INTESA SANPAOLO

Macroeconomic Outlook

Research Department

March 2015

BANCA IMI

Macroeconomic Outlook

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Quarterly

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INTESA SANPAOLO

The true impact of the weak Euro is difficult to assess

Luca Mezzomo

The ECB's purchase programme has triggered a currency earthquake. The exchange-rate trend could have a considerable impact on European exports and GDP, although everything depends on how long the phenomenon lasts and on the pricing policies implemented by business firms. In addition, wild fluctuations of the exchange rates could negatively affect the sustainability of global growth.

In the 1Q15, the diverging monetary policies of the Federal Reserve and the European Central Bank led to a rapid acceleration in the Euro's decline on the currency markets. The value of the euro slid from USD 1.2436 in mid-December to USD 1.11-1.15 in January-February, before dropping to USD 1.04-1.08 in March with the launch of the ECB's PSPP (Public Sector Purchase Programme). The monetary authorities of European countries that are not part of the Eurozone have faced increasing difficulties in maintaining stable exchange rates against the euro. The Swiss National Bank has abandoned its minimum exchange rate policy, which set a floor of CHF 1.20 for the exchange rate against the Euro, leading to appreciation of some 15%; other countries have been preparing for the ECB's expansionary measures (e.g. Denmark) or making provision for a potential rise in interest rates (UK). And in the United States, the strengthening dollar may have played a role in the increasing caution exercised by the Federal Reserve when planning the first official interest rate hike.

The impact of a weaker exchange rate is difficult to assess

Whereas falling oil prices redistributes growth from producers to consumers of oil, and impacts mainly by lowering prices and increasing households' real incomes, the exchange rate falls redistribute growth from the rest of the world to the Eurozone by substituting foreign production with domestic production. Depreciation should boost economic activity through the change in prices of imports and exports: but exporters can choose between gaining market share by cutting prices in foreign currencies in international markets, or improving their profitability by keeping prices unchanged; and importers can opt either to raise prices in Euros (with the risk of losing market share to local competitors) or to cut profit margins (thus protecting sales volumes). Besides, the transmission could be delayed by previous hedging of exchange rate risk, while the positive effects would be progressively reduced by the rising cost of imported production inputs. The invoicing currency also has an impact: the greater the amount of imports invoiced in local currency, the lower the tendency for exchange rate fluctuations to be transmitted to prices.

All this makes the impact of exchange rate changes hard to assess, and probably dependent on the specific context. In 2014, an econometric analysis performed by the European Commission[1] found significant and high elasticity of exports to effective exchange rates, at -0.77 for the Euro zone overall and varying from -0.40 to as low as -2.56 for the nine countries reviewed. The elasticity of global demand was 0.91. The impact on GDP, which is further increased by falling imports, depends on how open the economy is and the foreign value added content of exports. In the case of the US economy, the impact of dollar appreciation is transmitted much more by exports than imports as the latter is almost entirely invoiced in dollars, and it is more likely that fluctuations are absorbed by margins.[2]. Export elasticity is, however, the same as that recorded by the European Commission for the Euro zone, although much lower estimates on trans-Pacific

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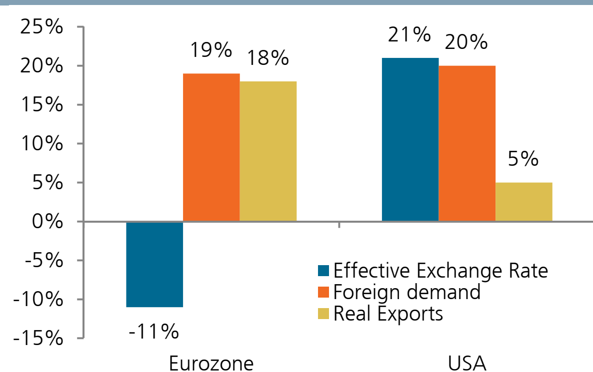
[1] Narcissa Balta, Karin Fischer, Plamen Nikolov and Lauri Vilmi: "Member State vulnerability to changes in the euro exchange rate", in *Quarterly Report on the Euro Area* vol 13 Issue 3, October 2014.

[2] See, for example L. Goldberg and E. Wiske Dillon, "Why a dollar depreciation may not close the U.S. trade deficit", *Current Issues* vol. 13 no 5, June 2007. Transmission to import prices after one year is half that of the Euro zone and Japan.

trade flows have been published. High elasticity is also implicit in econometric models available on the market, such as that of Oxford Economics. Oxford Economics tends to discount a rapid and powerful transfer to domestic prices, although this is not confirmed by the European Commission analysis.

Our forecasts are consistent with a 15% depreciation in the Euro's effective exchange rate between 2014 and 2015, and a 13% appreciation in the US Dollar's. Let's assume that such depreciation is permanent. In the light of these forecasts, we should therefore expect a sharp acceleration in export growth over the next few years, with a contribution of around 9% to cumulative growth, and a sharp drop in imports from the US. With added foreign value of exports in the 25-30% range, and with exports as a proportion of GDP standing at 44% for the Euro zone overall, the long-run cumulative impact on GDP would be as large as three percentage points.

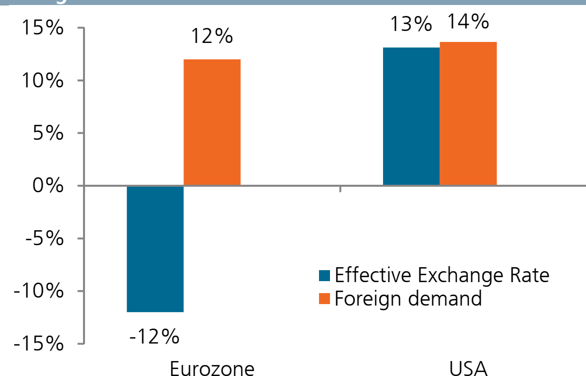
Fig. 1 – Exchange rates, foreign demand and exports in 1997-2000



Note: Cumulative variations between 3Q98 and 2000, except for the effective exchange rate of the Dollar (1997-2000).

Source: Intesa Sanpaolo data

Fig. 2 – Current variations are set against weaker growth in foreign demand



Note: Expected variations in effective exchange rates and foreign demand index for the country in 3Q13-2Q14 and 2016.

Source: Intesa Sanpaolo data

This is not the first time there has been a large fall in the external value of the Euro, so what happened on previous occasions? A review of past experience is a big dampener of the most bullish expectations. The first episode occurred when the single currency was launched. Its average value in 2000 was 11% lower than in 3Q98-2Q99. The second, more limited, episode occurred after the financial crisis and recession of 2008-09. In both cases, however, global demand was growing strongly, which is a better reason than the exchange rate for the large increase in exports from the Eurozone. In reality, although high, depreciation in 1999-2000 seemed unable to boost real export growth other than global demand. In contrast, data from the US are consistent with the strong dollar having a significant impact on US exports in 1999-2000, although it should be remembered that the cumulative change in the effective exchange rate from 1997 onwards was over 20%, compared with 13% in the current episode. In conclusion, if, over the coming months, businesses choose to raise profitability rather than gain market share, the impact on exports trends and GDP could be limited. This explains the relatively small upgrade made to growth forecasts for 2015-16 compared with the relatively large revisions to our euro/dollar exchange rate forecasts.

Risk of exchange rate overshooting and monetary policies

The prospect of two years of diverging monetary policies between the Euro zone and the US has encouraged forecasts of a further fall in the Euro/US dollar exchange rate towards the lows of 2000, i.e. below 0.90. Indeed, rate spread trends will remain unfavourable for many months to come. However, if monetary policy trends influence the forex markets, exchange rate trends could, in turn, impact monetary policy. Fluctuations that are overly wild and more than

temporary could further delay monetary tightening in the US and even call into question the ECB's stimulus measures; it could, for example, create a consensus for a gradual end to its public sector purchase programme (PSPP) during 2016 if it triggers a faster recovery in inflation. An overly rapid fall in the Euro could prove counterproductive in the medium term, as this could compromise the possibility of using monetary policy to reduce public sector debt. And conversely, it could (through rates being kept too low for too long) fuel unsustainable growth in private debt in the US.

There is a clear risk in this regard that neither monetary policy nor macroprudential supervision would intervene in time to stop excessive risk-taking, instead placing all the burden on capital buffers. Recently[3], Jerome Powell, a member of the Federal Reserve Board, highlighted the strong increase in leveraged loans since 2010, associated with ever-higher multiples and a progressive easing in covenants. However, he commented that, "unless there is a plausible threat to the core of the system or potential for damaging fire sales, I would set a high bar for supervisory interventions to lean against the credit cycle", because "such interventions would almost surely interfere with the traditional function of capital markets in allocating capital to productive uses [...]". So no "leaning against the wind", either on the regulatory front or in terms of rates.

Upgrade of European, but not global, growth

In conclusion, trends in the first few months of the year have improved the prospects for Euro zone growth, which we have now upgraded to 1.5% in 2015 and 2.0% in 2016. This is in contrast to 2014 when poor weather conditions slowed US growth, obliging us to cut our forecasts for average annual GDP. Globally, there could be a modest recovery driven by developed countries, alongside a further slowdown in developing countries.

Inflation forecasts have been revised in opposite directions in the US and in the Euro zone, largely due to opposing exchange rate trends. In general, inflation should begin to rise this year between 2Q and 3Q, though remain between 0% and 1% until 4Q.

Economic growth by geographical region

	2012	2013	2014	2015P	2016P
US	2.3	2.2	2.4	3.0	2.9
Japan	1.7	1.6	-0.1	1.0	1.8
Eurozone	-0.8	-0.4	0.9	1.5	2.0
Eastern Europe	2.3	1.8	1.3	-1.2	2.3
Latin America	2.6	2.5	0.8	0.7	2.2
OPEC	5.8	2.2	2.1	2.0	4.0
East Asia	6.1	5.2	8.0	6.9	6.4
Africa	3.1	3.1	3.9	4.1	4.7
World	3.4	3.3	3.3	3.6	4.1

Source: Intesa Sanpaolo

[3] J. Powell, "Financial institutions, Financial Markets, and Financial Stability", speech at the Stern School of Business, 18 February 2015.

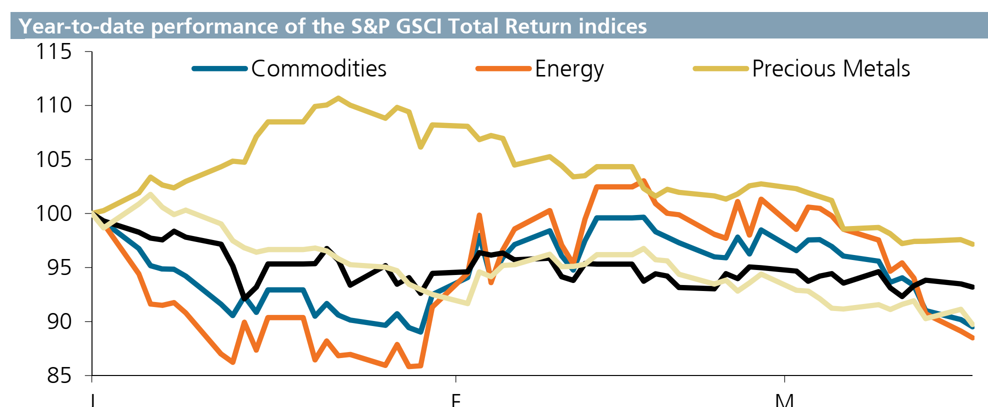
Commodities: downwards pressure has not yet eased off

In our view, the downwards pressure on the sector has not yet eased off, being driven by fears of excess supply, the strength of the US dollar, disappointment over some key macroeconomic figures - albeit in most cases caused by temporary factors - and negative market sentiment about the sector. Conversely, we think that in the second half of the year prices could start to respond to renewed concerns that the fundamentals for most commodities will become tighter.

Since the start of the year, correlations between energy, industrial metals and agricultural commodities have strengthened compared with the average recorded in 2014, partly driven by the substantial movement in the US dollar. The correlation between commodities and the US currency has strengthened significantly. For example, the average correlation between the S&P GSCI index and the Fed's trade-weighted US dollar index, which measures the strength of the greenback, moved from around -30% in 2014 to nearly -50% in early 2015.

Precious metals, driven by gold, continued to show a low correlation with other commodities; the positive correlation, however, changed to a negative one (from +8% in 2014 to -10% in 2015), probably on the back of the strong demand for safe-haven assets noted in January in response to renewed political concerns over Greece.

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



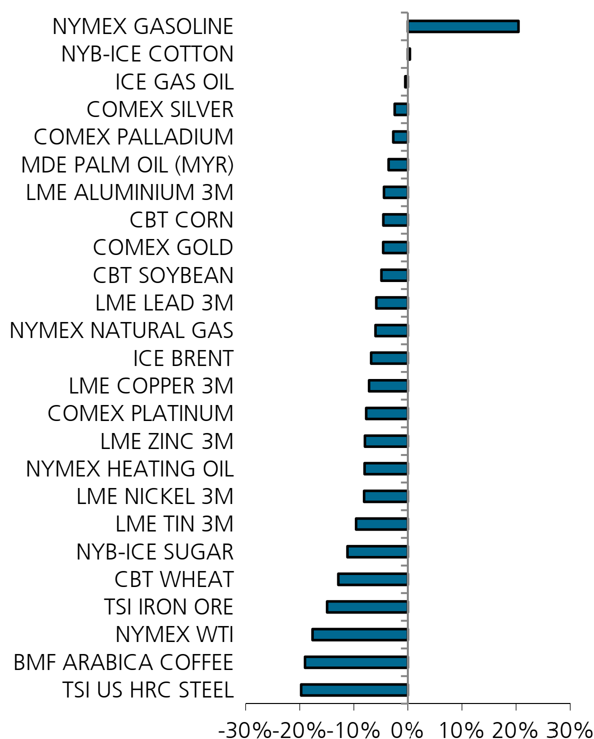
Source: Intesa Sanpaolo chart based on Bloomberg data

In our view, the downwards pressure on the sector has not yet eased off, having recently been exacerbated by the strength of the US dollar and disappointments over some key macroeconomic figures, although in most cases these were caused by temporary factors. In addition, most commodities will suffer from a temporary weakness in fundamentals, which will continue to fuel fears of excess supply and negative market sentiment.

The outlook for the sector will also be heavily influenced by oil prices. Specifically, low oil prices for prolonged periods are likely to further stoke negative pressure on energy, industrial metals and agricultural commodities (due to the lower cost of energy inputs) and on precious metals (due to the expected low inflation). It could also discourage financial investment in commodities.

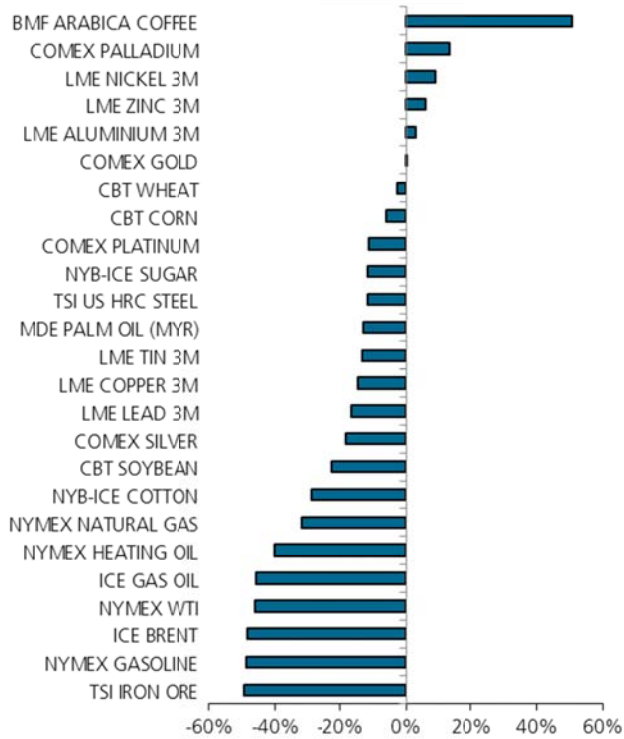
For the moment, we stand by our forecast that, from the second half of the year, the prices of most commodities should start to respond to the expected improvement in fundamentals, which should become tighter due to slowing supply and a pick-up in demand.

Performance since the beginning of the year



Source: Intesa Sanpaolo chart based on Bloomberg data

Performance in 2014



Source: Intesa Sanpaolo chart based on Bloomberg data

Our forecasts for the commodity universe

In January, we significantly revised downwards our oil price forecasts due to the severe deterioration in supply and demand fundamentals recorded in the last few months of 2014, and expectations that no major oil producers were likely to reduce supply in early 2015.

Currently, we continue to stress the risk of new downwards pressure in the short term, owing to the faster-than-expected stock building in the US, the strong dollar and expectations that negotiations between Iran and the P5+1 international powers (the US, the UK, France, China, Russia and Germany) could lead to a temporary agreement; this would entail at least a partial removal of sanctions, allowing Iranian exports to pick up significantly. For Brent, we maintain our forecast of a minimum threshold of USD 40; this price is considered equal to the marginal cost of production of conventional oil reserves, and the level at which technical analysis also identifies important resistance thresholds.

Once this downwards pressure has eased off (e.g. if the dollar stabilises due to less uncertainty about future US monetary policy or if sanctions on the Iranian energy sector are not lifted by the March deadline for signing a draft agreement), we forecast a long period of stabilisation for Brent around a short-term equilibrium price of USD 60, followed by a gradual climb to a target price of USD 70 towards the end of the year on the back of expectations of tighter supply and demand fundamentals. Our forecast of a short-term equilibrium price of USD 60 for Brent is based on an analysis of the marginal costs of the most dynamic supply components: shale oil and oil from unconventional sources.

At present, we forecast an average Brent price of USD 60 in 2Q15 and USD 60 for FY15. For WTI, however, we forecast an average price of USD 53 in 2Q15 and USD 55.3 for FY15. Moreover, once the downwards pressure caused by fears of excessive stock building in the US

has abated, we expect that WTI will rise more rapidly than Brent. In our view, the spread between the two grades of oil should gradually narrow thanks to robust domestic demand. Furthermore, we believe that new measures 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.

In the precious metals sector, we maintain our negative view on gold, but we have slightly revised up our forecasts on demand for safe-haven assets to above expectations. For now, we expect gold to stabilise at around USD 1.150 per ounce in the middle quarters of the year. Conversely, we continue to expect platinum, palladium and silver to rise during the year on the back of expectations of a recovery in industrial demand. Moreover, the low prices recorded in March could stimulate speculative purchases. We see the prolonged strengthening of the US dollar, and more abundant supply than expected in both mining output and recycling, as the main downside risks.

We also forecast an upturn in industrial metals by the end of the year. In the last quarterly outlook (prepared in December), we forecast substantial stability in the sector in 1Q. However, the more adverse macroeconomic environment and stronger dollar compared with the scenario we outlined at end-2014 explain much of the collapse in the prices of the main industrial metals. Despite this, we believe that the lows recorded in the quarter were also driven by excessive market reactions. We therefore stand by our forecast that the demand and supply fundamentals are likely to become tighter overall in the next few quarters, especially for copper, nickel and zinc.

With regard to agricultural commodities, fears of exceptional weather during the period and geopolitical risks could lead to prolonged divergences in prices from supply and demand fundamentals. For the main cereals, we reiterate our forecast that prices will remain weak in the first half of the year due to expectations of very high stock levels, a strong dollar and downwards pressure associated with lower energy input costs. At the end of the year, however, we should see a moderate upturn, driven by a modest recovery in global demand.

Oil: it all depends on supply

As we saw during the first months of the year, oil is now mainly driven by global supply forecasts and the resulting pace of stock building. In the coming months, Brent and WTI prices will remain volatile, and will be heavily affected by the data on the strength of non-OPEC production, the number of active drilling rigs in the US and utilisation percentages for the main storage sites. We maintain our forecast of low prices in the middle two quarters of the year; this is necessary to trigger a significant fall in the most flexible supply component with the highest marginal cost.

If we analyse the sharp fall in the oil price, which started in June 2014, we see that the main drivers were: the downgrade to global growth forecasts; a less favourable financial environment and a strengthening dollar; rapidly deteriorating supply and demand fundamentals; changes in Saudi Arabia's commercial strategy (and hence in that of OPEC); and lower perceived geopolitical risk.

In our view, the negative influence of most of these factors should now have run its course. Despite overall disappointing macroeconomic data in the first quarter, the series of substantial downgrades to global growth forecasts should be nearly at an end. We think the most significant risks are now to the upside, given that, until now, consensus forecasts have incorporated a conservative estimate of the positive effects of the fall in crude price on consumer countries' economies, while the negative effects on the main producer countries'

economies have been incorporated more quickly. In addition, the Euro zone could benefit from positive exchange rate surprises and a more expansive monetary policy thanks to the launch of the quantitative easing programme.

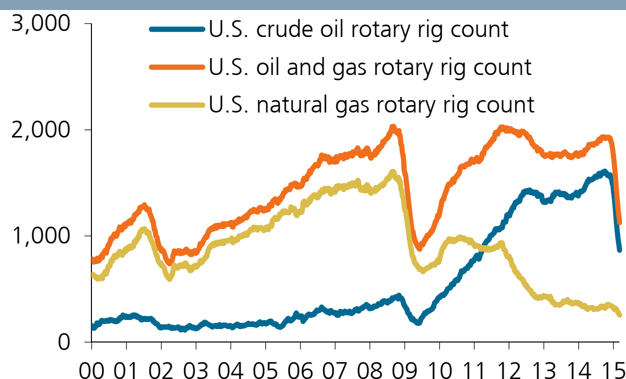
Also with regard to the dollar, in our central scenario we forecast that the downwards pressure from the negative correlation between commodities and the US currency could come to an end in a few months; this would hand back the reins as principal driver of oil prices to supply and demand fundamentals.

Supply and demand fundamentals

Supply and demand fundamentals turned out to be particularly weak in the first quarter, as anticipated by the main forecasters. However, supply was even more abundant than expected in the US.

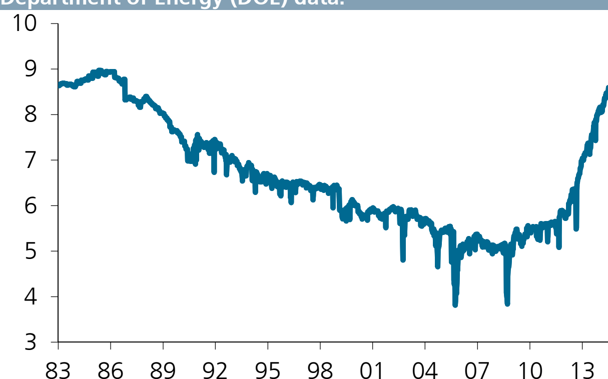
Even though the number of active drilling rigs fell for several weeks running, bringing the total number to its lowest since 2011, production continued to increase and hit new records. Weekly production is currently at its highest since 1982. Owing to particularly harsh weather, the seasonal closure of some refineries and the strike called by the union protecting workers in the sector, US demand was unable to absorb this abundant supply, leading to a very rapid increase in stocks and renewed fears that domestic storage capacity could be exhausted in the next few months.

Number of active drilling rigs in the US. Baker Hughes data.



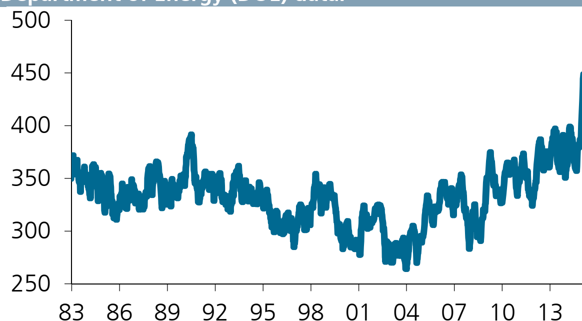
Source: Intesa Sanpaolo chart based on Baker Hughes data

Crude production in the US in million barrels/day (mb/d). US Department of Energy (DOE) data.



Source: Intesa Sanpaolo chart based on US DOE data

Crude production in the US in million barrels/day (mb/d). US Department of Energy (DOE) data.



Source: Intesa Sanpaolo chart based on US DOE data

Utilisation of domestic storage capacity. US Department of Energy (DOE) data.

	Utilisation rate as of 20 February	Working Storage Capacity in million barrels
PADD 1	85%	49
PADD 2	69%	115
PADD 3	56%	297
PADD 4	54%	25
PADD 5	55%	124
US Total	60%	610

Source: Intesa Sanpaolo chart based on US DOE data

In this regard, the figures on inventories (updated on 20 February) and domestic storage capacity (updated weekly and last revised in September 2014) contained in the report published by the US Energy Information Administration (EIA) on 4 March would seem to indicate that US deposits are 60% full, compared with utilisation of 48% in the same period in 2014. The bulk of domestic stocks of crude are held in deposits in the Midwest and the Gulf Coast, where utilisation rates are 69% and 56% respectively. In Cushing, where 14% of domestic storage capacity is located, utilisation rises to 67%, compared with 50% a year ago.

The latest figures published in the monthly reports of the Organisation of Petroleum Exporting Countries (OPEC), the U.S. Energy Information Administration (EIA) and the International Energy Agency (IEA) show a relative improvement in the supply and demand fundamentals compared with the estimates published in December. At end-2014, the three forecasters expected, on average, a "call on OPEC crude" (i.e. the quantity of oil that the group should supply to balance the markets) of around 29 million barrels/day (mb/d), revised up to around 29.3 million, on average, in the reports published in March.

However, the three main monthly reports confirm that there is substantial excess supply. On average, the "call on OPEC crude" is significantly lower than the 30 mb/d target and the actual OPEC production recorded in the last few months.

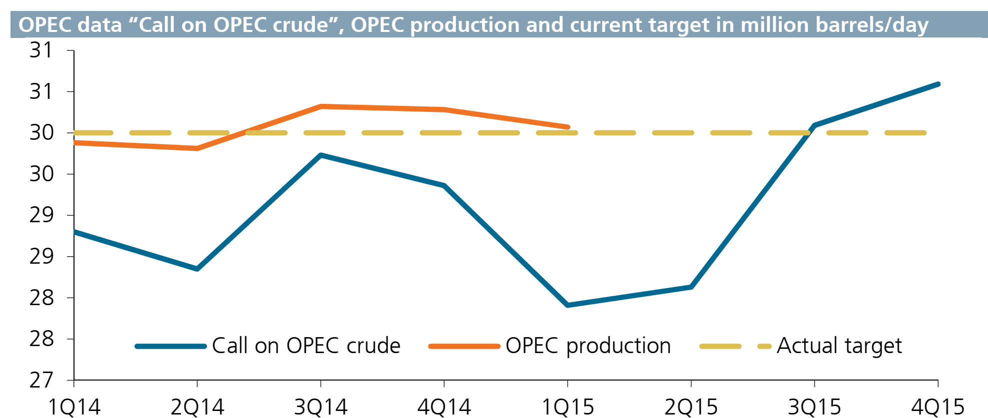
However, excess supply is likely to be mainly concentrated in the first two quarters of 2015, while the markets are set to become broadly balanced by the end of the year.

