BANCA IMI

Macroeconomic Outlook

Research Department
March 2016

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INTESA SANPAOLO

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Macroeconomic Outlook

March 2016

Quarterly

Intesa Sanpaolo
Research Department

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Based on information available up to 18.03.2016

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

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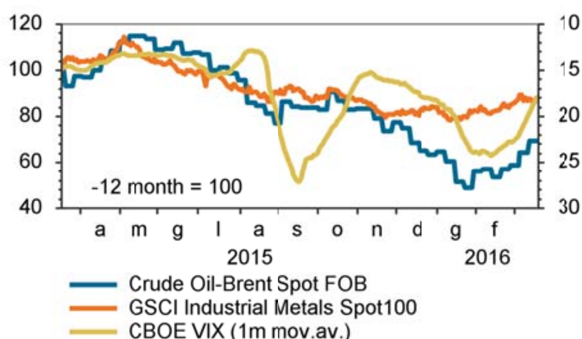
Better than it looks?

The flow of macroeconomic data and the evolution of the markets have improved after a poor start to the year. In advanced countries, economic policies and the positive trend of employment seem perfectly capable of buffering the decline in demand from emerging countries. However, global growth will remain modest, and monetary policies will be more accommodative than accounted for.

Luca Mezzomo

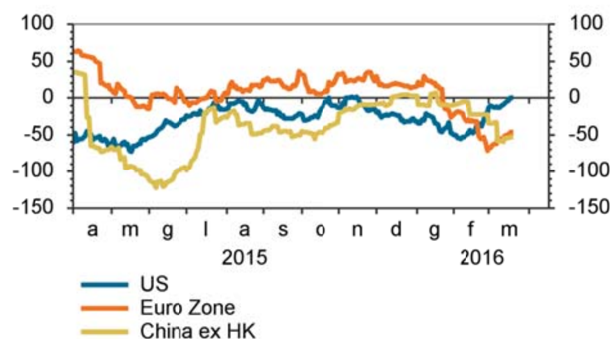
Based on the market developments, the opening quarter of 2016 seems to have been split clearly into two separate phases. Starting at the beginning of February, a pessimistic view on the overall evolution of the world economy prevailed, and translated into further commodity price declines and into a resurgence of volatility on stock markets to the same levels as seen in the summer of 2015. The violent movement of the markets at the beginning of 2016 was in all likeliness accentuated by portfolio adjustments of the sovereign wealth funds of commodity-exporting countries and by idiosyncratic factors (tied for instance to the European banking sector), but uncertainty over the global economy certainly played a crucial role, creating unfavourable conditions for the sales pressures generated by other categories of investors to be reabsorbed. The trend of macroeconomic data effectively fell short of expectations in Europe, the United States, and China. From February onwards, however, a gradual but clear improvement was observed on several fronts: commodity prices, stock market indices and volatility, and capital flows addressed to the emerging countries. In much the same was as turbulences at the beginning of the year were accompanied by disappointing data, the subsequent recovery has gone hand in hand with a more positive balance of US economic data. However, the improvement has extended to European and Chinese data only since early March.

Fig. 1 – Market climate has improved starting in February



Source: Intesa Sanpaolo elaborations

Fig. 2 – The flow of economic data has been less negative in the United States, but has kept disappointing in Europe, China



Source: Thomson Datastream Charting, CESI indexes.

Brighter market sentiment in March is more in line with our assessment of the overall macroeconomic scenario. Our view was, and is, that growing domestic demand in the advanced countries makes the latter more resilient to the slowdown in exports to the emerging economies. There is no doubt, however, that the weak demand expressed by the emerging economies significantly held back growth in the advanced economies in 2015. Between 2001 and 2015, annual export growth to the main emerging countries accounted on average for less than 0.2% of nominal GDP in the United States, and 0.5% in Germany; in the closing quarter of 2015, the contribution turned, respectively at -0.4% and -0.3% of nominal GDP in annual terms. As the trend progressively worsened in the course of the last year, the contribution in 2016 is likely to more unfavourable on average compared to 2015. This is also due to the fact that the recession in Brazil is proving more severe than forecast, trade flows towards China are struggling to recover, and oil-producer countries still lack a serious prospect of oil prices making a recovery. Iran's return to the economic scene is not enough to balance these negative factors

Evidence is supporting the view that domestic demand growth was sufficient to buffer the decline in exports to the emerging countries

in the immediate term.

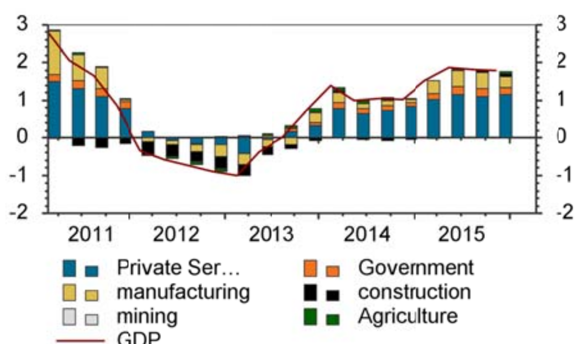
However, the trend of domestic demand in the advanced economies is still benefiting from a favourable combination of markedly accommodative monetary conditions, neutral or slightly expansive fiscal policies, and employment growth. This latter factor in particular guarantees some momentum, even in the presence of negative shocks. The likeliest scenario is that growth in consumption and construction will allow a buffering of the shock deriving from the process by which the imports of emerging country are adjusting to new, lower levels. This process should be completed in the next few months, laying the foundations for a future reacceleration.

Monetary policy more accommodative than accounted – although scepticism is mounting on its effectiveness

Moreover, financial turbulences at the beginning of 2016 have induced central banks in one case (Federal Reserve) to postpone an interest rate hike that was already expected, and in other cases to announce new monetary stimulus measures (ECB, Bank of Japan), resulting in more accommodative monetary conditions than expected. Long-term rates are currently lower than they were at the end of 2015, both in Europe and in the United States.

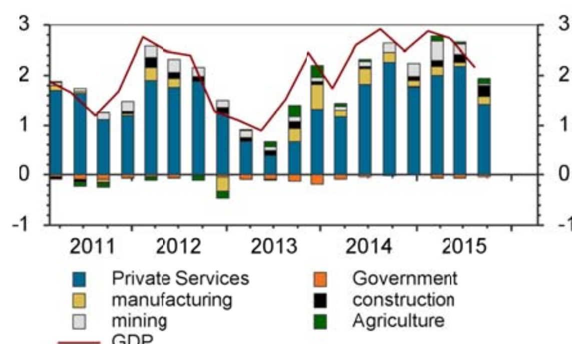
The latest accommodative monetary policy measures come at a time of increasing scepticism on their effectiveness in supporting aggregate demand. The negative perception has been accentuated by the strengthening of the euro and of the yen following the stimulus measures introduced by the Bank of Japan and the ECB, and in general by the persuasion that the transmission channel represented by the depreciation of the exchange rate has now dried up. Furthermore, monetary statistics have provided ample evidence that the expansion of the monetary base is largely sterilised by a compensatory change in monetary multipliers, which also prevent its transmission to credit aggregates. However, the cutting of interest rates into negative territory, and financial asset purchases, have reaped positive effects on the debt servicing of private and public non-financial firms, improving the financial solidity and profitability of the former, and allowing the latter to put in place more accommodative fiscal policies. Also, while business investments have been disappointing almost everywhere in 2015, some components of aggregate demand (construction, spending on durable goods), sensitive to interest rates, are responding to the more favourable financial conditions. The trend of investments could improve this year in the euro area, supported both by exceptionally favourable financial conditions and by the fiscal incentives introduced in some countries. The permanent shift of important shares of public debt from the balance sheets of private investors to those of central banks could even be useful in the future, to aid the adoption of structural solutions for debt reduction – although it is close to impossible to pursue this path in the institutional context of the euro area.

Fig.3 – Euro area: value added growth by sector



Source: Thomson Reuters, Datastream Charting

Fig. 4 – United States: value added growth by sector



Source: Thomson Reuters, Datastream Charting

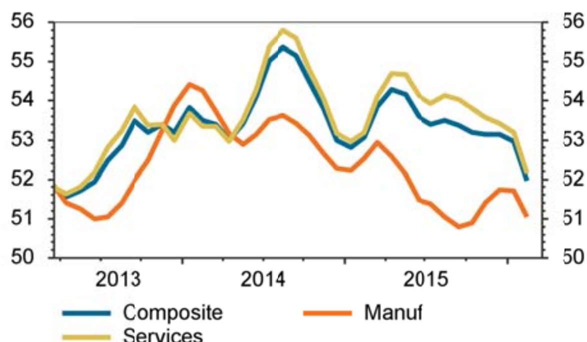
This is a phase in which growth is relying on the services sector more than in the past

The perception of a weak recovery also depends on the fact that the current growth phase is still mostly fuelled by services, which in 2015 contributed more than the long-term average in both the euro area and the United States, and which is typically less covered by statistical information compared to the manufacturing sector. This is a more evident aspect in the United States than in Europe, also due to the loss of competitiveness incurred by the industrial sector as a result of the strong dollar. At constant prices, 57% of consumption growth among US households was accounted for by services – a percentage which increases to over 90% at current prices – and 24% by durable goods. All other factors being the same, the further shift of final demand from goods to services implies a smaller activation of overall output and a lower absorption of imports. This may also help explain the contraction of global trade in 2015 (-1,877 billion dollars nominal, according to WTO data), 20% of which is explained is explained by the lower value of crude oil flows alone.

In the next few months, political risk in the advanced countries is likely to be an increasingly topical issue. In the European Union, in addition to the referendum on the UK's EU membership on 23 June, the renewal of many national parliaments, including the Bundestag, is scheduled between 2016 and 2017. In Europe, the governments which managed the debt crisis have been punished one after the other by the electors, who nonetheless are too split in the present phase to allow an alternative leadership to take hold. As a result, ungovernability (Spain) is increasingly a problem, as also the presence of governments stripped of the support of a stable parliamentary majority (Ireland), or reliant on very slim majorities (Portugal, Greece). The area of instability could extend in 2017 to Germany, in light of the increasingly fragmented political picture in the country. Such drift, which combines with the increasing focus of governments on domestic issues, will make any ambitious reform programme unlikely at the national level and, even more, at the European Union level; besides, it will weaken the Union's response capacity to external shocks, such as the migrant crisis. However, reform paralysis, though worrying in a long-term perspective, will not necessarily have negative repercussions on the current trend of the European economy. By contrast, a vote in favour of the United Kingdom's exit from the European Union holds the potential to destabilise the markets, although it will take many years for Brexit to effectively materialise. Moreover, this is also a presidential election year in the United States, and the unexpected success of Donald Trump in the Republican camp is causing increasing concern both inside and outside the country, due to the risk (possibly low, but not negligible *a priori*) that Trump is elected and that US foreign policy resumes playing a destabilising role, as was the case with the second Gulf War.

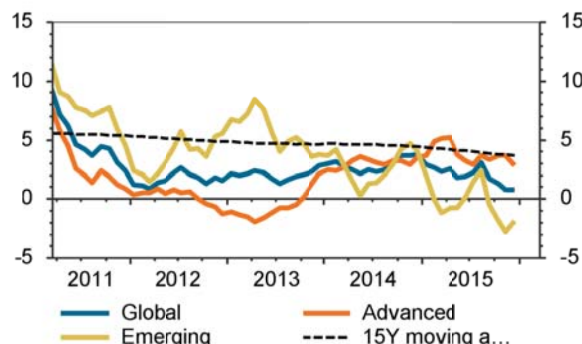
The trends of the global economy in 10 charts

Fig. A – Trend of global PMIs



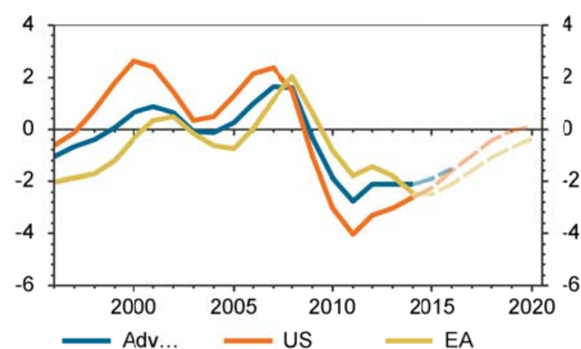
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Import growth, y/y



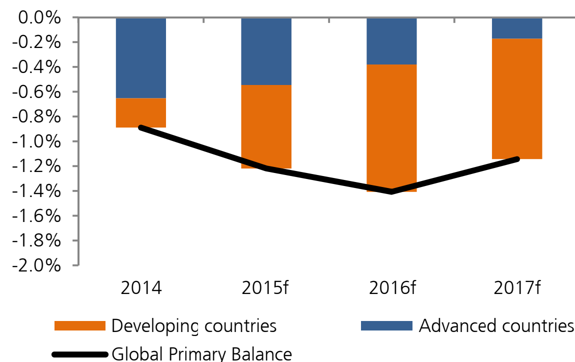
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



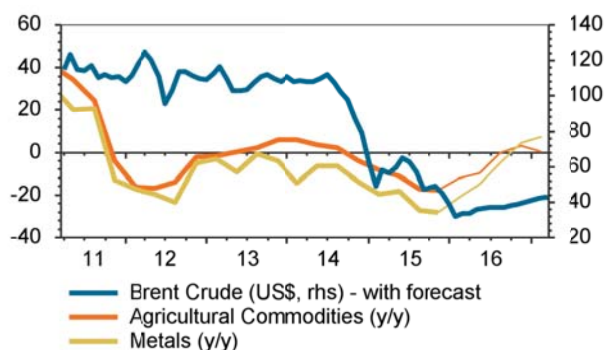
Source: Thomson Reuters-Datastream Charting and IMF

Fig. D – Public sector primary balance as % of global GDP



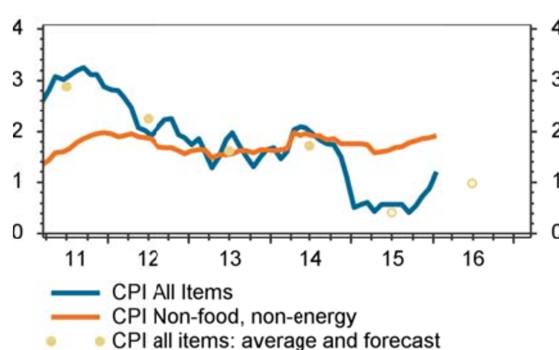
Note: based on the 11 top advanced countries and the 8 top emerging countries. Aggregated at current exchange rates. Source: Intesa Sanpaolo elaborations

Fig. E – Commodity prices



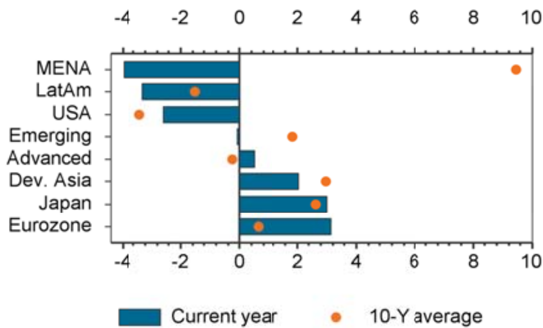
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



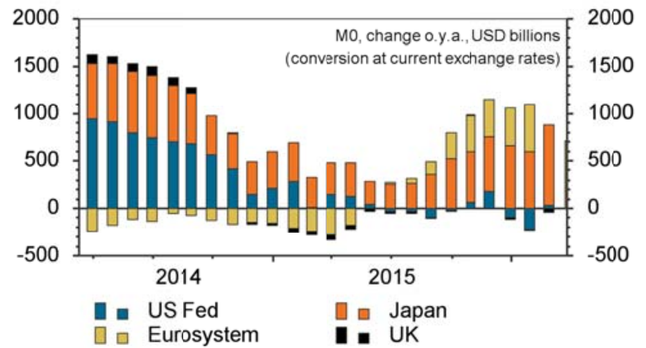
Source: OCSE, Thomson Reuters-Datastream Charting

Fig. G – Balance of payments: current account balances as % of GDP



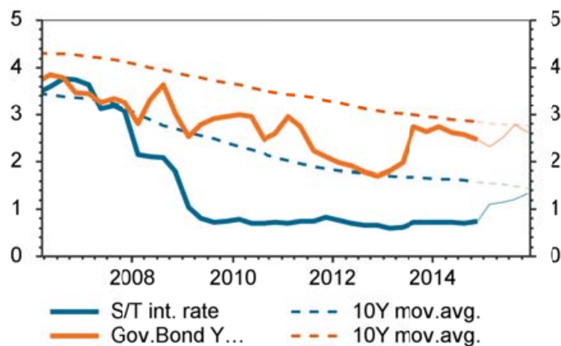
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

Fig. H – Monetary base, G-3 (change, USD billion)



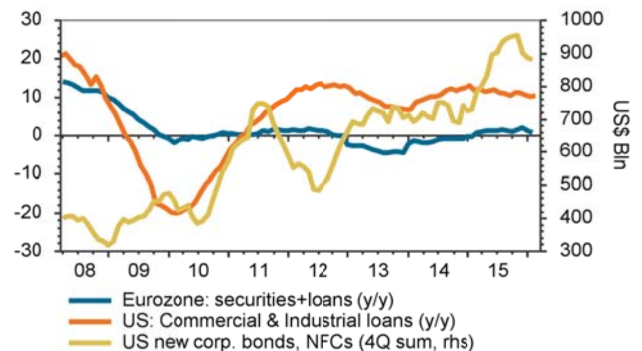
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



Note: The aggregate includes 44 countries, advanced and emerging. Source: Thomson Reuters--Datastream Charting and Oxford Economics

Fig. J – Credit to non-financial firms



Source: Thomson Reuters-Datastream Charting, BCE, Federal Reserve

Tab. 1 - Economic growth by geographical region

	2013	2014	2015	2016	2017
USA	1.5	2.4	2.4	2.2	2.3
Japan	1.4	-0.1	0.5	0.5	0.8
Eurozone	-0.2	0.9	1.5	1.5	1.6
Eastern Europe	1.8	1.3	-0.6	0.8	2.1
Latin America	2.5	1.0	-0.6	-0.8	1.7
OPEC	2.3	2.6	1.5	1.6	3.1
East Asia	6.1	6.3	6.0	5.8	6.0
Africa	3.1	4.1	3.3	3.2	4.0
World growth	3.3	3.4	3.1	3.1	3.6

Source: Intesa Sanpaolo data

Oil: global inventories growing

Daniela Corsini

The most recent published figures show that supply and demand fundamentals are still very weak, with inventories rising. In our base scenario, we rule out the possibility of a coordinated cut to production by OPEC members or an agreement with producers outside the group to reduce global supply. Consequently, we forecast that oil prices will remain low for a long time: a necessary condition to rebalance the market.

Supply and demand fundamentals still very weak

The most recent figures, released at the beginning of March and published in the monthly reports of the *Organization of the Petroleum Exporting Countries* (OPEC), *International Energy Agency* (IEA) and the *U.S. Energy Information Administration* (EIA), confirm the outlook of an ongoing supply surplus with inventories continuing to rise for the next few quarters, owing to the slow pace of the rebalancing now under way.

The latest estimates provided by the three main forecasters point to supply and demand fundamentals that are still very weak for a number of reasons, including the resilience of global production to low prices and the return of Iranian oil to the market. In addition, the rather subdued figures recorded in recent months in the US and China have led to global consumption estimates being revised downwards. Specifically, the current supply surplus should remain, on average, above 1.5 mb/d in the first half of the year, before falling sharply to around 0.2 mb/d in the second half. However, we will have to wait until at least mid-2017 before markets can be described as fully balanced.

Global demand is currently expected to rise for the next two years, albeit at a much slower pace than that recorded in 2015. On average, the three main forecasters expect consumption to reach 94.9 mb/d in 2016, an increase of 1.2 mb/d on 2015, and the EIA, the only agency to publish forecasts for 2017, predicts that demand could grow by a further 1.2 mb/d to 96.0 mb/d.

From 2016, non-OPEC supply is expected to fall for the first time since 2008. Production is forecast to average 56.8 mb/d in 2016, a fall of 0.6 mb/d on 2015, and according to EIA, it should fall by 0.5 mb/d to 56.7 mb/d in 2017. In both years, US crude is likely to record the biggest fall. Shale-oil production yields tend to decline rapidly after a well has been active for a year and, consequently, investment horizons for these deposits are much shorter than those for conventional oil fields. Outside the US, the results of cuts to investment in non-OPEC supply are only likely to become evident after 2017, given the limited room for growth in planned extraction in the short term.

With global demand expected to increase and non-OPEC supply to fall, the call on OPEC crude, i.e. the quantity of oil that group members should supply to balance the market, is expected to average 31.4 mb/d in 2016, a rise of 1.5 mb/d on 2015. According to the EIA, it is likely to reach 32.1 mb/d in 2017, a further rise of 1.4 mb/d. The call on OPEC crude will therefore probably be higher than the cumulative production target (31.5 mb/d) and broadly in line with actual production at the end of 2017.

The increase in global inventories of crude oil and derivative products is likely to continue: +1.6 mb/d in 2016 and +0.6 mb/d in 2017, according to EIA forecasts. This figure could become a greater cause for concern if global economic growth is less positive than expected. In particular, macroeconomic conditions in non-OECD countries should be monitored closely, as these will absorb almost all the additional volumes required on the market, due to the forecast growth in domestic fuel consumption.

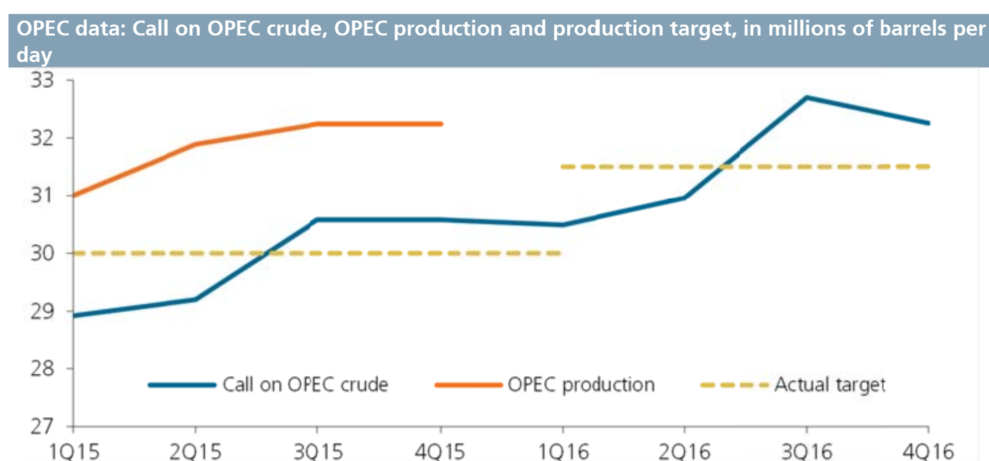
Supply and demand estimates published by OPEC, IEA and EIA for 2016				
Forecasts published on 11 March 2016 in millions of barrels per day	Total demand	Non-OPEC supply	OPEC LNG supply	Call on OPEC crude
OPEC	94.2	56.3	6.3	31.6
vs. 2015	1.3	-0.7	0.2	1.8
IEA	95.6	57.0	6.8	31.8
vs. 2015	1.2	-0.7	0.2	1.6
EIA	94.8	57.2	6.9	30.7
vs. 2015	1.1	-0.4	0.3	1.2

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

Supply and demand estimates published by EIA for 2017				
Forecasts published on 11 March 2016 in millions of barrels per day	Total demand	Non-OPEC supply	OPEC LNG supply	Call on OPEC crude
EIA	96.0	56.7	7.2	32.1
vs. 2016	1.2	-0.5	0.3	1.4

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

OPEC data: Call on OPEC crude, OPEC production and production target, in millions of barrels per day



Source: Intesa Sanpaolo chart based on OPEC data

In light of these forecasts for demand, supply and global inventories, we rule out the possibility of a coordinated cut in production by OPEC members or an agreement with producers outside the group to reduce global supply. In fact, such measures would benefit producers outside the organisation, which would quickly recover market share. In addition, simply from a political viewpoint, coordination within OPEC remains extremely difficult, given Iran's desire to raise export volumes and recover market share after years of tough sanctions, and the deterioration in the public accounts triggered by the collapse in prices that has affected all producers.

Consequently, we forecast that oil prices will remain low for a long time: a painful situation for producers, but one that is necessary to rebalance the market. Low prices should favour growth in global demand, slowing the processes of substitution and energy saving currently under way. They will reduce supply from producers with higher marginal production costs, leading to a slow, but steady, erosion in surplus supply.

Forecasts

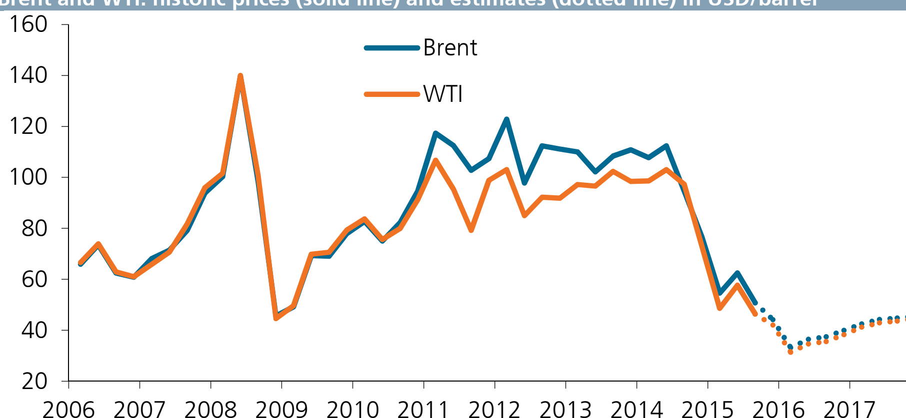
Our price forecasts have been formulated on the basis of our baseline macroeconomic outlook and estimates of supply and demand fundamentals. Weighing on these are uncertainties linked to the slow adjustment process and the size of future Iranian exports.

We are currently expecting the next few months to be marked by high volatility. The overall fragility of fundamentals continues to justify the forecast of persistently weak prices. This will continue for longer than previously forecast as a result of the disappointing pace of growth in global demand.

Over the next two years, we expect supply and demand fundamentals to become tighter, thereby fuelling a moderate recovery in prices, although we think that it will only be possible to describe markets as balanced in the second half of 2017.

We expect Brent and WTI oil to trade at an average of USD 36.5 and USD 34.7 per barrel respectively in the second quarter. For both of these, we forecast a moderate recovery in prices over the year to an average of USD 40 for Brent and around USD 38 for WTI in the last quarter of 2016.

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



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart based on Bloomberg data

Price estimates for Brent

On 11 March 2016	1Q16	2Q16	3Q16	4Q16	2016	2017	2018
Estimate	33.2	36.5	37.5	40.0	36.8	44.3	49.2
Bloomberg median	34.0	37.5	43.0	45.5	36.7	53.5	62.0
Forwards	35.4	42.6	43.9	45.0	41.8	47.1	49.3

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

On 11 March 2016	1Q16	2Q16	3Q16	4Q16	2016	2017	2018
Estimate	31.4	34.7	35.6	38.3	35.0	43.1	48.2
Bloomberg median	33.0	36.0	42.0	45.5	39.5	52.3	60.0
Forwards	33.9	42.5	43.9	44.6	41.3	46.0	47.6

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: "R" still stands for recovery, not recession

Giovanna Mossetti

At the beginning of 2016, weak macroeconomic data and significant tightening of financial conditions led the market to fear that the US recovery was about to derail. Our assessment of macroeconomic fundamentals has always remained positive with a central scenario of growth moderately above potential (2.2% in 2016). The modest slowdown forecast from the 2.4% growth of 2015 is largely due to the weak knock-on effects from the end of last year and weak international trade. The expectation of a recovery driven by domestic demand remains intact and, in our view, solid.

Based on macroeconomic data and fundamentals, our assessment of the recovery remains positive, with a central scenario of growth moderately above potential, again driven by domestic demand, in particular consumption and residential investment. The greatest risks for 2016 come from the economy and global markets. There is a positive side to the external and financial nature of risks for the US economy: the Fed has room to slow rate hikes and actively combat the tightening of financial conditions. It is true that recoveries do not die of old age, and the Fed can react to adverse events in the absence of imbalances in the real economy. Thus, changes in risks could still alter the direction of monetary policy, but would be much more unlikely to reverse the economic recovery.

1. Financial conditions. The shocks to the scenario since the beginning of 2016 have been violent: falling oil prices (-29% from 31/12 to 15/02), appreciation of the dollar (effective exchange rate up 2.7% from 31/12 to 20/01), and a significant correction on the US equity markets (-10.5% from 31/12 to 15/02), which was however more modest than elsewhere. These shocks have now largely receded (see figs 1-3): the dollar's effective exchange rate has fallen by 1.3% from 31/12, WTI is at end-2015 levels (around USD 37/bl), and equity markets have recovered (-1.3% versus 31/12). These movements are summarised by the performance of the Cleveland Fed Financial Stress Index: from January, the index trended sharply upwards, to over 1.8 in mid-February, before reversing and declining to around 1.5 in mid-March (see fig 1).

Financial conditions will remain in the FOMC's sights in the coming months, as it assesses the timing for the next hike. A drop in oil prices has a modest net positive effect on US growth, even taking into account the negative impact on the extraction industry, and slows the rise in inflation. On the other hand, the appreciation of the dollar has a "net" braking effect through foreign trade and corporate earnings, although it can contribute to delaying Fed hikes with a "self-correction" mechanism. A correction on the equity market slows growth through a decline in household financial wealth (as in the summer of 2015). Significant changes in these variables could again influence Fed decisions: the flexibility of its guidance allows the FOMC to respond to external variables, thereby protecting the recovery.

2. Macroeconomic outlook. The end- 2015/beginning of 2016 period was marked by disappointing data (see fig. 3), with a slowdown in GDP growth to 1% qoq ann. in 4Q15. However, the data were not universally weak: the labour market again put in a very strong performance, thereby supporting consumption and residential construction. Conversely, macro data from February onward has surprised on the upside (see fig. 3), with figures in line with moderate growth, above potential, driven by domestic demand.

Consumption. Household spending was supported by many positive forces: full employment on the labour market, employment growth, strong net wealth and a drop in petrol prices. Household savings are stabilising above the 5% level, and confidence is high. Consumption is expected to grow by 2.7% in 2016 and 2.5% in 2017.

Residential investment. Spending in this sector provided a contribution of 0.3 pp to growth in 2015, and is expected to contribute a similar amount in 2016 (see fig. 7). Housing starts,

construction spending and sales of new and existing units remain on a moderately upward trend. Investment in this sector is seen growing by 8.5% in 2016 and 7.1% in 2017.

Non-residential fixed investment. This sector contracted at the end of 2015, with a correction in machinery coming on top of the ongoing decline in structures, which continues to be squeezed by the mining industry recession. Figures for the beginning of 2016 are moderately positive, with a recovery in orders and deliveries, and an improvement in six-month expectations in manufacturing surveys. Annual growth is likely to remain limited (**2% in 2016, 4.4% in 2017**), while the brake exercised by the energy sector runs out.

Inventories. Inventories trimmed an average 0.6 pp from growth in 2H15, and are set to make a modest negative contribution in 2016. Initial data for 2016 show that inventories are more in line with companies' objectives, thereby limiting the risks associated with this component

Foreign trade. International trade remains weak: net exports are expected to slow growth in 2016 (-0.3 pp), but less so than in 2015 (-0.6 pp), with import and export flows staging a gradual recovery, particularly in 2017.

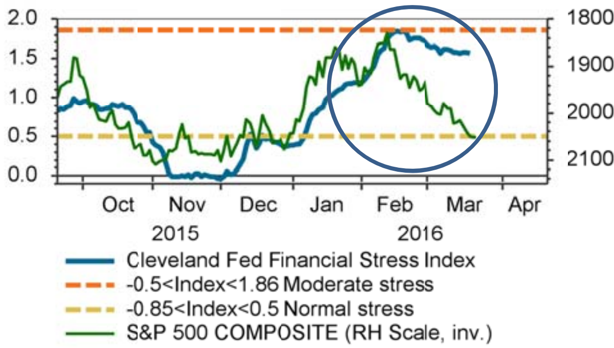
3. Monetary policy. Rates are taking a temporary break, but are still on a path of gradual hikes, which will be adjusted according to changes in data and financial conditions. The Fed confirmed that **monetary policy is dependent upon data,** and that guidance during this phase of the cycle may only be indicative, since the scenario is intrinsically uncertain: the dot plot projections are "best estimates", but are not a "predetermined plan, a commitment, a promise". The **March rate hike pause** occurred without an explicit assessment of risks, although the press release states that "global economic and financial developments continue to pose risks." The **central scenario remains positive,** with growth close to potential, falling unemployment and gradually rising inflation. Thus, the rate path continues to trend upward, with a median projection of two hikes in 2016, four in 2017 and five in 2018. Monetary policy management in 2016 confirms that the Fed will act as a buffer in this cycle, adapting to changing data and supporting the recovery, even at the risk of overshooting both the maximum employment and inflation rate targets.

