on time and as planned, combined with the first signs of a return to growth in the country, have had a positive effect, not least on the financial markets, where the Irish ten-year yield has been fallen to below 4%.

GDP



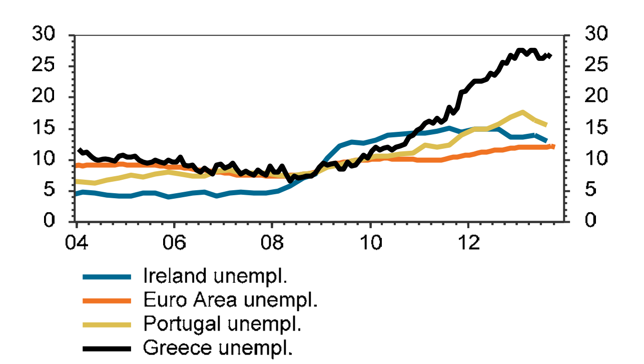
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



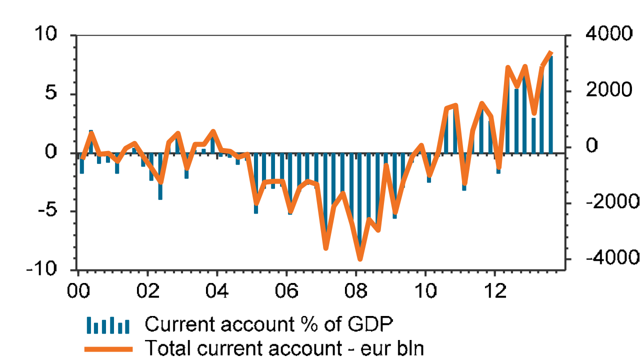
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Slovenia: 2014 - continuing austerity to avoid a bailout

Stress tests on Slovenia's banking system are proceeding slowly; the results had been by the end of October, but they are not likely to be completed before 13 December. Although the exact amount of non-performing loans to be transferred to the "bad bank", DUTB, has not yet been identified, it has been estimated that it could amount to EUR 4Bn (out of a total of some EUR 7.9Bn bad loans held by the country's banks, equivalent to 22% of GDP). The results of the stress tests will therefore give a precise indication of just how much the government will have to pay out to the financial sector next year. So far, a cautious figure of 1.2Bn (equivalent to 3.5% of GDP) has been earmarked, but more could be required, in which case the government could be forced to seek help of some kind from its European partners. The transfer of NPLs to DUTB was meant to start as early as December and be completed by the spring of next year. However, whether the country seeks aid or tries to resolve the problem under its own steam, the end result will be the same. In particular, to avoid the possibility of the rescue of the financial sector (which can no longer be postponed) taking the public accounts deeply into deficit, what is needed is a two-pronged approach consisting of the launch of a "slimming-down" programme in the public administration, while fostering greater development of the private sector in order to restore the country's competitiveness and exports, both of which have signally declined between 2012 and now.

Portugal: the end of a year of light and shade

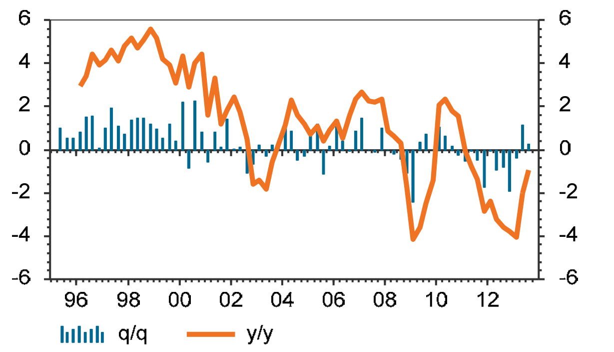
After successfully completing the eighth and ninth reviews together, Portugal, at the end of 2013, presents a picture of both light and shade. On the one hand, the long recession would appear to be behind it, and economic recovery under way, but, on the other, the reforms provided for in the bail-out package have been stalling for a number of months.

The second quarter of the year produced a surprise on the general economic front in the shape of an upturn (1.2% qoq) after ten quarters of contraction; this was attributable to the input from domestic demand, and the third quarter likewise (+0.2% qoq) showed that the economy is endeavouring to recover after three years of crises that battered the country, with, in particular, domestic demand stabilising and net exports picking up. Having hit the floor during the first quarter of this year (-4,1% yoy), the recession is relaxing its grip: -2.0% yoy in the second quarter, -1.0% yoy in the third, and we expect this trend to continue into the fourth (-1.5% qoq, -0.6% yoy). This year will therefore see a shift in annual average GDP growth from 2012's figure of -3.2% yoy to -1.9% yoy. Our expectation is that growth will be completely resumed in 2014, buoyed up in particular by net exports and a recovery in demand at home: in terms of an annual average our forecast (0.6% yoy) remains more cautious than the Commission's (0.8% yoy). While unemployment started to fall in the second quarter, this was more a decline in the participation rate than any actual increase in the number of people in work: unemployment is in fact expected to rise to 17.4% in 2013 from last year's figure of 15.9%, to peak next year at 17.7% and to start to fall again from 2015 onwards.

Turning to the public accounts, the draft budget for next year has been given final approval and provides for measures worth EUR 3.9Bn (2.3% of GDP) overall, cutting spending by around EUR 3.2Bn and raising EUR 0.7Bn in new revenue. The main measures planned for next year include pay cuts ranging from 2.5% to 12% for all public employees earning more than 600 euro a month, reductions in headcount in state-owned companies, raising the retirement age (to 66), and cutting old-age pensions in excess of 600 euro a month. The main revenue-raising measure will be a new tax on companies in the energy sector. Appeals against a number of these measures (notably those involving cuts to salaries and pensions) have already been brought before the Constitutional Court for a preliminary opinion. Tax revenues have remained solid throughout the first eight months of this year (direct taxes up by 19% yoy, indirect taxes by 2.3% yoy), while spending over the same period has been in line with forecasts, although, as the year draws to a close, there may be overruns due to thirteenth- or fourteenth-month payments to public employees and the postponement of some payments relating to the year. Overall, this year's deficit is likely to fall to 5.9%, from 6.4% in 2012. The original target set for this year – 5.5% – will be achieved, albeit excluding interventions to recapitalise the banking sector (BANIF), which will weigh on GDP to the tune of 0.4%, and hence make the deficit for 2013 5.9%. The Troika has, however, confirmed that its target for next year will be 4.0% even though the government requested a relaxing of the target to 4.5%. Having stood at 124.1% in 2012, public debt is expected to peak this year at 127.8%, then fall back to 126.7% in 2014 and to 125.7% in 2015.

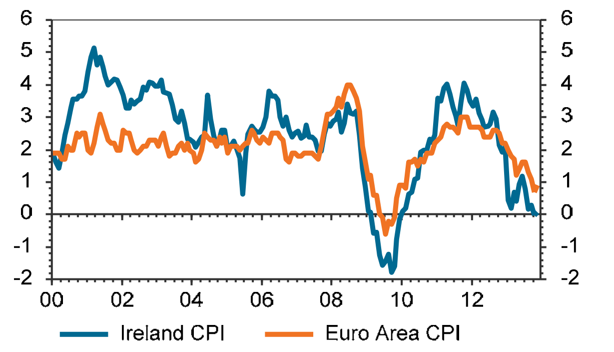
Under the bail-out programme, a total of EUR 72Bn – 90% of the total – has so far been paid out. The Commission has recommended that Lisbon should comply strictly with the deadlines as its room for manoeuvre is rather limited, especially considering the expected responses from the Constitutional Court by the end of the year both on a raft of measures in the 2013 budget (already put into effect) and measures to be implemented under the 2014 budget. It has also emerged from the periodic review reports that the country's banking system is still weakened, mainly by non-performing loans and by the still excessively high financing costs and hence the low profitability of banks (which recorded losses of over a billion in the first half of the year, of which 765M were in the second quarter alone). Lending to the non-financial private sector is still contracting (-20% last year by comparison with pre-crisis average levels), albeit more slowly than in the past. Portuguese banks are likely, though, to need an injection of fresh capital from new shareholders in order to strengthen their stability. As things stand at present, the approximate EUR 6Bn allocated to the bail-out fund for the banking sector may well turn out to be insufficient, as the governor of the Bank of Portugal, Carlos Costa, has also said. This last consideration could then have consequences not least for the borrowing shortfall in the 2014 budget, on which it has not yet been possible to shed light. On the one hand, the governor gives assurances that it will not exceed EUR 500M, while international partners think it possible that it may actually turn out to be around EUR 2Bn, in which case the problem would arise of how to raise the missing funds, as one proposed solution was to draw on the EUR 6Bn already advanced. Good news on this front has arrived in the shape of the results of the government auction in the first week of December, when maturing government bonds were renewed for some EUR 6.6Bn, of which EUR 0.8Bn matures in June 2014, EUR 1.6Bn in October 2014 and EUR 4.2Bn in October 2015. EUR 2.6Bn of the maturities of these bonds have been extended until October 2017, and the remaining EUR 3.9Bn to June 2018. This means that issues scheduled for next year have already fallen from EUR 10.5Bn to EUR 8.1Bn, leaving scope for dealing, among other things, with the worst-case scenario of a "hole" of 2Bn. Most of the risks in this outlook are to the downside, mainly because of the Constitutional Court's propensity for pronouncements that risk derailing the programme before it can be completed on time. The possibility of a second rescue plan has not yet been averted.

GDP



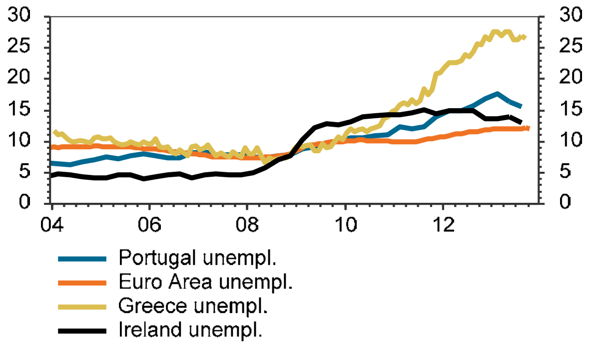
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



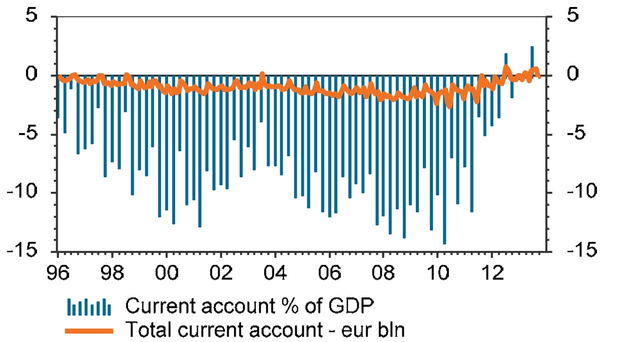
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Asia

Japan – 2014: the year of the fiscal turnaround

Giovanna Mossetti

- While 2013 was marked out by the consolidation of the recovery and the exit from deflation, the Japanese economic scenario in 2014 will be dominated by fiscal policy.
- The Japanese recovery is well established, thanks not least to monetary stimulus and to the depreciation of the yen. Growth in 2013 is set to be 1.7%, and the recovery likely to continue into 2014 despite the expected fiscal stringency. The growth forecast for 2014 is 1.7%, with considerable quarterly volatility resulting from the rise in consumption tax scheduled for April of that year.
- The hike in consumption tax will be the main factor in the predicted turnaround towards a deficit/decline in GDP of some three percentage points per annum in 2014-15. The fiscal tightening (circa 5.3Trn yen, 1.1% of GDP) will be offset by temporary expansionary measures on the public spending side amounting to around 5Trn yen (1% of GDP).
- Inflation net of indirect tax hikes is set to close 2014 at around 1% yoy and continue on an upward trend without however reaching the inflation target set by the central bank, namely 2% by the end of 2015.
- The BoJ is continuing with its strategy of qualitative and quantitative monetary stimulus, which up to now has produced satisfactory results, with deflation ended and a considerable depreciation of the yen. Its projections of achieving an inflation rate of 2% net of indirect tax rises are probably too optimistic, and are not endorsed by all members of the Board.
- The central bank is still, however, committed to stepping up stimulus if growth slows more than expected after the rise in consumption tax. We forecast that the securities purchases programme could be expanded in the central part of 2014, with more buying of long JGBs and high-risk assets.

Giappone - Forecast Table

	2012	2013	2014	2013				2014			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.4	1.7	1.7	-0.1	1.3	2.4	3.2	2.9	1.2	1.5	1.2
q/q annual rate				4.5	3.6	1.1	3.6	3.5	-3.2	2.4	2.2
Private consumption	2.1	2.0	0.5	4.0	2.7	0.8	2.6	3.3	-6.1	0.3	1.2
FI - private nonresidential	3.6	-1.3	3.7	-4.1	3.8	0.0	6.8	5.4	1.1	3.4	4.0
FI - private residential	2.8	7.7	2.2	9.2	1.3	11.0	3.1	0.9	-0.6	0.6	0.6
Government investment	2.2	9.2	1.9	4.6	27.9	28.9	-9.6	-5.1	6.1	-2.0	-5.6
Government consumption	1.7	2.0	2.3	2.6	2.5	1.0	1.5	1.8	2.8	4.5	2.8
Export	-0.1	2.0	9.1	16.7	12.2	-2.4	11.5	9.9	10.8	11.2	10.7
Import	5.4	2.8	7.5	4.1	7.1	9.2	7.5	10.4	3.5	5.9	9.3
Stockbuilding (% contrib. to GDP)	0.0	-0.2	0.1	-0.1	-0.3	0.2	0.2	0.2	-0.4	0.0	0.1
Current account (% of GDP)	1.1	0.9	1.0	0.7	1.9	0.5	0.5	0.5	0.9	1.2	1.5
Deficit (% of GDP)	-9.9	-9.7	-8.1								
Debt (% of GDP)	209.6	212.2	212.5								
CPI (y/y)	0.0	0.3	2.3	-0.6	-0.3	0.9	1.4	1.4	3.2	2.5	2.1
Industrial production	0.2	-0.4	6.3	2.3	6.2	7.0	11.3	6.7	2.3	4.6	4.8
Unemployment (%)	4.4	4.0	3.7	4.2	4.0	4.0	3.8	3.8	3.8	3.7	3.6
3-month CD rate	0.19	0.13	0.18	0.16	0.16	0.15	0.04	0.19	0.20	0.18	0.16
JPY/USD	79.8	97.5	105.2	92.3	98.6	98.7	100.3	104.2	106.4	105.9	104.4
Effective exch.rate (1990=100)	178.9	145.5	136.0	153.5	144.2	143.5	140.6	139.1	136.4	134.8	133.6

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

Japanese growth slowed in the central months of the year, after scoring average increases of +1% q/q in the first half of the year, with consumer spending and private investments weakening, and the foreign channel making another negative contribution. Forecasts point to a reacceleration between the end of 2013 and the beginning of 2014. In 3Q 2013, GDP growth (+0.5% q/q) was mostly driven by public investments and inventories, whereas the other components of final private demand, both domestic and foreign, showed significant weakness. Based on the indications provided by data, this slowdown is expected to prove temporary, and to be followed at the turn of the year by a reacceleration in private investments (orders are on the rise), household spending (ahead of the sales tax hike in April 2014), and exports, fuelled by the weak yen and by a moderate pickup in global growth. The second quarter of 2014 should then bring a sharp correction in the wake of the sales tax hike, followed by subsequent normalisation in the pace of growth.