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

Estimates in March 2015, in million barrels	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC crude"
OPEC	92.4	57.2	6.0	29.2
vs. 2014	1.2	0.9	0.2	0.1
IEA*	93.4	57.4	6.6	29.5
vs. 2014	1.0	0.8	0.2	0.0
EIA	93.1	57.6	6.4	29.1
vs. 2014	1.0	1.0	0.06	-0.1

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). * Estimates in February 2015,

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



Source: Intesa Sanpaolo elaborations on OPEC data

A further indication that the fundamentals might be better than feared in December also comes from the OPEC's estimates of spare capacity (i.e. excess production capacity, concentrated mainly in Saudi Arabia), reported by the EIA in the Short Term Energy Outlook. According to the March estimates, spare capacity should expand to 2.1 mb/d in 2015 and to 2.6 mb/d in 2016,

from an average 2.0 mb/d in 2014. In December, however, it was estimated that it would increase to 2.5 mb/d as early as 2015 from 2.1 mb/d on average in 2014. The EIA explains that normally spare capacity of less than 2.5 mb/d is an indication that the markets are stretched, but that the substantial re-stocking currently under way makes this estimate less representative.

Forecasts

In view of the current supply and demand fundamentals, we forecast that prices will remain weak, especially in the next two quarters, due to the faster-than-expected stock building in the US, the strong dollar and expectations that negotiations between Iran and the P5+1 international powers could lead to a temporary agreement, which would lead to a significant rise in Iranian exports (potentially adding 1 mb/d to global supply). If our worst-case scenario were to materialise, we maintain our forecast of a minimum threshold of USD 40 for Brent.

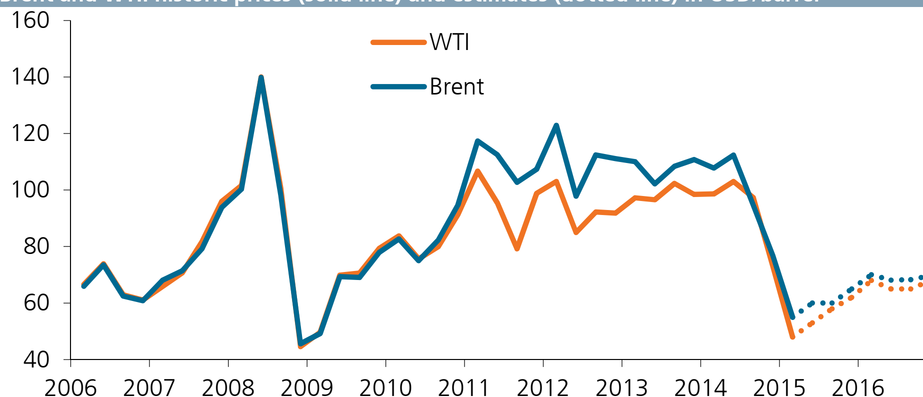
Overall, we forecast that oil prices will be very volatile in the coming months, since the weekly data on inventories, production and number of active drilling rigs in the US, and the monthly data on production, exports and official sales prices published by the main OPEC producers, will trigger market swings between phases of excessive pessimism and optimism.

We forecast that Brent will stabilise at around the equilibrium level of USD 60 dollars/barrel in the middle quarters of the year and subsequently recover to USD 70 dollars 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 60.

For WTI, we estimate an average price of USD 53 in 2Q15 and USD 55.3 for FY15. We expect that, once the current downwards pressure associated with the excessive stock building in the US has abated, WTI will rise more quickly than Brent thanks to robust domestic demand; the spread between the two grades of oil will therefore gradually narrow. Furthermore, 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. In any event, efforts will be made to avoid measures requiring the approval of Congress, given the conflict that currently marks US politics and the consequent difficulty of getting new bills approved by both sides passed into law.

In our view, the main downside risk at the moment is a definitive agreement between Iran and the P5+1 countries, which, when implemented, would lead to an additional flow of 1 mb/d onto the global market, destined mainly for Asian customers. There are no official estimates of the time it would take Iran to return to full production. Very likely it would take around six months. However, in the period immediately after the withdrawal of sanctions, the additional flow onto the global markets could even be higher than the estimate of 1 mb/d, given the abundance of Iranian stocks accumulated in the last few years due to the sanctions. We would point out that much of US Congress is currently against an agreement - even a temporary one - with Iran and the resulting withdrawal of sanctions. As a result, despite the efforts of the Obama administration, we may only see a temporary removal of sanctions, which would not structurally exacerbate the excess supply situation on the global markets.

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

As of 18.03.2015	2Q15	3Q15	4Q15	1Q16	2Q16	2015	2016	2017
Estimates	60.0	60.0	65.0	70.0	68.0	60.0	69.0	75.0
Bloomberg Median	57.5	65.0	70.0	N.A.	N.A.	62.0	75.0	79.9
Forward Contracts	55.0	57.6	59.6	61.4	62.9	56.8	63.5	67.6

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

As of 18.03.2015	2Q15	3Q15	4Q15	1Q16	2Q16	2015	2016	2017
Estimates	53.0	58.0	62.0	68.0	65.0	55.3	66.5	72.0
Bloomberg Median	52.5	62.0	70.0	N.A.	N.A.	58.0	71.0	73.3
Forward Contracts	47.4	50.8	52.9	54.6	55.9	49.8	56.4	60.2

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: recovery on track, but the Fed is not impatient

Giovanna Mossetti

- The US economy has returned to normal and is on course to **grow around 3% in 2015-16,** substantially above its potential. There are **no signs of overheating** in the outlook, in contrast to past experience during the phase leading up to monetary policy turnarounds: weak global growth, low inflation and an appreciating exchange rate keep excess demand in check. **Growth is expected at 3.0% in 2015 and 2.9% in 2016.**
- The engine of growth in 2015-16 is likely to be **private domestic demand,** driven in particular by **consumption.**
- The drop in the oil price and the appreciation of the dollar prevent **inflation** from heading back towards the Fed target, even with above-potential growth and the closing of the output gap.
- Despite the weakness of inflation, we believe that the outlook for the real economy is consistent with the start of the **normalisation of monetary policy in 2015.**
- In this apparently Goldilocks-style scenario, **risks are nearly balanced,** but associated with **potentially large volatility.** One set of risks concerns **transitory factors** (weather, Pacific harbors' workers' contracts) in Q115. The **main risks** relate to the **Fed rates lift-off. Downside risks**: the removal of monetary stimulus could lead to excessive tightening, linked to sudden fluctuations in exchange rates and interest rates. **Upside risks**: the Fed's policy shift, which could turn out to be excessively timid, especially if it comes with extremely low yields.
- The central element in the scenario is **the Fed's credible commitment to manage the policy shift flexibly,** adapting the pace of monetary stimulus removal to macroeconomic data and financial conditions and, if necessary, showing excessive caution rather than aggressiveness.

Forecast

	2014	2015	2016	2014			2015				2016
				2	3	4	1	2	3	4	1
GDP (1996 US$,y/y)	2.4	3.0	2.9	2.6	2.7	2.4	3.4	3.1	2.6	2.8	3.1
q/q annual rate				4.6	5.0	2.2	1.7	3.5	3.0	3.0	2.8
Private consumption	2.5	3.2	2.9	2.5	3.2	4.2	2.7	3.5	2.9	3.0	2.9
Fixed investment - nonresid.	6.3	5.5	6.0	9.7	8.9	4.8	2.3	6.4	6.2	6.0	5.5
Fixed investment - residential	1.6	5.0	7.9	8.8	3.3	3.3	2.3	7.0	8.0	8.5	10.1
Government consumption	-0.2	0.4	0.4	1.7	4.4	-1.8	-0.8	1.0	0.3	0.4	0.4
Export	3.1	2.9	4.5	11.0	4.6	3.2	-2.0	4.0	4.5	4.0	4.0
Import	4.0	4.5	4.8	11.3	-0.9	10.1	1.1	5.0	5.1	4.5	5.0
Stockbuilding (% contrib. to GDP)	0.1	0.1	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	-2.4	-2.2	-2.3	-2.3	-2.3	-2.5	-2.3	-2.2	-2.1	-2.2	-2.2
Federal Deficit (% of GDP)	-3.6	-3.4	-3.3								
Gov. Debt (% of GDP)	122.3	122.1	119.7								
CPI (y/y)	1.6	0.4	2.7	2.1	1.8	1.2	0.0	-0.2	0.4	1.4	2.7
Industrial production (y/y)	4.2	3.2	3.6	5.7	4.2	4.1	2.0	2.0	3.6	3.7	3.4
Unemployment (%)	6.2	5.3	4.9	6.2	6.1	5.7	5.5	5.4	5.2	5.1	5.0
Fed Funds	0.25	0.35	1.21	0.25	0.25	0.25	0.25	0.25	0.33	0.58	0.83
Effective exch.rate (1973=100)	78.3	93.1	90.6	76.4	77.8	82.1	88.6	93.2	95.6	95.0	93.2

Note: Annualised percentage changes on the previous period - except where otherwise indicated. Average levels for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Growth around 3%, nearly balanced risks

The US economy has returned to normal and is on course to grow around 3% in 2015-16, substantially above its potential (estimated by the Fed at +2.15%). All components of domestic demand are expanding: slack is declining, particularly in the labour market. The unemployment gap should close around mid-2015 and the output gap by 2016. There are no signs of overheating in the outlook, in contrast to past experience during the phase leading up to monetary policy turnarounds. This is because, while there is widespread growth in the private sector, there are a number of hindering exogenous factors in some areas (especially the exchange rate), versus boosts in other aspects of the economy (oil price, labour market, financial conditions). Growth is expected at 3.0% in 2015 and 2.9% in 2016.

The engine of growth in 2015-16 is likely to be private domestic demand, driven in particular by consumption. Fixed investment, residential and non-residential, is expected to expand moderately. Net exports should contribute negatively to growth due to the dollar's strength.

The drop in the oil price and the appreciation of the dollar prevent inflation from heading back towards the Fed target, even with above-potential growth and the closing of the output gap. At the start of the year, due to the collapse in energy prices, inflation slipped into marginally negative territory; there will be a subsequent rebound, still checked by the dollar's appreciation.

Despite the weakness of inflation, we believe that the outlook for the real economy is consistent with the start of the normalisation of monetary policy in 2015. The Fed rates lift-off, which we expect around the middle of the year, is the first step towards a gradual return to a neutral stance: for the moment, we do not expect the Fed to enter into restrictive territory in the next two years, thanks partly to the contribution of exchange rate. According to FOMC projections, neutrality is likely to be reached after 2017.

In this apparently Goldilocks-style scenario, risks are nearly balanced, but associated with potentially large volatility. One risk concerns transitory factors: at the start of the year, activity was slowed by the particularly harsh and snowy weather, and by the dispute over Pacific port contracts. These factors could once again slow growth in Q115, with magnified effects on the annual growth rate. Oil is also a factor: WTI has fallen -17% since the start of the year, with effects that are overall positive on 2015-16 growth, but negative on inflation.

The main risks relate to the Fed rates lift-off. The removal of monetary stimulus could lead to excessive tightening linked to sudden fluctuations in exchange rates and interest rates. The effective exchange rate rose by 6% from the start of the year, and will slow growth by around 0.2 pps both in 2015 and in 2016. Still, the FOMC's statement indicate that Yellen's Fed has a clear expansionary bias, and we believe the risk of excessive tightening to be fairly remote. On the international front, geopolitical tensions, Greece and the weakness of the Chinese economy represent potential restraining factors. Also upside risks are linked to the Fed's policy shift, which could turn out to be excessively timid, especially if it comes with extremely low yields. From abroad, the overwhelming increase in liquidity generated by the expansionary monetary policies of most central banks, and in particular the ECB and the BOJ, combined with the depreciation of the main currencies vis-à-vis the dollar, could lead to a global economic recovery stronger than is currently underestimated, and to "irrational exuberance" in financial markets.

With this combination of potentially significant risks, the central element in the scenario is the Fed's credible commitment to manage the policy shift flexibly, adapting the pace of monetary stimulus removal to macroeconomic data and financial conditions and, if necessary, showing excessive caution rather than aggressiveness. We are therefore "reasonably confident" that in the 2015-16 period, U.S. growth will be around 3%, and inflation will head back towards 2%.

1. Real economy: growth is in the hands of the consumer

The sustainability of the recovery is based on expectations of solid growth in consumption. First-quarter data was held back by bad weather, but we expect a continued improvement in the labour market and a comfortable level of savings, providing a solid basis for the normalisation of consumption trends, without the excesses of the two previous cycles. Jobs growth, stably above 2% yoy in 2014, and expansion in the number of hours worked, coupled with an expected acceleration in wages, should lead to nominal income growth close to 5%. Our forecast is for growth in consumption of 3% in 2015 and 2.9% in 2016.

The labour market is the basis for our positive consumption forecast; the unemployment rate stood at 5.5% in February. Jobs growth accelerated (6m average: +292,000, +2.3% yoy in February). All measures of labour market adjustment (flows, part-time for economic reasons jobs, augmented and long-term unemployment) are continuing to improve. Assuming a participation rate of 62.9% (up from 62.8% in February) and average employment growth of 250k (conservative assumptions), the unemployment rate would stand at 5.3% in June and at 4.7% in December. We forecast an unemployment rate of 4.9% in December. Hourly wages have shown a limited response to the reduction in slack, although various early indicators point to likely acceleration in coming months.

Residential construction should grow steadily, thanks to the favourable labour market, the increase in household formation, greater mobility and improved credit risk. For the start of 2015, there will be a slowdown linked to weather conditions, but after that the trend will be positive and accelerating. Growth in the sector is expected to be 5% in 2015 and 7.9% in 2016.

Non-residential fixed investment, although positive, will be held back by various factors. Besides the undoubtedly positive boost from consumption and from still-expansionary financial conditions, oil and the exchange rate will have a mixed impact on capital account spending. The collapse of oil prices reduces production costs, but leads to a contraction in investment in the energy sector. The strong exchange rate reduces import costs, but hinders exports, corporate profits and competitiveness. Our forecast is that the restrictive effects of the exchange rate and the fall in investments in the oil extraction sector will be more than offset by boosts from the positive factors, and we expect an increase of 5.5% in 2015 and 6% in 2016. Investment in structures are expected to decline, because of both the weather conditions and the energy sector, but we expect spending on machinery and equipment to grow, also on the basis of credit market indications (I&C loans in February: +12.1% yoy; corporate bonds outstanding: +6.5% yoy at the end of 2014).

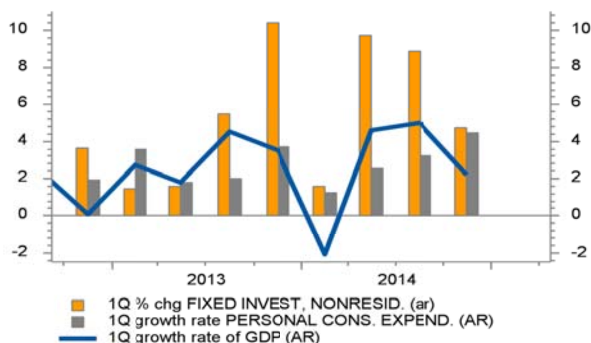
Net exports will, on the whole, dampen growth in 2015-16 because of exchange rate appreciation. Imports are expected to grow by 4.5% in 2015 and by 4.8% in 2016. Exports are forecast to rise by 2.9% in 2015 and by 4.5% in 2016.

Public spending is likely to make a modest positive contribution to growth in 2015-16. Fiscal policy in 2015 will once again be a source of open political conflict. On March 16, the debt ceiling is back in force, in September the extension in federal funding expires, the budgets presented by the Administration and by the House diverge greatly: in all likelihood, 2015 will proceed with no budget. From the middle of the year, there may be heightened uncertainty around fiscal policy, even if in a pre-election year confrontations are expected to remain verbal.

Inflation follows energy price fluctuations. With the collapse of the oil price, the yearly pace of inflation slowed to close to zero at the start of 2015, and should remain at around zero in the first half of the year, before bouncing back to between 1.5% and 2% in the first half of 2016. Our expectation is that yearly core inflation will be almost stable, and will end 2015 at around

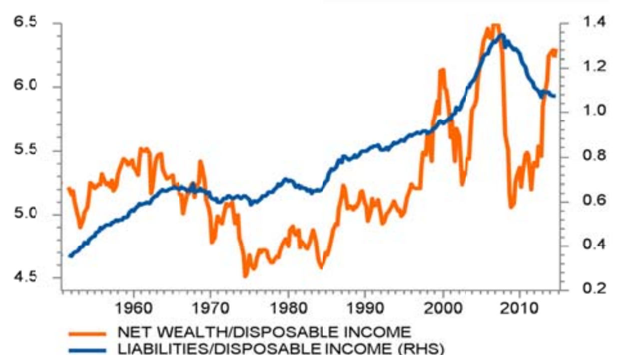
1.3% yoy for the deflator and 1.7% yoy for CPI. Expected average monthly changes are between 0.1% and 0.2%. This forecast is based on our oil scenario (stability in the central months of the year and a subsequent rebound) and of our exchange-rate scenario. The risks in the forecasts are to the downside.

Fig. 1 - GDP growth driven by consumption



Source: Thomson Reuters Datastream

Fig. 2 - Household balance sheets are in order

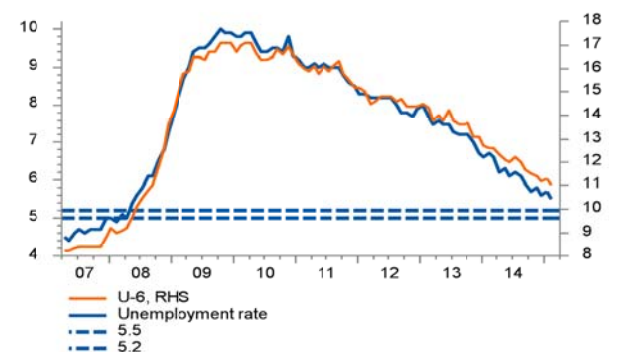


Source: Thomson Reuters Datastream

Fig. 3 – Consumption and real earnings

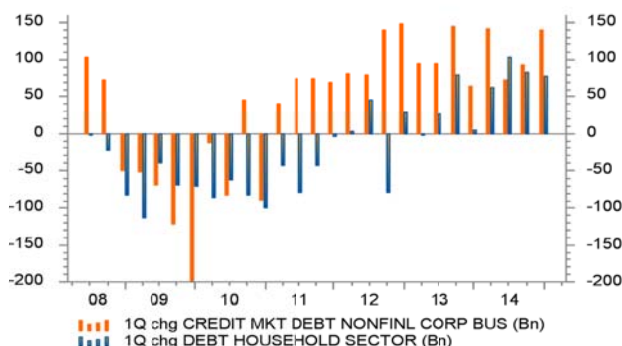
Source: Thomson Reuters Datastream

Fig. 4 – Unemployment rates: here comes full employment



Source: Thomson Reuters Datastream. U6: unemployment rate that includes discouraged workers, those marginally attached to the workforce, and those who work part-time for economic reasons

Fig. 5 – Quarterly changes in nonfinancial corporate business and household debt



Source: Thomson Reuters Datastream

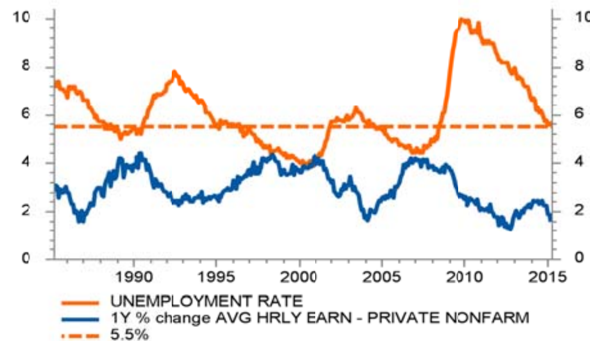
Fig. 6 – Non-residential fixed investment and capital goods orders

Source: Thomson Reuters Datastream

Fig. 7 – Businesses expect rising employment and wages

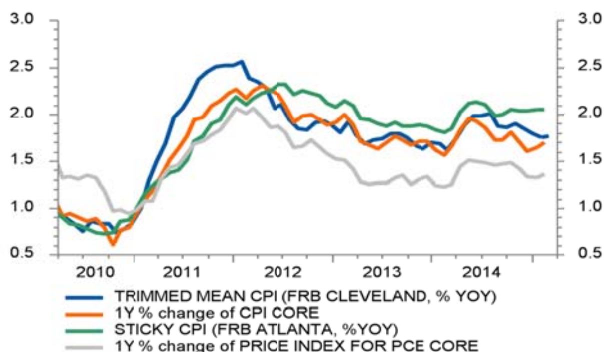
Source: Thomson Reuters Datastream, National Federation of Independent Business confidence survey

Fig. 8 – Wage growth always accelerates with a lag



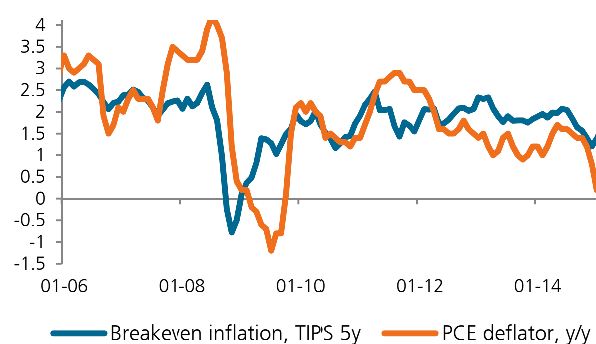
Source: Thomson Reuters Datastream

Fig. 9 – Core inflation measures



Source: Thomson Reuters Datastream

Fig. 10 – Inflation and market expectations



Source: Bloomberg

2. Monetary policy: FOMC no longer "patient", but in no way "impatient"

The **FOMC meeting** brought a number of important developments, which have modified the monetary policy scenario. Communication has changed on two fronts: 1) new statement text, in line with expectations, and 2) heavily revised forecasts, which alter the expected rate hike path.

1) The **statement** highlights a moderation of growth (and exports), despite solid progress in terms of labour market conditions and persistently low inflation. The text no longer uses the word "patience", but states that a rate increase is "unlikely" at the April meeting, adding new guidance, albeit very vague, on the conditions required for the reversal on rates. The Committee will deem a hike appropriate "when it has seen further improvement in the labour market and is reasonably confident that inflation will move back to its 2% objective over the medium term. This change in the forward guidance does not indicate that the Committee has decided on the timing of the initial increase". The new text of the statement is broadly in line with expectations: rates are free to rise at any time after April, but the conditions required for lift-off are tighter.

2) **Forecasts have been revolutionised across the board**: macroeconomic variables, long-term estimates, and interest path rate. The new dot chart is built on the revised macroeconomic projections.

- **Growth forecasts** have been revised downwards by 2-3 tenths both for 2015 and 2016: during the press conference, Yellen said that exports will represent a significant drag on growth (implicitly referring to the strong dollar).

- **Unemployment rate** forecasts have been brought down by a couple of tenths as usual, for each year up to 2017, but a major change has been made on this front. The estimate of the long-term unemployment rate interval has been lowered sharply, explicitly postponing the achievement of full employment. The equilibrium range is now 5-5.2%, from a previous interval of 5.2-5.5%.
- As regards **inflation,** the projections price in the recent decline towards zero and place the achievement of the 2% target in 2017. The core deflator is forecast at 1.3-1.4% at the end of 2015 (from 1.5-1.8%); the forecast for the end of 2016 has been revised downwards by two tenths.
- **Rate projections** have therefore been lowered all along the forecasting horizon: the FOMC expects that even at the end of 2017 monetary policy will still not have turned neutral.

With the new macroeconomic outlook and full employment postponed to end-2015, the **expected path of interest rates has shifted downwards**. The overwhelming majority of participants (15 out of 17) believes it will be appropriate to raise rates in 2015, but the pace of the upward cycle and the point of arrival at the end of 2017 are significantly below the December forecasts: the median projections are 0.5-0.75% at the end of 2015, 1.75-2% at the end of 2016, 3-3.25% at the end of 2017. On the longer run, the point of arrival remains 3.75%. Yellen also specified that the rate increases will depend on the main variables (labour market and inflation) and will not necessarily respond to wages: an acceleration of the wage trend is possible in the coming quarters, but the Fed seems to be shifting its focus again.

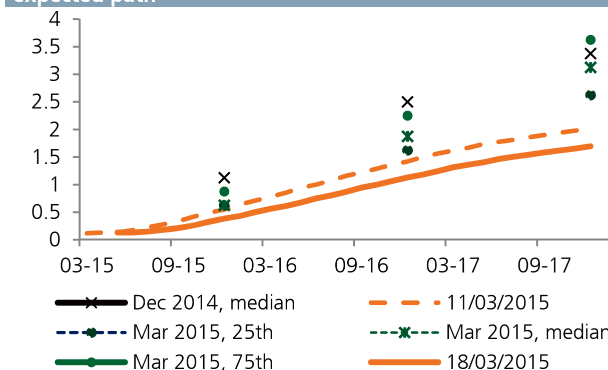
What are the implications for the interest rate path? Based on the new projections, **two hikes** should come this year: we think it reasonable to assume one will be implemented per quarter. Data and macroeconomic conditions will provide indications in the months ahead. If the FOMC's intention is to weaken the dollar, without going too far, we think it likely that **the first hike may come between June and September,** and the second in December. We maintain a preference for the first hike occurring between June and July, given the expected labor market improvement and the likelihood of at least stable core inflation. We stick to our forecast for a hike per quarter in 2016. The FOMC's new guidance is conveyed through macro projections and the dot chart: financial conditions have become more accommodative, with lower rates and a somewhat weaker exchange rate. This strengthens confidence in growth forecasts well above potential, close to 3%.

Projections of the Federal Reserve Governors and Reserve Banks Presidents – March 2015

Variable	2015	2016	2017	Longer term
GDP	2.3-2.7	2.3-2.7	2.0-2.4	2.0-2.3
December projection	2.6-3.0	2.5-3.0	2.3-2.5	2.0-2.3
Unemployment Rate	5.0-5.2	4.9-5.1	4.8-5.1	5.0-5.2
December projection	5.2-5.3	5.0-5.2	4.9-5.3	5.2-5.5
PCE Deflator	0.6-0.8	1.7-1.9	1.9-2.0	2
December projection	1.0-1.6	1.7-2.0	1.8-2.0	2
PCE Deflator core	1.3-1.4	1.5-1.9	1.8-2.0	1.3-1.4
December projection	1.5-1.8	1.7-2.0	1.8-2.0	1.5-1.8

Source: Federal Reserve Board

Fed revises rate projections and the market further lowers the expected path



Source: Intesa Sanpaolo with Bloomberg, Federal Reserve Board data

Euro zone: the perfect boost is in motion and will drive GDP above trend

Anna Maria Grimaldi

- The combination of the fall in oil prices and the depreciation of the exchange rate (both more pronounced than we had expected in December), the ECB's announcement of an effectively open-ended government bonds purchases program, and the more flexible interpretation of the Stability and Growt Pact create a perfect mix of stimuli for above-potential recovery in Euro zone growth already from 2015. We are therefore revising our growth forecast for the Euro zone by four-tenths of a point for 2015 and 2016, to 1.5% and to 2.0% respectively. Macro econometric models suggest upside risks of around two- to three-tenths of in 2015-16 to these estimates, but for the moment we await confirmation from the data.

- We are also maintaining a note of caution insofar as the geopolitical scenario remains fairly uncertain and could continue to weigh on spending decisions, especially those of companies. Greece will remain a dangerous unknown quantity until July of this year. The Euro zone political environment is further complicated by the upcoming regional elections in Spain and the rise of the Front National in France.

