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Macroeconomic Outlook

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Macroeconomic Outlook

Index

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Last season for ultra-expansive monetary policies?

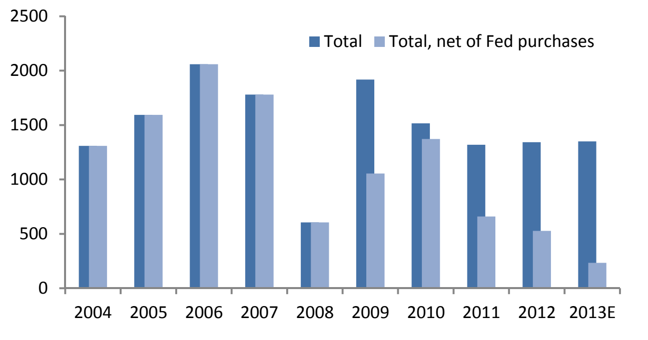
Luca Mezzomo

Active expansion of the monetary base is becoming less widespread. The first signs of a new direction in the monetary policy cycle have also been seen in the US. Global growth is not taking off and has been thwarted by differences in local economic cycles, and especially by problems in the Euro zone. The situation is likely to improve a little in the next few quarters.

Comments made by Federal Reserve Chairman Ben Bernanke on the likely end to the quantitative easing programme in 2014 are of the kind marking turning points in market performance - rather like Draghi's speech in London in July 2012. Listening to Bernanke, markets have realised that the many years of zero interest rates and excess liquidity are entering their final stage. Inasmuch as the rate hike period is still far in the future (2015), and purchases are likely to be sizeable for many months to come (at least six, but certainly more), this has brought the normalisation scenario within the markets' operating timeline, triggering an initial period of medium- and long-term rate hikes. It is easy to see how this could be confusing: in the US, for three years the Federal Reserve has absorbed more net bond issues than all other investors combined (see Fig. 1).

The risks of this turning point are limited for the US economy: the return of medium- and long-term real rates to positive levels does not make financial conditions restrictive in any way, and it is unlikely that the move will compromise the resilience of the economic expansion. Furthermore, lower growth in the monetary base (and its decline when bonds held start to mature) will likely be offset by a rise in monetary multipliers just as the injection was accompanied by a decline in the latter. And we must not forget that the Fed has never lacked prudence in recent years, and accordingly, any negative cyclical signs could inevitably lead to an expansion of the stimulus. On the other hand, there are still no signs that excess monetary stimulus is compromising monetary stability.

Fig. 1 - United States - Net bond issues (USD bn)



Source: IMF, Global Financial Stability Report, April 2013, Chart. 1.48 (modified)

Fig. 2. Cumulative change of GDP, M0 and M2 in the G7 countries (EUR bn)

Note: currency conversion at current exchange rates. Source: Intesa Sanpaolo charts

In the rest of the world, the future new direction in US monetary policy will have two opposite effects: on the one hand, the strengthening of the US dollar should make foreign products more competitive; on the other, however, there will be negative effects on demand components that are sensitive to interest rates as a result of the correlation between rate curves: since the beginning of May, the yield on the ten-year German bond rose by over 50bp compared to 88bp for the ten-year bond in the US. And as we saw in recent weeks, it is likely that in peripheral European countries the rate hike will automatically be offset by a decline in risk premia.

In the Euro zone, the monetary base is already declining and this is the main reason the aggregate has stabilised for the G7. The unique feature of the European situation is that the reduction does not happen as a result of a deliberate decision by the central bank to drain liquidity, but due to a drop in demand for reserves by the banks. The latter are voluntarily returning excess reserves accumulated with the long-term refinancing transactions in 2011 and 2012, and the decline in monetary base is offset by an increase in multipliers. In essence, it is more the lack of demand and the desire not to create non-performing loans that is curbing lending rather than liquidity or capital problems. In other areas, quantitative easing will continue for much longer. This is the case in Japan where a two-year securities purchase programme has just begun; its interim goal is to double the monetary base, and the stated end target is a 2% inflation rate. If the stated target is also the official one, this can be checked if and when inflation gets into the critical zone: at that point, the conflict between monetary policy goals and the need to ensure the sustainability of public debt will emerge. However, Japanese quantitative easing is not a perfect substitute for the US version as was also seen in recent weeks. Although it is reasonable to expect that Japanese investors will tend to increase exposure to foreign markets, it is unlikely that this will offset the restrictive impact of the rise in US rates on European markets.

Economic growth by geographical region

	2010	2011	2012	2013p	2014p
US	2.4	1.8	2.2	1.9	3.1
Japan	4.7	-0.5	1.9	1.8	2.3
Euro zone	1.9	1.5	-0.5	-0.7	0.9
Eastern Europe	3.6	3.7	2.8	1.9	3.1
Latin America	5.8	4.1	2.6	2.5	3.9
OPEC	3.8	4.8	5.4	4.0	4.8
East Asia	9.1	7.0	6.2	5.6	6.1
Africa	3.8	3.4	2.7	3.8	4.4
World growth	5.2	4.0	3.2	3.2	3.8

Source: Intesa Sanpaolo Research

While the liquidity tide is starting to ebb, the international economic cycle is not taking off. Unlike other historical periods, local economic cycles are out of sync. Although the pace of the expansion in global commerce is picking up, it is still modest, especially due to the decrease in European imports. In emerging countries, problems of macroeconomic control in Brazil and China are mounting. Forecasts of Chinese growth have been cut reflecting uncertain performance in recent months and the adoption of restrictive measures on the liquidity front. In emerging countries, the prospect of an increase in dollar-based rates is negative. The dramatic improvement in the financial structure makes crises, such as those that accompanied the cycle of Fed rate hikes in the 1990s, fairly unlikely, although there must be a considerable focus on the specific fundamentals.

Commodity price forecasts

	2010	2011	2012	2013p	2014p
Oil (Brent, USD/barrel)	79.5	111.3	112.0	106.7	111.4
	+29.2	+40.0	+0.6	-4.7	+4.4
Commodities excl. fuel (1990=100)	160.9	189.5	170.9	168.7	173.5
	+26.4	+17.8	-9.8	-1.3	+2.9
Metals (1990=100)	202.3	229.7	191.0	185.8	190.6
	+48.2	+13.5	-16.8	-2.7	+2.5
Agricultural commodities (1990=100)	125.1	153.5	134.0	127.0	123.9
	+33.2	+22.7	-12.7	-5.2	-2.4

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

Overview by region

United States

Growth in the USA is continuing, and although volatile it averages out at a satisfactory rate, averaging 2% between the start of 2011 and mid-2013. In 2H13 and 2014, we are expecting it to increase to 2.5-3%. Our growth forecast for 2013 is 1.9%, rising to 3.1% in 2014, with upside risks. The outlook hinges on whether private demand grows and accelerates (above all consumption), despite the presence of a gigantic fiscal brake. From 2H13, the negative contribution from public spending will reduce, leaving scope for overall growth to accelerate.

The Fed has started thinking about an exit strategy, indicating that if growth and employment progress as expected, the FOMC could start slowing the pace of bond buying "later this year" and, if conditions remain favourable, the Fed will continue to slow the pace of purchases "in measured steps" in 2014, ending interventions "around mid-year". The FOMC has signalled that it does not wish to sell bond holdings, preferring to reduce the balance sheet via bonds maturing from 2016 onwards. As regards rates, the FOMC is maintaining its forecast for them to remain unchanged until 2015. The Fed stressed that as long as purchases continue, the stimulus will keep increasing, and whatever happens, monetary policy will continue to be shaped by how the macroeconomic outlook develops. Fiscal policy is highly restrictive in 2013, with the deficit expected to fall to 4% of GDP; it will be less restrictive in 2014-15.

Euro zone

Although the debt crisis still cannot be considered to be over, the progressive "extinguishing" of crisis hot spots that gradually hit several countries in the eye of the storm (the completion of negotiations on the bail-in in Cyprus, the resolution of the political impasse in Italy, the extension of the durations on loans made to Ireland and Portugal, and the granting of more time to various other countries to achieve their fiscal correction) made it considerably less likely that the crisis would evolve in an "extreme" direction.

The first quarter of 2013 is likely to have represented the low point in the Euro zone's economic cycle. The economy looks set to stabilise in the spring, with a return to economic growth expected in the second half of the year, driven by exports and then corporate investment, although consumer spending and construction investment will still be rather weak. Moreover, the weak start to the year could result in GDP dropping slightly more than in 2012 (-0.7% vs. -0.5%). However, in our baseline scenario, the easing of tensions on the financial markets and the less restrictive development of fiscal policy will allow the economy to return to growth, which we estimate to be 0.9%, next year. In any event, we think the recovery will be very slow, for the following reasons: 1) although fiscal policy is gradually becoming more "flexible," it is still not able to provide a significant stimulus to the economy; 2) loan growth and quality indicators are still in recessionary territory, and the improvement in risk ratios in financial markets has still not translated into a significant easing of the terms and conditions on loans, especially for companies; 3) at least in part, the sharp deterioration in the labour market could result in an increase in structural unemployment.

Inflation has dropped from 2.6% yoy at the end of summer to 1.4% in May. Between the end of summer and March 2014, a favourable base effect from the energy component will push inflation to 1.0%. Available information suggests that upstream pressure is close to non-existent. The growth in the output gap and high unemployment rate will put further downward pressure on core inflation, at least until mid-2014. We believe the risk of deflation in the Euro zone average is low since the response of cyclical inflation to the slack in the economy could be limited, and because the labour market is likely to turn around in 2014. However, we believe that over the next 18 months risks to inflation are more to the downside than remain balanced, as in the ECB forecast.

For its own part, the European Central Bank could still limit the rate on key refinancing transactions, even though this would have little significance for the economy and markets. On the other hand, a cut in deposit rates, which are currently at zero, seems more unlikely. We do not expect unconventional measures apart from the maintenance of the current status quo (full allocation, OMT).

Asia: Japan

The change in direction embarked on by the Japanese economy last autumn with the new government and the announcement of radical changes to monetary policy continues. Growth is expected to be 1.8% in 2013 and to pick up further in 2014, at 2.3%. The recovery has now taken hold, with strong growth seen as early as the start of 2013, shored up by consumer spending and residential building. Inflation remains negative, but forecasts are for a gradual return to price rises at the end of 2013.

Monetary policy has become aggressively expansive, with the resulting increase in inflation expectations reflected in the substantial volatility on the bond market. The BoJ remains committed to maintaining a considerable monetary stimulus in order to reach its 2% inflation target by 2015. Inflation should return to positive territory by the end of 2013 but, stripping out the hike in indirect taxes, is not likely to reach 2% until after 2015. This would entail a prolonged period of monetary expansion through extensive purchases of Japanese government bonds (JGBs). Fiscal policy will remain expansive in 2013, with an increase in public investment and measures to stimulate capital investment by businesses. Details of the government's growth plan will be announced in the autumn, and are expected to include a reduction in corporation tax. From 2014 onwards, fiscal policy will change direction: consumption tax is set to rise from its current 5% to 8% in April 2014; a further hike to 10% is forecast for October 2015. These measures will have a significant impact on growth and inflation between early 2014 and the end of 2015.

China

In China we expect growth to pick up moderately in the second half of the year, following increased investment, especially in infrastructure and transport. Increase in consumption will be modest given the worsening of consumer confidence over recent months and the moderation of labour market indicators. The Central Bank is showing that it is focused on a more cautious form of liquidity management and less inclined than in the past to support increased lending. However, the growth of alternative forms of financing outside the banking sector (shadow banking), the increase in the amount of non-performing loans and in the level of local-authority debt are continuing causes of concern for both the authorities and the ratings agencies and put the country's growth scenario at risk. The expected slowdown in credit aggregates in future quarters will have a greater influence on growth rates over the coming year. Thus, we have lowered our growth forecast for 2014 from 8.2% to 7.5% and have slightly lowered the forecast for 2013 to 7.8%.

India

In India, the outlook for investments in the short term remain weak; however, the slight increase in investment plans and faster procedures, together with the impact of rate cuts, should foster a tentative recovery in investments at the end of the year, with steadier growth in 2014. We have revised down our growth forecasts from 5.4% to 5.0% in 2013 and from 6.9% to 6.0% in 2014. Risks to the growth scenario remain to the downside. At home, progress in structural and fiscal reforms still appears to be too limited to kick-start a strong, swift recovery in the business climate. To this should be added the risk of a slower fall in inflation than expected with a dampening effect on consumer spending. Abroad, the fragile state of international demand and market volatility will continue to have an impact on the already-high current account balance thereby exacerbating lending risks and affecting exchange rates.

Commodities: Back to fundamentals

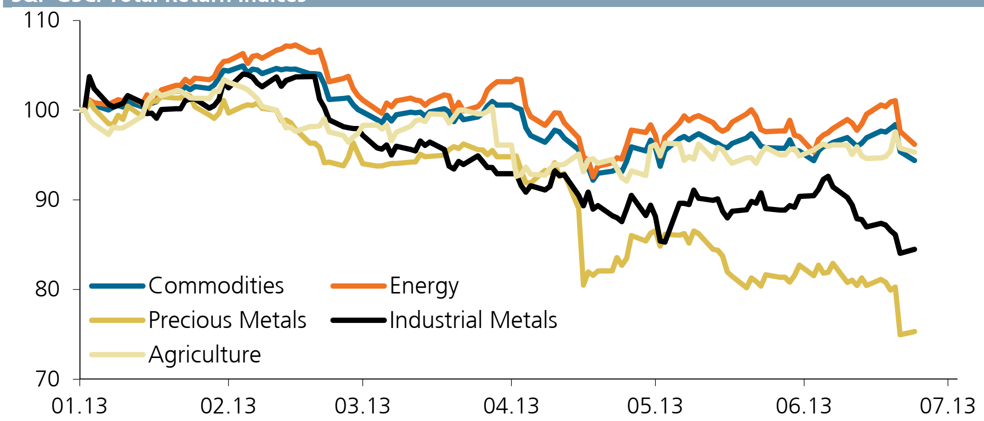
Daniela Corsini

Based on our baseline macroeconomic outlook and on supply and demand fundamentals, we expect commodity prices to remain relatively stable over the next few months and to start to increase from 2014 amid the expected improvement in global demand. However, the markets will remain jittery, leaving ample room for speculative movements. Commodities will be extremely vulnerable to news regarding developments in the Fed securities purchase programme, to the risk of strengthening of the American dollar and to surprises in macroeconomic data published in China.

Negative yields from the start of the year

From the start of the year, all the segments of the commodity universe have been in negative territory. The energy and agriculture segments have nevertheless been able to defend quite stable prices in 2013, remaining in a relatively narrow trading range. In contrast, industrial and precious metals have registered more significant losses since the start of the year, although for different reasons. Industrial metals have suffered as a result of macroeconomic data published in China, which have repeatedly disappointed expectations and which currently point toward weaker growth rates than estimated at the end of 2012. Precious metals, driven by gold and silver, have been affected by the collapse in investment demand given the expectation that the Federal Reserve (Fed) may start in the next few months its exit strategy from the quantitative easing (QE) programme.

S&P GSCI Total Return Indices

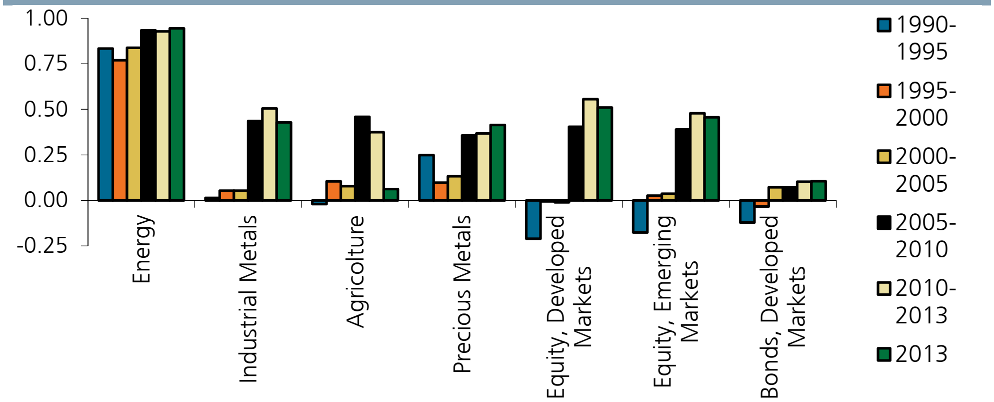


Source: Intesa Sanpaolo chart from Bloomberg data

Back to fundamentals

Over the last ten years we have witnessed a marked increase in correlations both between various commodities, due to the strong increase in emerging countries' demand fuelled by demographic growth, urbanisation and economic development processes, and between commodities and other asset classes, as a result of the inclusion of commodities in investment portfolios. The financialization of the commodities universe has increased the influence that financial variables, speculation and risk aversion/appetite have on this segment.

Correlation between Brent and indexes for commodities and the share and bond market



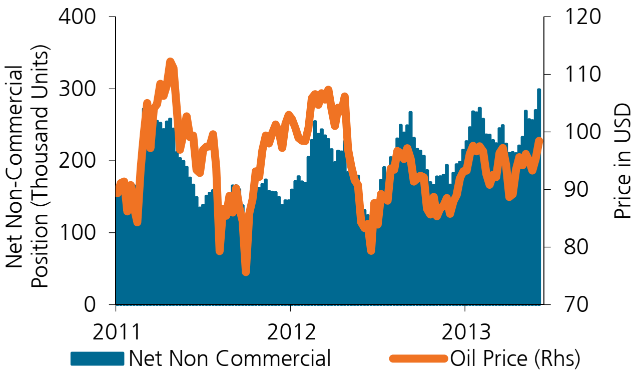
Source: Intesa Sanpaolo chart from Bloomberg data. S&P GSCI, MSCI World, MSCI Emerging Markets and JPM Global Bond indexes.

However, in 2013 we are witnessing important changes in the correlation matrix and, in particular, we are noticing a widespread weakening in the strength of the relationship both between various commodities and between commodities and other asset classes. In our opinion, this phenomenon is explained by the progress of a process of "normalisation", which is understood as "return to fundamentals of supply and demand" as the principal criteria in driving prices. Indeed, we believe that markets are beginning to incorporate new expectations about emerging countries' growth and the role of financial markets.

- On one hand, markets have acknowledged the evidence that growth rates in the main emerging countries returned to levels which are more sustainable in the long term. This implies that in the near future we will no longer see exponential growth in consumption – and consequently in prices – of all commodities, but commodities demand will be more varied and as a result prices will respond time by time to the heterogeneous signals from each commodity's expected balance in global physical markets.

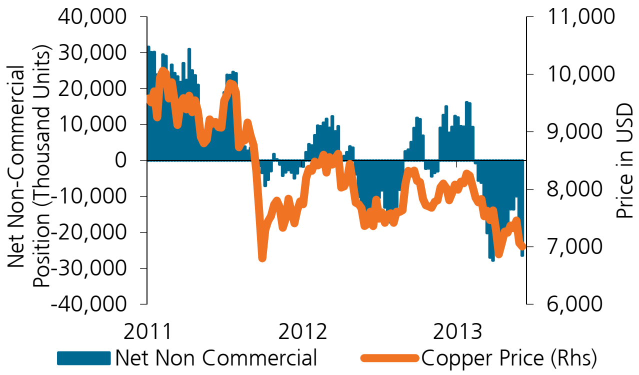
- On the other hand, the markets have started to factor in the expectation that liquidity will no longer play the leading role it has acquired over the last few years, returning to fundamentals its crown as the principal market driver. Furthermore, we believe that currently investments in commodities are mainly driven by the quest for yield and no longer by the wish of diversification in new asset classes. As evidence of this, we highlight how the speculative positions (using as a proxy the net non-commercial positions published by the U.S. Commodity Futures Trading Commission, CFTC, which show money manager and investor exposures) have recently followed prices and how prices have not been impacted by the introduction of new commodity-based financial instruments.

Speculative positions and WTI oil prices



Source: Intesa Sanpaolo chart from CFTC data

Speculative positions and copper prices



Source: Intesa Sanpaolo chart from CFTC data

Our forecasts for the commodity universe

Our forecasts for the commodity universe in 2013 incorporate the expectations of a persistent weakness in the global economic cycle, affected by significant downside risks, which are primarily linked to the development of the debt crisis in Europe and to the difficulties currently faced by various emerging economies.

In China, over the last few months property prices have continued to rise, suggesting that the Government needs to take more rigorous action in the sector, and exports have been particularly weak. Moreover, macroeconomic data have often missed expectations, despite economic growth remaining above the official target of 7.5%, inflation being under control and investments, industrial production and retail sales being strong (these indicators increased in the first five months of the year by: +20.4% yoy, +9.4% yoy and +12.6% yoy, respectively). Over the next few months, commodity markets – and mainly industrial metals - will be deeply influenced by developments in China. Negative investors' sentiment on this economy would lead to downward revisions in the expected commodities demand and could trigger deep price drops.

However, the government' willingness to accept short-term growth rates lower than those recorded on average in the last ten years in favour of a more balanced and sustainable economic development and of greater environmental and social protection – reduction in the gap in living standards between urban and rural population, greater focus on health and social security matters, reform of the *hukou* system for residence permits – will be very positive since in our opinion this should limit future risks of excessive overheating in the economy and contribute to social stability.

Based on our analysis of the macroeconomic cycle and supply and demand fundamentals, we are expecting commodity prices to float around relatively stable levels during the year. However, due to significant downside risks still threatening the recovery of the global economy, markets will remain jittery, leaving ample room for speculative movements. Commodities will be extremely vulnerable to news of an acceleration in the pace of reduction (or of a suspension) in the Fed securities purchase programme, to the risk of a strengthening American dollar and to surprises in macroeconomic data published in China.

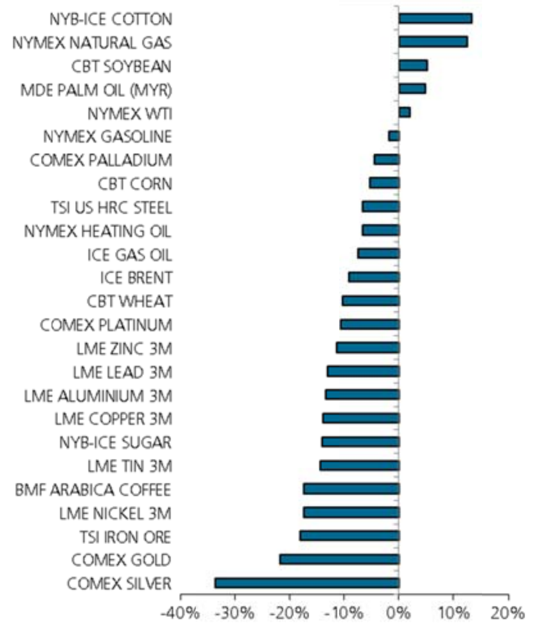
Turning to precious metals, we expect persistent weakness for gold and silver in the next few months, while they should partially recover ground in the last quarter thanks to the positive contribution of seasonal demand for physical gold in Asia and to the expected slowdown in divestment flows from Western investors. We maintain our estimate that platinum and palladium will over-perform in the segment thanks to their exposure to industrial demand and vehicles sales and to endemic problems in their mining production.

On the whole, we expect prices for industrial metals to be stable in the third quarter and to slightly recover in the fourth quarter, driven by the expected improvement in the global economic cycle. However, supply and demand fundamentals will limit the extent of both price increases – due to high global inventories, abundant supply and weak demand – and price decreases – due to support provided to most metals by marginal production costs and possible purchases in China by the State Reserve Bureau, which could intervene on the market in the event of extremely low prices.

Agricultural products' performances will be more mixed, in line with their different supply and demand fundamentals and their specific exposures to various risk factors. For each commodity, the market will scrutinise estimates for harvest and global demand. The principal exogenous factors which could significantly alter the balance in individual markets are political risks and, above all, climate risks, given the increased frequency of extreme weather events over the last few years.

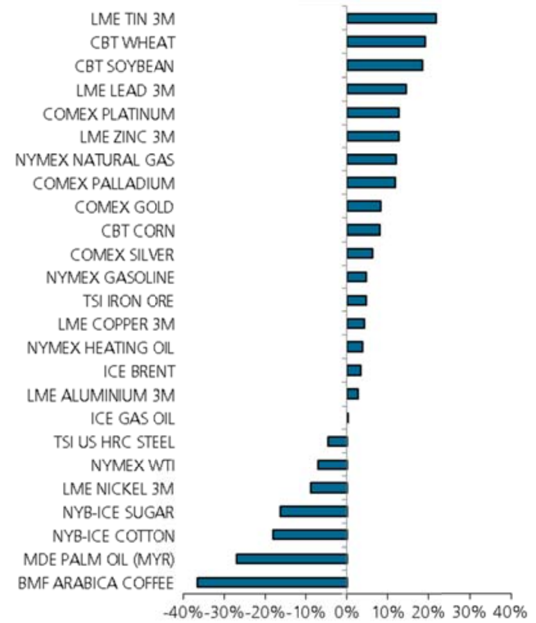
Finally, we expect oil prices to be stable in the next few months and to slightly rise from 2014 due to the expected increase in global demand. Geopolitical tensions will remain a key issue and will contribute to keep markets nervous. However, in our baseline scenario we do not expect any lasting divergence of Brent oil prices from the range of USD 100-120 per barrel.

Performances year-to-date (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

Performances in 2012 (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

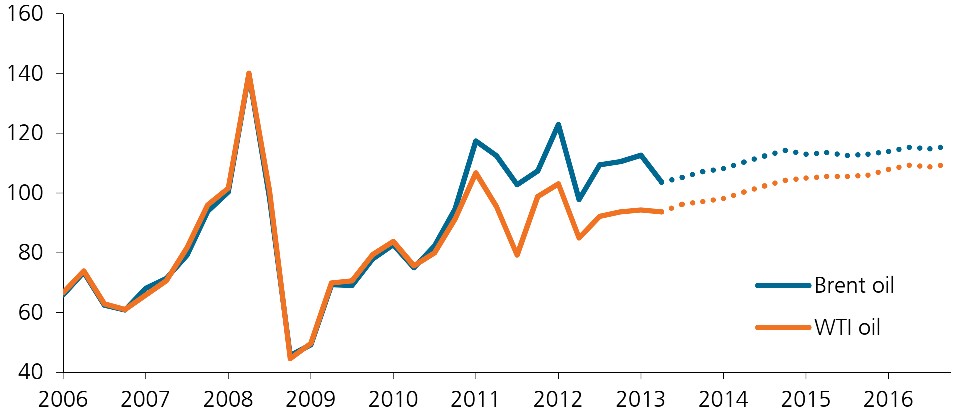
Oil

We maintain our expectation that Brent crude oil price will remain within a trading range. The support level is determined by geopolitical risks, production costs and technical issues keeping supply below its potential. The resistance level is mainly determined by weak global recovery and abundant production in North America.

Medium term forecasts for oil prices outlined in the previous outlook (March 2013) have remained almost unchanged, since the main market drivers have not diverged too much from our expectations and there have been no significant changes in our estimates about macroeconomic outlook, supply and demand fundamentals and geopolitical risks.

Our forecasting model for Brent crude oil price indicates an average price of USD 107 for 2013 and USD 111 for 2014. Therefore, we expect over the next few months a slight recovery from the average prices reported in May and June due to the expectation that global economic growth will progressively regain momentum. For WTI, we estimate an average price of USD 95 for 2013 and USD 101 for 2014. We therefore expect the spread between Brent and WTI to remain wide due to plentiful American production, technical limitations in infrastructures and transport network bottlenecks. We do not envisage the spread closing completely over our forecast horizon due to the growing relevance to total US production of shale oil and other crude oils extracted with unconventional methods, which entails structurally higher transport costs.

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



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

Price estimates for Brent

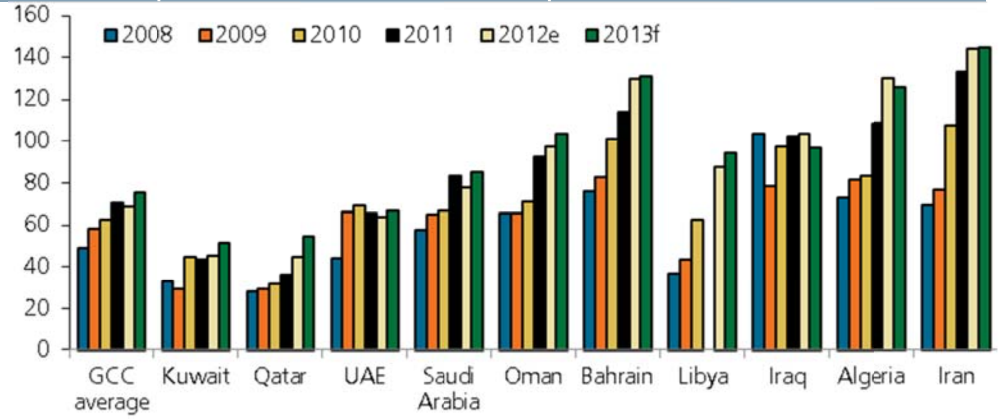
At 25.06.2013	3Q13	4Q13	1Q14	2Q14	2013	2014	2015	2016
Estimate	105.2	107.1	108.2	110.4	107.1	111.3	113.0	114.9
Bloomberg median	105.0	107.2	109.0	110.0	108.0	107.5	110.0	101.5
Forwards	103.3	100.6	99.6	98.7	103.9	97.2	93.5	90.7

Source: Intesa Sanpaolo chart from Bloomberg data

We also maintain our forecast that Brent will remain in a trading range between USD 100 and USD 120 per barrel. The support level is set by various factors, including geopolitical risks, high production costs for unconventional extraction methods and technical problems in fields and infrastructures, which keep supply below its potential. The resistance level is mainly determined by weak global recovery, abundant production in North America and the risk of an emergency reserves' release.

It is noteworthy that various OPEC members, including Saudi Arabia, have stated on several occasions that a price of USD 100 per barrel would be adequate for both producing and consuming countries. These statements are particularly relevant given the potential risks of production cuts. In fact, despite the lack of willingness by most OPEC members to reduce their current output, Saudi Arabia has so far proved its ability to adjust production to the state of global demand thanks to the flexibility of its production system. We believe that the likelihood of supply cuts is very high given the heavy fiscal spending in Middle Eastern countries, including important producing countries. In the last few years, the persistent political instability in Middle East and North Africa has resulted in an extremely steep increase in fiscal spending and a consequent increase in break-even oil prices, the price needed to balance fiscal budgets. As shown in the chart below, currently the Gulf Cooperation Council countries (GCC) are still very vulnerable to oil price drops due to growing public spending and expectation of decreasing volumes of oil exports.

Break-even oil prices for the countries of the Gulf Cooperation Council (GCC)



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart from Institute of International Finance (IIF) data

According to data from the Institute of International Finance (IIF), the break-even oil price will rise on average to USD 75.1 per barrel for GCC countries from USD 68.6 in 2012 and USD 62.3 in 2010. For Saudi Arabia, the break-even oil price will rise to USD 85.5 in 2013, from USD 77.7 in 2012 and USD 66.8 in 2010. Furthermore, according to estimates, break-even prices would be much higher than USD 115 per barrel for important producing countries such as Nigeria and Russia.

Supply and demand fundamentals still weak

The analysis of fundamentals has not shown any significant changes from the previous quarterly outlook: for 2013, non-OPEC supply should grow more quickly than global oil demand due to the rapid increase in North American output. As a consequence, OPEC would have to reduce its output target to 30 million barrels a day (Mb/d) to balance markets.

Furthermore, the spare capacity currently concentrated almost entirely in Saudi Arabia should increase steadily to 4.6 Mb/d in 4Q14 from 2.7 Mb/d recorded on average in 1Q13 (from 2.1 in 1Q12), according to estimates from the U.S. Energy Information Administration (EIA).

The commercial reserves of OECD countries are still abundant, but they are likely to contract slightly from the 2012 year-end figure of 2.65 Mb (equivalent to 57.7 days of consumption). The EIA estimates that by end-2013, commercial reserves of OECD countries will be 2.64 Mb (57.3 days of consumption), rising to 2.68 Mb (58.3 days) by end-2014.

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

Estimates, Millions of Barrels	Demand Total	Supply Non-OPEC	OPEC supply of LNG	Call on OPEC Crude
OPEC	89,6	54,0	5,9	29,8
vs. 2012	+0,8	+1,0	+0,2	-0,4
IEA	90,6	54,5	6,3	29,8
vs. 2012	+0,8	+1,1	+0,2	-0,6
EIA	90,0	53,9	5,8	30,2
vs. 2012	+0,9	+1,2	+0,2	-0,7

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).

Geopolitical risks in moderation

Turning to geopolitical risks, the main crisis areas continue to be Iran, Syria, Nigeria, Sudan and South Sudan. The positive developments achieved since March in easing the tensions between Sudan and South Sudan, thanks to the cooperation agreement signed between the two states, are threatened after the Sudan's President menaced, on 8 June, to block the flow of oil from South Sudan as retaliation for evidence of South Sudan's support to rebel groups in its western and southern states. However, the South Sudan’s President has denied any support to rebels in bordering countries and declared that the Sudan’s threat amounted to a declaration of war.

In Iran, the presidential elections in mid-June saw the victory of Hassan Rohani, a moderate, long-standing establishment figure and a former chief nuclear negotiator in international talks, who unexpectedly obtained an absolute majority with about 51% of the votes in the first round. The new President has promised to follow a policy of moderation to improve Iran’s relations in the region and with Western powers and to make the nuclear programme more transparent in order to ease tensions with the United States and reduce the economic impact of international sanctions. If these promises are kept, the geopolitical risk premium incorporated in Brent oil prices could shrink. However, it will be necessary to wait until August, when the new President takes office, to see if these declarations will lead to real changes in Iranian policies and, above all, to easing international tensions.

In our central scenario we continue to incorporate a moderate geopolitical risk premium in price estimates. Indeed, on one hand, the Iranian presidential elections potentially reduced the risk of unexpected deteriorations in the country’s diplomatic relations. On the other hand, the Western powers' recent declarations of firmer support to rebels in Syria are likely to keep high the risk of new conflict spreading in the Middle East. We are currently ruling out the hypothesis of direct military action against Iran or Syria and of temporary or permanent blockages of the Strait of Hormuz by Iran. However, if military intervention occurs in the area, Brent crude oil price could rocket above USD 130, albeit for a limited period given that emergency reserves would be released and demand would be rationed.

United States – The recovery: steady as she goes

Giovanna Mossetti

- The US recovery continues and growth, although volatile, averages out at a satisfactory rate, at 2% between the start of 2011 and mid-2013. In 2H13 and 2014, we are expecting it to increase to 2.5-3%. **Our growth forecast for 2013 is 1.9%, rising to 3.1% in 2014, with upside risks**.
- The outlook hinges on whether private demand grows and accelerates (above all consumption), despite the presence of a gigantic fiscal brake. From 2H13, the negative contribution from public spending will drop, leaving scope for overall growth to accelerate.
- The substantial improvement in the economic outlook is the result of **healing** of the two sectors hardest hit during the crisis: **residential investment and household balance sheets**. In the construction sector, prices of both new and existing houses are rising. The increase in house prices and wealth (total and net) is supporting current and future consumption.
- **Inflation** is expected to be stable and low until at least the start of 2014.
- **Monetary policy** - The Fed has started thinking about an exit strategy, indicating that if growth and employment progress as expected, the FOMC could start slowing the pace of bond buying "later this year" and, if conditions remain favourable, the Fed will continue to slow the pace of purchases "in measured steps" in 2014, ending interventions "around mid-year". It will probably leave its bond holdings to run off rather than sell them. The FOMC said that its MBS holdings will not be sold as part of its *exit strategy*. As regards rates, the FOMC is maintaining its forecast for no change until 2015. However, the distribution in rate forecasts shifted upwards at the June meeting.
- **Fiscal policy** – There will be a clear improvement in the federal deficit in 2013 (to 4% of GDP), falling to 2% in 2015. The lower deficit is due to higher revenues (tax rates up at the start of 2013), the acceleration in growth and the slowdown in spending. The structural deficit should drop from 4.3% of GDP in 2012 to -0.4% in 2015. The improvement in public finances is accompanied by a pause in negotiations over structural correction, although the issue of the debt ceiling, which will be hit again around October 2013, remains to be resolved.

