BANCA IMI

Macroeconomic Outlook

Research Department
June 2015

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INTESA SANPAOLO

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June 2015

Quarterly

Intesa Sanpaolo
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Based on information available up to 25.06.2015

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

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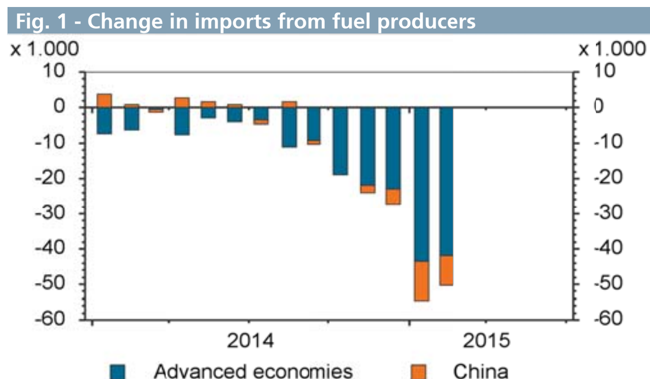
The emerging markets driver loses its sheen

Luca Mezzomo

Despite the Greek crisis, the outlook remains favourable to a strengthening of the recovery in the Euro zone. Having got through the usual negative first quarter, the US will return to modest growth, despite the impact of the strong dollar. However, the slowdown in the main emerging countries will largely offset the upturn in advanced economies. Unfortunately, non-conventional monetary policies are not having any miraculous effects on global growth, which will remain slow.

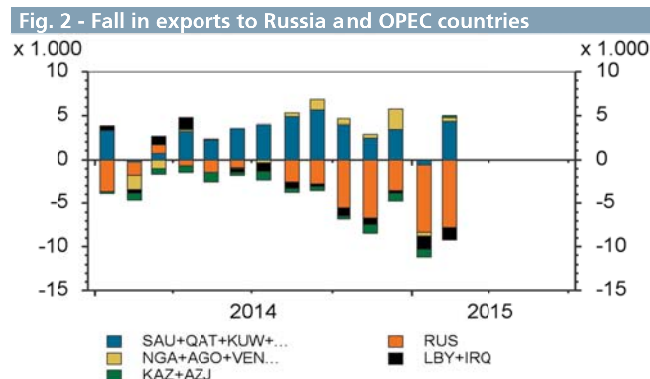
For months, economic data has been a little better than forecast in Europe, and a little worse in the US and in Asia. Likewise, the underlying trend has been towards an upturn in growth in Europe, albeit at extremely low levels, and towards a slowdown in the US and China. Overall, we cannot see any tendency towards more sustained growth in the global economy, despite accommodative financial conditions in advanced countries and the impetus that could result from the fall in oil prices. On this last front, savings on energy bills that are benefiting advanced countries and China are only partly offset by the fall in imports from oil-producing countries (significant for Russia alone, and more owing to the economic sanctions than the fall in energy prices). This impetus will gradually decline in the next few months, which could however be affected by a redistribution of the purchasing power released, and initially saved, by households.

Fig. 1 - Change in imports from fuel producers



Figures in USD million; changes compared with previous year.
Source: IMF, DOTS, via Thomson Reuters-Datastream

Fig. 2 - Fall in exports to Russia and OPEC countries

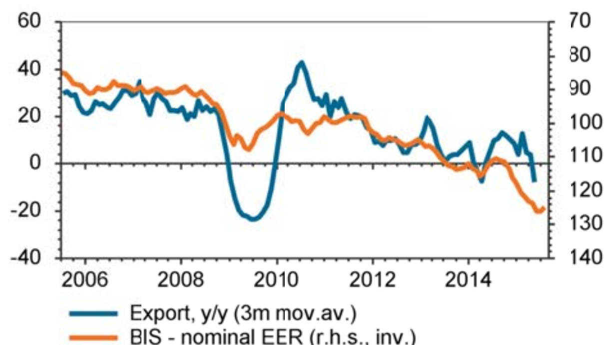


Figures in USD million; changes compared with previous year.
Source: IMF, DOTS, via Thomson Reuters-Datastream

The contrasting performances by region reflect both local factors (for example, very different winter weather in Europe and the US, excessive debt in China), and the consequences of currency movements, which in turn relate to diverging trends in monetary policies. Exports are treading water both in the US and China (see figs 3 and 4), and although not all of this decline is due to exchange rates, the loss of competitiveness is undoubtedly an important factor.

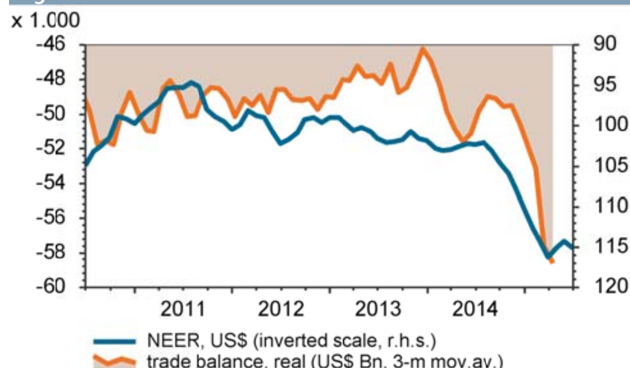
The consequences of the strong dollar have yet to be fully felt, and we do not believe that the trend in the exchange rate will reverse before monetary tightening is implemented in the US. Our theory is that the first rate hike in the US could be accompanied by a final period of a rising dollar on the currency markets before the end of the year. The performance of the Euro zone should therefore continue to benefit from the drive provided by exports, albeit offset more than previously by growth in imports, while the substitution of domestic production with imports could continue in the dollar area, restraining GDP growth.

Fig. 3 – China: exports and nominal effective exchange rate



NB: the exchange rate lags by three months. Source: Thomson Reuters-Datastream

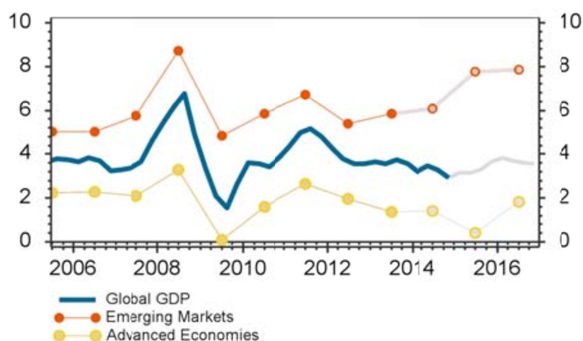
Fig. 4 – USA: trade balance and dollar



Source: Thomson Reuters-Datastream

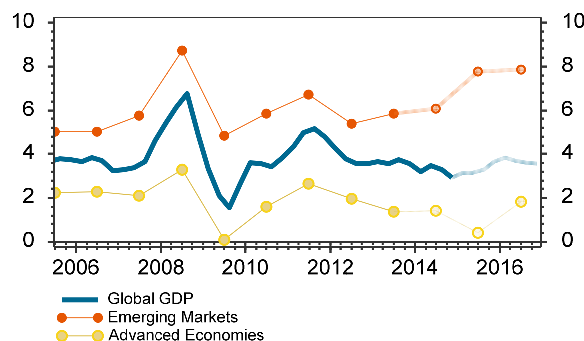
The negative surprise of the first quarter alone explains almost all the revision to the annual average growth forecast for the US, which has now fallen to 2.2%; in reality, the forecast scenario has been confirmed, and we expect to see a net upturn in domestic demand in Q2, which will be boosted by a return to normal weather and the recovery in port activity. Estimates for China have also worsened significantly, but in this case, temporary factors play a marginal role. The country is experiencing a slowdown in exports at the same time as a downturn in capital spending, both on construction and on machinery and plant: despite the economic policy reaction (infrastructure investment plans, easing of monetary policy and restructuring of local authority debt), we believe that growth could continue to fall also in 2016, to 6.5%.

Fig. 5 - Higher GDP growth for advanced countries, slower for emerging countries



Source: Intesa Sanpaolo and Oxford Economics (via Datastream Charting)

Fig. 6 - Inflation recovering from 2015 to 2016



Source: Intesa Sanpaolo and Oxford Economics (via Datastream Charting)

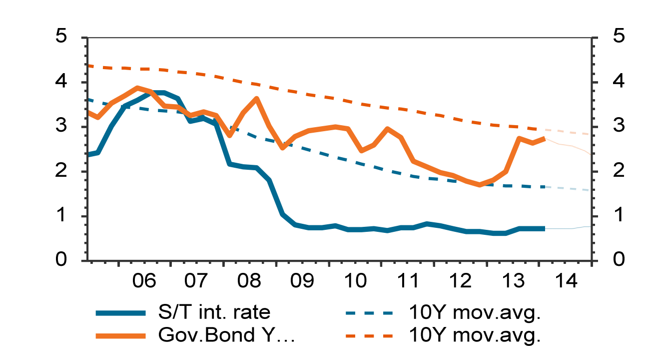
The slight trimming of our estimate for the Euro zone from 1.5% to 1.4% is due to the combination of a series of small downwards revisions to the outlook, relating to the exchange rate, higher medium- and long-term rates than in the first month of the EAPP, the absence of clear signs of an upturn as we moved into 2Q, and finally, the negative impact on confidence of the Greek crisis. With regard to the latter, even if an agreement is reached in the near future, the risk of insolvency will remain significant for a long time, owing to risks relating to the implementation of the programme and the need to negotiate a more lasting solution from the outset. However, we consider that the new instruments introduced by the ECB (mainly the EAPP), the other crisis management mechanisms and the more favourable environment would limit the impact of a Greek default on other countries. As for prices, we can only confirm that we expect inflation to rise: as predicted, the fall in prices was closely linked to trends in energy commodities, and came to a halt as these stabilised.

Economic growth by geographical region	2012	2013	2014	2015	2016
United States	2.3	2.2	2.4	2.2	2.9
Japan	1.7	1.6	-0.1	0.9	1.7
Euro zone	-0.8	-0.3	0.9	1.4	1.8
Eastern Europe	2.3	1.8	1.3	-0.5	2.3
Latin America	2.6	2.5	1.0	0.4	1.8
OPEC	5.8	2.2	2.2	2.1	3.4
East Asia	6.1	6.1	6.4	6.1	6.2
Africa	3.1	3.1	3.9	3.8	4.5
World growth	3.4	3.3	3.3	3.2	3.5

Source: Intesa Sanpaolo data

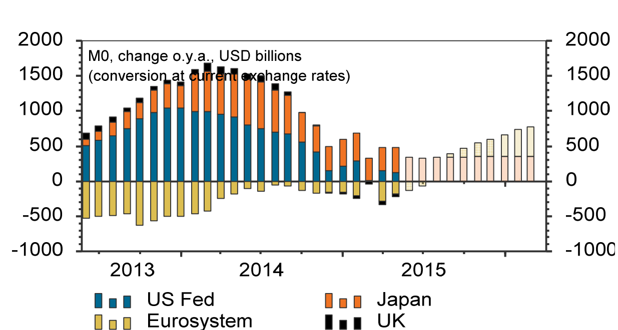
The experience of the last few months shows both the power and limitations of the non-conventional monetary policies implemented by the central banks in the last few years. They have been unquestionably effective in mitigating the effects of the financial crisis, and we have recently seen the power of asset purchase programmes in combating the risk of contagion in the Euro zone faced with the risk of a collapse in Greece. In addition, even if this remains taboo, they could represent an ideal solution to contain the negative effects of an excessive stock of public or private debt, to facilitate its management, and finally, also a means to subsequently restructure it without destabilising the financial sector.

Fig. 7 - Short- and long-term interest rates low compared with historic averages



Source: Thomson Reuters-Datastream Charting and Oxford Economics

Fig. 8 - Monetary expansion continues, driven by the ECB and the BoJ



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

Much less clear, however is how much they contribute to relaunching the real economy. Their impact through exchange rates can be seen through the substitution of domestic production with foreign production; in such cases, this generates effects on external accounts that are inconsistent with the reduction in international imbalances; furthermore, if implemented by "large" countries, it is likely to trigger an arms race among central banks that may take everything back to square one. Undoubtedly, the compression effect on the rates curve has positive effects on debt servicing, and – through lower interest spending – may either allow debt reduction to be speeded up, or enable a more accommodative bias in fiscal policy to be maintained. However, the transmission to private demand for capital goods no longer seems to really respond to central bank stimulus, which is offset by lower expectations on the outlook for demand, driven by delocalisation and pressure on profitability. The risk is that the upturn in risk tolerance remains confined to the financial sector, fuelling speculative bubbles more than economic recovery - although we are confident that, to some extent, it is a matter of lags in the transmission of the impulse.

Commodities: sideways markets

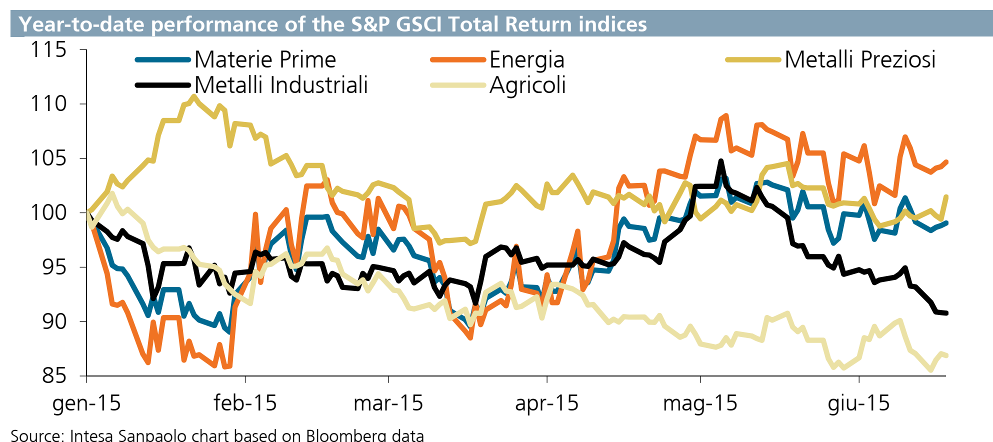
Daniela Corsini

We maintain our forecast that, after few months of sideways markets, we are likely to see an overall rise in prices for most commodities by the end of the year, thanks to the expected improvement in fundamentals. Specifically, we expect the markets of industrial metals and some precious metals (excluding gold) to become tighter amid a slowdown in supply and an upturn in demand. We confirm our scenario of persisting oversupply on crude oil markets, and forecast that it will take several months before markets become balanced. Furthermore, we currently consider downside risks to be more significant than upside risks, owing to the probable suspension (even partial) of sanctions against Iran by the end of the year.

In the second quarter of the year, oil prices undertook a rapid recovery, mainly concentrated in April, and then stabilised within a relatively narrow trading range in May and June. Conversely, industrial and precious metals and agricultural commodities are en route to end the quarter very close to the levels recorded at the end of March.

Stripping out the marked rebound in oil, which was mainly due to a physiological recovery after the excessively low levels recorded at the beginning of the year, this overall stability within the segment was brought about by particular macroeconomic conditions: the expected upturn in the global economy missed expectations, albeit partly due to temporary factors that hampered the performance of the US economy, and partly due to the uncertainty surrounding the result of negotiations over the Greek crisis, which had a negative effect on the confidence of consumers and companies in the Euro Zone; the Federal Reserve has not yet indicated when it will first raise rates, abandoning its forward guidance in favour of an approach that is much more dependent on macroeconomic data; the dollar has remained broadly stable, after the sharp rise recorded in the first quarter. In addition, geopolitical tensions have remained in the background, and have not affected prices for long periods, although tensions in Ukraine and the Middle East are still very high, and in our view, the recent terrorist attacks in Saudi Arabia represent a significant threat to regional balances.

Year-to-date performance of the S&P GSCI Total Return indices



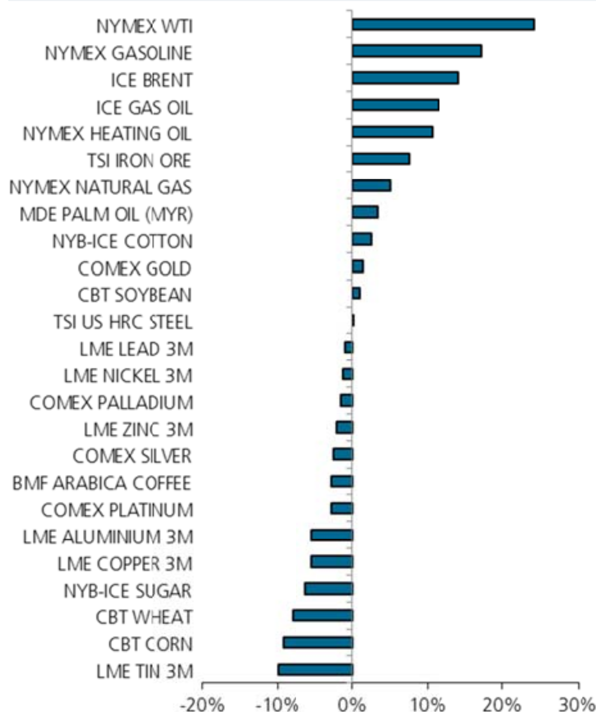
Source: Intesa Sanpaolo chart based on Bloomberg data

In the next few months, we are again likely to see most commodities markets move sideways, at least until there is a significant structural break from the past: the first rise in interest rates by the Fed or a geopolitical shock, such as a definitive agreement between Iran and international powers involving the rapid removal or suspension of international sanctions.

The main risk for agricultural markets is the weather, and in particular the possibility of a severe episode of El Niño, a periodic oscillation of the oceanic and atmospheric system linked to changes in temperature in the tropical Pacific Ocean that disrupts climatic patterns over huge

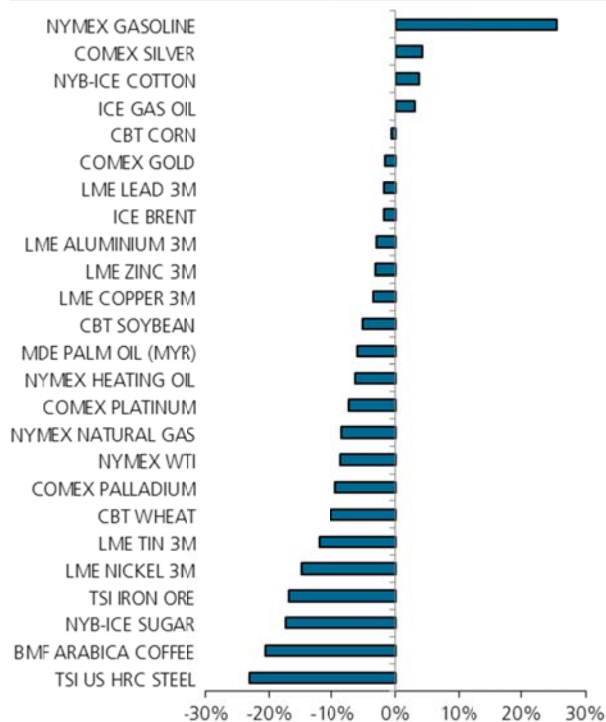
areas, normally bringing drought to South-East Asia and India, and higher than normal rainfall to South America. According to the latest forecasts published by the Australian Bureau of Meteorology, all climactic models suggest that the El Niño phenomenon is developing in the Pacific Ocean and that sea surface temperatures may remain above the threshold for the rest of the year. Furthermore, the broad spread of the phenomenon suggests that the El Niño event could be as severe as in 1997-1998, the strongest ever. Other weather forecasters warn that the phenomenon could even last until mid-2016.

Performance in 2Q15 up to 18.06.2015



Source: Intesa Sanpaolo chart from Bloomberg data

Performance in 1Q15



Source: Intesa Sanpaolo chart from Bloomberg data

Our forecasts for the commodity universe

Currently, we maintain our forecast that, after few months of sideways markets, we should see an overall rise in most commodities prices by the end of the year, thanks to the expected improvement in fundamentals. Specifically, we expect that the markets of industrial metals and of certain precious metals (particularly palladium) will become tighter amid a slowdown in supply and an upturn in demand.

We forecast that by the end of the year, industrial metals prices - particularly copper, nickel and zinc - will respond to the generally tighter supply and demand fundamentals. The markets will be mainly driven by the evolution in macroeconomic data in China and the consequent expectations of new stimulus measures from the Central Bank and the Government, as well as by the strength of the US dollar and news regarding world production and inventories. The situation is different for aluminium, where the market is expected to remain in substantial surplus for a long time to come. In fact, fundamentals significantly deteriorated for this metal in the first few months of the year, due to the abundant Chinese output, favoured by the slump in marginal production costs that followed the fall in energy input prices, and due to the consequent increase in Chinese exports. In addition, the new rules on the London Metal Exchange (LME) have enabled a substantial drop in inventories at official warehouses, which should further accelerate by the end of the year thanks to the higher decay factor which will be

implemented from August (for each specific warehouse, companies will have to withdraw a volume of metal equal to the volume delivered, so a new factor of 1 will be applied, up from the current 0.5), and the implementation of new rules intended to promote transparency about warehouse incentives and activity.

As regards precious metals, we maintain our negative view on gold. In fact, we expect that the Fed's forthcoming policy reversal may erode much of the support provided to this metal's prices early this year, while the overall improvement in the global macroeconomic cycle, once the uncertainties regarding the outcome of the negotiations with Greece have been resolved, is likely to discourage demand for gold as an investment. Furthermore, we expect demand for physical gold in emerging countries to miss consensus expectations, amid lower oil income in Middle Eastern countries and a monsoon season less favourable than the historical average.

We continue to expect a rise in the prices of palladium, silver and platinum over the year, on the back of the expected recovery in industrial demand, but we see as a main risk a more abundant than expected supply from both mining output and recycling activities.

The situation of excess supply on crude oil markets looks set to continue. At the half-yearly meeting of 5 June, OPEC rolled over its production target of 30 million barrels a day (mb/d), but the group continues to produce well above this level. Despite falling non-OPEC supply and stronger-than-expected global demand in the first few months of the year, we expect it will take many months before markets become balanced. For this reason, prices are set to remain low for a long time, and we repeat our end-of-year target of USD 70 per barrel for Brent. Currently, we view downside risks to be more significant than upside risks, owing to the probable suspension (even partial) of sanctions against Iran by the end of the year.

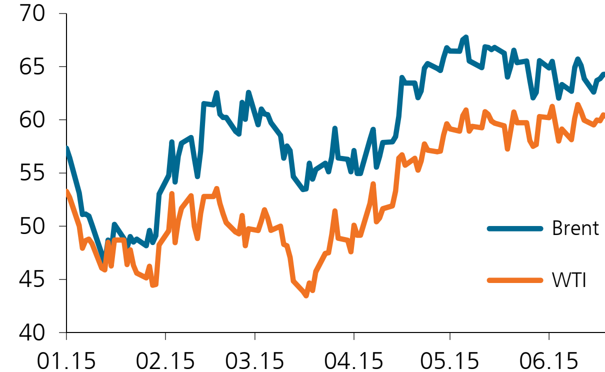
As regards agricultural commodities, the most important (and most difficult to forecast) variable will be weather conditions. The current low prices of cereals are justified by the expectation of very high final inventories and a drop in energy input costs. However, we are likely to see a moderate recovery for wheat and corn by the end of the year, driven by an improvement in fundamentals.

Oil: volatility due to geopolitical risks, supply estimates

Given the current supply and demand fundamentals, we expect prices to remain in trading range over the next quarter. However, we would highlight that volatility could prove particularly high, since news on the geopolitical front, weekly figures about U.S. inventories, production and oil rig count, monthly data published by the main OPEC producers about production, exports and official selling prices, will trigger market swings between phases of excessive pessimism and optimism. We expect prices then to recover by the end of the year, given the expected gradual absorption of the current oversupply.

In the second quarter, oil prices quickly gained ground, firmly returning to around (or just above) the level of USD 60, which we indicated as the probable equilibrium price for the middle quarters of the year, estimated at the beginning of the year based on marginal production costs for the most dynamic supply components, namely shale oil. The spread between Brent and WTI has narrowed significantly since the beginning of the year, falling below USD 4 in June, thanks to easing concerns about the massive stock increase in the US. In North America, the number of active drilling rigs has been falling steadily since December (now at its 2010 lows in the US), and finally led to a slowdown in US production. The lower growth rate in supply and the rise in demand from refineries, ahead of the high seasonal demand for refined products, enabled total oil stocks to fall, easing fears that storage capacity at Cushing could run out.

Brent and WTI prices since the beginning of the year

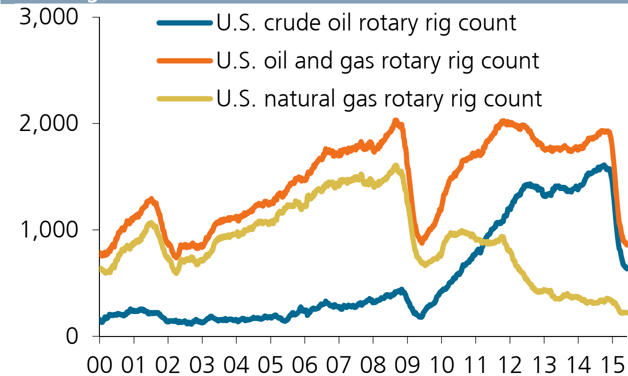


Source: Intesa Sanpaolo chart from Baker Hughes data

Brent-WTI spread

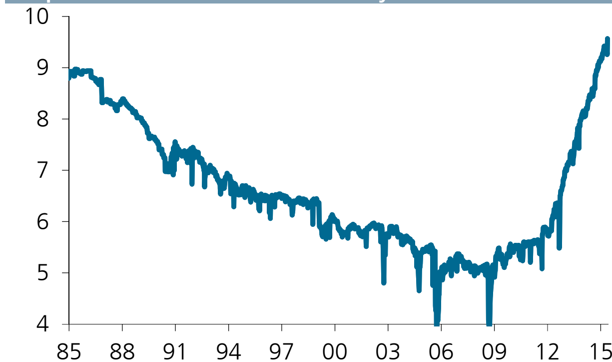
Source: Intesa Sanpaolo chart from US DOE data

US oil rig count



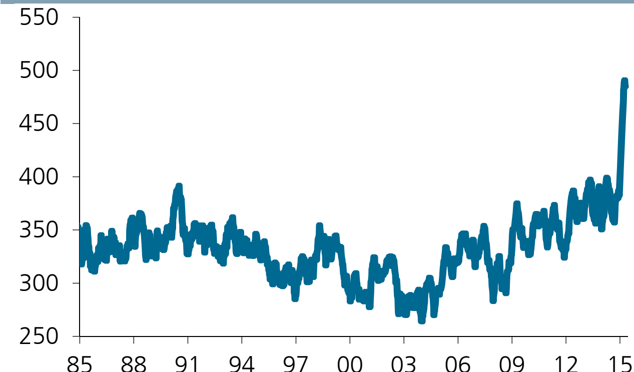
Source: Intesa Sanpaolo chart from Baker Hughes data

US production in million barrels a day



Source: Intesa Sanpaolo chart from US DOE data

US total oil stocks in million barrels



Source: Intesa Sanpaolo chart from US DOE data

Stocks at Cushing in million barrels

Source: Intesa Sanpaolo chart from US DOE data

Supply and demand fundamentals

The latest figures published in the monthly reports of OPEC, the US Energy Information Administration (EIA) and the International Energy Agency (IEA) show a relative deterioration in the supply and demand fundamentals compared with the estimates published in March. In fact, now the three forecasters expect, on average, a "call on OPEC crude" (i.e. the quantity of oil that the group must provide to balance the markets) lower than the level estimated in March,

equivalent to an average of approximately 29.1 million barrels a day (mb/d), following an overall upwards revision of non-OPEC supply estimates.

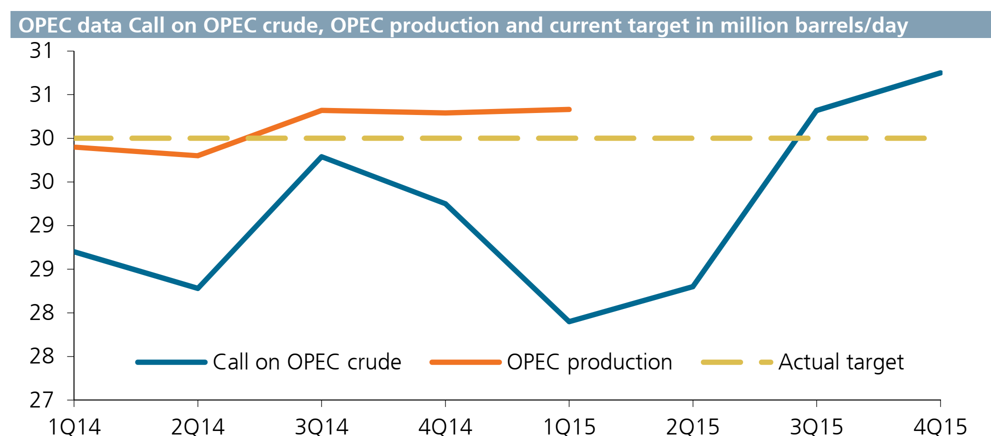
Supply and demand estimates for 2015, published by OPEC, IEA and EIA

Estimates in June 2015, in millions of barrels	Total demand	Non-OPEC supply	OPEC supply of LNG	Call on OPEC Crude
OPEC	92.5	57.2	6.0	29.3
vs. 2014	1.2	0.7	0.2	0.3
IEA*	93.6	57.8	6.6	29.2
vs. 2014	1.1	0.8	0.2	0.0
EIA	93.3	58.2	6.4	28.8
vs. 2014	1.3	1.3	0.1	-0.2

*Estimates in May 2015
Source: Intesa Sanpaolo chart from data published by the Organisation of Petroleum Exporting Countries (OPEC), the US Energy Information Administration (EIA) and the International Energy Agency (IEA)

Overall, the three main monthly reports confirm that there is substantial oversupply. On average, the "call on OPEC crude" is significantly lower than the 30 mb/d group's cumulative target and the actual OPEC production recorded in the last few months, close to its historic highs. However, we expect an overall improvement in the second half, and the latest estimates (which currently do not include a marked rise in Iranian output) indicate that the markets should came back in balance by the end of the year. Clearly, it will take several quarters to absorb the high level of stocks accumulated.

OPEC data Call on OPEC crude, OPEC production and current target in million barrels/day



Source: Intesa Sanpaolo chart from OPEC data

OPEC supply is close to its historical highs, driven by record production in Saudi Arabia and Iraq, and this has led to a significant downwards revision of OPEC spare capacity estimates (i.e. excess production capacity, mainly concentrated in Saudi Arabia) reported by the EIA in its Short Term Energy Outlook. According to the June estimates, spare capacity should contract to 1.8 mb/d in 2015 and rise to 2.1 mb/d in 2016, from an average 2.0 mb/d in 2014. In March 2015, it was estimated that it would increase to 2.1 mb/d on average for 2015, and in December 2014, an increase to 2.5 mb/d on average for 2015 was forecast. The EIA explains that normally spare capacity of less than 2.5 mb/d is an indication that the markets are tight, but that the substantial stock building recorded up to now makes this estimate less representative. In general, we believe that the reduction under way in OPEC spare capacity would make global markets particularly vulnerable to potential unexpected shocks involving a significant reduction in supply. However, we should highlight that, considering global supply, current geopolitical risks are unbalanced to the upside rather than the downside, given the expectation that negotiations between Iran and the global powers will make progress. If an agreement were to be reached by the deadline of 30 June, or in the subsequent weeks, it could lead to the immediate suspension of sanctions and immediately release onto the market around 40 million barrels of oil stored at

sea (according to Iranian sources). In addition, Iran estimates that it could expand production by at least 1 million barrels a day within six to nine months.

Libya also estimates, very optimistically, that it will again increase its production to 0.8 mb/d by the end of July, approximately doubling its current output of 0.40 – 0.46 mb/d.

Forecasts

Given current supply and demand fundamentals, we forecast prices in trading range over the next quarter. However, we would highlight that volatility could prove to be particularly high, since geopolitical news, weekly data on inventories, production and number of active drilling rigs in the US, and monthly data on production, exports and official selling prices published by the main OPEC producers, will trigger market swings between phases of excessive pessimism and optimism.

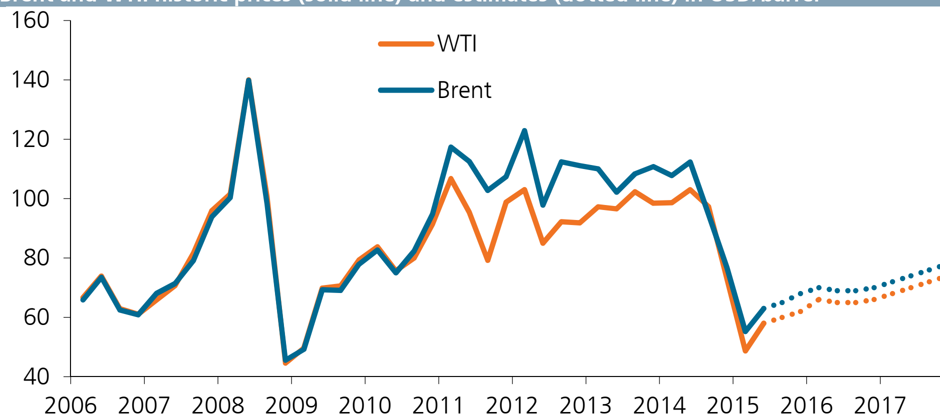
We forecast that Brent will trade within a range of USD 50-75 in the second half. We forecast an average price of USD 65 per barrel in 3Q, and a subsequent recovery to USD 70 by the year-end, given the expectations of a balanced market by the end of 2015. For FY15, we estimate an average price of USD 62.80.

We forecast that WTI will trade within a range of USD 40-70 in the second half. We estimate an average price of USD 60 for WTI in 3Q15 and set a target price of USD 65 for the end of the year. We therefore estimate an average price of USD 57.20 for FY15. We currently forecast an average spread of around USD 5 in the second half of the year, and of USD 4 for 2016, in line with structurally higher transport costs for oil obtained through non-conventional extraction methods.

In our baseline scenario, we forecast an (at least temporary) agreement between Iran and the P5+1 powers (US, U.K., France, Russia, China and Germany) by the end of the year, and the resulting suspension of international sanctions. We expect an initially highly negative reaction in anticipation of the agreement, due to fears of a sharp initial rise in oil exports, but subsequently, oil prices should recover, and return to levels consistent with the strength of the global economy and the signs of a slow improvement in supply and demand fundamentals. Furthermore, Iranian production is expected to rise very slowly and gradually, and exports are seen stabilising at least for a few months at levels much lower than the average levels preceding the imposition of international sanctions. Consequently, we believe that the impact of the increased Iranian supply on the global market will only be evident from 2016.

A further downside factor that could weigh on the global market over the next year relates to the development of US energy policy. We believe that new measures and regulations will be proposed to alleviate US producers' problems, such as authorising exports for certain selected types of fossil fuels, as happened in 2014 for condensates. Furthermore, despite the conflict that marks the current phase of US politics, it seems that various members of Congress are now more favourable to the idea of easing or even removing the oil exports’ ban, owing to low gasoline prices and to various studies that show how the impact on the US economy would be positive overall, while negative externalities on consumers would be very limited.

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



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

Price estimates for Brent

at 17.06.2015	3Q15	4Q15	1Q16	2Q16	3Q16	2015	2016	2017
Estimate	65.0	68.0	70.0	69.0	69.0	62.8	69.5	75.0
Bloomberg median	63.5	69.0	70.5	70.0	76.0	60.0	71.0	75.0
Forwards	64.8	66.5	67.7	68.6	69.3	62.6	68.9	71.2

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

at 17.06.2015	3Q15	4Q15	1Q16	2Q16	3Q16	2015	2016	2017
Estimate	60.0	62.0	66.0	65.0	65.0	57.2	65.5	71.0
Bloomberg median	58.0	63.5	67.3	69.0	72.0	55.0	67.8	71.0
Forwards	60.9	61.7	62.3	62.8	63.1	57.4	63.0	64.4

Source: Intesa Sanpaolo chart from Bloomberg data

United States: who's afraid of another negative Q1?

Giovanna Mossetti

- Our US outlook again incorporates downward revisions to GDP forecasts, although the job market is moving continuously towards its long-term equilibrium. With a significant contraction in 1Q (-0.7% qoq ann., according to the advance estimate), forecast annual growth for 2015 is down to 2.4%. The crucial issue is the pace of underlying growth, stripping out any temporary factors. In 2016, growth is expected to come in at around 2.8%-2.9%, before slowing modestly to 2.6% in 2017.

Start-of-year slowdown: to what extent is it temporary…

- What does the recent slowdown mean? There were various headwinds weighing on growth in Q1, some temporary (weather, ports dispute), and some longer-lasting (dollar, shale oil). In addition to these restrictive factors, there was a possible residual seasonality effect: the start-of-year slowdown may be overestimated (with further seasonally-adjusted 1Q growth put at between +1.2% and +1.6% qoq ann.). On top of weak manufacturing growth, households were also cautious, despite significant rises in disposable income and net wealth: modest consumer spending was partly due to adverse weather in the winter, and partly due to uncertainty regarding the trend in oil prices. What is the actual trend for the overall economy?