- Euro zone inflation is seen at 0.3% in 2015, on the back of the drop in oil prices to USD 55 in 1Q15, and is expected to pick up to 1.3% at the end of 2016, due to a depreciation of up to 20% in the effective euro/dollar exchange rate by September 2016. The inflationary trend in the Euro zone from early 2016 will chiefly depend on growth in core prices, which we expect to return to 1.1% in 2016-17, from 0.9% in 2015, less than estimated by the ECB:

- Monetary policy is on automatic pilot. On 9 March, the ECB got started with PSPP and in the first two weeks it bought 26.3 bln of government bonds. The EAPP programme will run at least until September 2016, and is expected to lead to a monthly average net issue of liquidity of EUR 60Bn. We believe this objective is achievable, albeit with difficulty, given the scarcity of eligible debt relative to net issues.

- We consider it unlikely that the pace of purchases will slow before September 2016. Risks to the macro scenario are barely balanced. The ECB's QE has substantially reduced the risk of excessively low inflation for a long period, but with the closing of the output gap, it is difficult to see inflationary pressures emerging between now and end-2017, even in the best-case scenario.

Forecasts

	2014	2015	2016	2014			2015				2016
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.9	1.5	2.0	0.8	0.8	0.9	0.9	1.4	1.8	2.0	2.1
- q/q change				0.1	0.2	0.3	0.4	0.5	0.6	0.5	0.5
Private consumption	1.0	1.7	1.7	0.2	0.5	0.4	0.4	0.4	0.4	0.5	0.5
Fixed investment	1.0	2.0	2.6	-0.5	0.0	0.4	0.7	0.8	0.7	0.7	0.7
Government consumption	0.7	0.6	0.5	0.2	0.2	0.2	0.1	0.1	0.2	0.1	0.1
Export	3.7	4.6	4.6	1.3	1.5	0.8	1.2	1.1	1.2	1.1	1.3
Import	3.8	5.2	4.5	1.3	1.7	0.4	1.6	1.6	1.0	1.3	1.2
Stockbuilding (% contrib. to GDP)	-0.1	0.1	0.2	0.0	-0.1	-0.2	0.1	0.3	0.0	0.1	0.0
Current account (% of GDP)	2.8	3.0	3.1								
Deficit (% of GDP)	-2.6	-2.3	-2.0								
Debt (% of GDP)	94.3	94.5	94.3								
CPI (y/y)	0.4	0.3	1.3	0.6	0.4	0.2	-0.4	0.3	0.4	1.0	1.6
Industrial production (y/y)	0.7	1.7	2.3	-0.3	-0.4	0.2	0.9	0.7	0.6	0.5	0.5
Unemployment (%)	11.6	11.0	10.5	11.6	11.5	11.4	11.2	11.1	10.9	10.8	10.7
3-month Euribor	0.21	0.02	0.02	0.30	0.16	0.08	0.05	0.01	0.00	0.02	0.02
EUR/USD	1.33	1.04	1.09	1.37	1.33	1.25	1.12	1.03	0.99	1.01	1.04

Note: Percentage changes on the previous period - except where otherwise indicated. Average levels for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Oil, the exchange rate and ECB's QE create the perfect boost for an unexpected above-trend recovery

Anna Maria Grimaldi

Our assessment of the Euro zone's growth outlook has improved significantly since December, when we were expecting growth of 1.1% in 2015 and 1.5-1.6% in 2016. The last two months have featured important developments:

1) The oil price has hovered at levels well below our end-of-year forecasts (in dollars, -41% in December and -55% in January). We consequently revised our oil price forecasts from USD 72 to USD 58 in 2015, and from USD 78 to USD 69 in 2016. This amounts to a revision of the December outlook of -20% in 2015 and -12% in 2016. Note that oil prices will rise by more in 2016 compared to 2015 than in previous forecasts.

2) The announcement of an effectively open-ended and larger-than-expected ECB asset purchase programme has accentuated the flattening of euro curves. That is also because surprisingly, the programme includes bonds with an average remaining maturity of up to 30 years. An open-ended (or unlimited) purchase programme considerably reduces uncertainty regarding the Euro zone outlook. The ECB has now crossed the Rubicon, and will do whatever it takes to combat the risk of low growth and low inflation. In our view, this significantly reduces the degree of uncertainty regarding the scenario. Moreover, as Chiara Manenti showed in a note issued on 12 February (see Intesa Sanpaolo - *Interest Rates Strategy - EAPP: technical implications for the government bond market*), ECB purchases will significantly reduce the refinancing risk for Euro zone countries, insofar as they will cover 130% of the net supply of government bonds in the Euro zone in 2015 and 142% in 2016. In addition, the ECB's QE represents an important shield against the risk of contagion from Greece.

3) It is obvious that the acceleration in the depreciation of the exchange rate observed since December (-8%) reflects increasing expectations for the ECB's QE. We believe that the weakness of the euro/dollar exchange rate will be confirmed in the next few months, reaching a low of 0.98 in September 2015. Compared to December estimates, we have revised downwards our EUR/USD exchange rate forecasts to an average of 1.03 in 2015, from 1.21 in December, and from 1.27 to 1.11 in 2016. This represents a revision in the effective exchange rate forecast of around -8% and -7% over the same period (given elasticity of 0.52 of the effective exchange rate to the euro/dollar exchange rate).

4) Fiscal policy is set to provide further support to the recovery in the Euro zone in 2015. 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 allow France and Italy to make a smaller fiscal correction this year than was implied in the July recommendations of the Council and upheld by the European Commission at the end of November, during the evaluation of the 2015 national budgets. In the case of France, the implicit correction in the structural balance is only 0.3 percentage points, whereas under the old interpretation, it would have been 0.8 percentage points. In the case of Italy, the requested correction is 0.3 percentage points, rather than 0.5 percentage points; in the case of Spain, it is 0.3 percentage points, compared with 0.8 percentage points previously. The countries that were in the ECB's sights in November thus find themselves assessed less strictly in March. However, the European Commission's winter estimates on structural balance variations in 2015 indicate that, while France and Italy will comply with the correction implicit in the flexible interpretation of the Pact, Spain is at risk. Even if the "new reading of the pact" will provide a waiver this year, for next year fiscal policy will again become restrictive for all three countries in 2016.

What impact on growth from the external tailwinds?

We set out to quantify the potential impact of the shocks described above on Euro zone GDP growth forecasts.

The ECB and European Commission models suggest that a 5% depreciation of the effective exchange rate will have an impact on growth of between 0.3% and 0.4% after a year, and between 0.2% and 0.4% for inflation. The impact of a 10% drop in oil prices is estimated to be smaller, whereas the impact of falling oil prices on inflation is more significant, and could more than offset the rise in inflation associated with the depreciation of the euro (see tab. 1 below).

Tab. 1 - Impact of an exchange rate depreciation of 5% and a drop in oil prices on Euro zone growth and inflation

	GDP growth		HICP inflation	
	+1 year	+2year	+1 year	+2year
		-5% Exchange rate		
ECB	0.4	0.4	+0.2-0.4	+0.2-0.4
EC	0.3	0.2	0.3	
		-10% Oil prices		
ECB	0.1		-0.4	
EC	0.2	0.0	-0.3	-0.1

Source: ECB December 2014 Bulletin, EC Commission, winter 2015 forecasts

To evaluate the impact of oil price and exchange rate trends from the beginning of December to the end of January, as well as of the new forecasts on the exogenous variables mentioned above, we simulated the shocks using the macro econometric model of Oxford Economics. The simulations suggest that:

1) The fall in oil prices of 20% in 2015 compared to the base scenario of December produces a rise in average Euro zone growth of only 0.05% in 2015 and of 0.1% in 2016, thus below ECB and European Commission estimates. However, this is due to the fact that the bulk of the shock, in terms of the oil price decline, is concentrated in the first month of the year, while oil prices are already expected to recover from the second quarter. The impact on GDP will reach a high in 4Q15-1Q16.

2) The depreciation in the effective exchange rate observed since early December (-8%) and the revision of projections over the forecast period should generate higher growth of 0.4% in 2015 and of 0.5% in 2016, given the elasticity of the European Commission and the ECB. Note that the depreciation in the exchange rate will accelerate in 2015 versus 2016, with a maximum effect on growth between the summer of this year and the spring of next year, given that the lag in shock transmission is generally four quarters. The Oxford Economics model would suggest a GDP growth response to a 22% drop in the euro/dollar exchange rate in 2015 of more than one percentage point this year, if short-term rates remain at current levels. The fairly substantial reaction suggested by the model depends on the non-linearity of the model and on the absence of a monetary policy response.

3) On the whole, the cumulative impact of the decline in oil prices and the exchange rate depreciation on Euro zone GDP growth is likely to be 0.44% in 2015 and 0.6% in 2016.

What is the impact of the ECB's QE?

- Quantifying the impact of the ECB's QE on growth and inflation is not a simple matter, given that econometric models typically do not incorporate the size of the central bank's balance sheet. An article in FAZ in April reported rumours regarding ECB simulations are said to have estimated the impact of a EUR 1Trn QE programme at between 0.4% and 0.8%.

- According to an ECB working paper (no. 1397, November 2011), an increase in the ECB balance sheet of EUR 270-300Bn corresponds to a 25 basis point cut in official rates. The lag in transmission of the monetary policy impetus is typically longer, and spreads over approximately six quarters. An approximation based on the results of the study in question indicates that an ECB balance sheet expansion of EUR 1.1Trn corresponds to a drop of around 90-100 basis points in official rates. According to the ECB model (see no. 944, ECB, October 2008), an interest rate cut by a standard amount (around 100 bps) generates **higher growth after a year of between +0.2% and +0.4%, and an inflation increase of between 0.1%-0.35%**. Using the Oxford Economics forecast model, we simulated the impact of a reduction in long-term rates of 160 basis points in 2015, and observe that the impact on growth is 0.1% in 2015 and 0.24% in 2016.

Overall, QE could strengthen the exchange rate shock on Euro zone GDP by 0.1% in 2015 and by 0.2-0.3% in 2016. **The overall impact of shocks and of the ECB's QE on Euro zone GDP growth is likely to be around 0.5-0.6% this year and 0.6-0.8% next year. However,** before we significantly revise upwards our growth forecasts, **we will await more convincing signals from confidence surveys.** Note that the expectations component of the manufacturing companies survey has improved in the last two months, and orders have stopped falling. For the moment, however, summary indices remain consistent with Euro zone GDP growth in line with the 0.3% qoq registered at end-2014. For average annual growth to accelerate to 1.5% in 2015, the quarterly growth rate should rise up to + 0.5% qoq from the Spring onwards. **We should also take into account that the models may overestimate the impact of exchange rate depreciation,** as the European Commission suggests in its winter estimates (see Box I-2 pp. 51-52). The standard elasticity of models could overestimate the effect on growth of a depreciation in the exchange rate. The reaction of imports may have become more significant, given that the output of large companies has a high import content. In addition, recent pricing policies may reduce the effect on export prices compared to the past. For many large companies, the sale price is set on the destination market. As regards **rates**, elasticities reflect a functioning monetary policy transmission mechanism, but in the Euro zone, the transmission of monetary policy is partly blocked. We can also not overlook geopolitical risks and the impact that they could have on exports, business confidence and therefore on investment decisions.

We therefore remain cautious and, for the moment, are revising our estimates for Euro zone GDP growth from 1.1% to 1.5% for 2015, and from 1.6% to 2.0% in 2016. Note that, for 2015, this represents a revision of only three-tenths of a percentage point, given that the 2015 forecast rose by one-tenth on account of higher-than-expected 4Q14 data (+0.3% qoq versus consensus estimates of +0.2% qoq). However, should geopolitical risks subside, the 2015 estimate could rise to 1.6% and the 2016 estimate to 2.1-2.2%. Thus, the Euro zone could finally return to sustained growth. After 2016, growth could slow to 1.5-1.7%, unless the structural reform process is accelerated.

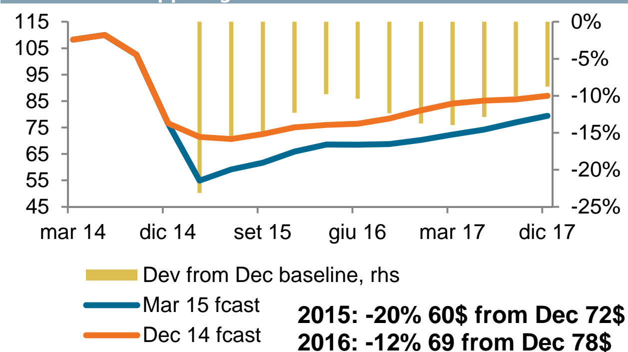
How will shocks be transmitted?

- Simulations show that the combined impact of shocks on corporate investment is around 0.8-1.0% a year. Spending on machinery and plant was disappointing in the middle months of 2014, showing only timid signs of recovery at the end of the year because of low profitability, the limited use of production capacity and ongoing uncertainty around the economic scenario and the geopolitical outlook. More recent data indicate that the use of production capacity is back in line with the historical average. Corporate profitability is expected to improve with the drop in interest rates, cost savings linked to falling oil prices, and, for exporting companies, the depreciation of the exchange rate. The most recent European Commission quarterly survey on investment shows companies' intentions to extend existing plants. However, the geopolitical environment remains uncertain, and could lead to a cautious stance, reducing the recovery in corporate investment compared with that shown by the models. Overall, we expect growth of 3.5% in 2015, up from 3.7% del 2014 (in part because of an unfavourable base effect in the first half of the year) and an acceleration to 4.3% in 2016. Investment in construction is seen recovering to +0.7% in 2015, from -0.8% in 2014, and the recovery may even generate higher investment also in peripheral countries in 2016.

- In 2015-16, growth in consumption is expected to accelerate to 1.7% from 1.0% in 2014, thanks to sustained growth in real wages (+1.3%, from +1.0% this year), the upturn in purchasing power generated by falling oil prices (Euro zone average of at least 0.2-0.4% in 2014-15), and employment growth (we forecast +0.8%, from +0.6% in 2014).

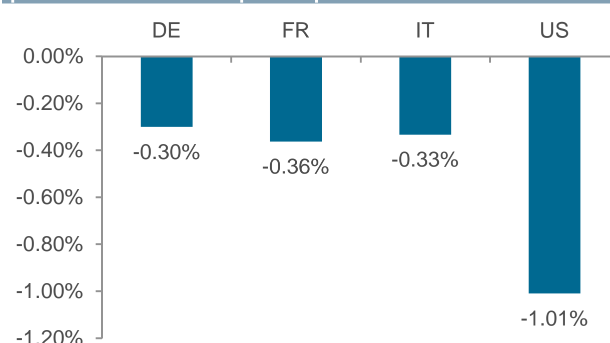
- Finally, in 2015 we also expect foreign trade to make a positive contribution to growth. The depreciation of the exchange rate (-20% in effective terms in 2015) and the upturn in global demand (we forecast average growth in 2015-16 of 4.6% in the demand index of the main trading partners of the Euro zone, up from 3.7% in 2014) should lift export growth from 3.7% to 4.6% in 2014. Growth in imports is also expected to accelerate, from 3.8% in 2014 to 5.2%, given more sustained growth in domestic demand and the high import content of exports.

Fig. 1 – The larger-than-expected drop in oil prices since end-2014 should support growth



Source: Intesa Sanpaolo with Oxford Economic Forecasting chart on Eurostate data

Fig. 2 – Estimated boost to Euro zone households' purchasing power from a 35% drop in oil prices



Source: Intesa Sanpaolo chart on Thomson Reuters-Datastream data

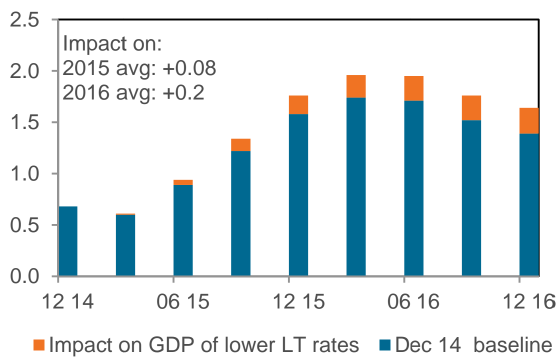
Fig. 3 – The depreciation in the effective euro exchange rate was faster than we expected in December, and the trend will be confirmed in the next few months

Source: Intesa Sanpaolo with Oxford Economic Forecasting chart on Eurostat data

Fig. 4 – Estimated potential impact of the EUR/USD exchange rate depreciation on Euro zone GDP growth in 2015 and 2016

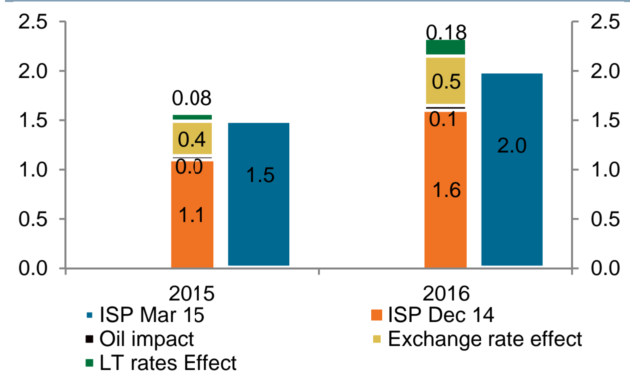
Source: Intesa Sanpoaolo chart based on Thomson Reuters-Datastream data, based on the elasticity of ECB and European Commission models

Fig. 5 – Impact of a 160 basis point drop in government bond yields in 2015 and of a 100 basis point drop in 2016 on Euro zone GDP growth



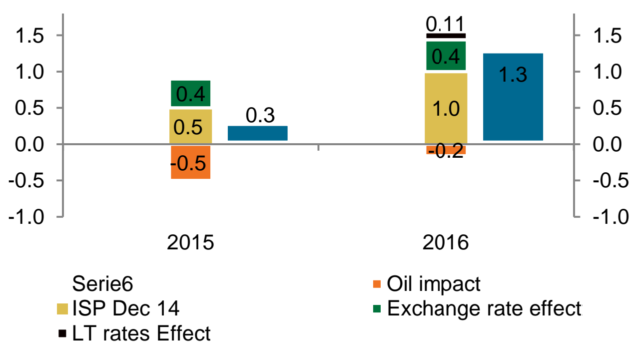
Source: Thomson Reuters-Datastream and ISP simulations with Oxford Economics

Fig. 6 – Overall impact of shocks on Euro zone GDP growth in 2015-16



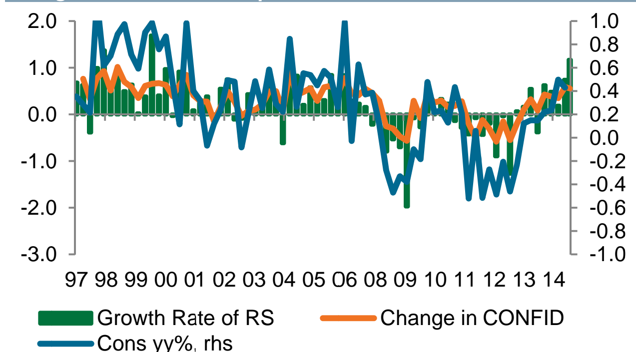
Source: Thomson Reuters-Datastream and ISP simulations with Oxford Economics

Fig. 7 – Inflation will rise to 1.3% in 2016



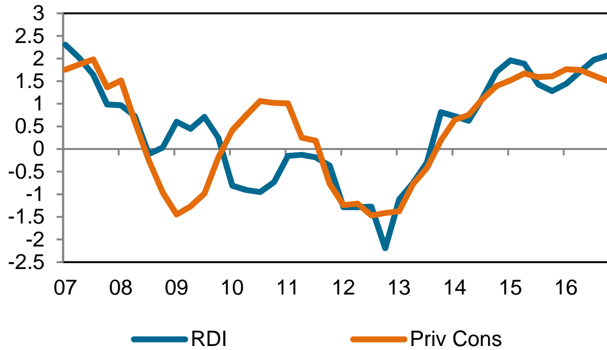
Source: Thomson Reuters-Datastream and ISP simulations with Oxford Economics

Fig. 8 – Confidence and retail sales suggest that consumption will grow at least at the pace seen at the end of 2014



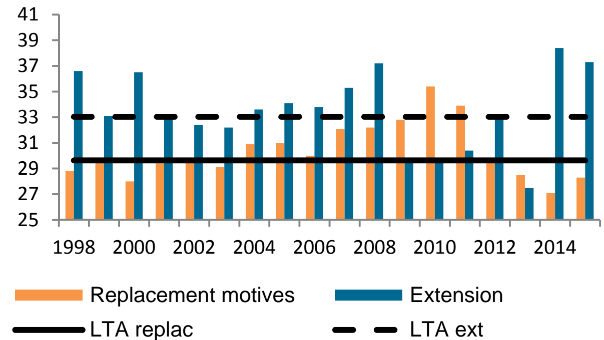
Source: Eurostat

Fig. 9 – Upturn in private consumption thanks to real disposable income growth of 1.6-1.7%



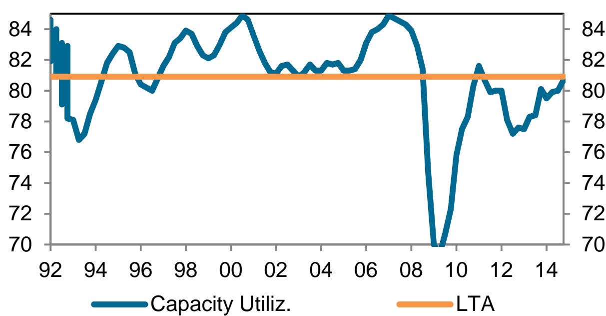
Source: Thomson Reuters-Datastream

Fig. 10 – The European Commission survey signals a strong rise in extension investment intentions



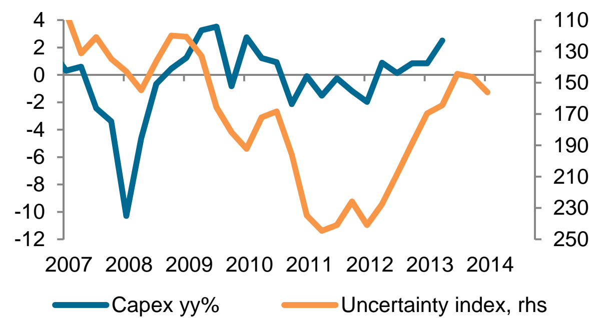
Source: Eurostat

Fig. 11 – The increase in utilisation of productive capacity to the historical average is supportive…



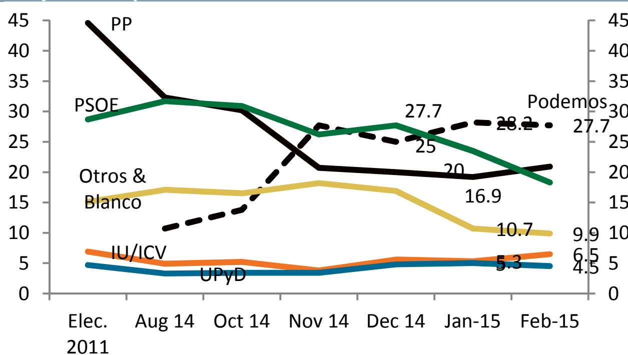
Source: Eurostat

Fig. 12 – … but the uncertainty regarding the policy scenario could continue to act as a brake



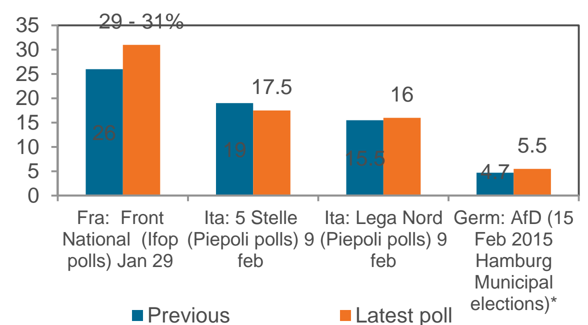
Source: Eurostat, www.PolicyUncertainty.com (Scott Baker, Nicholas Bloom and Steven J.

Fig. 13 – Geopolitical risks in the Euro zone remain high, and not just for Spain



Note: Next elections November 2015. Source: Metroscopia

Fig. 14 – The Front National is an increasing threat in France



Source: Eurostat, WTI, Intesa Sanpaolo estimates from Oxford Economics Forecasting

Outlook for consumer prices: still below 2% in 2017

Anna Maria Grimaldi

- Euro area inflation reached a low of -0.6% yoy in January, then rose to -0.3% yoy in February. Core inflation stood at 0.6%, setting a new post-1998 low. Consumer prices at the end of the year were significantly lower than expected compared with December estimates, once again on the back of a weaker-than-expected oil price. The February inflation rebound is also entirely attributable to the oil price, which recovered from its January low (USD 45 per barrel) to USD 60 per barrel. The weakening of the Euro/US Dollar exchange rate (-22% from its March 2014 high) only partly offset the drop in the price of crude, as exchange-rate fluctuations take longer to feed into domestic prices. Inflation - net of energy and seasonal food prices, the preferred ECB measure - of up to 0.6% yoy is largely attributable to the decline in non-energy goods, which are typically more affected by the prices of services than by exogenous factors. Still, the contribution of non-energy services to the inflation outlook decreased from 0.3% in September 2014 to 0.1% in January.[4] January should therefore represent a floor for Euro area inflation, which we expect to be back at zero in April.

- Our inflation estimates of 0.1% in 2015, 1.3% in 2016 and 1.6% in 2017 incorporate a rise in the oil price from USD 60 in 2015 to around USD 70 in 2016 and to USD 75 in 2017[5]. Compared with December, we have trimmed our estimate for the Euro/US Dollar exchange rate to 1.03 from 1.21 in 2015, and to 1.11 from 1.27 in 2016. Due to the revisions to our crude price forecasts (-17% as compared with the December scenario) our estimate for inflation drops to -0.1% from an earlier 0.5%, although the weakening exchange rate (8% in effective exchange rate terms compared with December) should leave the 2015 average at +0.4%. The weakening exchange rate in 2016 (-7% compared with our December scenario), the rebound in the oil price (compared with 2015: +14%), the acceleration of domestic demand, combined with the ECB measures should take Euro area inflation to between 1.4% and 1.5% in 2016, and to 1.6% by the end of 2017. Our technical hypotheses regarding exogenous variables are roughly in line with those of the ECB, which forecasts Euro area inflation at 0.0% in 2015, 1.5% in 2016 and 1.8% in 2017.

- With a broadly stable path for oil price and the exchange rate, a return of inflation to above 1.0% in 2016 depends largely on the response of core prices to accelerating growth and to the closing of the output gap, estimated by the EU Commission at -1.2% in 2016, from -2.8% in 2014. ECB estimates for the return of inflation to an average of 1.7%, from 1.5% in 2016 are based on an acceleration of core inflation from 0.8% in 2015 to 1.7% in 2017, largely on the back of the closing up of the output gap at the end of 2017; wage increases going from 1.5% in 2014 to 2.3% in 2017; and the limited risk of falling crude oil prices impacting on inflation and domestic price expectations. Second-round effects, via inflation expectations, should appear with the rebound in the oil price and the rise in inflation expectations as the ECB's QE program runs its course. We believe that risks to the inflation outlook are still to the downside because domestic demand, emerging from such a severe and prolonged crisis, could be less responsive than in the past, limiting the rebound in core inflation. Still, we recognize that with the ECB's QE, downside risks are substantially reduced. In a risk scenario where the Euro/US Dollar exchange rate remains at 0.90 between June 2015 and March 2016, roughly 4% lower in effective exchange rate terms, Euro area inflation - as compared to our central scenario - would rise by between 0.2% and 0.3% in 2015 and 2016, and by 0.2% in 2017.