On the whole, despite the expected volatility on a quarterly basis, the macroeconomic picture appears to be in line with the objectives laid out by the fiscal and monetary authorities: risks are skewed to the downside, but monetary and fiscal policy stimulus could be added to buffer any excessive reactions to the increase of indirect taxes. Growth in 2014 is forecast at 1.8%, and inflation net of the contribution of the indirect tax hikes should be close to 1% y/y at the end of 2014. The balance between structural fiscal consolidation and transitory stimulus, combined with the BoJ's ultra-accommodative monetary policy stance, lead us to think that the recovery may continue, despite the restrictive fiscal measures due to be put in place at the beginning of 2Q 2014, and that the process of exiting deflation will therefore continue.

Private demand: volatile consumer spending, investments recovering

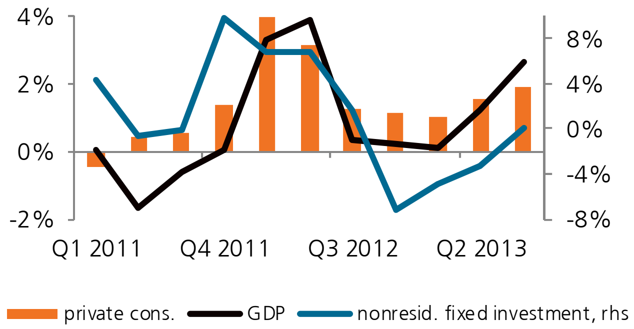
In 2014, the main factor of risk weighing on the Japanese economy will be the sales tax hike in April (to 8% from 5%). A stronger than expected reaction from consumers to fiscal tightening could interrupt the recovery, as was the case in 1997-98, following the increase of the tax from 2% to 5%. For the time being, this scenario is considered marginal by both private analysts and the economic policy authorities. Growth in 4Q 2013 and in 1Q 2014 is forecast at +0.8% q/q and +0.9% q/q respectively, driven by consumer spending growth of +0.7% at the end of 2013, and +0.8% q/q at the beginning of 2014. In 2Q 2014, consumer spending should correct by -1.2% q/q, and subsequently recover at gradual pace.

In 2014, private consumer spending is estimated to increase by 0.4%, from +1.7% in 2013, marking a change in line with 2011. Households' spending, beyond the effects of the sales tax hike, is being supported by an improving job market, by the exit from deflation, and by the easing of credit conditions. Also, the end of deflation has led to a recovery in the trend of earned income, back into positive territory since the beginning of 2013, supported not only by an increase in work hours, but also by higher nominal wages. Net wealth as a percentage of disposable income is growing consistently, allowing a stabilisation of the savings rate at its current levels, that are historically low for Japan (around 2% of disposable income).

As regards non-residential investments, the up-trend of surveys and positive data on orders, deliveries and industrial output, all point to a significant re-acceleration between the end of 2013 and the beginning of 2014. In 2013, fixed investments are expected to drop (-1.4%), due to the tail-end effects of the weakness incurred at the close of 2012; a recovery should follow in 2014 (+3.9%), with some volatility in 2Q due to the expected correction in consumer spending. In 3Q 2013, inventories made a strong contribution to growth (+0.4pp): we believe the replenishment of inventories to be intentional on the part of enterprises, to prepare for the acceleration of activity in the two quarters prior to the sales tax hike.

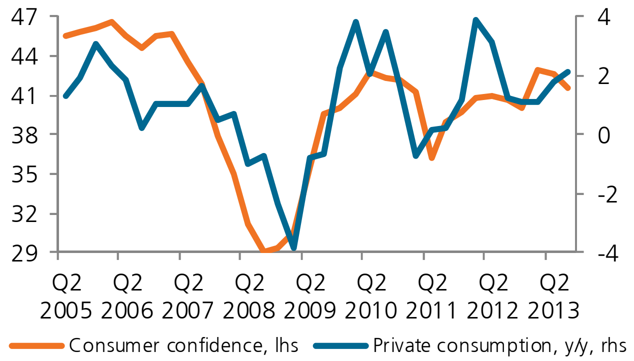
Net exports continue to act as a structural drag on growth, due to the energy component. In 2014, the JPY/USD exchange rate is forecast to depreciated by 8%, after dropping by 21.7% in 2013. Imports should grow by 7.6% in the year (vs. +2.8% in 2013) and exports, driven by the moderate expected acceleration in global growth, are estimated to increase by 9.2%. The trade deficit in relation to GDP should drop to 1% at the end of 2014, from a peak of close to 2.2% in mid-2013.

Fig.1 – GDP growth driven by consumption and investments



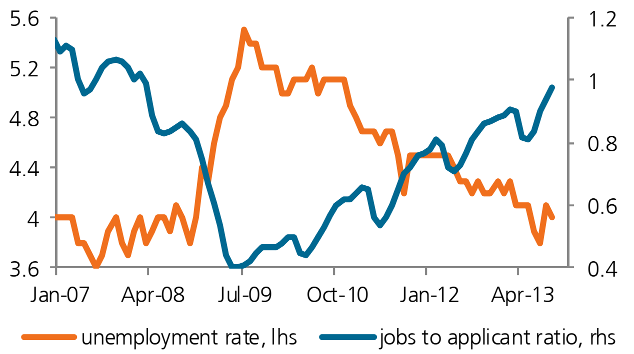
Source: Thomson Reuters Datastream. Var. % y/y

Fig. 2 – Consumption and households' confidence



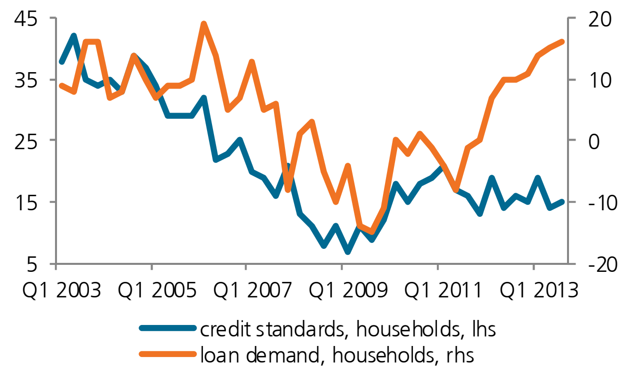
Source: Thomson Reuters Datastream

Fig. 3 – Labour market still improving



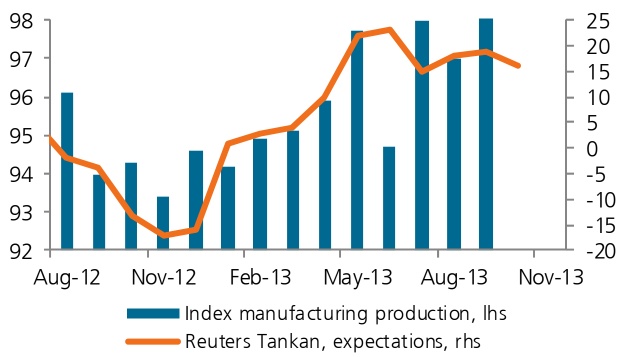
Source: Thomson Reuters Datastream

Fig. 4 – Credit conditions and demand for loans



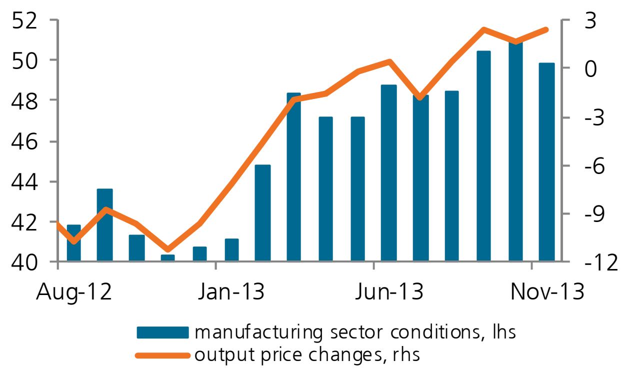
Source: BoJ. Diffusion indices: net % of banks recording an easing of credit conditions, and demand for loans from households

Fig. 5 – Industrial output expanding



Source: Thomson Reuters Datastream

Fig. 6 – Small company survey: gradual recovery



Source: Thomson Reuters Datastream

Fiscal policy at a turning point

While 2013 will mark a turnaround year for the macroeconomic picture, with return to positive growth and exit from deflation, 2014 will be a pivotal year for fiscal policy. In 2013 the **deficit/GDP** ratio should drop only slightly below the 10% mark, staying very close to the levels recorded since 2008; starting in 2014, however, the trend should reverse, with a reduction in spending/GDP, and a structural increase in revenues as a percentage of GDP. The change will not be enough to reduce the debt/GDP ratio, but should allow it to stabilise at around 212%, at least as long as the contained level of yields remains under the control of monetary policy (early 2016?). Tax revenues as a percentage of GDP are forecast to increase from 33.4% at the end of 2013 to 35.5% at the end of 2014 (+6% q/q in 2Q), and to 36.6% at the end of 2015 (+3.5% in 4Q), on the back of the two sales tax hikes in April 2014 and October 2015.

In 2014, the government will inject temporary stimulus on the spending side, balancing in part the effects of fiscal tightening in April, concentrating the new measures in the first two quarters of the year. The total package will be worth close to 5 trillion yen (around 1% of GDP), not far off the revenues expected to be generated by the tax hike (5.3 trillion yen). The details of the measures will be officially disclosed in December, with a supplementary budget for the current fiscal year (ending in March 2014). Despite the announced stimulus, the fiscal policy stance will be restrictive in 2014, with an estimated drop of the deficit/GDP ratio of almost 3 pp. The government's strategy is to put in place the necessary tightening to turn around public finances, after having restored the economy to positive growth and inflation conditions. The second sales tax hike planned in October 2015 is conditioned upon the continuation of the recovery, following the April 2014 increase. For the time being, growth in 2015 is forecast at a pace consistent with the implementation of the sales tax hike to 10% at the end of 2015.

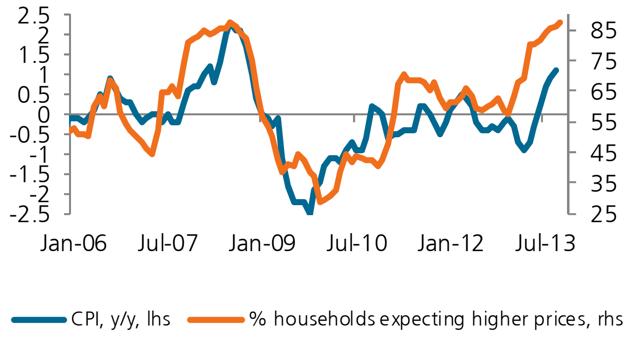
Monetary policy: 2014 and 2015 in the name of qualitative and quantitative stimulus

The BoJ is still adding quantitative and qualitative stimulus, by increasing the monetary base by 70 trillion yen a year, at least until inflation will have consistently risen to the 2% target (end of 2015). In its latest half-yearly economic outlook (31 October 2013), growth and inflation forecasts for 2014-2015 remain positive, despite the expected fiscal tightening: forecast growth in fiscal year 2014 was revised upwards from July, whereas inflation net of the sales tax hike remains in line with the 2% target, indicating that for the time being the central bank does not intend to step up monetary stimulus. The remarks made by Governor Kuroda, and the post-meeting statements, confirm in any case the BoJ's commitment to intervene in case of adverse reactions of the economy to the increase of indirect taxes.

The BoJ's asset purchase programme is rapidly inflating the share of JGBs held by the central bank, to 15.4% in June 2013 from 10.2% in June 2012. The programme provides for purchases of JGBs of around 50 trillion yen a year; net issues in the year are estimated by the government at around 44 trillion yen. The combination of the sharp increase in quantitative monetary stimulus, and of flat net issuance, will help stabilise yields on the intermediate and long ends of the curve, whereas the commitment to keep rates stable for an extended period is anchoring the short end. The entire curve remains stable despite rising inflation, keeping real rates in negative territory.

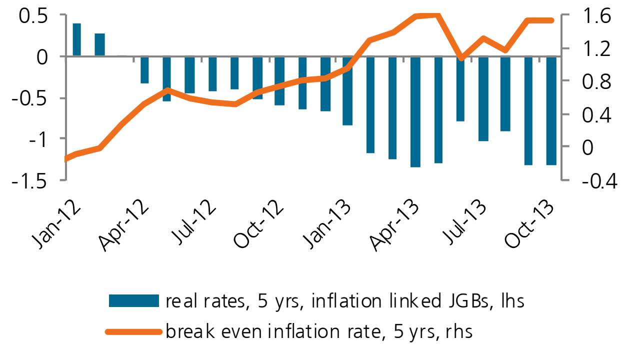
The monetary policy forecast for 2014 points to stable stimulus at its current levels at least until April 2014, with a possible increase in asset purchases in the second half of the year, should the growth trend weaken more than expected starting in 3Q.