… and what is the real trend?

- Growth is seen at between 2.5% and 3% qoq ann., for the rest of 2015 and 2016, with expansion driven by final domestic demand. Foreign trade is expected to make a negative contribution of a couple of tenths of a percentage point in both 2015 and 2016. We expect the output gap to close by end-2016: the CBO puts potential growth at 2.1%, the Fed at between 2.1% and 2.3%. The main drivers of the moderate growth expected in 2015-2016 are consumer spending and residential building, thanks to the positive support from labor income and households' wealth.

Moderate recovery in consumer spending, thanks to increase in net wealth…

… and the ongoing improvement on the job market

- The fundamentals of household balance sheets are on a positive and stable trend. Debt is falling (107% of disposable income, its lowest since end-2002) and wealth (both financial and real) has been rising since 2009 (see fig. 8). The saving rate is around 5.5%, a level comfortably above that of the 2000s, with monthly financial obligations at historic lows, just above 15% of disposable income (compared with an average of around 17% from 2000 to 2010). The constant improvement in net wealth, together with the healing of the labour market, provides a solid basis for growth in consumer spending of between 2.8% and 3%. Employment growth (+2.2% yoy, +3 million jobs) and the gradual recovery in wage growth (+2.3% yoy) are driving compensation (+4.3% yoy); real disposable income is up to around 3.5% yoy. Various indicators point to wage increases over the next few quarters (small business survey, Employment Cost Index, job openings). Household surveys show positive assessments of labour market prospects (Conference Board, NY Fed). At the end of 2015, the unemployment rate should be at its long-term equilibrium level (5%). The fall in unemployment also extends to wider measures, including discouraged individuals, those marginally attached to the workforce and involuntary part-time workers. Evidence of this improvement is the turnaround in household formation, which returned to pre-recession levels at the end of 2014, approximately three times the average level for the period 2007-2014.

Residential investment picking up, with increasing positive contribution to GDP

- Healthy balance sheets, an improving labour market, normal household formation and a falling stock of unsold existing homes are all positive indicators for residential investment (2015 forecast: +6.2%). Private residential investment rose to 3.3% of GDP (see fig. 4) at the beginning of 2015, higher than the lows of 2009 (2.6%), but still below the historic average (4.5%). Its contribution to growth in the next few years should more than offset the restraint linked to the correction in the mining sector, in terms of both spending and employment (December 2014-May 2015: people employed in mining; -68,000, construction +156,000).

- **Non-residential investment** slowed, owing to the restrictive effects of the dollar and oil prices. The manufacturing sector was affected by the downturn in activity in the mining sector. Sector surveys (ave. ISM manufacturing since the beginning of the year at 52.4), a modest upturn in orders, higher loan value (I&C loans +10.4% ann.), and the financing gap point to moderate growth, despite the contraction in the shale segment (see figs. 3-4). The restrictive effects of the exchange rate and energy sector are expected to ease over the year, while consumer spending and residential investment should support a modest expansion in non-residential investment (**2015 forecast: +3.7%**).

Non-residential investment curbed by the dollar and oil

- **Inflation** remains obstinately below the 2% target, hampered by the dollar and oil prices, the effects of which are expected to fade over 2015. Recently, core indices registered stronger monthly changes (see fig. 10); the median and trimmed mean indices are in line with inflation trending towards 2%. However, the spread between CPI and the PCE deflator is widening, and now stands at 0.6 pp, compared with a historic average of around 0.2 pp. The different definition and greater contribution of healthcare spending in the deflator amplify the effects of the freeze on Medicaid and Medicare rates, which are artificially low due to the healthcare reform, but this phenomenon is seen decreasing in 2016. The trend towards 2% is expected to continue, with the closure of the output gap and the easing of effects relating to the dollar and oil prices. Core CPI is seen just below 2% yoy in the next few quarters (1.8% in 2015, 2% in 2016). The core deflator should be around 1.7% yoy at end-2016.

Inflation still below 2%, but rising gradually

- **Monetary policy** - The **rates' liftoff is around the corner (our forecast is for September)**, with the normalisation of the labor market and a moderate upward trend in inflation. The Fed has indicated that rates will rise very slowly, and that it will respond to changes in macroeconomic data, financial conditions and international developments. A slowdown in global growth, significant corrections in yields or international crises would delay the reversal and/or slow the pace of rises. Recoveries don't die of old age, and the FOMC will do all it can not to kill off the current one, even if it is already six years old!

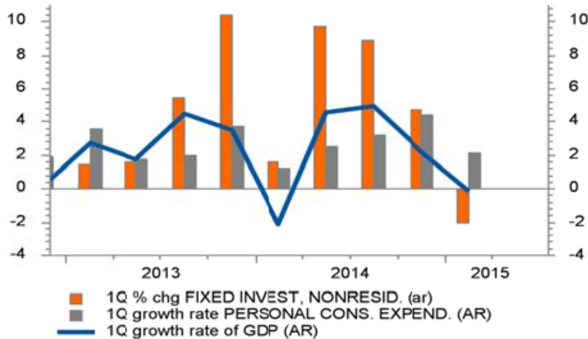
Watchful waiting by the Fed, liftoff to be followed by an extraordinarily cautious path

Forecasts

	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (1996 US$,y/y)	2.4	2.4	2.9	2.7	2.4	2.9	2.4	2.0	2.2	2.9	3.0
q/q annual rate				5.0	2.2	-0.2	2.9	3.1	3.0	2.8	3.0
Private consumption	2.5	3.0	2.9	3.2	4.4	2.1	2.8	3.3	3.0	2.9	2.8
Fixed investment - nonresid.	6.3	3.7	5.8	8.9	4.7	-2.0	2.8	6.2	6.0	5.5	6.3
Fixed investment - residential	1.6	6.2	7.9	3.3	3.8	4.9	7.5	8.0	8.5	10.1	7.6
Government consumption	-0.2	0.4	0.4	4.4	-1.9	6.5	1.0	0.3	0.4	0.4	0.4
Export	3.2	2.3	4.5	4.6	4.5	-5.9	5.0	4.5	4.0	4.0	5.2
Import	4.0	5.8	4.7	-0.9	10.4	7.1	3.6	5.1	4.5	5.0	4.7
Stockbuilding (% contrib. to GDP)	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
		-2.6									
Current account (% of GDP)	-2.4	-3.2	-2.5	-2.3	-2.6	-2.8	-2.6	-2.6	-2.6	-2.6	-2.5
Federal Deficit (% of GDP)	-3.5	122.9	-3.2								
Gov. Debt (% of GDP)	122.7	122.9	121.0								
CPI (y/y)	1.6	0.3	2.7	1.8	1.2	0.0	-0.3	0.3	1.3	2.6	3.0
Industrial production (y/y)	4.2	2.1	3.1	4.2	4.4	-0.5	0.3	2.7	2.9	3.0	3.8
Unemployment (%)	6.2	5.3	4.9	6.1	5.7	5.5	5.4	5.2	5.1	5.0	4.9
Fed Funds	0.25	0.35	1.21	0.25	0.25	0.25	0.25	0.33	0.58	0.83	1.08
Effective exch.rate (1973=100)	78.4	91.2	89.8	77.8	82.6	89.4	90.0	92.4	92.8	91.2	90.1

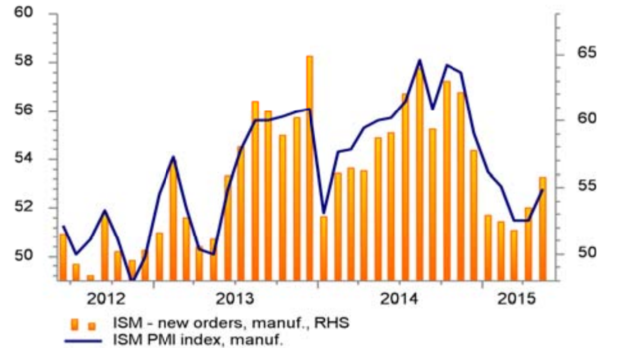
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – GDP: another winter freeze



Source: Thomson Reuters-Datastream

Fig. 2 – Manufacturing slowed by the dollar and oil

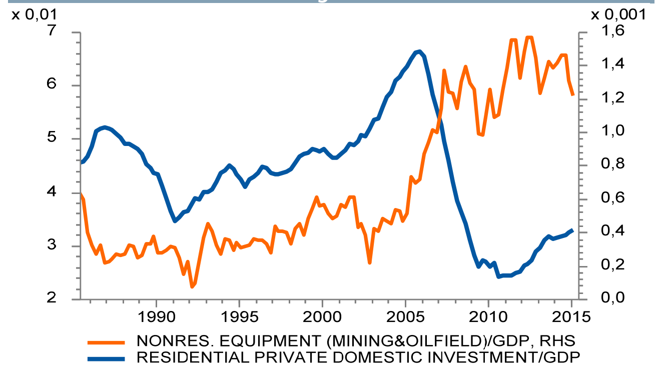


Source: Thomson Reuters-Datastream

Fig. 3 – Nonresidential investment, with mining as ballast

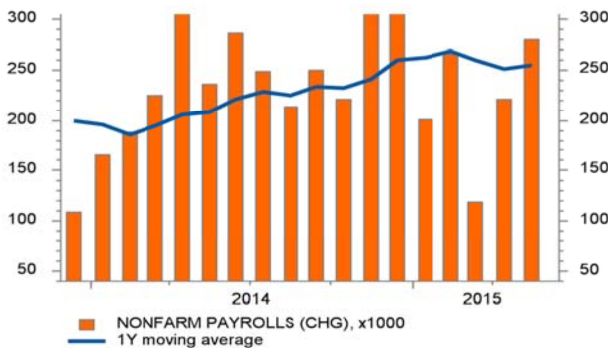
Source: Thomson Reuters-Datastream

Fig. 4 – The recovery in residential construction more than offsets the correction in mining



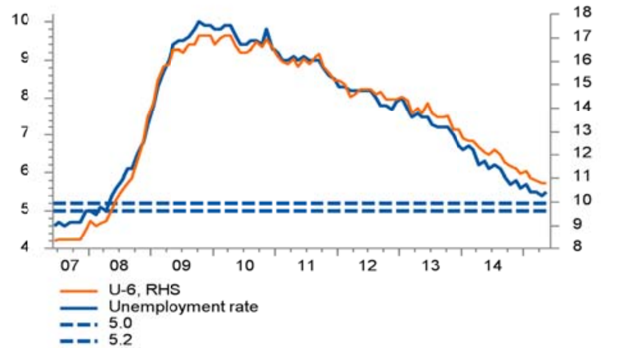
Source: Thomson Reuters-Datastream

Fig. 5 – There is indeed a recovery, otherwise companies would not be taking on more than 200,000 new staff a month



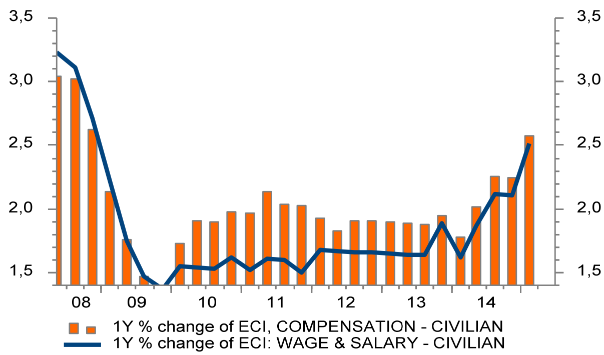
Source: Thomson Reuters-Datastream

Fig. 6 – The unemployment rate nearing equilibrium



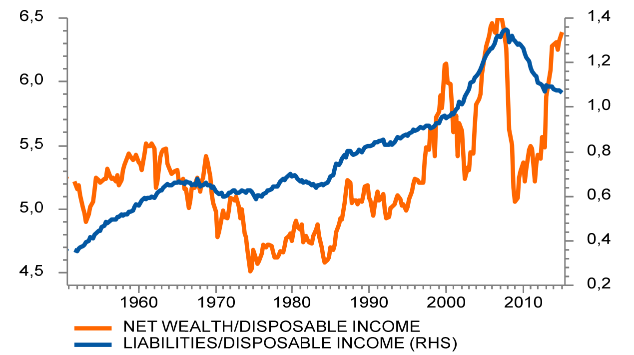
Source: Thomson Reuters – Datastream

Fig. 7 – Wages are beginning to respond to lower slack



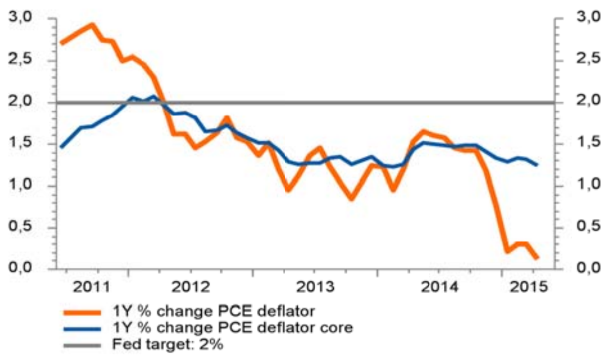
Source: Thomson Reuters-Datastream

Fig. 8 – Improved household balance sheets



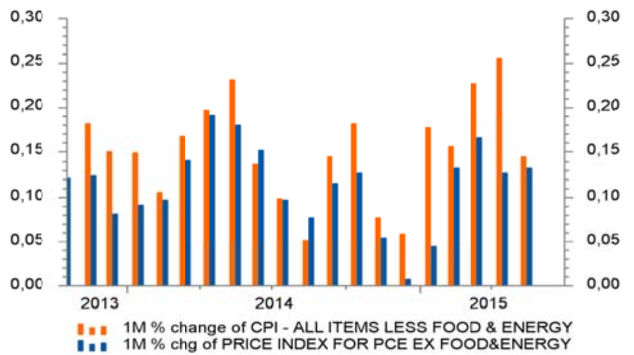
Source: Thomson Reuters-Datastream

Fig. 9 – Inflation still far from 2%...



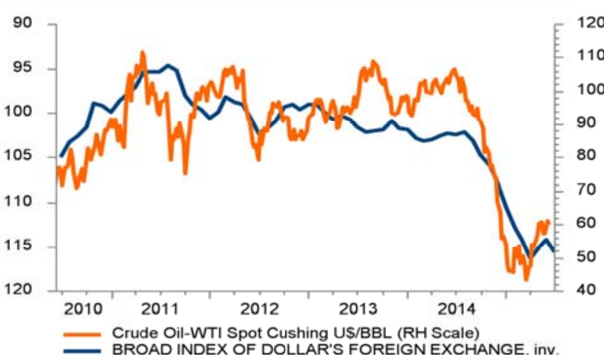
Source: Thomson Reuters-Datastream

Fig. 10 - ... but monthly changes are getting larger



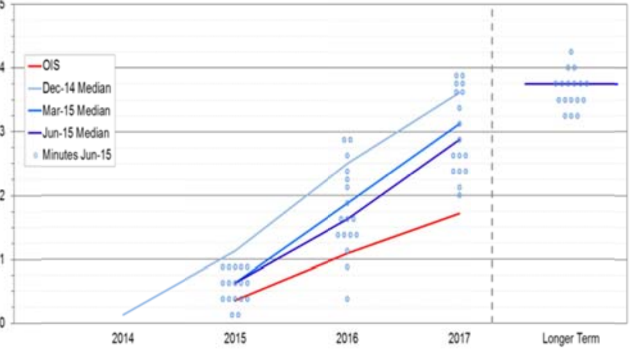
Source: Thomson Reuters-Datastream

Fig. 11 – External brakes on inflation should fadein 2015



Source: Thomson Reuters-Datastream

Fig. 12 – Official rates: liftoff getting close, but the path will be shallow



Source: Bloomberg

Euro area: recovery above trend confirmed

Anna Maria Grimaldi

- The recovery in the Euro area continues, but the boost provided by oil prices, exchange rates and more expansive financial conditions is being offset by a slowdown in the global economy and by heightened geopolitical uncertainty. Recent events and the uncertainty evident from confidence surveys suggest that the accelerated qoq growth of 0.5% in the second half of the year is under threat.

- We are therefore revising our Euro area GDP growth forecasts downwards by 0.1 percentage points to 1.4% in 2015 and by 0.2 percentage points to 1.8% in 2016. Above-potential growth will still be achieved over the forecast period, but sharper acceleration will again not take place until next year. Growth will continue to be driven by internal demand and, to a lesser extent, by exports. Spain and Germany will post above-average growth, while France and Italy will continue to lag behind. Among the smaller countries, Ireland will grow at around 3.5% owing to a strong post-support programme recovery, while Portugal will achieve growth in line with the Euro area average.

- Our core scenario assumes that Greece will remain in the Monetary Union and will strike a deal with its creditors by the end of the summer. During the transitional phase, there will still be considerable volatility on the markets, but we remain confident that Europe will be able to manage contagion risk effectively and therefore limit any negative repercussions. As an average across the Euro area, fiscal policy will be neutral in 2015 and moderately expansive in 2016, and we believe that the overall stance will be more flexible than in the past.

- We are sticking to our Euro area inflation forecasts of 1.3% in 2016 and 1.6% in 2017, up from 0.3% in 2015. Consumer price dynamics risks are reasonably balanced. However, from April 2016 inflation will depend largely on how core prices respond to the cyclical recovery.

- Under our core scenario, the ECB will continue to implement its Expanded Asset Purchase Programme (EAPP) within the pre-established criteria, but will provide plenty of verbal reassurance to the markets as regards the Council's resolution to do more if required. Having said that, we think an increase in the monthly purchase target will be announced only in response to a sudden and material deterioration in financial conditions.

Forecasts

	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.9	1.4	1.8	0.8	0.9	1.0	1.3	1.6	1.7	1.8	1.9
- q/q change				0.2	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Private consumption	1.0	1.7	1.8	0.5	0.4	0.5	0.4	0.4	0.5	0.5	0.4
Fixed investment	1.2	2.7	4.3	0.1	0.4	0.8	1.1	1.3	1.0	1.0	1.1
Government consumption	0.6	1.0	0.4	0.2	0.1	0.6	0.1	0.1	0.1	0.1	0.1
Export	3.7	4.2	4.5	1.4	0.8	0.6	1.4	1.1	1.1	1.2	1.1
Import	4.0	5.0	4.6	1.7	0.8	1.2	1.4	1.0	1.2	1.1	1.2
Stockbuilding (% contrib. to GDP)	-0.1	-0.1	-0.2	-0.1	0.0	0.1	-0.1	-0.1	0.0	-0.1	0.0
Current account (% of GDP)	2.9	3.2	3.3	2.6	2.3	3.0	3.0	2.7	2.1	3.1	3.2
Deficit (% of GDP)	-2.4	-2.0	-1.9								
Debt (% of GDP)	91.9	91.7	90.6								
CPI (y/y)	0.4	0.3	1.3	0.4	0.2	-0.3	0.2	0.3	1.1	1.5	1.3
Industrial production (y/y)	0.8	2.3	2.8	-0.2	0.4	0.9	0.6	1.2	0.5	0.3	1.0
Unemployment (%)	11.6	11.0	10.5	11.5	11.5	11.2	11.1	10.9	10.8	10.7	10.5
3-month Euribor	0.21	-0.01	-0.02	0.16	0.08	0.05	-0.01	-0.03	-0.03	-0.04	-0.03
EUR/USD	1.33	1.10	1.15	1.33	1.25	1.13	1.11	1.07	1.09	1.12	1.14

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

GDP accelerates but risks are shifting

In line with the forecasts, the Euro area economy grew by 0.4% qoq during the winter months, compared with 0.3% at the end of 2014. GDP growth increased to 1.0% yoy. Private consumption and corporate investment were the main drivers, while foreign trade weighed by two-tenths on quarterly growth. We still expect to see a gradual cyclical recovery in the months ahead, driven by a combination of external factors (a residual effect from the fall in the price of crude and the depreciation of the Euro) and broadly supportive economic policies. The SME and European Commission economic surveys are consistent with Euro area GDP growth of 0.4% qoq during the spring months. However, we are less confident about the strength of the recovery in the second half of 2015 and first part of 2016. This is because:

1. There is less impetus from external drivers... Much of the boost to Euro area GDP growth, from falling oil prices (-60% between July 2014 and January 2015) should already have taken place, and this explains some of the acceleration in consumption. In addition, we have revised our 2015 crude price estimates upwards, from USD 58 to USD 63. We retain our forecast of USD 69 on average in 2016. During 2Q, the exchange rate was around 1.10 on average, whereas in March we had expected this to be approximately 5% lower. In addition, we have revised our EUR/USD exchange rate forecast upwards by nearly 8% in 2H15 and the early part of 2016. Compared with our March forecasts, this represents a cumulative revision, in terms of the effective exchange rate, of around 7% in 2015 and 4.5% in 2016, which could reduce growth, at the end of 2015 and for a good portion of 2016, we estimate the impact could be of 0.2 - 0.3 percentage points.
2. ...and less impetus from monetary policy. The ECB's quantitative easing (QE) programme is advancing fairly smoothly, but the compression of medium- and long-term yields has partly subsided. The correction has extended to the equity and credit markets, with greater volatility caused by the uncertainty surrounding Greece's future and US monetary policy. In any event, the medium- and long-term yields and the 10-year government bond rate spreads between Italy and Spain versus Germany remain at extremely low levels, albeit not quite at the historical lows seen at the beginning of March. ECB Quantitative Easing is de facto shielding other peripheral countries from the risk of contagion from Greece.
3. The geopolitical situation is even more uncertain than we had predicted in March. Negotiations with Greece have lasted much longer than we expected, and the outcome is still uncertain. At the time of writing, there is no guarantee that the negotiations between the Greek government and its official creditors will be concluded successfully and it is still possible that the country will at least end with a temporary regime of capital controls. Moreover, there is plenty to worry about also in other Euro area countries, and in particular in Spain where the rise of the populist movements in regional elections may lead to a fragmented government coalition later this year when the country goes to the general vote. Lastly, we should not forget the depressing geopolitical situation in the Mediterranean and Eastern Europe, which could weigh on social cohesion and intra European political relationships.
4. Global demand slowed between January and April 2015, initially because of the slowdown in the US economy, which was caused by factors that are likely to be temporary[1], but more recently the emerging economies also seem to be losing momentum. We estimate that global demand for Euro area goods and services will increase by 2.0% in 2015 and by 4.6% in 2016, compared with previous estimates of 3.0% and 5.6%.
5. Support for the recovery will continue to come from fiscal policy. The "flexible" interpretation of the Stability and Growth Pact, approved on 12 January (for details on the new formulation of the Pact, see the January 2015 ECB Bulletin, Box 7, pp. 33-35) will

[1] Exceptionally tough climate and closure of ports on the East Coast. Please see the US outlook

allow Member States to make a smaller fiscal correction than was implied in the July 2014 recommendations of the European Council, particularly if reform efforts are redoubled. The European Commission's Spring Forecast shows the Euro area structural budget balance unchanged in 2015 and down by 0.2 percentage points in 2016.

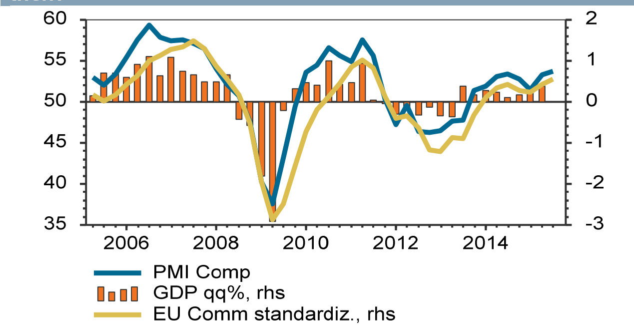
We are revising our Euro area GDP growth forecasts downwards from 1.5% to 1.4% in 2015 and from 2.0% to 1.8% in 2016. More specifically, we have revised our qoq forecasts for 4Q15 and 1H16 to 0.45 - 0.5% from 0,6% q/q previously. Over the forecast period, growth will still be driven by internal demand, which we expect to grow by 1.7% on average in 2015 and by 1.9% on average in 2016.

The growth in domestic demand will be driven by accelerating capex, up from 1.2% in 2014 to 2.6% in 2015 and 4.2% in 2016. Corporate investment grew by 1.0% qoq in 1Q15, compared with a contraction at the end of 2014, with falling energy prices resulting in higher gross operating margins. We expect that investments will continue to grow at the same rate in the quarters ahead. Expenditure on machinery should be stimulated by lower interest rates on new business loans, more expansive credit conditions, higher corporate profit margins and a normal use of production capacity. However, as we have seen recently, investments may fail to match recovery forecasts (which were already more cautious than in previous cycles). Corporate investment may be more seriously affected than private consumption by the high degree of uncertainty surrounding demand in 2H15, which could force companies to postpone their expansion plans. Thus, we have revised our forecasts for investment in machinery downwards from 3.3% to 3.0% in 2015 and from 4.3% to 3.7% in 2016. We stand by our prediction of a moderately expansive cycle in investments in construction (growth of 0.9% in 2015 and 1.5% in 2016) after around six consecutive years of decline. We also retain our private consumer spending growth forecast of 1.7%-1.8% over the forecast period. Although the effect of falling crude prices and low inflation should subside from mid-2015, we expect job creation to accelerate (from 0.6% in 2014 to 0.9% in 2015 and 1.2% in 2016). The impact from foreign trade is likely to be slightly negative this year and more or less neutral next year. We have revised our export growth forecast downwards from 4.6% to 4.3% on average in 2015 and 2016 because we expect a lower contribution from global demand (see above) and a stronger effective exchange rate. Imports are expected to grow by 5.0% in 2015 and by 4.6% in 2016, on the back of more sustained growth in domestic demand and the high import content of exports.

The risks to our forecasts appear to be broadly balanced since macroeconomic models suggest a wider impact from medium- and long-term yields and exchange rates, but uncertainty surrounding the global outlook and the Greek crisis could have a greater impact than we allowed for in making our forecasts. The crisis in Greece has again highlighted the structural weaknesses of the decision-making process within the Monetary Union. The so-called Five Presidents' Report, published on 22 June 2015[2] to coincide with the extraordinary European summit on Greece, sets out an ambitious long-term plan (set to run until 2025) to restructure the Monetary Union, including setting up a Euro area treasury. In addition, during his speech to the European Parliament on 15 June 2015, ECB President Mario Draghi called for "*a quantum leap*" in European integration. Angela Merkel has paved the way for institutional change to protect and "give sense to" Monetary Union in the future. Although it is a long-term plan, the a more open and flexible attitude is key for future changes.

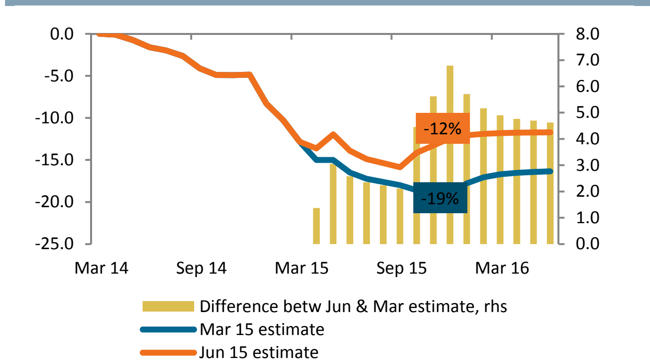
[2] Please see http://europa.eu/rapid/press-release_IP-15-5240_en.htm

Fig. 1 – Confidence surveys remain consistent with Euro area GDP growth continuing into the spring months, but what then?



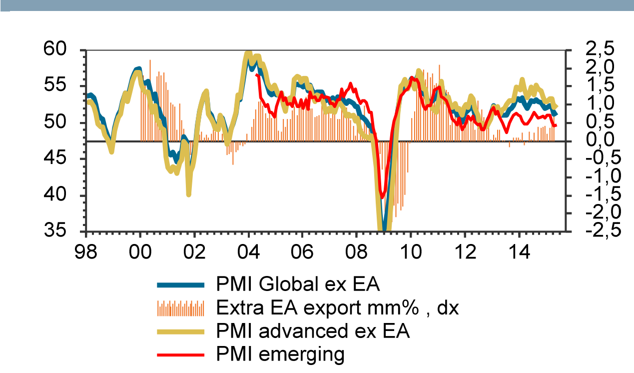
Source: Intesa Sanpaolo chart from Markit, European Commission and Eurostat data

Fig. 2 – 12% depreciation in the effective exchange rate in 2015, compared with a previous estimate of 19%



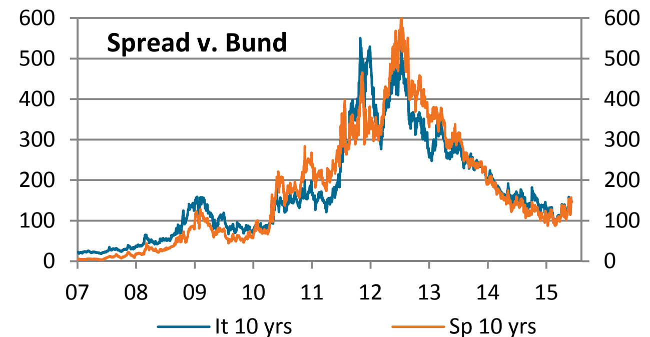
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – Global demand growing more slowly than we expected in March, with emerging economies now also slowing



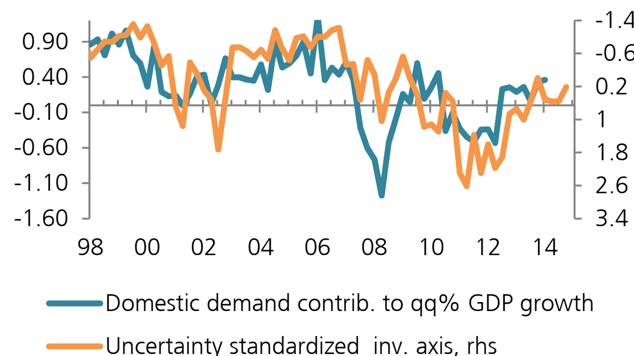
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 4 – Less expansive financial conditions than we expected three months ago, but ECB QE serves as a shield from the risk of Greek contagion



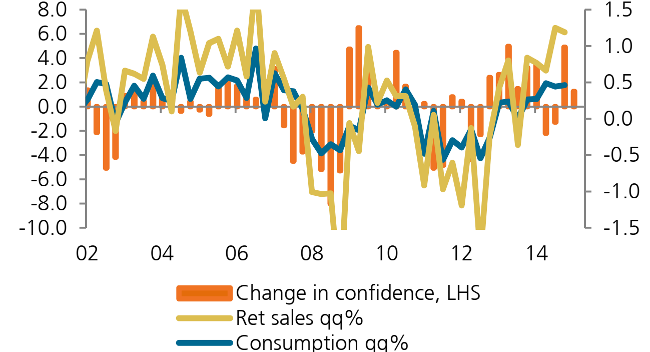
Source: Intesa Sanpaolo chart from Bloomberg data

Fig. 5 – Uncertainty could weigh on confidence and internal demand



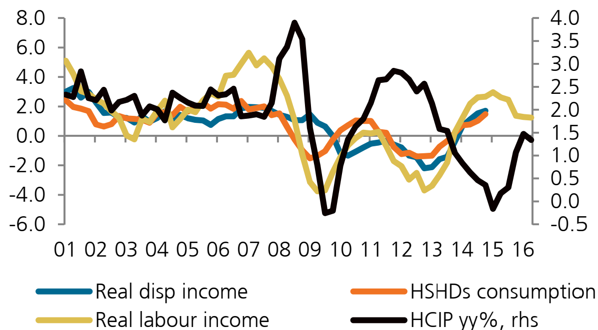
Source: Intesa Sanpaolo chart from Economic Policy Uncertainty and EU Commission data

Fig. 6 – Recent trend in confidence suggests that consumption could slow in spring/summer



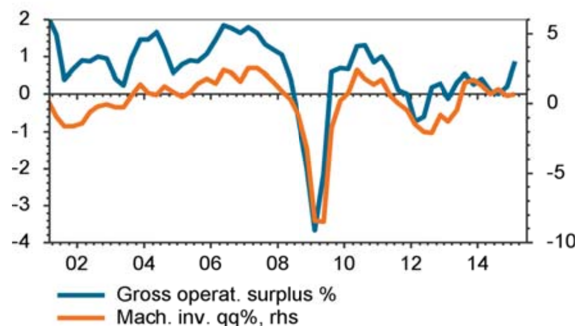
Source: Intesa Sanpaolo charts from EU Commission and Eurostat data

Fig. 7 – Upturn in private consumption thanks to real disposable income growth of 1.6-1.8%



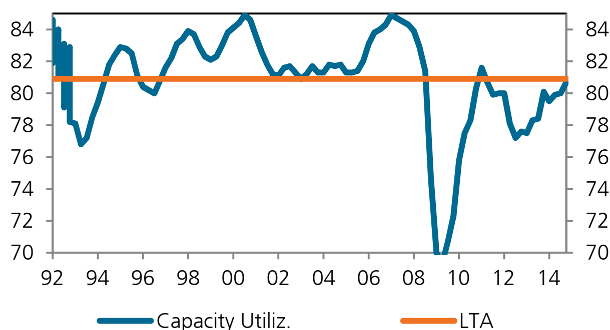
Source: Thomson Reuters-Datastream

Fig. 8 – Recent trend in gross operating margins suggests acceleration in investments in machinery



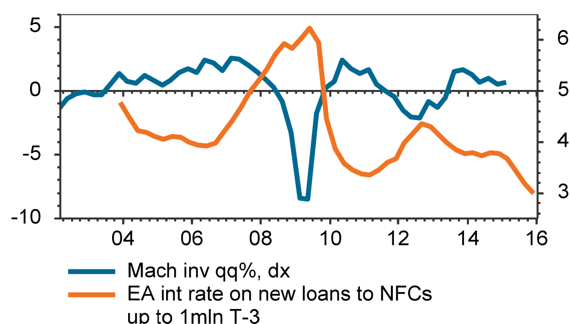
Source: Eurostat

Fig. 9 –Production capacity back to the historical average is in the right direction



Source: Intesa Sanpaolo chart from European Commission data

Fig. 10 – Lending conditions clearly favourable for corporate investment



Source: Intesa Sanpaolo chart from ECB and Eurostat data

Inflation: up to 2%? The road is long and dependent on how wide the output gap will stay

Anna Maria Grimaldi

- Euro zone inflation reached a low of -0.6% yoy in January to then rise to +0.3% yoy in May. The recovery is largely due to oil price rises (up to USD 62 from a low of USD 48.9, on average, in January) and, therefore, a less negative contribution from the energy component (-0.5% in May, from -1.0% in January). The contribution of food prices to overall inflation growth also increased, from -0.1% in January to +0.2% in May. The underlying trend accelerated from 0.6% at the start of the year to 0.9%. Our oil price estimates are broadly unchanged from March. We still expect oil to rise by less than USD 10 in 2016, to USD 69 from USD 62.3 in 2015. We have revised up our estimates for the EUR/USD exchange rate compared with March, to an average of 1.10 in 2015 and 1.15 in 2016 (previously 1.06 for both years).

- We confirm our forecast for inflation to rise from an average of 0.3% in 2015 to 1.3% in 2016 and 1.6% in 2017. In the next nine months, barring any significant movements in the oil price or exchange rate, **inflation will largely be determined by statistical effects**, i.e. by the rise in the energy component compared with 2014/early 2015. **The favourable baseline effect from the energy component will reach a high between November 2015 and January 2016, resulting in an expected rise in headline inflation to 2.0% at the end of 2015**; but as soon as the sharp fall in the oil price falls out of the annual comparison, inflation will tumble back to 1.3%. From April 2016, with the oil and exchange rate profiles broadly flat, whether inflation rises to 2% **will depend almost entirely on the trend in the core component**, which we see rising from 0.9% in 2015 to 1.0% in 2016 and 1.3% in 2017. Clearly, growth in core inflation depends on the response of domestic prices to closure of the output gap and on second-round effects from currency and oil prices[3]. The depreciation of the euro, which started in April 2014, should become visible with a lag of about three quarters; hence, the rise in inflation to 0.3% in May and, in particular, the recovery in non-energy prices (which are typically more sensitive than services to external factors) are likely to be only in part due to the currency's performance. The ECB's assumptions for oil (63.8 in 2015, 71 in 2016 and 73 in 2017) and the currency (1.12 in 2015-17) underlying its June forecasts are very close to ours, but the ECB is expecting inflation to accelerate more sharply – by around three-tenths of a point more than in our forecasts (from 0.3% in 2015 to 1.5% in 2016 and 1.8% in 2017) – due to a more sustained increase in core inflation, from 0.8% in 2015 to 1.4% in 2016 and 1.7% in 2017. As we have shown previously, the ECB has often underestimated core inflation when prices are falling and the output gap is widening, given the scepticism about the existence of a Phillips Curve. In this phase, however, the ECB would seem to be assuming a sharp reaction from core inflation to decreasing slack in the economy.
- We recognise that deflationary pressure has eased off considerably as a result of the ECB's securities purchases programme. We think, however, that the **risks for consumer price inflation are still to the downside.** Domestic demand may not recover as much as in previous cycles due to the sheer severity and length of this crisis. Moreover, in the current climate of geopolitical uncertainty, consumer spending and investment could prove particularly disappointing, thus hampering the rise in core inflation. The good news for the outlook is that the downward pressure upstream in the supply chain seems to have stabilised.

