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Macroeconomic Outlook

Research Department
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Macroeconomic Outlook

Index

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Quarterly

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Based on information available up to 21.03.2014

Recovery still on/off

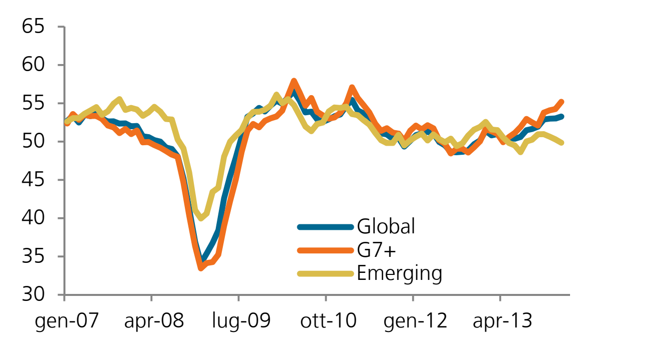
Luca Mezzomo

Harsh winter weather in the US and the difficulties experienced by emerging countries have cast a shadow over the prospects of a consolidation in the global recovery. Nevertheless, activity is set to pick up again in the US, the Euro zone is recovering, and pressures on emerging countries have become more selective. Overall, we can expect the expansion to continue in the next few quarters, despite the rather mixed picture and the continued "relay" race among the different geographical regions. The most significant doubt is that hanging over financial stability in China, in light of the high borrowing in the private sector.

The nasty surprises provided by US data in the last few months should not be over-estimated

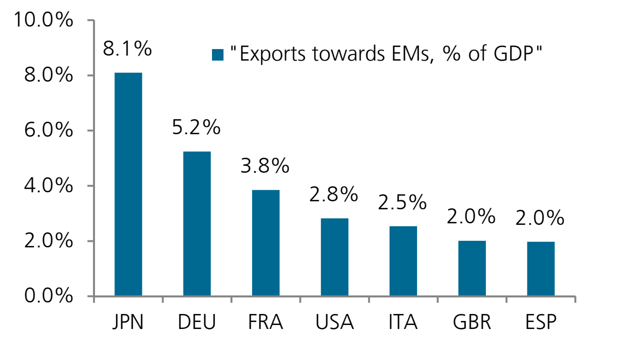
The first few months of this year have highlighted certain critical issues in the prospective strengthening of global growth. The first is that the "surprises" provided by economic indicators have taken on a markedly negative tone in the US and China. From this viewpoint, the picture will also remain mixed in the second quarter, albeit with very different characteristics, which are not, on the whole, cause for concern. The increase in indirect taxes in Japan will come into force in April; this is expected to cause a temporary slowdown in economic activity after having inflated domestic demand in previous months. Conversely, the return of normal weather to the US will lead to a marked improvement in US indicators, against a backdrop of fiscal policies providing less of a hindrance to growth and of broadly accommodative financial conditions. The recovery is also supported by trends in the Euro zone, which in the first quarter posted an improvement in line with expectations and which seems set to continue along the same path in the second quarter.

Manufacturing PMI



Source: Intesa Sanpaolo chart based on Markit Economics data
NB: G7+: US, Euro zone, Japan, UK, Canada. Emerging countries: China, Brazil, Russia, India, Poland, South Africa, Turkey, Mexico. GDP-weighted data

Exports to emerging countries as a % of GDP



Source: Intesa Sanpaolo calculations on IMF DOTS data, via Thomson Reuters Datastream

A simple slowdown in emerging economies does not represent a threat, even if it involves China...

The second problem, which was already evident three months ago, is that emerging countries have been shaken by financial turbulence, which was first widespread, them more localised and related to political tensions (Ukraine, Russia). The situation in emerging countries remains complex: investors' exit from specialised funds continued until February, but according to IIF in March the first signs of stabilisation have emerged, and exchange rate volatility has fallen significantly. The financial squeeze is likely to have widened the gap with advanced countries, which are sustaining economic growth during this period. However, in this phase, a "normal" cyclical slowdown in emerging countries would not be enough to compromise the recovery of advanced countries. The imports of emerging markets generally represent a modest portion, less than 5%, of advanced countries' GDP: a widespread and significant contraction in the imports of BRIC countries would therefore be necessary to create recessionary risks - not the kind to be expected in ordinary cyclical downturns. Furthermore, the greater currency stability and the cooling of inflation make further interest rate hikes less likely even in emerging markets.

... but the implications of a financial crisis in a large emerging country would be quite different

The really problematic scenario would, however, be that of a financial crisis, triggered either by capital flights or a domestic credit squeeze, hitting one or more of the large emerging countries. This became a more concrete risk following the rapid rise in borrowing recorded in the last few years in various emerging countries, including China, Brazil, Turkey and Hungary. While in Brazil and Turkey debt remains low by international standards, in China, the debt of non-financial companies rose from 56.4% to 151.4% of GDP from 2007 to 2013, reaching the highest level recorded among the major advanced and emerging economies. With such high growth rates and levels of borrowing, a credit crunch scenario preceded by a period of increasing insolvencies no longer seems impossible. The phenomenon would be extremely worrying owing to its high potential for financial contagion, firstly at regional level (South Korea, Taiwan), and then on account of its impact on confidence and global output. Undoubtedly, the Chinese economic policymakers have greater room for manoeuvre thanks to the abundance of currency reserves and the low level of public debt. However, even a prompt economic policy reaction would not be able to sterilise the effects of the crisis on the global economy. The problem, therefore, is whether tightening financial conditions and regulations will be enough to bring the problem under control before it becomes unmanageable.

Our interpretation of the Ukrainian crisis is similar. We do not expect it to have significant economic repercussions on advanced countries if it remains confined to the diplomatic arena, however significant the changes in relations between the European Union and Russia may be in the long term. We expect that, having annexed Crimea, Russia will confine itself to supporting the Russian-speaking minorities in the eastern regions, exerting pressure for greater autonomy to be granted within current borders; together with the high dependency of Ukraine on energy imports from Russia, this would grant Putin a great deal of influence over the neighbouring country . This risk assessment would change in the event of an escalation in the dispute, which could lead us to expect either disruptions in the gas flow to Europe (very important for Finland, Germany, Poland and Italy) or a risk of a capital flight from Russia. We had a taste of the capital flight phenomenon in the first phase of the crisis, when it was feared that heavier sanctions would be imposed than those then decided by the US and the EU, or that there would be an immediate extension of Russian targets to the eastern regions of Ukraine. The seasonal drop in gas demand and the high stocks, however, should make Europe resilient to any temporary disruption in gas supplies.

Scenario of consolidated global expansion confirmed

If, as we still consider probable at present, China does not suffer from a serious financial crisis and Russia is satisfied with the annexation of Crimea, the global economy will continue to grow slowly in the next few quarters. Elsewhere, economic policies remain favourable. The markets' reaction to the slow reversal of US monetary policy has been very muted, to the extent that the Fed funds rate priced in by futures is well below the levels that we consider likely for the end of 2015, despite the correction in mid-March. Given that Japan could boost monetary stimulus in the next half year, and that the ECB is set to maintain rates unchanged for the foreseeable future, real short-term rates will remain strongly negative in OECD countries. Stripping out cyclical factors, fiscal tightening is easing both in the US and the Euro zone, and we believe that it could be less than estimated in the last few months.

Projections have not undergone significant revisions since the previous report. The fall in GDP growth forecasts for the US reflects the negative performance of the first quarter, and was only partly offset by the improvement in the second. We have marginally revised up forecasts for the Euro zone (+0.1%). Forecasts for Japan are subject to a significant degree of uncertainty, relating to the fiscal measures to be introduced in April. The most significant change is the further cut in forecasts for emerging countries. The relay race among the main regions looks set to continue, although synchronisation between the US, the Euro zone and Japan is expected to increase in the second half.

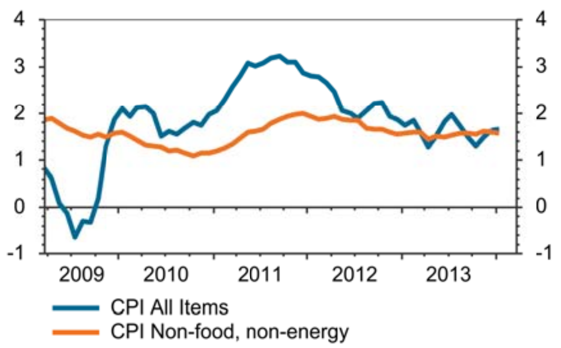
Economic growth by geographical region	2011	2012	2013	2014	2015
United States	1.8	2.8	1.9	2.8	3.0
Japan	-0.4	1.4	1.5	1.3	1.1
Euro zone	1.8	-0.6	-0.4	1.1	1.3
Eastern Europe	3.9	2.1	1.6	2.4	2.9
Latin America	4.1	2.9	3.1	2.6	3.1
OPEC	3.9	5.4	3.1	4.2	4.9
East Asia	7.0	5.5	5.7	6.0	5.9
Africa	3.4	3.2	3.5	4.0	4.6
World growth	3.9	3.1	3.0	3.5	3.8

Source: Intesa Sanpaolo calculations

Inflation will be curbed by modest global growth and the trend in commodities

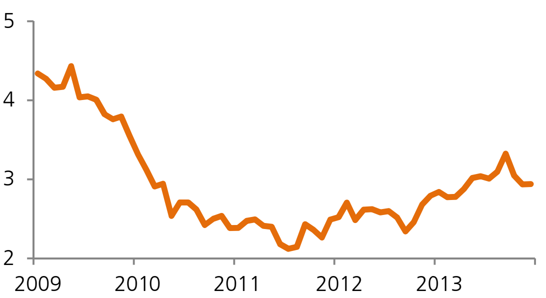
CPI inflation has been slowing in OECD countries since 2011, but is very stable and around 2% in the components other than energy and food. In any event, the general trend is set to remain moderate. As regards global factors, non-energy commodity prices are still contracting, and we do not expect oil prices to rise significantly. On the contrary, the underlying slow speed of global growth, the strength of the dollar and the slowdown in China could depress industrial and energy commodities in the second quarter. Only agricultural commodities are subject to upside pressures, due to the bad weather.

OECD countries, yoy inflation



Source: OECD, through Thomson Reuters Datastream

Standard deviation of inflation rates



Source: Intesa Sanpaolo calculations on national data (36 countries)

On the other hand, local factors are becoming increasingly important in the inflationary process, as shown by the increase in the dispersion of inflation rates from the lows of 2011-12. Apart from external factors, such as the state of the economy, exchange rates may also lead to significant deviations among countries. For example, the decline in European inflation in 2013 was affected by the significant 10% appreciation in the euro's effective exchange rate since mid-2012, which alone is estimated to have shaved 0.8% from the prices index. Looking ahead, the dollar should be supported by the approach of the phase in which official US rates will rise, which we expect to begin in mid-2015, and by the probable upwards revision of forward rates (which discount an excessively mild restrictive trend): in this way, one of the disinflationary factors that has affected the Euro zone should be reduced.

Overview by region

United States

More rapid growth after the slowdown in the first quarter

The extraordinarily cold weather at the beginning of 2014 slowed growth in the first quarter, but US fundamentals remain positive. GDP growth, which fell to 2% qoq (annualised) in 1Q14 is expected to pick up to more than 3% qoq annualised in subsequent quarters. In 2014, we see average growth at 2.8%, with a relatively rapid expansion in consumption and business investment, while residential investment is only expected to grow gradually through the sharp rise in house prices and a shortage of properties for sale. Public spending will slow slightly, although fiscal tightening is easing.

The labour market remains key for the macro scenario and monetary policy strategy. Unemployment has continued to fall: we forecast monthly employment growth of around 180-200,000 and a stabilisation in the participation rate: the unemployment rate is expected to fall to 5.8% at the end of 2014. The improvement in the labour market should reduce unused resources, support income and consumer spending, and lead to a recovery in wage growth, avoiding a drift into disinflation.

The Fed will complete tapering this year, raising rates from mid-2015

At the meeting of 18-19 March, the FOMC adopted "qualitative" rather than "quantitative" forward guidance. Tapering will continue and should be completed in the autumn. The new communication shifts the focus from the date of the first rise (probably June 2015) to the subsequent interest rate trend. To determine the first rise, indications are vague: progress will be monitored towards the objectives of maximum employment and 2% inflation.

The FOMC also gave qualitative indications for the period after the first rise. When the long-term objectives are met (i.e.: 2016), the Fed funds rate may "for some time" be maintained "below levels the Committee views as normal in the longer run" (i.e.: 4%). Our forecast is that Fed funds are above that currently priced in by the market, particularly in 2016 (our forecast: 1% at end-2015, 2.75% at end-2016).

Euro zone

The recovery will consolidate, with a greater contribution from domestic demand

2014 is a year of transition for the Euro zone, from the "great crisis" towards a return to growth in line with potential, which in all probability has been deferred to 2015. Economic activity will grow broadly at the pace seen at the end of 2013 (0.3% qoq) for the whole first half of 2014, before picking up in the second half. Average growth in 2014 is expected to be 1.1%. The recovery in demand from abroad is spreading, via the improvement in companies' profit margins, to company investment. A more significant strengthening in consumer demand is expected in the second half of the year. Developments in fiscal policy, which has become broadly neutral and which could change course over the year and beyond into 2015, could be favourable to the recovery, particularly of domestic demand. Six countries of the Euro zone (and nine in the EU) have announced or implemented tax cuts in the last few months, although in some cases, the measures are funded by spending cuts, and the impact on the economy is therefore uncertain.

Underlying inflation could remain low in the long term

Our central scenario sees inflation rising from 1.1% in 2014 to 1.3% in 2015 and 1.5% in 2016. However, underlying inflation could remain below 1.0% in 2014 and for some of 2015.

ECB probably set to keep rates on hold, but it may have to take concrete steps to strengthen forward guidance

The ECB recently strengthened its system of forward guidance, indicating that rates could remain unchanged until 2016 owing to the persistent excess capacity in the Eurozone economy. At the same time, the forecast of a rise in inflation and a consolidation of the recovery indicate that the ECB does not want to fuel strong expectations of extraordinary measures. If the rise in rates on the dollar were to generate excessive pressure on Euro zone money market rates and verbal intervention proved insufficient, the ECB could be forced to adopt concrete measures – starting with the most symbolic, such as a cut in the refi rate.

Asia:

Japan:
positive outlook, but with greater volatility

The outlook for the Japanese economy in 2014-15 will be defined by fiscal policy. The consumption tax rise from 5% to 8% in April will be pivotal to the economy in 2014. Volatility in growth will make it difficult to evaluate underlying trends, although for now, the outlook remains positive, and the recovery looks set to continue, albeit at a slower pace.

The key factors will be: 1) the response by consumer spending to the tax rise; 2) the trend in income from work and the prospects for wages during the spring negotiations; 3) the implementation of public spending increases aimed at curbing the effect of the restriction triggered by the tax rise; 4) the Bank of Japan's responsiveness to developments relating to aggregate demand.

Inflation has stabilised at just over 1% yoy, and is not expected to change much, stripping out the rise in taxes. The Bank of Japan is ready to intervene to support the economy in the event of an excessively negative reaction from demand to the hike in consumption tax. The central bank will assess information in the wake of the tax rise: if it deviates from its projections, to be updated in April, it has committed itself to increasing stimulus. This would imply an increase in JGB purchases from the current amount of JPY 50Trn a year, a measure that seems likely in the spring quarter.

China:
domestic demand continues to slow, partly due to monetary policy

2013 closed with growth of 7.7%, unchanged versus 2012, thanks to an upsurge in public consumption and exports. The data for the first two months of 2014, although difficult to evaluate due to the different timing of the holidays for Chinese New Year, point towards a continuation of the slowdown currently under way in industrial output and investment, as well as in consumption. The property sector also appears to be cooling.

At the plenary session of parliament in March, Premier Li Keqiang's opening address did not contain any significant new developments regarding the priorities already outlined at the Party's Plenum in the autumn, and the growth target for 2014 was left unchanged at 7.5%. We maintain our growth forecast at 7.3% for 2014, revise them slightly from 7.2% to 7,1% for 2015, and we keep the risks on the outlook to the downside.

In the absence over the next few months of any particularly negative economic data that could undermine the future outlook for the labour market and consumption, the People's Bank of China (PBOC) will continue its policy of slowing growth in bank lending, especially in non-productive sectors or those with excess capacity, as well as curbing and regulating credit outside the banking sector. This is partly in light of the recent first cases of default or problems of quasi-default on loans provided by trust companies. We therefore expect it to allow money market rates to rise again from their recent lows, continuing to drain off excess liquidity. As regards the currency, which has been allowed to depreciate sharply since mid-February, volatility will be higher than in the past, but we do not rule out a recovery based on a modest improvement in foreign trade figures.

India:
growth forecasts have been cut, but the easing of inflationary pressures could allow a more accommodative monetary policy from the second half

Owing to the downwards revision of GDP figures for 2012 and 2013, particularly for the investment variable, and given the different trend in consumption, we are revising our growth forecast from 5.2% to 4.8% in 2014 and from 5.7% to 5.3% in 2015. The risks to the outlook are balanced.

The central bank expects that core inflation will remain high, although the overall inflation trend will benefit from the slowdown in food prices, and will therefore continue to fall in the next few months. For now, official rates are likely to remain unchanged, also in light of the recent rise in real interest rates and signals from the RBI, but we cannot rule out another rise in June, in the event of a further increase in core inflation. Monetary policy could change direction in the second half of the year, in line with the expected greater easing of inflation.

Although the country is in a better external position than a year ago, the contribution of foreign capital flows to covering the borrowing requirement and the probable overshooting of public accounts targets for the current fiscal year urge caution. Against this backdrop, the reversal in US monetary policy could spark renewed exchange rate pressures.

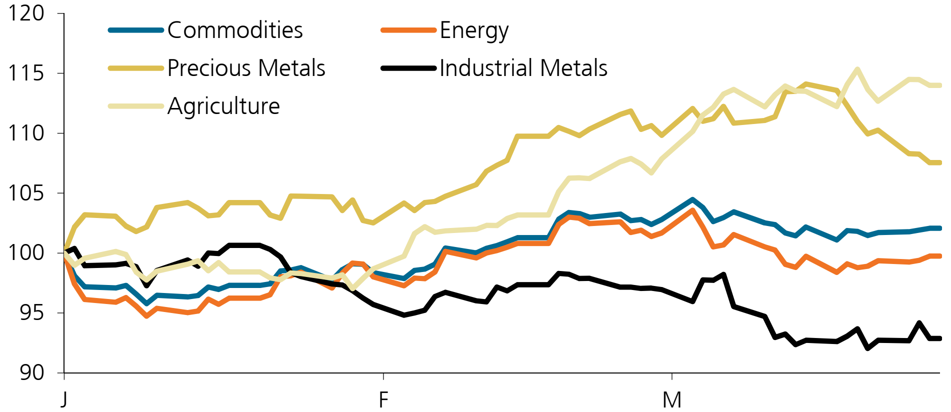
Commodities weaker in the second quarter

In the second quarter, the downward pressure affecting this sector is expected to gather strength again due to the anticipated appreciation of the US dollar. Demand and supply fundamentals will be the main drivers of performance. As a result, we should see a weakening of prices in the energy sector and for gold, and a moderate recovery for all industrial metals. Of the main risks affecting our scenario, the greatest concern will be China, where it will be important to monitor the state of health of economy and credit market.

During the current quarter, commodities have generated positive returns. This rally was the result of two elements:

- earnings were widely spread in the sector as they involved several unrelated commodities. For example, from the beginning of the year until 20 March, the best returns for the commodities we monitor were seen for coffee, wheat, nickel, corn and gold. This good performance attracted the attention of investors, as demonstrated by the rapid accumulation of long positions concentrated mainly in energy and agricultural commodities;
- the good returns were aided by a number of positive, but temporary, factors such as: extreme weather conditions, such as the drought in Brazil and the particularly harsh winter in North America, renewed concerns over geopolitical risks driven by the crisis in Ukraine, and high levels of commodity imports in China.

S&P GSCI Total Return Indices (100 = 31.12.2013)



Source: Intesa Sanpaolo chart from Bloomberg data

In the second half of the year, we expect that the positive influence of most of these factors will run out, and the downward pressures affecting this sector will start to resurface, tied mainly to macroeconomic and political concerns in emerging markets and the anticipated strengthening of the US dollar. As a result, the publication of macroeconomic data and announcements of policy makers will fuel short-term volatility and could generate speculative moves with a major impact on market sentiment toward commodity investments.

Within the sector, individual commodities will continue to offer good diversification and trading opportunities because demand and supply fundamentals are the main driver of prices over the medium term.

Our forecasts for commodities

Our forecasting model is based on current estimates of demand and supply fundamentals for individual commodities, on our benchmark macroeconomic scenario, and on the expected developments in geopolitical stability, which are still affected by significant uncertainty factors.

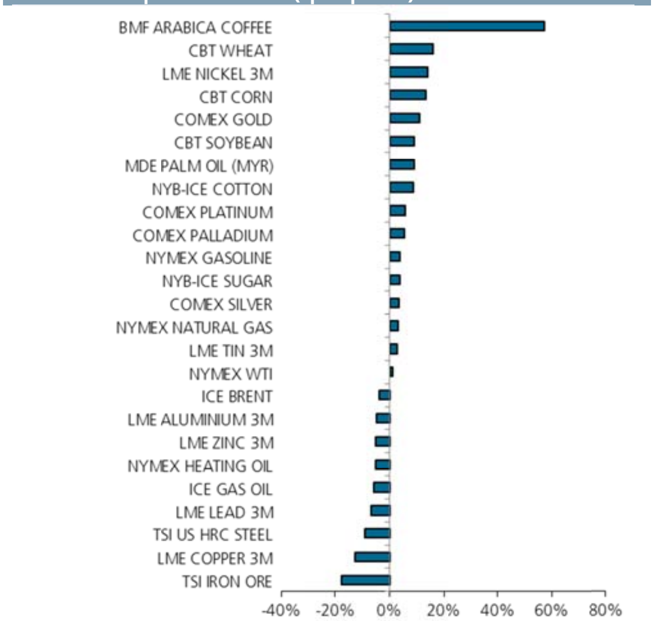
In the energy sector, oil and natural gas are expected to weaken from current levels due to the seasonal decline in demand and the abundant supply in the Middle East and North America. We do not expect geopolitical tensions to lead to prolonged interruptions in physical supply. In addition, even in the event of temporary supply problems, abundant commercial and strategic reserves should prevent markets from becoming too edgy and they should quickly cool down any potential price spikes.

Precious metals have been the best sector from the start of the year up to mid-March due to gold's role as a safe haven and concerns regarding the supply of platinum and palladium in South Africa and Russia. In the second quarter, gold and silver should weaken due to meagre demand for investment as a result of the absence of strong inflationary pressures and the strengthening of the dollar. Platinum and palladium are expected to perform better due to their exposure to industrial demand and due to continuing supply limitations.

Industrial metals have been the worst sector since the beginning of the year. They have all been driven down by large stocks and concerns over the risk of an economic slowdown in China. We believe that for many metals the market reaction to weak Chinese data published to date has been excessive, and thus we expect a moderate recovery in prices in the second quarter due to support provided by high marginal costs of production and due to recovery of global demand. However, fundamentals remain weak for most metals: supply is abundant and global stocks are high. As a result, we project that prices, on the whole, will be stable in the second half of the year.

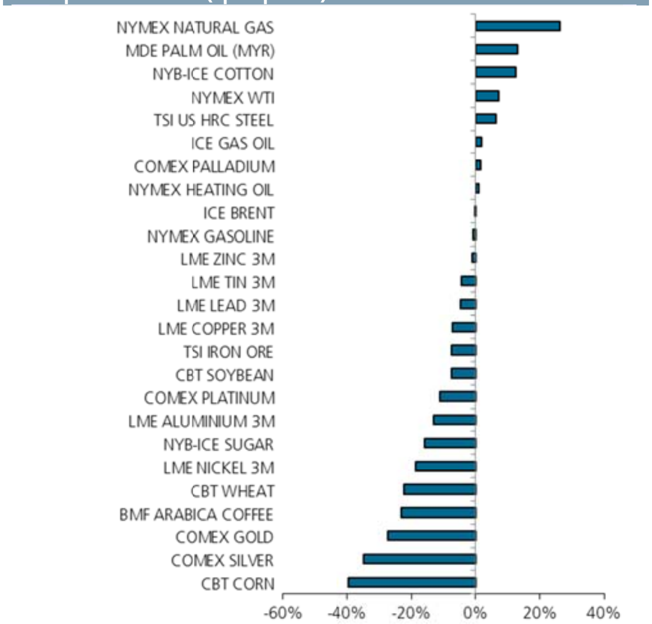
For agricultural products, the main market drivers are forecasts of global production and consumption. We believe that the risk of lower than expected harvests due to poor weather conditions has been fully incorporated in current grain prices, and thus we expect that downward pressures will regain momentum in the coming months.

Year-to-date performances (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

2013 performances (spot prices)



Source: Intesa Sanpaolo chart from Bloomberg data

Downward pressure on oil

Daniela Corsini

In the coming months, we expect that the oil price will be subject to downward pressures driven by negative market sentiment tied to the difficulties affecting major emerging economies, by weakness in demand and supply fundamentals and by seasonal factors. Once again, the main risks in our scenario are geopolitical tensions.

At the beginning of the year, oil prices benefited from various positive factors. In particular, supply was severely limited by several unplanned interruptions. For OPEC members alone, it is estimated that lost production was about 3 Mb/d due to sanctions against Iran, tensions in Libya, attacks on facilities in Iraq and thefts and sabotages in Nigeria. In addition, production was also below its potential in the North Sea, South Sudan and Yemen. Although it does not represent a serious threat for the physical market, the crisis in Ukraine has also led to a temporary increase in risk aversion, and has shored up prices.

On the demand side, extreme weather events have fuelled consumption. In fact, the exceptional cold wave that hit North America and Japan led to greater demand for heating, and the drought in South America reduced regional energy production from hydroelectric power plants thereby increasing imports of fuel to generate electricity. In China, despite the risk of a severe slowdown in the economy, oil imports were very high and registered a new record in January. This move was likely driven by a new phase of strategic reserve accumulation.

In the coming months we expect a weakening of the positive impact of these factors, which have thus far kept prices high for Brent and WTI. In the second quarter, markets could be driven down by:

- macroeconomic concerns in emerging countries tied to upcoming elections in India and fears of a slowdown in the Chinese economy. In particular, commodity markets are vulnerable to the risk of an excessive cooling in the property sector, tense conditions in the credit market and the risk of new waves of negative sentiment following the announcement of new defaults;
- the possible strengthening of the US dollar due to the strength of the US recovery and the monetary policy of the Fed, which is gradually reducing purchases, and which modified the forward guidance on rates in a qualitative direction at its March meeting. In addition, interest rate projections formulated by board members suggest that the first hike should occur in 2015 and, compared to what was indicated in December, these projections indicate an upward shift of a quarter point for Fed funds rates at the end of 2015 (estimated at 1% by the majority of participants) and at the end of 2016 (projected to be greater than or equal to 2% by three quarters of the board). The market reads these signs as an indication that the first rate hike could be anticipated toward the middle of 2015, and that once the rate hike process has begun, rates could be higher than what was previously expected. In the coming months, these expectations could fuel a significant appreciation of the dollar;
- weakness in fundamentals due to the expectation of a gradual increase in spare production capacity in OPEC countries favoured by the rapid growth in supply in major producing countries;
- negative seasonality due to the planned closure of numerous refineries for maintenance.

The main risk to our scenario is the exacerbation of geopolitical tensions. In the Middle East, the situation should remain nearly stable, at least over the short term, due to international agreements signed with Syria and Iran. However, recent tensions between western countries and Russia could also significantly complicate negotiations over the Iranian nuclear programme and the process of dismantling arsenals by the Assad government. In general, we believe that at present, all parties involved prefer diplomatic solutions that could avoid supply disruptions and direct confrontations. In the US, the mid-term elections make new armed interventions and heightened new international tensions undesirable. In Russia, foreign trade, and especially gas and oil exports to Europe, are too large a part of the economy to allow the government to maintain a totally uncooperative attitude towards the requests of western countries. In Iran, the agreement signed at the end of November between Iran and the P5+1 international powers (US, Russia, China, UK, France and Germany) is leading to a temporary lifting of sanctions that have heavily tested the Iranian economy. As a result, given our expectation of relatively stable geopolitical tensions, we have included in our projections a continuing, but moderate, risk premium during the year.

Supply and demand fundamentals

Projections concerning demand and supply fundamentals for oil in 2014 point to a scenario similar to what was seen in 2013: the growth in production should fully satisfy the estimated increase in global demand. In fact, the International Energy Agency (IEA), OPEC and the U.S. Energy Information Administration (EIA) estimate that in 2014 non-OPEC supply will rise much more than global demand due to the rapid increase in production in North America. Thus, to balance the market, OPEC would need to reduce its overall production by supplying a quantity of oil lower than current production, estimated at 30.12 million barrels a day (Mb/d) in February, and lower than the current production target of 30 Mb/d.

In future quarters, production cuts that will be implemented by certain OPEC member countries in response to higher supply by other producers will allow for a gradual increase in spare production capacity, making the market less vulnerable to new supply shocks. According to EIA estimates, spare capacity, which is concentrated almost entirely in Saudi Arabia, should gradually increase from 2.1 Mb/d reported on average in 2013 to 2.6 Mb/d in 2014 and 3.9 Mb/d in 2015. Commercial stocks in OECD countries should also grow from 2.59 billion barrels reported at year-end 2013 (equal to about 56 days of consumption) to 2.61 billion at the end of 2014 and 2.62 billion at the end of 2015.

Note that in the event of serious shocks to physical supply levels, these abundant commercial reserves would be supplemented by ample strategic reserves. In fact, in a scenario of this type, the International Energy Agency (IEA) could arrange a coordinated release. The United States could also intervene independently by releasing a portion of its emergency reserves. In this regard, on 12 March the U.S. Department of Energy (DOE) announced a release test that calls for the sale of 5 million barrels of oil from the Strategic Petroleum Reserve (SPR). This is the first test sale since September 1990, and it was motivated by the need to assess the effectiveness of the system in response to major structural changes that have affected North American production and facilities.

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

Estimates in March 2014, in million barrels	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC Crude"
OPEC	91,1	55,5	5,9	29,7
vs. 2013	1,1	1,3	0,1	-0,3
IEA	92,7	56,4	6,6	29,7
vs. 2013	1,4	1,8	0,2	-0,7
EIA	91,6	55,8	6,3	29,5
vs. 2013	1,2	1,8	0,0	-0,5

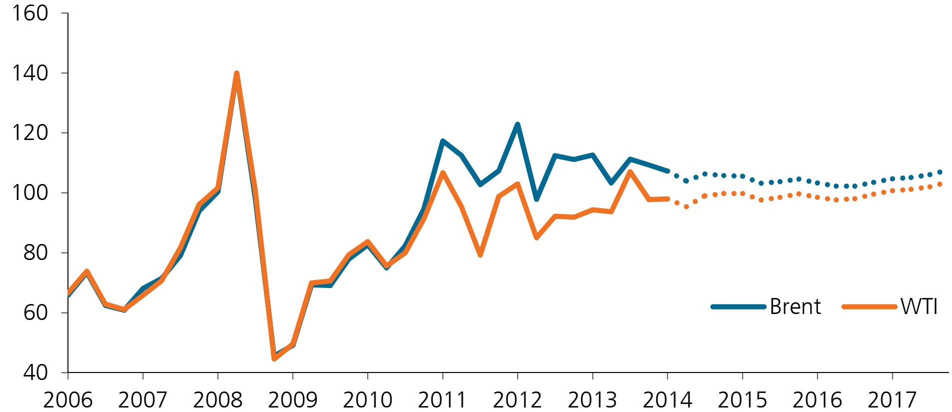
Source: Intesa Sanpaolo chart from data published by the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the U.S. Energy Information Administration (EIA)

Forecasts

Compared to the previous quarterly outlook outlined in December, we have adjusted our projections downward for Brent oil to an average price of USD 105.80 for 2014 stabilising around USD 106 in the second half of the year. The revision is driven the continuing weakness in demand and supply fundamentals and negative sentiment in emerging markets. Our resistance level remains at USD 120/barrel due to the risks still weighing on the macroeconomic scenario. In the worst case scenario of a serious escalation of geopolitical tensions, we would not expect prices to remain above USD 130/barrel for long since that level would not be consistent with the current strength of the global economy. Our support level remains at USD 100/barrel based on high levels of public spending in major producing countries and the high budget break-even oil price needed to balance fiscal budget. In the event of a greater than expected slowdown in emerging economies, prices could drop to USD 90/barrel.

We have also revised our estimates for WTI oil downward to an average price of USD 98 for 2014, stabilising at about USD 100 in the second half of 2014. We expect that the spread between Brent and WTI will continue to be volatile and affected by the relative strength of the US economy and the speed of developing the infrastructure needed to transport crude oil to refineries on the Gulf Coast.

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

al 21.03.2014	1T14	2T14	3T14	4T14	1T15	2014	2015	2016
Estimates	107.2	104.0	106.3	105.7	105.5	105.8	104.3	102.8
Bloomberg Median	106.0	103.0	104.5	102.0	102.5	104.4	102.0	102.0
Forward Contracts	109.2	108.6	107.6	106.5	105.3	105.7	100.7	97.1

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

al 21.03.2014	1T14	2T14	3T14	4T14	1T15	2014	2015	2016
Estimates	98.0	95.4	99.0	99.7	99.8	98.0	98.9	98.4
Bloomberg Median	97.0	95.0	97.5	94.5	96.5	97.5	96.5	97.0
Forward Contracts	98.5	98.4	95.6	93.1	90.8	96.4	88.4	83.8

Source: Intesa Sanpaolo chart from Bloomberg data

United States - Growth will accelerate after the harsh winter

Giovanna Mossetti

- The extremely cold weather at the beginning of 2014 will slow growth in 1Q, but the fundamentals for the US outlook remain positive. After a slowdown in annual growth to around 2% q/q ann. in 1Q, we project annual growth above 3% q/q ann. in subsequent quarters. **Growth in 2014 should be 2.8%, with a relatively rapid expansion in consumption and fixed investment,** while residential investment should grow only gradually due to sharply rising home prices and limited properties available for sale. Government spending will be almost neutral this the year.

- The **labour market** continues to be the key for the macroeconomic scenario and for monetary policy strategy. The unemployment rate has continued to drop: we project monthly employment growth of around 180-200,000 and stabilisation in the participation rate. **The unemployment rate should drop to 5.8% at the end of 2014** and to 5.2% in 2015. Improvement in the labour market should reduce slack, bolster income and consumption and result in a resurgence in salary growth thereby avoiding the drift toward disinflation.

- At its meeting from 18-19 March, **the FOMC replaced "quantitative" forward guidance, with a "qualitative" version**. Tapering will continue and should be completed in the fall. The new communication shifts the focus from the date of the first rate hike (likely in June 2015) to the subsequent rate path after lift-off. There is vague information about what will trigger the first hike: progress made toward the targets of maximum employment and 2% inflation will be monitored.

- The FOMC also gave qualitative indications concerning the period following the first rate hike. When long-term targets are met (i.e., 2016), it will be possible to keep, "for a certain period of time," the fed funds rate "below levels that the Committee considers normal over the long term (i.e., 4%). Our projection is that fed funds will be above the level currently projected in the market, especially in 2016 (Intesa Sanpaolo forecast: 1%, end of 2015, 2.75%, end of 2016).

Forecast Table

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (1996 US$,y/y)	1.9	2.8	3.0	1.6	2.0	2.5	2.8	2.9	2.7	2.9	3.0
q/q annual rate				2.5	4.1	2.4	2.0	3.1	3.3	3.2	2.5
Private consumption	2.0	2.5	2.8	1.8	2.0	2.6	2.2	3.2	3.1	2.7	2.7
Fixed investment - nonresid.	2.8	5.7	5.6	4.7	4.8	7.3	4.3	6.6	6.2	6.2	5.3
Fixed investment - residential	12.1	5.3	11.8	14.2	10.3	-8.8	3.4	10.5	11.4	12.2	12.2
Government consumption	-2.3	0.1	0.7	-0.4	0.4	-5.5	3.5	1.2	0.7	0.5	0.6
Export	2.7	5.0	5.7	8.0	3.9	9.4	0.4	5.7	6.5	5.7	5.4
Import	1.4	2.7	4.1	6.9	2.4	1.5	1.4	4.0	3.8	3.0	3.3
Stockbuilding (% contrib. to GDP)	0.2	-0.1	-0.2	0.1	0.4	0.0	-0.1	-0.1	-0.1	-0.1	-0.2
Current account (% of GDP)	-2.2	-1.8	-1.6	-2.3	-2.3	-1.9	-2.0	-1.8	-1.8	-1.8	-1.7
Federal Deficit (% of GDP)	-4.9	-4.4	-3.7								
Gov. Debt (% of GDP)	121.8	122.3	121.0								
CPI (y/y)	1.5	2.0	2.0	1.4	1.6	1.2	1.5	1.8	2.2	2.4	2.0
Industrial production	2.6	3.6	4.6	1.2	2.4	5.5	1.4	4.5	5.3	5.1	4.1
Unemployment (%)	7.4	6.2	5.3	7.5	7.2	7.0	6.7	6.4	6.2	5.8	5.6
Fed Funds (%)	0.25	0.25	0.48	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Effective exch.rate (1990=100)	73.5	76.0	77.1	74.0	74.0	73.2	74.9	76.6	76.7	76.0	77.1

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

Waiting for the thaw: first-quarter data covered by snow

The exceptionally cold weather in January and February had a significant impact on the activity data, and March has started on a similar note, with below-average temperatures for the period and exceptional rainfall in many areas of the country. The manufacturing sector was hardest hit, with the retail and construction segments taking the brunt of it (see graphs). Sector surveys (ISM, NAHB, Beige Book) report that companies are citing the weather as a significant factor hampering growth; they also state that they should make up a lot of lost ground when the weather improves. A downwards revision of 1Q growth forecasts to 2% qoq (ann.) is likely to be followed by a recovery from the second quarter onwards, which will then make up the ground lost at the start of the year, with limited knock-on effects on overall growth in 2014 (annual growth a couple of tenths of a percentage point lower). 2014 growth is now forecast at 2.8%, followed by a modest acceleration to 3% in 2015.

The information that is less influenced by the bad weather is in line with a continuation of the recovery at growth rates of around 3%. Household and business confidence, consumers' views of the labour market, credit conditions, and the neutral tone of fiscal policy are all positive. Based on financial accounts, companies have plenty of cash for investment (financing gap of USD -154Bn at end-2013), and household balance sheets continue to improve. Household net wealth rose by nearly USD 10Trn in 2013 (+13.8%): at end-2013 it was 6.37 times disposable income, up from 5.66 at end-2012; mortgage interest as a percentage of disposable income, at 4.8% at end-2013, was at its lowest since 1981. Moreover, some of the February data are beginning to show signs of stabilisation (retail sales, industrial production, ISM, employment and housing starts): for a clear recovery we will have to wait for March – April data.

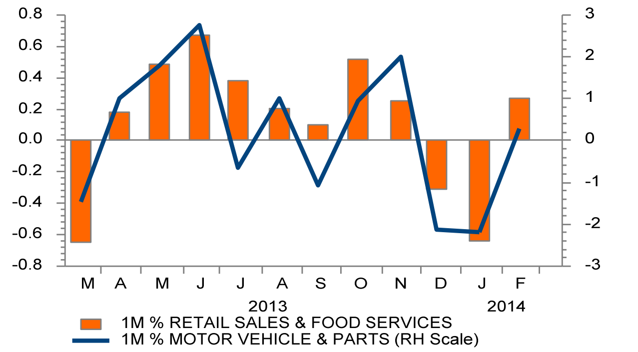
The forecast for consumption in 2014 is 2.6%, with a temporary slowdown to 2.2% qoq (ann.) in 1Q, followed by an acceleration to 3.1% qoq (ann.) in Q2 and Q3, thanks to the positive trends in the labour market, disposable income, net wealth and financial conditions. It is also likely that Congress will approve a retroactive extension to the federal funding of long-term unemployment benefits, of around USD 8-10Bn, to be paid in 2Q, which will give a further boost - albeit temporary - to consumer spending.

The labour market gave mixed signals, which, since they were slightly stronger than other activity data in February, is relatively encouraging as regards the overall picture. An average of 152k new non-farm jobs were created in the first two months of the year; although lower than the figure for 2H13 (187k), this should rise rapidly: as the weather returns to normal, employment is also likely to report a few months of above-average rises. Our forecast is for average monthly growth of 195k employees, in line with projections in 2013, leading to employment growth of 2% yoy (2.1% in 2013). Assuming a participation rate that is stable at 63% in 2014 and declining very slightly (by around two-tenths of a percentage point per year) thereafter, the workforce should grow by around 0.5% per year, which is very close to the CBO and BLS forecasts (+0.4%). The unemployment rate should therefore continue on its downward path, touching 5.8% at end-2014 and 5.5% in mid-2015. The reduction in slack is likely to cause hourly salaries to rise, to 2.5% yoy at end-2014.