Fig. 7 – Inflation and the expectations of households on the rise



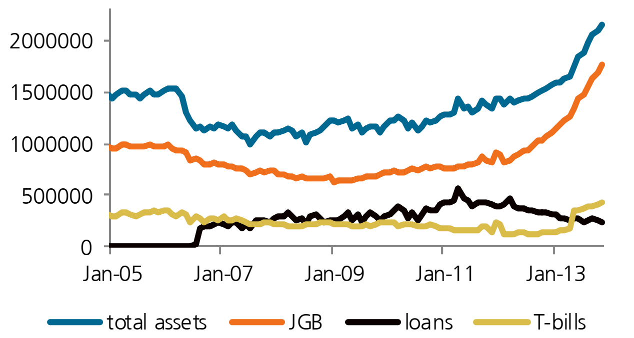
Source: Thomson Reuters Datastream, Intesa Sanpaolo elaborations

Fig. 8 – Market's inflation expectations positive, real rates negative



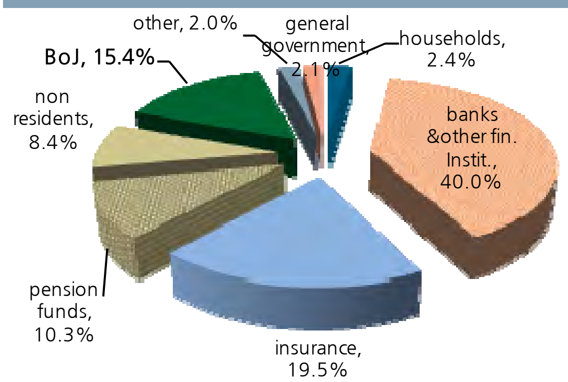
Source: Bloomberg

Fig. 9 – BoJ balance sheet up to 24% of GDP at the end of 2013, driven by JGB purchases



Source: Thomson Reuters Datastream

Fig. 10 – JGB shares by bondholder (June 2013)



Source: Ministry of Finance

Tab. 1 – Balance sheet: BoJ objectives

	end of 2012	end of 2013	end of 2014
JGB	89	140	190
Commercial paper	2.1	2.2	2.2
Corporate bonds	2.9	3.2	3.2
ETF	1.5	2.5	3.5
J-REIT	0.11	0.14	0.17
Lending programme	3.3	13	18
Total assets (including other)	**158**	**220**	**290**
Banknotes	87	88	90
Current deposits	47	107	175
Total liabilities (including other)	**158**	**220**	**290**

Source: BoJ

Tab. 2 – The BoJ's economic projections

	GDP	CPI excl. fresh food	
			Excl. sales tax
Fiscal year 2013	**2.7**	**0.7**	
prev. July 2013	2.8	0.6	
Fiscal year 2014	**1.5**	**3.3**	**1.3**
prev. July 2013	1.3	3.3	1.3
Fiscal year 2015	**1.5**	**2.6**	**1.9**
prev. July 2013	1.5	2.6	1.9

Source: BoJ

China: awaiting the reforms

Silvia Guizzo

- GDP growth rose again in the third quarter to 7.8% year on year, compared with the low of 7.5% in the second quarter. A strong performance from the farming sector boosted the supply side. In terms of demand, quarterly figures on household expenditure show a year-on-year increase in consumer spending in the third quarter, driven mainly by higher levels of disposable income among rural households. In addition, the monthly data show a slight slowdown in investments in real terms, as well as a smaller contribution from net exports.
- With the exception of an improvement in foreign trade flows, the figures for October show no acceleration on the previous month, whether in terms of retail sales, industrial production or capital investment, within which residential construction continues to slow down. PMIs remained broadly unchanged from October to November. Combined with an unfavourable base effect, this situation points to a slowdown in year-on-year GDP growth in the fourth quarter, leaving our annual growth forecast for 2013 unchanged at 7.6%, with slight upside risks of better-than-expected consumer spending.
- A gradual slowdown in monetary aggregates in the coming quarters will have a detrimental effect, particularly on investments, and will have more impact on growth in 2014, which we continue to forecast at 7.3%. The positive employment market conditions that continue to support spending will surely be affected by the economic slowdown forecast for the next two years. As these conditions worsen, there will be no chance of rapid growth in consumer spending, helping to keep inflation at around 3%. We expect growth to be broadly stable at 7.2% in 2015.
- The reforms proposed by the recent Plenum should definitely allow for a more balanced and sustainable growth over the long term, but it will be difficult to implement them given the obvious opposition of the most powerful groups, i.e. state-owned enterprises and local politicians, which benefit from the current system. In the short term, certain reforms, such as the liberalisation of energy commodity prices and public services, could trigger a temporary slowdown in growth and a rise in inflation.
- The expansion of non-banking forms of finance, the increase in non-performing loans and local authority debt, and the risk of a reversal in property prices, are continuing causes for concern for both the authorities and ratings agencies, and represent downside risks to the country's growth outlook.

Macro forecasts	2009	2010	2011	2012	2013E	2014F	2015F
GDP (at current prices)	9.2	10.4	9.3	7.7	7.6	7.3	7.2
Consumer spending	11	8.7	12.7	9.5	8.4	8.7	8.9
Public consumption	3.7	9.7	4.1	6.6	7.9	8.3	8.3
Capital investment	22.2	11.3	9.2	6.9	6.3	3.8	6.3
Exports	-11.2	25.9	4	2.9	5.6	7.3	8.5
Imports	5.2	18.4	3.3	3.7	7.7	7.6	8.4
Industrial production	9.9	12.3	10.3	7.9	7.8	7.1	7.1
Inflation (CPI)	-0.7	3.3	5.4	2.6	2.6	2.8	2.9
Unemployment	4.3	4.2	4.1	4.1	4.1	4.1	4.0
Average wages	11.6	13.4	14.4	11.9	11.4	11	10.5
1-year deposit rate	1.9	2.7	5.4	4.6	4.7	4.5	4.5
USD/CNY exchange rate (average)	6.83	6.77	6.46	6.31	6.15	6.05	6.01
Current account balance	1661.6	1604.2	874.7	1218.6	1488.7	2003.1	2246.9
Current account balance (% of GDP)	4.9	4.0	1.8	2.3	3.2	3.3	3.3
Budget balance (% of GDP)	-2.3	-1.7	-1.1	-1.7	-1.6	-2.4	-2.5

NB: Percentage change versus previous period except where otherwise indicated.
Source: Oxford Economic Forecasting and Intesa Sanpaolo

Real economy and inflation

GDP growth rose again in the third quarter to 7.8% year on year, compared with the low of 7.5% in the second quarter. This was boosted by a favourable base effect, but there was also a quarter-on-quarter acceleration for the third consecutive quarter: up by 2.2% according to figures from the National Bureau of Statistics. A strong performance from the farming sector boosted the supply side. In terms of demand, quarterly figures on household expenditure show a year-on-year increase in consumer spending in the third quarter, driven mainly by higher levels of disposable income among rural households. In addition, the monthly data show a slight slowdown in investments in real terms, as well as a smaller contribution from net exports.

In real terms, retail sales grew by the same amount in October as in September (+11.2%), slowing slightly compared with the summer. Consumer confidence, however, has gradually improved since the lows of June (97), reaching 102.9 in October mainly as a result of a sharp rise in expectations compared with current conditions. Car sales gathered pace (13.5% yoy in October) in terms of volume, while sales of domestic appliances continued at the same rate and clothing sales slowed down.

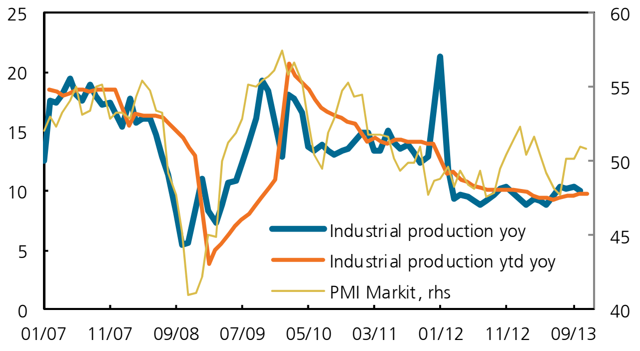
Industrial production gradually accelerated from the low point of June (8.9% yoy), reaching a high of 10.4% in August and falling back by just 0.1 percentage points in October. The manufacturing sector grew by 11.4% yoy in October, while there was also a rise for the metals sector but a slowdown in the mining sector. There was acceleration in machine production (especially in the transport sector), but deceleration in textile production. We can deduce, therefore, that heavy industry[14] has continued to play a major role in the recovery, as suggested by the improvement in the large companies' PMI, the stability of the medium-sized companies' PMI (which is just above 50) and the further deterioration in the small businesses' PMI. The PMI used by the National Bureau of Statistics improved from 50.3 in July to 51.4 in October, but it remained unchanged in November. There is a similar trend in the PMI used by Markit, although it is slightly lower at around 50. Although it continues to rise year on year, the pace of electricity production has slowed in the last three months compared with the previous quarter. As a result, there are no signs of a rapid acceleration of activity, as also suggested by the data on capital investment. Growth in capital investment has remained stable since June (20.1% yoy), while investment in real estate (particularly residential property), has continued to slow. Manufacturing investment, however, recorded a slight acceleration, while investment in transport infrastructure slowed marginally.

Residential property prices have continued to climb in most cities. Average month-on-month changes were slightly lower in October, but they were above average in more than half the major cities where prices were recorded. Year on year, prices continue to rise sharply: in many cities, they are increasing by more than 10% yoy, with rises of more than 20% yoy in the largest cities such as Shanghai, Beijing, Guangzhou and Shenzhen, prompting some local authorities to announce the introduction of new anti-speculative measures in November. Although slowing down, residential property sales in terms of surface area continue to grow quickly (+21.8% yoy in October), while the surface area of vacant residential property awaiting sale also continues to rise (+40.7% yoy). Although it remains higher than in 2012, property developer confidence is starting to fall slowly, and several major developers are seeking to diversify their portfolios by buying properties abroad[15].

[14] In order to bring itself into line with international standards of classification for economic sectors, the National Bureau of Statistics has not published a breakdown of heavy and light industry since July.

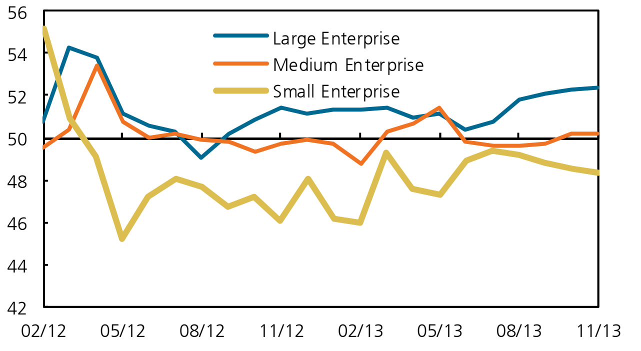
[15] See "Haunted housing", in *The Economist* issue dated 16 November 2013.

Industrial production marginally recovering



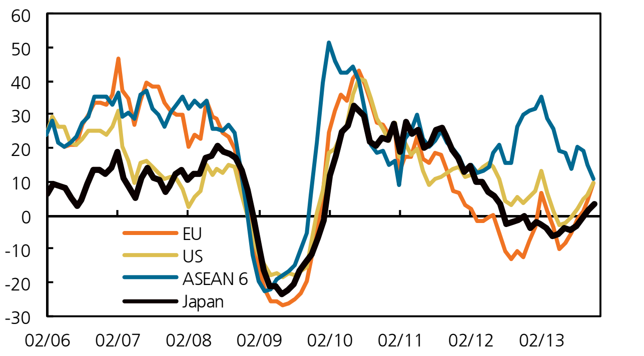
Source: CEIC, Markit

Small businesses are still finding it difficult



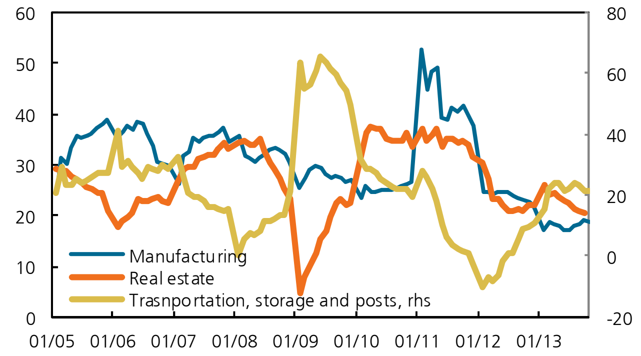
NB: Manufacturing PMI; source: CEIC

Exports improve



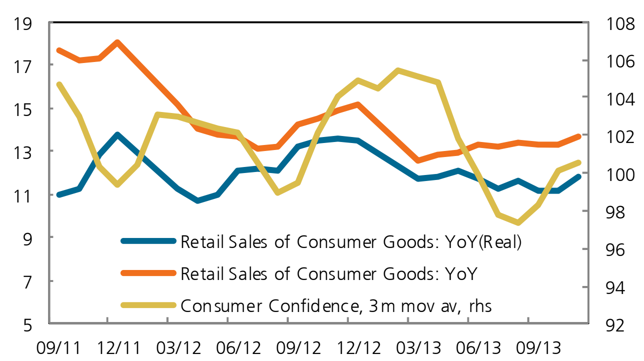
NB: Chg. % 3m yoy. Source: Intesa Sanpaolo chart from Bloomberg data

Transport and real estate drive investment (%)



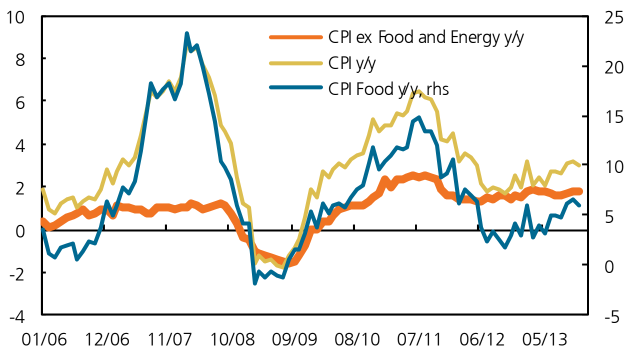
NB: Nominal investments, chg. yoy. Source: Datastream

Consumer confidence grows



Source: Intesa Sanpaolo chart from Bloomberg and CEIC data

Food prices start to climb again



Source: Bloomberg

Foreign trade figures show a rise in imports and, to a lesser extent, exports. Exports to the EU, the US and Japan are accelerating moderately, while those to ASEAN countries are slowing down. Imports are gathering pace with the exception of those from the ASEAN countries, which continue to fall. The acceleration of imports is driven by a sharp increase in ordinary products, commodities and some metals, while imports of machines and manufactured goods are slowing. This means that the rise may be coming not from a true increase in domestic demand but from a need to rebuild stocks of commodities, particularly while prices are falling, given the lows recorded by the Shanghai futures market for some metals. Although it is rising, the quarterly average for the foreign-orders component remains only just above 50. Total goods traffic continues to grow robustly (+10.5% yoy in October), although rail cargo is slowing.

Inflation rose from 2.6% yoy in August to 3.1% in September and then 3.2% in October. The October figure suffered from an unfavourable base effect, while the rise in the previous months was due to higher food prices (+6.5% yoy), particularly vegetables. Food prices are expected to rise further ahead of the Chinese New Year celebrations (February 10-15), which will affect the inflation figure for February. Inflation should then start to slowly fall again as a result of lower meat prices (+18.8% yoy in October) and no demand pressures. Producer prices and factor prices continue to fall, while inflation excluding food prices is low and remains at 1.6%, and inflation excluding food and energy prices is climbing only marginally (+1.8% yoy).