Forecast Table

	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (1996 US$,y/y)	2.4	2.2	2.3	2.7	2.1	1.9	2.3	1.9	2.0	2.4	2.4
q/q annual rate				3.9	2.0	1.0	2.4	2.3	2.2	2.4	2.4
Private consumption	3.1	2.6	2.5	3.6	3.0	2.0	2.7	2.7	2.3	2.7	2.6
Fixed investment - nonresid.	2.9	2.0	4.4	4.1	2.6	-1.9	1.2	3.5	4.5	4.5	4.7
Fixed investment - residential	8.7	8.5	7.1	9.4	8.2	7.9	8.6	9.8	8.2	6.2	6.2
Government consumption	0.7	0.7	0.5	2.6	1.8	-0.1	0.4	0.7	0.7	0.7	0.3
Export	1.1	1.5	3.8	5.1	0.7	-2.7	2.5	2.6	2.8	3.0	4.5
Import	4.9	2.9	3.8	3.0	2.3	-0.6	4.2	4.1	3.8	4.0	3.5
Stockbuilding (% contrib. to GDP)	0.2	-0.1	-0.2	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	-0.1
Current account (% of GDP)	-2.7	-2.5	-2.3	-2.5	-2.8	-2.7	-2.5	-2.5	-2.5	-2.5	-2.5
Federal Deficit (% of GDP)	-3.5	-3.3	-3.4								
Gov. Debt (% of GDP)	124.7	124.6	123.3								
CPI (y/y)	0.1	1.2	2.4	0.0	0.1	0.5	1.1	1.0	1.3	1.5	1.9
Industrial production (y/y)	1.3	0.8	3.1	-2.1	2.5	-3.2	0.4	3.1	2.4	3.8	3.4
Unemployment (%)	5.3	4.8	4.7	5.4	5.2	5.0	4.9	4.8	4.8	4.7	4.8
Fed Funds	0.26	0.66	1.38	0.25	0.25	0.29	0.50	0.54	0.75	0.83	1.00
Effective exch.rate (1973=100)	91.1	93.8	89.0	89.9	91.7	93.1	93.3	94.6	94.7	92.6	90.6

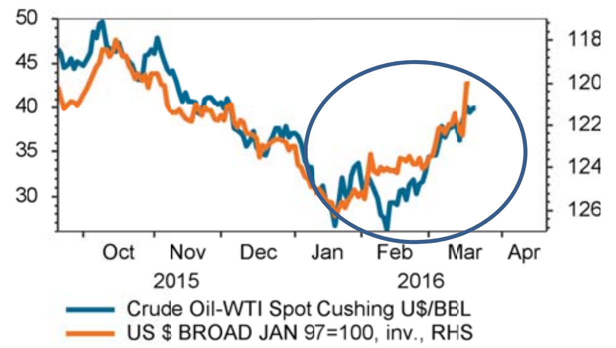
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 - Financial conditions: Is the worst over?



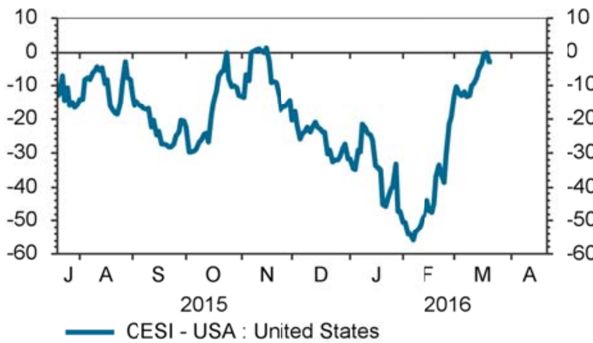
Source: Thomson Reuters-Datastream

Fig. 2 - Stable dollar and rising oil prices: the likelihood of a 2% inflation rate is rising



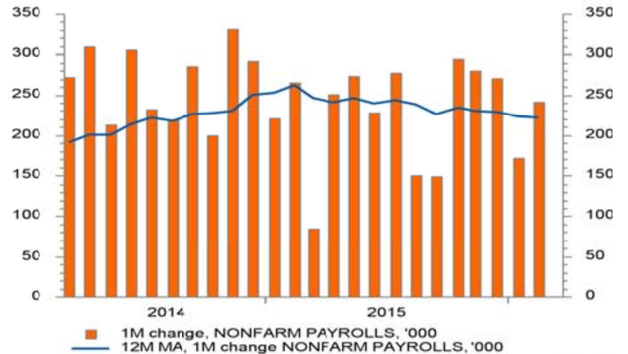
Source: Thomson Reuters-Datastream

Fig. 3 - Even surprises are no longer in one direction



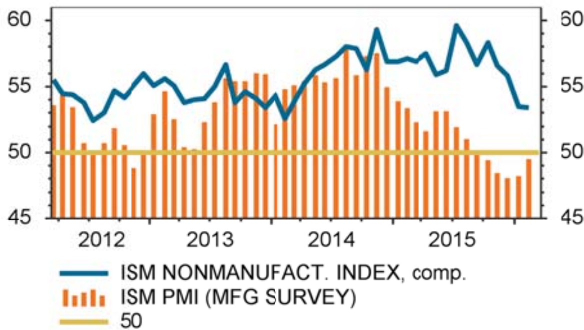
Source: Thomson Reuters-Datastream

Fig. 4 - Non-farm employment rising sharply



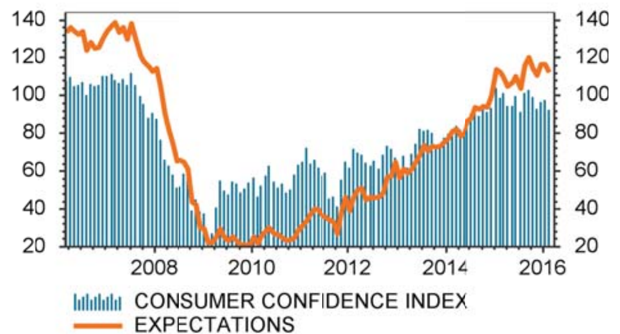
Source: Thomson Reuters-Datastream

Fig. 5 - Services continue to expand, and manufacturing has stopped shrinking



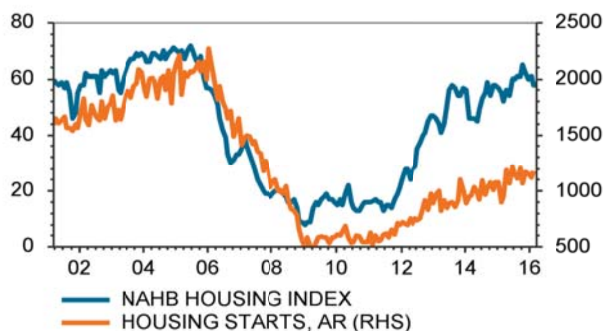
Source: Thomson Reuters-Datastream

Fig. 6 - Households remain optimistic



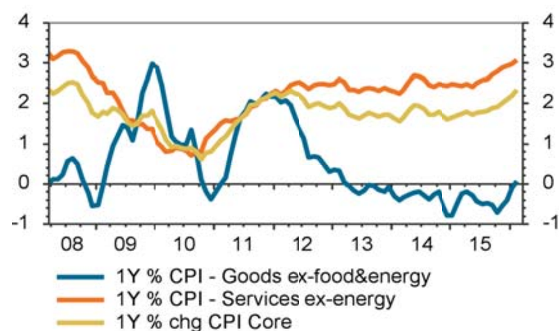
NB: figures in millions. Source: Thomson Reuters-Datastream

Fig. 7 - Housing starts and builder confidence



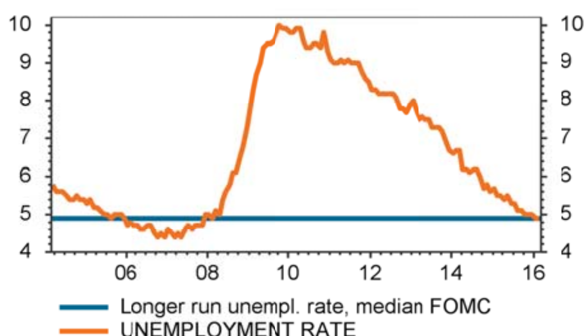
Source: Thomson Reuters-Datastream

Fig. 8 - Inflation on the rise



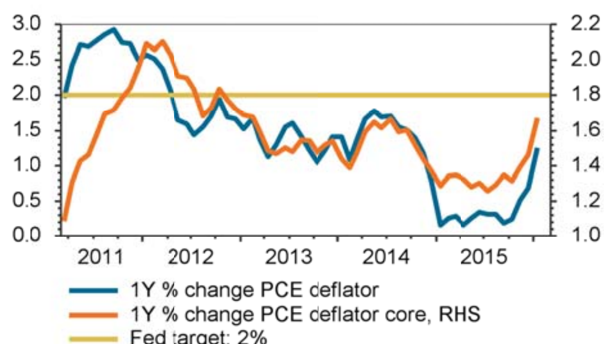
Source: Census Bureau

Fig. 9 - Full employment is here……



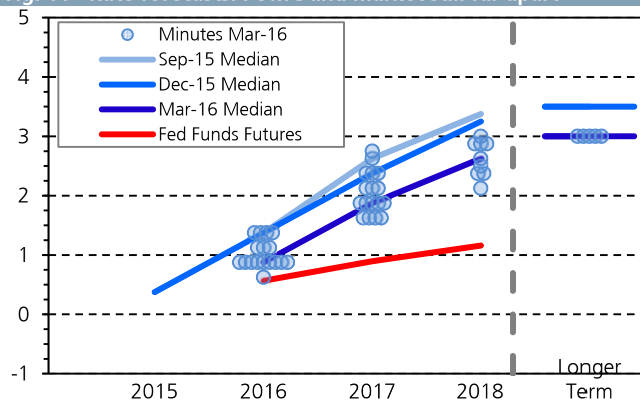
Source: Thomson Reuters-Datastream

Fig. 10 - …and inflation is not far from 2%



Source: Thomson Reuters-Datastream

Fig. 11 - Rate forecasts: FOMC and market still far apart



Source: Bloomberg, data at 16 March 2016

Tab. 1 - Fed macroeconomic projections - March 2016

Variable	Median 2016	2017	2018	Long term.
Real GDP	2.2	2.1	2.0	2.0
December projection	2.4	2.2	2.0	2.0
Unemployment rate	4.7	4.6	4.5	4.8
December projection	4.7	4.7	4.7	4.9
Consumption deflator	1.2	1.9	2.0	2.0
December projection	1.6	1.9	2-0	2.0
Core consumption deflator	1.6	1.8	2.0	
December projection	1.6	1.9	2.0	
NB:				
Projections of appropriate rate path				
Fed funds rate	0.9	1.9	3.0	3.3
December projection	1.4	2.4	3.3	3.5

Source: Federal Reserve Board GDP data: yoy % change in 4Q

Euro area: growth continuing but not accelerating

Anna Maria Grimaldi

- Economic growth in the euro area continues, but is proving weaker than we expected three months ago. In 2016, growth will stabilise at 1.5%. The impact of the slowdown in demand from the emerging countries will be offset by the trend of consumption and by investments in residential construction. Growth is forecast to accelerate in 2017 to 1.7%, thanks to the expected recovery of foreign demand, and to the lagged effects of ECB measures.
- In 2015, growth was driven by the acceleration of peripheral euro area countries, with Spain and Ireland at the fore, although peak growth levels should now be behind us. In 2016, GDP will pick up speed mostly in Italy (to 1.2% from 0.6% in 2015). Germany will advance at the same pace as in 2015 (1.7%), and in France we expect growth to accelerate to 1.3% from 1.1% in 2015.
- The balance of risks to the scenario is still skewed to the downside, and is tied to the high level of uncertainty clouding the international context, which could weigh not only on exports, but also on investment plans. However, the main risk in the new term is still political. The outcome of the elections in Germany show that populist winds are now blowing in many countries. Political instability could increase in the next few months, given the busy agenda: regional elections in Italy (May), Brexit referendum in the UK (23 June), Spanish elections (26 June). Also, there are still major divisions on the management of border policies and of the refugee crisis.
- Fiscal policy will offer very limited support to 2016 GDP growth of 0.2%. However, given the current delicate geopolitical scenario, the Commission may effectively concede maximum flexibility in managing public finances.
- The string of downward surprises from the price of oil and expectations for a modest recovery leave our inflation projections at 0.2% in 2016 and 1.4% in 2017. The trend of inflation remains entirely dependent on the response of underlying inflation (at 1.4% at the end of 2017) to the closing of the output gap. Risks of second-round effects from the energy component and from the lingering of price expectations at low levels should not be overlooked.
- The new measures announced by the ECB in March could further step up assets, by almost 2.000 billion euros. Therefore, we believe the Council will want to pause in order to assess the cyclical developments and the effect of the interventions over the past year. Moreover, some of the measures announced are still waiting to be activated. The ECB's strong easing bias is still in place, and we do not rule out further measures in the event of negative surprises from growth and inflation.

Forecast Table

	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	1.5	1.5	1.6	1.6	1.6	1.6	1.4	1.4	1.5	1.7	1.7
- q/q change				0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.3
Private consumption	1.7	1.9	1.9	0.3	0.5	0.2	0.6	0.6	0.5	0.4	0.6
Fixed investment	2.6	2.8	2.9	0.1	0.4	1.3	0.2	0.8	0.8	0.6	0.7
Government consumption	1.3	1.6	1.2	0.3	0.3	0.6	0.4	0.4	0.3	0.3	0.4
Export	4.9	2.9	3.7	1.7	0.2	0.2	0.5	1.0	1.1	1.3	0.8
Import	5.6	5.0	4.8	1.0	1.2	0.9	1.5	1.5	0.9	1.1	1.6
Stockbuilding (% contrib. to GDP)	-0.1	0.4	0.1	-0.2	0.3	0.1	0.3	0.0	-0.2	-0.1	0.2
Current account (% of GDP)	3.0	3.3	2.6	3.1	3.0	3.0	3.7	3.4	3.1	3.0	3.0
Deficit (% of GDP)	-2.1	-2.2	-1.9								
Debt (% of GDP)	93.5	92.7	91.4								
CPI (y/y)	0.0	0.2	1.4	0.2	0.1	0.2	0.0	-0.1	0.1	0.6	1.4
Industrial production (y/y)	1.5	2.6	1.8	0.1	0.2	0.4	1.7	0.4	0.3	-0.2	0.3
Unemployment (%)	10.9	10.1	9.6	11.0	10.7	10.5	10.3	10.2	10.1	9.9	9.8
3-month Euribor	-0.02	-0.27	-0.28	-0.01	-0.03	-0.09	-0.18	-0.29	-0.30	-0.30	-0.30
EUR/USD	1.11	1.08	1.15	1.10	1.11	1.10	1.10	1.08	1.07	1.09	1.12

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

Domestic demand supporting the recovery

Euro area GDP disappointed at the end of 2015, due to the slowdown of exports throughout the Eurozone. The weaker than forecast exit from last year, and the greater sluggishness of global demand than we had estimated three months ago, from emerging countries especially, have prompted a revision of our forecast for this year from 1.7% to 1.5%. The acceleration of the expansion phase to rates above potential is postponed to 2017. This year, growth will be again supported by a mix of markedly favourable external factors:

1) The drop in oil price, which was stronger than we had forecast three months ago. On average, in 2016 we expect a 25% reduction, from -47% in 2015. In 2017, we expect oil prices to increase by only four dollars per barrel. The boost effect on the trend of disposable income of households and businesses, generated by oil prices, will amount to around 0.5-0.6% in 2016 as well;

2) Global demand will remain lacklustre until the summer, when it should start to recover gradually. In 2017, foreign demand addressed to the euro area should increase by 5%, from 3.4% in 2016;

3) We stick to our forecast for a broadly stable nominal effective exchange rate in 2016 (it depreciated at the beginning of the year), after a 9% decline in 2015, the residual effect of which on euro area GDP growth should amount to +0.2% in the spring quarter, given the lag at which the shock is usually transmitted (12-18 months).

Growth will also be supported by more accommodative economic policies. Specifically:

1) The non-standard monetary policy measures put in place by the ECB between December and March should significantly boost monetary stimulus. Changes to the APP (life extension, expansion to embrace corporate bonds, and increase in volumes combined with the principal reinvestment policy) will result in a larger portfolio by around 1.000 billion. Also, the new four-year refinancing operations have already reaped effects on the funding conditions of banks, and are easing doubts on the solidity of the banking sector. Last December, the ECB estimated the impact of asset purchases at around 1.1% of GDP over three years; with the measures adopted in March, the effect in 2016-17 could increase to 0.4% a year.
2) Fiscal policy will be only moderately expansive. The flexibility conceded by Brussels, in part to face strong migrant inflows (0.25% per year in Germany), will allow an easing of the structural balance worth 0.3% of GDP. This marks a significant change of pace compared to 2011-2014, when fiscal correction averaged 1.0% of GDP per year. We cannot rule out a sharper than expected worsening of structural balances *ex-post,* compared to the Commission's winter forecasts, in part tied to the effort to contain populist drifts.

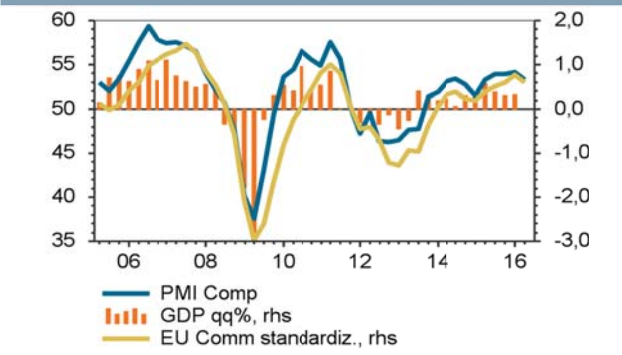
On the forecast horizon, growth will continue to be driven by the trend of domestic demand, whereas foreign trade should contribute negatively to growth by 0.6%. Exports are estimated to increase by 3.3% in 2016, from 4.8% in 2015 (in part due to the slowdown at the end of the year), whereas imports will grow by 4.7%. Domestic demand should accelerate to 2.0%, from 1.7% in 2015. Households' consumption will continue to expand at pre-crisis rates, accelerating to 1.9% from 1.7% in 2015, fuelled by livelier spending in peripheral countries as well. The consumption trend is still supported by the decline in oil prices (+0.5%, see Fig. 3), by more expansive financial and credit conditions, by the gradual improvement in the employment trend (+1.1% in 2016 from 0.8% in 2015), and by a 1.8% increase in negotiated wages, from +2.3%[1] (Fig. 7). Inflation is still close to zero in 2016, and expected to rise back modestly. The savings rate could decrease only marginally, to 12.7% from 12.9% this year.

[1] For the time being, the increase in negotiated wages is almost entirely accounted for by Germany.

Investments in machinery are still the weak link of the current recovery phase, although at the end of 2015 they accelerated to +1.1% q/q, after the semi-stagnation seen in the central months of the year. Our estimates price in average growth of 0.9% q/q between now and the end of 2017 (growth forecast at 3.4% in 2016 from 3.9% in 2015, due to unfavourable base effects at the beginning of the year). Production capacity is now above the average of the past 10 years (Fig. 8). The latest European Commission survey outlined an increase in spending on extending machinery and equipment (Fig. 9). Credit and financing conditions are supportive (Figs. 10 & 11), and should further improve thanks to the measures put in place by the ECB in March. However, the main drag remains political uncertainty (Fig. 12). Confidence surveys point to a recovery in **residential construction** in almost all countries. Our estimates point to an acceleration to 2.2% in 2016-17.

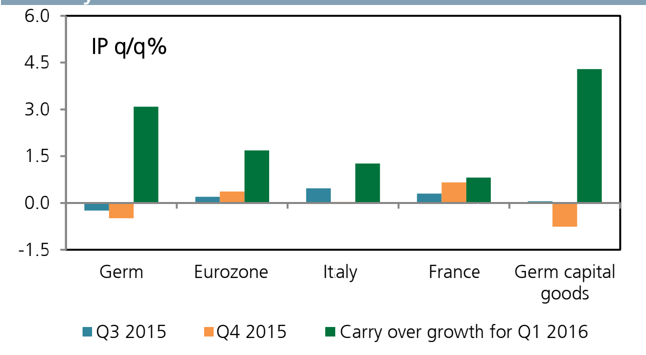
Risks to the scenario are still skewed to the downside, despite the two-tenth revision of our forecasts compared to three months ago. Risks stem from the high uncertainty clouding the international scenario and the stabilisation of the emerging economies. However, the main source of risk in the next three months will be the political scene. After the populist drift witnessed in Portugal and France, the regional elections in Germany on 13 March also yielded a strengthening of populist and anti-European positions. In the next few months, the political agenda will be busy with events which could add to political instability: local elections in Italy (May), Brexit referendum (23 June), and elections in Spain (26 June). Moreover, there are still deep divisions over border management policies and the refugee crisis.

Fig. 1 – Confidence surveys at the beginning of the year point to GDP growth of +0.3% q/q at best



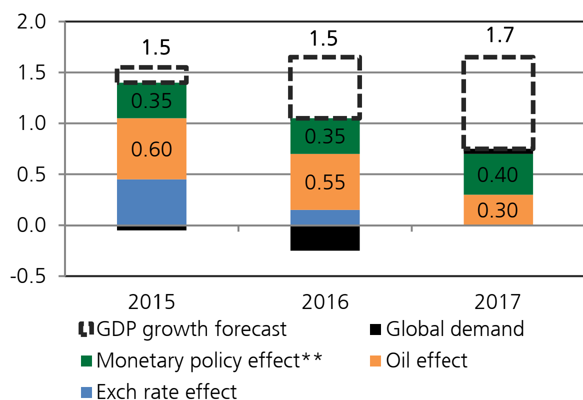
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 2 – However, January industrial output data seem to promise much more solid growth. Temporary rebound or real recovery?



Source: Thomson Reuters and Intesa Sanpaolo elaborations

Fig. 3 – Monetary policy and the drop in oil prices will continue to drive euro area growth



Note: effect of QE on growth: 1.1% in 3 years (Draghi, December 2015 press conference) Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Tab. 1 – Weaker demand in the emerging countries will keep holding back exports

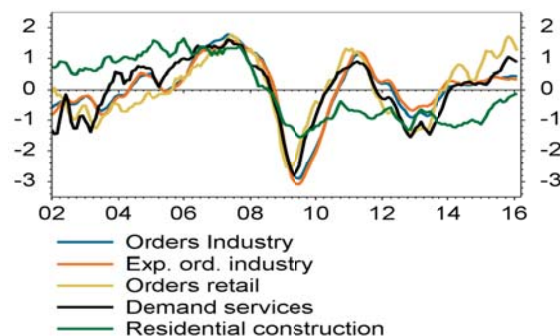
Region's % share of total exports		Exports y/y %		y/y % contribution by area	
	2015	2015	2016*	2015	2016e*
East. Europe	16.4	7.5	3.6	0.5	0.6
Asia ex Ch & JP	14.8	6.9	0.4	0.5	0.1
China	6.8	-1.0	-0.6	-0.1	0.0
OPEC	6.4	3.6	-9.4	0.2	-0.6
Latam	4.8	4.2	-7.5	0.3	-0.4
Russia	4.1	-29.2	-10.3	-2.0	-0.4
UK	13.0	8.9	5.1	0.6	0.7
US	12.4	16.1	-0.2	1.1	0.0
Nord Europe	6.3	2.9	4.3	0.2	0.3
JP	2.2	5.4	-2.7	0.4	-0.1
CD	1.2	11.0	0.6	0.7	0.0
Emerging	53.2	-1.3	-4.0	-0.5	-0.8
Advanced	35.1	8.9	1.4	3.0	0.9

Note: (*) = January data. Contribution to annual export growth estimated based on the change in exports in January 2016

Fig. 4 – Outlook for foreign trade in the next few months still scarcely encouraging

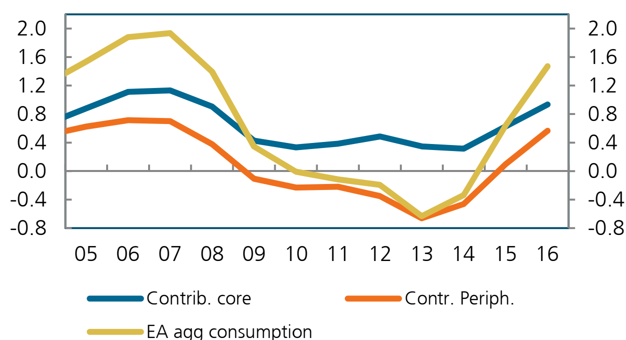
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 5 – Growth in the euro area will stay solid, driven by services, retail sales, and the recovery of residential housing



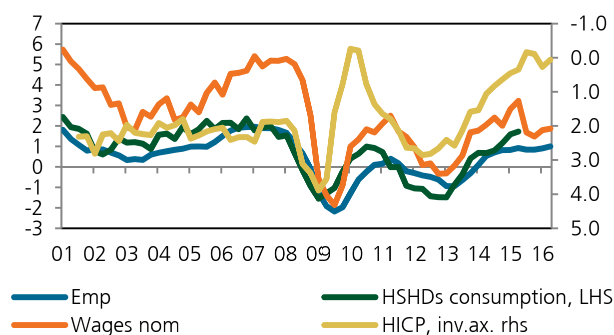
Note: the series are in standard deviation from the medium-long term average. Three-month moving averages. Source: Thomson Reuters Datastream-Charting and Intesa Sanpaolo elaborations

Fig. 6 – Households' consumption advancing at pre-crisis rates, thanks to low oil prices…



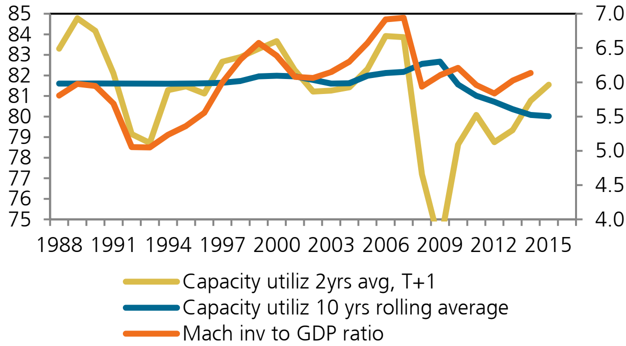
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 7 – …and the support of wages and employment



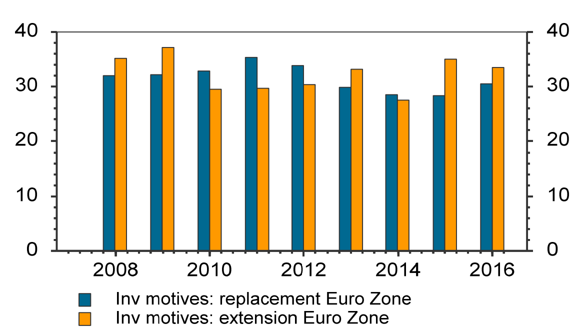
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 8 – Towards a livelier investment cycle? Productive capacity above the average for the past 10 years



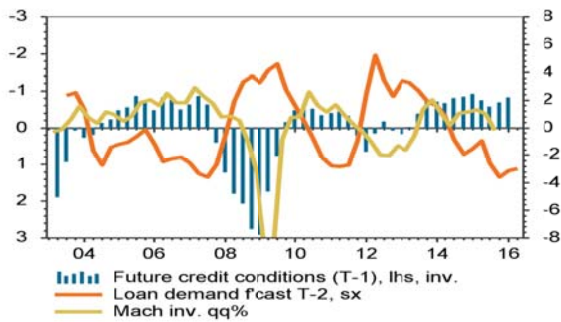
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 9 – The Commission's survey at the end of 2015 pointed to higher spending on extension



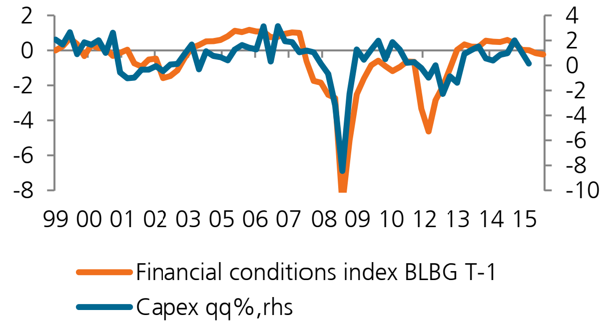
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 10 – The improvement of credit conditions…



Source: Bloomberg Eurostat Thomson Reuters

Fig. 11 – …and the stabilisation of financial conditions following the ECB's intervention should support growth

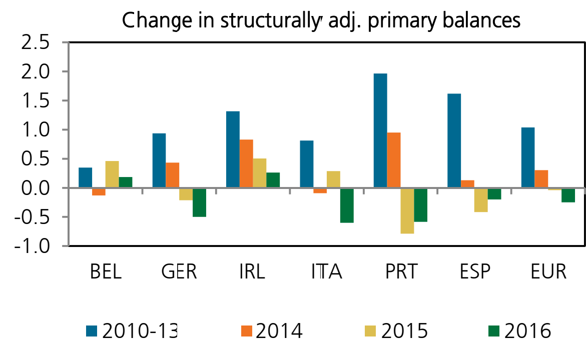


Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 12 – Political uncertainty is the most important drag on investments in machinery

Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 13 – Fiscal policy will be only marginally expansive in 2016



Source: EU Commission (AMECO November 2015) and Intesa Sanpaolo elaborations

Inflation: a moving target

Anna Maria Grimaldi

We have again cut our inflation forecasts compared with three months ago: by almost one point for the current year to 0.2% and by two-tenths of a point for 2017 to 1.4%. We expect Euro zone inflation to rise back to 1.5% in 2018, thus remaining a long way off the ECB target. However, should the economy hold up well and in the absence of second-round effects, underlying inflation could rise to 1.8%-1.9%.

The continuous downgrades are largely due to the relentless fall of oil prices and to the continuous downward adjustment to crude oil price forecasts. In 2016, we now expect an average oil price of USD 40 per barrel, USD 10 lower than in December. This means that the price of crude oil will fall by a further 24% this year, after shedding 47% in 2015. Our forecast for the euro exchange rate is broadly unchanged from three months ago: 1.10 on average in 2016 and up to 1.17-1.20 on average in 2017-18[2]. With oil prices still falling sharply in the first half of this year, energy will continue to curb inflation, which could remain close to zero or in marginally negative territory until late summer. Given the modest contribution from energy in 2016-17, the focus, including that of the ECB (as indicated by François Villeroy de Galhau from the Bank of France) will shift to core inflation (see Fig. 2), and on how quickly underlying prices respond to the lower excess supply in the economy. The depreciation of the exchange rate in 2015 has already been fully transferred to import prices, but it will still take six to nine months for the residual effect (+0.25%)[3] to filter through to consumer prices (see Figs. 2 and 3). Lower excess supply is likely to contribute around 0.2% over two years (see Fig. 5). According to our GDP growth forecasts, the output gap will nevertheless remain in negative territory at the end of 2017 (-0.8% from -1.8% estimated by the European Commission for 2015). In addition, there are no pressures from unit labour costs. Contractual wages in industry grew by 1.6% yoy in the third quarter of last year. Nevertheless, growth in labour costs is likely to remain around 0.8%-1.1% also in 2016-17. Growth in productivity is expected to remain positive (0.6% yoy), because employment will continue to grow (1.0% in 2016) at a slower rate than GDP. Risks for inflation remain marginally to the downside, and stem from the uncertain economic outlook as well as potential second-round effects on medium-term inflation expectations, wage growth and domestic prices. Medium-term inflation expectations continue to fall, not only in terms of market expectations (see Figs. 4 and 5), but also price expectations for the next few months based on PMI and European Commission confidence indices, as well as the five-year forecasts of the professional forecasters in the ECB's survey. The package of measures announced by the ECB in March should help revive inflation expectations in the medium term, but for the moment, the effect on implicit market expectations in forward agreements remains negligible. The ECB cannot therefore let its guard down.

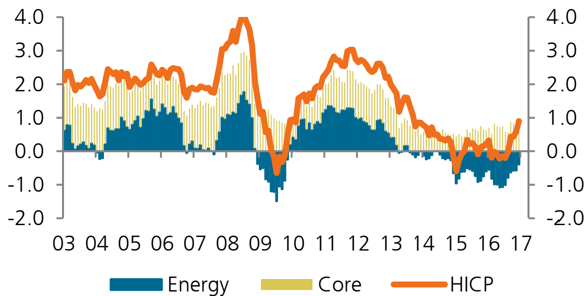
Tab. 1 – Inflation forecasts by country

	GRC	CYP	FRA	PRT	IRL	BEL	FRA	EA	MLT	ESP	ITA	GER	NLD	AUT
2015	-1.1	-1.5	0.1	0.5	0.0	0.6	0.1	0.0	1.2	-0.6	0.1	0.1	0.2	0.8
2016	-0.8	-1.3	0.3	-0.2	-0.2	1.1	0.3	0.2	1.1	-0.2	0.1	0.1	0.4	1.2
2017	-1.8	0.4	1.2	1.0	1.2	1.4	1.2	1.4	1.6	1.6	1.6	1.6	1.6	1.9
2018	-1.8	0.5	1.2	1.1	1.2	1.4	1.2	1.5	1.7	1.6	1.6	1.6	1.6	1.9

NB: Intesa Sanpaolo estimates Source: Eurostat

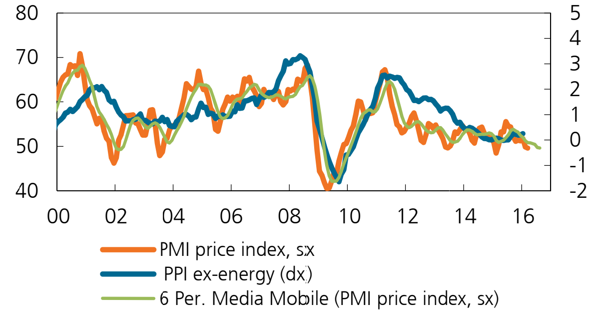
[2] The standard elasticities contained in the ECB and European Commission models suggest that the effect of a 5% fall in the price of crude oil on headline inflation is between -0.15% and -0.3% after four quarters.
[3] Standard elasticities suggest that a depreciation of 5% in the exchange rate translates into an increase of 0.3% in inflation on average after two years.