Firms' fixed investment growth slowed in the first three quarters of 2013. The restrictive fiscal policy and high political uncertainty more than offset the expansionary financial conditions and never-ending wide financing gap. The re-acceleration seen at the end of 2013 (7.3% yoy, ann.) will be derailed in Q1 by the bad weather. New and unfulfilled orders give an indication of the recovery that is likely to materialise from the second quarter onwards: the forecast is for fixed investment growth of 5.7% in 2014 with upside risks.

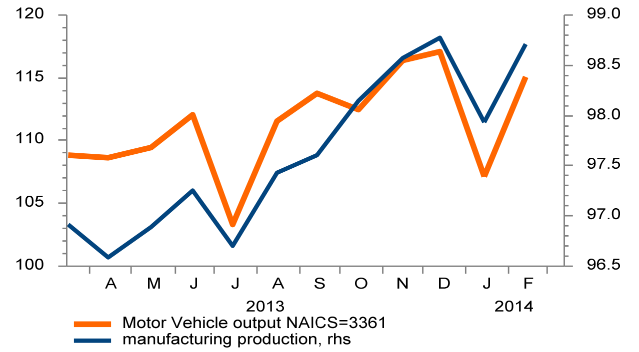
Residential investment came to a halt in 2H13, as a result of higher mortgage rates and steep price rises, partly associated with the low stocks of housing and residential plots. The creation of new households, together with the increase in the building of condominiums and the development of building areas will help support expansion in the residential construction sector, which can only continue if price growth moderates. Residential investment is set to grow by 5.3% in 2014 and by 11.9% in 2015.

Fig. 1 – The collapse of retail sales is already over



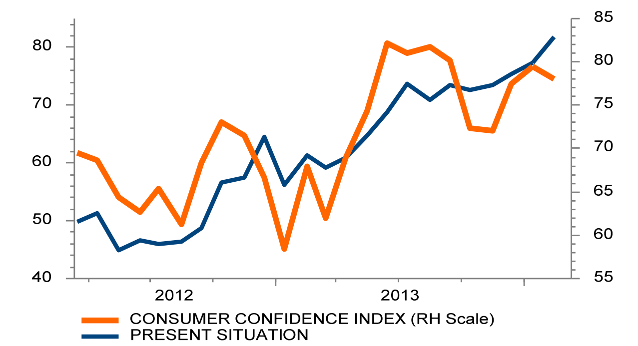
Source: Thomson Reuters – Datastream

Fig. 2 - Manufacturing output temporarily frozen



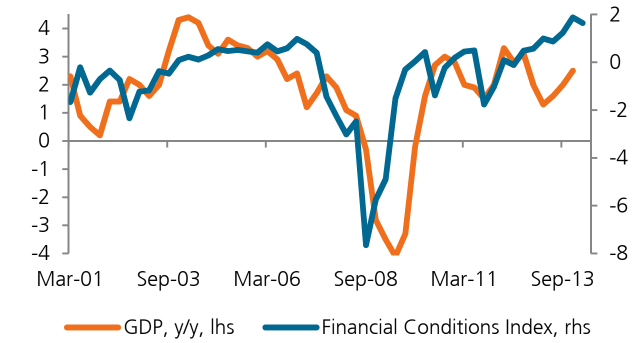
Source: Thomson Reuters – Datastream

Fig. 3 - Consumer confidence is impervious to the weather



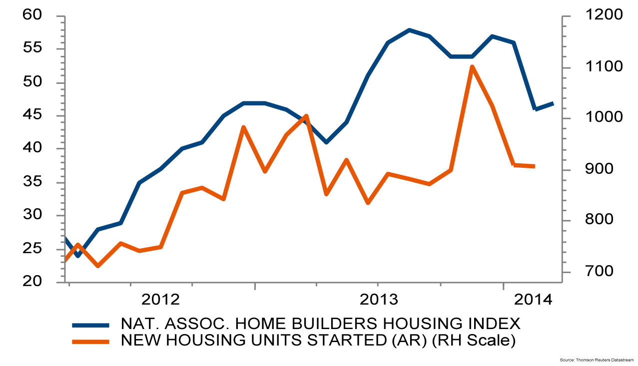
Source: Thomson Reuters – Datastream

Fig. 4 – Financial conditions still ultra- expansionary



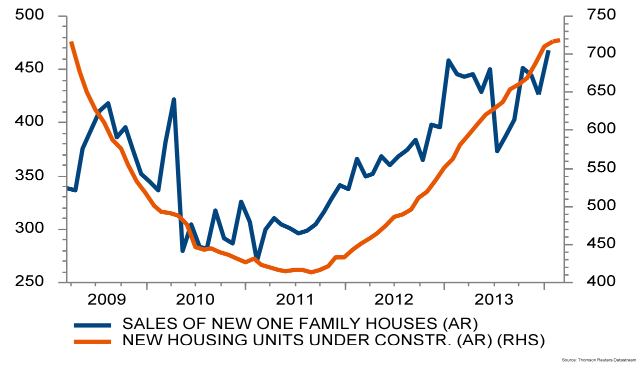
Source: Bloomberg

Fig. 5 – Residential building: collapses...



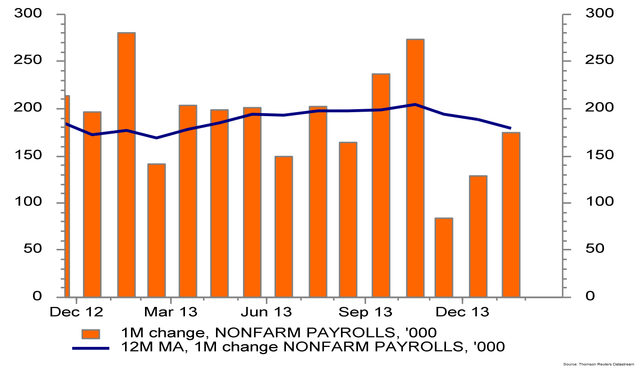
Source: Thomson Reuters – Datastream. Housing starts in '000.

Fig. 6 - ... and rises



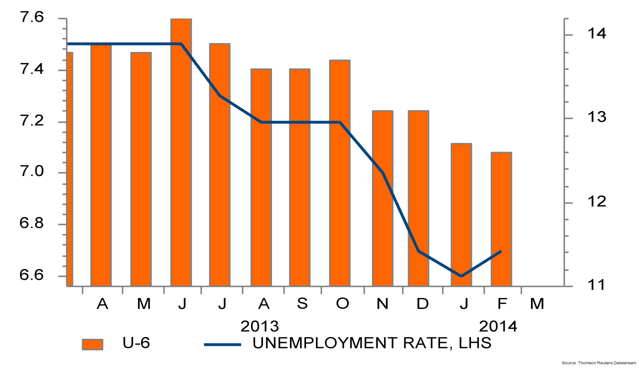
Source: Thomson Reuters – Datastream

Fig. 7 – Employment growth slowed by bad weather



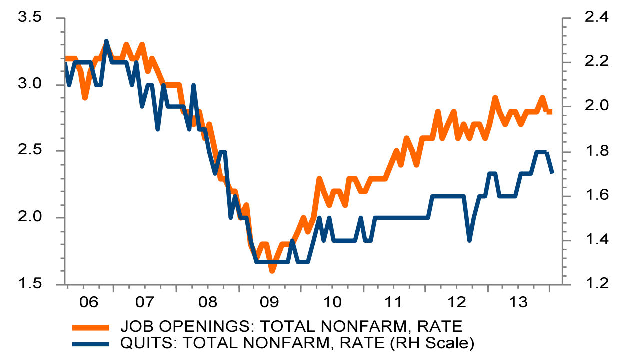
Source: Thomson Reuters – Datastream

Fig. 8 – Unemployment close to 6.5%



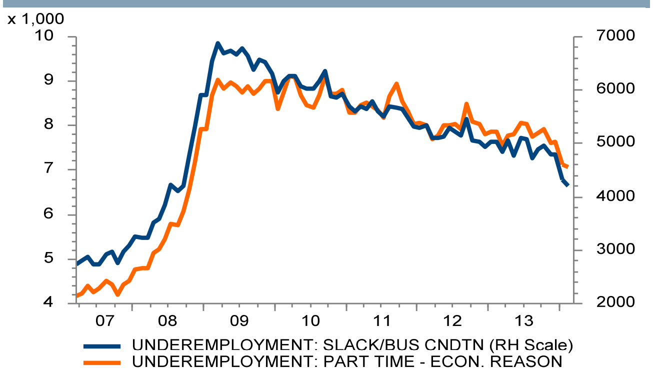
Source: Thomson Reuters – Datastream. U6= Unemployment rate, expanded to include discouraged workers, workers marginally attached to the labour force, and workers in part-time employment for financial reasons

Fig. 9 – Supply and demand flows confirm the gradual improvement in the job market



Source: Thomson Reuters – Datastream

Fig. 10 – Under-employment is falling



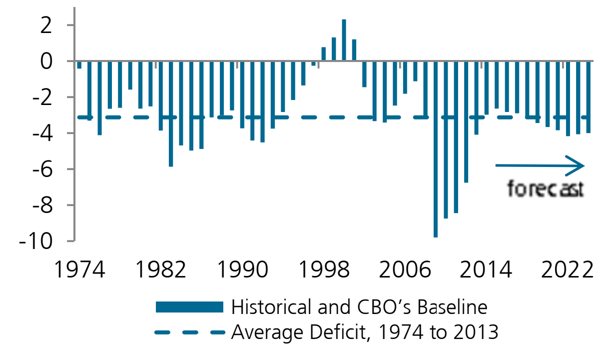
Source: Thomson Reuters – Datastream. Slack/business conditions: part-time workers through the reduction of working hours by employers; economic reasons: all involuntary part-time workers

Fiscal policy – Finally, a quiet year without major shocks. All calm on the fiscal policy front for the first time in years. At the start of the year, all the obstacles that led to the government logjam in 2013 had been resolved, albeit only temporarily. The debt ceiling will not be binding until early 2015 and the budget agreement will enable the country to reach the end of the year without any new clashes. The truce in Congress has led to a modest stimulus for this year, with a reduction in the restrictions of the Budget Control Act. Moreover, in April, approval is likely to be given for the federal government extension of the funding for long-term unemployment subsidies, probably through June. This amount of approximately USD 10Bn (which may also be paid retrospectively) will be granted to some two million individuals, who would otherwise have lost their right to long-term benefits in the first half of the year. This scenario, coupled with the fiscal expansion forecast for local and state governments, would mean that, after falling by 2.2% in 2013, public spending will be broadly unchanged in 2014 (+0.1%) and will rise by 0.7% in 2015. The removal of the huge fiscal policy brake in 2014 is one of the key elements supporting the forecast that overall growth will return to "normal" for this stage of the cycle.

The budget scenario is positive in the short term, but remains at risk in the medium term. The CBO forecasts that the deficit/GDP ratio will fall to 3% in 2014 and to 2.6% in 2015 (from 4.1% in 2013). From 2016 onwards, weaker growth and high debt levels will cause the deficit to grow again. The CBO notes that, based on current legislation, there will be an increase in social security spending, in the 10-year period under consideration, of 1.7 percentage points of

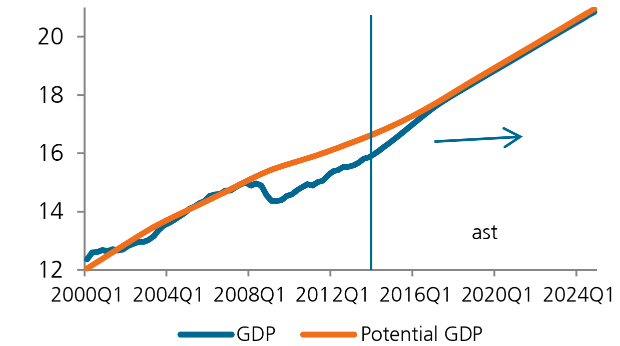
GDP and in health spending of 1.3 percentage points of GDP, compared with an overall fall in discretionary spending of 1.7 percentage points of GDP. Revenues as a percentage of GDP are stable at around the historical average. It is still difficult to see how this imbalance will be corrected. Spending is growing more rapidly than revenues and this will cause the debt/GDP ratio to rise continuously from 2017 onwards. Moreover, the continuous fall in discretionary spending means that levels of this component of spending are difficult to be maintained without impairing the functioning of the federal government. To consolidate the federal accounts, cuts need to be made in health and pensions spending and/or revenues must increase: measures of this nature will not be considered until after the presidential elections in 2016. Nevertheless, the fiscal scenario is quiet for the moment and should not give rise to volatility in 2014-15.

Fig. 11 – Deficit/GDP ratio falling until 2015, when the trend will invert



Source: Congressional Budget Office Figures as a % of GDP

Fig. 12 – The output gap set to disappear in 2016



Source: Congressional Budget Office

Monetary policy - Forward Janet, sensibly

The FOMC is heading gradually towards the exit. March's meeting ended, as expected, with a USD 10Bn reduction in asset purchases and a qualitative change to forward guidance. The statement and the projections for macroeconomic variables and policy rates held a few surprises in store, with some moving in a less dovish direction compared with December's statement. The message however is generally unchanged: the FOMC will be patient before beginning to raise rates (probably mid-2015) and fed funds will probably be maintained "for a certain period of time" below the levels considered "normal in the longer term". The central issue is now not so much "when", but "how much" rates will rise from 2015 onwards. Rates will perhaps be a little higher than the market expected before the meeting, but very probably well below that which would have been forecast based on previous experience or the Taylor rule.

In its economic assessment, as expected, the FOMC believes that the recent weakness in data "in part reflects adverse weather conditions". In any event, despite the negative surprises and the volatility in indicators, the Committee still sees signs of improvement in the labour market and growth in consumption and investment, while residential construction remains stagnant and public spending continues to put a brake on growth, but this is waning. The assessment on prices is unchanged: inflation is below target, but expectations are anchored. The FOMC's conclusion is that risks for the economy and the labour market are now "nearly balanced" (in January, the assessment was that risks were "more nearly balanced"). Furthermore, the committee judges that the economy now has sufficient "underlying strength" to support ongoing improvement in labour market conditions. These two considerations are important for opening the door to the exit.

On the tapering front, there were no changes from December: a scenario in line with forecasts enables the central bank to proceed at a "measured" pace, while continuing to signal that the process is not automatic and remains dependent upon trends in data.

As the unemployment threshold of 6.5% nears, the Committee has adopted qualitative guidance, but stresses that this does not imply a change in "policy intentions". There are two parts to the new formulation: 1) when to start raising rates; and 2) how quickly to raise them. Regarding point 1), according to the statement, a highly accommodative stance remains "appropriate"; in determining "how long" to maintain the current level, "the Committee will assess progress – both realized and expected - towards its objective of maximum employment and 2% inflation". The assessment will be led by the analysis of a "wide range of information", which includes various measures of labour market conditions and inflationary pressures, as set out in previous statements. As regards point 2), in another new development, the statement reads that "when the Committee decides to begin to remove policy accommodation, it will take a balanced approach" in relation to its two objectives; furthermore, the Committee anticipates that even when the longer-run goals are reached (i.e. 2016), economic conditions may, "for some time" warrant keeping the target federal funds rate "below levels the Committee views as normal in the longer run" (i.e. 4%). This is the heart of the message from March's meeting.

Some variations were expected as regards projections. The upper limit of the growth range has been lowered by two tenths of a point at the end of every year of the forecast horizon (2014-16). At the end of 2014, growth is seen at between 2.8% and 3% (3%-3.2% in December). The projected unemployment rate has been revised down to 6.1%-6.3%, from 6.3%-6.6% at the end of 2014, and the estimated range for long-term unemployment (5.2%-5.6%) is expected to be reached at the end of 2016. There were no significant changes for inflation. The estimated long-term unemployment rate is marginally lower (between 5.2% and 5.6%, from 5.2%-5.8%); potential growth is also slightly lower than December's figure (at 2.2%-2.3%, from 2.2%-2.4%).

Interest rate projections have shifted marginally upwards; the vast majority of members (13 out of 16) continue to expect the first rise to take place in 2015, but the majority (11) now see the fed funds rate at 1% at the end of 2015 (from 0.75% in December), and 12 out of 16 expect the rate to be equal to or higher than 2% at the end of 2016 (also an upwards revision of a quarter of a point since December). This was interpreted by the market as a sign that rates will be higher than expected, once the process of rate rises begins, and led to a significant steepening of the yield curve, and a clear appreciation of the dollar against all other currencies.

At the press conference, Janet Yellen played down the importance of the marginal shifts in projections, stressing that the message that the market should focus on is one of the new developments in the statement, namely the explicit reference to the fact that the Committee considers that rates will remain below the medium-term level for "some time" after full employment is reached, particularly if inflation remains below the 2% target for a long time. Yellen thus stressed that the longer inflation remains below target, the longer the period in which rates are below "normal" levels could be. To a question regarding the length of the "considerable time" that should elapse between the end of tapering and the beginning of rate rises, with some hesitation (and then perhaps with some regret at having quantified what "considerable" means), Yellen said that it could be something "around six months". This statement means that we can attribute to Yellen, if not to the majority of the FOMC, the forecast that the first rise may take place around the second quarter of 2015 (our forecast is June, meeting with press conference), assuming that, as according to Yellen, asset purchases come to an end around autumn this year. At the press conference, Yellen also gave some room to the discussion on the variables that the FOMC will monitor to assess progress on the labour market, without however revealing any significant new developments compared with what has emerged in previous speeches.

Yellen overall communicated efficiently and transparently, and chose to constantly highlight the opinions of the Committee as a whole and of its individual members, rather than her personal vision: as expected, Yellen has a highly collective leadership style. Her task will not be an easy one, as she will have to guide market expectations in preparation for the period of rate hikes. For now, the market has not so much listened to the reassuring words, but looked at the "dots" on the chart showing the FOMC's rate projections, and interpreted the indication regarding the "six months" pause between the end of tapering and the first rate hike. A modest upwards adjustment in expectations was probably due, in light of economic prospects.

Our forecast for fed funds is that the period for the rate lift-off will begin in June 2015. Subsequently, our forecast scenario is **more aggressive than as factored in by the market after the FOMC March meeting.** We forecast that the rate hikes could take **the fed funds rate to 1.25% at the end of 2015** (fed funds futures on 20 March at 0.75% for December 2015) and **to around 3% at the end of 2016** (fed funds futures on 20 March at 1.8% for December 2016). Our scenario is consistent with rises of 25 bps at almost all meetings (there are eight a year) between mid-2015 and end-2016, and would keep policy rates below their long-term levels (4%) for a "certain period" even after the inflation and full employment targets have been met, which we expect to happen in the first half of 2016. **We expect the pace of rate hikes to be slower in 2017,** with an expected "pause for reflection" and **the rate closing the year at around 3.5%.**

Projections of Federal Reserve Governors and of Reserve Bank Presidents – March 2014

Variable	Central trend			Long term
	2014	2015	2016	
Real GDP	2.8-3.0	3.0-3.2	2.5-3.0	2.2-2.3
September projection	2.8-3.2	3.0-3.4	2.5-3.2	2.2-2.4
Unemployment	6.1-6.3	5.6-5.9	5.2-5.6	5.2-5.6
September projection	6.3-6.6	5.8-6.1	5.3-5.8	5.2-5.8
Consumption deflator	1.5-1.6	1.5-2.0	1.7-2.0	2.0
September projection	1.4-1.6	1.5-2.0	1.7-2.0	2.0
Core consumption deflator	1.4-1.6	1.7-2.0	1.8-2.0	
September projection	1.4-1.6	1.6-2.0	1.8-2.0	

Source: Federal Reserve Board. Projections of change in GDP and inflation from 4Q of the previous year to 4Q of the year indicated. Unemployment in 4Q of the year indicated

Euro zone - A year of transition, ECB in wait-and-see mode

Paolo Mameli
Anna Maria Grimaldi

- 2014 is a year of transition for the Euro zone, from "major crisis" to a return of GDP growth to its potential, which in all likelihood will be postponed until 2015. We believe that economic activity will continue to grow at about the same pace as at year end 2013 (0.3% qoq) for the entire first half of 2014 with a faster pace expected in the second half, for an average of 1.1% in 2014.

- We are now at a stage when the recovery of demand from abroad will result in an improvement in business profit margins and corporate investments. The last link in the chain will be a more significant recovery in consumer demand, which, in the best case scenario, is expected in the second half of the year.

- Changes in fiscal policy (which has become largely neutral, and which, during the year and moving forward to 2015 could move in the opposite direction) could bolster the recovery, especially in terms of internal demand. There are some six countries in the Euro zone (nine in the EU) that have announced or passed tax reductions in recent months, although in certain cases these measures are covered by spending cuts, and thus the impact on the cycle is uncertain.

- We expect inflation to recover from the second quarter. The year average will drop to 1.1% in 2014, and then rise to1.3% in 2015 and 1.5% on 2016. However, core inflation may stay below 1% for the entire year.

- The ECB recently strengthened its system of forward guidance, indicating that rates could remain unchanged until 2016 owing to the persistent excess capacity in the Eurozone economy. At the same time, the forecast of a rise in inflation and a consolidation of the recovery indicate that the ECB does not want to fuel expectations of extraordinary measures. If the rise in rates on the dollar were to generate excessive pressure on Euro zone money market rates and verbal intervention proved insufficient, the ECB could be forced to adopt concrete measures – starting with the most symbolic, such as a cut in the refi rate.

Macro forecasts

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	-0.4	1.1	1.3	-0.6	-0.3	0.5	0.9	0.9	1.2	1.3	1.4
- q/q change				0.3	0.1	0.3	0.2	0.3	0.4	0.4	0.3
Private consumption	-0.4	0.7	1.0	0.2	0.1	0.1	0.1	0.3	0.2	0.3	0.2
Fixed investment	-2.8	2.3	2.4	0.2	0.6	1.1	0.5	0.4	0.6	0.5	0.5
Government consumption	0.3	0.3	0.4	0.0	0.4	-0.2	0.1	0.1	0.1	0.1	0.1
Export	1.3	4.5	4.3	2.3	0.0	1.2	1.3	1.1	1.0	1.3	1.0
Import	0.1	3.8	4.2	1.7	1.0	0.4	1.1	0.9	1.1	0.9	1.0
Stockbuilding (% contrib. to GDP)	-0.2	-0.3	0.0	-0.2	0.3	-0.3	-0.1	-0.1	0.1	-0.1	0.0
Current account (% of GDP)	2.3	2.0	1.6	2.6	1.8	2.8	2.6	2.5	1.4	1.5	2.0
Deficit (% of GDP)	-3.0	-3.0	-2.5								
Debt (% of GDP)	93.4	95.1	96.5								
CPI (y/y)	1.4	1.1	1.4	1.4	1.3	0.8	0.7	1.2	1.1	1.6	1.5
Industrial production (y/y)	-0.7	1.6	1.8	0.7	0.0	0.4	0.2	0.6	0.7	0.1	0.1
Unemployment (%)	12.1	11.8	11.4	12.1	12.1	12.0	12.0	11.9	11.8	11.6	11.6
3-month Euribor	0.22	0.28	0.31	0.21	0.22	0.24	0.27	0.29	0.29	0.27	0.29
10Y Go. Yield	3.00	2.84	3.21	2.82	3.15	2.97	2.71	2.74	2.90	3.03	3.10
EUR/USD	1.32	1.33	1.28	1.31	1.32	1.36	1.37	1.35	1.32	1.29	1.28

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

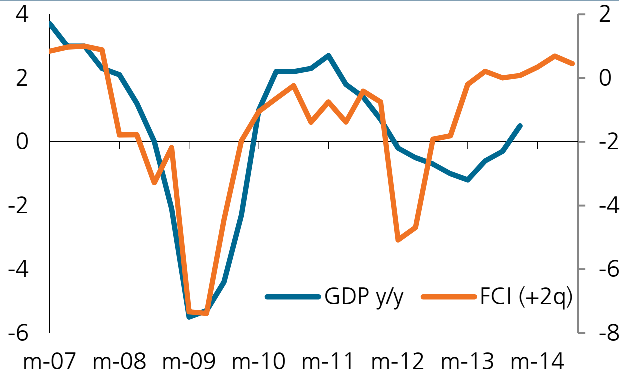
The economic situation – Chronicle of a recovery foretold

Paolo Mameli

Recovery moving forward at projected pace

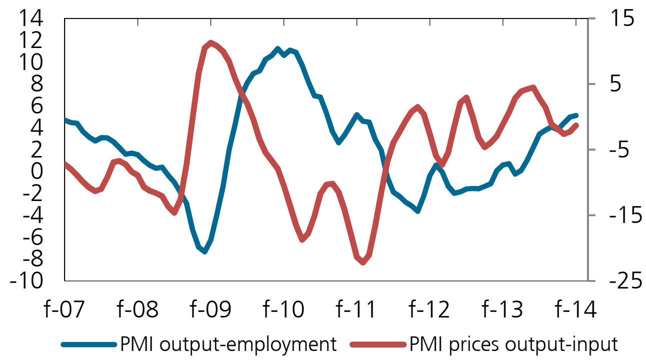
In the Euro zone, the recovery is moving forward at the projected pace. Indeed, the recovery was stronger than expected at year-end 2013, with GDP growth of 0.3% qoq (a tenth stronger than expectations), which was in line with the growth reported in 2Q in the same year, and after a slowdown to 0.1% qoq in the summer months. It is comforting to know that the 4Q 2013 recovery would have been greater net of the change in inventories, which made a negative contribution of three tenths to GDP (the most pronounced in two years). This is a positive sign for the future of production activity. The recovery continues to be driven by foreign trade (that added 0.4% qoq to economic activity), but there was also significant growth in investments (from 0.2% qoq in the spring quarter to 0.6% in the summer to 1.1% qoq in winter months). Consumption growth was still weak (+0.1% qoq, as in the previous quarter), but in any case this was the third consecutive quarter of growth. We believe the pace of economic activity will be around the same level seen at year-end 2013 for the entire first half of 2014, with an acceleration expected in the second half of the year. In qualitative terms, we are now at a stage when the recovery of demand from abroad will result in an improvement in business profit margins and corporate investments. The last link in the chain will be a more significant recovery in consumer demand, which, in the best case scenario, is delayed to the second half of the year.

The improvement in financial conditions that began a year and a half ago points to the possibility of a stronger recovery phase



NB: FCI= Financial Conditions Index Bloomberg (index of stress in money, bond and equities markets). Source: Intesa Sanpaolo chart based on Eurostat and Bloomberg data

Corporate profit margin proxies available through economic surveys show a clear upward trend



Note: 3-month moving average. Source: Markit (PMI survey in the manufacturing sector) and Intesa Sanpaolo chart

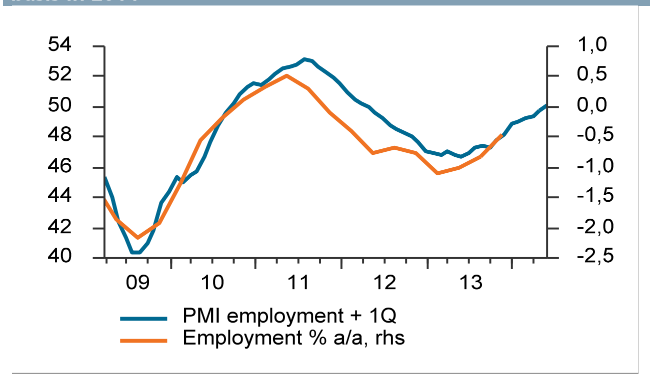
The adjustment in the labour market is nearing an end, while recovery in lending activity is delayed

Returning to the attempt of describing a timeframe of the process of exit from the "big crisis" which was covered in the last edition of this publication, after the relaxation of financial tensions in the autumn of 2012 showed flickers of hope for a recovery, and after the fact that there has been economic recovery, as seen in the GDP, since the spring of 2013, we indicated that there may be an improvement in the labour market and lending activity, which are traditionally "late" indicators of the cycle, starting in the autumn and winter. In fact:

1) With regard to the labour market: employment moved into positive territory in 4Q13, and it took two and a half years to get there. The unemployment rate also seems to have reached its high point, since, after hitting a level of 12.1% from April to September 2013, it then dropped to 12% between October and January in the new year. These are still very weak signs, but corporate hiring intentions are showing a clear trend leading to an outlook of truly improved conditions in the labour market, and in particular, growing employment, which could soon move into positive territory on an annual basis (up from -0.5% at year-end 2013).

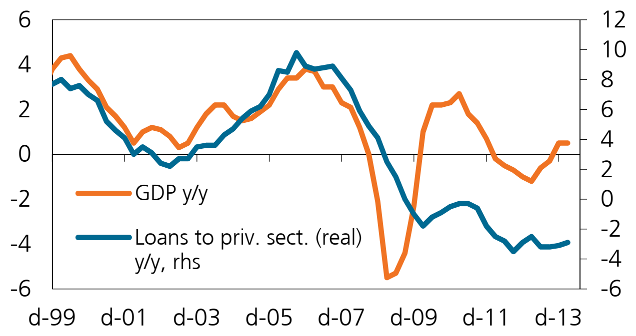
2) Signs coming from **lending activity** are much weaker (and this is not just a quirk given the financial implications of the crisis): the recovery in GDP has so far not translated at all into a recovery in loans to the private sector, which continue to decline heavily, even at the beginning of 2014 (-2.2% yoy in January), especially as far as it concerns loans to companies. However, the survey on bank lending conducted in January showed that the net percentage of banks that reported tighter lending conditions is gradually lowering, now at 2%, and banks expect an increase in demand in all loan categories in 1Q14 (this was due to lower credit risk of borrowers and an improved economic outlook, as well as factors tied to the liquidity of banks and their access to funding markets). In essence, only in the best case scenario in 2014 would it be possible to see a recovery in conditions in the lending market. This is one of the main factors slowing down the recovery, as a result of which, we maintain our projection of modest growth (just above 1% in 2014).

The resumption of greater corporate hiring intentions points to employment resuming its upward movement on an annual basis in 2014



Source: Intesa Sanpaolo chart based on Eurostat and Markit data

The economic recovery cycle has failed to trigger a recovery in lending to the private sector

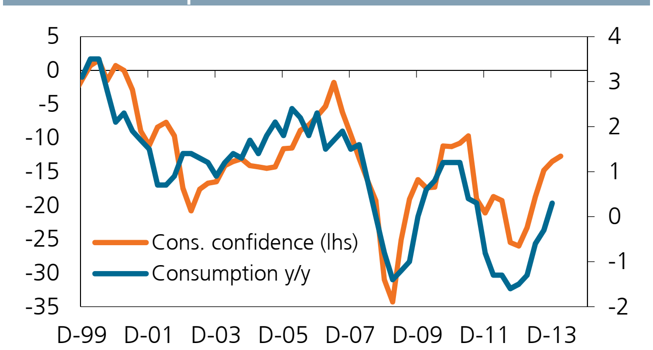


Source: ECB, Eurostat

The last link in the chain of recovery will be a more significant growth in consumer demand, which could occur in the second half of the year. Signs of improvement have already been seen, such as the fact that retail sales rose 1.3% on an annual basis in January and are close to a six-year high. Although not generating major optimism, household confidence levels are consistent with a further recovery in consumption. Moreover, the increase in confidence is not unusual given the improvement in fundamentals in terms of purchasing power. In fact, **2014 will be the first year of growth in households' real disposable income after five consecutive years of contraction, but a more sizeable recovery will occur only next year.** Consumption could be bolstered not only by a jump in income but also in wealth due to good financial market performance and despite the fact that property prices still have room to grow. Obviously, the rise in real terms of both income and wealth has been accentuated by the drop in inflation.

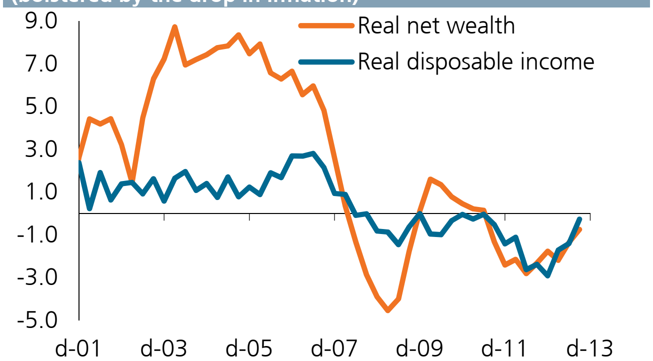
The missing link is the recovery in consumption

The worst is also over for consumption, which is driven by lower household pessimism...



Source: Intesa Sanpaolo charts based on European Commission data

... and by the recovery of both income and wealth in real terms (bolstered by the drop in inflation)



Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

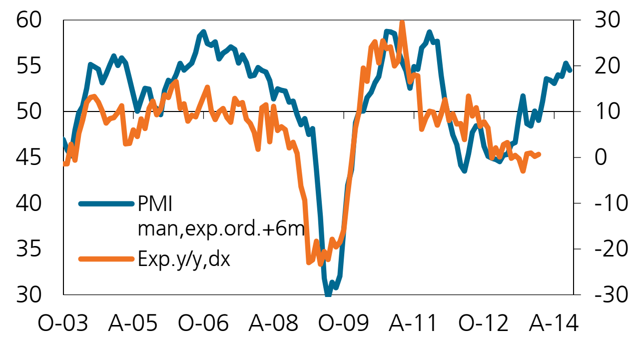
Nominal and real disposable household income (annual % chg.)									
	2007	2008	2009	2010	2011	2012	2013	2014p	2015p
Disposable income	4.4	3.5	-0.3	1.1	2.0	0.2	0.6	1.3	2.4
Inflation	2.1	3.3	0.3	1.6	2.7	2.5	1.4	1.1	1.4
Purchasing powero	2.3	0.2	-0.6	-0.5	-0.7	-2.3	-0.8	0.2	1.0

Source: Intesa Sanpaolo charts and forecasts based on Eurostat and OEF data

To summarise, in our central scenario, the economy in the Euro zone will resume average annual growth in 2014, which we project to be 1.1%, still driven by a significant contribution (which we estimate to be a half percentage point as in 2013) from foreign trade, but there will also be a recovery in domestic demand (+0.9% adjusted for inventories). We project a significant jump in investments (+2.3%), while growth in consumption will be lower than GDP growth (0.7%). An acceleration in GDP growth in 2015 is possible. To summarise, 2014 should be seen as a year "of transition" from the "major crisis" to a return to growth in keeping with the economy's potential, which seems to be postponed to next year.

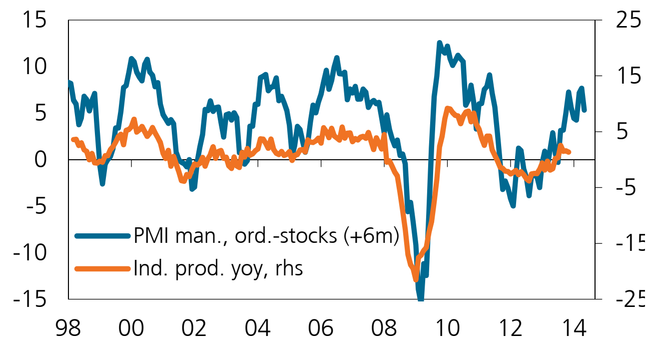
The recovery in the current year will be driven by both exports and investments

Surveys are consistent with acceleration not only in demand from abroad...



Source: Intesa Sanpaolo chart based on Eurostat and Markit data

... but also in domestic demand, especially with respect to companies



Source: Intesa Sanpaolo chart based on Eurostat and Markit data

A change in fiscal policy, which was crucial in triggering the recession of 2012-2013, could bolster the recovery, especially as far as domestic demand is concerned. In fact, as we indicated three months ago, 2014 will be the first year of broadly neutral fiscal policy after three years of strong restriction. Based on the Commission's winter projections, in 2014 the amount of the tax squeeze, measured by the change in the cyclically adjusted primary balance, will be equal to just 0.3% of GDP after a level of 0.9% in 2013 (and an average of 1.2% for the three years from 2011-2013). This would imply a negative impact on GDP limited to one tenth of a percentage point. Compared with three months ago, governments have further lessened the squeeze in the current year. What is more, during the year, and looking ahead to 2015, fiscal policy could move in the opposite direction. According to the Commission's projections, and assuming no changes in legislation, the change in the cyclically adjusted budget balance would be negative in 2015 (-0.4%), implying an expansionary impact of about two tenths of a percentage point on GDP (however, this forecast is preliminary since an additional correction would be necessary in several countries to achieve targets agreed to in Europe).

Fiscal policy is moving in the opposite direction than that seen in past years…

The shift toward a less tight fiscal policy can be seen from the fact that in recent months, six Euro zone countries (and nine in the EU) have announced or implemented tax reductions, although in certain cases, tax relief is funded by cutting expenses, making the impact on the economic cycle at least uncertain.

... opening the door to significant tax reductions in several countries

In France, on 14 January the government announced the "Responsibility Pact," which, on the revenue side, will result in the elimination of social security contributions paid by employers to be used for financial incentives for households (EUR 30Bn from now until 2017). On the other hand, the target of reducing government spending by more than EUR 50Bn from 2015-2017 was confirmed (so, the impact on public finances and the cycle is uncertain at the moment).

In Italy, on 12 March the new government announced a plan of EUR 10Bn in tax relief on IRPEF (personal income tax) and EUR 2.4Bn on IRAP (regional tax on production) at regime, funded by savings from the so-called spending review, in addition to interest spending savings and the possible use of margins on the deficit (and by the increase in taxes on capital gains). In any case, our projections show this would have a positive impact on the cycle starting in 2014.

At the end of February Spain introduced a flat tax of EUR 100 per month on social security contributions in the first two years of employment, and Prime Minister Rajoy promised other tax relief by the end of 2014 (elections are scheduled for the autumn of 2015). It is possible there will be a tax cut on individuals with low and medium-sized incomes. However, Spain is far from achieving goals set for 2015 (when the Commission projects a deficit rising to 6.5% of GDP from 5.8% in 2014). This will make it necessary to adequately fund these measures as well as prepare a net correction plan.

Portugal, which in May will leave the EU/IMF adjustment programme, announced a decrease in corporate tax last July from 31.5% to 19% by 2018, and in February a task force was set up to prepare the tax reform for individuals that will be implemented in 2015. These measures appear sustainable since the country is essentially meeting agreed fiscal objectives and does not need a further net restriction.

Ireland, which successfully completed the adjustment programme at year-end 2013, and since January has returned to the bond markets, is also looking into a reduction in personal taxes (with broader brackets) while maintaining the highly preferential tax rate for companies (12.5%). Exemptions were also introduced for those unemployed more than 15 months who decide to start a new business (this measure is valued at EUR 500M). Once again, there seems to be room for tax-related measures since the country completed the required structural adjustment.

Lastly, Finland has also decided to reduce corporate taxation from 24.5% to 20% starting in 2014. Outside the Euro zone, there are three EU countries that have chosen to reduce taxes: the UK, Sweden and Denmark. In all these cases, it was decided to reduce corporate tax (from 28% to 20% on 1 April 2015 in the UK; from 26.2% to 22% starting in 2013 in Sweden; and from 25% to 22% starting February 2013 in Denmark). In the case of Sweden, in September 2013 a tax cut on the lowest incomes was also announced along with the widening of brackets.

As a side note, Germany has chosen to buck the trend, and instead of tax cuts, preferred to increase welfare spending, and decided to abolish the scheduled reduction in social security contributions originally planned for 2014 in order to fund additional pension transfer payments, mainly for the benefit of mothers, and to facilitate early retirement for those who have made pension contributions for at least 45 years.

To summarise, as noted, the impact of the announced tax cuts is uncertain since in certain cases (such as France) they must inevitably be covered by reductions in spending. However, now that the most severe phase of the crisis is over, this is a sign that fiscal policy will again become at least neutral and will serve as a tool to support the fragile recovery under way.

Strategy of fiscal policy in the Euro zone and its impact on growth	2010	2011	2012	2013	2014	2015
C. a. primary balance (EU Comm. Estimates)	-2.3	-0.5	0.5	1.4	1.7	1.3
% change (ie stance of fiscal policy)	-0.6	1.8	1.0	0.9	0.3	-0.4
Impact on GDP growth	0.3	-0.8	-0.5	-0.4	-0.1	0.2

NB: The impact on growth was calculated using the multipliers of the OECD Interlink model. Source: Intesa Sanpaolo charts based on EU Commission data (winter 2014 projections)

Endogenous risks are declining...

Downward risks affecting the economic situation seem to have subsided considerably, even compared with just three months ago. In fact, the first risk that we indicated in the December edition of this publication, i.e., the possibility of the resurgence of the financial crisis brought about by a political impasse in peripheral countries (we pointed out, in particular, that the possibility of early elections in Italy would be the main factor contributing to triggering an escalation of this type), seems to have lost a lot of its significance (in fact in Italy, as the prospect of elections moves further away and the institutional and economic reform process gathers speed, the political factor seems to represent an upward risk, rather than a downward risk, on growth projections). It should also be noted that the performance of public finance in assisted countries did not generate the feared negative surprises. In Greece, the most recent data show that the target for the primary budget balance for 2013 set in the EU/IMF adjustment programme was achieved with a broad margin. In Portugal, the cash deficit in 2013 was substantially lower than the target, partly due to macroeconomic performance exceeding expectations, and the country is largely meeting due dates to comply with the final deadline of 2015 set by the Excessive Deficit Procedure. In Ireland, based on cash figures for 2013 for the central administration, the government deficit was lower than the target set by the EDP of 7.5% of GDP for 2013 as a result of tight controls over spending and compliance with revenue programmes; in addition, the EU/IMF adjustment programme was successfully concluded, allowing the country to return to the markets (under rather favourable conditions) starting in January.