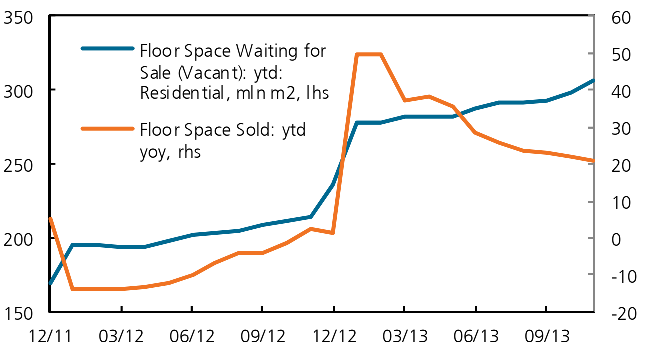
Economic, monetary and exchange rate policy

In November, the Central Committee of the Communist Party of China published a document outlining the major reform programmes for the coming years[16]. The fundamental principle underlying the reforms concerns the role of market forces in guiding the economy, which has gone from being previously described as "basic" to "decisive", in a socialist market economy where the private sector is called on to assume as much importance as the public sector, and the state to take on a strong supervisory and regulatory role, favouring transparency in decision-making processes and greater power of control by citizens. The document covers a broad range of areas, setting out proposals not only for economic and fiscal reform, but also for legal and socio-political reform. It does not provide details or a specific time frame for their implementation, but proposes to achieve "decisive" results in the most important areas of reform and in the key sectors by 2020. The proposed reforms should definitely allow for more balanced and sustainable growth over the long term, but it will be difficult to implement them given the obvious opposition of the most powerful groups, i.e. state-owned enterprises and local politicians, which benefit from the current system. In the short term, certain reforms, such as the liberalisation of energy commodity prices and public services, could trigger a temporary slowdown in growth and a rise in inflation.

We expect to get more details on the direction of economic policy for 2014 from the Central Economic Work Conference scheduled for mid-December. Even if it is not explicitly stated, the growth target is likely to be between 7% and 7.5%. A lower rate of growth would start to weigh on unemployment, which so far does not appear to have been affected by the economic slowdown. The number of employed people in urban areas rose by 5 million from the second quarter to the third quarter, and the urban unemployment rate dropped from 4.1% to 4.0%. The average wage increased by 10.8% yoy in the third quarter (+10.7% in the second quarter), and in cities demand from companies for work continues to outweigh supply. The employment market remains more healthy in the services sector, where the employment component of the PMIs is low but above 50, than in the manufacturing sector, where it has been below 50 since April. Prime Minister Li Keqiang has stressed that only growth of more than 7.2% will sustain adequate employment levels. Fiscal policy in 2014 should continue to be "proactive", i.e. to support income (particularly in rural areas) and to increase the proportion of spending dedicated to social services, with the launch of some concrete measures in line with the proposed reforms, such as another rise in the percentage of dividends that state-owned enterprises will have to pay to the state, a measure that has been discussed for some time. In February, the Chinese government approved an increase of five percentage points in the dividends/revenue ratio in terms of dividends to be paid to the state. In the wake of this, the pilot reform of VAT is being gradually extended, including as of January 1 to rail and postal services.

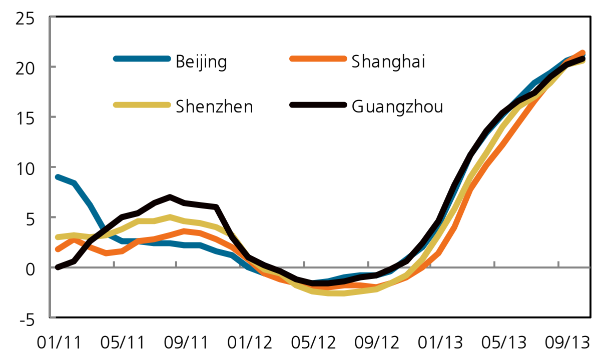
[16] See Focus.

Residential property: stock of unsold property remains high



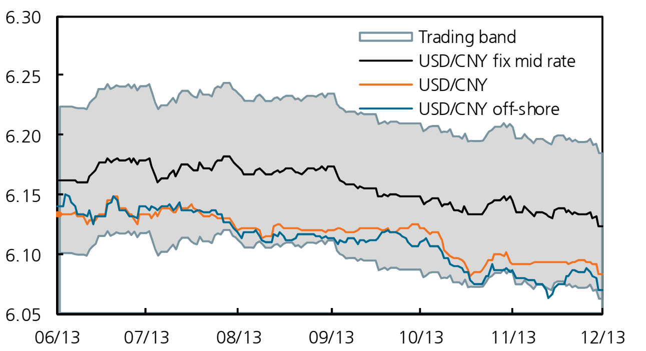
Source: Bloomberg, CEIC

Residential property prices continue to rise



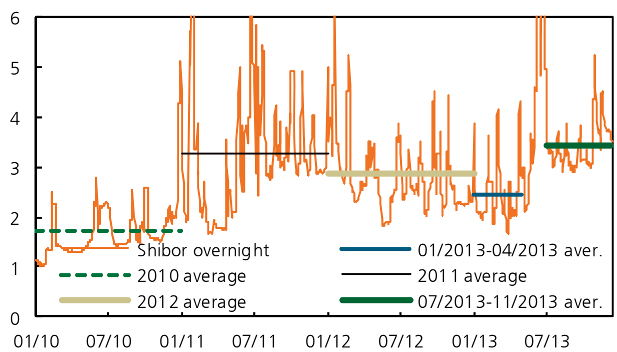
NB: yoy % changes. Source: CEIC

The CNY is appreciating slightly against the USD



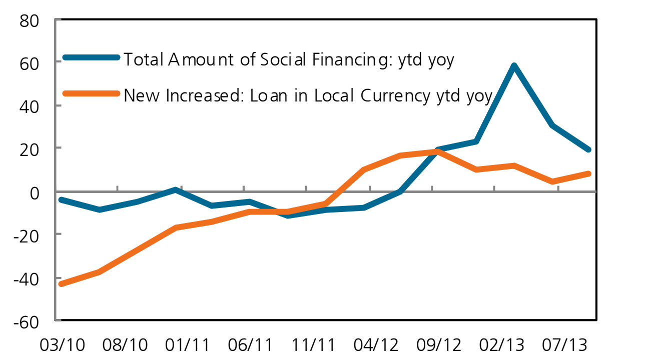
Source: Intesa Sanpaolo chart from Bloomberg data

Money rates remain higher than in the past



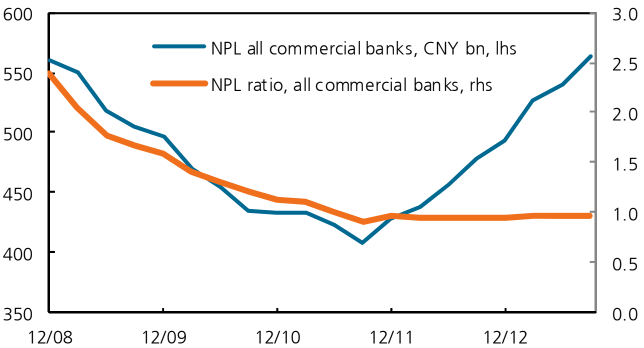
Source: Intesa Sanpaolo chart from Bloomberg data NB: Graph cut off at 6%.

The flow of credit slows



NB: Cumulative quarterly data since the start of the year, % yoy changes. Source: CEIC

Non-performing loans continue to rise



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

We expect financial reforms to continue in 2014, specifically via the implementation of the measures announced before the plenum, i.e. the creation of privately owned banks, the creation of large-scale deposit certificates that can be traded on the interbank market and the introduction of insurance on deposits. Although it will continue to be described as "prudent", monetary policy will in fact be restrictive and implemented as usual through transactions on the open market. Money market and repo rates remain higher than at the beginning of the year, in spite of better market liquidity.

We expect the deposit rate ceiling (currently 10% above the benchmark) to be increased during 2014, but full liberalisation is unlikely before the introduction of insurance on deposits. New lending increased by 8.3% yoy on a cumulative basis in the third quarter, representing an acceleration compared with the second quarter (+4.6%) but a slowdown compared with the same quarter of the previous year (+18.3%). Monthly figures show a slowdown in October. The total aggregate flow of social finance continues to slow rapidly, growing by 13.9% yoy on a cumulative basis in October compared with 30.6% in June and 22.8% in the first 10 months of 2012. However, as a percentage of GDP, the flow of social finance in the first three quarters of the year was 36.1%, up compared with 33.2% in the first three quarters of 2012, sustaining investment. The survey of industrial companies shows a deterioration in general economic conditions in the third quarter, but in the second quarter (details of the third quarter have not yet been published) the component showing the willingness of banks to lend money rose sharply to reach record highs. However, there was only a small increase compared with June in companies' demand for bank loans. Monetary policy will continue to discourage rapid growth in lending, which will further slow the Chinese economy in 2014 and prevent the CNY from appreciating sharply.

Having remained at around 6.12 throughout the summer, the USD/CNY exchange rate fell by 0.6% between October 8 and 24, arriving at around 6.08; it returned to that level at the beginning of December following a temporary rise. The central bank's foreign-exchange reserves rose by USD165.9 billion in the third quarter, while the banks' foreign-currency net purchase position increased by USD71.9 billion in October, signalling heavy capital inflows that have also been a feature of other emerging countries after the US Federal Reserve appeared intent on further delaying the scaling back of its asset-purchasing programme. We expect a more volatile exchange rate in line with the authorities' wish to give market forces and fundamentals a greater role in determining the rate; however, we also expect that the authorities will continue to step in to prevent excessive appreciation, particularly if the recovery in global demand is weaker than forecast.

The Third Plenum and the reforms proposed

What is the Third Plenum?

The Central Committee[17] of the Communist Party of China, elected during the first plenary session of the 18th Party Congress in November 2012, met behind closed doors in its third plenary session from 9 to 12 November 2013. The second plenary session was held from 26 to 28 February 2013 to formalise the candidacies for the National People's Congress, which in March re-elected the highest offices of the state, and to discuss the reforms of the State Council and the administration of central government. The Second Plenum is usually dedicated to internal political and administrative issues, while the third plenary session, by which time the newly elected political leadership is more firmly established, generally focuses on wider political and economic discussions. For this reason, it is considered more important even though it has not always been notable or heralded significant reform. With the exception of the first year, the Central Committee usually meets only once a year, in the autumn.

Given the scope of the proposed reforms, this third plenary session has been compared to two other third sessions that gave rise to very significant reforms for the Chinese economy: a) the Third Plenum of the Central Committee of the 11th Communist Party Congress, held in 1978, two years after Mao Zedong's death, when Deng Xiaoping introduced the policy of "reform and opening up", outlining rural reform and opening the country to foreign investors; b) the Third Plenum of the Central Committee of the 14th Communist Party Congress, held in 1993, four years after the Tiananmen Square protests, when Zhu Rongji launched the first major reforms of state-owned enterprises and gave official and broad support to the "socialist market economy",

[17] Comprising 372 members: 205 full-time and 167 alternate members.

opening the way to the privatisation of small and medium-sized state-owned companies and keeping the largest and most important under state control, with the motto "grasping the big and letting go the small".

The documents paving the way for reforms

The reforms set out in the recent plenum communiqué are not completely new. They relate both to the principles of the 12th five-year plan and to the reforms and action plans proposed in two recent documents to which the director of the National Development and Reform Commission (NDRC) and the head of the Central Leading Group on Financial and Economic Affairs, as well as the director of the Development Research Centre[18] (DRC) of the State Council, Liu He, an economist appointed by Xi Jinping and his close adviser, contributed. First, there is the document published by the World Bank in cooperation with the DRC in 2012, "*China 2030: Building a Modern, Harmonious and Creative High-Income Society*" and second, the document entitled "*Plan 383*". The latter document, produced by the DRC, some extracts of which were published at the end of October, clarifies three principles or general areas of reform (market, state, companies), eight key sectors and related priority reforms, and three general strategies to implement them (hence the name).

The general principles of the proposed reforms

The third Central Committee plenary session published a document of 22,000 characters entitled "*Decisions of the Central Committee on Major Issues Concerning Comprehensively Deepening Reforms*", which was also accompanied by a statement from President Xi Jinping illustrating the reform proposals it contains. The fundamental principle that marks the document concerns the role of market forces in guiding the economy, which has gone from being previously described as "basic" to "decisive", in a socialist market economy where the private sector is called on to assume as much importance as the public sector, and the state to take on a strong supervisory and regulatory role, favouring transparency in decision-making processes and greater power of control by citizens.

According to many commentators, the document shows the increasingly dominant political influence of President Xi, who at the same time announced the creation of the Central Party Leading Group on Comprehensively Deepening Reform and the National Security Commission (NSC). The Leading Group, which may be headed by President Xi or Prime Minister Li, is tasked with drawing up more detailed plans for the reforms, coordinating and promoting the various reform measures, and supervising and pushing forward their implementation. The NSC's objective is to improve the national security system and related strategies.

The most significant reform proposals

The document covers a broad range of areas, setting out proposals not only for economic and fiscal reform, but also for legal and socio-political reform. It does not provide details or a specific time frame for their implementation, but proposes to achieve "decisive" results in the most important areas of reform and in the key sectors by 2020. In short, the wider objectives relate to judicial and fiscal reforms, to reforms that affect various rights and aspects of the lives of China's population, particularly people in rural areas, to lowering entry barriers for private and/or foreign investors in certain sectors traditionally dominated by the state, and to environmental sustainability.

Judicial reform

The most significant new developments in terms of judicial reform concern the field of human rights. The document proposes the gradual reduction of crimes carrying the death penalty and the abolition of labour camps for "re-education" in which thousands of citizens are held,

[18] An official committee of experts serving the government.

particularly activists and religious people, without trial for up to four years. According to the United Nations, 190,000 people were held in labour camps in 2009. The document does not deal with other very common forms of extra-judicial detention, but notes the need to have judicial jurisdiction systems separate from administrative power, in which local judges are no longer controlled by and dependent on local politicians, as happens now. Judges' dependence on the executive power and local legislature is in fact the main cause of the corruption that has become widespread among judges and magistrates, and is a source of oppression for citizens. The recent Opinion of the Constitutional Court on Judicial Reform published at the end of October also goes in this direction. The document also states that it wants to promote the development of "social organisations", meaning, in essence, the heavily opposed non-government organisations (NGOs). These have long been considered a dangerous vehicle for the spread of western political ideas and sources of subversion, but their capacity to provide assistance to the sick, the old and the poor is beginning to be recognised, with the ageing population and the need to extend welfare and healthcare services expected to weigh quite significantly on the public accounts in the next few years.

Fiscal and tax reform

As regards fiscal reform, the document makes reference to the need for greater transparency in public finances, which should be clearer and presented in a unified manner[19], but above all to the need for a redistribution of the spending responsibilities and the tax-levying authority and capacity of local governments and central government. Currently, public spending is extremely decentralised, while tax revenues are heavily centralised. Local governments are responsible for 80% of public spending, providing public services, such as healthcare and basic education, pensions, unemployment benefits and accident compensation, public housing, infrastructure maintenance and support to those on a minimum wage. However, local governments' tax revenues, available through a sharing mechanism with central government and intergovernmental transfers, are not commensurate with their spending responsibilities. On average, local governments' share of tax revenues from central government amounts to only 40-50% of spending. Furthermore, they are not legally entitled to freely issue debt securities to raise funds or take out bank loans. To raise funds, they have therefore been encouraged to sell land rights – a significant source of funding – and to create vehicle companies through which to issue bonds or borrow money from banks, often offering the land as collateral. Moreover, the transfer of funds to other local bodies within the province[20] is completely discretionary and decided by the provincial government.