Fig. 1 – With the new oil price forecasts, energy will continue to dampen overall inflation until the beginning of 2017



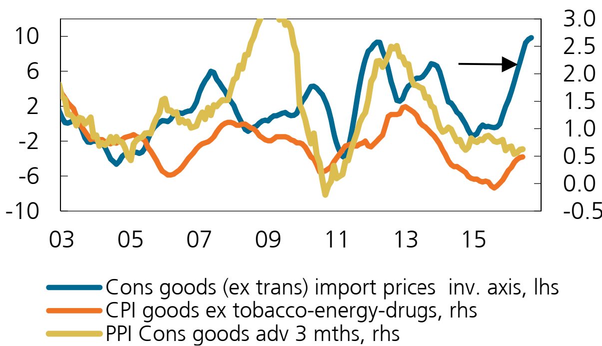
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 - Downward pressure upstream in the supply chain seems to have stabilised.



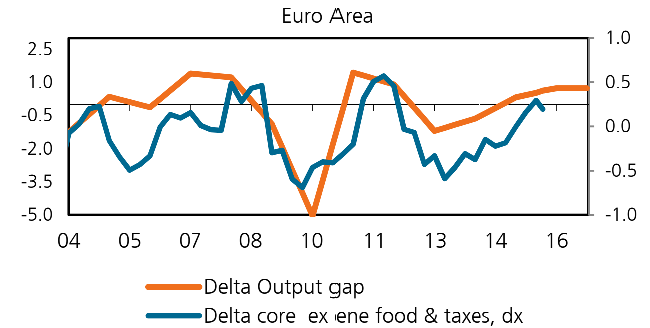
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 3 – It will take a few more months for the increase in import prices to be fully transmitted to consumer prices



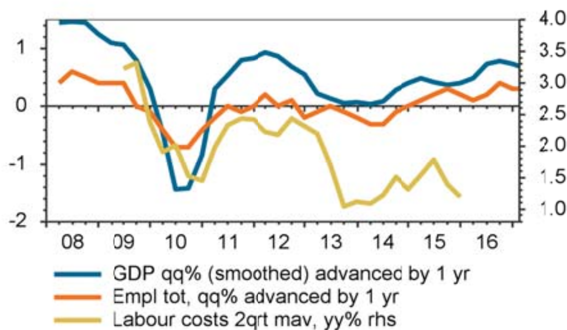
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – Focus will shift to the response of *core* prices to the reduced slack in the economy



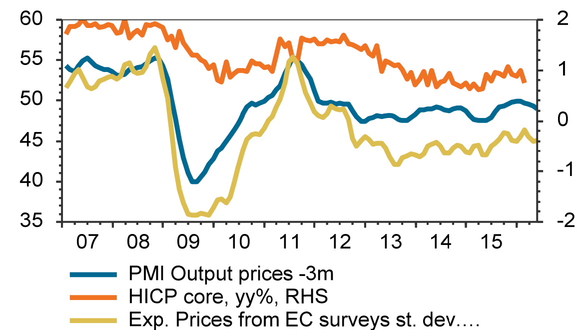
Source: OECD (output gap), Intesa Sanpaolo chart from Eurostat data

Fig. 5 – Limited pressures from unit labour costs. Output will continue to grow over the forecast horizon



Source: OECD (output gap), Intesa Sanpaolo chart from Eurostat data

Fig. 6 – Risks of second-round effects on wage growth and domestic prices if inflation expectations remain at low levels compared with the ECB target



NB: price expectations based on the European Commission's sector surveys; the series show standard deviation from the MLT, and are aggregated with the weightings in value added (industry, retail trade, construction and services). A negative value for expectations indicates that they remain below the historical average. Source: European Commission (price expectations for industry, services and retail trade) Eurostat (CPI core) Markit (PMI) ECB and Intesa Sanpaolo chart via Thomson Reuters-Datastream charting

ECB: will the bazooka fire again?

Anna Maria Grimaldi

At its March's meeting, only three months after the package announced in December 2015, the ECB announced with an "overwhelming majority", in President Mario Draghi's words, a broad and diverse set of monetary policy measures. On this occasion, the package was much more extensive than expected (see Focus below). The overhaul of monetary policy comes on the back of projections that put inflation at 1.6% also in 2018, well below target for the fifth year running.

The most significant measure announced at the March meeting is that which Draghi described as a "credit measure", i.e. four four-year TLTROs, a halfway house between a liquidity measure for the banking sector and a lending support programme for the economy. With the new four-year operations, banks can potentially borrow up to a maximum of EUR 1,480Bn. Through the LTROs launched in December 2011 and February 2012, a more difficult period in terms of funding, banks borrowed EUR 1,000Bn.

The increase in the monthly purchase target to EUR 80Bn announced in March implies an overall increase of EUR 240Bn, which comes on top of the additional purchases of EUR 360Bn decided in December with the extension of the APP by six months to March 2017. The rise in monthly purchases will be made up in part by corporate bonds (perhaps between EUR 6-7Bn a month, but this will depend on how the ECB sets the programme limits); the remainder should continue to come from government bonds and other categories of financial assets covered by the programme. Overall, the APP is likely to total EUR 1,740Bn.

With regard to rates, Draghi stated that the deposit rate is not far from the lower bound, and explained that the reluctance to introduce a tiered system for the deposit rate is partly because of the desire not to signal that rate cuts will continue indefinitely. Furthermore, Draghi recognised that more negative rates could prove ineffective in stimulating the money multiplier and, conversely, generate an undesired increase in savings.

The announcements of 10 March, particularly the reassurance that the lower bound for the deposit rate has almost been reached and the launch of the TLTRO II programme, may help allay concerns created by previous monetary measures regarding their impact on the profitability of European banks. The TLTRO II programme seems designed to ensure that participating banks will achieve tangible savings compared with bond issues with the same maturity, and to prevent recourse to this programme being interpreted as a sign of weakness. The incentive mechanism with which the auctions have been designed should also stimulate lending to the private sector from 2017. If the banks do not use the funds borrowed to increase volumes of loans granted or to substitute maturing bonds, they will have to pay 0.4% on deposits in excess of minimum reserve requirements.

The increase in the volume of monthly purchases of the APP programme, together with the cut in the deposit rate, should provide marginally more favourable financing conditions - with regard to the component relating to interest rates - for companies, governments and households for at least a year. Corporate bond purchases could provide issuers with even more generous financing conditions than currently on offer.

And what if all this doesn't work? Overall, with the measures announced between December 2014 and March 2016, the ECB could expand its balance sheet by EUR 3,500Bn (see Tab.1), which according to ECB forecasts, would be equivalent to a cut of 370 bps in official rates[4]. For

[4] See ECB *Working paper* no. 1937

the moment, the Governing Council would like to *wait and see* how the economy develops, and assess the impact of the measures put in place on growth and inflation. We cannot however rule out further interventions; the ECB maintains an easing bias, since March's statement indicates that the risks for the macro outlook are still to the downside, and that the Council "will carefully assess" the risks of second-round effects on domestic prices from the persistent drop in oil prices.

Tab. 1 - The ECB bazooka could inject EUR 3,580Bn

Time of the announcement and measure	EUR Bn
Dec 2014 - EAPP	1140
Dec 2015 - Extension of EAPP until March 2017	360
Dec 2015 - Reinvestment policy	320
Mar 2016 - Increase by 20 bn in the monthly purchase target to 80 bn a month effective in April	240
Mar 2016 - TLTRO II in the event of maximum take-up - First operation to be held in June 2017	1480
Total value of measures announced between December 2014 and March 2016	**3580**
GDP nominal	10396
Measures as % of GDP	34.1

Source: BCE and Intesa Sanpaolo estimates

Draghi and other members of the Council stated that the tool-box is not yet empty, with other options available if necessary. After this further use of the fund, there is not much more that can be done in terms of less unorthodox, non-conventional measures.

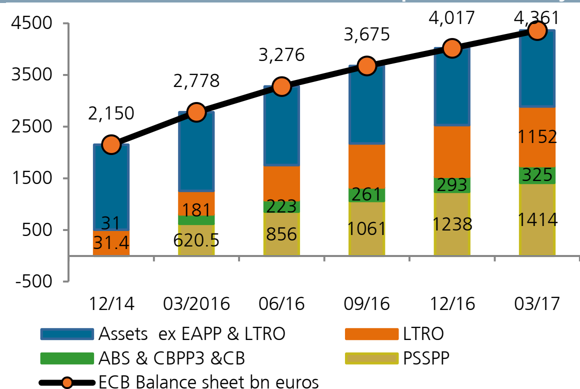
For now, the ECB **has not altered the parameters of the APP, but we cannot rule out that it will do so in future if this proves necessary to meet its quantitative objectives;** the easing of issuer and issue limits for supranational bonds lowers the threshold, with the ECB thereby modifying the parameters of government bond purchases.

We can also not rule out that the ECB could extend the programme to other asset categories. Note that the eligibility criteria for outright purchases are similar to those for collateral eligibility in refinancing operations. Purchases of **ETFs** are a possibility, and would circumvent potential governance problems that could emerge with share purchases. Purchases of **bank bonds,** advocated in the weeks leading up to the March meeting, cannot be ruled out and are eligible. However, the ECB would have to hold unsecured bank securities on its balance sheet until maturity, and these securities could potentially be involved in the new banking resolution procedures; certain problems could be avoided if the ECB declared it would proceed on a *pari passu* basis in the event of restructuring, but the issue of a potential conflict of interests would remain. Furthermore, the Central Bank could presumably purchase investment grade tranches of non-performing loan (NPL) securitisations, both on the primary and secondary market, should an NPL securitisation market be launched. An NPL ABS purchase programme would perhaps speed up the process of reducing problem assets.

We cannot rule out **a further tweak to the deposit rate to -50 basis points, partly with a view to encouraging banks to take part in the new TLTRO II.** Cuts below this threshold would however seem unlikely, since the ECB seems to have decided that it does not want to continue to drive it downwards in order to weaken or stabilise the exchange rate.

The ECB seems to have also considered more unorthodox ideas. During the March press conference, Mario Draghi answered a question on "**helicopter money**", i.e. the direct injection of money into the balance sheets or private or public operators. The ECB President did not completely rule out this solution, but stressed that it was a rather complex measure, with accounting and legal implications that may prove difficult to resolve. In principle, in some of its forms, the measure would not breach article 123 of the Treaty of the Functioning of the European Union, which prohibits the monetary financing of the public and private sectors.

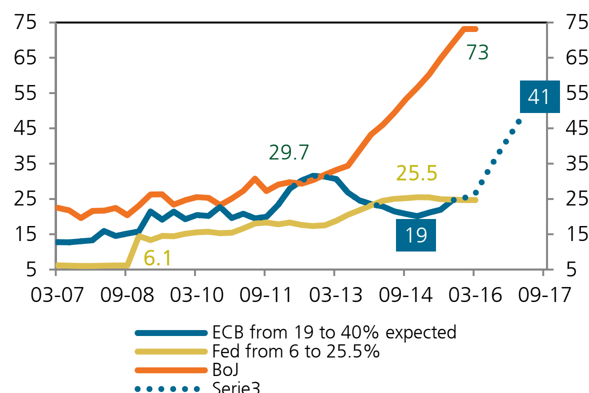
Fig. 1 – The ECB balance sheet will reach EUR 4.36Trn by March 2017 thanks to the mix of measures adopted in the last year



NB: We assume that the ECB will purchase ABS and CB at the same pace as in the last 17 months, EUR 2,2Bn and EUR 2,020M respectively. Corporate bond purchases will range between EUR 5-7Bn. We assume that the banks will take EUR 1,000Bn in the TLTRO I auctions, as in the auctions of December 2011 and February 2012.

Source: Intesa Sanpaolo chart from ECB data

Fig. 2 – The ECB will double its assets by March 2017



Source: National central banks and Intesa Sanpaolo estimates

Focus: March's ECB package in detail

According to Draghi, the TLTRO II programme "will offer attractive long-term funding conditions to banks to stimulate credit creation and provide funding certainty to 2012, in an environment of increasing volatility and one of large bank bond redemptions". The first auction will be held in June 2016 and the last one in March 2017. The maximum amount that banks can borrow is 30% of the volume of loans to the private sector, excluding mortgages, as at 31 January 2016 (EUR 5,642Bn), less amounts previously borrowed under 2014's TLTRO I programme (EUR 212.44Bn). In order to switch to the new programme, banks may repay the loans granted under the old programme early, without incurring penalties. In total, therefore, banks could theoretically borrow a maximum of EUR 1,480Bn.

Unlike under TLTRO I, there is no early repayment obligation in the event of failure to comply with the conditions on the loans: in this case, the bank pays the refi rate for the entire duration of the operation, but can still benefit from access to cheap liquidity with a four-year duration. At the auction in June 2016, banks will be able to request liquidity up to 30% of existing loans at 31 January 2016, and will pay the refi rate (currently 0%) applied on the main refinancing operations prevailing at the time of the auction. If, as of January 2018, the bank has exceeded its benchmark of loans (which will not be more than the stock in January 2016 for any bank) by 2.5%, it will obtain a rate reduction equal to the difference between the refi rate and the deposit rate applicable at the time of the auction (presumably -0.4% in June 2016). If, conversely, the stock has increased by less than 2.5% above the benchmark, the rate reduction will be adjusted according to growth in net lending in the twelve months to January 2018. The benchmark on net lending will be set to zero for banks that have recorded an increase in lending in the twelve months to 31 January 2016, but equal to net loans for those that recorded a decrease in lending.

This measure should help allay concerns over banking sector profitability following the introduction of negative interest rates, as well as promoting stability in this period of transition towards the new regulations. As a comparison, the yield-to-maturity of senior Italian banking bonds maturing in 2020 is around 0.9% for the safest issuers, but rises to several percentage points for the weakest.

As Draghi explained, the other series of measures consists of "monetary easing measures" intended to combat the biggest risks for growth and inflation. These include:

1. the cut in official rates: marginal refinancing at 0.25%, refi rate at 0.0% and deposit rate at -0.40%;

2. increase in the monthly purchases target for the APP programme from EUR 60 to EUR 80Bn a month, with effect from March 2016.

3. the increase in the monthly purchases target is partly made possible by the increase in the issuer and issue limit for supranational bonds from 33% to 50%. The percentage of supranational purchases will however be reduced from 12% to 10%. These changes reflect the lack of securities available in this segment, and in any event imply an increase in the monthly purchases of government stocks;

4. in addition, from June 2016, the ECB will extend the APP programme to corporate bond purchases, excluding the issues of companies linked to banking groups. The ECB has yet to specify how much of an individual issue will be eligible for purchase, but the limit would presumably be no more than 30%, as for government bonds. It is estimated that the issues of Italian issuers potentially eligible for purchase is EUR 69Bn, while this figure rises to EUR 400Bn at Euro zone level;

5. the ECB also strengthened its forward guidance, stating that rates will remain "at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases".

Germany: expansion on track, amidst political tensions and uncertainty

Anna Maria Grimaldi

The phase of above-potential expansion continues

Despite mounting domestic political tensions, and uncertainty over the international scenario, the growth outlook for the country remains solid. The slowdown of global demand, in particular from the emerging economies, with China at the fore, weighed on German exports in the second half of 2015, and explains weaker than expected manufacturing and GDP growth starting in mid-2015. Last year closed showing average GDP growth at 1.7% (1.5% net of calendar effects), one tenth stronger than in 2014. GDP growth in Germany should continue at a marginally faster-than-potential pace (1.3% in the Bundesbank's latest estimates[5]) this biennium, although recent developments indicate that an acceleration from last year's 1.7% rate is unlikely. Compared to three months ago, we have cut our forecasts for 2016 by two tenths, due to the weaker than expected exit from 2015. In 2017, we estimate GDP growth at 1.8% (1.6% net of calendar effects), in part on the back of a recovery of the international cycle, and thanks to financial conditions that have remained markedly accommodative, following the package of measures announced by the ECB in March.

Fiscal policy will be accommodative both this year and next, partly on rising expenditure to absorb large flow of migrants. The risks to the outlook are broadly balanced as monetary policy stimulus should compensate weaker external demand, compared to our forecasts, and protracted geopolitical uncertainty. Furthermore, the level of the public balances allows, if necessary, to provide further support.

Strong start to 2016, thanks to the surge in industrial output, but the worsening of confidence between November and February signals downside risks

Short term prospects. The monthly ZEW, IFO and PMI surveys have dipped rapidly compared to the end of 2015. The trend of the IFO index between November and February (-3.3 points to 105.7) is explained by a worsening of the expectations component, whereas the current views index has improved. It is therefore possible that concerns over the global cycle, exacerbated by the wave of sales on the financial markets in the first two months of this year, may have prompted companies to revise their output forecasts. However, the manufacturing data component of the IFO survey also revealed a clear deterioration in demand indicators, and of foreign demand in particular. The same picture is drawn by the trend of the PMI. In retail sales and services, typically more sensitive to the trend of domestic demand, confidence and orders have decreased, but remain above the long-term average, therefore suggesting that the expansion phase continues, although it may have peaked. On the whole, confidence surveys available to date are compatible with German GDP growth in 1Q in line with the end of 2015 at best: 0.3% q/q (Fig. 1). However, data on industrial orders and output in January outlined a much brighter picture, highlighting a sharp rebound in activity (Fig. 4), in the capital goods segment in particular. January data may have been inflated by exceptional calendar effects (only 18 workdays vs. 21-22 in the previous years), and a normalisation may follow in February, especially in the instrumental goods segment, also indicated by broken down IFO data. January data leave output on course for a 2.5% q/q increase in March, and signal GDP growth of 0.5% q/q, although it is too soon to say if this pace of growth, at least in the manufacturing sector, is sustainable.

Foreign trade, and in particular demand from emerging countries, will hold back growth in 2016

In the opening months of 2016, uncertainty over the international scenario, the weakening of demand from oil-producer countries, and the drag effect of the Chinese slowdown on some sectors of industry could continue to weigh on growth in the export and manufacturing sectors. German exports towards oil producer countries account for 5% of the total, and those towards

[5] In December, the Bundesbank revised upwards by one tenth its estimate of potential GDP growth, in view of the effects of the strong inflow of refugees on the workforce trend, and indirectly on productivity growth and on fixed capital formation. The differential between aggregate demand and supply, already positive in 2015, should keep widening. Production capacity utilisation should increase further compared to the long-term average, fuelling business investments.

BRIC countries for a 10.4% share. Weaker exports to these regions could therefore offset resilient sales to in the other advanced countries (the United States, the United Kingdom, and Japan account for around 17% of German exports) and the rest of the euro area. In January, German exports dropped by.5% m/m, and the indications provided by the IFO and global PMI indices pointed to a further slowdown (Fig. 3).

On the whole, foreign trade should start contributing negatively again to GDP growth in 2016 (-0.5% from +0.1% in 2015), as imports are expected to grow more than exports, given the high imported content of exports, consumption, and investments. As a result, the trade surplus should drop to 7.6% from 8.0% in 2015. In 2017 we expect foreign trade to make a broadly neutral contribution, as global demand is expected to reaccelerate to 4.8% from 3.9% estimated this year.

Consumption supported by still solid employment growth, accommodative financial conditions, declining oil prices, and 2.5% wage growth

While the near-term outlook for exports is not encouraging, confidence surveys suggest that domestic demand should keeping driving growth. Retail sales increased on average by 0.65% between December and January. Auto registrations increased again at the beginning of 2016. The outlook for private consumption in the remainder of 2016 remains markedly positive, and we estimate an average growth of 2.0% in 2016 (from +1.9% this year), a pace last seen at the end of the 1990s, explained by the recovery in purchasing power associated with the decline in oil prices, markedly accommodative financial conditions, an easing of the fiscal burden, and resilient real earned income (2.3% in 2016 from +2.7% in 2015). Overall wages are forecast to increase by around 2.6% in 2016-17, on a positive wage drift[6]. Employment should grow by just under 1.0%, at least in the first six months of 2016, down from +1.3% at the end of 2015, in line with the indications of the PMI surveys (Fig. 4). In the closing months of 2015, around 223k new jobs were created, subject to social contributions, i.e. the so-called good jobs, +1.3% y/y from the previous year, more than indicated a few months ago by hiring intention surveys. Job creation is concentrated in the business services sector, and in health and social services. The public sector experienced an increase in employment in the closing months of 2015, most likely in response to the strong inflow of refugees. The unemployment rate came close to setting new lows at 6.2% in January, a rate compatible with full employment. Further declines will depend on the trend of the labour force and on the speed at which the immigration inflow translates into higher participation[7]. Overall wages are estimated to grow by around 2.5% in 2016-17, on a positive wage drift[8]. Real disposable income growth will stay at around al 2.5% this year, and pull back to around 1.0-1.3% once the purchasing power of households is eroded in part by inflation, to 1.6% in 2017 from +0.2% estimated this year (Fig. 5).

Residential construction: growth still solid. Uncertainty may weigh on business investments

Further support to growth should come from investments in residential construction, given the sharp rise in orders (Fig. 8), building permits, output, and the evolution of confidence in the sector seen over the past few months. We expect growth to average 3.0% in 2016-2017. The trend between the end of 2015 and the beginning of 2016 may have been inflated by exceptionally mild weather conditions. In the closing months of 2015, business investments recovered, rising by 0.9% q/q from 0.3% q/q in the summer months. The high level of facility

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[6] Overall wages grew by 2.9% in 2015, more than negotiated wages, at 2.4%, on a positive wage drift tied to the introduction of the minimum hourly wage last January. The effect on wages of the introduction of the minimum wage should wane in 2016, whereas the wage drift should remain positive, as the labour market is at full employment levels, and there is a shortage of skilled labour.

[7] Demand for labour is still largely met by immigration from the rest of the European Union, whereas for the time being the Bundesbank estimates that only an irrelevant percentage of the refugees which reached the country last year have managed to access the labour market.

[8] Overall wages grew by 2.9% in 2015, more than negotiated wages, at 2.4%, on a positive wage drift tied to the introduction of the minimum hourly wage last January. The effect on wages of the introduction of the minimum wage should wane in 2016, whereas the wage drift should remain positive, as the labour market is at full employment levels, and there is a shortage of skilled labour.

utilisation, markedly supportive financial conditions, and the more than solid financial position of businesses, point to a livelier spending cycle in the course of this year. However, geopolitical uncertainty remains risk for the expansion of facilities (Figs. 7 and 8), therefore our growth forecasts of around 3.8% for the current biennium are subject to be revised downwards.

Fiscal policy slightly expansionary

Twenty-fifteen came to a close with a budget surplus of 0.5% of GDP, up from 0.3% in 2014, thanks to the favourable economic cycle, but also to the support of one-off factors[9]. The structural balance worsened slightly, from 0.85% in 2014 to 0.5% in 2015. The structural surplus will be eroded by the end of 2017. Measures on the revenue side[10] will have a limited impact on balances, whereas overall spending is expected to grow at a faster pace than GDP, from 44% in 2015, as the drop in interest expenditure will be more than balanced by higher primary spending on infrastructure, education, health care, research and housing. A further impact will be reaped by spending tied to the management of refugees and migrants seeking humanitarian protection, which according to the Bundesbank should average around seven billion euros a year (0.25% of GDP) between 2015-17. Favourable economic conditions should allow the higher spending required by the management of strong immigration inflows to be easily reabsorbed in the near term. In the longer term, however, the impact on public finance balances will depend on how many asylum seekers will actually stop in Germany, on the integration polices pursued, and on the percentage of the new entrants that will join the labour force. The debt/GDP ratio is estimated to decrease to 66% of GDP in 2017, from 71.9% in 2015, despite a more expansive fiscal policy, thanks to the decline in interest expenditure and the prospected acceleration of nominal growth.

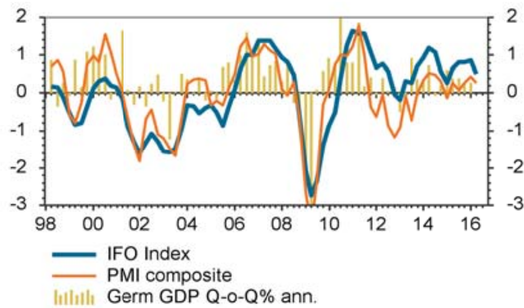
Forecast Table	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (1995 prices, y/y)	1.4	1.6	1.8	1.6	1.7	1.3	1.5	1.5	1.7	1.8	1.8
- q/q change				0.4	0.3	0.3	0.5	0.4	0.4	0.4	0.5
Private consumption	1.9	2.0	1.9	0.1	0.6	0.3	0.6	0.7	0.5	0.5	0.6
Fixed investment	1.7	3.4	3.6	-0.5	0.1	1.5	1.0	0.8	1.1	0.9	0.9
Government consumption	2.4	3.7	2.6	0.7	0.5	1.0	1.1	1.0	0.8	0.8	0.7
Export	4.8	3.0	4.8	1.8	0.3	-0.6	0.6	1.5	1.5	1.4	0.9
Import	5.4	4.7	5.4	0.6	1.1	0.5	1.6	1.4	1.1	1.6	1.6
Stockbuilding (% contrib. to GDP)	-0.5	-0.4	-0.5	-0.3	0.1	0.2	0.2	-0.4	-0.5	-0.2	0.1
Current account (% of GDP)	8.3	7.8	6.6	8.4	8.9	8.1	8.4	8.0	7.8	7.3	6.9
Deficit (% of GDP)	0.5	0.2	0.0								
Debt (% of GDP)	71.9	68.9	66.2								
CPI (y/y)	0.2	0.2	1.4	0.5	0.1	0.3	0.1	0.0	0.2	0.6	1.5
Industrial production (y/y)	0.6	2.8	2.2	0.1	-0.2	-0.5	2.5	0.3	0.9	0.1	0.1
Unemployment (%)	6.4	6.1	6.0	6.4	6.4	6.3	6.2	6.2	6.1	6.1	6.1
10-year yield	0.52	0.52	1.00	0.53	0.68	0.57	0.27	0.44	0.58	0.79	0.86
Effective exch.rate (2005=100)	94.9	94.9	95.7	94.4	95.0	94.8	95.2	94.9	94.5	94.9	95.2

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

[9] Revenues from the high frequency mobile telephony auction: EUR 0.5 billion in 2015. Residual 4.6 billion allocated as follows: 3.8 billion in 2017 and 0.6 billion in 2018. Tax refunds weighed negatively (higher spending) on 2014 balances.

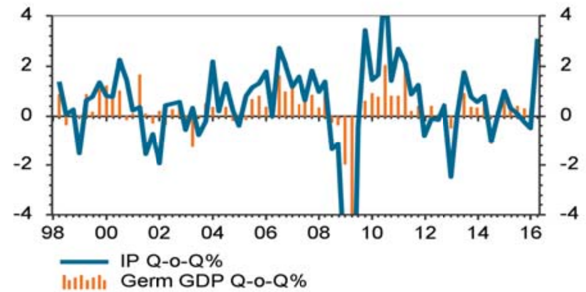
[10] The raising of the exemption threshold, and additional welfare contribution cuts for children, should be offset in part by an increase in contributions for health care services.

Fig. 1 – Confidence surveys compatible with growth of +0.3% q/q at the beginning of 2016 as well



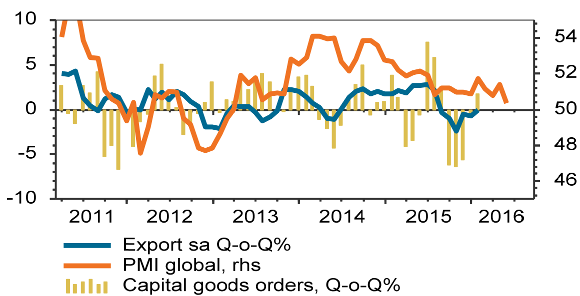
Source: FSO via Datastream

Fig. 2 – But the sharp rebound in industrial output leaves hope of 0.5% q/q growth



Source: FSO via Datastream

Fig. 3 – Exports may stagnate in the next few months

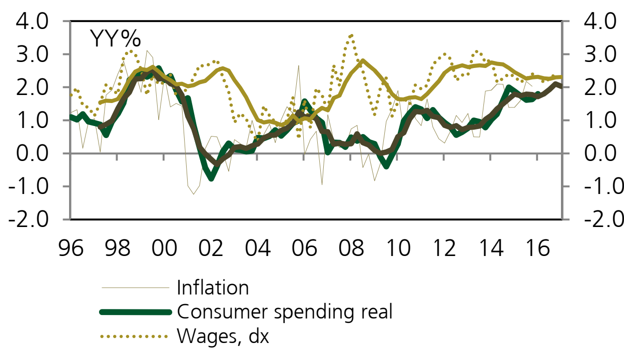


Source: FSO via Datastream

Fig. 4 – GDP growth to be supported by private consumption, thanks to the surprising trend of employment and…

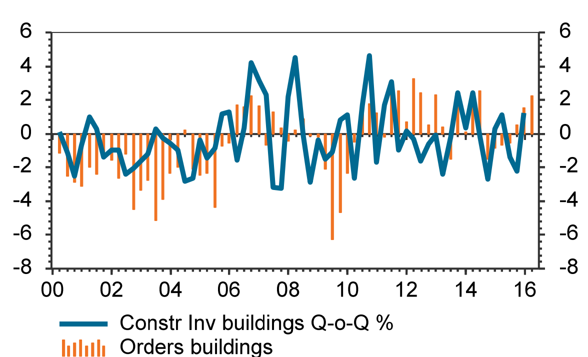
Source: FSO via Datastream

Fig. 5 – …Nominal wages are still growing sharply, and purchasing power will be supported this year by low inflation



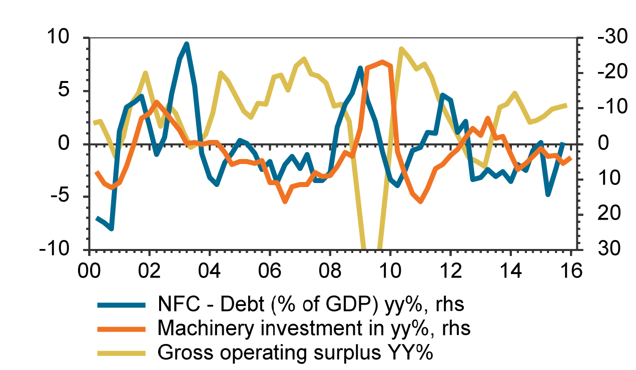
Source: FSO via Datastream

Fig. 6 – Construction boom!



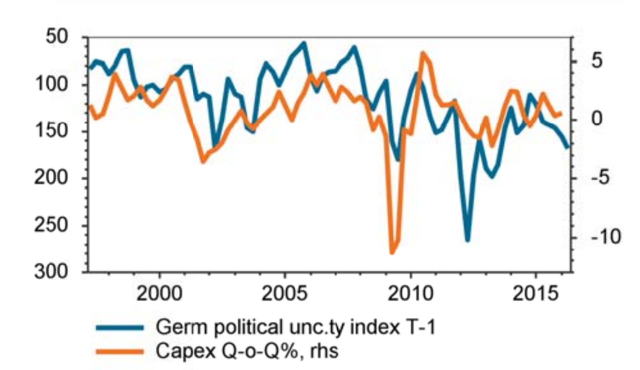
Source: FSO via Datastream

Fig. 7 – Solid financial position and the rise in gross operating surplus point to a pick-up in capex



Source: FSO via Datastream

Fig. 8 – Mounting uncertainty may prompt businesses to delay their spending plans



Source: FSO via Datastream

Focus: will Merkel resist to populist waves?

The regional elections held on 13 March (in Baden-Wuerttemberg, Rhine-Palatinate, and Saxony-Anhalt), at which voted over 20% of the population, revealed mounting opposition to Merkel's open-borders policy. In the three Lander (Fig. 1), the right-wing populist party AfD, *Alternative fur Deutschland* gained significant consensus, coming in second in Saxony-Anhalt, with a 24.2% share of the votes, and third in Baden Wurttemberg (12.7%) and Rhine-Palatinate (12.6%). Until a few months ago, the polls had pointed to the traditional parties, SPD, CDU and the Green Party, as favourites. The AfD leader Frauke Petry, a young chemist, built her campaign on the protest against the Chancellor's open borders stance, and the strategy paid off. However, it should be noted that 80% of voters continued to support, together with the CDU, the Greens (which won in Baden Wuerttemberg), and the SPD (in Rhine-Platinate), parties which openly supported Merkel's policy.

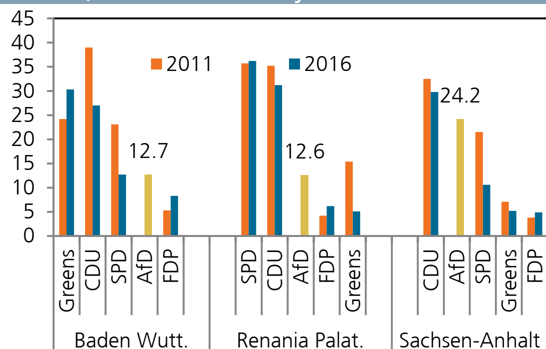
The Chancellor has undoubtedly been weakened by the vote, and the split with the Bavarian (the most densely populated Lander) wing of the CDU has widened, given the open dissent expressed by party Chairman Horst Seehofer. Article 68[11] of the German constitutional law contemplates a no confidence vote against the Chancellor and the early dissolution of the Bundestag. Despite talk of a government crisis, Merkel is unlikely to be removed from the helm of the country, given her still high personal popularity ratings (still at 46%, albeit down from 75% a year ago, according to a ARD-DeutschlandTREND/Infratest Dimap survey carried out at the beginning of February) and the lack of candidates who may find convenient to manage the transition towards the political elections of 2017. Rather pragmatically, the Chancellor will ask for more time to find a solution to the refugee crisis. However, evidently the tone of the debate must change, as openly acknowledged by CSU Chairman Horst Seehofer.