Forecast Table

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (1996 US$,y/y)	2.2	1.9	3.1	2.6	1.7	1.6	1.7	1.7	2.4	2.8	3.2
q/q annual rate				3.1	0.4	1.8	1.7	3.0	3.1	3.3	3.3
Private consumption	1.9	2.3	2.8	1.6	1.8	2.6	2.6	2.8	2.9	2.8	2.6
Fixed investment - nonresid.	8.0	4.5	6.8	-1.8	13.1	0.4	4.4	6.1	6.4	6.3	7.6
Fixed investment - residential	12.1	13.6	9.1	13.6	17.5	14.0	13.5	11.7	9.6	8.2	7.9
Government consumption	-1.7	-3.1	0.1	3.9	-7.0	-4.8	-4.9	-0.1	-1.0	1.0	1.2
Export	3.4	1.4	6.8	1.9	-2.8	-1.1	3.3	5.0	6.5	7.6	7.6
Import	2.4	0.8	5.1	-0.6	-4.2	-0.4	4.4	4.2	4.4	4.9	5.4
Stockbuilding (% contrib. to GDP)	0.1	0.0	0.0	0.1	-0.3	0.2	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	-3.0	-2.8	-2.6	-2.9	-2.8	-3.1	-2.7	-2.8	-2.8	-2.7	-2.6
Federal Deficit (% of GDP)	-7.5	-5.3	-4.6								
Gov. Debt (% of GDP)	106.5	109.8	109.8								
CPI (y/y)	2.1	1.4	1.7	1.7	1.9	1.7	1.3	1.4	1.3	1.3	1.8
Industrial production	3.6	2.5	3.9	0.4	2.4	4.6	0.8	2.7	4.0	4.5	4.2
Unemployment (%)	8.1	7.3	6.8	8.0	7.8	7.7	7.6	7.1	7.0	7.0	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)	73.5	76.6	76.1	74.0	73.1	74.8	76.3	77.8	77.4	76.3	76.0

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

The recovery keeps going: private demand is rising, despite the fiscal brake

Growth in the USA is continuing, and although volatile it averages out at a satisfactory rate, around 2% between the start of 2011 and mid-2013; in the same period, unemployment fell by around 1.5 percentage points. The fall in the unemployment rate was faster than forecast, considering the fairly modest growth posted since the end of the recession. Although GDP growth has surprised on the downside since 2010, the unemployment rate has corrected much faster than the historical relationship between the two variables would suggest. Overall, there are two critical points in the outlook: 1) private demand is growing at a fairly solid rate, and the sectors hardest hit by the crisis (household budgets and residential real estate) are definitely recovering; 2) the fiscal brake is huge, particularly in 2013, shaving around 1.5 pp off growth this year, although it is set to make a less negative contribution to growth in aggregate demand from next year on.

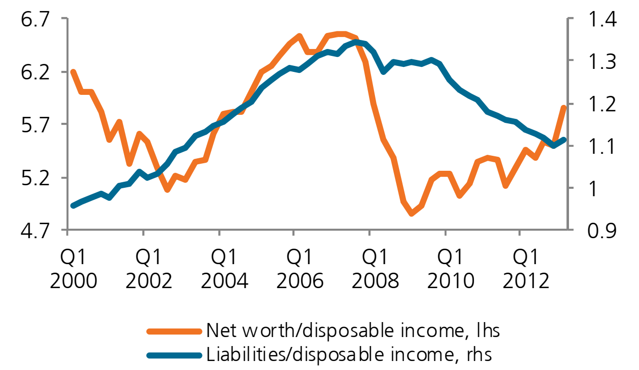
The extensive monetary stimulus injected, together with the healing of household balance sheets and of the real estate sector, has more than offset fiscal tightening. In addition, the wealth effect from the sharp increase in property values and from the easing in financial conditions that is still expected in most of 2013 will have an expansionary impact in 2014, supporting growth forecasts for 2H13 and next year. Our forecast is for growth to rise to around 3% between 2H13 and the start of 2014, buoyed up by dynamic private demand, particularly from consumption and residential investments.

1. Private demand: growth driven by consumption and residential investment. The main surprise in 1H13 was the growth in consumption despite the massive increase in fiscal tightening. Consumption in 1Q13 increased by 2.6% qoq ann. Although it will probably stabilise in 2Q, average growth in 2H13 should be only slightly below 3%. Consumption has been supported by the upturn that has now taken hold in house prices, the improvement in the labour market and by accommodative financial conditions, which more than offset increasing fiscal tightening. The latest flow of funds data show that net household wealth has increased further (see fig. 1), to an all-time high since the series began in 1945, with the net worth/disposable income ratio rising to 5.9, its level at the start of 2008. Wealth will continue to increase, buoyed up by higher house prices (see fig. 3) and financial assets: according to the San Francisco Fed, the USD 3Trn increase in wealth in 1Q increased spending by around USD 90Bn (0.8%). The liabilities/disposable income ratio, which was around 1.1 in 2H12, has fallen to levels not seen since 2003, thanks to the on-going drop in mortgages. The labour market is improving steadily, despite the impact of automatic public spending cuts. Growth in non-farm payrolls has accelerated, from 152,000 in 3Q12 (before the Fed injected fresh stimulus) to 192,000 for the first 5 months of 2013; unemployment has fallen from 8.2% in July 2012 to 7.6% in May 2013. All labour market indicators are pointing to a gradual but uninterrupted improvement that will be faster than in recent months, despite the growth pause in manufacturing in 2Q. The outlook for salaries and jobs seems to show a "substantial" improvement. Wages and the wealth effect (particularly real estate) are therefore supporting expectations of accelerating consumption, which is forecast to grow by 2.8% in 2H13 and in 2014 (from 2.5% forecast for 2013 overall).

Residential investment upturn continues. Residential construction continues to expand at a steady pace, driven by house price rises and a low level of unsold housing stock. The sector's indicators are positive across the board: residential investments are forecast to increase by 13.6% in 2013 and by 9.1% in 2014 (with upside risks).

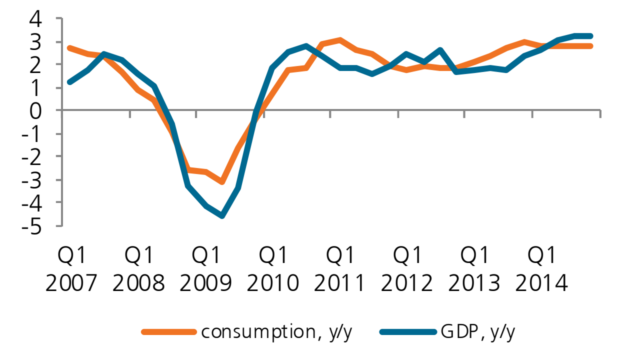
Non-residential fixed investment. Midway through 2013, the weakest link in the upturn in private demand has been businesses. Tax rises, fiscal uncertainty, and automatic public spending cuts (with a huge impact on defence) have curbed manufacturing activity. Orders data and the likely downsizing of tax cuts, together with the healthy state of consumption, suggest an upturn in 2H, with the auto sector making a sizeable contribution. The forecast is for a 4.5% increase in 2013 (from 8% in 2012), followed by slightly stronger growth in 2014 (+6.8%).

Fig. 1 – Household net wealth still growing, with assets on the rise and liabilities decreasing



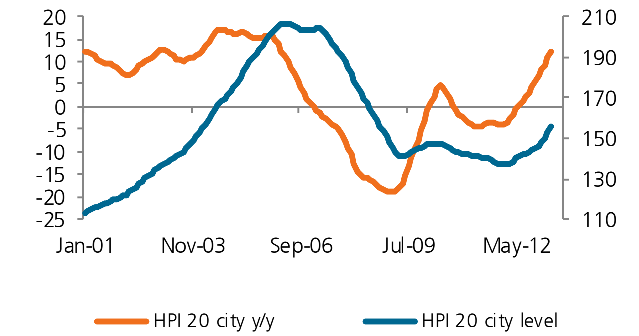
Source: Flow of Funds, Federal Reserve Board

Fig 2 – Consumption and GDP: acceleration expected from mid-2013 onwards



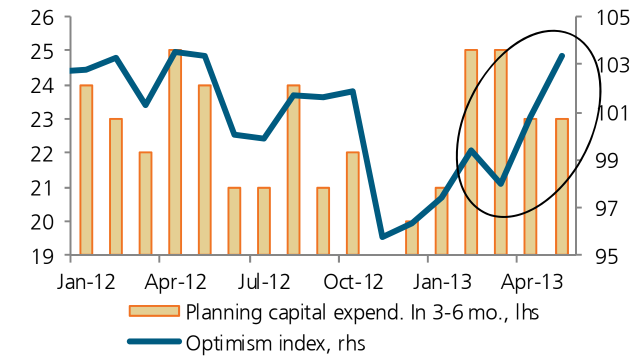
Source: Thomson Reuters Datastream. Yoy change. Intesa Sanpaolo forecasts

Fig. 3 – House prices have definitely reversed



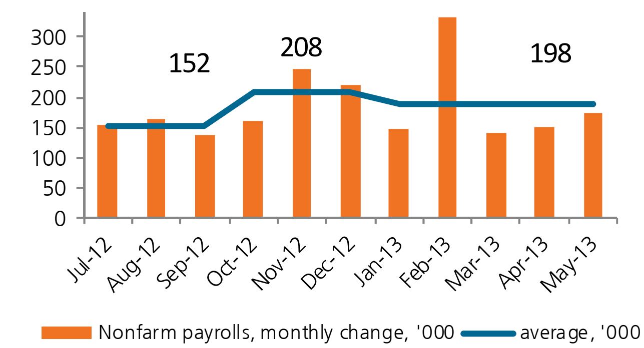
Source: Thomson Reuters – Datastream. House Price Index Case-Shiller, monthly, 20 main metropolitan areas

Fig. 4 – NFIB small firms survey: the *fiscal cliff* effect is over, firms becoming optimistic



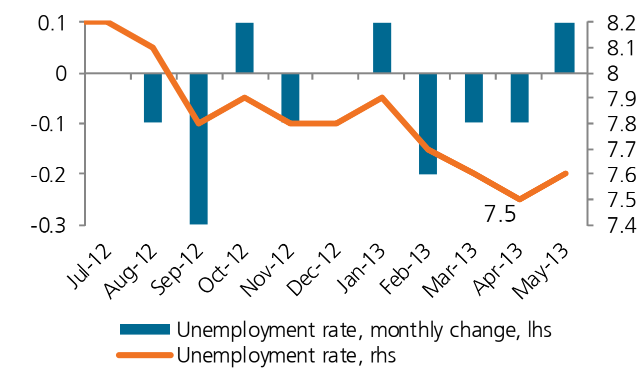
Source: Thomson Reuters – Datastream

Fig. 5 – Employment change moving up



Source: Thomson Reuters – Datastream

Fig. 6 – Unemployment rate: clear downtrend



Source: Thomson Reuters – Datastream. Monthly change

2. Fiscal policy: the deficit is falling more rapidly than forecast, thanks to increased revenues, spending cuts and growth in GDP. The Congressional Budget Office (CBO) has published updated growth and budget projections for the ten-year period 2013-2023: The outlook is rosier than that published in February 2013, largely due to the improvement in revenues between 2013 and 2015. In 2013, revenues are 15% higher than in 2012, which is 4% higher than the CBO's projections in February 2013; a substantial portion of revenues in 2013 derives in part from extraordinary factors, such as the payment of USD 95Bn in special dividends by Fannie Mae and Freddie Mac, and in part from higher tax revenue (+69Bn) due to VAT rises and extraordinary dividends paid in the autumn, and also an increase in corporation tax (+40Bn) driven by improved growth. Between 2014 and 2017, the forecast is set to improve, thanks in part to more robust tax revenue, but also to expenditure. Compared with the forecast in February, there is a marked reduction in growth in health and pension spending, with the change in health spending trends due to lower-than-expected growth recorded in recent years.

The CBO's new outlook shows a **deficit in 2013 of USD 642Bn (4% of GDP)**, which has more than halved from the figure in 2009 of 10.1% of GDP; in February 2013, the CBO was projecting a deficit of around USD 200Bn above the revised projection in May (USD 845Bn). The deficit should reduce to 2.1% of GDP in 2015, then increase in subsequent years to 3.5% of GDP in 2023, driven by growth in health spending and population ageing. Public debt is forecast to fall temporarily, from 76% of GDP in 2014 to 71% in 2018. Thereafter, the debt/GDP ratio is set to start increasing again (to 74% in 2023, and will not stabilise if current legislation remains in effect), even after the anticipated normalisation in interest costs. The **improvement in the fiscal picture**, although temporary, **reduces the pressure to implement fiscal consolidation measures**, postpones the date when the debt ceiling starts to bite again and paves the way, at least in the short term, for possible reductions in issuance of Treasury bonds.

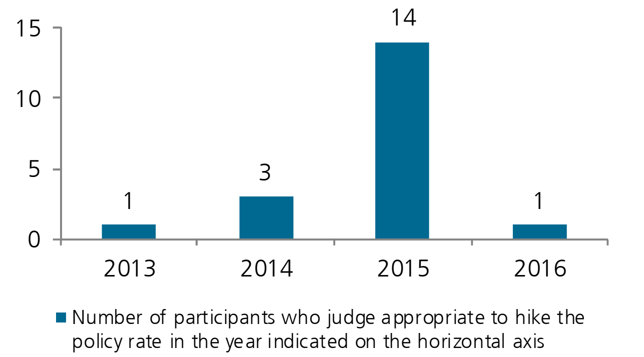
3. Monetary policy: the Fed has moved a first step towards the exit. The FOMC meeting in June signalled that "downside risks to the outlook for the economy and labor market have diminished since the fall", and that labour market conditions have improved further. Speaking at the press conference, Ben Bernanke indicated that if growth and employment progressed as anticipated, the FOMC could start reducing the pace of buying bonds "later this year".

If conditions remain favourable, the Fed would continue to scale back bond purchases "in measured steps" in 2014, ending interventions by "around mid-year". Bernanke added that a "strong majority" on the FOMC now expects not to sell MBS holdings as part of the *exit strategy*. The FOMC reiterated that monetary policy will remain highly accommodative for a considerable time, with the process depending on financial developments. The Chairman stressed that slowing the pace of bond-buying would not be a restrictive move, but simply a slowdown in the injection of fresh monetary stimulus. Unconventional monetary policy, according to the Fed, acts via portfolio effects, i.e. via stocks. When the balance sheet is expanding, the stimulus expands; when the balance sheet is stable, the stimulus remains unchanged; in essence, the Fed has its foot on the accelerator but is pressing it less.

However, information on policy rates has had a more significant effect on the markets' assessment of the policy outlook: rate hikes would be genuine steps on the stimulus brake. According to Bernanke, a reversal "is far in the future", with 14 of the 19 FOMC members believing it would be appropriate to raise the fed funds rate by the end of 2015 (13 in March). The distribution of assessments of the level of the fed funds rate sends a more hawkish message than in March, with rates expected to move higher (see fig. 9). This, more than the talk about tapering, explains most of the sharp market correction after the meeting.

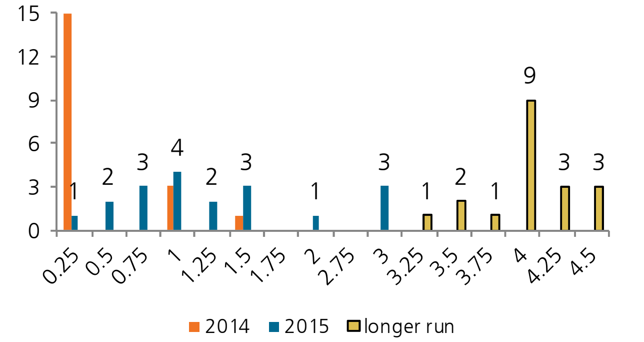
However, an **exit is still a long way off**, and Bernanke's Fed (as probably Janet Yellen's Fed from 2014), has an easing bias: Yellen has confirmed (December 2012) that an optimal policy would involve more accommodative measures first and possibly more restrictive ones later. The **steps towards an exit** are: 1) slowing the pace of purchases, to be defined meeting by meeting, from currently USD 85Bn a month to about USD 65-70Bn a month (i.e. increase in stimulus for 6-9 months from announcement); 2) a stable balance sheet (i.e. stable unconventional stimulus) until the end of 2015. **The actual exit** (i.e. the start of policy tightening) will come via: 1) a policy rate hike some time in 2015, after the unemployment rate has fallen below 6.5% (around the end of 2014); 2) later on, a reduction in the size of the balance sheet through maturing bonds.

Fig. 7 – Broad consensus on timing of reversal…



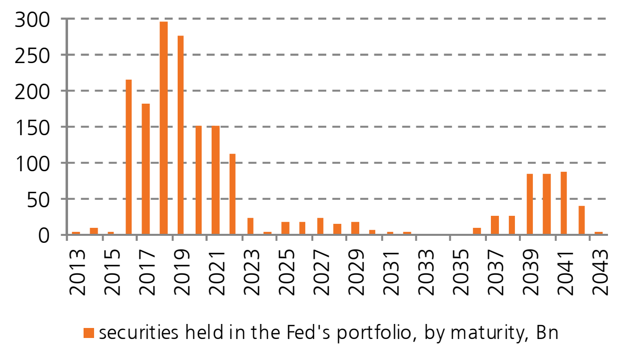
Source: Federal Reserve Board. Projections: June 2013

Fig. 8 – … but wide dispersion of opinions on appropriate level



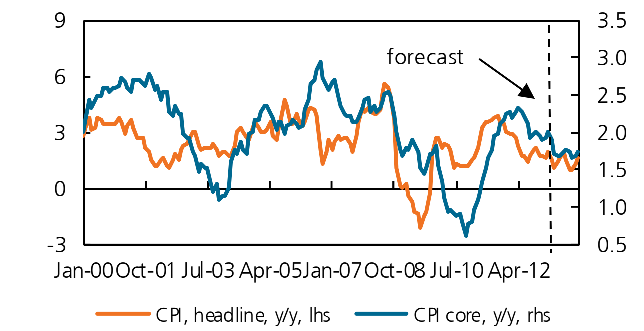
Source: Federal Reserve Board. Projections: June 2013

Fig. 9 – Securities in the Fed's portfolio by maturity (6/3/2013)



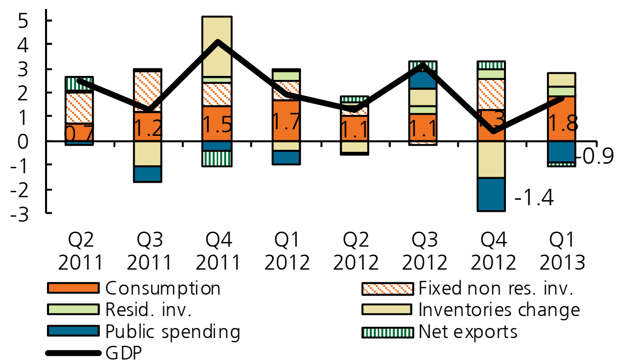
Source: Intesa Sanpaolo calculations on Bloomberg data

Fig. 10 – All quiet on the inflation front



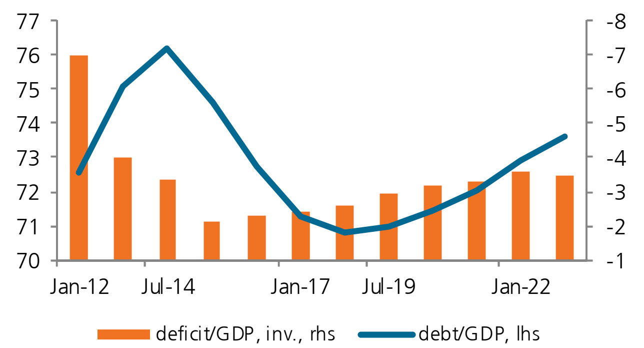
Source: Thomson Reuters Datastream, Intesa Sanpaolo forecasts.

Fig. 11 – Public spending is curbing growth



Source: Thomson Reuters Datastream. Contributions to qq ann. Growth

Fig. 12 – Deficit/GDP: rapid correction by 2015

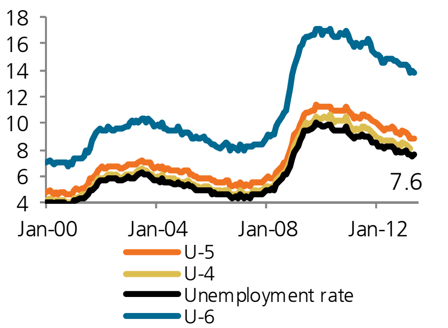


Source: Congressional Budget Office

The Fed's dashboard

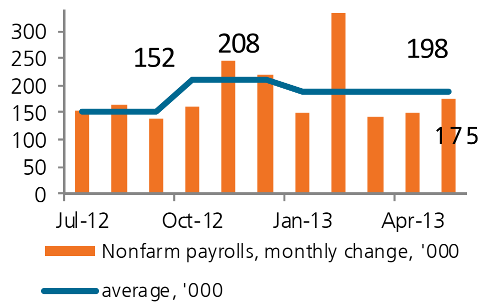
This set of 4 charts summarises the indicators that the Fed is following in order to assess what constitutes "substantial improvement in the labour market".

Fig. 1 – Unemployment



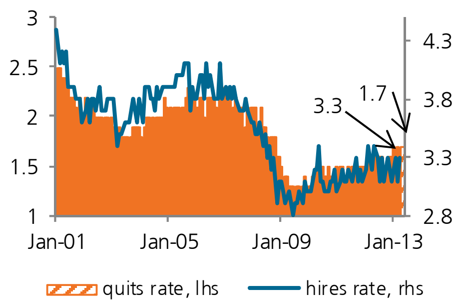
Source: Bureau of Labor Statistics. See note below for definition of the variables

Fig. 2 – Change in non-farm payrolls



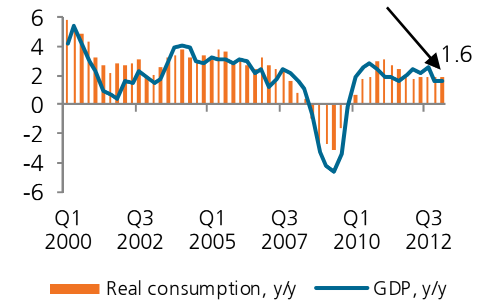
Source: Bureau of Labor Statistics

Fig. 3 – Gross labour flows



Source: Bureau of Labor Statistics, JOLTS

Fig. 4 – Growth in real demand: consumption and GDP



Source: Thomson Reuters – Datastream

Note re Figure 1: U-4: total unemployed + discouraged workers, as a percent of the labour force plus discouraged workers. U-5 = total unemployed, plus all other persons marginally attached to the labour force, as a percent of the labour force plus all persons marginally attached to the labour force. U-6 = U-5 plus persons employed part time for economic reasons, as a percent of the labour force plus all persons marginally attached to the labour force. Persons marginally attached to the labour force are not part of the labour force, would like to work, would be available to work and have looked for work in the last 12 months.

Note re Figure 3: Hires level = hires as a percent of total employed. Separations level = voluntary separations as a percent of total separations (quits, layoffs, discharges resulting from mergers, etc.).

Euro zone – Economy at a turning point, but recovery will be slow

- **The first quarter of 2013 should prove to be the low point of the current economic cycle in the Euro area.** The economy is expected to have stabilised in the Spring and to return to growth in the second half of the year, driven first by exports, then by corporate investments, while consumer spending and investments in the construction sector remain very frail. However, a weak start to the year could result in a slightly sharper GDP contraction in 2013 than in 2012 (-0.7% vs. -0.5%). Nonetheless, in our base-case scenario the easing of tensions on financial markets, and a less contractionary fiscal policy, should allow the economy to resume growing, in our estimate by 0.9%, next year.
- **More in detail, risks of a financial nature seem to have receded**: with the "safety net" represented by the ESM and the OMT mechanism fully in place, the risk of contagion are less of a concern, despite the problems with support programmes in Greece and Portugal.
- **In any case, the recovery will be very slow, in our view**, as: 1) fiscal policy, while becoming gradually more flexible, remains a drag; 2) the improvement of risk indices on financial markets has still not translated into a visible easing of credit conditions; 3) at least in part, the marked deterioration of labour market conditions may result in an increase in structural unemployment. The main risks weighing on the scenario are: i) a possible re-exacerbation of the financial crisis (always possible, albeit buffered in its effects by the safety net formed jointly by the ESM and the ECB); ii) a potential reversal of the international economic cycle (albeit in our view rather unlikely).
- Inflation is declining. Between the end of summer and March 2014, a favourable base effect from the energy component will push inflation to 1.0%. Available information suggests that upstream pressure is close to non-existent. The growth in the output gap and high unemployment rate will put further downward pressure on core inflation, at least until mid-2014. We believe the risk of deflation in the Euro zone average is low since the response of cyclical inflation to the slack in the economy could be limited, and because the labour market is likely to turn around in 2014. However, we believe that over the next 18 months risks to inflation are more to the downside.
- For its own part, the European Central Bank could still limit the rate on key refinancing transactions, even though this would have little significance for the economy and markets. On the other hand, a cut in deposit rates, which are currently at zero, seems more unlikely. We do not expect unconventional measures apart from the maintenance of the current status quo (full allocation, OMT).

Macro forecasts - Eurozone

				2012		2013				2014	
	2012	2013	2014	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	-0.5	-0.7	0.9	-0.7	-1.0	-1.1	-0.9	-0.7	0.0	0.5	0.8
- q/q change				-0.1	-0.6	-0.2	0.0	0.1	0.2	0.3	0.3
Private consumption	-1.3	-0.5	0.6	-0.2	-0.6	0.1	-0.1	0.1	0.2	0.1	0.1
Fixed investment	-4.2	-3.2	2.0	-0.9	-1.4	-1.6	-0.1	0.4	0.6	0.5	0.5
Government consumption	-0.4	-0.2	0.4	-0.2	0.0	-0.1	0.0	0.0	0.1	0.1	0.1
Export	2.9	1.0	4.4	0.8	-0.9	-0.8	1.0	1.3	1.1	1.0	1.1
Import	-0.7	-0.4	4.3	0.2	-1.2	-1.1	0.8	0.8	1.2	1.2	1.0
Stockbuilding (%contr.to GDP)	-0.5	-0.4	-0.1	-0.1	-0.1	0.0	0.0	-0.3	-0.2	0.1	0.1
Current account (% of GDP)	1.3	1.8	1.8	1.3	1.6	2.5	1.7	1.5	1.5	2.8	1.7
Deficit (% of GDP)	-3.7	-3.2	-3.0								
Debt (% of GDP)	90.6	93.6	94.0								
CPI (y/y)	2.5	1.4	1.4	2.5	2.3	1.9	1.4	1.2	1.1	1.1	1.5
Industrial production	-2.4	-0.4	2.0	0.1	-2.0	0.1	1.1	0.5	0.2	0.4	0.7
Unemployment (%)	11.4	12.3	12.1	11.5	11.8	12.0	12.3	12.4	12.4	12.4	12.3
3-month Euribor	0.57	0.16	0.15	0.36	0.20	0.17	0.20	0.15	0.12	0.10	0.10

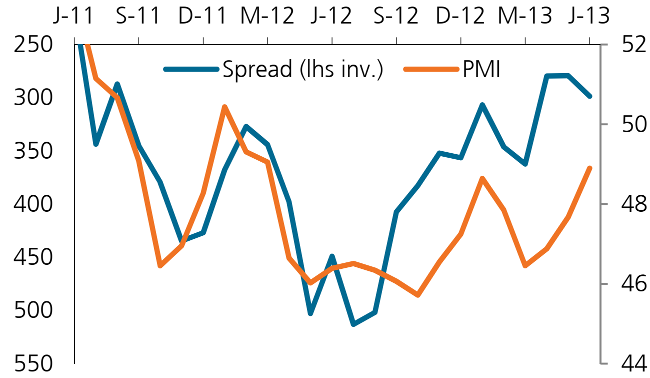
Note: Percentage annualised growth rates over previous period, if not otherwise specified.
Source: Eurostat; Intesa Sanpaolo forecasts

Risks to economic activity remain to the downside…

Paolo Mameli

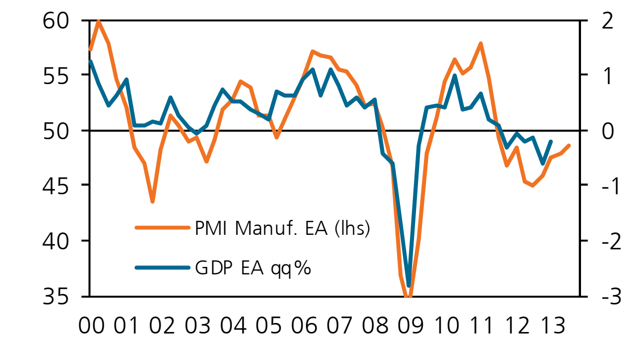
The latest figures for the Euro zone economy show that the significant easing of tensions on the financial markets that began at the end of last Summer has yet to convert into a substantial improvement in real economic activity. Confidence (summarised by the PMI composite index) only started showing signs of improvement in the Spring, reaching 48.9 in June, which is below the threshold value for the seventeenth month in a row although a 15-month high. More generally, however, the level of the main leading indicators (even in industry, where there was a significant recovery in production between 1Q and 2Q) remains consistent with a slight contraction in economic activity.

Business confidence indices are reflecting only partially the easing of financial tensions…



Note: "spread" is the average of the 10Y spread between BTP/Bonos and Bund.
Source: Intesa Sanpaolo chart from Markit Economics and Bloomberg data

… and remain consistent with growth still in slightly negative territory

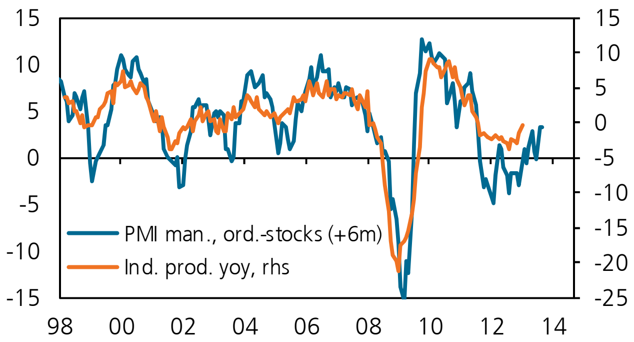


Source: Intesa Sanpaolo charts based on Eurostat and Markit data

However, we believe it is only a question of time before progress in the financial crisis, which played such a major role (through its impact on confidence and lending) in pushing the real economy into the current recession, translates into a recovery in economic operators' morale and in real activity. We will have to wait until 2014 to see an improvement in lending conditions, given that they remain tight, due now to the economy's weakness rather than supply-side factors, which has led to higher insolvency rates amongst households and above all companies. However, it is not from the lending, which traditionally lags the cycle, that we will see the first signs of recovery.

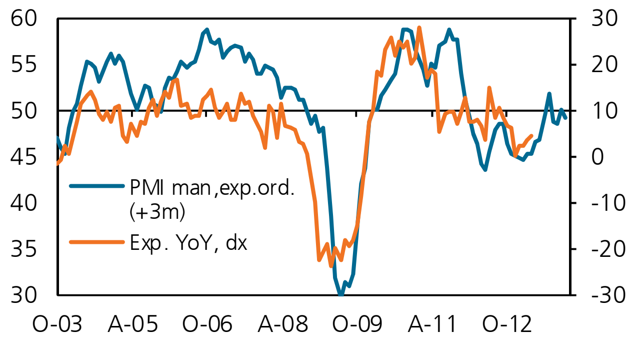
While consumer confidence and spending continue to be weighed down by the weak job market (which pushed unemployment to all-time highs and continues to squeeze households' disposable income), recovery will, as usual, come from companies, through exports. In fact, the upturn in world trade indices and in demand from the Euro zone's main trading partners has boosted foreign orders for manufacturing companies, which suggests that Euro zone exports will rise in the next few months. If, as in our central scenario, growth in the global economy accelerates in 2014 to a cruising speed closer to 4%, having slowed to just over 3% in 2012-13, the Euro zone (which has become decidedly more export-led of late, as a consequence of the crisis hitting domestic demand) only stands to gain. The healthy effect on company earnings of foreign sales is likely to lead with a certain lag to a recovery in company investment. The combination of the recovery in orders and the fall in inventories, as reported by companies in the surveys, already suggests that the low point of the cycle could be past for industry, the sector that offers the earliest indication of a turning point in the cycle. As such, the upturn in industrial production between February and April is encouraging, although it could be partly due to one-off factors that will probably drop out of May's figure. As regards construction, it is not reasonable to expect a recovery here, given that past imbalances are still being corrected in most peripheral countries.

Industry seems to have overcome the worst…



Source: Intesa Sanpaolo charts based on Eurostat and Markit data

… and the recovery will be export-driven



Source: Intesa Sanpaolo charts based on Eurostat and Markit data

In any case, we believe that the recovery will be very slow, since: 1) public finances are still squeezed, and while fiscal policy has gradually become more "flexible", it is still not able to provide an appreciable economic stimulus; 2) quantitative and qualitative indicators on credit remain in recessionary territory, and the improvement in financial market indices has yet to reflect in a substantial easing of lending conditions, particularly to companies; 3) the marked deterioration in the job market could, at least in part, lead to in a rise in structural unemployment: long-term unemployment (more than 12 months) has been growing uninterruptedly since mid-2009, and is now almost half the total; the percentage of unemployed young people that are not taking part in study or training programmes is high; NAWRU (non-accelerating wage rate of unemployment) estimates provided by the European Commission show a marked increase since 2008 (as well as a worsening of mismatch indicators on the job market). In addition to the above three factors, which are the main risks weighing on the scenario, we should mention two more: i) the financial crisis could flare up (although its likeliness has receded and its effects would be mitigated by the safety net provided by the ESM and ECB); ii) the global economic cycle could reverse (although we believe this is unlikely).

… but the economy should return to growth between spring and summer

After six consecutive quarters of contracting (a record in the more than 20 years of the series), economic activity in the Euro zone should have at least stabilised in the Spring quarter, which could represent the lower turning point of the economic cycle (GDP is also reversing on an annual basis, from -1.1% to -0.9%). It is expected to further improve in the second half of the year, when GDP growth should return to slightly positive territory. However, in light of disappointing data in the final quarter of 2012 and the first quarter of 2013, the contraction in GDP this year could be more pronounced than that registered last year (-0.7% versus -0.5%). Compared with three months ago, hard data for the first few months of the year are worse than expected, but the outlook for the remainder of the year seems to have improved, thanks to two factors:

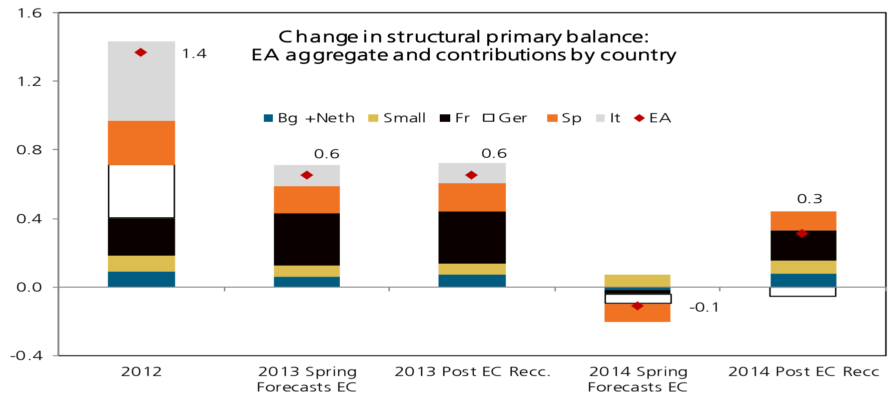
1) the easing of financial risks: the environment has become more favourable now that the "safety net" – comprising the ESM and the OMT mechanism established by the ECB – is fully effective. The trouble spots that erupted bit by bit in the various countries in the eye of the storm have been extinguished (negotiations on the bail-in for Cyprus completed, the political stalemate in Italy ended, maturities extended on loans granted to Ireland and Portugal, and more time granted to various other countries for fiscal correction), slashing the odds of an "extreme" outcome to the crisis (and consequently heralding a significant retreat in risk premium indices). Given that financial factors were a major cause of the recession in the last year and a half, it is reasonable to expect their contribution to the real economy to be just as

significant should these risks recede (they could, however, make less of a contribution: various studies[1] show an asymmetry in the financial cycle's impact on the real economy). It is true that the recovery in financial market risk premium indices has yet to feed through to a substantial improvement in company confidence indices, and via these, to the real economic indicators (we cannot, however, rule out the possibility that the recovery registered in May and June by most business confidence indices is linked to this factor; we therefore believe that we may have seen the start of such a trend, and that it is only a matter of time before it has a more significant impact on economic activity);

2) the adoption of less tight fiscal policies, which will take two forms: a) a less restrictionary revision of public account balances, which can be seen from a comparison of the targets contained in the 2013 Stability Programmes with last year's (particularly marked for Italy, Spain, Portugal, but also Belgium and the Netherlands) and in the granting of more time to various countries (Spain, France, the Netherlands, Portugal and Slovenia) to correct their excessive deficits; b) a restructuring of the fiscal correction (assuming equal balances) in a manner less damaging for growth: The measures adopted in Italy and France can be read in this light: Italy's measures include repaying the Public Administration's outstanding debts (which only have a limited impact on the 2013 deficit) and those contained in the "decreto del fare" (the "decree of doing", which includes extending access to credit and tax credits for companies, a fiscal bonus for investment in machinery, dividing tax payables into instalments, unblocking certain building projects, speeding up civil proceedings); and France's measures are contained in the National Pact for Growth, Competitiveness and Employment (which include tax breaks for companies and improved access to financing for small companies).

Moreover, despite its more flexible approach to fiscal adjustment, the European Commission, having examined the Stability Programmes for 2013-2016, recommended an additional structural fiscal correction, particularly for France and Spain. As a consequence, in 2014, fiscal policy will tighten further by 0.3% of GDP, while Commission forecasts in the Spring pointed to an easing of 0.1%. In any case, the drag on the cycle from fiscal policy has already had an impact of 0.6% of GDP in 2013, less than half that registered the previous year, and will have little relevance next year. Therefore, once the effects of the fiscal correction have been absorbed, and given that financial tensions have already eased significantly, the economy could return to growth in 2014 (we estimate 0.9%, after -0.7% this year).