The document also states that it is necessary to reform and improve tax legislation as only three of the 18 categories of taxes in China are currently regulated by the National People's Congress (China's parliament) acts, while the others are defined only by regulations issued by the State Council (the government)[21]. Finally, the reform plan pushes for the introduction of an annual tax on property values, which would provide a secure and stable source of tax revenues for local governments. Currently, there are only taxes on the value of property transactions (from 1% to 2%) and, in some cities, on the capital gain generated by the transaction (20% in Beijing). Under a pilot project launched in 2011 in Shanghai and Chongqing, the cities are permitted to collect a value-based property tax, but this applies only to new-build residential property and luxury and second homes.

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[19] China currently presents four kinds of public accounts: "general", which accounts for the bulk of public spending, including the revenues shared with the provinces and fiscal transfers thereto; "government-funded", which includes off-budget expenses and revenues; "state capital", which is financed by dividends from state-owned enterprises; and the "social security fund budget".
[20] Sub-provincial local organisations, prefectures, counties, towns and villages.
[21] See: "The Government's Budget Revolution" at www.caixin.com

From a social viewpoint, but with significant economic consequences, the document's main objectives concern the partial reform of the household registration (*hukou*) system and of rural land use rights, and the easing of the one-child policy.

Household registration

Currently, Chinese citizens may be resident in an urban or rural area; a person who moves to a city without obtaining the residence document, thereby remaining resident in their area of origin and being a "migrant", loses the right to basic social services such as welfare and healthcare, and access to education in their new city. The problem is becoming greater given the massive presence of migrant workers in cities. According to the Economist[22], around 40% (270 million people) of people living in urban areas had a household registration in a rural area in 2011. The services offered by local authorities are in any case much more widespread and of higher quality in the cities compared with the countryside. All this has helped create strong discrimination both between urban and rural residents, and between urban residents and migrant workers. Acquiring a residence permit in a city is very expensive and complicated because many municipal authorities, which must cover the costs of basic social services, are reluctant to grant them. They fear that migration will spiral out of control, particularly in the larger cities that offer the best services, which will have a serious impact on the already stretched local public finances. Urban residents are also ill-disposed to sharing services with the new arrivals, fearing a decline in the quality and quantity of services provided to them. The proposed reform envisages the abolition of the need for the *hukou* in the smaller cities and the easing of regulations in medium-sized cities, while the system will remain in force in the larger cities, although various experiments are already in place in many provinces.

The strengthening and protection of rural property rights and the creation of a single property rights market

As well as not being able to enjoy the rights of urban residents migrants have a further problem: they cannot even completely enjoy the property rights on their own land and houses in the countryside. The Chinese constitution sets out three types of property: state, collective and private. The ownership of rural and suburban land is collective, and rural residents are assigned individual property use rights[23] that may be sold according to the terms established by law with the collective's consensus. Conversely, in the case of urban areas, property use rights are valid for 70 years and may be freely sold. According to the Property Law (2007), all three types of property have the right to the same level of legal protection. This law categorises the rights of use of rural residents as property rights, i.e. as real rights, rather than contractual rights, as they were defined in previous laws[24]. The Property Law provides that property rights are guaranteed, may be exercised in accordance with the law, and may not be violated by any body or individual. It therefore offers greater protection to rural property rights than in the past. Nevertheless, forms of property right enjoyment and protection remain weak in the countryside. Rural residents still cannot mortgage their property rights on land and cannot therefore apply for loans, although experiments have been launched in some towns, nor can they freely transfer the rights without the collective's or local authority's approval. Migrant rural residents may not sell their house to buy another in the area to which they are moving. Furthermore, they may not sell the right of use to the land directly to property developers, and they remain at the mercy of requisitions of agricultural land conducted by the local authorities at their discretion. These authorities change the intended use of the land, designating it as buildable, to then sell it to developers. The expropriation of land by local authorities has become one of the main reasons for social protest in the last few years, also because local governments offer rural residents very

[22] See: "A world to turn upside down", The Economist, 2 November 2013.
[23] From 1998 for a period of 30 years for cultivated land. In 2008, the Party's "Decision on Important Issues Concerning Rural Reform and Development" extended it for an unlimited period, but it has not yet been converted into law.
[24] Specifically the Rural Land Contracting Law of 2002. For further details, see chapter 6 in *China 2030: Building a Modern, Harmonious and Creative High-Income Society,* World Bank 2012.

low levels of compensation based on the agricultural value of the land[25], while when they sell the land use rights to property companies for construction, they value it at market prices, which are much higher. Some innovative compensation measures, currently being tested in some areas, provide for access to basic social services in exchange for the transfer of the right of use to the local authority. The proposed reform is to make property use rights transferable in rural areas and in the long term put them on the same footing as property rights in urban areas, thereby creating a single property rights market. The document also sets out a reform of expropriation procedures, with a strict definition of local authorities' expropriation rights and the cases in which they may be exercised. The reform is undoubtedly important because in the medium to long term, along with the reform of *hukou,* its implementation will guarantee people more freedom of movement and access to basic social services, the fundamental requirements for greater urbanisation and higher household consumption. All this will however require a long time to define and implement, owing not only to the opposition of local governments and urban residents, but also to the practical difficulty of redefining the land register and proceeding with the extensive registration of property rights and land values, at present far from completion, particularly in rural areas.

Reform of the one-child policy

The working-age population (15-63 years old) fell for the first time between 2011 and 2012, while the percentage of pensioners (over 65) is increasing rapidly and the fertility rate is falling, partly because of the male/female disparity (1.17 on average in the five-year period 2005-2010 compared with 1.08 worldwide). The decline in demographic indicators, which is considerable if compared with other emerging countries at the same stage of development, has prompted the Party to propose a further easing of the one-child policy. Introduced in 1979, this policy is not implemented strictly everywhere. In rural areas, people are permitted to have two children if the first is a girl, while in urban areas, since 2011, couples have been allowed to have two children only if both parents are an only child; other exceptions relate to ethnic minorities. The reform proposes that couples in which only one parent is an only child may also have a second child. According to some analysts, this measure could lead to 1,000,000 more babies a year on average in the next few years, which is an insignificant increase. Furthermore, with the rise in urbanisation and industrialisation, many couples are already opting to have only one child, even though they are entitled to have two. In any event, the effects on the workforce will be visible only in about 20 years' time.

The financial sector

The reforms concerning the financial sector are not new and are in part already being implemented. Some reforms have been mooted since the summer, such as the launch of privately owned banks, while others had already been announced (the future introduction of insurance on deposits) or had in part already been launched (the internationalisation of the yuan and the liberalisation of interest rates). The document reiterates that the liberalisation of interest rates and the convertibility of current accounts must be accelerated. It highlights in general the need to redefine a capital market system on several levels, i.e. to promote greater access to the capital market for companies through the issue of bonds or shares, and to move to a share-issuing system based on registration. The main new development concerns procedures for initial public offerings (IPOs). Under the current system, the China Securities Regulatory Commission examines every single bid and assesses if the company is suitable for placement, a process that can take years. Furthermore, IPOs have been suspended since October 2012, owing to the excessive volatility and slump of the stock market. The reform, to be implemented gradually, would see the adoption of a simple registration system, in which the regulator checks only if the company's financial statements and public documents comply with accounting requirements

[25] At the average agricultural value of the last three years multiplied by the duration of the right of use, therefore generally 30 years.

and the law, but does not give assessments of the company or the operation itself; these will be left to the market.

The opening up of sectors traditionally dominated by state-owned enterprises to private and foreign investors

The document highlights that all types of investor will be given equal access to the market: state, private and foreign, in all sectors except for those included on the list of prohibited investments. It will therefore be possible to launch a new company based on registration and no longer on approval, along the lines of the experiment recently conducted in the Shanghai Free Trade Zone (FTZ). In particular, service industries, specifically those of finance, education, culture and healthcare, will benefit from a gradual and orderly opening to foreign investment (and private domestic investment), while existing restrictions on childcare, pensions, architectural design, accounting and auditing, trade and logistics, and e-commerce will be eased. There are also plans to create other free trade zones in major cities or surrounding areas, in order to test the reforms before rolling them out over the entire country. The document also mentions the need for greater protection of intellectual property rights with a plan to create dedicated courts.

The market's role in supporting environmental sustainability

The document targets greater competitiveness and expresses the desire to let the markets determine all the prices that it is able to determine, particularly those of energy commodities such as oil, coal, gas and fuels, but also electricity, transport and telecommunications. Commodity prices, particularly energy, have to date been set by the government, to the great benefit of manufacturing and heavy industry, particularly state-owned enterprises. The reform, which will lead to greater efficiency in resource allocation, is intended not only to further open up the country to the market economy, but also to promote environmental sustainability. Administered prices have not yet been allowed to incorporate negative external factors, and have favoured not only the formation of excess capacity in some industries, but also the excessive exploitation of natural resources and a very high level of pollution and consequent environmental damage. The document places emphasis on the concept of "ecological civilisation", considered the key to more sustainable economic development and the protection of the environment, and calls for the acceleration of pilot reforms to introduce an environmental tax and environmental compensation mechanisms to regulate CO_2 emissions and redefine water rights. It also calls for local administrators no longer to be assessed solely on the basis of GDP growth, which has been the case until now, but also on the basis of indicators relating to the quality of growth, which range from environmental sustainability objectives to the provision of social services and employment, in line with the recent draft amendment of the Environmental Protection Law.

The crucial role of state-owned enterprises in the socialist market economy

According to the document, state-owned enterprises (SOEs) will continue, however, to play a key role and will remain the "main body" in strategic sectors of the "socialist market economy with Chinese characteristics". Analysts consider this to be highly controversial, because it is deemed to go against the objective to allow the market to take on a "decisive" role. However, the need expressed for reform of the market supervision and control system and for a state regulator and supervisor should guarantee equal opportunities to all types of company. The main problem is not so much the strong presence of state-owned enterprises in the economy, but their strong connections with political power, inefficient management, the lack of accounting transparency and the absence of a bankruptcy procedure, as well as the high level of corruption. Details on the reform of SOEs have been limited. The biggest new development concerns the increase to 30% of the percentage of dividends that must be paid to the state – currently between 10% and 15% – in order that they make a greater contribution to state finances by 2020. The document also mentions a proposal to manage SOEs – also put forward in "Plan 383"– through state investment funds, similar to the system in force in Singapore through the Temasek sovereign wealth fund.

Conclusions

Analysts and markets have warmly welcomed the plan because the proposed reforms promote more balanced and sustainable growth in the long term, with a greater contribution from private consumption and services, although in the short term, some reforms (such as the liberalisation of energy commodity prices and public services) could trigger a temporary slowdown in growth and a rise in inflation. The detailed definition of the reforms and their implementation will however take a long time and be strewn with obstacles given the obvious opposition of the most powerful groups, i.e. state-owned enterprises and local politicians, which benefit greatly from the current system. The sequence of reforms is also a crucial and determining factor. A reform of *hukou* without greater protection of rural property rights and greater tax-levying powers for local governments, or a greater contribution to social services from central government, would be difficult to implement. The China 2030 document suggests that higher priority should be given to reforms that already enjoy widespread support among the people and that will meet little resistance, such as those regarding citizens' greater participation in reform processes, the greater respect for human rights and the introduction of qualitative indicators in the assessment of local administrators. This should be followed by reforms that lead to immediate advantages and reduce short-term economic risks (such as the liberalisation of lending and deposit rates, the increase in dividends from SOEs and the regulation of land expropriation) and, finally, reforms concerning the state's system of taxation.

India: has growth bottomed out?

Silvia Guizzo

- GDP was up 4.8% yoy in the third quarter, above expectations and rising faster than the low point of 4.4% in the second quarter. On the demand side, a strong positive contribution from the foreign channel came along with marginal improvements in capital investment and consumer spending. On the supply side, after several weak quarters, the farming sector performed better than expected (+4.6%), boosted by the favourable summer monsoon.

- The manufacturing sector seems to have bottomed out in the second quarter, as suggested by the industrial production data for October and the improvement in the PMI in November. The same would appear to be true for investments, which should continue to benefit from the renewal of previously blocked projects and new authorisations. However, the recovery will remain tentative, affected negatively by falling business confidence in the fourth quarter and high levels of corporate debt. Falling consumer confidence and high inflation make it hard to predict whether consumer spending will recover in 2014. The foreign channel, however, should continue to contribute positively to growth. We are slightly upgrading our growth forecast for 2013 from 4.6% to 4.8%, and we continue to expect a slight acceleration of growth in 2014. A stronger recovery is predicted only from 2015, with greater contributions coming from consumer spending and investments.

- The expected drop in food prices in 2014 and a favourable base effect will be offset by higher administered energy prices and by currency depreciation. Despite the predicted fall, consumer price inflation will thus remain high at 9% on average in 2014. We expect the RBI (Reserve Bank of India) to raise rates by another 25 bps around the turn of the year. Monetary policy can be relaxed only from the second quarter of 2014, together with a corresponding tangible improvement in inflationary dynamics.

- India is in a slightly better position than it was during the summer owing to an improvement in the current account balance, the RBI's interventions, the public deficit being only fractionally higher than expected in the current financial year and the prospect that growth bottomed out during the second quarter. However, volatility factors on the international markets leave the risks of financing the current account balance unchanged, which limits the scope for intervention by monetary policy. Exchange rates will therefore remain under pressure in the next few months, affecting the balance sheets of banks and businesses, with a knock-on negative effect on economic growth, which is already showing signs of weakness.

Macro forecasts

	2009	2010	2011	2012	2013E	2014F	2015F
GDP (constant prices, at factor cost)	6.5	9.7	7.5	5.1	4.8	5.2	5.7
Consumer spending	6.9	8.6	7.3	5.3	1.7	3.9	6.3
Public consumption	9.2	8.1	7.8	5.8	5.3	7.5	6.7
Capital investment	-0.7	17.5	6.2	1.5	0.8	4.8	5.4
Exports	-7.7	15.4	18.3	6.6	8	10	9.7
Imports	-8.3	18.2	18.4	11.7	1.5	5.1	7.3
Industrial production	0.2	9.7	4.8	0.7	1	2.5	6.4
Inflation (CPI)	10.9	12	8.9	9.3	11	9	8.1
Unemployment	12.5	12.5	12.5	12.5	12.3	11.9	11.8
Average wages	9.1	21.4	16.3	9.2	11.3	11.3	10.3
1-year loan rate	5.5	6.3	9.5	9.5	9.4	7.7	7.8
USD/INR exchange rate (average)	48.37	45.74	46.69	53.48	58.40	61.0	59.0
Current account balance	-1247	-2396	-2958	-4894	-3447	-3679	-3769
Current account balance (% of GDP)	-2.0	-3.2	-3.4	-5.0	-3.1	-2.9	-2.6
Budget balance (% of GDP)	-7.0	-3.8	-6.7	-5.5	-5.0	-3.7	-2.9

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

Real growth and inflation

GDP was up 4.8% yoy in the third quarter, above expectations and rising faster than the low point of 4.4% in the second quarter. On the demand side, a strong positive contribution from the foreign channel came along with marginal improvements in capital investment and consumer spending. On the supply side, after several weak quarters, the farming sector performed better than expected (+4.6%), boosted by the favourable summer monsoon.