The transition towards the general elections scheduled in the late summer of 2017 (the first possible date is after 20 August) will seemingly be rather complex. The right-wing populists of

[11] Art. 68. - (I) Should a request from the Federal Chancellor to be confirmed confidence not be approved by the majority of Bundestag members, the Federal President has the power, on the Federal Chancellor's proposal, and within 21 days, to dissolve the Bundestag. The dissolution power is removed as soon as the Bundestag elects, with a majority vote of its members, another Federal Chancellor. (II) Forty-eight hours must pass between the motion and the vote. Art. 69. - (I) The Federal Chancellor appoints a Federal Minister as a substitute.

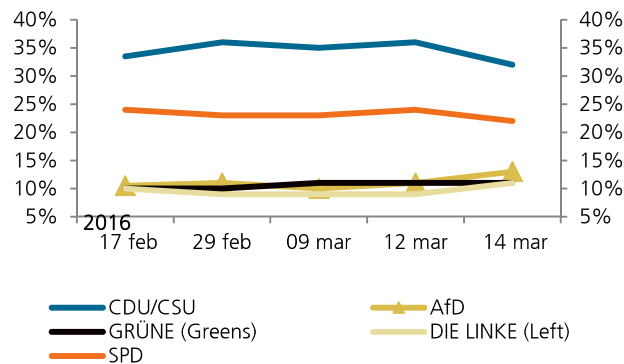
the AfD are now present in eight of the 16 Lander Parliaments, and on a national scale they are the third largest party, with 13% of the consensus, ahead of the Green party (Fig. 10).

Fig 9 – At Sunday's elections, the AfD won votes from the main parties: CDU, SPD and Green Party



Fonte: Wipedia e stampa tedesca

Fig 10 – The AfD right-wing populists are the third party at the national scale



Fonte: sondaggi Forsa, Infratest, GMS e INSA (14/03/2016)

The next electoral test for Merkel will come in September this year, when two further Landers will be called to renew their Parliaments (Mecklenburg-Pomerania and Berlin, currently governed by the SPD and CDU respectively). The last taste of what could be the German political scene following the general election in 2017 will come in the spring of next year, when another 22% of the voters will be called to the polling stations in North Rhein, Saarland, and Schleswig-Holstein (majority currently held by the SPD and the CDU).

Risks tied to the ascent of the populists to third largest formation at the national level will mostly weigh on the aftermath of the general election of 2017

Should the success of the AfD populists be confirmed at the next regional elections and at the national level at the end of the summer of 2017, the formation of government alliances in Germany would become significantly more complex. It is hard to imagine a CDU-AfD coalition. In the meantime, the SPD is dangerously losing consensus, and this seems to be the most worrying trend laid bare by last Sunday's vote. The main risk which emerges from this latest electoral test, and from the ascent of the right-wing populists, is that Germany too may also find itself in a situation of political impasse

France: the recovery will continue in 2016, albeit slowly

Guido Valerio Ceoloni

The French economic recovery is gaining a foothold. After closing 2015 at +1.1%, it could accelerate slightly in 2016. Apart from the crucial contribution of consumption, which is still the main engine of growth, the government's efforts to support businesses appear to be finally bearing fruit, as shown by the increase in capital spending at the end of the year. Meanwhile, the recovery in the construction sector will not materialise before 2017. The process of correcting the public accounts is, however, still slower than in other Euro zone countries despite increasing fiscal pressure.

GDP growth up by two-tenths of a point to 1.3% in 2016

As expected, 2015 closed with GDP growth of over 1% (+1.1% from 0.2% in 2014). However, uncertainty has returned in early 2016. The fourth quarter closed with growth of 0.3% qoq, the same pace as in the third quarter. The main growth drivers were final domestic demand, which contributed 0.2 points, and the build-up of inventories (+0.7 points), while net exports had a negative impact (-0.5 points). Since the second half of last year, French foreign trade has continued to limit growth as a result of the marked build-up in inventories, while GDP is still driven mainly by internal demand. For 2016 we forecast growth of 1.3% yoy, slightly below consensus estimates. In the first quarter, GDP could grow by 0.3% qoq, in line with Bank of France estimates, before rising by one-tenth of a point during the two middle quarters of the year. The risks to this forecast are, therefore, to the upside: namely, the current uncertainty regarding global demand might come to an end, providing support for net exports once more, or the construction sector might finally resume growth during 2016 at a faster rate than forecast.

Consumption remains positive; good news for the increase in capital expenditure at the end of 2015

Household confidence in the first few months of year (96.4) remained at the level seen in the last quarter of 2015 (96.2), although this could improve if purchasing power recovers and employment rises. The recovery in purchasing power due to the extremely low level of inflation could continue to bolster consumption, which we expect to grow in 2016 by 1.4%, in line with the figures for 2015. Car sales, although still weak, are once again slowly becoming a driver of consumption, rather than a brake. However, household investment continued to fall in the last quarter of 2015 (-3.4%) and will remain one of the weak areas of the French economy in 2016 (-0.4%). The situation is different for corporate investment. Growth of 4.9% yoy from 1.9% yoy is an encouraging reaction to the Hollande government's efforts in relaunching corporate investments through a solidarity pact agreed in January 2015, in an environment that was also favourable for credit conditions. In terms of annual averages, thanks to a positive contribution from capital expenditure, we forecast growth in the investment component of 2.3% in 2016, from 1.0% in 2015.

Industrial output incorporates a mild winter at the start of the year, as well as uncertainty as to whether global demand will hold up.

Industrial output accelerated unexpectedly in the fourth quarter from 0.3% qoq to 0.7% qoq, in contrast to the forecasts of the national confidence surveys. Meanwhile, since the beginning of 2016, the PMIs have started to signal a slowdown in the already-flat trend at the end of the year (the average for January-February fell from 50.9 to 50.1 in the fourth quarter). New orders also slowed at the start of the year, falling to 48.6. In addition, the exceptionally mild winter significantly reduced energy production and the turbulence in global demand dampened optimism in the manufacturing sector. The January industrial output figures contradicted the indices once again, recording +1.4% mom, the best figures since December 2014. In addition, the limited dependence of French manufacturing on energy exporting countries compared with the big European players such as Germany and Italy is ensuring that output is holding firm (its contribution to GDP could be higher than +0.2% in the first quarter). Overall, output is expected to grow in 2016 at the same pace as in 2015 (+1.3%). We may not see an acceleration to the 2010 rates until next year. As far as construction is concerned, the 2015 INSEE confidence indicators showed a slight improvement to 90.1, but remain depressed and significantly lower than their long-term average (101), although their low point is now behind them and a modest

recovery has begun. The sector is slowly starting to inch forward again, with the start of the year seeing a recovery (average at 92.5). The January figures show that construction output recorded +4.6% yoy (2015 average: -4.3% yoy). Lastly, the services sector experienced a slowdown at the turn of the year, which we believe, however, to be temporary. The PMI index fell to 49.8 between December and February from an average of 51.2 in the fourth quarter. Services should return to growth from the next quarter.

Net exports drag on growth in 2015 and 2016

Foreign trade once again made a negative contribution to GDP (-0.5 from -0.7) in the last quarter. This despite the fact that the weakness of the euro provided significant support to exports, which grew by 6.1% in 2015 after recording 2.4% in 2014. Imports accelerated at the end of the year (+2.5% qoq from +1.7% qoq) while exports resumed growth, albeit at a slower pace (+1.0% from -0.6% qoq). In 2016, the weakness of the euro will continue to support exports, although less than in 2015 (+3.2% annual average from +6.1% annual average). The boost to internal demand in a context of weak external demand will ensure that the contribution from net exports continues to be unfavourable.

Unemployment stabilised in 2015. From 2017 it will begin to fall again

Employment grew moderately in 2015 to 64.2%, and could improve to around 64.8% this year due partly to the measures announced in January. After three years of job losses (around 235,000 jobs were shed in the three-year period 2012-14), in 2015, approximately 82,000 net new jobs were created, spread among various sectors except for construction. The unemployment trend in 2015 was broadly stable at around 10%, with the last-quarter figure showing a fall of one-tenth of a point to 10.0% for metropolitan France. The company surveys and PMI indices at the turn of the year show employment levels holding up in manufacturing and services (the sub-index relating to the hiring of workers rose to -25 between January and February from -29.3 in the third quarter, although it remains some way off its historical average of -5). The annual average for unemployment is expected to stabilise at around 9.9% this year, from 10.0% in 2015.

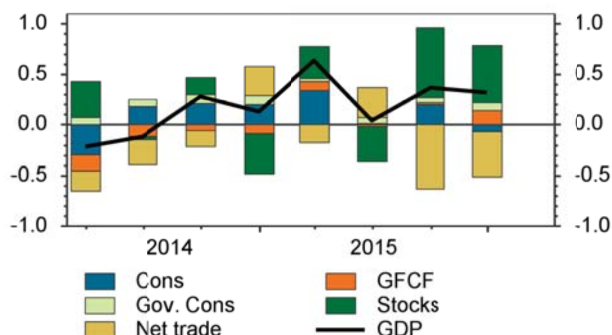
Inflation fairly flat in 2016, above 1% only from 2017

Consumer prices closed 2015 with annual-average inflation at zero on the national index and 0.1% on the harmonised index, down around five-tenths of a point on 2014. The large fall in the price of energy kept consumer prices weak and, in the absence of any appreciable recovery in the energy component, the inflation trend will be determined by its core component, which is expected to rise in 2016 to 0.7% from 0.4% in 2014, with CPI at 0.4% this year (HCPI at 0.4%) and 1.2% (HCPI at 1.6%) in 2017.

Public accounts improving slightly, although the deficit will only fall below 3% in 2018

The deficit is likely to fall by three-tenths of a point from -3.7% in 2015 (better than the -3.8% to which the government had committed) to -3.3% in 2016 and -3.0% in 2017 thanks to an improvement in revenues and, most of all, to the continuing consolidation of public spending. The structural deficit is forecast at -2.6% in 2015 and is seen as likely to remain fairly stable in the two-year period 2016-17, at -2.5%. Public spending growth was up one-tenth of a point last year (+1.7% yoy versus +1.6% in 2014), partly because investment in the public sector in 2015 was broadly stable (yearly average +0.1%), thanks mainly to the reduction in government funding to local authorities. In 2016, the increase in public spending is likely to slow further to +1.3% yoy, while revenues are expected to increase by 2.3% yoy. Public debt will also increase further this year, from 96.2% of GDP in 2015 to 96.8%. It could rise a further three-tenths of a point to 97.1% in 2017.

Contribution to GDP

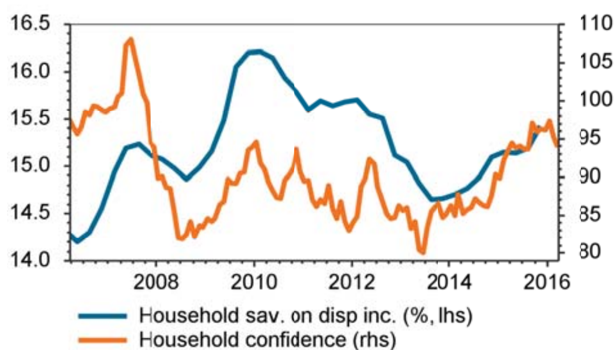


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

GDP and economic confidence

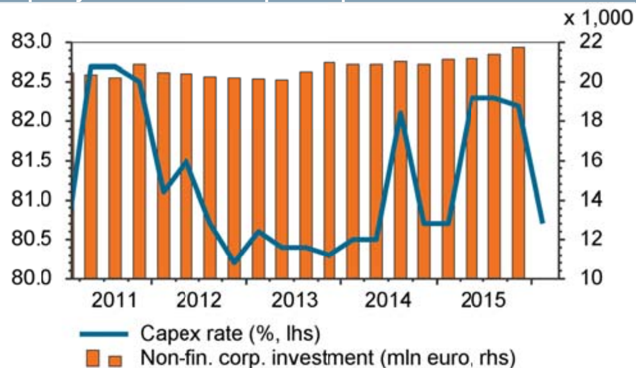
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Household savings and investment rates



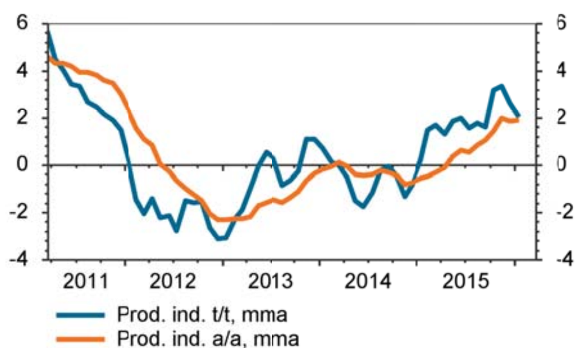
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Capacity utilisation and capital expenditure



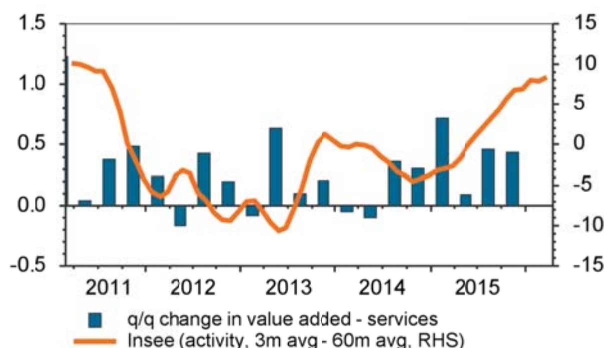
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial production



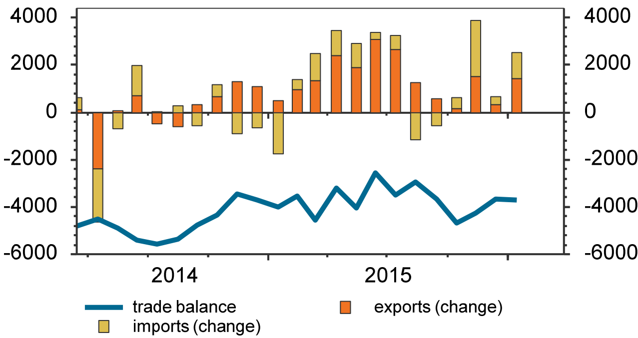
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Added value in services and economic confidence



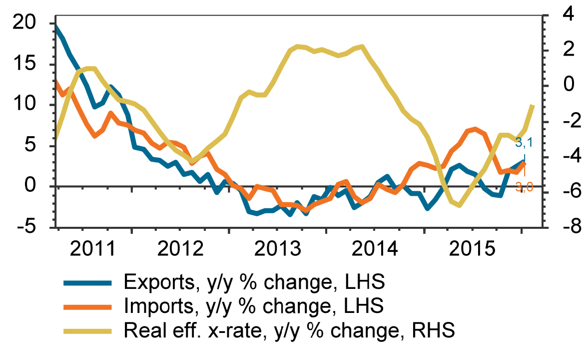
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Trade balance New house-building and construction sector confidence



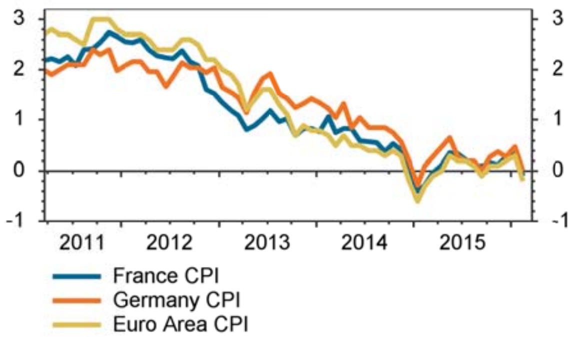
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Real efffective exchange rate and net exports



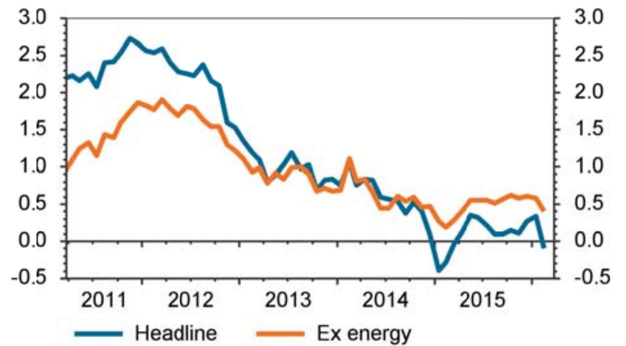
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI at comparison



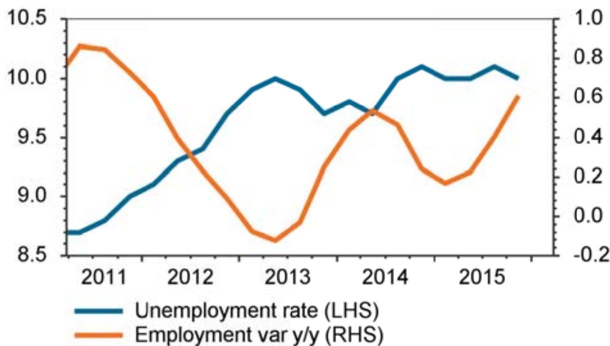
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI ex energy



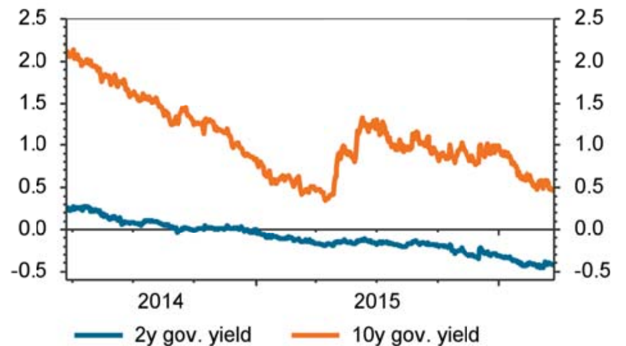
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment rate and changes in employment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Forecast Table											
	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	1.1	1.3	1.5	1.1	1.1	1.4	1.0	1.4	1.4	1.6	1.6
- q/q change				0.0	0.3	0.3	0.3	0.4	0.4	0.5	0.3
Private consumption	1.4	1.4	1.5	0.0	0.4	-0.2	0.6	0.4	0.4	0.4	0.4
Fixed investment	-0.2	1.7	1.9	-0.1	0.1	0.7	0.6	0.3	0.4	0.6	0.5
Government consumption	1.6	1.3	1.2	0.4	0.4	0.5	0.3	0.2	0.2	0.2	0.4
Export	6.1	3.2	4.2	2.2	-0.6	1.0	0.5	0.7	1.2	1.8	0.8
Import	6.5	4.8	3.3	0.7	1.7	2.5	0.7	0.8	0.7	0.8	0.8
Stockbuilding (% contrib. to GDP)	0.2	0.5	-0.2	-0.5	0.7	0.7	-0.2	0.1	-0.1	-0.2	-0.1
Current account (% of GDP)	-0.1	0.0	-0.2	0.4	0.2	-0.7	0.1	0.1	0.0	0.0	0.0
Deficit (% of GDP)	-3.7	-3.3	-3.0								
Debt (% of GDP)	96.2	96.8	97.1								
CPI (y/y)	0.0	0.4	1.1	0.2	0.1	0.1	0.0	0.1	0.6	0.8	1.3
Industrial production	1.8	1.9	2.0	0.0	0.3	0.7	1.1	-0.5	0.7	0.5	0.4
Unemployment (%)	10.0	9.9	9.8	10.0	10.1	10.0	10.0	9.9	9.9	9.9	9.9
Effective exch.rate (1990=100)	95.3	95.8	96.9	94.8	95.5	95.3	96.0	95.7	95.5	96.0	96.4

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

Netherlands: slowing consumption could weigh on 2016 GDP

Guido Valerio Ceoloni

Although 2015 was a good year for the Dutch economy, a close look at GDP for the last quarter shows certain weaknesses: stagnating consumption for the second quarter in a row, despite extremely low inflation and nose-diving energy prices, together with the end of the investment incentive promoted by the government, could be two elements of weakness capable of weighing on growth in 2016, despite rosy year-end forecasts.

2015 GDP at 1.9%, but slowing this year to 1.7%

In the last quarter, GDP grew by 0.3% qoq after two quarters of near-stagnation, at +0.1% qoq. On an annual average basis, GDP is expected to rise by 1.9%, almost double the pace of 2014 (1.0% p.a.), making it the best result in eight years. At the moment, GDP growth is expected to slow to 1.7% in 2016, before picking up again in 2017 (2.0%). For the year in progress, growth should be driven by personal consumption, on the back of a planned tax cuts and the upturn in both production and residential investment. At the same time, foreign trade could continue to dampen growth this year, owing to the more sustained growth of imports over exports. The economic confidence index prepared by the European Commission points out that despite a slight correction at the turn of the year, morale in the Netherlands is in line with the Euro zone average.

The building boom in 2015 will slow down in 2016, and households will try to reduce overall debt.

Contrary to expectations, consumption dropped in the last quarter after stagnating in the third quarter. Consumer confidence was indicative of a deterioration in household morale at the turn of the year, and we expect a slow recovery at the end of the first and start of the second quarter of 2016. Once the uncertainty of the beginning of the year has cleared, however, consumption should almost keep pace (+1.6% p.a.) with that seen in 2016 (+1.7% p.a.), due in part to the tax cut of approximately EUR 5Bn that the government plans to launch in April. The easing of the tax burden may nevertheless only have a partial impact on consumption, since the slowdown in household spending under way is also probably the result of an increase in the savings rate aimed at reducing debt levels in household budgets. Last year, the government's accommodative financial conditions and measures taken in the building sector provided support to residential investment and investment in construction. We expect the level of residential investment to be lower than in 2015, but do not think it will dry up completely. Overall, fixed investment rose sharply at the end of the year, and we forecast that after a correction in the first quarter, it will increase considerably even if volatility should return to international markets.

The contribution of foreign trade will continue to hamper growth in 2016

With respect to foreign trade, exports slowed significantly in the second half of 2015 (4.2% annual average), compared with a less pronounced decline in imports (4.9% annual average). Thus, net exports dampened GDP growth in 2015, and we expect this trend to continue in 2016. Exports are expected to slow further (+2.2% annual average) compared with imports (+3.2% annual average). However, the current account balance should increase this year (10.8% of GDP), returning to 2014 levels after contracting in 2015 (9.8% of GDP).

In 2015, industrial output treaded water (at -4.2% yoy, from -2.8% yoy in 2014 with a negative contribution to GDP of -0.3 pp in the final quarter), due in part to the sharp fall in energy output this winter owing to the unusually mild temperatures. Output is seen recovering this year, but will remain in negative territory (-1.8% yoy). The major contribution of vehicle production, which supported output in the last quarter of 2015 (+18% yoy) is set to subside, since taxes on company vehicle fleets rose on 1 January. After stabilising in the third quarter, the capacity utilisation rate in the manufacturing sector again began to fall in the fourth quarter, and is currently around 81.2%. The construction sector continues to trend upwards, with confidence indicators again improving (from 7.8 to 8.3) in the first two months of the year. Although there was a boom last year, the end of the two-year property crisis and accommodative financial conditions should support a further moderate expansion in the sector in 2016.

Unemployment is expected to stabilise this year at 2015 levels (6.9%), and then drop by an annual average of a couple of tenths of a point in 2017 (6.7%). In 2015, labour market conditions improved, with unemployment dropping five tenths of a point and employment rising by 0.9% to around 60.2%, despite the slowdown in GDP growth in the second half of the year. Quarterly *vacancy surveys* still indicate a good labour supply level, although the trend is showing signs of slowing: **employment** is however seen increasing by around 0.9% in 2016. For the time being, while the flow of migrants should have only a marginal impact on the participation rate, due to strict regulations on work permits for those requesting asylum.

Unemployment stable at 6.9% in 2016

Inflation ended 2015 at 0.6% on the national index, and is expected to rise slightly to around 0.8% for the current year, before heading towards 2% in 2017 (1.8%). Low energy prices should offset a moderate rise in core inflation this year, following pressures on consumer prices due to increases in salary levels, particularly in the public sector.

The sharp reduction in gas extracted from the Groningen plant reduced state revenues by 0.1% of GDP in 2015, and could have an impact of 0.3% of GDP a year for the two-year period 2016-2017. Furthermore, the tax cut totaling an additional amount of approximately 0.7% of GDP expected for the spring, and the allocation of extraordinary funds for the immigration crisis will lead to a decline in revenues of over one point of GDP. Higher expenditure will be covered by appropriate compensatory measures, then there is a limited risk of a downturn in the public accounts in 2016. Compared with estimates in our previous quarterly report, we expect the 2015 **deficit** to fall to 2.2%, from 2.4% (one-tenth less than previously estimated), while we expect it to come out at 1.9% (from 1.5%) in 2016 and 1.6% in 2017. **Public debt** will drop just below 67% in 2015, and is expected to come in at around 66.2% this year and 65.2% in 2017.

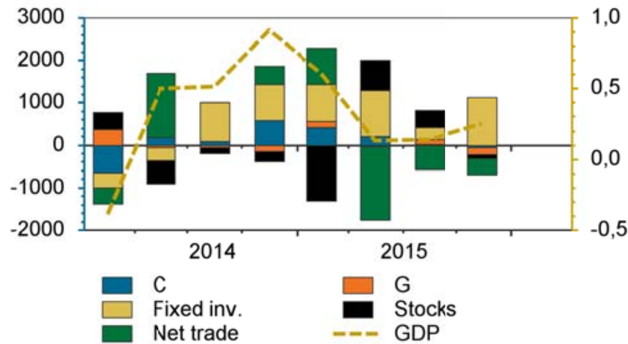
The government will deliver fiscal expansion measures totaling 1% of GDP in 2016

Forecast Table

	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (constant prices)	1.9	1.8	2.0	2.2	1.8	1.1	0.9	1.6	2.1	2.5	2.5
- q/q change				0.1	0.1	0.3	0.4	0.8	0.6	0.7	0.4
Private consumption	1.6	1.7	2.0	0.3	0.0	-0.1	0.5	0.9	0.7	0.6	0.4
Fixed investment	10.3	5.2	2.8	3.4	0.8	3.3	-0.5	1.0	1.6	1.4	0.1
Deficit (% of GDP)	-2.2	-1.9	-1.6								
Debt (% of GDP)	66.9	66.2	65.2								
CPI (y/y)	0.6	0.8	1.8	0.9	0.7	0.6	0.7	0.9	0.5	1.0	1.6
Unemployment (%)	8.3	8.2	8.1	8.9	8.5	8.3	8.2	8.2	8.2	8.2	8.2
Effective exch.rate (2005=100)	107.6	107.5	108.3	107.3	107.7	107.4	107.9	107.6	107.1	107.4	107.8

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

Contribution to GDP

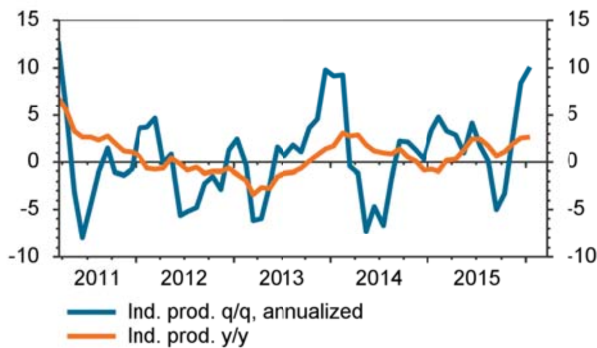


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales and household confidence

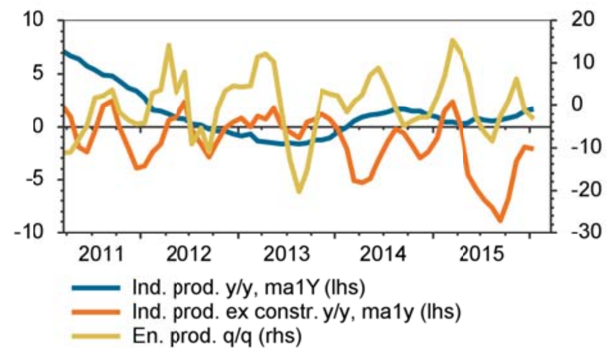
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output (manufacturing)



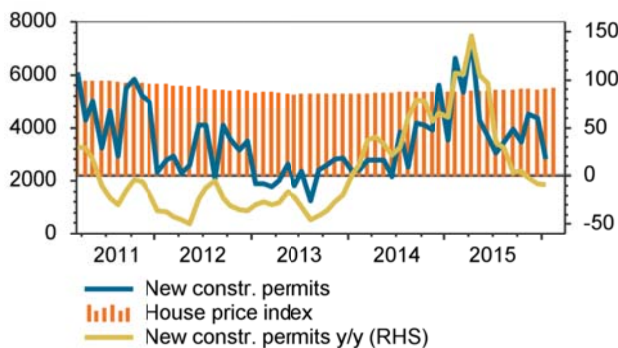
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output and energy segment



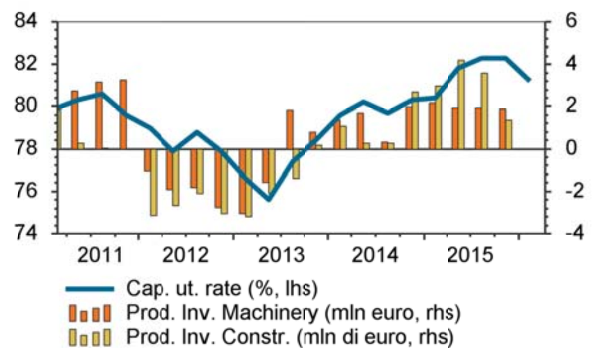
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Building sector performance



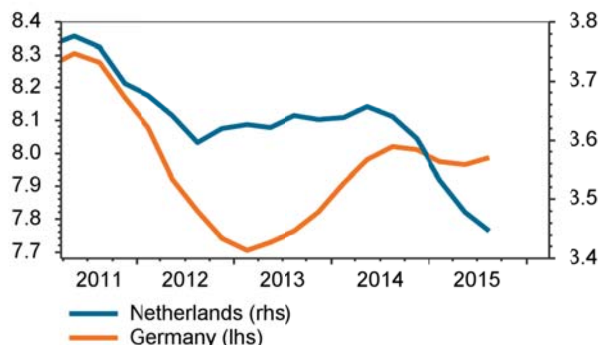
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Utilisation rate of productive and investment capacity



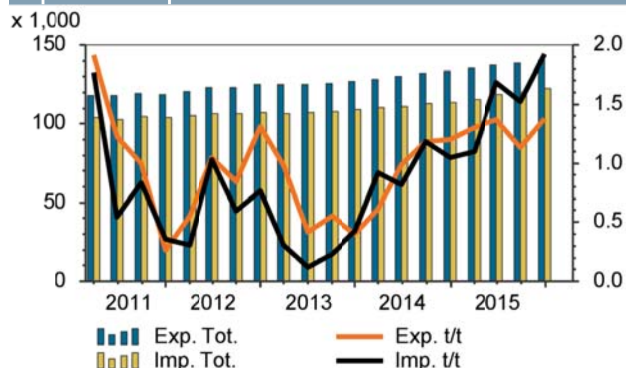
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Global exports



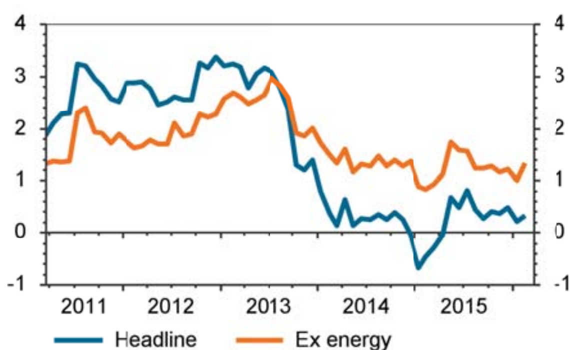
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Exports and imports



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Headline and core inflation

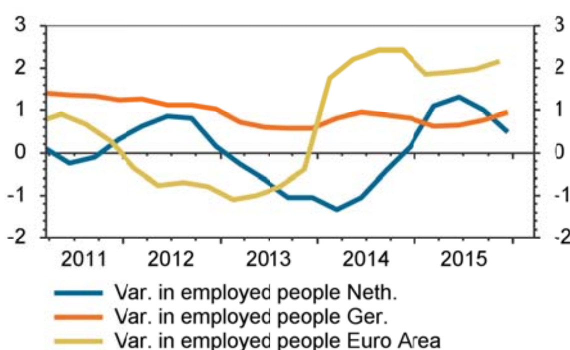


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Production prices

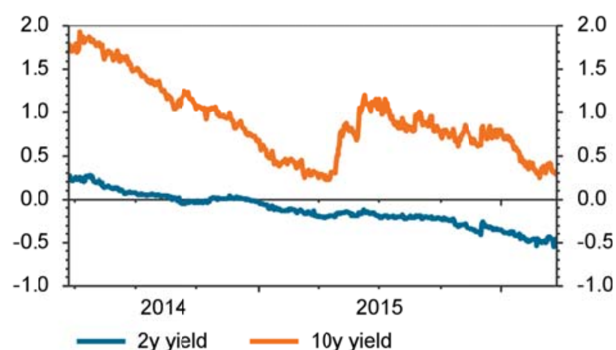
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Changes in employment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Italy: the recovery of domestic demand continues. But risks linger

Paolo Mameli

GDP growth lost steam in the course of 2015, but domestic demand still seems to be recovering

The Italian economy reversed in 2015, achieving positive growth for the first time since 2011. However, the recovery gradually lost steam in quarterly terms in the course of the year: 0.4% q/q in 1Q 2015, 0.3% q/q in the spring, 0.2% q/q in the summer quarter, and 0.1% q/q at the end of the year (Figure 1). As a result, average growth in 2015 fell somewhat short of expectations, at 0.8% unadjusted and 0.6% adjusted by workdays (three more than in 2014). Four factors emerge when the reasons which caused the loss of pace:

1) Consumption did not slow; in fact, from a weak 0.1% q/q at the beginning of the year, it grew at an average rate of 0.4% q/q in the remaining three quarters;

2) Investments virtually came to a standstill in the two central quarters of the year, whereas they grew at the beginning of 2015 and at the end of the year, driven in both cases by investments in means of transport; the construction sector improved visibly, as after contracting again in the opening months of the year, it recovered in the second half (0.2% q/q in 3Q, 0.9% q/q in 4Q), as was not the case in over seven years;

3) Foreign trade made a negative contribution in the first three quarters of 2015, and turned positive at the end of the year;

4) The slowdown is not explained by public spending, either, as the trend of this component of demand actually increased in the course of 2015 (from -0.7% q/q in 1Q to +0.6% q/q at the end of the year).