... but there are still exogenous risks

There continue to be the risks we indicated three months ago of an exogenous nature, i.e., tied to the impact of the following due to exports: 1) a less buoyant trend in demand in the rest of the world, and 2) the appreciation of the exchange rate.

With regard to the first point: 1) the economic slowdown reflected in the most recent data in the United States is not likely to have a significant negative impact on growth in the Euro zone in our opinion, since this is a temporary situation caused by one-off events such as weather conditions; 2) compared with three months ago, the risk of a financial or currency crisis in the emerging countries most vulnerable from the standpoint of foreign debt seems to be much lower, although, as we get closer to the period of an interest rate inversion in the US, we cannot rule out the possibility of periodic resurgence of potential hotbeds; however, the situation in "emerging" countries is highly diversified, and only a synchronised recession/financial crisis in all emerging countries or in a whole geographic area could have a major impact on the GDP of the Euro zone (but in the current phase, this widespread crisis seems hard to imagine since the reasons for concern seem to come from specific endogenous causes in certain emerging economies). Yet, with regard to the contribution of emerging countries to global growth, there are still concerns. At the moment, the most problematic areas seem to be (for different reasons) China (due to concerns about a hard landing), Russia (due to the diplomatic crisis with Ukraine) and Turkey (due to the impact of financial tensions that emerged two months ago). The percentage of GDP represented by exports from the Euro zone to these countries is as follows: 1.1% (China), 0.8% (Russia) and 0.6% (Turkey). Thus, a shock that caused a decline of 10% in exports to one of these three countries would have a negative impact of one tenth of a percentage point on the Euro zone's GDP. There would only be a significant impact (three tenths of a percentage point) if there were a synchronised 10% drop in exports in all three countries, which is not so likely in our view. Of the major Euro zone countries, the most significant effect by far would be on Germany. Obviously this is a simplification, since there could be an indirect impact on investments in addition to the spread of the effects through financial channels. On the other hand, lower demand from some of the most important emerging countries (mainly China) could have a dampening effect on commodity prices that would mitigate the negative impact on growth. If we limit the analysis to China, which has the highest percentage of exports from the Euro zone, using a simulation of the Oxford Economics Forecasting model, we have estimated that a hard landing scenario for Chinese GDP to 5% in 2014 (instead of 7.5% according to official estimates), would have an impact of -0.1% on GDP growth in the Euro zone after a year (the simulation is performed by applying a 5% shock to fixed Chinese investments in the second quarter of this year, assuming an additional shock on demand for imported goods of -3% in the first four quarters). The negative effect of a decline of exports to China is partly offset by an indirect drop in commodity prices, which supports domestic demand and fosters a marginally more accommodating monetary policy. The impact on inflation would be -0.15%.

With regard to the second point, our scenario assumes an average EUR/USD exchange rate for 2014 that differs little from the average of 1.33 for 2013. However, if the exchange rate were to remain at current levels (1.38) for the rest of the year, this, in our estimates, would have a negative impact of -0.3% on GDP if the shock is permanent. The actual impact could be lower if any monetary policy reaction by the ECB is incorporated. In any event, the impact on GDP would be significant, and potentially greater than that from a major decline in exports to certain of the main emerging markets.

Exports to China, Russia and Turkey as a percentage of GDP for the Euro zone and four major countries

	China	Russia	Turkey	C+R+T
EA	1.1%	0.8%	0.6%	2.5%
GER	2.0%	1.3%	0.7%	4.0%
FRA	0.7%	0.4%	0.3%	1.4%
ITA	0.6%	0.6%	0.6%	1.8%
SPA	0.4%	0.3%	0.5%	1.1%

Source: Intesa Sanpaolo table from Eurostat data

Impact of the exchange rate on GDP and CPI after a year if the EUR/USD rate remains at current levels (1.38) or goes to 1.40/1.45 on average in 2014 (instead of 1.33, as in our base scenario)

	GDP	CPI
EUR/USD=1.38 (on average in 2014)	-0.3	-0.4
EUR/USD=1.40 (on average in 2014)	-0.4	-0.5
EUR/USD=1.45 (on average in 2014)	-0.8	-1.0

Source: Intesa Sanpaolo table using Oxford Economics Forecasting model

Inflation: oh where art thou?

Anna Maria Grimaldi

Euro zone inflation fluctuated between 0.7 and 0.8% between October 2013 and February 2014, down from 2.0% a year earlier (see Fig. 1). The dynamics of the consumption deflators mimic those of the CPI and confirm the downward trend in prices across the euro area (see Fig. 3 and 4). In our central scenario, inflation should gradually rise from 1.1% in 2014, to 1.3% in 2015 and 1.5% in 2016. Our projections are in line with the latest ECB forecasts. We still believe that the risk of deflation in the Euro zone average is low, but risks to consumer prices are clearly tilted to the downside, and we cannot rule out that inflation may hover below 1.0% in 2014 and 2015 should the exchange rate remain at current levels and/or the cyclical recovery prove to be less pronounced than generally assumed, especially in the peripheral Euro zone countries.

Roughly 50% of the fall in inflation in 2013 is explained by slowing energy prices, but the deceleration in core prices accounted for a good 30%, whereas it had only been 6% in 2009 (see Fig. 1). Core inflation, which is calculated on the index net of energy, food and tobacco, trended downward in the last six months from 1.3% in June to 0.7% in December, an all-time low in the history of monetary union, and then rose back to 1.0% in February. Stripping out the contribution of taxes, core inflation fell to 0.6% in January compared with 1.0% in January 2013 an unprecedented level on our records. According to our projections, the trend in consumer prices net of energy, food, taxes and administered prices[1], defined as "cyclical" inflation, was still +0.6% in February. The drop in core inflation at constant tax rates from July 2012 to January 2014 was largely due to the peripheral countries (see Fig. 5), especially Spain and Italy[2], but significant decreases also occurred in France and the Netherlands (see Tab. 1). Thus, there is a downward trend in underlying inflation net of taxes in all major countries except Germany.

Table 1 - Core inflation at constant tax rates for the Euro zone and major countries

	Ger	Bg	Nl	Ie	Euro zone	Ita	Fra	Spa	Pt	Gr
15/06/12	1.4	1.8	2.0	0.6	1.4	1.9	1.4	0.8	-0.3	-1.4
15/03/13	1.3	1.3	1.5	0.2	1.0	1.5	0.8	0.0	-0.5	-1.4
15/12/13	1.1	1.6	1.5	0.3	0.8	0.6	0.9	-0.1	0.1	-2.0
15/01/14	1.6	1.7	1.0	0.6	0.6	0.5	0.1	0.0	-0.2	-0.5
Change 1Q14/ 2Q12	0.2	-0.2	-1.0	0.0	-0.7	-1.4	-1.3	-0.9	0.1	0.9

NB: For Ireland, Eurostat does not publish indices at constant tax rates; the measure is inflation net of energy, food and tobacco.
Source: Intesa Sanpaolo chart from Eurostat data

The ECB believes that the risk of Japanification in the Euro zone is unfounded

The slowdown in inflation in the Euro zone continues to fuel fears of a *Japanification* of the Euro zone. The ECB repeatedly stressed that the Euro zone's position is very different from that of Japan in the early 1990s, and that the risk of real deflation is low because:

1) the fall in inflation is mainly explained by global factors, and in particular, the drop in commodities prices (see Fig. 1);
2) the drop in prices is more pronounced for non-energy goods than for services (see ECB Bulletin, March 2014, Box on pages 61-62): in a global market, the prices of goods are more affected by external factors than those of services which are typically produced locally;

[1] Eurostat provides energy, food and tobacco indices at constant tax rates, and thus core inflation can be calculated at constant tax rates. The contribution of administered prices to core inflation is estimated on the basis of the Eurostat index for administered prices net of tobacco.

[2] In recent months, the drop in core inflation in Italy was partly driven by a sharp drop in communications prices.

3) the drop in prices of non-energy goods and services is more pronounced in the peripheral countries than in core countries, and this reflects the rebalancing process in the periphery, which the ECB stresses is, by nature, a temporary phenomenon;

4) the percentage of non-energy goods and services with an annual decrease in prices is no higher than in the past (see ECB Bulletin, March 2014, pages 61-62);

5) inflation expectations derived from the ECB survey of professional forecasters are stable at 1,9%. At the last press conference, Draghi reiterated that the ECB finds this measure reliable;

6) the ECB has taken appropriate action in the past;

7) the AQR will contribute to restoring the mechanism for transmitting monetary policy.

Below we attempt to assess the risks of a prolonged period of disinflation in the Euro zone average.

As the ECB noted in its March bulletin, there is certainly a global component in the explanation of inflation net of energy in the Euro zone, since typically a shock to commodity prices or exchange rates affects domestic prices with a lag. Also, the percentage of goods and services with a decrease in prices is actually no higher than in the past (see Figs. 8 and 9)[3] but the percentage of services with a change in prices of less than 1.0% is the highest since 1999, and this suggests that distribution is moving toward the low end due to domestic factors.

The drop is more pronounced for domestic prices in peripheral countries, and is related to the internal rebalancing which will not end quickly

The more pronounced drop in prices for non-energy goods and services in peripheral countries than in core countries is certainly due to the internal rebalancing which we hope is indeed temporary, as the ECB claims, but which will not be over quickly. The disinflation in labour costs in peripheral countries is set to continue. In 2013, the cost of labour dropped on average from 1.9% to 1.4% yoy, about a point below the average for the previous ten years. In 4Q of last year, average Euro zone labour costs accelerated to 1.4% yoy from the previous level of 1.1% yoy. The acceleration in 4Q was driven by a sharp increase in labour costs in Spain, to 3.1% yoy, from an average of -0.3% yoy over the three previous quarters. Labour costs also rose at year-end 2013 at a faster pace in Ireland (0.7% yoy from the previous level of -1.7% yoy) and Italy (1.6% yoy, up from 0.9% yoy). The acceleration in Spain, Ireland and Italy is due to steadier salaries growth. Thus, at the end of 2013, labour costs again rose more in peripheral countries (1.9% yoy up from an average of 0.2% yoy over the four previous quarters) than in central countries (1.3% yoy from 2.0% over the four previous quarters). Yet, the acceleration may be a temporary phenomenon as heavy excess labour supply should keep salaries under control in future quarters (see Fig. 10).

Market inflation expectations are moving downward

Stable inflation expectations are crucial for the determination of prices. Five years ahead inflation expectations, from the ECB survey of professional forecasters, are stable at 1.9%, but the frequency distribution is shifting toward the low end (see Fig. 12). The EU Commission's consumer survey shows a downward revision of price expectations for the coming twelve months (see Fig. 13). Perhaps even more significant is the drop, albeit gradual, in market expectations, that can be traced from inflation swaps (see Fig. 17).

[3] Since the ECB has started monitoring how the price distribution for goods and services is moving, we have calculated the percentage of non-energy goods and services with a price change of less than 1.0% and with a decrease, starting with 148 sub-indices. Our results show that the percentage of non-energy goods with a decrease has risen to 30% and the percentage of goods with changes of less than 1.0% is around 40%, but similar levels are not unprecedented. The ECB obtains higher percentages since the calculation of percentages probably starts with pure indices. The trend over time, however, is comparable.

Thus, the risk that disinflation will become more widespread and that price expectations over the medium term will start to move is not insignificant. Much will depend on changes in external factors such as commodity prices and exchange rates, and the strength of the recovery in the coming months.

What are the risks from external factors?

Going forward, external risks affecting consumer prices seem limited: commodity prices are still low despite recent upward pressure, partly caused by the crisis in Ukraine. The recent rise in agricultural commodity prices, which was associated with the weather, could push food prices higher, but note that prices for agricultural products in Europe are determined to a large extent by common agricultural policies.

Information on selling prices intentions in industry, services, construction and retail from the EU Commission's survey, and PMI prices charged indices, suggests that downward pressure at the top of the production chain has come to a halt (see Fig. 14).

ECB estimates for March are based on a projected exchange rate of 1.36 for the forecasting horizon

In our opinion, the real risk from external factors is from exchange rate trends. Between July 2012 and January 2014 the effective EUR exchange rate rose by 10%. In its March 2014 bulletin, the ECB notes that an appreciation of 10% in the effective exchange rate depresses inflation from goods by about four-tenths of a point after a year, and inflation from services by two-tenths of a point Using Oxford Economic Forecasting, we simulated the impact of a 10% appreciation in the effective exchange rate, and obtained the result of a 0.8% impact on consumer prices after a year, which is not far from the ECB estimate.

Our 2014-2016 inflation estimates are based on an effective depreciation of 6% in the exchange rate in 2014, and in the absence of such a correction, Euro zone inflation would be four-tenths of a point lower in 2014. The ECB's March estimates are based on a stable EUR exchange rate of 1.36 over the forecasting horizon. If the exchange rate stays at 1.39, this would imply an appreciation in the effective exchange rate of only 0.5% compared to the ECB's March estimates, with an insignificant impact on consumer prices. Thus, ECB inflation estimates do not seem to be subject to downside risks due to the exchange rate remaining at current levels.

ECB March inflation estimates envisage a return of annual consumer price dynamics to 1.7% at the end of 2016, and thus, are in line with the ECB target. However, core inflation is more sustained than overall inflation in ECB estimates, and significantly higher than would be suggested by a forecast based purely on mechanical factors or on the monthly seasonality observed over the last four years. Note that the rise in ECB core inflation estimates is not even justified by rising taxes. Note that in March, the ECB revised down its core inflation forecast for 2014 by two-tenths of a point. It seems to us that the ECB is underestimating the impact of the considerable slack in the economy on domestic price trends.

Table 2 - Main assumptions on which the ECB's March inflation estimates are based for Intesa Sanpaolo

	2013	2014	2015	2016	2016 T4
USD/EUR Mar 14 BCE	1.33	1.36	1.36	1.36	
USD/EUR Dec 13 BCE	1.33	1.34	1.34	1.34	
USD/EUR ISP	*1.33*	*1.33*	*1.28*	*1.28*	
Nom eff exch rate Mar 14 BCE	3.8	1.6	0.0	0.0	
Nom eff exch rate Dic 13 BCE	3.7	0.8	0.0	0.0	
Nom eff exch rate ISP	*3.7*	*-6*	*0.0*	*0.0*	
Oil Mar 14 BCE	108.8	105.8	101.1	96.9	
Oil ISP	*108.8*	*106*	*104*	*103*	
Headline inflation Mar 14 BCE	1.4	1	1.3	1.5	1.7
Headline inflation Mar 14 ISP	*1.4*	*1.1*	*1.3*	*1.5*	*1.6*
Core inflation Mar 14 BCE	1.1	1.1	1.4	1.7	
Core inflation Mar 14 ISP	*1.1*	*0.9*	*0.8*	*1.2*	
Core inflationestimates base solely on seasonal factors	*1.1*	*1.0*	*1.0*	*1.1*	

Source: ECB and Intesa Sanpaolo estimates

A return to growth is key for heading off deflation in Spain and Portugal

The key issue for core price dynamics is the speed and strength of the recovery, i.e. how quickly the output gap can be closed. On several occasions, the ECB has expressed scepticism over the existence in the Euro zone of a relationship between excess supply variables and the core inflation trend (see Economic Bulletin for November 2013). The ECB believes that only very large changes in the output gap can explain a portion of core inflation trends in the Euro zone, and that from a forecasting standpoint, it is not clear that the output gap provides a better explanation of core inflation trends than an autoregressive model.

However, it is hard to believe that the large output gap and salary devaluation under way in Spain, Portugal and Greece will not continue to put pressure on inflationary trends. Country level estimates of the relationship between core inflation at constant tax rates and the level of the output gap suggest that lags in the output gap and changes in the effective exchange rate provide quite a good explanation of core inflation trends net of taxes in Spain, Portugal, Greece and Ireland from 1997 to 2013, and in particular from 2008-2013. Meanwhile, the output gap is not as useful for explaining this relationship in Germany, France and Italy. In the case of Germany, one possible explanation is that the output gap is not large enough. In the case of Italy, an explanation can be found in the rigid downward path of salaries, which has also continued in the most recent period. The cut in labour costs in Italy is not comparable to the cut in other peripheral countries. Although rather rudimentary, the regressions suggest that if the output gap starts to close in the second half of this year, the risks of core inflation falling in negative territory would also diminish in peripheral countries.

Above and beyond considerations based on econometric estimates, perhaps what is truly important is to attempt to understand if there are the systemic conditions that would cause the Euro zone to enter into deflation. In his famous speech in November 2012 ("Making sure that it doesn't happen here"), Bernanke explained the conditions necessary to prevent deflation:

i) an adequate inflation buffer. In this regard, Draghi indicated that the November cut was intended to create an adequate inflation buffer. But for the moment, the cut has had a rather limited effect on both price and exchange rate trends;

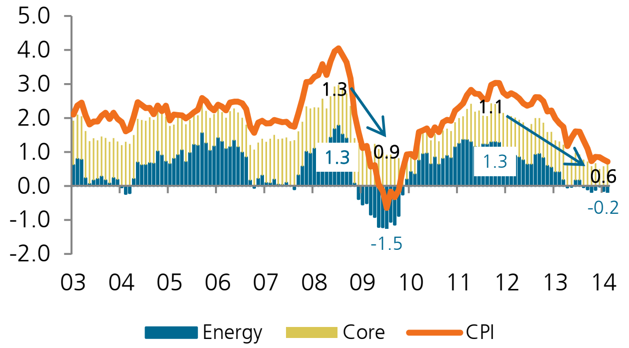
ii) a solid and well capitalised financial system. Banking union and AQR will be an important step once completed, but for now, the process is still at a preliminary stage, and even the

ECB acknowledges that in the short term the process of rebalancing budgets could have a restrictive effect on lending, which is at an all-time low;

iii) a central bank that takes preventive measures. In January, Draghi claimed that the situation in the Euro zone was quite different from that in Japan, partly because the ECB took preventive measures.

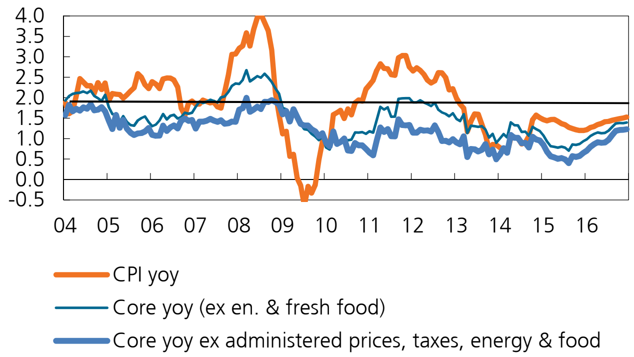
The impact of measures taken by the ECB over the last two years may show with a lag on lending and the economy. What is certain is that the inflation buffer is dwindling, and further preventive measures by the ECB might be necessary.

Fig. 1 - Falling inflation is mainly due to energy, but the slowdown core prices contributed more than in the past



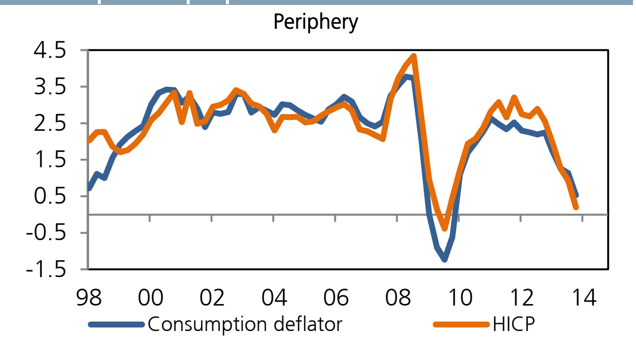
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 2 - Our central scenario projects falling core inflation until the beginning of 2015



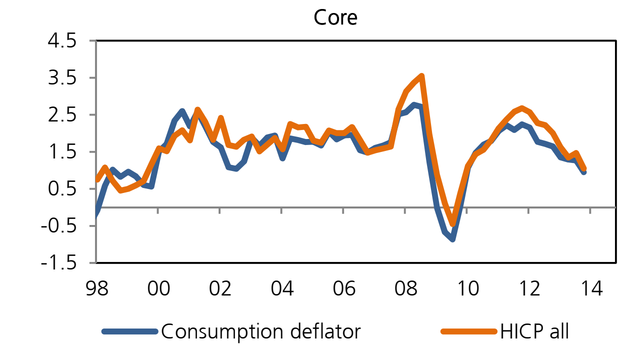
Source: Intesa Sanpaolo forecasts from Eurostat data

Fig. 3 - The consumption deflator confirms a higher fall in consumer prices in peripheral countries than...



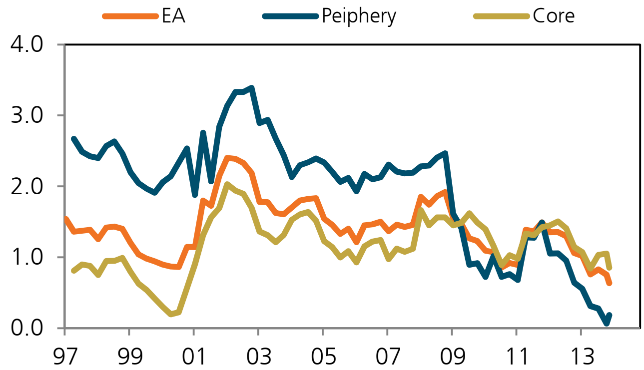
NB: Peripheral countries = Ita+Spa+Gr+Pt+Ire
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 4 - ... in central countries



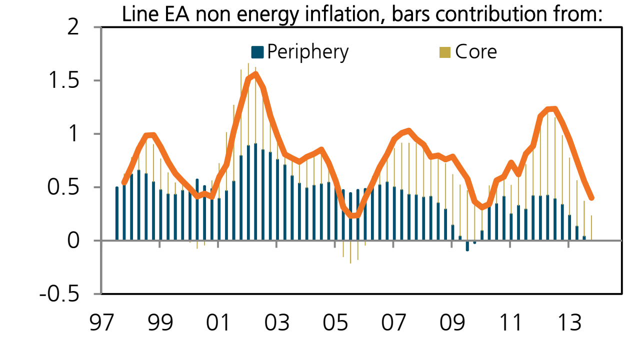
NB: Central countries = Germ +Fr+Neth+Bg
Source: Intesa Sanpaolo forecasts from Eurostat data

Fig. 5 - Core inflation net of taxes has slowed in both peripheral and central countries



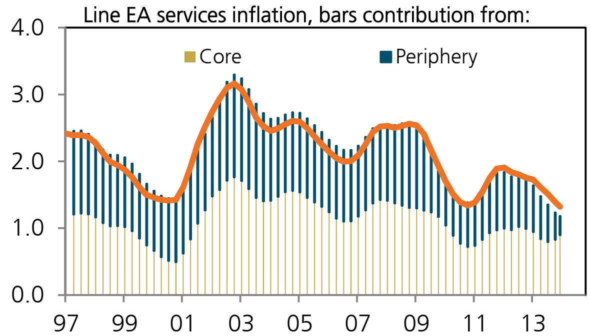
NB: Peripheral countries = Ita+Spa+Gr+Pt+Ire Central countries = Germ +Fr+Neth+Bg
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 6 - The price of non-energy goods fell more in peripheral countries than in central countries



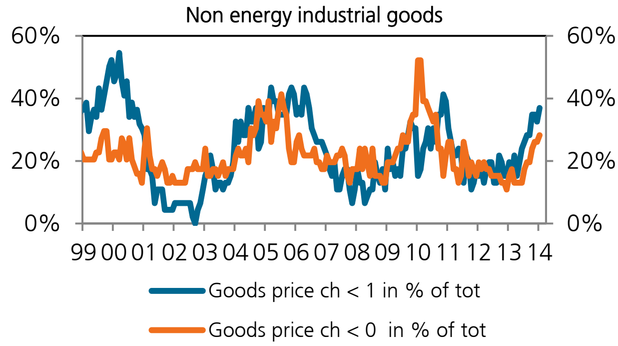
NB: Peripheral countries = Ita+Spa+Gr+Pt+Ire Central countries = Germ +Fr+Neth+Bg
Source: Intesa Sanpaolo forecasts from Eurostat data

Fig. 7 - The price of services most affected by domestic factors slowed more in peripheral countries



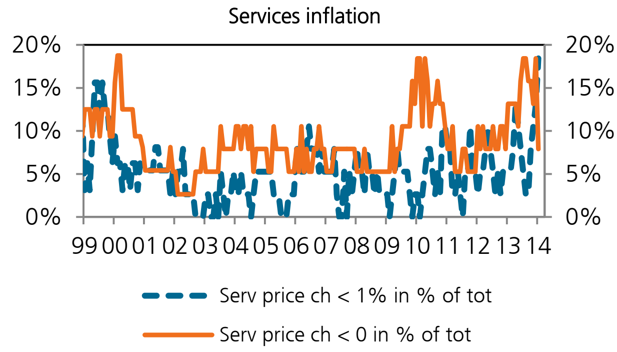
NB: Peripheral countries = Ita+Spa+Gr+Pt+Ire Central countries = Germ +Fr+Neth+Bg
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 8 - In the main Euro zone, the percentage of goods with prices in negative territory is no higher than in the past, but…



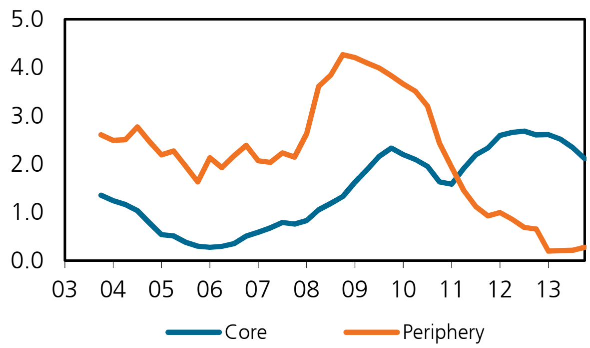
NB: Percentages are calculated on 46 non-energy goods sub-indices.
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 9 - … for services, the percentage with changes of less than 1.0% has never been so high



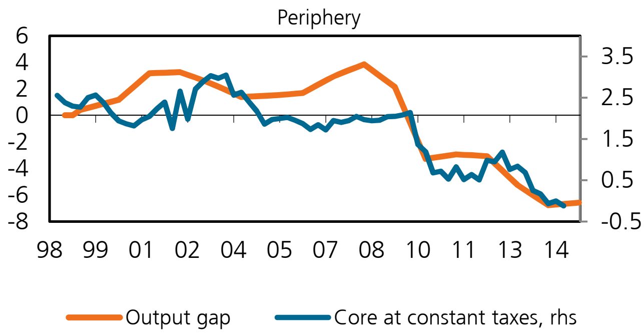
NB: Percentages are calculated on 38 service sub-indices. Source: Intesa Sanpaolo chart from Eurostat data

Fig. 10 - The (temporary) process of domestic salary reductions has not ended and will continue to keep labour costs low in peripheral countries



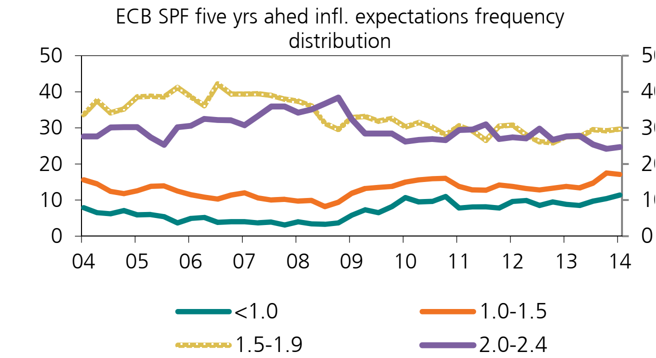
NB: 6-month averages. In 4Q13 the trend in labour costs in peripheral countries was stronger than in central countries. Peripheral countries = Ita+Spa+Gr+Pt+Ire Central countries = Germ +Fr+Neth+Bg
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 11 - The extent and speed of the recovery will strongly affect whether peripheral countries will succumb to deflation



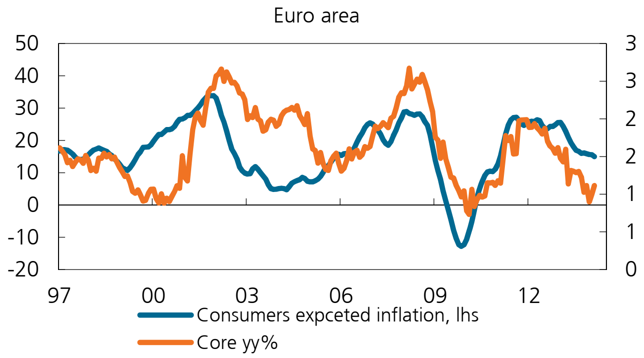
NB: The output gap is based on OECD estimates. Source: Intesa Sanpaolo chart from Eurostat data

Fig. 12 - Medium-term expectations from the professional forecasters' survey are 1.9% on average, but the frequency distribution is shifting toward the short end



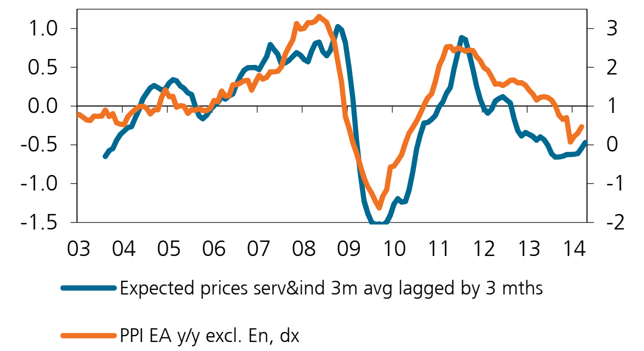
Source: ECB Survey of Professional Forecasters and Intesa Sanpaolo chart

Fig. 13 - Household expectations are slowly sliding but are not at a historical low



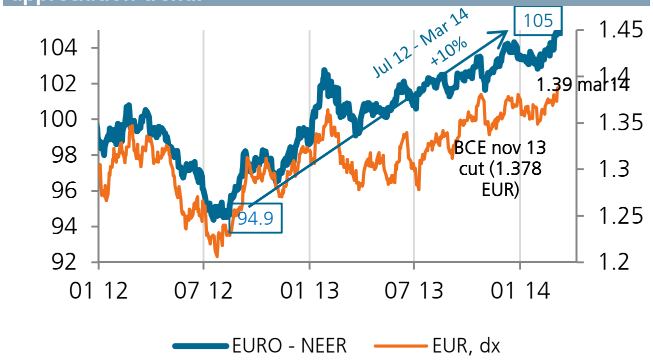
Source: Intesa Sanpaolo chart from ECB data

Fig. 14 - Limited pressure further up the production chain net of energy



NB: Expectations of prices applied: Average of indices for prices applied in industry, services, retail trade and construction from EU Commission survey. The series are standardised. Source: European Commission, Eurostat and Intesa Sanpaolo calculations

Fig. 15 - But the EUR remains at high levels and constitutes the main risk for the CPI trend in the next 6-12 months. A cut in the refi rate might not be enough to halt the exchange rate appreciation trend.



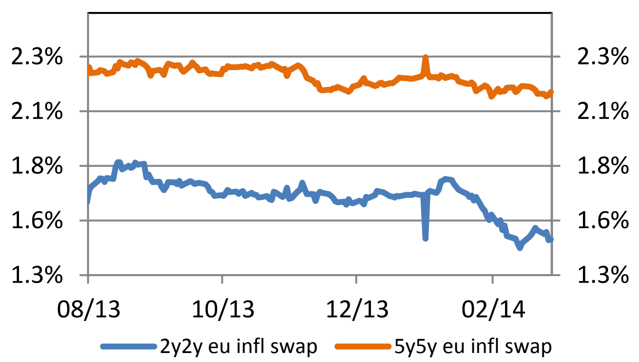
Source: Intesa Sanpaolo chart from ECB data

Fig. 16 - Response of inflation to a 10% effective appreciation in the EUR exchange rate after a year

	impact of +10% effective exchange rate one year after shock
BCE	-0.6
Oxford Economic Forecasting	-0.8

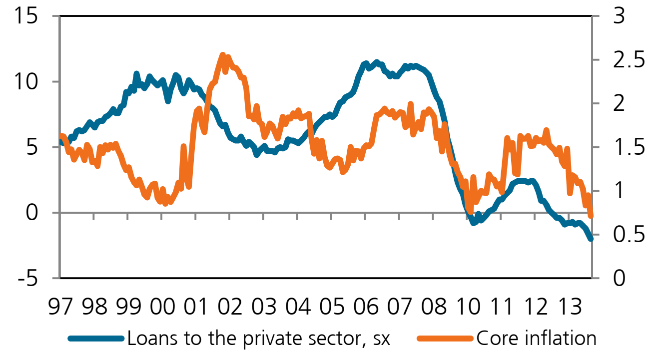
Sources: ECB: March 2014 Bulletin and ECB and Oxford Economic Forecasting

Fig. 17 – Market revises down 2-year inflation estimates



Source: Intesa Sanpaolo chart from Bloomberg data

Fig. 18 - The steep fall in lending is not a reassuring sign for consumer price trends



Source: Intesa Sanpaolo chart from ECB data

ECB: will verbal interventions be enough?

Anna Maria Grimaldi

In line with our assumptions in the December macroeconomic outlook, the ECB left the refi rate unchanged at 0.25% in 1Q14 and did not introduce new unconventional monetary policy measures. However, during the press conference in March, Draghi attempted to strengthen *forward guidance*, stressing that rates will remain at current levels or lower even when the economy in 2015 resumes above-potential growth (1.3% according to the latest OECD estimates) and inflation approaches 2%, i.e. at the end of 2016 according to ECB estimates. The *guidance* is still qualitative, but introduces a specific reference to the ample output gap, and thus aligns ECB's communication with that adopted by the Bank of England's (12 February 2014) and brings it closer to that of the Federal Reserve.

The message form the March press conference, which markets did not seem to fully appreciate, is that the ECB is committed to maintaining rates at current levels or lower at least until 1Q16. The measures of excess supply considered by the ECB[4] (output gap and unemployment gap as estimated by the European Commission, OECD and IMF; and survey-based measures of excess capacity due to lack of demand or excess of labour) indicate that that unused capacity will remain ample in the Euro zone also in 2015-16 (see figs. 1 and 2). The ECB has therefore signalled that rates in the Euro area will remain low for longer than those of the Fed and BoE, which, in all probability, will start to rise from 2015.

The issue is whether the *guidance* on rates is sufficient or whether the ECB should do more to maintain the still highly accommodative monetary policy conditions and/or restore the monetary policy transition mechanism in the Euro zone. According to Draghi, the forward guidance "*creates a de facto loosening of monetary stance over the projection horizon…as it implies that short-term real rates, which are negative today, will become even more negative in the foreseeable future… because our policy rates will remain low or lower in nominal terms, while inflation is projected to gradually pick up.*" Draghi stressed several times that the AQR is a crucial step for the prospects of recovery in the Euro zone as, typically, banks with re-capitalisation needs are the ones which do not transfer the decline in monetary policy rates to lending rates. Draghi indicated that "*as deleveraging and the improvement in the financial sector continue, we should see, as early as 2014, an improvement in monetary policy transmission and this should be reflected in widening interest rates differential between Europe and the United States and hence on the exchange rate*". The ECB, with Constancio and Draghi,

[4] See the November 2013 Bulletin, pages 89-94.

has, however, recognised, on other occasions, that AQR could have a restrictive effect on lending in the short-term and therefore on domestic demand.

Draghi talks suggest that all the ECB would have to do would be to remain comfortably seated and "watch the river flow". Indeed, the March ECB staff estimates do not justify further monetary policy moves since they show an acceleration in the Euro zone economy from 1.2% in 2014 (revised up by a tenth of a percentage point compared with the December estimates) to 1.5% in 2015 and 1.8% in 2016 and a return of inflation to 1.7% in 4Q16, in line with the target. The unemployment rate is seen as stable, falling to 11.4% in 2016 from 11.9% in 2014. Yet, Draghi conceded that "*if any downside risks to this scenario appear, we stand ready to take additional monetary policy measures that ensure our mandate is fulfilled.*"

Table 1 – Main ECB macro forecasts versus Intesa Sanpaolo and consensus Economics

	ECB estimates: March 2014				Intesa Sanpaolo (consensus, if available)		
	2013	2014	2015	2016	2014	2015	2016
PIL	-0.4	1.2↑	1.5	1.8	1.1 (1.1)	1.3 (1.4)	1.6
Disoccupazione %	12.1	11.9	11.7	11.4	11.9 (12.0)	11.7 (11.7)	11.6
IPC a/a%	1.4	1.0↓	1.3	1.5	1.1 (0.9)	1.3 (1.3)	1.5
IPC Core a/a%	1.1	1.1↓	1.4	1.7	0.9	0.8	1.2
Ipotesi su EUR*	1.33	1.36	1.36	1.36	1.34 (1,34)	1,28 (1.30)	1,27 (1,31)

Note: the arrows indicate revisions down ↓ or up ↑. *Intesa Sanpaolo and Consensus exchange rate forecasts are for June 2014, March 2015 and March 2016. Source: ECB, Consensus Economics and Intesa Sanpaolo estimates

Given the reference to the explicit ECB reference to the ample output gap in the economy, we have used a simple Taylor rule, with the inflation path and employment gap based on ECB staff estimates, to assess what the appropriate path for policy rates would be. For the employment gap we have used the ECB unemployment forecast, and the OECD estimates for the natural rate (2014: 10.2 and for 2015 the 2005-2012 average: 9.6%). This exercise points to rates of approximately 100 bps lower until the end of 2015. Needless to say, a Taylor rule for the peripheral countries would indicate significantly lower rates than those in force since the start of 2012 (see figs. 3 and 4).

Moreover, the ECB announcement at the March meeting disappointed markets somewhat. Following the meeting, 6 and 12-month Euribor futures and the EONIA OIS have risen (see fig. 5); the Euro rose to 1.3934, from 1.3735 before the meeting. Draghi's statements, a week after the March meeting, "*that the Euro is becoming increasingly relevant in the assessment of the inflation outlook*" calmed money markets, but had only a limited impact on the currency. The ascent of the EUR was only curbed by the FOMC's new forecasts of more aggressive rises in the Fed funds rate (to 1.0% at the end of 2015 and to 2% at the end of 2016) compared with the December estimates. By contrast, this slightly revived the pressure on monetary rates. In the past week money markets rates have declined again. On balance the ECB guidance managed to keep the short-end of the yield curve well under check. The European Commission monetary conditions (see fig. 6) indicated more restrictive conditions in January and February than at the end of 2013 due to the appreciation of the real effective exchange rate. The risk is that if the exchange rate actually were to depreciate, monetary conditions would become more restrictive anyways, should ECB guidance fail to keep money market rates and inflation expectations under control[5]. Real two-year rates, which can be derived from swaps, have already risen in the Euro zone since November 2013, while they have remained unchanged in the United States. The explanation can be found in the fall, albeit gradual, in two-year inflation expectations (see figs 7

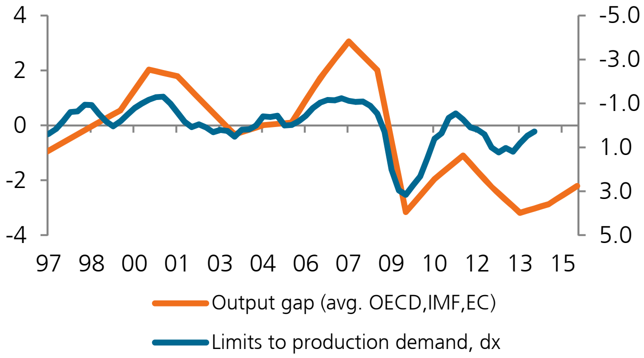
[5] The rule of thumb is that an increase in short-term rates reduces inflation by 0.3%, while depreciation in the effective exchange rate of 5% (as implied in the consensus estimates if it is assumed that the other Euro crosses remain at current levels) causes inflation to increase by approximately three-tenths of a percentage point. The impact on GDP of an increase of 100 bps in short-term rates is approximately 0.8% after one year, while depreciation in the exchange rate of 5% only has an effect of 0.3%.

and 8). The market essentially believes that the ECB is underestimating the risk of prolonged disinflation.

We do not, therefore, rule out the possibility that the ECB might do more in the coming months. Draghi clarified the conditions necessary for further monetary policy intervention: 1) an undesirable increase in money market rates; and/or 2) a worsening in the inflation scenario. It would therefore be appropriate to monitor: 1) the trend in money market rates; 2) any downside surprises on growth relating to ECB staff estimates, since inflation depends on the speed and strength of the recovery; 3) the trend in the unemployment rate to see whether the employment gap is closing at the speed implied in the staff estimates; 4) inflation expectations. We deem it unlikely that the ECB will react to a month of weaker-than-expected figures.