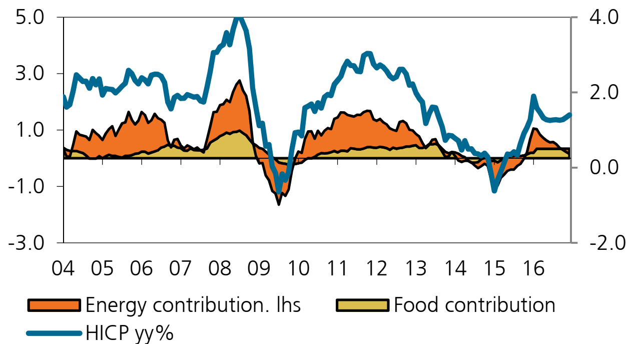
[4] The percentage of non-energy goods with annual price changes below-zero is at a historical record high. The percentage of services showing annual consumer price falls is close to an all-time high.

[5] Compared with the December scenario, we revised crude price estimates down by an average of USD 10 in 2015 and by an average of USD 8 in 2016.

Table 1 - Inflation estimates by country and Euro area average with new oil price estimates	BEL	FRA	DEU	ESP	ITA	NLD	AUT	FIN	Eurozone
2013	1.2	1.0	1.6	1.5	1.3	2.6	2.1	2.2	**1.4**
2014	0.5	0.6	0.8	-0.2	0.2	0.3	1.5	1.2	**0.4**
2015	0.5	-1.2	1.0	0.6	0.3	0.8	1.3	0.0	**0.3**
2016	2.2	0.0	1.7	1.4	1.4	1.8	2.7	1.3	**1.3**

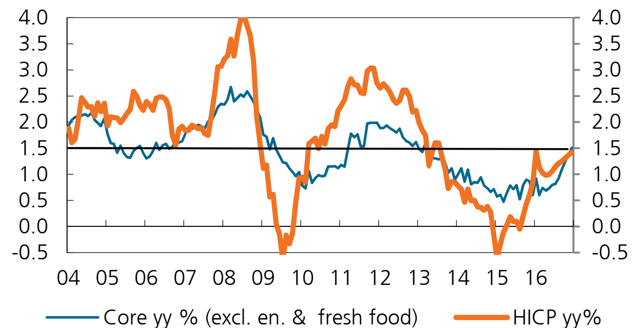
Source: Eurostat and Intesa Sanpaolo estimates

Fig. 1 - Inflation will lack the energy boost from early 2016 as oil prices are seen broadly stable over the forecast horizon



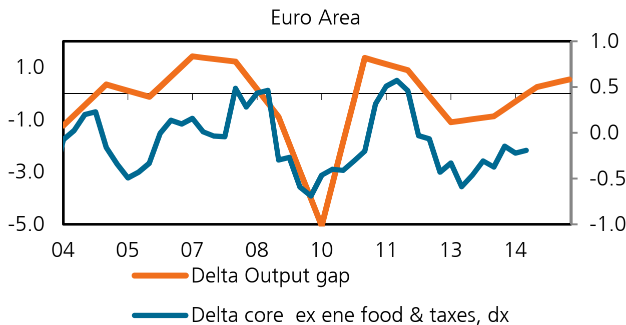
Source: Eurostat and Intesa Sanpaolo data

Fig. 2 - The return of inflation towards 1.7% depends, therefore, on core inflation, and on…



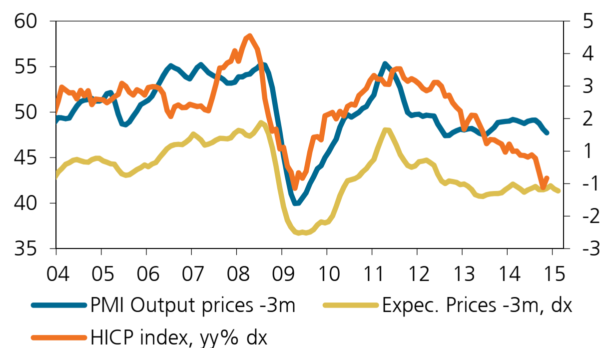
Source: Eurostat and Intesa Sanpaolo data

Fig. 3 - … how fast the output gap closes



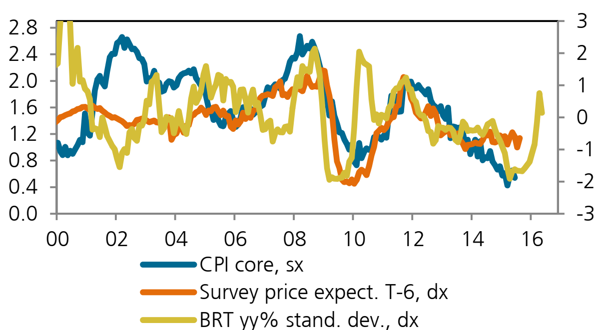
Source: Eurostat, EU Commission (for the output gap) and Intesa Sanpaolo data

Fig. 4 - For the time being upstream pressures remain limited



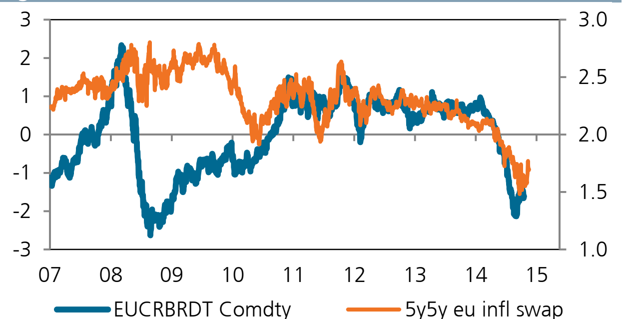
Source: Eurostat, Markit, Bloomberg and Intesa Sanpaolo data

Fig. 5 - Core inflation influenced by the dynamic of price expectations



Source: Eurostat, Bloomberg and Intesa Sanpaolo data

Fig. 6 - Market expectations should gradually return to close to 2% with the bounce back in oil prices and lower exchange rate, alongside the ECB measures



Source: Bloomberg and Intesa Sanpaolo data

FOCUS – Europe's got its QE

- As we had predicted, on 22 January, the ECB announced that it was time to extend assets purchases to Euro zone government bonds. Details of the PSPP (*Public Sector Purchase Programme*) were released at the 5 March meeting. For the technical features of the programme, see the text box following this editorial. The ECB announcement was, to some extent, above expectations, given that the Governing Council committed to **a net monthly liquidity injection of EUR 60Bn, comprising purchases of government bonds, ABS and covered bonds,** at least until September 2016. But more importantly, the ECB linked the **duration and size of the programme to inflation returning towards the close but below 2% target.** Council members have repeatedly said that the ECB would buy at least until September 2016 and, in any event, until inflation expectations return to levels consistent with medium-term price stability.

Surprises regarding the programme size and duration offset by the risk spread mechanism

- **Higher than expected purchases and the effectively open-ended nature of the programme were offset by more limited risk sharing among member states.** Risk will only be shared for just 9% of the total of government bonds purchased under PSPP. Various factors contribute to limiting the practical impact of the decision to keep much of the risk at the level of each national central bank. To start with, the program will have a positive effect on issuers' ability to service their debt via a reduction in interest paid, will help extend maturities, reduce private investors' exposure, and potentially, lead to a higher level of nominal growth. Moreover, states that are in difficulty can still activate an ESM programme and request the support of OMT, for which the risk is shared.

- Total purchases under the EAPP will amount to EUR 1.140Trn, and we estimate that government bond purchases at market prices could come to around EUR 650Bn. In the first week of the government bond purchase programme (PSPP, or Public Sector Purchase Programme), the ECB bought debt worth EUR 9.75Bn, with an average maturity of nine years. In the second week, the ECB purchased EUR 16.5Bn, with an average maturity of eight years.

QE: the price effect is in force and could have a significant effect on debt financing costs

- The impact on yields was significant, particularly on the long end of the curve, with the 30-year Bund shedding more than 30 bps to hit a low of 0.6%. The BTP-Bund spread dropped below 100 to a low of 88 bps. Stock markets celebrated, with widespread gains of between 3% and 8% since the start of the year. Based on the principal amount, for Germany, government bond purchases represent 28% of outstanding debt and more than 3,000% of net German issue in 2015-16. In the case of Italy, ECB purchases represent 13% of outstanding debt and more than 100% of net issues estimated for 2015-16 (see *Interest Rates Strategy*, 12.02.2015). **Bond purchases by the ECB will therefore continue to put pressure on German yields in particular, at least over the next three months**. We estimate that the 10-year BTP-Bund spread (and the Bonos-Bund spread) could drop as low as 70 bps by September 2015. The ECB's QE has triggered a decline in yields on Euro zone corporate bonds (on 7- to 10-year maturities) of 10 bps for AA-rated bonds and of 13 bps for BBB-rated bonds. The drop in long-term yields indicates that QE is having a **direct effect on government bond prices,** and that it will therefore bring down interest expenses and the average cost of debt, with significant implications for fiscal policy from 2016.

- In the meantime, **the decline in corporate spreads and the equity market rally suggest that portfolio rebalancing has already begun**. Nevertheless, **it remains to be seen whether QE will have a quantitative impact on the volume of new loans.** Much will depend on whether the banks are ready to move along the risk curve and switch to assets and customer loans with yields adjusted to reflect the higher risk of government bonds. In a speech given on 10 March, Executive Board member Benoît Cœuré[6] indicated that the ECB expects this to happen over time. More time is required for this to take effect, because the functioning of monetary policy

[6] http://www.ecb.europa.eu/press/key/date/2015/html/sp150310_1.en.html

in the Euro zone remains partly hampered, and monetary base multipliers will go back to behaving in a historically predictable way once the real economy has shown more convincing signs of recovery.

QE: the portfolio rebalancing effect has begun

- In addition, QE has an important (potential) signalling effect on the future direction of monetary policy, and integrates forward guidance on rates. The programme is expected to last at least until September 2016, and therefore, at least until then, it is fairly unlikely that the ECB will revise the level of official rates: refi rates and deposit rates.

How serious is the scarcity effect?

- There are now concerns over the ECB's ability to meet the government bond purchase target, given the modest level of average net issues in the Euro zone in 2015: EUR 277Bn according to Chiara Manenti's forecasts, and just above EUR 200Bn, according to the Euro zone's Debt Management Office (DMO), particularly in Germany (EUR 3Bn according to our forecasts). In his 10 March speech, Cœuré noted that concerns about the potential supply of bonds relative to the size of the programme should be mitigated, given that: i) the quantities indicated by the ECB are valued at market prices; and ii) that the outstanding debt stock in the 2-30 year maturity range is more than abundant: EUR 4.6Trn in central government bonds and EUR 277Bn in supranational agency debt. Yet, banks' and insurance companies' willingness to sell remains to be seen, given, also, the regulatory limits on liquidity. Cœuré notes that these concerns seem excessive, at least as regards the banks - especially since, in exchange for bonds, the banks receive reserves that, in the current zero-rate environment, can be seen as an immediate substitute for government bonds in the calculation of liquidity ratios. Secondly, banks will realize capital gains on the sales, and thus bolster their capital position and ability to lend. Cœuré adds that it should be in lenders' interests to reduce their exposure to sovereign domestic debt. A further cause for concern regarding the ECB's capacity to meet its objectives is that potential sellers are reluctant to sell in an environment of fairly low alternative yields. Cœuré notes, however, that, at least in the programme's initial phase, international central banks and asset managers have been the ones doing the selling. In the meantime, it is worth noting that the scarcity of bonds available for purchase, particularly at the long end of the curve, could strengthen the programme's effect on yields, an effect that is already being seen on German 30-year bonds. Overall, based on the considerations set out above, we believe that the ECB will face a relative scarcity of bonds, but it should not be impossible for it to meet its objectives.

- Perhaps the factor that remains to be seen is whether QE will trigger the hoped-for rebalancing of bank portfolios towards customer loans, and/or will reactivate the functioning of the monetary base multipliers. The fact that QE comes after the end of the AQR and at the same time as the cyclical recovery should pave the way for a return to a more normal functioning of monetary policy, with positive effects on growth and inflation.

- Based on approximations derived from models (see above), we believe that QE could have an impact of 0.2% in 2016, and between 0.3% and 0.4% on Euro zone inflation in 2017. Our most recent forecast for Euro zone inflation is of an increase from 1.3% in 2016 to 1.6% in 2017, and to 1.7% in 4Q17.

- In conclusion, we believe that, with the measures fully implemented, and in the absence of negative external shocks, ECB monetary policy decisions should help stabilise the economy and considerably reduce the risk of a period of excessively low inflation taking root. That said, in our view, ECB estimates of a return of inflation to 1.8% in 2017 and to 1.7% by mid-2016 could be in for a surprise, particularly because the ECB profile again incorporates core inflation rebounding to 1.7% in 2017, from an average of 0.8% in 2015. This indicates that the ECB assumes a unit elasticity of core prices to the output gap of around 0.3%. According to Executive Board member Peter Praet, the output gap should close in 2017, from the -2.8% estimated by the Commission in 2014, with average potential growth of 0.7% in 2015-16. However, the ECB has always overestimated core inflation during a period of decline in headline prices and ahead of a widening of the output gap, given the manifested scepticism over the existence of a Phillips curve for the Euro zone.

- Monetary policy is set to remain on automatic pilot over the next 18 months. We do not believe that, in the event of an upturn in the recovery, the ECB will taper the pace of purchases during the period indicated, given that its inflation forecasts, already more optimistic than ours, assume the measures will be fully implemented.

Tab. 1 - Main ECB macroeconomic forecasts versus Intesa Sanpaolo and Consensus Economics

	Mar 15 ECB estimate			Intesa Sanpaolo (Consensus)		
	2015	2016	2017	2015	2016	2017
GDP y/y %	1.5	1.9	2.1	1.5 (1.4)	2.0 (1.7)	1.9
CPI y/y %	0	1.5	1.8	0.4	-0.3 (-0.1)	1.0 (1.1)
Core CPI y/y %	0.9	1.3	1.8	0.9	1.0	1.1
Mar 2015 EUR profile	1.14	1.13	1.13	1.01 (1.102*)	1.05(1.08*)	1.20 (1.099*)
Mar 2015 Oil price profile	58.5	66.8	70.7	57.5 (60.4*)	69 (68*)	72

Source: ECB macroeconomic forecasts, March 2015, *Consensus economics (March 2015) and Intesa Sanpaolo forecasts

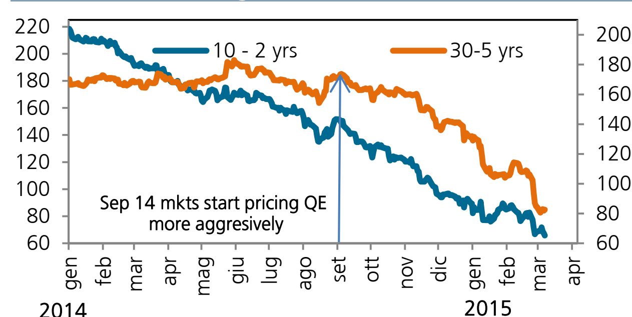
Other monetary policy decisions adopted by the ECB in recent months

- On 22 January, at the same time as the EAPP announcement, the ECB established that for 4-years TLTRO financing operations scheduled between March 2015 and September 2016, the financing cost will be equal to the *refi rate*, rather than the refi rate plus 10 bps. In the first operation on 18 March, with a settlement date of 25 March 2015, funds totalling EUR 97.74Bn were allocated, following the EUR 129.84Bn of the previous auction on 17 February 2014. This is an issue of net liquidity for equivalent amounts, given that after the auction, no destruction of liquidity was observed in ordinary refinancing operations.

- On 18 March 2015, the ECB extended ABS purchases to intermediate tranches, on the assumption that these are accompanied by unconditional and irrevocable guarantees, as set out in the Eurosystem's regulations on guarantees (2011/4 Chapter 6.3.2).

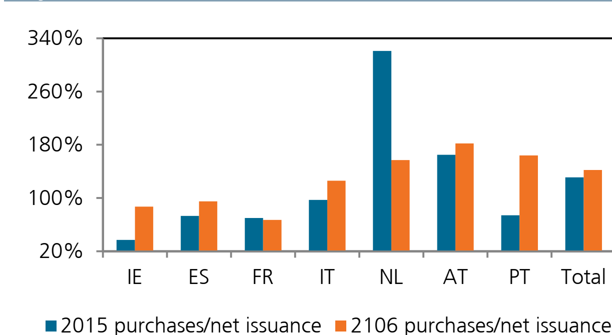
- The ECB also established that the introduction of the minimum size threshold of EUR 500,000 for credits earmarked as guarantees in refinancing operations would be postponed to September 2018, when the first four-year refinancing operations will mature.

Fig. 1 – Monetary policy change of direction: ECB QE has triggered a significant flattening of the EUR curve. Yields will continue to fall as long as…



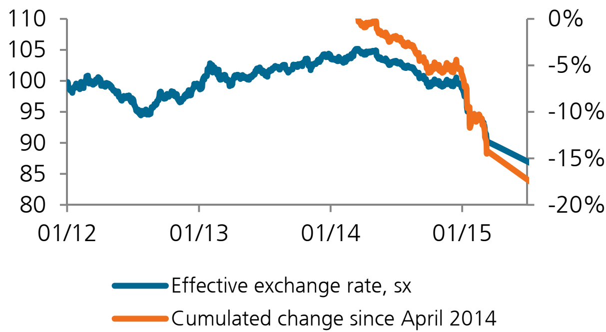
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 2 – …the ECB gets rid of all net issues of Italy and Spain. For Germany, the Netherlands and Austria, the ECB will have to buy sub-national debt



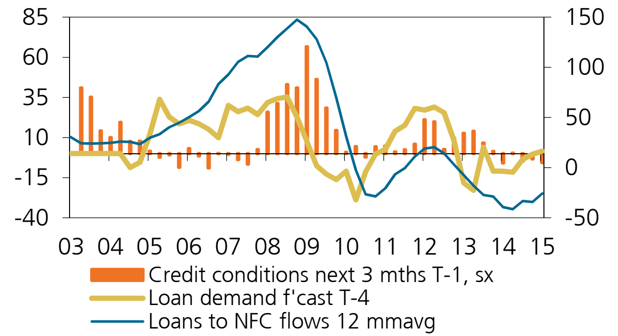
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 3 – The prospect of ECB QE has triggered a depreciation in the effective EUR exchange rate, which could fall by 20% by September



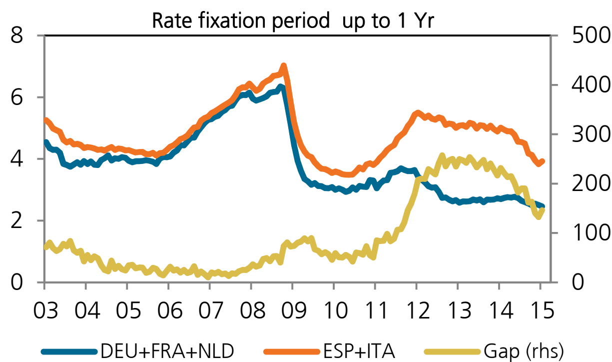
Source: Intesa Sanpaolo chart on ECB data

Fig. 4 - ECB purchases and the cyclical recovery should prompt the banks to move along the risk curve and increase lending. The volume of new loans has already bounced back



Source: ECB and Intesa Sanpaolo chart

Fig. 5 – The rates spread on customer loans between core and peripheral countries is narrowing



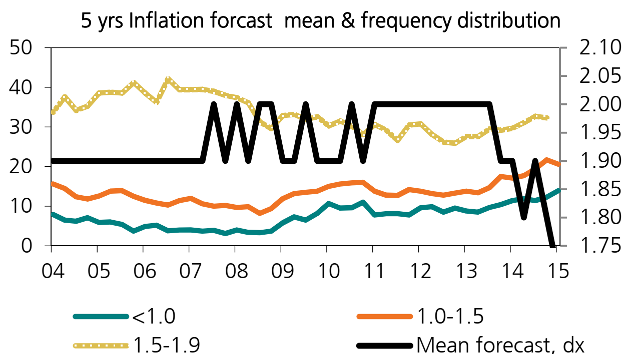
Source: Intesa Sanpaolo chart on ECB data

Tab. 2 - ECB budget for main asset classes on 20 March 2015

	19.12.2014	20.03.2015
Total	2134.8	2142.1*
MRO	147.9	141.8
LTRO	480.4	323
SMP	143.9	140.9
CBPP 1&2	37.81	37.8
CBPP3	28.5	59.99
ABSPP	1.5	4.0
PSSPP	0	26.3

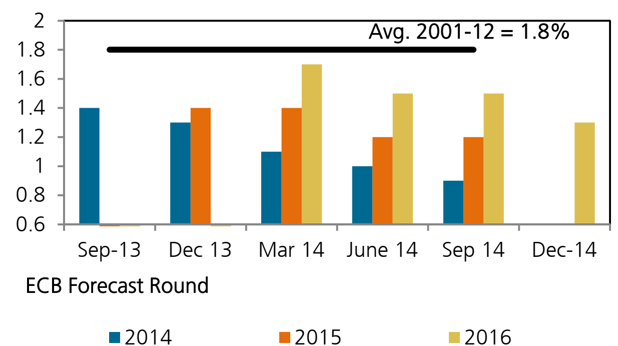
*Balance sheet size as of 13 March 2013. Source: Intesa Sanpaolo chart on ECB data

Fig. 6 – Will ECB QE be enough to raise medium-term inflation expectations?



Source: Intesa Sanpaolo chart on ECB data

Fig. 7 – The ECB has systematically overestimated core inflation since end-2013



Source: Intesa Sanpaolo chart on ECB data

Technical features of the EAPP

- On 22 January, the ECB announced[7] the EAPP (Extended Asset Purchase Programme), i.e. the extensions of the purchase programmes for covered bonds and ABS (CBPP and ABSPP), to bonds issued by European agencies or institutions and by governments of the Euro zone, provided that they are investment grade and denominated in euro. The operational details on the implementation of the government bond purchases through the PSPP (Public Sector Purchase Programme) were released on March 5th through the publication of a technical note, a Q&A session[8] and a legal opinion][9].
- With the EAPP, **the ECB has committed to purchasing up to EUR 60Bn in financial assets per month.** As an exceptional measure, the programme may also purchase bonds issued by states that do not meet the minimum rating requirement, as long as they are accepted as collateral in monetary policy operations. However, the purchases will be suspended during reviews of financial support programmes.
- The **purchases will be made between March 2015 and September 2016** by national central banks (NCBs). Overall, the new purchases, together with the EUR 35.3bn in covered bonds and ABS acquired since October, **should guarantee a total balance sheet expansion of more than EUR 1.14Trn**.

Assuming that the ECB will continue to purchase covered bonds and ABS at the average rate observed since the end of 2014 (EUR 2.5Bn in covered bonds and EUR 200m in ABS), **we estimate that purchases of government debt should total around EUR 40Bn a month**, and purchases of supranational bonds EUR 7Bn a month. The total amount of government bonds that the ECB could purchase over 19 months should come to EUR 779Bn. **Note, however, that the ECB is targeting an issue of net liquidity of EUR 60Bn a month** (see point 7 of the legal document), which indicates that actual purchases will be lower in nominal terms, bearing in mind that market prices are, on average, considerably above par. Even taking into account the valuation at market prices, ECB purchases will cover 156% of the net issues of the Euro zone in 2015, according to Chiara Manenti's calculations (see *Interest Rate Strategy* of 12 February 2015). **The ECB will therefore be faced with a scarcity effect that could make the management of purchases on a proportionate basis by country rather complicated, particularly in Germany, the Netherlands, and other smaller countries of Eastern Europe.** Proportionate purchases of German bonds would amount to more than 3000% of net issues.

Allocation by issuer will be **based on each country's share of the ECB's capital**, with **a total issue limit** of 25% on individual securities, and an **aggregate holding limit** of no more than 30% of the total debt of the individual country, "with the aim of preserving market functioning and allowing the formation of a market price."

The debt of European agencies and institutions will represent 12% of additional purchases, with the other 88% represented by government bonds.

20% of the risk on new purchases will be shared by the national central banks according to ratios by country, while the remaining 80% will come under the national central banks' own quota of purchases. Risks are fully shared for the 12% represented by supranational debt, whereas **only 9% of the purchases of government debt will be subject to risk sharing** (and taken on directly by the ECB). There is some perplexity concerning returns on the bond portfolio: the

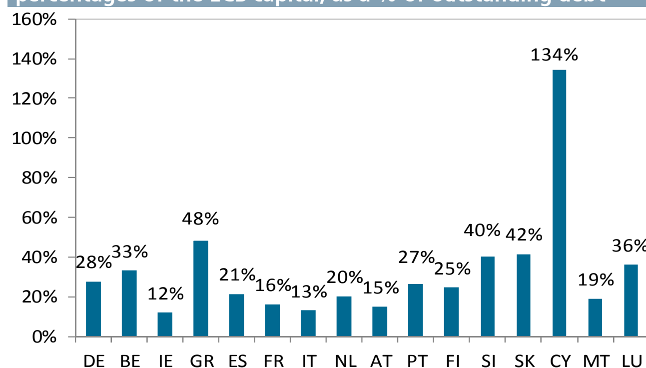
[7] See: http://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html
[8] http://www.ecb.europa.eu/mopo/liq/html/pspp-qa.en.html
[9] See http://www.ecb.europa.eu/ecb/legal/pdf/en_dec_ecb_2015_10_f_.sign.pdf

release mentions loss sharing on two occasions, and risk sharing on one occasion, without clarifying whether the distinction also concerns coupon payments and any capital gains. Logically, treatment should be symmetrical, given that the higher yield compensates for the higher risk taken on by the purchaser.

Each NCB will purchase eligible securities of its own jurisdiction. Eligible securities issued by international organisations and multilateral development banks may be purchased by all NCBs. The National Central Banks will maintain a margin of flexibility in the choice of sovereign debt and/or of **the debt of agencies and entities on the list indicated in the release** (see http://www.ecb.europa.eu/mopo/liq/html/pspp.en.html).

- The ECB will accept the **same (*pari passu*) treatment** as other investors in the event of a debt restructuring.
- The ECB will buy securities with a **remaining maturity of between 2 and 30 years.**
- Securities **indexed to interest rates and to inflation are considered eligible**.
- **Based on article 3.5, the yield to maturity of eligible securities may not be lower than the deposit facility rate (currently -0.20%).** Moreover, at around that threshold, banks may prefer to hold the liquidity in the form of deposits instead of in government bonds.
- The technical press release issued on 5 March indicates that **the ECB will seek to distort the market as little as possible, and to respect the neutrality principle**. Purchases by maturity should be weighted according to outstanding debt with maturities of between 2 and 30 years, but the ECB will determine how to respect the neutrality criterion during the implementation phase and according to daily flows.
- Furthermore, a **black-out period** (article 4.1) will be fixed to avoid interferences with primary market activity. Moreover securities purchased under PSPP will be made available for lending.
- As defined in article 7 of the legal framework, execution will take place through the Eurosystem's official counterparties; this means that **purchases will be conducted through bilateral transactions**, and not through more rigid mechanisms, such as REPO auctions. The March 5 press release and Q&A session show that the central bank does not wish to have its hands tied when it comes to implementing the programme. In our view, this is justifiable, given that in some jurisdictions the purchases could put considerable pressure on the government bond market.
- Moreover, in article 6 concerning the allocation of limits between NCBs and the ECB, not to mention the allocation among NCBs, reference is made to the "total value" of securities purchased, a formulation that will allow, if necessary, monthly flows to be adjusted according to bond category and country, depending on market conditions. Finally, as the objectives are defined in terms of countervalue and not in terms of nominal value of the securities, a further degree of flexibility is provided by the presence of listed securities trading well above par (a factor that also helps mitigate the possible scarcity risk on some markets).
- The ECB will provide details of how much of each asset class it has purchased during the following week. "Transactions in securities purchased under the programme will be published in a weekly report which will list holdings at amortised cost by asset type. In addition, for securities purchased under the expanded asset purchase programme that are not covered by the ABSPP or CBPP3, a report of the amounts held, valued at amortised cost, and the weighted average remaining maturity by issuer residence will be released on a monthly basis."