As a result, the main culprit for the slowing of the growth trend is the contribution of inventories, which dropped from +0.8% q/q at the beginning of the year to +0.1/0.2% q/q in the central quarters, and to -0.4% q/q at the end of the year. In particular (Figure 3), final domestic demand (net of inventories), after having grown by just 0.1% q/q on average in the first part of 2015 (in line with 2H 2014), subsequently accelerated to 0.4% q/q on the second half of last year: while certainly no "boom", this had not happened in over five years.

In essence, a detailed analysis of GDP data in the course of 2015 does not suggest that the recovery of domestic demand has ended or weakened. Rather, probably at the beginning of the year excessive expectations took shape among companies on the evolution of demand, translating into an over-sizing of warehouses, which then eased back on slightly less optimistic expectations. This is compatible with the clear recovery of expectations for the economic cycle contained in sentiment surveys among businesses and households, observed between the end of 2014 and the beginning of 2015, which then waned in the course of the year and lost significant steam at the end of 2015 (Figure 4).

In 2016, consumption should keep up the cruising speed recorded in 2015…

Going forward, with respect to the evolution of the main components of demand in the course of the year, we believe that:

1) Households' spending could keep up a pace of growth of 0.3% q/q in 2016, in line with the average rate in 2015; the decline in consumer confidence in February does not seem of particular concern, as it is a "physiological" correction after the peak hit in January, a high since a comparable historical series began, i.e. at least 21 years ago (the deterioration mostly affected the perception of the overall economic climate in the country, rather than the personal situation of respondents, and expectations for the future rather than current conditions, in other words, the more volatile and less fundamentals-based components: Figures 5 and 6); ongoing consumption growth (albeit not at spectacular rates) should be driven by the further recovery in purchasing power (expected to increase by 2.1% in 2016, a

high in the past 15 years) **and employment** (our estimate is 0.9% in 2016, in line with 2015): in essence, we see consumption growth at 1.2% on average in 2016 (from 0.9% in 2015);

… and the construction sector should confirm the recent signs of a recovery…

2) **The construction sector is confirming the signs of a recovery observed in the course of 2015**: output in the sector increased by 1.2% q/q in the closing quarter of the year (the largest positive change in five and a half years: Figure 8); construction businesses confidence was the only sentiment indicator to improve in February compared to the end of 2015 (and is 19% higher than the average reading for 2010, vs. 5% for all the other sectors, i.e. manufacturing, retail sales and services: Figure 7); the recovery is even more evident on the secondary market: the number of property sales grew for the second year in a row in 2015 (+4.7%), with prices still on the decline in average annual terms, but stabilising in the closing quarter (Figure 10). The recovery of the construction industry, after years on the decline, is supported on the demand side by the current upturn in the income of households, and by improved access to the credit market thanks to greater employment stability and the widespread improvement of credit conditions: it should be noted that **capacity to access the housing market, as measured by the affordability ratio, was at its most favourable in 2015 since a comparable historical series was initiated,** i.e. since 2000 (Figure 9); in a nutshell, we confirm our view (as we have been doing for some time) that 2016 may prove to be the year in which investments in the construction sector finally recover (+1.2% estimated from -0.9% in 2015);

… although uncertainty lingers on the evolution of investments…

3) **The highest uncertainty regards the evolution of business investments**, in machinery and equipment in particular, which contracted in three of the four quarters of 2015 despite the recovery of final demand; in effect, the evolution of the core component of investments is proving slower, in the current phase of the cycle, than could have been forecast based on a simple "accelerator model" (Figure 11); this is probably explained by the fact that **the share of profits of nonfinancial firms has only recovered modestly from the lows hit between the end of 2014 and the beginning of 2015** (Figure 12); the comparison with Spain (Figure 13) shows that in the past few years Spanish businesses have improved their gross savings much more than their Italian peers; **however, going forward fundamentals seem consistent with a recovery**, as shown by the strong correlation between the capex spending of businesses in machinery and equipment and their expectations on the evolution of the economy (which, while back down slightly at the beginning 2016, remain more than expansionary: Figure 14), or with the **credit standards applied to enterprises (at their most accommodative ever, since the historical series began,** i.e. 2003, Figure 15); it should also be said that, based on data provided by the Bank Lending Survey, not only demand for credit is improving visibly, but also the component geared to new investments: between 2003 and today, it scored a higher level only in 1Q 2007 (Figure 16); an impact may also be reaped, starting already at the beginning of 2016, following the regulatory haziness which probably undermined its effects in the closing months of 2015, by the **maxi-amortisation allowed on new instrumental goods** purchased between 15 October 2015 and the end of 2016; in essence, in 2016 we expect an acceleration to +2.3% (from +0.6% in 2015) for investments in machinery and equipment, as opposed to a slowdown (to +7.8% from +19.7% previously) in investments in means of transport; as a result, **overall investments (including construction spending) would be up by 2% in 2016 (from a previous change of 0.6%): this would mark a high since 2006**;

… and downside risks to exports are on the rise

4) Lastly, we **confirm downside risks to exports**: we had signalled the temporary nature of the rebound in trade flows seen at the end of 2015, and trade with non-EU countries in particular effectively slowed back sharply at the beginning of 2016 (Figure 17); risks mostly stem from oil producer countries and some Asian countries, but Russia and Latin America should also keep contributing negatively to overall exports (although presumably less so than in 2015); it should also be pointed out that the significant support offered to exports by the depreciation of the exchange rate in 2015 will be not be matched in 2016, therefore we

expect, for instance (Figure 18), a significant reduction of the pace of growth of sales to the US (from 20.9% on average last year); in essence, **in 2016 foreign trade could hold back growth by at least one tenth of a percentage point** (as opposed to the three tenths subtracted from GDP growth in 2015), with flows in both directions slowing (imports from 5.8% to 2%, exports from 4.1% to 1.5%).

In a nutshell, **we believe quarterly GDP growth may improve compared to the end of 2015**, but not significantly compared to the average for 2015: we forecast average growth in the year of 0.3% q/q (from 0.25% in 2015). **Based on the rebound of industrial output in January, growth in Q1 2016 should be around 0.2-0.3% q/q**, i.e. on the recovery from a weak 0.1% q/q at the end of 2015 (Figure 2). However, **our forecast of average annual GDP growth, of 1.2%** (twice the pace recorded in 2015 adjusted by workdays)**, is** in any case **still exposed to downside risks**.

In essence, already starting at the beginning of the year, GDP could resume growing at rates of close to 0.3% q/q

With respect to prices, **2016 will be the third consecutive year with inflation broadly at zero**. As we expected, the January rebound proved to be temporary, and **the CPI could stay in slightly negative territory** (from -0.3% in February) **throughout the central months of the year** (Figure 19). In fact, the risk exists of core inflation also closing in on zero. Inflation may rise back slightly only in the final months of 2016, on the statistical created by the energy component. Energy prices will drop further, in our estimate by -4%, from -6.8% in 2015. Shelter item spending could change sign, levelling off at 0.5% from -0.8% previously. Communication prices are expected to stabilise, after having made a significant negative contribution in the recent years. The only components which may experience a slowdown in inflation could be hotels & restaurants, and education.

For the third consecutive year, inflation will stay at broadly close to zero

For what concerns public finances, **in 2015 the government met its targets in terms of both the deficit** (2.6% of GDP, at its lowest since 2007) **and debt** (in fact, at 132.6% of GDP the result was two tenths lower than the target, and just one tenth higher than the previous year). As we suspected would be the case, the target was not achieved through an improvement of the primary balance (which in fact decreased, albeit only by one tenth, for the third year running, to 1.5% of GDP, a low since 2011), but on the back of savings on interest expenditure. **In 2016, we expect a stable deficit, at 2.6%, as opposed to a further contraction of the primary balance**, to 1.3% of GDP (Figure 20); **debt should start to decrease** (for the first time in eight years), **albeit very modestly**, to 132.4% of GDP in our estimation (Figure 22). The "quarrel" with the EU Commission may result in the request being made for a slight correction of accounts this year, by around 3 billion euros, as the flexibility conceded by the EU on 2016 could stop at 0.8% of GDP, as opposed to the 1% implied in the final version of the Stability Law approved by the government (upon the unveiling of the 2016 Budget, we had already signalled that the additional 0.2% allowed by the so-called "migrant clause" was unlikely to be "accepted" at the European level).

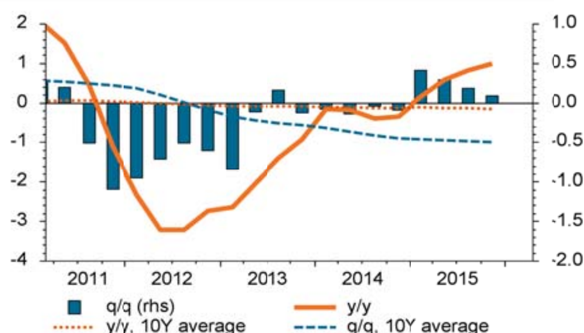
In 2015, the government met its deficit and debt targets. In 2016 a modest correction could be necessary…

The most delicate aspect, however, is not the evolution of public accounts in 2016 (which seems "in the box", once again mostly thanks to the wide margin offered by interest expenditure), **but the challenges fiscal policy will have to take on in 2017**, that will be preceded by the drafting of the DEF in April, and then laid out in detail in the Stability Law in what will in all likeliness be a "heated" autumn (the government will also have to face the test posed by the institutional referendum, on which its survival will probably rest). The residual part of the safeguard clauses will have to be funded (avoiding having to hike indirect taxes), worth 15 billion, as well as the further fiscal cuts promised, worth at least 12 billion euros (at the end of August the President of the Council had mentioned cuts to the Ires tax – a taste of which came with the Stability Law – and to Irap; subsequently, some government representatives mentioned the possibility of bringing forward an Irpef tax cut, originally planned for 2018, together with the extension of the 80 euro per month bonus to pensioners). Furthermore, at least in theory the government will have to correct the structural balance (in accordance with European rules) by half a point, which will require budgetary measures worth around circa 9 billion euros. In essence, over 35

…but the problem is postponed to 2017

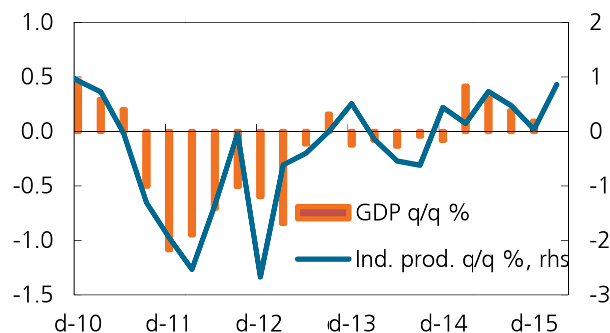
billion euros will need to be raised (2% of GDP) in 2017, on the rise to 63 billion (3.5% of GDP) in 2018; savings on interest expenditure will help, but won't be enough (Figure 22). Quite a challenge, which may even induce the government, should the institutional reform be completed, to consider postponing fiscal consolidation to the next legislature.

Fig. 1 – The recovery lost steam in quarterly terms in the course of 2015…



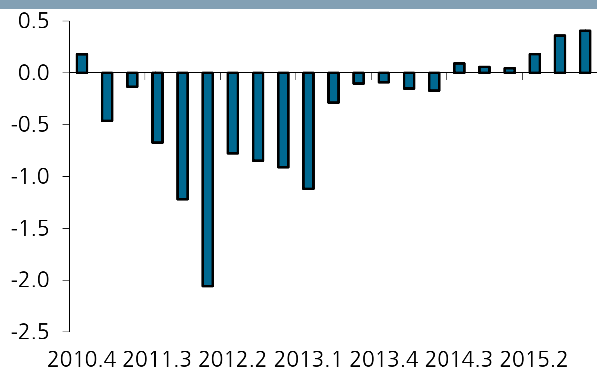
Source: Thomson Reuters-Datastream

Fig. 2 – … but, based on the rebound of industrial output, a reacceleration is likely at the beginning of 2016



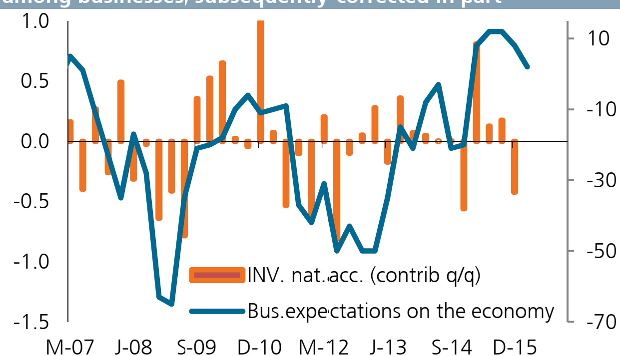
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 3 – Final domestic demand (net of inventories) is gradually improving



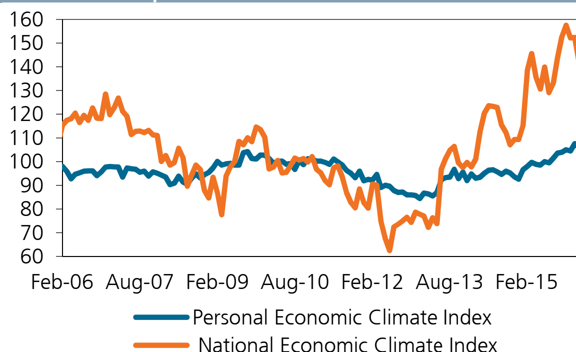
Note: % qoq change in final domestic demand. Source: Intesa Sanpaolo elaborations on Istat data

Fig. 4 – The over-sizing of national accounts inventories at the beginning of 2015 was tied to excessive optimism on the cycle among businesses, subsequently corrected in part



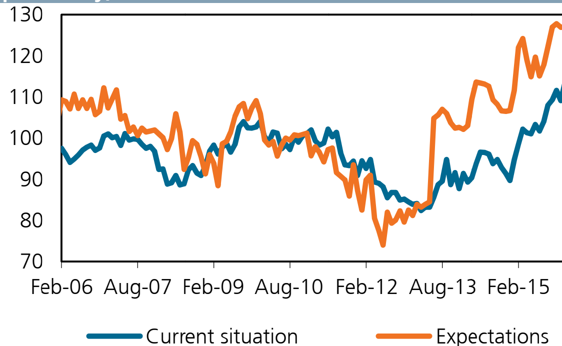
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 5 – The recent correction of optimism among households is tied more to the national economic picture than the personal situation of respondents …



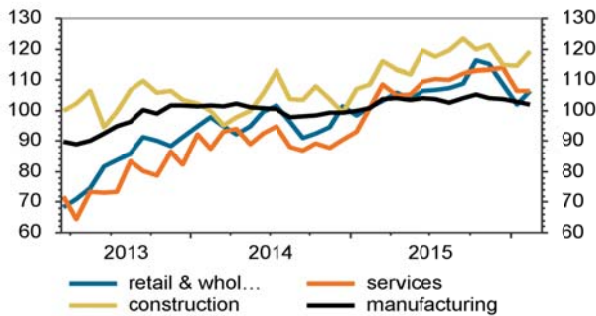
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 6 –… and more to future expectations than to current views (i.e. the more volatile components, which had risen most previously)



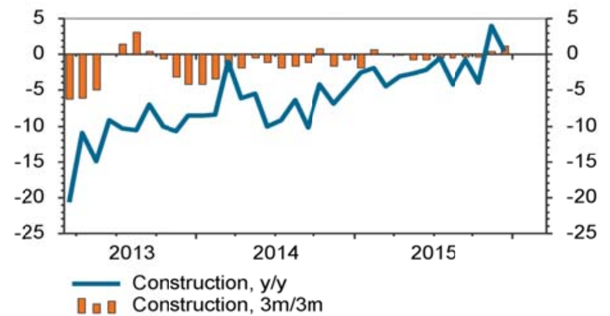
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 7 – Based on the Istat survey of business sentiment, confidence is proving more resilient in the construction sector…



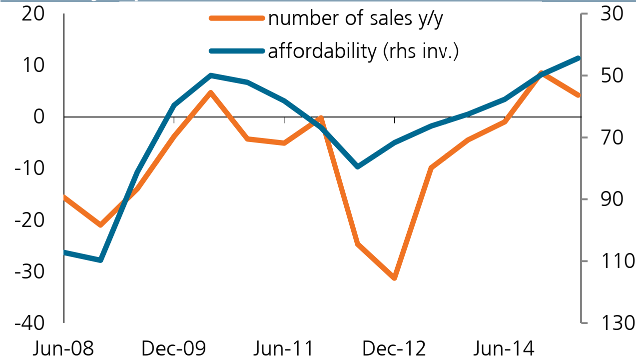
Source: Thomson Reuters-Datastream

Fig. 8 – …where the recovery in confidence has translated into higher output, after years of "structural" crisis



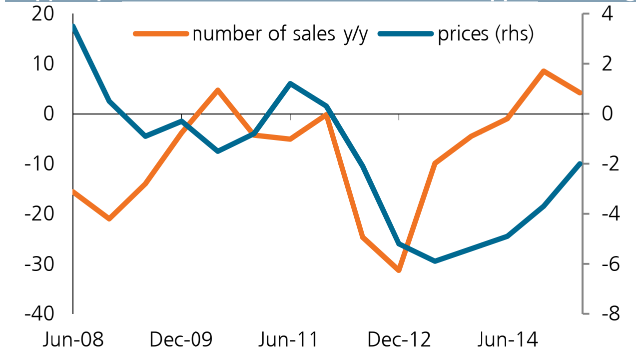
Source: Thomson Reuters-Datastream

Fig. 9 – On the demand side, the recovery of housing is being driven by improved access to the market for households



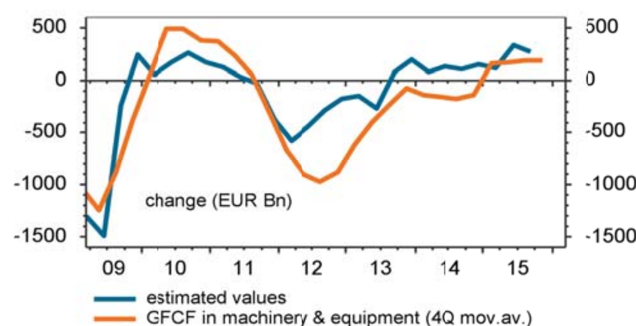
Source: Bank of Italy

Fig. 10 – The recovery of transactions will take some time to support prices, which for now seem to have stopped declining



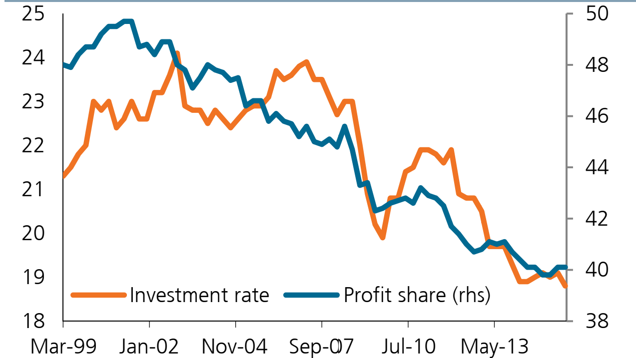
Source: Bank of Italy

Fig. 11 – In the past few years, the growth of investments in machinery and equipment was slower than could be predicted using an accelerator model



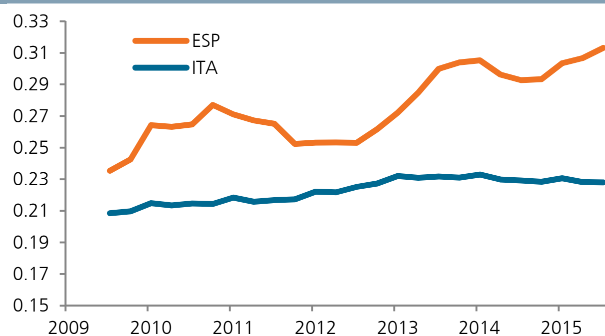
Source: Intesa Sanpaolo. The model explains the growth of investments in machinery and equipment based on: (i) the growth of final demand (net of investments), (ii) GDP growth in 1Q, (iii) the investment/GDP ratio in 1Q.

Fig. 12 – One explanation maybe that the share of profits of non-financial firms has not recovered significantly from its lows



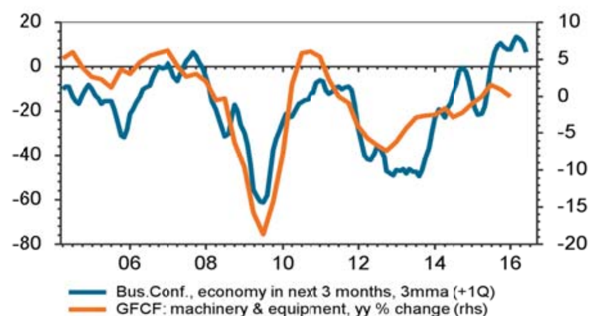
Source: Istat

Fig. 13 – The low gross savings rate of Italian companies compared to Spanish businesses should be noted



Source: INE and Istat

Fig. 14 – Going forward, the relaunching of investments is suggested by the expectations of businesses for the demand trend…

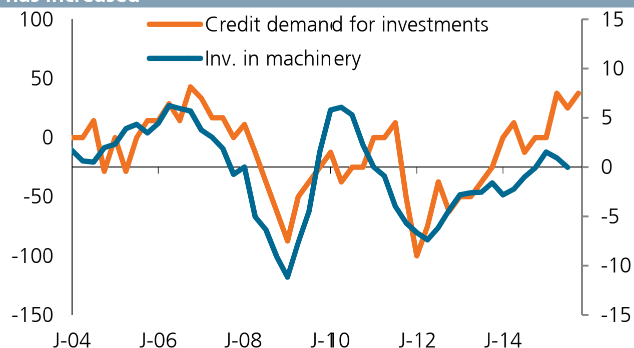


Source: Thomson Reuters-Datastream

Fig. 15 – …and by the further easing of financial conditions (to unprecedented rates in the past decade)

Source: Thomson Reuters-Datastream

Fig. 16 – In particular, demand for credit for new investments has increased

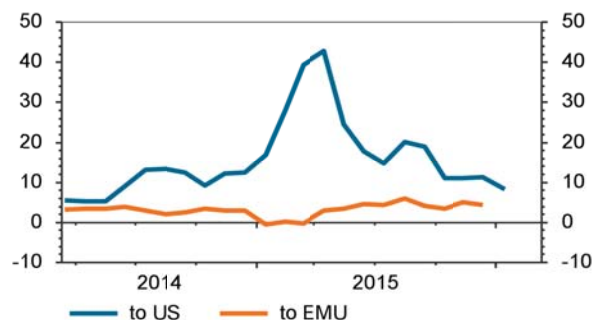


Source: Istat, ECB (BLS)

Fig. 17 – Exports to non-EU countries slowing

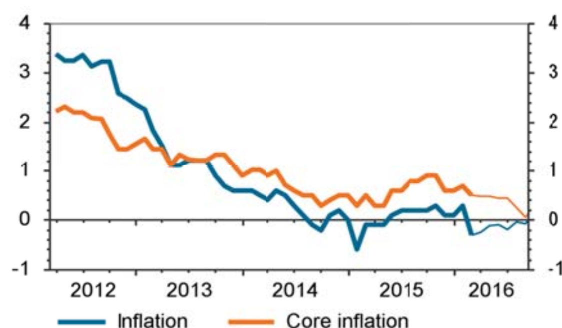
Note: % change y/y of exports (3mma). Source: Thomson Reuters-Datastream

Fig. 18 – Drag not only from the emerging countries, but also from the correction of the anomalous "boom" of sales to the US



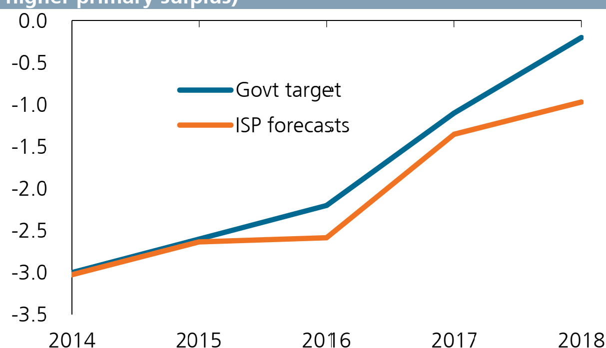
Note: % change y/y of exports (3mma).Source: Thomson Reuters-Datastream

Fig. 19 – Inflation could stay negative until the summer (and there are risks of the core CPI slowing to zero)



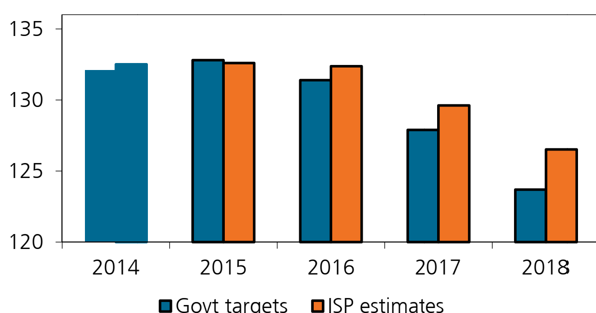
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 20 – We expect the deficit to improve in the next few years (albeit due more to savings on interest expenditure than to a higher primary surplus)



Source: MEF and Intesa Sanpaolo forecasts

Fig. 21 – Debt is estimated to have peaked in 2015, although the drop will be slower than forecast by the government



Source: MEF and Intesa Sanpaolo forecasts

Fig. 22 – Over 35 billion euros in funds will need to be raised in 2017, and would increase to 63 billion in 2018 (savings on interest expenditure will help, but will not be enough)

GROSS BUDGET (EUR Bn)	2017	2018
Safeguard clauses (A)	15.1	19.6
New tax cuts promised (B)	11.5	25.7
Correction required by EU rules (C)	8.6	17.4
Total funds (D=A+B+C)	35.2	62.6
Savings on interest expenditure (E)	23.3	28.7
Net budget required (F=D-E)	11.9	33.9
as % of GDP	0.7	1.9

Source: Intesa Sanpaolo elaborations on MEF data

Macroeconomic forecasts

	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.6	1.2	1.4	0.6	0.8	1.0	0.9	1.0	1.2	1.4	1.4
q/q				0.3	0.2	0.1	0.3	0.4	0.3	0.3	0.3
Private consumption	0.9	1.2	1.2	0.4	0.5	0.3	0.2	0.3	0.3	0.4	0.4
Gross fixed investments	0.6	2.0	2.2	0.0	0.2	0.8	0.5	0.5	0.5	0.6	0.6
Public spending	-0.7	0.3	0.3	-0.3	0.2	0.6	-0.1	-0.1	0.0	0.0	0.1
Exports	4.1	1.5	3.6	1.4	-1.3	1.3	-0.5	1.0	0.9	0.8	0.9
Imports	5.8	2.0	3.6	1.6	-0.2	1.0	-0.2	0.7	0.8	0.9	1.0
Inv. chg. (contrib., % PIL)	0.5	0.1	0.1	0.1	0.2	-0.4	0.2	0.1	0.0	0.0	0.0
Current account (% of GDP)	2.2	2.4	2.6								
Deficit (% of GDP)	-2.6	-2.6	-1.3								
Debt (% of GDP)	132.6	132.4	129.6								
CPI (y/y)	0.0	0.0	1.5	0.1	0.2	0.2	-0.1	-0.1	0.0	0.5	1.4
Industrial output	0.8	1.9	1.4	0.7	0.5	0.0	0.9	0.4	0.3	0.3	0.3
Unemployment (%)	11.9	11.3	10.7	12.2	11.5	11.5	11.5	11.4	11.3	11.0	10.9
10Y rate	1.71	1.65	2.00	1.80	1.91	1.62	1.52	1.58	1.69	1.81	1.86

Note: percentage changes annualised on previous period – unless indicated otherwise. Source: Intesa Sanpaolo elaborations

United Kingdom: what effects from the UK referendum on the EU?

Luca Mezzomo

The new settlement between the United Kingdom and the EU paved the way for a popular referendum promised by Prime Minister Cameron to be held on June 23rd. But what are the implications of the agreement? And what will happen if anti-European Union votes prevail? All considered, a victory of the euro-sceptics would be dangerous for the British economy: although the exit would probably take many years, some negative economic effects could be felt immediately.

On 2 February, the Presidency of the European Union published a set of documents which represent a summary of the negotiations conducted in the past few months with the British government, and which in a few months' time will lead to a popular referendum on the country's EU membership. Prime Minister Cameron reported to the British Parliament on the agreement on Wednesday, 3 February. Later, the EU Council approved the agreement, which paved the way for a referendum to be held in the UK on June 23rd. This paper illustrates the main contents of the agreement, the next steps in the process, and some thoughts on the different implications of a favourable or negative outcome of the referendum.

The road leading up to the agreement of 2 February

Notoriously, the United Kingdom's relations with the European Union have always been conflictual, and already in 1975 the country voted to confirm its membership of the European Community. Subsequently, upon the establishment of the European Union, the United Kingdom obtained the right not to adopt the euro and to opt out of the Schengen Area. Furthermore, other protocols limit its participation in measures relating to the area of justice, freedom, and security. Even the cooperation with police forces and courts of law of other Member States is limited. In general, the UK is the Member State with the looser links with the Union.

The process which will ultimately lead up to the referendum began several years ago, but was probably accelerated by the efforts to strengthen the institutions of the Eurozone after the debt crisis, especially because that affected the sensitive area of banking and finance. The Conservative party has been split on the issue for some time, also due to the pressures exerted on the right by the nationalist UKIP party. In 2010, the government introduced the so-called "referendum lock", based on which any new treaty assigning greater powers to the EU would have to be ratified by a popular referendum. More recently, in a speech delivered in January 2013, the Conservative leader Cameron asked for "a mandate from the British people for a Conservative Government to negotiate a new settlement with our European partners" […] as a prelude to "an in-out referendum", to be held by the end of 2017. In 2014, the British government published an articulated report on the balance of competences between the EU and the United Kingdom, as a technical basis for the negotiations[12]. Subsequently, during the electoral campaign of 2015, Cameron confirmed the referendum, although his position has since fluctuated ambiguously and opportunistically between the ambitious goal of a general reform of the European Union, and the more modest aspiration of obtaining specific changes to the treaties for the United Kingdom. In the course of 2015, political analysts observed that the United Kingdom's negotiation platform had definitively focused on more modest and tangible objectives, such as the concession of blocking powers to national parliaments on EU legislation, the removal from the treaties of the obligation to work towards an "ever closer union", and the possibility of limiting the social benefits provided to immigrant workers from the EU[13]. The letter

[12] HM Government, *Review of the Balance of Competences between the UK and the EU,* 2014.
[13] See for instance: A. Glencross, *Why a British referendum on EU membership will not solve the Europe question*, International Affairs, Vol. 91 No 2 (2015), p. 303-17.

sent on 10 November by David Cameron the Donald Tusk[14] then formally identified four areas of discussion:

- Competitiveness: targeting a reduction in the burden from existing legislation and regulations;
- Sovereignty: ending Britain's obligation to work towards an "ever closer union". Allowing groups of national parliaments to stop unwanted legislative proposals at the EU level;
- Economic governance: a safeguard mechanism against the discrimination of businesses on the basis of the currency of their country; voluntary adoption of reforms proposed in the euro area for non-euro countries; independence in banking supervision; participation in the decisions that affect all Member States; no financial liability for operations to support the euro area; introduction of specific safeguard mechanisms for non-euro countries;
- Immigration: the Conservative government considered as "not sustainable" the net migration inflow of over 300k a year. Therefore, it asked to end the automatic concession of free movement rights to people from potential new Member States, to crack down on the abuse of free movement, and to limit social welfare benefits for EU immigrants.

As we will see below, these issues are all covered in the EU-UK agreement. However, supporters of "Brexit" affirm that the goals laid out by the Cameron government have always fallen short of their ambition to restore the sovereignty of the British Parliament. The campaign in favour of the UK's exit from the EU, which stigmatises in particular the existence of a supremacy of the 19 euro area countries over the rest of the Union, aims to abolish the prevalence of community rules over national legislation, to reallocate to national priorities the contributions to the EU Budget, and to negotiate a new free trade agreement with the EU[15].