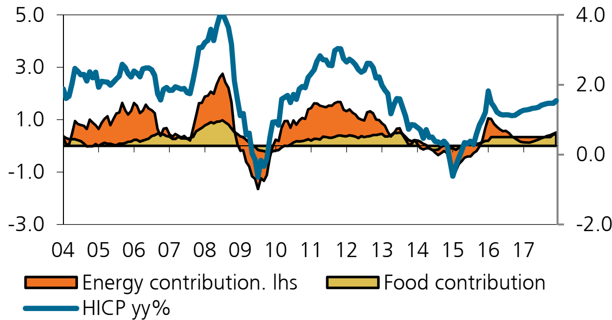
Table 1 - Inflation forecasts by country and Euro zone average with new oil and exchange rate estimates

	CYP	IRL	PRT	ITA	FIN	ESP	Eurozone	MLT	DEU	NLD	BEL	AUT
2013	0.4	0.5	0.4	1.3	2.2	1.5	**1.4**	1.0	1.6	2.6	1.2	2.1
2014	-0.3	0.3	-0.2	0.2	1.2	-0.2	**0.4**	0.8	0.8	0.3	0.5	1.5
2015	-1.5	-0.7	-0.5	0.2	-0.1	-0.1	**0.3**	0.8	0.7	0.2	-0.1	0.5
2016	0.7	0.8	1.1	1.2	1.3	1.3	**1.3**	1.4	1.7	1.7	1.8	2.0

Source: Eurostat and Intesa Sanpaolo estimates

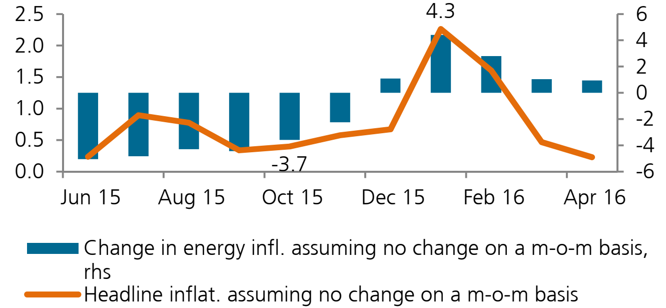
[3] According to our model for underlying inflation, the change in inflation net of energy, food and tobacco is due to the change in the output gap in 2Q and in movements in the effective exchange rate, the annual energy index trend, and food inflation (with lags of three, one and four quarters respectively). The one-point change in the output gap causes an increase/decrease in core inflation of 0.11 after two quarters. A 10% depreciation in the effective exchange rate causes a 0.26% rise in core inflation after two/three quarters.

Fig. 1 - Euro zone inflation will lack energy with oil increasing only USD 8 over the forecast horizon



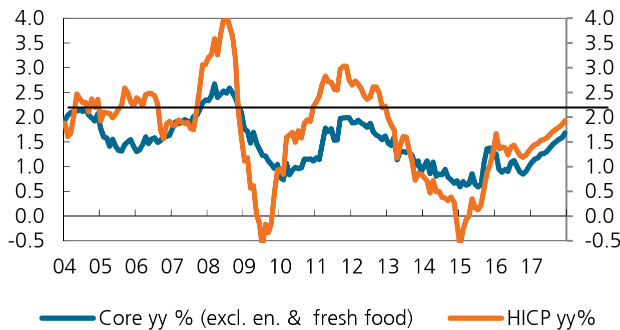
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 - The favourable base effect from energy will push inflation temporarily up to 2% at the turn of the year but …



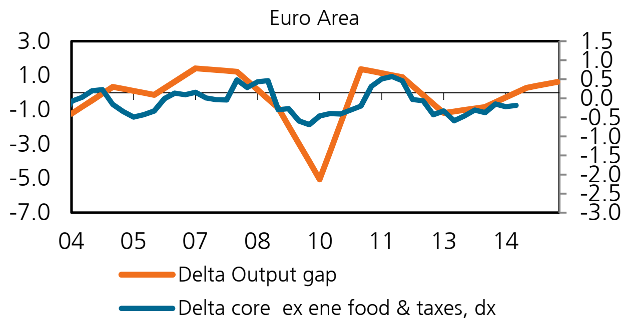
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 3 - … from April 2016, the headline inflation trend will depend on domestic prices, especially …



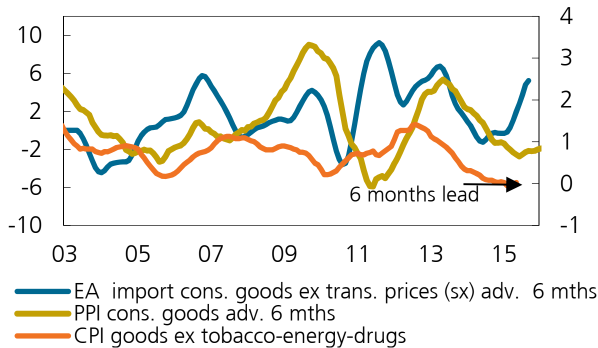
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 - … how fast the output gap closes



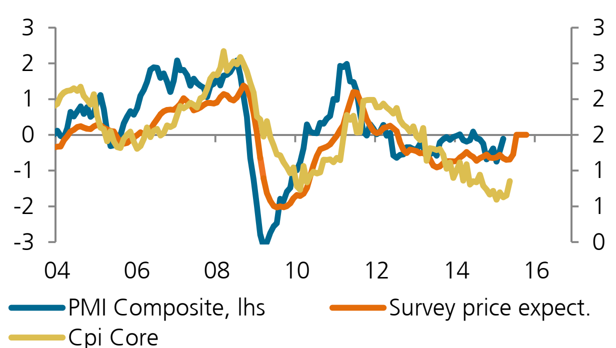
Source: Intesa Sanpaolo chart based on Eurostat and EU Commission (for the output gap) data

Fig. 5 - Currency depreciation takes longer than oil price falls to filter through to consumer goods prices, whereas it has already impacted import and production prices



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 6 - Core inflation trend affected by price expectations but these are heading back up again



Source: Intesa Sanpaolo chart based on Markit and European Commission data

The ECB may do more not less

Anna Maria Grimaldi

- The Extended Asset Purchase Program (EAPP), launched on 6 March, is advancing as planed and without any particular difficulties, despite fears of a lack of government bonds available for purchase. The ECB reached its target of 60 billion purchases a month in both March and April (see Table 1), complying with the capital keys rule (see Fig. 2). In May, it bought bonds worth EUR 63Bn, but on 19 May, Coeuré said that the ECB had, to a moderate extent, brought forward some of its summer purchases as it was "*aware of the seasonal element in the bond market*". On June 19th, the EAPP portfolio totalled EUR 268.3 Bn, of which EUR 170Bn related to sovereign and supranational bonds (see Table 1). The ECB's balance sheet expanded more rapidly since early March (see Fig. 1); we estimate that it may well, by September 2016, reach EUR 3.45Trn, exceeding the 2012 peak by some EUR 300Bn. The average remaining maturity of the government and agency debt portfolio is 8.3 years, so the balance sheet expansion is here to stay.

QE is making headway. Draghi hinted to possible increases to the 60 monthly target, if needed

- During the hearing at the European Parliament on 15 June, Mr Draghi reaffirmed his determination to press on with the EAPP programme, buying up bonds at a rate of 60Bn a month up to September 2016 and "in any case, until we see a sustained adjustment in the path of inflation that is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term". He once again observed that the ECB's plan for a gradual return to growth (1.5% in 2015, 1.9% in 2016, and 2.0% in 2017) and for a steady rise in inflation (0.3% in 2015, 1.5% in 2016, and 1.8% in 2017) towards the 2% target, is conditional on the full implementation of unconventional monetary policy measures. At the June press conference, Mr Draghi acknowledged that the recovery had lost some of its vigour as the economies outside the Euro zone were weaker than had been expected[4]. Our view is that, last month, with rising uncertainties on Greece and the geopolitical tensions around the Mediterranean, risks to growth have shifted downwards. Any tapering of monthly target before September 2016 is therefore completely out of the question. As Draghi stressed "*exit strategies are a high class problem we are really far from that*" Instead, he hinted that the ECB could do more, "if *there were an unwanted tightening of monetary conditions*", that is to say, if there were adverse developments in the negotiations with Greece, thus offering a slight guarantee against the risk of contagion. The stock market might completely erode the substantial gains achieved since the beginning of the year, just as the corporate market might well be affected by the increased risk aversion. During the acute phase of the crisis, the exchange rate could fall to, or a little below, parity, before reverting to around 1.12. Our view is that, in such a scenario, the ECP would, at least at first, press on with the EAPP within the parameters already set in order (without increasing volumes) to reassure the markets of the Council's willingness to do more to ensure that the financial conditions do not compromise the economic recovery and to prevent inflation heading back up towards 2%.

If the Greek banks were to shut temporarily while the country remained in the Euro zone, we think the ECB would turn to verbal interventions

- The ECB will want to point out, as Mr Draghi did at the European Parliament hearing, that European governance should be able to manage the risks associated with unrest in Greece efficiently. In our central scenario of a Greek default, in which the country would have to deal with official creditors (the IMF and the ECB) but would remain in the Euro zone thanks to a period of restrictions on the movement of capital and on the closure of the banks, promptly followed by a change of government and the signing of a new programme, the financial conditions would worsen still further. The effects on the medium- and long-term rates in peripheral countries would not be negligible but neither would they be as dramatic as in 2011. Note also that the ECB's QE policy, together with the launch of a banking union and the orderly conclusion of the AQR, is helping to restore the transmission of monetary policy to credit growth, and this is likely to help sustain recovery.

[4] In June, the ECB saw the risks to the macro scenario as balanced, but pointed out that the upside risks that its staff had identified in March and April had failed to materialise.

- If the repercussions for the markets of our central scenario for Greece were to prove more severe than we have assumed, and/or if events in Greece were to degenerate, the risk of contagion might be stemmed by the activation of the OMT (Outright Monetary Transactions) plan. There have, moreover, been no more objections by the German parliament, claiming a breach of the Treaties, since the European Court of Justice gave its approval on 16 June. We think it more likely, though, that the ECB will opt to address the emergency by increasing the number of monthly purchases through the EAPP. Purchases to the tune of 85 billion a month might also be tolerated by the Germans on the ECB Council, since purchases could be reduced before September 2016 if pressures were to resume.

If financial conditions were to worsen still further, the ECB might step up its monthly purchases. Of course OMT could still be activated, if needed

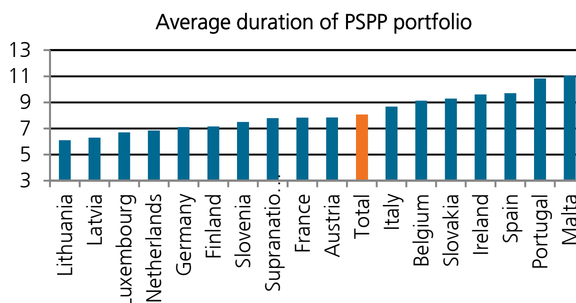
- In conclusion, we are still confident that the ECB will continue to keep a vigilant eye on risks to price stability over the forecast period and will be ready to intervene if financial conditions change in unwelcome or unexpected ways. This encourages us to believe that the recovery could continue, albeit at a more leisurely pace than we had assumed in March. Even though the ECB will try to muffle the repercussions of the Greek crisis, the uncertainty of the past few months and the deterioration in financial conditions have already deflate some of the impetus from the oil and forex story.

Table 1 – The EAPP is proceeding on track

	ABSPP	CBPP3	PSPP	EAPP
	Monthly flows (bln euros)			
31/03/2015	1.1	12.4	47.4	61
30/04/2015	1.2	11.5	47.7	60
31/05/2015	1.4	10.0	51.6	63
	EAPP portfolio total outstanding			
12/06/2015	4.8	40.9	182.2	227.9
Residual purchases	19.2	195.1	697.8	912.1
EAPP in Sept. 2016	24	236	880	1,140

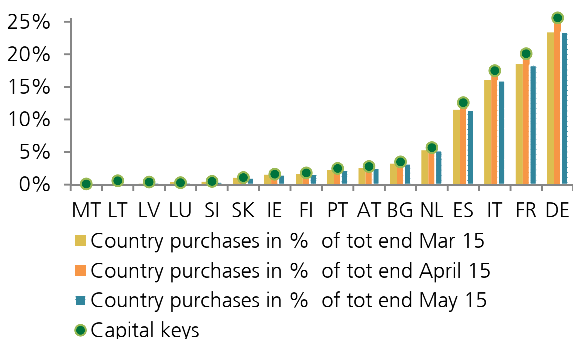
Source: Intesa Sanpaolo chart on ECB data

Fig. 1 – The average maturity of the ECB's portfolio was 8.05 years at the end of May



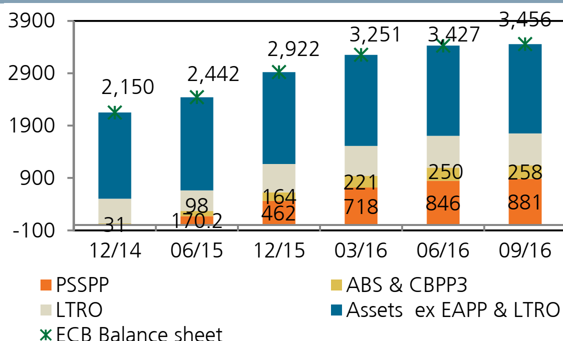
Source: Intesa Sanpaolo chart on ECB data

Fig. 2 – The ECB has complied with the capital keys rule



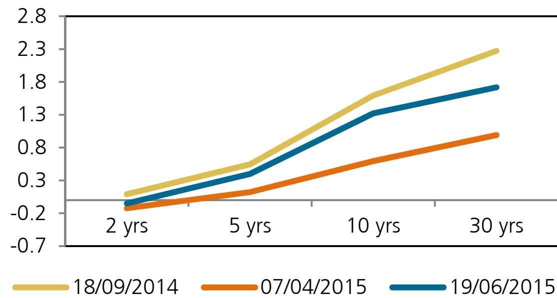
Source: Intesa Sanpaolo chart on ECB data

Fig. 3 – The ECB's balance sheet is expanding rapidly thanks to EAPP



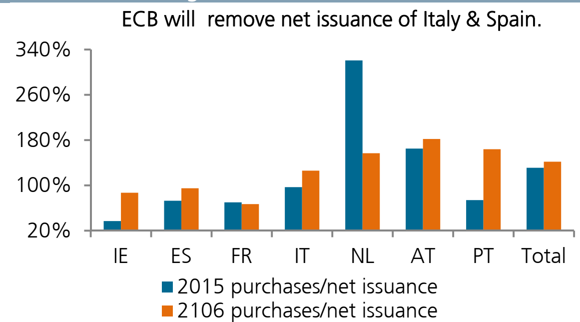
Source: ECB and Intesa Sanpaolo estimates

Fig. 4 – Less expansive financial conditions last month due both to uncertainties over Greece and the Fed effect



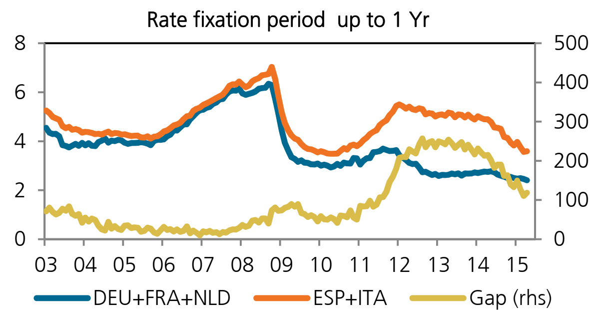
Source: Intesa Sanpaolo charts from Bloomberg data

Fig. 5 - The PSSP is likely to accord governments more favourable financing conditions



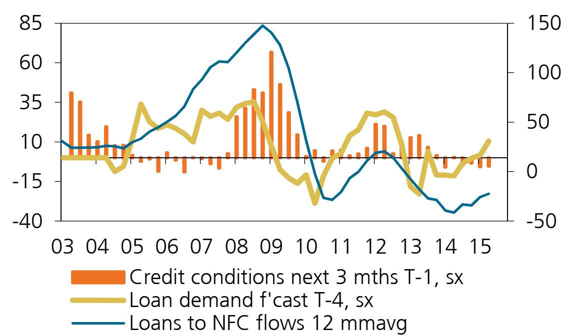
Source: Intesa Sanpaolo charts from ECB data

Fig. 6 – The ECB's QE is starting to have an effect on lending rates to bank clients in peripheral countries too



Source: Intesa Sanpaolo chart on ECB data

Fig. 7 - ECB purchases and the cyclical recovery should foster stronger credit dynamics



Source: Intesa Sanpaolo chart from ECB data

Germany: growing but not booming

Anna Maria Grimaldi

Growth above trend over the forecast horizon. After the surge at the end of 2014, GDP did not perform as well as expected at the beginning of 2015, with growth standing at 0.3% qoq. Exports were negatively impacted by the downturn in international trade, and in particular by the slowdown in the US and eastern Europe. Growth in domestic demand, however, accelerated relative to the end of 2014. The weaker-than-expected start to the year leaves the 2015 average at 1.8%, compared with the previous estimate of 2.0% (1.6% net of calendar effects). For 2016, we continue to forecast that GDP growth will pick up to 2.0% (1.8% net of calendar effects). Germany will therefore grow significantly above potential (1.2% according to Bundesbank forecasts), and above the Euro area average. Over the forecast horizon, growth will continue to be driven more by domestic demand than foreign trade. Nevertheless, the current account balance is seen rising to 8.4% of GDP this year, from 7.4% in 2014, owing to the improvement in the terms of trade following the depreciation of the euro. In its report of April 2015[5], the European Commission judged economic policy measures, and in particular the use of fiscal leverage to shore up domestic demand, to be "insufficient" to manage excessive macroeconomic imbalances (MIP), and indicated that this would need to be closely monitored. The risks to the scenario are shifting to the downside, given the current slowdown on emerging markets and the ongoing geopolitical uncertainty.

Growth at 2.0% in 2015-16

Solid growth in private consumption

Short-term outlook. After the slowdown at the beginning of the year, we expect growth of around 0.5% qoq for the rest of the year. Figures for industrial output, manufactured goods orders and exports point to a substantial upturn in the spring months. Specifically, industrial output is expected to register growth of 0.7% qoq, up slightly compared with the first quarter. After the sharp upturn in April, exports are on course for growth of 3.0% in real terms, compared with +0.8% qoq at the beginning of the year. Confidence surveys suggest caution as regards the trend in exports, given the fall in expectations on orders from abroad. The current slowdown in emerging countries could weigh on export growth, curbing the boost generated by the exchange rate. On average, we expect exports to advance by 5.0% in 2015 and by 4.4% in 2016, from 3.7% in 2014. International trade figures point to a slowdown in imports in 2Q to 0.5% qoq, after +4.5% qoq at the beginning of the year. Imports are seen growing by 5.3% in 2015 and by 5.4% in 2016, on the back of the upturn in domestic demand and given the high import content of German production. Domestic demand is expected to grow by 2.1% in 2015 and by 1.8% in 2016.

Private consumption grew by 0.7% in the second half of last year, and by 0.6% qoq in the first few months of 2015. Growth in the last few months is due to exceptional factors: the sharp drop in oil prices (with savings for households estimated by the Bundesbank at around EUR 3.5 billion), and the sustained increase in the non-salaries component of remuneration due to the lower pensions contribution rate[6]. Retail sales in the spring months show a slowdown in goods consumption to +0.4% qoq, on the back of a drop in new car registrations. From the summer, consumption is seen growing at 0.5% qoq per quarter, resulting in average annual growth of around 2.1%. Real disposable income is forecast to grow by 1.9% in 2015 and by 2.0% in 2016, from 2.4% in 2014, owing to the expected slowdown in the growth of contractual wages compared with 2014 and employment growth at best matching the pace of last year. In addition, inflation is seen rising to an average of 1.8% in 2016 (see below). The household savings rate is expected to remain broadly stable at 9.2% in 2015, before rising slightly in the

[5] See http://ec.europa.eu/economy_finance/eu/countries/pdf/report2015/germany_en.pdf

[6] The pension fund contribution rate has risen by 0.3% in 2015 to 2.35% (2.6% for individuals without children). Two-thirds of the additional payments will be used to finance the higher spending associated with the reduction in the retirement age, and a third will be allocated to an extraordinary reserve. Mandatory contributions to the pension fund have been reduced from 18.9% to 18.7%.

second half of 2016 to 9.5%.

Thanks to wage growth of 2.6% and resilient employment trend

Contractual wages grew by 2.3% in the first few months of this year, from 2.9% in 2014, less than we expected in March. Wage demands submitted by trade associations should ensure an average increase in salaries of 2.5% this year and 2.6% next year. Total payroll is expected to grow by around 3.0%, partly owing to a positive wage drift associated with the introduction of the minimum wage of EUR 8.50 per hour, and partly owing to more sustained growth in bonuses compared with 2014. In the first quarter of this year, 175,000 jobs subject to social security contributions, known as "good jobs", were created, an improvement on the end-2014 figure, representing annual growth of 1.8%. Overall employment is growing at a slower pace, at 0.5% yoy, compared with +0.8% yoy at the end of 2014. We may be seeing a shift from poorly-paid, part-time work to full-time work. The breakdown by sector suggests that business services continue to contribute significantly to new job creation. We expect employment growth of 0.8% this year and 0.7% next year. The trend in IFO and PMI employment indices, as well as the increase in vacancies between the end of 2014 and early 2015 continue to point to more sustained growth in employment in the spring/summer months, partly owing to the need to replace qualified workers who are leaving the workforce by taking advantage of the change in the retirement age.

The fall in the unemployment rate will be fairly modest over the forecast horizon, to 6.2% by the end of 2016. Unemployment fell to 2.78 million in April 2015, from 2.84 million in December 2014, with the unemployment rate down by a tenth of a point to 6.4%. Unemployment is now at its long-term structural level; a further significant drop in the current two-year period is therefore unlikely, without further growth in the workforce. By our estimates, in the first few months of this year, the workforce shrank on a cumulative basis by 15,000, after increasing by an average of 0.6% in 2014 (470,000). The sharp increase in the workforce last year is unlikely to be repeated in the near future, despite net migration flows of approximately 350,000 over the next two years (according to Bundesbank forecasts), since a significant portion of immigrants consists of political refugees who will not have immediate access to the job market.

Many conditions are in place for a more buoyant capex cycle, but uncertainty is a risk

After strong growth at the end of 2014/early 2015 (+1.5% qoq on average), construction is likely to have eased up in the spring, as indicated by the survey conducted by the European Commission on the recent production trend. Nevertheless, the prospects for the sector remain positive. The figures relating to orders and permits point to sustained growth, particularly in investment in buildings. Residential construction should in part benefit from the EUR 10 billion public investment plan for 2016-18. The sector continues to be supported by highly favourable financial conditions and the resilience of the job market. However, the growth rate for the current two-year period may come in at just over 2.2%, from 3.8% in 2014, since the high demand should be broadly met by the increase in the new housing supply, thanks to the investment made in the last few years.

Investment in machinery grew by 1.2% at the beginning of 2015, and is expected to continue to grow at this pace for the rest of the year. Machinery orders from abroad fell in March, but then rose again in April. Next year should see more sustained growth in company investment, at around 3.5%, thanks to the improvement in business conditions, the fall in interest rates, stronger growth in lending to companies and a probable more intensive use of production capacity. There is a risk that investment in machinery may again prove disappointing over the forecast horizon, should the high degree of geopolitical uncertainty persist.

Inflation will return to 2% thanks to the closing of the output gap by the end of 2016

Inflation rose rapidly at the beginning of 2015, to 0.7% yoy in May, from a low of -0.3% yoy in January (-0.5% yoy on a harmonised basis). The upturn is due to the rebound in the energy component, as well as in fresh food and the prices of non-energy goods. The trend in food prices and other spending components may have started to be affected by the depreciation of the euro, from March/April, and the trend is expected to consolidate in the next few months.

Over the summer, inflation will likely fluctuate around May levels before picking up to 2.2% yoy between end-2015 and March 2016, when the sharp drop in energy prices will not feature in the yoy comparison. We expect German inflation to average 0.8% in 2015 and return to 1.7% in 2017, partly thanks to rising core prices as a result of above-potential growth.

Insufficient use of fiscal policy to support domestic demand

The outlook for public finances is seen stable over the forecast horizon, thanks to the cyclical recovery and the fall in interest expenses. Despite a marginally expansionary fiscal policy, the structural balance (1.0% in 2015 and 0.7% in 2016) will continue to significantly exceed the medium-term break-even target.

Moderately expansionary fiscal policy, yet the structural surplus will significantly exceed the medium-term target

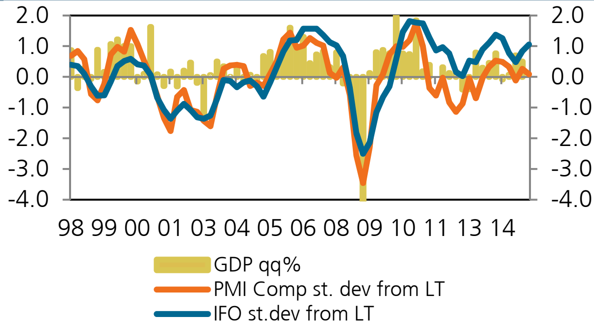
The cyclical recovery should ensure that tax revenues hold up, despite structural cuts in social security contributions, and the raising of the minimum amount exempt from taxation and deductions for child benefits. Tax receipts could fall to 39.3% as a percentage of GDP, from 39.7% in 2014. Meanwhile, we expect to see a fall in the ratio of primary expenditure to GDP thanks to the trend in the denominator and the fall in spending on unemployment benefits, which will partly offset the increase in pensions spending (associated with the change in the retirement age). Interest expenditure is expected to fall further over the forecast horizon (after decreasing by approximately EUR 6 billion last year) to 1.4% in 2016, from 1.7% in 2014, thanks to the fall in interest and debt levels. Debt is seen falling as a percentage of GDP from 74.7% in 2014 to 68.2%.

Forecasts

	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (1995 prices, y/y)	1.6	1.6	1.9	1.2	1.5	1.0	1.5	2.0	1.8	2.0	2.0
- q/q change				0.1	0.7	0.3	0.5	0.5	0.5	0.4	0.5
Private consumption	1.2	2.2	1.8	0.7	0.7	0.6	0.5	0.4	0.5	0.5	0.4
Fixed investment	3.3	2.5	3.0	-1.2	0.8	1.5	1.0	1.0	0.6	0.7	0.8
Government consumption	1.2	1.9	1.2	0.6	0.3	0.7	0.3	0.3	0.3	0.3	0.3
Export	3.7	5.1	4.4	1.5	1.0	0.8	2.0	1.4	1.0	0.9	1.2
Import	3.4	5.3	5.4	0.8	1.9	1.5	1.0	1.0	1.9	1.0	1.8
Stockbuilding (% contrib. to GDP)	-0.3	-0.8	0.1	-0.6	0.4	-0.3	-0.6	-0.2	0.4	-0.1	0.2
Current account (% of GDP)	7.8	8.6	8.3	8.4	8.3	8.8	8.7	8.9	8.6	8.5	8.3
Deficit (% of GDP)	0.7	0.4	0.3								
Debt (% of GDP)	74.4	71.7	68.4								
CPI (y/y)	0.9	0.8	1.5	0.8	0.5	0.0	0.5	0.7	1.7	2.0	1.6
Industrial production (y/y)	1.5	1.6	1.7	0.0	0.8	0.5	0.7	0.6	0.0	-0.1	1.0
Unemployment (%)	6.7	6.4	6.3	6.7	6.6	6.5	6.4	6.4	6.4	6.3	6.3
10-year yield	1.24	0.65	1.21	1.06	0.77	0.33	0.53	0.83	0.92	1.05	1.15
Effective exch.rate (2005=100)	99.8	94.7	95.8	99.4	98.7	95.3	94.7	94.1	94.6	95.4	95.7

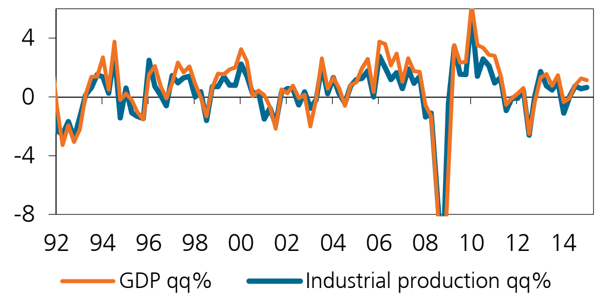
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

IFO shows more sustained GDP growth in 2Q but the PMI suggested some caution



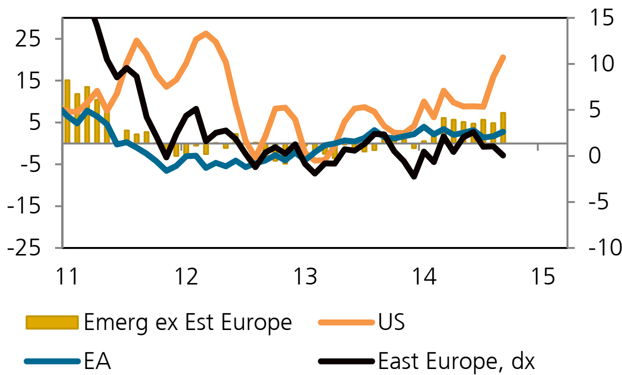
Source: FSO and Intesa Sanpaolo research

The strong entry of production and orders in 2Q is consistent with GDP growth of 0.5% qoq in June



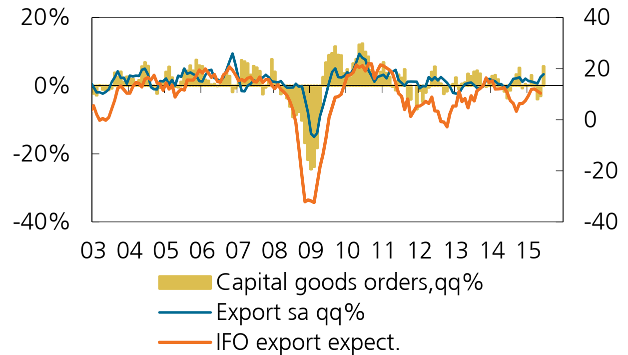
Source: FSO and Intesa Sanpaolo research

Exports rebounded sharply in April thanks to the recovery in flows with the US after the cold winder and port closures



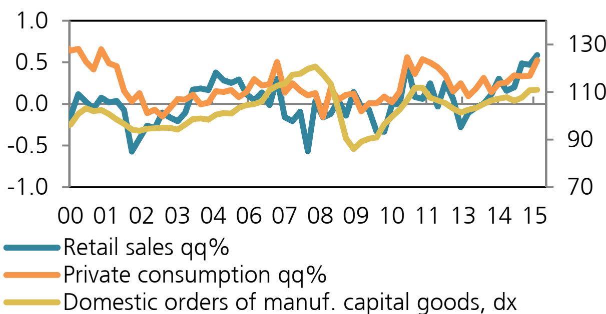
Source: Deutsche Bundesbank and Intesa Sanpaolo research

Export recovery driven by capital goods, after the fall in the Euro area aerospace industry at the start of the year



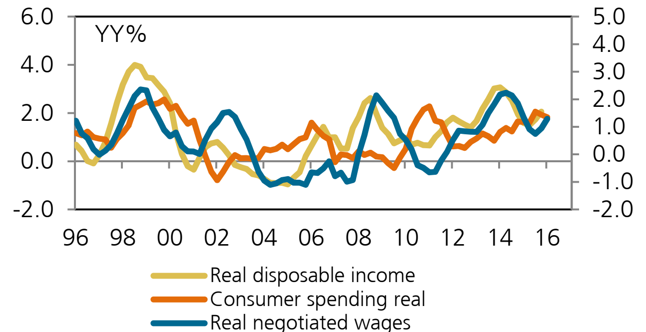
Source: IFO, FSO and Intesa Sanpaolo research

Retail sales and car registrations suggest a continuation of stronger consumer spending in the Spring



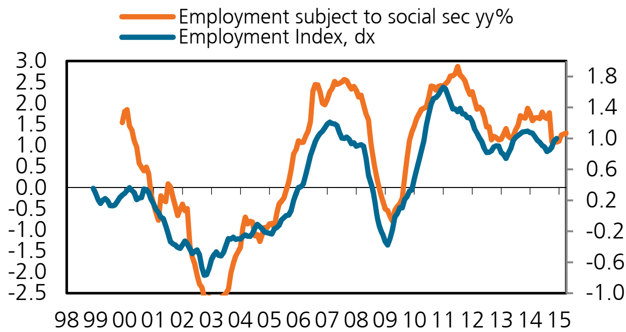
Source: Mrkit FSO and Intesa Sanpaolo research

Household consumption sustained by 2.0% growth in real wages



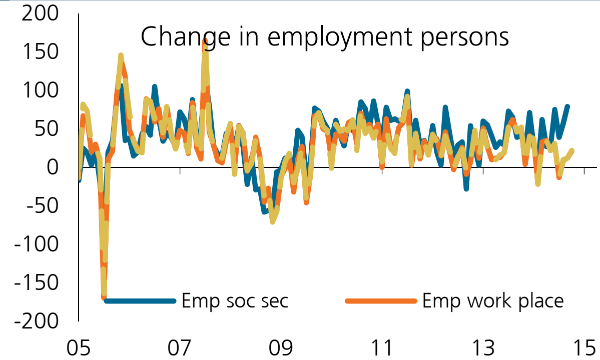
Source: FSO and Intesa Sanpaolo research

Economic surveys point 0.89%-1.0% employment growth in 2015



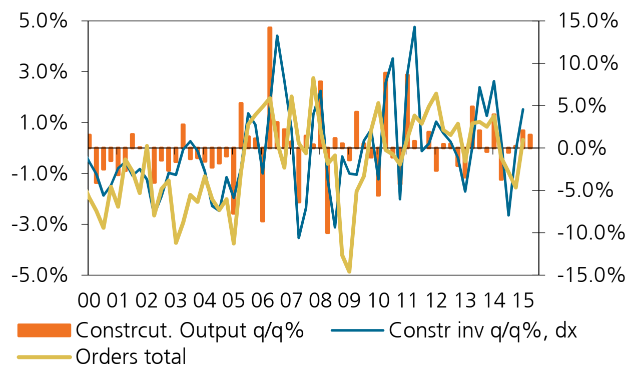
Source: IFO, FSO and Intesa Sanpaolo research

The bulk of jobs' creation came from positions subject to social security contributions



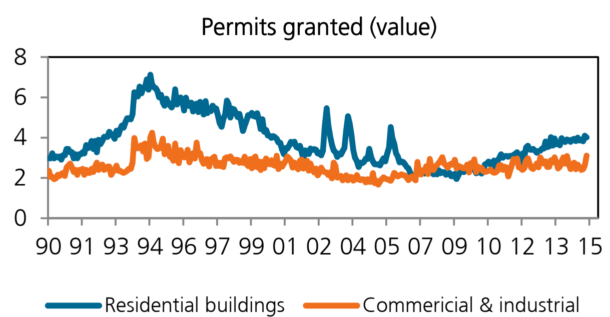
Source: FSO and Intesa Sanpaolo research

Construction: softer expansion in the spring after the sharp increases of the previous six months



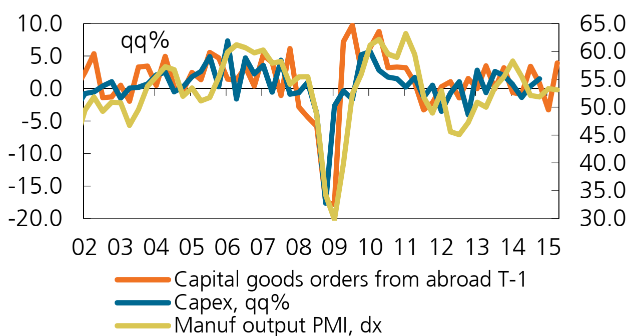
Source: FSO and Intesa Sanpaolo research

But the outlook for the sector remains positive



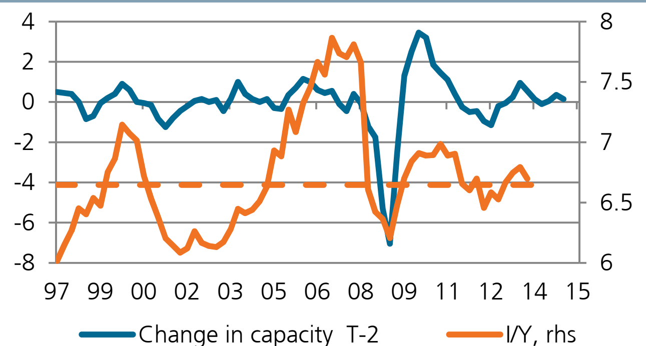
Source: FSO and Intesa Sanpaolo research

Orders point to an acceleration in capex in summer, but PMI output levels suggest a stabilisation



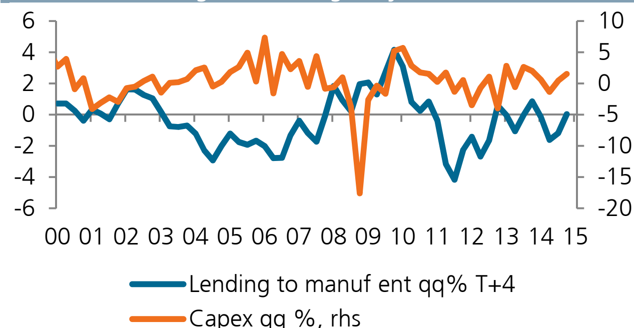
Source: FSO and Intesa Sanpaolo research

The increase in production capacity seems to have come to a halt…



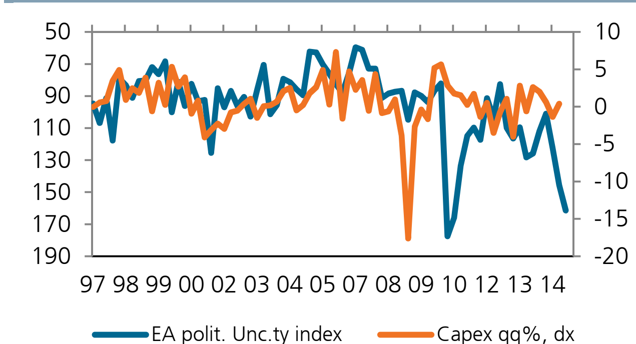
Source: Deutsche Bundesbank, FSO and Intesa Sanpaolo research

...continuing highly expansive financial conditions raise hopes of more sustained growth during the year



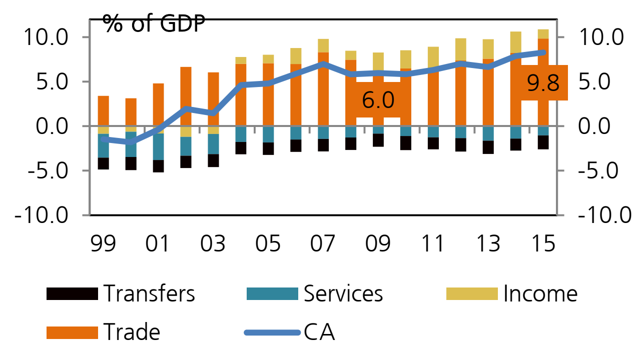
Source: Deutsche Bundesbank, FSO Intesa Sanpaolo elaborations

But geopolitical uncertainty could weigh on corporate investment



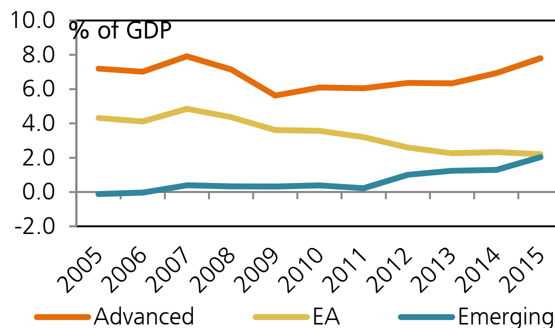
Source: Intesa Sanpaolo chart on Economic Policy Uncertainty and FSO data

That current account surplus that won't stop growing The trade balance is expanding....