Fig. 1 - Purchases of government bonds based on country percentages of the ECB capital, as a % of outstanding debt



Source: ECB, Bloomberg and Intesa Sanpaolo estimates

Tab. 1 - ECB purchases via EAPP by asset type (estimates)

	Monthly	Total	2015	2016
EAPP	60	1140	600	540
Covered	9.6	182	96	86
ABS	2.4	46	24	22
Supranationals	7	133	70	63
Government bonds, agencies	41	779	410	369

Source: ECB, Bloomberg and Intesa Sanpaolo estimates

Tab. 2 – ECB purchases will cover 156% of the net Euro zone government bond issues in 2015, and 170% in 2016

	2015 Gross issuance	2015 Net issuance	2015 purchases/ gross issuance	2015 purchases/ net issuance	2016 Gross issuance	2016 Net issuance	2016 purchases/ gross issuance	2016 purchases/ net issuance
DE	158	3	54%	3513%	155	2	50%	3832%
BE	31	4	36%	327%	35	10	29%	105%
IE	18	15	32%	45%	14	6	36%	87%
GR	-	-7	-	-	-	-	-	-
ES	144	58	29%	89%	120	40	32%	95%
FR	212	95	31%	88%	240	89	25%	67%
IT	264	60	22%	119%	223	42	24%	126%
NL	47	6	43%	378%	41	11	43%	157%
AT	19	6	50%	199%	16	5	53%	182%
PT	19	12	48%	85%	13	5	62%	164%
FI	13	5	52%	148%	11	4	53%	129%
SI	6	4	31%	58%	4	1	40%	145%
SK	5	1	74%	354%	5	2	65%	159%
CY	2	1	44%	177%	2	1	40%	159%
MT	1	1	32%	76%	1	1	29%	58%
LU	0.1	0.1	1018%	1189%	0.1	0.1	916%	916%
EE	0.1	0.1	-	-	0.1	0.1	-	-
LV	0.8	0.4	189%	413%	0.8	0.4	170%	340%
LT	0.3	0.1	699%	2420%	0.3	0.1	629%	1886%
Total	**939**	**264**	**44%**	**156%**	**882**	**219**	**42%**	**170%**

Source: ECB, Bloomberg and Intesa Sanpaolo estimates

Germany: in great shape, thanks to the consumption boom

Anna Maria Grimaldi

Germany will grow 2.1% in 2015 and 2.2% in 2016, significantly above its potential (1.1% according to the most recent Bundesbank estimates) and above the Euro area average. After a disappointing performance in the middle of last year on account of the Russia-Ukraine crisis, German GDP growth performed much better than expected at the end of 2014: +0.7% qoq versus consensus estimates of +0.3% qoq. The surprising end to 2014 leaves the 2015 forecast average at 1.4%, up from an earlier estimate of 1.1%. Downward revisions to crude price and the exchange rate, together with the drop in long-term interest rates between the beginning of December and January [10] should push German growth to at least 2.1% this year, and to 2.2% in 2016, from a previous estimate of 1.9%. For the first time in months, the risks to the growth scenario are skewed on the upside, with the models suggesting an impact of oil, the exchange rate and interest rates of around 0.7% in 2015 and 0.4% in 2016[11]. We have maintained a prudent estimate, given that the response of household consumption and, in particular, investment, to exogenous shocks (oil and the exchange rate) could be less marked than that indicated by the standard elasticity observed after a prolonged crisis and continuing geopolitical uncertainty. For now, improvement in the manufacturing surveys has been fairly contained; we therefore prefer to await confirmation from the data before fully factoring in the effects of standard elasticities.

Growth at 2.0% in 2015-16

Private consumption is the main engine of growth, sustained by a drop in energy bills and by a 2.0% rise in real wages

Short-term outlook: The IFO and ZEW surveys, after the declines observed between August and October, have returned to showing sustained improvement in the last four months. The composite PMI in the 1st quarter of 2015 averaged 54.2, from 52.5 at the end of 2014, thanks to a clear improvement in the outlook for services and to a less marked extent in manufacturing. The IFO index rose between December and March and is now back at its July 2014; the manufacturing PMI averaged 51.4 in the first three months of 2015, matching its July 2014 levels. Manufacturing production is on course to achieve growth of 0.8% qoq, after the 0.5% posted in December, thanks to last year's strong performance. Data on export orders, expectations of external demand from the IFO and PMI surveys signal an acceleration in exports in the first few months of 2015, after average growth of 0.9% qoq at the end of 2014[12]. The significant weakening of the Euro/US Dollar exchange rate of over 22% in the last year (-2% since the end of December 2014) should sustain exports outside the Euro zone (following the +2.9% increase in early 2015), despite the still moderate pace of global growth. Data available so far therefore indicate German GDP growth of at least 0.6% qoq at the start of 2015.

Jobs growth of around 1.0%, thanks to business services

Support for growth in the forecast period should come from the trend for domestic demand which we expect to rise by an average of 2.0% in the current two-year period, thanks to a surge in consumption (+2.1% in 2015 and 1.9% in 2016 versus 1.2% last year), and a recovery, albeit modest compared to previous cycles, of corporate investment. Foreign trade should make a positive contribution (+0.2% in 2015 and zero in 2016), insofar as imports are expected to accelerate to 5.2% in 2015 and to 5.0% in 2016, up from 3.8% in 2014, boosted by consumption and investment, and by the high imported content of exports and industrial production. Exports, sustained by the weakening of the exchange rate, are expected to grow by 4.5% in 2015 and by 4.3% in 2016, from 3.7% last year.

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[10] German 10-year rates in the first quarter averaged 0.38% versus an estimate of 0.84% in December.

[11] The impact of the exchange-rate shock on Germany may be below the Euro zone average but is still +0.4% in 2015. A recent EU Commission report indicates that the overall elasticity of German exports when set against changes in the real effective exchange rate (-0.81%) is lower than in France (-1.4%) and Italy (-2.6%), partly because of exports' higher concentration in capital goods.

[12] Data up to December indicate growth in exports to industrialized countries outside the Euro area, and to Asian economies. Trade flows to China and Japan, on the other hand, slowed. The breakdown by trade category shows that exports of cars and vehicles grew significantly after the drop in the summer months. Exports of capital goods also grew at a sustained pace. The rise in imports in the final months of last year matched the rise in exports. Adjusted for energy price effects, imports of consumer goods grew most noticeably, with a substantial contribution from pharmaceutical products.

After stagnating in the second quarter, private consumption grew by an average of 0.75% in the second half of 2014, and retail sales data suggest a similar rate of growth for consumer goods at the start of 2015, thanks to the drop in crude prices and the sustained growth in real wages of 1.9%, from 1.2% in the first half of 2014. According to Bundesbank estimates, savings on energy bills in the second half of 2014 amounted to EUR 3.5Bn, and could be even higher in 2015. However, consumption will benefit from more sustained growth in nominal wages and jobs. Negotiated wage increase demands amounted to between 5% and 6% in the first few months of 2015, below last year's demands. We therefore estimate that the growth in contractual wages could average between approximately 2.7% and 2.8% in 2015 from an average of 2.9% in 2014 (some of the highest rates of the last 20 years). The minimum hourly wage of EUR 8.50 came into force on the 1st of January 2015. Moreover, the jobs outlook continues to outperform our estimates. In 2014, 404,000 new jobs were created, resulting in average annual growth in total employment of 1.0%, from 0.9% in 2013. Growth in jobs subject to social contributions, the so-called "good jobs," was even more solid, with 500,000 jobs created on average, an annual growth rate of 1.8%. The number of workers in part-time or short-term contracts earning the minimum wage grew only marginally. A breakdown by sector suggests that business services contributed more to job creation, for cyclical reasons, and also due to substitution of retiring 63 years old workers. Unemployment dropped to 2.84 million at the end of 2014, from 2.95 million, resulting in an unemployment rate of 6.5% versus 6.9% at the end of 2013. Unemployment averaged 6.5% of the workforce, from 6.9% in 2013, and is now at long-term structural levels; it is therefore difficult to predict another significant drop in the current two-year period, unless there is further growth in the workforce. In 2014, the workforce grew by 470,000, with a significant contribution from asylum-seeking political refugees. Hiring intentions in the IFO survey suggest that job creations at the start of 2015 should at least match that at the end of 2014. In addition, strong growth in job vacancies between the end of 2014 and the start of 2015 (+40,000, net of seasonal effects and on a cumulative basis) suggests that, in the face of cyclical growth in domestic demand and services, there is a need to replace qualified workers who exiting the job market by taking advantage of the reduction in the retirement age.

Lower residential construction growth

Construction returned to solid growth at the end of 2014 (+2.1% qoq) after showing weakness in the middle of the year. Commercial buildings, more than residential buildings, are likely to have contributed to the expansion. Orders at the end of 2014 point to sustained construction activity, although a further acceleration from the end of 2014 is unlikely. Construction permits grew by around 1% in the second half of 2014, from 2.8% in the first six months of the year. The fundamentals of residential construction still look positive, given the drop in interest rates and the sustained demand, associate with strong immigration flows and to the continued increase in disposable income. House prices again rose steadily in the second half of 2014: +5.3% in urban areas, from +10% in the three previous years. The slowdown is due to to an increase in the supply of new homes. In 2015, we expect average growth of 0.8%, partly down to the strong performance of 2014. Investments in machinery grew by an anaemic 0.4% qoq at the end of 2014. Corporate spending should benefit, with a longer lag, from the crude price drop and the exchange-rate weakening. Over time, the improvement in business conditions, the drop in lending rates and a likely additional increase in productive capacity should lead to a more sustained recovery in machinery investments, closer to an annual average of 3.5%. However, there is a risk that the uncertain Eastern European geopolitical outlook might limit the recovery of investments in machinery in particular.

We expect corporate investment to pick up in the spring, but a boom is unlikely, particularly if uncertainty continues to hold sway

Inflation fell more than expected from September 2014 to a minimum of -0.4% yoy in January 2015, before recovering to +0.1% yoy in February. As in the rest of the Euro area, January should represent a floor for German inflation. The consumer price trend is almost entirely due to fluctuations in crude prices, whereas the impact of the depreciation of the effective exchange rate should become visible from spring. Core inflation remained in positive territory, and in February it rose to 1.4% from a previous 1.2%, thanks to a recovery in the annual growth in

non-energy prices. We expect German inflation to average 1.0% in 2015 and return to 1.7% in 2017, thanks to rising core prices as a result of above-potential growth.

Public finances

Neutral fiscal policy

The outlook for German public finances improved in 2014. The balance of payments showed a surplus of 0.4% with an essentially neutral contribution from cyclical factors. The structural balance came in at the same level. The improvement in the balance of payments is attributable to the sharp drop in interest spending (EUR -5.5Bn), whereas primary spending as a percentage of GDP remained roughly unchanged. The ratio between revenues and GDP was unchanged at 44.5% of GDP, as lower tax revenue was offset by a rise in the profits paid by the Bundesbank to central government of EUR 2Bn. Savings in interest spending will extend to 2015-16, when we expect a balance of payments surplus of 0.2% of GPD. Higher pension spending (linked to the reduction in the retirement age) for certain categories of pensioners will be partly offset by a long-term rise in social contributions. The structural balance is expected to remain at +0.4% of GDP over the forecast period. The debt/GDP ratio is expected to drop to 68.5% of GDP in 2016 from 74.6% last year.

The European Commission recommends "decisive action" to correct current account imbalances

Notwithstanding the potential for fiscal policy to sustain domestic demand and in particular public and corporate investments, the Bundesbank indicated in its February Bulletin that it was necessary to maintain the structural surplus to guarantee that the debt/GDP ratio was lowered towards 60%, and that German domestic demand stimulus policies would have a fairly limited impact on the rest of the Euro area. The March 10 Ecofin did not share that view when it received the Commission's February recommendations, and asked that "decisive actions" be taken to correct macroeconomic imbalances. The current account balance is therefore expected to rise in 2015 to 8.0%, from 7.4% in 2014, largely because of an improvement in exchange-rate conditions, combined with a drop in the price of crude. The current account balance[13] is well in excess of the threshold of 6%, on average for two years, required in the rules on procedures governing macroeconomic imbalances.

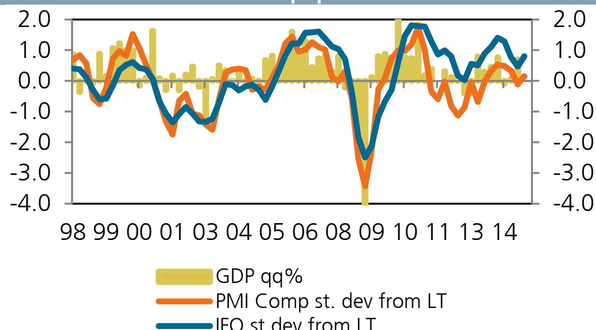
Forecasts

	2014	2015	2016	2014			2015				2016
				2	3	4	1	2	3	4	1
GDP (1995 prices, y/y)	1.6	1.9	2.1	1.4	1.2	1.5	1.3	1.8	2.2	2.2	2.2
- q/q change				-0.1	0.1	0.7	0.6	0.4	0.5	0.6	0.6
Private consumption	1.2	2.2	2.0	0.0	0.8	0.7	0.5	0.6	0.5	0.6	0.6
Fixed investment	3.4	2.7	3.6	-1.7	-1.2	1.2	1.1	1.1	1.2	0.8	0.9
Government consumption	1.2	1.4	1.2	0.6	0.6	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.9	5.4	4.2	1.0	2.0	1.9	0.8	1.1	1.4	1.0	0.9
Import	3.5	6.0	6.0	1.2	1.3	1.9	2.0	1.4	0.0	1.9	2.0
Stockbuilding (% contrib. to GDP)	-0.4	-0.3	0.5	0.2	-0.6	-0.1	0.4	-0.1	-0.7	0.4	0.4
Current account (% of GDP)	7.5	8.0	7.6	7.0	8.0	8.0	8.0	7.8	8.4	7.9	7.4
Deficit (% of GDP)	0.7	0.8	0.4								
Debt (% of GDP)	62.4	62.4	62.2								
CPI (y/y)	0.9	1.0	1.5	1.1	0.8	0.5	0.1	0.9	1.2	1.9	2.3
Industrial production (y/y)	1.5	2.8	2.9	-1.0	-0.2	0.7	1.4	1.0	1.0	0.2	0.0
Unemployment (%)	6.7	6.5	6.4	6.7	6.7	6.6	6.5	6.5	6.5	6.5	6.4
10-year yield	1.24	0.32	0.81	1.42	1.06	0.77	0.35	0.21	0.31	0.43	0.57
Effective exch.rate (2005=100)	99.9	93.8	95.2	100.5	99.4	98.9	95.9	93.7	92.6	93.0	93.9

Note: Percentage changes on the previous period - except where otherwise indicated. Average levels for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

[13] The current-account surplus is historically attributable to extra saving by households and, since 2009, to extra saving by companies.

The IFO and PMI confidence surveys indicate a growth in German GDP of around 1.0% qoq at the start of 2015



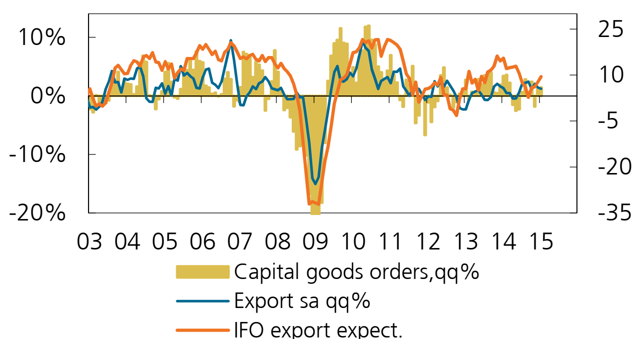
Source: FSO and Intesa Sanpaolo data

Effect of exchange rate, oil and interest-rate shocks on German GDP growth estimates

	2014	2015	2016	2017
Germ GDP Dec 14	1.6	1.3	1.9	1.7
Stronger exit from 2014		*0.3*		
Shocks of which		0.7	0.4	0.2
Eff Exch rate		0.4	0.2	0.0
Oil price effect		0.1	0.0	0.1
Rates effect		0.2	0.2	0.1
Overall impact on GDP growth		0.9	0.4	0.2
Not pencilled in our Mar 15 forecast		0.2	0.1	0.1
Germ GDP Mar 15	1.6	2.1	2.2	1.8

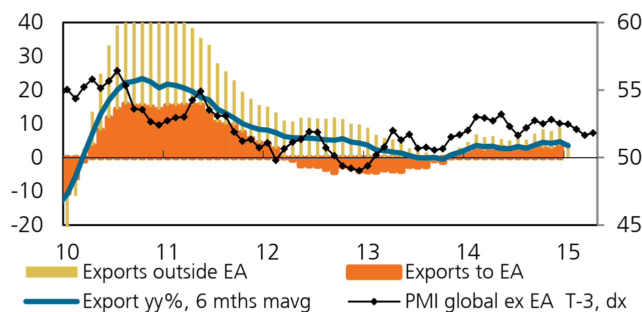
Source: FSO and Intesa Sanpaolo data based on the Oxford Economic Forecast model

IFO and the outlook for foreign orders of capital goods signal modest growth in exports at the start of 2015



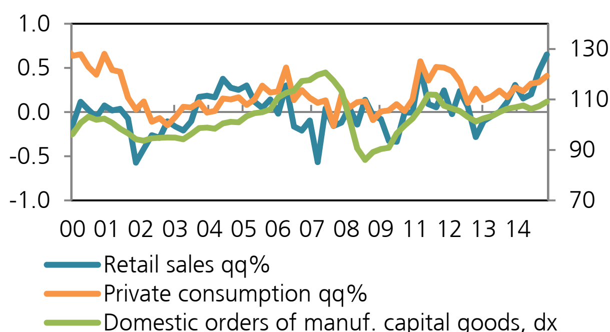
Source: IFO, FSO and Intesa Sanpaolo data

Exports driven by countries outside the Euro zone



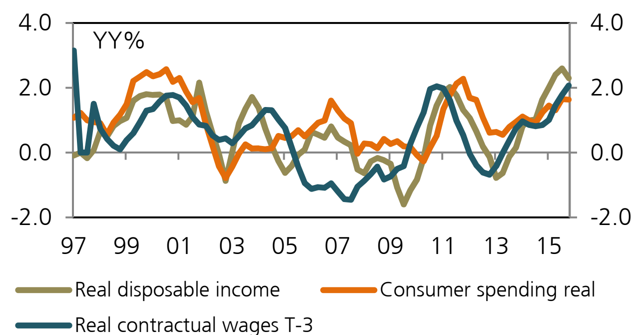
Source: Markit, FSO and Intesa Sanpaolo data

Retail sales and car registrations suggest another acceleration in consumer goods in early 2015



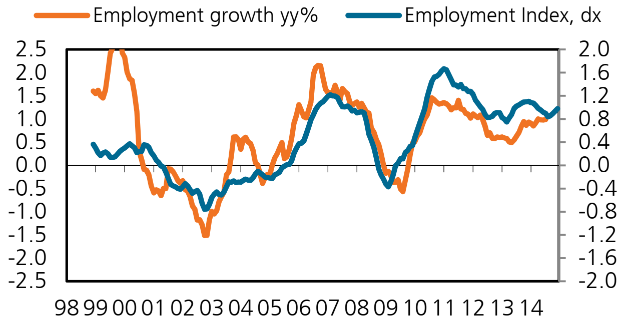
Source: Markit, FSO and Intesa Sanpaolo data

Household consumption sustained by a 2% growth in real wages



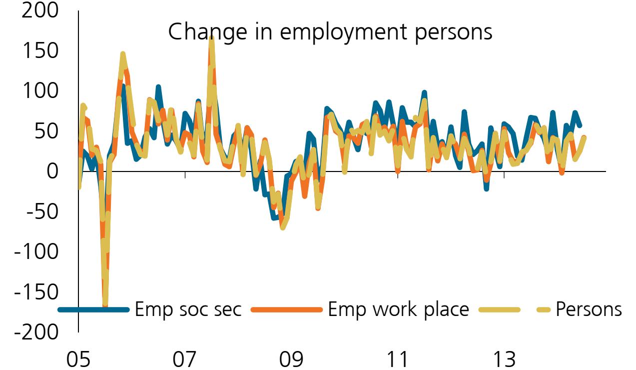
Source: FSO and Intesa Sanpaolo data

Economic surveys indicate jobs growth of around 0.8% to 1.0% in 2015



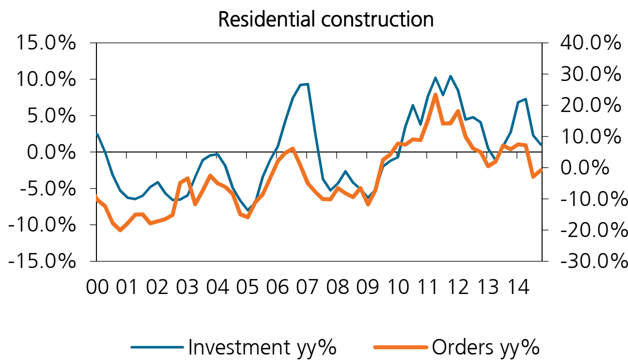
Source: IFO, FSO and Intesa Sanpaolo data

The bulk of job growth came from jobs subject to social security contributions



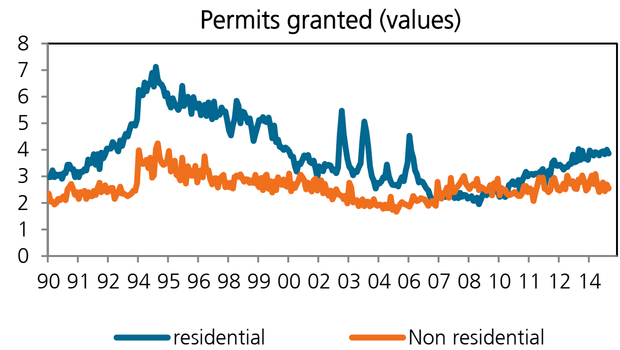
Source: FSO and Intesa Sanpaolo data

Residential construction, a positive outlook overall but a probable slowdown because of data on orders and…



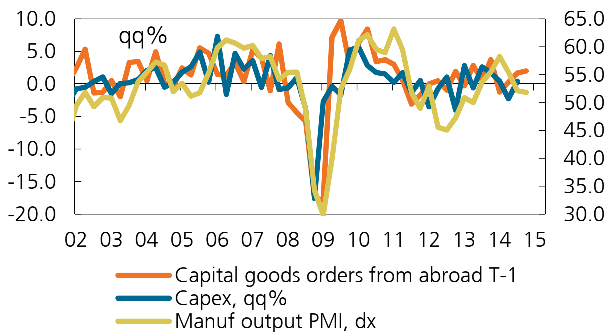
Source: FSO and Intesa Sanpaolo data

Less sustained growth in construction permits



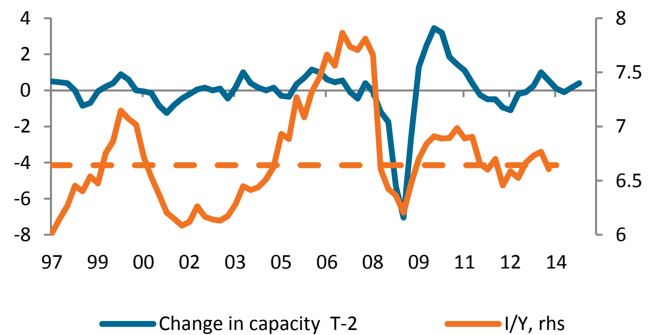
Source: FSO and Intesa Sanpaolo data

Orders signal an acceleration of capex in early 2015, but PMI output levels recommend prudence



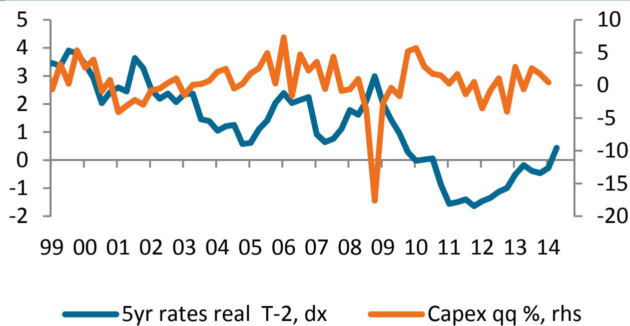
Source: FSO and Intesa Sanpaolo data

The rise in use of productive capacity and…



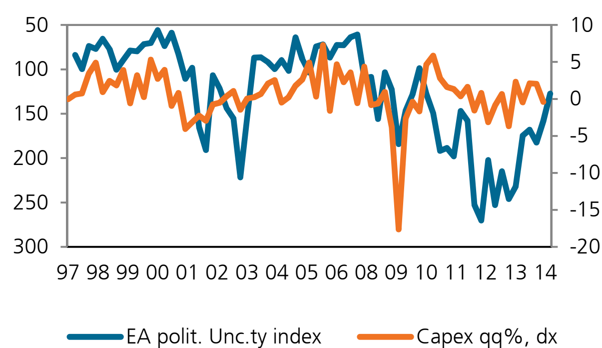
Source: Deutsche Bundesbank, FSO and Intesa Sanpaolo data

…still abundantly expansive financial conditions raise hopes of more sustained growth during the year



Source: Deutsche Bundesbank, FSO and Intesa Sanpaolo data

But geopolitical uncertainty could weigh on corporate investment



Source: Economic Policy Uncertainty, FSO and Intesa Sanpaolo data

France: growth accelerates slightly, but fiscal tightening looms

Luca Mezzomo

- The French economy ended 2014 with GDP growth of 0.1% qoq and 0.2% yoy, resulting in an average annual increase of 0.4%. As in the third quarter, final domestic demand and net exports made a positive contribution, and the slowdown was entirely due to a decline in inventories. Prospects for the first quarter are mixed. On the one hand, confidence in the construction sector remains at very depressed levels, even worse than in the first quarter of 2014, and residential building activity continues to shrink. Despite this, Banque de France and Insee surveys show that confidence in the service industry is improving, while the solid performance of industrial output at the end of 2014/early 2015 - albeit inflated by weather-related factors - should contribute 0.1% to GDP growth in 1Q15. Overall, we could see an acceleration in GDP growth to +0.3% qoq and 0.5% yoy in the current quarter. Annual average growth in 2015 should therefore come to 0.9%.

- As regards the drivers of the 2015 scenario, France, like the rest of the Euro zone, will receive a significant boost from the drop in oil prices and the accommodative financial conditions. On the latter front, the loosening of credit conditions for households and businesses is continuing, while the net fund flow figures show an improvement in lending to businesses (see fig. 12). Moreover, the depreciation of the euro will have a favourable impact on the trade balance.