The contents of the new settlement

The letter of the President of the European Union and the statement released by the EU Council[16] on February 19th show that the United Kingdom has obtained some concessions on all four items on the agenda:

1. On sovereignty, it acknowledges that the United Kingdom is not committed to further political integration, and sets forth a mechanism by which EU legislative proposals may be rejected if a sufficient number of national parliaments (55% of the allocated votes) is against them, based on the principle of subsidiarity;
2. On economic governance, the biggest concession is the possibility of indicating a reasoned opposition to decisions of the governments which participate in the banking union, following which the Council shall "do all in its power to reach, within a reasonable time and without prejudicing obligatory time limits laid down by Union Law, a satisfactory solution to address concerns" raised by these governments[17]. However, no right of veto is given;
3. On competitiveness and simplifying legislation, the goal laid out is accepted, and the promise is made to regularly assess the progress made;
4. Lastly, while reasserting full respect of fundamental freedoms, and in general of all the Treaties, the Union makes concessions to the United Kingdom by exploiting the margin for interpretation of the rules. In particular, changes will be proposed to EU legislation as

[14] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/475679/Donald_Tusk_letter.pdf
[15] See, for example: http://www.voteleavetakecontrol.org/campaign
[16] European Council Meeting (18 and 19 February 2016), Conclusions, EUCO 1/16, http://www.consilium.europa.eu/en/press/press-releases/2016/02/19-euco-conclusions/
[17] *Statement on Section A of the Decision of the Heads of State or Government,* EUCO 1/16, annex II.

regards the export of child benefits, and a "safeguard mechanism" will be created "to respond to exceptional situations of inflow of workers from other Member States"[18].

An important aspect of the new settlement is that the two sides have avoided reopening the Pandora's box of proposing changes to the Treaties, that would have made a successful completion of the process much more difficult to achieve, and heightened risks tied to the possibility of other countries also making claims. Based on Tusk's words in the letter of 2 February, "most of the substance of this proposal takes the form of a legally binding Decision of the Heads of State or Governments", and no immediate process for the revision of the Treaties is on the table. Only for a few elements, it will be necessary to discuss "the possible incorporation […] into the Treaties at the time of their next revision".

How will events pan out?

The new settlement published on 2 February was approved by the EU Council of 18-19 February. As the decision-making process begins in Europe, the United Kingdom kicked off the one leading up to the popular referendum, which will on June 23rd.

Polls offer mixed indications on the outcome of the vote: in general, the electorate seems split in half and uncertain, although some surveys outline a more significant prevalence of the Remain vote. As pointed out in the section below, the pro-EU campaign has excellent and tangible cases to make to shift public opinion to its advantage. The business and finance worlds have will also mostly side with the Prime Minister. However, it is far from certain that voters will decide on the basis of a rational assessment of economic implications.

In case of a victory of the "Remain" front, the next step will be implementation of the February settlement. If on the other hand the "Vote Leave" campaign prevails, the Cameron government will have to initiate procedures for an orderly exit of the United Kingdom from the European Union, as provided for by Article 50 of the Treaty on European Union, starting with a parliamentary vote.

What will happen if the "Vote Leave" group wins?

Article 50 of the Treaty on European Union provides for a decision to be made at the parliamentary level in the Member State that intends to exit the Union, to be subsequently notified to the European Council. Negotiations would follow to reach an agreement defining the technicalities of the exit and the framework of future relations with the Union. The guidelines for the negotiations must be decided unanimously by the European Council, which means that each state has veto power. The final agreement, on the other hand, requires a qualified majority of the Council (72% of the members of the Council, in representation of at least 65% of the population), with the European Parliament's pre-emptive approval. The United Kingdom would no longer be bound by the Treaties and by EU legislation starting on first day of validity of the agreement, and not on the date of the parliamentary vote on the country's exit, nor on the date of the referendum.

A long transition period, as long as two years and possibly even more, is needed to guarantee that departure from the EU takes place in an orderly manner, with no legislative voids and guaranteeing the maximum level of continuity in trade and financial relations. In addition to deciding what to make of the rules adopted to embrace EU directives, treaties would also have to be negotiated in replacement of those (in great number) signed by the Union with other countries, that would cease to apply to the United Kingdom; agreements would have to be

[18] *Letter by President Donald Tusk to the Members of the European Council on his proposal for a new settlement for the UK within the EU*, 2 February 2016.

reached to govern the treatment of the many UK citizens residing abroad in the different countries of the Union; new customs laws and tariffs would have to be defined in replacement of the European ones; a new trade agreement with the Union would have to be negotiated, to prevent the application of duty on its goods; trade agreements would also have to be negotiated in replacement of those signed by the EU, numbering around 60, but from a much weaker position. The anti-EU camp simply takes for granted a high degree of continuity in trade relations that instead is highly uncertain. Clearly, the long-run economic impact of Brexit depends on the specific arrangements that will be agreed.

The experiences of the Scandinavian countries and of Switzerland prove that it is possible to achieve a high level of economic and financial integration with the EU even as non-member. However, these very experiences show that the ambition of the British nationalists to be able to ignore EU rules and standards risks being sorely disappointed. The truth of the matter is that the relationship between the United Kingdom and the European Union would be markedly asymmetrical, and this would be reflected by the exit agreement.

The countries of the European Economic Area (EEA) accept to abide European rules in exchange for access to the single market, and contribute to the EU budget. Plausibly, the United Kingdom would opt for the **bilateral treaty** path, which nonetheless would by no means exempt it from being imposed (and having to accept) rules and regulations aid out by the stronger partner. Furthermore, what kind of bilateral treaty would be signed? A taxonomy based on 7 possible technical settlements was recently proposed by Jean Claude Piris[19]. At one end of the spectrum lies the assumption of a "special relationship" treaty between the EU and the United Kingdom, that would exclude, for instance, participation in common agricultural policy and cohesion policies, but would probably imply the ongoing concession of sovereignty in many other fields, which would be hard to sell to the British electorate. In particular, it is an illusion to think that the EU would allow participation in the single market without commitments on the standards which reduce the risk of unfair competition or discrimination of EU businesses and workers. What's more, while within the Union trade retaliation initiatives are forbidden in case of breach of the rules, as it is the European Commission's duty to investigate, and the Court of Justice's to issue rulings, any unilateral rule changes by the United Kingdom from outside the EU would trigger countermeasures on the Union's part.

In essence, "access to the single market would come at a cost – financial and political. Norway and Switzerland make significant payments to the EU budget"[20]. Furthermore, according to Jean Claude Piris, the EU is unlikely to offer the Swiss option, as it implied the need for permanent negotiations with the Swiss authorities to guarantee the equivalence of local legislation and EU rules and is currently under review[21]. Ultimately, relations with the EU could be governed solely by a **free trade agreement,** which, however, would not cover services and would only bring the benefit of lower tariffs compared to those provided for by WTO rules.

All the above clearly shows that **a victory of the "Leave" front would probably be followed by a phase of high uncertainty**, during which the UK economy could be hit by delocalisation initiatives taken by non-European companies to the advantage of other Member States, in order not to lose access to the EU market, and by a virtual freeze on direct foreign investments. These developments could also impact the financial sector. In negotiating the treaty for Britain's exit from the Union, the government charged with managing the transition would have to strike a difficult compromise between limiting damage to the UK economy and conceding as little

[19] J-C. Piris, *If the UK votes to leave: the seven alternatives to EU membership*, Centre for European Reform, January 2016.
[20] J-C. Piris, *Brexit is the easy bit*, Financial Times, 12 January 2016.
[21] J-C. Piris, *If the UK votes to leave: the seven alternatives to EU membership*, cit., p. 8.

sovereignty as possible to respect popular mandate. Besides, after Britain ceases to be a member of the EU, the increase in non-tariff barriers to trade would have economic effects largely in excess of the savings on transfers to the EU budget, even in the most favourable scenarios in terms of trade arrangements between the EU and the UK[22].

Also, a Brexit victory would probably also be accompanied by a change in leadership in the Conservative Party, and by the re-emergence of separatist tensions in Scotland. It comes as no surprise that several major international corporations actively support the *Britain Stronger in Europe* campaign, which calls for a vote to stay in the Union[23].

If the United Kingdom stays in the European Union…

The success of the pro-European Union front would guarantee the highest level of continuity with the pre-referendum scenario. Besides, the implications of the settlement for the functioning of the European Union seem to us of little relevance.

However, several commentators stress that this would not necessarily mark the definitive overcoming of anti-EU positions. On the contrary, the issue of immigration is likely to offer good perspectives to the anti-EU camp in the medium term, even if they fail to win the referendum. As a result, the Conservative Party would continue to feel the pressure exerted by the nationalists. However, the issue of Britain's exit from the EU is unlikely to be brought to the table again for many years, unless the nationalists achieve a shock victory at the next general election.

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[22] G. Ottaviano e altri: *Brexit or Fixit? The Trade and Welfare Effects of Leaving the EU*, CEP Policy Analysis, May 2014.
[23] L. Noonan and G. Parker, *Banks lead as business buys into UK's pro-EU campaign*, FT, 22 January 2016.

Asia

Japan: growth and inflation crushed by excessive savings

Giovanna Mossetti

Growth stagnant after the contraction at end-2015: excessive saving

We are again revising down our outlook for the Japanese economy in 2016, following the disappointing figures at the end of 2015: our forecast for 2016-17 depends heavily on fiscal policy decisions. The rise in aggregate savings continues to represent the main brake on the Japanese economy. National savings continue to trend upwards, driven not only by households but also by businesses and the public sector. In 2016-17, we forecast that the public sector will reverse the trend, at least temporarily, but for the moment there are no signs of any reduction in private saving, despite negative interest rates.

Risks from consumption if there is no fiscal stimulus

For 2016, the recent weakness heralds a year of near stagnation, with weak consumption and exports curbed by global demand and by the strong yen. Against this backdrop, we believe the government will introduce further stimulus and delay implementation of the consolidation objectives, in order to offset the effects of the on-going rise in households' propensity to save and the weakness of global demand. In our core scenario, assuming a public spending stimulus package in fiscal year 2016 of around 1.5% of GDP, we forecast moderately positive growth in 2016 of 0.5%, as in 2015, although this is subject to downside risks.

Possible further postponement of the second hike in consumption tax

The outlook for 2017 is particularly uncertain. The key event next year will be the planned second increase in consumption tax, planned for April 2017, which is likely to lead to a further, significant contraction in GDP in the middle quarters of the year. However, the national elections in July 2016, against a backdrop of weak growth and poor opinion polls for the government, make it likely, in our view, that the further increase in consumption tax will be postponed to 2018 at the earliest. Growth of 0.8% is forecast for 2017, leaving the government's fiscal programme unchanged (VAT from 8% to 10% in April 2017). The experience of 2015 suggests significant risks to the downside for the year in which changes to indirect taxes are introduced. If the increase in VAT is postponed (to October 2018), growth in 2017 is likely to be 0.9%, with balanced risks.

Largely ineffective monetary policy, the main transmission channel being the indirect easing of constraints on fiscal policy

With the output gap almost closed and growth in line with potential[24], monetary policy is relatively ineffective in terms of demand stimulus. Core inflation (CPI excluding food and energy) is flat at just below 1% yoy and is unlikely to rise over the next two years. In 2015, the depreciation of the yen boosted growth in corporate earnings, but had only a modest impact on exports and on non-residential investments. The cut in rates into negative territory was accompanied by a fall in yields, although also by an appreciation of the yen (see below). JGB purchases continue, but cannot increase much due to scarcity problems. If the BoJ and the government do not explore avenues that are more unconventional than those tried so far (helicopter money?), the Japanese outlook could remain a prisoner of excessive savings, with slow growth and inflation that is too low. In the short term, room for an (effective) expansionary economic policy is limited to fiscal policy.

Non-residential investment rising slightly

Non-residential investment. Non-residential investment is expected to rise by 2.2% in 2016, from 1.4% in 2015. The rate of growth in capital spending remains moderate, while profits are turning sour due to the appreciation of the yen (see fig. 3). Gross corporate saving has been above 20% of GDP for the last decade, compared with an average of 10-15% in other advanced nations. Net saving has been between 5% and 10% of GDP since 2009. The government plans to reduce corporate taxes and provide incentives to invest. This could stimulate capital spending. However, in the absence of a more robust outlook for aggregate demand growth, corporate saving will not drop in a significant way.

[24] https://www.boj.or.jp/en/mopo/gp_2015/gp1512b.pdf, https://www.boj.or.jp/en/research/research_data/gap.pdf

Consumption. Consumption fell by 1.2% in 2015, following a drop of 1% in 2014. For 2016, the figure is forecast to remain broadly unchanged (+0.1%). Apart from quarterly volatility, exacerbated, to a certain extent, by weather conditions (bad weather in the spring, high temperatures in the autumn), the propensity to save is on a clear upward trend, with "structural" leaps (see fig. 6) coinciding with rises in the consumption tax (1997, 2015). The explanation for this behaviour, running against the forecasts of traditional economic theory, could be that each hike in the tax was announced as the "first of a series" (even though this turned out not to be the case in reality). Households, therefore, associated the increases with the advent of a **series of fiscal tightening measures** and adapted their saving to forecasts of protracted falls in disposable income in the short and medium term. Hence, if the 2017 tax rise is not postponed, in 2016 too consumption could remain weak, despite the strong labour market. Due, in part, to demographic trends, the unemployment rate is still falling (3.2% in January, its lowest since 1997), in a market marked by excess demand. The number of people in employment has risen, and the last year has even seen a modest increase in wages, albeit one not sufficient to offset the fall in the propensity to spend.

The rise in the propensity to save continues, on fears that disposable income will be squeezed further

Foreign trade. 2016 is likely to see a **marginally negative contribution** from foreign trade, with a weak, albeit recovering, trend in exports (+0.3%) and imports (+1%).

Net exports; marginally negative net contribution

Fiscal policy. As discussed above, our scenario assumes that the government will announce a **stimulus package of around 1-1.5% of GDP**. The next few months could see also the announcement of a postponement of the second consumption tax hike, towards late 2018.

It is time for fiscal expansion

Monetary policy. The inflation target of 2% remains extremely distant. **The BoJ will probably increase stimulus again**, with further interest rate cuts in negative territory, and possible (modest) rises in the volumes and duration of monthly purchases. Other classes of assets could be added (corporate bonds, securities issued by semi-public agencies). It would be possible for the BoJ to create a "helicopter money à la Bernanke" scheme, coordinating fiscal policy (tax cuts) and monetary policy (purchasing special perpetual securities issued to finance fiscal expansion). Japan is the only advanced nation that can implement coordinated measures, although this will probably have to wait until after the elections and the nomination of the two members of the Board of the BoJ whose positions will become vacant over the next few months.

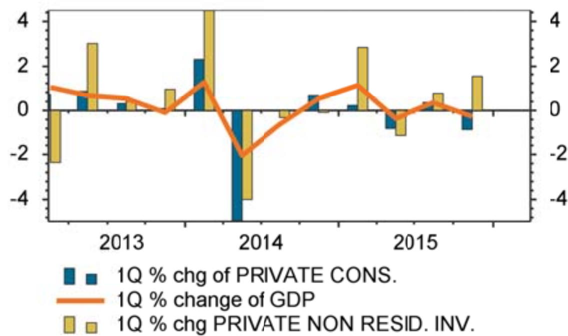
Inflation target also unlikely to be achieved in 2017: largely ineffective monetary policy

Forecast Table

	2015	2016	2017	2015			2016				2017
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.5	0.5	0.8	0.7	1.7	0.8	-0.2	0.4	0.4	1.3	2.3
q/q annual rate				-1.4	1.4	-1.1	0.3	1.0	1.6	2.4	4.2
Private consumption	-1.2	0.1	1.0	-3.3	1.4	-3.4	1.2	0.8	1.2	2.8	10.7
FI - private nonresidential	1.5	2.3	3.0	-4.5	3.0	6.3	1.2	1.6	2.4	2.9	9.1
FI - private residential	-2.7	1.0	0.8	9.7	6.6	-4.7	0.6	1.3	0.7	0.7	0.9
Government investment	-2.0	-1.4	2.7	13.4	-8.1	-12.7	0.0	3.6	4.1	4.5	4.5
Government consumption	1.2	1.3	0.8	1.9	0.8	2.4	0.8	1.2	1.2	1.2	1.2
Export	2.7	0.3	3.4	-17.2	10.9	-3.3	-0.4	1.6	3.2	3.2	3.2
Import	0.2	1.0	4.1	-9.8	5.2	-5.6	2.0	4.4	4.3	4.3	14.9
Stockbuilding (% contrib. to GDP)	0.6	0.0	-0.4	0.4	-0.2	0.0	-0.1	0.1	0.1	0.0	-0.5
Current account (% of GDP)	3.3	3.2	3.0	3.1	3.3	3.9	3.4	3.2	3.2	3.2	2.6
Deficit (% of GDP)	-6.7	-7.1	-5.8								
Debt (% of GDP)	230.3	235.4	237.7								
CPI (y/y)	0.8	0.1	2.3	0.4	0.2	0.3	-0.2	-0.1	0.2	0.6	1.4
Industrial production	-0.9	1.4	1.5	-5.6	-4.8	2.8	3.7	2.5	2.5	2.5	10.4
Unemployment (%)	3.4	3.2	3.2	3.4	3.4	3.3	3.2	3.2	3.2	3.1	3.1
JPY/USD	121.0	119.9	121.6	121.4	122.2	121.4	115.2	117.3	123.2	124.0	122.5
Effective exch. rate (1990=100)	125.8	129.0	123.6	125.3	124.7	126.3	133.6	132.5	126.0	123.8	123.9

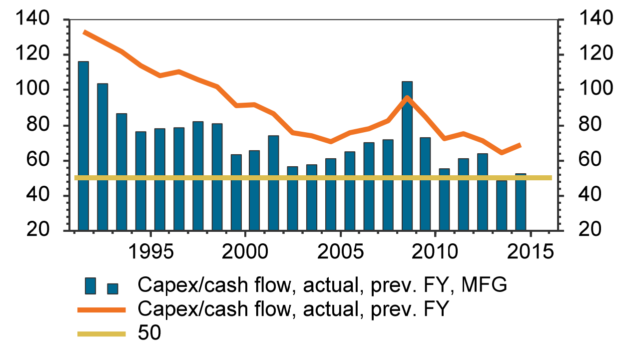
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth negative again at end-2015



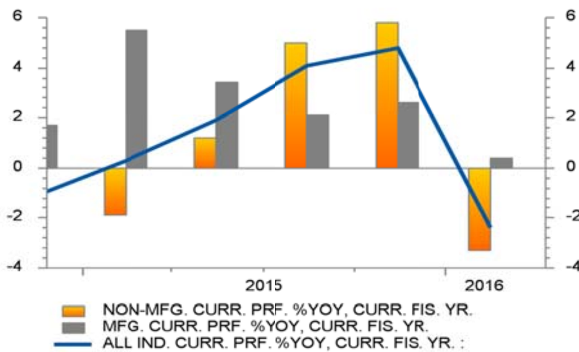
Source: Thomson Reuters-Datastream

Fig. 2 – Business investment remains sluggish…



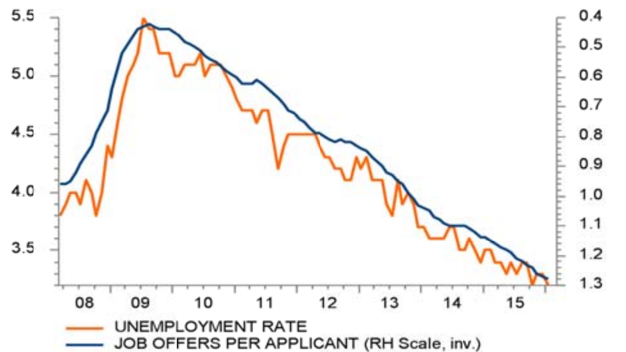
Source: Thomson Reuters-Datastream, Ministry of Finance survey of businesses investment plans.

Fig. 3 – … while profits fall due to the strong yen



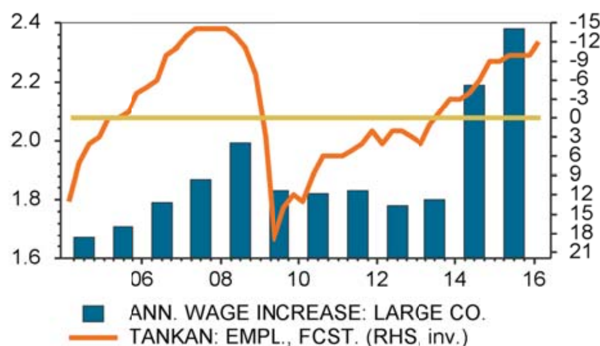
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment is falling



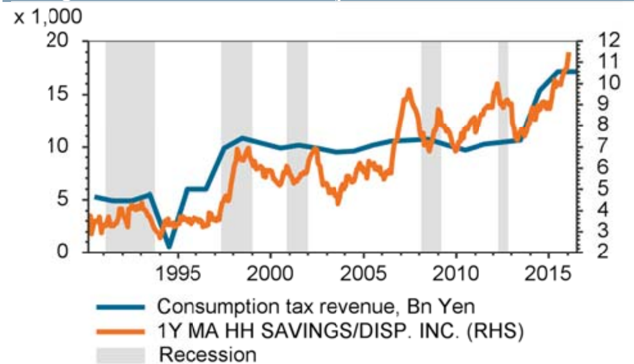
Source: Thomson Reuters-Datastream

Fig. 5 – Wage growth is accelerating…



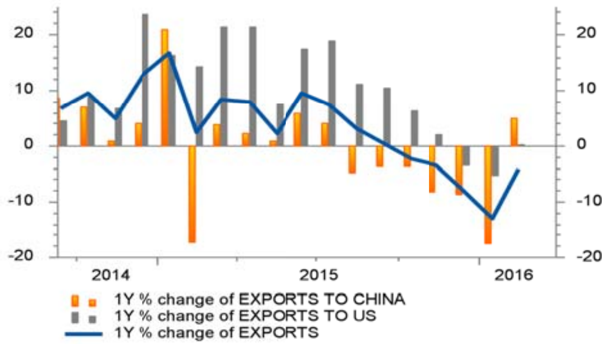
Source: Thomson Reuters-Datastream

Fig. 6 – …but the propensity to save will continue to rise: owing to the increase in consumption tax?



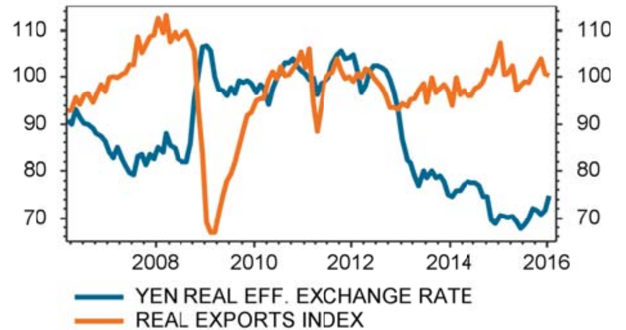
Source: Thomson Reuters-Datastream

Fig. 7 – Some hope for exports?



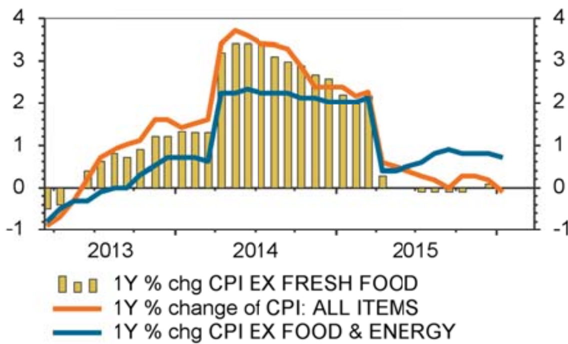
Source: Thomson Reuters-Datastream

Fig. 8 – Exports react very little to exchange rate depreciation



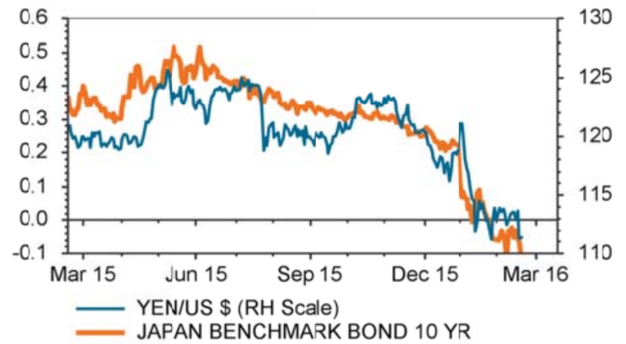
Source: Thomson Reuters-Datastream

Fig. 9 – Core inflation just under 1%: 2% remains distant



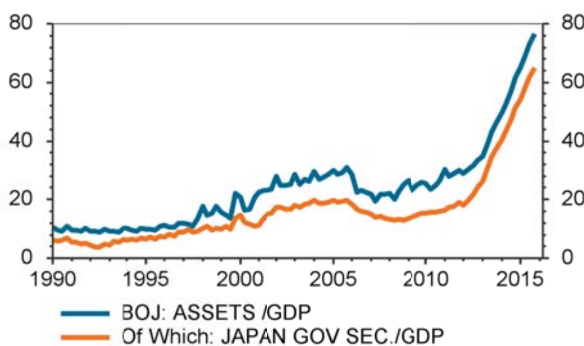
Source: Thomson Reuters-Datastream

Fig. 10 – New BoJ stimulus: negative impact of negative rates?



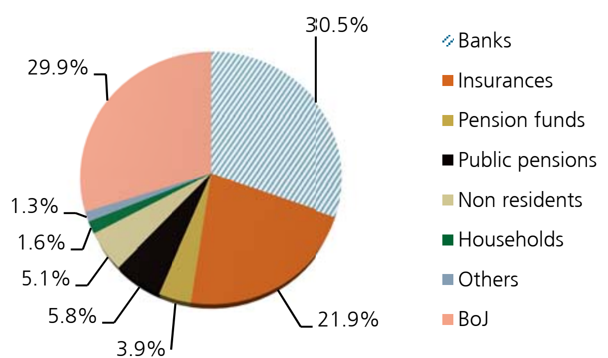
Source: Bloomberg

Fig. 11 – Meanwhile, the BoJ buys JGBs...



Source: Thomson Reuters-Datastream

Fig. 12 – ... and frees up the banks' balance sheets



Figures at end-September 2015; total JGBs: JPY 898.5Trn
Source: Ministry of Finance

China: mixed signs from data, support from monetary policy

Silvia Guizzo

- The Chinese economy grew by 6.9% in 2015, compared with 7.3% in 2014, slightly above our forecast (+6.8%). In the fourth quarter, growth slowed marginally to 6.8% yoy, from 6.9% in the third quarter, owing to the slowdown in investment and private consumption. January and February data, less affected than previous years by the Chinese New Year, which this year again fell in February, were mixed.

- Retail sales slowed (+10.2% cum yoy vs. 10.7% cum yoy in December), although month-on-month changes remained stable at the quarterly average of around 0.81-0.82 points in the last few months. Consumer confidence improved slightly from the lows of December in the NBS survey, but fell in other surveys (Unionpay and ANZ Roy Morgan). Car sales continue to recover from the lows of mid-2015, although they slowed in the first two months of the year. Sales of commercial vehicles continue to fall. Industrial output also slowed, falling to 5.4% cum yoy in February, from 6.1% in December, owing to the lower output of state-owned enterprises, probably relating to the restructuring of the mining sector. The PMI index of the manufacturing sector remained below 50, and has been falling steadily since November in both surveys (NBS and Markit). A similar trend was registered in the total and foreign orders components, the latter only marginally up in February. The breakdown by type of industry follows the trend in the general index, while the index for small companies has fallen to the lowest in the series.

- Conversely, fixed investment picked up slightly to 10.2% cum yoy in February, from a low of 10% cum yoy in December, thanks to a marked upturn in investment in state-owned enterprises (+20.2% cum yoy, from 10.9% yoy in December, see fig. 2), which accounted for 32% of the total, and the upturn in investment in the property sector (+3%, from a low of 1% in December) and agricultural sectors. While investment in manufacturing continued to slow and investment in the mining sector fell, a moderate increase was seen in the services sector, where the marked slowdown in investment in transport infrastructure was offset by the upturn in public utilities, environmental conservation, water management and education.

- Foreign trade is less weak than it seems. Imports fell by 12.9% 3m yoy in February, but improved from a low of -17.8% in October. They continue to be affected by the fall in commodity prices (in fact, the index in volume terms registered an increase of 5% 3m yoy in January), and by over-invoicing, particularly for those from Hong Kong. The figure for exports, down by 11.6% 3m yoy in February vs. a drop of 5% in December, was impacted by a highly unfavourable base effect, as well as the exchange rate effect in the conversion into dollars, particularly in relation to the currency of countries against which the dollar has strengthened (figs. 5 and 6). Exports registered a marginal improvement in volume terms, particularly in certain food products (tea, sugar), refined oil products, cement and steel products. Certain types of machinery and components continue to trend downwards, however.

- The property market continues to show signs of improvement. Residential land sales picked up sharply in the first two months of the year, both in value and volume terms, and, after two years in decline, floor space started was on the rise again (+13.4% cum yoy in February, from -14% in December). Although it remains high (+10.6% yoy), growth in residential space awaiting sale continues to slow, while business confidence in the sector has improved marginally from its lows. Purchases of land still remain down. Prices remain flat in third-tier cities, but are rising in first-tier cities and, to a lesser extent, in second-tier cities (fig. 8). The cuts to the tax on first-home purchases announced in mid-February, together with the reduction of the downpayment decided in September 2015 (excluding first-tier cities) and the moderate upturn in lending (fig.11), should continue to support transactions. The government confirmed that it will introduce further measures to support the property market in 2016, with a view to reducing the stock of unsold residential and commercial property and converting building for the private sector into social housing. We believe, however, that the level of unsold housing stock is still high compared with market demand, particularly in third-

tier cities, so the outlook for the sector remains weak. The upturn in the property market could in part be down to speculative activities. According to recent press reports, the PBOC is planning to issue new rules to prevent people requesting loans to cover deposits for house purchases. This practice, popular in the last few years, could mean that financial institutions are more exposed to the property sector than is shown by data on mortgages only. The central bank is, in fact, planning to strengthen stress tests for property-related loans.

- Consumer price inflation rose from a low of 1.3% yoy in October to 2.3% yoy in February, mainly owing to increases in the food sector (pork +25.4% and vegetables +30.6%) and, to a lesser extent, in transport and communication. Core inflation, stable at 1.5% from October to January, fell to 1.3%, due to the slowdown in the clothing segment and housing services. Production prices continue to fall (-4.9% yoy in February), but have risen slightly since October, thanks to the recovery in the prices of metals, industrial commodities and livestock. Pork stocks keep signalling upward pressure for the food sector at least until the middle of the year. In addition, administered prices may rise following the liberalisation of prices in various product categories announced at the beginning of November. The slowdown in commodity and transport prices will partly offset these factors. We forecast a moderate rise in inflation from 1.4% in 2015 to 1.8% in 2016, particularly in the second half of the year, and to 2.3% in 2017.

- From 5 to 15 March, the Chinese parliament held its usual annual session, which saw the presentation of the Government Work Report, economic policy guidelines and the state budget for 2016. The GDP growth target for 2016 has been set at between 6.5% and 7%, compared with "around 7%" in 2015, which is more optimistic than the consensus estimates of around 6.5%. The authorities aim to stabilise growth in nominal fixed investment at 10.5% (vs. 10% recorded in 2015) and in M2 at 13% (vs. 13.3% recorded in 2015), and have for the first time set a target for growth in total "social financing" at 13% (vs. 12.4% recorded in 2015), which is difficult to reconcile with the objective of strengthening the market's role. Unlike previous years, growth targets for exports have not been announced, while job market targets have been confirmed, with an unemployment rate of less than 4.5% and 10 million new jobs. The inflation target remains unchanged at 3% (vs. 1.4% inflation recorded in 2015).

- According to the Government Work Report, wide-ranging measures will provide support to growth, mainly coming from an expansionary fiscal policy and a monetary policy defined as "prudent but flexible". The deficit/GDP ratio for 2016 is seen rising from 2.3% set for 2015 to 3%, but could rise to around 4-4.5%, given that it exceeded the target in 2015, at 3.5%, owing to an upturn in spending. Tax cuts will total approximately CNY 500Bn (equivalent to 0.7% of GDP), and will support companies and individuals. By the end of May, VAT will be extended to the sectors not yet covered (construction, property, financial services and consumer services). Public investment in infrastructure, particularly railways, roads and water management, will again play an important role. However, ratings agency Moody's revised its outlook on sovereign debt from stable to negative at the beginning of March, owing to the fall in reserves and uncertainty over the ability of the Chinese authorities to enact reforms. The agency points to a rising probability that the government will have to intervene to cover some of the debt of local governments, banks and state-owned enterprises, with a consequent risk that public debt will increase.