Note: 2015 available until March. Source: Deutsche Bundesbank, FSO and Intesa Sanpaolo research

...thanks to the contribution of the emerging markets and, to a lesser extent, the advanced economies outside the Euro area



Source: Deutsche Bundesbank, FSO and Intesa Sanpaolo research

France: economy gets into gear

The outlook for the French economy has turned around, after better-than-expected GDP figures for 1Q. Domestic demand and, in particular, consumption will continue to contribute in 2Q, while net exports are likely to remain stable compared with March. Output growth, however, will be 0.2% qoq, down from 0.6% qoq. Over the year as whole, the French economy should grow by around 1.1%.

Guido Valerio Ceoloni

Growth in 2015 above 1%, for the first time since 2011

2015 got off to a good start, with the stagnation at the end of 2014 giving way to a better-than-expected first quarter, with growth at 0.6% qoq. The boost came from domestic demand, which grew by 0.5% qoq (previously -0.3% qoq), and from a 0.5% qoq increase in inventories (previously +0.1% qoq). Net exports, however, fell by 0.5% qoq. For 2Q, we expect a slowdown in growth to just +0.2% qoq (1.0% yoy), mainly because of a dip in the industrial sector in April, which has very probably compromised the quarterly performance, and the usual impact of de-stocking from the high levels in 1Q. Growth in the services sector should remain on a par with 1Q. Overall, the Bank of France and INSEE surveys are still improving, and industry and services are recovering at a steady pace. Construction, which was very depressed in 2014, should see improvement, with annual average growth rising from 0.2% in 2014 to 1.1% in 2015, with risks to the upside. However, the rate of recovery will remain below the average for the Euro zone.

Growth drivers in 2015 are mainly external

The three factors driving the outlook for 2015 are all well known, and are mainly external: the sharp depreciation of the euro, which should support foreign trade throughout the year, thereby boosting the trade balance; the falling oil price, which despite the recent rally, remains at historically very low levels, facilitating energy supplies; and lastly, accommodative financial conditions (impact of QE implemented by the ECB), which will support lending to households and companies and is already benefiting the housing sector, where purchases of new houses have surged since March.

Domestic demand will be the main growth driver this year. Investment remains weak, but construction is at last showing positive signs

The upturn in private demand will continue throughout the year, driven by growth in consumption due to the increase in real incomes, although we will still need to keep an eye on the average indebtedness of both households and firms; this is growing every year in France, so is being closely monitored in Europe. Income is showing no signs of growing at the moment either. The effect of energy prices on consumption is set to disappear mid-year, while rising inflation, although moderate, and higher oil prices towards the end of the year will erode the current increase in purchasing power. Capital spending by households will likely continue to slow in 2Q; although this should tail off in the second half of the year, growth will remain negative over 2015 as a whole (-4.7% yoy vs -5.3% yoy). Business investment could grow slightly, especially in 2H, encouraged by better lending conditions, although for investment to really pick up, companies must first again generate adequate profit margins, and increase their utilisation of production capacity. There is also likely to be a tentative improvement in construction spending, but not until the second half of the year. The first signs from the property sector show, however, that activity is picking up compared with last year's gloomy situation.

Industrial output is set to advance by about 0.6% for the whole year, from -1.1% in 2014. The first quarter has set a good tone for the rest of 2015, but we are expecting a slowdown in the middle part of the year due to the fall in energy production.

The recovery underway in Europe will improve the trade balance

Foreign trade should benefit from the economic recovery underway throughout Europe. The fall in energy prices will boost the trade balance in the middle part of the year, unlike what happened at the start of the year; however, this will not change France's structural deficit, which in terms of trade in goods, will expand by about 0.5% of GDP this year, from -2.5% to

approximately -3.0%. The current account balance is expected to deteriorate slightly compared with 2014 (from -1.5% of GDP to -1.7%), but then improve marginally in 2016 (-1.6% of GDP). The euro's weakness should make French products more competitive, so we are expecting non-Euro area exports to make an appreciable contribution, especially those to the UK and the US, although the benefits have yet to be felt. Overall, however, the structural fall in the competitiveness of French products has not yet been resolved and the ratio of French goods to global exports continues to decline – despite all the measures implemented to boost competitiveness, which have so far not been enough to reverse the trend.

Unemployment at 10.0% this year; 9.9% in 2016

Growth will help stabilize employment amongst the active population, with the number of employed people this year rising by around 100,000/110,000. This comes on the back of new employment contracts introduced by the government, as also indicated by business surveys. However, it is still too early to see any marked inversion in the unemployment curve this year: the latest data show a slight fall in 1Q from 10.1% at end-2014 to 10.0%. Unemployment should therefore remain at around 10.0%[7] this year, and fall by one or at most two-tenths of a point in 2016, if the pace of recovery matches current expectations.

Inflation very weak throughout the year, well below 1%

Inflation is expected to remain very weak due to the ECB's QE programme, averaging around 0.6% for the remainder of 2015, but not exceeding an annual average of 0.3%. Prices have moved on from their low (-0.4% yoy) in 1Q and are slowly rising, which should boost the CPI to 1% at year-end; they are expected to rise further in 2016 (1.1% annual average). The core index is set to decelerate, averaging around 0.4% over the year (0.8% in 2014).

Public finances not in order until 2017, deficit in tortuous decline and debt in excess of 100% of GDP in 2016

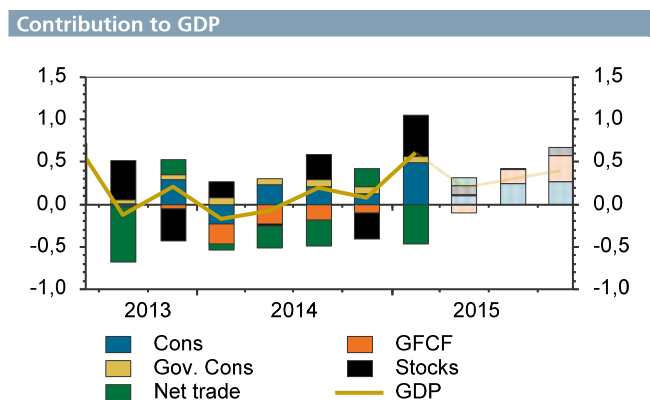
Overall, fiscal policy is expected to dampen growth over the next three years. Contrary to expectations, public spending made a positive contribution to GDP in 1Q, but we think its contribution for the rest of the year will be negative overall. The decline in debt servicing costs will certainly play a part in this; however, an effective reduction in public spending cannot be avoided, particularly for local government agencies, which are completing cuts planned under the project to aggregate various regions. The European authorities have granted France additional time until 2017 to bring its deficit below 3%, and the structural measures agreed with the EU will result in a more modest reduction than Brussels had requested, of 0.5% p.a. of the deficit to 2017, via a further EUR 4Bn cut in government spending this year (bringing the total to EUR 25Bn, about 1.2% of GDP). The planned reduction in the structural deficit is therefore likely to be met, reducing it to 1.6% this year, 1.1% in 2016 and 0.6% in 2017; this equates to a reduction in the deficit of 3.8% this year, 3.5% in 2016 and 2.8% in 2017. Public debt will increase further this year, from 95.3% of GDP in 2014 to 98%, and in 2016 could break through the 100% threshold.

[7] According to the ILO definition, calculated for metropolitan France.

Forecast	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.2	1.1	1.3	0.2	0.0	0.7	1.0	1.1	1.5	1.2	1.3
- q/q change				0.2	0.0	0.6	0.2	0.3	0.4	0.3	0.3
Private consumption	0.7	1.7	1.6	0.3	0.2	0.8	0.2	0.4	0.5	0.5	0.4
Fixed investment	-1.2	-0.7	1.8	-0.5	-0.4	-0.2	-0.2	0.3	0.5	0.5	0.5
Government consumption	1.5	1.1	-0.1	0.5	0.5	0.4	0.0	0.0	-0.1	0.0	0.0
Export	2.4	4.9	3.4	0.9	2.5	0.9	1.2	0.9	1.0	0.7	0.7
Import	3.9	5.9	3.4	1.8	1.5	2.3	0.8	0.8	1.0	0.7	0.8
Stockbuilding (% contrib. to GDP)	0.2	0.5	0.2	0.3	-0.3	0.5	0.0	0.0	0.1	-0.1	0.0
Current account (% of GDP)	-1.5	-1.7	-1.6	-1.8	-1.3	-1.3	-1.7	-1.9	-1.9	-1.7	-1.5
Deficit (% of GDP)	-4.0	-3.8	-3.5								
Debt (% of GDP)	95.3	98.0	99.8								
CPI (y/y)	0.5	0.3	1.1	0.4	0.3	-0.2	0.2	0.4	0.8	1.2	1.1
Industrial production	-1.1	0.6	1.1	0.6	-0.6	1.6	-1.0	0.0	0.1	0.3	0.7
Unemployment (%)	9.9	10.0	9.9	10.0	10.1	10.0	10.0	10.0	9.9	9.9	9.9
Effective exch.rate (1990=100)	99.7	94.8	96.2	99.5	98.5	95.5	94.7	94.1	94.8	95.7	96.1

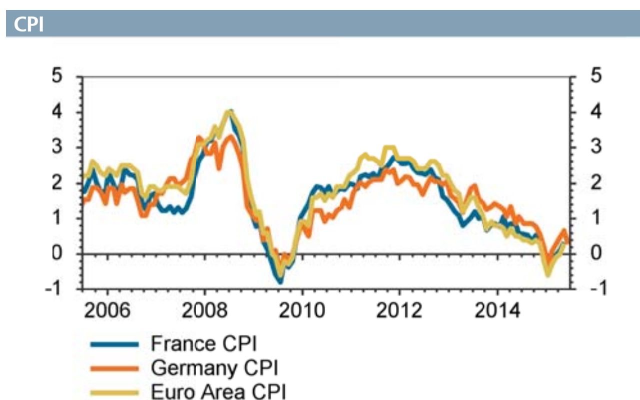
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Contribution to GDP



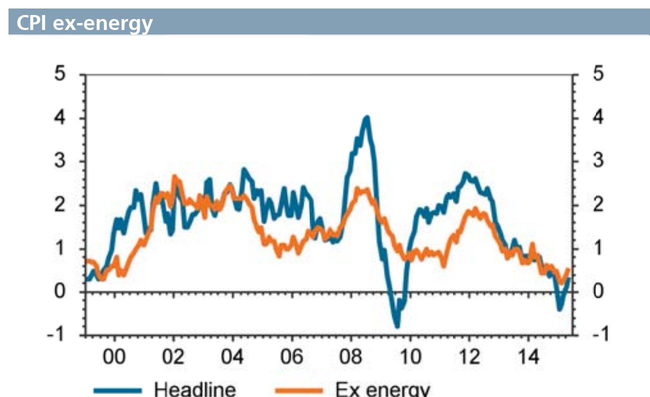
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI



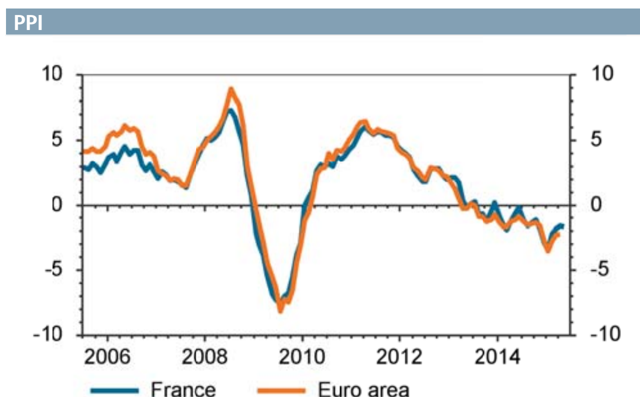
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI ex-energy



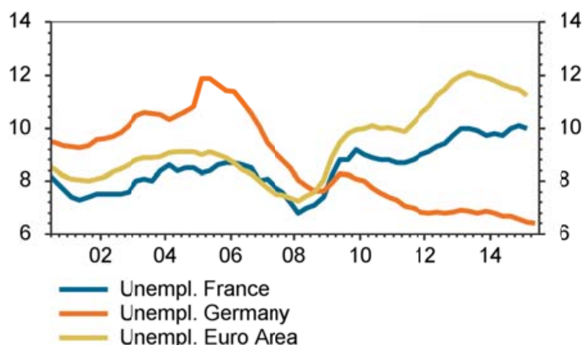
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

PPI



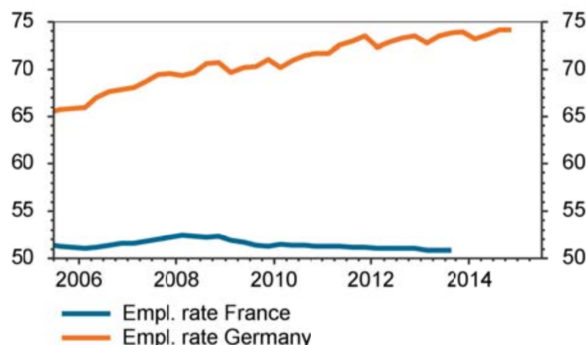
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment



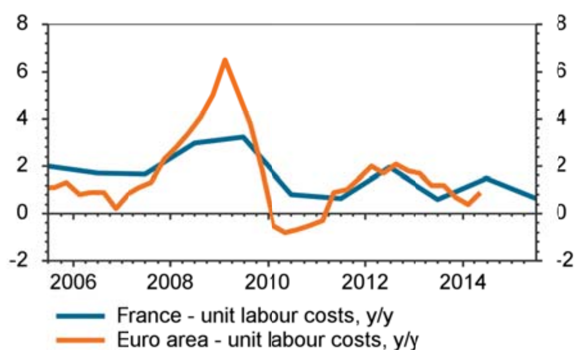
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Employment



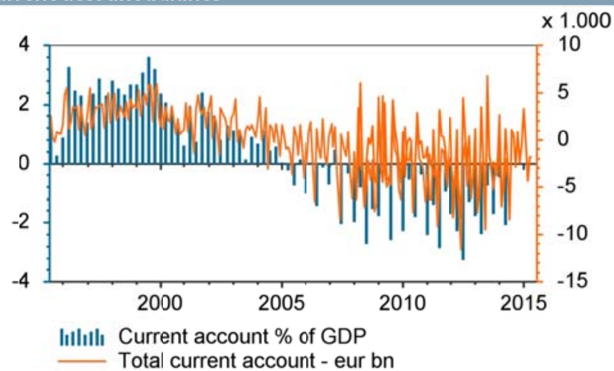
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unit labour cost



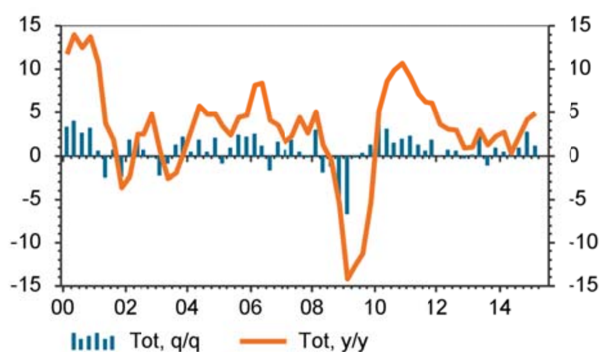
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Current account balance



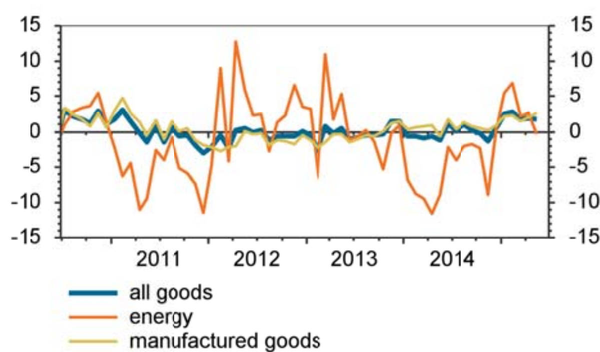
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Global exports



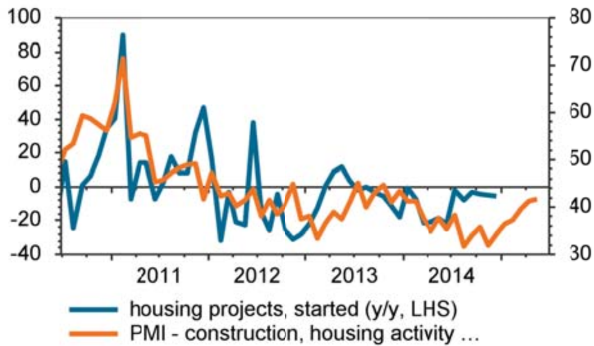
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales



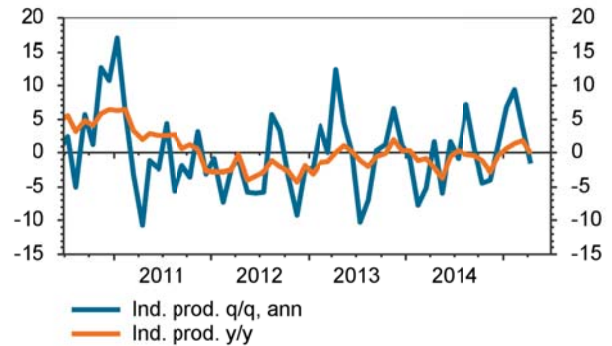
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

New house building, total



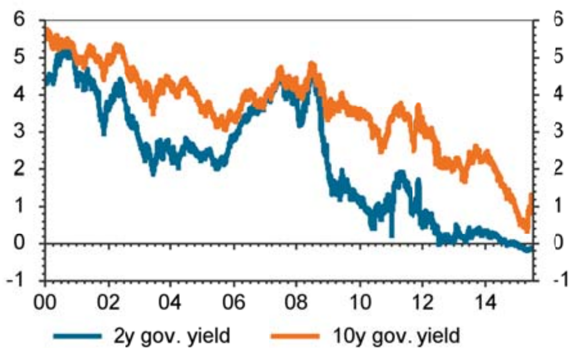
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output



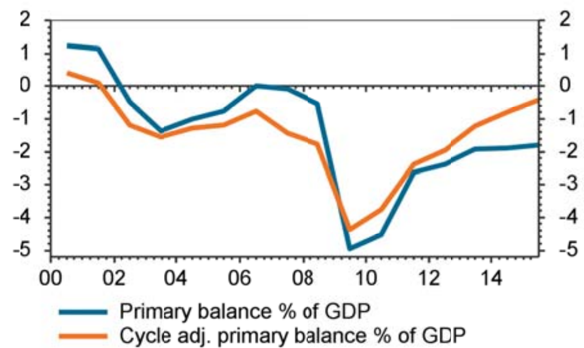
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



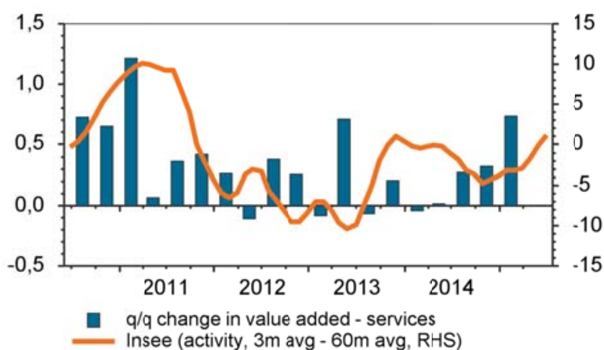
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Primary balance



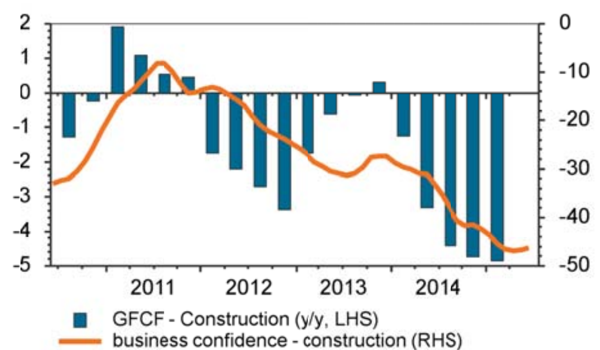
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Added value in services and confidence indicators



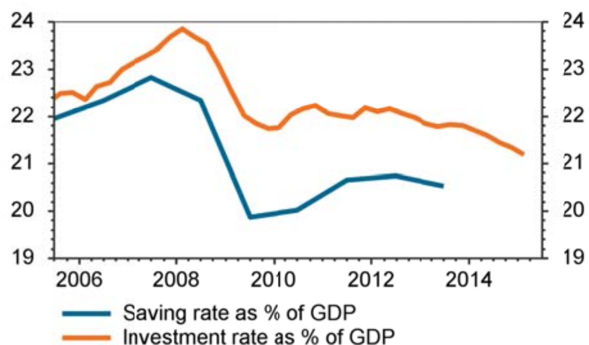
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Investment and confidence in construction sector



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

Household saving and investment rates

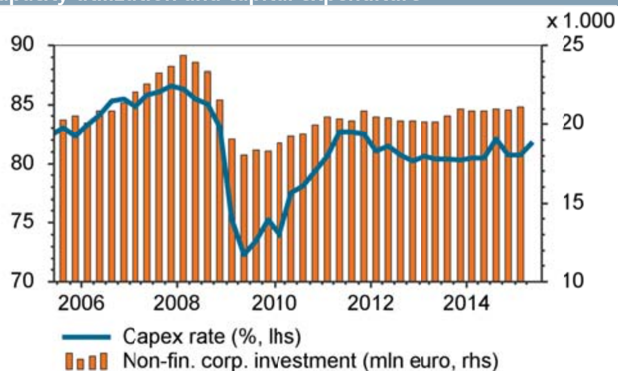


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Household confidence and purchases of durable goods

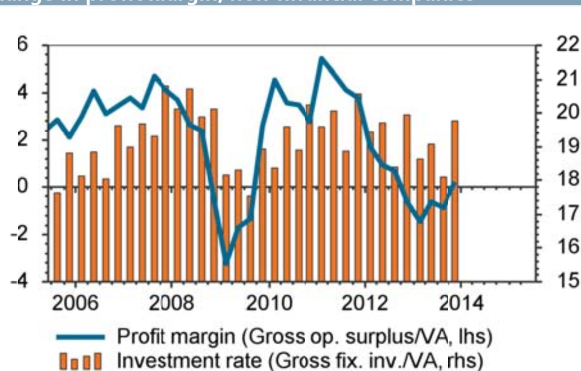
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Capacity utilization and capital expenditure



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

Change in profit margin, non-financial companies



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

Italy: recovery sustainable, but still modest and subject to risks

Paolo Mameli

After the encouraging performance in 1Q 2015 (+0.3% q/q), the Italian economy should keep up more or less the same pace of growth in the remainder of the year. In fact, there is some risk of a slowdown in the spring quarter, to 0.2% q/q, due to the smaller contribution of inventories from +0.5% q/q at the beginning of the year.

Consumption disappointed, but may benefit from the delayed effects (albeit not full) of the drop in energy prices

Consumption disappointed at the beginning of 2015 (-0.1% q/q: first negative reading after a year and a half of positive growth, albeit modest), but in our view should recover in the remainder of the year, averaging at least +0.1% q/q, as was the case between mid-2013 and the end of 2014, or even accelerate slightly. However, the weak start to the beginning of the year risks limiting consumption growth in 2015 to 0.5% (up only slightly compared to last year); on the other hand, 2015 should be only the first year of consumer purchasing power growth since 2007, therefore it is no surprise that households remain cautious; improvements on the employment front will help.

Investments in means of transport are already back on the rise…

Investments, on the other hand, beat expectations at the beginning of 2015 (+1.5% q/q: a high since 2006), albeit mostly on the back of investments in means of transport (+28.7% q/q), a very volatile component with a small weight on the total (around 5% of total investments, and less than 1% of GDP). The means of transport sector is by far the strongest driver in the present phase, as confirmed by industrial output data (and one of the strongest drivers in terms of revenues and orders to the industrial sector: Figure 5); demand seems to be activated abroad, as sales of means of transport (to the United States in particular) explain a large portion of the improvement in exports recorded in the opening months of 2015 (see below).

…whereas investments in machinery are still struggling to pick up

Vice versa, investments in machinery and equipment dipped surprisingly at the beginning of the year (-0.9% q/q), following the modest rebound seen at the end of 2014 (+0.3% q/q). In addition to uncertainty over the sustainability of the recovery, the tail end effects of the crisis terms of the low level of profits, production capacity (Figure 6), and capacity utilisation, still seem to be weighing (by no chance, investments recovered first in the means of transport segment, in which the obsolescence rate is higher and replacement is easier). However, strengthening recovery expectations, and improving financial conditions (visible in both the easing of terms and the drop in the rates applied to businesses) signal that the recovery may gradually extend to spending on machinery and equipment (Figure 7 and 8).

The recovery of the construction sector is the most important development affecting the economic scenario: however, the recovery will be very irregular

Investments in construction are a different story, and in 1Q 2015 posted the first positive change (+0.5% q/q) in almost five years. The recovery of the sector is the main and most important development of the economic scenario seen in the past few months in Italy, as the recession in the construction industry lasted almost uninterruptedly for the past seven years. Other signals in this direction came in the course of 2015: business sentiment among construction firms finally reversed upwards (Figure 9), as also output in the sector, as well as in the industrial segments which provide the main input to construction companies; building permits also rose modestly, especially in the residential segment. The recovery in pending sales on the housing market is also compatible with an improvement in the access capacity of households, already seen at the end of 2014 (Figure 10), and destined to accentuate further in the course of 2015 (with the cost of servicing debt on the decline, and disposable income on the rise). However, in light of persistent excess supply (the stock of unsold homes, while down gradually from the peak hit in 2012, remains large, at around 200k units), we believe the recovery in the construction sector is destined to prove very irregular: therefore, the average annual change in investments may rise back into positive territory no sooner than 2016.

Exports lacklustre at the beginning of year, but will go back to supporting growth…

The impulse provided by exports seems to have stalled somewhat at the beginning of 2015. However, we believe the boost impressed by the relatively weak euro is still not entirely exhausted (despite a rebound in the spring, the euro's effective exchange rate remains 10%

more competitive compared to last year's average). On the other hand, however, exports are not exempt from risks. First of all, monthly data show that most of the increase in exports over the opening four months of the year (+4.7%) was tied to sales to the United States (+3.4%; more in detail, sales of means of transport to the US accounted for over half of all the growth of overall exports: in addition to motor vehicles, the item also includes ships). However, it should be said that the performance of Italian exports to the US (+39% in the first four months of 2015 compared to the same period in 2014), at a like-for-like shock to the exchange rate, has been stronger (especially in terms of volumes) than that of German and French exports (Figures 11 and 12). Vice versa, the contribution of exports to the other euro area countries was only marginal (+0.3%), due in particular to a contraction of sales to France (in the metal works sector in particular). An important drag, which may continue in the next few months, was represented by the reduction of exports to Russia (-29%, contributing -0.5% to overall exports in the opening four months of the year), affecting not only food (-42%), hit by Russia's counter-sanctions, but also all the other sectors, due to the joint effects of the sharp recession of the local economy and of the depreciation of the rouble (means of transport dove by -62%, with motor vehicles plummeting by -79%). Exports to OPEC countries are contributing positively (with double-digit growth in electronics, food & beverages, furniture, chemicals and pharmaceuticals, leather articles, engineering), as the greater competitiveness allowed by the exchange rate has prevailed over slower demand.

…although risks do exists, especially tied to Greece and Russia

Going forward, the Russian standoff will continue to weigh, and sales to other euro area countries (with the exception of Spain) are failing to recover significantly, as the economic cycle in the rest of the euro area is not accelerating appreciably. On the other hand, exports to the United States, and more in general to dollar area countries, will continue to prove rewarding; European countries that do not belong to the euro area (The United Kingdom, Switzerland, and Eastern European countries, with Poland first among them), should continue to contribute positively (Figure 13). By contrast, sales to Turkey may reverse (following the positive 0.1% contribution made in the first four months of the year) if political uncertainty continues to weigh. Exports towards China and other Asian economies could slow as a result of the economic downturn, whereas geopolitical uncertainty throughout the Middle East should continue to have a rather limited impact, all considered, on Italian exports. Sales to Greece, which in 1Q decreased moderately, all considered (-4.4%), obviously face a major risk of incurring a much sharper slowdown in case of the temporary introduction of forms of capital control, or even worse if Greece exits the monetary union; on the other hand, a 30% drop in sales to Greece could hold back total Italian exports by three tenths at the worst, and GDP by one tenth (Figure 14).

In a nutshell, we believe the recovery is sustainable, but we do not expect a significant acceleration of the quarterly growth rate

In a nutshell, we believe that the recovery seen at the beginning of 2015 may continue in the remainder of the year (with growth averaging 0.6% in 2015 and 1.2% in 2016), mostly thanks to the ongoing joint effects of the tailwinds we pointed out as factors capable of "triggering" the recovery at the beginning of 2015 (drop in the price of energy, depreciation of the exchange rate, effects of the ECB's quantitative easing, moderately expansive fiscal policy). However, we do not expect a significant acceleration in quarterly terms from the pace of 0.3% q/q recorded at the beginning of year, as:

1. The intensity of the aforementioned tailwinds has weakened, given the recent movements on the financial markets (recovery of commodity prices, of the euro's exchange rate, and of government bond yields), and the fact that margins for fiscal policy expansion are contracting;
2. Compared to three months ago, risks, both external and internal, have increased (see hereunder).

Tailwinds still supporting the recovery, but losing intensity…

In essence, if the intensity of the tailwinds we described three months ago as factors capable of triggering the recovery has decreased, they will in any case reap significant effects, in 2015 especially. The combined effects of the drop in the price of energy, of the depreciation of the exchange rate, of the effects of QE and of fiscal policy, could in our view reap a **positive impact on 2015 GDP of around 0.7-0.8%** (from a maximum impact of 1.3% estimated at the beginning of year); the strongest effect is tied to the depreciation del exchange rate (Table 1).

Next year, the waning impact of the positive shocks should be more than balanced by the **reacceleration in global demand** (at least from Italy's main trade partners). The mix of all these factors will result in **GDP growth in Italy of 0.6% this year and 1.2% the next**. Risks to this forecast seem balanced for the time being. The baseline scenario does not take into account the risks outlined above.

…however, risks of both an external and internal nature should not be underestimated

There are **two main risks** weighing on the scenario:

1) **The external risk represented by the repercussions of an "extreme" evolution of the Greek crisis:** probably, the lengthening of the standoff with creditors, or some form of default within the euro area, would have only a negligible impact on Italian GDP; only a "disorderly" exit of Greece from the euro area (an event which as we write cannot be ruled out from the scenario) could have a significant impact, although very hard to estimate (this is "uncharted territory", as also acknowledged by Draghi). The obvious tensions in terms of the **widening of the risk premium** on all peripheral countries could be effectively countered only by an **acceleration in the pace of government bond purchases by the ECB**. The main impact would materialise through a deterioration of sentiment, whereas **direct economic contagion channels are limited**, as:

    a) **Italian exports to Greece** account for less than 1% of total exports, and less than 0.3% of GDP (Figure 15);

    b) **The private financial sector's exposure** was estimated at around one billion euros (less than 0.1% of GDP) based on BIS data at the end of 2014 (from almost 7 billion at the end of 2009), although exposure is likely to have been further reduced in the past few months, to negligible levels;

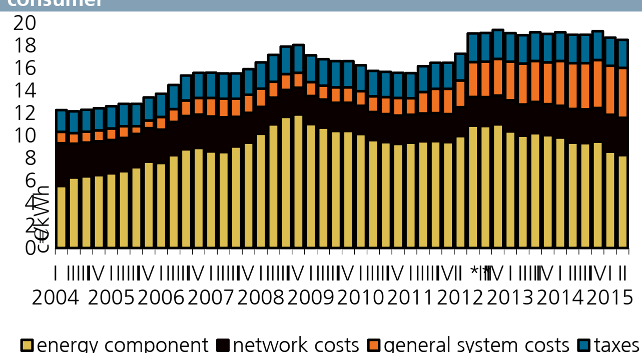
    c) The most serious financial consequence would affect **state sector exposure worth 40 billion euros** or just over (through the bilateral loan, guarantees offered to the EFSF, and the implied share of Greek bonds purchased by the ECB under the SMP; Target 2 imbalances are excluded, which will almost certainly not be reabsorbed), which in any case would translate into losses only when effectively put to books (mostly starting in 2023).

2) **The risk, entirely of a domestic nature, of the government losing steam in implementing its reform agenda:** the recent drop in the government's popularity ratings, as well as increasing controversy within the majority, and in particular within the leading party, advise us not to entirely rule out this scenario. While we believe political risk in terms of the chances of the a government crisis, and therefore of an early election, remains contained, centrifugal forces within the majority could water down the reform process: now that the electoral reform and the labour market reform have been implemented, risks seem to have mounted in terms of the completion of institutional reforms (necessary for the electoral law to come into force, as it considers only one of the two houses of parliament), as well as of other reforms, first among them the education reform. For the time being at least, this may prevent an improvement in Italy's ratings country risk index.