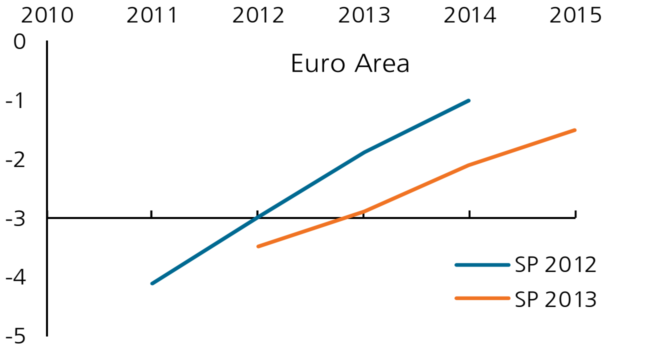
Fiscal policy trends in the Euro zone (before and after the Commission's recommendations at the end of May)



Note: Small = PRT, IRL, GRC, SLJ, SLK. Source: European Commission forecasts in spring and European Commission recommendations of 29 May 2013

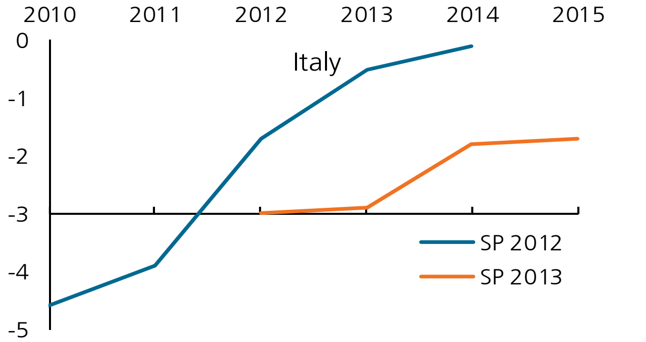
[1] Aizenman, J., B. Pinto e V. Sushko, "Financial sector ups and downs and the real economy: Up by the stairs, down by the parachute", BIS Working Papers, No. 411, April 2013.

Revision of fiscal targets in the 2013 Stability Programme versus the 2012 Stability Programme: Euro zone...



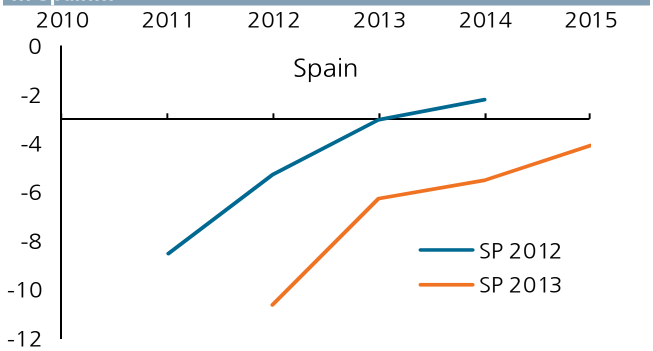
Source: National Stability Programmes for 2012 and 2013

... Italy...



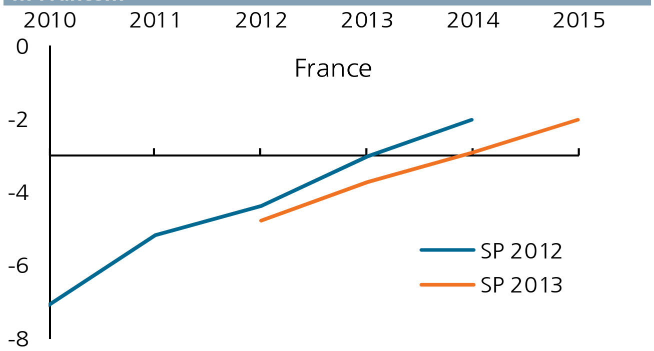
Source: National Stability Programmes for 2012 and 2013

... Spain...



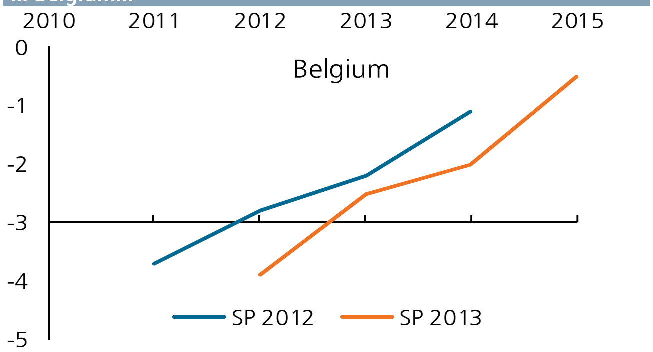
Source: National Stability Programmes for 2012 and 2013

... France...



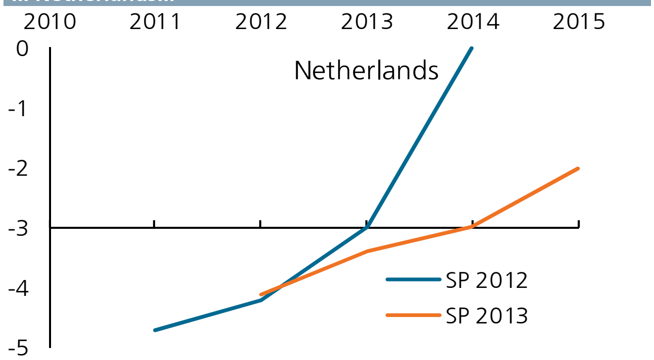
Source: National Stability Programmes for 2012 and 2013

... Belgium...



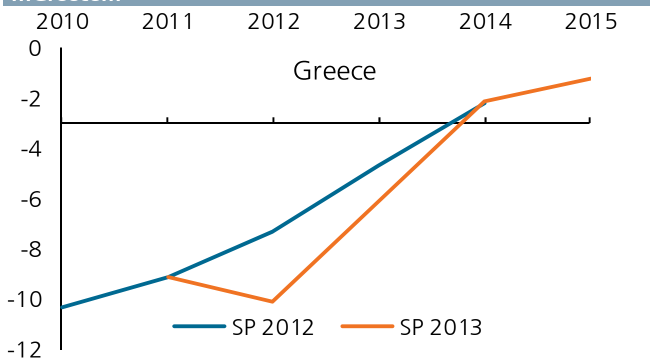
Source: National Stability Programmes for 2012 and 2013

... Netherlands...



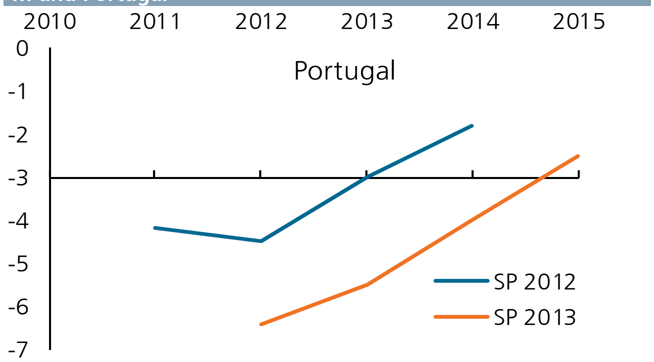
Source: National Stability Programmes for 2012 and 2013

...Greece...



Source: National Stability Programmes for 2012 and 2013

... and Portugal



Source: National Stability Programmes for 2012 and 2013

Euro area inflation: gauging deflation risks

Anna Maria Grimaldi

Euro area inflation dropped from 2.6% y/y last August to 1.2% y/y in April, and rose back to 1.4% y/y in May. The drop in inflation was sharper than had been forecasted last September (both by Consensus forecast (1.6%) and the ECB (1.9%) as the energy component slowed more than anticipated from 9.0% y/y at the end of the summer to -0.25% y/y in May. Food prices had a modest impact on the overall trend of consumer prices in the past nine months, as the drop in the prices of processed products offset the increase in fresh products. Yet the slowdown of inflations is not only due to the volatile energy and food components but also to declines in core prices. Inflation excluding energy and seasonal food, - ECB's preferred measure of core inflation-fell to 1.3% y/y from 1.7% y/y last August. Inflation stripping off energy, food and the effect of administered prices and taxes, a proxy for cyclical inflation, plunged from 2.0% last August to 0.8% y/y in May, an all-time low since the series for prices excluding administered prices and taxes were introduced (2003 and 2004 respectively). It goes without saying that the average hides wide divergences within the area, with cyclical inflation in peripheral countries decreasing more rapidly than in core countries. In Greece cyclical inflation has been in negative territory since march 2010 and in Ireland and Portugal returned to positive territory in the past year but remains close to zero. The trend in core inflation is starting to raise concerns the Euro area may enter into deflation territory. During his latest press conference, Draghi said he sees no deflation risks as the year-on-year drop in domestic prices is limited to only a few countries and to certain categories of goods. More importantly, he added, medium-term inflation expectations remain well-anchored. On the whole, the ECB believes risks to the consumer price trend are still balanced, and stressed the recent downward revisions to inflation projections were triggered by surprises from the energy component.

What should we expect from euro area inflation? Our forecasting scenario prices in a temporary increase in euro area inflation to 1.5% in the summer, followed by a decline towards 1.0% in the autumn, largely due to a favourable base effect in the energy component. In general, euro area inflation remains strongly dependent on the energy prices dynamics and on oil prices abrupt movements. Our estimates is based on oil price at USD 107.7 in the second half of this year (from USD 109 in 1H) and rising to USD 111 next year. We expect the EUR/USD exchange rate to move from its current levels to 1.29 in 2H 2013, and 1.28 next year. Food prices should make a gradually smaller contribution in the second half of this year, in part as the effect of the shock to agricultural commodity prices last summer should wane from the year-on-year comparison and as producer prices in the food sector slowed down the past six months. On balance we see inflation averaging 1.4% this year and next.

In general, available data point to mounting downside pressures at the top of the supply chain: in May, PMI price indices (composite, prices paid, and prices asked) hit a low since mid-2009 and then rose back in June respectively to 50.4 and 48.1. Prices' expectations, based on the EU Commission's surveys, decreased steadily since September, and in May hit a low since the end of 2010. The decline in price expectations was sharper in the services sector which is more closely tied to domestic demand dynamics. The PMI manufacturing prices paid index stood at 44.6 in June signalling a deceleration in producer prices excluding energy in the coming months. Moreover the decline in consumer goods' producer prices since the summer suggests a further slowdown in non-energy consumer prices over the next four months. External factors, and the trend of upstream prices, should therefore exert downward pressures on consumer prices over the next four to six months. As it is always the case, the trend of producer prices is heavily conditioned by potential surprises on commodity prices.

How much further can core inflation drop

The real question for inflation dynamics is by how much core prices can fall over the forecasting horizon. Economic literature and historical precedents suggest that the change in core inflation is inversely related with the change in the output gap[2]. The IMF, in its latest WEO outlook[3], noted that in the past ten years the response of core inflation to the output gap dynamics decreased significantly in advanced countries [4], as more stable inflation expectations, associated with credible monetary policies and to a more or less explicit medium-term inflation targeting, helped keep the inflation under check and less linked to past inflation. The existence of a Phillips curve for the euro area remains controversial[5]. In its January 2011 Bulletin, the ECB indicated that for the euro area the reaction of core inflation to the economic slack is rather limited, unless the changes in the output gap are rather ample, or at least this was the case in the 2006-2010 period. The ECB suggested as an explanation the increasing weight of inflation expectation and, to a lesser degree, the downwards stickiness of wages and prices in the euro area. The studies that point to a fall in the slope of the Phillips curve suggest that the scope for much larger drops in euro area core inflation are limited. Yet, another issue arises when trying to gauge the effects of the output gap on core inflation dynamics. Output gap estimates are typically marred by a wide margin of uncertainty, and therefore the impact on core inflation is hard to quantify *a priori*. For the euro area, the OECD estimates an output gap of -4% still in 2014 almost unchanged from this year. In its Spring forecasts, the European Commission projected an output gap of -2.2% (from -2.9% in 2013) for the Euro area in 2014 almost half the size of the OECD estimates. The discrepancies between the EC and OECD output gap projections, are due to the fact the Commission estimates that rise in unemployment, triggered by the Euro area crisis, is in part structural and thus leads to lower potential growth[6]. Needless to say that a tighter output gap reduces the scope for significant additional downside for euro core inflation dynamics. Conversely if the slack in the economy is smaller the risk of inflation picking up significantly, when the economy turns, is also more muted. Beyond estimation difficulties and possible structural changes, it is hard to believe that with an all-time high euro area unemployment rate, and which may keep rising until the end of 2013, exerting downward pressures on labour costs, there will be no effect on the trend of domestic prices in the euro area. Hourly labour costs slowed to 1.2% y/y in December 2012, from 2.4% in 2011 and then rose back to 1.6% in March on the back of wage increases, mostly concentrated in Germany, and one off effect in Italy's non-wage costs. We think the deceleration trend in labour cost is set to stay in place, in particular in the Periphery. The reforms implemented in recent years may even amplify the reaction of wages to the wide output gap. The ECB, in its May Bulletin, signalled that wage cuts in the public sector in peripheral countries helped generate downside pressures on the trend of contractual wages. Labour costs in the periphery decelerated in the past four years, whilst accelerating in core countries, and in Germany in particular. The trend is also confirmed by the dynamics of unit labour costs (with the exception of Italy), therefore a convergence process both nominal and real is undergoing in the euro area. On balance, we think that the high unemployment rate should keep wages and domestic prices under on a downward trend in the Euro area average.

Deflation risk in the Periphery (Greece is already in deflation territory and Ireland and Portugal only recently exit deflation territory) is not negligible. Yet, we think the risk of deflation risk in the euro area as whole is contained partly as the response of inflation to economic slack may prove blander than in the past, as part of the rise in unemployment may be of a structural nature, and given the increasing weight of expectations in determining domestic prices. In addition wages in Germany are rising fast and well above the rest of Europe average. Last but not least, most of the deterioration of the labour market should now be behind us, not only in

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[2] See IMF working paper No. 189, August 2010.

[3] See WEO, April 2013, Chapter 3.

[4] Also see Anderton et al. "*Key elements of global inflation*" Reserve bank of Australia Volume 2010

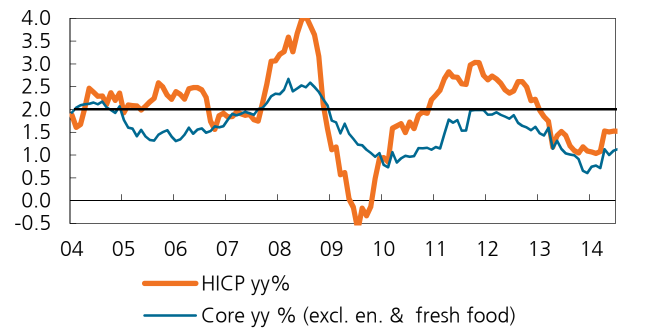
[5] See A. Musso, L. Stracca, D. van Dijk ECB working paper no. 811, September 2007

[6] See EC *Spring forecasts* Box 1.1, pp 11 - 13

core countries but in the periphery as well, and the output gap should start to close in the second half of this year. Therefore, downside pressures to the trend of domestic prices should gradually wane if growth resumes. Overall we see core inflation (excluding energy and seasonal food) averaging 1.1% this year and next, yet the dispersion within the EA will remain high.

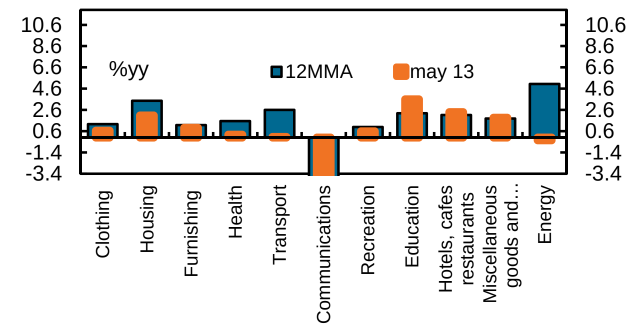
In conclusion, while we think that deflation risk in the euro area is rising but still contained, we continue to consider risks to euro area inflation to be more skewed to the downside than balanced, as the ECB assessed in its June introductory statement. If the risk of deflation is limited in terms of the euro area average, the same does not apply to peripheral countries, where core inflation net of administered prices and taxes could keep slowing, as the adjustment process requires a change in the domestic demand trend, which could still last for a while, especially in Spain and Portugal.

Inflation to stay well below 2% until June 2014



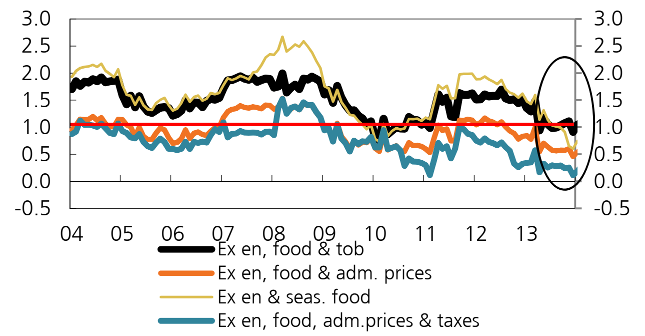
Source: Eurostat and Intesa Sanpaolo elaborations

Drop in inflation in the past nine months mostly tied to the energy component



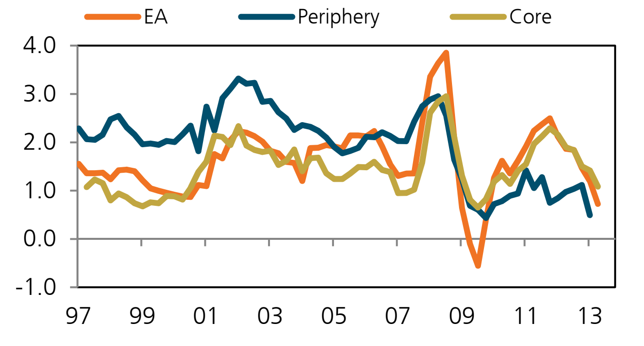
Source: Eurostat and Intesa Sanpaolo elaborations

The core price trend slowed significantly, especially when excluding the contribution of taxes and administered prices



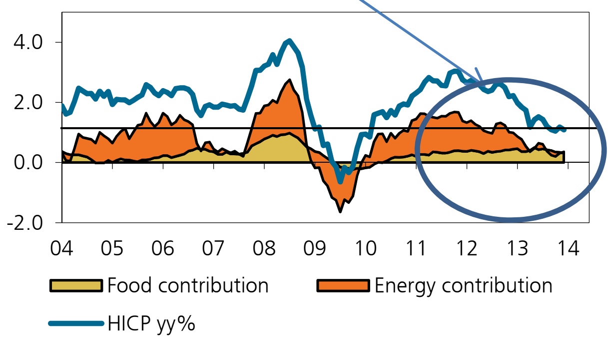
Source: Eurostat and Intesa Sanpaolo elaborations

Drop in cyclical inflation – core inflation net of taxes and administered prices – especially sharp in peripheral countries



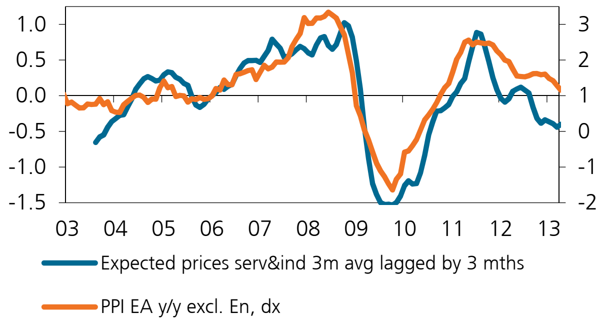
Note: The weight assigned to Core (Ger, Fra, Holland, Belgium) and Periphery (Ita, Spa. Port, Irl, Gr.) country weights are those used in euro area HICP. Source: Eurostat and Intesa Sanpaolo elaborations.

Inflation profile still dependent on the trend of energy and fresh food



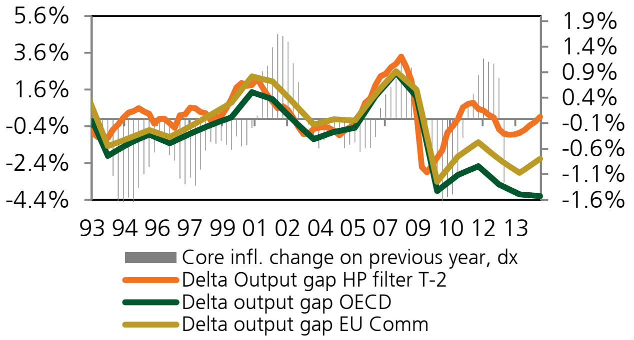
Source: Eurostat and Intesa Sanpaolo elaborations

Pressures upstream of the supply chain are on the downside



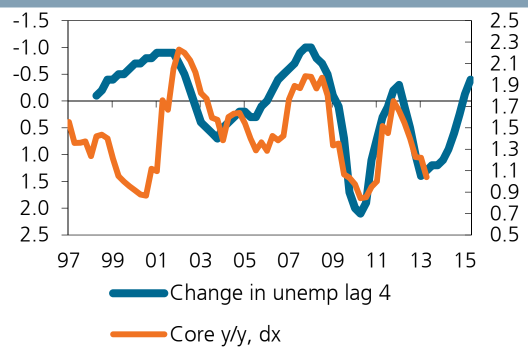
Source: EU Commission, Eurostat and Intesa Sanpaolo elaborations

The width of the output gap remains uncertain. The response of inflation to economic slack may be somewhat lower than in the past



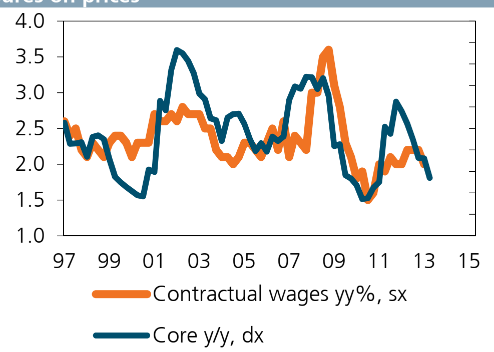
Source: OECD, EU Commission, Eurostat and Intesa Sanpaolo

Yet it is hard to think the high unemployment rate and …



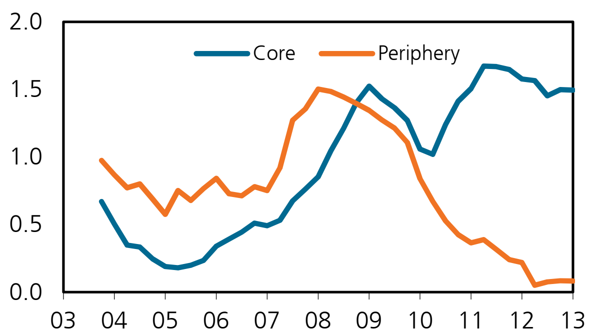
Source: Eurostat and Intesa Sanpaolo

… slowing labour costs will not exert further downward pressures on prices



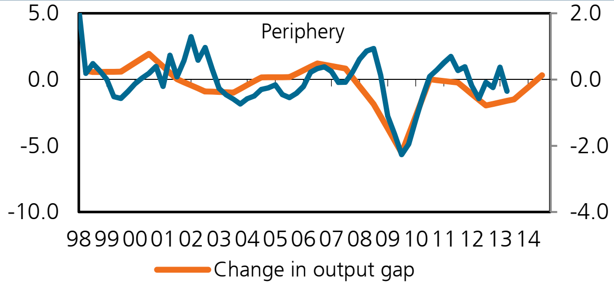
Source: Eurostat and Intesa Sanpaolo

Labour costs fell in the Periphery but accelerated in Core



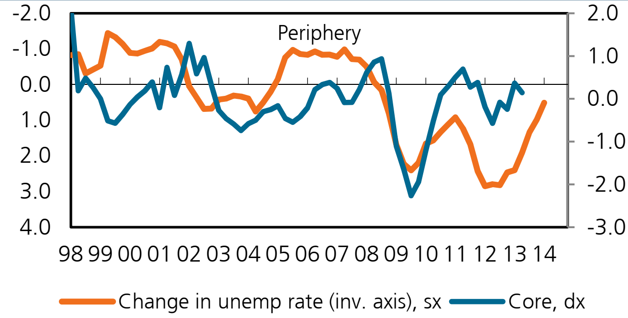
Note: Periphery (Ita, Spa. Port, Irl, Gr.) country weights are derived from GDP weights. Source: Eurostat and Intesa Sanpaolo

The output gap in the Periphery suggests downward risk for cyclical inflation



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

Yet, should the labour market turn the deflationary forces should slowly recede



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

ECB: to keep all options open for a while

Anna Maria Grimaldi

At its June meeting, the ECB offered a detailed list of the policy instruments it may use in case of need. In our view, these instruments will be kept "on the shelf" for the time being, to better assess developments in terms of economic data and on the markets before adding new monetary stimulus. The ECB's rhetoric will remain accommodative, and should economic data prove disappointing over the summer, it could opt for a further 25 basis point cut, justifying the move with a revision of growth estimates in September. Risks to the inflation trend remain skewed to the downside, as discussed in our WEM of 21 June. The ECB will surely keep an easing bias as Draghi, on June 26th, assured that the ECB stands "stand ready to act again when needed" and that in any case "an exit is very distant and monetary policy will remain accommodative for as long as needed". A refi rate cut would in any case have limited effects on the real economy, as the benchmark rate is the deposit rate.

A refi cut by the end of the summer is a possibility if data disappoint yet a negative deposit rate is still unlikely

A reduction of the deposit rate into negative territory remains an option for the ECB. In the past two meetings, Draghi stressed that the ECB is ready to manage the unintended consequences associated with a negative deposit rate, should it consider such a cut necessary. As explained in detail in the Focus which follows this editorial, a deposit rate below zero should encourage circulation of liquidity on the interbank market. The measure should act on the monetary base multiplier, reducing bank's preference for reserves and fostering lending. However, the main positive effect would come via a drop in short-term government rates and a probable redistribution of excess reserves towards peripheral countries, rather than through an increase in volumes on the interbank market. Beyond the considerations on the effectiveness of the measure, the decision whether or not to cut the deposit rate will depend on the level of market fragmentation within the euro area. For now, TARGET II balances continue to improve and, over time, an effect on the circulation of capitals within the euro area should also become visible. The ECB assured that it would closely monitor all money market developments and act accordingly. Presumably, if a rise in short-term rates takes shape, chances of a deposit rate cut should increase.

OMTs: a safety net in case of heightened market volatility

The market (over) reaction triggered to the Fed announcement could partly reabsorb over the coming weeks, also considering that if the Fed is to remove stimulus gradually the BoJ will step up JGB purchases, guaranteeing abundant liquidity worldwide. In any case, OMTs represent a safety net in the event of market tensions persisting or intensifying. The Bundesbank's opposition and the Karlsruhe *querelle* should not prevent the ECB from intervening if it deems it necessary. The German court will issue its ruling at the end of September, but has no power to judge the actions of the ECB – that is the task of the European Court of Justice. The ECB, as indicated by Asmussen, head of ECB legal affairs, believes it acted fully within the borders of its mandate, and is confident of the qualified legal opinions it received. Draghi has strenuously defended the legitimacy and necessity of OMTs, stressing their undeniable beneficial effects. Therefore, we think the constitutional court's pending ruling is unlikely to hinder the activation of OMTs should the ECB deem it necessary.

Additional liquidity measures do not seem urgent

We do not expect the announcement of new medium-long term refinancing operations in the summer. Liquidity no longer seems to be such an urgent problem. Repayments of LTRO funds now amount to 303 billion euros, and have resulted in a drop in the system's excess reserves to 248 billion euros. The ECB's latest lending survey shows that banks in the periphery still find it harder to access the market than core country banks, but the gap is closing. Therefore, we believe policies on collateral aimed at correcting the lack of funds for some euro system banks (presumably of small size) are not so urgent. The activation of measures of this type, if the ECB deems them necessary, should not meet with opposition within the Council, especially if the risk associated with the changes in collateral stays on the balance sheets of national central banks.

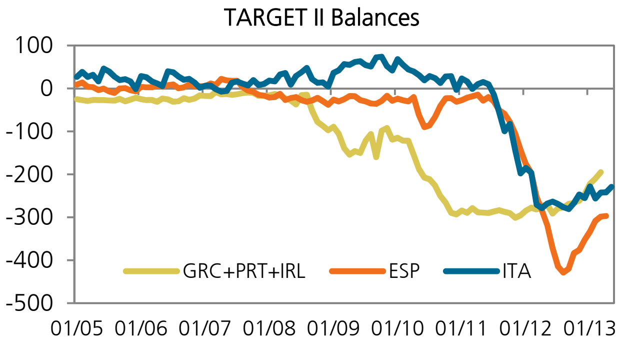
It should be pointed out that excess reserves are approaching the 200 billion euro mark, a threshold level according to the ECB, beneath which the EONIA rate could distance itself from the floor of the refi rate's fluctuation range. The FRA 1*4 on the EONIA rise to 0.27 from 0.20 on 4/06/2013, but remains on historically very low levels, as is also the case for the 3m EONIA swap rate. Even if money market rates rise further, the ECB could intervene with a refi rate cut. In a full-allotment auction regime, the refi represents a limit for money rates, as at significantly higher rates it would be more convenient for banks to fund themselves by tapping the ECB window.

Credit easing measures for SME to fall under EIB and EU Commission responsibility

Despite somewhat more normal financial markets trends and lower uncertainty, credit to the private sector remains sluggish in core countries and keeps on falling in the periphery, due to high credit and sector risk. The ECB has indicated that it is a matter of time before the easing of market tensions starts to reflect on the real economy and on the loans trend. According the Reuters, the European Commission and the EIB are working on a project aimed at activating between 55 and 100 billion euros in loans to enterprises in Southern Europe, leveraging 10 billion euros of structural EU balance sheet funds. Apparently, the ECB will not be directly involved in the project. As we had expected credit easing measures would have not met with sufficient consensus within the Council if credit risk, associated with them, was to fall directly or indirectly on the ECB balance sheet.

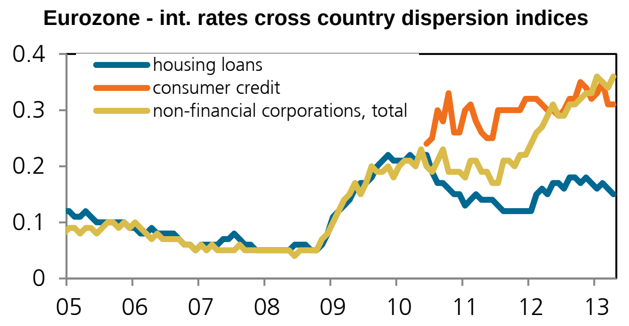
In conclusion. Yet, we cannot rule out a 25bp refi rate cut by the ECB during the summer months in case of renewed economic data weakness and/or rising money market rates over the summer. A negative deposit rate remains a possibility but we think it remains a low probability event. We do not expect measures on liquidity, given the signs of improvement on markets' fragmentation. In our view, if the upward trend in bond prices, triggered by the announcement of the Fed's reversal, should last or accelerates in the next few months, recourse to the ESM and to OMTs would continue to represent a credible safety net, despite the Bundesbank's stern opposition.

The ongoing improvement in TARGET II balances suggests a gradual normalisation of imbalances within the euro area



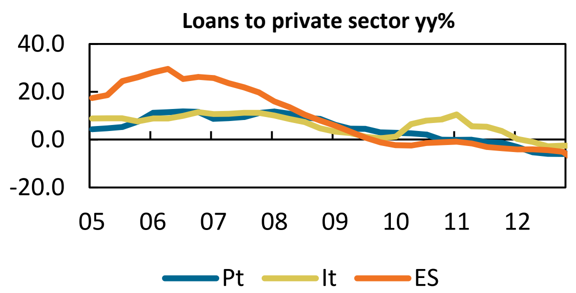
Source: ECB and Intesa Sanpaolo elaborations

For the time being, dispersion in rates applied to borrowers remains high within the euro area



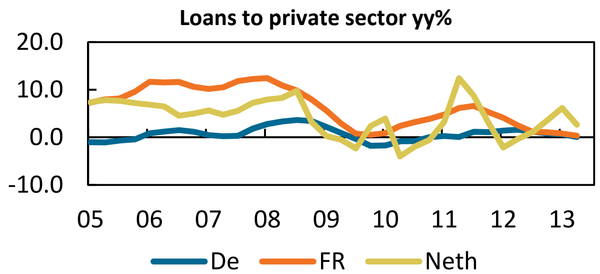
Source: ECB and Intesa Sanpaolo elaborations

Credit trend still slower in peripheral countries…



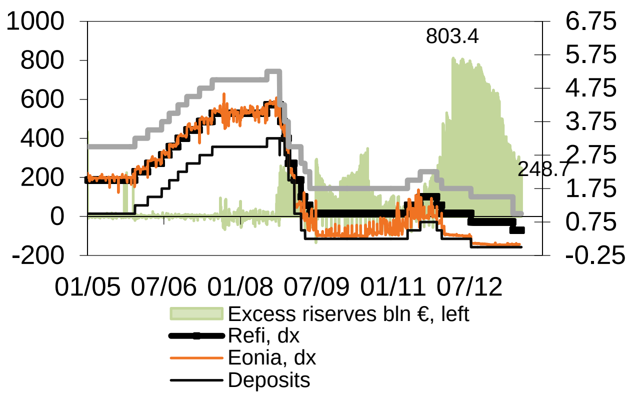
Source: ECB and Intesa Sanpaolo elaborations

… than in core euro area countries



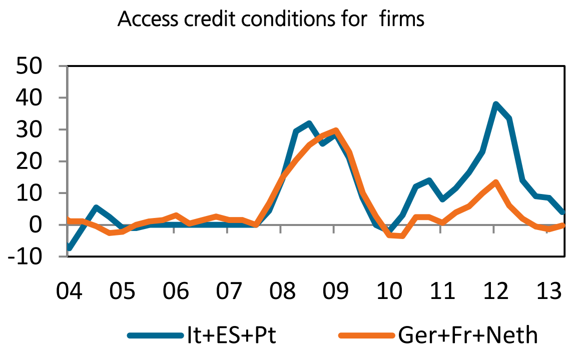
Source: ECB and Intesa Sanpaolo elaborations

Excess reserves down on average in recent months for euro area banks



Source: ECB and Intesa Sanpaolo elaborations

Conditions to access credit continue to hinder lending (albeit gradually less) in peripheral euro area countries



Source: ECB and Intesa Sanpaolo elaborations

Germany: some fiscal stimulus in the pipeline

Anna Maria Grimaldi

Germany is set to grow 0.4% in 2013, compared with 0.9% in 2012. This year growth average is being depressed by the lower-than-expected dynamics at the end of 2012 (-0.7% qoq) and in the winter months (+0.1% qoq). Germany has not been immune from the recession in domestic demand in the rest of the Euro zone, which has only been partially offset by exports to the rest of the world and stronger consumer spending. The German economy should have returned to more dynamic growth from the spring, as industrial and construction orders and production rallied considerably between March and April. We expect exports to pick up sufficiently in the summer to produce a sustained recovery. From the end of 2013, the German economy will return to healthy growth, buoyed up by foreign demand, continued favourable financial conditions and moderately expansionary fiscal policy. If the 22 September elections return a CDU-SPD-Green coalition – the SPD are building their campaign around redistribution of wealth issues – the focus could shift on social security spending and a tax reform to create a more progressive fiscal regime, even though fiscal policies are unlikely to become much more expansionary. GDP is expected to grow 1.7% next year, slightly above the most recent OECD potential estimates. Growth will continue to move away from net exports towards domestic demand, yet the trade surplus should improve only very gradually. Risks to our scenario remain skewed on the downside as the recovery in the rest of the Euro zone and in global demand could fall short of our expectations.

GDP set to advance 0.4% in the second quarter, but the recovery will only be consolidated if exports pick up

Business sentiment indices moved sideways since year-start. In June, the IFO Index stood at 105.9, still lower than in February (107.4), the manufacturing PMI at 48.6 was also under this January levels. Expectations for the coming months are more cautious than at the start of the year, while the assessment of the current situation has improved. The sharp rise in industrial production in March and April has exceeded indications from industrial surveys. Carry over growth for Q2 industrial output was at 2.5% qoq in April, following the stagnation recorded in Q1. As a result, industrial production should have added at least 0.5% to GDO growth in the Spring. Construction activity is also on an upward trend, having dropped off in the winter due to the exceptionally cold weather. In contrast, activity in the service sector may contract slightly in Q2. On balance, we predict GDP will rise by 0.4% - 0.5% qoq in the second quarter up from 0.1% at the start of the year. This suggests that the worst should now be behind us.

Domestic demand will drive GDP growth more than exports…

Nevertheless, the gap between the PMI new orders and stock indices suggests that the spring upturn in production and GDP could taper off in the summer should global demand fail to accelerate. The decline in exports largely explained weaker-than-expected growth in early 2013 (0.1% qoq; consensus: 0.2-0.3% qoq). We still believe that foreign demand will pick up significantly in the summer and that the bulk of export demand will come from non-Euro zone countries. Both exports and imports are set to average zero growth in 2013 due to the weak year-start. In 2014, imports will rise by 5.8% in 2014 more than exports (4,4%). The increase in in import content of German exports and investment is set to continue over the coming years, as companies find it more convenient to use free production capacity abroad. Overall, foreign trade will make a zero contribution to GDP growth in 2013 and will have a negative effect in 2014 (-0.3pp). Domestic demand will continue to boost GDP growth over the forecasting period: with a 0.6% gain this year and +1.9% in 2014, outperforming GDP.