- On the issue of reforms, the guidelines that emerged at the beginning of December from the Central Economic Work Conference were reiterated: the need to focus on supply-side reforms, continuing the restructuring of sectors with excess production capacity, supporting new productive sectors with high value added and services, strengthening the market's role and providing further welfare services. In reality, the reforms could proceed less quickly than expected if the impact on the job market is more negative than predicted, as demonstrated by the reform of state-owned enterprises, which has until now been based more on company mergers than on really cutting out the dead wood. Safeguarding employment remains, in our

view, the government's main objective, at a time when conditions in the labour market are showing some signs of deteriorating. According to the *China Labour Bulletin*, 2015 saw a doubling in worker strikes, to 2,772 incidents, from 1,379 in 2014, in many cases owing to non-payment of wages, sometimes even involving local government employees. The percentage of companies planning to hire staff in the third quarter, according to the Manpower survey, is still positive, but in decline and close to the lows of the series. The employment component of the PMI remains below 50, with the exception of services (in the Markit survey only). Although the number of new jobs (13.12 million) was higher than the target in 2015, it was, for the first time, lower than the previous year (-0.8%). Minister of Human Resources and Social Security Yin Weimin has estimated that almost two million jobs will be lost in the restructuring of the coal (1.3 million) and steel (500,000) sectors alone, and has announced the creation of a CNY 100Bn fund to relocate workers, to be used over the next two years.

- Parliament has announced monetary policy support through a wide range of instruments, but central bank governor Zhou Xiaochuan has subsequently stated that "excessive stimulus is not necessary". The PBOC made huge cash injections in January to ease money market tensions around Chinese New Year and, at the end of February, after a break of four months and in a period of stabilising exchange rates, it lowered the reserve requirement ratio by 50 bps. With the one-year deposit rate at 1.50% and inflation at 2.3%, real short-term rates are already negative for depositors and, at the same time, banks' margins have been falling owing to liberalisation. Room for rates to fall therefore seems limited. In addition, measures to support the exchange rate complicate monetary policy at a time of its transition towards the creation of an interest rate corridor at the short end of the curve. We believe that monetary policy expansion will remain limited, and will be conducted through two further cuts to the reserve requirement ratio and the use of liquidity management instruments rather than further tweaks to interest rates, particularly in the event of a return to depreciation of the exchange rate.

- The renminbi began to weaken against the dollar in December, and did so quite sharply in early 2016, when it reached a high of 6.60. Subsequently, it retreated to around 6.50 in mid-March, in line with the general depreciation of the dollar following the lowering of expectations regarding Fed rate hikes. The effective exchange rate registered less movement, but in the opposite direction (fig. 13). While the fall in reserves was still significant in January (- CNY 99. 5Bn vs. - CNY 107.9Bn in December), it was much lower in February (- CNY 28.6Bn), helping, along with further statements from the PBOC, to calm the markets. Governor Zhou has in fact again reiterated that China is not targeting a competitive devaluation, but stability in the effective exchange rate.

- In our view, the global macroeconomic environment will continue to be marked by uncertainty at least until the summer, with Fed rate hikes conditional upon global economic and financial data and developments, and developments of the new, expansive policy of the BOJ difficult to assess. The global situation is likely to become clearer in the second half of the year. We will therefore see greater risks of high volatility of the renminbi in the second quarter and the third quarter, but we believe that the PBOC will continue to act to prevent an excessive and sudden deprecation of the exchange rate against the USD. Given recent trends in the markets, the low point could be lower (around 6.70) than we expected at the beginning of the year[25] (6.90), in the absence of a marked decline in Chinese data or a significant revision in expectations regarding the Fed. We therefore expect a limited depreciation of the CNY/USD exchange rate mid-year, and subsequently, given the expected depreciation of the dollar against other currencies, a recovery for the end of the year, with a marginal depreciation in the effective exchange rate (-2.1%) compared with end-2015 levels.

[25] See China, Economy Focus, of 5 February 2016.

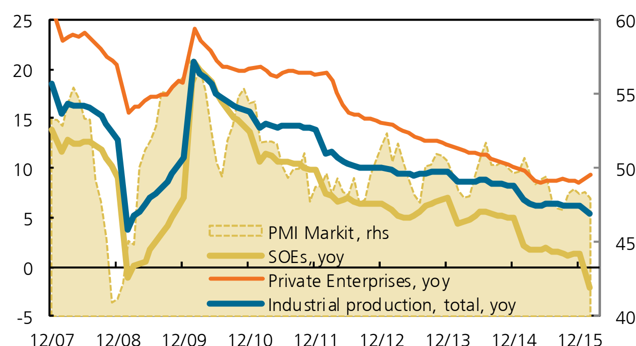
- We think that the increase in **non-performing loans** will continue to dampen lending growth in the next two years, despite the further easing of monetary policy expected this year. The **slowdown** in investment in property, construction and manufacturing **will continue in 2016**, impacting the job market and ultimately consumer spending. Furthermore, investment in infrastructure will be unlikely to sustain the pace of 2015, and could fall more sharply in the medium term. **We therefore maintain our growth forecasts unchanged at 6.3% in 2016,** with a slight deceleration **to 6.1% in 2017.** Risks to the medium- and long-term outlook remain to the downside, but are to the upside in the short term.

Forecast table

	2011	2012	2013	2014	2015S	2016P	2017P
GDP (constant prices)	9.5	7.7	7.7	7.3	6.9	6.3	6.1
Private consumption	11.6	9.7	7.9	8.4	8.1	7.5	7
Public consumption	11.7	3.6	4.1	3.4	11.5	16.3	6.6
Fixed investment	8.1	8.8	9	6.9	5.7	5	4.6
Exports	13.9	6.3	9	5.8	-3.2	2.1	4.9
Imports	17.3	6.9	11.6	6.6	2.5	5.2	4.8
Industrial output	10.6	8.2	7.9	7.3	6	5.2	4.8
Inflation (CPI)	5.4	2.6	2.6	2	1.4	1.8	2.3
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Average salaries	16.8	14.4	11.8	9.2	8.5	7.4	7.1
90-day interbank rate (average) (%)	5.3	4.2	4.9	4.8	3.8	2.8	2.8
USD/CNY exchange rate (average)	6.46	6.31	6.15	6.16	6.28	6.58	6.47
Current account balance (CNY Bn)	874	1360	912	1358	1843	1962	1784
Current account balance (% of GDP)	1.8	2.5	1.6	2.1	2.7	2.7	2.3
Budget balance* (% of GDP)	-1.1	-1.6	-1.8	-1.8	-3.5	-4.5	-4.3

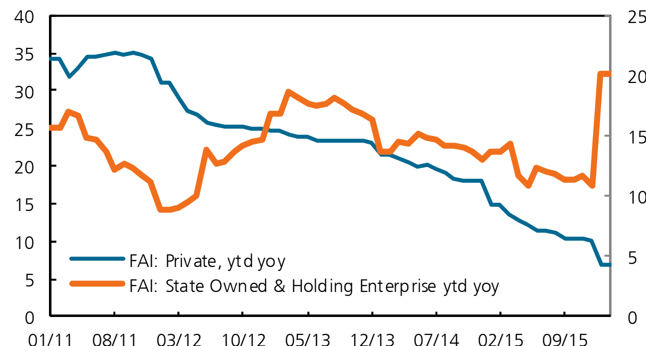
NB: Percentage change versus previous period except where otherwise indicated; *IMF Article IV 2015 estimates
Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Fig. 1 – Industrial output is slowing



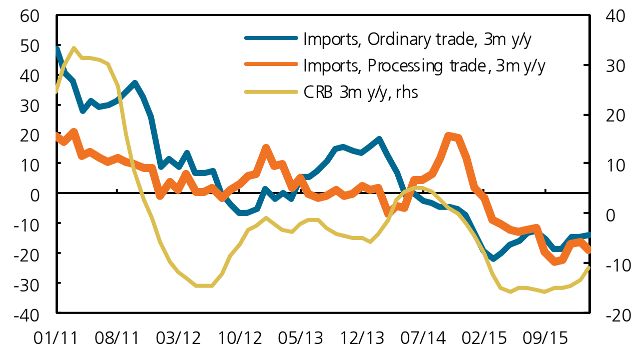
N.B. Value added in real terms ytd. Source: CEIC, Markit

Fig. 2 – State sector investments are surging



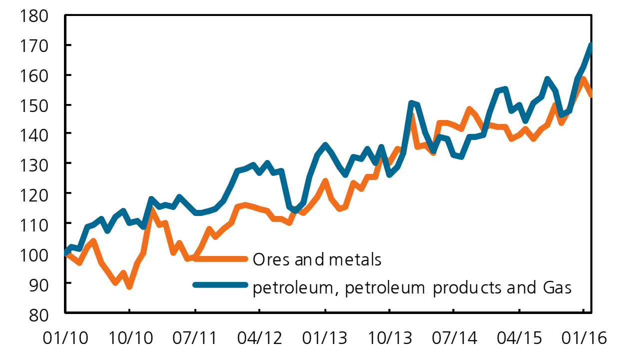
Source: CEIC

Fig. 3 – Imports affected by falling prices



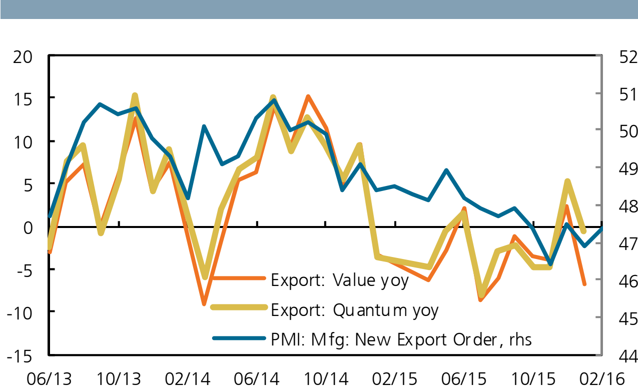
Source: Bloomberg, CEIC

Fig. 4 – Raw material imports hold up in volume terms



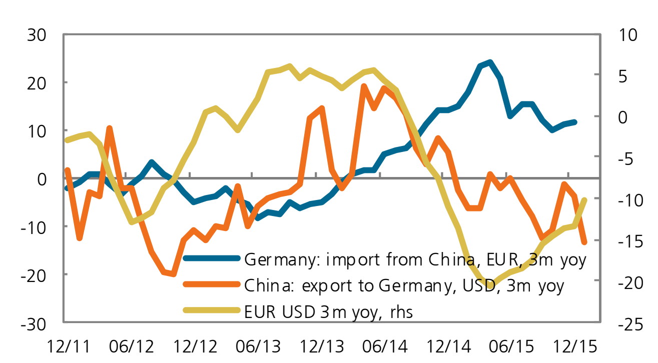
NB: Imports in tons, 3m moving average, rebased at 01/01/2010 = 100. Source: CEIC

Fig. 5 – Marginal improvement in exports in volume terms



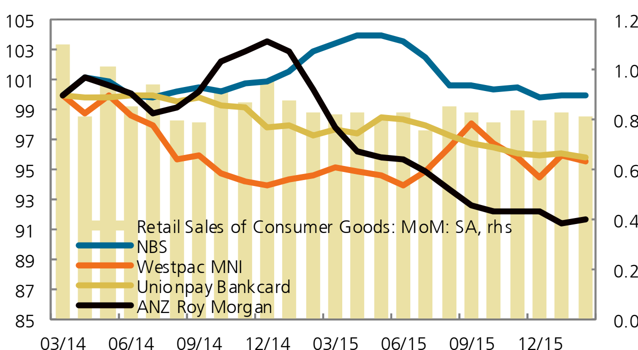
Source: CEIC

Fig. 6 – Exports in value terms also affected by the exchange rate



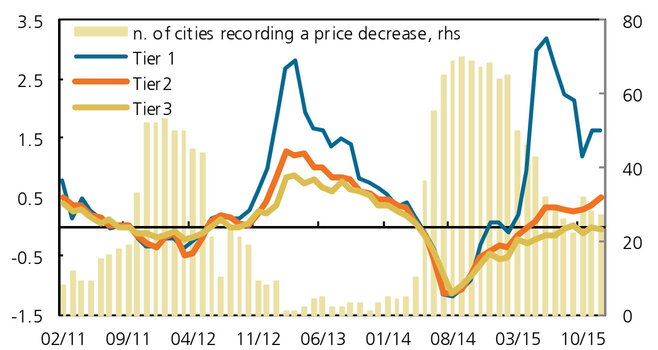
Source: CEIC

Fig. 7 – Consumer confidence stabilises



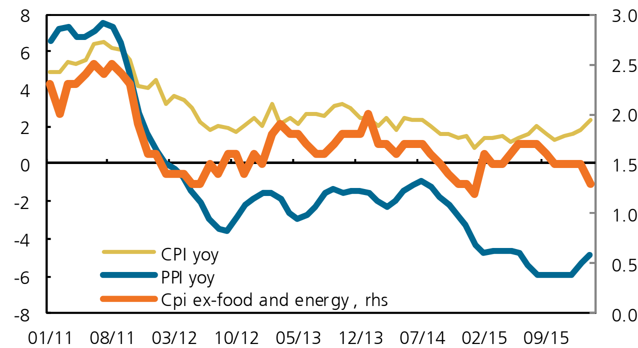
N.B. Confidence indices, 3-month moving average, rebased to March 2014=100. Source: CEIC

Fig. 8 – Signs of improvement in the property market



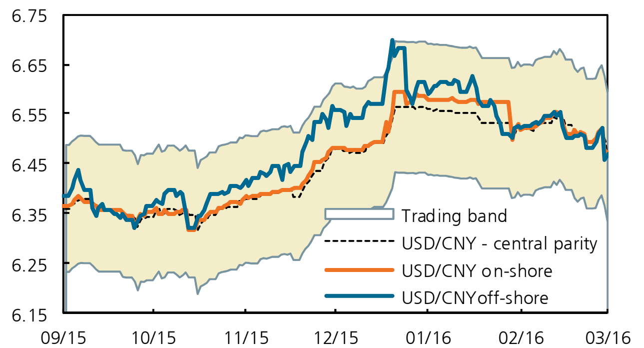
NB: Average % price change mom. New-build residential properties. Source: Intesa Sanpaolo chart from CEIC data

Fig. 9 – Inflation



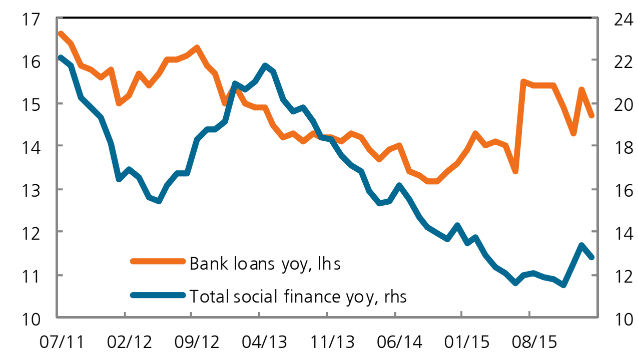
Source: CEIC, Bloomberg

Fig. 10 – The exchange rate stabilises



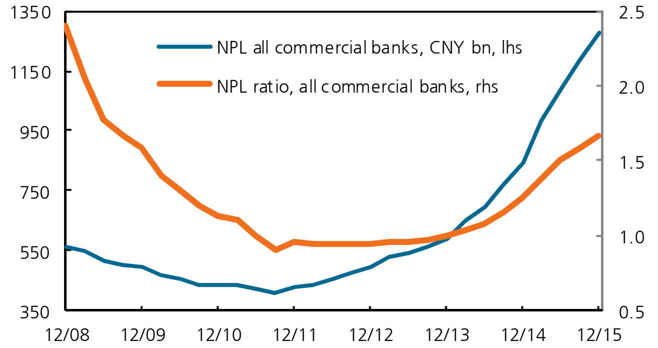
Source: Bloomberg

Fig. 11 – Lending picks up pace



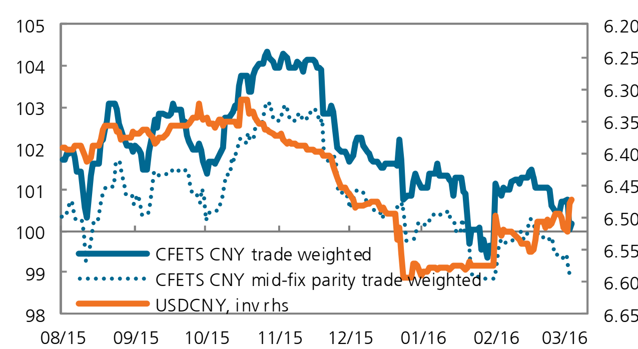
NB: stock, monthly figures, % yoy chg. Source: CEIC and Intesa Sanpaolo estimates

Fig. 12 – Non-performing loans continue to rise



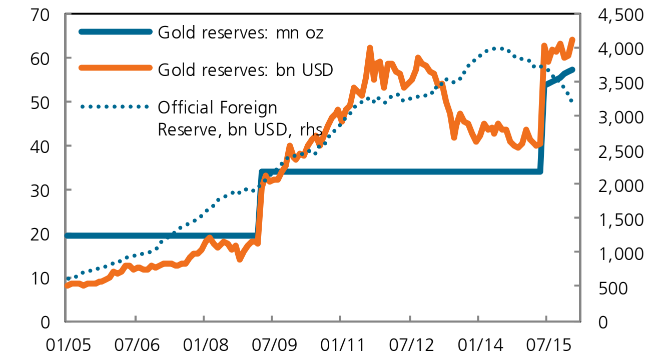
NB: Non-performing loans (NPL) of commercial banks. Source: CEIC

Fig. 13 – Effective exchange rate and rate against the USD



Source: ISP chart from Bloomberg and CFETS data

Fig. 14 – Foreign currency reserves



Source: CEIC

India: investment recovery still not rock solid

Silvia Guizzo

- India closed 2015 with annual growth of 7.3%, slightly below our forecasts (7.4% yoy) and three tenths of a point higher than in 2014, thanks to an upturn in investment and the precious metals segment. In 4Q15, GDP growth slowed to 7.3%, from 7.7% in 3Q, owing to a deceleration in investment. The fourth quarter also saw a downwards trend in industrial output. Despite the upturn in lending and government support to investment, the number of investment projects stalled (mainly for administrative reasons) continued to rise. As such, some uncertainty remains over the solidity of investment recovery. The outlook for consumption remains positive, however, driven by the rise in consumer confidence, the positive trend on the labour market and expectations of a recovery in agriculture.
- The government has confirmed its forecast of a deficit/GDP ratio of 3.9% in FY 2015-16, and set targets of 3.5% in FY 2016-17 and 3% in FY 2017-18, reiterating its commitment to consolidating the public accounts in the medium term. The budget is largely geared towards the economic development of rural areas and the support of the poorest members of society through social welfare programmes. It also seeks to promote investment in manufacturing and infrastructure through tax breaks and cuts. The lack of clarity on allocation regarding the planned increases in public-sector salaries, together with uncertainty over income from the sale of state shareholdings and the auctions of telecommunications frequencies, leaves the risks on the forecast deficit/GDP ratio to the upside.
- After reaching a high of 5.7% in January, consumer price inflation fell to 5.2% yoy in February, thanks to the fall in food prices and a favourable base effect. Inflation excluding food and fuel rose, however, from 4.7% to 5%, owing to the increase in the services segment. We expect oil prices to remain low in 2016 and below those of 2015, and that the state management of cereal stocks will keep a lid on food price rises. On the basis of these assumptions and a still favourable base effect for much of the year, we forecast a slowdown in inflation from 4.9% yoy in 2015 to 4.5% in 2016, and, in line with the recovery in fuel prices and domestic demand, an upturn to 5.2% in 2017. Risks remain to the upside, however. The government's renewed commitment to fiscal consolidation allows more room for manoeuvre in monetary policy, which will remain accommodative if forthcoming data confirm the drop in inflation.
- The support from fiscal and monetary policy should continue to favour the consolidation of growth over the medium term. We are revising our forecasts of an upturn in growth down slightly, to 7.5% in 2016 and in 2017, from 7.6% previously.

Forecast table

	2011	2012	2013	2014	2015	2016	2017
GDP (constant prices)	7	5.6	6.3	7	7.3	7.5	7.5
Private consumption	7.3	6.7	5.7	6.7	6.2	7	7.4
Public consumption	7.9	4.6	2.2	9.5	1.9	5.2	7.9
Fixed investment	6.2	2.3	7.4	2.8	5.2	6.3	7.8
Exports	18.2	10	4.4	7	-6.5	6.3	7.2
Imports	18.4	11.3	-6	0.5	-6.3	6.1	6.2
Industrial output	4.8	0.7	0.6	1.8	3.2	4.9	7.3
Inflation (CPI)	8.3	9.4	9.9	6.6	4.9	4.5	5.2
Unemployment rate (%)	5.8	5.6	5.6	5.6	5.5	5.5	5.4
Average salaries	14.3	19.3	11.2	10.7	10.4	9.9	9.8
3-month MIBOR (average)	9.5	9.5	9.3	9.1	8	6.2	6.9
USD/INR exchange rate (average)	46.69	53.47	58.57	61.04	64.15	67.50	64.14
Current account balance (INR Bn)	-2945.1	-4893.2	-2779.6	-1661.2	-1122.6	-2094.5	-1688.9
Current account balance (% of GDP)	-3.5	-5.1	-2.5	-1.4	-0.8	-1.4	-1.0
Budget balance (% of GDP)	-6.9	-5.5	-5.5	-4.3	-3.5	-3.6	-3.0

NB: % changes versus previous period – except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

India closed 2015 with annual growth of 7.3%, slightly below our forecasts (7.4% yoy) and three tenths of a point higher than in 2014, thanks to an upturn in investment and the precious metals segment. Foreign trade made a positive but marginal contribution (+0.1%), with greater contributions coming from inventories (+0.2%) and the valuables segment (+0.4%), which had been negative in the two previous years. In 4Q15, GDP growth slowed to 7.3%, from 7.7% in 3Q, owing to a downturn in investment. On the supply side, the upturn in manufacturing offset the moderate slowdown in services and the stagnation in the agricultural sector, taking annual growth in value added to 7% in 2015, from 6.8% in 2014.

In 2015, growth in fixed investment picked up to 5.2% yoy, after a low of 2.8% yoy in 2014, and for the first time after four years of falls, the number of industrial investment proposals awaiting approval from the Ministry of Industry rose (+8.4%), although the total amount remained down (-23.2%). Growth in fixed investment slowed in 4Q15, however (2.8% yoy). According to the CMIE (Centre for Monitoring Indian Economy), stalled investment projects (owing to problems in acquiring land, a lack of administrative permits or environmental authorisations, as well as a lack of funds or unfavourable market conditions) picked up again in 2H15 (+10.7% yoy in 4Q15), and also rose in relation to the total number of projects being implemented. Blocked projects are mainly private, and equal 19.4% of projects being implemented (compared with 4.8% for public projects). Companies are undergoing a period of budgetary adjustment, owing to the need to reduce debt, which rose from 40% of GDP in mid-2007 to a high of almost 53% in mid-2013, according to BIS data, before falling to 50% in 3Q15. Hence there remains some uncertainty regarding the solidity of the recovery in investment in the private sector, while public investment is expected to increase only slightly, according to the budget presented recently (see below). Various positive factors remain for the trend in investment: the government programme Start-Up India, intended to create better conditions for the development of start-ups, the improvement in machinery imports in the last few months, and the upturn in lending in the second half of 2015 (growth at 9.5% yoy in February 2016, from a low of 7.7% yoy in June 2015).

Growth in private consumption slowed to 6.2% yoy in 2015, from 6.7% in 2014, but rose to 6.4% yoy in 4Q, supported in part by a highly favourable base effect. The slowdown in car sales was offset by an upturn in sales of commercial and three-wheel vehicles. After declining in 3Q, consumer confidence rose marginally in 4Q, particularly in the expectations component. In light of the positive trend on the labour market, the increase in domestic passenger traffic and expectations of a recovery in the agricultural sector, and therefore in incomes in rural areas, the outlook for private consumption remains positive for the next few quarters.

The fall in the revenues of private manufacturing firms was offset by a reduction in costs (owing to both the fall in commodity prices and improved efficiency), meaning a limited upturn in earnings at least until 3Q15. The manufacturing sector registered growth of 12.5% yoy in 4Q, compared with 9% in 3Q, according to data on real value added. Over the same time period, however, growth in industrial output slowed to 1.6% yoy, from 4.8%, dragged downwards by the contraction in capital goods production as well as the effects of the floods that hit certain parts of Tamil Nadu and Andhra Pradesh in November and at the beginning of December. In January, industrial output contracted by 1.5% yoy and that of the manufacturing sector by 2.8%. The production of energy commodities and materials for infrastructure registered a similar trend. The PMI fell in 2H15, reaching a low of 49.1 in December. It remained stable, however, at 51.1 in January and February, with a rise in the total orders component. Furthermore, both the RBI and Dun & Bradstreet surveys of industrial firms registered an increase in expectations for 1Q16, with an upturn in orders indicating a recovery in industrial output in the current quarter.

The **services sector** registered growth of 9.4% in 4Q, again providing the greatest contribution to GDP growth. Mobile phone subscriptions registered a steady increase of approximately 7% yoy. Tourist arrivals, which slowed in 2015 compared with 2014 (+4.4% yoy versus +10.2% yoy), seem to have stabilised in the last few months, as does the sector's revenue in dollars, which was negatively impacted by the depreciation of the rupee (5.2% on average in 2015). Service companies' earnings registered double-digit growth at least until 3Q15, ahead of those of manufacturing companies. Despite this, the services PMI fell to 51.4 in February, after rising for three months. The quarterly average increased, however, and remained above 52. After falling for 11 months and reaching an historic low of 49.9 in November, the expectations component recorded a sharp improvement in the last three months, suggesting that the outlook for the sector remains positive.

Foreign trade continues to trend downwards, owing to both an unfavourable base effect (although this will not be a problem from February onwards) and the impact of the decline in commodity prices. It has however improved from the lows of the autumn, particularly as regards imports excluding oil (-7.5% 3m yoy in January versus -15.5% 3m yoy in November), which fell by less than exports (-13.3% 3m yoy). The outlook for exports is one of moderate growth: the foreign orders component of the PMI rose from a low of 50.4 in September to a high of 52.5 in January, and was 51.1 in February, while international air cargo traffic is rising.

After reaching a high of 5.7% in January, **consumer price inflation** fell to 5.2% yoy in February, thanks to the fall in food prices (particularly fruit and vegetables) from December and a favourable base effect. According to our estimates, non-food inflation rose, however, from 4.8% in December to 4.9% in February, while inflation excluding food and fuel increased from 4.7% to 5%, owing to the increase in the services segment (housing, transport, telecommunications and personal care costs). Wholesale prices continue to fall (-0.9% yoy in February), although they have registered a significant recovery from the lows of August 2015 (-5.1% yoy). We expect oil prices to remain low in 2016 and below those of 2015, and that the state management of cereal stocks will keep a lid on food price rises. On the basis of these assumptions and a still favourable base effect for much of the year, we forecast a slowdown in inflation from 4.9% yoy in 2015 to 4.5% in 2016, and, in line with the recovery in fuel prices and domestic demand, an upturn to 5.2% in 2017. **Risks remain to the upside:** resilient core inflation, higher-than-expected rises in the prices of agricultural products and the implementation of the recommendations of the Seventh Central Pay Commission, calling for an increase in public-sector salaries of 0.5% of GDP in FY 2016-17.

After the last cut of 50 bps at the end of September, the **central bank** has left rates unchanged. At the meeting held at the beginning of February, it repeated that the inflation target of 6% for March 2016 would be met, and that subsequently, assuming a normal monsoon season after two years of drought and with oil prices still low, inflation would remain sluggish, and would fall to around 5% by March 2017. According to the RBI, risks in this scenario remain to the upside, since the planned increase in public-sector salaries, which has not been incorporated, will trigger an upwards shift in the profile over the next one/two years. GDP growth forecasts based on value added remain at 7.4% in FY 2015-16 and 7.6% in FY 2016-17. The RBI considers the current speed of economic growth to be "reasonable", although lower than that anticipated in the medium term. Various crucial growth drivers, including support to the recovery in private investment, stable inflation and curbed public spending, therefore need to be supported. The government's renewed commitment to fiscal consolidation allows more room for manoeuvre in monetary policy, which will remain accommodative if forthcoming data confirm the drop in inflation. The RBI therefore remains watchful pending its evaluation of forthcoming data. **We think the RBI could further reduce the repo rate by a total of between 50 and 75 basis points between the second and third quarters of 2016** if core inflation starts to fall again and the upside risks to inflation and exchange rate volatility do not materialise.

The rupee fell by 3.9% against the dollar from the beginning of January to the high of 68.71 at the end of February, before subsequently falling to just above 67, in line with the general depreciation of the dollar. While net FDI flows remained positive and stable in 2Q/3Q15, net portfolio inflows were negative. Monthly data on net capital inflows from institutional investors were positive in 4Q, with substantial inflows in October, but there were net outflows from November to February. After peaking at USD 330Bn in October, foreign currency reserves fell to USD 325Bn in February. They remain up, however, on the end-2014 figure (USD 295Bn), and can cover more than 10 months of imports and 3.8 times short-term external debt. Compared with the same period of the previous year, the current account deficit remained stable at 1.2% of GDP in the first three quarters of 2015. The greater macroeconomic stability generated by the commitment to consolidate the public accounts, a lower current account balance than in the past and inflation that is slightly trending down should support the rupee. Despite this, given the greater volatility on international markets, we believe that the exchange rate may remain under pressure at around 68 in the first half of the year, before staging a gradual recovery in the second half, in line with the expected depreciation of the dollar.

Finance Minister Arun Jaitley presented the budget for FY 2016-2017 (April – March) to Parliament on 29 February. The government has confirmed its forecast of a deficit/GDP ratio of 3.9% in FY 2015-16, and set targets of 3.5% in FY 2016-17 and 3% in FY 2017-18, reiterating its commitment to consolidating the public accounts in the medium term. The budget projects an 11.7% increase in tax receipts, lower than the previous year. This is mainly sustained by the rise in direct taxes (seen increasing by 12.6% on FY 2015-16), which offsets the lower receipts expected from indirect taxes (+11% versus +28.9% in FY 2015-16). It also provides for an increase in non-tax revenue of 24.9%, lower than in the previous fiscal year, and a fall of 2.3% in capital revenue. Within this, the fall in certain items (such as credit recovery, short-term loans and other unspecified items) is offset by expected rises in receipts from the sale of shareholdings in public sector undertakings (PSUs). These revenues are estimated at INR 56Bn, up 123% on FY 2015-16. This objective seems very optimistic, given that India has met its disinvestment target only three times in the last 15 years, and not once in the last five years[26] . Spending on subsidies (food, fertilisers and oil) is expected to fall by 4.2% to 1.6% of GDP, versus 1.9% estimated for FY 2015-16, substantially down from the high of 2.6% of GDP in FY 2011-12. Together with defence (12.6%), this spending continues to represent one of the main items of expenditure (14.4% of total public spending in FY 2015-16) after interest expense (24.8%). At the same time, spending on social security and economic services is rising. Capital spending is seen rising by 3.9% compared with FY 2015-16. Here, the largest increases include those in defence services (+6%) and loans to PSUs (+34%), including INR 250M for the recapitalisation of banks.

The budget is largely geared towards the economic development of rural areas and supporting the poorest members of society. Allocations for agriculture and social services, as well as those for transport and general economic services, rose as a proportion of the total, while those for energy fell. The budget seeks to promote investment in manufacturing and infrastructure through tax breaks and cuts, and by supporting demand in rural areas through social welfare programmes. There was little clarity regarding how the 23.6% rise in the salaries of approximately 10 million public-sector workers and pensioners will be covered, in accordance with the recommendations of the Seventh Central Pay Commission. The government has allocated a total of INR 700Bn (approximately 68% of the total necessary, i.e. INR 1.02Trn), and divided it among various ministries without providing details. This factor, together with the uncertainty regarding income from the sales of state shareholdings and the auctions of telecommunications frequencies (forecast at INR 98.9Bn, up 72.5% on last year), leaves risks on the estimated deficit/GDP ratio to the upside.

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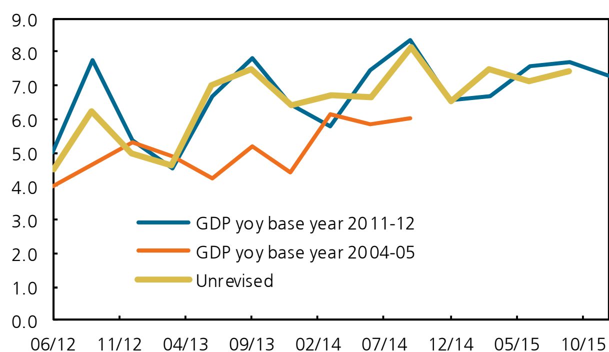
[26] Institute for Policy Research Studies, PRS Legislative Research.

The government did not manage to push through the law for the introduction of the goods and services tax (GST) and the amendments to the law on the purchase of land in Parliament's winter session. The laws will be re-examined in the current budget session (from 23 February to 16 March and from 25 April to 13 May). The government has also repeated its commitment to pushing through the law on bank insolvency and bankruptcy, and to encouraging the listing of state-owned insurance companies. **The lack of majority** of the government coalition (National Democratic Alliance, NDA), led by the Prime Minister Narendra Modi's party (BJP, Bharatiya Janata Party) **in the Upper House** (Rajya Sabha), **remains a key obstacle** to the approval of the reforms before its current mandate expires in May 2019. Following the BJP's defeat in Bihar in November, an important test will be the forthcoming legislative assembly elections in April/May in five states (Assam, Kerala, Puducherry, Tamil Nadu and West Bengal), which account for 20.8% of the seats in the Upper House, and which are currently governed by the opposition party (Indian National Congress) or rival regional parties.