Forecasts	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (constant prices)	-0.4	0.6	1.2	-0.5	-0.4	0.1	0.5	0.8	1.1	1.1	1.2
- q/q change				-0.1	0.0	0.3	0.2	0.2	0.3	0.3	0.3
Private consumption	0.3	0.5	1.1	0.2	0.1	-0.1	0.2	0.3	0.3	0.2	0.2
Fixed investment	-3.2	1.3	2.1	-0.7	0.2	1.5	-0.4	0.5	0.6	0.6	0.6
Government consumption	-1.0	0.2	-0.2	0.2	0.4	0.1	-0.1	0.0	0.0	-0.1	-0.1
Export	2.4	3.7	4.1	0.4	1.8	0.0	1.5	1.0	0.8	1.1	1.0
Import	1.7	3.7	3.9	0.8	0.5	1.4	0.7	0.9	1.0	1.0	0.9
Stockbuilding (% contrib. to GDP)	0.0	-0.1	0.0	0.0	-0.6	0.5	-0.1	-0.1	0.0	0.0	0.0
Current account (% of GDP)	1.9	2.7	3.1	2.6	3.6	1.4	2.3	3.6	3.7	1.6	2.5
Deficit (% of GDP)	-3.0	-2.7	-2.1								
Debt (% of GDP)	132.0	133.2	132.2								
CPI (y/y)	0.2	0.2	1.2	-0.1	0.1	-0.2	0.1	0.3	0.7	1.1	1.1
Industrial production	-0.5	0.6	1.2	-0.5	0.1	0.4	0.4	0.3	0.5	0.1	0.6
Unemployment (%)	12.7	12.3	11.9	12.7	12.7	12.4	12.4	12.3	12.2	12.1	12.0
10-year rate	2.89	1.95	2.11	2.61	2.23	1.53	1.78	2.42	2.07	2.04	2.03
Effective exch.rate (2010=100)	99.8	95.7	96.5	99.4	98.9	96.2	95.7	95.3	95.6	96.2	96.4

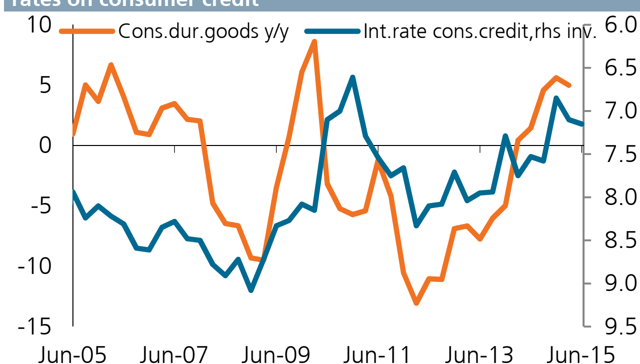
Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: Intesa Sanpaolo elaborations on Thomson Reuters-Datastream data

Fig. 1 – Trend of the price of energy for the typical residential consumer



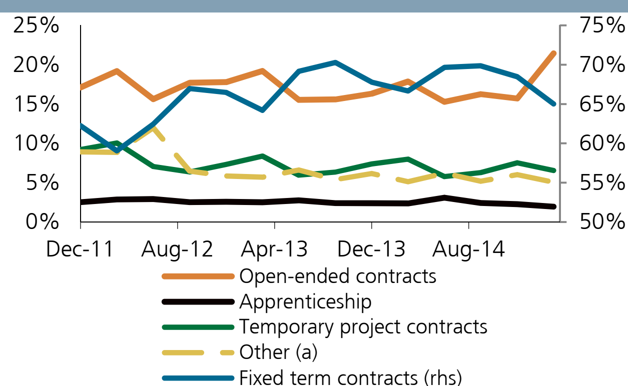
Note: prices for the supply of energy to a household with an installed load of 3 kW and annual consumption of 2,700 kWh. Source: Energy authority

Fig. 2 – Consumption of durable goods benefiting from lower rates on consumer credit



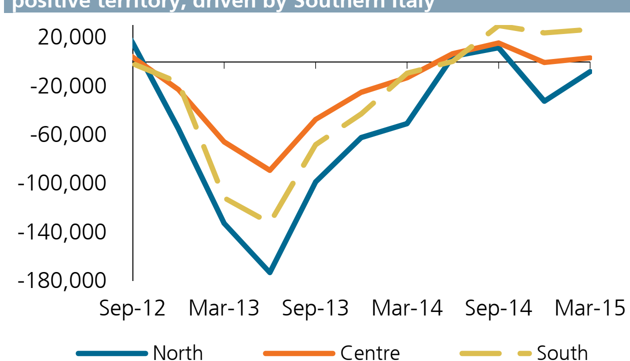
Source: Intesa Sanpaolo elaborations on Istat data, BCE

Fig. 3 – Share of new unlimited contracts on the rise



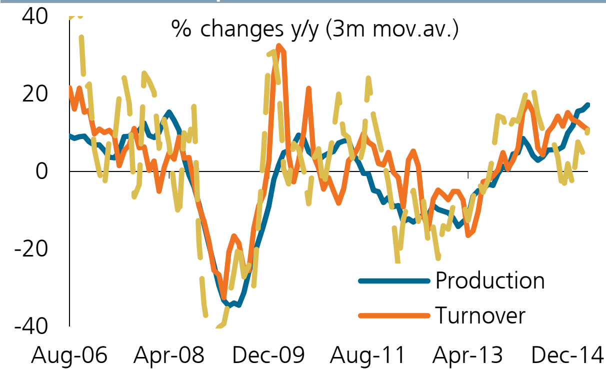
Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 4 – Balance of new and terminated work contracts back in positive territory, driven by Southern Italy



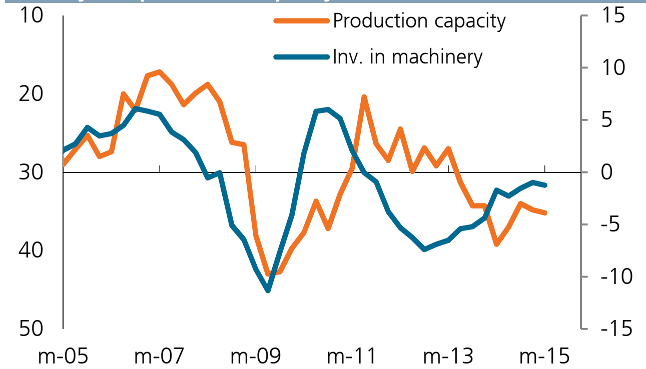
Note: 4 quarters moving averages. Source: Intesa Sanpaolo elaborations on Labour Ministry data

Fig. 5 – The means of transport sector seems to be the main driver in the current phase



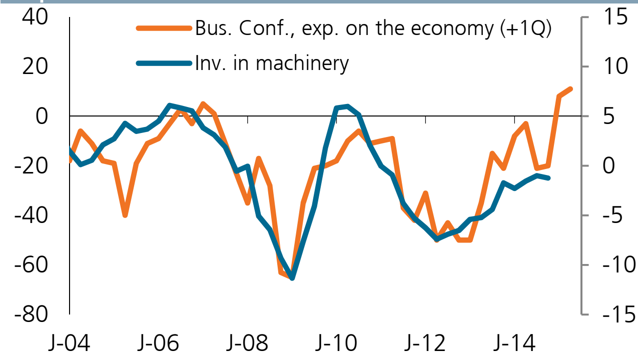
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 6 – Investments in machinery remain at a standstill, held back by low productive capacity…



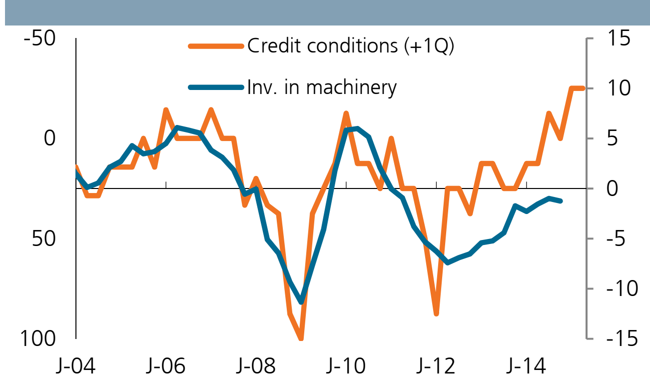
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 7 – …but stronger business expectations for a recovery will help…



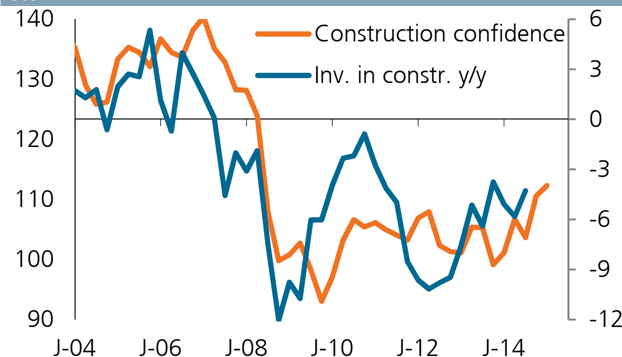
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 8 – …as also the current easing of credit conditions



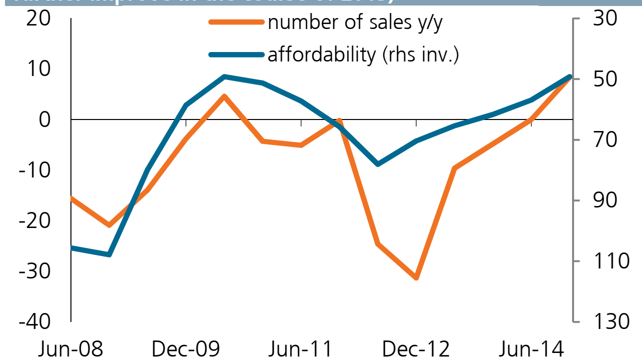
Source: Intesa Sanpaolo elaborations on Istat data, BCE

Fig. 9 – The confidence of builders is recovering, but a sustainable recovery of investments in construction is still far off



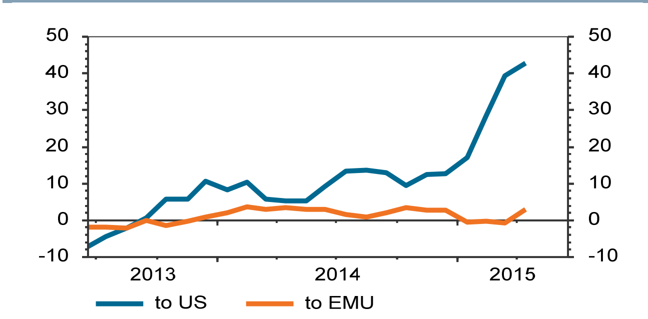
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 10 – Recovery in sales on the housing market compatible with the stronger affordability of households (which should further improve in the course of 2015)



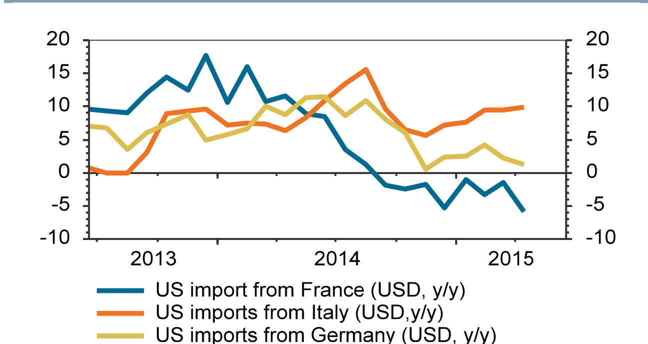
Note: the housing market "affordability" indicator is the ratio of debt service on new mortgage loans – proxied by the product of house prices and interest rates – to household disposable income; a decrease indicates that housing is more affordable.
Source: Intesa Sanpaolo elaborations on Bank of Italy data

Fig. 11 – Exports driven by sales to the United States (as opposed to a modest contribution from the rest of the euro area)



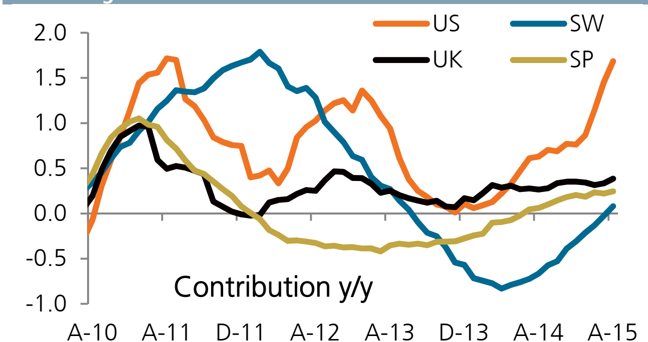
Source: Thomson Reuters - Datastream

Fig. 12 – Italian exports to the US outperformed Germany's and France's



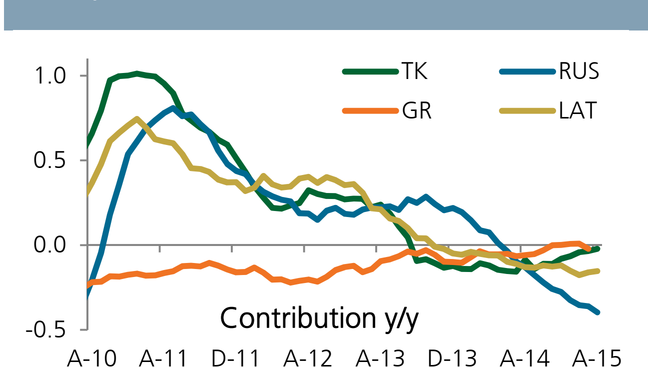
Source: Thomson Reuters - Datastream

Fig. 13 – As well as to the United States exports to the United Kingdom, Spain and Switzerland should continue to prove rewarding…



Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 14 – …whereas exports to verso Russia, Turkey, Latin America, and Greece are at risk



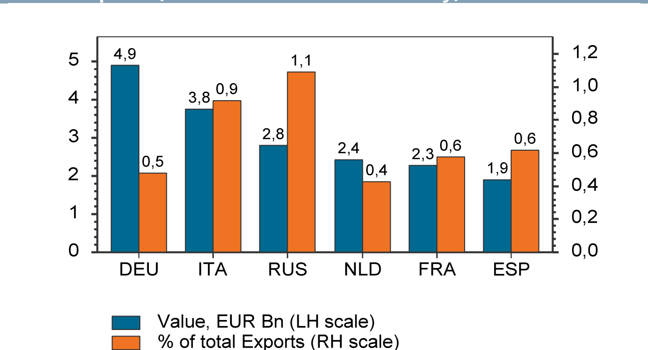
Source: Intesa Sanpaolo elaborations on ISTAT data

Tab. 1 – Breakdown of the Intesa Sanpaolo estimate of Italian GDP growth in 2015-16, based on the various factors impacting the cycle

	2015	2016
Drop in the price of oil	0.2	0.2
Depreciation of the exchange rate	0.3	0.3
Drop in interest rates	0.1	0.0
Fiscal policy	0.1	0.0
Foreign demand	0.0	0.6
External risks (Greece + geopolitical tensions)	-0.2	0.0
GDP forecast	0.6	1.2

Source: Intesa Sanpaolo elaborations and forecasts

Fig. 15– As is also the case for the other main European countries, exports to Greece account for less than 1% of total Italian exports (around 0.3% of GDP for Italy)



Source: Thomson Reuters - Datastream

Spain: riding high at the moment, but risks abound

Anna Maria Grimaldi

Spain has been growing since 2H13, initially at a fairly weak pace but since 2Q14 at 2%-2.8% annualised. At the beginning of 2015, with GDP growth surprised again with a +0.9% qoq (3.6% ann.) which execeed most upbeat expectations. The surprise start to 2015 means we have raised our estimate for the current year to 2.8%. We are expecting growth of 2.3% in 2016, which is still higher than the potential estimated by the European Commission (0.2%). The return to such buoyant rates is the product both of the reform process implemented during the crisis years and of fiscal policy, which was less restrictive in 2013-14 (change in structural balance -1.3 points from -2.7 points in 2012) and is set to be moderately expansive in 2015 (change in structural balance +0.4 points). Spain has also benefited from progressively more accommodative financial conditions[8]. Further support came from the fall in the oil price of over 60%. The Spanish economy is highly dependent on energy imports and thus the impact of a drop in the energy bill is quite sizeable (+0.7% extra GDP growth after one year of 60% decline in oil prices). **Risks to the forecast.** While positive on the country, we remain cautious: deleveraging must continue, as some of the gains made in competitiveness over the last few years have waned; and labour, products and taxation all require further reform efforts. The high level of public debt (100.8% in 2015) is a potential vulnerability if the markets reverse, but the main risk for 2015 is undoubtedly political. A simulation carried out by *El País* using the results of the regional elections on 24 May suggests that in the national elections at the end of 2015, the PP would win only 120 seats (132 in 2011), the PSOE 108 (from 119), *Podemos* 37 and *Ciudadanos* 18. So after the national elections, Spain could, for the first time since 1978, be governed by a large coalition, which might be the only option.

Consumption and machinery are growing at pre-crisis levels …

Short-term outlook. The composite PMI averaged 58.7 between April and May 2015, compared with 56.6 in 1Q15 and 54.5 at end-2014 (see Fig. 1) and is consistent with GDP growth of around 0.7% qoq in the middle months of the year. Industrial output was stable in April, after two months of sharp increases, and is on course to grow 1.1% qoq in June, as in March. Most of the increase will be driven by internal demand, which we expect to contribute 2.4 points to GDP growth, compared with +2.0% in 2014. **Consumption**, in particular, should grow 2.7% in 2015, after 2.4% in 2014. The confidence indices are at their highest since 1993. Real disposable income accelerated more than 1.5% in 2014, supported by tax cuts, falling petrol prices, higher-than-expected growth in employment and more favourable financial conditions. The collective wage bargaining process for 2015 will determine a 0.6% increase, compared with 0.5% in 2014. Real salaries are expected to continue rising by about 0.8% in 2015. **Investment in machinery** is expected to increase by 6.0%, up from 5.8% in 2014, buoyed by a range of factors: productive capacity utilisation levels are back in line with the historical average, gross operating margins have recovered strongly (see Figs. 5-17), financing conditions have improved, loans have gradually reversed and the outlook for growth in domestic and foreign demand is more solid. Residential construction, after plummeting for seven years, seems to have bottomed out and to be close to starting a very gradual reversal. The contribution of residential **construction** to GDP fell to 3.8% in 2014, after peaking at 8.8% in 2010 (see Fig. 9). House prices have slipped by 2.2%, or 7.3% in real terms, since 2013. However, the reversal in the residential sector will be slow. Although house sales have started to improve, the unsold housing stock is still fairly high (see Fig. 10), which will dampen new residential investment. Manufacturing picked up speed in the winter months, compared with end-2014. It was supported by a sharp acceleration in exports to the US until December, and when US demand slowed, exports found support from Latin America, and to an extent the European recovery. The shift in orientation from Eastern Europe to dynamic markets should help isolate Spanish exports

… construction has also turned around

Manufacturing activity supported by diversification of exports towards more dynamic economies

[8] First with the resolution of the banking crisis in 2012 and then with the gradual fall in short and long-term rates and currency depreciation, which was accentuated by the PSPP (public sector purchase programme).

from the geopolitical tensions in Eastern Europe. The global PMI suggests export performance will be weaker in the next few months (see Fig. 11). In theory, currency depreciation should provide additional support to trade flows (see Fig. 13). However, the risks in the short term are to the upside, given the fairly rapid response of imports to exchange rate fluctuations (see Fig. 13). Overall, we expect **exports** to advance by 5.1% in 2015 and by 4.2% in 2014. **Imports** should follow up their strong acceleration in 2014 (+7.6%) with 5.0% growth, which is in line with the elasticity in internal demand seen in the past.

The high level of unemployment is one of the main challenges in the medium term

The recovery has spread to the **labour market:** growth in total employment (annualised) averaged 2.1% in 2014 after a 1.9% fall in 2013. On average, 150,000 new jobs were created per quarter between June 2014 and March 2015. The private sector created 468,000 new jobs (between March 2014 and March 2015). The upturn in employment has exceeded the amount suggested by hiring intention surveys (see Fig. 5). **Unemployment** has fallen more quickly than we expected, to 22.7% in April from a peak of 27% in March 2013, and in recent months has been trending flat. The fall is partly due to the drop in the participation rate, from 60.2% to 59.5%, owing to an increase in the inactive population. Over the forecast horizon, we expect a modest drop in unemployment, to 21.2% at end-2016.

The old controversy between the Government and the European Commission about the level of the structural balance has been re-ignited

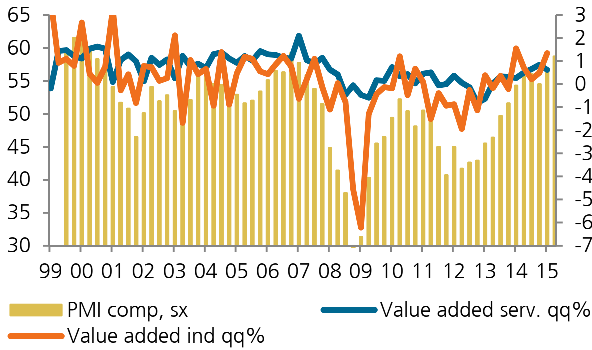
Public finances. The deficit closed at -5.8% of GDP, in line with our estimates (-5.7%) and the European Commission's forecasts of a year ago (-5.6%). The one-point fall since 2013 is due to better cyclical dynamics. The structural deficit in 2014 was virtually unchanged at -2.0%. We expect the deficit to drop to -4.7% of GDP in 2015, then to shed another point to close 2016 at -3.7% of GDP. In the updated Stability Programme, the fiscal effort to be implemented in the current year has been slashed from 1.0% to 0.5%, in light of the still wide output gap (estimated at -3.8% in the spring). But even under the revised Stability Programme, Spain would be non-compliant, since the European Commission is forecasting its structural balance to worsen to 0.4%. The European Commission has given Spain the green light for 2015, in part because of the high level of reforms, but also in light of the political elections at the end of the year. The country will have to get back to making corrections in 2016, when the output gap is estimated to narrow to 1.8%. But as was already the case in recent years, the debate between the European Commission and the Spanish government over the level of the country's structural balance and, consequently, over its medium-term structural correction is still ongoing.

Forecasts

	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (constant prices)	1.4	2.7	2.3	1.6	2.1	2.7	2.8	2.8	2.7	2.4	2.3
- q/q change				0.5	0.7	0.9	0.6	0.5	0.6	0.6	0.5
Private consumption	2.4	2.7	1.9	0.8	0.9	0.7	0.5	0.4	0.4	0.7	0.4
Fixed investment	1.8	3.6	2.3	3.0	0.8	0.5	0.4	0.6	0.8	0.4	0.8
Deficit (% of GDP)	-5.8	-4.7	-3.7								
Debt (% of GDP)	97.2	99.3	102.6								
CPI (y/y)	-0.2	0.0	1.3	-0.3	-0.5	-1.0	-0.4	0.0	1.5	1.6	1.5
Unemployment (%)	25.4	21.7	20.3	25.6	25.4	25.2	22.5	22.1	21.7	21.3	20.9
Effective exch.rate (2005=100)	99.4	96.2	96.7	99.1	98.7	96.6	96.2	95.8	96.0	96.5	96.6

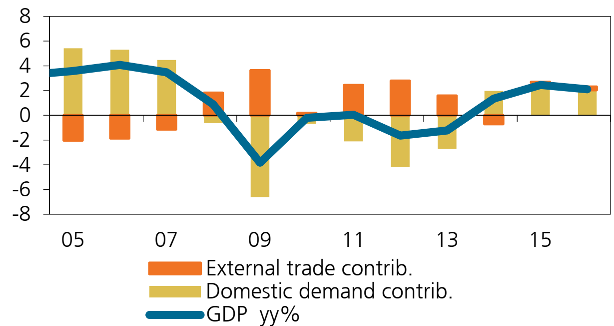
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – The recovery will remain solid in the spring/summer. Industry is accelerating



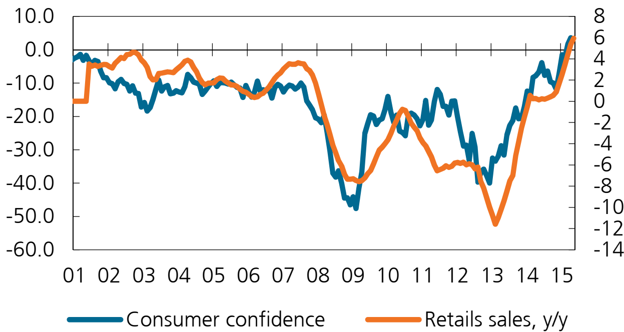
Source: Intesa Sanpaolo chart from INE and Markit data

Fig. 2 – Over the forecast horizon, support to growth will come largely from domestic demand rather than from foreign trade



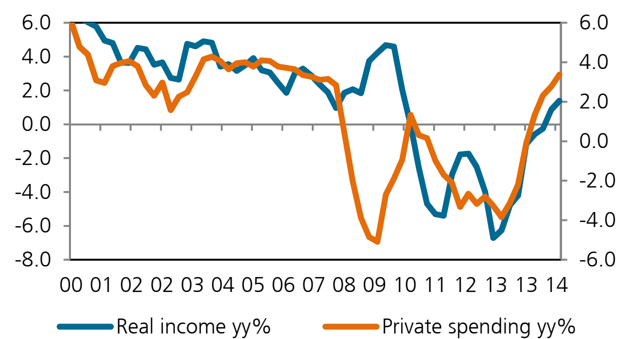
Source: Intesa Sanpaolo chart from INE data

Fig. 3 – Private consumption is recovering, with confidence at its highest levels in 15 years



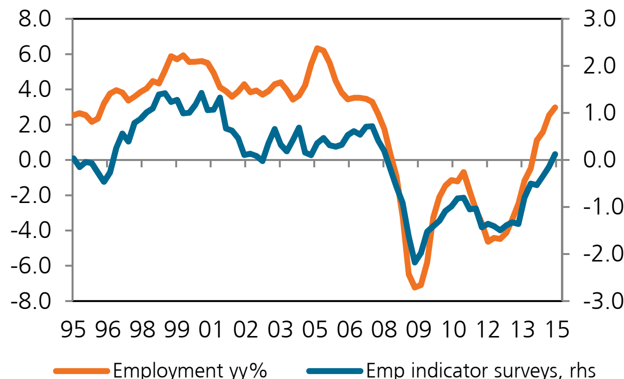
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 4 – Strong support to spending from disposable income growth, boosted by …



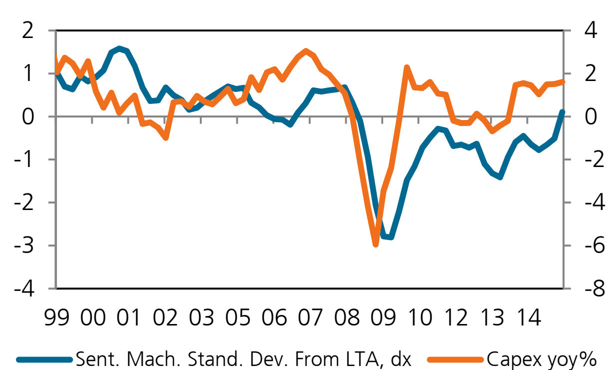
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 5 – … employment acceleration, which exceeded business confidence surveys' indications



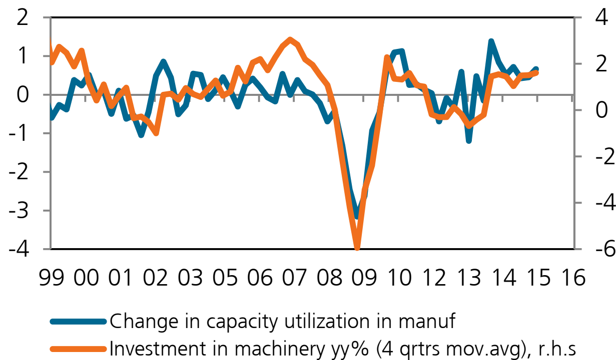
Source: Intesa Sanpaolo charts from UE Commission and INE data

Fig. 6 – Capex grew faster than was suggested by the upturn in confidence …



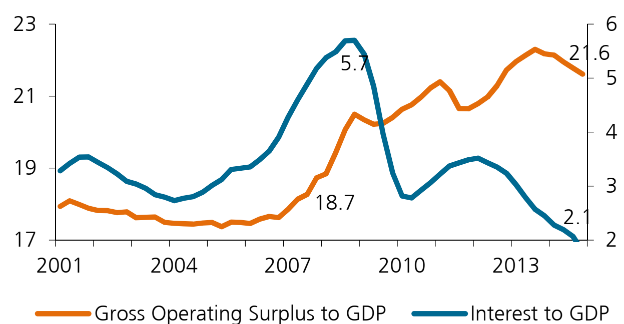
Source: Intesa Sanpaolo chart from INE data

Fig. 7 – … but it is in line with rising capacity utilization rate, which is back to its historical average, and …



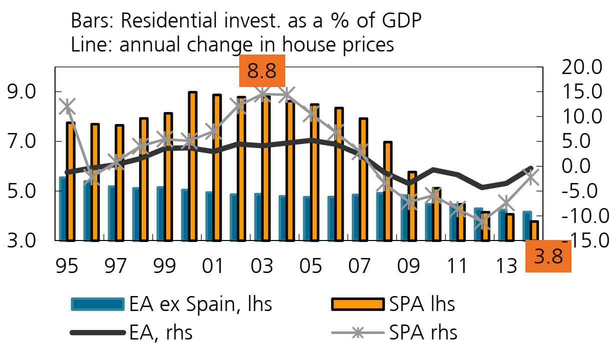
Source: Intesa Sanpaolo chart from European Commission and Eurostat data

Fig. 8 – … investment is supported by higher gross operating margins and falling interest expenditure



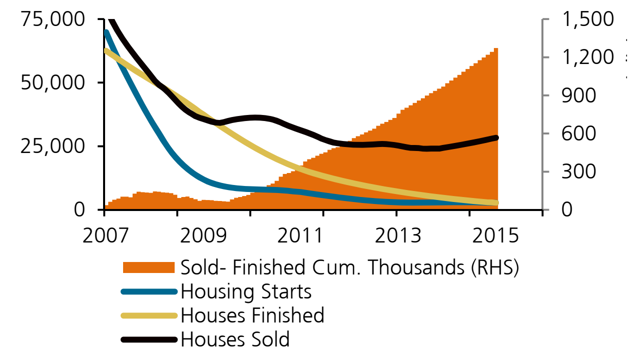
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – Construction has also turned around: the ratio of residential investment to GDP has fallen below the EU average, prices are starting to rise, but …



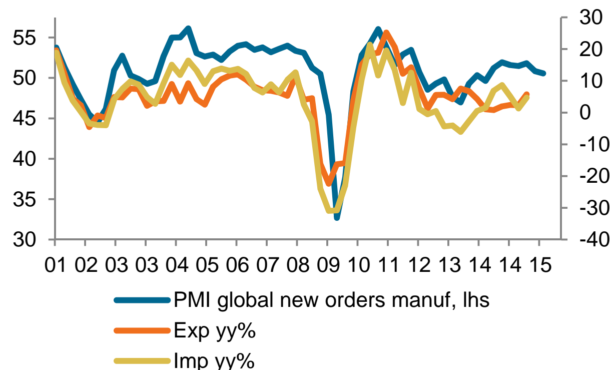
Source: Intesa Sanpaolo chart from INE and ECB data

Fig. 10 – … we expect only marginal growth in construction, given the high stock of unsold housing



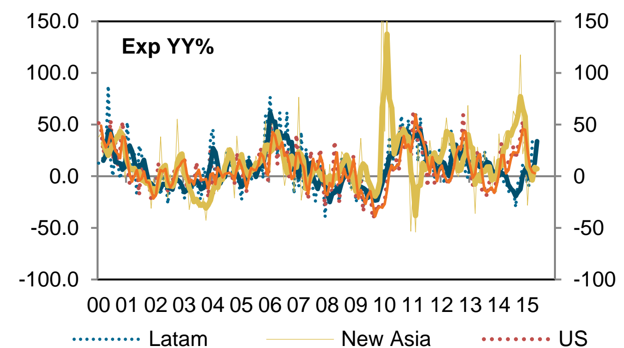
Source: Intesa Sanpaolo chart from INE data

Fig. 11 – The Markit PMI for global orders suggests foreign trade is stabilising



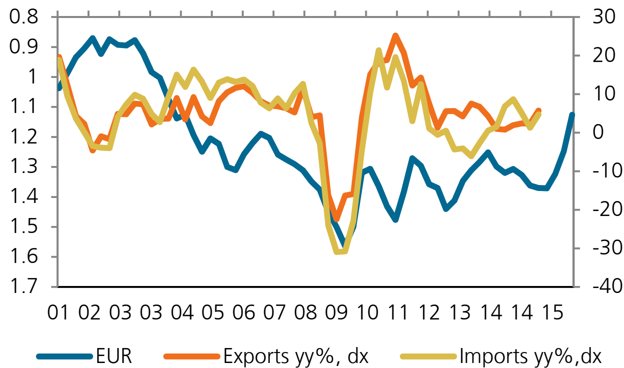
Source: Intesa Sanpaolo chart from INE and Markit data

Fig. 12 – Exports supported by diversification of main markets towards more dynamic economies and by …



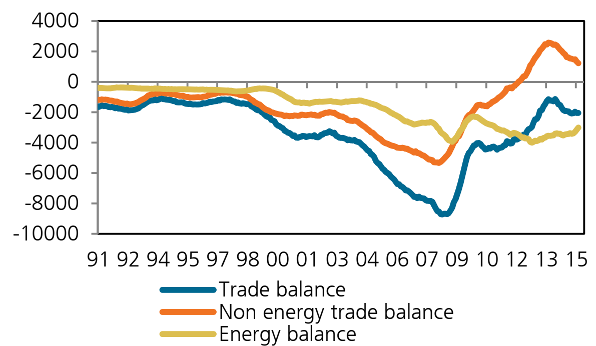
Source: Intesa Sanpaolo chart from INE data

Fig. 13 – …exchange rate depreciation. Imports are reacting more quickly than exports to currency fluctuations



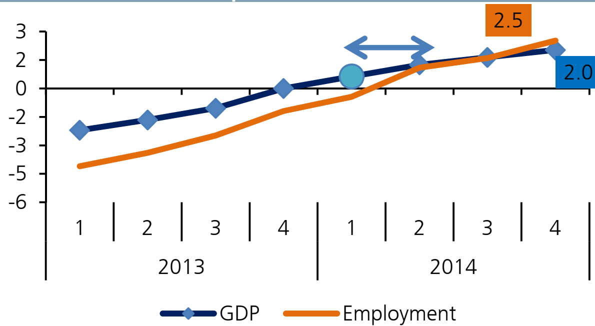
Source: Intesa Sanpaolo chart from INE data

Fig. 14 – This could further depress non-energy goods balance



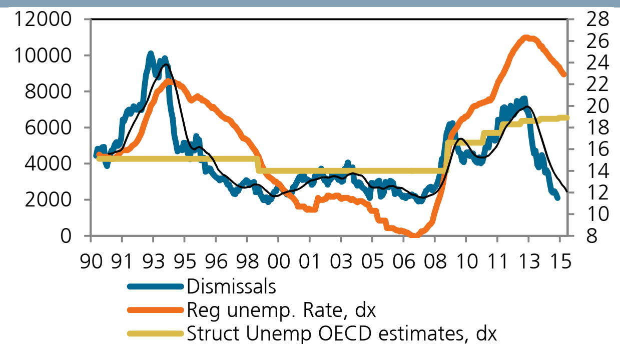
Source: Intesa Sanpaolo chart from INE data

Fig. 15 – The lag between growth in GDP and employment has narrowed: from 4 quarters in 1993-94 to 1-2 quarters lately. Effect of the reforms or post-crisis rebound?