- As regards private demand, consumer spending is expected to strengthen this year. It is already marginally higher than in 2014, and will be sustained by the rise in real incomes and a slight fall in the propensity to save. Prospects for capital expenditure remain poor: while the decline in investment in machinery should come to an end in 2015, construction spending will continue to fall.

- The strengthening economic recovery in the rest of the Euro zone should contribute positively to the 2015 scenario. The outlook for exports improved in the last quarter of 2014, and the slowdown seen in January may have been caused by calendar factors. The fall in energy prices led to a drop in the monthly trade deficit from -5.5Bn a year ago to an average of -3.4Bn in the period November 2014 to January 2015. However, much of the improvements are of a cyclical nature, and would be reabsorbed if growth were to take off again. For the moment, France has not managed to make a dent in its structural trade deficit balance and has seen its share of global exports fall rapidly. Measures reducing the tax wedge on the workforce are still not enough to bring about a rebound in competitiveness.

- Fiscal policy should impact negatively on aggregate demand in the next three-year period. Although the Council has granted France additional time, until 2017, to bring its government deficit below 3% of GDP, the country is still required to improve its structural budget balance by 0.5% in 2015 and 0.8% in 2016, corresponding to a reduction in the deficit of 0.3% and 0.6% respectively. The burden will be partly lessened by lower interest on debt, but the benefits for France are not comparable to those for Italy. According to the European Commission, this adjustment path will require additional measures of 0.2% of GDP this year and 1.2% in 2016: without additional measures, the deficit would remain unchanged at 4.1% from 2015 to 2017. The Commission estimates that such fiscal restriction would restrain growth at 0.7-0.8% in 2016 and 2017, one percentage point below initial estimates, widening the output gap to 3.4%. For this and other reasons, we do not rule out the structural correction being reduced to 0.5% again in 2016. Based on statements in the fiscal planning documents, the correction would include further spending cuts totalling EUR 25Bn in the 2015-2017 three-year period, which could bring the total to EUR 50Bn. In the meantime, public debt will continue to rise as a percentage of GDP: it is likely to rise from 95.3% in 2014 to over 97% this year.

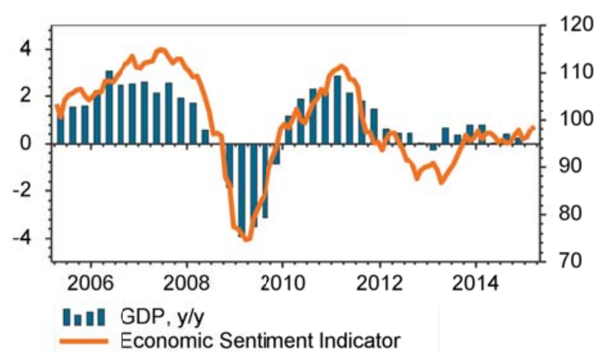
- The difficulty in making the fiscal correction is exacerbated by the **crisis in the traditional political parties**, including the ruling Socialist Party, which are losing ground to the far-right Front National (FN). However, the rise of FN may have reached its limits: in the recent departmental elections, the FN came second after the centre-right UMP-UDI coalition, although ahead of PS (Parti Socialiste), which is still deeply in crisis, despite the partial recovery in President Hollande's popularity.
- The modest growth that France is currently experiencing will push up employment levels, but is still insufficient to reduce **unemployment**, which will remain at current levels in the first half of 2015. Growth in hourly wages in the manufacturing sector has further slowed to 1.6% yoy (Q314).
- **Inflation** has progressively dropped from 1.1% in February to -0.4-0.3% in January-February. Inflation has **probably already bottomed out**, and looks poised to head back up in March to reach **0.7% by the end of 2015**, which would therefore take the annual average to 0.3% (2014: 0.5%). Underlying inflation should fall again, taking the annual average to 0.4% in 2015 (2014: 0.8%).

Forecasts

	2014	2015	2016	2014			2015				2016
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.4	0.9	1.4	0.0	0.4	0.2	0.5	0.9	1.0	1.3	1.3
- q/q change				-0.1	0.3	0.1	0.3	0.2	0.3	0.4	0.3
Private consumption	0.6	1.2	1.7	0.4	0.3	0.2	0.2	0.3	0.4	0.5	0.5
Fixed investment	-1.6	-0.4	2.0	-0.8	-0.6	-0.5	-0.1	0.2	0.4	0.6	0.5
Government consumption	1.9	0.9	0.1	0.4	0.6	0.4	0.1	0.0	0.1	0.1	0.0
Export	2.7	4.9	3.3	0.1	0.7	2.3	1.4	0.8	0.9	1.0	0.7
Import	3.8	4.7	3.5	0.6	1.3	1.7	1.3	0.8	0.8	1.0	0.8
Stockbuilding (% contrib. to GDP)	0.3	0.2	0.1	-0.1	0.3	-0.2	0.2	0.0	0.0	0.0	0.0
Current account (% of GDP)	-1.1	-1.5	-1.4	-1.5	-1.3	-0.7	-1.2	-1.6	-1.7	-1.5	-1.4
Deficit (% of GDP)	-4.1	-4.0	-3.6								
Debt (% of GDP)	95.3	97.2	98.3								
CPI (y/y)	0.5	0.3	1.0	0.6	0.4	0.3	-0.2	0.3	0.4	0.8	1.1
Industrial production	-1.1	0.7	1.7	-0.6	0.7	-0.4	0.3	0.3	0.4	0.5	0.4
Unemployment (%)	9.7	9.6	9.3	9.7	9.7	9.6	9.6	9.6	9.5	9.5	9.4
Effective exch.rate (1990=100)	99.7	93.3	94.8	100.3	99.5	98.4	95.4	93.2	92.1	92.5	93.4

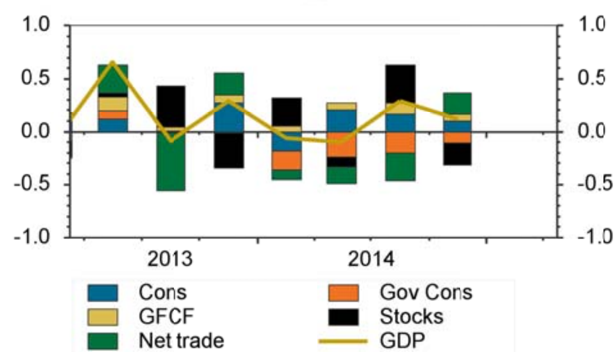
Note: Percentage changes on the previous period - except where otherwise indicated. Average levels for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Economic sentiment and GDP growth



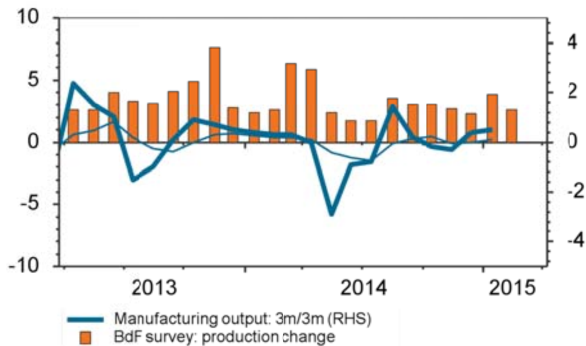
Source Thomson Reuters-Datastream

Fig. 2 – Contribution to GDP growth



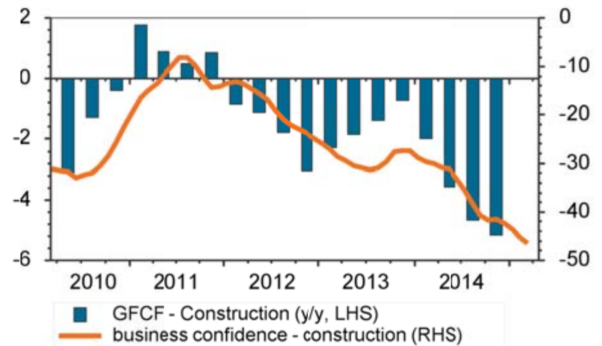
Source: Thomson Reuters-Datastream

Fig. 3 – Manufacturing output (3m/3m) and BdF index



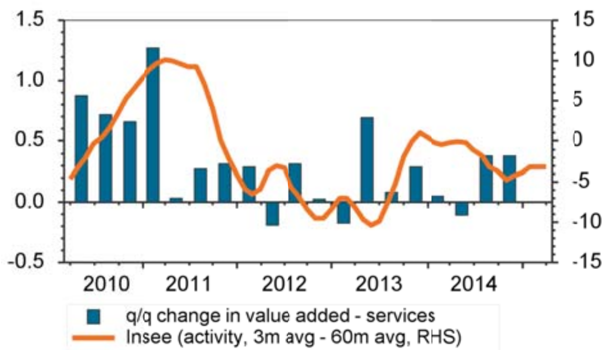
Source: Thomson Reuters-Datastream

Fig. 4 – Investment in construction and business confidence



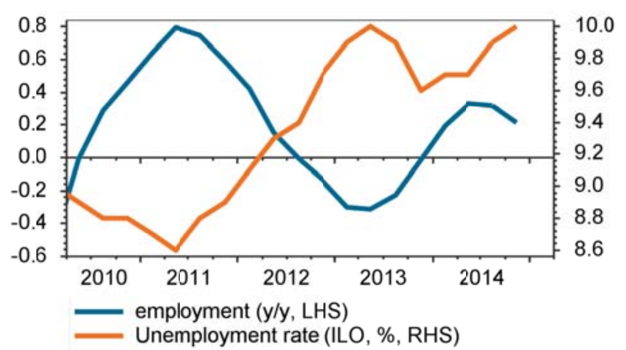
Source: Thomson Reuters-Datastream

Fig. 5 – Services: business confidence and growth in added value



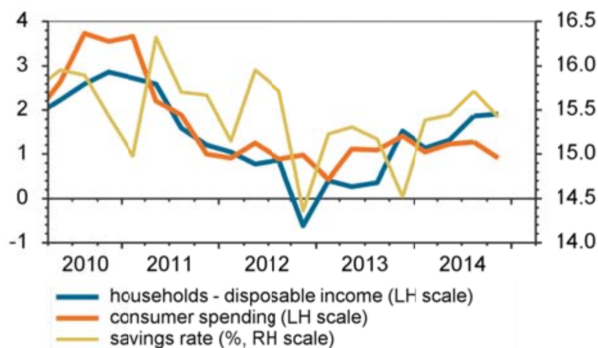
Source: Thomson Reuters-Datastream

Fig. 6 – Employment and unemployment



Source: Thomson Reuters-Datastream.

Fig. 7 – Income, consumer spending and propensity to save

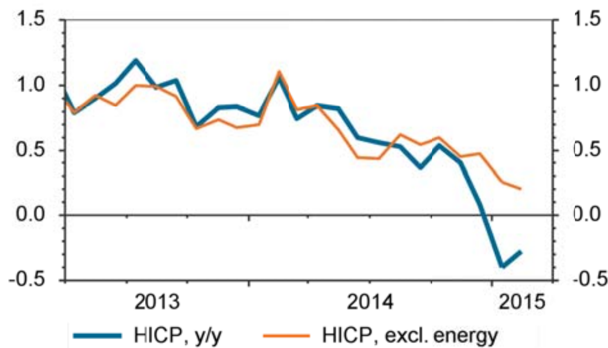


Source: Thomson Reuters-Datastream

Fig. 8 – French export trend

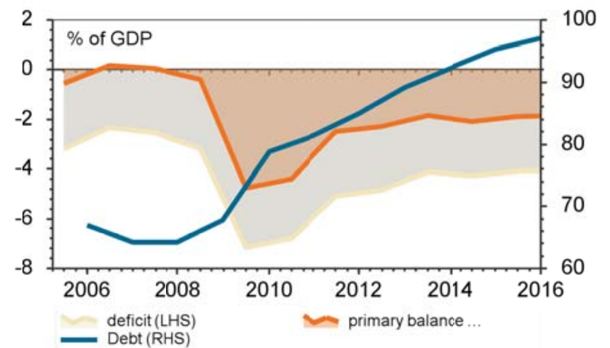
Source: Thomson Reuters-Datastream

Fig. 9 – Consumer prices y/y % change



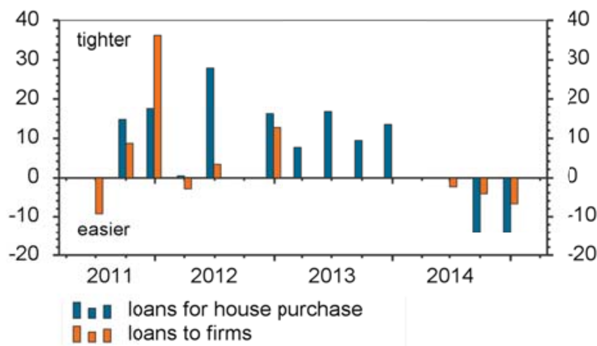
Source: Thomson Reuters-Datastream

Fig. 10 – Public debt and deficit, with EC projections



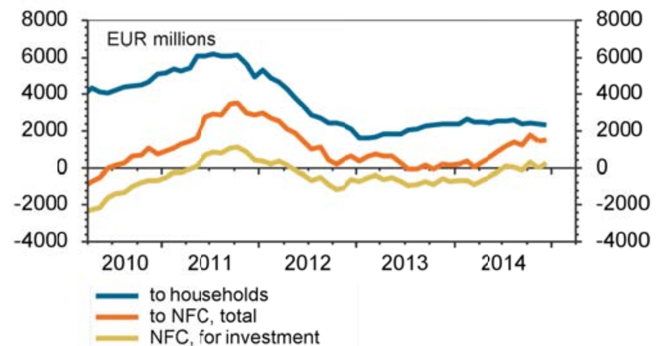
Source: Thomson Reuters-Datastream

Fig. 11 – BLS: net change in credit conditions (%)



Source: Thomson Reuters-Datastream

Fig. 12 – Net lending by banks (flow)



Note: Moving 12-month average.
Source: Thomson Reuters-Datastream

Italy: far from brilliant start to the year, but the recovery should strengthen in the course of 2015

Paolo Mameli

After a hopeful close to 2014 for domestic demand, 2015 began on a less positive note than expected. In light of the lacklustre start to the year, and of the risks still weighing on the scenario, we have left our forecast of GDP growth in 2015 unchanged at 0.4% for the time being. However, we believe the recovery could strengthen in the course of the year, at a pace of at least 0.3% q/q, thanks to the positive effects of exogenous shocks (exchange rate, oil and QE). The hope is that the efforts being made on the front of reforms will help to create the right conditions for a self-sustainable domestic recovery once the impact of the shocks will have waned.

2014 ended with final demand on the recovery…

The year 2014 came to an end with the Italian economy showing **zero growth** in the closing three months of the year. However, the year-end breakdown of GDP components was encouraging, as both consumption and investments progressed slightly (by 0.1% and 0.2% q/q respectively): while the recovery of the former is not surprising, as it is in line with the trend recorded over the five previous quarters, investments marked their first increase in a year and a half. The lingering recession in the construction sector came as no surprise (-0.6% q/q: the sector achieved positive growth in only one of the past 27 quarters). On the other hand, we expected poorer data on investments in machinery and equipment (+0.2% q/q). The rebound of investments in means of transport was sharper (+7.7% from a previous -6.5% q/q), although this item accounts for less than 1% of GDP, and is typically very volatile (Figure 1). Public spending also grew surprisingly, by 0.4% q/q, although this component cannot for obvious reasons be the engine of economic growth. As a result, **domestic demand net of inventories improved for the first time in four years, by 0.2% q/q** (Figure 2). Foreign demand made an even stronger contribution: +0.4% q/q, fuelled by a robust acceleration of exports (+1.6% q/q, the strongest increase in two years and a half), in all likeliness tied to the depreciation of the exchange rate, in combination with a slowdown in import growth (0.3% q/q).

In essence, had inventories not made a significantly negative contribution, GDP would have grown by +0.6% q/q at the end of 2014. What's more, **persistently negative inventories**, which subtracted 0.2% q/q from GDP on average in each quarter of 2014, could be tied to measurement problems, given the residual method used in Italy to estimate this variable. Indeed, based on the indications provided by manufacturing companies, inventories were assessed as being below "normal" values in 2012 and in the first half of 2013, and to have subsequently scored a rebound, of which there is no trace in national accounts data (Figure 3).

…but 2015 should prove to have got off to a less positive start than expected

In any case, the return of investments into positive growth territory, with final domestic demand following suit at the end of 2014, is a good omen for the evolution of the cycle in the opening months of 2015: GDP growth could have turned positive in 1Q 2015. Consumption and investments will probably remain only marginally positive (0.1% q/q), whereas the contribution of foreign demand and inventories could be opposite, as was the case at the end of 2014, with an uncertain net effect, prompting us to conclude that **the confidence interval** may be of **between zero and +0.2% q/q**.

Indeed, the opening months of 2015 brought several **signals of an improvement of the economic cycle on a monthly basis**, with particular reference to:

1) Significant progress outlined by **sentiment surveys** among both businesses (not only in manufacturing, but also in the other sectors of economic activity: Figures 5 and 6) and households; admittedly, the rebound was more due to views on the national economic picture, rather than on the personal situation of the respondents (Figure 7), and more to

future expectations than to current conditions (Figure 8); in particular, views on the future course of the economy and employment have shown an encouraging improvement;

2) Unlike last year, signals of an improvement are starting to come not only from surveys, but also from hard data; for instance, auto sales expressed double-digit growth in the first two months of 2015 (+13.2% y/y in February); this is clearly a rebound from very compressed levels, although in year-on-year terms it marks an unprecedented high in almost five years (Figure 4); retail sales ex auto also made some progress and returned into positive territory at the end of 2014 (+0.1% y/y);

3) Not only did employment confirm the signs of an improvement seen in 2014 (+0.6% y/y in January 2015, a high since October 2011), but also the unemployment rate, which dropped to 12.6%; admittedly, still at the end of 2014, the recovery in employment numbers was being driven by women (+1% vs. +0.5% among males), foreign workers (+113k vs. +44k Italian), part-time workers (+3.2% vs. +0.2% for full-time workers; around 64% accounted for by involuntary part-timers) and by "flexible" workers (employees on temporary contracts were up by 145k, and collaborators by 31k, whereas full-time workers on permanent, unlimited contracts, an increase in which would make the labour market's current reversal more credible, decreased by 53k); the marked improvement in the outlook for employment of both households and businesses makes the more favourable trend of the labour market sustainable (Figure 11);

4) Lastly, deflation pressures are also easing: the CPI, after hitting a low in January (at -0.6% at the national level and a -0.5% in harmonised terms), climbed back in February (to -0.1% for the national index and +0.1% in harmonised terms), and the recent rebound from lows in the price of oil, combined with the further depreciation of the exchange rate (and effects of the QE), have pushed inflation projections upwards; in our view, throughout the central months of the year the CPI could stay very close to zero, subsequently rising back in the closing months of the year and heading towards 1% already at the beginning of 2016.

Vice versa, January industrial output and export data have cast doubts on the sustainability of the recovery. Indeed, industrial output declined by -0.7% m/m after having progressed by 0.3% in November and 0.4% in December, and exports decreased by -2.5% m/m (vs. a +1% m/m rise in imports). However, IP data at least could be distorted by the presence of two long festive weekends at the beginning of the month (2 and 5 January). Therefore, in February we expect a rebound in both industrial output (that would also be compatible with the recent trend of orders: +5.8% y/y in December), and in exports. As regards exports in particular, the month of March brought a sharp acceleration in the depreciation of the exchange rate, which will inevitably have an impact on the competitiveness of exports to countries outside the euro area. We will have to wait for February data to verify the size of the rebound. In any case, the weak start to the year indicates that 2015 will not begin with a brilliant performance in terms of GDP growth, and this could weigh on the annual average.

A model to "organically" capture the support of external variables

Much has been said on the impact of the recent external shocks on the Italian economy. An "organic" approach to the issue is the building of an econometric model on Italian GDP, including as determinants the exchange rate, the price of oil, and the evolution of long term yields. To this end, we have built a model to forecast Italian GDP (year-on-year change), taking as independent variables the "fundamentals" that drive growth: in addition to those mentioned above, the determinants of the cycle that emerge as being significant are global demand and fiscal policy. As a proxy of global trade we have selected the index of demand addressed to Italy and built as the weighted average of imports from the various trade partners (taking their shares of the Italian exports as weights); as a proxy of fiscal policy stance, we have chosen the primary balance (net of interest). To capture the effects of monetary policy, the variable that emerges as

being most significant is not the level of long-term yields, but rather the slope of the yield curve (negatively correlated with growth): in the current situation, as the ECB proceeds with its purchases of medium-long term securities, considering that short-term rates are already at zero, the curve flattens, implying stronger future growth. In essence, a model can be built that explains Italian growth based on five factors: international trade, the EUR/USD exchange rate, the price of Brent oil (in dollars), fiscal policy, and the slope of the yield curve. We have chosen to run the model on the past 10 years. An interesting fit emerges (Figure 9). The model provides several indications:

1) It signals a return to positive year-on-year GDP growth in the course of 2015, albeit at levels not much higher than zero, and shows that the strongest thrust from independent variables will come in mid-2016;

2) It signals that growth in 2015 could improve by around 0.8% over 2014 (-0.4%); an almost equally significant "additional" impact is expected in 2016 (0.7%);

3) Most importantly, it allows an analysis of the positive effects deriving from the set of variables considerate, at least in terms of "differential" impact compared to the previous year (Figure 10).

Upside risks to 2015 growth forecasts confirmed

In essence, we confirm that upside risks prevail on the growth scenario, tied to four factors: 1) the depreciation of the exchange rate; 2) the drop in the price of oil; 3) the effects of the ECB's quantitative easing; 4) a fiscal policy which, thanks to a more growth-supportive approach at the European level, and most importantly to savings on interest expenditure, is becoming marginally more expansionary. In particular, among those shocks, in recent weeks the importance of the contributions made by lower Government bond yields and the decline of the euro has increased (whereas the effects of the oil shock seem to have waned, following the rebound from January lows).

However, some reasons for caution advise us not to revise upwards, for the time being, our current forecast for 2015 (0.4%):

1) Industrial output and export data for the opening weeks of the year, while distorted by one-off factors, cast doubts over the assumption of a recovery already starting in 1Q 2015, which will significantly affect the annual average;

2) Some risks linger, tied to external factors: first of all, a new escalation of the Greek crisis cannot be ruled out (although the EAPP represents an important shield against contagion risks to other countries); secondly the scope of geopolitical risks stemming from North-African (Libya in particular) and Middle-Eastern countries, or the Russian-Ukrainian front, should not be underestimated.

For these reasons, while confirming that for the first time in years the balance of risks to the growth scenario is clearly skewed to the upside, we maintain a cautious outlook on GDP growth over the 2015-16 biennium (0.4% and 1%, respectively). In any case, we believe that after a still rather weak start to the year, the recovery may strengthen in the course of the year, with GDP growth reaching a pace of at least 0.3% q/q.

As we have repeatedly stressed, the factors that are driving the Italian economy out of the recession are mostly exogenous; however, as clearly outlined by broken down sentiment data as surveyed among businesses and households, something is moving also on the domestic front. While the shocks that are fuelling the recovery are of a temporary nature, the hope is that current brightening of sentiment among households and businesses, also prompted by the

progress being made on the front of reforms, may help create a virtuous circle, which could become self-sustaining once the effects of the shocks will have been fully absorbed.

Once the impact of external shocks is reabsorbed, help could come from the effects of reform

The government's action, with particular reference to reforms, could impress the potentially decisive thrust to make the recovery self-sustaining once the effect of the current shocks will have disappeared. To date, as well as on reducing the fiscal wedge, the government has concentrated its reform efforts on two fronts:

1) **Labour market** reform:

    a. On 21 March 2014, the legislative decree No. 34 came into force (later converted into Law No. 78 of 16 May), significantly slackening legislation on **temporary employment and apprenticeships**, and seems to have had an appreciable impact in stimulating new temporary hiring already in the course of last year;

    b. The Parliament then approved the enabling law No. 183 of 10 December 2014 on the overall reform of the labour market (the so-called **Jobs Act**), which included five delegated decrees to be exercised within six months; of these, three were converted into four enacting decrees by the government on 20 February (the new single labour contract, reform of redundancy schemes, review of existing labour contracts, conciliation of life and work times); on 7 March, the first two of these decrees came into force, and most importantly the new single labour contract, whereas the other two are awaiting the opinions of the Parliamentary Committees; still pending at present are the enacting decrees on active policies and on the simplification of labour-related legal requirements;

    c. In addition to the above, starting in January two **fiscal measures** came into force that we believe may have an impact on employment: 1) de-contribution for three years on new hiring with unlimited contracts made in 2015; 2) the deductibility of cost of labour (on full-time employees) from the Irap taxable base. Hopes are that these two measures will result in higher employment not only in absolute terms, but in particular in the full-time unlimited contract segment.

2) **Institutional reforms**: on 10 March the House approved the Boschi Decree on Constitutional reform ("overcoming" of egalitarian bicameralism and review of Title V of Part II of the Constitution), with 357 votes in favour and 125 against. The law will now return for a second reading to the Senate, that will only have to examine the changes made in the House; the bill will then have to be approved with a subsequent majority vote by each of the houses of Parliament, after a period no shorter than three months; lastly, it will be the object of a confirmation referendum (which may not be possible before February 2016 for technical reasons). At the same time work will also proceed on the new electoral law, already approved by the Senate, and which is expected to be passed by the House with no particular problems (the reform applies only to the House of Representatives and therefore implies the completion of the Boschi decree; also, a specific clause rules that it will come into force only on 1st July 2016).

3) **Judicial system**:

    a. Civil justice was reformed first with the **decree law on the backlog of civil court cases** (legislative decree No. 132 of 12 September 2014, converted into law No. 162 of 10 November 2014), which introduces several changes to the Civil Procedure Code (possibility of resorting to arbitration in both the first and second degrees, negotiation option, prohibition of written testimonies also in civil procedures, widening of the applicability of the short divorce procedure, reduction of the holiday

periods enjoyed by magistrates and of the holiday periods in which the courts of justice work at a slower pace);

b. The Council of Ministers then approved, on 10 February 2015, the Orlando delegation bill on the reform of the Civil Procedure, which integrates the legislative decree on the civil court case backlog mentioned above, integrates the measures contained in the regulations governing the accountability of magistrates, already approved (Law No. 18 of 27 February 2015), and is part of the organic reform of honorary court judges and of other measures on justices of the peace, currently being examined by the Senate Committee. The main innovations are the strengthening of the Business Tribunal, the establishment of the Family and Individual Rights Tribunal, and the classification in lists of the reasons for complaints brought before the Court of Appeals and the Court of and in Cassation;

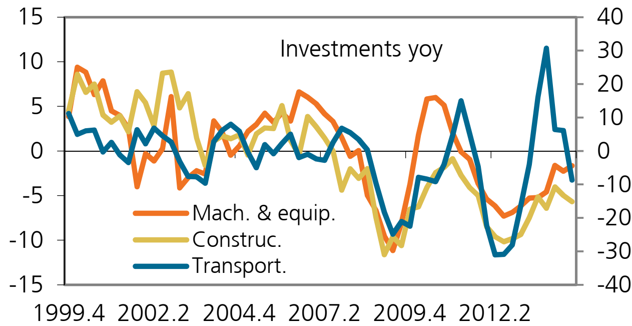
c. False accounting: the government has transmitted to the Minister of Relations with the Parliament, for submission to the Senate Justice Committee, the amendment to the corruption legislative decree on false accounting, which no longer provides for non-prosecution thresholds, neither in percentage terms nor in relation to business volumes, although a distinction is safeguarded only between listed and non-listed companies, and the punishment for the latter is lowered from a minimum of one to a maximum of five years of imprisonment. On the other hand, the penalty for listed companies remains 3-8 years of imprisonment, with automatic prosecutability.

d. Sidelined for the time being are the other legislative bills approved by the Council of Ministers on 29 August: the legislative decree containing changes to criminal, substantive, procedural and code law, for the strengthening of defence guarantees and the reasonable duration of trials, as well as the penitentiary law on the re-educational effectiveness of prison sentences; and the delegation legislative decree for the reform of Book XI of the Code of Criminal Procedure (changes to the rules governing extradition abroad: term for the handing over and maximum duration of coercive measures).