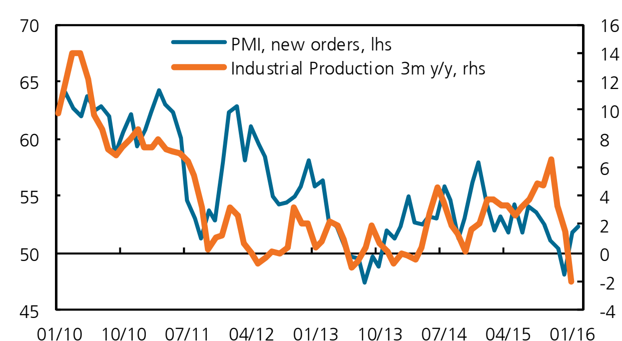
The government's commitment to reducing bureaucratic restrictions and supporting investment and the central bank's still-accommodative monetary policy stance should continue to facilitate the consolidation of medium-term growth. On the supply side, a monsoon season with average rainfall after two seasons of drought would help agricultural production recover. However, the improvement in business confidence and the recovery of investment could be slower than initially expected. **We have slightly revised down our forecasts for growth to 7.5% in 2016 and 2017, from the previous 7.6%,** driven by the resilience of consumer spending and a moderate upturn in investment.

Fig. 1 – Rebasing of GDP series takes growth higher



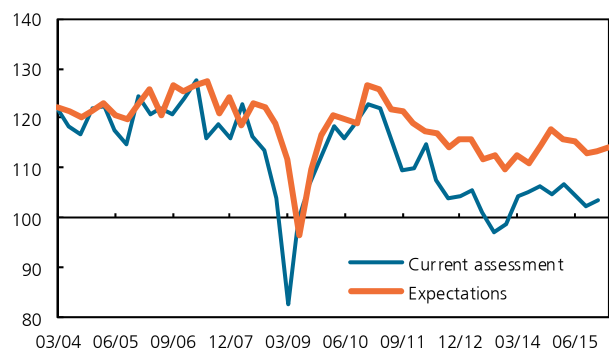
Source: CEIC

Fig. 2 – Industrial output is slowing



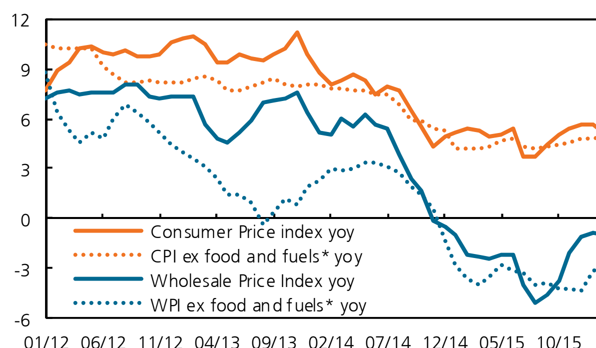
Source: Markit-HSBC, CEIC

Fig. 3 – Business confidence



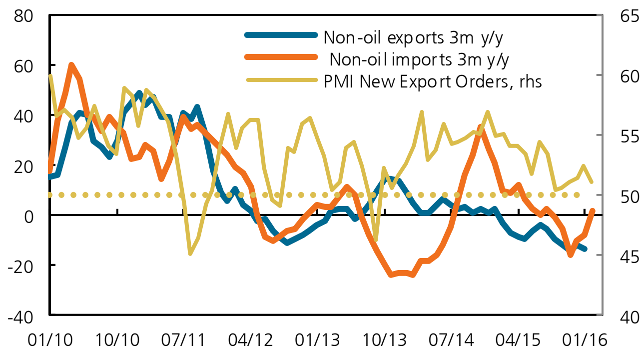
N.B.Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 – Core* inflation is not falling



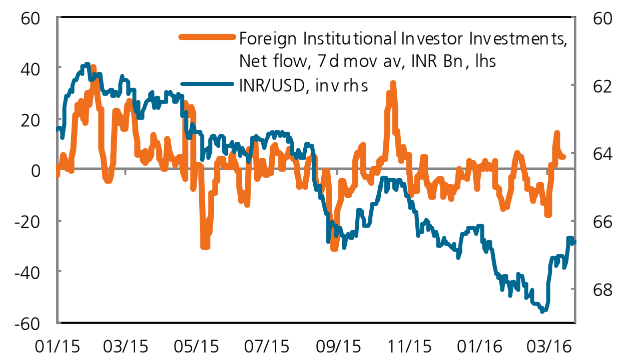
*Intesa Sanpaolo estimates Source: CEIC

Fig. 5 – Imports excluding oil are improving



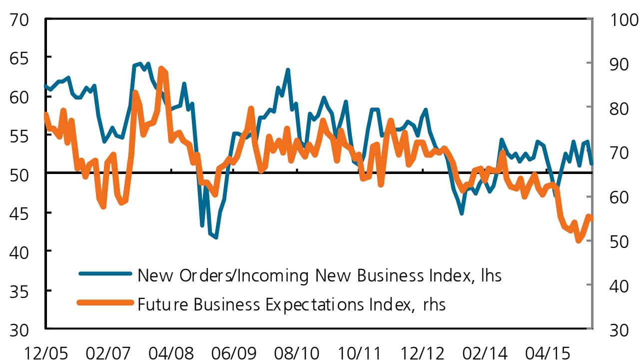
Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Fig. 6 – The rupee recovers from its end-of-year lows



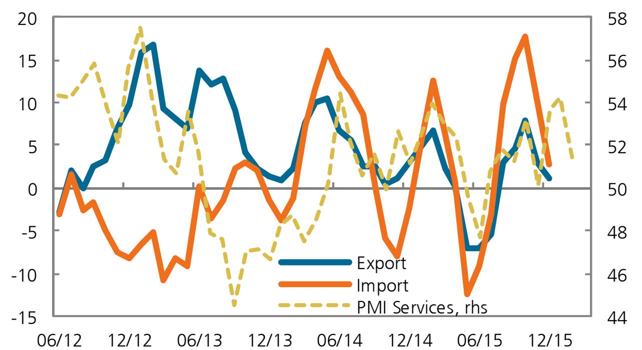
Source: CEIC

Fig. 7 – Services: expectations are improving



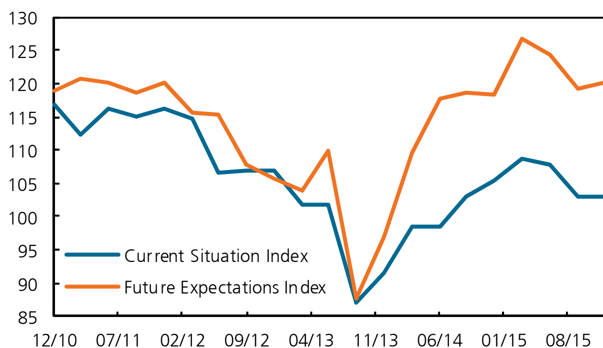
Source: Markit

Fig. 8 – Trade in services



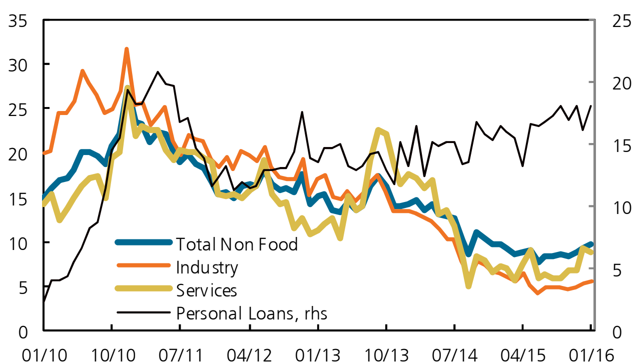
Source: CEIC, Markit

Fig. 9 – Consumer confidence



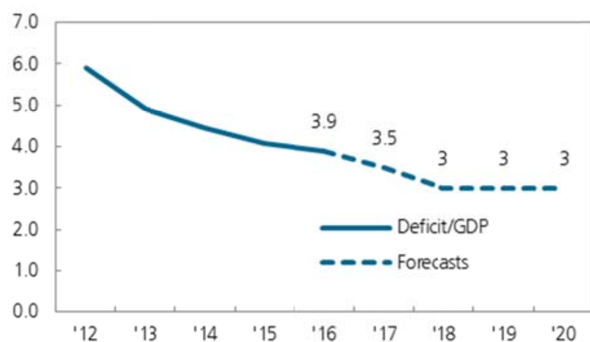
NB: Quarterly consumer confidence survey by the RBI. Source: CEIC

Fig. 10 - Lending is picking up (% change yoy)



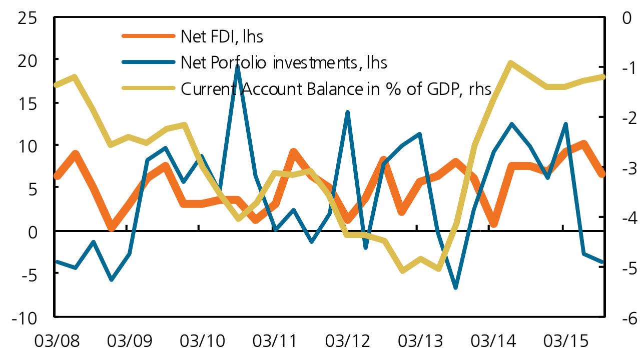
Source: CEIC

Fig. 11 – Public accounts (%)



Source: CEIC, Ministry of Finance

Fig. 12 – Current accounts



N.B. y axis in USD Bn. Source: Intesa Sanpaolo chart based on Bloomberg data

Currency markets: Uncertainty trumps divergence

Asmara Jamaleh

2016 began amid renewed concerns over global growth. Fears of a slowdown in the Chinese economy have driven oil prices down further, and with them, inflation.

The response of central banks was unambiguous: a delay in the normalisation of monetary policies:

- the Fed, which began to raise rates last year, has put the process on hold,
- while a good number of other central banks (ECB, BoJ, RBNZ, Riksbank, Norges Bank) continue to increase monetary stimulus.

Thus, **during this phase, uncertainty and weakness in the global environment prevail over the specific features of individual economies. The end result is a reduction in monetary policy divergence between the Fed and other central banks.**

The key issues of the second quarter will be: **(1)** when the Fed will resume rate hikes; **(2)** whether other central banks will still need to increase monetary stimulus; and **(3)** whether fears over the global picture at the beginning of the year are still justified, or whether instead, the market reaction was excessive.

DOLLAR

The Fed will resume its rate hikes, but the upside of the dollar is likely to be limited.

In December 2015, the Fed launched its rate hike cycle, indicating that it would more or less raise rates by 25 bps every quarter in 2016. However, with the global economy making a negative start to the year, the Fed was forced to take a break by skipping the first quarter.

The dollar fell, due not so much to the negative signals from the domestic economy, at least in the short term, but to the overall uncertainty in the global outlook, which necessarily has an impact on the Fed's actions.

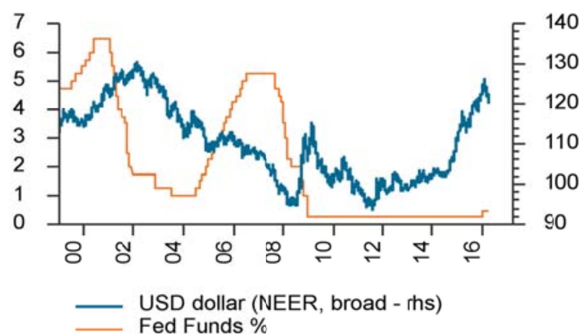
In fact, at the FOMC meeting on 16 March, rates remained unchanged at 0.25-0.50%, but most importantly, **the internal distribution of preferences indicated that now most participants are in favour of two rate hikes this year, not the four indicated in the December meeting, nor the three that could have been assumed after the first-quarter break.** However, a sizeable minority believes that three rises are still possible. The main reason for caution remains the extremely delicate phase in the global economy. If there are no significant improvements at international level, and at the same time no uniformly positive indications for the US economy, we may have to wait longer for the second Fed hike than expected. However, Janet Yellen has indicated that any meeting may be the right one to raise rates, if data and market conditions allow. Thus, even the FOMC in April is an open option. **And since the market continues to be even more cautious than the Fed with regard to rate rises, the dollar is likely to strengthen when we see signs suggesting that the next hike is approaching.**

The question is whether during its ascent, the dollar can hit new highs, or if instead the upside is limited, more or less around last year's highs. We are more inclined to favour the latter hypothesis. At first glance, it may seem to be a weak hypothesis, because what should be more important is that the Fed is the only central bank raising rates, while the others are not only unable to raise them, but are keeping them around zero, resulting in a widening of spreads.

The point is that **after the further monetary stimulus measures recently implemented by the other major central banks (led by the ECB and BoJ)**, with a further cut in rates (for some) into negative territory, **the expansionary monetary policy phases are likely to come to an end.** In general, at the end of an expansionary phase, the domestic currency does not decline further, but gradually reverses trend and starts to recover.

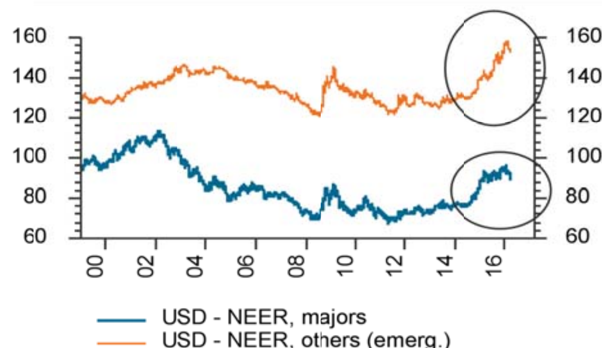
Another issue is that **the way exchange rates react to changes in rate/yield spreads could change with respect to before the crisis, when central banks used "normal" monetary policies.** In fact, at present, the substantial, widespread and prolonged use of unconventional stimulus measures is causing greater market volatility. Another element of uncertainty may, for example, concern the exit strategy. In the case of the Fed, the "normal" impact of rate hikes will be significantly diminished until the QE stimulus is eliminated.

Fig. A - Dollar: upward macro trend before the start of rate hikes



Source: Thomson Reuters-Datastream

Fig. B - The dollar rose mainly against emerging currencies



Source: Thomson Reuters-Datastream

Furthermore, after the dollar's significant appreciation between mid-2014 and the beginning of 2015, a further rise now, in an environment of prolonged weakness in the global economy, would again restrict financial conditions for the Fed, forcing it to raise rates more gradually.

Lastly, **we should not overlook movements in emerging currencies. During the recent uptrend, the dollar appreciated the most against these currencies** (fig. B). It is against these currencies that the greenback is continually registering new highs, a situation that continued into the beginning of this year. If we assume that the global economy will improve in 2016, albeit gradually, thereby easing the vulnerability of emerging economies, risk aversion is likely to decline significantly, benefiting the currencies of these countries. While not projecting a sharp or rapid rally for these currencies, their downward trend would then come to an end, and with it, the dollar's upward macro-trend.

EURO

Range-bound: the ECB will stop increasing stimulus, and the Fed will resume rate hikes.

As in 2015, the start of 2016 was marked by a contrast between the ECB and Fed, but in the opposite way. Last year saw the beginning of the period of maximum divergence between their respective monetary policies, while at the start of this year, the divergence was reduced. The ECB has had to further step up its monetary stimulus, and the Fed has had to interrupt the rate hike cycle, which had only just begun.

At the beginning of the year, negative developments in the global economy prevailed over domestic developments, shifting the focus onto a common theme: the increased downside risks to growth, and in particular, to inflation. Thus, while the euro weakened against the dollar in 1Q15 (from EUR/USD 1.21 to 1.04: -12%), in 1Q16, it strengthened (from EUR/USD 1.07 to 1.13: +6%).

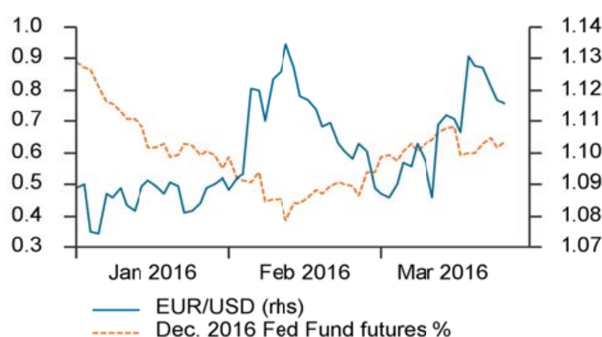
The impact on the EUR/USD exchange rate from the lesser divergence between the ECB and Fed should be a reduction in the directional component of exchange rate movements in favour of "range-bound" movements.

The ECB's ultra-accommodative position would push the euro downwards, but the downside should be limited because in the meantime, the Fed is taking a break from rate hikes. Thus, during the downward phase, the key support area could be around the lows reached last year of EUR/USD 1.05-1.04.

On the other hand, at a certain point later in the year, the ECB will (presumably) no longer have to increase monetary stimulus, which should enable the euro to strengthen. Meanwhile, however, the Fed will resume its rate hikes, which should limit the euro's upside, with a resistance area around the highs of last year between EUR/USD 1.15-1.20.

This could be seen at the end of the ECB's last meeting (10 March). Then, the euro fell, as soon as new stimulus measures exceeding expectations were announced. Shortly afterwards, however, it rallied, and gained more than it fell, because during the press conference, Mario Draghi suggested that with the March cuts, rates may have already reached their lows. Similarly, following the Fed's last meeting (16 March), the euro rose significantly, because now the majority of participants in the FOMC see two rate hikes occurring over the year instead of the four estimated in December.

Fig. C - EUR/USD vs market expectations for Fed Funds



Source: Thomson Reuters-Datastream

Fig. D - Euro and ECB refi rate

Source: Thomson Reuters-Datastream

Thus, in our central scenario, the euro is expected to fall further in the first half of the year, following the rally registered after the FOMC meeting in March. The Fed Fund rate rises, which have already been priced in by the market, remain very cautious, even with respect to the path projected by the Fed.

Later, however, in the second half of the year, when the ECB stops increasing monetary stimulus, the euro should start to strengthen again.

Generally, even over the short term, the risks of such a scenario could be slightly skewed to the upside for the euro: during the final period of an expansionary monetary policy phase, downward pressures on the exchange rate come to an end.

YEN

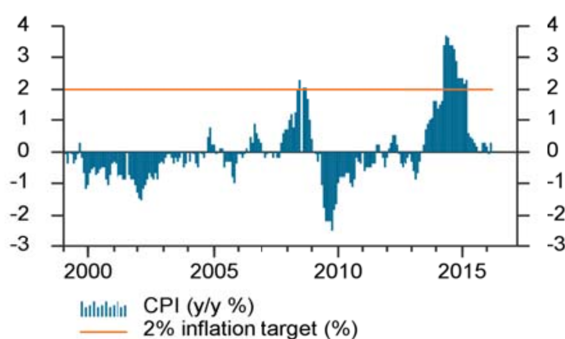
First, negative rates, then time-off, but the yen is likely to resume its decline.

The BoJ also began the year by stepping up monetary stimulus with the unexpected adoption of a negative interest rate, at -0.10%. The yen weakened upon the announcement, but only slightly, and more importantly, not for every long. It fell from USD/JPY 118 to 121 against the dollar, and from EUR/JPY129 to 132 against the euro.

The drop was extremely short-lived, since the increased risk aversion triggered by renewed concerns for the global economy at the beginning of the year quickly prevailed over the central bank's measure. Thus, the Japanese currency quickly rallied, and more than made up for the post-BoJ drop. It appreciated to USD/JPY 111 against the dollar (a high last seen in October 2014 when the Bank of Japan expanded QQE) and to EUR/JPY 122 against the euro (a level abandoned even earlier, in April 2013).

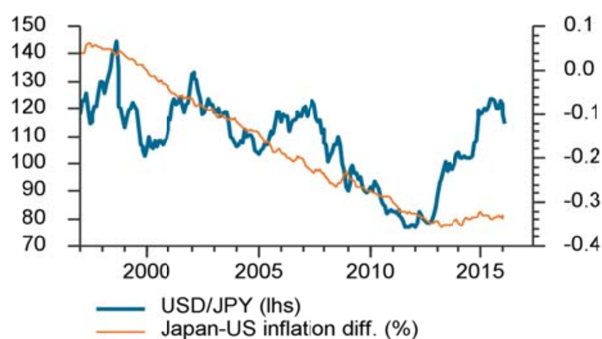
However, the yen is expected to resume its decline in the next few months. Given the prevailing downside risks on both growth and inflation, the BoJ may again expand monetary stimulus measures if necessary. At the same time, the Fed will resume rate hikes. During the period of maximum divergence between the BoJ and Fed, the exchange rate should be within the USD/JPY 120-125 range, in the second and third quarters. The low recorded by the yen last year was USD/JPY 125, and is the level closest to the all-time low of USD/JPY 135 recorded in 2002. The anticipated decline of the yen is also likely to apply against the euro, with a fall to the EUR/JPY 135-140 range later in the year.

Fig. E - The inflation target eludes the BoJ



Source: Thomson Reuters-Datastream

Fig. F – Yen's fall excessive relative to inflation differentials



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

We cannot rule out that the Japanese currency will fall below the lows seen last year to within the USD/JPY 125-130 against the dollar, but in our central scenario, downside is limited, for the following reasons:

(1) the BoJ has little room for further monetary stimulus: at the current QQE conditions and interest rate levels, the marginal effectiveness of additional measures is being reduced;

(2) if equal monetary stimulus is applied, the yen will react much more to the BoJ than to the Fed;

(3) at least part of the lack of monetary stimulus can be offset by fiscal policy, with a new package of expansionary measures (in the coming months, the tax hike on consumption planned for April 2017 could also be postponed);

(4) the yen has strengthened considerably in the last few years, and its nominal effective exchange rate is close to its all-time high (fig. 3), but its real effective exchange rate recently hit its all-time low (fig. 9);

(5) Japan's current account balance in its balance of payments is again well into positive territory (around 3% of GDP);

(6) the difficulty encountered by the BoJ in pursuing the inflation target (fig. E) does not allow inflation differentials between Japan and the US (fig. F) to reverse rapidly in a direction that would prompt the yen to weaken significantly against the dollar.

With regard to the short term, the risks for the yen could be more to the upside, i.e. a stronger yen than expected (the low end of the USD/JPY 110-115 range, or a possible risk of a temporary downside breakout of USD/JPY 110.00), mainly for three reasons: (1) at the March meeting, the BoJ took a break from rate cuts; (2) the Fed instead took a break from rate hikes; (3) uncertainties over the global economy could re-emerge, resulting in a temporary resurgence of risk aversion.

STERLING

The burden of the EU referendum (23 June).

The pound fell significantly at the beginning of 2016, largely due to the Brexit issue: the referendum for a possible withdrawal from the EU will be held on 23 June. The pound fell to GBP/USD 1.38 against the dollar, which was below last year's low of GBP/USD 1.45, marking a return to levels last seen in 2009, at GBP/USD 1.35, which was the lowest since 1985. The decline against the euro was much more limited, to EUR/GBP 0.79, which was very close to last year's low of around EUR/GBP 0.78.

On the back of fears relating to the negative economic impact of a possible exit from the EU, the market has significantly revised downwards its projections for BoE rate (currently at 0.50%) hikes. In January and February, futures went from two hikes of 0.25 bps to no hike this year, postponing the beginning of the policy reversal (fig. G) entirely to next year. The revision is even greater compared with March 2015, when the market projected four hikes of 0.25 bps by the end of 2016.

One comment that can be made regarding the extent of the most recent drop is that, at least from the exchange rate viewpoint, the market seems to have fully priced in the scenario of no rate rises from the Bank of England this year. Thus, further downside for the pound in relation to the timing of the rate reversal should be relatively limited, and thus, further falls, especially below the end-February lows of around GBP/USD 1.38, are mainly likely to be seen in the event of negative developments on the Brexit front, or in any case, in the event of extremely disappointing data on the domestic economy.

For the pound, the intersta rate decisions of the Bank of England in relation to the Fed and ECB are secondary to the Brexit issue. Uncertainty over the outcome of the referendum keeps risks to the downside for the UK currency, and significantly limits upside even with positive domestic data.

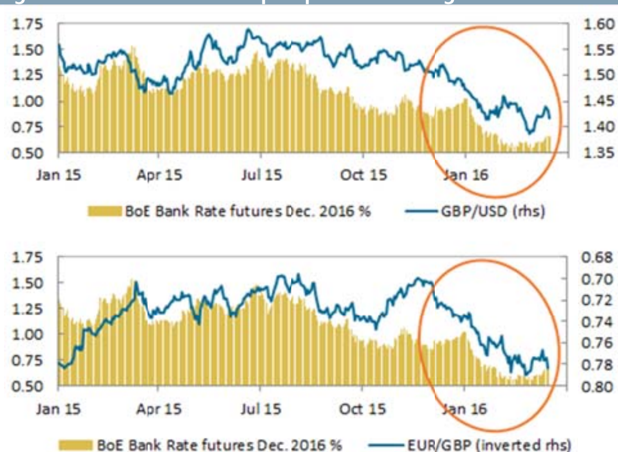
Surveys on voter intentions are inconclusive with regard to preferences: the margin of advantage for yes votes (those wishing to stay in the EU) compared to no votes (those wishing to leave) ranges between +5% and -4% in the recent surveys conducted online. Only in telephone surveys is there a clear advantage of yes votes, of between +12% and +18%. In both cases, the number of undecided voters is very high: an average of 13% in February in telephone surveys and 19% in online surveys.

From now until June, the exchange rate may respond to changes in sentiment that emerge from surveys if a clear trend should arise. Since it will be undecided voters who make the difference in the outcome of the referendum, the tone of the referendum campaign is likely to be bitter, partly due to disagreements within the Conservative governing party. In fact, while Prime Minister David Cameron is heading the yes vote faction, the (Conservative) Mayor of London, Boris Johnson, is campaigning to leave.

The Chancellor of the Exchequer George Osborne announced that by mid-April the Treasury will publish an in-depth analysis on the costs/benefits of remaining in the EU and the risks associated with a possible exit. Osborne has also stated that if the "leave" campaign wins, the economy would suffer an immediate shock and pay other costs over the long term.

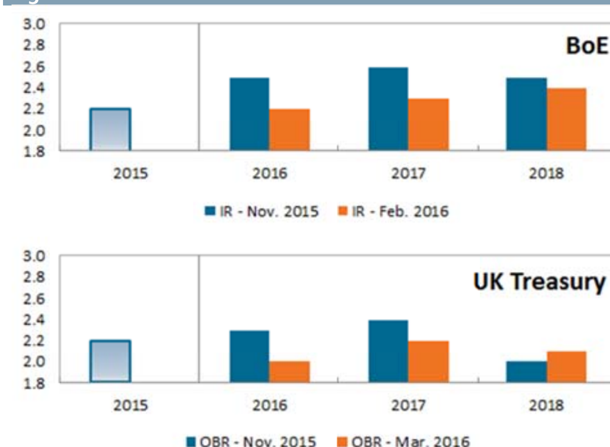
The period of transition in the event of a Brexit would be very complex and very long. According to the Treasury, uncertainty could last for a decade or more, and in any case, well beyond the two-year limit set by the Treaty for completion of the negotiations to redefine relations between the UK and EU. In fact, this would be an unprecedented case, and the uncertainty would have clear repercussions on financial markets, investments and the pound. In addition to revising its relationship with the EU, the UK would have to actually renegotiate all trade agreements with non-EU countries, i.e. with the rest of the world. In a report published at the end of February on procedures that would be triggered in the event of a "leave" vote, the Treasury actually expresses its preference to remain in the EU in light of the new (more favourable) "special member state" status that the UK managed to agree on with the EU at the important summit on 18-19 February in Brussels.

Fig. G - First BoE rate hike postponed: sterling's fall



Source: Thomson Reuters-Datastream

Fig. H - Growth revised downwards



Source: Bank of England and Office for Budget Responsibility (OBR)

- In the event of a "yes" vote

In the event of a "yes" vote, and thus, if the UK remains in the EU, the market should shift its focus back to domestic growth and inflation, and thus, on when the Bank of England can start raising rates. In fact, the immediate impact of a "yes" vote should be positive for the pound, with a return to the range of GBP/USD 1.45-1.50 against the dollar, and a return to EUR/GBP 0.75 against the euro.

Assuming the first BoE rate hike is in the fourth quarter of this year/first quarter of next year, the pound is likely to strengthen further (towards GBP/USD 1.55 against the dollar and in the EUR/GBP 0.75-0.70 range against the euro over a period of about 12 months). At present, **the Bank of England's rate hike strategy priced in by the market is extremely conservative,** with just one, or at most two, hikes in 2017. If the UK remains in the EU, the short-term macro outlook cannot be worse than it would be in the event of a "leave" victory. In fact, not only has the market already significantly revised down the BoE rate hike path, but **both the BoE and government (OBR) has revised growth and inflation projections down** (fig. H). In the February Inflation Report, the BoE lowered growth projections for the entire 2016-2018 period: from 2.5% to 2.2% this year, from 2.6% to 2.3% next year and from 2.5% to 2.4% in 2018. Similarly, on 16 March, when the government submitted its budget, it lowered growth projections from 2.4% to 2.0% in 2016, from 2.5% to 2.2% in 2017 and from 2.4% to 2.1% in 2018.

With regards to inflation, the BoE has revised its projections downwards from 1.2% to 0.8% for end-2016, and from 2.0% to 1.9% for end-2017. The projection for the end of 2018 remained unchanged at 2.2%. The OBR has also revised its inflation projections downwards from 1.0% to

0.7% this year and from 1.8% to 1.6% next year. However, it slightly raised the projection for 2018 from 1.9% to 2.0%.

In both cases, the assumption underlying the forecasts is that the UK will remain in the EU.

- In the event of a "leave" vote

In the event of a "leave" vote, the pound would probably fall immediately, due to the numerous unknown issues relating to Brexit, an unprecedented event. The most likely scenario is that there would be a swift and substantial drop in investments, along with a significant slowing of growth, resulting in the Bank of England deciding not only not to raise rates, but to further relax monetary policy. All this would be accompanied by an increase in inflation.

While we cannot provide a reliable projection of the anticipated depreciation of the exchange rate, we can draw up various hypotheses. Against the dollar, the first downside target would be GBP/USD 1.35, the 2009 low, with a possible incursion between GBP/USD 1.35 and 1.30; these levels were last seen in 1985, when the pound fell to an all-time low of GBP/USD 1.05. With regard to the euro, the downside would likely be limited to the EUR/GBP 0.80-0.85 range, assuming that the euro will also, at least in part (and at least initially), be negatively affected by the announcement of a "leave" vote. If instead the euro benefits from this, the pound would register a greater correction, towards the EUR/GBP 0.85-0.90 range. However, in relation to the euro, these lows were only recently left behind (2013), while the (projected) lows against the dollar are more striking.

As a precautionary measure against likely market turbulence in the event of a "leave" victory, the BoE has planned additional injections of liquidity near the time of the referendum on 23 June, and it claims it is ready to take other measures as necessary to safeguard the stability of the financial system in general, and to offer support to banks in particular.

The risks of the scenario for the pound are to the downside, meaning that the pound, while responding favourably to a "yes" vote, may then rise less than expected due to a deterioration in the macroeconomic outlook, regardless of the outcome of the referendum. In this respect, the BoE Inflation Report due to be published on 12 May will be crucial. In this case, the new growth and inflation projections will incorporate the impact that the uncertainty over Brexit has had on the domestic economy at the beginning of the year.

Thus, data released from now until the beginning of May will return to the market spotlight during this period, mainly inflation on 12 April and Q1 GDP figures on 27 April.

Fig. 1 – Dollar, nominal effective exchange rate

Source: Thomson Reuters-Datastream

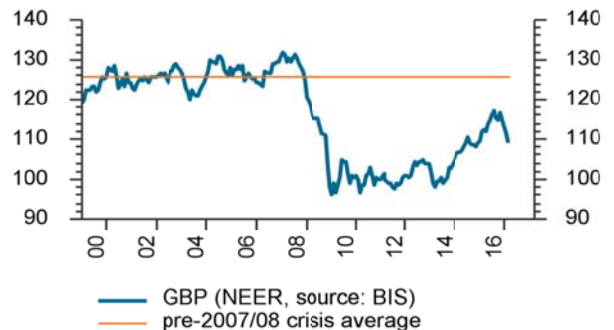
Fig. 2 – Euro, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate

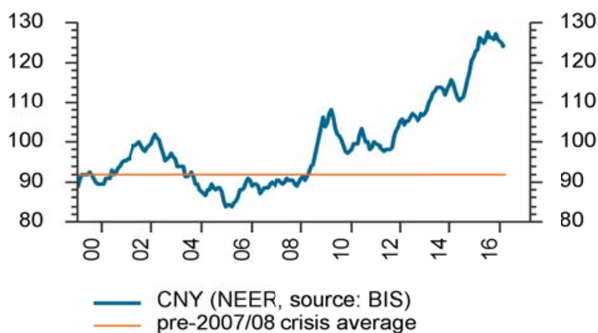
Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 5 – Yuan renminbi, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 7 – Dollar, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate

Source: Thomson Reuters-Datastream

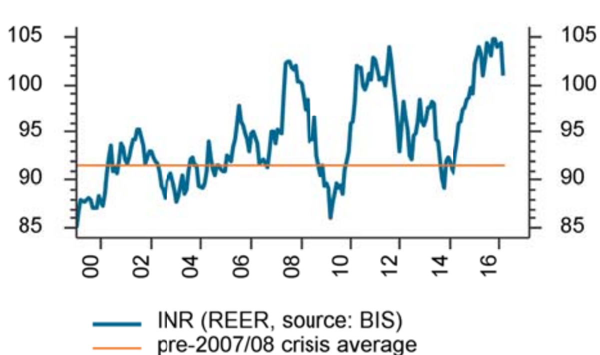
Fig. 10 - Sterling, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate



Source: Thomson Reuters-Datastream

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Appendix

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