… sustained by expansionary monetary policy

Very favourable monetary conditions and moderately expansionary fiscal policy should support an acceleration in domestic demand over the next 18 months. Bank lending rates continued to move on a downward trend in the past three months. We may see a reversal by the end of 2013, but credit conditions will remain extremely favourable. The Bundesbank lending survey for the first quarter of 2013 showed that lending conditions improved in the first quarter and stabilised in the second. The proportion of companies who reported problems obtaining credit remained low. As far as fiscal policy is concerned, the measure with most significant cyclical impact should be the reduction in social security contributions from 19.6% to 18.9%. Growth will also be boosted by the increase in the income tax exemption threshold, new childcare bonuses and the abolishment of tickets on specialists consultation.

We predict that fixed investments will pick up in the second half of the year

The rise in domestic demand over the forecasting horizon will largely reflect the upturn in fixed investment, which is expected to advance 4.7% in 2014 in the wake of a 2% contraction in 2013. In early 2013, corporate investment dropped by 0.7% in response to prevailing uncertainties and downward revisions to sales forecasts, notably towards the rest of the Euro zone. Replacement investment should have picked up already in late Spring in anticipation of stronger global demand and courtesy of lower uncertainty. As production capacity utilisation rises, investment in new machinery should also pick up. Overall, corporate investment is set to increase by 4.9% in 2014, following a 2.4% fall in 2013, prompted by poor performance in late 2012 and early 2013.

Construction investment is expected to regain momentum between the Spring and Summer, having posted a larger-than-expected drop in early 2013 due to the extremely harsh weather conditions. Construction investment, particularly residential construction, should rise healthily over the forecasting horizon as permits were still rising in excess of the long term average in April However the pace of expansion of residential construction spending should be lower than in 2011 as permits have fallen below the 2010 peak. In 2014, construction investment is expected to rise by 2.8%, compared with -1.6% in 2013.

Public sector investment fell in 2012 as stimulus packages were withdrawn, but should pick up again in 2013, in light of the anticipated temporary increase in infrastructure spending.

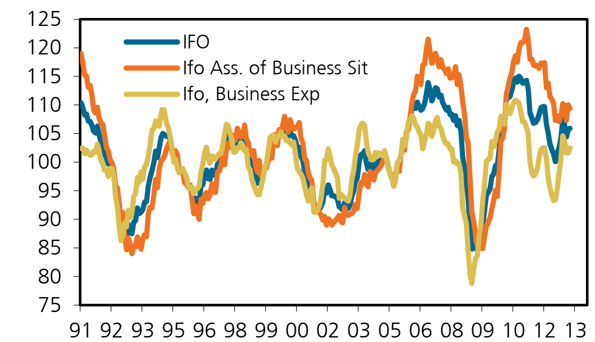
Consumer spending buoyed up by increase in real disposable income: up 1-1.5%

Consumer spending exceeded expectations in early 2013, advancing 0.6% qoq, compared with an average of 0.2% qoq in the second half of 2012. We forecast a 1.1% rise consumer spending in 2013 and 1.4% in 2014, boosted by lower uncertainty, rising employment, falling inflation and supportive fiscal and monetary policies. Workers are expected to see real disposable income rise by nearly 1% in 2013 and 1.6% next year. The labour market outperformed forecasts between late 2012 and early 2013. The number of workers paying social security contributions rose by 171,000 between November 2012 and March 2013, then stabilised as of April. Working hours rather than staff numbers are still being used to adjust employment levels in response to cyclical changes. The Bundesbank's May bulletin hints that the rise in employment could reflect in part hiring of high skill immigrants from Eastern Europe. Economic surveys suggest that recruitment is set to slow, but it will remain consistent with positive employment growth. Companies held on to workers during the crisis and even hoarded skilled labour forces thus we expect employment growth to remain subdued this year (0,5%) but we could well see an increase in hours worked as the recovery picks up. The unemployment rate may only rise by a few tenths of a percentage point between now and the autumn. The average annual unemployment rate should remain unchanged at 6.9% in 2013. As the unemployment rate is probably already close to the structural level we do not expect significant declines in 2014 and beyond, barring large increases in the labour force. Disposable income gains should be supported by salary growth at just under 3%, in line with the agreements concluded in late 2012 and early 2013. Basic salary growth slowed to 2.6% in March, from 3% in December 2012. Wages are expected to lag behind salaries due to the fall in hours worked. Labour costs will increase at a moderate pace by 2.5% in 2013 and 2.6% in 2014, partly as a result of reduced social security contributions. Unit labour costs will be affected by limited productivity growth in both 2013 and 2014, which will put pressure on domestic prices.

Inflation fell from 2.0% in December to 1.6% yoy in May to then rise back to 1.8% in June, on the back of volatility in energy and food prices. Inflation should average 1.7% in 2013 and 2014 (2012: 2.1%). Underlying inflation could rise from 1.6% to 1.8% in 2014 as labour costs picked up.

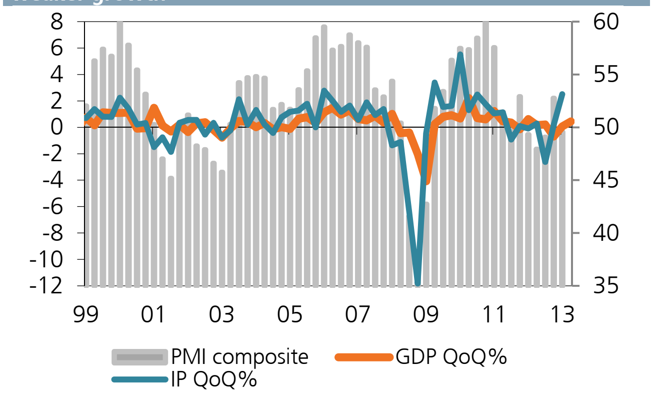
Public finances. Germany ended 2012 with a modest budget surplus: 0.2% of GDP, a large improvement from the 2011 deficit (-0.9%) and far better than -0.9% target indicated in the 2012 SP. The structural balance surplus came in at 0.3% of GDP for 2012. Public debt rose to 81.9% of GDP (2011: 80.5%), as a result of payments to the European Stability Mechanism (ESM; EUR 29 billion held by the European Financial Stability Fund and EUR 27 billion by the ESM) and the sale of the WestLB regional bank. In 2013, we expect a modest budget deficit of 0.1-0.2%. The economic slowdown between late 2012 and early 2013 will have a negative effect on public finances. The fiscal measures adopted by the German Government in the run-up to the autumn elections will make for a slightly expansionary fiscal policy. The most relevant measures in place are: i) a reduction in social security contributions from 19.6% to 18.8%; ii) increase in the income tax free threshold; iii) the abolition of charges for specialist medical examinations, iv) and new tax incentives for home renovation. These measures will only be partially offset by spending cuts. The bulk of savings will be generated by lower interest payments, as there is usually a time lag before falling yields impact interest rate spending. We predict a balanced budget in 2014, when cyclical effects will be counterbalanced by a slightly more expansionary fiscal policy. The structural balance is expected to remain on a par with 2012 for the next two years. Public debt should fall to 78.8% of GDP in 2014.

In recent months, the IFO current conditions index improved more than the expectations component



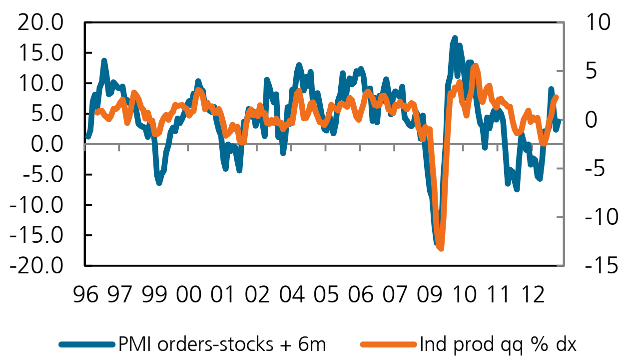
Source: IFO Institute and Intesa Sanpaolo calculations

Production bounced back in the Spring and is now consistent with GDP growth at 0.4% qoq, but the composite PMI points to weaker growth



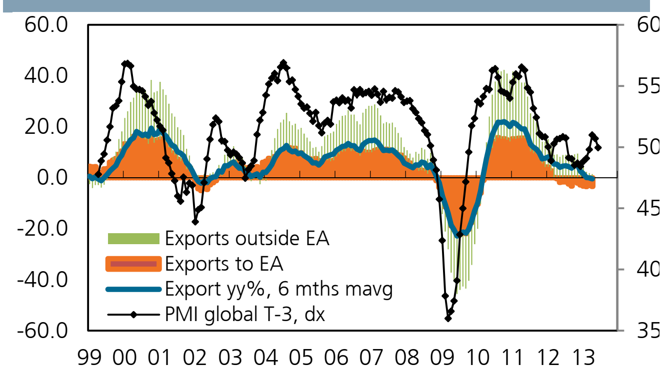
Source: Markit, FSO and Intesa Sanpaolo calculations

The dynamics of orders and stocks from the PMI suggests a slight correction in production unless …



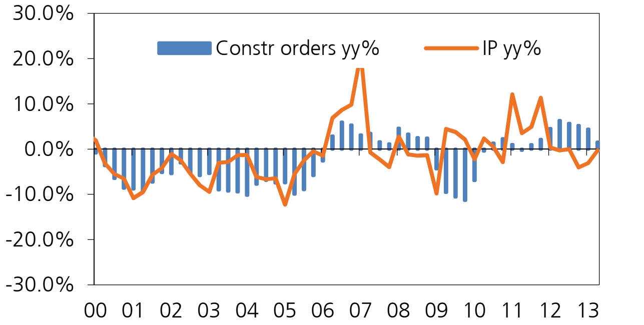
Source: IFO Institute, Markit and Intesa Sanpaolo calculations

…Global trade pick up



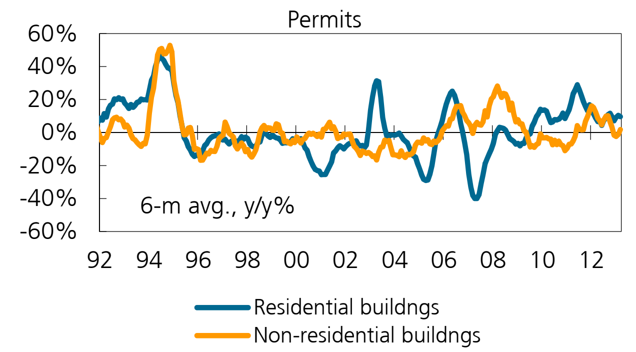
Source: Markit, FSO and Intesa Sanpaolo calculations

Construction should rebounded after the weather related sharp drop recorded in the winter



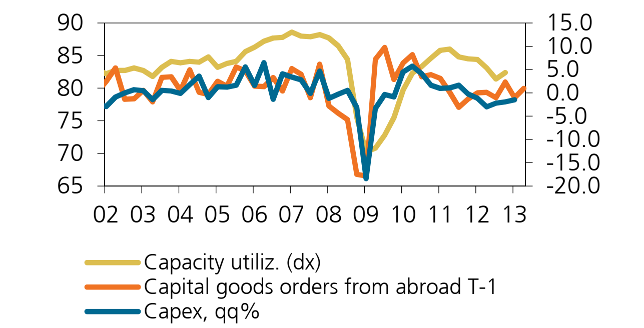
Source: FSO and Intesa Sanpaolo calculations

Residential construction permits remain at high levels, but below the 2011 peak



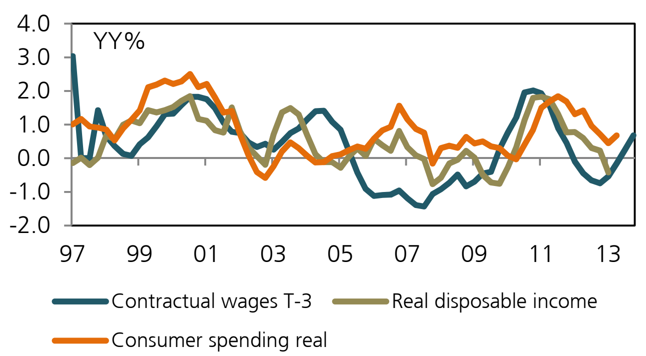
Source: FSO and Intesa Sanpaolo calculations

Corporate investment should pick up in the second half of 2013



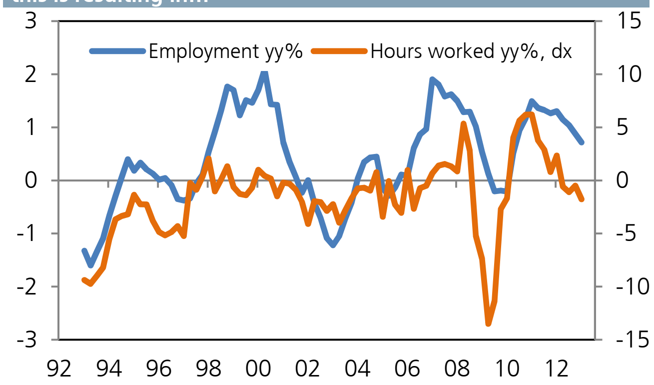
Source: Bundesbank, FSO and Intesa Sanpaolo calculations

Consumption should accelerate, buoyed up by strong salary growth



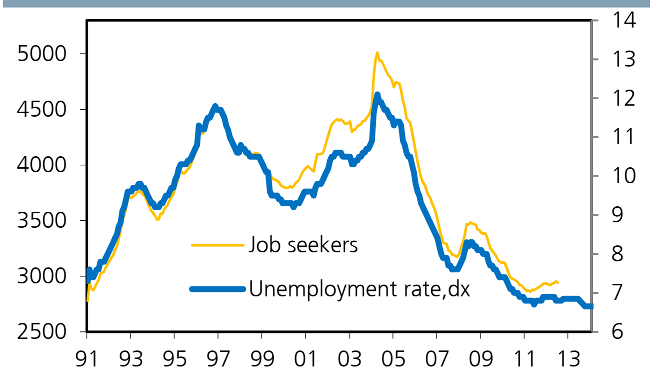
Source: Bundesbank, FSO and Intesa Sanpaolo calculations

Labour input adjusted more through hours than bodies and this is resulting in…



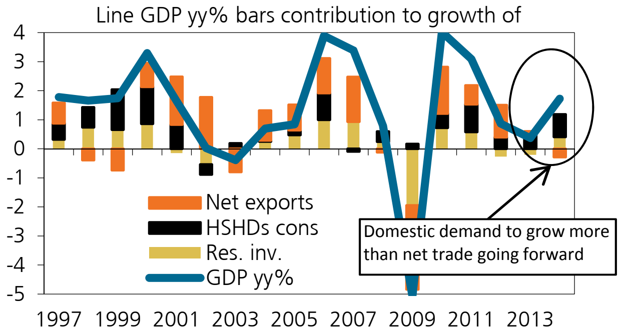
Source: FSO and Intesa Sanpaolo calculations

… stable unemployment rate



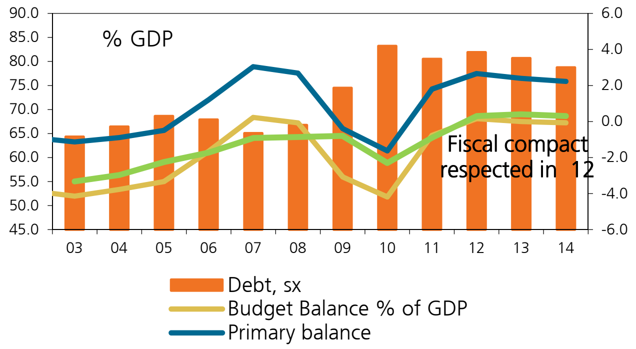
Source: FSO and Intesa Sanpaolo calculations

GDP growth increasingly driven by domestic demand



Source: FSO and Intesa Sanpaolo calculations

Public finances well under control



Source: AMECO and Intesa Sanpaolo calculations

Forecast Table

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (1995 prices, y/y)	0.9	0.4	1.7	0.9	0.3	-0.3	0.0	0.3	1.4	1.8	1.8
- q/q change				0.2	-0.7	0.1	0.4	0.5	0.4	0.5	0.4
Private consumption	0.7	1.1	1.4	0.1	-0.3	0.8	0.3	0.3	0.4	0.4	0.3
Fixed investment	-2.0	-2.0	3.9	-0.6	-1.1	-1.4	0.4	1.0	0.9	1.2	1.0
Government consumption	1.2	0.9	1.7	0.7	0.1	-0.1	0.4	0.5	0.6	0.4	0.4
Export	4.5	0.0	4.4	1.4	-2.4	-1.8	1.4	2.0	0.8	0.8	1.1
Import	2.6	0.0	5.8	0.6	-1.3	-2.1	1.8	1.4	1.0	1.7	1.5
Stockbuilding (% contrib. to GDP)	-0.5	-0.1	0.3	-0.3	0.3	-0.1	0.2	-0.3	-0.1	0.3	0.1
Current account (% of GDP)	7.1	7.3	6.2	7.6	6.9	7.1	7.4	7.6	7.2	6.6	6.4
Deficit (% of GDP)	0.2	0.0	-0.1								
Debt (% of GDP)	81.9	80.7	78.8								
CPI (y/y)	2.0	1.5	1.6	2.0	2.0	1.5	1.5	1.5	1.5	1.5	1.7
Industrial production (y/y)	-0.4	0.8	2.6	0.2	-2.6	0.2	2.5	1.1	0.2	0.0	1.0
Unemployment (%)	6.8	6.9	6.8	6.8	6.9	6.9	6.8	6.8	6.9	6.9	6.8

Note: Percentage variations over previous period, if not otherwise specified
Source: Intesa Sanpaolo elaborations

France: mild recession under way

An appraisal of François Hollande's government one year after it took office shows that France is trying to deal with its various structural problems, which have now reached boiling point. The crisis, which led to 2012 closing with zero growth, has taken the country into a recession.

Our estimates for 2013 maintain a zero growth scenario, like last year, although risks are to the downside. The weakness at the close of last year (-0.2 qoq in December) also extended into the first quarter of the year (-0.16 qoq). The second quarter is seen to be recovering slightly, while an improvement is expected from the third quarter of the year, according to confidence indicators. We are, however, far from the December estimates - +0.8% yoy for 2013 - for which the French government was aiming. Less uncertainty about the sovereign debt crisis should encourage real activity although the effects of the restrictive fiscal manoeuvres will continue to weigh on economic growth in France. Better scenarios are likely to appear from 2014, the year in which GDP is likely to return to growth of 1.2% yoy while for 2015-2017 GDP growth is estimated at 2.0% year-on-year. Steady recovery in 2013-2014 will be ensured by the improved international situation and the implementation of structural reforms on employment and productivity promoted by the Government, focusing primarily on the reduction of labour costs and support for capital investments, as well as the modernisation of the public spending system, primarily through significant and long-overdue reform of the pension system. During the summer, consultations between the unions about pensions (the *conférence sociale*, launched last 20 June) should enable the parties to agree on a draft bill in September so that reform can be implemented by the end of the year.

Consumer spending is expected to recover slightly in the second quarter after a difficult start to the year (+0.2% qoq in June from -0.16% qoq in March). The increase in unemployment and, to a lesser extent, the current restrictive fiscal manoeuvres, will continue to weigh on this variable. However, the government has decided to spread more of the effect over the next year in order to avoid putting an excessive burden on the depressed economic phase that the country is experiencing.

Proiezioni

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	**0.0**	0.0	1.2	**0.0**	**-0.3**	**-0.4**	-0.1	0.0	0.5	1.0	1.2
- q/q change				**0.1**	**-0.2**	**-0.2**	0.2	0.2	0.3	0.3	0.4
Private consumption	**-0.3**	0.2	0.9	**0.0**	**0.0**	**-0.1**	0.2	0.3	0.2	0.2	0.2
Fixed investment	**-1.2**	-1.7	1.3	**-0.7**	**-0.8**	**-0.9**	0.0	0.1	0.3	0.3	0.3
Government consumption	**1.4**	1.2	1.3	**0.3**	**0.3**	**0.3**	0.3	0.2	0.3	0.3	0.4
Export	**2.5**	0.9	4.3	**0.5**	**-0.7**	**-0.5**	1.0	0.9	1.0	1.1	1.6
Import	**-0.9**	0.6	5.0	**0.1**	**-1.3**	**0.1**	0.6	0.8	2.0	1.4	1.0
Stockbuilding (% contrib. to GDP)	**-0.8**	-0.2	0.4	**0.0**	**-0.3**	**0.1**	-0.1	-0.1	0.4	0.2	0.0
Current account (% of GDP)	**-2.3**	-2.0	-2.1	**-2.3**	**-1.6**	**-2.5**	-1.9	-1.8	-2.0	-2.1	-2.0
Deficit (% of GDP)	**-4.8**	-4.0	-4.2								
Debt (% of GDP)	**90.2**	94.0	96.0								
CPI (y/y)	**2.0**	0.9	1.2	**2.0**	**1.5**	**1.1**	0.8	0.9	0.9	0.9	1.3
Industrial production	**-2.3**	-0.3	1.7	**0.6**	**-2.0**	**-0.1**	2.0	0.0	-0.3	0.4	0.7
Unemployment (%)	**9.9**	10.8	10.9	**9.9**	**10.2**	**10.5**	10.9	10.9	10.9	10.9	10.9

Nota: Variazioni percentuali annualizzate sul periodo precedente - salvo quando diversamente indicato.
Fonte: elaborazioni Intesa Sanpaolo

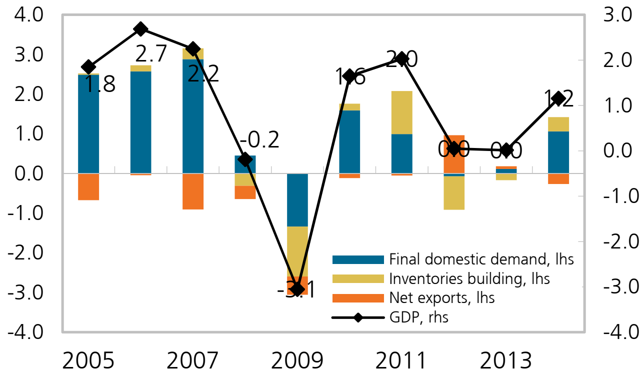
Corporate investment should see an improvement in the second half of the year thanks partly to the government's reform (particularly, the creation of the Banque Publique d'Investissement and reform of the banking system) aimed at encouraging lending to SMEs and reforming the regulatory framework governing the credit sector. Specifically, after a sudden halt during the winter (-0.7% qoq, -2.6% yoy), we expect a stagnation in the second quarter, followed by a recovery in the second half of the year, but with the yearly average remaining in negative territory (-1.7% yoy).

Although the French government estimates **exports** to pick up by around 2% on average for 2013, we do not think it likely that they will increase by more than 0.9% since the largest portion of French exports is to the Euro Zone, which this year is likely to record a total average decline in GDP of -0.7% yoy. The contribution of **net exports** to GDP is, however, expected to be positive (+0.1%), given that imports are expected to fall as a result of a less-than-stellar performance forecast for domestic demand.

The contribution of the **change in inventories** on GDP will also remain negative this year (-0.2% on average this year) due to the effect of the de-stocking of inventories at the end of 2012.

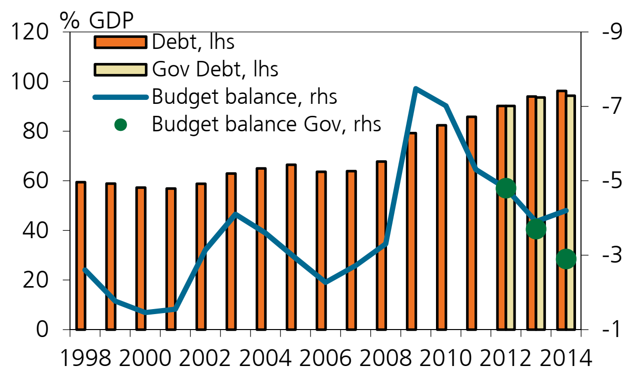
In addition to stagnant growth, **unemployment** remains a key problem that Hollande must tackle. The unemployment rate has increased every year from 2011 until now and we expect that it will increase to 10.9% this year. We do not expect that the slight recovery in growth in the second half of the year and the many measures to support employment implemented by the government in the last ten months, particularly the CICE (*Crédit d'impôt pour la compétitivité et l'emploi)*, will have a positive impact on employment this year but only from 2014, as Noyer, the Governor of the Bank of France, also recently confirmed in his annual report.

Risk of recession in 2013



Source: Intesa Sanpaolo charts based on INSEE data

Deficit and public debt trends



Source: France Trésor and Intesa Sanpaolo charts

Turning to prices, **inflation** has gradually slowed since the end of last year, primarily due to the combined effect of reduced energy prices and the drop in domestic demand. We expect that the current trend will continue for the rest of the year, although in the last two months it is likely to pick up slightly due to an upturn in consumer spending. The annual average figure for inflation is forecast to be around 0.9% this year, while the hoped-for recovery in growth and forecast VAT hike are likely to take inflation to 1.2% in 2014. The core component (net of energy and food) in the first half of the year is set to drop to an average of 0.8% yoy, a significant slowdown compared with 2012 (1.6% annual average); we expect that this will pick up by a tenth of a point in the second half of the year (0.9% annual average). For 2014, we estimate that the core component will reach an annual average of around 1.0% yoy.

The **public deficit** stood at 4.8% yoy in 2012, from 5.3% yoy in 2011, an improvement of 0.5%, which, in a year of zero growth, led to a structural adjustment of 1.2% of GDP. The efforts made last year will continue this year, when the structural adjustment will be 1.9% of GDP and should reduce the deficit/GDP ratio likely to be around 3.9% (compared with an official estimate of 3.7%). France will therefore have until 2014 to reach the target of 3.0% as it was given a year-long extension from Europe. The additional adjustment for 2014 has been assessed at one GDP percentage point. The structural balance, however, should fall this year to -2.2% from -3.7% last year, due primarily to the streamlining of the fiscal system (reduction of the tax-exempt areas and compulsory charges) and spending cuts (which will apply uniformly across all levels of the public administration, from the centre to the periphery), and then rise again by a tenth of a percentage point to -2.3% in 2014. The social services provided by the government rose by 3.5% in 2012 compared with 3.1% in 2011, particularly due to unemployment benefits (+5.3% in 2012 from -0.6% in 2011). It is estimated that in 2013 expenses will slow – albeit only slightly - to +3.3%: given the reduction in the number of old-age pensions granted, we expect a further increase in unemployment benefits. In 2014, total social services provided are estimated to fall significantly to 2.4% thanks to the economic recovery, which should reduce the impact of unemployment benefits.

Italy: the longest recession is approaching an end

Paolo Mameli

- **Due to a weaker-than-expected first half of the year, Italian GDP should contract this year at a similar pace to 2012** (we estimate by 2%). However, the risks weighing on the second half of the year seem to have at least partially eased: political stability and a favourable international cycle are the necessary conditions required to avoid new shocks to risk premiums and to exit the recession. Some monthly surveys (including the recovery of manufacturing orders and consumer confidence) indicate that a significant attenuation of the recession may already be possible starting in the Summer quarter; for the time being, we continue to forecast a return to growth in the closing quarter of the year. The present recession should be the longest since 1981 (at least 9 quarters vs. 6 in 1992-93). For another 1-2 quarters, the export trend will be too modest to balance the crash in domestic demand, but a (small) recovery (of the domestic demand components as well) should materialise in 2014 (at around 0.5%, based on our central scenario).
- **The easing of recession expected in 2H 2013, and the modest recovery in 2014, will be due to**: 1) an easing of financial tensions, which is already reflecting on confidence surveys carried out with enterprises and households, and which should then transfer, at a lag, to the credit system; 2) less contractionary fiscal policy: the level of tightening required this year is already less than half that of 2012, and fiscal policy should turn neutral next year. This evolution will also be supported by the payment of arrears owed by the PA, which is proceeding on schedule; the first payments to companies have already been made, and the effects on the economic cycle could start to become visible already during the Summer quarter. We confirm our estimate that the payment of arrears worth EUR 40Bn should have an impact of 0.8% of GDP in the 2013-14 biennium; the full impact on economic activity, in any case, will be felt next year.
- The Letta government has hitherto covered the most pressing needs and is trying to win time to raise adequate resources for the measures announced in the inauguration speech. Uncertainty lingers on the cabinet's stance on the VAT hike and on the IMU property tax. In any case, crunch time will come in the Autumn. In our view, the path for public finances remains very narrow: this year the 3% of GDP deficit target is already at risk; a margin of half a percentage point of GDP for expansionary measures may open up (in theory) only next year.

Macro forecasts - Italy

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (2005 prices, yoy)	-2.4	-2.0	0.5	-2.6	-2.8	-2.4	-2.4	-2.2	-1.1	-0.3	0.5
qoq				-0.3	-0.9	-0.6	-0.6	-0.1	0.2	0.1	0.2
Private consumption	-4.3	-2.4	0.2	-1.2	-0.8	-0.5	-0.5	-0.3	0.1	0.1	0.2
Public consumption	-2.9	-0.4	-0.4	-0.4	0.1	0.1	0.0	-0.3	-0.2	-0.1	0.0
Gross capital investment	-8.0	-7.4	0.1	-1.2	-1.8	-3.3	-2.3	-0.7	0.5	0.1	0.2
Imports	-7.8	-3.4	2.1	-1.8	-1.1	-1.6	0.2	-0.2	0.3	0.7	0.7
Exports	2.2	-0.4	3.1	1.1	0.1	-1.9	0.5	0.5	0.6	0.8	0.9
Chg. inventories (contrib., % GDP)	-0.6	0.0	0.1	0.0	-0.4	0.3	-0.1	0.1	0.0	0.0	0.0
Current accounts (% GDP)	-0.6	0.3	0.6								
Deficit (% of GDP)	-3.0	-3.3	-2.6								
Debt (% GDP)	127.0	133.0	134.5								
CPI (yoy)	3.0	1.4	1.8	3.2	2.5	1.9	1.2	1.1	1.4	1.5	1.9
Industrial output	-6.3	-3.8	0.3	-0.5	-2.3	-0.5	-1.4	-0.1	0.0	0.0	0.5
Unemployment (%)	10.6	12.0	12.2	10.7	11.2	11.8	11.9	12.2	12.3	12.4	12.3

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

Italian GDP growth in 2013: -1.6% is the "carry-over" from 2012, but the year could close at -2%

The revision to the forecast is due entirely to a worse than expected performance in the first half of the year; the forecast on the second half remains broadly unchanged

The revision to our Italian GDP growth estimate for 2013, from -1.5% in February to -2%, is due to:

1) **worse than expected growth in 1Q13** (the ISTAT figure is -0.6% qoq, revised downwards from an initial estimate of -0.5% qoq, already lower than consensus estimates of -0.4% qoq just before the figure was published);

2) a **downwards revision of the forecast for 2Q**, for which preliminary indications do not point to any improvement compared with the start of the year; in fact, industrial production (traditionally one of the most reliable indicators for forecasting GDP) is on track for a 1.4% qoq fall in the Spring quarter, after contracting by 0.5% qoq in 1Q, so industry in its narrowest sense will show a more marked decrease in added value compared with the -0.7% qoq at the beginning of the year; assuming other sectors make less negative contributions (bearing in mind that some confidence indicators rose in the Spring months), we assume that GDP growth for the current quarter will be approximately in line with that of the previous quarter (-0.6% qoq).

In essence, **the downwards revision of the forecast for the 2013 average is entirely due to a worse-than-expected performance in the first half**. In contrast, we are leaving the forecast on the remaining quarters of the year almost unchanged, with a slight upwards revision (bearing in mind the upturn recorded by some confidence indices and the potential positive impact of certain government measures, such as the payment of the Public Administration's debts and the adoption of a less restrictionary fiscal policy). In particular, we continue to expect (modest) economic growth to return only in the last quarter of the year.

In 2013, after the 1Q figure, the carry-over from in 2012 is -1.6%, so even assuming no change in GDP for the remaining quarters of the year, the forecast of -1.5% has become optimistic; furthermore, at least for 2Q (and probably, albeit to a lesser extent, also for the Summer months) it seems unrealistic to assume GDP growth will avoid going into negative territory. **If the current quarter came out in line with the previous one, "carry-over" growth alone would be -2.1%.**

The determining factors behind the revision of -0.5% in our 2013 GDP growth forecast (from -1.5% in February to -2%)

	in %
Already-release data for Q1	-0.3
Estimate on the current quarter	-0.3
Forecast for second half of the year	+0.1
TOTAL	-0.5

Note: breakdown of the revision on average 2013 GDP growth forecast from -1.5% to -2%. Source: Intesa Sanpaolo forecasts

We believe that consensus estimates on Italian GDP growth will continue to trend downwards

The forecast of -2% is lower than the consensus average for June (source: *Consensus Forecasts* by Consensus Economics), which, stripping out Intesa Sanpaolo's forecast (already more pessimistic than the forecasters' average in the last few months) came in at -1.6%, and is also lower than the estimates of the main "official" forecasters.

However, **we believe that consensus forecasts on 2013 GDP growth will continue to trend downwards,** in the wake of the revision of 1Q GDP figures and not particularly encouraging signs for the current quarter. **The most recent revisions** (issued after the publication of 1Q data) include those of: **1) the OECD**, which cut (for the second time in a month) its estimate of Italian GDP growth to -1.8% in the *World Economic Outlook* of 29 May (the last revision had been from -1%

to -1.5% in the *Economic Survey* on Italy of 2 May); **2) Prometeia**, which, after cutting its estimate in April's Forecast Report to -1.5% (from -0.6% in the previous report), trimmed it further to

-1.9% in the Update to the Forecast Report of 27 May (it also revised down its 2014 forecast from 0.7% to 0.6%); **3) other private forecasters**, the most recent of which was Barclays (-1.7% on 11 June, from the previous -1.5%).

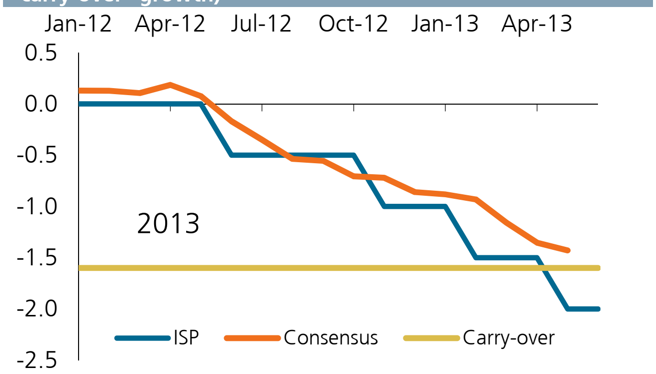
Italian GDP – Consensus and other significant forecasts

	2013	2014
ABI	-1.2	0.8
UBS	-1.2	0.3
HSBC	-1.4	0.6
Moody's Analytics	-1.4	0.8
Centro Europa Ricerche	-1.5	0.8
ING Financial Markets	-1.5	0.6
Goldman Sachs	-1.7	0.4
UniCredit	-1.7	0.6
Econ Intelligence Unit	-1.8	0.3
Banca Nazionale del Lavoro	-1.8	0.3
Bank of America - Merrill	-1.9	-0.3
Citigroup	-1.9	-0.6
Prometeia	-1.9	0.6
IHS Global Insight	-2	0.6
Avg.	-1.6	0.4
OFFICIAL FORECASTS		
Government (April 2013)	-1.3	1.3
Bank of Italy (Jan 2013)	-1	0.7
Istat (May 2013)	-1.4	0.7
IMF (April 2013)	-1.5	0.5
EU Commission (May 2013)	-1.3	0.7
OECD (May 2013)	-1.8	0.4

Source: *Consensus Economics*, June, Government, Bank of Italy, European Commission, IMF, OECD

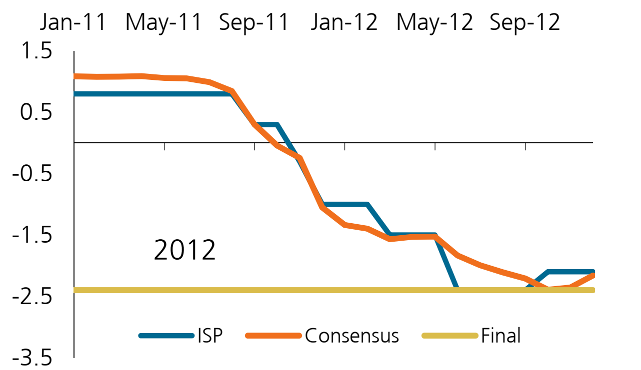
More generally, as shown in the charts below, **historically over the last two years, consensus has seemed to lag behind our forecasts**, which on average have been more pessimistic than those of other forecasters; this greater pessimism has then been borne out by the final figures.