After a fall in the second quarter, the manufacturing sector resumed marginal growth. There was slight growth in industrial production during the three summer months, climbing by 2.0% yoy in September, boosted by the production of non-durable consumer goods and intermediate goods, as well as by infrastructure and the energy commodities industry. Production of capital goods, however, continued to decline. Having been below 50 for three months, the manufacturing PMI rose to 51.3 in November, owing mainly to the total orders component climbing to 51.9. Domestic goods traffic is increasing gradually.

However, the business confidence survey carried out by the Reserve Bank of India on industrial companies paints a different picture. While their assessment[26] of fourth-quarter production remained largely unchanged, their assessment of orders, used capacity, imports and exports deteriorated significantly. In the third quarter, the synthetic index assessing the current situation dropped below 100 - the threshold between business growth and contraction - for the first time since mid-2009, while the index relating to fourth-quarter forecasts declined following two stable quarters. It could be the case, however, that this survey was affected too much by the summer exchange rate crisis and did not factor in the improvement of the last two months. Indeed, the Dun & Bradstreet index for the fourth quarter shows a slight improvement in confidence, although the order assessment continues to decline. Industrial production may therefore have halted its decline and recorded growth, albeit weak, in the fourth quarter. We expect investments to follow a similar pattern, since they should benefit from the renewal of certain previously blocked projects and from new authorisations by the Cabinet Committee on Investment.

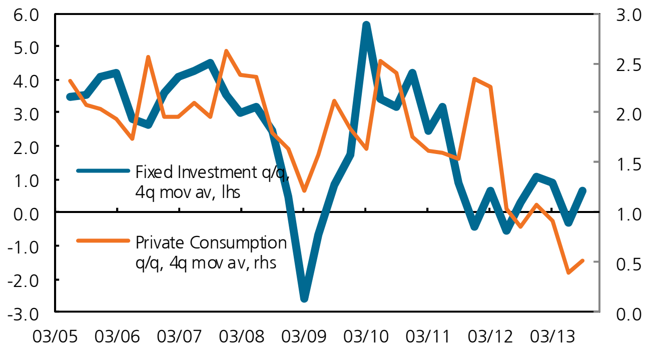
While imports continue to decline (-14.5% yoy in October; -22.8% yoy net of oil), exports continue to grow strongly (+13.5% yoy in October), particularly exports net of oil (+21.6%). This enabled a significant reduction in the trade deficit from the second to the third quarter (in FOB-CIF terms). The decline in the monthly figures for October is attributable to the dynamic of the oil trade balance deficit. Machine imports continue to decline, with the exception of electrical machines, which are on the up together with transport equipment, issuing a positive signal about investments. After rising to 52.3 in October, the foreign-orders component of the PMI dropped to 50.6 in November, but being above 50 it still bodes well for exports, which in 2014 should also benefit from an expected recovery in demand from the US, India's biggest export market after the European Union.

The services PMI remained broadly unchanged in November (47.2%) and remains below 50 despite an improvement since the summer, hinting at a further slowdown in the sector. Mobile phone sales remain flat and are declining year on year, while the increase in incoming tourists and the number of domestic and international passengers should continue to sustain the tourism services sector. After months of decline, car sales resumed year-on-year growth in September and increased by 12.6% yoy in October. In the third quarter, consumer confidence dropped beneath 100 and is at its lowest since 2010, both in the component assessing the current situation and in the one for forecasts. Prospects of a recovery in consumer spending remain uncertain in light of a decline in the jobs market outlook and in spending intentions,

[26] The assessment is based on net responses, i.e. the percentage of interviewees who declare an increase minus those who declare a decrease.

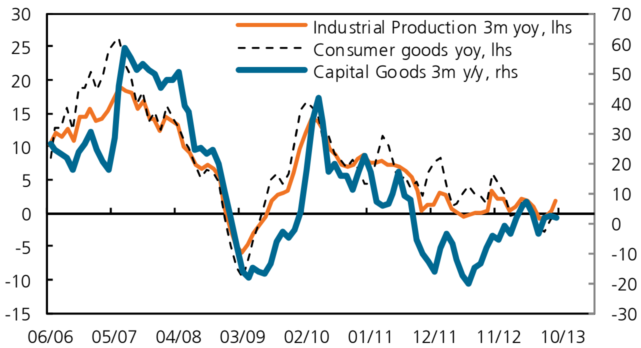
both currently and for next year. In a jobs market that remains healthy, the rise in salaries (particularly for farm workers) is negated by high inflation.

A tentative rise in investments



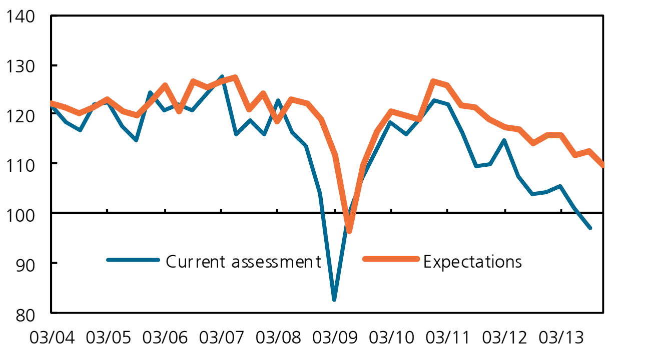
Source: Intesa Sanpaolo chart from CEIC data

Industrial production is positive but still very weak



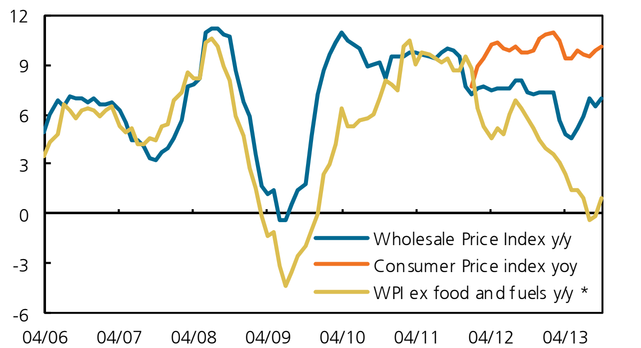
Source: Intesa Sanpaolo chart from CEIC data

Industrial outlook survey*



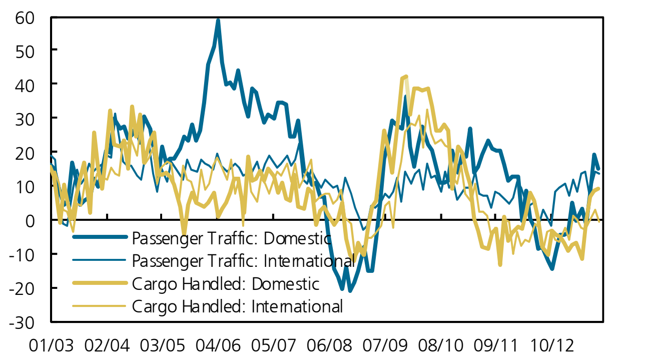
*synthetic index: > 100 expansion, < 100 contraction Source: CEIC

Inflation remains high



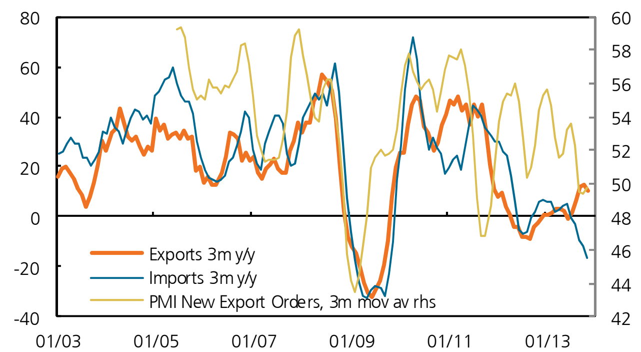
Source: Intesa Sanpaolo chart from CEIC data, * Intesa Sanpaolo estimates

Upturn in domestic and international traffic



Source: CEIC. % change yoy

Foreign trade: exports are increasing



Source: Intesa Sanpaolo chart from Bloomberg and HSBC-Markit data

The rise in inflation continues to be linked to supply factors. After a fall to 6.5% in September, wholesale inflation returned to the levels seen in August (7.0%), driven by soaring food (+18.2% in October) and energy prices. The sharp rises in fruit and vegetable prices (+45.8%) as a result of bad weather should start to be reversed in the coming months, while grain prices should also fall in light of a successful harvest. However, the prices of non-food primary products have also begun to climb again from the low point of August (1.2% yoy; +6.8% yoy in October), owing to the increase in raw fibrous textiles prices, particularly cotton and silk. Consumer price inflation continues to rise (10.1% yoy in October), driven by the same factors and by housing services. However, a favourable base effect and a fall in the price of farm produce should see inflation pegged back in 2014, still at a high average level but below that of 2013.

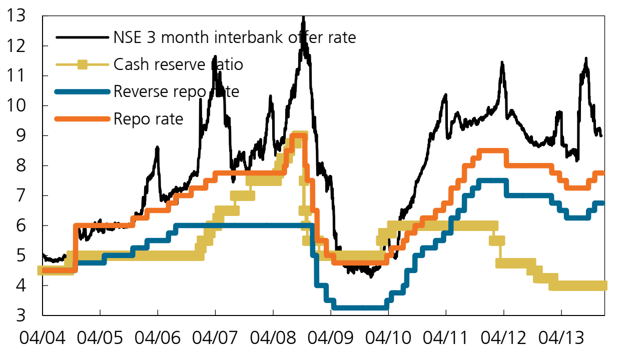
Economic, monetary and exchange rate policy

With less than six months until the general election, there have recently been elections in five of India's 28 states. The Indian National Congress party, which leads the current governing coalition (United Progressive Alliance, UPA) was unable to take the majority held by the opposition party (Bharatiya Janata) in Madhya Pradesh and Chhattisgarh, and lost its majority in Delhi and Rajasthan. Analysts believe these results confirm the possibility that the Bharatiya Janata party may win the general election in spring 2014, albeit without an absolute majority and thus remaining dependent on its alliance with emerging regional parties. The government has proposed a reduction in the public deficit to 4.8% of GDP in the current financial year, down from 4.9% in 2012/13, thanks in particular to a scaling back of energy subsidies. This aim hangs in the balance given the depreciation of the rupee (which has lost 10% on average against the USD since 2012/13) and the simultaneous rise in oil prices (up almost 8% on average in the same period). Combined with likely spending increases before the election, all this makes possible a slight upward revision of the deficit for the current financial year, which is then expected to resume its downward trend from 2014/15.

The growth of M3 money supply accelerated to 13% yoy in October from the low of 12.2% in August, and lending to the non-food sector is growing robustly (+16.9% yoy), continuing to support businesses having to face higher nominal and real rates of interest. The central bank is gradually easing back on the extraordinary measures introduced during the summer to sustain the exchange rate. However, in order to keep a check on inflation, the bank implemented two 25bps increases in the repo rate during the autumn, taking it to 7.75% at its meeting at the end of October. The RBI has again stressed that the rise in inflation is attributable mainly to supply factors that cannot be influenced by monetary policy. Nevertheless, these factors are contributing to the current rise in inflation and therefore inflation expectations, which go against an increase in rates. In its October meeting, the RBI revised its March 2013 growth forecast for 2013/14 up from 4.4% to 5%. Despite the expected fall in food prices, consumer price inflation is likely to remain around or just above 9% without any action on rates. The factors determining a drop in inflation will be offset by currency depreciation and a predicted rise in administered energy prices. Inflationary risks should therefore be closely monitored, and the RBI says it will act accordingly. We therefore expect another 25bps rise around the turn of the year, followed by successive rate holds. Monetary policy can be relaxed only from the second quarter of 2014, together with a corresponding tangible improvement in inflationary dynamics.

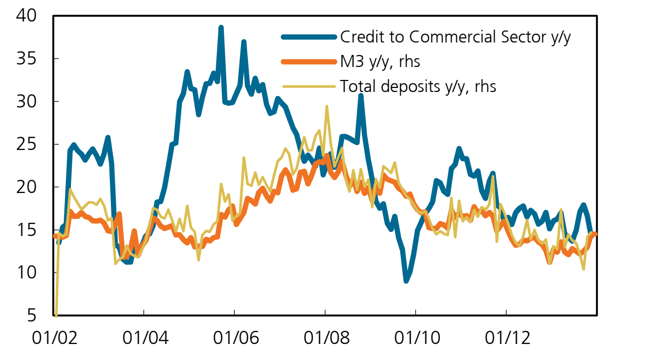
The current-account deficit improved considerably in the third quarter, dropping to USD5.2 billion from USD21.8 billion in the second quarter as a result of a fall in the trade deficit and a good performance from the balance of services and invisibles. This offset the fall in capital balance, restricting the decline in reserves from the second to the third quarter to USD7.3 billion. Thanks to renewed capital flows from foreign investors, which turned positive in September, foreign-exchange reserves have risen from the low point of USD245.5 billion at the end of August to USD263.7 billion at the end of November, taking the import cover ratio from 6.7 months to 7.0 months. After overshooting at the end of August, the exchange rate has been stable at around 61/62 in the last three months. The brief flirtation with 63 in November, in conjunction with positive employment data from the US, confirms that the exchange rate remains highly sensitive to the prospect of the Fed bringing forward the slowing of its quantitative easing programme. India is, however, in a slightly better position than it was during the summer owing to an improvement in the current account balance, the RBI's interventions, the public deficit being only fractionally higher than expected in the current financial year and the prospect that growth bottomed out during the second quarter.