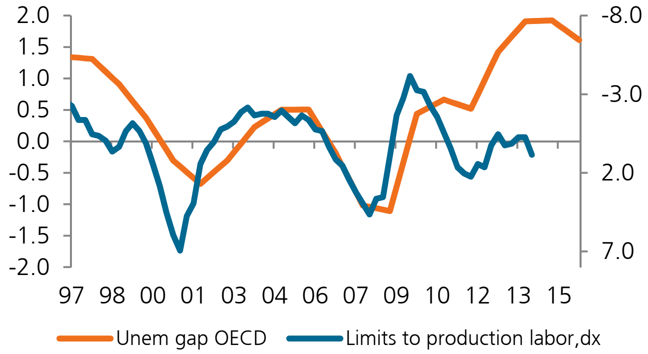
In conclusion, we think that the ECB will keep rates at current levels until at least the beginning of 2016, but it is possible that it may be forced to do more. If the upward trend in money market rates were to become more marked and verbal invention proved insufficient to convince the markets, the ECB could trim the REFI rate to 0.10%; in the event of downward surprises on growth and inflation, the ECB could suspend the sterilization of the SMP and cut the deposit rate and, only as a last resort - and if there is a clear risk of deflation - proceed with a securities purchase programme.

Fig. 1 – The ECB takes into account the output gap and/or ...



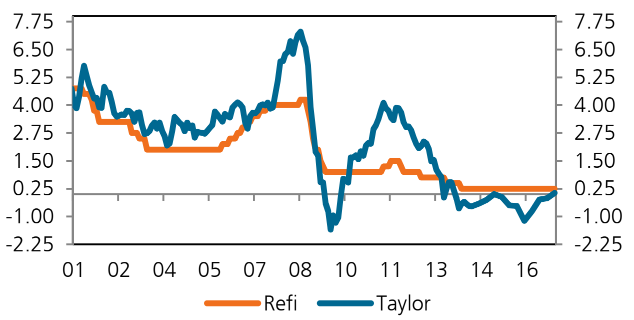
Note: The figures for the output gap are interpolated from the annual estimates of international institutes. Source: OECD, IMF, European Commission

Fig. 2 - ... the unemployment gas which will still be wide even after 2015



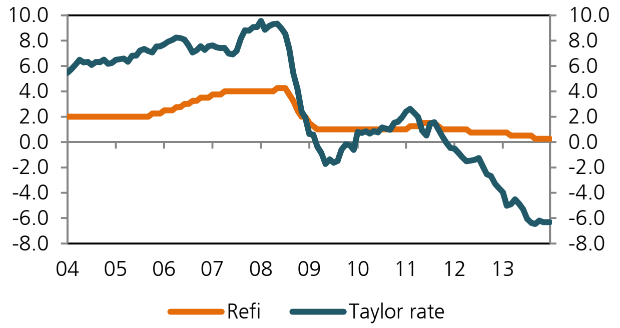
Note: See graph on the left. Source: OECD, IMF, European Commission

Fig. 3 – The Taylor rule, with ECB estimates of inflation and unemployment gap , indicates rates lower by approximately 100 bps until the end of 2015 and zero at the end of 2016



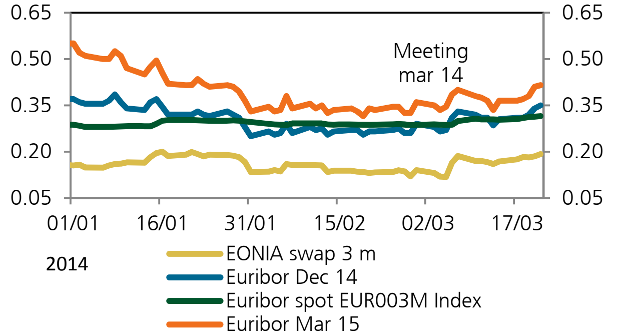
Source: Bloomberg ECB staff projections. The unemployment gap is estimated on a quarterly basis from ECB unemployment estimates and the unemployment rate

Fig. 4 – Needless to say, the Taylor rule indicates that rates in peripheral countries are not appropriate



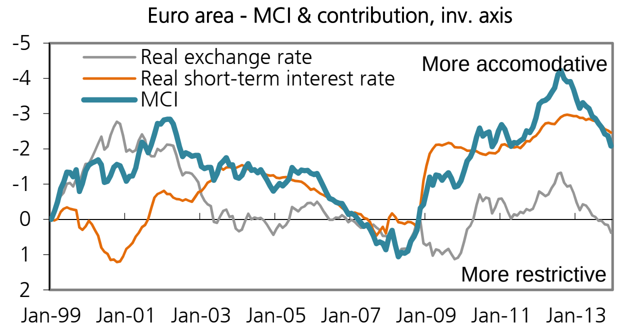
Source: Bloomberg

Fig. 5 – Money market rates under control until the ECB March meeting and then started to rise: the movement was cemented by the FOMC announcement



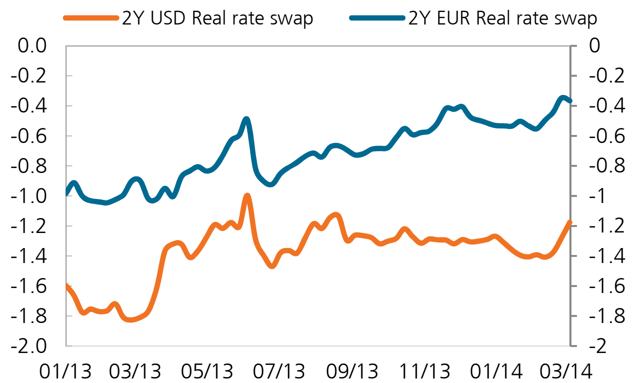
Source: Intesa Sanpaolo charts from Datastream data

Fig. 6 – Monetary conditions in the Euro zone became clearly more restrictive in the last three months due to the appreciation of the Euro, but now the risk is that effective rates will also rise



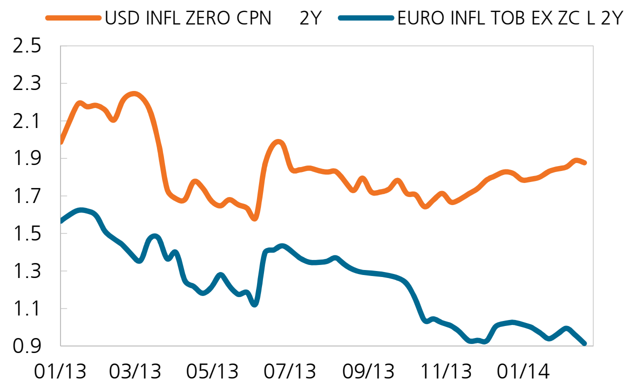
Source: Intesa Sanpaolo charts from European Commission data

Fig. 7 – The real two-year short-term rates rose in Europe but remained stable in America



Source: Intesa Sanpaolo charts from Bloomberg data

Fig. 8 – The increase is explained by the fall in short-term inflation expectations in the Euro zone



Source: Intesa Sanpaolo charts from Bloomberg data

Germany: *Andante con Brio*

Anna Maria Grimaldi

The recovery in Germany is well under way: GDP is expected to grow by 1.8% this year and by 2.0% in 2015 (1.8% net of calendar effects), therefore at a faster pace than the latest estimates of potential growth. The recovery will be driven by the reacceleration of private spending, and in particular by an expansive industrial investment cycle, given the strong increase in the orders of capital goods, the high utilization of production capacity, still markedly accommodative financial conditions, and reduced political uncertainty. The German recovery will have a positive fallout on the rest of the euro area, and in particular on Holland, France, and Italy. Risks to the outlook are still skewed to the downside, but even a sharp slowdown in the emerging economies is not expected to derail the recovery.

Growth in Germany will accelerate, according to our estimates, from 1.8% this year to 2.0% (1.8% net of calendar effects) in 2015, above the most recent potential GDP growth projections (1.4% from the Bundesbank). Our assessment of Germany's outlook is broadly unchanged compared to six months ago when we forecasted growth of 1.7% for 2014 and 1.8% for 2015. The fundamentals remain solid and should allow the economy to weather well potential negative shocks. In particular, the public sector, households and companies are not heavily indebted. The European Commission's in-depth review of Germany from March 2014 concluded the country's imbalances are not excessive. However, Germany needs to prevent its current account surplus increasing further. That said, it is unlikely that a highly expansionary fiscal policy could create positive spill overs for the rest of the Euro zone. The IMF, in its latest Article IV, emphasises that a 1% increase in German domestic spending typically has an impact of just 0.2% on the rest of the Euro zone. The countries that would benefit the most are Austria, the Czech Republic and the Netherlands, given the close trading links. In its annual report, the Bundesbank openly criticised pressures to stimulate German domestic demand to help correct macro imbalances within the Euro zone, stressing that German exports will slow as exports of other Euro zone countries become more competitive. The Bundesbank also objected the introduction of a national minimum wage and the reduction in the retirement age and stressed the measures could damage employment growth and competitiveness in the medium term.

The risks to the growth outlook are still tilted to the downside, and could come from less sustained growth in global demand, in particular in emerging countries. Germany exports around 2% of its GDP to China, 1.3% to Russia and 0.7% to Turkey. A sudden deceleration in the “hottest” emerging countries could, therefore, have a considerable effect on German growth prospects, but would not derail the recovery (For further details of the impact of a Chinese hard landing on German growth see the *Weekly Economic Monitor* from 21/02/2014). Risks of downward surprises from domestic demand are more limited as the outlook for real disposable income is positive, financial conditions are expected to remain highly expansionary and there is generally less political uncertainty which is a positive for spending decisions.

GDP growth will average 0.4% qoq in 1H14

Short-term outlook. The main growth drivers in mid-2013 were consumer spending (1.0%) and construction investment. Fourth-quarter GDP grew by 0.4% qoq following 0.3% qoq in the summer months, driven by 2.6% qoq growth in exports largely on the back of recovering demand in the rest of the Euro zone. The IFO and PMI surveys, as well as industrial orders and output figures for January, suggest that GDP growth will at least match that of the fourth quarter: +0.4% qoq. GDP growth will be increasingly driven by internal demand than by net exports in 2014-15. The January figures for international trade showed a modest slowdown in exports compared with the final months of 2013. However, the recovery in the global PMI and the recovery in orders highlighted by the IFO and PMI manufacturing surveys in January, both for countries outside the Euro zone and the rest of the Euro zone, suggest that exports will remain firm in the months ahead. Over the forecasting horizon, we expect export growth of 4.1% in 2014 and 4.4% in 2015, up from 1.0% in 2013. Accelerating exports and a recovery in investment spending (see below), typically with a high import component, should favour import growth of 5.5% in 2014 and 5.7% in 2015. Thus, net exports should make a negative contribution as early as 2014 at -0.2%. The current account surplus will fall only slowly, from 7% in 2013 to 6.3% in 2015.

Towards a more robust cycle of corporate investment

Accelerating export growth, high production capacity utilisation in the manufacturing sector (now in line with the historical average) and financial conditions that are still expansionary, should support corporate investment growth over the forecasting horizon. The IFO industrial investment survey indicates that around 66% of companies interviewed intend to increase investment spending in 2014. These results suggest a rise of 9% in spending in nominal terms, which corresponds to a spending increase of 8% in real terms, according to the research institute. Another factor supporting corporate investment spending is the reduced political uncertainty in the Euro zone. The political uncertainty index for the Euro zone, as calculated by the research institute *Economic Policy Uncertainty*, helps explain the trend in investment spending in Germany in the most recent cycle. The Bundesbank, in its December bulletin, notes that corporate investment could be lower in Germany than in previous cycles, as improved competitiveness in other Euro zone countries could make it more profitable for German firms to invest in those countries. In addition, German companies may find it more cost-effective to move a part of their production to locations that are closer to end consumers, thereby increasing investment outside Germany. It is therefore possible that the recovery in investment spending will be less marked than in previous cycles (on average 7.9% between 2004 and 2008). Over the forecasting horizon, we expect capex to hover at 4.4% in 2014 and 5.0% in 2015.

Residential construction still growing strongly. No sign of a bubble at the moment

In the face of a negative contribution from net exports, internal demand should grow by 1.7% in 2014 and 2015 (from 0.16% in 2013). The expansion of residential construction will most likely continue at a fast pace also in 2014-15. Residential building permits and orders grew at a sustained pace at the end of last year, while production capacity utilisation touched levels not seen in the past 20-years. On an annual basis, we forecast construction investment growth of 4.2% in 2014, in part thanks to sustained growth in the second half of 2013. In 2015, we expect construction investment to grow by 2.5%. House prices rose 8% in real terms between 2008 and 2013, whereas the Euro zone average fell by 10%. Worries that a bubble is developing in the property sector seem overblown to us. Investment in residential construction increased from a low of 4.8% of GDP in 2008 to 5.2% in 2013 (according to European Commission estimates). The same ratio for the rest of the Euro zone, excluding Germany, fell in the same period from 6.8% to 4.9% of GDP. The figure for residential construction investment in Germany is therefore in line with the Euro zone average. In addition, the housing affordability index (ratio of prices to disposable income) remains much lower than in other developed countries.

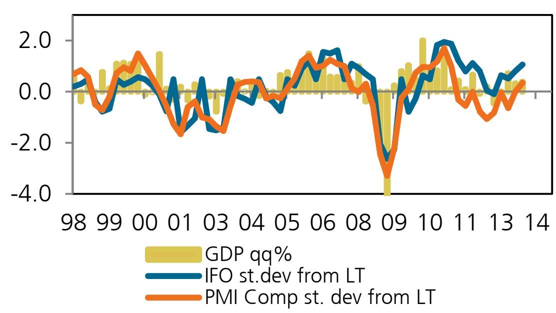
Consumer spending rising rapidly. Real income growing by 3%

Consumer spending should be supported by real disposable income growth of 1.3% over the forecasting horizon. The utilization of labour in mid - 2013, was mainly achieved through an increase in the number of hours worked, although these dipped again at the end of 2013. The number of hours worked remains below the historical average, so the potential for a sustained rise in the number of employees is still limited. Job indices from the IFO survey suggest employment should still grow at a pace similar rate to that seen in 2014: 0.6-0.7%. Unemployment is expected to fall to 6.5% in 2015 from 6.8% at the end of 2013, as the increase in the workforce will remain limited, even with an influx of more than 300,000 immigrants, as estimated by the Bundesbank. The increase in contractual wages was around 2.4% in the last few months of 2013, down from 2.1% last June. On the basis of agreements finalised to date, wage growth could average 2.6%-2.7% in 2014 and 2015. Labour costs will rise by 2.7%-2.8% in 2014-15, in part due to reduced social security contributions. The introduction of a national minimum wage of EUR 8.5 per hour from 1 January 2015 should have a limited impact on aggregate wage costs initially, as the sectors where wages are currently lower than the minimum are not expected to fully implement the change until 2017. There is a possibility, in light of upbeat households' morale, that the increase in consumer spending over the forecasting horizon might exceed growth in real disposable income. We might therefore see a fall in the savings rate from 10.0% in 2013 to 9.5% in 2015.

Inflation fell by more than expected between the end of 2013 and the start of 2014 (1.2% in February from 1.4% in September). The main reason for the drop in inflation was the lower contribution from the energy component, although the increase in the prices of services slowed significantly to 1.0% from 2.5% the year before. Core inflation fell to 1.4% yoy from 2.3% yoy at the end of 2013. We believe that German inflation has already reached its minimum, and that the increased labour costs expected this year should push inflation towards 1.5%-1.6% at the end of 2014. We expect average annual inflation to be 1.4% both this year and next.

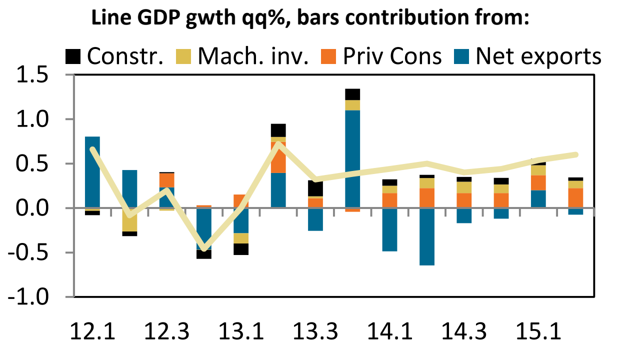
Public finances. Germany's outstanding management of its public finances will be confirmed over the next few years. In mid-March Schäuble unveiled the 2014budget and the 2015-18 fiscal plan. The budget will be structurally balanced already this year. From 2015 onwards, the borrowing requirement will be zero. In 2014, the borrowing requirement is estimated to be EUR 6.5Bn, the lowest by far in the last 40 years. Total expenditure should be around EUR 298.5BN, rising to EUR 327.2Bn in 2018. Priority measures in the coalition agreement provide for an increase in spending of EUR 23Bn, which should mostly be covered by higher tax revenues due to the cyclical recovery and the increase in excise duties. The fiscal plan provides for an increase in infrastructure investment spending to EUR 27Bn, around 10% higher than current levels. It also includes an increase of EUR 2Bn in pension spending by 2017, EUR 6Bn in education spending and EUR 3Bn in research spending. We forecast a balanced budget this year following an estimated deficit for 2013 of -0.1% of GDP. We expect public debt for 2013 to drop to 79.6% from 81% in 2012 and to fall to 75% of GDP in 2015.

The recovery is well underway



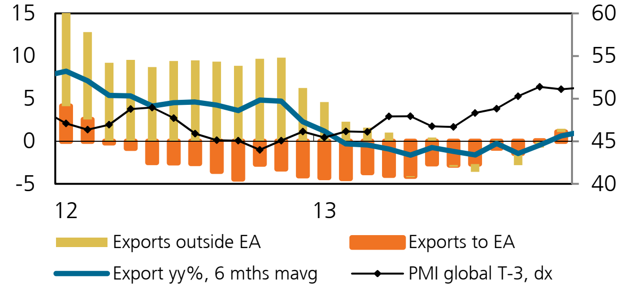
Source: Markit, IFO, FSO and Intesa Sanpaolo calculations

Strong acceleration in exports at end-2013, but from Q1 2014 domestic demand should take the lead



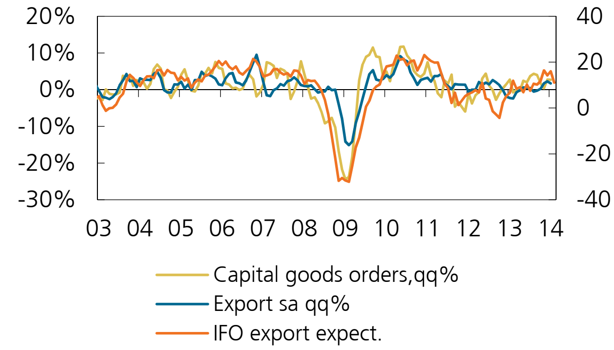
Source: FSO and Intesa Sanpaolo calculations

Sign of revival in Euro zone trade



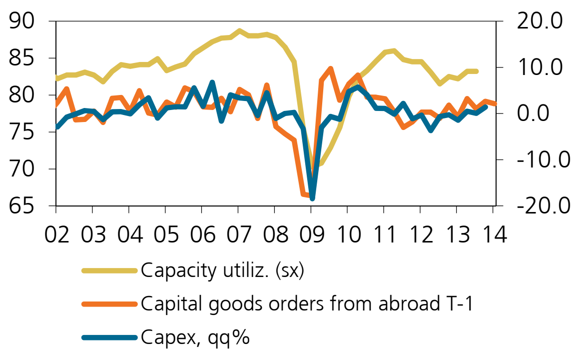
Source: Markit, FSO and Intesa Sanpaolo calculations

Surveys point to aaccelerating exports which together with…



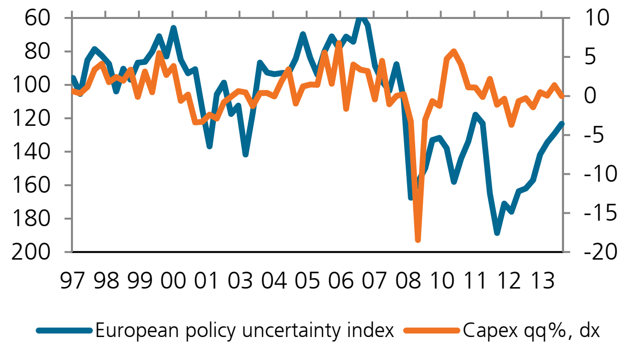
Source: IFO, FSO and Intesa Sanpaolo calculations

… high capacity utilization, and…



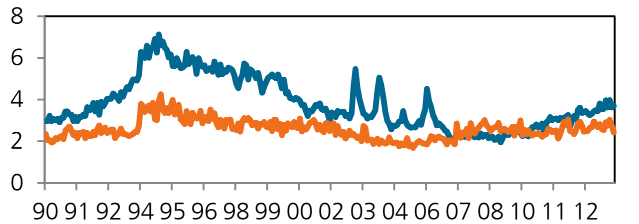
Source: FSO and Intesa Sanpaolo calculations

… less political uncertainty in the Euro zone, should favour a more buoyant capex cycle



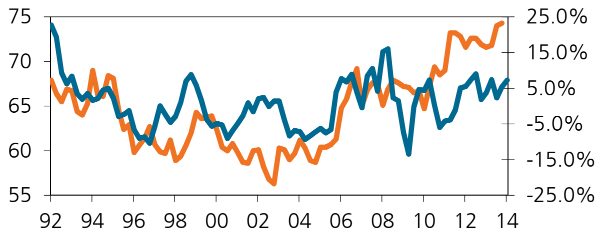
Source: Economic Policy Uncertainty, FSO and Intesa Sanpaolo calculations

Growth in the residential construction sector is expected to continue



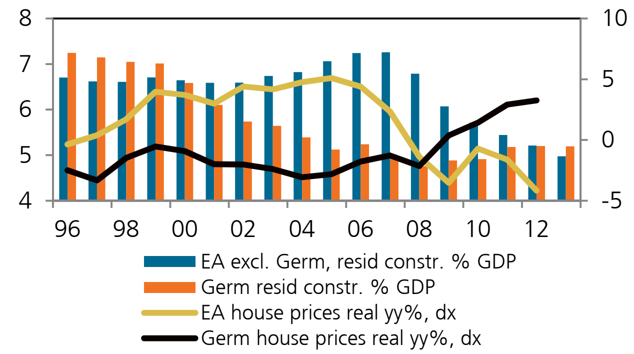
Source: FSO and Intesa Sanpaolo calculations

Capacity utilisation in the construction sector is above historical average and orders continue to rise



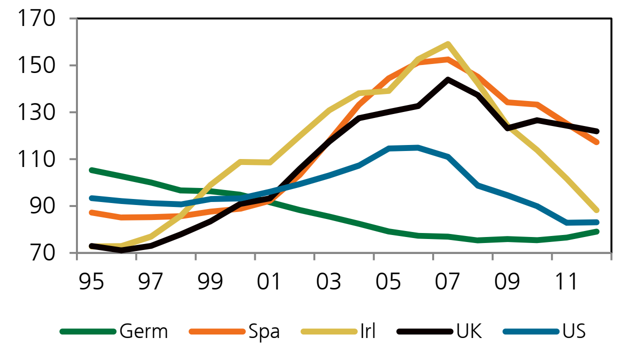
Source: IFO, FSO and Intesa Sanpaolo calculations

Real property prices rose by more than the Euro zone average over the last 5 years and the ratio of residential investment to GDP is back in line with the Euro zone average



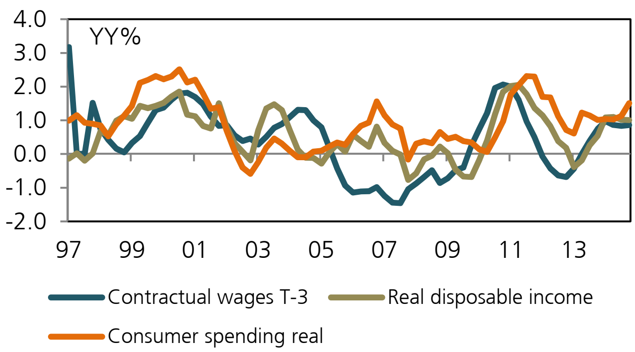
Source: ECB, European Commission and Intesa San Paolo calculations

For the moment, we see no signs of a bubble in the property sector; housing is still affordable



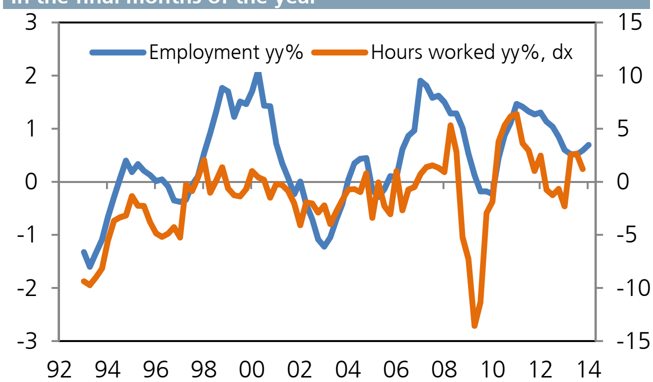
Source: OECD and Intesa Sanpaolo calculations

Consumer spending should recover rapidly, supported by growth in real incomes of over 1%



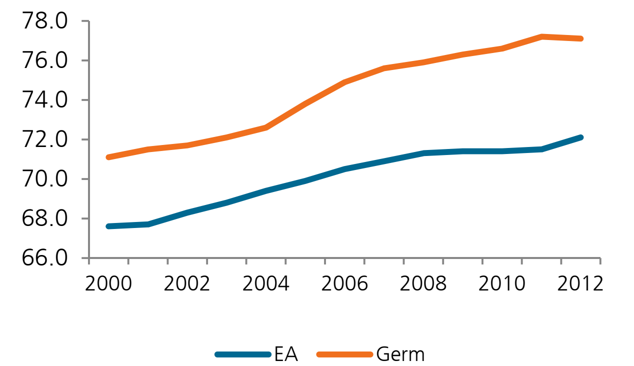
Source: Economic Policy Uncertainty, FSO and Intesa Sanpaolo calculations

Hours worked rose markedly in 2013 to the then slowed down in the final months of the year



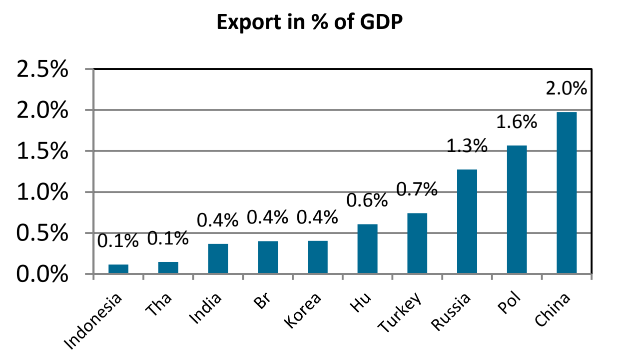
Source: FSO and Intesa Sanpaolo calculations

The fall in unemployment will be limited over the forecasting horizon as the participation rate is unlikely to increase to any significant extent



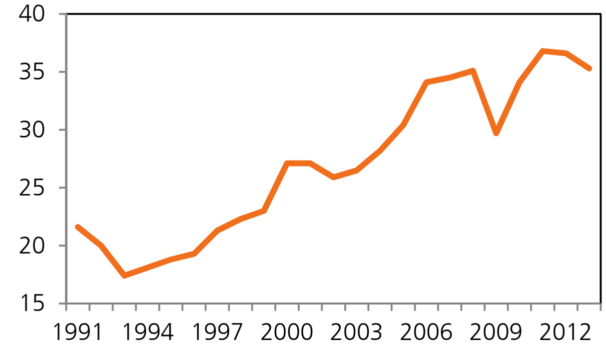
Source: IFO, FSO and Intesa Sanpaolo calculations

A slowdown in Russia and China could have a considerable impact on German growth



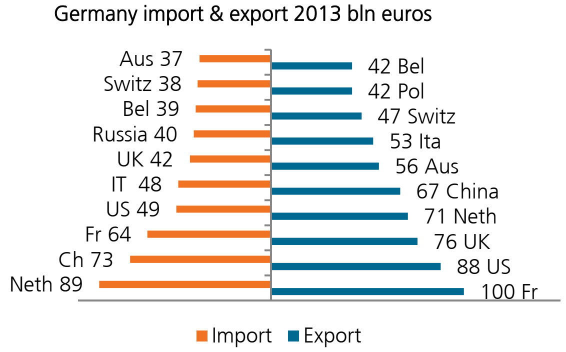
Source: IMF Direction of Trade Statistics

Import content of German exports remains high and keeps on rising



Source: FSO and Intesa Sanpaolo calculations

Which countries will benefit the most from the cyclical recovery in Germany?



Source: FSO and Intesa Sanpaolo calculations

Forecast table

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (1995 prices, y/y)	0.5	1.8	2.0	0.5	0.6	1.4	1.9	1.7	1.7	1.8	1.9
- q/q change				0.7	0.3	0.4	0.4	0.5	0.4	0.4	0.5
Private consumption	1.0	1.0	1.3	0.6	0.2	-0.1	0.3	0.4	0.3	0.3	0.3
Fixed investment	-0.6	4.3	3.7	1.2	1.2	1.4	0.9	0.8	1.0	1.0	1.0
Government consumption	0.7	1.4	1.4	-0.4	1.2	0.0	0.4	0.4	0.2	0.5	0.3
Export	1.0	4.1	4.4	2.4	0.2	2.6	0.7	0.0	0.9	1.0	1.6
Import	1.0	5.5	5.7	1.9	0.8	0.6	1.9	1.4	1.4	1.4	1.4
Stockbuilding (% contrib. to GDP)	-0.1	0.5	0.6	-0.1	0.0	-0.9	0.5	0.7	0.2	0.1	-0.1
Current account (% of GDP)	7.4	6.8	6.2	7.4	7.1	8.3	7.6	7.0	6.6	6.3	6.5
Deficit (% of GDP)	-0.1	0.0	0.0								
Debt (% of GDP)	78.4	77.6	75.0								
CPI (y/y)	1.5	1.4	1.4	1.5	1.6	1.3	1.2	1.5	1.4	1.7	1.7
Industrial production (y/y)	0.0	3.9	4.1	1.4	0.8	0.5	1.7	0.8	0.9	-0.1	1.0
Unemployment (%)	6.9	6.7	6.5	6.9	6.8	6.9	6.8	6.8	6.7	6.7	6.6

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

2014 will be year of recovery for France

Valerio Ceoloni

2014 should be the year in which the French economy recovers, with 2013 closing slightly better than expected. Following eight quarters of stagnation and contraction, in the last quarter of 2013 GDP beat forecasts to grow by 0.3% qoq, after stagnating in the third quarter. This boosted average annual GDP growth to 0.3% in 2013, compared with estimates of 0.1% after the stagnation seen in 2012. The forecast for the current year has also been revised upwards as a result, to 0.9%, with projected growth of 1.2% in 2015 (these estimates are slightly lower than European Commission forecasts of 1.0% and 1.5% respectively in 2014 and 2015). Confidence surveys in the manufacturing industry improved in the final months of 2013, returning in early 2014 to the long-term average (100), particularly in respect of future production estimates. However, the indicators show that total and foreign demand remain weak, and we expect activity to slow in 1Q14. The PMI indicators also confirm this sentiment, placing France as the last major Euro zone economy to return to growth. The manufacturing PMI has been under 50 since February 2012; the services component, after rising briefly around October 2013, returned to somewhat depressed levels well below the expansion threshold of 50. We therefore do not expect to see any substantial acceleration in either manufacturing or services before the second half of the year. Industrial output should make a positive contribution to average annual GDP of about two tenths of a point, with more rapid growth in the second half. The competitiveness pact promoted by François Hollande in January, which is aimed at reducing labour costs and boosting employment, will start to take effect by the end of the second quarter/beginning of the third quarter, although its contents are not yet sufficiently clear. We have therefore not computed it into our forecasts. Overall, the risks to the growth forecasts are balanced. Upside risks are supported by the upturn in global demand and the possible positive impact of the responsibility pact, and there are downside risks if the recovery in domestic demand proves weaker than expected, or if the public sector restructuring is not as rigorous as required.

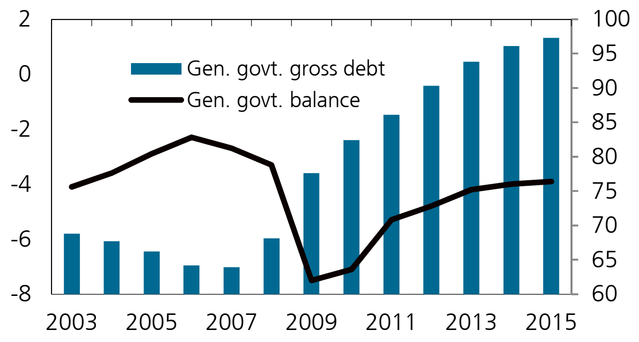
We expect consumption, traditionally the engine of French growth, to grow by 0.5% and 1.0% respectively in 2014 and 2015, making a major contribution to GDP. Consumer confidence surveys are still fairly weak, and below the long-term average, but we expect to see good acceleration from the third quarter onwards, underpinned by stabilising unemployment and low consumer prices. Investments, which had improved at end-2013, should continue to recover, thanks in part to the positive effects of the CICE (French tax credit for competitiveness and employment), and emerge from two straight years of contraction. However, it will be 2015 before we see the full effect of the CICE and its positive impact on production capacity usage and increased aggregate demand emerge. Exports are also set to improve on the back of the upturn in global demand, accelerating in 2014 and reducing France's current loss of international market share (although this will slow the trend rather than reverse it). In view of the increase in imports, buoyed by reviving domestic demand, we expect net exports to make a negligible contribution to GDP this year.

We have no concerns about inflation, either this year or in 2015. Despite the VAT hike that took effect on 1 January, adding 2 percentage points to inflation (up from 0.7% to 0.9%) in February, we expect pressure on consumer prices to remain very weak, in part because energy costs are contained. Inflation is unlikely to rise above 1.5% until the end of the year, and then only gradually. We estimate that average annual inflation could increase to 1.2%, from 0.9% in 2013, and should stabilise at around 1.3% in 2015. The core component should follow the headline index in 2014, rising to around 1.2% from 0.6% in 2013, but could slow again to 1.0% in 2015.

Given a moderate upturn, we are more likely to see higher productivity than a *bona fide* increase in employment this year. Furthermore, planned public spending cuts will reduce the number of public sector employees; we therefore think that **unemployment** levels will not improve on last year, but remain stable at 10.8% and possibly fall to 10.7% in 2015.

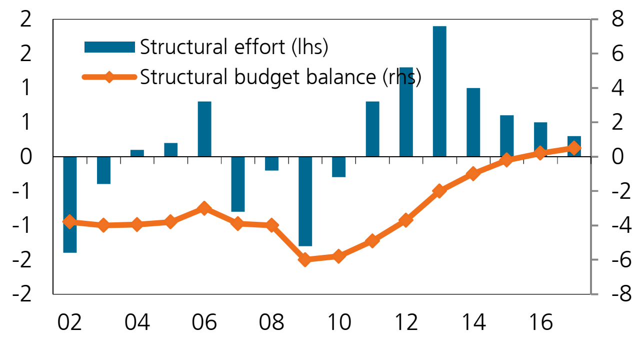
French **public debt** is further increased in 2013, reaching an estimated level of 93.9% (higher than the government's estimates), from 90.2% in 2012. The threshold is slightly below the euro area average of 95.5%, but well above the 60% ceiling set by European treaties. France exceeded the 60% limit for the first time in 2003, and public debt consistently increased over the following years.

General government gross debt and gen. govt. balance



Source: Intesa Sanpaolo chart based on Eurostat data

Return to structural budget balance: government estimates



Source: 2013 Stability Programme

Evolution of public accounts based on the French government's estimates, PLF 2013

	2011	2012	2013	2014	2015	2016	2017
Structural budget balance	-4.9	-3.7	-2.0	-1.0	-0.2	0.2	0.5
Structural budget effort	0.8	1.3	1.9	1.0	0.6	0.5	0.3
General government. balance (government estimates)	-5.3	-4.8	-3.7	-2.9	-2.0	-1.2	-0.7
General government. balance (EC estimates)	-5.3	-4.8	-4.2	-4.0	-3.9	-	-
Fiscal burden	43.7	44.9	46.3	46.5	46.5	46.5	46.3
Public spending % GDP	55.9	56.6	56.9	56.4	55.5	54.7	54.0
General government gross debt (government estimates)	85.8	90.2	93.6	94.3	93.0	90.8	88.2
General government gross debt (EC estimates)	85.8	90.2	93.9	96.1	97.3	-	-

Source: 2013 Stability Programme

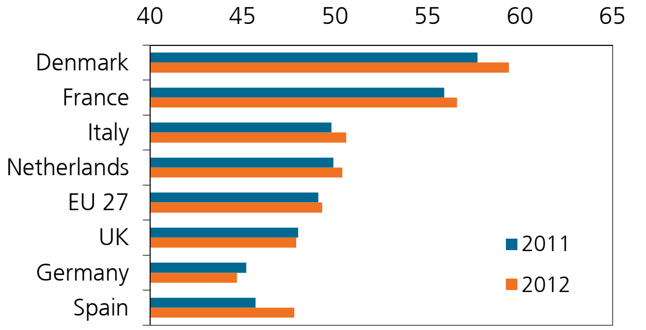
As for the current year, debt is expected to increase by a further 2.2pp, to 96.1% (still above the government's estimates), therefore less than last year, when it is estimated to have increased by 3.7pp. The deficit, on the other hand, is forecast to shrink in 2014, dropping from 4.2% in 2013 to 4.0%, based on the Commission's estimates, supported by expectations for stronger GDP growth (1.0% y/y) compared to those experienced last year, when GDP only increased by an average rate of 0.3%. However, while growth may slow the pace at which debt increases, it will not manage to reverse the uptrend. Indeed, based on the government's estimates, the trend reversal should begin in 2015, and debt would gradually be restored to 90% by 2017, before the end of the current Government. However, in light of past experiences, we believe this objective is unlikely to be confirmed, therefore risks to the forecast are skewed to the upside. The debt targets laid out in previous stability laws were consistently revised upwards at a later stage. The latest revision dates back to last year, when the government had targeted a debt of 80% by 2017, around 10pp lower than the current target. Therefore, we believe risks will continue to weigh on public finances in the medium term.

In any case, under the assumption of unchanged fiscal policies, the European Commission believes public debt will not drop below 95% between now and 2030. Also, the evolution of public debt is closely linked with the stability of the national financial sector, which experienced an increase in the share of government bonds held in portfolio. In June 2013, the exposure of the four largest French banks amounted to around 150 billion euros, according to the EBA[6], up by 30% from 115 billion the previous year. For the time being, this has not been a problem, since the sovereign yields were shielded from tensions such as the ones that materialised in 2011, and stayed below their long-term average, averting capital account losses. A rise in interest rates on debt could also have negative impacts on non-financial firms, as the yields of government bonds remain a key parameter for the issue of credit to the productive system, and in France, as is also the case of many other European nations, the banking sector is still the main channel of debt financing for the private sector. In turn, this would impact profitability, and therefore the entire country-system's ability to compete, given the difficulties already being experienced on this front. The risk is the triggering of a vicious circle: if no decisive action is taken on the debt trend in a reasonably short time, the markets may perceive the government's efforts as lacking credibility, triggering potential tensions on credit conditions, which in turn would damage France's growth potential, further eroding the possibility of reducing the deficit. For the time being, however, interest expenditure has remained broadly stable, at around 2.5% of GDP in recent years: the average interest rate on debt has decreased from 4.5% in 2000-2007 to around 3.5% in the 2008-2013 period. This has prevented the need for cuts to other spending items, such as investment spending. From this point of view, France seems to be in a relatively strong position when compared to other countries, as its investment spending has remained broadly stable at around 3% of GDP in the past 20 years. Germany and Italy have had to progressively reduce investment spending, and since the outbreak of the crisis Spain has had to implement swift cuts on this front. Overall, debt is expected to keep growing between now and 2017. As a result, increased interest spending cannot be ruled out in the near future, although an effective strategy to improve public accounts, lacking to date, could in any case keep rates contained.

The public expenditure reduction plan in France provides savings for overall 65 billion euros in the 2014-2017 period, of which 15 billion in 2014, 18 in 2015 and 2016, and 14 billion in 2017. In 2013, a further 10 billion euros were saved, bringing the reduction of public expenditure in the 2013-2017 five-year period at 75 billion euros, the largest national budget reduction ever achieved. Public spending had risen to 118 billion euros in 2011, and today accounts for 57.1% of GDP, the largest share in Europe behind Denmark, and 10pp higher than the euro area average. As regards the containment of public expenditure, however, some action has already been taken: in 2009, at the peak of the recession, with a GDP contraction of 3.1%, the deficit had risen to 7.5%, but had already been curbed in 2011 to 5.3%. In 2012 it levelled off at 4.8%, and in 2013 forecasts point to a 4.1% deficit, although the French Court of Accounts recently warned that a "significant risk" exists that public debt may exceed the already revised target of 4.1% in 2013, while the 3.6% target set for 2014 "seems uncertain, as there is no leeway in case of unexpected spending items".