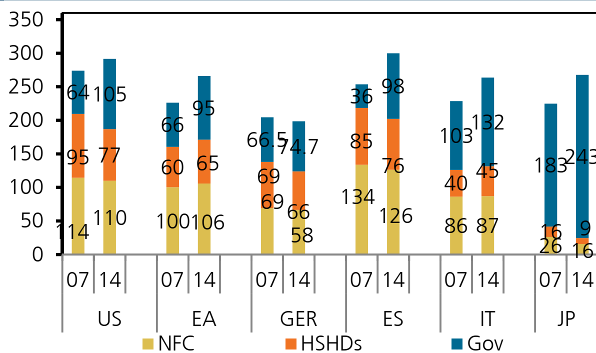
Source: Intesa Sanpaolo chart from INE data

Fig. 16 – Challenge no1: remaining challenges: high unemployment rate is no mean the key challenge for Spain



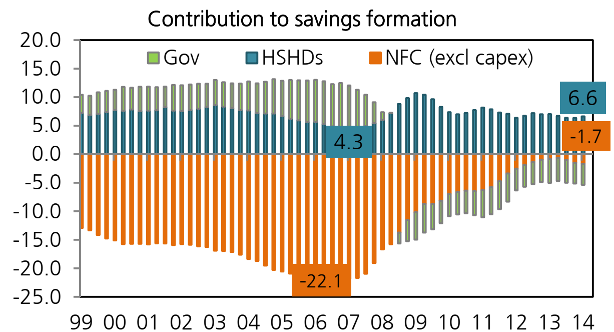
Source: Intesa Sanpaolo chart from INE and OECD data

Fig. 17 – Challenge no. 2: continue to grow with a high deficit



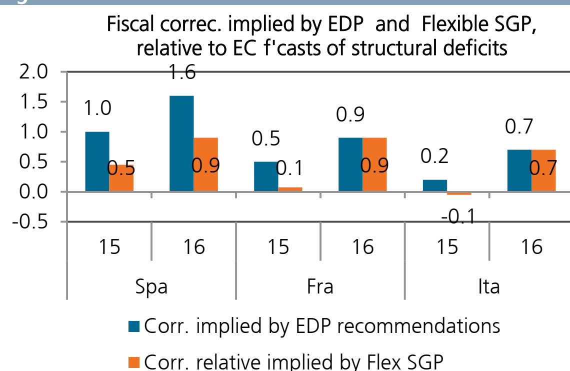
Source: Intesa Sanpaolo chart from ECB and national accounts data

Fig. 18 – Most of the increase in savings has come from firms and households in the last two years



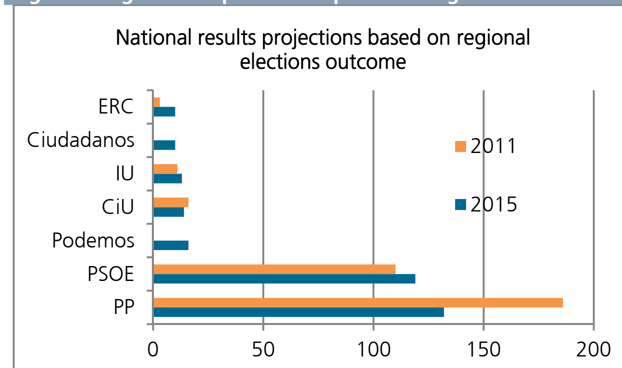
Source: Intesa Sanpaolo chart from INE and national accounts data

Fig. 19 – The fiscal correction that needs to come after 2015



Source: Intesa Sanpaolo charts from European Commission data

Fig. 20 – High risk of protracted political fragmentation



Source: Intesa Sanpaolo charts from El Pais Metroscopia

Netherlands: growth is stabilizing

Guido Valerio Ceoloni

The economy of the Netherlands (EUR 633Bn, about one-third the size of France's) is set to outperform average Euro zone growth this year: Dutch exports should receive a big boost from the euro's weakness, while domestic demand will remain positive, although not yet especially bubbly. Overall, the country has no problems; its trade balance is clearly in the black, its public accounts are in order and unemployment is already far better than the EU average. Still, one point of note is household debt, which remains high.

Compared with the Euro zone average, the Netherlands should see **satisfactory average annual growth of around 2.0% p.a. this year, up from 0.9% in 2014**. Output is expected to slow overall in the first half of 2015, given the surprising figures at end-2014, which were stronger than consensus expectations (+0.8% qoq, the best result in four years). The satisfactory start to 1Q (0.6% qoq, final estimate, up of two tenths after a first estimate of 0,4% qoq) included a positive contribution from net exports and domestic demand, offset by sharp and unusual (the largest in five years) de-stocking. 2Q should see net exports virtually stable, while domestic demand slows after the unexpected increase in capital investment in 1Q: overall, output in 2Q is expected to rise by 0.3% qoq (from 0.6% qoq previously).

The growth drivers in 2015 will be evenly distributed across the various components of GDP: consumption and capital spending will improve, as will exports, which –as in the rest of the Euro zone– are supported by the euro's weakness. The risks to this forecast are mixed, and mainly related to foreign trade, which accounts for a significant portion of the Dutch economy (more than 50% of GDP): if the impact of the weak euro exceeds expectations, net exports could receive a further boost; conversely, a slowdown in global demand could slam the brakes on growth.

Domestic demand will receive support in equal measure from consumption, which is stable and positive but not particularly strong, from capital spending and from the public sector. The confidence indicators for April and May showed consumer and business confidence at a high. Consumer spending will be stable over the year, buoyed by fairly weak inflation. Investment, encouraged by the **accommodative financial conditions** implemented by the ECB, is expected to mainly come from the manufacturing sector, although we do not expect very high rates of investment in machinery, given the still law capacity utilization in the manufacturing sector (currently around 82%). Household investment (property), conversely, is expected to slow after the year-end boom (property market +20%), which was fuelled by state incentives for the residential market. As such, the main focus in the overall picture remains **the growing level of household debt**, which could be both a weakness to be monitored and a brake on consumer

expansion. The public sector is expected to make a positive contribution in 2015, after a year in which spending cuts depressed growth.

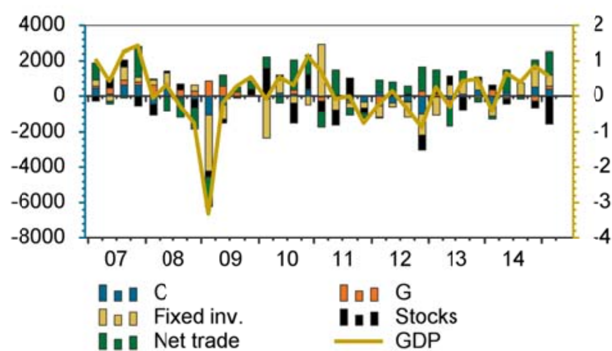
Exports will continue to benefit from the weak euro and the Euro zone's recovery, so will remain positive on a net basis throughout the year, adding two-tenths on average to growth, qoq. **Imports** have benefited greatly from the fall in oil prices since the start of the year; some of this effect has been clawed back in the current quarter, but the overall impact for the year will be positive, given the historically low price of Brent. The trade balance is expected to improve by about EUR 14Bn in 2015, having risen from EUR 67.5Bn at end-2014 to EUR 84Bn in March. The current account balance is also expected to expand, from +10.3% of GDP in 2014 to +13.5% this year. The country's overall share of exports will remain stable at around 4%.

Unemployment could shed another tenth of a point in 2Q, from 7.0% in March to 6.9%, but given the usual lag in the cycle, we are not expecting a large fall; although unemployment is well above pre-2011 levels, it remains one of the lowest in Europe. As an annual average, it should fall from 7.4% in 2014 to 7.0%. Unemployment is expected to fall marginally in 2015, to 6.7%.

In 2Q, **inflation** should accelerate (0.7% on average from 0.2% in 1Q), then slow slightly over the summer before closing the year higher. The average CPI should be similar to last year, at 0.5% versus 1.0% in 2014, but should rise above 1% from 2016 (1.3% p.a.).

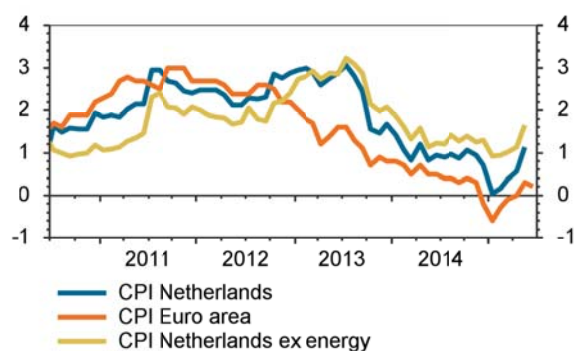
There are no problems with regard to **public finances**, with the deficit expected to shrink from 2.3% of GDP in 2014 to 1.7% this year and 1.2% in 2016; this comes on the back of improving economic conditions, which should boost treasury coffers, and spending cuts, which were fully implemented and included pensions and healthcare expenditure. The structural deficit correction target is 0.3% this year and 0.2% next. Public debt is expected to rise from 68.8% in 2014 to 70% this year, but fall back to 69% in 2016.

Contribution to GDP



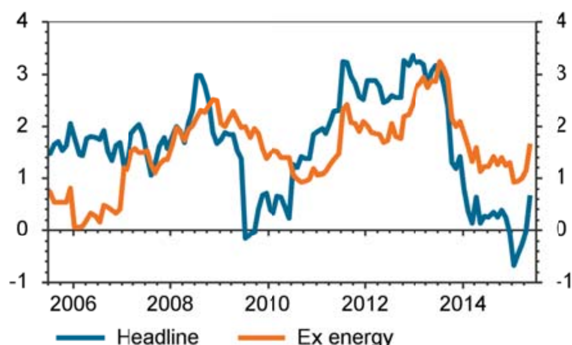
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI



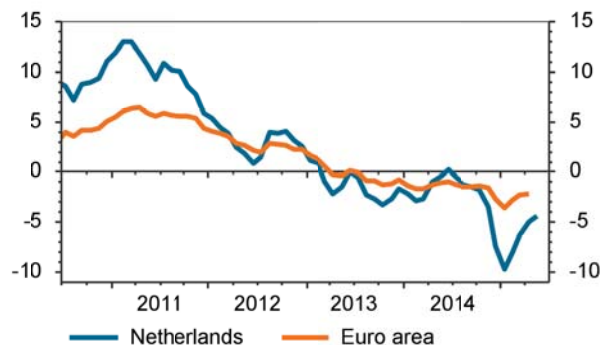
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

CPI excluding energy



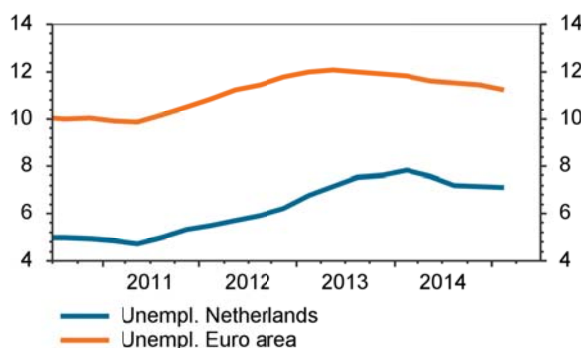
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

PPI



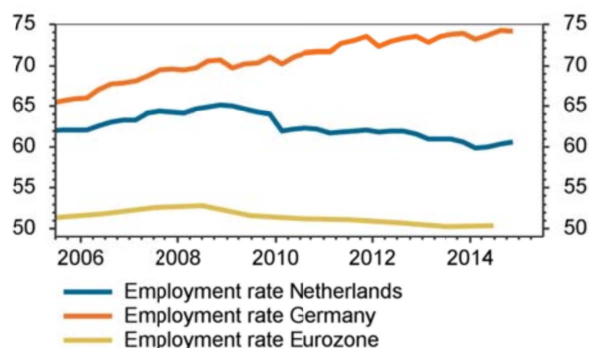
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unemployment



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

Employment

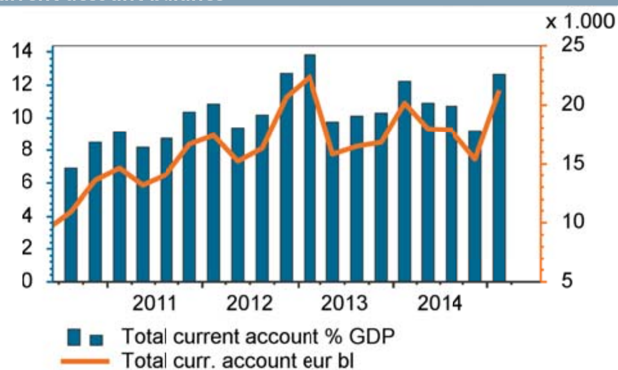


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Unit labour cost

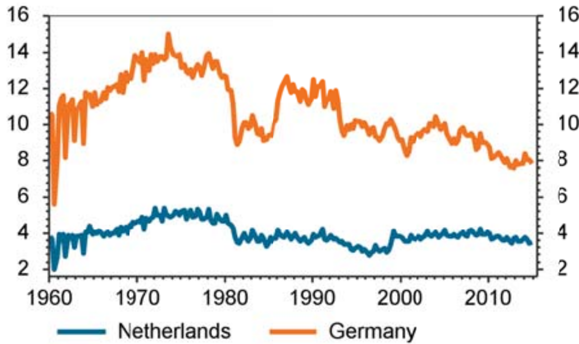
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Current account balance



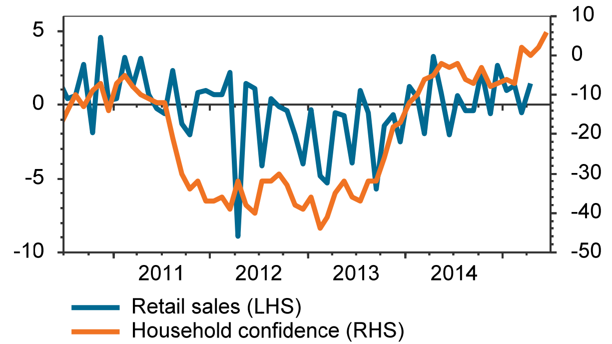
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Share of world exports



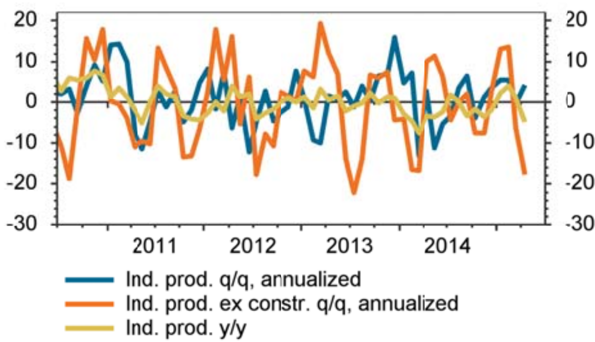
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Retail sales and household confidence



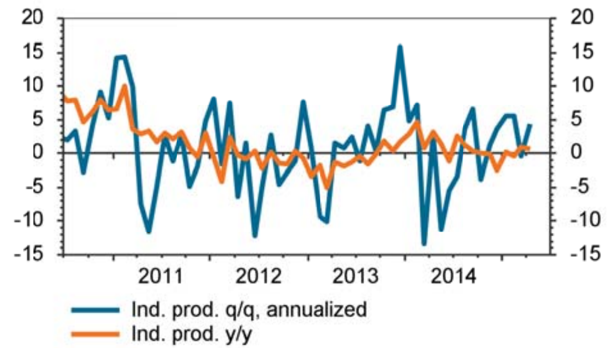
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output (ex construction)



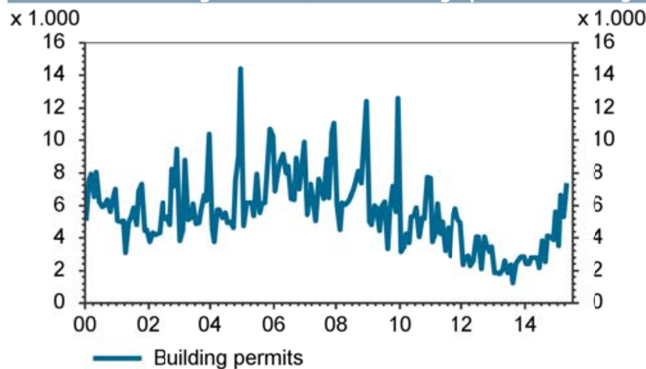
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Industrial output (manufacturing)



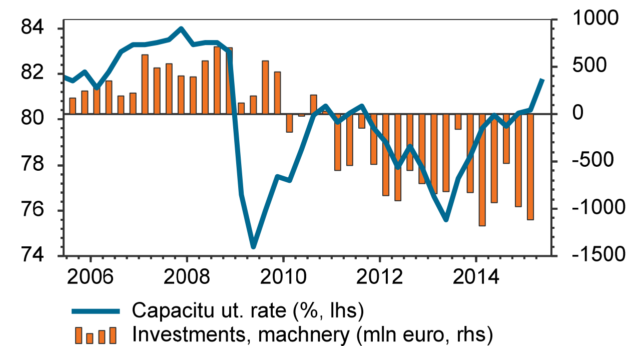
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Residential housing: new builds and average price of housing



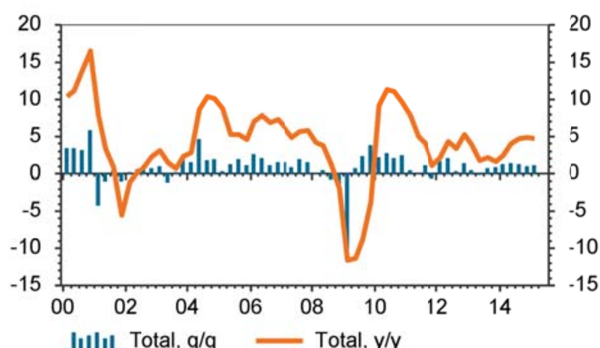
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Utilisation rate of productive capacity



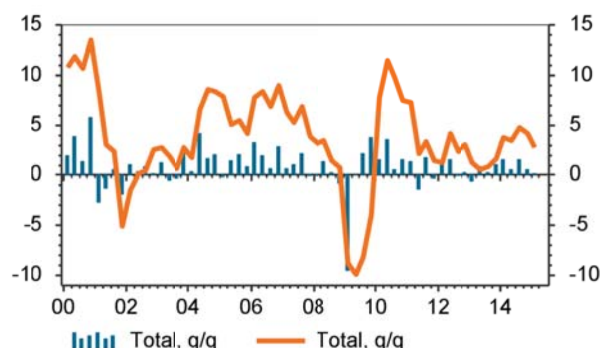
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Exports of goods and services



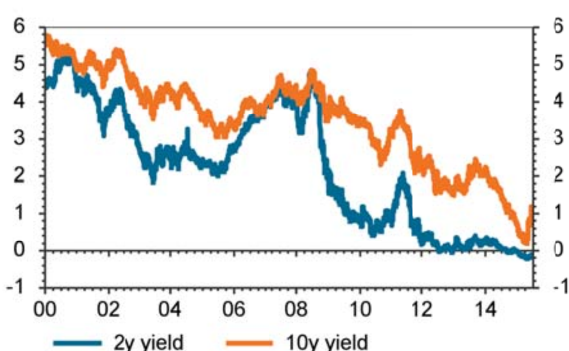
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Imports of goods and services



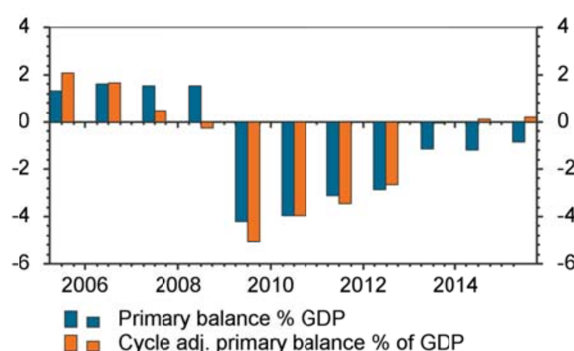
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

2-year and 10-year govt. bond yields



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

Primary balance



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

Greece: Tsipras government crashes at full speed into a wall[9]

Luca Mezzomo

No agreement has been reached to extend the bail-out programme beyond June 30 and Greece has defaulted on the IMF payment. A referendum has been called on July 5 which is very much a referendum on Syriza and the euro. What should we expect? What would help Greece? And what would happen if Greece abandoned monetary union?

The IMF-EFSF programme is over

After the elections on 25 January, the new Greek government, led by Alexis Tsipras, initially refused to extend the second programme of financial assistance, asking instead for its debt to be restructured and for its maturing loans from the IMF and maturing bonds held by the ECB to be refinanced with ESM and ECB funds. On 20 February, a statement by the Eurogroup indirectly ruled out any chance of extraordinary financial measures and reiterated that financial support would only be possible under the second programme, which Greece would be required to complete. Following this, the negotiating positions were virtually frozen until the start of June: the Greek government made several attempts to move the discussion to the level of European government heads, but on each occasion the creditors stressed that the technical agreement with the "three institutions" (IMF, European Commission and ECB) took priority and that the IMF should remain involved. In the meantime, the Tsipras government dealt with the

[9] This piece was extensively updated on July 1 to take into account new developments.

financial emergency (accentuated by falling tax revenue) by cutting capital spending (so diverting European funds to other uses), suspending payments to suppliers of public sector and implementing measures to centralise the cash of all public entities.

On 3 June, the creditors presented Greece with a series of conditions prerequisite to concluding an agreement; they consented to a drastic reduction in the primary balance targets (from 2.5% to 1.0% in 2015), but asked Greece to keep pension system flows balances, preserve previous labour market reforms and reorganise VAT to ensure the required budgetary correction. As at 17 June, the Greek government has not changed its position, in the apparent conviction that fear of the impact on the financial markets and on the stability of other European countries would force the creditors to make concessions. In addition, it requested and received consent to merge all the IMF payments into one maturity at the end of the month, thereby gaining time.

In mid-June, however, after another failed European meeting, the Greek people began to realise that the risk of a liquidity crisis was becoming more real, and the withdrawal of deposits from banks suddenly picked up pace: almost EUR 4Bn was taken out in the week 15-19 June, with about EUR 2Bn leaving banks on the Thursday and Friday. On Thursday, 18 June, the creditors issued the Greek government with an ultimatum, giving it until Monday to accept the imposed conditions or to draft a counterproposal consistent with these; reinforcing the message, the ECB switched approval of increases in emergency liquidity from a weekly to a daily basis, while the IMF warned that it would not grant a "grace period" if Greece missed payment of the EUR 1.5Bn tranche due on 30 June. The markets' rather restrained reaction has further demonstrated that time is running out for Greece much more rapidly than it is for its creditors.

On Monday, 22 June, a couple of hours before meeting its creditors, the Greek government presented a proposal, much closer to what had been asked for, in that it accepted the primary surplus target of 1% and suggested relevant corrective measures. In total, the correction amounted to EUR 7.9Bn in 2015 and 2016, almost entirely coming from higher tax revenues. However, such commitments were becoming less and less credible by the day, given the steep decline in tax compliance and the evident deterioration of economic activity. Further changes were required especially by the IMF; besides, the request to restructure outstanding official debt was rejected again. No substantial progress could be achieved by June 27, when Greece rejected the last offer by the creditors, announced a referendum to be held on July 5 on the programme and asked for an extension of a few days, until past the referendum. The Greek government announced that it was supporting the 'no' campaign. Of course, the request was not accepted by the Eurogroup. On Sunday 28 June, as a result the stop in the negotiations, the ECB froze the amount of ELA available to the Greek banks. As the bank run had already resumed the day before, the Greek monetary authorities were forced to call a bank holiday until July 6, freeze all payments from Greek to foreign counterparties and set a daily limit of EUR60 on cash withdrawals.

In the following days, Greeks rushed to stock supplies and fill fuel tanks, while there was evidence that the cash reserves of the Treasury were not sufficient to pay the pensions for the month of June in time. The European Commission President made a secret last attempt to have Tsipras accept the creditors' offer on Monday night. On June 30, the Greek government replied with a request to start a new ESM loan programme, restructure EFSF debt and extend the second programme to prevent default on the IMF payment coming due at the end of the day. The programme extension was obviously rejected and Greece failed to pay 1.5Bn euros to the IMF. As for the ESM programme, the prevailing attitude was to discuss it either after the referendum or after a written commitment by Tsipras to support the yes campaign (or call the referendum off). Any contact has been suspended until after the referendum.

Polls show that the yes camp is leading in the referendum campaign, but by a small margin. The government asserts that if the proposal is rejected, its negotiating power against the creditors

will rise; the 'yes' camp and international lenders, instead, suggest that the outcome would instead be the need to introduce a new currency and leave the monetary union. As a matter of fact, the document on which voters are asked to vote is no longer on the table after Jun 30.

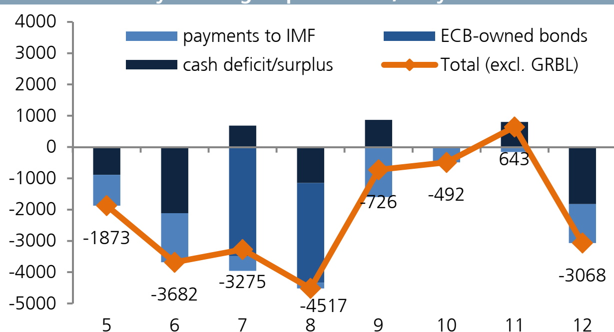
What will help Greece?

Greece has a problem with the long-term sustainability of its debt (from 2023 onwards in particular), and also one with its short and medium-term financial equilibrium, primarily (but not exclusively) associated with repayment of IMF loans and of bonds held by the ECB (Greece must also, in reality, finance a budget deficit that has worsened since the onset of the political crisis, and which seems even larger considering the substantial transfers of EU funds, from which it has benefited).

1. Assuming that all the Greek bonds are renewed as they fall due and that measures are taken to increase the primary surplus to 1% of GDP (something which looks less and less feasible by the day), we expect EUR 15Bn to be required between June and December: some EUR 3Bn to cover the public accounts deficit, EUR 12.3Bn for debt servicing; in practice, due to the damage inflicted to the economy, more will be needed. Had an agreement be reached before June 30, the financial gap would have been bridged by freeing up the remaining funds in the second programme (some EUR 7Bn), and by redeploying resources originally allocated to the recapitalisation of banks but not actually used, amounting to nearly EUR 11Bn. The planned mechanism will take the form of the traditional reforms-for-cash scheme, with the gradual release of funds in exchange for the implementation of fiscal corrective measures and reforms. Given the general unreliability of the new executive, there would appear to be no alternative to this mechanism.

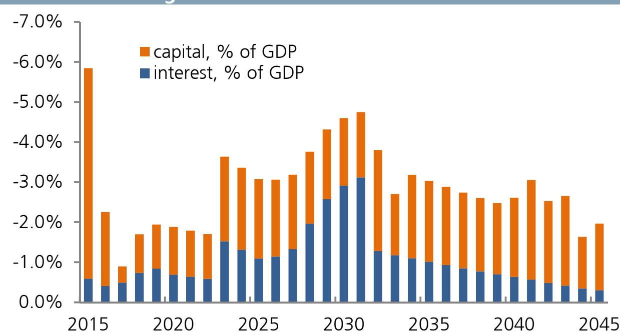
2. Looking at the period from 2016 to 2020, the financial requirement could rise from EUR 73Bn to EUR 93Bn, depending on whether or not the primary surplus is increased to 3% of GDP as planned. Based on this scenario, the portion attributable to the deficit could rise from EUR16Bn to over EUR 30Bn. To this must be added EUR 12.5Bn in loan repayments and EUR 44.5Bn in maturing bonds (including some held by the euro system). Contrary to what the Syriza government has asserted for a long time, the refinancing could be accomplished only with the aid of the ESM and the ECB, and hence as part of a new ESM loan programme. The programme could include at least EUR 50Bn in new loans, full refinancing of the Greek bond falling due (approx. EUR 15Bn), and EUR 10Bn from the markets. In reality, the programme could then set off a number of virtuous circles, including an increase in the Greek bond issue ceiling and the restoration of access to the market, which might – as has already happened in Portugal – make ESM and IMF support less urgently needed. Over-ambitious targets, by contrast, in the shape of a primary surplus and economic policy measures inimical to investments, could make the need for funds more urgent.

Greece: Treasury funding requirements, May-December 2015



Source: Intesa Sanpaolo estimates

Greece: servicing of debt due to institutions



Source: Intesa Sanpaolo charts

3. The activation of virtuous circles is made more likely if the debt is structured in such a way as to produce maturities that are sustainable after 2022, especially between 2023 and 2032. Moreover, without resorting to reducing the nominal value, we can envisage a restructuring of the maturities and the rates paid (which are in any case very low) that would ensure that debt servicing was a tolerable burden. Long-term sustainability, though, also depends on the country's ability to ensure growth at an adequate rate, by making structural improvements at home and making itself attractive to businesses.

Default scenarios and consequences for Greece

Greece has already defaulted to the IMF on 30 June, and will not be able to pay on the bonds coming due on 20 July unless a new ESM programme is agreed soon after the referendum. Even if agreement is reached, a crisis could be triggered if Greece were unable to guarantee compliance with its terms and conditions. Closing the banks and bringing in controls on movements of capital buys a few weeks' worth of time at most, but such a situation can have only two potential outcomes: either an unconditional surrender to its creditors, in order to restore the flow of liquidity, or the reassertion of monetary sovereignty.

The latter could be brought about by the introduction of a new currency to replace the euro, accompanied by the renaming of agreements via the adoption of a new parallel currency. An even more dramatic, and far from unlikely, scenario is that in which Greece retains the euro but required the Bank of Greece to stop complying with the requirements of the Treaty and to no longer answer to the ECB, but to supply liquidity to the banking system and to underwrite issuances by the Treasury. While this is not the place to discuss the pros and cons of the various options, the intermediate scenarios would be likely, sooner or later, to bring about complete currency redenomination.

By making a clean sweep of all debt owed to the official institutions, and resuming control over money base creation, the Greek State’s debt would become sustainable again. Debt should be refinanced at market costs, undoubtedly higher than those offered by the programme, although control over the central bank may induce the government to impose some form of monetary base financing of new issuance. Gross debt would decrease from 425 billion euros to just over 200 billion.

For what concerns its participation in the institutions of the European Union, Greece would continue to hold membership until completion of the procedure provided for by Art. 50 of the Treaty, which ends with an exit agreement which needs to be ratified by all the other member states; in theory, therefore, Greece would continue to be subjected to the obligations and duties of the Treaty throughout the transition phase. Upon completion of the transition phase, however, it would no longer be represented in the EU’s official bodies, and Community Law would no longer apply in Greece. The country could retain access to the single market, if so provided by the exit agreement, whereas it would lose the substantial flow of transfers from the European Union’s balance sheet, which it currently benefits of (in 2013, the net receipts amounted to a hefty 2.94% of national income).

However, the economic consequences of this scenario remain hard to foresee, as it poses significant criticalities in terms of the management of international payments, and the risk of capital flight. In the immediate term, a slump in economic activity may be expected, due to the freezing of banking activity and foreign trade, as well as issues in the transition of payment systems. The settlement of trade flows could represent a serious problem, as the central bank would start out without adequate currency reserves. The banking system’s assets in foreign currency would immediately have to be pooled, in order to build up an adequate reserve buffer to guarantee ongoing import-export flows. Presumably, the central bank will also have to retain

strict control over the foreign investments of residents for an extended period of time. At the end of March 2015, faced with an aggregate value of imports of around 36 billion euros a year, the Greek monetary and financial institutions, including the central bank, could count on aggregate of non-resident assets of 119 billion euros, of which 63.5 billion in bonds issued by entities resident in other euro area countries, plus around 30 billion in credits towards foreign banks, and 5 billion euros in gold reserves. Among liabilities, the 96 billion euros tied to the imbalance of Target 2 should not drain reserves, although they may slow the accumulation of currency reserves allowed by balance of payment surpluses versus the Eurozone [10].

Further issues are the new government's loss of credibility in the past months, and its political stance, by no means appealing for foreign investors. Fears that implementation of the government's electoral manifesto could accelerate sharply in the event of international control being lifted, may encourage a further increase in tax evasion and capital flight; in turn, capital flight could impress a further tightening of control over economic policy. The post-Grexit picture will not be appealing for foreign investors, and – notwithstanding the possibility of capital inflows prompted by geopolitical considerations – net flows of foreign capitals are unlikely to be positive. Ultimately, despite the current account surplus, an important devaluation of the exchange rate is likely in any case. Devaluation would then be followed by price and wage increases (the Syriza government would probably aim to protect the purchasing power of workers), which would undermine most of the competitive gains achieved through currency devaluation. However, Greece's trading balance is dominated on the export side by agricultural, food and refined oil products that are unlikely to derive much benefit from any revaluation. In addition, since revenues from sea freight would not benefit much from the devaluation, it would fall to tourism to counteract the rise in the value of imports. These considerations explain why the idea of abandoning monetary union has so far been confined to Syriza's more radical wing.

Consequences for the Euro zone

The consequences for the other Euro zone countries of a Grexit scenario would be numerous:

1. Certainty that credits issued under the GLF and EFSF loans would not be repaid, and loss of all related interest flows. This would also have consequences in cash terms for the other states, which would have to honour the guarantees lent (and already classified under debt, but not funded). However, this would compared with the need implied by the alternative scenario to provide new assistance and/or to restructure existing debt. The net balance depends on the confidence in Greece's intention/ability to respect a potential conditioned agreement. Assuming conditions on debt are eased by an equivalent of 100 billion euros current, and that net fund injections worth a further 30 billion are required, the cost would amount to 90 billion euros current;
2. However, by leaving the European Union Greece will lose access to European funds; for the period 2014-20, 15.2 billion euro have been allocated, and Greece is among the countries that receive more than it pays (in 2013, the surplus amounted to 2.94% of national income). The average savings for the EU would be 2-3 billion euro per year, and would offset most of missing debt-repayments;
3. Certainty that Target 2 imbalances (98.7 billion at the end of April) will not be reabsorbed. Upon devaluation of the credits put to the balance sheets of the other national central bank, the flows of profits paid to the states could be reduced. In the best-case scenario, the dependence of Greek banks on the Eurosystem would normalise over time, allowing a reduction of the imbalance between the Bank of Greece and the rest of the Eurosystem;
4. Negative impact on exports (but no Eurozone countries depends on Greece for more than 1% of its exports);

[10] See note 5. Credit balances held with other Euro zone central banks might help to reduce the liabilities built up during the crisis.

5. Transitory deterioration of sentiment;
6. Tensions on government bond yields and widening of risk premia on peripheral issuers. The BTP-Bund spread jumped at the opening on June 29, then recovered and currently is no higher than in mid-June. This rather modest response may well reflect either the absence of significant concerns about the risk of contagion or an over-optimistic view of how the crisis will develop after the referendum. My view, though, is that any tensions that are not merely temporary or signs of panic would be counteracted by the ECB's pressing forward at greater speed with the buying up of government bonds as part of the PSPP programme;
7. Greater structural volatility of risk premiums, as Greece's exit would deny the principle of the irrevocability of the monetary union. Should Greece ultimately recover successfully outside the monetary union, instability could increase. On the other hand, a problematic transition could weaken the position of those advocating a return to national currencies in other countries;

In conclusion, the insolvency of Greece is not a desirable scenario, except in the high-risk context of the Greek government opting to default in later years. This does, however, appear to be a situation that Europe would be perfectly able to cope with, given that it already has the tools to cushion the impact of it.

Asia

Japan: recovery in 2015-16, but the 2% inflation goal remains a mirage

Giovanna Mossetti

The recovery in Japan seems consolidated, with two consecutive quarters of positive growth, driven by private domestic demand. The indications for the remainder of 2015 and for 2016 are positive, with forecasts of a moderate acceleration of growth across all components of domestic demand, and modestly stronger exports. Growth is forecast at 1.1% in 2015 and 1.8% in 2016, from -0.1% in 2014. The year 2017 will again be exposed to volatility and risks tied to the second consumption tax hike. Inflation should stay below the 2% goal in 2016. The BoJ may step up monetary stimulus in 2016 for "pre-emptive" reasons, to impress a solid momentum on the economy on the eve of the 2017 fiscal shock.

Moderate growth. In 1Q, growth was at 1.0% q/q, from +0.3% q/q at the end of 2014. The latest cyclical indicators are encouraging, and strong monetary stimulus should support the current reflationary phase. Moderate growth should take hold starting in 2Q, in the wake of more solid consumption and investments. 1Q GDP outlines a solid trend of private domestic demand, with consumption, fixed corporate investments, and residential investments on the rise. One risk weighing on the scenario of the next few quarters is the strong contribution of inventories (+0.6 pp), which could slow output in the spring. The information provided by surveys are moderately positive. The BoJ has also revised upwards its economic assessment.

Employment and wage growth will support the consumption trend

Consumption has picked up, rising by 0.4% q/q ann., in both Q42014 and 1Q 2015, driven by the solid trend of the labour market (Fig. 4). The unemployment rate is falling again (3.3% in April). Higher job openings, in the face of a still declining workforce (albeit at a slower pace than observed in 2014) confirm excess demand on the labour market. Hourly wages and compensation are also recovering significantly at last (Figs. 3 and 5). The drop in energy prices, and the waning effects of the consumption tax hike, are helping support a positive trend of real wages as well. Private consumption will continue to fuel growth in 2015 (0.5%). The scenario for 2016 will again be volatile, due to the second tranche of the consumption tax increase, scheduled for April 2017.

Fixed investments driven by the yen, the recovery in demand, and the second consumption tax hike

Fixed corporate investments are also recovering, thanks to the weak exchange rate, to a sharp increase in corporate earnings, and to improving domestic and global demand. Business loans accelerated sharply in the closing months of 2014, and are now growing at a pace of close to 2.5% y/y. Earnings, after decreasing in mid-2014, turned back up (11.6% y/y at the end of 2014). The expected recovery in exports, and the capital account spending of businesses should stay in moderately expansive territory until the end of 2016, on the thrust expected from the second consumption tax hike (April 2017). Subsequently, a correction is likely, as was the case in 2014: the expected strengthening of global demand should mitigate at least in part domestic volatility. In light of the 2014 precedent, risks remain high in any case.