The RBI raises rates



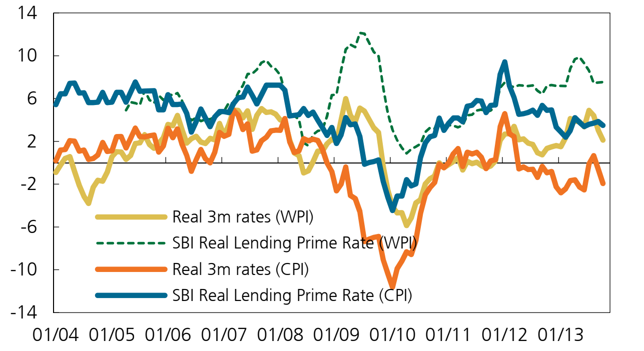
Source: Bloomberg

Credit trend



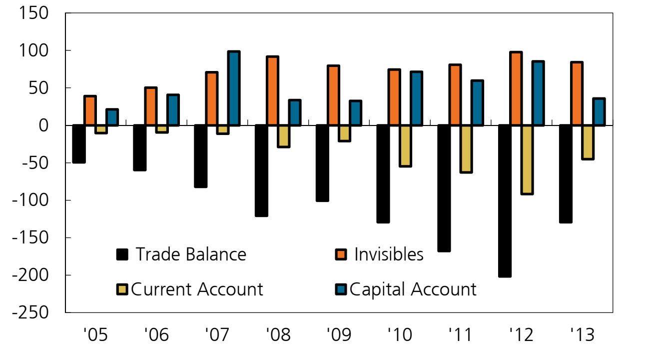
Source: Intesa Sanpaolo chart from Bloomberg data

Real rates



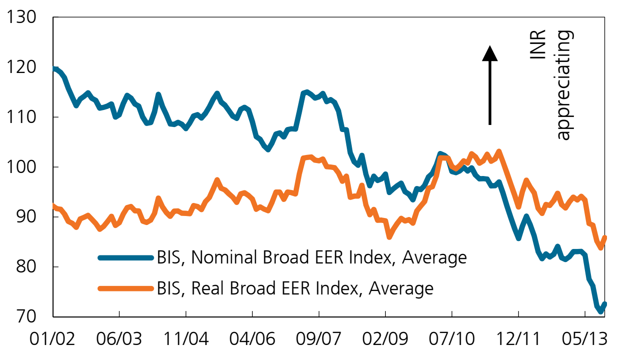
Source: Intesa Sanpaolo chart from Bloomberg data

Current account balance * (USD billions)



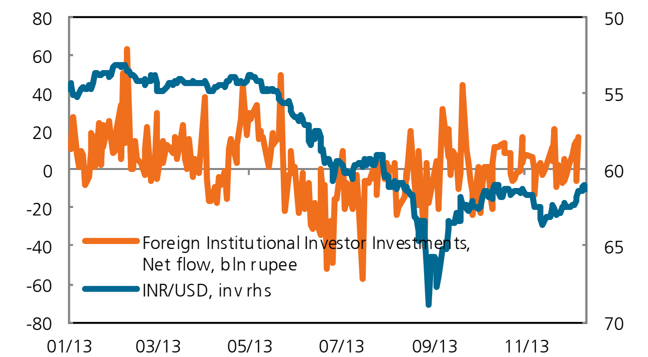
*The first three quarters for 2013. Source: Bloomberg

Effective exchange rate



Source: CEIC

The return of capital stabilises the rupee



NB: left-hand scale in INR billions. Source: CEIC

Currency markets: 2014, a year of redemption for the dollar?

Asmara Jamaleh

2013 was a year of missed opportunities for the US dollar. 2014 is set to be a year of redemption.

2013 was a year of missed opportunities for the US dollar, but it should be able to redeem itself in 2014. 2013 was actually a year of missed opportunities for the Fed, which, having indicated that it was at last close to reversing its monetary policy line, was forced into a gradual retreat, postponing the planned reversal indefinitely. In September, when the markets believed that tapering was set to begin, the Fed disappointed expectations and left policy unchanged, on the grounds that the economic recovery was not yet sufficiently solid. The same applied in October, but this time the outcome was anticipated, the Fed's hands being tied due to the government shutdown. The dollar, therefore, which had begun to recover strongly in the spring due to the Fed's opening towards the end of QE, depreciated again in the late summer, weakened by the Fed's step back from tapering (Fig. 1). After the most recent shock of the shutdown, however, it began to recover (Fig. 2),and, while this recovery remains limited, it is based on firm foundations: the widespread and continuous improvement in recent US figures, which the Fed is also looking at to decide whether to go ahead and launch tapering this month (18 December) or to postpone it again, until the early New Year (the earliest date being the FOMC meeting of 25 January, and the second and "last" being 13 March).

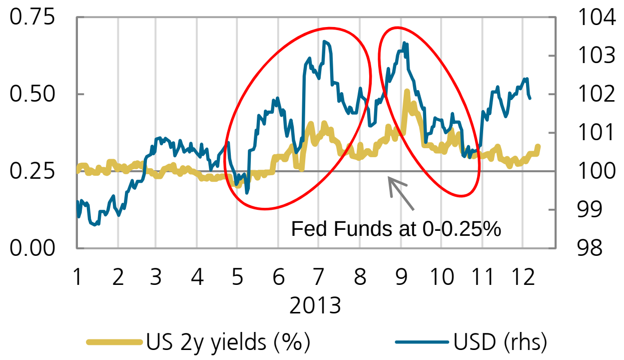
The time for the most expansive monetary conditions is now over and a reversal of policy cannot be put off any longer. Most importantly, this is a "big" reversal, in the true sense of the word, for the following reasons: (1) interest rates are starting at an absolute minimum (close to zero: Fig. 3), (2) the period of unchanged rates at almost zero was (is) very long (five years: Fig. 3), and (3) the reversal confirms the exit from a crisis that has also been "big": the global economic and financial crisis that began in 2008. Considering that the dollar is also starting from historically very low levels, closer to all-time lows than the pre-crisis average (Fig. 4), it seems reasonable to think that such a reversal could push the greenback up beyond current levels, and perhaps as high as in the first part of the year.

Now that uncertainties over the "if" and the "when" of tapering have been resolved, another one has arisen and that is the "how". It is possible that the Fed, particularly if it starts reducing purchases in December, will try to tone down the effects of tapering by strengthening its forward guidance, to anchor the yield curve close to current levels. However, we think that this would not affect the possibility of dollar appreciation and might only reduce its strength in the initial period of this new monetary policy phase. The Fed will temper the way it normalises the policy context according to US economic performance. If the recovery continues, the associated upward pressure on interest rates will gradually increase. The prospect of higher interest rates and yields (i) resulting from the forecast acceleration in US growth in 2014, and (ii) in view of the transition to "phase 2" of the monetary policy normalisation process (i.e. the launch of the upward cycle in Fed Funds, which is currently not expected to take place until the second half of 2015) is likely to be the key upward driver for the dollar. Confidence about the dollar's expected path has been strongly influenced by the (almost) absolute minimum starting points of US interest rates/yields (Figs 3-4).

Beyond the US, the other factor that should drive the dollar higher is the fact that monetary policy will probably not be reversed anywhere else. Recently, the general trend has been to extend the deadlines for exit strategies (the only exception being the BoE), while some institutions have even taken a step backwards: the ECB, for example, cut its rates in November. In terms of the emerging economies, while the picture is mixed, it is hard to make out any significant indications that a virtuous cycle of autonomous recovery is imminent that could favour higher but riskier emerging currency yields over US dollar yields, which are lower but rising consistently, and safer.

Since uncertainty is temporarily hovering over many of the main currencies, the greater certainty over the Fed's next move will probably channel flows to the US, at least for the time being. However, when the global impasse still holding the markets in check in 2013 is resolved (between late 2014 and 2015), the international process of diversifying dollar currency reserves (which has been under way for years) could again clip the greenback's wings, not necessarily causing depreciation, but limiting its upside potential. China could play a key role in this context, since the debate over the future free fluctuation of the yen was recently resumed. This subject will probably be on the agenda in 2015 or 2016, but could help to explain why, although US dollar appreciation is forecast for 2014, it currently seems relatively unlikely that it will come close to its pre-crisis peaks.

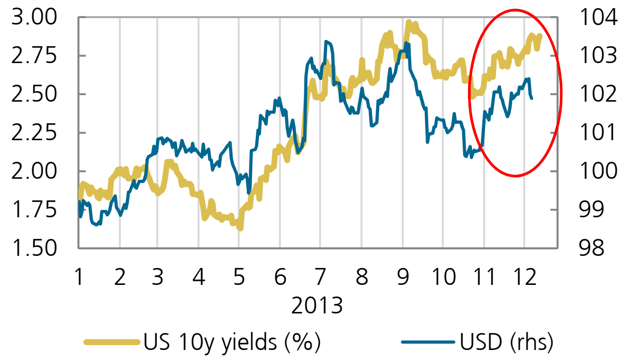
Fig. 1 – Dollar: rise and fall on Fed forecasts



Source: Thomson Reuters – Datastream

NB: USD = dollar, nominal effective exchange rate (broad" index. Source: Fed)

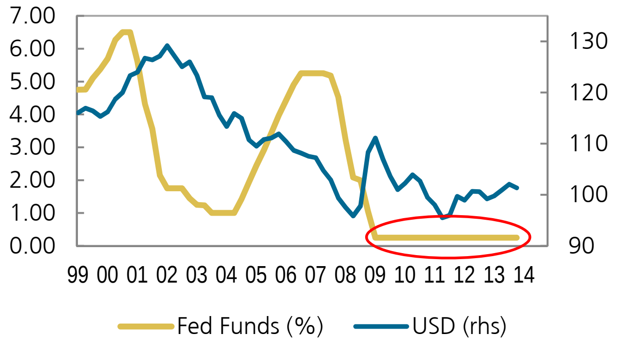
Fig. 2 – Dollar: post-shutdown recovery



Source: Thomson Reuters – Datastream

NB: USD = dollar, nominal effective exchange rate (broad" index. Source: Fed)

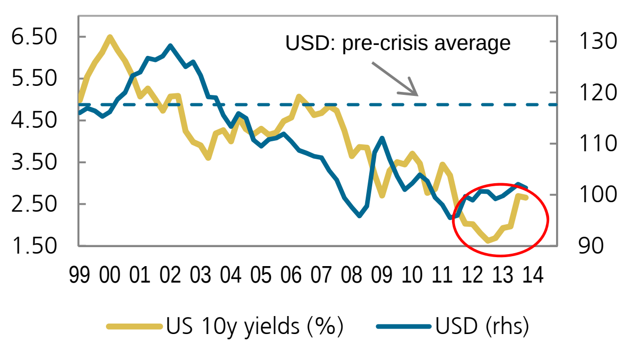
Fig. 3 – Interest rates at (almost) zero for five years



Source: Thomson Reuters – Datastream

NB: USD = dollar, nominal effective exchange rate (broad" index. Source: Fed)

Fig. 4 – Dollar and yields still at (almost) all-time lows

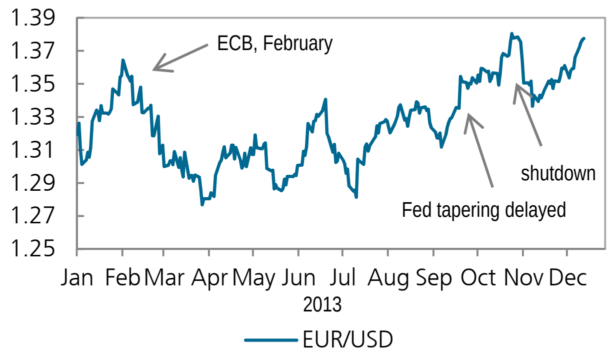


Source: Thomson Reuters – Datastream

NB: USD = dollar, nominal effective exchange rate (broad" index. Source: Fed)

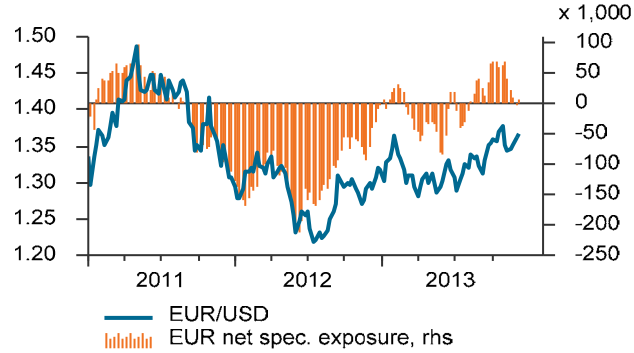
EUR – Euro

Fig. 1 – The euro in 2013



Fonte: Thomson Reuters-Datastream

Fig. 2 – EUR: speculative positions (CME)



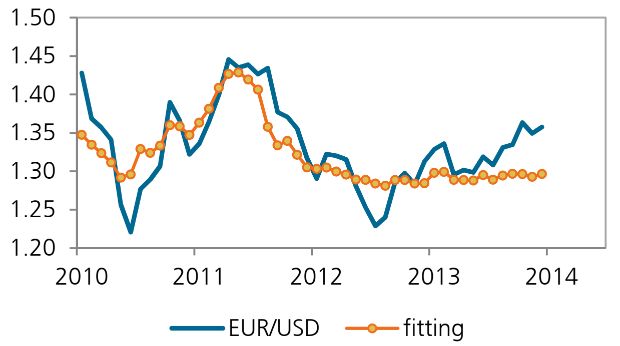
Source: CME and Thomson Reuters Datastream

With the sovereign debt crisis in the Euro zone forgotten, the euro has been used as a kind of safe haven against the dollar in 2013. When the Fed got cold feet over the imminent launch of its exit strategy, disappointing the markets, the euro benefited greatly from the dollar's decline (Fig. 1). This became even clearer during (and after) the US fiscal crisis in October, when the single currency topped the highs seen at the start of the year, rising to 1.38 EUR/USD from 1.27 in July. This appreciation continued, despite the fact that, on a comparison of fundamentals, the outlook for US growth was much better than for the Euro zone, and despite the ECB's surprise interest rate cut in November (apart from a short, sharp drop after the announcement, as an impact response). Basically the euro has been shining, not with its own light but with a reflected light, and "profiting" from the dollar's vulnerability (uncertainty created by the Fed's indefinite postponement of tapering and the shutdown). In our view, the most important aspect of this situation is that the euro was chosen as an alternative to the dollar as a default option with respect to other currencies, i.e. (1) because the period of greatest uncertainty about the US economy coincided with similar uncertainty about much of the rest of the world, including the emerging economies, and (2) international investors, needing to "differentiate" from the dollar (here trends in global currency reserves, and the role of China, come into play), and in view of the scarcity of valid alternatives, decided to "park" their resources with the euro. This demonstrates that the euro was chosen in the absence of anything else and not because it was regarded as particularly attractive, and that the recent phase of appreciation was accompanied by a sharp decline (to zero) in the speculative long (Fig. 2).

The euro has therefore been a temporary parking place pending better times that will offer investment opportunities with a higher return (and that are not too risky). The arrival of better times could be signalled by the launch of tapering by the Fed, which, as already mentioned, we expect to favour the dollar. The euro is therefore likely to depreciate, correcting down to 1.30 EUR/USD or just under this level. We believe that the euro has been overvalued at its recent peaks: we have estimated fair value of approximately 1.29-1.30 (Fig. 3), based on the relationship between the EUR/USD exchange rate and short-term European and US yields. The speed of the correction will depend on the Fed's tapering procedures: if these come in tandem with stronger forward guidance, the decline could be smaller and more gradual. Monetary policy divergence with the ECB, which, unlike the Fed, could become more expansive if necessary, combined with expectations of much stronger growth in the US than in the Euro zone, is expected to limit – if not prevent – the possibility of a subsequent rebound in the single currency later in 2014. In this period, moreover, the greater probability of a more robust recovery in the rest of the world, including some emerging economies, could tarnish the euro's appeal and boost currencies offering higher yields.