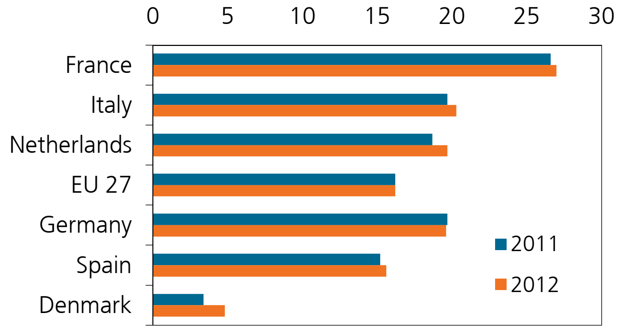
[6] EBA 2013 EU-wide Transparency exercise.

Government expenditure as % of GDP among highest in Europe



Source: Eurostat

Welfare expenditure as % of GDP



Source: Eurostat

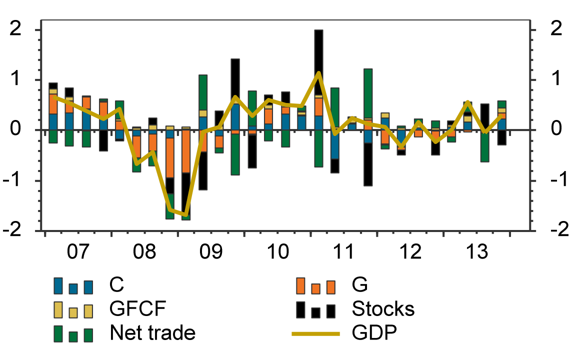
Therefore, the general budget deficit should level off at 74.9 billion euros in 2013, from 87.2 in 2012, with a 12.3 billion decrease. Of these 12.3 billion, around 2.3 will be achieved tanks to lower interest spending on debt, whereas 10 billion will come from primary spending cuts:

- 2.8 billion from wage cuts, achieved by halving the turnover (only half of the retiring public employees have been replaced, reducing the total headcount by around 30,000 in 2013). This will lead to a stabilisation of the state's spending on wages in subsequent years at 0.2% of GDP, with an additional 5.0% reduction of the public administration's running costs.
- 1.8 billion from the reduction of appropriations for urban and rural territorial agencies, without reducing the horizontal equalization between the various parts of the country.
- 2.2 billion from reduction in the defence budget.
- 1.2 billion from public investment cuts, also through fostering of public-private partnership.
- Finally, a further 2 billion euros in savings will come by abolishing many discretionary measures, such as financial assistance to enterprises and to seasonal agricultural sector workers.

The central budget accounts for 34% of public spending, welfare state for 46%, and local administrations for the residual 20%. In the 2013 budget law, public spending was originally set at 374.6 billion euros, and subsequently revised to 373.3 billion, thanks to savings on the *assurance-maladie* (Ondam) scheme. As for 2014, of the 15 billion euros in prospected savings, nine will come from the reduction of government and local agency costs, through a reduction and rationalisation of staff costs, spread over all individual ministries, regions and departments, and the residual nine billion will be achieved on the welfare state interventions aimed at modifying the running of the national health care system, including the reduction of medial prescriptions and examinations, the prescription of generic drugs and more in general the removal of all redundancies in the health care system. Overall, the total economies obtainable from structural interventions on the national health care system are estimated by the government at around 40 billion euros, or 2% of GDP. To understand the extent of the effort, suffice it to say that in over the previous five years (2008-2012), under the Sarkozy administration, overall public spending cuts had amounted to only 12 billion euros.

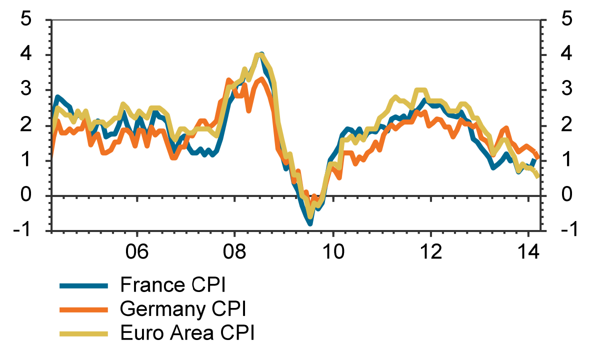
Overall, we consider the French stability law (2013-2017), aimed at restoring public accounts to health and containing debt, as slightly optimistic, as it assumes the fiscal consolidation effort will be maintained throughout the five-year period, with no real buffer margin, with a stronger impact between 2013 and 2014 (2.9% of GDP), and progressively decreasing in the 2015-2017 period (1.4% GDP). However, it should be pointed out that already in 2013 the target was not achieved, given that the structural deficit will fall from -3.7% in 2012 to -2.8% (falling short of the -2.0% target), making it impossible to meet the -1.0% target laid out for this year, and actually delaying the debt reduction process by at least one year. We will not expect the structural deficit to drop below -2.3% in 2014, in line with the European Commission's forecasts. Even assuming the targets laid out for 2015-2017 can be reached, the reduction of the deficit below 3% is very likely to be pushed back by at least one year (2015), also in light of the government's growth estimates, marred by downside risks (the government expects GDP growth of 1.2% in 2014, vs. the Commission's forecast of 1.0%).

Contribution to GDP



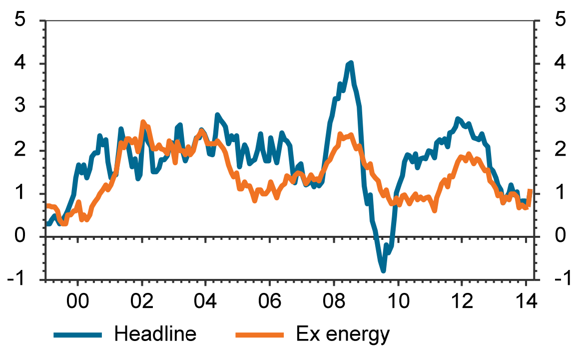
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



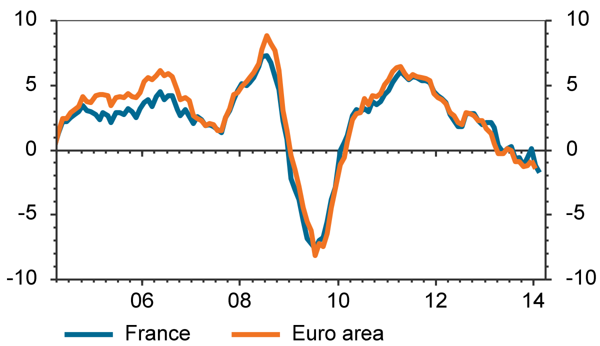
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

French non-energy CPI



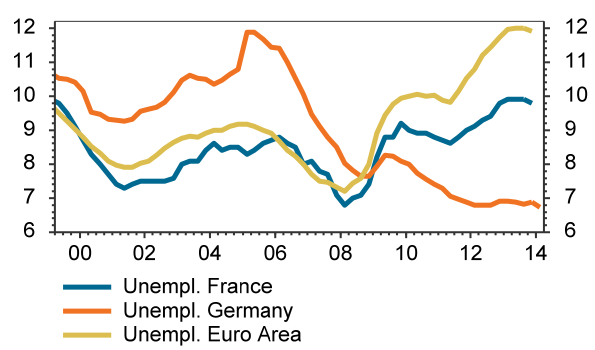
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

PPI



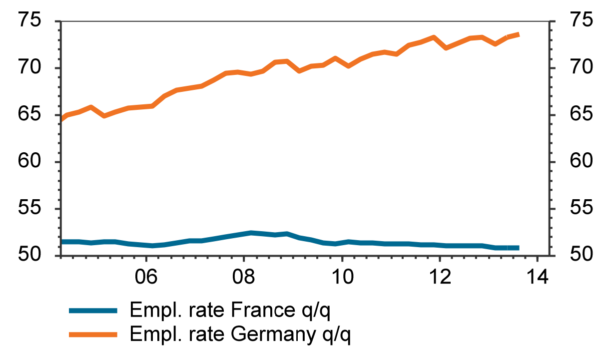
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



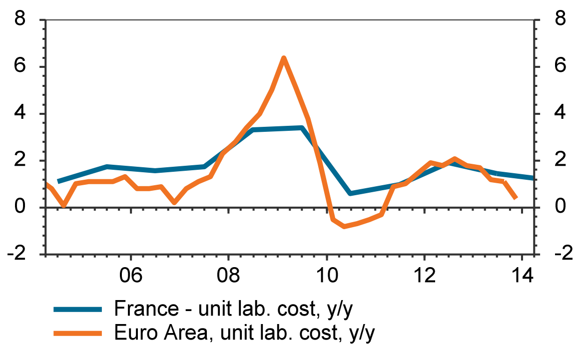
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



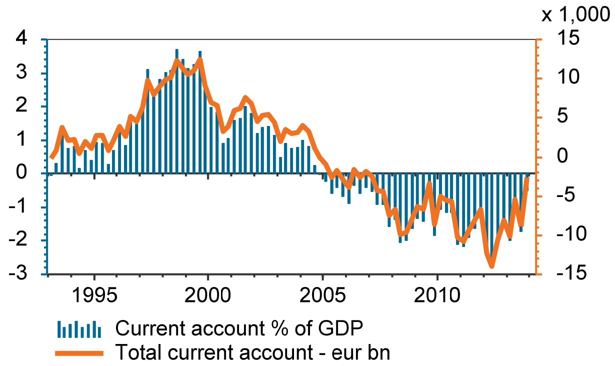
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unit labour cost



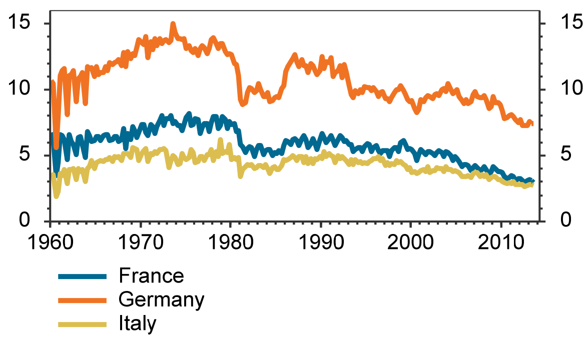
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



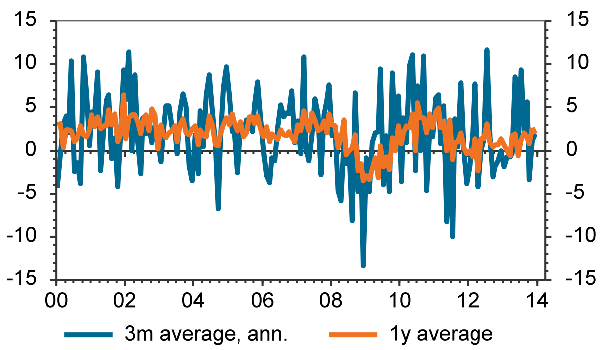
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Global exports



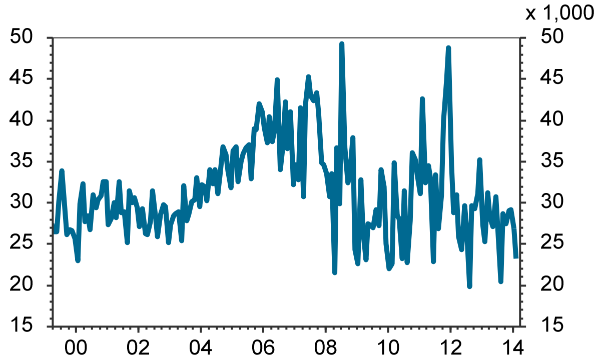
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Retail sales



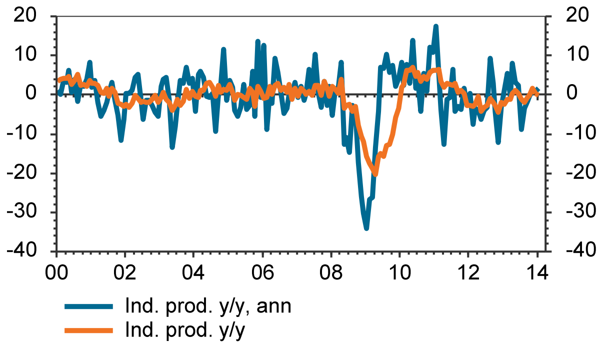
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

New house building, total



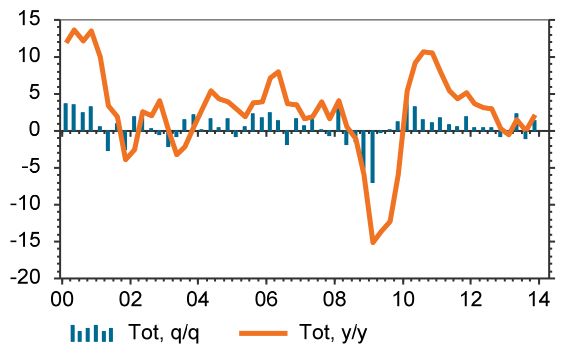
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Industrial output



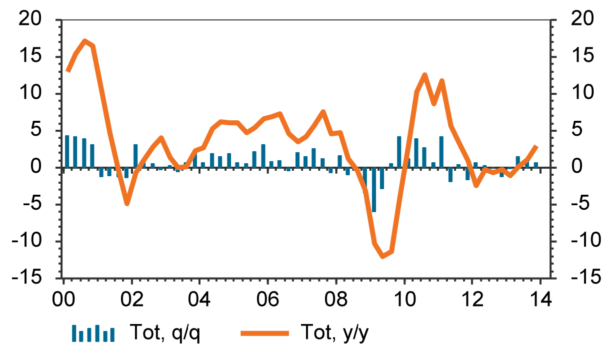
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Exports of goods and services



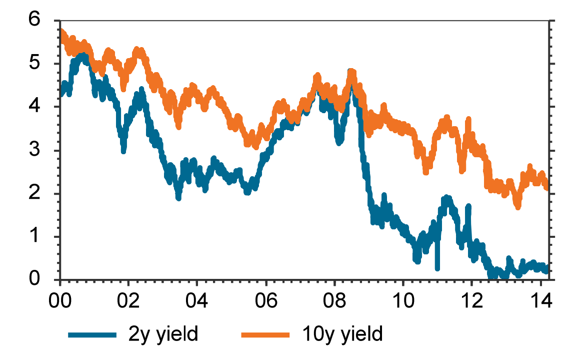
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Imports of goods and services



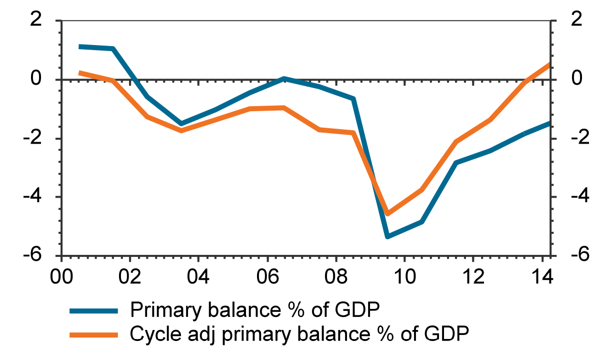
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

2-year and 10-year Govt. bond yields



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Primary balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Macroeconomic forecasts

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.3	0.9	1.2	0.5	0.3	0.8	0.9	0.6	1.0	1.0	1.1
- q/q change				0.6	0.0	0.3	0.1	0.2	0.4	0.3	0.2
Private consumption	0.4	0.9	1.2	0.4	0.1	0.3	0.2	0.2	0.2	0.3	0.4
Fixed investment	-2.2	1.0	2.1	-0.3	-0.3	0.3	0.3	0.3	0.5	0.5	0.3
Government consumption	1.7	1.4	0.6	0.7	0.2	0.3	0.3	0.4	0.3	0.3	0.1
Export	0.5	3.3	3.8	2.4	-1.6	0.9	1.1	1.6	0.4	1.0	0.8
Import	0.9	4.3	3.4	1.5	0.8	0.9	1.4	1.0	1.0	0.7	0.8
Stockbuilding (% contrib. to GDP)	0.1	0.2	-0.1	0.0	0.6	0.0	0.0	-0.2	0.3	-0.1	-0.1
Current account (% of GDP)	-1.5	-1.8	-1.9	-1.2	-1.9	-1.0	-1.9	-1.5	-1.9	-1.9	-2.0
Deficit (% of GDP)	-4.2	-4.0	-3.7								
Debt (% of GDP)	93.9	96.2	96.9								
CPI (y/y)	0.9	1.2	1.1	0.8	0.9	0.6	0.8	1.2	1.1	1.4	1.2
Industrial production	-0.5	0.5	1.4	1.1	-1.2	0.1	-0.2	0.6	0.7	0.5	0.2
Unemployment (%)	10.8	11.2	11.1	10.4	10.5	11.0	11.1	11.2	11.2	11.2	11.2

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

Italy: *andante moderato* for the economy, *allegro con brio* about politics

Paolo Mameli

The recovery has now also begun in Italy but, as in our baseline scenario, is slow, modest and mainly export-driven; domestic demand, while no longer trending downwards, remains flat. The measures announced by the government could speed up the recovery and in particular kickstart domestic demand. If implemented quickly and financed by actual savings on "non-productive" spending, tax breaks could have an appreciable effect (two to three tenths of a point) on GDP. The announced repayment of the public sector's arrears could have an even more significant effect, but the size of these payments is uncertain and they are unlikely to have a full impact in the current year. In any event, risks to the growth scenario for 2014 and 2015 are currently to the upside.

Recovery remains moderate and export-driven…

The timing and scale of the recovery in Italy is proceeding in line with what has been our base scenario for some time – that is, lagging behind and on a smaller scale than the other Euro zone countries. As expected, the economic recovery is gradually spreading from the confidence indices (which started to see a trend reversal almost a year ago) to hard data, including industrial output and GDP (both registering growth since the end of 2013). In contrast, given that the recovery is still at an embryonic stage, it is no surprise that the labour market (we expect unemployment to peak at 12.8% in 2014) and credit market (and the property market) have yet to completely adjust.

As we forecast in this publication a year ago[7], GDP returned to growth on a quarterly basis at the end of last year. Economic activity grew by 0.1% qoq in 4Q13, after nine consecutive quarters of recession (the longest since the quarterly series came into existence). Over 2013 as a whole, GDP contracted by 1.8%, after shrinking by 2.4% in 2012. Although distorted by the anomalous surge in investment in transport (+14.4% qoq), the breakdown of growth components at the end of 2013 was encouraging. The fall in inventories (contribution: -0.4% qoq) is a positive sign for the future. Net exports continue to drive the recovery (contribution: +0.3% qoq), but we can see the first signs that domestic demand is at least bottoming out (consumer spending and investment in machinery both posted only very slight falls; construction, however, remains mired in recession). Based on information available today, we believe that in 1Q14, GDP growth can at least keep pace with its end-2013 rate, and it will more likely pick up to +0.2% qoq.

… but we could see an upturn in the remainder of the year, driven by the stimuli announced by the government

Our base scenario for the remainder of the year projects only a fairly modest upturn in GDP growth, which could remain at around 0.2-0.3% qoq for the whole year, with an annual average of approximately 0.5% (and a possible rise to 1.1% in 2015). However, a new factor that has recently come into play is that from the second quarter, we could see a more marked upturn following the implementation of stimulus measures announced by the government. Specifically, if the cut in personal income tax (IRPEF) is implemented within the announced timeframe (from the end of May), disposable income and consumption could surge in 3Q14.

Political risk has changed course compared to three months ago

We have been saying since the release of this publication a year ago that the main (and virtually only) downside risk to our scenario of modest growth (0.5%) in 2014 was political risk, i.e. the risk of either a stalemate in government activity or elections in the near future. In recent weeks, this risk, which had the potential to smother the recovery at birth, has not only failed to materialise (the prospect of elections has greatly receded), but ,conversely, the political factor

[7] Intesa Sanpaolo, Macroeconomic Outlook March 2013, page 45: "a return to qoq GDP growth is deferred until the end of the year: in the central quarters, GDP could remain negative (incidentally, the current recession is set to be the longest since quarterly data has been available, i.e. 1981: nine quarters, with six quarters since 1992-1993)".

now seems to pose upside risks to growth forecasts. If implemented as proposed, the government's measures could impact economic activity in both the short term (the package, and the tax cuts in particular, could trigger an upward revision of the 2014 GDP forecast) and the medium term (certain economic reforms, such as those relating to the labour market, as well as institutional reforms, could have a beneficial impact on potential GDP).

The first measures proposed…

The first economic measures announced by the Renzi government are:

1. Tax measures. Measures include tax relief for employees earning less than EUR 25,000 a year, worth a total of EUR 10Bn (EUR 6.7Bn in 2014, from May), a 10% or EUR 2.4Bn cut in regional productive tax (IRAP) and an increase in withholding tax on capital gains from 20% to 26% (to fund the cut in IRAP).
2. Labour market. A decree law will extend the duration of the first fixed-term contract from 12 to 36 months, with a 20% limit of the total workforce, and will introduce other simplifications. The remaining labour market reforms will be covered in a draft legislative decree aimed at introducing a single contract with increasing job protection and at reforming welfare payments by reducing the application of the wage guarantee fund (CIG) to the benefit of unemployment subsidies (ASpI). The new labour code will also rationalise active work policies and simplify the administration of contracts.
3. Public sector debt. The government has a twofold objective here: to speed up the payment of arrears at a minimum cost to the state, and to align payment times with those required by European legislation. The proposed draft law includes mechanisms to make it easier to discount invoices to banks and the obligation to register invoices, backed up by a penalty mechanism.
4. Other measures: housing plan (reduction of the flat rate tax on rents, redevelopment and sale of public housing, refinancing of rent funds, etc.), reduction of energy bills for SMEs (which will, however, involve rises in charges for other users), school building plan.

… are expected to have a limited impact on public finances…

These measures will be funded by the spending review (EUR 3Bn considered feasible by Commissioner Cottarelli), savings on borrowing costs and additional VAT revenues from the payment of outstanding bills (in our view, this funding is uncertain and it would be better to ignore it). For the remainder, Renzi has mentioned the possibility of using the margin between the trend deficit of 2.6% (as estimated by the European Commission) and the ceiling of 3% (in our view, the real trend, even taking into account non-deferrable expenses that need to be refinanced this year, is worse than the Commission's estimate, and the margin is are therefore very narrow). The housing and school building plans are to be financed by drawing down earmarked funds that have not yet been used; the reform of welfare payments is unlikely to lead to higher expenses in 2014. The repayment of public sector arrears will initially rely on credit discounting by the banks, but government bond issues will need to be increased to finance the rise in the dedicated state fund and to create a new fund to finance the debt owed by local authorities to their own subsidiary companies. For the portion relating to capital spending, the actual repayment of debt could, as happened last year, have an impact on the deficit, but at present this is impossible to quantify.

Measures and funding of measures, effects on the 2014 deficit		
Measures	Bn	% GDP
IRPEF cut	6.7	0.4
IRAP cut	1.6	0.1
Total	8.3	0.5
Funding	Bn	% GDP
Spending review	3.0	0.2
Interest expenditure	2.3	0.1
Tax on capital gains	1.7	0.1
Taxes on PA arrears payment*	1.6	0.1
Total	8.7	0.5
Balance (incl. VAT on public sector debt payment*)	0.4	0.0
Balance (excl. VAT on public sector debt payment*)	-1.2	-0.1

NB: * we believe this funding is uncertain, so the balance excluding this figure is more credible.
Source: Intesa Sanpaolo chart on government information

... but could have an appreciable effect on the economy…

In brief, the measures are a step in the direction that has been desired for some time, particularly those targeting the labour market reform. The tax breaks understandably focus more on increasing workers' net incomes than on reducing labour costs, which is for the moment limited to a small cut in IRAP: but this decision could help the measures pass through parliament and guarantee union support. Dealings with the European Union will be more problematic, since the measures imply that the debt reduction obligation imposed by the new stability pact will be ignored; it could be crucial at this point for the measures to receive rapid parliamentary approval.

The most uncertain measure seems to be the "full" repayment of public sector arrears. But even stripping out this measure, **the package, if implemented within the projected timeframe, could have a positive impact on 2014 GDP of two to three tenths of a point. The impact could be much greater in 2015 if the public sector arrears are actually paid.**

"Theoretical" impact on GDP of the measures announced by Renzi	
	% impact on GDP
IRPEF cut	0.2
Other measures (IRAP cut, housing plan, energy costs for SMEs)	0.1
Payment of all remaining public sector arrears*	0.9
Total (with *)	1.2
Total (without *)	0.3

NB: * we believe this measure is uncertain, so the total impact on GDP of the measures announced is more credible if this item is excluded. Source: Intesa Sanpaolo estimates on government information

... particularly as regards the announced IRPEF cut…

The simulation of the IRPEF cut alone, using the Oxford Economics Forecasting simultaneous equations model, **implies a positive impact on 2014 GDP of two tenths of a point, if the measure is entirely deficit-financed**. The main effect will be on consumption, but it will also have an indirect impact on corporate investment and industrial output. The effect will be amplified in 2015 when the tax breaks are fully implemented.

Impact of the IRPEF cut proposed by the government on the main macroeconomic variables in 2014 and 2015 (yoy %)						
	2014	2015	2014		2015	
	Impact		ISP estimate	With shock	ISP estimate	With shock
GDP	0.2	0.2	0.5	0.7	1.1	1.3
Real consumption	0.3	0.7	0.1	0.4	0.1	0.8
Nominal consumption	0.3	0.9	0.7	1.1	2.9	3.7
Total fixed investments	0.2	0.4	1.1	1.3	2.2	2.5
Industrial output	0.3	0.5	1.5	1.8	1.7	2.2
CPI	0.0	0.1	1.0	1.1	1.6	1.7

NB: the shock consists of the IRPEF cut proposed by the government, financed through the deficit for the sake of simplicity.
Source: Intesa Sanpaolo simulations using the Oxford Economics Forecasting model

This simulation is, however, conducted "as if" the cut is deficit-financed, while this is not the case in the current hypothesis. In fact, the measure is partly funded by savings on borrowing costs (by definition "non-productive"), partly by the possible use of the margin available in the deficit, and partly through spending cuts set out in the spending review. In theory, if the tax break is financed wholly by spending cuts, the short-term effect on the economy would be negative, since the public spending multiplier is on average higher than the tax multiplier. There are three reasons why this may not be true in this case: 1) at a very high level of taxation, a tax cut financed by a spending cut can have a net positive effect; 2) a tax break financed by spending cuts may have a similar effect as a deficit-financed tax cut if "non-productive" expenses are reduced; 3) the "expense" also includes transfers, which are similar to negative taxes.

... but to assess this it will be crucial to know how it is funded

Commissioner Cottarelli's plan sets out a mixed bag of cuts. Of the EUR 7Bn projected annually by the plan, the following look to fall into the category of "savings on non-productive expenses", or in any case into public spending categories with a low multiplier: undoubtedly the EUR 2.2Bn resulting from "direct efficiency measures" (EUR 0.8Bn from initiatives on goods and services, EUR 0.2Bn from the electronic publication of public tenders, EUR 0.1Bn from consultancy and official cars, EUR 0.5Bn from directors' salaries, EUR 0.1Bn from training courses, EUR 0.1Bn from light pollution, EUR 0.4Bn from other proposals of ministerial groups); EUR 0.2Bn from "reorganisation" (half from the reform of the provinces and the other half from the expenses of other public bodies); and EUR 0.4Bn from savings on political costs (half from local authorities, regions and party financing, and the other half from constitutional bodies and auxiliary bodies). More doubtful is the inclusion in this category of the "reduction of inefficient transfers" (EUR 2Bn, of which EUR 1.4Bn relates to transfers to companies owned by the state or the regions, as well as micro-allocations, transfers to rail transport and local subsidiaries) and "sector expenses" (EUR 2.2Bn, of which undoubtedly only defence cuts – EUR 0.1Bn – and perhaps the measures on the health pact and standard costs – EUR 0.3Bn – can be considered to have a low multiplier, whereas measures on pensions, which are expected to generate as much as EUR 1.8Bn, could have an impact on the economy). In short, the impact shown in the table should be seen as the "maximum" impact, depending on whether the measures are financed wholly or through the use of the margin available in the deficit, or by lower borrowing costs, or by real savings on "non-productive" expenses.

Macro forecasts

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (2005 prices, yoy)	-1.8	0.5	1.1	-2.1	-1.9	-0.9	-0.1	0.3	0.7	0.9	1.0
qoq				-0.3	-0.1	0.1	0.2	0.2	0.3	0.3	0.3
Household Consumption	-2.6	0.1	1.0	-0.6	-0.2	-0.1	0.1	0.2	0.2	0.3	0.2
Collective Consumption	-0.8	0.1	0.3	-0.1	-0.2	0.2	0.0	0.0	0.0	0.1	0.1
Capital investment	-4.6	1.1	2.2	0.1	-0.6	0.9	0.2	0.3	0.5	0.3	0.5
Imports	-2.9	2.2	4.1	-0.2	0.9	0.2	0.7	0.4	0.7	1.0	1.0
Exports	0.0	3.6	4.1	0.6	0.5	1.2	0.8	0.9	1.0	1.0	1.0
Chg. Inventories (contrib., % GDP)	-0.1	-0.3	-0.1	-0.2	0.2	-0.4	0.0	-0.1	-0.1	0.0	0.0
Current Accounts (% GDP)	0.8	1.0	0.8								
PA Balance (% GDP)	-3.0	-3.0	-2.4								
Debt (% GDP)	132.6	135.1	133.2								
Consumer Prices (yoy)	1.2	1.0	1.6	1.2	1.1	0.7	0.5	0.8	1.0	1.8	1.9
Industrial Output	-2.9	1.5	1.7	-0.3	-0.4	0.9	0.4	0.6	0.5	0.2	0.2
Unemployment (%)	12.2	12.8	12.4	12.1	12.3	12.7	12.9	12.9	12.8	12.7	12.6

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

Spain: back in business!

Anna Maria Grimaldi

The recession in Spain is now behind us. GDP started growing again in the summer, and at year-end 2013, it even made a surprising upward move. Given this improving trend, we have revised up our growth projection for Spain to +0.8% in 2014 from the previous +0.5%, and in 2015, growth is likely to accelerate to 1.0%. The assessment of the country is more positive than six months ago, and it is clear that the reforms of past years are starting to bear fruit. The orderly conclusion of the ESM aid programme to reform the financial sector, together with more widespread confidence, contributed to bringing foreign investors back to Spain. Exports rose at a fast pace in the second half of 2013, due to gains in cost competitiveness in recent years. The current account ended 2013 with a surplus of 1.1% of GDP due to the improvement in the goods balance (net of energy) and the substantial contribution of the services balance for tourism. Much headway has been made also in the real estate market adjustment, although we cannot rule out that investments will continue to fall from 2014-2015. In its detailed review of Spain at the beginning of March, the Commission estimated that the country's imbalances are no longer excessive. Over the forecasting period, growth will be driven equally by net exports and domestic demand, which we project will return to positive growth rates. Financial conditions should gradually become less restrictive, and fiscal policy should be less punishing than in the last three years, giving the still tentative recovery in private consumption and corporate investments time to breathe. The risks for our scenario are still to the downside, and come from a slower pace of growth in global demand. It should also be noted that the country is still burdened by the need to correct internal imbalances. The deleveraging of households, businesses and the public sector will have to continue, given the high foreign debt position. Gains in competitiveness in recent years need to be stronger. The European Commission notes that it is necessary to advance further with the reforms to make the market for production factors more competitive and that a reform of the insolvency procedure for corporates would contribute to smoothing the deleveraging process. In addition, further advances need to be made to speed up the fall in unemployment, which is still at historical highs. The strengthening of public finances must continue since the deficit is still a long way from the target of a return to 3%. The fiscal reform proposal made at the end of February is a step forward, but it must be accompanied by a more structured spending cut plan.

Growth will be driven equally by exports and domestic demand, which rose unexpectedly in 2H13

Short-term outlook: at the end of 2013 Spanish GDP surprised to the upside (+0.2% qoq) after rising +0.1% qoq in the summer. Annual growth stabilised at year-end 2013, and we project it to return to a marginally positive rate of change at the beginning of 2014 (0.5% yoy). Economic surveys point to steady industrial production and GDP growth at the year-end 2013 pace. Exports slowed at year-end 2013, but continued to grow at more than 2.5% on an annual basis. However, global PMI and the foreign order component of the manufacturing PMI suggest a resurgence starting in February. Over the forecasting horizon, we anticipate export growth of just under 5.0%. Given the high import content of Spanish exports, it is likely that imports will resume growth at a more sustained pace of about 4.0%, but not at a level to compromise the improvement in the current account balance. Net exports should contribute 0.4% - 0.5% over the forecasting horizon.

The uptick in household consumption in the second half of 2013 comes after two years of rather steep falls attributable to fiscal consolidation measures with a negative wealth effect. In 2013, the actual fiscal correction was 0.8% of GDP, which was significantly lower than the 2.1% level in 2012. The jump in consumption was partly driven by a more widespread climate of confidence, a financial wealth effect (due to the recovery of government bonds and the stock market), and the less pronounced fall in real disposable income. The factors that bolstered consumption in the second half of 2013 should also support household spending during the current two-year period. In 2014, fiscal policy should have an impact of a half percent of GDP, and Rajoy has promised tax relief on low incomes for year-end, in addition to the EUR 100 flat tax per month on social security contributions in the first two years of employment. Financial conditions should gradually become less restrictive. However, it is unlikely that the growth in consumption will remain at the pace of the second half of 2013 (+0.5% qoq). On average, we project quarterly growth of 0.4% qoq and an annual increase of 1.1% in 2014 (partly due to growth achieved of 0.7%) and 0.9% in 2015. With regard to business investment, after the expansion in mid-2013, there was a pause at year-end 2013. For the moment, the increase in production capacity is still modest, and financial conditions are still too punishing for an expansion in plant assets. For the most part, spending will continue to be limited to replacement investments, and thus, we are projecting corporate investment growth of 4.0% in 2014 (growth due to the 2013 positive change is 2.5%) and 3.5% in 2015. With regard to construction investments, the worst should now be over. As a proportion of GDP, investment in residential construction is again below the European average with house prices falling 4.5% yoy in the third quarter of last year, and by 28.8% since the peak at the beginning of 2008 (implying an adjustment of over 35% in real terms). The drop in building permits to a new low in 2013 suggests that investments could again continue to fall in 2014, for the seventh year in a row - albeit at a substantially slower pace (-3.0%) than the average for the last five years (-10.5%) - but less than the previous six months. In 2015, investments in residential construction is likely to be broadly unchanged.

The labour market: the unemployment rate fell to 25.8% in January of this year from the all-time high of 27.1% at the beginning of 2013. The number of unemployed between June and December decreased (-306,000) more than the labour force (-347,000) since participation in the labour market is at the lowest level since the 1970s. The number of economically inactive individuals increased again in the second half of 2013, but remained broadly stable in the first half of last year, which is why the drop in unemployment was less pronounced at the end of 2013. Unemployment in Spain is still at its highest since the 1970s, and is one of the main challenges for future years, as noted by the European Commission in its detailed review of Spain. Unemployment will fall very gradually in 2014, when we project it will be around 25.4% on average. In 2015 when the recovery gathers speed, we should see more sustained employment growth, and hence a more rapid fall in unemployment to 24.7%. Economic surveys point to a year of stagnant or slightly negative employment growth in 2014, which is consistent with another slight fall in employment in the first half of the year, and stabilisation in the third and fourth quarters. In the fourth quarter of 2013, redundancies were only seen in the public sector, while the private sector added 24,000 jobs thanks to services where the creation of work offsets the loss of jobs in industry and construction. Unemployment indices from the European Commission's economic confidence surveys suggest that the fall in employment looks set to slow, including in the construction sector in 2014.

Labour market reform in 2012 had a tangible impact on wage growth. Under collective wage bargaining for 2013, an increase of 0.6% was agreed, down from 1.7% in 2012: real wages remain firmly in negative territory. The initial agreements for 2014 call for a slight uptick in wages (0.9%), but this is, in any case, well below the historical average. The cost of labour through indexation dropped by 4.9% yoy on a cumulative basis from the end of 2012 to September 2013. At end-2013, there was a 3.1% increase yoy, but more than likely this was a base effect, especially in the public sector after the huge cuts at the end of 2012. The de-indexation mechanism and high unemployment rate should keep wage increases under control in the near future. We project a 0.5% average increase in labour costs in 2014-2015. Real salary growth will remain marginally negative in 2014-2015.

Inflation reached a low of -0.1% yoy in October on the national index, and remained close to zero until February (+0.1% yoy). Core inflation fell further to 0.5% yoy in February from 2.3% a year earlier. In the coming months we project that headline inflation will gradually rise partly due to a base effect from the energy component, but on average it will be around +0.6%-+0.7% in 2014 compared with 1.7% in 2013. Core inflation will stay close to zero, curbed by the large slack in the economy and wages moderation. Spain is also not immune to the risk of deflation, but this risk should be reduced with the recovery of growth, and especially domestic demand.

The European Commission gave its Ok for 2014, but considerable uncertainties remain. The challenge begins in 2015. Debt will continue to rise until 2017

Public finances: the budget deficit will probably end 2013 at least at 7.2%, over half a point higher than the target agreed with Brussels (6.5%). Data on the public sector suggest an overshoot of more than half a point above the target (-3.8% of GDP) partly due to disappointing revenue growth, and to a lesser extent, to a lower-than-expected drop in spending. Bank recapitalisation measures accounted for 3.8 percentage points of GDP in 2012 and 0.3 in 2013. The target agreed with Brussels last July for 2014 was a deficit declining to 5.8% with a structural improvement of 0.8%. The European Commission believes that this target is achievable, thanks to the extension of the measures on personal and corporate income tax[8] and the cut in the number of additional days of holiday entitlement for public employees. In addition, at year-end 2013 additional measures were announced totalling about 0.3% of GDP. For the current year these measures call for a broader tax base definition for social security contributions. In terms of spending, cuts were also introduced for retirement bonuses. We still believe that there is a wide margin of uncertainty over public finances: on the one hand, the measures to broaden the tax base through the fight against tax evasion could have disappointing results, falling short of the 0.1% of GDP forecast by the government; on the other hand, planned cuts in spending through the reform of local authorities could be ambitious (EUR 1.1Bn in 2014). The European Commission's winter projections show a structural deficit that is broadly unchanged in 2014, which would imply less of an improvement in the structural balance than that required by Stability Law recommendations (-0.8%). However, it is clear that 2014 will likely end on a good note, and the incipient recovery will continue. The problem arises in 2015. According to the European Commission the starting point is a structural deficit of -5.8% of GDP in 2015, a slight deterioration from 2014. However, the fiscal correction still needs to be implemented, and at the moment, we cannot see how the country will be able to meet the objective of bringing the deficit under the 3% target in 2016. Thus, the country will need to make a significant tax effort from 2015 going forward, which could compromise the return to more sustained growth rates than the estimated 0.8% for 2014. Debt is expected to rise to 104% of GDP in 2015 and start to come down only in 2017.

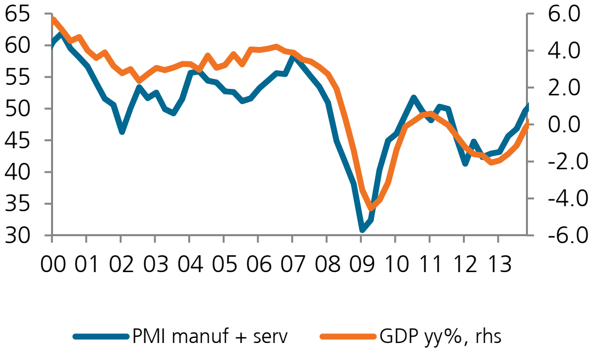
Table 1 - Public finance forecasts: the correction is still to come

	2012	2013	2014	2015
European Commission Winter 2014 *(Nov. 2013 estimates)*				
Target balance – Recomm. June 2013	-10.6	-6.5	-5.8	-4.2
Balance	-10.6	-7,2	-5.8 *(-5,9)*	-6,5 (-6.6)
Interests	3.0	3.5	3.6	3.6
Cyclical adjusted balance	-8.2	-4.3	-4.3	-6,3
Cyclically adjusted primary balance	-5.2	-1.3	-0.7	-2.6
Structural balance	**-5.2**	**-4,3** *(-4.1)*	**-4.2**	**-5.8**
Structural balance government estimate		*-3.4*	*-3.3*	*-2.0*
Structural effort from June 2013 Recomm.		**+1.1**	**+0.8**	**+0.8**
Debt	86.0	94.3	98.9	103.3
Balance	-10.6	-7.2	-5.9	-6.2**
Interests	3	3.4	3.6	3.6
Cyclically adjusted balance	-8.4	-4.8	-4.4	-6.0
Cyclically adjusted primary balance	-5.4	-1.3	-0.8	-2.4
Structural balance	-5.2	-4.4	-4.3	-5.1
Debt	86.0	94.3	99.1	104

Source: European Commission winter forecasts and Intesa Sanpaolo estimates. **Estimates under the laws in force are based on the European Commission deficit estimate made in the autumn (-6.4%). These estimates take into account the impact of a growth estimate of +1.0% in 2015, or seven-tenths of a percentage point below those of the Commission, which could be of the order of -0.3% on the cycle, but we assume that measures for at least half a percentage point of GDP will be confirmed in 2015

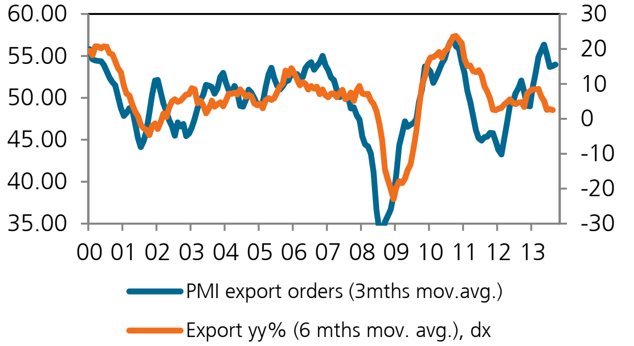
[8] The deadline for deducting write-downs has also been extended to 2014-15, with an effect on tax receipts of 0.2% of GDP. Government legislation passed on 28 June excluded foreign losses from the tax base of companies. We estimate that this measure could account for 0.1%-0.2% of GDP.