2013 Italian GDP forecasts: Intesa Sanpaolo vs consensus (and "carry-over" growth)



Source: Istat and Intesa Sanpaolo forecasts vs *Consensus Forecasts*

2012 Italian GDP forecasts: Intesa Sanpaolo vs consensus (and "final" growth)



Source: Istat and Intesa Sanpaolo forecasts vs *Consensus Forecasts*

Focus – The Letta government's first moves

The main measures adopted by the Letta government

The main economic policy measures adopted to date by the Letta government which took office at the end of April are:

1) **decree law 54 of 21 May 2013**[7], approved by the Chamber of Deputies on 18 June and currently under discussion in the Senate (the decree must be signed into law by 20 July), contains:

- the **suspension of the first instalment of the IMU property tax on first homes** (with the exclusion of luxury homes, villas, castles or buildings of historic or artistic value): this is for the present simply a postponement pending a complete reform of tax on property assets, with the inclusion in the new provision of the municipal tax on waste and services, and taxation on company properties (in this regard, the government has promised that there will be forms of tax-deductibility for warehouses and industrial buildings); the decree includes a protection clause under which the reform must be implemented (in accordance with the planned objectives set out in the Economic and Financial Document approved by Parliament and the commitments made by Italy to the European Union) by 31 August 2013, otherwise the instalment of 16 September will be due; according to Economy Minister Fabrizio Saccomanni, 50% of the missing income from the first instalment of IMU on first homes will be covered by the authorisation to increase cash advances to municipal authorities, with the government bearing the cost (this is, however, a temporary way of "covering" the municipalities' cash deficit);
- the **refinancing of the exceptional state-subsidised wages fund** (Cassa-Integrazione-Guadagni) for 2013, with a further EUR 1Bn in addition to the EUR 990M already allocated by Law 92 of 2012; the government also intends to use these funds to free up resources for job-sharing agreements; this amount is covered by EUR 250M from the fund for contribution relief for second-level contracts for 2013 (funds which would not have been used in 2013 and which will be added back at a later time); EUR 288M from resources for the Cohesion Action Plan implementing the planning of EU structural funds for 2007-2013; EUR 246M allocated to professional training; EUR 100M from the development and cohesion fund (on the balance sheet for 2016 but not used); an unused EUR 100M from the Italy-Libya agreement; EUR 19M from antitrust fines and lastly EUR 57M freed up from job-security contracts; the figure allocated may however not be sufficient to cover the exceptional needs of the wages guarantee fund until the end of the year;
- the **extension of temporary Public Administration job contracts**: the decree extends from 31 July to 31 December 2013 the possibility for public administrations to make use of temporary workers (it is estimated that 115,000 jobs under threat have been "saved" by the provision); after the further extension, between EUR 50M and EUR 100M will have to be found to finance the measure;
- the cut in the salaries of ministers and parliamentary undersecretaries (a symbolic measure, but one that does not have a significant impact on the public finances: barely EUR 4M once fully implemented).

According to the Economy Minister, the decree will not change public finance balances overall, although certain items only seem to be partially covered; in any case, it is only a postponement while the government finds sufficient resources to cover the potential lower income generated by the tax on property.

[7] "urgent provisions regarding the suspension of the municipal property tax, the refinancing of exceptional welfare payments, the extension of temporary employment contracts within the Public Administration and the abolition of salaries of government parliamentary representatives"

2) the "decreto del fare" ("to do" decree, decree law 69 of 21 June 2013), containing "urgent provisions for companies, infrastructure and the simplification of administrative, fiscal and civil proceedings", which attempts, alongside the subsequent decree approved by the Italian cabinet on 19 June to simplify bureaucracy, to respond to the six recommendations made by the European Commission on 29 May 2013 as part of the procedure to coordinate economic reforms to boost competitiveness ("European Semester"); the provision also includes numerous measures in the following sectors:

   - infrastructure: establishment of a EUR 2Bn fund for the four-year period 2013-17 to unfreeze various building projects; EUR 300M road safety programme for the improvement of the road network's bridges, viaducts and tunnels; relaunch of ports and shipping by cutting taxes on boats and simplifying port procedures;
   - measures to benefit companies: increase of the guarantee and subsidised financing fund for the purchase of machinery, plant and equipment for small and medium-sized companies; liberalisation of the gas sector and reduction of electricity bills; simplification of administrative procedures;
   - liberalisation of internet access and other measures included in the digital agenda;
   - various measures to simplify tax and citizenship-related issues;
   - measures regarding education and research: extended powers for universities and research bodies in the areas of recruitment and the granting of travel awards to capable and deserving students, simplification of procedures for allocating resources to universities, incentives for research;
   - measures aimed at reducing the time required for civil proceedings and improving their efficiency.

   Overall, these represent a series of micro-measures that on the one hand are not expected to have a significant impact on the public accounts (they are mainly covered by the use of funds that have already been allocated), but on the other, will not, in our view, have a decisive impact on economic activity.

3) the decree law 63 of 4 June 2013 containing "urgent provisions for the implementation of EU obligations and for the incorporation of EU directive 31/2010 on energy performance in buildings", now under discussion in the Senate, which provides for the relief on energy-saving measures (the "ecobonus") to be increased from 55% to 65% (until 31 December 2013, or until 30 June 2014 for significant reconstruction work), and the extension until the end of the year of the relief of 50% for restructuring work (also broadened to include a "furniture bonus"). These tax breaks would otherwise have been "absorbed" by the less favourable relief of 36% from 1 July 2013. The extension of the ecobonus for energy efficiency and tax breaks for building restructuring will cost approximately EUR 200M a year, and are covered through measures to rationalise VAT rates (the increase from 4% to 21% for non-publishing products sold alongside publishing products and from 4% to 10% for food and drink sold in vending machines).

4) the draft decree approved by the Italian government on 26 June, which provides for:

   - a deferment of three months, from 1 July to 1 October, of the increase from 21% to 22% in the standard rate of VAT; the Prime Minister, Mr Letta, added that Parliament would explore the possibility of a further deferment when enacting the decree; the funding (around one billion euros) would come from tax on e-cigarettes and, to a greater extent, from an increase in advance payments of personal income tax (IRPEF), corporate income tax (IRES) and regional business taxes (IRAP) payable in 2013;

- the labour plan, which provides for contribution reliefs (totally eliminating contributions for the first 18 months and for 12 months where temporary contracts are made permanent) where new recruits are young persons between the ages of 18 and 29 (who have not completed secondary school education or vocational training and live alone with one or more dependents, which limits eligibility to around 200,000 persons), as well as incentives to employ disabled persons, workers who have been made redundant, persons over the age of 50 and the long-term unemployed; this labour package has been funded to a total of 1.5 billion euros by European Union funds and national resources for the period 2013 to 2016 (precise details of the funding not yet known);

- the extension to the end of year of the social card for 425,000 persons, with the addition of a new "social inclusion" card for persons living in absolute poverty in Southern Italy (it would apply to 170,000 persons).

Impact on public finances and on the economy

Overall, while the series of measures adopted to date do not have a negative impact on the public accounts (at least not a significant one), they do not seem sufficient to trigger an upturn in the economic cycle. Furthermore, in some cases, the government has simply played for time before making a definitive decision, as in the case of IMU (to abolish the tax on first homes, it needs EUR 4Bn, but with little over EUR 2Bn, an exemption of more than 80% of main homes can be obtained) and VAT (avoiding the projected increase costs 4Bn per year). Any final decision on IMU and VAT has thereby been deferred to the next Stability Law.

At present, it seems unlikely that the government could propose other expansionary measures such as: 1) some form of "guaranteed income" as announced in the inaugural speech (it would cost several billion euro and would involve a more general reform of welfare payments); 2) there was also talk (although not mentioned in Letta's inaugural speech) of abandoning the increase in co-payments for healthcare from 2014 (cost: EUR 2Bn) and postponing the Tares waste disposal tax (cost: EUR 1Bn a year for the two-year period 2013-2014). Furthermore: 1) there could be residual refinancing needs this year for the wage guarantee fund, military missions (financed until September) and some service and local public transport contracts (in total, a few hundred million euro); 2) for next year, non-deferrable expenditures (exceptional wage guarantee fund, peace-keeping missions, service contracts) could amount to around EUR 4Bn.

How will the measures be financed?

In theory, therefore, if the government wants to fully implement its programme, it would have to find resources totalling at least EUR 4Bn this year and at least double that next year. The financial resources could in theory be raised by:

1) savings on interest expenditure: the estimates included in the DEF incorporate the rates implicit in the yield curve in mid-March; from then to the end of April, yields significantly trended downwards, projecting savings on interest expenditure of approximately EUR 1Bn this year, compared with the estimates included in the DEF; since then, however, the trend in yields has reversed, which means that savings are likely to have been substantially reduced from this figure; in essence, the government cannot rely on savings on interest to finance expansionary measures such as cutting IMU or VAT;

2) *spending review*: hopefully the process launched by will be sped up and expanded; it is possible that a "third tranche" of the spending review could be launched with the Stability Law; however, savings on spending seem so far to have been much lower than the targets announced beforehand (EUR 3-4Bn for the first tranche and EUR 10-12Bn on an annual basis for the second), and so the process seems slow and unable to guarantee economies of spending sufficient to finance the expansionary measures announced;

3) **fight against tax evasion**: it seems rather imprudent to use uncertain income to cover definite lower receipts; furthermore, for the first time in many years, 2012 saw a decline in revenues from the fight against tax evasion (EUR 12.5Bn versus EUR 12.7Bn in 2011);

4) **tax and social security reform**, also in compliance with the powers requested by the government in the previous legislature, which reviews the system of allowances, deductions and incentives for households and companies; this, therefore, would not be a real tax cut but rather a reshuffling among different taxes.

We believe it will be difficult for the government to obtain sufficient additional financial resources through the commitment "negotiated" with Europe. The only possibilities are that Italy is allowed to use all the funds awarded by the EU for youth employment in the first year or to exclude ex-ante national co-funding expenses for structural funds from the deficit calculation (this would be more difficult for the resources allocated to large cross-border infrastructure and European strategic projects). There is also the possibility that, in the event that ex-post figures show that Italy has overrun the 3% deficit target by half a point of GDP for 2013, the country will be allowed to use the repayment of Public Administration arrears as an "extenuating circumstance" (as this had a one-off impact of half a point of GDP on 2013 accounts). However, **we think that, although exiting the Excessive Deficit Procedure, the Italian Government will find it difficult to obtain from EU sufficient additional financial resources to fully implement the expansionary measures announced** in its programme.

The point is that, **even without hypothesizing any additional manoeuvres, the target of keeping the deficit within the limit of 3% of GDP already looks dangerously at risk**. We therefore confirm our belief, expressed three months ago in this publication, that there is no room for expansionary fiscal policy this year; in theory, there is margin for a manoeuvre of half a point of GDP for next year (if we accept that the deficit will be broadly in line with 3% of GDP for the third year in a row).

Spain: still a long way to go to correct imbalances

Anna Maria Grimaldi

Our view on the Spanish economy remains very cautious, despite the positive developments which took place in 2012. We expect GDP to drop by 1.5% this year, and to resume growing by 0.5% in 2014, although risks are skewed to the downside. The European Commission has extended to 2016 the deadline to bring the public deficit below the 3% threshold. However, despite the more flexible approach, the fiscal consolidation required to Spain (3 points of GDP) by the end of 2016 is second only to that asked on Cyprus. The Commission has given Spain a pause this year judging the fiscal effort implicit in current legislation adequate to meet the new deficit target. Spain should thus tighten further fiscal policy in 2014, when the acceleration in global demand will hopefully have boosted productive activity. Yet, the risk of a negative spiral of lower than expected growth, and missed budget targets is still high. Spain comes from five years of severe recession, and domestic demand will fall in 2014 as well. The country remains extremely vulnerable to foreign capitals outflows. Money from abroad returned in September 2012, but then slowed again at the end of last year. Spain's net external position (net of the Bank of Spain's contribution) remains in debt, and worsened further at the end of 2012. Therefore, deleveraging in the financial and private sectors must continue over the coming years. Household debt dropped to 79% of GDP at the end of 2012 from 85% in 2007, but it is still well above the euro area average. Non-financial corporates debt at 134% of GDP, is also much higher than the euro area average. In its detailed review of Spain from last April, the European Commission estimated that household debt must drop by a further 29 points, and the debt of enterprises by 12 points[8] to returned to a sustainable path. Thus, credit will continue to contract over the coming years, with negative repercussions on growth. Correction in the real estate sector is at an advanced stage: the share of residential investments as a percentage of GDP is back in line with its levels at the end of the 1980s, and below the euro area average, although further undershooting cannot be ruled out. Labour market deterioration remains a major concern. The unemployment rate hit a new high of 27.2% in May, and could rise further until the end of 2013.

Short-term outlook: some signs of an improvement

Against this very fragile background, it should be noted that business cycle indicators have reversed from very depressed levels. The manufacturing and services PMIs have been on the rise since the end of 2012, although they remain below the 50 mark. Retail sales and household confidence indices are also on higher levels than they were in 1Q. Foreign trade data show exports have been growing since February, while imports are still declining. The industrial output data from March and April also suggest a recovery in activity, albeit from markedly depressed levels. Therefore, we expect GDP to have contracted in 2Q by -0.3% q/q, less than the -0.5% q/q in 1Q, and to stagnate during the summer. GDP should resume growing very gradually, at the end of 2013. Domestic demand will continue to contract at a shaper pace than GDP: -3.7% in 2013, and -0.9% in 2014 hampered by the deleveraging process, a restrictive fiscal policy, and financial conditions which are set to remain largely unfavourable. We expect household spending to drop by 2.8% this year and -0.4% in 2014, from -2.1% in 2012. Corporate investments should fall by -4.2% in 2013, as orders prospect remain fragile and access to credit difficult. Yet, we look for substitution investment to gradually pick up from 2014. The on-going reduction in building permits suggests that the real estate sector will continue to adjust at least until 2015. Therefore, we expect construction investments to contract both this year and the next.

Net exports will be the only engine of growth over the forecasting horizon. Exports are estimated to increase by 2.9% in 2013 and 5.6% in 2014. While imports should drop by 3.8% this year and improve by 2.7% in 2014, we expect a further improvement in the current account

[8] See: http://ec.europa.eu/europe2020/pdf/nd/idr2013_spain_en.pdf

balance, from -1% in 2012 to a surplus of 1.4 points of GDP in 2013. The reduction of the current account deficit is largely explained by an improvement in the goods balance excluding the energy component (the energy deficit is structural and will hardly improve over the short term); the reduction should due to both cyclical factors (trend of imports cooled by domestic demand) and structural ones (accelerating exports driven by higher competitiveness). ECB data show that in the past five years unit labour costs in the country have slowed more than the euro area average. In addition Spain has been able to retain export market shares over the past five to seven years and expand its presence on emerging markets not in South America but also in Asia.

Wages and inflation on the decline

Contract-based wages have slowed significantly in the past 12 months, following the reform implemented at the beginning of 2012. Data referred to the September 2012 / March 2013 period clearly indicate that contract-based wages have not been adjusted to compensate for the rise in inflation triggered by the September 12 VAT hike. The wide output gap should contribute to keep inflation under check in the next few months, from 2.0% in June to 1.4% at the end of the summer, when the effect of the VAT rate hike will no longer affect the year-on-year figure. In terms of the annual average, inflation is forecasted at 1.9% in 2013 and 1.8% in 2014.

Labour market outlook still worrying

The outlook for the labour market remains a reason for major concern. Unemployment increased to 27.2% in March 2013, hitting a high since 1980, in line with our forecasts. We expect unemployment to keep rising in the months ahead, albeit at a much slower pace. Sentiment surveys suggest that staff downsizing will continue in the coming months, in the construction sector as well. Workforce expulsion from the construction industry has pushed employment in the sector back to levels just above those recorded at the end of the 1980s. We consider a significant drop below that level unlikely. In the current phase, job destruction is more severe in the public sector than in the private sector, as a result of the measures adopted in 2012 to curb public spending. In our opinion, unemployment may rise to 27.5% by the end of 2013. How much unemployment will drop in the next few years will depend on how much the Government will push on active labour market policies aimed at retraining long-term unemployed workers in particular, and workers expelled from the residential construction sector.

Public finances path still an uphill one

In 2012, the public sector deficit closed at 10.6% of GDP, from -9.4% in 2011. Net of the funds used to recapitalise the banking sector, the deficit levelled off at 7%, seven-tenths higher than the target agreed on with Brussels in the summer of 2012. The difference between the targeted balances and the actual budget results is due to both social security and Region slippages. From a functional point of view, the gap between the 2012 SP target and actual deficit figure is largely explained by lower than expected tax receipts and by higher social spending than initially forecasted, due to the shift towards a less rich tax base, and to higher unemployment. Government debt rose to 84.2% from 69.3% in 2011; contributions to the EFSF and to the ESM weighed by 1.7 points of GDP on the 2012 dynamics. The update of the Stability Program for 2013 - 2016 projects a deficit of 6.5% of GDP in 2013, 5.8% in 2014, and 2.7% in 2016. The Commission evaluates that the measures already approved with the 2013 Budget should guarantee a structural improvement of one point of GDP. The improvement in the primary structural balance should prove more significant: 1.4 points of GDP as interest spending will rise to 3.3% from 3.0% in 2012.

Thus Spain should tighten fiscal policy further from 2014 onwards. The EU Commission in its Spring forecasted estimated that at current legislation would rise to 7% in 2014, unless temporary measures in force 2012 and 2013 are confirmed (wealth tax and change in personal income tax, cut in public employees Xmas bonus and three days holidays). The EU Commission recommendations to the Stability Program point to fiscal measures worth 2 points of GDP in 2014, 1 point of GDP in 2015, and 1.5 points in 2016. The Commission's recommendations are consistent with structural budget improvements of 1.1%, 0.8%, 0.8%, and 1.2% in 2013-16 period. Our estimates point to a reduction of the deficit to 6.7% in 2013, as we believe implementation risk still weighs on spending cuts at the Regional level, and revenues are also exposed to downward risks. We forecast a deficit of 6.1% in 2014, as we believe that at least the measures affecting public sector employees (0.7% of GDP) and the changes made to the tax deductible depreciation (0.3% of GDP) will be confirmed. For the time being, there is no indication of any additional measures that would make achievement of the 5.8% target next year possible. Based on our estimates, borrowing will continue to increase, to 101% of GDP in 2016.

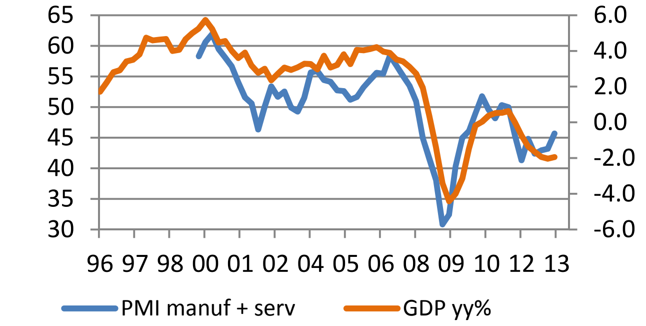
The structural measures needed to abide to the Commission recommendations will be presented with the 2014 Budget which is due by October. By October, the government will have to present the 2014 Budget and detail the structural measures for the 2014-2016 period, as per the Commission's recommendations, with particular focus on containing the Social spending deficit. On 19 June, Prime Minister Rajoy presented the Commission's report on the public sector reform. The document lists over 200 measures which could potentially reduce public spending and improve the efficiency of the PA. The government's spokesperson, Saenz de Santamaria, said that the reforms could potentially generate savings on spending of 37 billion euros. The recovery plan laid out for the next few years could again focus on public spending cuts (44.1% of GDP vs. a euro area average of 46.8%). However, Spain has some leeway on the front of fiscal revenues as well. Fiscal pressure (including social welfare contributions) was 36.8%, vs. a European average of 41.6%. For the time being, the road to fiscal consolidation remains an uphill one.

Public finances forecasts: Intesa Sanpaolo vs. government 2013-16 SP and EU Commission

% of GDP	2012	2013	2014	2015	2016
		2013-2016 SP			
Budget balance	-10.6	-6.3	-5.5	-4.1	-2.7
Interest	3.0	3.3	3.5	3.6	3.6
Budget balance cycl. adj. *	-7.0	-2.2	-1.8	-0.9	-0.2
Primary balance adj. cycl. adj.	-4.0	1.1	1.7	2.7	3.4
Structural balance	-4.3	-2.2	-1.8	-0.9	-0.2
Government Debt	84.2	91.4	96.2	97.2	98.2
		Commission SP Recommendations			
Budget balance	-10.6	-6.5	-5.8	-4.2	-2.8
Interest	3.0	3.3	3.5	3.6	3.6
Budget balance cycl. adj. *	-8.4	-4.3	-3.6	-2.8	-1.6
Primary balance cycl. adj.	-5.4	-1.0	-0.1	0.8	2.0
Structural balance	-5.5	-4.4	-3.6	-2.8	-1.6
Government Debt	84.2	91.4	n.a.	n.a.	n.a.
		Intesa Sanpaolo			
Budget balance	-10.6	-6.7	-6.0	-5.4	-5.4
Interest	3.0	3.3	3.5	3.6	3.6
Budget balance cycl. adj.	-8.4	-4.5	-3.8	-4.0	-4.2
Primary balance cycl. adj.	-5.5	-1.2	-0.3	-0.4	-0.6
Structural balance	-5.5	-4.6	-3.8	-4.0	-4.2
Government Debt	84.2	91.4	97.0	99.0	101.0

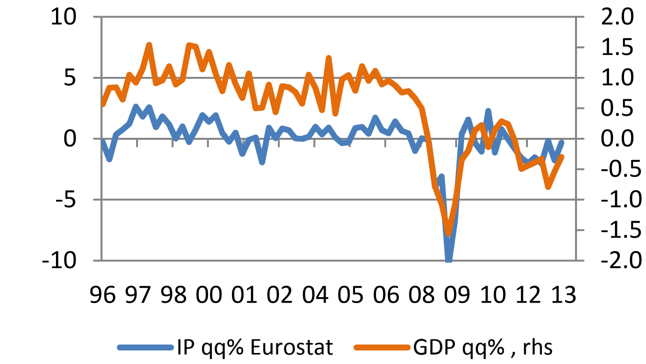
Source: 2013-2016 SP update and Commission Recommendations SWD 2013 383 *Note that the difference between the estimate of the cyclically adjusted budget balance is due to the difference in the output gap estimates of the EU Commission and the Government

PMI indices point to a gradual recovery



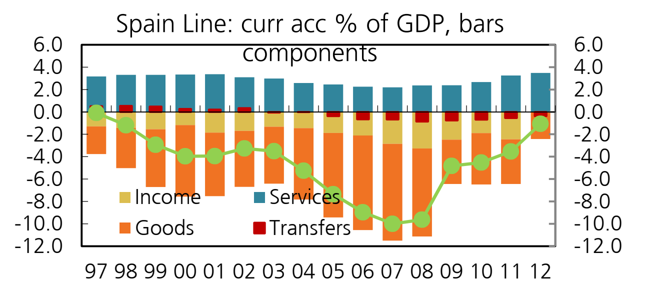
Source: Markit and Intesa Sanpaolo elaborations

Industrial output recovered between March and April



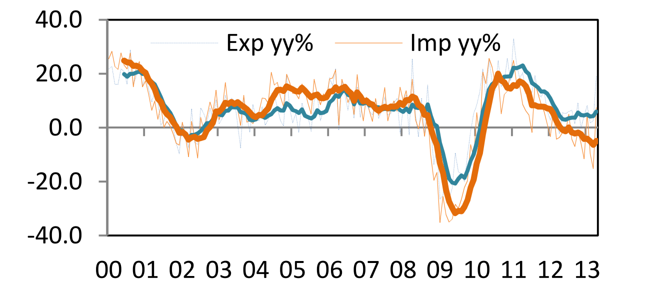
Source: Bank of Spain, INE and Intesa Sanpaolo elaborations

Current balance improvement continues, thanks to the goods balance



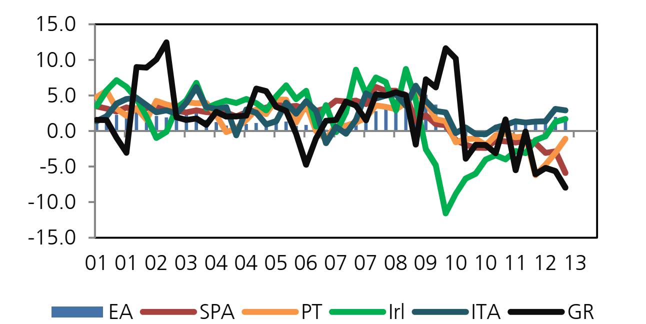
Source: IFO institut, Markit and Intesa Sanpaolo elaborations

Exports accelerating gradually, while imports plummet on very weak domestic demand



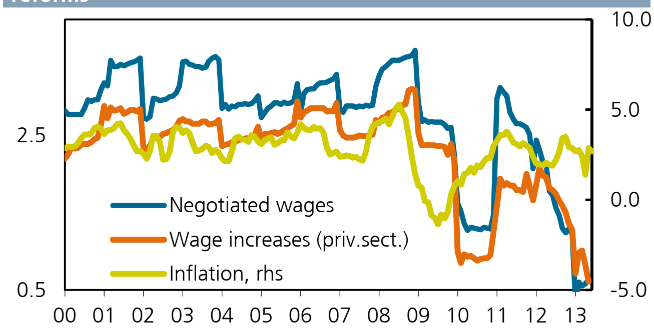
Source: INE and Intesa Sanpaolo elaborations

Spain has achieved important competitiveness gains, which should help cure foreign imbalances



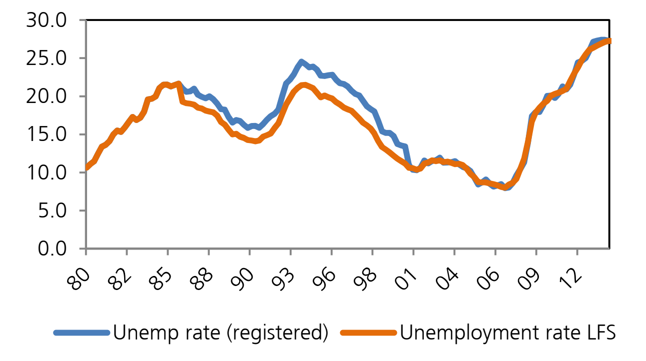
Source: BCE and Intesa Sanpaolo elaborations

Contract-based wages less tied to inflation after last year's reforms



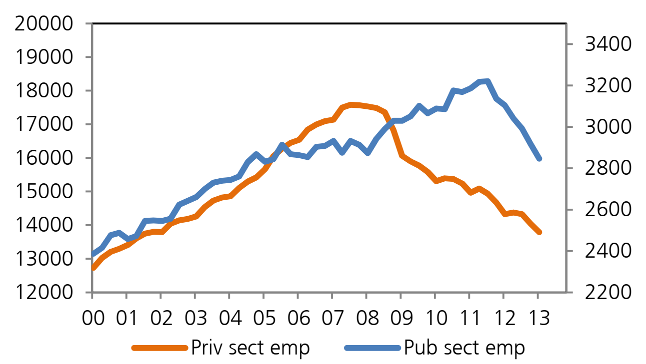
Source: INE and Intesa Sanpaolo elaborations

Unemployment rate to peak at 27.5% by the end of 2013, but will stay high in the coming future barring structural reforms



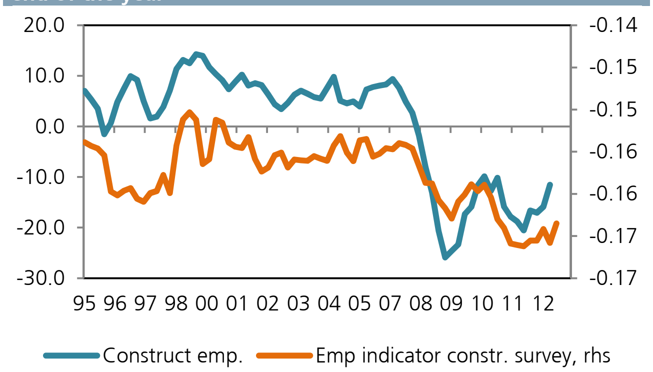
Source: INE and Intesa Sanpaolo elaborations

Expulsion of workforce from the public sector accelerated in the past two quarters, driven by public spending containment measures



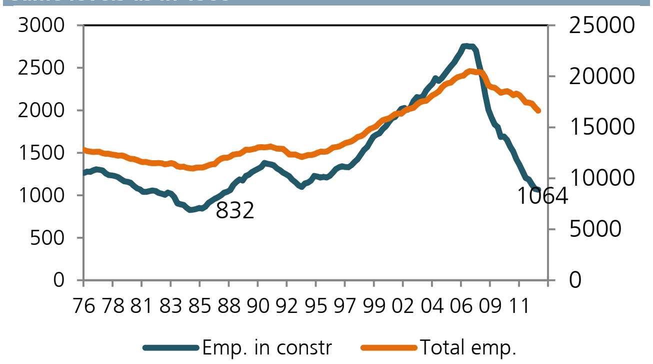
Source: Bundesbank, INE and Intesa Sanpaolo elaborations

Expulsion of workforce from construction should stop by the end of the year



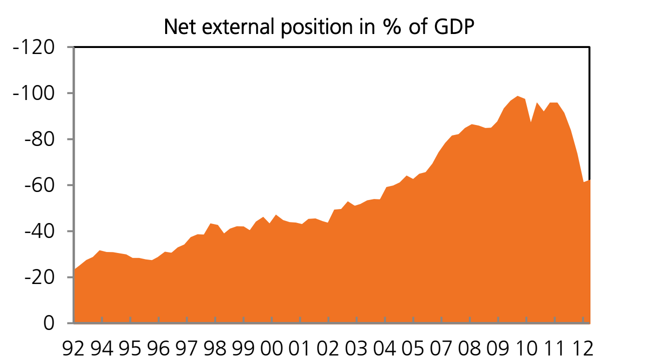
Source: INE and Intesa Sanpaolo elaborations

Employment in the construction sector almost back to the same levels as in 1988



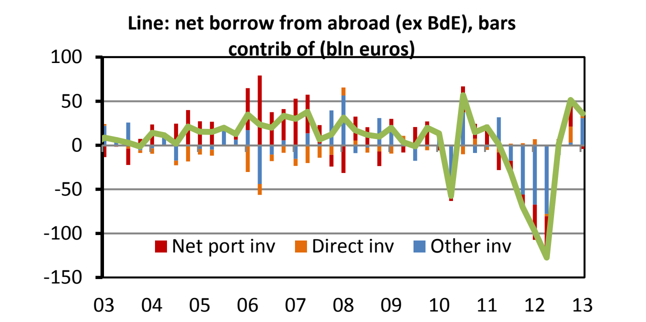
Source: INE and Intesa Sanpaolo elaborations

Foreign debt position worsened at the end of 2012



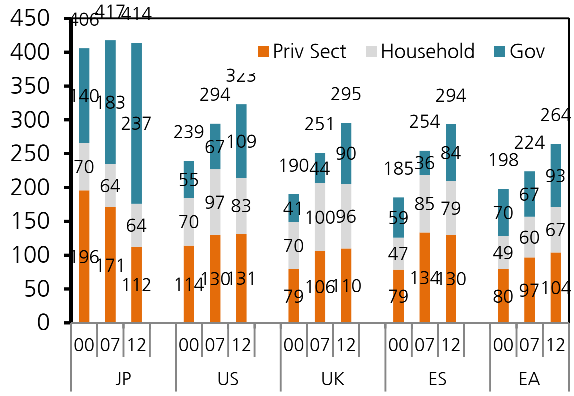
Source: Bank of Spain and Intesa Sanpaolo elaborations

Foreign flow portfolio investments had dropped in March



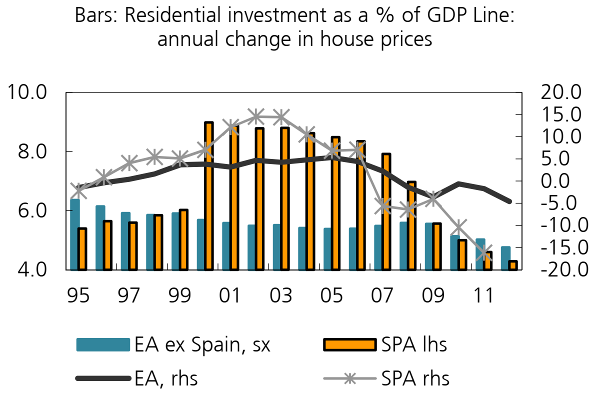
Source: AMECO and Intesa Sanpaolo elaborations

The deleveraging process must continue



Source: Bank of Spain and Intesa Sanpaolo elaborations

Home prices (real) still plummeting, but the worst should be over: residential investments back in line with the long-term average



Source: INE, Eurostat, ECB (home prices) and Intesa Sanpaolo elaborations

Greece, Cyprus, Portugal and Ireland: the way to stability remains elusive

Greece, new problems on the horizon

Guido Valerio Ceoloni

Recently, the situation in Greece has started to become more complicated. Just a few days ago, news broke about the Left's departure from the government following the abrupt closure of Greek State TV to begin the privatisation process. The current coalition was formed in June 2012 as the government of national unity, sustained by the three moderate parties after two inconclusive election campaigns. But the most significant event in recent weeks is the IMF's warning to its European partners that it could suspend aid if the review of the adjustment programme is not completed by July as planned (some weeks ago the IMF issued a partial *mea culpa* about the excessive rigidity of the first bailout programme implemented in 2010).

Recently, the pace of the programme has slowed, especially as regards the ongoing privatisations that cannot be completed (another example concerns the national gas company, Deka, for which a buyer cannot be found). To recap, Greece's second adjustment programme started in 2012 and is scheduled to end in 2014. In total, the country has so far received about EUR 198Bn in aid, including €73Bn in the first programme and about EUR 125Bn of the EUR 165Bn for the second programme. As part of the second programme, the IMF contributes about EUR 20Bn. Last November, the country was granted an extension of two years to meet its fiscal targets, and now has a 1.5% surplus (instead of 4.5%) as the target for 2014, to be improved at a rate of 1.5% per annum in 2015 and 2016 (in which year it will therefore have to have dropped to 1.5%). Public debt is currently 157% of GDP (and expected to grow by nearly 20 points as early as this year) and must drop to 124% by 2020, partly thanks to the easing of certain financial conditions on the debt issued (100-bp cut in interest rates etc.) In February, the EFSF (which, compared to the first programme of aid, in the second programme, completely replaced the bilateral operations of individual European partners in its payments), paid out the second tranche of aid totalling EUR 49.2Bn. Of this, EUR 34.3Bn, paid out in one tranche, is essential to cover the country's fiscal requirement. Another EUR 7.2Bn will be for recapitalising expenses and bankruptcy liabilities for the banking sector. The remaining EUR 7.7Bn is to be paid in monthly instalments from January to May. The points agreed upon to help achieve the country's fiscal targets included the transfer to Greece by member states of an amount equivalent to the income on the SMP portfolio relating to the respective national central banks. These transfers have recently been considered by some central bankers in the Euro zone, equivalent to direct financing by the ECB (whose national central banks form part as the Eurosystem) to an individual Member State, a procedure that is banned by the ECB statutes in force. This has triggered the IMF reserves discussed above, and means that there is a real risk that the system will become jammed. We anticipate that the continuation of the bailout programme will neither be easy nor fast, also bearing in mind that Germany has already made it clear that until September (the month when elections will be held for the new Chancellor), further displays of "generosity" should not be expected. Based on the current scenario, estimates for corrective action this year and next are 7.2% of GDP. In addition, the estimate of the deficit/GDP ratio for this year will be -2.8%. Public debt is expected to reach a peak of 175.6% this year and then gradually decline at an increasing rate. The next review is expected to be completed in July.

Cyprus, start of a challenging bailout programme

Cyprus formally asked for help from the European Commission and the IMF in June last year to resolve the serious crisis in its financial system. The final agreement on the bailout programme was reached in April this year for the European Commission and May for the IMF. The plan, whose success appears far from granted, will have a four-year duration (2013-2016) and provides for a total grant of approximately EUR 10Bn. EUR 1Bn of this is to be provided by the

IMF and the remaining EUR 9Bn by the ESM, which officially came into operation in July 2012 and, since then, will be the only entity in charge of managing all the future bailout programmes (except for Greece, for which the decision was made to keep the programme under the control of the EFSF). Within the programme agreements, it was decided that aid will be conditional on the orderly liquidation of Laiki, the second largest bank in the country, and hence merge its assets with those of the Bank of Cyprus, the island's biggest bank. Bank of Cyprus will be subject to the recapitalisation process, which will involve, in various ways, depositors' current accounts. A portion of these amounts will therefore be converted into the bank's equity. This is the first case of a bailout where depositors are forced to become shareholders of the bank where they were customers. In order to avoid large capital outflows, the government decided to establish restrictions on the free movement of capital. The constraints have been relaxed but not yet removed.

The bailout has three main objectives: to restructure the country's financial system, the size of which was abnormal compared to the country's real economy; to continue the fiscal consolidation process of the country's public finances after the explosion of its deficit budget; and to promote structural reforms to increase the economy's competitiveness. Currently the first tranche of aid, totalling about EUR 2.1Bn (from the IMF and ESM) was granted in May. The ESM will pay out another billion by the end of June. For the current year, the programme anticipates GDP to contract by 8.7% and public debt to rise from 86% to 110%. On 16 May, the European Council granted an extension of four years to the deadline for correcting the country's public finances, in line with the programme's objectives. In the 2013-2018 period, the rescue will therefore total 12 percentage points of GDP, 7.2 of which have already been approved and are in the process of being adopted. The review programmes will occur quarterly and the first is likely to be in September.

Ireland: an assisted return to the market looks likely

Ireland is beginning to see the light at the end of the tunnel. In June, the country received the last tranche of financial aid and, within the year, it should have successfully completed the bailout programme launched in 2010.

The country received a total of about EUR 85Bn from the Troika. The tenth revision to the programme was successfully completed in May, confirming expected GDP growth of 1% this year and just over 2% next year. Between the end of 2012 and the first quarter of 2013, the main fiscal objectives were successfully achieved and the deficit of the public administration was brought to 7.6% of GDP, 1,0% less than the limit of 8.6% established by the programme.