Exports recovering

Net exports contributed negatively to growth in 1Q (-0.2 pp), after three positive monthly contributions. In April, nominal exports were up by 8% y/y, and imports by 4% y/y. The trade balance in April was negative, after two consecutive months on the rise (which had put an end to an extended string of monthly deficits, since February 2011). In real terms, exports grew by 3.2% q/q in 1Q 2015: the weak yen and the recovery of US growth, however, should prove supportive in the rest of the year (growth in real exports to the US: +7.1% y/y in April). In April, real exports were rising towards all economic regions except the European Union. Real imports are also recovering, in the wake of accelerating domestic demand. Net exports should make a modest negative contribution to growth in the year.

Prices: deflation is over, but the 2% goal remains a mirage

Core inflation net of the consumption tax has been around zero since the beginning of the year, and the BoJ expects stability "for the time being". Since mid-2014, the prices of goods have been on a sharp downtrend due to the correction of energy prices and to weak consumption in

the durable goods segment following the consumption tax increase. However, there are two positive factors: 1) the recovery in consumption under way since the end of 2014 should exert upward pressures on prices, and 2) prices of services have been growing since 2013. The change in the prices of services net of rents and of the consumption tax has averaged around 1% y/y since the beginning of the year, whereas during deflation phases the prices of both goods and services were falling. **Inflation should rise to around 1% y/y at the beginning of 2016.**

The BoJ has pushed forward the date by which it expects to reach the 2% inflation goal

At the end of April **the BoJ** revised downwards its inflation projections for the next two years, and **has pushed forward the date by which it expects the 2% inflation goal to be reached, from** "period centred on fiscal year 2015" to "around the first half of fiscal year 2016". All the same, **for the time being the central bank considers the current level of monetary stimulus as appropriate** (80 trillion yen increase of the monetary base in 2015). The BoJ will maintain its wait-and-see stance. In its May monthly report, the assessment of the scenario is more positive, however, we believe that in H22015 signals will increase that achieving the 2% goal by the end of fiscal year 2016 will be difficult, especially in view of the 2017 consumption tax hike. Therefore, **in our view a "pre-emptive" increase in monetary stimulus is possible,** to be announced in November, and **implemented in 2016**, to increase the credibility of the 2% goal.

Monetary stimulus likely to be stepped up in 2016

Fiscal policy rather bland on the reform front

Ambitious targets, but risks to sustainability remain in place

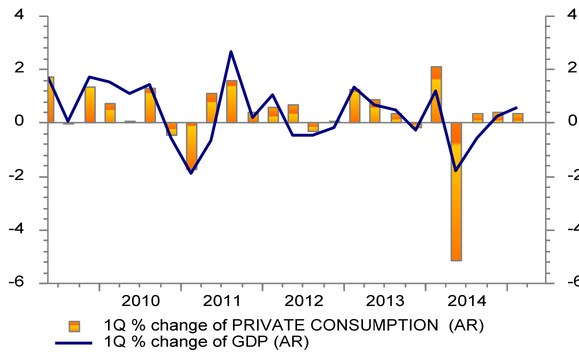
Fiscal policy is still geared to the overall consolidation of public accounts. In fiscal year 2015, the deficit is forecast at -7.3% of GDP, and the primary balance at -2.7% of GDP. The government aims to achieve a **primary surplus by 2020**, thanks to higher revenues and structural reforms. Revenue targets are credible, whereas there are still no details on structural reforms. Specifically, the labour market reform, geared to encouraging the participation of women in the workforce, remains on hold. The steps forward made in terms of the Trans-Pacific Partnership, on the other hand, are positive for the opening of trade. The government aims to unveil its fiscal consolidation plan by the end of the summer. The recovery in **nominal growth** at the beginning of 2015 (+1.9% y/y), and low interest rates, are helping mitigate risks to the credibility of fiscal goals, but do not clear doubts over the sustainability of debt.

Forecasts

	2014	2015	2016	2014		2015				2016	
				3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	-0.1	0.9	1.7	-1.4	-0.9	-1.0	1.0	1.8	1.9	1.4	1.7
q/q annual rate				-2.0	1.2	3.9	1.0	1.0	1.8	2.0	2.0
Private consumption	-1.3	0.3	2.0	1.4	1.5	1.5	2.0	2.4	2.4	1.6	1.6
FI - private nonresidential	3.6	1.6	2.3	0.3	1.0	11.0	-3.2	3.2	3.2	2.4	2.4
FI - private residential	-4.9	-0.9	3.3	-23.3	-2.5	7.0	19.5	8.2	0.0	0.4	0.4
Government investment	3.8	-1.9	-3.6	6.6	0.4	-5.9	-4.3	-3.6	-3.6	-3.6	-3.7
Government consumption	0.3	0.5	0.0	0.8	1.1	0.3	0.5	0.0	0.0	0.0	0.0
Export	8.4	6.8	3.4	6.5	13.5	9.9	4.1	2.0	2.0	4.1	4.1
Import	7.4	5.7	4.0	4.3	5.8	12.2	8.1	6.1	4.1	3.2	3.2
Stockbuilding (% contrib. to GDP)	-0.2	0.2	0.3	-0.7	-0.3	0.4	0.1	-0.1	0.1	0.2	0.2
Current account (% of GDP)	0.5	1.7	1.2	0.4	2.2	3.1	1.5	1.3	1.2	1.1	1.2
Deficit (% of GDP)	-8.5	-7.1	-6.4								
Debt (% of GDP)	229.7	232.6	235.6								
CPI (y/y)	2.7	0.1	1.1	3.3	2.5	0.0	0.1	0.0	0.4	0.9	1.2
Industrial production	2.1	1.2	2.3	-5.3	3.0	6.4	0.3	2.4	2.4	2.4	2.4
Unemployment (%)	3.6	3.5	3.6	3.6	3.5	3.5	3.4	3.5	3.5	3.6	3.6
JPY/USD	105.8	124.0	127.3	104.0	114.5	119.2	121.4	126.3	129.3	129.0	127.5
Effective exch.rate (1990=100)	134.0	123.0	117.8	136.1	127.0	127.1	125.3	121.6	118.3	117.1	117.9

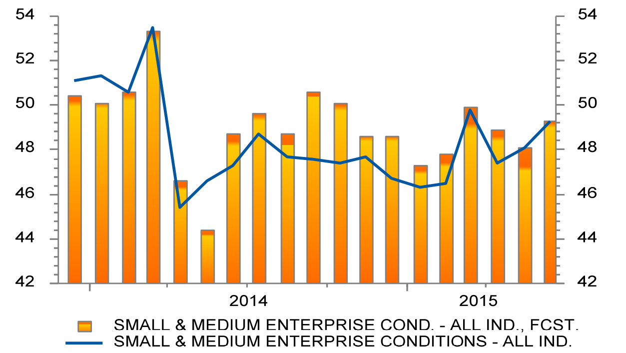
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth recovering



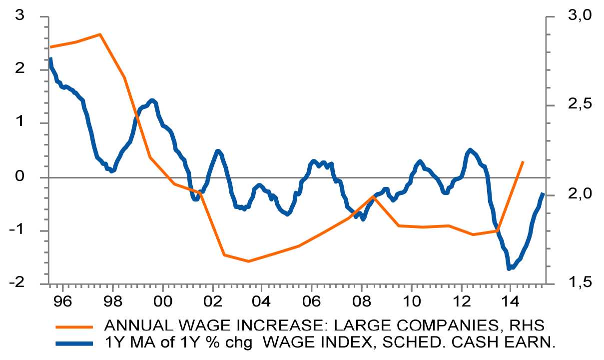
Source: Thomson Reuters-Datastream

Fig. 2 – Businesses see improvements



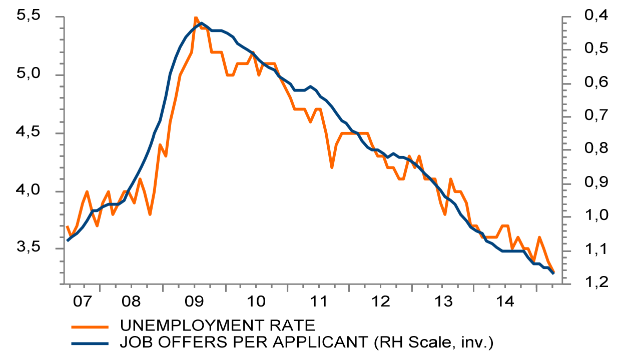
Source: Thomson Reuters-Datastream

Fig. 3 – Positive indications from wage negotiations



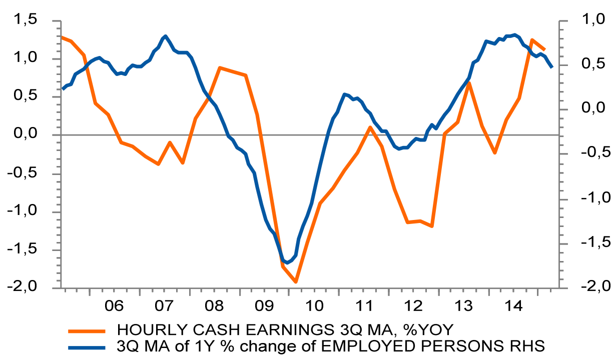
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment keeps falling



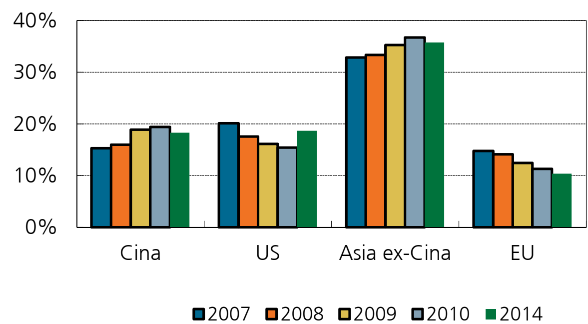
Source: Thomson Reuters-Datastream

Fig. 5 – Hourly wages trending up



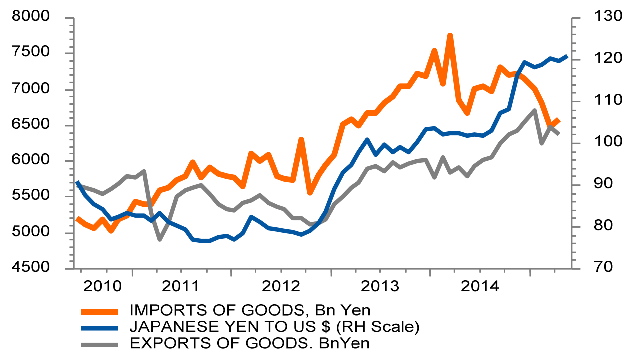
Source: Thomson Reuters Datastream

Fig. 6 – Export shares on total



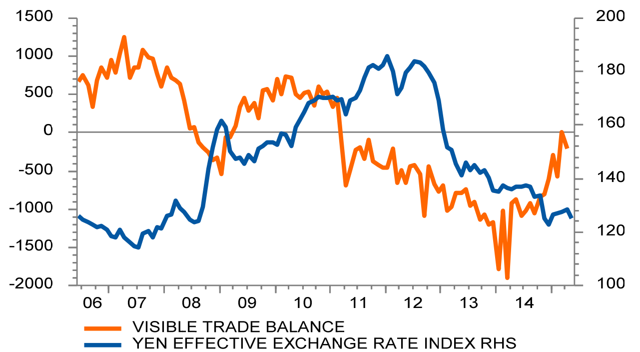
Source: Intesa Sanpaolo computations on Cabinet Office data

Fig. 7 – Gradual recovery in exports



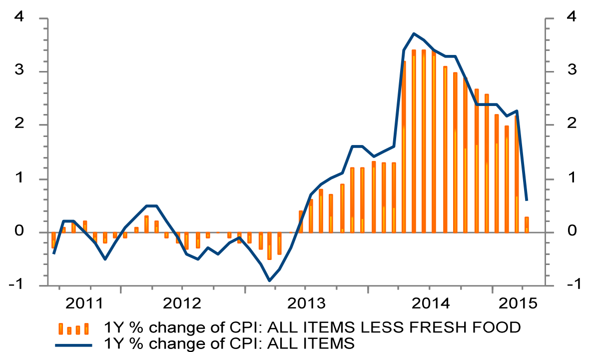
Source: Thomson Reuters-Datastream

Fig. 8 – Effects of the yen starting to become visible



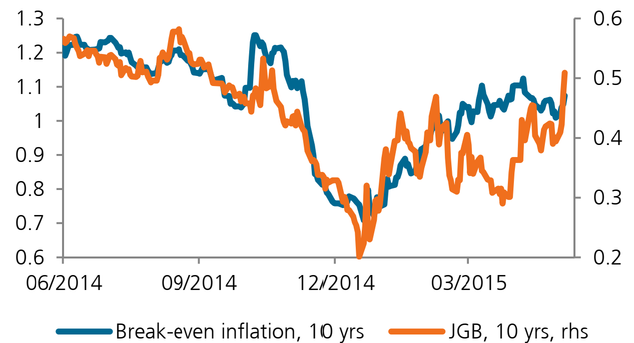
Source: Thomson Reuters-Datastream

Fig. 9 – Inflation net of the consumption tax hike still distant from the 2% goal



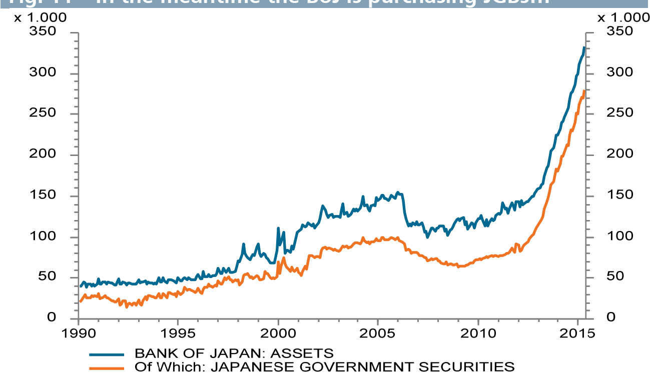
Source: Thomson Reuters-Datastream

Fig. 10 – No-one believes the 2% goal



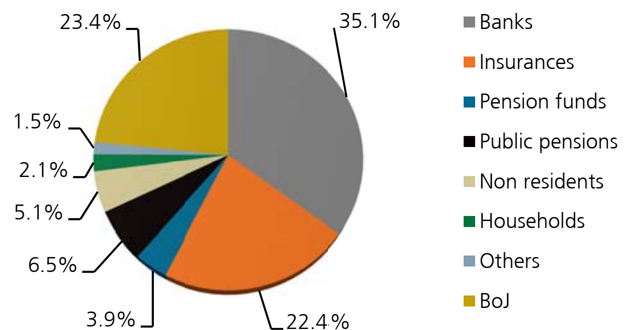
Source: Bloomberg

Fig. 11 – In the meantime the BoJ is purchasing JGBs…



Source: Thomson Reuters-Datastream

Fig. 12 – … giving more lending room to banks' balance sheets



Source: Ministry of Finance. Data as at the end of December 2014; total JGBs: 885.2 trillion yen

China: the general picture remains weak

Silvia Guizzo

- The first quarter of 2015 saw a further fall in GDP growth, from 7.3% in the last two quarters of 2014 to 7% yoy, with qoq growth down to 1.3%, its lowest since 2011. The slowdown largely affected the industrial and farm sectors and, on the demand side, investment. We expect consumer spending to have grown at broadly the same rate as in 4Q, as indicated by the trend in the real pro-capita spending of urban households. The monthly figures for April and May showed that retail sales were stable and industrial output was improving compared with the lows of March (Figs. 1 and 7). Foreign trade, however, is continuing to decline, especially imports (Fig. 3), attesting to the weakness of internal demand. Imports of machinery and electrical components continued to slow, down 7.2% 3m yoy in May and heralding a further deceleration in investment (Fig. 6). Despite the tentative signs of improvement in the last two months, exports are still plunging (-7.7% 3m yoy in May, Fig. 5), and the sharp decline in the "new export orders" component of the HSBC PMI (down to 46.7 in May from 50.3 in April), the weakness in the National Bureau of Statistics (NBS) PMI survey and the appreciation of the effective exchange rate indicate that the outlook for exports in the next few months is still fragile.

- Fixed investment continued to slow, from 13.5% yoy in March to 11.4% yoy in May; this was mainly due to the slowdown in government investment, particularly by the central government, and the real estate sector (Fig. 2). Investment growth in the real estate sector slowed to 5.1% cum yoy in the first five months of the year, its lowest since 2009, although it is likely to have trended slightly upwards from March to May. The property market showed signs of improvement (Fig. 8) from March to May, especially in first-tier cities, where average prices have soared, thanks to further loosening of monetary policy in the first half of the year and the anti-speculative measures decided in April.

- Inflation fell to 1.2% yoy in May, from a peak of 1.5% in April (Fig. 9), due partly to a strong base effect and partly to slowing food prices; both these factors are likely to reverse in the second half of the year. Core inflation, however, returned to 1.6% yoy after two months at 1.5%, driven by rises in the housing sector, health spending, clothing and the cigarette tax that took effect in mid-May. Even though production prices continue to fall (-4.6% yoy in May), we expect consumer price inflation to head back up again in the next few months to just over 2% at the end of the year, with the annual average sticking at 1.5% in 2015, lower than the 2% recorded in 2014.

- After trimming the reserve requirement ratio in February, the PBOC made a second cut of 100 bps on 20 April and a further 25-bps rate cut in early May. In early June, the PBOC slightly revised down its growth forecasts for 2015 from 7.1% to 7.0%, and cut its inflation forecasts more dramatically from 2.2% to 1.4%. The central bank expects year-on-year growth to improve in the second half of the year but stresses that the economy is deteriorating, mainly due to weak exports. We therefore expect the PBOC to make at least another two cuts to the reserve requirement ratio in the second half of the year. In light of the entry into force of insurance on deposits in May and the rush to have the yuan included in the basket of SDRs (special drawing rights) at the review in October (see Focus), we expect that the PBOC will completely abolish the limit on deposits by the end of the year. Moreover, we think it might also tweak the existing minimum limit on mortgages[11] in line with the objective of full interest rate liberalisation.

[11] Currently, the mortgage interest rate is 70% of the benchmark interest rate for a first home and 110% for a second home.

- The government continues to support investment in infrastructure with the approval of projects for the railways (CNY 243Bn) and metro lines (CNY 215Bn). It also supports public-private partnership investment, especially in transport and water conservation, for which it has published a list of projects totalling CNY 1.97Trn in which 25 provinces should participate. Measures have also been taken to shore up consumer spending, including halving import duties for many consumer goods (from clothing to cosmetics) form 1 June, and creating a pilot programme to develop consumer credit services, especially for low-income households.
- The Finance Ministry, PBOC and China Banking Regulatory Commission (CBRC) have issued the regulations for the programme of local government debt swap announced in March. The programme allows local governments to swap their generally short- or medium-term bank debt for longer-dated bonds issued and guaranteed by local governments at lower interest rates. In early June, the authorities added a further tranche of 1 trillion yuan to that originally allocated, despite the lukewarm reception given by the banks to a programme in which they are seemingly being urged to take part. It is true that, apart from being able to use the securities as collateral in refinancing operations, the terms of the programme are not overly advantageous for banks: the securities cannot be traded on the market, and yields are rather low and not tailored to the risk, as shown by the first issues. The programme is, however, good for debt management and considerably reduces the risk of fiscal restriction at local level, which emerged following the entry into force of the new Budget Law in January combined with local governments' restricted access to the market.
- GDP growth could bottom out in 2Q, while the easing of monetary policy and measures to boost consumer spending are likely to support a slight acceleration in growth in the second half of the year, which will continue to be driven mainly by investment in infrastructure. The increase in non-performing loans (at 1.39% of total loans, and up 52% yoy in 1Q, Fig. 12) will continue to curb lending (Fig. 11), even if there are further interest rate cuts. The continuing weak performance of the property sector will eventually have more tangible effects on the economy, hampering consumer spending, especially in 2016. Moreover, in light of the disappointing performance of exports, the contribution of foreign trade could be lower than our previous estimates. We therefore revise down our forecasts for 2015 from 7.1% to 6.8%, and keep them at 6.5% for 2016. Downside risks to the scenario remain unchanged.

Forecasts

	2010	2011	2012	2013	2014	2015	2016
GDP (at constant prices)	10.6	9.5	7.7	7.7	7.4	6.8	6.5
Consumer spending	8.2	10.3	9.4	8	7.7	7.4	7.2
Public consumption	11.5	12.2	5.8	7.2	7.1	6.5	6.8
Capital investment	11.3	8.7	9	9.2	8.3	5.6	5
Exports	26.1	4.1	3.2	5.8	5.9	1.7	5.7
Imports	19.8	6.3	4.3	8.3	7	-2.7	5.2
Industrial output	12.7	10.6	8.2	7.9	7.3	6.1	5.7
Inflation (CPI)	3.3	5.4	2.6	2.6	2	1.5	1.5
Unemployment	4.2	4.1	4.1	4.1	4.1	4.1	4.1
Average wages	14.1	16.8	14.4	11.8	10.8	9.2	8.7
90-day interbank rate (average)	2.7	5.3	4.6	5	5.1	4.3	3.5
USD/CNY exchange rate (average)	6.77	6.46	6.31	6.15	6.16	6.25	6.13
Current account balance (CNY bn)	1603.7	874.1	1360.1	911.9	1357.5	2559.2	2523.7
Current account balance (% of GDP)	3.9	1.8	2.5	1.6	2.1	3.8	3.5
Budget balance (% of GDP)	-1.7	-1.1	-1.6	-1.8	-1.8	-3.0	-4.3

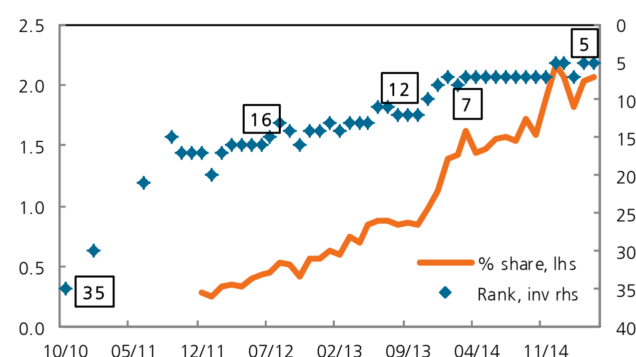
Note: Percentage change versus previous period except where otherwise indicated; Source: Intesa Sanpaolo chart from Oxford Economic Forecasting data

Focus: the renminbi and the review of the basket of SDRs

In the press release on the conclusion of the Article IV[12] consultations at the end of May, the IMF reiterated that, after its significant appreciation in real terms last year, the yuan was no longer undervalued. Since China's external financial position is still too strong compared with the fundamentals, the IMF hopes that the Chinese authorities will continue with the reforms necessary to bring it more in line with the long-term equilibrium and reduce excess savings. The IMF emphasised that the effective exchange rate needs to change in tandem with the fundamentals (e.g. it should appreciate to reflect its faster productivity growth relative to its trading partners) and that the exchange rate should be freely determined by the market in two to three years, with interventions limited to reducing excess volatility.

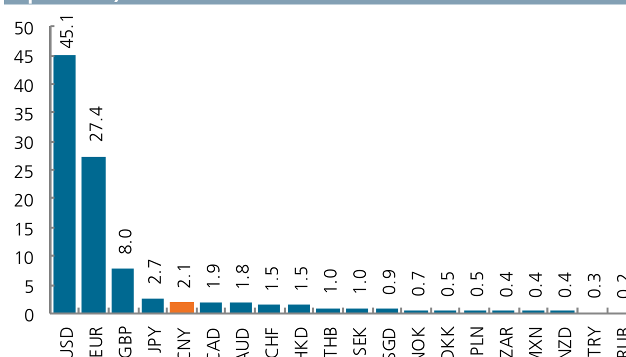
The rapid internationalisation of the renminbi and its use, albeit still limited, as a reserve currency by some central banks, as well as the greater convertibility of the current account, has raised expectations that the Chinese currency will be admitted to the basket of SDRs [13]. As early as 2010[14], the IMF recognised that the size of China's economy and trade called for the renminbi to be recognised as a potential candidate for inclusion in the basket of currencies of SDRs, ahead of a review of the composition of the basket. However, the currency was then rejected as it was deemed that not all the conditions for entry had been met. More recently[15], partly in view of China's interest – expressed publicly by the Governor of the PBOC in April[16] – in the yuan being included in the basket of SDRs, ahead of the five-year review planned for October, the IMF stated that it wanted to work with the Chinese authorities to achieve this objective, in what appeared to be a more positive tone. Indeed, the only question is not whether the renminbi will be included in the basket, but when.

Rise of the renminbi as a payment currency



Source: SWIFT

Breakdown of global payments by currency (as % of total, April 2015)



Source: SWIFT

[12] IMF Staff Completes the 2015 Article IV Consultation Mission to China, Press Release No. 15/237, 26 May 2015.

[13] For more details, see our China Paper: "The internationalisation of the renminbi: where are we up to?" dated 12 June 2014.

[14] IMF, Review of the Method of Valuation of the SDR Prepared by the Finance Department In consultation with the Legal and Other Departments Approved by Andrew Tweedie, October 26, 2010.

[15] See note 11.

[16] IMF and Financial Committee, 31st meeting, April 18, 2015, Statement by Zhou Xiaochuan, Governor, People's Republic of China.

In the last year, the Chinese authorities have enacted new measures to further liberalise the current and capital accounts and to enhance the currency's convertibility. The measures encompass new or renewed swap agreements, increased quotas for the QFII and RQFII (*Qualified Foreign Institutional Investors* and *Renminbi Qualified Foreign Institutional Investors*) programmes and the appointment of new clearing banks in various countries. Other measures include the launch of the Hong Kong Shanghai Connect programme in November 2014, the recently approved Hong Kong-China mutual fund recognition scheme with a pilot programme due to enter into force on 1 July, the opening of the interbank repo market to foreign banks that already participate in the bond interbank market, and the issue of deposit certificates to the individuals and companies announced in early June.

Governor Zhou reiterated that the capital account is not yet fully convertible although it is very close to it. The currency fails five of the 40 criteria listed by the IMF: in particular, cross-border investment by individuals and the issue of shares and other financial instruments by non-residents in China are not yet permitted. The Governor has stated that China will introduce various measures in the next few months aimed at achieving convertibility in these areas. These notably include: a pilot programme for individual investors (*Qualified Domestic Individual Investor Program, QDII2*) in six cities; the introduction of the Shenzhen Hong Kong Connect programme, which is similar to Shanghai Hong Kong Connect; permission to issue equities (except for derivatives) to foreign investors; and further measures aimed at facilitating the entry of foreign investors into the Chinese capital market. The partial convertibility of the current account has so far prevented the major equities indices (FTSE and MSCI) from including Chinese equities traded on the domestic market (A shares) in their benchmark indices for emerging markets, except in some transition indices and only in percentages that reflect the shares of QFII and RQFII.

The considerable measures to liberalise the capital account are, however, largely pilot programmes and/or subject to quotas; and in some cases they are limited to special economic zones (SEZs), such as Shanghai, and do not yet cover the whole market. A more rapid and expansive opening up of the capital market than is currently under way might also be inconvenient for China at a time when the economy is slowing and Fed rate rises are looming.

China has, however, reiterated that it is not aiming to achieve full convertibility but, given its experience of the financial crisis in 2008, wishes to achieve managed convertibility; that is, it wants to increase the convertibility of the capital account but continue to use macro-prudential measures to minimise the risks arising from capital inflows and outflows (e.g. relating to companies' foreign currency debt) to maintain the stability of the currency and the security of the financial system. This will certainly not be a barrier to approval by the IMF, given that the international debate, even with the contribution of IMF representatives and central bank governors, has recently seemed to be heading in this direction[17].

The greater opening of the current and capital accounts and simultaneous liberalisation of interest rates cannot be seen in isolation from the need to develop a solid banking system together with a large, liquid and well-regulated domestic financial market. These conditions are much more important to enabling the yuan to become more widely used as a reserve currency than to facilitating entry to the basket of SDRs, insofar as the IMF's endorsement would benefit both China and, at an international, political level, the IMF itself, in view of the stalemate over the reform to increase emerging countries' contributions to managing the Fund, which is

[17] See for example: "Going Bust for Growth" (Remarks by Dr. Raghuram Rajan, Governor of the Reserve Bank of India on 19 May 2015 to the Economic Club of New York) and "Monetary spillovers? Boom and bust? Currency wars? The international monetary system strikes back", Dinner Speech by Fabrizio Saccomanni, BIS Special Governors' Meeting, Manila, 6 February 2015.

opposed, in particular, by the US[18]. In China, the liberalisation, development and supervision of the domestic financial market and the strengthening of the banking system are still a long way from those of industrialised countries. The reforms necessary to achieve these aims take time and are difficult to implement, especially in the current economic climate, not least because of the far-from-subtle political resistance to the changes they entail for the economic system.

Although it is seen positively, the full convertibility of the financial account is not required for currency entry to the basket of SDRs. The currency must, however, be considered by the IMF as "freely usable"[19], meaning that it should be widely used as a payment currency in international transactions and actively traded on the currency spot market. It should also be used as a reserve currency and a currency of denomination for international debt instruments (bonds and bank liabilities). In addition, the country of the candidate currency should be among the world's top five exporters of goods and services. This quantitative criterion has been used since the 1980s, and the "freely usable" criterion has been in place since 2000.

The current basket of SDRs is made up of the US Dollar (41.9%), the Euro (37.4%), the Pound Sterling (11.3%) and the Yen (9.4%)[20]. As part of the discussion on the criteria for joining the basket, the IMF has declared that although the number of currencies is not set in stone, it should remain low (maximum of five or six) in order to preserve the stability and representability of international transactions, and to reduce costs and facilitate currency hedges. In the proposed simulations[21], it is considered reasonable to compare the parameters of a new currency with the currency that has the fourth-largest share in the current basket or the one that was ranked fifth at the evaluation stage, i.e. the best-placed currency outside the basket.

There is no problem with meeting the leading exporter criterion, with China the fourth-largest global exporter between 2006 and 2010 and now ranked second with a share of 10.5%, behind only the Euro area (25.3%). In 2014, 22.1% of cross-border commercial transactions of goods and services with China were settled in Renminbi, compared with 2.4% in 2010, when the last review of the SDR basket was carried out. The Renminbi is now fifth[22] in the SWIFT classification of the most used currencies in international payments with a share of 2.07% at April 2015, just below the yen (the fourth currency in the SDR basket), which has a share of 2.73% (see Figs. 1 and 2).

According to data from the Bank for International Settlements (BIS)[23], the Yuan's share of daily turnover on the global foreign exchange market was 0.9% in April 2010 and 2.2% in April 2013. By contrast, the Yen had a share of 23% and the Sterling 11.8%[24]. The Renminbi's share was 1.7% for the spot market but higher for some derivatives (e.g. 5.1% for options). Even if we assume that the Renminbi's use on the currency spot market has increased at the same pace as its use for commercial transactions, where its share tripled between April 2013 (0.69%) and April 2015 (2.07%), it will not have reached the share of the Sterling (11.1%) or the Yen

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[18] Note that the US has not yet ratified the reform of quotas of representation and governance of the IMF approved in 2010.

[19] IMF Executive Board Discusses the Criteria for Broadening the SDR Currency Basket, Public Information Notice No. 11/137, 11 November 2011.

[20] IMF Determines New Currency Weights for SDR Valuation Basket Press Release No. 10/434 15 November 2010.

[21] IMF, Criteria for Broadening the SDR Currency Basket Prepared by the Finance and Strategy, Policy, and Review Departments (In consultation with other departments) Approved by Andrew Tweedie and Reza Moghadam, 23 September 2011.

[22] Up from 35th in October 2010 and 13th in April 2013.

[23] BIS, Triennial Central Bank Survey, Foreign Exchange Turnover 2013.

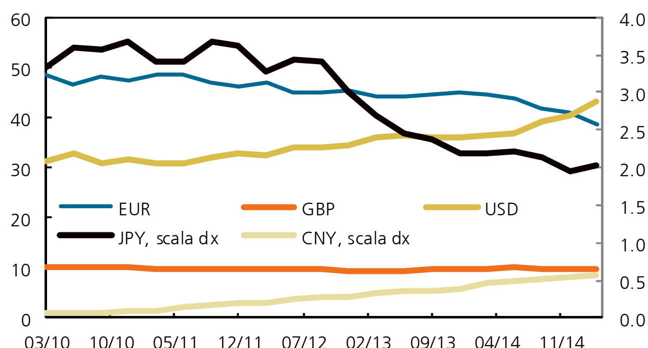
[24] Since two currencies are involved in each transaction, the sum of the individual shares is 200% rather than 100%. Dividing by two may make it easier to understand.

(29.9%). It may, however, have reached the levels of other reserve currencies outside the basket, such as the Swiss Franc or the Canadian Dollar, which had shares of 4.1% and 4.6% respectively in 2013.

In spite of huge strides being made, particularly with the issue of off-shore securities, use as a denomination currency for international debt instruments remains low compared with other currencies (Fig. 3). According to BIS data on bond and money market instrument issues, the amount in Renminbi was 0.6% of the total outstanding in 1Q15, up by 0.1 percentage point on 4Q10 by way off the Yen's 2.2% share.

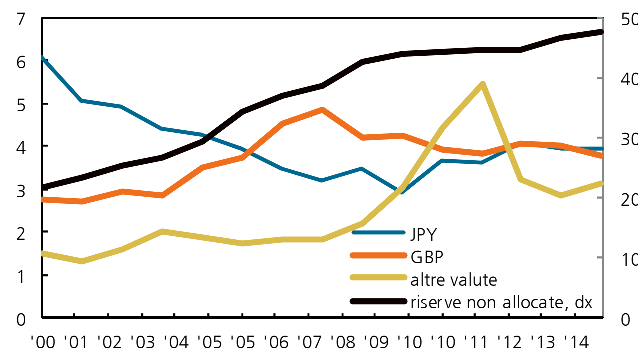
It is much harder to assess the use of the Renminbi as a denomination currency for international bank liabilities and as a reserve currency because the available BIS and IMF statistics provide a breakdown only for the major currencies. Having said that, it is reasonable to assume that the increase from 5.6% at the end of 2010 to 7.1% at the end of 2014 in the share of "other currencies" used as a denomination currency for bank liabilities (the Sterling and the Yen had respective shares of 5.4% and 2.7% at the end of 2014, followed by the Swiss Franc with 1.6%) is attributable to a greater use of the Renminbi. A similar logic can be applied to the share of "other currencies" in the allocated reserves and for the increase in the share of unallocated reserves, which rose to 47.5% of total foreign currency reserves in 2014 (Fig. 4). This is due almost entirely to emerging nations, whose share has surpassed that of the allocated reserves since the mid 2000s to reach 65.7% at the end of 2014.

Fig. 3 International debt securities – breakdown of outstanding amount by currency (as a % of the total)



Source: Intesa Sanpaolo chart from BIS Debt Securities Statistics Tables 13A and 13B

Fig. 4 Increase in share of "other currencies" in allocated reserves (as a % of the total allocated reserves)



NB: unallocated reserves as a % of total reserves. Source: Intesa Sanpaolo chart from IMF and COFER data

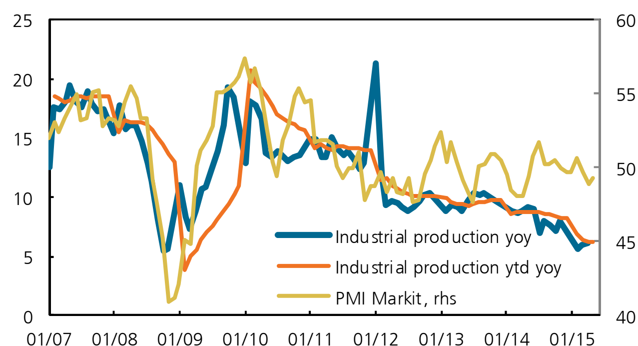
During its 2011 review, the IMF discussed the possible introduction of another SDR basket entry criterion[25] and judged it could be complementary to the "freely usable" criterion in terms of better evaluating this latter one[26]. According to this complementary reserve asset criterion (RAC), the candidate currency must be actively exchanged on the foreign exchange derivatives market as well as on the spot currency market. It should also be used as a reserve currency, and the country of the currency in question should use financial instruments traded on the international markets based on interest rates freely determined by the market.

Strictly speaking, we still believe that the Renminbi does not fully meet all the requirements for being defined as "freely usable", nor those for the complementary RAC, but it is getting very close. The RAC meets the demand for a more pluralistic international monetary system, given that the development of emerging economies in the last ten years is not yet reflected in either the IMF’s quotas or the basket of SDRs. Ultimately, this need could steer the IMF’s decision given

[25] See note 20
[26] See note 18

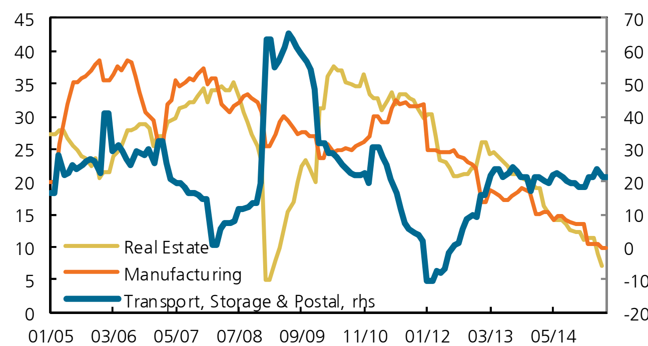
the discretionary nature of the assessment criteria; this is partly to recognise the importance that China has now assumed in the global economy and its progress towards liberalising the financial account, and partly to facilitate the gradual development of the international monetary system.