Fig. 1 - PMI indices confirm the recovery has begun



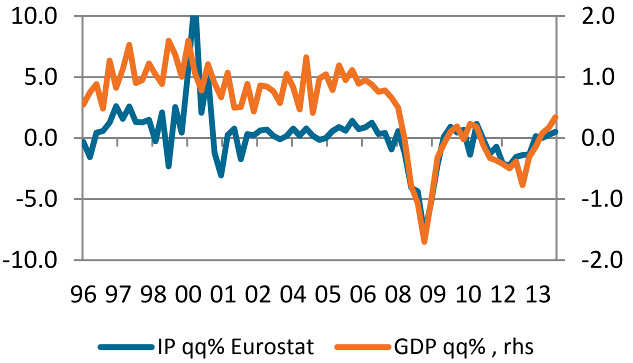
Source: INE. Intesa Sanpaolo charts based on Markit data

Fig. 2 - The PMI index on orders from abroad suggests that exports should resume their growth at a stronger pace after the year-end 2013 slowdown



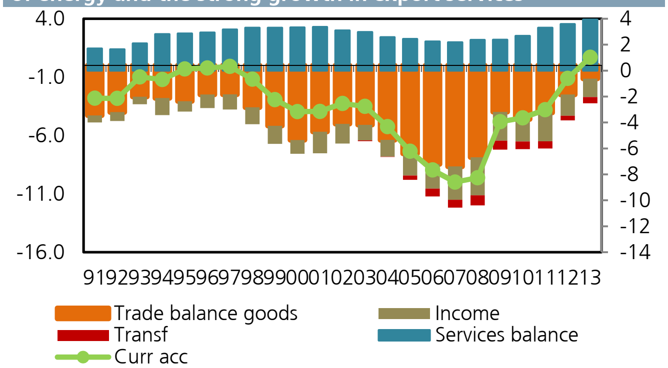
Source: INE. Intesa Sanpaolo charts based on Markit data

Fig. 3 - Industrial production was stagnant in January but on track to keep GDP growth at the year-end 2013 pace (+0.2% qoq)



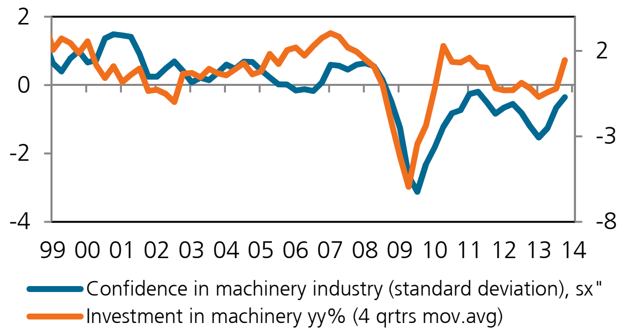
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 4 - Moving towards a current account surplus as early as year-end 2013 due to the improvement in the goods balance net of energy and the strong growth in export services



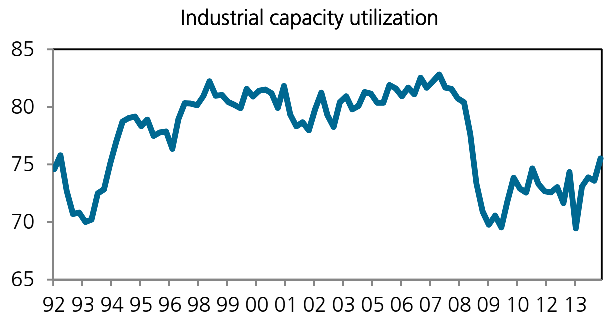
Source: Intesa Sanpaolo chart from INE data

Fig. 5 – Moderately positive signs for machinery spending, but we are unlikely to see a sustained cycle...



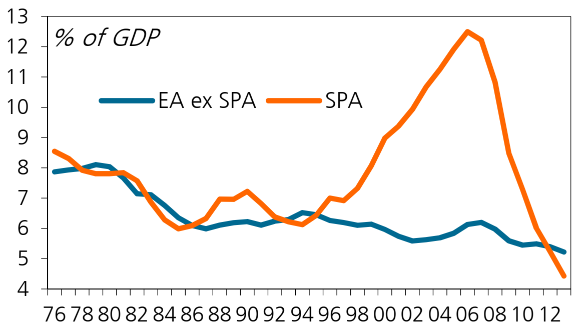
Source: Intesa Sanpaolo chart from Eurostat data

Fig. 6 –...as there is still considerable unused industrial capacity, but this is decreasing



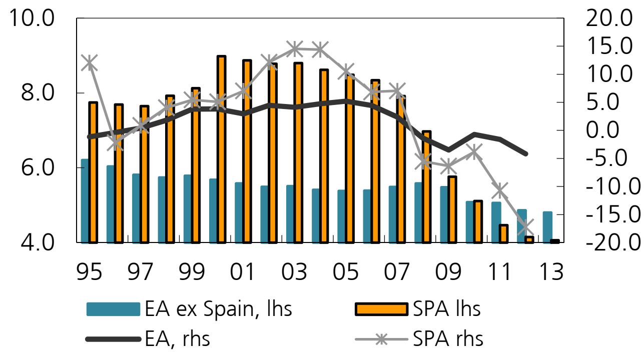
Source: Intesa Sanpaolo chart from INE data

Fig. 7 – Investment in residential construction as a % of GDP at its lowest level since 1976 and now below the Euro zone average



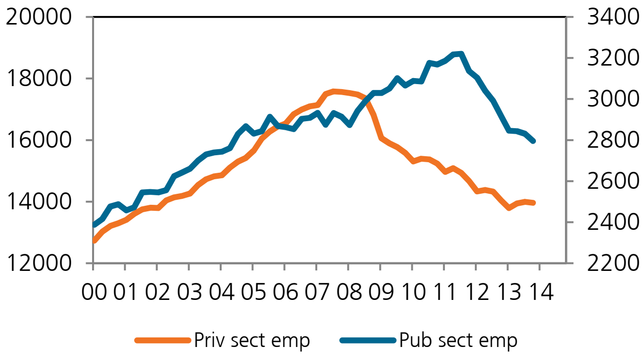
Source: Intesa Sanpaolo chart from AMECO data

Fig. 8 – House prices continue to fall, by 13% per year in real terms



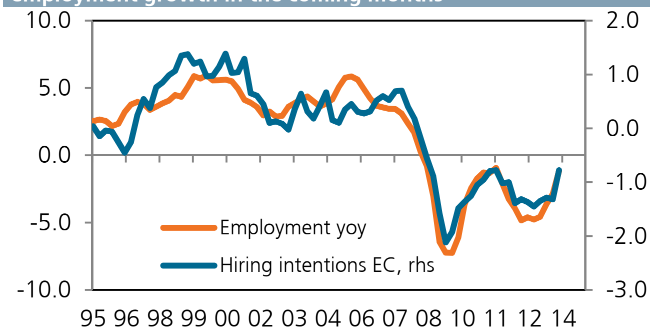
N.B. Bars: Residential investment as a % of GDP. Lines: house prices yoy %, dx. Source: Intesa Sanpaolo chart based on AMECO, ECB and INE data

Fig. 9 – Private sector employment began to rise in the summer



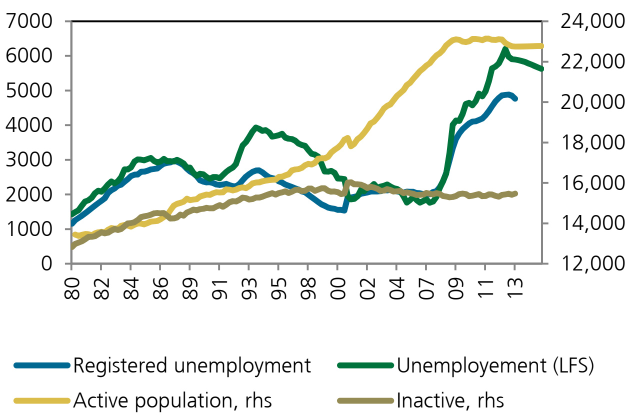
Source: Intesa Sanpaolo chart from INE data

Fig. 10 - Confidence surveys suggest a further improvement in employment growth in the coming months



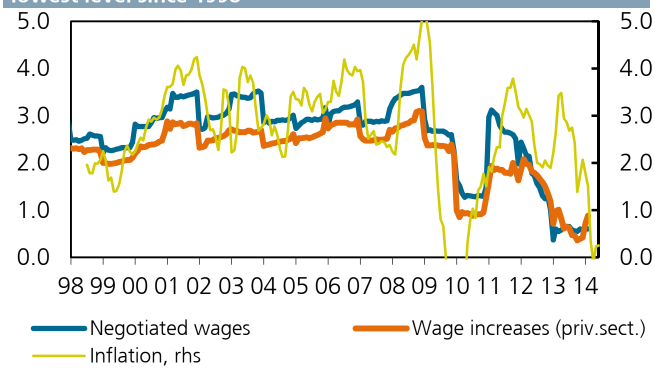
Source: Intesa Sanpaolo charts from European Commission and INE data

Fig. 11 – The number of unemployed has fallen by more than the active population



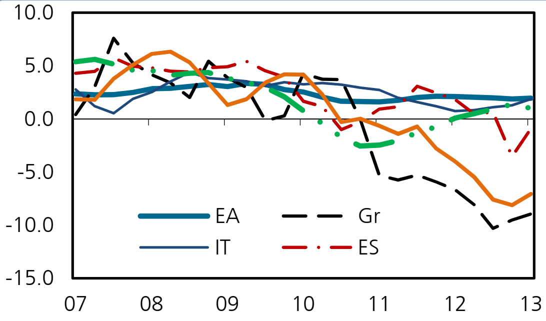
Source: Intesa Sanpaolo chart from INE data

Fig. 12 - De-indexing worked: contractual wages are at their lowest level since 1998



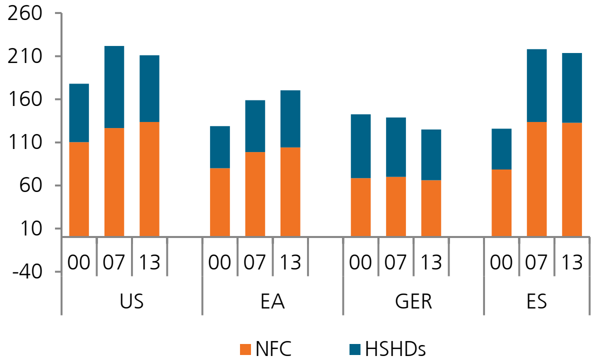
Source: Intesa Sanpaolo chart from INE data

Fig. 13 – Labour costs have fallen by more than in other countries, but competitiveness gains need to be consolidated



Source: Intesa Sanpaolo chart from Eurostat data

Fig. 14 – Deleveraging of the private sector must continue



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

Macro forecasts

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	-1.2	0.8	1.0	-1.6	-1.1	-0.2	0.5	0.8	1.0	0.9	0.9
- q/q change				-0.1	0.1	0.2	0.3	0.3	0.2	0.1	0.3
Private consumption	-2.1	1.1	0.9	0.1	0.5	0.5	0.3	0.0	0.1	0.1	0.4
Fixed investment	-5.1	2.0	0.8	-1.9	0.7	0.7	1.7	-0.2	-0.1	0.3	0.1
Deficit (% of GDP)	-7.2	-6.0	-6.1								
Debt (% of GDP)	94.3	100.0	104.0								
CPI (y/y)	1.4	0.4	0.7	1.7	1.2	0.1	0.0	0.5	0.0	1.1	0.7
Unemployment (%)	26.1	25.4	24.7	26.4	26.5	26.1	25.8	25.7	25.6	25.4	25.2
10-year yield	4.56	4.00	4.51	4.50	4.53	4.16	3.64	4.01	4.04	4.32	4.31
Effective exch.rate (1990=100)	102.4	102.1	101.1	102.2	102.5	102.7	102.7	102.5	101.8	101.4	101.2

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

Greece: return to growth from 2015

The contraction of the Greek economy continues to slow: 2013 closed with a drop in GDP of 6.8% in the fourth quarter, making an annual average fall of 3.9% (versus -4.0% set out in autumn forecasts), compared with -6.9% in 2012, the lowest fall since 2008. The situation seems to be improving very slowly. We expect this trend to continue over this year, with a further improvement to -0.4%, while we should see the first positive figure in 2015, with actual growth of 1.3%. The main driver is again expected to be net exports, driven by the fairly significant cuts in production costs, and the tourism sector, which started to make a positive contribution again last summer. We expect domestic consumption to continue to contract, owing to the ongoing decline in disposable income. Forecast risks are generally to the downside, owing in particular to the ongoing fragility of the government as a whole and possible social unrest. On the whole, though, market sentiment on Greece is definitely picking up, with ten-year yields again around 6% and the stock market at a two-year high.

Unemployment is expected to come in at around 27.3% for 2013. Last year's wage reforms have already had a significant impact on squeezing production costs and increasing productivity, which should lead to a recovery in investment this year and an upturn in employment, which could reduce unemployment from 26.0% this year to 25% in 2015.

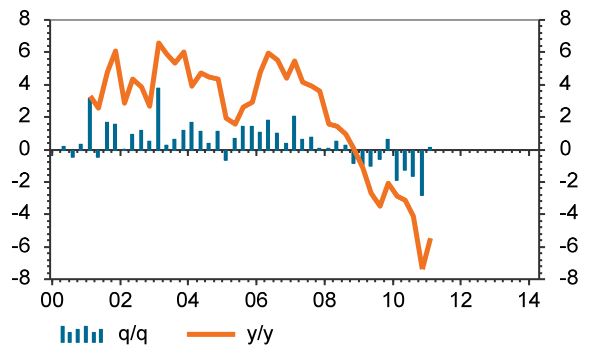
The reversal of the current disinflation process is only expected in 2015, with inflation seen falling to -0.9% in 2013, -0.6% in 2014 and finally 0.2% in 2015.

As regards the bailout plan expected to conclude at the end of 2014, progress since December has been limited, as the review following the third one conducted in July 2013 (when EUR 3Bn in aid was allocated) has not yet been completed, owing to a significant slowdown in the implementation of the reforms agreed with international partners.

Following the Eurogroup meeting in February, the Troika announced that it will not talk about any debt relief for Greece until August, and that it will proceed "step by step" in considering the excessive debt issue. For the moment, therefore, the country is financed until August. German Finance Minister Wolfgang Schäuble also said that it "is too early" to discuss new aid packages for Greece. The fourth regular review of the progress of the bailout plan is currently in progress in Athens, and the results are expected to be announced by the end of March, so that the next tranche of aid can be released, enabling the country to honour the redemption of bonds maturing in May.

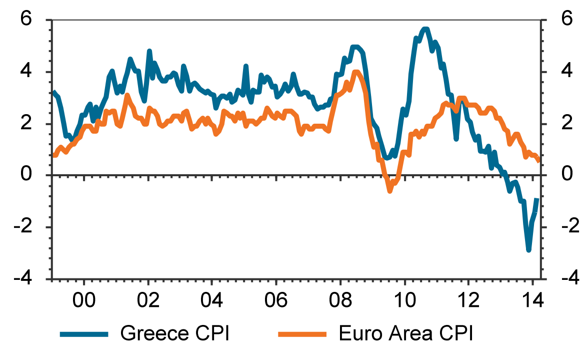
Public debt is expected to have peaked last year at 177.3% of GDP, after 157% in 2012, and to stabilise this year (177.0%), before starting to fall from 2015 onwards (171.9%). The target is still to reduce debt to below the 125% level by 2020. The deficit/GDP ratio should rise significantly this year to -2.2% of GDP, after -13.1% last year, driven downwards by the calculation of costs to recapitalise the banking sector. The structural figure is expected to remain in positive territory, with a surplus at 0.7% this year, versus 1.7% in 2013.

GDP



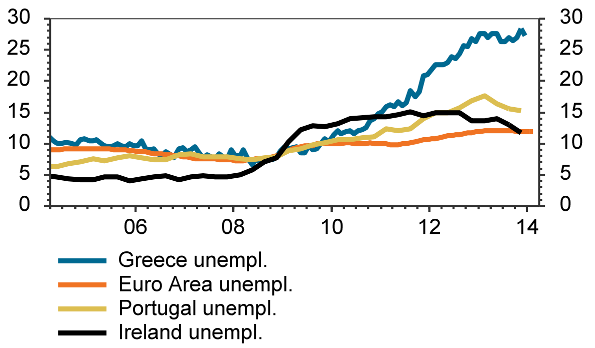
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



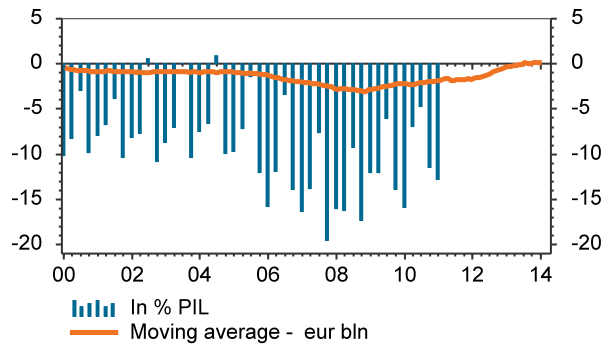
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Ireland: 4Q13 negative, but recovery in 2014

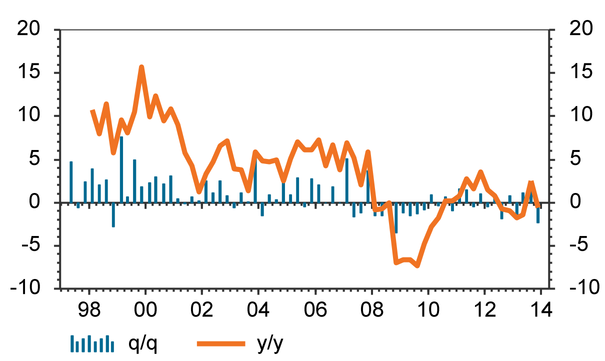
Ireland was hit by a nasty surprise in the last quarter of 2013, with GDP unexpectedly contracting by 2.3% qoq, after 2.1% qoq in 3Q13, largely due to the "patent cliff" (the expiry of the use of industrial patents, mainly in the pharmaceutical sector). This had a negative impact on the annual average forecast, which had projected an expansion in output of 0.3% over the year, but instead saw a contraction of -0.3%, after 0.2% in 2012. However, the country's exit from the bailout plan in December is clearly seen as a success among the Euro zone countries that received aid packages. Ireland met all the fiscal, deficit and reform objectives set by the Troika. Ten-year yields have fallen significantly (they are currently around 2.9%), the 2014 budget is fully financed and the growth outlook for this year is good, thanks in particular to the contribution of services and a stabilisation in domestic demand (annual average of 1.4% for 2014, 2.6% for 2015). Growth should be sustained by trade with the UK, which is expected to experience an upturn in output from 2013 to 2014. Risks to growth forecasts are balanced overall.

The adjustment of the structural deficit was 6.5% of GDP last year, second only to that generated by Greece in the Euro zone (excluding costs to recapitalise the banking sector). Nevertheless, we should point out that Ireland's public debt is expected to rise to 122.3% of GDP in 2013, from 117.4% in 2012 and 91% in 2010, when the bailout programme began. The increase of more than 30 points was however set out in the original bailout programme, which put debt at 124.5% of GDP at end-2013. This year, it is expected to register its first fall to 120.3%, and then drop further to 119.7% in 2015.

In any event, the objective of fiscal sustainability is not yet considered to have been met, given the high debt/GDP ratio with which the country emerged from the bailout plan, of which only a part is ready for restructuring. In this regard, it will be essential for the country to keep the cost of debt low and maintain good levels of GDP growth. Unemployment fell to 12.4% in December, its lowest since June 2009: we believe that the increase in part-time work registered in the first half of 2013 is being turned into actual employment, without however putting pressure on wages. Inflation remains under the Euro zone average at 0.5% in 2013 and 0.8% on average for 2014.

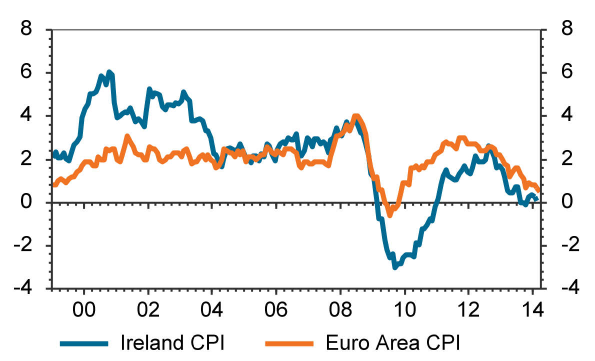
For 2014, the deficit is seen at 4.8% of GDP, a clear improvement on 2013's figure of 7.2%. The forecast also includes discretionary measures presented in the 2014 budget equivalent to 1.5% of GDP and other one-off discretionary measures, such as the hike in excise duty on tobacco and alcohol, bank deposits and pension funds. We expect the deficit to improve further in 2015 to 4.3%. The structural deficit is seen falling from 6.5% in 2013 to 4.9% in 2014 and to 4.6% in 2015.

GDP



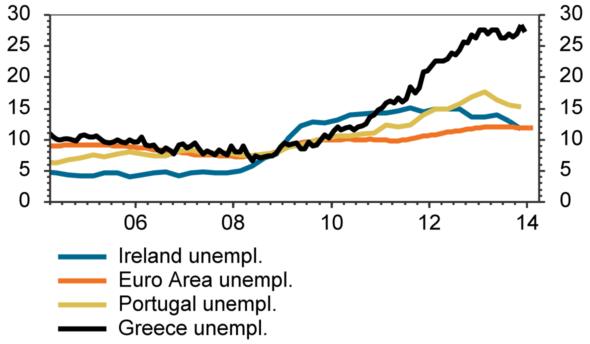
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



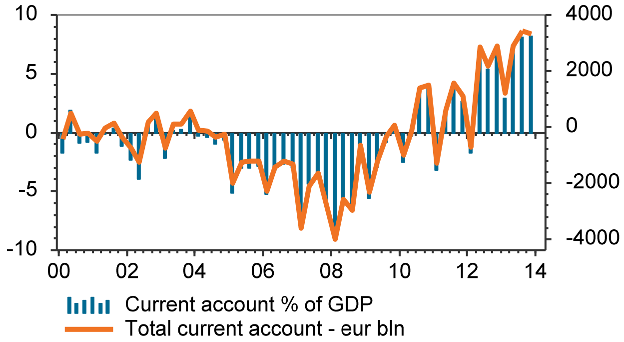
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Portugal: 2014 a year of growth

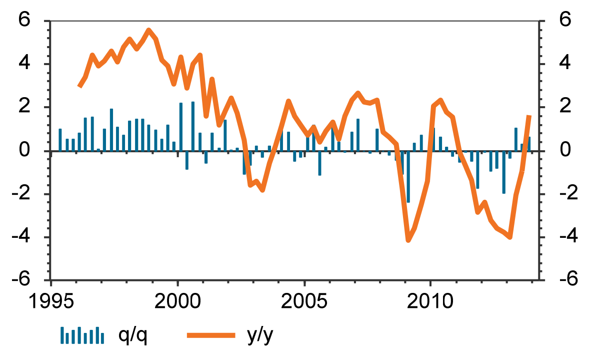
2013 closed with an upturn in growth in the final quarter, which registered an expansion in GDP of 0.6% qoq, well above the consensus estimates of 0.2% qoq, and thereby taking the annual change to -1.3% in 2013, from -3.2% in 2012. The acceleration at the end of the year was due to an increase in domestic demand, net exports (particularly to the Euro zone, while exports to other foreign partners remained flat owing the strength of the euro) and investments (+3.4% qoq), all encouraging factors, which, based on confidence indicators around the turn of the year, suggest that 1Q14 may be another positive quarter for growth (+0.1% qoq). Furthermore, the increase in orders seen at the end of the year, particularly the increase in those from abroad, suggests that the beginning of 2014 may be another positive one for the Portuguese economy. For 2014, we believe that the country may return to growth (annual average of +0.9% in 2014, +1.1% in 2015) after three years of uninterrupted contraction. Risks to the forecast are balanced. On the one hand, an upturn in the global economy and a better than expected recovery in the Euro zone could improve the forecast, while it could be revised downwards by new problems relating to the conclusion of the bailout plan, which cannot be completely ruled out and which would have a negative impact on the markets and the sustainability of Portugal's debt.

Portuguese consumer confidence has also returned to its 2010 highs, with a marked improvement in retail sales and unemployment falling constantly since March 2013 to reach 15.3% in December, three tenths of a point less than the 15.6% recorded in the third quarter: the increase in employment registered in 2013 is probably not due to seasonal effects, but to the actual increase in the number of permanent contracts. Unemployment should continue to fall this year, and we expect that the annual average figure will come in at 16.6% in 2014 and 16.4% in 2015, which is still however above the Euro zone average.

We believe that Portugal's chances of following Ireland's example have also increased in light of encouraging signs of a recovery in growth seen at the end of the year. However, in our view, some form of returned control to the market through debt restructuring or in the form of a precautionary credit line from the ESM remains probable, given that yields on ten-year Portuguese government bonds, currently around 4.35%, remain higher than the corresponding yields on ten-year Irish bonds last year, and also considering that while Ireland has managed to completely fund itself for the whole of 2014, Portugal has not. Another factor to be monitored is the deflation risk, which could make it difficult to reduce public debt, although, at present, according to Commission forecasts, inflation is expected to again rise moderately from 0.4% in 2013 to 0.8% this year and 1.2% in 2015.

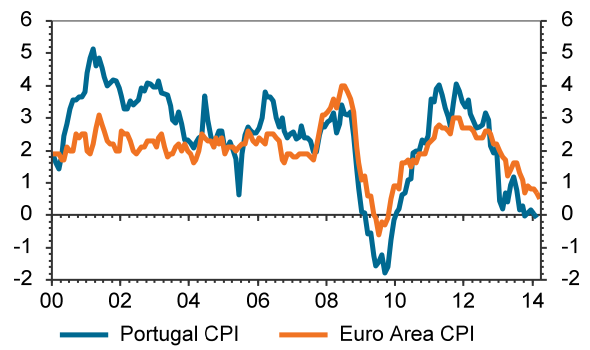
There has been little news since December with regard to progress in the bailout programme. The eleventh review of the programme was completed in February, and revealed positive signs of an economic recovery. The current account surplus of 0.4% at the end of 2013 is expected to improve further to 0.8% this year, according to European Commission forecasts. The fiscal objectives for 2013 should have been met and exceeded, given that the deficit is expected to come in at 4.5% of GDP (excluding the recapitalisation of Banif) compared with a previously estimated figure of 5.9%. The better than expected result must be attributed to higher than expected tax revenues thanks to one-off measures, and, on the expenditure side, to the rationalisation and reduction of social spending. The deficit target for 2014 has therefore been set at 4.0%, with discretionary measures equal to 2.3% of GDP, while the target for 2015 has been set at 2.5%, with discretionary measures equal to 1.2% of GDP. Public debt is expected to fall from 129.4% of GDP in 2013 to 126.6% in 2014 and 125.8% in 2015, according to Commission estimates. The financial sector continues to stabilise, but still suffers from low profitability and high levels of exposure to the non-financial private sector, although the sector's liquidity levels are acceptable, and the recapitalisation process is continuing according to the timetable established in agreements with the Troika. The conclusion of the eleventh review in mid-April will enable a total of EUR 2.5Bn to be released (EUR 1.6Bn by the European Commission and EUR 0.9Bn by the IMF).

GDP



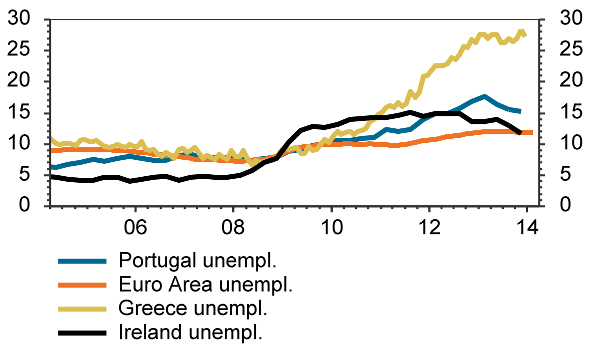
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



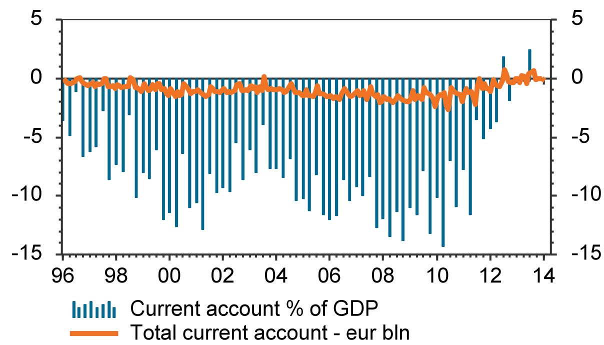
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Asia

Japan – Fasten your seatbelts, turbulence ahead!

Giovanna Mossetti

- The outlook for the Japanese economy in 2014-15, as expected, will be conditioned by fiscal policy. Growth volatility will make it hard to assess underlying trends, although for the time being the picture remains positive and the continuation of the recovery, albeit at a slower pace, does not seem at risk.
- The crucial factors in the next few quarters will be: 1) the reaction of consumption to the tax hike; 2) the trend of earned income and prospects for wages, ahead of the spring negotiation phase; 3) increased public spending at containing the restrictive effects of the consumption tax hike; 4) the BoJ's reactivity to developments on the front of aggregate demand.
- Inflation has stabilised at just over 1% yoy, and is not expected to change much, stripping out the rise in taxes.
- The Bank of Japan is ready to intervene to support the economy in the event of an excessively negative reaction of demand to the hike in the consumption tax. The first important event will be the publication of half-yearly macroeconomic projections at the end of April, in which the Bank of Japan will provide forecasts on growth and inflation. Subsequently, the central bank will assess information following the rise in taxes: in the event that it deviates from its projections, it has committed itself to increasing stimulus. This would imply an increase in JGB purchases from the current amount of JPY 50 trillion a year. Our central scenario includes larger JGB purchases around the end of 2Q/beginning of 3Q.

Forecast Table

	2013	2014	2015	2013			2014				2015
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	1.5	1.3	1.1	1.3	2.4	2.6	2.6	0.6	0.9	1.2	0.6
q/q annual rate				3.6	1.1	1.3	4.3	-4.0	2.0	2.6	1.9
Private consumption	2.0	0.5	0.3	2.7	0.8	1.6	5.3	-7.5	-0.1	0.9	1.3
FI - private nonresidential	-1.5	3.1	2.8	3.8	0.0	3.0	6.9	-0.3	3.1	3.9	3.2
FI - private residential	8.6	2.8	-2.0	1.3	11.0	17.6	3.4	-6.8	-9.8	2.9	-0.4
Government investment	10.6	5.3	-6.2	27.9	28.9	8.7	4.7	-4.3	-7.0	-5.9	-6.4
Government consumption	2.0	1.7	1.1	2.5	1.0	1.9	1.0	2.0	2.8	2.0	1.2
Export	1.4	6.6	8.3	12.2	-2.4	1.7	8.6	9.3	10.6	10.5	7.5
Import	3.2	5.4	5.6	7.1	9.2	14.7	1.6	0.2	4.1	3.9	6.3
Stockbuilding (% contrib. to GDP)	-0.3	-0.2	0.1	-0.3	0.2	0.1	-0.3	-0.2	0.2	0.0	0.1
Current account (% of GDP)	0.7	0.1	0.7	1.6	0.5	0.0	-0.5	0.1	0.3	0.5	0.6
Deficit (% of GDP)	-9.0	-7.0	-5.4								
Debt (% of GDP)	212.8	213.6	212.5								
CPI (y/y)	0.4	2.9	1.9	-0.3	0.9	1.4	1.4	3.8	3.3	3.2	3.1
Industrial production	-0.6	6.3	4.7	6.2	7.0	7.6	14.9	-5.0	5.4	6.5	5.9
Unemployment (%)	4.0	3.7	3.8	4.0	4.0	3.9	3.8	3.7	3.7	3.6	3.6
3-month CD rate	0.15	0.00	0.07	0.16	0.15	0.14	0.00	0.00	0.00	0.00	0.00
JPY/USD	98.3	105.1	109.2	98.7	98.9	100.4	102.8	103.8	106.1	107.6	108.6
Effective exch.rate (1990=100)	145.2	134.4	131.0	144.2	143.5	139.7	136.1	135.5	133.6	132.5	131.5

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

Fasten your seatbelts, there's turbulence ahead!

The outlook for the Japanese economy in 2014-15, as expected, will be conditioned by fiscal policy. Growth volatility will make it hard to assess underlying trends, although for the time being the picture remains positive and the continuation of the recovery, albeit at a slower pace, does not seem at risk. Forecasts price in an acceleration of growth in 1Q, and a subsequent contraction of GDP in 2Q. The size of the quarterly changes will be important in maintaining a generally positive outlook for growth in the year. The weaker than expected increase in GDP at the end of 2013 has led us to revise downwards our growth forecasts for 2013 (to 1.5% from 1.7%) and 2014 (to 1.3%).

The crucial factors in the next few quarters will be: 1) the reaction of **consumption** to the tax hike; 2) the trend of earned income and prospects for **wages,** ahead of the spring negotiation phase; 3) increased **public spending** at containing the restrictive effects of the consumption tax hike; 4) the **BoJ's reactivity** to developments on the front of aggregate demand.

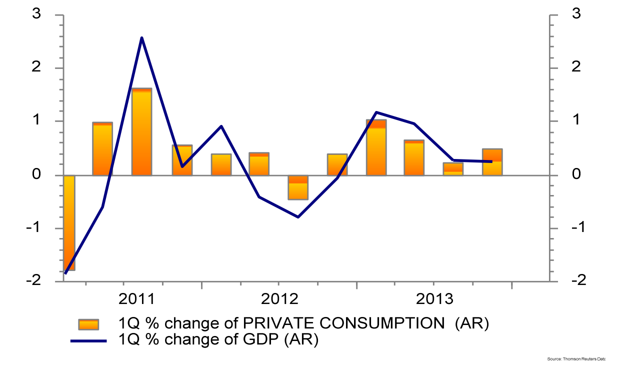
Consumption and investment: negative shock in April, support may come from wages and reforms

Consumption will be the key issue in 2014. After a +0.5% q/q increase in 4Q 2013, initial data for 2014 point to an acceleration, with retail sales and consumption on the rise by 1.1% y/y and 1.4% y/y respectively: the uptrend will continue for another two months before turning negative. In the year as a whole, consumer spending is forecast to grow by 0.4%, from +2% in 2013. The crucial aspect for the trend over the following quarters will be the resilience of real wages. The effect of the consumption tax on the CPI will be worth around 2pp, resulting in a strong contraction in the purchasing power of households. Earnings have already been declining in real terms for several months (Fig. 3), in part also due to the still large share of part-time workers (close to 30% of the total). Annual wage negotiations in large companies ("*shunto*", the "spring wage offensive") are under way, and indications point to the possibility of moderately higher wage increases than seen in the past (Fig. 4). The **labour market** keeps improving and for months now enterprises have been signalling excess demand, typically associated with an acceleration in contract-based wages (Figs. 4 and 5). Also, company earnings are rising sharply (+26.6% y/y at the end of 2013). The overall effect of an increase in negotiated wages will in any case be contained, as it directly affects only around 20% of the country's workforce: even a 2-2.5% rise would translate into a 0.4 pp acceleration of overall income, potentially strengthened by an increase in the number of workers employed full-time. In conclusion, real wages will probably stay negative throughout 2014, albeit less so than in 2013.

As regards the business sector, all monthly indicators reflect the fluctuation in activity ahead of the April consumption tax hike, showing an acceleration in the growth of **industrial output** (+4% m/m in January) and **investments** between the end of 2013 and the beginning of 2014 (capital goods deliveries in January, +8.3% m/m). Projected output in March is on the decline (METI projections -3.2% m/m in March), in line with the indications provided by the Tankan expectations index (14 in March, vs. the current assessment index of 16 in December). The support offered by fiscal policy to capex spending, and the possible introduction in June of a structural reform of corporate taxation, combined with expansive monetary conditions, should contain the slowdown in non-residential investments in the central months of the year.

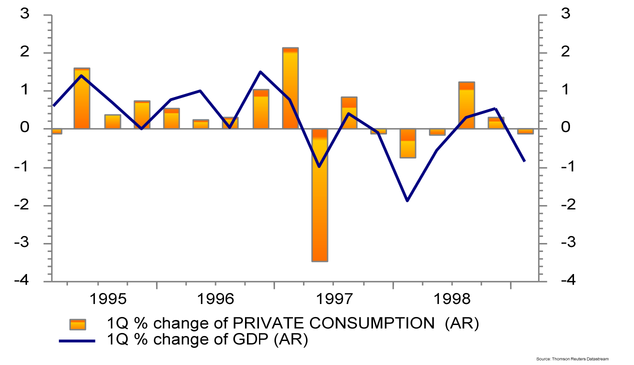
Net exports remains the Achilles' heel of the Japanese economy. The deterioration of the trade balance resulted in a contraction of the current account surplus to 3.3 trillion yen (from 17.9 trillion in 2010, 9.6 in 2011, and 4.8 in 2012). The trade deficit widened by 5 trillion to 10.6 trillion in 2013; however, the marked depreciation of the exchange rate helped support dividends and interest in the income balance (up to 16.5 trillion in 2013 from 14.3 in 2012), and to reduce the services deficit (to -1.6 trillion in 2013 from -2.5 in 2012). The trade balance will stay negative in the future, given the rise in energy imports following the 2011 earthquake, and the depreciation of the yen; the current account balance, however, should continue to show a surplus.