Unlike countries like Portugal and Greece, Ireland had to cope with less harsh fiscal tightening, partly thanks to healthy exports, which offsets weak domestic demand and the problems in the labour market. Moreover, it regained access to international markets thanks to a new ten-year bond issue in March, which raised EUR 5Bn, at a rate that kept below 3.5%. Even the banks' lending conditions and overall financial system have improved. For the current year, the target to bring the deficit to under 7.5% of GDP seems fully consistent with its commitments (mainly liabilities related to the liquidation of the Irish Bank Resolution Corporation and the expiry of the interest rate suspension period); attention will be focused on cutting health care costs, which exceeded the cap set last year: the goal is to match the quality/cost ratio of the other European partners as soon as possible. For next year, a further reduction of the deficit/GDP ratio to 4.3% is expected; public debt should also continue to decline in 2014, going from a high of 123.3% for the year to 119.5% in 2014.

Once the financial sector is back on its feet, the country's main risks will continue to be weak domestic demand, high unemployment (14.2% forecast this year) and, as an external risk, the impact on net exports given the disappointing economic dynamics in Europe, which is the main market for the island's exports.

The Irish Government has begun to look to the future again, announcing that it intends, on its exit from the programme next year, to structure a long-term economic plan (2014-2020) to ensure that the country stays on the virtuous path embarked on during these four years of sacrifices. Note, however, that after the end of the programme, the Troika will still provide support to ensure the full recovery of the banking system (which could cost about EUR 60Bn in total); stress tests will also be prepared to check the level of banking recapitalization reached, while it would seem reasonable to start a precautionary support programme as a protective measure against the risk that problems of access to the market will occur. The next review is expected in July.

Portugal: the austerity plan becomes increasingly difficult to complete

The eighth review of the aid programme to Portugal began on 24 June with a mandate to monitor the progress of the process of reforms and fiscal consolidation, which are experiencing a slowdown compared to the timetable envisaged. The aid programme launched in 2011 is expected to be completed in mid-2014. The previous review in April lasted almost three months due to a new ruling by the Constitutional Court, which rejected some austerity measures with a net impact on the balance of 0.8% of GDP, forcing the government to identify alternative measures totalling 2.8% of GDP in 2014 compared with this year's balance. Tax increases are no longer a viable option as fiscal pressures are already at a historic high. Moreover, the third consecutive year of recession is creating more of a problem for the Portuguese government in its implementation of a restructuring plan that will see - in the face of about EUR 78Bn in financial aid - the launch of a long series of spending cuts and revenue increases, which are a burden on the population and make it difficult to make further cuts. The government obtained a first result, with the grant of an extension to the expiry date for the loans to the country, ratified by ECOFIN in June. Moreover, improved public finances have allowed the country to obtain loans on the international markets: in addition to short-term 6- and 18-month investments, Portugal has raised EUR 5.5Bn with long-term issues and has announced its intention to issue debt via auction on the domestic market.

The weakness of economic growth has also persuaded the Troika to ease the recovery targets for 2013 and the following years: this year, therefore, the deficit/GDP ratio will be reduced to 4.5% (from an original 5.5%), and then to 4.0% in 2014 and 2.5% in 2015. The deficit of the public administration rose to 6.4% of GDP in 2012, from 4.4% in 2011, due to the completion of one-off transactions to support the banking system and the statistical treatment of some privatisation transactions (sale of rights to operate the major airports in the country by state-owned ANA to French group Vinci). Estimates about economic recovery remain bleak: after the -3.2% contraction in 2012, -2.3% is expected this year, although risks are to the downside due to the worsening of the economic situation and the deterioration in the labour market in the first half of the year. Signs of recovery in the second half of the year should come from industrial production and incentives for investors, promoted by the government while the "redirection" of exports from the European market to the non-European market could be disappointing. For 2014, growth could recover by 0.6%. In terms of the public accounts, the structural deficit fell to 4.2% thanks to a fiscal effort of about 2.2 percentage points of GDP and should further reduce to -3.6% in the current year. Public debt looks set to peak in 2014 (124.3% of GDP) and is then likely to fall (estimated at 117% in 2016). It should be borne in mind, however, that only in December, estimates said that public debt would stop at 122% of GDP, so in just six months, estimates on debt have risen by a good two points.

Overall, risks to completing the programme under the terms and conditions agreed are still thought to be high and the main consensus estimates show a 2.7% decline in GDP this year and stagnation next year. The main causes are still the very fragile public finances, a not-very-reassuring economic situation, possible further action by the Constitutional Court on the measures taken in April and increasing structural unemployment (expected to reach 18.2% this year, up from 2014). Domestic political tensions are also rising: the polls show that the majority parties have suffered a big loss of popular support, and CDS, the junior coalition party, shows increasing resistance towards austerity policies. The ongoing review is expected to be completed in July.

Focus: a crash course on euro area fiscal rules

Luca Mezzomo
Anna Maria Grimaldi

The fiscal rules in the euro area have evolved over the years into a complex stratification of Treaties and Rules, with the latter significantly amended between 2011 and 2013. Procedures are increasingly shifting towards the use of balances adjusted by cyclical factors, although the historical thresholds defining excessive deficit remain set in absolute terms. A brief navigation guide is offered below. Taking into account the cyclical position of a Member State does not necessarily mean making the fiscal consolidation process more tolerable. Preventive rules for countries with a smaller output gap risk proving more vexing than the application of the deficit and debt reduction rules.

The control system over the government accounts of euro area Member States is notoriously based on a "corrective arm", in essence the old stability and growth pact, revised and corrected, plus a "preventive arm", aimed at guiding Member States towards achieving a balanced budget, prompting them to implement the corrections during cyclical expansion phases. The rules derive from the prescriptions of the "Treaty On The Functioning Of The European Union" and from some Council Regulations, amended in 2011, with the addition in 2012 of the intergovernmental Treaty known as Fiscal Compact (*Treaty On Stability, Coordination and Governance in the Economic and Monetary Union*). Some of the measures included in the Fiscal Compact have been inserted in the regulations known as the Two Pack, which came into force in May 2013, and translated into national laws.

The fiscal crime: when is the deficit considered to be excessive?

The most ancient part of the fiscal control system is the one geared to correcting "excessive" fiscal deficits. The concept of excessive fiscal deficit encompasses both the flow (public sector deficit) and the stock (gross public sector debt). In particular, the rule laid out in Art. 126(2) of the Treaty On The Functioning Of The European Union (TFEU) requires Member States to ensure that:

1. The deficit/GDP ratio be lower than 3% of GDP; or "has declined substantially and continuously and reached a level that comes close to" 3%; or the excess over the reference value is only exceptional and temporary, and the ratio remains close to 3%.

2. The debt/GDP ratio be lower than 60%; or, if the limit is exceeded, the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

If one of these conditions is not met, the deficit is excessive. In the past, the attention of the European authorities was very much concentrated on flows, and the debt criterion was almost ignored. The flexibility margins provided for by the Treaty in the interpretation of the debt criterion were reduced by the reform of Regulation 1467/97 in 2011, strongly conditioned by the perception that high-debt countries could pose fatal risks to the survival of the monetary union. In exchange for the introduction of support mechanisms, stricter obligations were introduced in terms of the reduction of debt. The current regime in force imposes that the difference between the debt/GDP ratio and the 60% threshold be reduced on average by one-twentieth a year on here-year observations periods. If exceptions or flexible interpretations were not provided for, the rule would be virtually impossible to respect in the next few years, when real growth will be predictably non-existent or very low in several euro area member states. However, some leeway is still allowed:

- The observation period comprises either the last three years for which data are available, or the latest period for which data are available, and the European Commission's projections for the following biennium.

The main surviving margin of flexibility concerns the very influence of growth: indeed, the European Commission's assessment will have to take into account the "influence of the cycle on the pace of debt reduction"[9]. This aspect will be crucial in the years ahead, as the negative impact of the austerity measures on gross domestic product makes cutting debt highly unlikely in deficit-reduction phases. The current methodological approach includes the calculation of a cyclical adjustment for debt ratios: the adjusted debt ratio is computed by subtracting from the actual debt ratio the cyclical component of the last three years; the result is then divided by potential GDP instead of actual GDP[10]. Debt is excessive if all the three measures envisaged (backward, forward and cyclically-adjusted) are not compliant with the 1/20 rule.

- The regulation provides for a delayed enforcement of the rule for countries subject to excessive deficit procedure as at 8 November 2011: in this case, the rule comes into force three years following exit from the procedure[11]. This applies to all Eurozone countries, except Luxembourg, Finland and Estonia. Germany was cleared only later, in June 2012, and Italy should follow this year.

- Other margins of flexibility are also provided for if the deficit limit is met: in this case, the Commission also takes into account other factors: developments in terms of potential growth, precedents in terms of the respect of fiscal programmes, adoption of measures against macroeconomic imbalances, medium term debt developments, sustainability parameters, participation in European assistance programmes[12].

Excessive deficit procedures (ongoing, or recently closed)

Country	Start	End	Country	Start	End
Austria	Dec 2009	2013	Italy	Dec 2009	June 2013(+)
Belgium	Dec 2009	2013 (2012)	Luxembourg	-	-
Cyprus	Jul 2010	2016	Malta	June 2013(*)	2014
Estonia	-	-	Netherlands	Dec 2009	2014 (2013)
Finland	Jul 2010	Jul 2011	Portugal	Dec 2009	2015 (2014)
France	Apr 2009	2015 (2013)	Slovenia	Dec 2009	2015 (2013)
Germany	Dec 2009	Jun 2012	Slovakia	Dec 2009	2013
Greece	Apr 2009	2016	Spain	Apr 2009	2016 (2014)
Ireland	Apr 2009	2015			

Notes: (*) proposed by the Commission; previous EDP from July 2009 to December 2012; (+) proposed by the Commission, yet to be approved by the Council. Source: European Commission website

As regards the deficit limit, regulation 1467/97 specifies in Art. 2.1 when breach of the 3% ceiling may be considered as "exceptional and temporary":

- It is considered exceptional "when resulting from an unusual event outside the control of the Member State concerned", or if determined by a "severe economic downturn". The excess will be considered as exceptional if it "results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential" (art. 2.2).

- It is considered temporary if the Commission's projections indicate that the deficit will drop to below the benchmark value once the unusual event, or the serious economic recession, are over.

Exceptionality, therefore, does not apply if the excess is tied to one-off measures (temporary, but not exceptional), whereas it may apply if the excess is explained by a contraction in GDP.

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[9] Regulation 1467/97, consolidated version, Art. 2.1a, last paragraph.
[10] See "Vade mecum on the Stability and Growth Pact", *European Economy: Occasional Papers* no 151, p. 50.
[11] Regulation 1467/97, consolidated version, Art. 2.1a, second paragraph.
[12] Complete list provided in Reg. 1467/97, Art. 2.3.

Repressive measures against excessive deficit

Once ascertained that the deficit is excessive (based, as mentioned above on flows or debt), the **Excessive Deficit Procedure** is triggered. The starting point is a **recommendation** drawn up by the Commission, which sets a **deadline** for the correction of the deficit, and a **sequence of annual budget targets**. The minimum correction required is established based on the structural balance (i.e. net of one-offs and cyclical effects), which must improve by *at least* 0.5% a year, and in any case enough to guarantee a reduction of the deficit to below the limit within the established deadline. The recommendation usually indicates the size of the necessary budget cuts required with respect to the unchanged-policy scenario. also, the new regulations known as Two Pack introduce the imposition of structural reform plans geared to improving growth and productivity, and the obligation of providing information on the progress made in implementing the budget; if the Member State is also facing financial difficulties, a special monitoring process by the European Commission is triggered ("**enhanced surveillance**")[13]. The recommendation must be approved by the European Council. The Member State then has a maximum period of **six months in which to adopt the necessary actions**, which may be reduced to three if the situation is deemed very serious. Therefore, the countries identified this year as requiring new fiscal corrections for 2014 should announce the new measures by the end of the year.
The procedure allows the **possibility of pushing back the deadline** for the correction of the excessive deficit, an option frequently resorted to in recent years. The two necessary conditions provided for by Art. 3.5 of regulation 1467/97 are the following:

1. The Commission must certify that effective measures have been adopted, in line with the recommendations.
2. Unexpected adverse economic events have materialised following the issue of the recommendation, with important negative repercussions on public finances.

In these circumstances, the Commission may propose an extension, by one or more years, of the deadline for deficit correction.

If the correction plan is respected, the procedure is suspended, and no actions are taken by the European authorities. By contrast, the procedure includes a number of further steps is the Member State fails to adopt the required measures. In case of persistent breach of the rules, the escalation of interventions may lead to the imposition of penalties, worth up to 0.5% of GDP in a year.

Preventing the crime – Medium-term fiscal planning mechanisms

The medium-term fiscal picture for euro area countries is bound to the rules of the so-called preventive arm of the stability pact, Regulation 1466/97, repeatedly amended, and of the Fiscal Compact, the integrative Treaty subscribed to by 23 Member States. The regulations introduced by the Two Pack, mentioned above, have also added themselves to the body of rules.

By subscribing to the **Fiscal Compact**[14], Member States have committed to achieving a **zero or positive structural balance, with a tolerance of 0.5% of GDP** (Art. 1), and to ensuring rapid convergence on medium-term objectives. Only when the debt/GDP ratio is significantly lower than 60%, and if non-sustainability risks are low, may the tolerance margin be raised to 1% of GDP, as provided for by the stability pact. Deviations from this limit are only allowed in

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[13] The provisions are included in regulations No. 472/2013 and No. 473/2013 of 21 May 2013, which embrace prescriptions included in the Fiscal Compact. Reg. 473/2013 also introduced the obligation of presenting the budget by 15 October every year, and to adopt it by 31 December, following the Commission's view, issued by 30 November.
[14] See *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, 2 March 2012.

exceptional circumstances, i.e. in the face of unusual events that are beyond the control of the Member State, or serious recessions. Breach of the Treaty may lead to the case being brought before the Court of Justice and to the issue of penalties of up to 0.1% of annual GDP[15].

These provisions intersect with those laid included in the stability pact. Each Member State has a **medium-term fiscal target**, set in order to guarantee respect of the 3% ceiling, the sustainability of debt, and an adequate leeway for counter-cyclical policies[16]. This latter condition is rarely respected, as fiscal consolidation has mostly been implemented in periods of recession. Also, until the objective is achieved, the multi-year fiscal plan presented by Member States by 30 April each year must guarantee that the **growth rate of primary spending, net of the impact of discretional measures on revenues, is lower than the potential GDP growth rate**; any excess must be balanced by discretionary revenue increases. Similar limits apply to discretionary revenue reductions, which must be covered by spending cuts or by increases in other revenues. [17]

Convergence towards the medium-term objective takes place with a **minimum correction of the structural of 0.5% of GDP a year**, which however may be higher if the debt/GDP ratio exceeds 60%, or if evident risks to sustainability are deemed to exist. In essence, a larger correction is the norm when the starting level of the structural balance is further from being balanced.

Performance monitoring allows a **small tolerance margin**. Deviation from the consolidation path is significant if, in terms of the structural deficit, it exceeds 0.5% in one year, or 0.25% for two consecutive years; deviation is also significant if the spending trend exceeds the target by at least 0.5% in one or two years. Even if one of these two conditions stands, the deviation can in any case be ignored, if it caused by factors beyond the control of the Member State, or by a severe recession in the euro area as a whole[18].

The conditions laid out for the preventive arm of the procedure are normally more restrictive in terms of the criteria defining excessive deficit, but this cannot apply in the presence of very wide output gaps. Indeed, it cannot be ruled out that, following a long period of recession, the achievement of a balanced structural budget proves to be insufficient in order to keep the non-cycle adjusted deficit below the 3% threshold, or to guarantee an adequate reduction of the debt. In this case, it is desirable that the margins of flexibility allowed by the stability pact be used to justify a breach of the limits, rather than to impose untimely pro-cyclical fiscal policies leading to structural balance surpluses.

The preventive and corrective arms of the new fiscal regime have different implications depending on the starting points: the cases of Spain and Italy

Illustrated below are the implications of the application of the corrective arm and of the preventive arm of the new fiscal policy regime in Spain and Italy. We simulate the impact of the new fiscal regime on the primary balance of Spain and Italy. We have used the EU Commission forecasts for real GDP growth for the period 2013-2014 and potential GDP, and thus output gap projections (as in the latest EU Commission Fiscal sustainability report[19]), for the fiscal balances we use the targets indicated in the EU recommendations for Spain and the EU Commission spring forecasts for Italy.

Spain is still subject to an excessive deficit procedure, and the Commission has allowed the country two extra years, until 2016, to restore its deficit to below the 3% threshold. The

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[15] See Art. 8 of the Treaty.
[16] Regulation 1466/97, consolidated text, Art. 2a.
[17] Ib., Art.5.1.
[18] Ib., Art. 6.3.
[19] http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-8_en.pdf

excessive deficit reduction path has been agreed on up to that date. In the recommendations issued on 29 May, the Commission indicates that it expects the deficit to drop to 2.8% in 2016, from 10.6% in 2012 (7.0% net of the measures put in place in support of the banking system). In the conservative assumption that interest expenditure will remain unchanged at the level forecast by the Commission in 2014, the primary balance would close showing a surplus of 0.9% of GDP in 2016, vs. a deficit of 7.7% in 2012.

Let's start with the calculation of the primary balance consolidation needed to abide to "corrective arm" of the new regime. Starting in 2017, the strict respect of the rule would require the debt to fall by 1/20 a year in the case of Spain this means raising the primary balance in 2017 to 2.2 % of GDP, 1.3 points higher than in 2016. However, as provided for by the new stability pact, when the excessive deficit procedure is concluded in the previous year, the application of the rule is "flexible" in the following three years[20]. In this case the Spanish primary balance should improve by at least 1 percentage points of GDP compared to 2016. Application of the "preventive arm", i.e. respect in the medium term of a structural deficit no higher than 0.5% of GDP, would imply for Spain an improvement of the primary balance in 2017 of 2.5 points of GDP. The rule will become stringent when the country exits the excessive deficit procedure, and therefore structural balance objectives will not be agreed on with the Commission. It should be pointed out that Spain's structural deficit closed at 5.5% of GDP in 2012, and that in its May recommendations the Commission estimates a further decline to 1.5% of GDP in 2016, with a structural improvement of 1.1 points in 2013, 0.8 in 2014-2015, and 1.2 in 2016.

We will now examine the case of Italy. The Commission, with the recommendations issued in May, confirmed the country's exit from the excessive deficit procedure. The Commission estimates Italy's deficit at 2.9% of GDP this year, and at 2.5% in 2014. The primary balance is expected by the Commission to come in at 3.1% of GDP in 2014, up from 2.5% in 2012. The "strict" application of the debt rule would impose on Italy the a primary balance of 5.6 points of GDP, and therefore a fiscal consolidation effort of 2,5 points of GDP in just one year. However, as Italy has exited the excessive deficit procedure in 2013, for the next three years the Treaty allows for some flexibility, but the benefit will be limited just to a few tenths of a percentage point. Application of the fiscal compact rule would impose on Italy an additional primary balance correction of only 0.5 points of GDP in 2015, as based on the Commission's estimates the structural deficit should be -0.7% of GDP already in 2014.

The examples illustrated above suggest that the preventive rule is not necessarily less vexing than the corrective rule. In the Spanish case, the respect of the structural deficit limit of 0.5% of GDP is more demanding than the debt reduction rule, whereas the exact opposite is true for Italy. As is often the case in economics, this is explained by the different staring points. Italy's debt is much higher than Spain's, while the deficit is much lower; therefore, the debt reduction rule, even if applied with mitigation, is harder to comply with than the requirements on deficits. At the same time, based on the Commission's estimates, upon application of the fiscal compact (2015 for Italy and 2017 for Spain), Italy should show an output gap around twice the size of Spain's, and therefore the weight of the cyclical component is higher for Italy, and the residual required structural correction smaller; however, the overall deficit is likely to be close to 3%, due to a large cyclical component.

The estimate of the output gap weighs heavily on the fiscal effort required of Member States

Given the greater emphasis placed by the fiscal compact on structural balances, it is worth remembering that the determination of an economy's cyclical position becomes very important. Notoriously, the width of the output gap depends on the estimate of potential GDP, which may

[20] See Annex 6 in the above mentioned *Vade mecum on the Stability and Growth Pact* for the details.

in some ways be considered as "unobservable" and is usually estimated moving from a production function with capital and full-employment work force as inputs. Therefore, the estimate of potential GDP depends on the estimate of capital stock, and on the estimate of the potential work force, which depends on the trend of the participation rate, and of the long-term unemployment rate.

The Commission itself acknowledges that output gap estimates are typically subject to a wide margin of discretion, in part tied to the difficulty in defining and estimating long-term structural unemployment and the investment trends. The method used by the European Commission to estimate potential growth and the output gap was agreed on by a dedicated working group (OGWG).

As shown in Table 1, the Commission's estimates of the output gap differ significantly from the OECD's. The implications are by no means negligible in terms of the structural fiscal consolidation required of the countries considered.

Indeed, the weight of the cycle in the correction of budget balances changes depending on whether larger or smaller output gaps are considered. The cyclical component of the deficit is the result of the interaction of elasticity to the cycle, and of the output gap. The wider the output gap, the wider the cyclical component, and vice versa. In Spain's case, the difference between the Commission's and the OECD's estimates is especially significant. According to the OECD, potential GDP growth will remain broadly stable at 1.3%, as opposed to the Commission's forecast of a drop in potential GDP in 2013 of 1.5%. This explains the much wider output gap estimated by the OECD for Spain. As shown in the table below, if the OECD's estimates of the output gap were used, the cyclical component of the Spanish budget balance would be around five times higher than estimated by the Commission, and therefore the structural correction of the balances would be significantly smaller.

Tab. 1 – Estimate of the output gap weighs dramatically on the correction of structural balances

	2010	2011	2012	2013	2014
			Output gap		
Italy EU Comm.	-1.8	-1.6	-3.1	-4.0	-3.2
Italy OECD	-2.8	-2.4	-4.5	-5.8	-5.3
Spain EU Comm.	-4.7	-4.1	-4.6	-4.6	-2.3
Spain OECD	-5.4	-5.9	-7.7	-9.6	-9.4
		Cyclical component of the budget balance in as % of GDP			
Italy EU Comm.	-1.0	-0.9	-1.7	-2.2	-1.7
Italy OECD	-1.5	-1.3	-2.4	-3.2	-2.9
Spain EU Comm.	-2.3	-2.0	-2.2	-2.2	-1.1
Spain OECD	-2.6	-2.8	-3.7	-4.6	-4.5

Source: AMECO, OECD and Intesa Sanpaolo elaborations

Additional readings

The European Commission has recently published three papers that explain in great detail how the new fiscal rules will be applied:

1. A non-technical introduction is provided by "Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact", *European Economy: Occasional Papers* no 150, May 2013.

2. Far more detailed is the "Vade mecum on the Stability and Growth Pact", *European Economy: Occasional Papers* no 151, May 2013.

3. Cyclical adjustment is the topic of "The cyclically-adjusted budget balance used in the EU fiscal framework: an update", *European Economy: Economic Papers* no 478, March 2013.

UK: recovery: would be better with more stimulus

Asmara Jamaleh

Slightly revised expectations of growth in the UK this year, from 0.7% to 0.9%. The start of 2013 was marked by a 0.3% rebound in GDP following the contraction in 4Q12, although the GDP breakdown is not very encouraging. Private consumption has slowed, and growth in investments was barely positive. Exports and imports have again contracted, as they did in 4Q, and the contribution of foreign trade to growth is positive rather than negative only because imports have decreased so much. There has been a lot of destocking too. The second quarter is set to show only slight improvement. Overall GDP growth is likely to remain more or less what it was in 1Q (estimated +0.3% qoq), but with a slightly more balanced breakdown by components: modest recovery in investment and an expected return to positive territory for import and export growth, the former not least thanks to the weakening of the exchange rate. Under these conditions, however, the overall picture is one of a fragile recovery at risk of collapsing at the first adverse external shock. It is for this reason that further support in terms of monetary policy would be welcome, especially if it comes in time. In recent months, a significant split has been emerging at the Bank of England, with three of its nine MPC members, among them the ex-Governor Mervyn King, having voted for an increase in the APF for five months in a row. King has been replaced by Mark Carney since 1 July, and August will see the Bank adopting new guidelines on the monetary policy framework following the revision of the "remit" in March. It is expected that they will roll out Fed or Bank of Canada-style forward guidance, but the BoE has a wide and varied range of tools that it could use to provide additional monetary stimulus, as the APF for instance. The problem is that the structural imbalances of the UK's economy cannot be addressed by monetary policy alone. As for fiscal policy, the support that can be provided this year is small, if not zero, as the government is engaged in fiscal consolidation. Finally, on the exchange rate side, we expect sterling to recover if UK data do not disappoint and if the BoE takes action to support the recovery; we do not expect the reallocation between domestic and foreign demand to happen through any exchange rate adjustment. Although the extension of the Funding for Lending Scheme (FLS) has not yet had a massive effect, it has achieved some positive outcomes notwithstanding the current troubles. In order to re-establish a virtuous circle of growth and domestic demand, it is clearly vital for the current recovery to remain intact, and support from monetary policy, even if only partial, would be a welcome option.

Forecast Table

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.2	0.9	1.9	0.1	0.0	0.3	1.1	0.8	1.5	1.9	2.0
- q/q change				0.7	-0.2	0.3	0.3	0.4	0.5	0.6	0.5
Private consumption	1.2	1.5	1.9	0.3	0.5	0.3	0.3	0.4	0.5	0.6	0.4
Fixed investment	0.5	-2.0	6.6	-1.6	-4.9	0.2	1.4	3.0	2.0	1.5	1.0
Government consumption	2.8	0.8	-0.6	0.9	0.8	0.1	0.0	-0.1	-0.2	-0.2	-0.2
Export	0.9	0.1	4.1	1.9	-1.9	-0.1	0.1	1.1	1.0	1.3	0.7
Import	2.8	-0.9	4.5	0.6	-1.0	-2.0	0.2	1.3	1.4	1.4	0.9
Current account (% of GDP)	-3.7	-3.1	-2.9								
Deficit (% of GDP)	-6.5	-6.0	-5.5								
CPI (y/y)	2.8	2.6	2.5	2.4	2.7	2.8	2.5	2.6	2.5	2.4	2.6
Industrial production	-2.4	-0.7	1.2	0.6	-2.1	0.1	0.4	0.3	0.9	0.1	0.1
Unemployment (%)	4.8	4.5	4.5	4.7	4.7	4.6	4.5	4.5	4.5	4.5	4.5
3m interbank rate	0.83	0.50	0.53	0.73	0.53	0.51	0.51	0.50	0.50	0.50	0.50
GBP/USD	1.58	1.55	1.63	1.58	1.61	1.55	1.54	1.53	1.58	1.61	1.63
Effective exch.rate (1990=100)	83.1	81.9	87.3	84.1	83.7	80.4	80.7	82.1	84.3	85.5	87.2

Note: Percentage variations over previous period, if not otherwise specified.
Source: Intesa Sanpaolo elaborations

Asia

Japan – Honeymoon over: desperately seeking tools to manage the effects positive inflation expectations

Giovanna Mossetti

- The change in the direction of the Japanese economy initiated last autumn with the new government and the announcement of radical changes to monetary policy, continues. Growth is expected to be 1.8% in 2013 and to pick up further in 2014, at 2.3%.
- The recovery has now taken hold, with strong growth seen already at the start of 2013, shored up by consumer spending and residential building. In the next few quarters, we should see a significant upturn in all components of aggregate demand, involving not just public investment but exports and non-residential fixed investment too.
- Inflation remains in negative territory, but forecasts are for a gradual return to price rises by the end of 2013.
- An aggressively expansionary monetary policy has been adopted, with the resulting increase in inflation expectations reflected in the substantial volatility on the bond market. The BoJ remains committed to maintaining a considerable monetary stimulus in order to reach its 2% inflation target by 2015. The central bank's forecasts are probably too optimistic: inflation should return to positive territory by the end of 2013 but, stripping out the effects of the indirect tax hikes in early 2014 and late 2015, it is not likely to reach 2% until after 2015. This would entail a prolonged period of monetary expansion through extensive purchases of Japanese government bonds (JGBs).
- Fiscal policy will remain accommodative in 2013, with an increase in public investment and measures to stimulate firms' fixed investment. The government's growth plan, details of will be announced in the autumn, is likely to include a reduction in corporate taxes. From 2014 onwards, fiscal policy will change direction as the Japanese economy comes up against its own fiscal cliff. The consumption tax is set to rise to 8% from its current 5% in April 2014; a further hike in the rate to 10% is forecast for October 2015. These measures will have a significantly restrictive impact on growth and inflation from early 2014 to the end of 2015.

Macroeconomic forecasts

	2012	2013	2014	2012		2013				2014	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.9	1.8	2.3	0.3	0.4	0.2	0.9	2.7	3.4	3.6	2.1
q/q annual rate				-3.6	1.2	4.1	1.9	3.6	3.9	5.1	-4.1
Private consumption	2.3	1.8	1.5	-1.6	1.8	3.6	2.0	1.8	2.5	5.0	-5.1
FI - private nonresidential	1.9	-2.6	4.4	-12.4	-5.7	-1.2	0.5	1.5	3.0	4.5	7.3
FI - private residential	3.0	8.6	0.5	6.3	14.9	7.6	2.7	12.0	10.0	-5.0	-5.5
Government investment	12.6	8.9	-2.5	13.6	11.1	1.6	5.0	18.0	1.5	-5.1	-14.9
Government consumption	2.4	1.3	1.0	1.4	2.6	1.7	-0.6	1.2	1.6	1.2	1.2
Export	-0.1	0.8	8.4	-16.5	-11.3	16.1	2.0	7.0	6.5	10.5	9.0
Import	5.5	1.0	4.6	-1.2	-8.5	4.0	3.5	4.0	4.0	5.5	4.0
Stockbuilding (% contrib. to GDP)	0.0	0.2	0.1	0.2	0.0	-0.1	0.2	0.1	0.2	0.2	-0.5
Current account (% of GDP)	1.1	0.5	1.1	0.8	0.9	0.6	0.5	0.4	0.5	0.7	0.9
Deficit (% of GDP)	-9.9	-9.4	-6.9								
Debt (% of GDP)	209.6	212.7	210.0								
CPI (y/y)	0.0	0.1	2.9	-0.3	-0.2	-0.6	-0.4	0.4	0.9	1.3	3.5
Industrial production	-1.0	0.4	6.9	-15.8	-7.2	8.9	7.3	4.7	8.4	7.3	7.1
Unemployment (%)	4.4	3.9	3.6	4.3	4.2	4.2	4.1	3.7	3.7	3.7	3.6
3-month CD rate	0.19	0.38	0.91	0.20	0.19	0.17	0.01	0.57	0.78	0.64	0.82
JPY/USD	79.8	98.8	106.1	78.6	81.2	92.1	98.7	100.3	104.1	105.5	106.5
Effective exch.rate (1990=100)	178.9	144.2	133.8	183.1	175.0	153.5	143.9	142.7	136.9	134.3	133.2

Note: Annualised percentage change versus previous period except where otherwise indicated.
Source: Datastream, Intesa Sanpaolo

Economic recovery under way: private and public demand strengthen each other

The change in the direction of the Japanese economy initiated last autumn with the new government and the announcement of radical changes to monetary policy, continues. The clear reversal in the financial variables (exchange rate, stock market, yields), which continued uninterruptedly until early May, is filtering through to the real variables. The recent market volatility is not at the moment jeopardizing the solid exit from recession seen in the second half of 2012: the economy has been picking up - and in a more sustained manner than expected - since as early as the first quarter (+0.9% qoq), on the back of a strong trend in consumer spending and residential building, coupled with a moderate recovery in exports. In previous economic cycles, the cyclical turns in Japan followed the same script: the driving force was provided by exports, which stimulated corporate demand and only subsequently gave way to a recovery in personal spending. In this cycle, however, the strength of the yen, which lasted until late 2012, weakened exports and corporate investment: this time it falls to consumer spending to act as growth driver.

In the next few quarters, growth should firm up with a contribution from private investment, which should at last be positive (it fell for the 5th consecutive quarter at the beginning of 2013) and thanks to a rise in public investment in the middle two quarters of the year. GDP growth in 2013 is forecast at 1.8%, and is expected to pick up the pace to 2.3% in 2014. As has been widely publicized, 2014-2015 is likely to see considerable growth volatility due to the expected two-stage rise in the consumption tax (April 2014 and October 2015). At the moment, the government's strategy - aimed at strengthening the recovery in 2013 so that it can implement fiscal tightening in the next two years - seems to be in line with expectations. Moreover, the BoJ’s aggressively expansionary monetary policy, one of the objects of which is to achieve the announced 2% inflation target, is bearing fruit in terms of inflation expectations and the assumption that real rates will be pushed into negative territory.

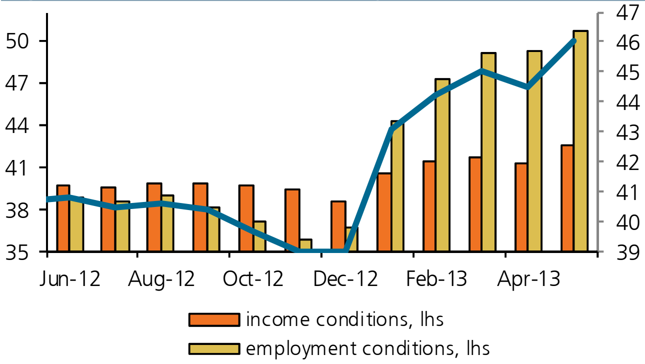
Consumer spending and residential building pick up pace; corporate investment begins to recover.

Private domestic demand grew by 0.5% qoq at the beginning of 2013. Specifically, GDP first-quarter and revised fourth-quarter figures paint a rosy picture for consumer spending, which rose by 0.9% qoq and 0.4% qoq respectively. The improvement in the job market, increase in confidence and significant rise in inflation expectations indicate that household spending is likely to remain brisk. Salaries increased by 2.1% qoq (annualised) in the first quarter, which more than made up for the fall of 1.6% qoq at the end of 2012: the rise in employment income and the reduction in the savings rate supported the upturn in consumer spending. In 2013, consumer spending is likely to grow by 1.8%, with a strong rally at the end of 2013/early 2014, ahead of the consumption tax hike. Inflation expectations jumped in April (see fig. 7).

In this cycle, unlike in the previous ones, corporate investment is the weakest link of the cyclical chain. Capital investment fell again in the first quarter of 2013, by 0.7% qoq, but surveys show it stabilising in the second quarter and picking up later, partly thanks to the continuing depreciation of the yen. Industrial output staged an impressive recovery in April (+1.7% mom): based on company projections, which see it stabilising in May and falling by 1.4% mom in June, the quarterly increase in output production is, in any event, likely to be sustained at 1.9% qoq. In sector surveys, orders are picking up and expectations indices are consistent with increases in capital investment in the second half of the year. Growth is likely to be negative (-3.1%) in 2013, followed by positive growth in 2014 (+4.4%).

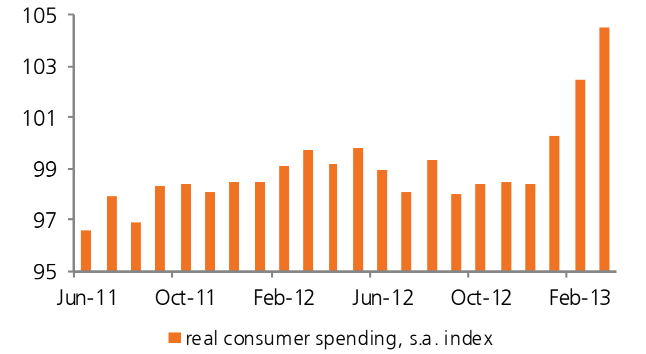
Exports made a marginal contribution to growth at the beginning of 2013, with a surprising rise of 3.8% qoq. The depreciation of the yen is likely to drive up exports in the second quarter and in 2014, with annual increases of 0.8% in 2013 and 8.4% in 2014. Imports in the next two years will be hampered by the depreciation of the currency (+1% in 2013 and +4.6% in 2014).