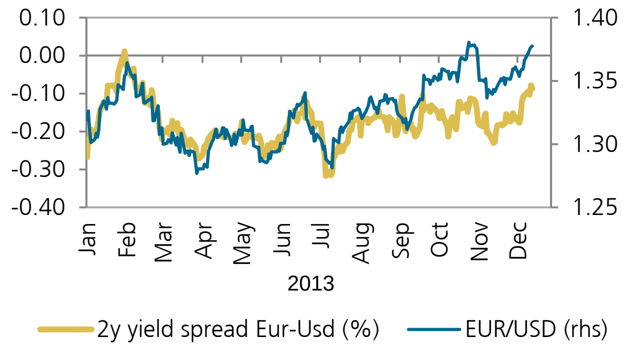
Overall, however, the risks to the central scenario seem to be towards the upside, i.e. the possibility of a stronger euro than expected. The sort of "benign neglect" (in terms of strengthening the exchange rate) implicitly conveyed by the ECB at its December meeting has helped to increase this upside risk. While, in February, when the euro stood at 1.37 EUR/USD the ECB played a not insignificant role in sending it downwards, simply by mentioning the downside risk to growth of a runaway exchange rate, in December, the central bank refrained from mentioning the exchange rate, although the euro had climbed back to its February levels. Furthermore, when questioned about this silence in a press conference, Mario Draghi simply replied that the exchange rate was not a policy target, but merely one of the variables on which the central bank based its monetary policy decisions. Mr Draghi's response may indicate that the ECB is aware that in this phase the forces driving the euro are mainly outside the Euro zone, and continue to centre on the United States and Fed monetary policy, and that perhaps tapering is imminent, which might be enough to push up the dollar and pull down the euro. This does not take away from the fact that the ECB could decide to say in the future what it did not in December, if the economic landscape in the zone were to deteriorate or the euro appreciate too much. In the meantime, however, if the Fed does not start tapering in December but postpones it again, the euro could benefit further, testing recent highs in the area of 1.40. But it is unlikely to stay at these levels for long, because this time, if tapering is halted again, it can only be a matter of postponement, and for a very short time.

Fig. 3 – Estimates based on relation to yields



Source: Intesa Sanpaolo charts based on Thomson Reuters-DataStream data

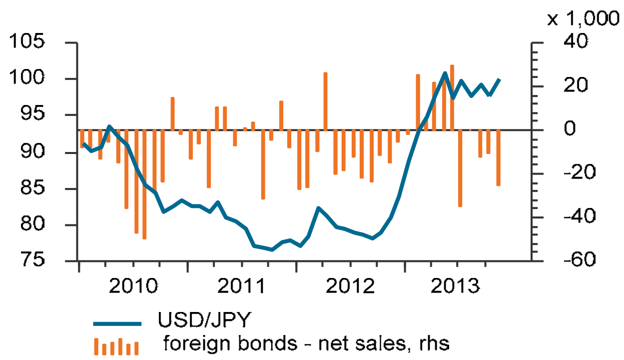
Fig. 4 – Euro and short-term yield differentials



Source: Thomson Reuters – Datastream

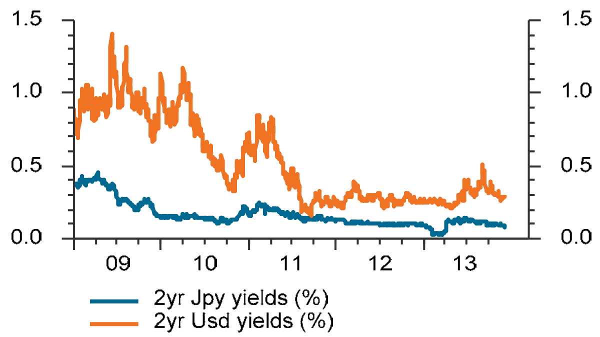
JPY – Yen

Fig. 1 – Yen and international transactions in financial assets



Source: Japanese Ministry of Finance and Thomson Reuters-Datastream
NB: a negative histogram level indicates "net purchases"

Fig. 2 – US and Japanese yields



Source: Thomson Reuters – Datastream

2013 has been a paradigmatic year for the yen, as the economic policy revolution of Shinzo Abe's new government has shown the markets that the yen could start to follow a new paradigm, moving away from the path it has travelled for many years. The implementation of policies that are extremely expansive, not simply designed to promote growth but to boost inflation (with the adoption of inflation targeting), could have a significant effect on Japanese interest rate and yield curve forecasts, due to an "irreversible" upwards shift.

The prospect, albeit not in the very short term, of durably higher rates/yields in the future, due to a structural increase in inflation and growth levels, could help to create a higher fair value for the yen than in the past. Some of the flows that Japanese investors have traditionally channelled abroad as they sought higher returns could be redirected to domestic assets, if these generate profits that are structurally higher than in the past. This is what might have happened in the first half of 2013, when the new macroeconomic policies were implemented: net purchases (purchases – sales) of foreign bonds by Japanese residents entered negative territory (net sales), when they would normally have been positive, because the Japanese sought (and found) higher yields outside Japan (Fig. 1).

In subsequent months, after the first indication that the Fed might soon launch its exit strategy, in the short term, flow directions returned to normal. Despite this, the yen did not start to fall. It weakened, but only initially, sliding below the psychological threshold of 100 USD/JPY (to lows last seen in 2008), but when the markets began to realise that the Fed would have to postpone the exit strategy, they rebounded, stopped falling and stabilised, entering a lateral phase. Although this type of resilience in the yen might previously have been attributed to increased risk aversion, this time sentiment can provide no more than a partial explanation.

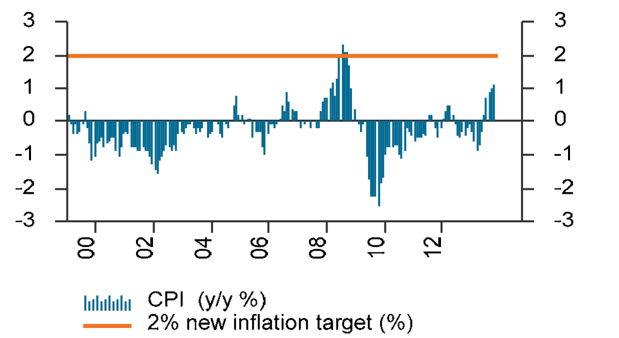
The Japanese currency was in fact borne up by trends in Japanese yields, which stabilised towards mid-year at higher levels than in previous months. And even when they subsequently started to fall, they nevertheless remained higher than in the early months of the year. The yen dropped back to May levels only recently, in early December, when, as expectations of imminent tapering by the Fed revived, the BoJ gave further expansive policy signals, saying that it was ready to introduce further monetary stimuli if necessary, to (i) support recovery and (ii) offset any restrictive effects caused by the higher consumption tax that will come into force next year. In the meantime, the government has already made a move in this direction, with the launch of a new package of fiscal stimulus measures.

The forecast scenario for the yen could therefore ideally be divided into two phases: the short/medium term and the medium/long term. The lowest common denominator for both is that the forecast trend in Japanese yields should continue to drive exchange rates, this time in both absolute terms (i.e. looking at the levels reached) and by comparison with US yields.

Therefore, in the **first phase**, when imminent tapering by the Fed generates more upward space on the US curve, while the BoJ's policy of maximum expansion keeps the Japanese curve flattened, the yen is likely to weaken further against the dollar, to lower levels than in 2013 (approximately 105-107 on a 3m-6m forecasting horizon). The main risks to the central scenario are likely to be to the downside in the short/medium term, i.e. the risk of a weaker yen if the US recovery is more robust and/or faster than projected and the markets start to anticipate expected rises in Fed Funds.

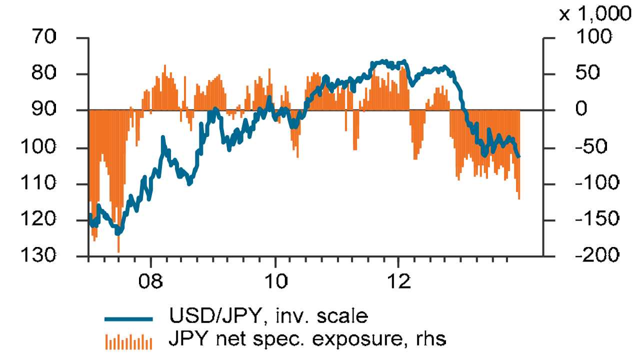
In the **second phase**, however, in the medium/long term, Shinzo Abe's **new economic policies will be put to the test**. If there is convergence towards the planned higher growth and inflation objectives (but without compromising the aim of fiscal consolidation), upward pressure on the Japanese yield curve should start to intensify. This should enable the yen to begin a gradual recovery (trending towards 105-103 USD/JPY on a 12m forecasting horizon, and approximately 100-98 USD/JPY on a 24m forecasting horizon). However, because uncertainty over the validity of the new Japanese paradigm is fairly high, because it involves a radical structural change, rather than a normal cyclical one, in this case the risks in the central scenario could be to the downside, i.e. a weaker yen in the event that the objectives are not met and/or the price of achieving them is the risk of fiscal unsustainability.

Fig. 3 – Inflation and new target (2%)



Source: Thomson Reuters – Datastream

Fig. 4 – JPY: speculative positions (CME)



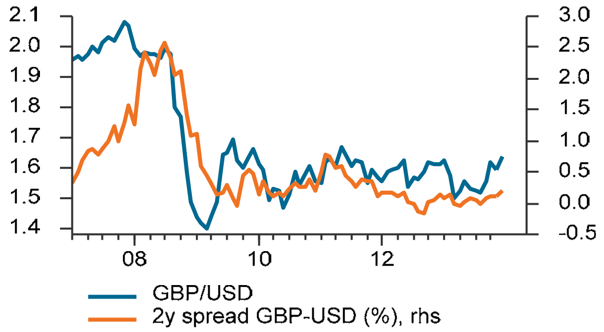
Source: CME and Thomson Reuters Datastream

GBP – Sterling

2013 saw a change of governorship at the Bank of England (when Mervyn King handed over the reins to Mark Carney), and the launch of the BoE's new policy, which is similar to the policies previously adopted by the Fed and introduced later by the ECB, but different enough to be more effective as soon as it was implemented. The policy is "conditional forward guidance" (CFG), which was launched in August. With forward guidance, the BoE is committed to maintaining existing accommodative monetary conditions (with interest rates officially maintained at an all-time low of 0.50%) until unemployment (ILO index) drops below the "threshold" of 7%, on condition that (1) the objective of stable inflation and (2) financial stability are not compromised in the meantime. This set-up allows the central bank to act much more flexibly than in the past, enabling it to maintain credibility as regards its primary policy objective (inflation target), without, however, compromising the chances of economic recovery in this sensitive phase, when strenuous efforts are being made to exit from the crisis of recent years, as well as minimise the risk that the markets will start to price in interest rate rises out of synch with changes in the macroeconomic picture. Growth, unemployment and inflation figures have thus become direct benchmarks for the markets, not only in terms of interest rates and yields, but also exchange rates. Since CFG was introduced, sterling has gained extensive ground (from just over 1.50 GBP/USD to nearly 1.65 GBP/USD), in keeping with the economic improvements observable in the data. Acknowledging this progress, the BoE made a further upward revision to its growth forecasts in its November inflation report, while revising projected inflation downward, and brought forward the expected timing of the achievement of the benchmark unemployment threshold from the end of 2016 to about the end of 2015. However, to prevent premature forecasts of interest rate rises, Mark Carney clearly stated that rates could remain unchanged for a certain period even when unemployment had fallen to 7%, because the downside risks in the growth scenario were still significant. Because it believes that, overall, the recovery under way is sufficiently solid, the BoE hinted that the likelihood that it would have to increase the APF further was significantly reduced, and in November it also announced, alongside the Treasury, that the Funding for Lending Scheme would be trimmed back. In its Autumn Statement in December, the government also made a substantial upward revision to its growth forecasts for the UK economy compared with the Budget forecasts announced in March: from 0.6% to 1.4% in 2013 and from 1.8% to 2.4% in 2014.

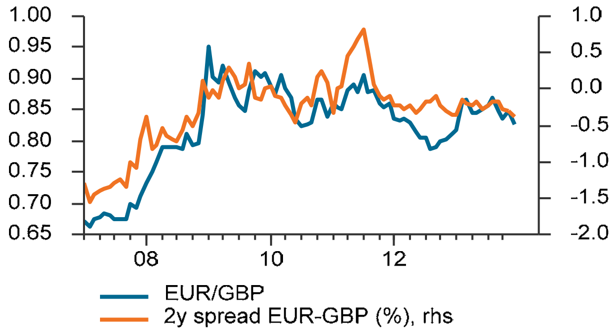
The positive acceleration in growth forecast for next year, combined with indications that monetary policy has entered a pre-exit strategy stage, form the basis of our scenario that the pound will strengthen further in 2014, peaking at higher levels than in 2013 (within a range of 1.65-1.70 GBP/USD to 0.80-0.77 EUR/GBP). Upside probability could be greater against the euro than against the dollar, because monetary policy divergence is greater between the BoE and the ECB than between the BoE and the Fed, and because the UK is expected to record better growth levels than the Euro zone. In the short term, the expected start of tapering by the Fed, which we believe will favour the dollar, could consequently weaken the pound slightly (with a downside limited to the central part of the range of 1.60-1.55 GBP/USD), but would weaken the euro less, resulting in a positive effect for the UK currency in euro exchanges. It seems most likely that sterling will reach the forecast highs in late 2014, when consolidation of the recovery should be under way; this could start to generate expectations that the BoE might be first (before the Fed and the ECB) to start the cycle of interest rate hikes (presumably in 2015). In the very short term, however, the moderate deceleration predicted for the fourth quarter, a physiological effect of faster-than-expected acceleration in the third quarter, could temporarily limit any surge in sterling. Overall, the risks to the central scenario will also be to the downside in 2014, i.e. the risk of a weaker pound than expected in the event that growth is weaker than forecast, since, by contrast with the ECB's implicit "benign neglect", the BoE made reference, in its recent report on exchange rates, to possible positive consequences for inflation as well as possible negative consequences for growth.

Fig. 1 – GBP/USD and short-term yield differentials



Source: Thomson Reuters – Datastream

Fig. 2 – EUR/GBP and short-term yield differentials



Source: Thomson Reuters – Datastream

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Appendix

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