Fig. 1 – GDP and consumption: waiting for the tax shock



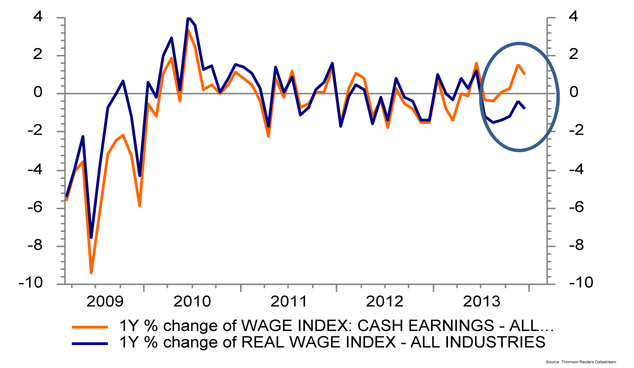
Source: Thomson Reuters-Datastream

Fig. 2 – The experience of the '90s: huge volatility



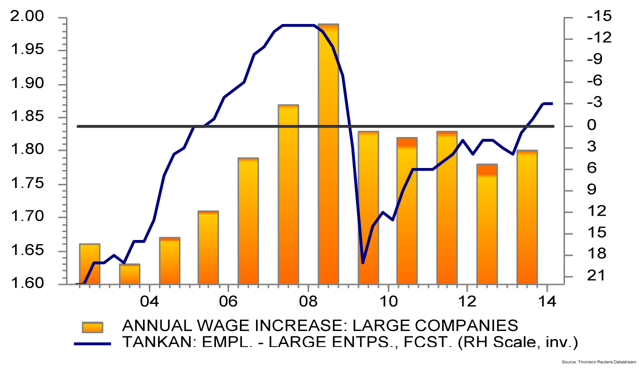
Source: Thomson Reuters-Datastream

Fig. 3 – Nominal and real earnings: negative growth



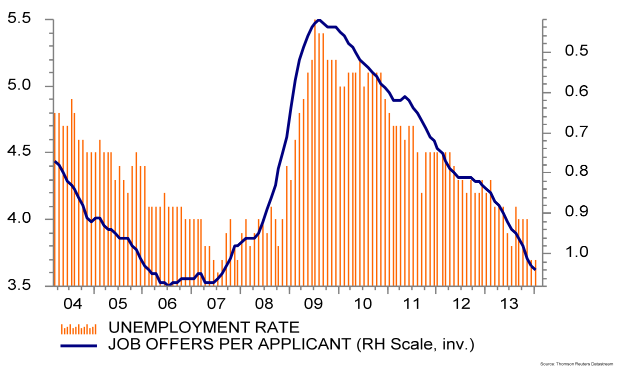
Source: Thomson Reuters-Datastream

Fig. 4 – Increases set in the "spring wage offensive" (shunto) and labor excess demand



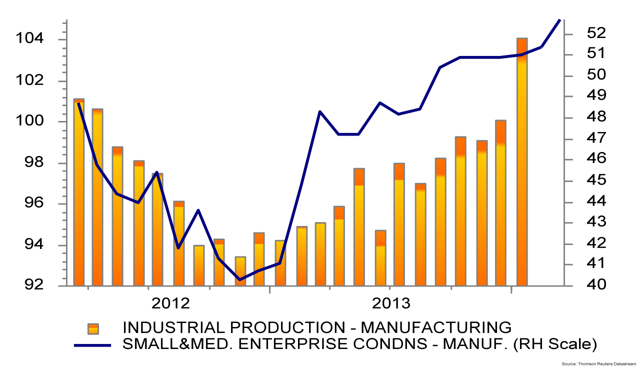
Source: Thomson Reuters-Datastream. Labor demand conditions as are from the Tankan Survey; numbers >0 signal excess demand

Fig. 5 – Unemployment rate and "job/offers ratio"



Source: Thomson Reuters-Datastream

Fig. 6 – Industrial production and Shoko Chukin survey



Source: Thomson Reuters-Datastream

Fiscal policy at the fore: deep changes in tax policies

The consumption tax (CT) hike should be implemented in two stages: a rate increase from 5% to 8% in April 2014, and another one from 8% al 10% in October 2015. The CT hike marks an epochal change in Japanese public finance management, necessary in order to start consolidating public accounts. In 1997 the CT was raised from 3% to 5%: the hike was followed by a fall back into recession (Fig. 2), with a further worsening of deflation. Revenues from the CT amounted in 2013 to 2.1% of GDP, and to 11% of total tax revenue. A part of the CT is paid to the central government (80%), and a part to local administrations; the central government uses CT revenue to finance the welfare and health care programs. The rate hike scheduled in April will increase revenue by around 5 trillion yen (1.04% of GDP), and will be entirely transferred to the central government to be used for welfare and healthcare programs.

The 2014 budget and the additional mini-budget for 2013 contain spending measures aimed at buffering the restrictive effects of the consumption tax hike due to come into force in April 2014 (Fig. 8). The government's medium-term goal is to reduce the primary deficit by controlling the growth in spending and achieving a sharp increase in fiscal revenues. Budget projections for the end of 2013 point to a lower primary balance by 39% between 2014 and 2020. According to the Cabinet Office's long-term projections, as a results of the government's "revitalisation" programme (end of deflation and consolidation of public accounts), average growth between 2014 and 2020 will be 2.1% (vs. 1.3% under current policies), and the primary balance would improve to -2% of GDP in 2020 from -3.2% under current policies (Fig. 9). In June 2014, a corporate tax reform should be presented, reducing the effective tax rate from 39% at present to 25% (OECD average), and introducing other measures aimed at supporting investments. The government has reserved to confirm the CT hike planned for October 2015 based on the evolution of the recovery in the second half of 2014. On the whole, the Abe government's fiscal policy strategy marks an important turning point, although still not sufficient to generate expectations for a significant reduction of the debt/GDP ratio in the next decade.

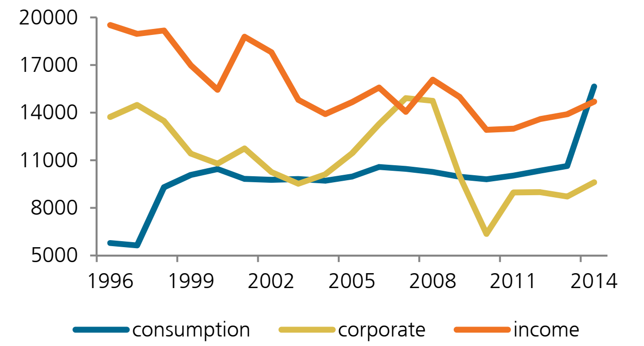
Monetary policy – BoJ ready to step up stimulus if slowdown is too sharp

The BoJ is ready to intervene to support the recovery if the growth and inflation trends deviate from projections in the next two years. At the February meeting, an expansive signal was sent. The monetary base target and the asset purchase programmes were left unchanged, whereas the central bank has doubled the size of its funding programmes to support bank lending and growth (see Focus section). Also, the two programmes have been extended by a year, and will no longer expire in March 2014. The programme for the financing of reconstruction in the areas hit by the earthquake of 2011 has also been extended by one year. According to the BoJ, the expansion of the programmes supporting credit growth should encourage the demand and supply of loans and strengthen the recovery. While the central bank's assessment of current economic conditions remains positive, its decision to step up stimulus, albeit through less central programmes than the asset purchase programmes, may represent a response to disappointing 4Q GDP data, that did not prove to be as solid as expected.

Inflation has stabilised in the past few months. The CPI net of fresh food (BoJ target) in January was at +1.3% y/y, as in December. In its latest statement, the central bank forecasts "inflation net of fresh food prices at around 1.25% for some time": previously, the BoJ expected inflation to increase gradually. Therefore, on the inflation front as well, there are no signals for the time being that could prompt the central bank to intervene swiftly with new accommodative measures.

A potential intervention on the size of purchases, and on the monetary base target, may only come after the economic situation is assessed between April and June, and once the BoJ has drawn up its new growth and inflation forecasts, due for release at the end of April. Our base-case scenario includes an increase in asset purchases, although we attach a probability of just over 50% to this outcome, which will also depend on the path of consumption and inflation in 2H 2014, following the CT hike.

Fig. 7 – Tax revenues by type



Note: Data in Bn Yen; 2013 and 2014 budget projections
Source: Ministry of Finance

Fig. 8 – 2014 Budget: higher revenues more than outweigh spending increase

	2012	2013*	2014
Total outlays	97.1	98.1	95.9
Primary spending	59.2	54.0	56.5
Transfers to local govts	16.8	16.4	16.1
Interests	21.0	22.2	23.3
Total revenues	97.0	98.1	95.9
Tax revenues	43.0	45.4	50.0
Household income	14.0	14.0	14.0
Corporations	9.0	10.0	10.0
Consumption	10.0	10.0	15.0
Other	9.0	9.0	9.0
Non tax revenues	13.0	9.0	4.0
Net issues	50.0	42.0	41.0

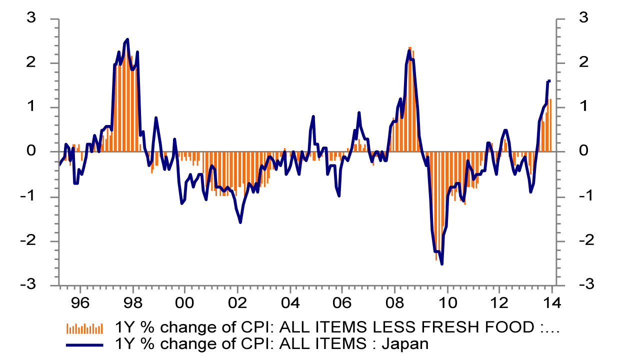
Note: Data in Tln Yen, years indicate fiscal years. Memo: nominal GDP 481 tln Yen.
* 2013 data include supplementary budget approved at end-2013
Source: Ministry of Finance

Fig. 9 –2014 budget

	Budget 2014 preliminary	Projections 2014	2015	2020
Primary spending	72.6	72.0	73.9	83.1
Tax revenues	50.0	49.4	55.0	67.9
Other revenues	4.6	3.7	3.7	4.2
Primary balance	-18	-18.9	-15.2	-11.0
Primary balance/GDP (%)		-4.3	-3.3	-2.0
Debt/GDP* (%)		191.4	190.4	187.9

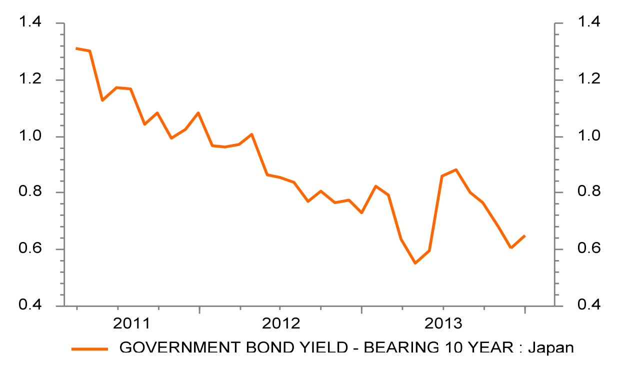
Note: Data in trillion yen, except when otherwise indicated. * Debt calculated excluding measures for recovery and reconstruction. 2014 total debt is projected at 202% of GDP
Source: Economic and Fiscal Projections for Medium to Long Term Analysis, Cabinet Office

Fig. 10 – Inflation steady around 1.25%



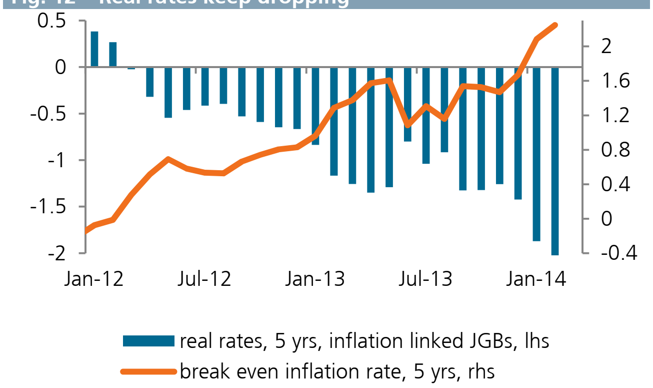
Source: Thomson Reuters-Datastream

Fig. 11 – BoJ purchases put a brake on JGB yields



Source: Thomson Reuters-Datastream

Fig. 12 – Real rates keep dropping



Source: Bloomberg

Focus: strengthening of the "Loan Support Program"

The Loan Support Program (LSP) was established in 2010 and stepped up in December 2012, when it was split into two programmes aimed a providing funds to:

1. Stimulate bank lending ("*Stimulating Bank Lending Facility*"); funding with no ceiling against collateral. Duration of the loans: between 0 and 3 years, as requested by the borrower (terms and conditions available at:
https://www.boj.or.jp/en/announcements/release_2012/rel121220c.pdf);

2. Modify existing programmes aimed at supporting economic growth fundamentals ("*Growth-Supporting Funding Facility*"), worth 3.5 trillion yen. Special rules for i) "equity investments" (investments and loans in stocks) and loans against collateral other than real estate (worth 0.5 trillion yen); ii) small investments and loans of between one and 10 million yen (worth 0.5 trillion); 3) investments and loans in foreign currency (to be issued in USD, worth 12 billion dollars).

At its February 2014meeting, the BoJ stepped up its LSP
(https://www.boj.or.jp/en/announcements/release_2014/k140218a.pdf).

3. «*Stimulating Bank Lending Facility*» - Banks may receive funds amounting to twice as much as the net increase in their lending. The deadline for fund applications has been postponed by one year (March 2015). The interest rate applied to the facility is fixed at 0.1 percent per annum for four years. Based on the assumption that the growth rate of bank lending and the utilization rate of the facility remain more or less at current levels, the BoJ estimates fund-provisioning under this programme at around 30 trillion yen. The new terms of the programme will come into force starting in June 2014.
4. «*Growth-Supporting Funding Facility*» - Funding ceiling doubled to 7 trillion yen. Ceiling on funds issued to single institutions raised from 150 billion yen to one trillion yen. Interest rate fixed at 0.1 percent per annum for four years. The financial institutions may opt to pay back the funds every year.

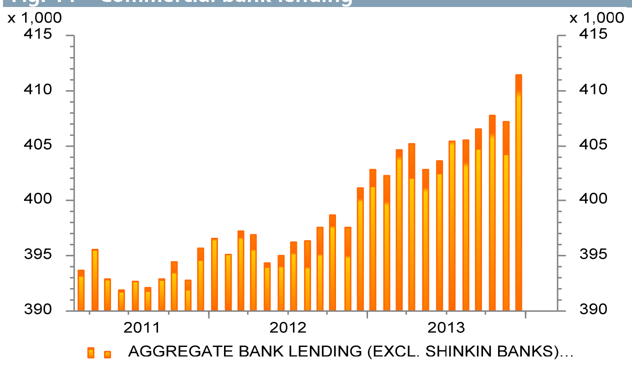
Around five trillion yen were provided to financial institutions through the LSP in 2013, almost entirely concentrated on the long maturities covered by the programme (3Y loans), and according to the BoJ's objectives, the programme should continue to grow. The net effect on credit is not clear, as loans may well have been issued by the banks even in the absence of the programme, against a background of accommodative conditions for credit. In any case, the expansion of the LSP signals that the BoJ is ready to add monetary stimulus in the next few quarters, possibly by stepping up JGB purchases.

Fig. 13 – LSP loans

Amount	1 year loans	2 years loans	3 years loans	Total loans
June 2013	191.4	0.0	2960.5	3151.9
September 2013	30.0	9.4	841.8	881.2
December 2013	111.1	0.0	941.7	1052.8
Total	**332.5**	**9.4**	**4744**	**5085.9**

Note: Data in Bn Yen
Source: BoJ

Fig. 14 – Commercial bank lending



Note: Data in Bn Yen. Source: Thomson Reuters-Datastream

China: the PBOC puts the brakes on speculation while the economy slows

Silvia Guizzo

- In the fourth quarter of 2013 GDP growth was 7.7% yoy compared with 7.8% for the third quarter, while it slowed to 1.8% qoq from 2.2% qoq the previous quarter. 2013 thus closed with growth of 7.7%, unchanged on 2012, thanks to an upsurge in public consumption and exports. Both consumer spending and capital investment slowed, although they still grew at a faster rate than GDP.
- The figures for the first two months of 2014, although difficult to evaluate as the Chinese New Year fell on a different date this year, point to a continuation of the slowdown currently under way in industrial output and investment, as well as in consumption. The price data for residential property and the difficulties faced by some property companies, as well as the number of unsold units, confirm the forecast of a slowdown in the real estate sector during the year.
- At the plenary session of parliament in March, premier Li Keqiang's opening address did not contain any great changes to the priorities already outlined at the Party's Plenum in the autumn, and the growth target for 2014 was left unchanged at 7.5% The objective of rebalancing the economy in favour of greater consumption remains a priority, and is supported by greater emphasis on the importance of positive trends in the labour market and incomes, together with prudent policies for containing local government debt and financial risks. However, investment, especially in transport infrastructure and social housing, remains the key growth driver in the government's economic policy.
- We believe that in the absence, over the next few months, of any particularly negative economic data that could undermine the future resilience of the labour market and consumer spending, the PBOC intends to continue its policy of slowing growth in bank lending, especially in non-productive sectors or sectors with excess capacity, as well as curbing and regulating lending outside the banking sector. This is partly in light of the first cases of default or problems of quasi-default on trust companies' products that have recently appeared. We therefore expect it to allow money market rates to rise once again from their recent lows, and continue to drain off excess liquidity. Volatility in the exchange rate, which has been allowed to depreciate sharply since the middle of February, will be higher than in the past, but we do not rule out a recovery based on a modest improvement in the foreign trade figures.
- We maintain our forecasts of growth of 7.3% for 2014 and revise them slightly from 7.2% to 7.1% for 2015. We maintain risks to the downside for the outlook.

Macro forecasts	2009	2010	2011	2012	2013E	2014F	2015F
GDP (constant prices, at factor cost)	9.2	10.4	9.3	7.7	7.7	7.3	7.1
Consumer spending	10.3	8.2	10.3	9.4	8.8	8.4	8.3
Public consumption	6	11.4	12	5.5	7.4	7.4	7.4
Capital investment	22.4	11.3	8.7	9	8.2	5.8	6.5
Exports	-11.4	26.1	4	3.2	6.6	6.8	8.3
Imports	5.7	18.3	3.3	4.2	8.8	8.5	8.5
Industrial production	9.9	12.3	10.3	7.9	7.8	6.8	6.9
Inflation (CPI)	-0.7	3.3	5.4	2.6	2.6	2.5	2.5
Unemployment	4.3	4.2	4.1	4.1	4.1	4.1	4.0
Average wages	11.6	13.4	14.4	11.9	11.4	11	10.5
90-day Interbank Rate (average, %)	1.7	2.7	5.3	4.6	5	4.9	4.5
USD/CNY exchange rate (average)	6.83	6.77	6.46	6.31	6.2	6.11	6.01
Current account balance	1661.7592	1604.3045	873.696868	1219.7521	1168.728	2142.3545	2056.1696
Current account balance (% of GDP)	3.2	3.1	1.7	2.4	2.3	4.2	4.0
Budget balance (% of GDP)	-0.2	-1.5	-1.3	-1.0	-1.7	-2.1	-2.9

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

Real economy and inflation

In the fourth quarter of 2013 GDP grew by 7.7% yoy compared with 7.8% yoy in the third quarter and, over the shorter term, slowed to 1.8% qoq from 2.2% qoq in the previous quarter. 2013 thus closed with growth of 7.7%, unchanged on 2012, thanks to an upsurge in public consumption and exports. Both consumer spending and capital investment slowed, although they still grew at a faster pace than GDP. On the supply side, an acceleration in the services sector was offset by a slowdown in the agriculture sector and, to a lesser extent, in the industrial sector.

The figures for the first two months of 2014, although difficult to evaluate as the Chinese New Year fell on a different date this year, point to a continuation of the slowdown currently under way in industrial output and investment, as well as in consumption. The same may be said for the property market.

In the first two months of the year exports fell 1.6% cum. yoy on the same period last year while imports rose by 10.1%. Exports were affected in part by the comparison with the high rates of growth for the same period of 2013, which were boosted by over-invoicing, and in part by the bringing forward of exports to January due to the Chinese New Year celebrations in the first week of February. The impact of such seasonal factors, however, should be less than for last year, given that the Chinese New Year also fell in February, albeit a week later, in 2013. Other countries, such as Vietnam and Taiwan, which essentially have the same festive period, did not record such negative or volatile figures. The subdued performance of exports in recent months is in line with the fall in the foreign orders component of the PMI, which has steadily fallen from 51.3 in October to 48.5 in February in the HSBC-Markit survey, and is largely unchanged compared with January (48.4). In the last four months, exports to ASEAN countries have slowed the most. However, imports have remained high, in particular those of ordinary goods for domestic demand, (+18.1% 3m yoy), and much greater for energy commodities, metals and foodstuffs than for machinery (electronic equipment and machines): +3.2% 3m yoy), except for transport vehicles. The aggregate foreign orders component for Asian countries has remained around 51 over the last four months, although falling slightly, given that the considerable improvement for some countries (Hong Kong, Taiwan and India) has been offset by the deterioration for China and Japan. This trend points to foreign demand that, while still positive, is far from rising sharply.

The orders component of the PMI has followed the same trend, falling below 50 in the HSBC-Markit survey, and the total PMI of the National Bureau of Statistics remains below 50 both for medium-sized and small businesses. The PBOC's industrial outlook survey for the first quarter of 2014 showed an improvement in the assessment of general economic conditions but a deterioration in business confidence. Both domestic and foreign orders continued to fall. Industrial output rose by 8.6% ytd yoy in the first two months of the year, much less rapidly than the 9.7% ytd yoy in December, led by the weak trend for state industrial output, mining output and energy and water distribution.

New investment (flow) in the first two months of the year fell (0.4%) compared with the same period in 2013 and the growth in capital investment stock slowed (17.9% cum. yoy vs 19.6% cum. yoy in December). This was particularly noticeable in the slowdown of investment by state-owned companies and of investment in machinery and equipment, while investment in residential building, which was down in relation to the property sector, rose slightly overall. Investment in the manufacturing sector slowed further, while investment in transport infrastructure accelerated somewhat. All of this was in line with the government's announcements of further improvements to the rail network and increased urbanisation.

Signs continue of a slowdown in the property market. Average house prices and land sales fell in February, as did started and completed residential floor space, although all the variables were to some extent negatively impacted by the comparison with the sharp increases in the same period of 2013. Prices of residential property started to slow month-on-month in October, and in a more marked manner in December, with the number of cities recording price increases still high (58 out of 70 for prices of new-build commercial[9] residential property) although falling (69 out of 70 in October). In the autumn, the cities that recorded the biggest price rises last year toughened up the administrative measures already in place in an attempt to control prices. Both the government and the PBOC seem to have softened their tone as regards the need to put a brake on price rises in recent months, or at least they appear to want to propose different measures for different cities, as well as focus on the development of social housing. The construction industry's confidence index fell slightly in February compared with December, and from the beginning of the year to mid- March the Shanghai stock exchange real estate index shed 10.8%, double the figure for the index as a whole (5.3%). The recent collapse of the Zhejiang Xingrun real estate company in Fenghua, Zhejiang, with debts of CNY 3.5Bn (USD 565M), casts a shadow over the sector, and most importantly, according to analysts, on the outlook for small/medium real estate companies, which have high levels of debt, even outside the traditional banking sector, and are experiencing greater difficulty obtaining credit. We believe that the slowdown in the real estate market is likely to continue over the months ahead, not least in light of the high level of unsold stock.

In 2013, households' per capita consumer spending slowed slightly, both in the cities and rural areas, and in both nominal and real terms. Nominal per capita disposable income for urban areas continued to rise at a fast pace (9.7% in 2013), but more slowly than in 2012 (12.6% yoy); this was also the case for rural areas (12.2% yoy in 2013 vs 13.3% yoy in 2012). Urban income remains 3.03 times higher than in rural areas: the ratio has fallen slightly from its peak of 3.33 in 2007 and in 2009. Labour market conditions continue to be good: in 2003, 13.1 million new jobs were created, the ratio of companies' demand for labour to supply is still greater than 1, while unemployment in urban areas has remained low and is stable at 4.1%. Hiring intentions, as measured by the Manpower survey for the second quarter, are still increasing, especially in the mining and construction sectors. However, all of this is in contrast with the trend for the employment component of the PMI index, which is still below 50 and has been falling for the last five months. It also contrasts with the present and future assessment of the labour market in the quarterly household survey, which is improving slightly but is below 50.

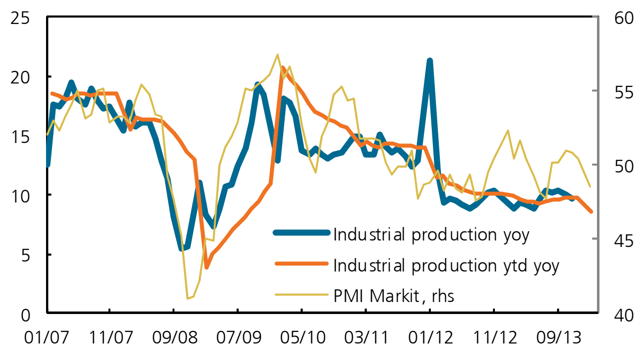
In the first two months of the year, retail sales recorded nominal growth of 11.8% yoy, a marked slowdown compared with the 13.1% for December, although the monthly changes were on average greater than those for the first two months of 2013 and 2012, making the trend difficult to interpret. The slowdown in the catering sector is probably the result of the anti-corruption campaign that has now been under way since 2013, and has limited spending on banquets and gifts, with a negative impact on the luxury sector. In addition, many consumers are gradually moving towards online purchasing, which in 2012 comprised 6% of retail sales and in 2013 recorded growth rates of over 50% in many cities. The Unionpay consumer confidence index has fallen continuously since October, while the NBS (National Bureau of Statistics) index, which is much more volatile, has been improving in recent months, although its twelve-month moving average remains low and well below pre-crisis levels.

Thanks to the slowdown in food price increases, consumer price inflation fell from its peak of 3.2% yoy in October to 2% yoy in February, and inflation net of food prices returned to its end-year level of 1.6%. Production and input prices continued to fall. The slowdown in food price

[9] Social housing excluded

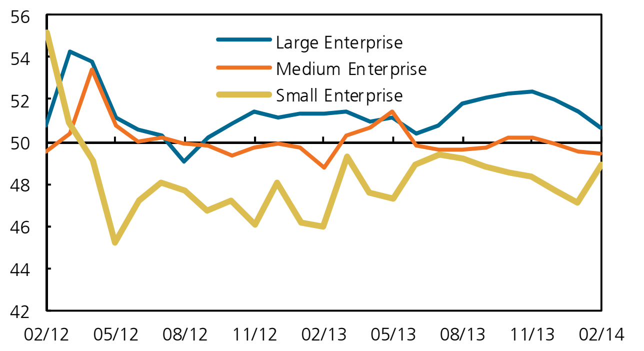
increases, the absence of any pressure from demand, and the fall in raw materials prices point towards inflation that will be, on average, slightly lower (2.5%) than in 2013 (2.6%). This will be contained at around 2% over the coming months before rising again in the second half of the year due to the unfavourable base effect.

Industrial output slowing slightly



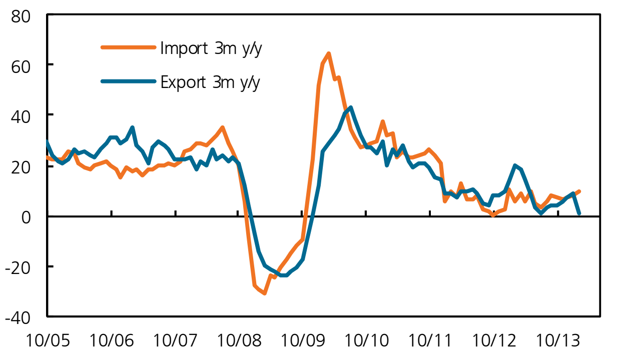
Source: CEIC, Markit

Small and medium-sized businesses still in difficulty



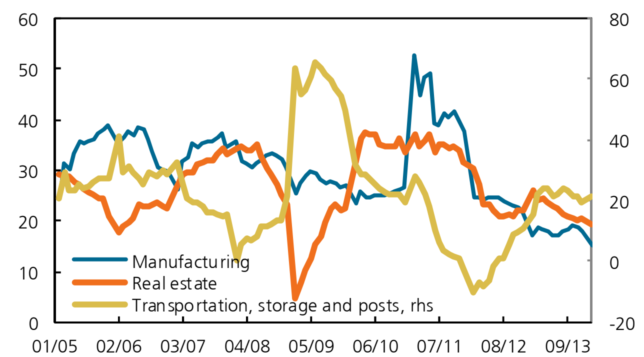
NB: Manufacturing PMI; source: CEIC

Exports are not taking off



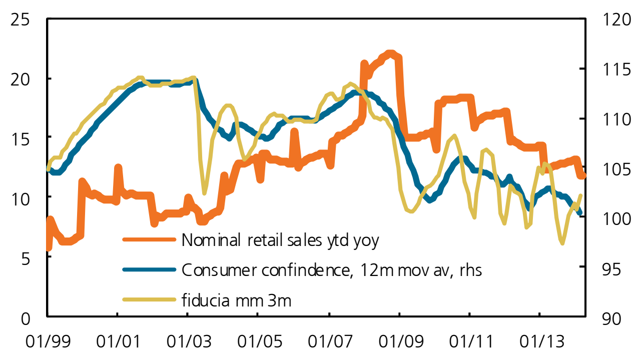
NB: Chg. % 3m yoy. Source: Bloomberg

Investment in transport infrastructure is holding up (%)



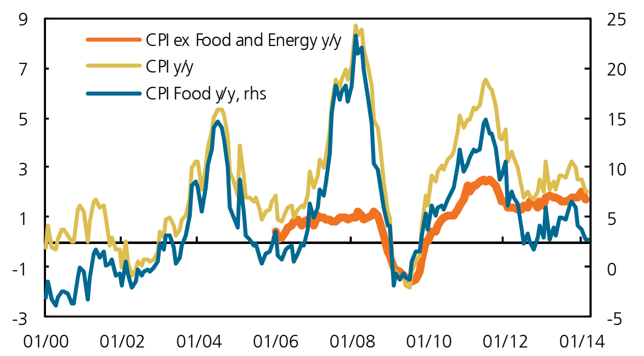
NB: Nominal investments, chg. yoy. Source: Datastream

Consumer confidence is improving but remains low



Source: Intesa Sanpaolo chart from Bloomberg and CEIC data

Inflation remains subdued



Source: Bloomberg

Economic, monetary and exchange rate policy

Parliament met at the beginning of March for its usual annual session where premier Li presented the government work report outlining the economic policy objectives for 2014. These remain essentially unchanged compared with 2013, with only targets for capital investment and trade growth being reduced slightly. In an interview, the finance minister, Lou Jiwei, stated that the target is "around 7.5%", emphasising that it was flexible so that even growth of 7.2%, 7.3% or 7.7% would be considered to be in line with the objective.

Economic policy targets

		2013 effective	2013 targets	2014 targets
GDP	%	7.7	7.5	7.5
CPI	%	2.6	3.5	3.5
M3	%	13.6	13	13
Affordable housing	million started units	6.6	6.3	7
	million completed units	5.4	4.7	4.8
New jobs	million persons	13.1	9.0	10
Urban unemployment rate	%	4.1	4.6	4.6
Fixed Investments	%	19.6	18	17.5
Foreign trade	%	7.6	8	7.5

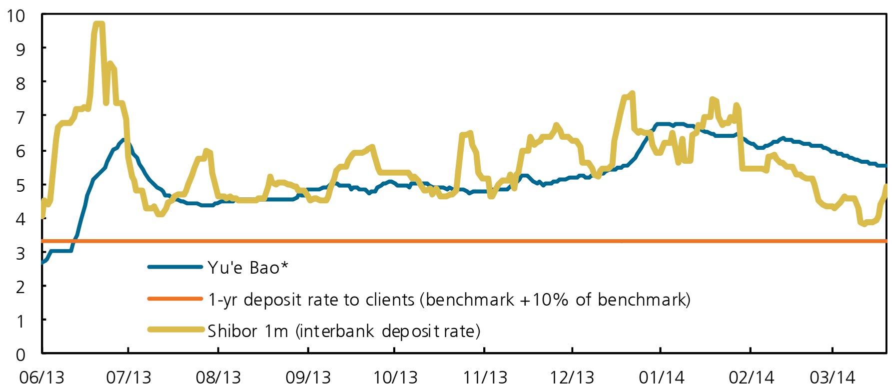
Source: Xinhua

The opening address of premier Li Keqiang did not contain any major changes to the priorities already set out in the Party's autumn Plenum. The government's task will be to maintain a high level of growth, contain inflation, create ten million new jobs, combat pollution and cut energy use, reduce excess capacity in the steel, cement and plate glass industries, and minimise financial risks, all of which while simultaneously transforming the growth strategy. This all seems almost contradictory given that investment is still considered to be the key variable in maintaining stable economic growth, which is, however, essential given the need - economic and especially social - to create new jobs for the over seven million new graduates that China produces each year. Efforts include, inter alia, increasing investment in social housing and in the railways, especially in the central and western regions, reducing pollution in the big cities, improving water management and modernising agriculture. In the conference closing the parliamentary proceedings, premier Li emphasised that the government is not chasing growth and that employment and household incomes remain priorities.

More than 200 procedures requiring the approval of the State Council will be cancelled or delegated to lower administrative levels. The local government funding mechanism will be expanded through the issue of bonds and all local authorities will have to submit final financial statements. The pilot project for the changeover from a sales tax to a tax on value-added, which was also extended in January to railways and postal services, will be progressively expanded to include the telecommunications, construction and real estate, and finance sectors. A property and an environmental tax are on the table, changes to the consumption tax and the tax on energy resources are also possible. The public deficit is forecast to reach 2.1%, slightly higher than the 2% target in 2013.

As regards the liberalisation of the financial sector, the government has reiterated its intention to open up some public sectors to private investment and to give the banks more power to determine interest rates. The governor of the central bank has recently stated that the process of interest rate liberalisation will be completed within one or two years. He also referred for the first time to the growing need to regulate internet finance in conjunction with the regulation of traditional finance. The popularity of savings management products sold via the internet is rising rapidly and this is worrying both financial institutions, since these products are diverting funds away from traditional bank deposits, and the central bank, given the risks connected with these products, of which savers are not always aware. Savings management products sold online[10] are able to offer rates of over 6% per year, much higher than the one-year benchmark deposit rate, set at 3.3%. Recently, the largest banks introduced limits on fast payments via the internet (quick response codes) through which customers can purchase these such products online. In addition, on 14 March, the PBOC issued a directive temporarily blocking virtual credit cards and fast payments via the internet, and also prohibited banks from opening accounts involving online payment platforms such as Alipay and Tenpay, owned by Alibaba Group Holding Ltd and Tencent Holdings Ltd respectively. The central bank also requires that banks provide information on their security systems, on which it intends to carry out risk assessments below allowing the services to be restored.

Deposits interest rates versus on-line products



*See footnote below. Source: http://www.thfund.com.cn, Bloomberg

In 2013, new bank lending rose by 8.4% yoy, more slowly than the 9.8% of 2012. Total social financing recorded a more marked slowdown, rising by 9.7% compared with the figure of 22.9% in 2012. Both figures as a proportion of GDP (15.6% and 30.4% respectively) have, however, remained broadly unchanged compared with the previous year. The stock of bank loans rose by 14.2% yoy in February, roughly unmoved in recent months. In the first two months of the year, new lending rose by 16.0% yoy while total social financing fell by 2.1% as a result of the big drop in bill financing, net issues by companies and trust loans, which were probably hit by the recent cases of quasi-default. However, in the December – February quarter, social financing and credit rose by 35% and 27.5% respectively compared with the previous quarter, in line with the increase recorded in the same period of 2013. According to the industrial outlook survey, banks' willingness to lend was also at record levels for the series during the fourth quarter too, and demand for loans to businesses, although well off its peak, also recovered at least until the third quarter.

The audit of local government's public accounts completed by the National Audit Office (NAO) in the autumn, while not completely comparable with the previous audit as it included in the analysis other bodies connected with the local authorities, showed that local authority debt had increased from CNY 10.7Trn at the end of 2010 (26% of GDP) to CNY 17.9Trn at the end of June 2013 (32% of GDP). Around 61% of this comprises direct local government debt, 15% is guaranteed by local governments and the remainder comprises debt from local government financing vehicles (LGFV), which carry implicit guarantees. 19.9% of total debt matures in 2014; a further 15.5% matures in 2015[11]. Most of the debt went towards financing transport

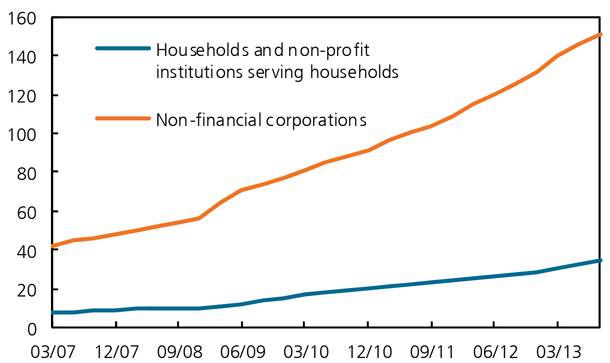
[10] Like the popular Yu E' Bao, sold on Alipay, Alibaba on-line payment platform. Launched in June 2013 it has 81 million users and has reached 500bn yuan aggregate deposits in February.

[11] IIF Research note: "China getting serious about local government debt", 5 February 2014

infrastructure projects and urban building. The maturity mismatch between investments and the debt used to finance them remains a source of worry. It is estimated that LGFVs are mainly short term and entered into by the banking sector and trusts.

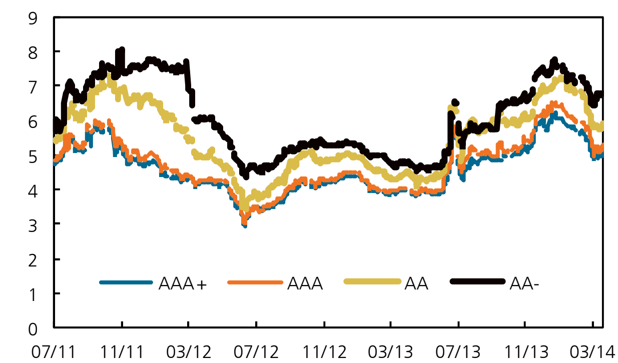
In addition, the amount of non-financial corporate debt increased a lot in recent years, jumping from 56.4% of GDP at the end of 2008 to 151,4 in the 3rd quarter of 2013 and reaching, according to IIF, the highest level vs GDP among both industrial and emerging economies. According to Bloomberg CNY 2.6Trn (USD 427Bn) of non-financial corporate debt (bonds and interest) will be maturing in 2014. In a context where lending is slowing the recent first cases of default (bonds of Chaori Solar Energy Science and Technology Co., coupon 8.98% and maturity 03/2017, and the real estate company Zhejiang Xingrun) can still be viewed as positive for the Chinese market in that they will lead to a greater differentiation of credit risk, as well as limited lending and higher rates for the weakest companies. This is of paramount importance to achieve a more efficient credit allocation and a reduction of financial systemic risks in the medium term and is in line with the authorities' objectives of strengthening the financial sector and containing risk, in view of the progressive liberalisation of the market. The number of corporate defaults is expected to increase in the course of the year, as it is physiologic in market economies, even if it is likely that the authorities will adopt a more benevolent approach to any larger defaults or defaults involving public companies, than in the case of private and/or smaller companies.

Corporate debt is at historical highs (in % of GDP)



Source: Intesa Sanpaolo chart from BIS data

Debt servicing cost is increasing even for AAA rated bonds*

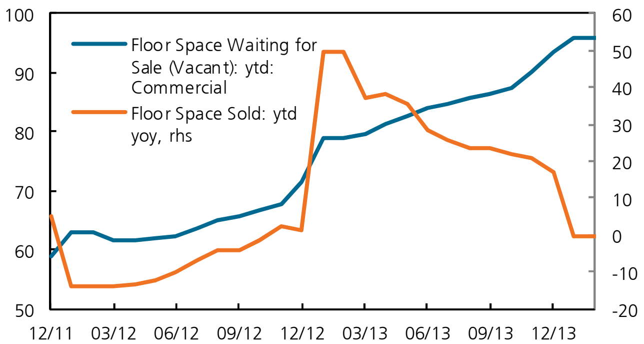


* 1 year notes yield. Source: CEIC

The slowdown in social financing in the second half of 2013 was "driven" by the central bank both by taking administrative measures for regulating the sector and by raising money market rates, which also had an impact on bank lending. The money market rates trend in the last two weeks is, however, raising some doubts as to whether the PBOC really intends to continue along this path. The overnight Shibor rate and the one-week repo rate, following a further significant increase at the end of the year which lasted until February, have recently fallen to levels not seen since spring last year. In fact the PBOC, despite having drained off - through repo operations in February - all the liquidity injected in January, seems not to have "sterilised" its intervention on the currency, allowing it fall freely by 1.35% in the second half of February, guiding the daily fixing higher and higher. The central bank was very worried by the one-way appreciation of the currency in the last quarter of 2013 and the simultaneous speculative capital flows that caused banks to increase their purchases of foreign exchange to the tune of CNY 1.1Bn in the last quarter of 2013, vs CNY 130M in the previous quarter. The PBOC has for some time spoken in favour of the market having greater influence over the exchange rate, even though it did not hesitate to stop the currency's appreciation (in the first half of 2012) when it considered it necessary to drive it down, as during the recent episode. What the PBOC wants most of all is to avoid one-way movements in the exchange rate that will fuel expectations of a further appreciation. In this direction goes the recent depreciation of the renminbi and the widening of the fluctuation band vs the dollar from 1% to 2%, in place since the middle of March.

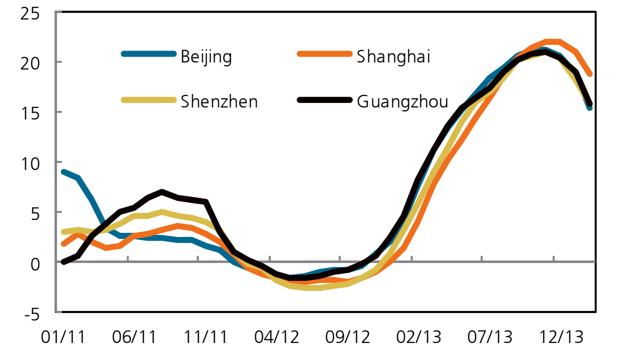
We believe that, in the absence in the coming months of any particularly negative macroeconomic data that could undermine the resilience of the labour market and consumer spending, the PBOC intends to continue its policy of slowing the growth of bank lending, especially in non-productive sectors or those with excess capacity, and of limiting and regulating lending outside the banking sector. We therefore expect it to allow money market rates to rise once again from their recent lows, and continue to drain off excess liquidity. The currency, which depreciated by a further 0.8% in the first half of March, probably partly because of the unwinding of positions in structured products in off-shore markets, will likely suffer from higher volatility than in the past, although we do not rule out a recovery based on a modest improvement in the foreign trade figures.