Fig. 1 - Industrial output stabilises



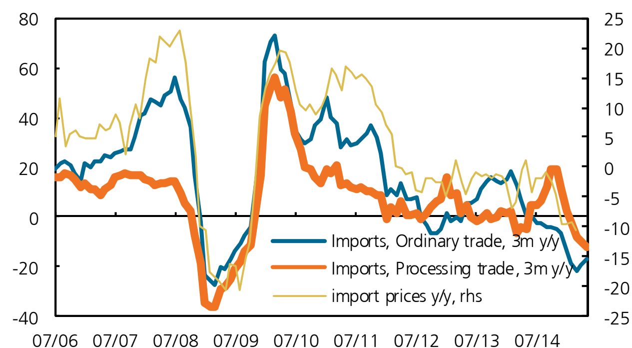
Source: CEIC, Markit

Fig. 2 - Property investment still slowing



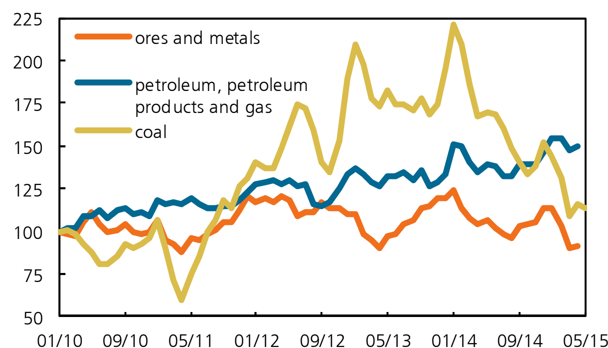
N.B. Cumulative nominal investments, chg. yoy. Source: CIEC

Fig. 3 - Imports affected by falling prices



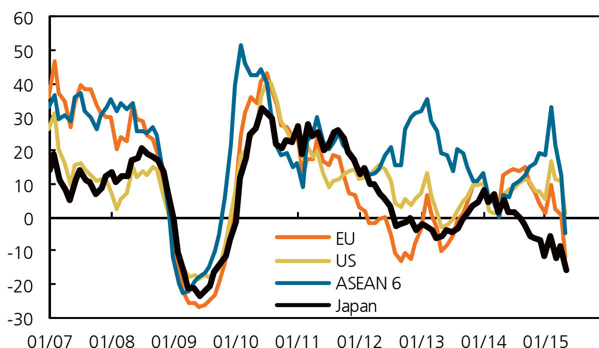
Source: Bloomberg, Thompson Reuters Datastream, Markit

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



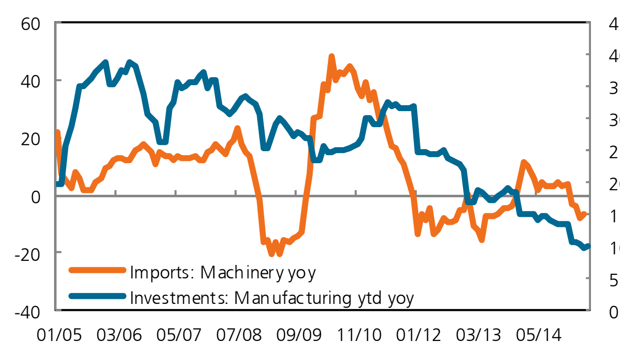
NB: Imports in tons, rebased at 01/01/2010 = 100. Source: Intesa Sanpaolo chart from CEIC data

Fig. 5 - Exports slow



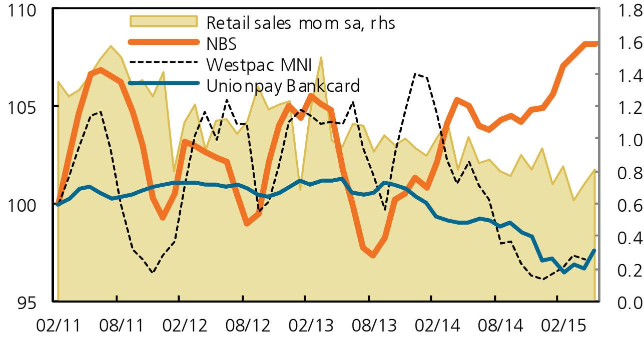
Source: Bloomberg; % chg. 3m yoy

Fig. 6 - Manufacturing sector investment



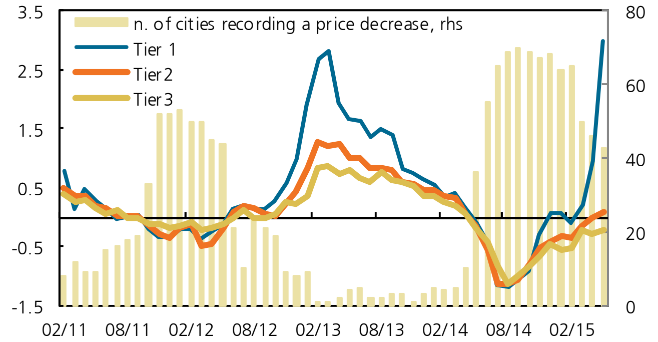
Source: CEIC

Fig. 7 - Confidence indices on the rise



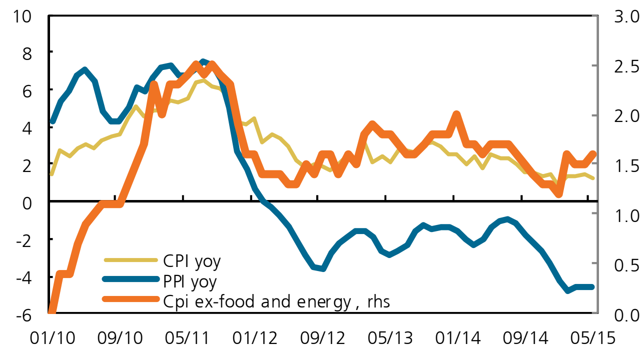
N.B. Confidence indices, 3-month moving average, rebased at February 2011=100. Source: CEIC

Fig. 8 - Signs of improvement in the property market; prices jump in first-tier cities



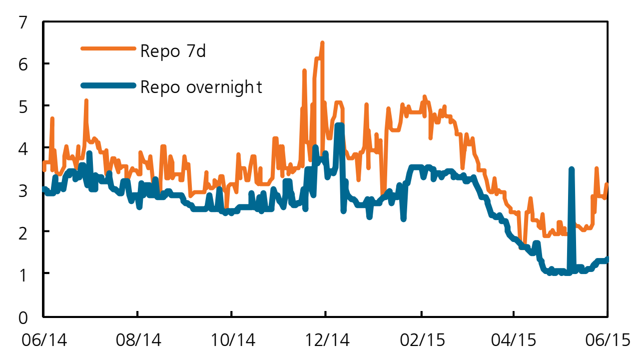
NB: Average % price change mom New-build residential properties. Source: Intesa Sanpaolo chart from CEIC data

Fig. 9 - Core inflation rising



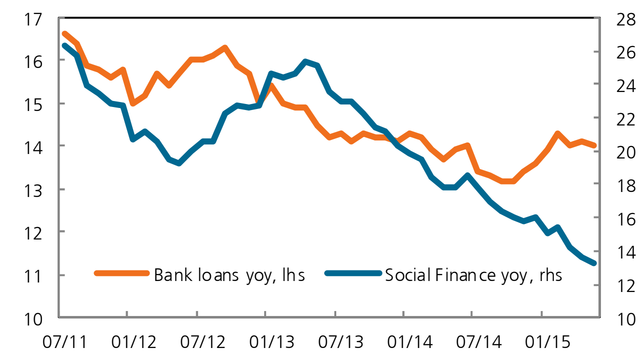
Source: CEIC, Bloomberg

Fig. 10 - Money market rates decline



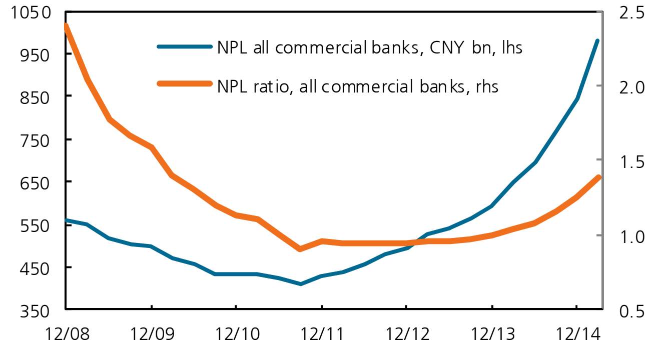
Source: Bloomberg

Fig. 11 - Bank lending stabilises



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

Fig. 12 - Non-performing loans continue to rise



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

India: recovery under way but still patchy

Silvia Guizzo

- GDP jumped 7.5% yoy in 1Q15, closing the 2014-2015 financial year (FY2014-2015) with growth of 7.3% yoy vs 6.9% in FY 2013-2014. 1Q benefited from accelerating private consumption and investment, which offset a fall in public spending. Foreign trade made a positive contribution due to the deterioration in imports. On the supply side, acceleration in the manufacturing sector offset a moderate slowdown in services and a sharp fall in the agricultural sector. The monthly data for March to May show that the recovery under way is still patchy.
- The outlook for private consumption, which jumped 7.9% in 1Q, remains solid. It is supported by improving consumer expectations, which are at a high after two stable quarters, and by the continuing positive performance of the labour market: the PMI component (both in the services and manufacturing sectors) is steady at around 50 and hiring intentions in the Manpower survey, although marginally down in 3Q, remained high in the previous quarters. Added to this is the recovery in auto sales. However, sales of commercial vehicles are languishing, especially for three-wheel versions, which could signal difficulties in consumer spending in rural areas.
- Capital investment rose 4.1% yoy in 1Q from 2.4% in 4Q14, boosted in part by an appreciable, positive base effect. Although the number of industrial investment proposals awaiting approval from the Ministry of Industry is still down on last year, there is a slow improvement since the lows at the turn of the year, plus project values have also risen between March and May. Total exports have fallen sharply in recent months and more than imports, in part because of lower oil prices (Fig. 5); such was the fall that the foreign trade contribution might no longer be positive in 2Q. Exports, excluding oil as well, are continuing to contract in line with the weakness in foreign orders, whereas imports, although slower than at end-2014, remain positive (+6.9% 3m yoy in May). The preliminary data show that they are supported by gold and industrial metals. The trend in imports of machinery remains negative (-6.8% 3m yoy in May), suggesting that investments will be slow to recover.
- Industrial output accelerated between March and April (+4.1% yoy in April), thanks in part to the modest improvement in capital goods production, but also to intermediate and durable consumer goods, which posted their first gains (+1.3% yoy) since June 2014. In contrast, output of the six infrastructure production slowed sharply, closing April down 0.4% yoy. There is unlikely to be more than a modest improvement in industrial output in the coming months, given the non-linear increase in the new orders component of the PMI index in the last three months (rising to 54.3 in May, Fig. 2), the fall in capacity utilisation and the marginal decrease in order expectations in 2Q in the RBI (Reserve Bank of India) industrial outlook survey. In fact, the industrial outlook survey shows that expectations for 2Q are stable, after peaking in 4Q14, and that output and orders are deteriorating slightly (Fig. 3).
- The services sector is sending mixed signals. Growth in 1Q was high, despite the slowdown (+9.2% yoy vs 12.5% in 4Q14), but a sharp decline in new orders has sent the services PMI plummeting in recent months, from 53 in March to 49.6 in May (Fig. 7). Negative signals, however, are still coming from the agricultural sector, which could be impacted, in 2Q as well, by a smaller summer harvest (*rabi*) caused by the heavy rains and hurricanes that hit northern parts of the country in March. The Ministry of Agriculture's estimates suggest a 5% fall on last year. The risks also remain to the downside for the autumn harvest (*kharif*), with the Indian Meteorological Department forecasting rainfall to be 7% lower than the seasonal average and the Australian Bureau of Meteorology confirming the onset of the El Niño phenomenon.

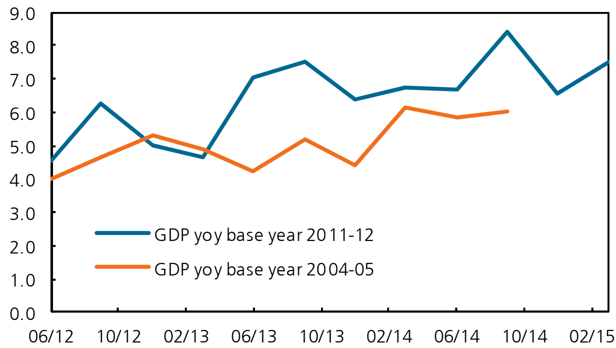
- Consumer price inflation dropped from 5.4% in February to 5% in May under the impact of slowing food prices and supported by a favourable base effect which will continue until August. Core inflation edged up on the back of increases in healthcare spending and tobacco (Fig. 4). Inflation should rise between September and the end of the year to almost 6%, with the annual average sticking at 5.0% in 2015 and rising to 5.4% in 2016; this assumes cautious public management of cereal stocks, which will suppress growth in food prices. The risks for inflation are to the upside, given the weather forecasts, stabilisation of the oil price and increased fuel prices, as well as the impact of the hike in the services tax (from 12.36% to 14%) effective from 1 June.
- Liquidity in the system remains ample, and the monetary authorities have taken various measures to manage non-performing loans and encourage medium-term lending to infrastructure projects; the RBI has also introduced new rules to restructure corporate debt. Despite these measures and the rate cuts, growth in lending remains at a low (Fig. 8). The RBI downgraded growth forecasts for FY2015-2016 from 7.8% in April to 7.6% in June, and opted to cut the repo rate at the beginning of June to 7.25%, in expectation that the figures for the next few months will clarify the amount of inflation risk. We think the RBI will lower the repo rate to 7% by the autumn, but only if these risks are removed.
- The Modi government has undertaken various reforms to support the economy in the first year of its mandate, but has so far failed to get the fundamental ones through Parliament; these include legislation on land acquisition and the Goods and Service Tax (GST), as well as a number of proposals to change labour law at federal level. However, it hopes to obtain approval in the July session. On top of this comes the stalemate in the legal dispute over retrospective application of the Minimum Alternative Tax on capital gains on foreign investment portfolios.
- The Government's commitment to reducing bureaucratic restrictions and to supporting investment and accommodative monetary policy should continue to support growth consolidation in 2015. The fall in oil prices has significantly improved the trade deficit and the current account deficit, which dropped from 2.6% of GDP in 2013 to 1.4% in 2014, but weaker-than-expected exports could prevent a further reduction over the year and restrict the contribution of foreign trade to growth. We have slightly downgraded our forecasts for GDP growth to 7.4% in 2015 and 7.6% in 2016, which is supported by healthy consumer spending and an upturn in investment.

Forecasts

	2010	2011	2012	2013	2014	2015	2016
Gross Domestic Product	11	6.2	4.4	6.4	7.1	7.4	7.6
Private Consumption	8.6	7.3	7.2	5.2	6.1	6.9	7.3
Public Consumption	8.4	7.9	5.5	8.5	6.5	5.6	8.4
Total Fixed Investment	17.5	6.2	-1.3	5.2	3.1	4.8	7.8
Exp. of Goods and Serv.	15.5	18.3	11.2	2.9	4.9	0	9.4
Imp. of goods and serv.	18.2	18.4	11.8	-6.7	-1.8	-0.6	8.6
Industrial production	9.7	4.8	0.7	0.6	1.8	4.9	6.6
Inflation (CPI)	10.3	9.6	9.7	10.7	6.6	5	5.4
Unemployment rate (%)	6.1	5.8	5.6	5.6	5.6	5.5	5.5
Average wages	19.4	13.5	20.2	11.2	10.7	10.3	9.6
3- month Mibor (%)	6.3	9.5	9.5	9.3	9.1	8.3	8.1
Exchange rate USD/INR (average)	45.74	46.69	53.47	58.57	61.04	63.25	62.60
Current account balance (bn INR)	-2498.0	-2945.1	-4893.2	-2779.6	-1665.5	-1488.6	-2318.2
Current account balance (% of GDP)	-3.4	-3.4	-5.1	-2.5	-1.4	-1.1	-1.5
Government balance (% of GDP)	-3.8	-6.8	-5.5	-5.5	-4.2	-4.3	-4.1

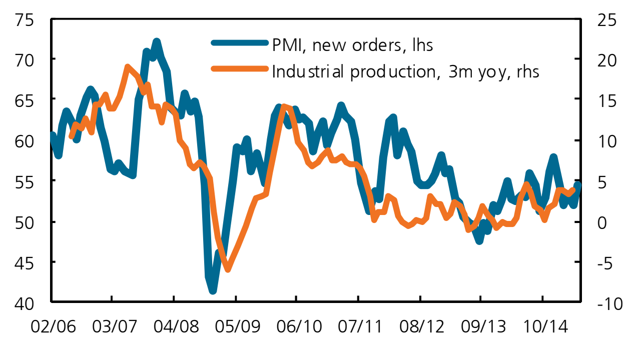
NB: Percentage changes versus previous period - except where otherwise indicated. Figures relate to the calendar year.
Source: Intesa Sanpaolo chart from Oxford Economic Forecasting data

Fig. 1 - Rebasing of GDP series takes growth higher



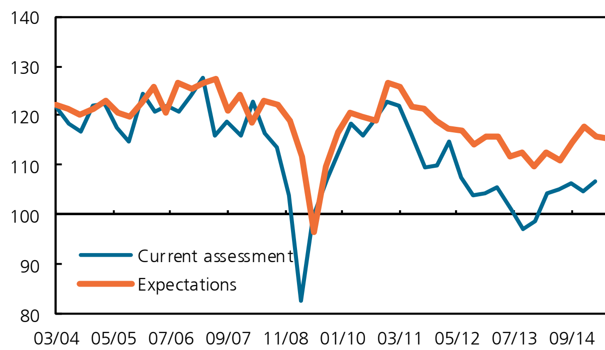
Source: CEIC

Fig. 2 - Domestic orders are volatile



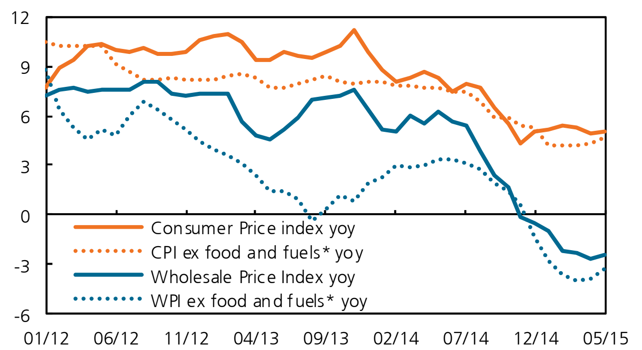
Source: Markit-HSBC, CEIC

Fig. 3 - Business confidence



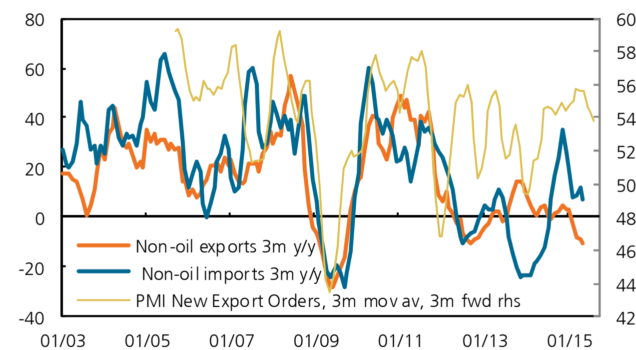
Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 - Inflation stabilising, core inflation slightly higher



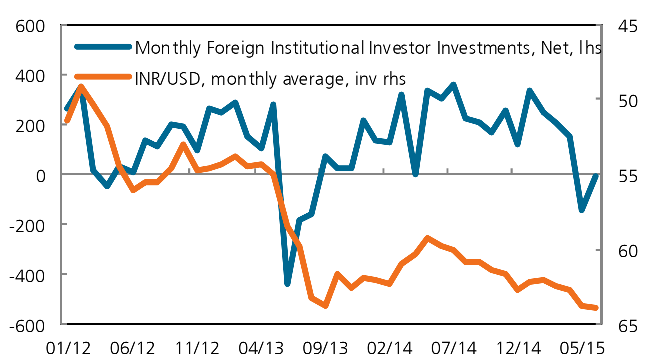
*Intesa Sanpaolo estimates Source: CEIC

Fig. 5 - Foreign trade still falling, orders slowing



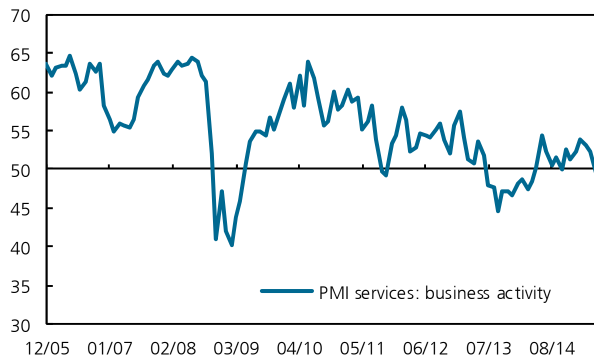
Source: Bloomberg, Markit

Fig. 6 - Rupee depreciation remains moderate



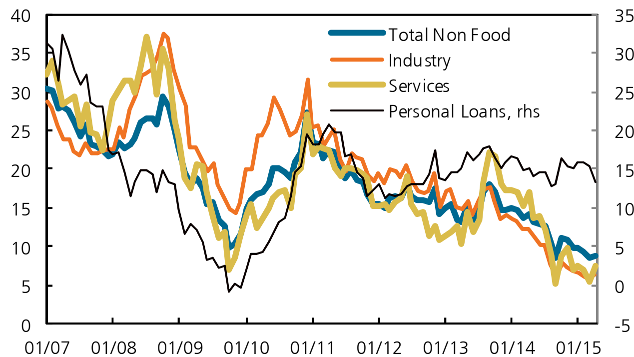
Source: CEIC

Fig. 7 - Services PMI falling



Source: Markit

Fig. 8 - No acceleration in lending (% change yoy)



Source: CEIC

Forex markets

US dollar: upside nearly at an end, but not quite. While the Fed delays its first rate hike, (many) other central banks are cutting interest rates.

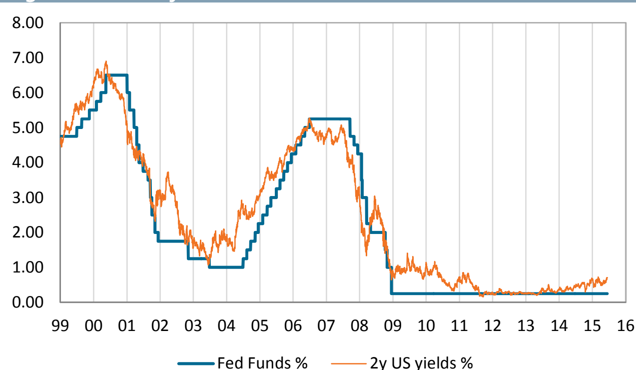
Asmara Jamaleh

Dollar

After an exceptional start to the year, which in March brought highs not seen since 2003 (Fig. 1), the dollar retreated slightly in 2Q. In light of the negative performance of the US economy in 1Q, the Fed has postponed the timing of the first rate rise, which had previously been expected in June. This is an understandable retracement, especially given the very bullish macro trend in the dollar over the last year: +16% for the "broad" nominal effective exchange rate (Fig. 1), rising to +23% for the index relating to just the majors. This appreciation has taken the dollar to its pre-crisis average (Fig. 1), i.e. to levels that may be considered high and which suggest, as such, that at least part of the Fed's policy reversal has already been priced in by the forex market.

Fig. 1 – The “complete” rise of the dollar

Fig. 2 – The “very” reversal of the Fed



Source: Thomson Reuters-Datastream

But this is not enough to conclude that the highs are behind us, mainly for three reasons:

1. the reversal the Fed is about to undertake is a real reversal that is unprecedented, both with regard to the starting point for rates – zero – and the extremely long period – six years – in which these have been kept at zero (Fig. 2);
2. the upside in US rates and yields – from current levels – is very high;
3. even if the Fed has postponed – compared with expectations – the timing of the first rate hike, the gap (and therefore the divergence) with the other main central banks has not narrowed. This is because most of these have now further eased monetary policy, in many cases by making additional rate cuts, just when the Fed is about to hike.

The dollar could therefore return to its mid-March highs – perhaps even temporarily edging above them – in the (actual) run-up to the first Fed rise. The probability of large rises could fall, however, if the Fed drags its feet too much, as would be the case if it implemented its reversal in 4Q rather than 3Q. The next FOMC meetings will be held on 29 July, 17 September, 28 October and 16 December, and at present the most credible hypothesis is for a rate reversal in September.

Euro

2015 began with a substantial depreciation by the euro, from EUR/USD 1.21 to 1.04, **but over half of the fall was made up in 2Q** with the exchange rate rising from 1.04 to 1.14. The conditions in which the rally took place would suggest that the **probability of hitting new lows – at parity or below** – has significantly **reduced**.

The euro's recovery was mainly driven by the postponement in the expected timing of the first Fed rate rise (Fig. 3). It also received support from the trend in European yields, which have become less negative at the short end and have risen sharply at the long end. These two variables – US rates and European rates/yields – will continue to play a significant role in the next few months, but at different times.

The short term is set to be dominated by the run-up to the first Fed rate hike, which is now expected in September. This suggests a fresh correction by the euro, with a return **towards** – but not below – its March lows at **EUR/USD 1.05-1.04**.

In the medium term, however, the expected gradual adjustment of European rates/yields should prevail. This would be consistent, particularly over the next year, with the trend in macro fundamentals, i.e. the expected improvement in the inflation and growth outlook for the area. This should favour the euro's gradual recovery, with a return towards EUR/USD 1.15-1.20 over the 12m-24m horizon. The prospect that Fed rate rises will be more gradual than previously expected should also lead in this direction.

Fig. 3 – Euro and delay in expected timing of the first Fed hike

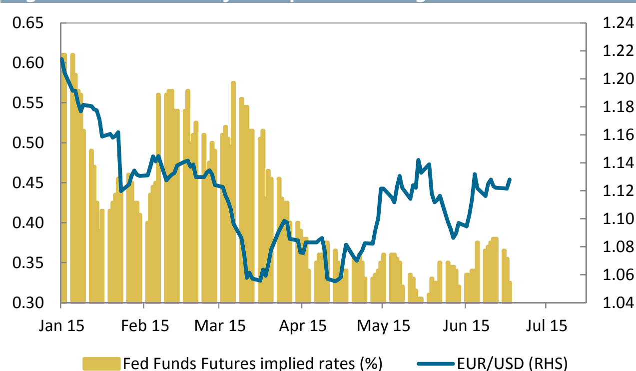
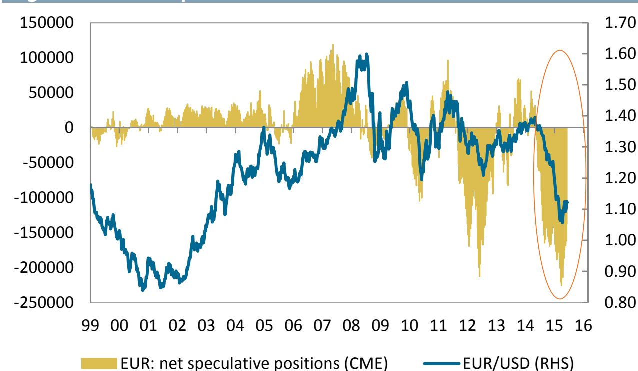


Fig. 4 – Lows of speculative euro shorts behind us



Source: Thomson Reuters-Datastream

The relationship between the exchange rate and the Greek crisis seems **more complex,** however. The euro appears, in fact, not to have been affected in the slightest by the negative escalation of the crisis. Even looking at the fall in speculative euro shorts – which had reached an all-time high in March (Fig. 4) – the euro's rally seems to be correlated with the delay in the Fed's policy reversal and not with developments in the crisis. In itself, this is not enough to rule out a euro correction if Greece defaults/exits from the Euro zone; it could be just a temporary reaction. It has even been suggested that the single currency could react positively and strengthen in the event of a Grexit. Similarly, if a positive solution to the crisis is found and given the significant volume of speculative shorts – which although lower than the all-time highs of March remains substantial – there could be a bearish rather than a "banal" bullish reaction. In reality, whatever the outcome of the crisis and whatever the reaction, the most probable scenario is that in a relatively short time the markets will return to focusing on purely macro trends in the Euro area and US and on Fed monetary policy decisions.

Yen

The delay in the expected timing of the first Fed rate hike does not make a weakening further of the yen against the dollar less likely, even though it has already depreciated sharply in the last three years, recently reaching USD/JPY 125; this is very close to its all-time low of USD/JPY 135 recorded in 2002 (Fig. 5). The Fed's "postponement" **means that the first rise in the Fed Funds rate will be closer in timing to any further extension of the QQE by the BoJ**, which could take place by the autumn.

Reducing inflation to target within the timeframe set by Japan's central bank looks a difficult task and would suggest an increase in monetary stimulus. The BoJ is open to this option, but has made less explicit statements on this point of late. Governor Haruhiko Kuroda has stated that **the effects that monetary policy will have on the exchange rate will depend on how much the market prices in future policy actions**. In this regard, **the BoJ's "verbal" caution may "favour" a more bearish impact** on the yen if fresh monetary stimulus is provided. According to Kuroda, "it is difficult to say if the dollar will rise when the Fed raises its rates" and therefore if the yen will fall. We think that the dollar is likely to generally strengthen when this happens; but a simultaneous increase in the BoJ's QQE – and therefore maximum divergence in action between the two central banks – would facilitate a further decline in the yen, which has already fallen sharply, to USD/JPY 125-130.

Last year, when the first expansion in QQE was announced (31 October 2014), the yen slumped (Fig. 5) against both the dollar (from USD/JPY 105 to more than 120) **and the euro** (from EUR/JPY 135 to 150). Again in this case, the yen is likely to fall further against the euro, beyond the recent lows of EUR/JPY 140, but it may first have to go through a bullish retracement towards EUR/JPY 135-130, because the initial bearish impact of a Fed rate rise could be greater for the euro than for the yen.

Fig. 5 – Fed reversal more yen-bearish if the BoJ extends QQE

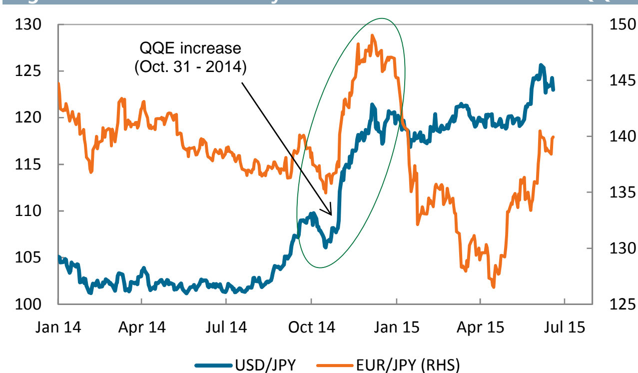
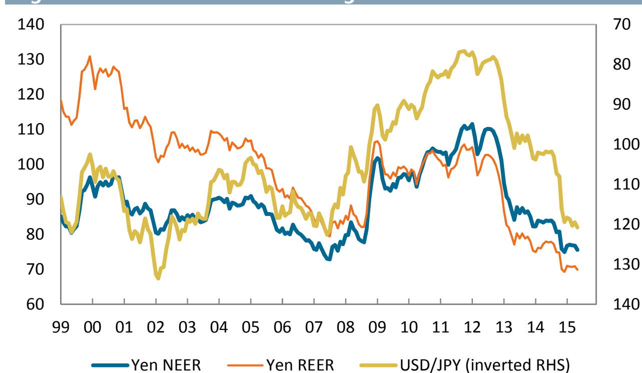


Fig. 6 – Yen real effective exchange rate at all-time lows



Source: Thomson Reuters-Datastream

However, the yen's residual downside, particularly against the dollar, is not significant. Kuroda recently stated that "the yen is unlikely to weaken further on a **real effective exchange rate** (REER) basis", which is now at **an all-time low** (Fig. 6). This statement was initially misinterpreted by the markets, who thought the BoJ governor was signalling that a USD/JPY exchange rate above 125 was not welcome. But Kuroda then specified that he was not referring to the yen/dollar exchange rate, but the real effective exchange rate. This covertly put the focus on what could be seen as an attempted competitive devaluation of the yen, particularly against the currencies of other Asian economies, primarily China. In the last three years, the Chinese yuan has appreciated by 40% against the yen, but has "taken" more than three-times as long (ten years) to rise by 38% against the dollar.

Sterling

Sterling remains an exception to the other G10 currencies in terms of the dollar, since the Bank of England remains the only central bank whose policy does not diverge from that of the Fed, and it will be the first to raise rates after the Fed. In fact, sterling's decline against the dollar began (a year ago: Fig. 7) when the market started pricing in the Fed reversing its rates policy before the BoE; up to that point the UK central bank had been expected to make the first move.

Early this year, however, the "non-divergence" between the BoE and the Fed was the factor that pushed up sterling against the euro (from EUR/GBP 0.80 to 0.70), while it depreciated against the dollar (Fig. 7). **The divergence between the BoE and the ECB should take the pound to new highs against the euro** in the next few months, at between EUR/GBP 0.70 and 0.65. The exchange rate against the dollar could, however, be a little more irregular in the second half of the year. Of late, **the postponement of the expected timing of the first Fed rate hike has particularly favoured sterling because some of the UK's data have, at the same time, surprised to the upside**. This was the case with the job market figures published on the same day as the FOMC meeting (17 June). The impact on rates/yields has also been significant, and the spread between BoE and Fed implicit futures rates for December 2015 maturities has widened (Fig 8). But it seems **unlikely that market expectations will reverse or that the BoE will be in a position to reverse its** monetary policy **before the Fed**.

Fig. 7 – Divergent trend of the pound vs. dollar and euro

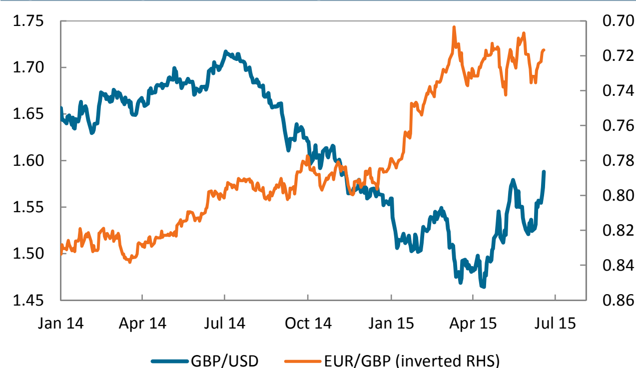
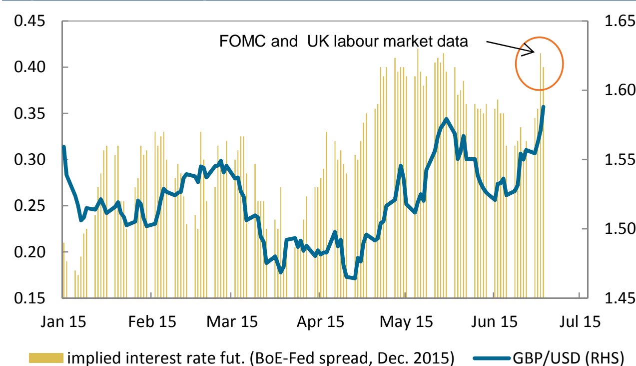


Fig. 8 – Rate rise expectations: BoE vs. Fed



Source: Thomson Reuters-Datastream

For both central banks, the decisive factor is wage growth. In the UK this has only shown encouraging signs in the last couple of months, and another (consecutive) positive figure alone would probably not be enough to prompt the BoE to raise rates quickly. The Fed, however, probably only needs one more very positive employment report to raise rates in September – provided that overall figures do not decline in the meantime. In both cases, inflation remains crucial. In the UK, this has been below the lower limit of the target band (1.0%) for the last six months; however, after falling to -0.1% in April it rose to +0.1% in May, and the BoE expects it to rise significantly towards the end of the year. If, in the meantime, further progress is seen in the job market, the BoE could begin to raise rates at the end of this year (November). The market has not yet ruled out this possibility, but believes that the first rise will in all probability take place in 1Q16 and 2Q16. **In the short term, in the absence of further highly favourable surprises for the UK economy, sterling could** therefore **retrace against the dollar**, from the recent high of almost GBP/USD 1.60. This decline should, however, be limited in size and time, pending – one or two quarters after the Fed – a rate hike by the BoE.

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Appendix

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