Fig. 1 - Households drive the recovery



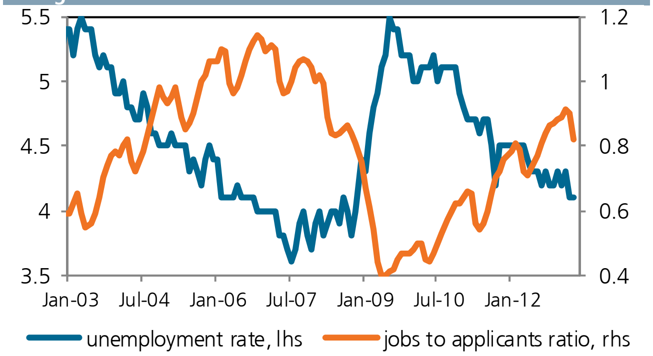
Source: Thomson Reuters – Datastream

Fig. 2 - Consumer spending soars



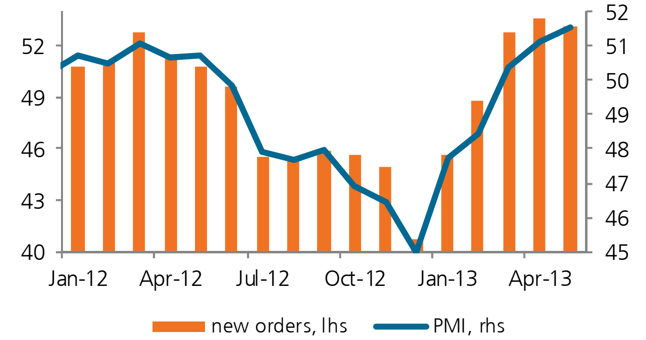
Source: Thomson Reuters – Datastream

Fig. 3 - The labour market is improving: unfilled positions are rising



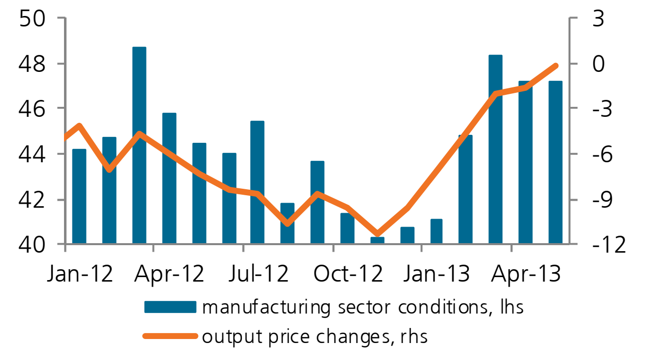
Source: Thomson Reuters – Datastream

Fig. 4 – The change in direction is starting to filter through to companies: PMI Markit manufacturing index and orders



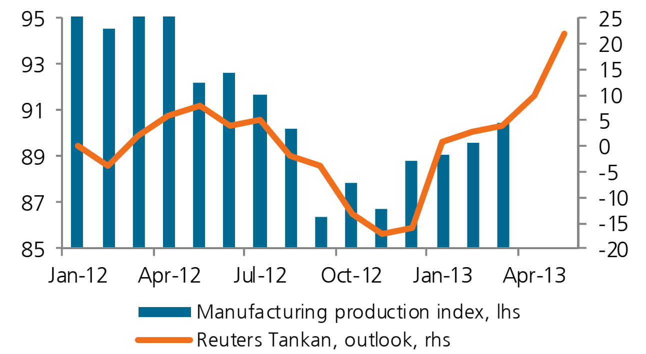
Source: Thomson Reuters – Datastream

Fig. 5 - Shoko Chukin survey: manufacturing companies start planning sales price rises



Source: Thomson Reuters – Datastream

Fig. 6 - Industrial output and expectations - Reuters Tankan: signs of recovery



Source: Thomson Reuters – Datastream

Economic policies: the end of deflation is the pivot of the cyclical turn, but it is difficult to manage

1. Monetary policy. In early April, the BoJ announced its new line on monetary policy (see WEM 5/4/2013). The new leadership's strategy closely follows that of the Fed, assigning a central role to the change in expectations in its communication of stimulus measures. Until early May, this "qualitative" mechanism was highly effective and generated strongly expansionary, homogeneous trends in the key financial variables, with considerable price rises across all types

of financial asset and currency depreciation. More recently, the substantial rise in bond yields recorded in April, partly associated with the increased inflation expectations, was accompanied by significant profit-taking on the equity market and contributed to interrupt the yen's downward slide. To some extent, this retracement is normal (the Nikkei had risen by 80.3% from early November to its peak on 22 May, and by 50.3% from January to the same date). Following the corrections made between 22 May and 3 June, the index is still 53.1% above the level it reached in early November 2012. The yen depreciated by 30% against the dollar between November and 22 May; if the period is extended to 3 June, the figure is slightly reduced to 26.3%. The macroeconomic fundamentals have not changed and there is no reason for the financial markets to fall significantly. On the contrary, from a macroeconomic point of view, we are starting to see the effects of the financial stimulus on growth, especially consumer spending.

The BoJ is now aiming to control the risk premium on JGBs, a factor made crucial by the fact that not only expectations but also actual inflation are gradually rising. The central bank held a meeting with market specialists aimed at improving communication, and has increased the amount of information available about the type and quantity of securities purchases. At the June monetary policy meeting the central bank disappointed expectations for the introduction of longer refinancing operations and maintained in place existing measures: 1) monetary base up by 60-70 trillion yen a year, 2) JGB purchases worth around 50 trillion yen a year, with an average maturity of 7 years, 3) ETF and J-REITs purchases by increments of one trillion and 30 billion yen a year respectively, 4) purchases of commercial paper and corporate bonds geared to holding 2.2 and 3.3 trillion yen worth of these assets at the end of 2013, with the aim of keeping the levels stable thereafter for the time being the central bank intends to calibrate purchases (higher frequency, better distribution along all curve segments) before introducing any new measures. In April, when JGB prices crashed, banks reduced their government securities portfolios (see fig. 11) to 156Trn from 166.6Trn in March. The monthly correction of 10.5Trn more than offset the increase of 5.4Trn in banks' assets from December to March. There is a risk, though, that banks will carry any long-term funding by the BoJ only on government securities and not on new loans and/or purchases of riskier assets. However, the more recent evidence is in favour of the use of financing operations. On the days of greatest volatility, the BoJ intervened by injecting liquidity into the market with one-year operations, which produced moderately positive results in terms of containing the rise in JGB yields. The focus has now shifted to fiscal policy.

Features of the BoJ's securities purchases prog

1. Total amount of purchases: approximately JPY 7Trn a month
2. Frequency of purchases: around 8 times a month
3. Purchases by type of securities:

Monthly purchases of JGBs by duration					
<1 year	1-5 years	5-10 years	>10 years	variable-rate bonds	inflation-indexed bonds
JPY 0.22Trn a month	3-3.5Trn a month	3-3.5Trn a month	0.8-1.2Trn a month	JPY 0.14Trn a month (every two months)	0.02Trn a month (every two months)

Source: Ministry of Finance

2. Fiscal policy: the third arrow of "Abenomics" has been shot. The strategy of the government in power since autumn 2012, dubbed “Abenomics”, has three parts (the three "arrows"): a huge fiscal stimulus, aggressive monetary stimulus and structural reform to support competitiveness. The first two arrows were shot in early 2013. The fiscal stimulus was announced in the form of a supplementary budget of JPY 13.7Trn (2.7% of GDP) aimed at

stoking public investment in the middle quarters of 2013, in order to give growth a shot in the arm. The government aims to kickstart growth before implementing fiscal consolidation in the form of consumption tax rises from 5% to 8% in April 2014 and then to 10% in October 2015. The change of direction in monetary policy was officially confirmed in early April. On 5 June, the Prime Minister announced the guidelines for the pro-growth plan, which contains ambitious targets, but provided little new information on how it would be implemented. According to Mr Abe, the reforms should increase the number of women in the workforce and promote innovation and investment to enable GDP growth to reach 2% in the next decade, along with 3% annual salaries growth (provided that the inflation target of 2% is reached within two years). The pro-growth package includes a long list of deregulation targets for the various markets (including the labour market) and measures to increase companies' competitiveness through tax cuts and tax relief on investment, initiatives to re-open nuclear power stations and reduce the cost of energy, and changes to the way the country's bureaucracy works. The plan also includes a raft of measures that are likely to have short-term effects, e.g. changes to the restrictions on public pension funds, which will allow companies to diversify their portfolios by investing in assets that are riskier than Japanese bonds. Mr Abe's speech disappointed expectations, as he gave few details of the measures to be implemented to achieve the announced targets and indicated that the reforms would not be likely to take effect before autumn.

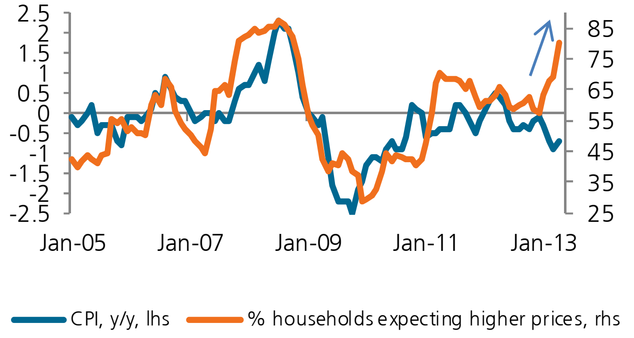
The Abe Government's pro-growth plan. The government presented various parts of the pro-growth package between April and June. The preliminary calendar for approval and implementation of the plan is as follows: 14 June: approval of the definitive package by the government; 26 June: end of the current parliamentary session's business; 4 July: announcement of the elections for the Upper House; 21 July: elections. The implementing laws for the pro-growth package will be presented in parliament between September and December. As the table below clearly shows, the plan is still vague, requires a considerable amount of time, and does not currently include any clear explanation of the measures that could be most effective in supporting growth, especially corporate tax cuts and labour market reform (deregulation of redundancies). For this reason, it will be crucial to define the features of the "special zones", which must have competitive taxes compared with the rest of Asia and the OECD.

Key measures of the pro-growth plan

Category	Objective
Women and employment	Quotas for leadership positions. Removal of waiting lists for child care facilities/crèches and other support for child care and return to work after the birth of children
Medical services and healthcare	Public/private initiatives, research funds, the streamlining of procedures for the certification of new instruments, the establishment of a national medical research centre, permission to sell OTC medicines on the internet
Jobs and employment	Smooth shift of the workforce between sectors, obligation to provide English courses for public officials, support for voluntary professional training courses
Corporate business	Increase in private investment of JPY 7Trn (1.5% of GDP) in 3 years, incentives for accelerated depreciation, support for the funding of SMEs, measures for the efficient use of large databases and support for reorganisation
Industry	Doubling of agricultural income in 10 years, deregulation to incentivise large companies, doubling of farm product exports in 10 years, support for funding in the agricultural sector
Special zones	Creation of special economic zones with favourable tax treatment and deregulation
Reform of the electricity sector	Full deregulation of supply to private consumers, one-and-a-half times increase in investment in the sector compared with 2010

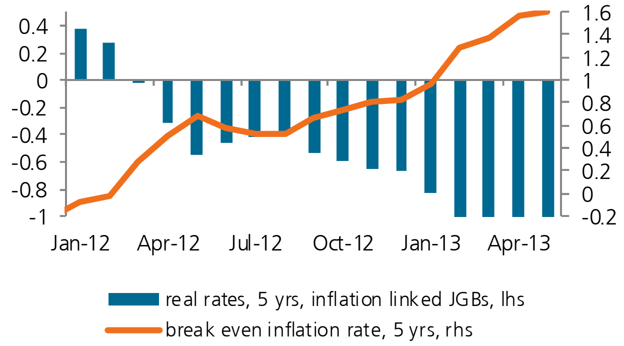
Source: Bloomberg, Prime Minister's Office

Fig. 7 - Inflation expectations: the announcements worked!



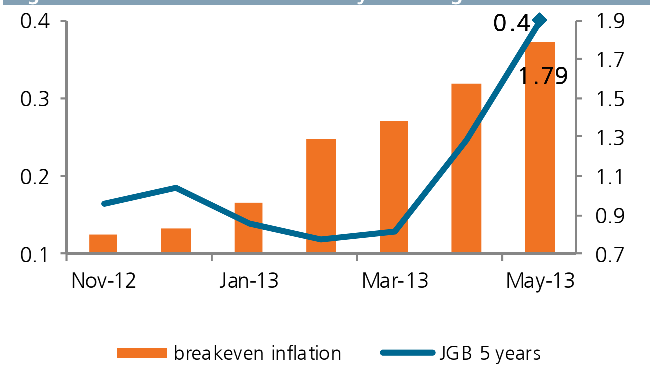
Source: Thomson Reuters – Datastream.

Fig. 8 – Inflation expectations also rising on the markets: real rates falling.....



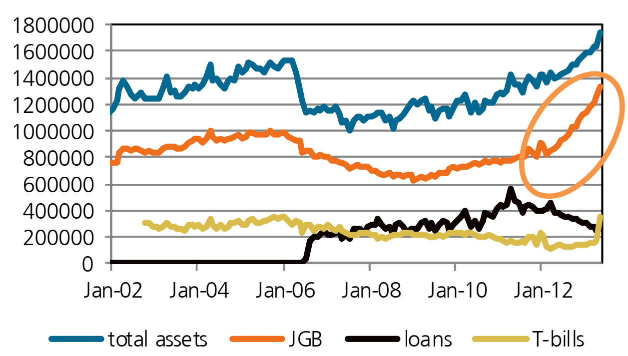
Source: Bloomberg

Fig. 9 – ... but nominal rates are skyrocketing



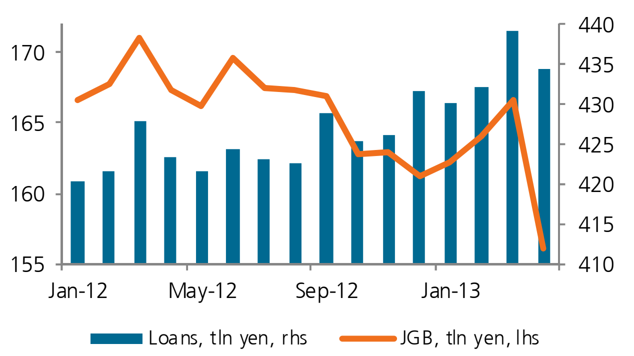
Source: Bloomberg

Fig. 10 – BoJ's balance sheet: assets are really rising



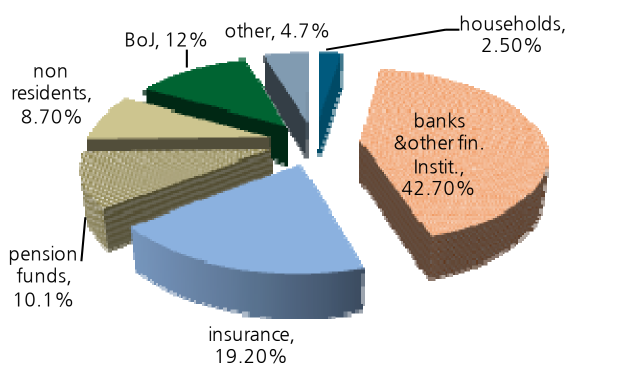
Source: Thomson Reuters – Datastream. Hundreds of millions

Fig. 11 – The Banks liquidated JGBs worth JPY 10.5YTrn in April



Source: BoJ

Fig. 12 – JGBs: distribution by holder (Dec. 2012)



Source: Ministry of Finance

China: recovery slips away

Silvia Guizzo

- Acceleration in the services sector was unable to offset the continuing slowdown in the industrial and agricultural sectors; GDP rose by 7.7% yoy in the first quarter of 2013, slowing further from the 7.9% achieved in the fourth quarter of 2012, with growth of 1.6% qoq. The performance of monetary and credit aggregates, which is reflected in GDP growth with a lag of 3-4 quarters, would have pointed instead to a rebound in growth.

- Figures for April and May were mixed and indicate that a marginal deceleration is under way also in the second quarter. Growth in investments, industrial output and retail sales has been largely stable, while new credit, albeit growing at still-high levels, has slowed down amid strong and persistent tensions on the money market. Import and export figures have been influenced by more stringent controls on over-invoicing and by the base effect, while the orders component and orders from abroad in the PMI index continue to fall. Prices for residential property have continued to rise in most cities, supporting the retention of anti-speculative measures. Consumer price inflation fell significantly to 2.1%, in May, led by the price of vegetables. However, even though there is no longer upward pressure on commodities and producer prices, the expected rise in the price of food, especially meat, is set to lead to a rise in inflation over the coming months that will take its average for 2013 to 2.8%.

- We expect growth to start to pick up again moderately in the second half of the year, driven by increased investment, especially in infrastructure and transport. The increase in consumption will be modest given the reversal in consumer confidence over recent months and the descend in labour market indicators. The Central Bank has shown itself to be more interested in cautious liquidity management and less inclined than in the past to lend more. The expected slowdown in credit aggregates will have a greater influence on growth rates next year. We therefore revise down our forecast for 2014 from 8.2% to 7.5% and lower marginally the one for 2013 from 7.9% to 7.8%.

- The economic reform plan for 2013 announced in early May - in part already under way – including, among other things, the internationalisation of the renminbi, VAT reform and health reforms – will certainly promote more balanced and sustainable growth over the medium to long term. However, the expansion of alternative forms of finance outside the banking sector (shadow banking), the increase in non-performing loans and the level of local governments debt are continuing causes of concern not only to the authorities but also to the ratings agencies, which means that downside risks to the country's growth scenario remain.

Macro Forecasts

	2008	2009	2010	2011	2012E	2013F	2014F
GDP (at current prices)	9.6	9.2	10.4	9.3	7.8	7.8	7.5
Private Consumption	9.5	11	11.4	8.5	8.4	8.6	8.4
Public Consumption	4.8	3.8	6.9	9.4	9.7	9.5	9
Capital Investments	9.2	22.2	11.3	9.2	7.2	8	6.9
Exports	-1.1	-11.2	25.9	4	2.9	7.8	5.7
Imports	-6	5.2	18.4	3.3	3.7	8.8	7.8
Industrial Production	9.9	9.9	12.3	10.3	8.1	8	7.9
Inflation (CPI)	5.9	-0.7	3.3	5.4	2.6	2.8	3.8
Unemployment	4.1	4.3	4.2	4.1	4.1	4.0	4.1
Average wages	16	10.6	12.8	14.9	14.9	15.8	16.4
1-year deposit rate	4.3	1.9	2.7	5.4	4.6	4.2	4.3
USD/CNY exchange rate (average)	6.95	6.83	6.77	6.46	6.31	6.12	6.08
Current account balance	2912.1	1661.6	1604.2	874.7	1218.3	1783.6	1718.9
Current account balance (% of GDP)	5.7	3.2	3.1	1.7	2.4	3.6	3.4
Budget balance (% of GDP)	13.7	15.5	18.2	20.2	22.7	26.1	29.6

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

Real economy and inflation

GDP rose by 7.7% yoy in the first quarter of 2013, a slowdown from the 7.9% achieved in the fourth quarter of 2012, with growth of 1.6% qoq. Acceleration in the services sector was unable to offset the continuing slowdown in the industrial and agricultural sectors.

Industrial output rose at a rate of 9.2% in May, largely stable compared with April's figure and a slight improvement over March's 8.9%. However, it represents a slowdown on the 10.3% yoy at the end of 2012 on account of weaker performance by light industry. May saw the PMI Markit index fall to below 50 (49.2), including in the new orders component, which dropped to 48.7. The PMI index, reported by the National Bureau of Statistics (NBS), which is more representative of large-scale industries, has remained largely unchanged around 50 over the past three months, with an improvement in its sub-index on large and medium-sized enterprises in May, while the sub-index for small enterprises continued to fall and remain under the 50 threshold. The inventory/orders ratio, which shows a perceptible rise since January in the Markit survey but a broadly stable and lower figure in the Statistics Office index, is consistent with a further moderate slowdown in industrial output.

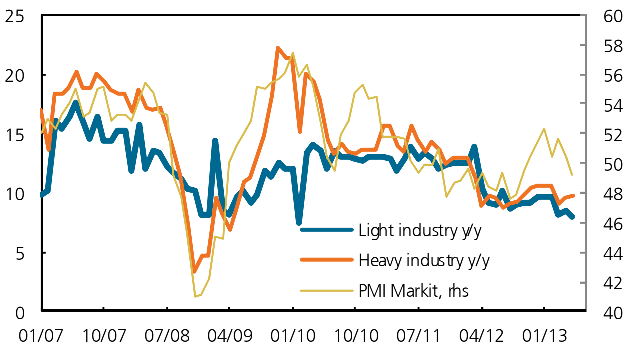
In the wake of double-digit growth rates in March and April, both imports and exports slowed down perceptibly in May (-0.3% yoy and 1% yoy respectively). The trend only partly reflected the tighter controls on the practices of over-invoicing that have swelled exports and imports over recent months, with the object of bringing speculative capital into the country in expectation of an appreciation in the exchange rate. Evidence of this is to be found in the figures for imports from a number of trading partners, notably Hong Kong, Taiwan, Singapore, Korea and, to a lesser extent, the UK (all of which, with the exception of Korea, are centres in which the off-shore renminbi is in widespread use), which are lower than the corresponding figures for exports to these countries supplied by China. The base effect is another factor that has affected both export and import trends, given the considerable increase recorded in May 2012, even stripping out seasonal factors. Seasonally adjusted growth, however, remains muted in line with the fall in the “new orders” and “orders from abroad”components of the PMI index, which indicates a continuing slowdown. In the next few months, though, this will appear less than it is in yoy changes, due to the opposite base effect.

Fixed asset investment remained largely stable from March (20.9% cum yoy) to May (20.4% cumulative yoy), still driven by strong investment in infrastructure, especially that of state-owned enterprises. Investment in the manufacturing sector, however, continues to decline. Investment in the real estate sector slowed to 20.4% cumulative yoy in May from 22.8 cumulative yoy in February. Residential property followed the same trend. Real estate sales continue to increase sharply at 52.8% yoy in May, but is slowing compared with its February peak of 77.6% yoy, while floor space completed decelerated. Residential property prices continued to rise in most cities, albeit to no greater extent than in past months.

Household spending figures in the first quarter of 2013 indicate reduced consumption in real terms by comparison with the fourth quarter of 2012, in line with income trends. The trend in retail sales was broadly unchanged in nominal terms between March (12.6% yoy) and May (12.9% yoy). Consumer confidence remains, however, highly volatile and, after an upturn in the first few months of the year, started to fall again and by May had reached the low levels last seen in mid-2012. Over the last three months, the employment component of the PMI index had fallen to below 50 in both surveys, while hiring intentions for the third quarter, as measured by the Manpower survey, fell perceptibly from what they were in the second quarter, from 18% to 12%. The number of people in employment fell by comparison with the preceding quarter, although the demand for labour by businesses continues to exceed supply and is still rising.

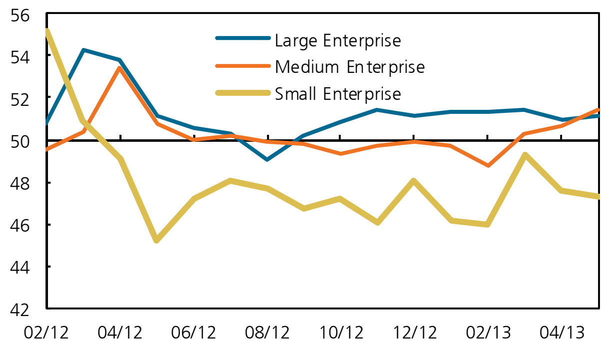
After rising from April to May, inflation reverted to its March level of 2,1% yoy, largely in response to falls in the prices of vegetables and transport, while the price of meat continues to rise. This trend, associated with the price of pork and changes in animal stocks, is set to continue over the coming months. Over the last two months, core inflation has remained stable at 1.8%. Producer prices continue to fall along with the price components of the PMI index and the international prices of commodities, indicating the lack of upside pressure. A moderate increase in inflation is expected for the second half of the year, before reaching an average of 2.8% for 2013, and hence short of the PBOC's target of 3.5%.

Industrial output: Light industry slows



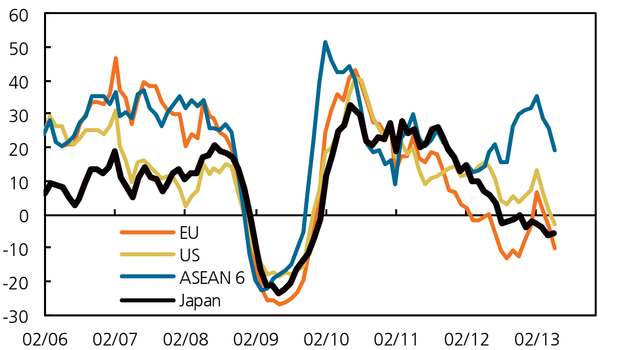
Source: CEIC, Markit

Small businesses are still finding it difficult



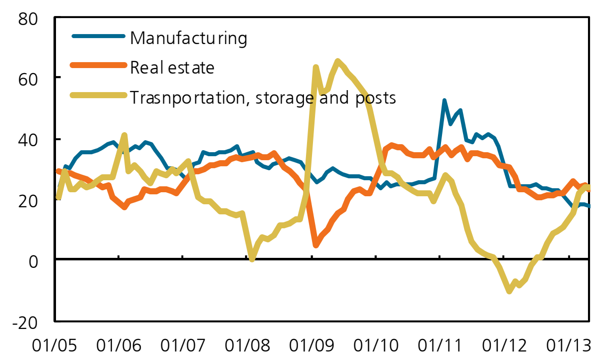
NB: Manufacturing PMI; source: CEIC

Exports start slowing again



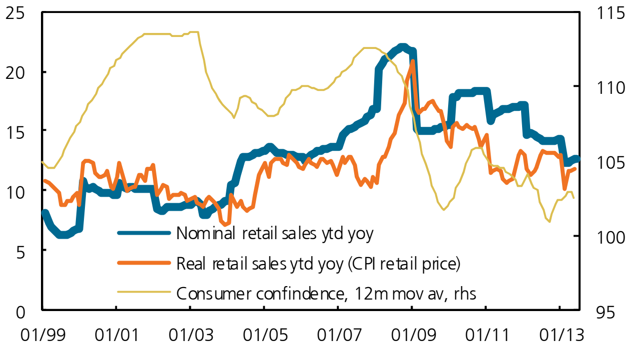
NB: Chg. % 3m yoy. Source: Intesa Sanpaolo chart from Bloomberg data

Transport and real estate drive investment (%)



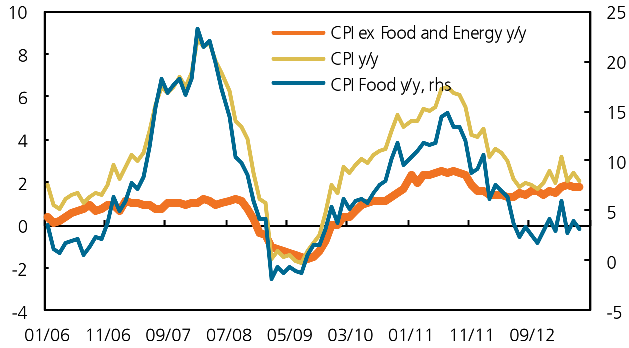
NB: Nominal investment, chg. yoy. Source: Datastream

Consumer confidence improving again



Source: Intesa Sanpaolo chart from Bloomberg and CEIC data

Inflation remains low



Source: Bloomberg

Monetary policy and exchange rate

In the first quarter of the year, new lending, made up of the total aggregate of social finance, rose by 58.5% yoy as against the 12% rise in new bank loans in local currency alone, with marked increases in trust company loans and loans in foreign currencies. From April to May, the increase in both aggregates slowed yoy, but to a lesser extent in the case of the social finance aggregate (52%) as against bank loans (7.1%). The stock of bank loans declined slowly (14.5% yoy in May, compared with 15% in February), as the weak trend in loans to businesses was offset by greater activity in lending to households, particularly in the form of mortgages. Long-term loans increased slowly (11.3% yoy in May from 10.1% in February). The trend in monetary and credit aggregates suggests that growth will only pick up in the fourth quarter of the year.

The M2 monetary aggregate rose 15.8% in May, slightly down from April's figure but nevertheless above the PBOC's target of 13%. In the second week of June, withdrawals in advance of the 10-12 June festivities contributed to increased tensions on the money market, which had already been under pressure since the end of May on account of the capital required to close the quarter and for imminent tax payments. The three-month Shibor rate went up 130bps in the space of a week and the overnight rate hit peaks of 9.5% and 13,4%, way above the 2007 and 2011 hikes. The money market yield curve inverted, as did the swap curve in the 1-5 year segment. The PBOC has shown itself more reluctant than in the past to accommodate the expectations of the interbank market with substantial injections of liquidity and is concentrating more on discouraging a further unconditional increase in credit growth. The authorities are still inclined to accept a lower GDP growth rate in the short term in order to be able to press ahead with the reforms required to bring about greater economic and financial stability and sustainability in the long term. The PBOC would resort to a cut in the CRR only if the macro data continue to worsen were the ongoing tensions on the money market to persist despite injections of liquidity.

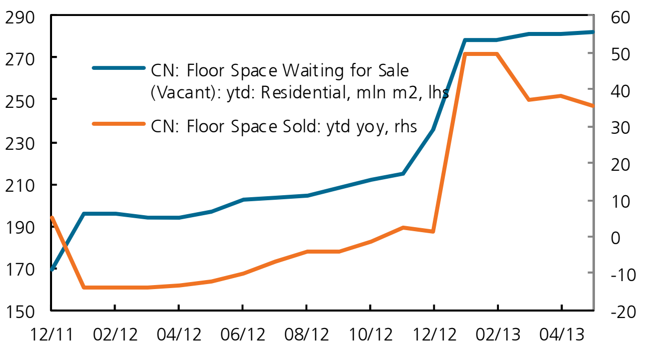
However, the expansion of alternative forms of finance outside the banking sector (shadow banking), the increase in the amount of non-performing loans and in the level of local governments debt are continuing causes of concern not only to the Authorities but also to the ratings agencies and mean that downside risk to the country's growth scenario remain. That the monetary regulators are seeking to reduce the financial risks is demonstrated by the recent rules imposed by the China Banking Regulatory Commission (CBRC) limiting the extension of credit to local government financial vehicles (LGFVs) and endeavouring to regulate the growth of wealth management products to a greater degree. Such measures notwithstanding, Fitch downgraded the long-term local currency debt by one notch (from AA- to A+), while Moody's, in the first half of April, changed the outlook for sovereign credit from positive to stable. Fitch, in particular, estimates that the level of the above-mentioned shadow banking will have reached 198% of GDP by the end of 2012, having stood at 125% in 2008[21], and believes that the level of local government debt had risen to 25% of GDP by the end of 2012 from 23.4% at the end of 2011 and amounted to USD 12.85Trn. Xiang Huaicheng, who was Minister of Finance from 1998 to 2003, has recently estimated this at around CNY 20Trn, more or less double the estimate produced by the National Audit Office for the end of 2010 (CNY 10.7Trn).

New lending in foreign currencies increased perceptibly in 2012 (+60.4% yoy) and in particular from the second half of the year onwards, driven by expectations of an appreciating yuan. The stock of loans in foreign currencies went up by 29.3% from August 2012, while deposits rose

[21] This definition of shadow banking is not standard. Equally, the estimates of its size are not standard and depend on whether or not traditional off-balance sheet items such as letters of credit, bank receipts, bank guarantees or committed credit lines are excluded. For example, the agency S&Ps, which excludes such items from its calculations, estimates that the amount of credit extended through shadow banking is much smaller, albeit rapidly growing, at 44% of GDP in 2012, i.e. 34% of total lending. See: S&P's "Why Shadow Banking Is Yet To Destabilize China's Financial System", 27 March 2013.

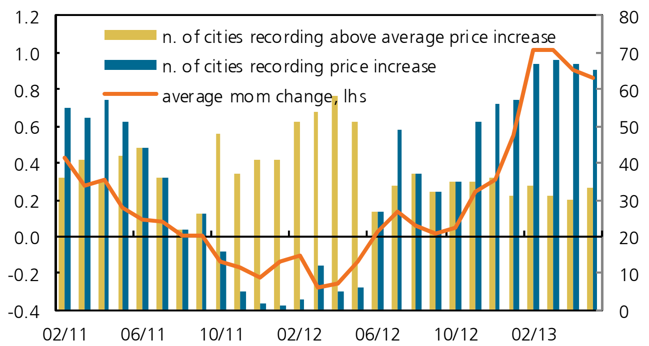
by 7.1%, prompting the State Administration of Foreign Exchange to redefine the minimum loan to deposit ratio to 100% for foreign banks and 75% for Chinese banks, imposing a minimum position for net exposure in foreign currencies for banks exceeding these limits. The measure entered into force on 10 June and, together with tighter controls on the invoicing of goods, helped to stabilise the exchange rate within the 6.12 – 6.13 range between the end of May and mid-June. Previously the yuan had very rapidly strengthened against the dollar by 1.0% between mid-March and mid-May, and was constantly hovering around the lower edge of the fluctuation band. However, between March and May, the effective exchange rate rose even more rapidly, by 2.4% in nominal terms and by 1.9% in real terms, largely on account of the depreciation of the yen. We believe that the yuan/dollar exchange rate will continue to fluctuate within the 6.12 – 6.14 range over the next few months.

Floor space unsold stock still at very high level



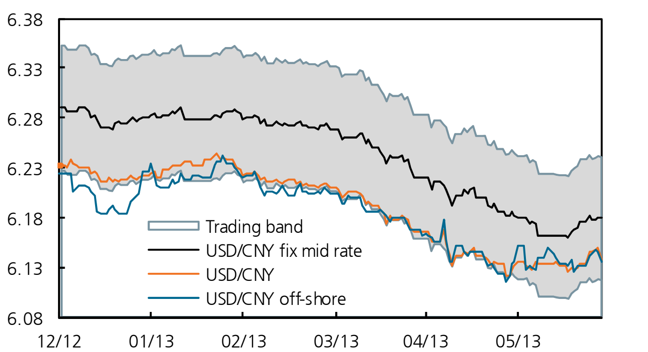
Source: Bloomberg, CEIC

Residential property prices continue to rise



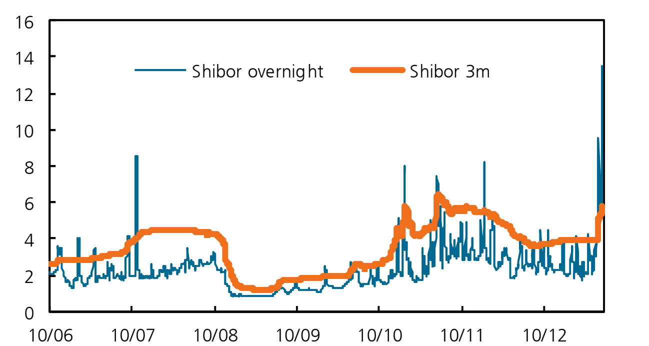
Source: Intesa Sanpaolo chart from CEIC data

After rapid appreciation the renminbi stabilises



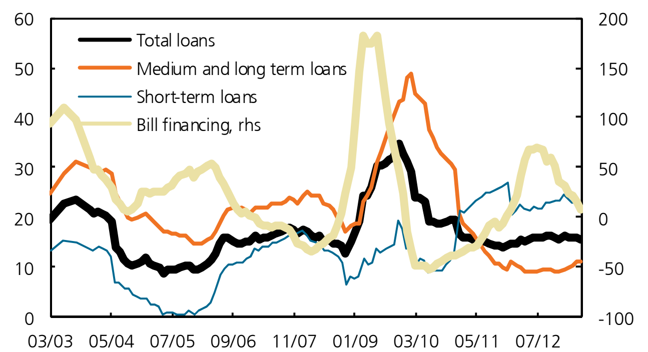
Source: Intesa Sanpaolo chart from Bloomberg data

Tensions on the money market



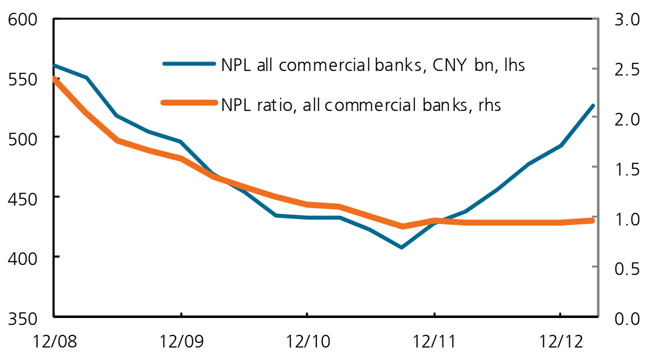
Source: Intesa Sanpaolo chart from Bloomberg data

Lending growth stabilises



NB: yoy % changes. Source: CEIC, Monetary and Financial Institutions Survey

The level of non-performing loans continues to rise



NB: NPLs of commercial banks. Source: CEIC

India: growth flat

Silvia Guizzo

- The Indian economy grew by 4.8% in the first quarter of 2013, only one-tenth of a percentage point more than in the fourth quarter in 2012, thereby remaining at its three-year lows and closing the fiscal year 2012-2013 (April to March) with growth of 5%. After improving in the fourth quarter, consumer spending and private investment started to slow again, year-on-year, a trend that went hand in hand with a perceptible slowdown in public spending and a negative contribution from exports. The monthly figures point to flat growth again in the second quarter.
- After rising by 7.3% yoy on average for five consecutive months, wholesale price inflation gradually fell from March onwards, reaching 4.7% yoy in May. The fall affected all categories of goods and the trend looks set to continue at least until the summer. However, the depreciation of the currency, probable new upwards revisions to administrated energy prices and to minimum support prices for certain agricultural products, and salary increases mean that upwards pressure on inflation will remain for the rest of the year.
- Despite the improvement in the trade balance in the first quarter of 2013, the Fed's announcement that it would scale back quantitative easing earlier than expected by the market, exacerbated the outflow of foreign capital that had already started at the end of May, a development that severely affected the currency. The estimate of the deficit/GDP ratio for the fiscal year 2012-2013 is better than expected but the ongoing consolidation of the public accounts will be hard to pull off during an election year. Moreover, 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.
- The outlook for short-term investment is still poor on account of the trends in production and imports of capital goods. However, the combination of a slight increase in investment proposals, the speeding up of approval procedures and the impact of rate cuts, is likely to stimulate a recovery in investment, which although modest in the last part of the year, will be more sustained in 2014. We have revised our growth forecasts down from 5.4% to 5.0% in 2013 and from 6.9% to 6.0% for 2014. Risks to the growth scenario remain to the downside. On the domestic front, progress in structural and tax reforms is still too tentative to stimulate a strong and rapid recovery in the business climate, and there is also the risk of a slower fall in inflation than expected with a dampening effect on consumer spending. Abroad, fragile international demand and volatile markets will continue to weigh on the already high current account balance, exacerbating the risks of its financing, with a resulting negative impact on the currency.