Residential property: stock of unsold property remains high



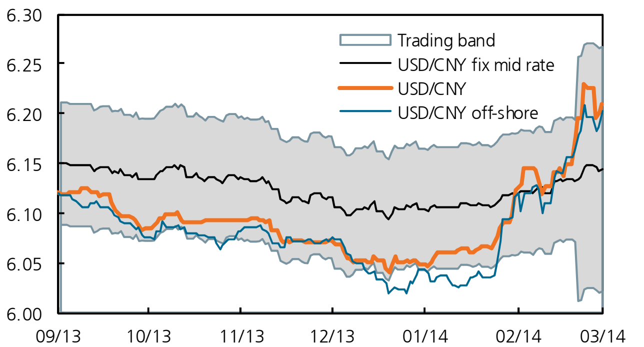
Source: Bloomberg, CEIC

The prices of residential property are beginning to slow



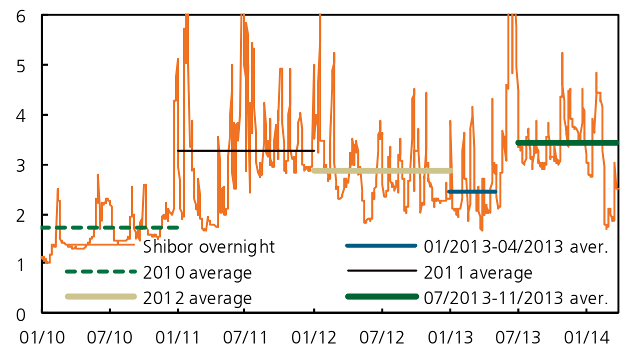
NB: yoy % changes. Source: CEIC

The PBOC guides the yuan depreciation



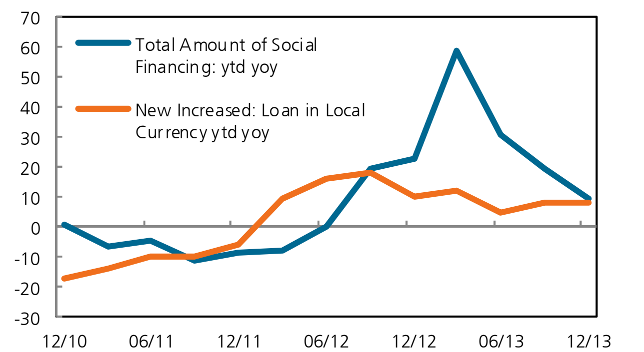
Source: Intesa Sanpaolo chart from Bloomberg data

Money market rates are falling



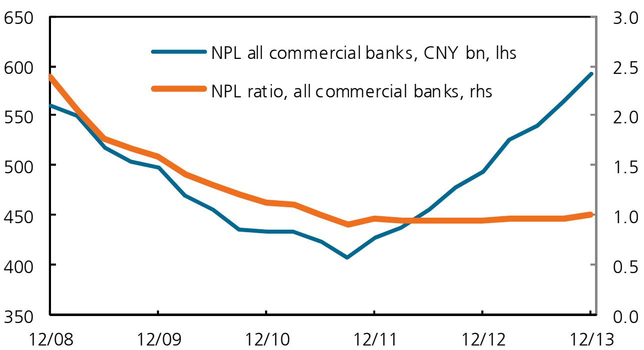
Source: Intesa Sanpaolo chart from Bloomberg data NB: Graph cut off at 6%

The flow of credit slows



Source: CEIC

Non-performing loans continue to rise



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

India: tentative improvement in growth

Silvia Guizzo

- In 2013, GDP grew by 4.7% compared with 4.6% in 2012, slowed by the marked downturn in consumer spending (+2.8% vs. +6% in 2012), in combination with a still very weak trend in capital investment (+0.1%). On the supply side, the upturn in the agriculture sector offset the slowdown in services and industry. In 4Q, GDP (at factor cost) grew by 4.7%, slightly below the 4.8% recorded in 3Q13, with domestic demand still flat and a positive contribution from foreign trade.
- Data on industrial output and investment proposals remain very weak. The improvement in PMI activity indices, under way since November also in the orders component, and business confidence indices, as well as the increase in approvals for infrastructure projects granted by the Cabinet Committee, is however expected to provide some limited support to the economy in the next few months, which will gradually increase in the second half of the year.
- The central bank expects that core inflation will remain high, although the overall inflation trend will benefit from the slowdown in food price growth, and will therefore continue to fall in the next few months. We reiterate our scenario that rates will remain unchanged, even in light of the recent rise in real interest rates and signals from the RBI. However, we do not rule out the risk of a further hike in June if core inflation rises again. We believe that there may be room for an easing in monetary policy only in the second half of the year, in line with the expected greater fall in inflation.
- Although the country is in a better external position than a year ago, the contribution of foreign capital flows to covering the external borrowing requirement and the probable overshooting of public accounts targets for the current fiscal year urge caution. Against this backdrop, the change of American monetary policy leaves the exchange rate exposed to further downside movements.
- Owing to the downwards revision of GDP figures for 2012 and 2013, particularly for the investment variable, and given the different trend in consumption, we are revising our growth forecast from 5.2% to 4.8% in 2014 and from 5.7% to 5.3% in 2015. The risks to the outlook are balanced.

Macro forecasts

	2009	2010	2011	2012	2013	2014P	2015P
GDP (at factor costs)	6.5	9.7	7.5	4.6	4.7	4.8	5.3
Private consumption	6.9	8.6	7.9	6	2.8	3.6	5.6
Public consumption	9.2	8.1	6.1	7.8	3.9	5.8	8.5
Fixed investment	-0.7	17.5	10	0.6	0.1	3.8	5.6
Exports	-7.7	15.4	17.9	9	5.9	11.3	7.3
Imports	-8.3	18.2	17.7	11.8	1	3.8	7.2
Industrial production	0.2	9.7	4.8	0.7	0.5	3.8	7
Inflation (CPI)	10.9	12	8.9	9.3	10.9	7.2	6.9
Unemployment rate (%)	12.5	12.5	12.5	12.5	12.5	12.4	12.3
Average wages	10.6	19.6	16.2	7.1	11.2	10.8	10.5
3-month Mibor (%)	5.5	6.3	9.5	9.5	9.3	8.9	8.1
Exchange rate USD/INR (average)	48.37	45.74	46.69	53.47	58.57	63	63.5
Current account balance	-1247.01327	-2396	-2958	-4894	-3551	-3761	-3936
Current account balance (in % of GDP)	-2.2	-3.4	-3.6	-5.4	-3.5	-3.3	-3.0
Budget balance (in % of GDP)	-7.4	-4.0	-7.2	-5.9	-5.9	-5.9	-4.9

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

Real economy and inflation

In 2013, GDP grew by an estimated 4.7% compared with 4.6% in 2012, slowed by the marked downturn in private consumer spending (+2.8% vs. +6% in 2012), in combination with a still very weak trend in capital investment (+0.1%). On the supply side, the upturn in the agriculture sector offset the slowdown in services and industry. In 4Q, GDP (at factor cost) grew by 4.7%, slightly below the 4.8% recorded in 3Q13, with domestic demand still flat and a positive contribution from foreign trade.

Industrial output remained flat, and despite the marginal year-on-year rise, after two months of decline, it fell by 0.4% 3m yoy in January, dragged down by the drop in manufacturing, particularly of capital goods and consumer durables. The manufacturing PMI has been above 50 and rising steadily since November, with a significant improvement in January and February in both the total orders and orders from abroad components. The survey of industrial companies relating to 4Q13 shows the same trend, with an improvement in the assessment of the current situation and in expectations on orders in 1Q14. The improvement is marginal as regards the overall assessment of the current economic situation, where the index remains under the 100 threshold, while the assessment of the future outlook remains above this level. Figures on industrial investment with government support show another fall in the number of investment proposals (-18.8%) in the first two months of the year compared with the same period of 2013, meaning that the outlook for investment remains weak. On this front, however the increase in the number of approvals by the Cabinet Committee on Investment and the Project Monitoring Group (which were flat in 2013) is a positive development, as it should provide support at least to investment in infrastructure over the year.

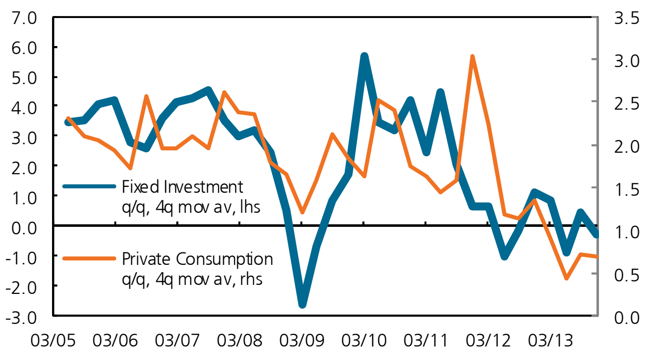
The current account deficit fell from 5.4% of GDP in 2012 to 3.5% in 2013, on the back of the fall in the trade deficit in the second half of the year. Stripping out oil, the trade deficit showed a marked improvement due to the block on gold imports as well as the slowdown in imports consistent with the weakness in domestic demand, and the upturn in exports in the autumn. Exports though slowed between December and February, recording a fall of 3.7% yoy in February, while imports continued to drop (-17.1% yoy), particularly if oil is excluded (-24.5%). The trade deficit in the first two months of the year was USD 18Bn , just over half the figure for the same period of 2013 (USD 34.1Bn). The increase in orders in the PMI index heralds an improvement in foreign trade in the next few months.

After peaking at 7.5% in November, wholesale price inflation has fallen sharply to 4.7%, thanks to the marked slowdown in the price growth of food (8.1% in February versus 19.7% yoy in November), fuel and electricity, and the fall in the growth of minerals prices (-1.6% yoy). Price growth of non-primary food products marginally picked up in February owing to rises in the price of sugar cane and animal feed, and high inflation in the prices of raw fibrous textiles (+19.6%). Inflation excluding food and fuel rose again to 2.2%. Consumer price inflation remains higher (8.1% yoy in February), but has slowed significantly since peaking at 11.2% in November. Inflation excluding food and fuel remains very high however, at 7.9%, and is cause for concern to the RBI (Reserve Bank of India).

The services sector saw an upturn in growth in the fourth quarter of last year (6.7% vs. 5.8% in 3Q), above all thanks to the commercial real estate and services sector (+12.5% yoy), while the construction sector continued to slow. While the services PMI has remained below 50 since July, it rose from a low of 46.7 in December to 48.8 in February. Another positive sign came from sales of mobile telephones, which recorded their first year-on-year rises in December and January, after a year of falling figures. Revenues in local currency from tourist inflows are also rising, fuelled by the increase in the number of arrivals and the strength of the dollar.

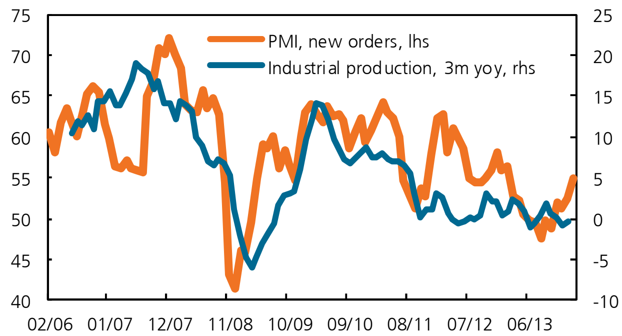
Domestic car sales recorded an increase of 1.4% in January, after months of falls. In 4Q, consumer confidence rose from its low of the series (88.00 in 3Q) to 90.7, although remained below the threshold of 100. Expectations recorded a bigger jump. Most of those interviewed said they spent more during the quarter, but spending intentions for the next quarter remained unchanged. Assessments on income and job prospects improved. The quarterly average of the employment component of the PMI remains only marginally above 50 in both the manufacturing and services sectors, but a brighter picture was painted as regards hiring intentions in the Manpower Survey: they improved significantly in 2Q, to just below their series highs.

Domestic demand still weak



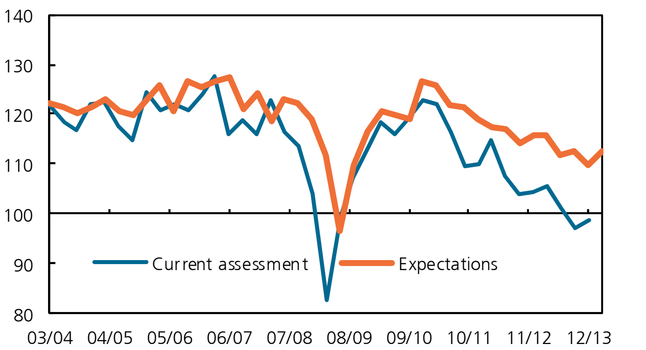
Source: Intesa Sanpaolo chart from CEIC data

Industrial output flat, but orders are rising



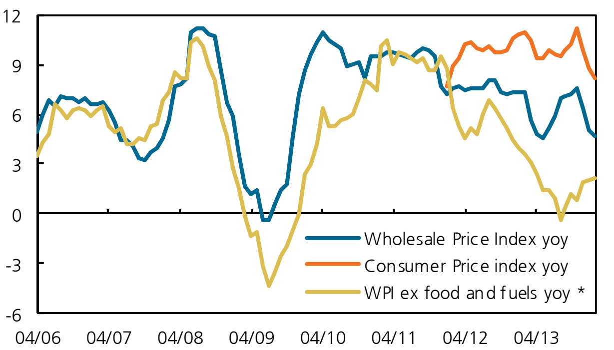
Source: CEIC, Markit

Business confidence improves slightly*



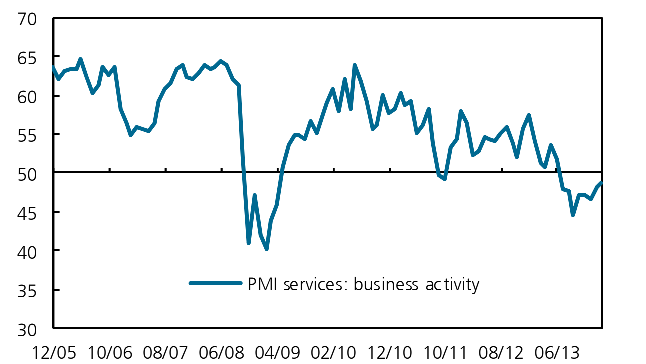
*Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Inflation slows thanks to food and energy



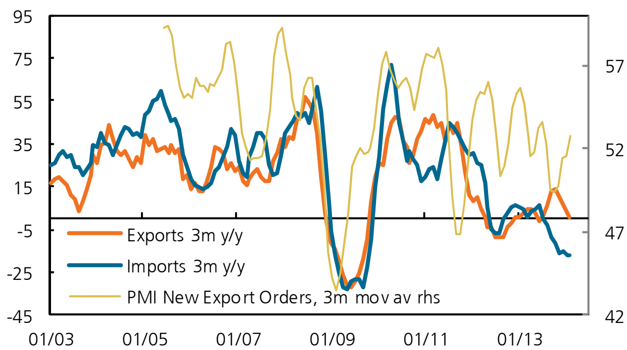
*ISP estimate. Source: CEIC

Tentative improvement in services sector outlook



Source: Markit

Imports continue to fall



Source: CEIC, Markit

Economic, monetary and exchange rate policy

Elections for the lower chamber of India's parliament (*Lok Saba*, or House of the People) will take place over nine different days between 7 April and 12 May, depending on the state and constituency. Votes will be counted on 16 May. Opinion polls to date have put the National Democratic Alliance (NDA) coalition led by the Bharatiya Janata Party (BJP), the biggest opposition party, in front. The current government coalition, the United Progressive Alliance (UPA), has been in power since 2004 (having been re-elected in 2009), and has always been led by members of the Gandhi family. Rahul Gandhi is vice-president and current leader of the election campaign. The NDA governed the country in 1999-2004, and Narendra Modi, the Chief Minister of the state of Gujarat in office since 2001, is the coalition's candidate for prime minister. Then, there is the Third Front, elected in 1996-98, an alliance of regional parties, some of which support the current government coalition. Other regional parties do not belong to any coalition, but have recently had modest success, including the Aam Admi Party (led by the former Chief Minister of Delhi, Arvind Kejriwal), in the fight against corruption.

The government recently reaffirmed its public deficit forecast for fiscal year 2013-2014 of 4.6%, down from the 4.8% initially forecasted, although the RBI is also sceptical[12] about its chances of achieving this target: in 4Q13, government receipts slowed, owing to a fall in tax revenues, while expenditure rose compared with 3Q. The public deficit in calendar year 2013 was 5.9%, and in the first three quarters of FY 2013-2014 (which will end in March), it has already reached 98.4% of the government estimate. The deficit for FY 2013-2014 is therefore highly likely to come in at around 5%. The provisional budget proposed in mid-February for FY 2014-2015 targets a further cut in the deficit to 4.1%. There was nothing particularly new in the budget: it repeated its intention to increase investment in infrastructure (railways, nuclear and solar power), including through public-private partnerships, and projected an increase in subsidies and military spending. On the tax front, it proposed a cut in excise duty on many goods, including capital goods, to be in force at least until 30 June 2014. The final budget will be approved in the summer.

Lending to the non-food commercial sector rose by 14.9% yoy in January, up slightly on November's figure (14.6%), thereby continuing to provide support to the economy and remaining in line with central bank forecasts. The rise in core inflation prompted the Reserve Bank of India to raise rates by 25 bps at the end of January, taking the repo rate to 8%. The central bank expects that core inflation will remain high, although the overall inflation trend will benefit from the slowdown in food prices, and will therefore continue to fall in the next few months. It sees some upside risk to the central forecast of the Patel Committee[13] of 8% for March 2015. From now on, the central bank will meet every two months, with the next meeting scheduled for 1 April. We reiterate our scenario that rates will remain unchanged in the next few months, even in light of the recent rise in real interest rates and signals from the RBI. In any case, we do not rule out the risk of a further hike in June if core inflation rises again. We believe that there may be room for an easing in monetary policy only in the second half of the year, in line with the expected greater easing of inflation.

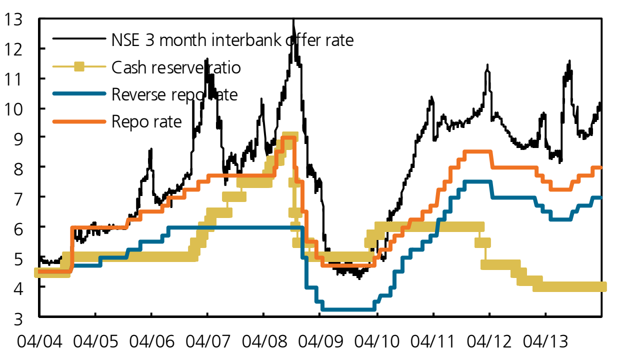
The rupee gained 1.85% against the dollar between mid-December and mid-March, and 3% since the low at the end of January (63.10). As stated above, the trade deficit improved significantly in the second half of the year, with the current account deficit closing 2013 at 3.5% of GDP, from 5.4% in 2012. The second half of the year also saw an improvement in the

[12] RBI: Macroeconomic and Monetary Policy Development Third Quarter Review 2013-2014, January 2014.

[13] Committee set up in September 2013 to examine monetary policy and make recommendations, in line with the objective of giving more weight to consumer price inflation in determining monetary policy, which until now has only been based on wholesale prices.

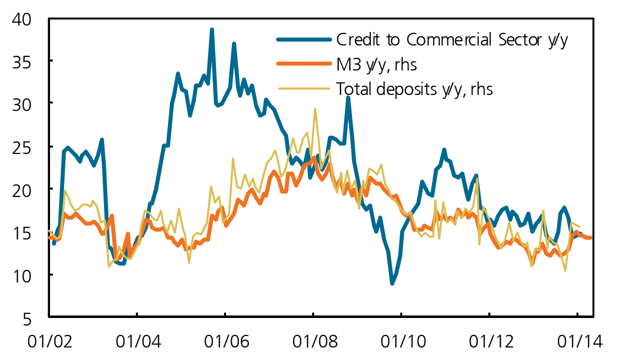
financial account balance, which enabled the central bank to increase foreign currency reserves from a low of USD 247.0Bn in August to USD 268Bn at the end of December, which helped stabilise the rupee. The effective exchange rate has remained broadly unchanged in the last six months, and the depreciation of 12.4% in nominal terms and 9.9% in real terms from a year ago should help sustain the recovery in exports in the next few months. Although the country is in a better external position than last year, the contribution of foreign capital flows to covering the borrowing requirement and the probable overshooting of public accounts targets for the current fiscal year urge caution. Against this backdrop, the change of American monetary policy leaves the exchange rate exposed to further downside.

The RBI raises rates



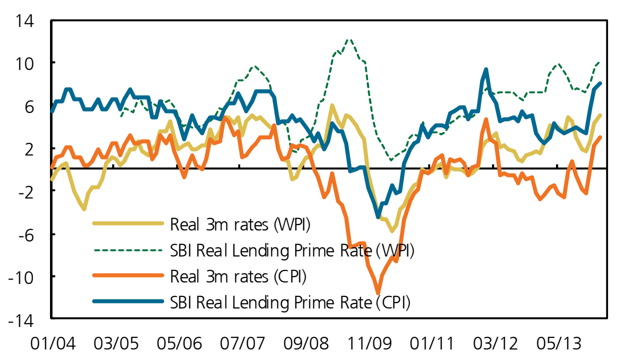
Source: Bloomberg

Lending is stable



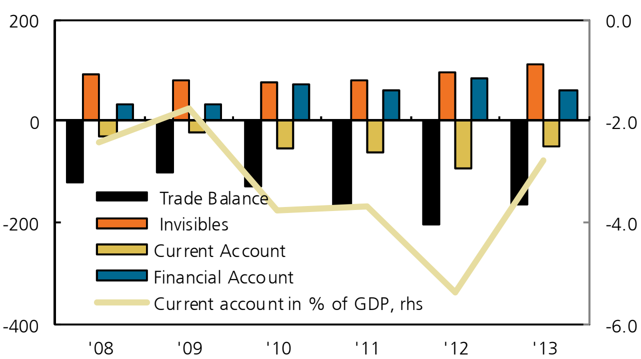
Source: Bloomberg

Real rates are rising



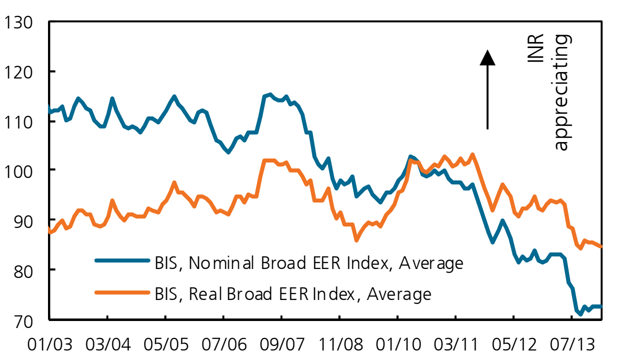
Source: Intesa Sanpaolo chart from Bloomberg data

Current account balance (USD billions)



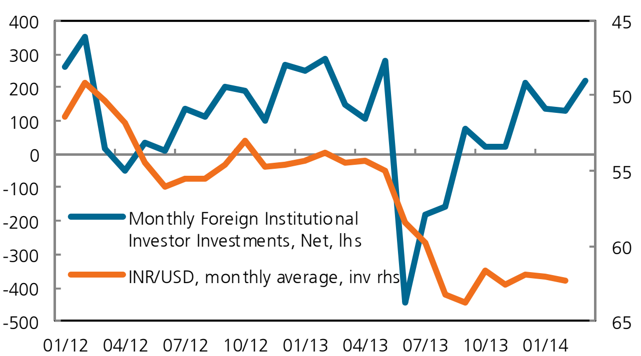
Source: Bloomberg

Effective exchange rate



Source: CEIC

The return of financial capital stabilises the rupee



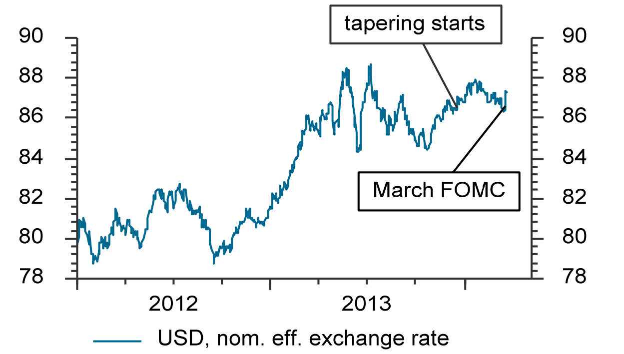
NB: left-hand scale in INR billion. Source: CEIC

Forex Markets – Fed reassured the markets: dollar to start again

US DOLLAR

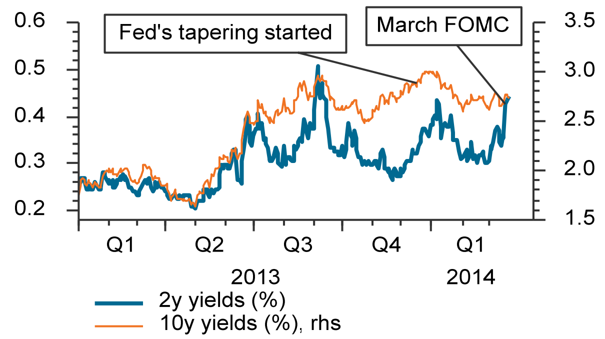
Asmara Jamaleh

Fig. 1 – FOMC-driven US dollar



Source: Thomson Reuters-Datastream

Fig. 2 – US yields and FOMC



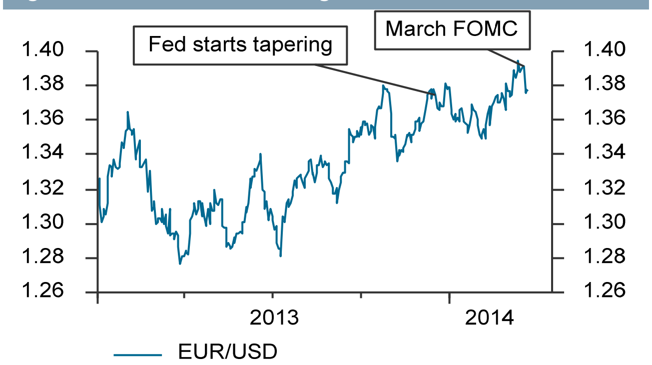
Source: Thomson Reuters-Datastream

Since the beginning of February, the dollar has resumed depreciating (mostly against the majors), but the outcome of the FOMC of 18-19 March should have set the stage for a rebound already in the short term, and a further, widespread appreciation, later on in the year. This is because the February slide was due to a weaker around of data releases than expected in the US, which generated fears of a slowdown in US growth, rather than a consolidation of the recovery. In actual fact, data was negatively impacted by adverse weather conditions during the period, which caused growth to stray from the expected path. However, the deviation was due to transitory factors and, most importantly, did not compromise the recovery trend in the following quarters. This was the main message conveyed in March by the Fed, which seems to have succeeded in reassuring the markets on the resilience and quality of the US recovery, triggering an immediate, widespread rebound effect on the dollar. The fed confirmed the tapering of asset purchases at the same pace as in the previous months, and despite the weaker than expected start to the year it "currently judges that there is sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions". The downward revision of estimated average growth was only marginal (to 2.9% from 3.0% this year, and to 3.1% from 3.2% the next), but most importantly (1) the forecast unemployment rate was lowered along the entire forecasting horizon, and (2) policy rate projections were revised slightly upwards: the majority of FOMC participants continue to expect an initial Fed Fund rate hike in 2015, although with a slightly higher point of arrival for rates than estimated in December, at 1.00% at the end of 2015 (instead of 0.75%), and 2.00% or higher at the end of 2016 (instead of 1.75%). The cycle of interest rate increases could therefore start already in mid-2015, although the news at this latest FOMC was that focus seems to have shifted from "when to start hiking rates", to "how far Fed Fund rates will increase starting in 2015". This is the direction in which the change in forward guidance adopted at the March meeting goes. For what concerns "when the first hike will take place", in deciding for how long to keep Fed Fund rates at their current levels, the Fed has abandoned the minimum condition represented by achievement of a specific unemployment rate threshold (6.5%), replacing it with the assessment (based no longer on a single variable, but on a broader set of data) the "progress – both realized and expected – toward its objectives of maximum employment and 2% inflation". With regards to "how far Fed Funds will increase starting in 2015": if until the previous meeting (January) the Fed's concern was to signal that it would probably have been appropriate to maintain Fed Funds at their current level even after the achievement of the 6.5% unemployment rate threshold, in March it went as far as providing a signal on the point of arrival of the hike cycle, which could be lower than the level that would have been adequate in the past, before the crisis. Specifically: "even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run". This suggests that in the initial phase of the hike cycle, rates could prove (i) higher than expected by the market before the latest FOMC meeting, which should support a recovery of the dollar in the short term from the recent decline, (ii) but lower than they would have been in past (pre-crisis) cycles, which could curb the dollar's subsequent upside. However, as regards the expected trend of the dollar in the remainder of 2014, and at least the opening months of 2015, the former point should apply more than the latter, especially as long as the Fed retains a head start (in the timing of the first hike) over the other main advanced economy central banks, the ECB first among them. **An important condition will be the need for US growth not to disappoint in the coming months, although this risk now seems smaller**, both in light of the March FOMC and of the fact that the dollar is emerging from a correction phase, incurred due to the weaker than expected start to the year, but only because of transitory factors.

EURO – Fall resumed after Fed's reassurances and ECB's "benign neglect" dropped.

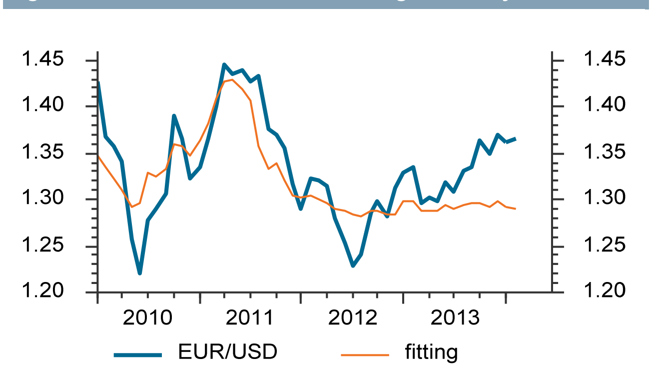
The Fed's "reassurances" on US growth at the **FOMC meeting of 19 March**, a few days **following the ECB's abandonment of its "benign neglect"** of the exchange rate (13 March: Draghi's speech in Vienna, see below), **should open the second phase of the expected correction of the single current**. The depreciation triggered by the FOMC meeting of 18 December – from EUR/USD 1.38 a 1.34 – (announcement of the taper), was interrupted at the start of February by weaker than expected US data, which hurt the dollar. The "benign neglect" of the exchange rate adopted by the ECB at its December meeting, and reasserted at the following ones, added to the euro's sharp reversal, propelling it to exceed its 2013 highs and enter the 1.39 area. From here, before the critical threshold at 1.40 was reached, it was pushed back by the March FOMC, and in less than two days the single currency retreated from 1.39 to 1.37.

Fig. 3 – Euro and FOMC meetings



Source: Thomson Reuters-Datastream

Fig. 4 – Estimates based on the exchange rate-to-yields relation

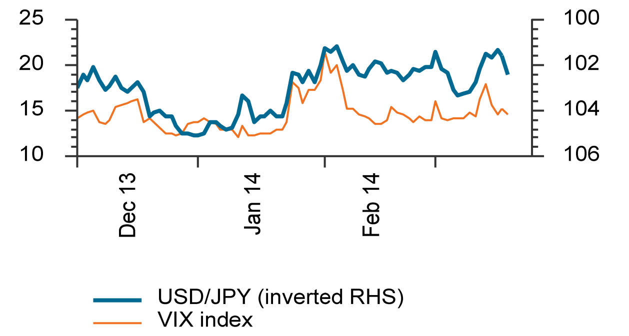


Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

A crucial factor for the correction to continue will be the absence of further disappointments from US data. This assumption, barring residual consequences of adverse weather in the very short term (which, however, the market has probably already priced in) seems in any case rather reasonable, both in light of the outlook drawn by the Fed, and of the fact that the US recovery in 2Q 2014 should prove even more convincing following the slowdown in Q1. At the same time, the extent of the euro's overvaluation became even more evident (Fig. 3), and when the exchange rate rose close to 1.4000 (hitting a high of 1.3967 on 13 March), **Draghi openly took on the issue of the exchange rate** in a speech in Vienna, stressing two aspects: **(1)** "the ECB's forward guidance creates a de facto loosening of policy stance", therefore real interest rates should drop, both in absolute terms and in terms of the spread vs. the rest of the world and this should put downside pressure on the euro, everything else being equal; (2) the strengthening of the euro's effective exchange rate in the past year and a half has played a significant role in curbing inflation, and given current low levels of inflation, it is becoming increasingly important for the ECB in its assessment of price stability. This means that in the present phase a further appreciation of the euro would start to be viewed by the ECB as undesirable, as it could further distance inflation (on the downside) from the targeted rate, a risk that the ECB does not want to run. Indeed, it has said that it is ready to cut rates and to adopt all the other necessary measures to combat the risk of deflation. What's more, an even stronger exchange rate could pose serious downside risks to growth, especially now that it is just starting to strengthen back, and at a very gradual pace at that. Therefore, we continue to expect a further decline of the euro, towards 1.35-1.34 at least within a 3m horizon, and towards 1.30 or just under towards the end of the year, when the Fed's asset purchase programme will be fully unwound, and the countdown towards the initial interest rate hike in the United States will begin. Risks are still skewed to the upside, i.e. the euro could drop less than expected, or more slowly, especially in the short term.

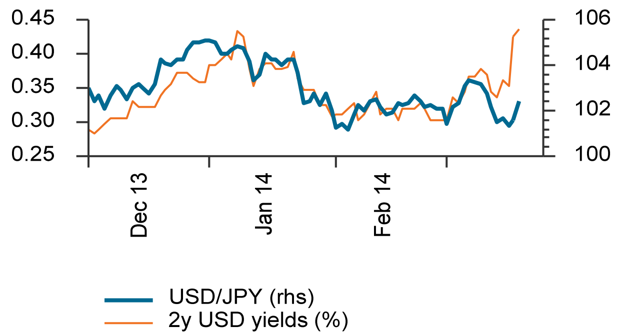
YEN – Fundamentals still negative: rebound recorded in Q1 close to being reabsorbed.

Fig. 5 – USD/JPY and risk aversion



Source: Thomson Reuters-Datastream

Fig. 6 – USD/JPY and USD government yields

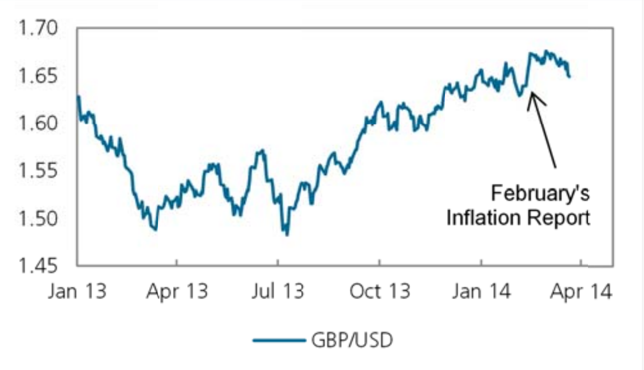


Source: Thomson Reuters-Datastream

The yen continues not to move of its own accord. Its trend remains guided by developments on the US front and by the evolution of risk aversion. When the latter mounts, it tends to strengthen the Japanese currency (Fig. 1), as was also evident in recent times on then outbreak of the Russia-Ukraine crisis. On the other hand, developments on the US front are effectively reflected by the trend of US yields (both short and long), matched by the USD/JPY exchange rate's (Fig. 2). Since the beginning of the year, the correlation has been very strong indeed (88% with two-year yields, 94% with 10-year yields), and also remains in place with e USA-Japan spreads, as the level of domestic yields is low, and the trend almost entirely smothered by the BoJ's ultra-accommodative monetary policy. The correlation with spreads is in any case slacker, testifying to the fact that US yields are acting as drivers. Therefore, when the Fed announced the long-awaited start of the asset purchase tapering process at its December FOMC meeting, the yen slipped, from USD/JPY 102 to 105. Subsequently, however, once it became clear that the taper would not have allowed the US curve to rise so easily, and most importantly due to an unexpected round of weak US data releases at the beginning of the year, US yields eased back, and the yen strengthened, rising back as far as USD/JPY100. US data should in any case start to improve again already in the short term, whereas in Japan, by contrast, growth will be negatively impacted by the consumption tax hike due in April, and the BoJ is ready to inject additional monetary stimulus to buffer the problem. Therefore, we continue to expect the yen to return towards its January lows (USD/JPY 105 area) on a 3m horizon. In the second half of the year, with the consolidation of the US recovery and the nearing of the full unwinding of the Fed's asset purchase programme, upward pressures on US yields should begin to prevail, especially in the run-up to the first Fed Fund rate hike, forecast in 2015. Therefore, we confirm our expectations for a further depreciation of the yen, to between USD/JPY 105 and 110 on the 6m-12m horizon. On the other hand, we have lowered our forecast on a 24m horizon from USD/JPY 105 to 110, on the possibility of a new slowdown phase of the Japanese economy in 2015, also tied to the second tranche of the consumption tax hike scheduled in October next year. Risks on that time horizon are skewed to the downside, i.e. the yen could weaken to beyond USD/JPY 110, especially if the Fed should bring forward the start of the interest rate hike cycle. In this case as well, however, the potential crossing of the 110 mark should not prove lasting nor substantial: at that level, the yen would already be undervalued by around 15%, based on our estimates, and the overall fallout on the domestic economy could turn negative.

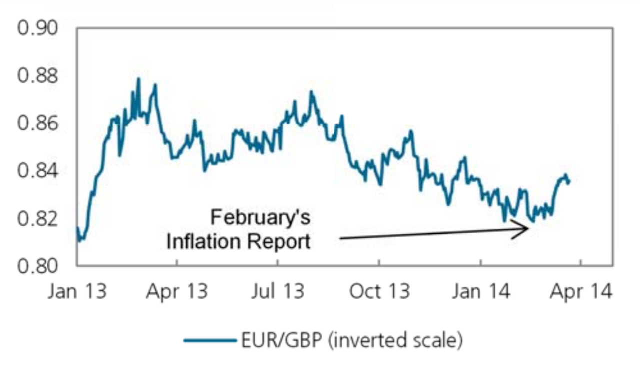
STERLING - BoE's new forward guidance. Upside still there for GBP, more vs. EUR than vs. USD.

Fig. 7 – Sterling's highs on the February's inflation report



Source: Thomson Reuters-Datastream

Fig. 8 – … against the euro too.



Source: Thomson Reuters-Datastream

Sterling strengthened further, and beat its 2013 highs in February, reaching GBP/USD 1.68 and EUR/GBP 0.81. The resilience of the pound's upswing was mostly due to the consolidation of the UK economy's recovery, although the upside acceleration was triggered by the BoE's Inflation Report (12 February), which contained the announcement of new forward guidance. As the achievement came closer and closer of the 7.0% unemployment rate threshold, upon which – based on previous f.g. – the BoE could theoretically have started to consider hiking rates, the central bank had to change the conditions that would enable it to start normalizing monetary policy, as doing so immediately could have compromised the incipient recovery. According to the new guidance, which will start to be applied when the aforementioned 7% threshold is reached, keeping the inflation targeting in place, the BoE is seeking to absorb all the spare capacity in the economy over the next two to three years. How? First of all by waiting to hike rates until an initial portion of spare capacity is absorbed (affording priority to growth, for now: "the MPC will not take risks with the recovery"), and only later by means of rate hikes, that will in any case be gradual and limited (i.e. delaying the timing of the first hike even further, and an estimated point of arrival that is lower than in past, pre-crisis cycles). The market seems to have correctly received the BoE's message: yields, both on the short and long ends of the curve, have already dropped (in line with a scenario which sees higher rates not already this year, but the next – approximately in mid-2015), whereas sterling appreciated, (in line with the UK economy's currently stronger performance in terms of growth against both the USA and the euro area). Sterling also corrected against the dollar on the outcome of the March FOMC, albeit slightly less than the euro, and this could signal an initial, temporary hiatus, in the uptrend recorded since the summer, for two reasons: (1) 2014 growth forecasts in the United Kingdom and in the United States are very similar, at 2.6%-2.7% and 2.7% respectively, as is also the timing of the first rate hike by the BoE and the Fed (around mid-2015); (2) downside risks to UK inflation seem slightly stronger at present than those faced by US inflation, which at like-for-like growth could induce the BoE to hold out a short while longer before hiking rates. On the whole, this should not prevent the pound from reaching new highs in the course of the year (towards GBP/USD 1.70), but could stop it from rising already in the very short term, a horizon on which UK inflation seems more likely to stay lower. On the other hand, there is more room for an appreciation against the euro, due both to diverging monetary policies, and to the UK economy's markedly stronger performance compared to the euro area (where growth is less than half that of the UK, at 1.1% this year), with new forecast highs of at least close to EUR/GBP 0.80-0.78.

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Appendix

Analyst Certification

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(1) The views expressed on companies mentioned herein accurately reflect independent, fair and balanced personal views;

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