Other reforms at a less advanced phase are focused on the PA (examination of the government initiative bill A.S. No. 1577, called "Reorganisation of the pubic administrations", began with the Senate Constitutional Affairs Committee on 3 September 2014; the Constitutional Affairs Committee reviewed the amendments in several sessions up to 5 March, and ultimately the number of proposed amendments was so great as to impose a re-drafting of the measure), education (the Council of Ministers approved the so-called "Good Education" bill only on 3 March), and competition (on 20 February the Council of Ministers approved a bill that, for the first time, enforces the annual measure on competition imposed by the law in the following fields: insurance; pension funds; communication; mail service; electric power, gas and fuels; banks; lawyers; notaries; engineers; pharmacies).

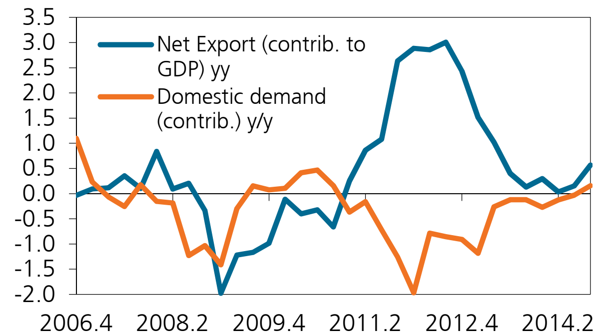
These reforms, based on the government's estimates, should have a significant impact on GDP in the medium term, slightly in excess of the impact estimated by the OECD (percentage deviation from the baseline scenario up to 2020 of 3.6% vs. 3.3%: Figure 12). The result is obtained through simulations run with the IGEM and QUEST models. Of the total impact of 3.6%, 0.2% should be generated by the fiscal wedge, 0.9% by the labour market reform, and the rest by the effects of the PA and judicial system reform (1.4%), and reforms focused on aiding competition on the product markets (1.1%). In any case, the reforms are unlikely to have a tangible impact in the short term (with the relevant exception of the cut in the tax wedge and the labour market measures), although we share the idea that the reforms mentioned will have appreciable effects on GDP in the medium-long term (bolstered by institutional reforms, capable of improving governability and making the legislative process more efficient).

Fig. 1 – Investments still the weak link in the macroeconomic scenario



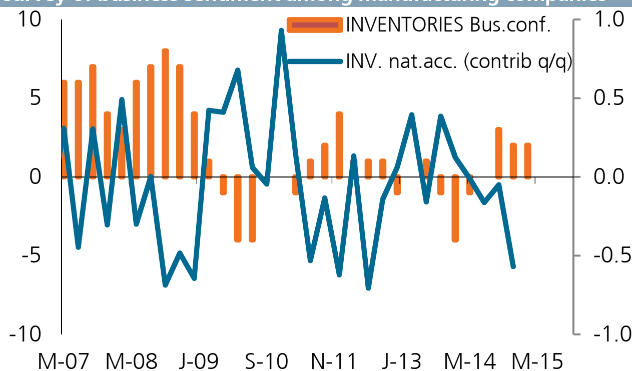
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 2 – For the first time in four years, at the end of 2014 both net exports and final domestic were in positive growth territory



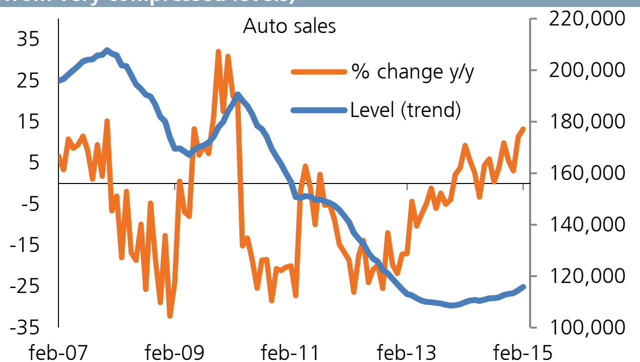
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 3 – The sharp drop in inventories outlined by national accounts at the end of 2014 clashes with the indications provided by the survey of business sentiment among manufacturing companies



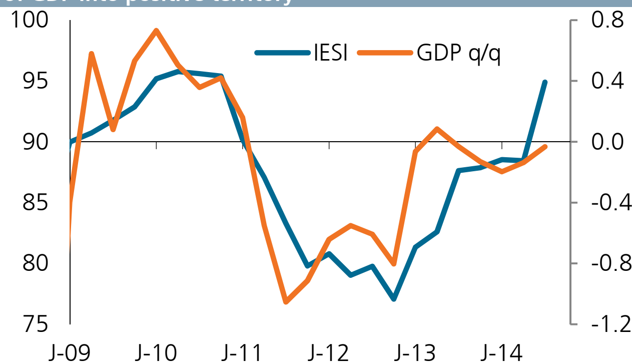
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 4 – Improving consumer sentiment confirmed by sales of durable goods, with autos at the fore (although the rebound is from very compressed levels)



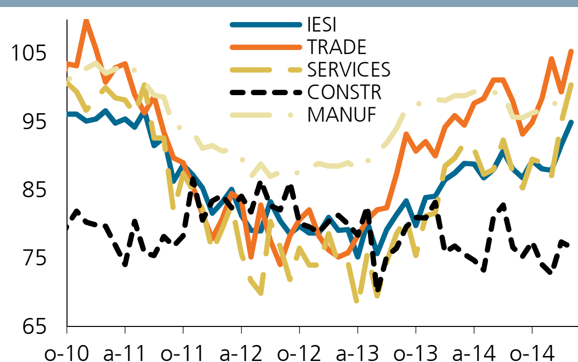
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 5 – Brightening business sentiment (according to the composite index drawn up by ISTAT) is consistent with a return of GDP into positive territory



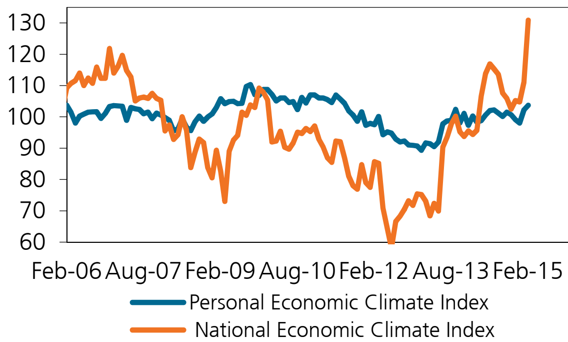
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 6 – The only sector left lagging behind (in terms of business sentiment) is construction



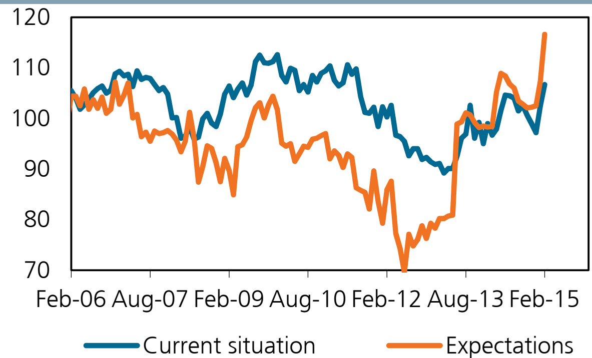
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 7 – The more optimistic outlook of households at the beginning of 2015 is referred more to the national economic picture than to the personal situation of respondents…



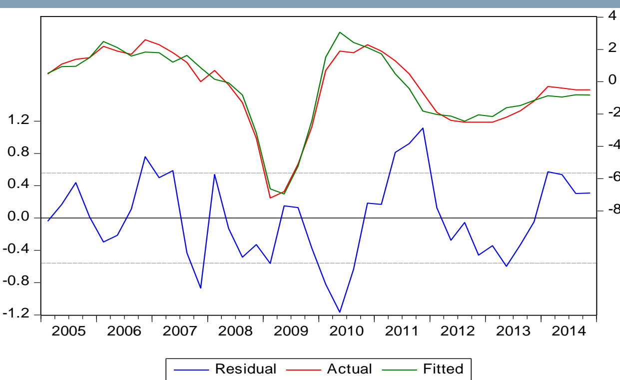
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 8 – …and more to expectations for the future than to current conditions



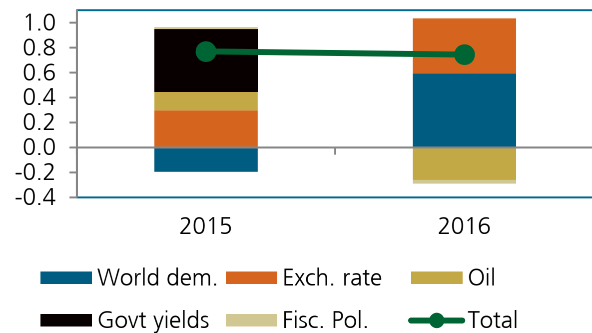
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 9 – Intesa Sanpaolo model which estimates y/y GDP based on: international trade, EUR/USD exchange rate, price of oil, yield curve, primary balance: forecasting value



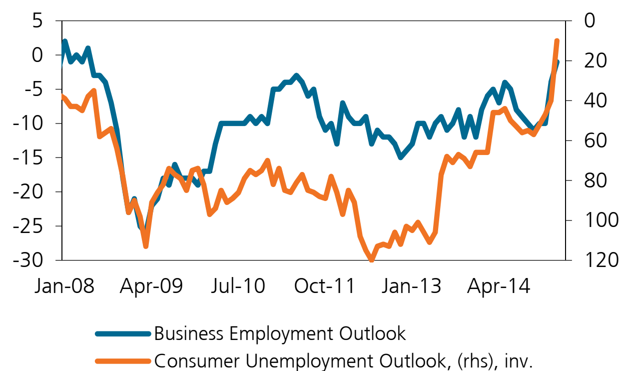
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 10 – Intesa Sanpaolo model which estimates y/y GDP based on: international trade, EUR/USD exchange rate, price of oil, yield curve, primary balance: "additional" contribution to GDP (compared to the previous year) of independent variables



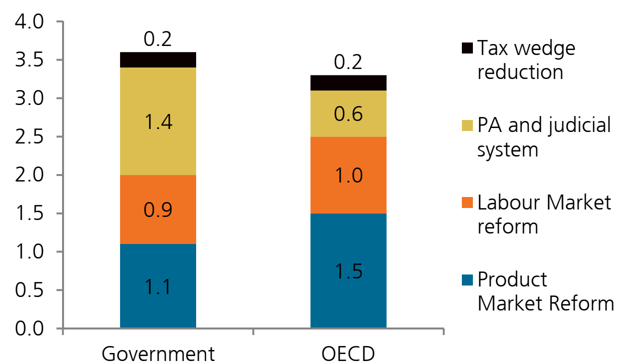
Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 11 – In recent months, employment expectations have improved both among households and companies



Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 12 – Estimated impact of reforms: % deviations from the baseline scenario up to 2020: Government and OECD estimates



Source: Intesa Sanpaolo elaborations on ISTAT data

Greece: on the brink of the abyss, again

Luca Mezzomo

From November 2014 onwards, in the run-up to the political elections and subsequent installation of the new Greek government, the country's financial situation worsened dramatically. Even tax collection came to a halt in the first two months of 2015 (EUR 1.7Bn less than in 2014), which the government partially compensated for with a squeeze on cash outlays (EUR -1.0Bn). The fundamental problem (which surfaced immediately following the decision to set the deadline for the programme at 28 February, shortly after the elections) hinges around the initial refusal to extend the second financial bailout programme, without which everyone had thought that Greece's ability to honour its payment deadlines in the first half of 2015 was unrealistic. The new government's attempt to finance itself without the assistance of any programme, by selling short-term treasury bills to banks, which would then have refinanced them using ECB facilities, was instantly blocked, as it was obvious it would be. Without the certainly that maturing debt payments would be covered, the haemorrhaging of deposits in the banking system accelerated, the ECB had to remove the exception allowing it to accept Greek government bonds as guarantees, and Greek banks became increasingly dependent on emergency liquidity supplied by the Bank of Greece (more than 65Bn euros at end February, plus more than 30Bn in recourse to the MRO). After that, on February 20th Greece resigned itself to accepting the extension of the second bailout programme. However, a lack of confidence led the Eurogroup to postpone the release of payments until April (i.e. until the commitments started to become concrete measures). In the last few days, it has become increasingly clear that the agreement means very different things to the Tsipras government than it does to the Eurogroup.

The seriousness of the Greek financial situation relates to all time horizons. In the short term, between March and December, the government will need to find at least EUR 27Bn in funds, rising to EUR 7.7Bn in June, in order to finance cash outflows, with a cash balance of just 1.9Bn at the end of February. The renewal of expiring T-bills could cover just over a third of the total borrowing requirement, or around EUR 10Bn. That would leave a minimum of around EUR 17Bn to be financed, of which EUR 6.9Bn would be needed by the end of June. Immediate demands can be met with the release of the last tranche of the loan, and a modicum of financial creativity (i.e. constraints on the use of the liquidity reserves of publicly owned companies and pension funds). However, it is difficult to see how Greece could meet its requirement in the second half, which has been inflated by bonds totalling EUR 6.7Bn held by the ECB and maturing between July and August, without a third assistance programme (or a 'Contract for Recovery and Development', as the Greek side prefers to call it). An assistance programme in the region of tens of billions of euros would seem to be necessary even on a multi-year basis, especially if Greece were not able to balance its budget in the near term. In the longer term, the final problem will have to be tackled, that of the debt repayment plan to the EFSF starting in 2020: a further loosening of conditions on interest payments and capital repayments could be necessary, as pre-announced by the Eurogroup in November 2012. Note, however, that debt restructuring would not lead to any reduction in the financial borrowing requirement for the next four to five years.

Despite the agreement with the Eurogroup, it is by no means certain that the Greek government has really agreed to operate within the current European framework. Pessimists see at least two paths that could lead to Greece's exit from the monetary union:

- According to the first scenario, the government has no intention of reaching a compromise with its creditors, but finds it convenient to feed expectations of an agreement to buy time and avoid a run on the banks. In the meantime, it is preparing extraordinary measures to take the country out of monetary union. The identification of a credible foreign enemy (Germany) would serve to make the negative consequences of this dramatic step more acceptable.

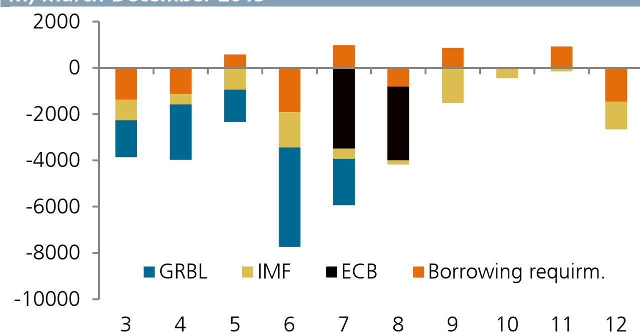
- In the alternate scenario, breaking-point is reached through inexperience the accumulation of errors which, at a certain point, make it impossible to reach agreement with creditors in time to avert financial disaster. The country's exit is therefore the result of an unplanned "incident".

In a positive scenario, on the other hand, Syriza prepares to present draft laws to parliament with the aim of securing funding, going back on some of its electoral promises, and moving closer to the position of the centre-left parties. The reforms would be aimed at improving tax collection and providing a stabler financial environment. In exchange, the Eurogroup would quickly release some funds to prevent a default. In this scenario, a more aggressive tone towards Germany would represent an attempt to blame the shift in position about to be formalised on the intransigence of the external "enemy". Such more positive scenario seems more likely following the meeting of Tsipras with the Eurozone leadership on March 19 and with the German prime minister on March 23. However, as explained above, the difficulties will not end with the release of the EUR 7Bn left over from the second bailout, since a third support programme will have to be rapidly negotiated and launched, preferably by end June. It is not certain that Syriza would survive such a scenario without suffering defections, and one cannot rule out a government crisis and a change in the ruling majority.

How serious would Greece's exit from monetary union be for the other Euro zone countries? In the short term, there would be economic damage associated with the collapse in trade flows to and from Greece, which absorb 1%-2% of the exports of the other Euro zone countries, and possible repercussions on confidence. Greece's exit would make it unlikely that the remaining loans under the Greek Loan Facility and the EFSF would be repaid, which would force member states to pay the guarantees provided on the vehicle's bonds. Moreover, the Eurosystem would lose any prospects of receiving repayment of the virtual loans to the Bank of Greece linked to the current account deficit, which at the end of February amounted to EUR 91.2Bn, apart from the repayments of EUR 6.7Bn in bonds expiring in July and August. On the other hand, the EU's non-repayable transfers to Greece would cease, which are currently worth over EUR 4Bn a year.

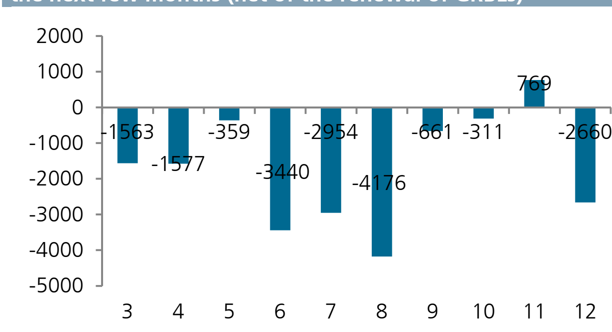
However, as five years have now passed since the outbreak of the crisis, many international banks and investors have withdrawn from Greece, and the PSPP is now being implemented by the ECB, there is virtually no risk of "contagion" to other countries. Nor is there any good reason to believe that Greece's exit will make it more likely that other countries will follow suit, although, over the longer term, it may weigh on investors' assessments of the possibility of a new debt crisis.

Fig. 1 – Estimated gross financial borrowing requirement (EUR M) March-December 2015



Source: Intesa Sanpaolo calculations on national and IMF data

Fig. 2 – Net financial borrowing requirement to be funded in the next few months (net of the renewal of GRBLs)



Source: Intesa Sanpaolo estimates

Asia

Japan: growth is back, but will need more help from the BoJ

Giovanna Mossetti

The macroeconomic outlook is positive for Japan over the 2015-16 horizon. Growth is reaccelerating, with forecasts at 1% in 2015 and 1.8% in 2016. Investments and exports should make positive contributions, driven by the weak yen and accommodative financial conditions.

The key factor for a sustainable recovery however is consumption, expected to expand moderately, but dependent on the wage trend. The outcome of current negotiations for wage increases at large companies (Shunto) will be crucial in supporting forecasts for an increase in spending.

Inflation net of the April 2014 consumption tax hike is slowed by lower energy prices. Price growth is likely to remain around zero in the middle of the year, and will gradually pick up in the final part of 2015, but it is unlikely to move close to 2% next year.

The fiscal scenario will be broadly neutral this year. In our view, the inflation path, increasingly divergent from the BoJ's 2% goal, will prompt the central bank to step up monetary accommodation in the second half of the year.

Forecasts

	2014	2015	2016	2014			2015				2016
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	-0.1	1.0	1.8	-0.4	-1.4	-0.7	-1.3	1.0	2.2	2.3	2.0
q/q annual rate				-6.4	-2.6	1.5	2.7	2.5	2.2	1.9	1.6
Private consumption	-1.2	0.7	2.4	-18.7	1.1	2.0	2.0	2.5	3.0	2.9	2.0
FI - private nonresidential	3.8	0.6	2.7	-18.5	-0.6	-0.3	3.2	3.7	2.8	3.2	2.9
FI - private residential	-4.9	-0.3	3.5	-35.3	-25.1	-4.6	16.9	12.6	8.7	0.8	0.9
Government investment	3.7	-0.7	-5.0	4.5	8.7	3.3	-0.8	-6.4	-6.4	-6.0	-5.2
Government consumption	0.3	0.3	0.1	1.5	0.9	1.2	-0.8	0.4	0.4	0.0	0.0
Export	8.2	5.8	3.0	-1.3	6.2	11.5	5.7	5.8	2.9	2.0	3.2
Import	7.2	3.8	6.0	-19.7	4.2	5.3	5.7	6.4	5.3	7.0	5.9
Stockbuilding (% contrib. to GDP)	-0.2	0.1	0.5	1.5	-0.8	-0.2	0.2	0.1	0.1	0.2	0.1
Current account (% of GDP)	0.6	1.6	0.8	0.8	0.5	2.0	1.7	1.8	1.7	1.4	1.1
Deficit (% of GDP)	-8.4	-7.0	-6.1								
Debt (% of GDP)	229.5	233.3	234.9								
CPI (y/y)	2.7	0.1	1.1	3.6	3.3	2.5	0.0	0.1	0.0	0.4	0.9
Industrial production	2.1	1.6	2.0	-14.4	-7.5	6.8	4.4	3.6	3.2	2.5	1.8
Unemployment (%)	3.6	3.5	3.6	3.6	3.6	3.5	3.5	3.4	3.5	3.5	3.6
JPY/USD	105.7	123.0	128.3	102.1	104.0	114.5	119.3	121.0	124.5	127.3	129.3
Effective exch.rate (1990=100)	134.0	126.6	118.9	136.8	136.1	127.0	126.8	129.2	126.9	123.4	120.1

Note: Annualised percentage changes on the previous period - except where otherwise indicated. Average levels for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Moderate growth in 2015, waiting for wage hikes

The Japanese economy resumed growing at the end of 2014, after contracting for two quarters. Indications for 2015 are positive, and compatible with a moderate recovery. Forecasts in any case point to growth well above potential in 2015-16, thanks to a combination of expansionary factors: accommodative fiscal and monetary policies, weak exchange rate, lower price of oil, and change in the allocation of pension fund assets towards riskier asset classes. GDP growth is forecast at 1% in 2015 and 1.8% in 2016.

Recent data are encouraging, both in terms of domestic and foreign demand, with positive signals, at last, also coming from exports. However, the crucial (and so far largely missing) link to achieve sustainable growth is the wage trend, which for most of 2014 remained weak despite

the positive inflation trend. Negotiations over 2015 wage increases, to be completed in coming weeks, will be a decisive factor in conditioning forecasts for the next two years.

1. Demand increasing on the back of investments and exports, consumption waiting for stronger nominal wage growth.

Investments and exports pushing up growth in 2015

In 2015, the quarterly trend of GDP is forecast to average +2% q/q ann., with a yearly change of 0.9% in 2015 and 1.8% in 2016, after a flat trend in 2014. The recovery is expected to be driven by investments and exports, supported by the weak yen and the lower price of oil. The recovery of exports and a moderate reacceleration of consumption should drive industrial production and investments upwards in 2015, in line with the indications provided by the surveys and by economic data seen since the beginning of the year. At the end of 2014, corporate earnings and revenues increased sharply (+20.2% y/y and 5.6% y/y, respectively), albeit with very mixed results across sectors. Earnings and revenues were up for manufacturing companies (24.4% y/y and 2% y/y, respectively), as opposed to a weak picture in the services sector, with earnings and revenues both on the decline; however, services should recover as the consumption trend returns into positive territory, given the postponement of the second consumption tax hike to 2017.

Net exports expected to contribute around 0.5pp to GDP growth

The positive picture should be further reinforced by confirmation of the export trend reversal, which began in 2H 2014 (see Fig. 3). In January, exports were up by 17% y/y in nominal terms, and by 11.2% in real terms, achieving solid growth towards all geographical regions, and especially Asia (+22.7% y/y) and the USA (16.5% y/y), but also Europe (+7.4% y/y). The slowdown of nominal imports was largely due to the drop in oil prices. Forecasts for 2015 point to a positive contribution of net exports to growth, by around 0.5pp.

Fixed corporate investments estimated to increase on average by 0.7% q/q in 2015

Lastly, accommodative financial conditions, and increased JGB purchases by the BoJ, have allowed banks greater freedom in managing their portfolios, and this is translating into a surge in loans (Fig. 7). These factors, combined with the depreciation of the exchange rate, and falling energy prices, point to annual growth of fixed corporate investments in 2015 of 0.6%, from 3.8% in 2014. The apparent weakness of investments is due the sharp corrections which followed the consumption tax hike in April 2014. A more accurate picture of the outlook is drawn by average quarterly growth in 2015, forecast at 0.7% q/q.

Consumption growth, and the sustainability of the recovery, will depend on nominal wages

Forecasts for the consumption trend are modestly positive, but open to downward risks, given the persistent weakness of nominal and real income. After the volatility phase triggered by the consumption tax hike, households' spending picked up in 2H 2014, growing by +0.3% q/q on average. In 2015, mostly neutral fiscal policy and on-going employment growth should contribute positively, although the wage trend represents a risk to forecasts. Until the end of 2014, despite the constant decline of the unemployment rate, wage growth was not in line with the return of inflation into stably positive territory, even net of the increase in indirect taxes. In January 2015, real disposable income (for households with an employed breadwinner) declined by -2.5% y/y, and real consumption contracted by -4.3% y/y (Fig. 6).

However, starting at the end of 2014, signs of an improvement appeared at last: earnings growth in January 2015 accelerated, to 0.9% y/y (Fig. 5), the largest change since March 2000; the scheduled component of earnings increased at its sharpest rate in 14 years, by 0.8% y/y. In real terms, this leaves earnings on a year-on-year downtrend, but as shown in Fig. 6, net of the consumption tax hike, real earnings are increasing. Given the prospect of an inflation rate of around 0.5% y/y from April onwards, real income should therefore be recovering with both wages and the number of employed workers making a contribution. Negotiations over the wage increases in large corporations (Shunto) are currently under way for fiscal year 2015. In 2014, the pay increases agreed on were higher than in the previous years (2.2% in 2014, from 1.8% in 2013, for large corporation workers). For 2015, the unions are seeking an annual wage

increase of at least 2%. The government has taken an aggressive stance, putting pressure on businesses to concede pay rises, in light of the sharp rise in corporate profits. Recently, many large companies have signed large increases in the auto and electronic sectors (e.g., Toyota around 3.2% in 2015). Our forecast is that wages will accelerate moderately this year, with inflation stabilising at between 0.5% and 1% y/y, supporting a moderate expansion of consumption (forecast for 2015: 0.7%). Forecasts for 2016 (+2.4%) are much stronger, also because 2016H2 will be influenced by the second consumption tax hike moving closer (from 8% to 10%, scheduled for April 2017).