Macro forecasts

	2008	2009	2010	2011	2012E	2013F	2014F
GDP (constant prices, at factor cost)	8.1	6.5	9.7	7.5	5.1	5.0	6.0
Consumer spending	8.4	6.9	8.6	7.3	5.3	5.4	5.8
Public Consumption	18	9.2	8.1	7.8	5.8	2	6.2
Fixed Investments	9.4	-0.7	17.5	6.2	1.5	4.2	6
Exports	18	-7.7	15.4	18.3	6.6	4.5	9
Imports	32.6	-8.3	18.2	18.4	11.7	6.4	7.4
Industrial Production	7.7	0.2	9.7	4.8	0.7	3.2	6.5
Inflation (CPI)	8.3	10.9	12	8.9	9.3	9.5	7.1
Unemployment	12.6	12.5	12.5	12.5	12.5	12.5	12.6
Average wages	15.2	9.1	21.4	16.3	9.2	11.2	10.5
1-year loan rate	9.9	5.5	6.3	9.5	9.5	8.5	7.6
USD/INR exchange rate (average)	43.5	48.37	45.74	46.69	53.48	56.00	54.00
Current account balance	-1393.9201	-1247	-2396	-2958	-5000	-5171	-5057
Current account balance (% of GDP)	-2.5	-2.0	-3.2	-3.4	-5.1	-4.7	-4.0
Budget balance (% of GDP)	-4.8	-7.0	-3.8	-6.7	-5.5	-5.1	-4.8

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

Real economy and inflation

The Indian economy grew by 4.8% in the first quarter of 2013, one-tenth of a point above that of the fourth quarter in 2012, thereby remaining at its three-year lows and closing the fiscal year 2012-2013 (FY 2012-13) with growth of 5%. This came in at lower than forecast by the Reserve Bank of India (RBI, 5.5%). After improving in the fourth quarter of 2012, consumer spending and private investment started to slow again, year-on-year, only partly due to the unfavourable base effect. To this must be added a considerable slowdown in public spending and a negative contribution from exports. Inventories were the only component on the rise. On the supply side, the limited recovery in services (from 6.2% to 6.3%) was accompanied by a slowdown in the agricultural sector and, to a lesser extent, in the industrial sector. Growth is also expected to be flat in the second quarter and will then stage a moderate improvement in the second half of the year, reaching an average of 5.0% in 2013, and rising to 6.0% in 2014.

The manufacturing sector's performance was particularly affected by the decline in mining output (-4.0% in the first quarter) due to the closure of certain mines that were operating without complying with all the relevant requirements and the slowdown in the production of energy commodities. Industrial output slowed in April (+2.3% vs 3.4% in March), due especially to the fall in production of consumer durables. After two months of improvement, the production of capital goods also started to decelerate again in April (+1.0% yoy), as further evidence of weak investment demand. Business confidence fell again in the expectations component in both the Dun&Bradstreet survey and the Reserve Bank of India survey (Industrial Outlook Survey) for the second quarter of 2013, with a considerable decline in the orders and capacity utilisation components. The manufacturing PMI fell from 54.2 in February to 50.1 in May, posting a gradual decline in the new orders component but an improvement in foreign orders, although this was modest in May. Industrial output is therefore likely to remain weak in the next few months. The services PMI, although falling since the beginning of the year, showed an improvement in May, when it reached 52.2. The new orders component followed a similar trend.

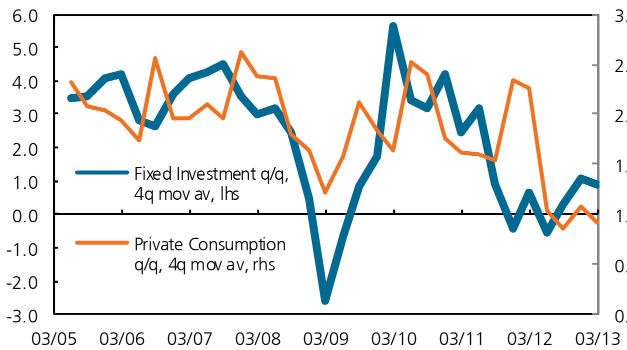
Consumer confidence fell sharply in the first quarter in terms of consumers' assessment of the present situation and, to a lesser extent, as regards future expectations; there was only a slight rise in the number of respondents who intended to increase their consumer spending, although not on durables, in the future. The majority of people interviewed remain optimistic about the employment outlook. The quarterly report on employment[22] indicates that the number of people in work also increased in the first quarter of the year, although to a lesser extent than in the fourth quarter of 2012. Despite this, the quarterly average of the employment component of both the manufacturing and the services PMI fell in the last few months, although remaining slightly above 50, and hiring intentions for the third quarter fell (26%) compared with the second quarter (30%). Car sales are declining (-12.3% yoy) and do not show any improvement in the quarterly trend.

Exports rose by 4.6% yoy in the first quarter, picking up pace compared with the fourth quarter of 2012, while imports slowed (+1.7% vs 7.5% yoy in the fourth quarter) in the wake of the slowdown in oil imports, leading to an improvement in the trade deficit (USD 45.6Bn) compared with the fourth quarter (USD 58.4Bn) and with the first quarter of 2012 (USD 51.6Bn). Imports of capital goods - with the exception of electronic machinery (+9.7%) - recorded a fall. However, the fortunes of imports and exports reversed in April and May; exports (excluding oil) remained weak while imports (excluding oil) staged a recovery, and the trade deficit began to expand again.

[22] See: Ministry of Labour and Employment, Quarterly Report on Changes in Employment in Selected Sectors (January, 2013 to March, 2013), May 2013.

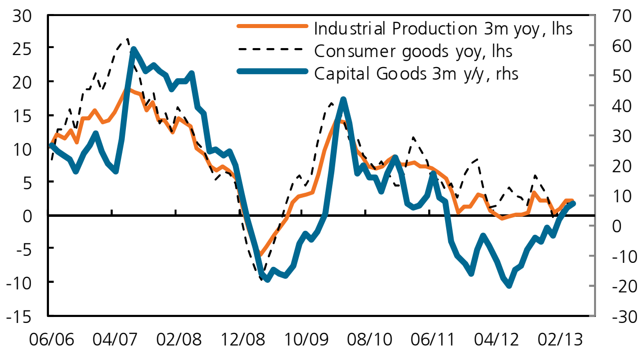
After rising by 7.3% yoy on average for five consecutive months, wholesale price inflation gradually fell from March onwards, reaching 4.7% yoy in May. The deceleration in prices affected all categories of goods. In the fuels category, the fall in the prices of coal and mineral oils partly offset the upside review of electricity prices (+27.9%), while the fall in commodities prices facilitated the deceleration in the prices of non-food manufactured products. In May, however, the foods sector again recorded a rise (+8.2%) led by the price of vegetables. Consumer price inflation fell slightly to 9.3% in May, from an average of 10.7% from December to March. The depreciation of the currency, probable new upwards revisions to the administered prices of energy and to minimum support prices for certain agricultural products, and salary increases mean that upwards pressure on inflation will remain for the rest of the year.

Investment and consumer spending still weak



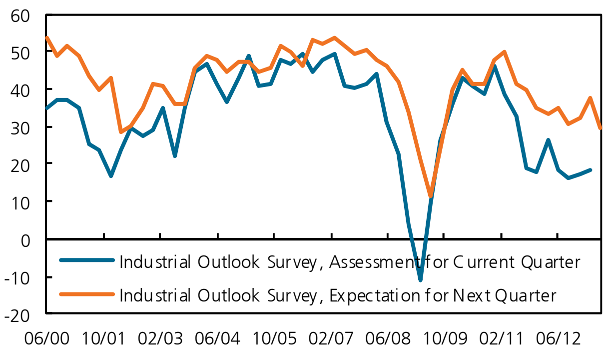
Source: Intesa Sanpaolo chart from CEIC data

Industrial output is still weak



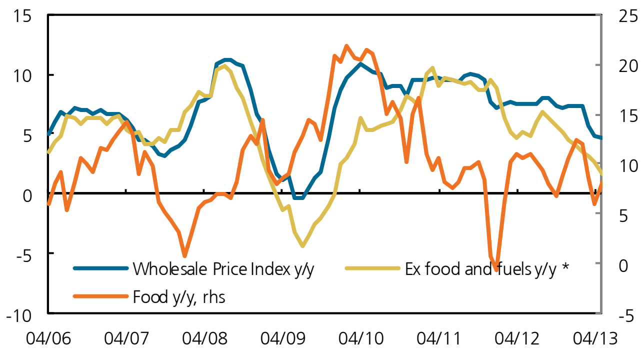
Source: Intesa Sanpaolo chart from CEIC data

Business confidence indices



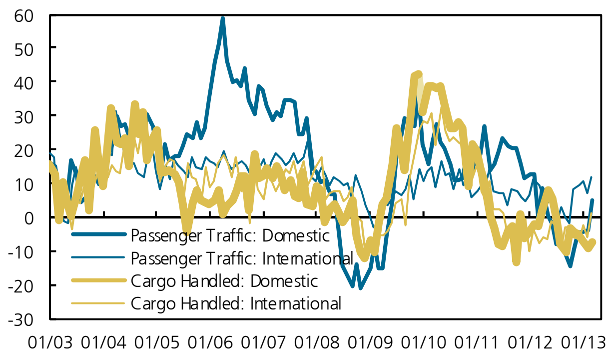
Source: CEIC

Wholesale price inflation falls



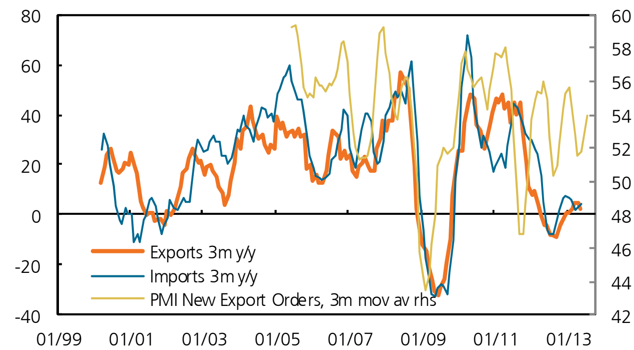
Source: Intesa Sanpaolo chart from CEIC data, * Intesa Sanpaolo estimates

Domestic and international traffic



Source: CEIC. % change yoy

Foreign trade shows moderate recovery



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

Monetary policy, external position and currency

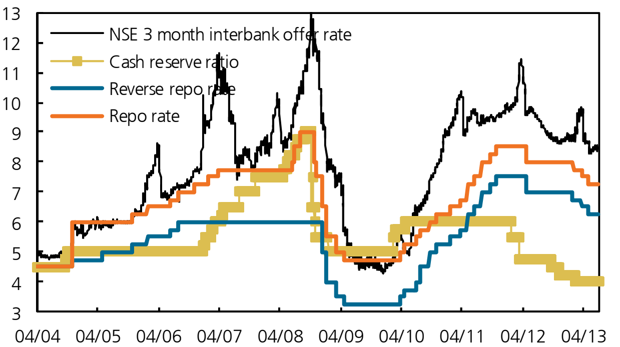
Growth in lending to the commercial sector slowed to 14.1% yoy in May, from 17% yoy in March, essentially due to the slowdown in lending to the food sector, while loans to the non-food sector slowed slightly, continuing to provide support to the economy. M3 followed a similar trend. Liquidity conditions improved as the average daily amount requested by the banks through LAF (Liquidity Adjustment Facility) fell from an average of INR 1.1Trn in March to around INR 650Bn in the first half of June. This improvement came on the back of the liquidity injected into the system via the 25-bp cut in the mandatory cash reserve ratio in January and subsequent open market operations. The RBI has cut interest rates by 25 bps three times since January, bringing the repo rate to 7.25% at the early-May meeting. Nevertheless, real rates on medium to long-term durations have risen slightly. Despite a total cut of 75 bps in the official rates since the beginning of the year, transmission on the medium to long part of the swap and government bond curves has been minimal and the base rates of the main banks have fallen by only 10 bps on average since the start of the year to the end of May.

The current account deficit closed 2012 at 5.4% of GDP, a deterioration on the figure of 3.4% in 2011, after peaking at 7.2% in the fourth quarter due to the worsening of the trade balance. In the first quarter of 2013, the current account balance was USD 18.2Bn (4% of GDP), a reduction on the EUR 21Bn (5% of GDP) in the last period of 2012, thanks to the improvement in the trade balance. Lower commodities prices combined with measures taken to scale back gold imports are likely to fend off a further deterioration in the trade balance during 2013, bringing the current account balance to 4.7%. However, this is still far from the level considered sustainable by the RBI (2.5%). There is therefore still the problem of funding it during periods of sudden changes in risk aversion on the international markets. The Fed's indication that it might scale back quantitative easing earlier than expected by the market, exacerbated the outflow of foreign capital that had already started at the end of May, a development that severely affected the currency. Net capital inflows (in the equities and bond markets) from foreign institutional investors fell from a peak of INR 284Bn in February to INR 107Bn in April. Subsequently, after a sharp rise in the first three weeks of May, substantial amounts of capital began to flow out, such that net capital outflows totaled INR 410Bn in the first 26 days in June. From the start of May to 26 June, the rupee lost 12.2% against the dollar, taking it to around 60. In contrast, the effective exchange rate remained broadly stable compared with the beginning of the year, depreciating by 0.8% between March and May in nominal terms and appreciating by 0.2% in real terms.

Recent estimates by the Central Statistics Office indicate that the deficit/GDP ratio for the fiscal year 2012-2013 (FY2012-2013) has fallen to 4.9% compared with a preliminary estimate of 5.2% and last year's estimate of 5.7%. The government's target is to keep the deficit/GDP ratio at 4.8% in FY2013-2014. This improvement in the public accounts, combined with the measures taken back in autumn 2012 to liberalize foreign investment and the creation of an investment committee to expedite the procedures for approving projects, led ratings agency Fitch to raise the outlook on sovereign debt from negative to stable in early June. We reiterate, however, that despite these positive factors, the ongoing consolidation of the public accounts currently under way will be difficult to implement in an election year. Moreover, 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.

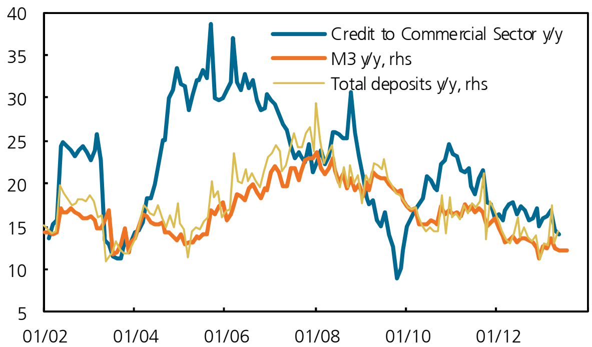
The RBI forecasts growth of 5.7% in the fiscal year 2013-2014, an increase on the 5% for the fiscal year 2012-2013, provided that the current summer monsoon season is normal and leads to an increase in agricultural production. The central bank forecasts inflation of 5.5% on average, made up of the current slowdown, a recovery in the latter part of the year and a return to 5% yoy in March 2014. In the recent press release for the 17 June meeting, the RBI highlighted that its monetary policy stance will be determined by developments in the growth and inflation profiles in the next few months and by the trend in the balance of payments but that only a lasting, stable fall in inflation will pave the way for further rate cuts. We think the RBI will wait until the second half of the year before making another two rate cuts, as it wants to see what inflation actually does in the summer months as well as monitor developments in capital flows and the exchange rate.

The RBI cuts rates



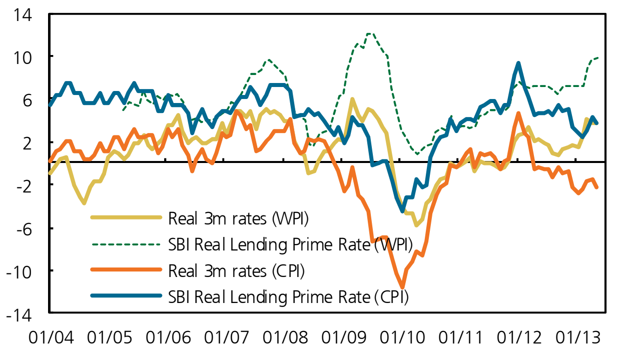
Source: Bloomberg

Lending is not picking up



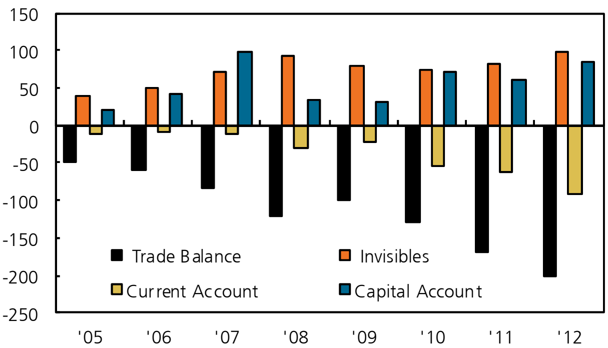
Source: Intesa Sanpaolo chart from Bloomberg data

Real rates



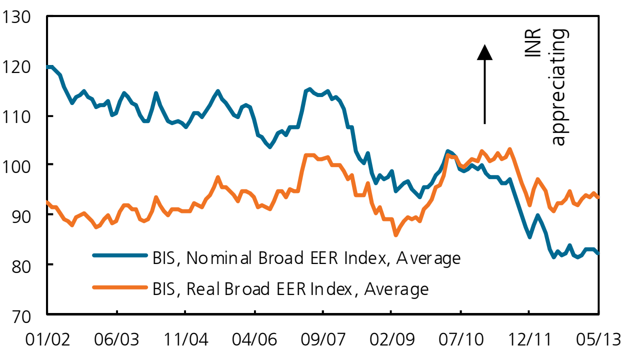
Source: Intesa Sanpaolo chart from Bloomberg data

Current account balance worsens (USD billions)



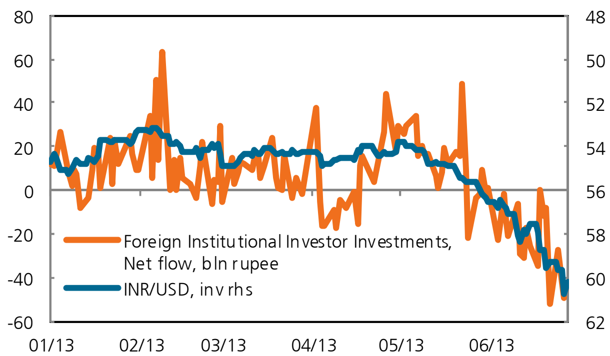
Source: Bloomberg

Effective exchange rate



Source: CEIC

Financial capital outflows weakens the rupee



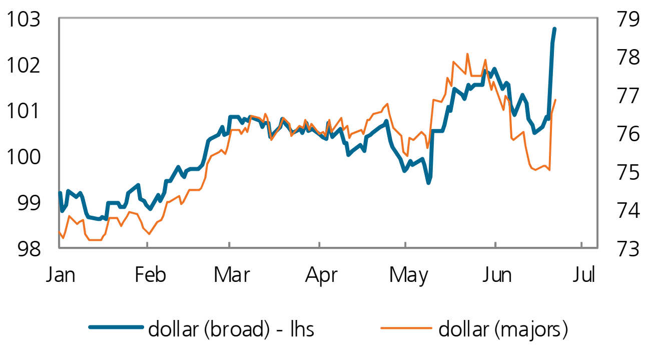
Note: left-hand scale in INR billions. Source: CEIC

Forex Markets – Dollar boosted by the countdown for the Fed's turn

Asmara Jamaleh

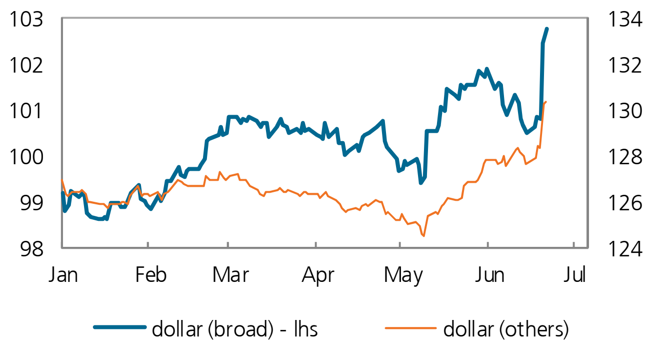
The FOMC of 19 June reassured the markets that the Fed may start to remove existing stimulus soon, potentially by the end of the summer: the next two meetings scheduled this summer will be on 31 July and 18 September. The necessary condition for the Fed to actually implement its policy reversal is that data releases confirm that the economic recovery is sufficiently solid and capable of reducing unemployment (without generating undesired inflation pressures). The dollar's reaction to the Fed's message was incontrovertible: it appreciated across the board, rebounding against the majors (Fig. 1), and building on its existing uptrend against the emerging currencies (Fig. 2).

Fig. 1 – Dollar up post-FOMC. Rebound against the majors…



Source: Thomson Reuters-Datastream
Note: dollar = nominal effective exchange rate ("broad" and "majors". Indices. Source: Fed)

Fig. 2 – …and further uptrend against emerging currencies

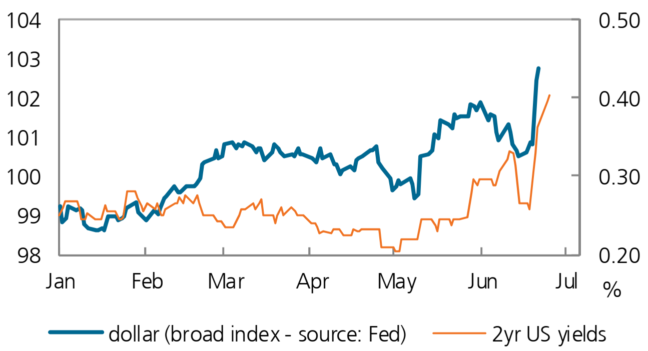


Source: Thomson Reuters-Datastream

Note: dollar = nominal effective exchange rate ("broad" and "others" indices. The "others" index is calculated with reference to currencies "other" than the majors. The "other" currencies are effectively only the emerging currencies. Source: Fed)

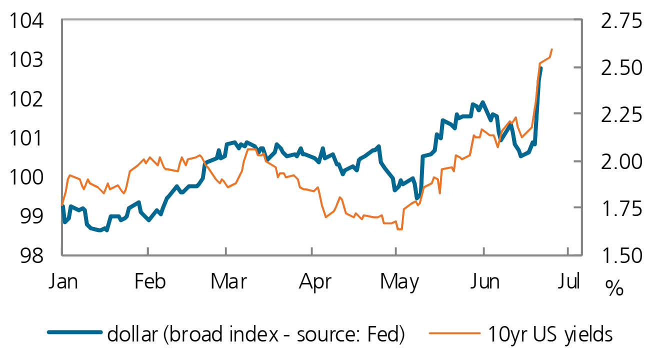
Despite being priced in by the markets to some extent, we believe that the Fed's policy reversal, once effectively implemented – or in the run-up to that moment – will result in a further strengthening of the dollar, against all the other currencies. Only at a later stage will upside start to wane or slow, with the various currencies showing different reactions.

Fig. 3 – Dollar and short-term US yields both up…



Source: Thomson Reuters-Datastream
Note: dollar = nominal effective exchange rate ("broad" index)

Fig. 4 – … and long term yields as well



Source: Thomson Reuters-Datastream
Note: dollar = nominal effective exchange rate ("broad" index)

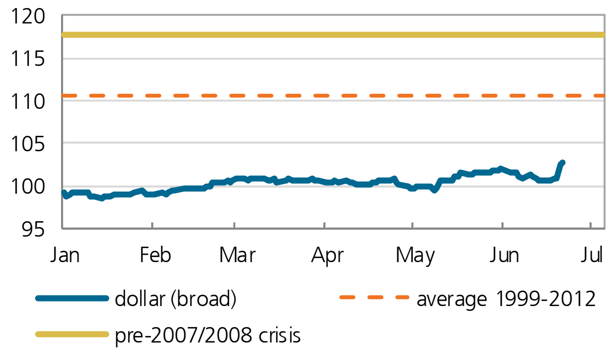
There are at least three good reasons for which the dollar should keep rising:

(1) The main driver is the trend of expected rates/US yields, which have already started to rise stably (Fig. 3 and Fig. 4) in two stages: after the FOMC meeting on 1st May, and following the meeting on 19 June;

(2) US yields, in this case, still show a margin for growth (upside) from current levels, both because Fed Funds have been close to zero for over four years (the last Fed Fund rate cut from 1.00% to 0.25% came in December 2008), and because they reflect a combination of growth and inflation expectations which point to a rise between this year and the next;

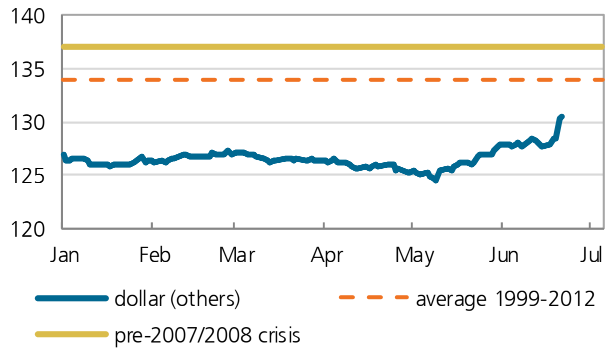
(3) Despite its strengthening, the dollar remains below its long-term average (and even further below its pre-crisis average of 2007/2008): well below when referring to its "broad" nominal effective exchange rate (i.e. against all the currencies: majors and emerging – Fig. 5) and "majors" nominal effective exchange rate; still below, but to a little less so, when referring to the effective exchange rate calculated against the emerging currencies ("others" index: Fig. 6).

Fig. 5 – Dollar still well below its long-term average…



Source: Thomson Reuters-Datastream

Fig. 6 – … a little less so against emerging currencies



Source: Thomson Reuters-Datastream

Focusing in particular on upside on US yields, a simple comparison between the current level (2.25% for 10Y yields: June average) and the combination of growth and inflation forecasts (growth at 1.9% and 2.8% in 2013 and 2014 respectively, and inflation at 1.6% and 1.9% in 2013 and 2014 – based on the OECD's latest estimates: Fig. 7) suggests an upside of between 120bps and 240bps (Fig. 7). When running the same analysis (Fig. 7) on the euro area, Japan, the United Kingdom, Canada, and Australia (to stay within the realm of "majors"), overall upside is highest on US yields – and therefore on the dollar – followed, in this order, by the United Kingdom, Australia, Japan, Canada and the euro area. We consider the implications of this "classification" as valid for the United Kingdom (and therefore sterling) and Japan (and therefore the yen), but potentially misleading for Australia (and therefore the Australian dollar).

Fig. 7 – Theoretical "upside" on yields

	GDP growth y/y (%)			CPI y/y (%)			(A) 10yr yields (%)	(B) GDP growth + CPI inflation			theoretical "upside" for yields (B) - (A)		
	2012	2013	2014	2012	2013	2014		2012	2013	2014	2012	2013	2014
United States	2.2	1.9	2.8	2.1	1.6	1.9	2.25	4.3	3.5	4.7	2.0	1.2	2.4
Euro Area	-0.5	-0.6	1.1	2.5	1.5	1.2	1.60	2.0	0.9	2.3	0.4	-0.7	0.7
Japan	2.0	1.6	1.4	0	-0.1	1.8	0.84	2.0	1.5	3.2	1.2	0.7	2.4
United Kingdom	0.3	0.8	1.5	2.8	2.8	2.4	2.17	3.1	3.6	3.9	0.9	1.4	1.7
Canada	1.8	1.4	2.3	1.5	1.3	1.7	2.21	3.3	2.7	4.0	1.1	0.5	1.8
Australia	3.6	2.6	3.2	1.7	2.1	2.1	3.48	5.3	4.7	5.3	1.8	1.2	1.8

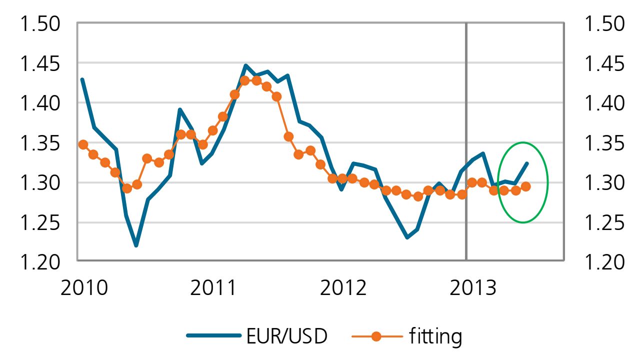
Note: (*) Growth and inflation sourced from the OECD (Economic Outlook of 29 May 2013)
(**) (Government) yields calculated as June averages
Source: OECD, Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

EURO - Euro penalised by the Fed, rather than by the ECB.

After dropping in May, the euro recovered in June, rising from EUR/USD **1.29 to 1.34,** on levels abandoned last February. A large part of the rebound came about on occasion of the June ECB meeting, at which rates were left unchanged, after the May cut. The improvement of some data series, albeit modest, allowed the central bank to take some time before possibly resorting to another interest rate cut, so as to better assess monthly developments. **On the other hand, as we had assumed last month, the euro was penalised by the Fed**. At the end of the FOMC meeting of 19 June, on mounting expectations that the expected change in the Fed's policy is now imminent, the dollar appreciated, and the euro corrected as a result, retreating from EUR/USD 1.34 to 1.30.

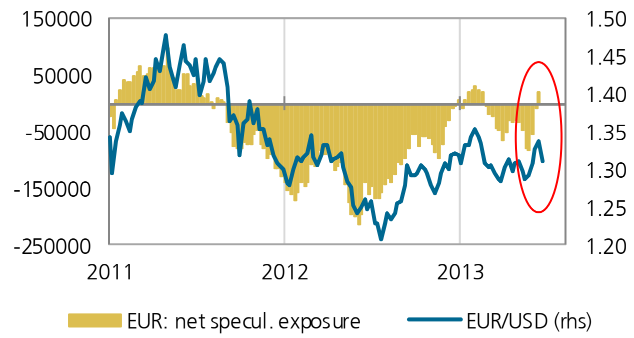
As in the short term economic data from both the euro area and the US will play a very important role in guiding the exchange rate trend, in case of upside surprises in the euro area and disappointments in the United States, the euro's post-FOMC correction could undergo a temporary setback. We confirm our 3m projection for the EUR/USD at 1.26, assuming that on this time horizon the prospect of the Fed effectively reversing its policy will again support the dollar, penalising the euro especially if in the meantime European data releases should prove disappointing, prompting the ECB to cut rates again (downside of 1.26-1.25).

Fig. 8 – Estimates based on the exchange rate-to-yields relation



Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 9 – EUR: Speculative positions (CME)



Source: CME and Thomson Reuters-Datastream

The **unwinding of speculative short euro positions** following the latest ECB meeting, and the return of net exposure into positive territory (long euro: Fig. 9), may cause further weakness of the exchange rate in the short term, albeit on condition of euro area data proving unfavourable and/or the next ECB meeting on 4 July, unlike the previous, fail to safeguard the improvement in confidence in the euro area recorded at the beginning of June. The Fed's next meetings will be held on 31 July and 18 September.

According to our model's estimates, based on the relation between exchange rate and short term yields, the size of the euro's appreciation in June was slightly excessive: while in May the exchange rate stayed broadly in line with its fair value (deviation of +0.8% from the estimated technical value), in June the deviation increased to 2.1%, with an exchange rate of 1.32, vs. a fair value of 1.29 (Fig. 8). However, this is a margin of overvaluation which may be maintained in the short term, as long as the picture in the euro area effectively improves somewhat.

Sterling – Waiting for favourable developments from the BoE

In the wake of the positive correlation with the euro, sterling appreciated in the first part of June, rising from GBP/USD 1.51 to 1.57, only to backtrack again, with the other currencies, following the FOMC. The correlation between the GBP/USD and EUR/USD could slacken once the new BoE governor Mark Carney takes over from Mervyn King on 1st July. Carney is expected to show more openness than his predecessor to implement a more actively growth-supportive monetary policy, thus stepping up positive input of domestic origin for the exchange rate.

The latest BoE meeting brought a development which increases the chances of the central bank putting in place new accommodative measures in the next few months. A split opened among the board members who continued to vote against expanding the APF: some claimed they were potentially open to vote for an expansion of the APF in the future, if necessary, as recent developments have proven the effectiveness of the measure. King (outgoing governor), Fisher, and Miles, on their part, voted for the fifth consecutive month in favour of the expansion. The overall impression is that within the BoE there is mounting awareness that the recovery, while credible in its substance, is very modest, which makes it potentially more fragile.

Following the first BoE meeting chaired by Carney (on 4 July), any relevant policy news are expected to come at 1st August's meeting, as the BoE will be called to illustrate the guidelines of the new policy framework with the Inflation Report of 7 August. At the moment, the likeliest outcome is the introduction of forward guidance, in Fed or Bank of Canada style. Whatever the option chosen by the BoE, we consider this as a positive turn in monetary policy in relation to the effects it will reap on the economy. Therefore, in the months ahead the pound should achieve a more lasting strengthening, especially against the euro. Against the dollar, on the other hand, as is the case for most other currencies, sterling is exposed to a new drop in correspondence with the Fed's expected policy reversal. The revision of the BoE's remit, on the other hand, will offer the BoE an advantage in terms of flexibility compared to the ECB, therefore potential downside on the pound against the dollar, barring disappointing economic data, should be smaller than for the euro, supporting sterling against the single currency as a result.

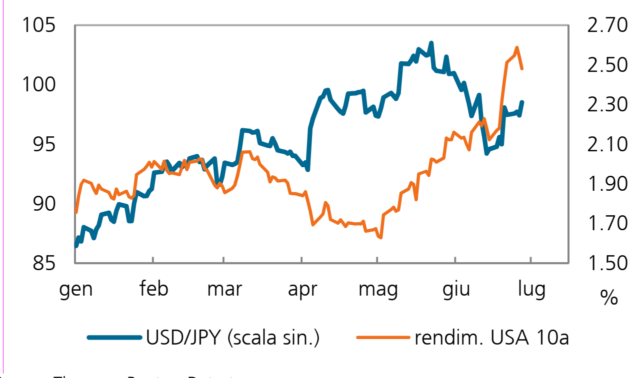
Yen - Yen towards new equilibrium levels?

In the opening part of June, the yen appreciated, recovering from USD/JPY 100 to 93 USD/JPY. The movement, although in part due to the widespread decline of the dollar against the other majors, is in actual fact tied both to "old" factors, which have already conditioned the exchange rate in the past, and to factors which could take on new relevance. Of the "old" factors, the one which contributed to the strengthening of the yen was a moderate risk rise back in aversion.

The potentially new factor, on the other hand is the recent rise in Japanese yields. While in part tied to the movement of US yields, this movement also reflects expectations for a combination of higher growth and inflation in Japan. If the monetary policy revolution carried out by the BoJ in the past few months succeeds in effectively prompting structurally higher growth and inflation, the further ascent of domestic yields in the future could become a factor of own strength for the yen.

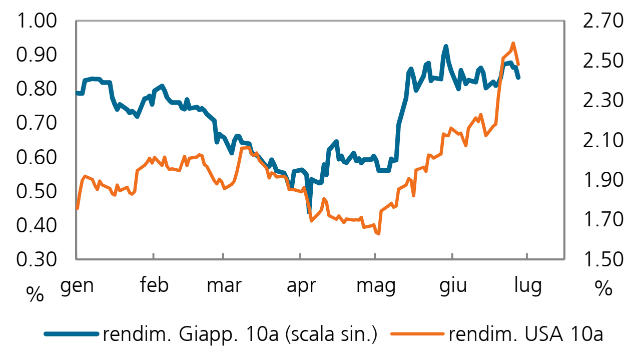
In any case, this would not happen in the immediate future, as the effectiveness of the BoJ's new policy still needs to be verified, but in the medium-long term. Therefore, we could soon revise upwards our 24-month projection for the yen, bringing the exchange rate back below the USD/JPY 100 threshold, if the improvement of the economy and the expected resurgence of inflation into positive territory are confirmed.

Fig. 10 – USD/JPY vs US yields



Source: Thomson Reuters-Datastream

Fig. 11 – Japanese yields vs US yields



Source: Thomson Reuters-Datastream

In the short term, on the other hand, the Fed could continue to be the main driver of the exchange rate. Beyond the mid-month mark, the yen reversed, returning to USD/JPY 98 solely as a result of the FOMC. Potential upside seems potentially much higher in the short on US yields than on Japanese yields, due both to the Fed's expected policy reversal, and to the almost-certainty that the Fed will resume hiking rates well ahead of the BoJ. Exchange rate projections of between 103 and 107 should therefore be read mostly in response to the Fed's policy reversal.

Risks to the base-case scenario are in any case skewed to the upside for the yen, i.e. there is a risk that the Japanese currency depreciates less and for a shorter period of time compared to expectations. The main reason which may push in this direction is the aforementioned hypothesis of Japan managing to achieve in the next few years a combination of stronger growth and higher inflation than in the past (or that expectations consolidate in this sense), with a naturally positive fallout on the domestic currency.

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Appendix

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