2. Monetary policy and inflation: further accommodation is a matter of time

The path of inflation, net of the consumption tax hike, continues to diverge from the BoJ's 2% goal. In January, the central bank revised its inflation forecast for fiscal year 2015, to 1% from 1.7% in November 2014. In march, Governor Kuroda said that inflation is expected to hover around zero in coming months. Based on the latest data, forecasts are likely to be further lowered, if not already in April, then in mid-July at the latest. Governor Kuroda reasserted, at the beginning of March, that the BoJ expects the 2% goal to be achieved "in or around fiscal year 2015", while also assuring that the central bank will not hesitate in making "adjustments as appropriate", also in light of existing risks. Our expectation is that, with inflation still forecast at below 2% in 2016, the BoJ should step up monetary accommodation either in July, or at the latest in October, triggering a further depreciation of the exchange rate, a shift in portfolio investments towards riskier asset classes, and an acceleration in credit growth.

3. Fiscal policy: new budget and new medium-term targets, but the sustainability of public accounts is in the hands of the BoJ.

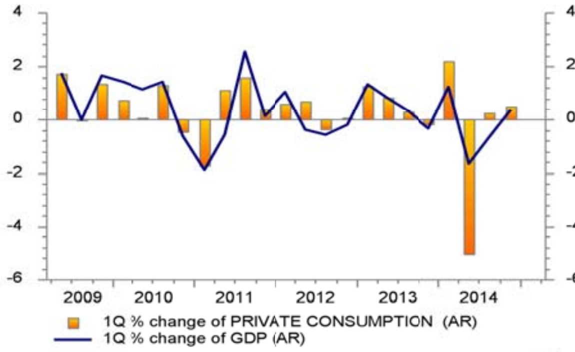
The government published its budget for f.y. 2015, and its medium-term and longer-run fiscal outlook. Based on the government's projections, the primary balance in 2015 is forecast at -3.3% of GDP, and is in line with the goal of halving the deficit compared to 2010; the overall deficit remains large, at -7.3% of GDP. In 2015, the Ministry of Finances (MoF) estimates net issuance at 36.9 trillion yen, 4.4 trillion yen (0.9% of GDP) lower compared to 2014. Net issuance will finance 38.3% of overall spending. In 2015, the BoJ will purchase around 80 trillion yen in JGBs, more than twice the government's net issuance.

Thanks to stronger growth and to the consumption tax hike, since 2009 revenues have been increasing (11.8% of GDP, a high since 1994), whereas spending has decreased moderately; interest expenditure will be 4.7% of GDP in 2015. The debt/GDP ratio budgeted by the government is 233.8% in 2015. Given the postponement of the second VAT hike to 2017, the 2015-16 biennium is unlikely to bring "active" fiscal consolidation, in addition to effects of the cyclical improvement and of the increase in nominal GDP, also due to stably positive inflation.

Medium-term forecasts place the primary deficit/GDP ratio in 2020 at -1.8%, in an "economic recovery" scenario (with real growth in excess of 2%), and at -3% in a "baseline" scenario (with real growth in line with potential, estimated at around 0.5%). The government has indicated that by the summer a fiscal plan will be presented, geared to achieving a positive primary balance in 2020. The measures that should be announced in the summer of 2015 are unlikely to result in a significant improvement of the public accounts path. The sustainability of Japan's public debt is in the hands of the BoJ, on two fronts. On the one hand, is it crucial for inflation to stay positive to push up the denominator of the debt/GDP ratio. On the other, the on-going, rapid increase in the share of JGBs held by the central bank must continue to allow increasing monetisation of debt, that is essential in keeping the private sector solvent.

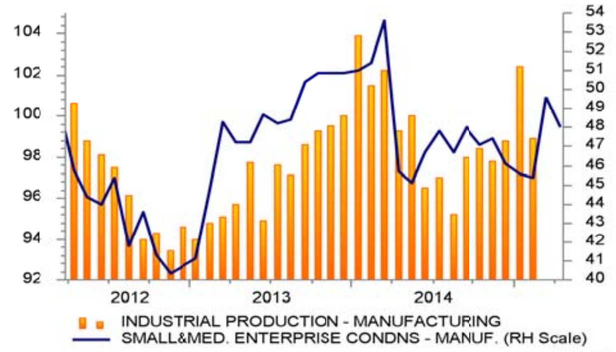
Therefore, between 3Q and 4Q 2015 we expect the BoJ to announce further monetary accommodation, whereas fiscal measures are unlikely to prove path-breaking.

Fig. 1 – GDP has resumed growing, but consumption remains weak



Source: Thomson Reuters Datastream

Fig. 2 – Industrial output and manufacturers' confidence are recovering

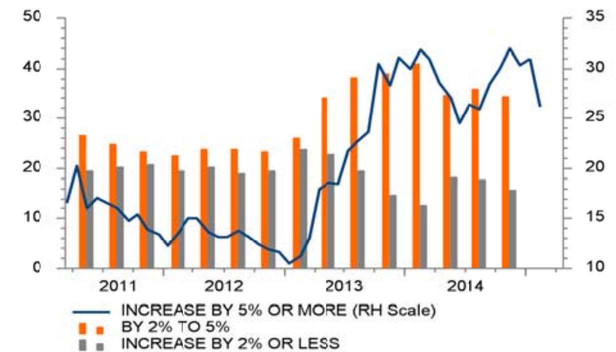


Source: Thomson Reuters Datastream

Fig. 3 – Weak yen driving exports, lower oil prices slowing imports

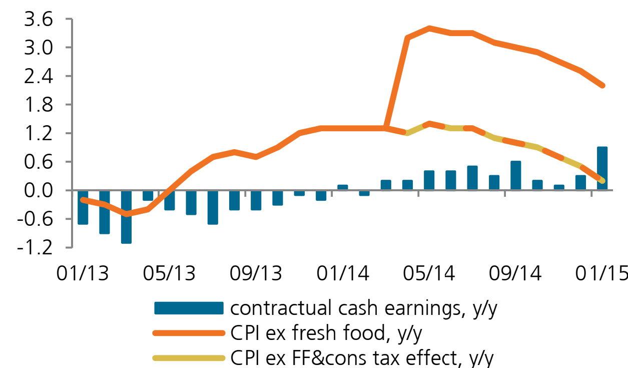
Source: Thomson Reuters Datastream

Fig. 4 – Inflation expectations of households now excessively high



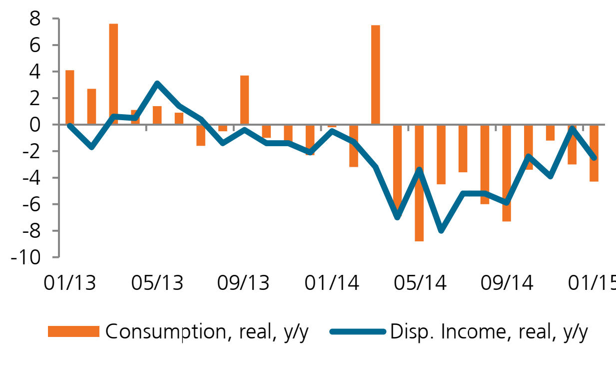
Source: Thomson Reuters Datastream

Fig. 5 – Wage growth accelerating, should outpace inflation starting in the spring



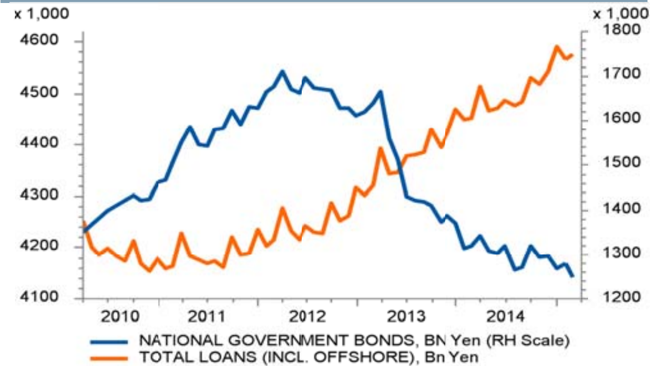
Source: Ministry of Internal Affairs, Intesa Sanpaolo elaborations

Fig. 6 – Consumption and disposable income markedly negative in real terms, following the fiscal shock of April 2014



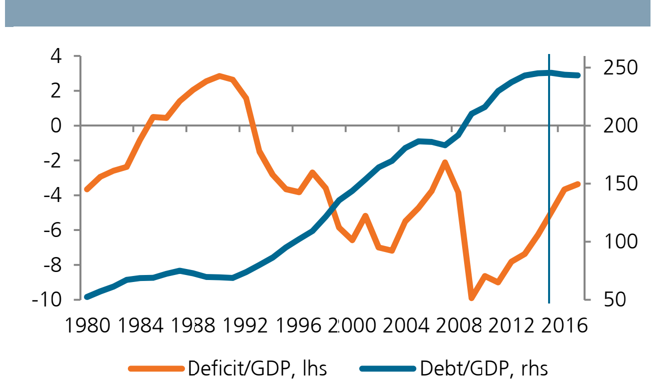
Source: Intesa Sanpaolo estimates and elaborations on Bloomberg data

Fig. 7 – Reallocation of banks' assets: loans up, government bonds down



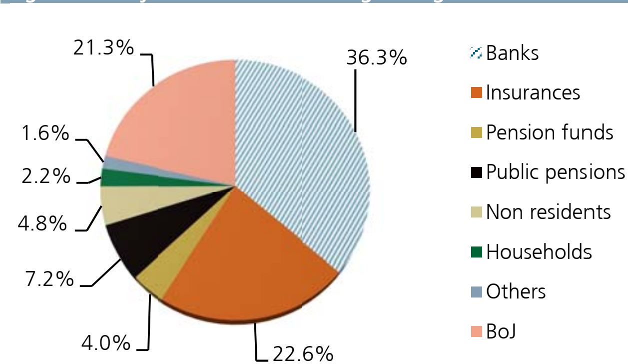
Source: Thomson Reuters Datastream

Fig. 8 – Debt/GDP ratio should stabilise in 2016



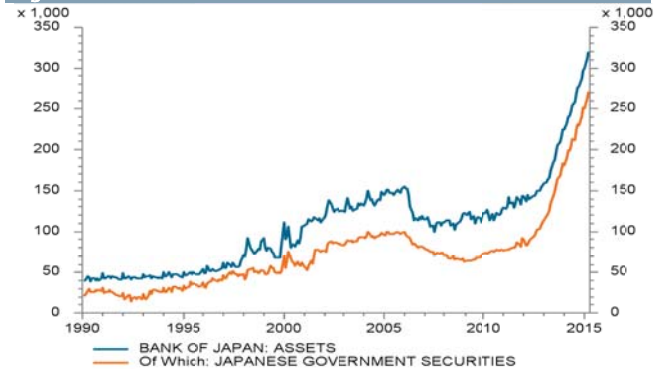
Source: IMF. IMF forecasts for 2015-17

Fig. 9 – JGB by holders: BoJ's share growing fast



Source: Ministry of Finance, data as of September 2014

Fig. 10 – BoJ assets in excess of 60% of GDP



Source: Thomson Reuters Datastream

China: striving for balance under the *new normal*

Silvia Guizzo

- GDP grew 7.3% yoy in 4Q, unchanged from 3Q but slower in qoq terms (1.5% versus 1.9% qoq). This took growth at the end of 2014 to 7.4%, slightly above our forecasts (7.3%). Private consumption, although slowing moderately, rose 7.8% on the back of a rise in real wages in both urban and rural areas. For the fourth consecutive year, private consumption growth outstripped GDP, helping raise total consumption share of GDP to 51.2% from a low of 48.2% in 2010. The slowdown in fixed investments was more pronounced, but their contribution to growth was still positive, despite dropping to 3% from 4% in 2013; foreign trade made a slightly negative contribution. The January and February data, which are difficult to interpret and are published cumulatively to remedy the volatility arising from the varying date of the Chinese New Year holidays, were lower than expected and show that the economy is still slowing.

- Industrial output slowed to a low of 6.8% ytd yoy in February (Fig. 1). The PMI index is still below 50 for small and medium-sized businesses, and only marginally above for large ones; total orders improved slightly but foreign orders remain weak (NBS) or are declining (Markit). Imports of goods for assembly and re-export slowed at the end of the year (-1.5% 3m yoy to February, Fig. 3), although their pace of growth has improved compared to ordinary goods (-18.8% yoy), which were driven down by the drop in the price of oil and industrial raw materials. Imports of industrial raw materials increased slightly in volume terms, with the exception of carbon (Fig. 4), in line with the target of reducing more polluting energy sources and with the acceleration in investments in infrastructure for storage and transport (+21.3% yoy in February). Investments in the manufacturing and property sectors, on the other hand, continued to slow (Fig. 2), contributing to a further deceleration in total investments (from 15.7% cum. yoy in December to 13.7% cum. yoy in February). Exports benefitted from a strong base effect to post substantial growth, particularly exports of ordinary goods (+20.9% cum. yoy in February) and exports to the ASEAN-6 region (+32.7%). Our assumption is that the rebound is only temporary, given the PMI of Asian countries (which is only just above 50), the recent slowdown in US and Japanese retail sales and the sharp appreciation in the effective exchange rate (Fig. 7).

- Growth in retail sales were basically stable in mom terms still supported by cars, domestic appliances and electronic equipment but slowed (+10.7% cum. yoy in February versus 12.0% cum. yoy in December) in yoy terms. Consumer confidence, as measured by the National Bureau of Statistics, is on the rise and near 2011 highs, but other measures showed a sharp fall from the year end (Fig. 5). The unemployment rate was unchanged at 4.1% and the ratio of labour demand to supply is still over 1 and rising. The Manpower survey for 2Q indicates a 9% increase in hiring intentions, which is in line with the previous two quarters but the lowest since 2009. Input and production prices continue to drop (-4.8% and -5.9% yoy respectively in February), helped by falling raw material prices. However, consumer price inflation rose to 1.4% yoy in February because of the seasonal surge in food prices, recreational services and transport linked to the Chinese New Year. Core inflation also rebounded, to 1.6% from 1.2% in January, due to increases in utilities and telecommunications and an unfavourable base effect. Inflation as an annual average is expected at around 1.5% in 2015; it should stabilise at current levels in the first part of the year, then rise in line with the increase in oil and administered prices.

- The central bank trimmed 50 bps off the reserve requirement ratio for big banks at the beginning of February to 19.5%; it made another 25 bps cut at the end of February, after a 40 bps cut in November, to take the one-year lending rate to 5.35% and the deposit rate to 2.50%. The deposit rate ceiling was further raised from 120% of the benchmark to 130%, in line with the objective of gradually liberalising rates before introducing insurance on deposits.

- Outstanding loans by banks accelerated for the fourth consecutive month to 14.3% yoy in February, thanks to the boost provided to new lending by the loosening of monetary policy and by the seasonal increase early in the year due to the allocation of new quotas. Total social financing was stable, held back by the substantial drop in fiduciary and business-to-business loans (which were hindered by more stringent regulation), but supported by the substantial increase in bond and equity issues. Despite the cuts and liquidity injections, money market rates still rose from their mid-November levels (Fig. 8), albeit to a lesser extent in the longer maturities; as a result, the monetary and swap curves flattened. We do not believe that the acceleration in new lending will be sustained, given the substantial scaling down of the target for nominal investment growth to 15% in 2015, compared with a target of 17.5% in 2014 (although the new target is actually stable compared to the effective rate of 15.7%), and an indicative reduction of M2 growth from 13% to 12%. In light of the current slowdown, unchanged money market interest rates and difficult financing conditions for businesses, we expect the PBOC to make another 50 bps cut in the reserve requirement ratio and another rate cut in the second quarter.
- The renminbi continued to depreciate against the dollar, shedding 2.7% from the beginning of November to mid-March, despite the PBOC selling foreign currency in December and January. Balance of payment data show that capital flights in 2Q and 3Q only concerned "other investments", in particular because of less net bank lending, and may continue in 4Q. However, the renminbi's weakness seems more attributable to the practice of not exchanging dollar export proceeds – as evidenced by the additional increase in foreign currency deposits – pending further dollar appreciation. The effective exchange rate, on the other hand, has appreciated substantially (+12.6% in real terms since June 2014, Fig. 7), above all because of the appreciation against the yen and the euro, which will have displeased the authorities. We think the authorities will favour a small depreciation against the dollar to limit the renminbi's appreciation against other currencies, limiting one-way trends.
- The economic policy targets for 2015 for the main macroeconomic variables, as announced at the annual plenary session of Parliament by Prime Minister Li Keqiang, were revised compared to 2014, except those for the labour market. The growth target was lowered from 7.5% to 7.0%, the inflation target from 3.5% to 3%, and the foreign trade target from 7.5% to 6%. The authorities strongly reiterated their determination to push forward with the previously announced reforms, and the need to target lower but more sustainable growth, with a higher contribution from the services, high-tech manufacturing and agriculture sectors. At the same time, they confirmed greater support for household incomes, in part through larger pension and healthcare cover. But international and domestic economic conditions are more difficult than in the past, making efforts towards change more arduous. As a result, it is essential to find a balance between "what is necessary and what is possible" under the "new normal". The authorities therefore seem fully aware of the downside risks to the scenario and ready to intervene to limit the growth slowdown – especially if it were to have a visible effect on the labour market – but not to push for further acceleration.
- The 2015 public deficit target is CNY 1.62Trn or 2.3%, slightly above the 2.1% of 2014. The target for local government deficit, which will be entirely financed by bond issues, is CNY 500Bn versus 400Bn in 2014. Despite this increase, fiscal policy at local level may not be expansive at all. With the entry into force in January 2015 of the new Budget Law, all previously off-balance sheet inflows and outflows have to be recognised on-balance sheet; and local governments are no longer allowed to obtain financing through their own financial vehicles. Projects that are already underway as of 30 September 2014 are exempt from this rule; financing for them can continue to be obtained via the vehicles, but only until the end of 2015. This may lead to a tightening of financing, which in recent years was partly taken out to refinance existing debt, and therefore of spending. In part to confront this situation, the government has announced a CNY 1Trn programme of local debt swaps, which will see the replacement of some of the debt maturing in 2015 by the issuance of longer-term bonds for certain provinces.

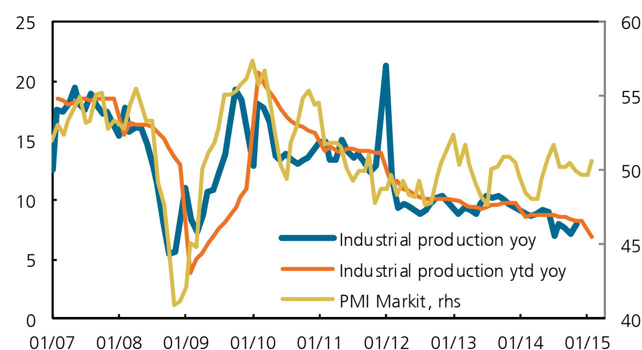
- Investments in residential construction accelerated in February to 9.5% cum. yoy from 7.9% in December. However, property prices continued to fall in most cities (65 out of the 70 monitored) at the start of the year, but particularly in second- and third-tier cities (Fig. 6), whereas first-tier ones showed a degree of stabilisation. Sales of residential property dropped by 16.7% cum. yoy in value terms in February, as did residential floor space sales. Even though lending to the sector declined only marginally, confidence among developers remains just below the lows of 2012, and the volume of residential vacant floor space remains high.
- We reiterate that a further slowdown in the property sector cannot fail to impact the economy, and therefore the labour market, given also the links with many manufacturing sub-sectors; this will dampen consumption next year. However, growth in 2015 will still be sustained by infrastructure investment, in particular in the central and western regions. The rise in non-performing loans (+42.3% yoy in 4Q; the level versus total loans rose to 1.23% from 1% at end-2013) will continue to hold back credit growth, even in the event of further rate cuts. We reiterate our forecasts of an economic slowdown to 7.1% in 2015, and revised them down from 6.7% to 6,5% in 2016, because of the weakness in investment and the deceleration in private consumption. 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	7.1	6.5
Consumer spending	8.2	10.3	9.4	8	7.8	7.5	7.3
Public consumption	11.5	12.2	5.8	7.2	7.1	6.8	6.4
Capital investment	11.3	8.7	9	9.2	8.3	5.9	5.3
Exports	26.1	4.1	3.2	5.8	5.7	7.4	8.2
Imports	19.8	6.3	4.3	8.3	7.2	5.7	5.7
Industrial output	12.7	10.6	8.2	7.9	7.3	6.6	6.1
Inflation (CPI)	3.3	5.4	2.6	2.6	2	1.5	1.6
Unemployment	4.2	4.1	4.1	4.1	4.1	4.1	4.0
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	4.6	5.1
USD/CNY exchange rate (average)	6.77	6.46	6.31	6.15	6.16	6.32	6.22
Current account balance (CNY bn)	1603.7	874.1	1360.1	1124.3	1321.1	2601.2	2881.8
Current account balance (% of GDP)	3.9	1.8	2.5	1.9	2.1	3.8	3.9
Budget balance (% of GDP)	-1.7	-1.1	-1.6	-1.8	-1.8	-2.8	-3.5

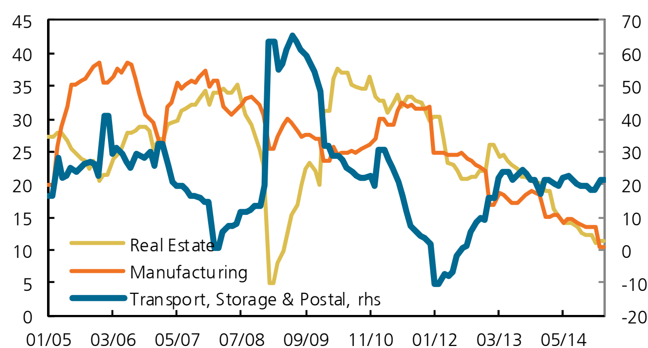
NB: Percentage change versus previous period except where otherwise indicated. Source: Intesa Sanpaolo and Oxford Economic Forecasting

Fig. 1 - Industrial output is slowing further



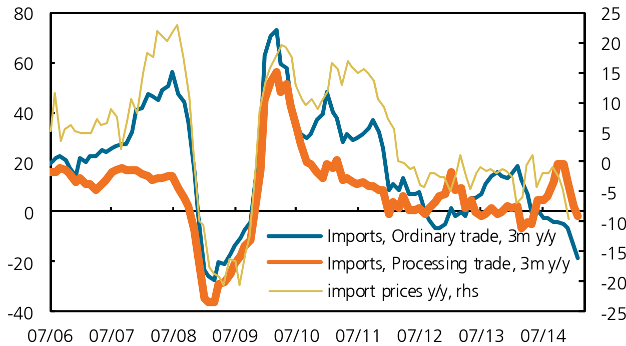
Source: CEIC, Markit

Fig. 2 - Investments by sector



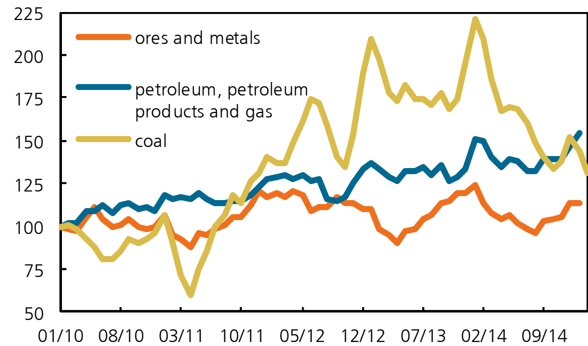
NB Cumulative nominal investments, chg. yoy. Source: CEIC

Fig. 3 - Imports affected by the drop in prices



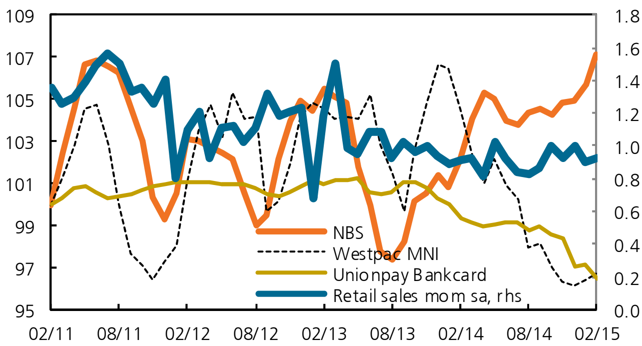
Source: Bloomberg, Thompson Reuters Datastream, Markit

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



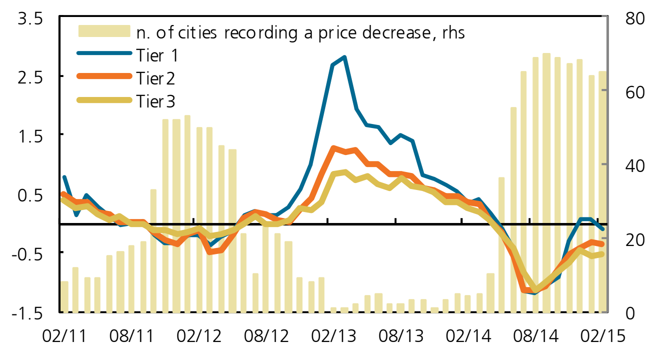
NB: Imports in tons, rebased at 01/01/2010 = 100. Source: Intesa Sanpaolo chart from CEIC data

Fig. 5 - Diverging consumer confidence indices



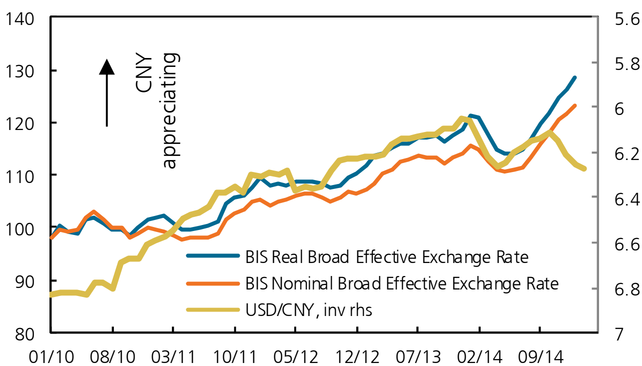
NB Confidence indices, 3-month moving average, rebased at February 2011=100. Source: CEIC

Fig. 6 - Residential property prices drop further



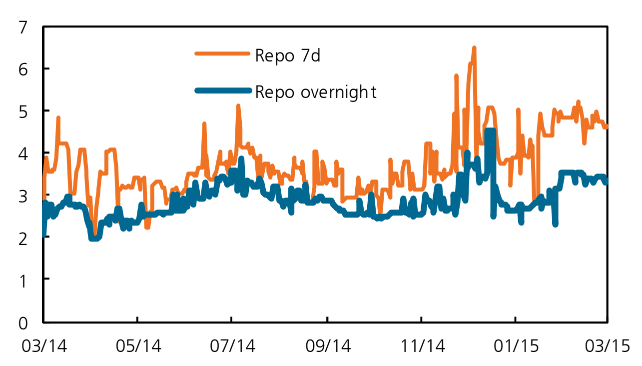
NB: Average price change mom. New-build residential properties. Source: Intesa Sanpaolo chart from CEIC data

Fig. 7 - Effective exchange rate appreciating



Source: CEIC, *2010=100

Fig. 8 - Money market rates on the rise



Source: Bloomberg

India: new national accounts at odds with weakness in the monthly data

Silvia Guizzo

- The Statistical Office has published a new series of national accounts, changing the base year from 2004-05 to 2011-12 and adapting the methodology to international guidelines. It has also included data from the most recent household surveys and surveys of unregistered companies. The revision of GDP growth was significant (Fig. 1), especially for 2013, when it increased from 4.7% to 6.4% yoy due to higher growth of consumption and private investment. This trend extended to 2014, which closed with growth higher at 7.2%, private consumption accelerating and a positive contribution from foreign trade. On the supply side, the manufacturing sector held up well in 2014 and growth in services continued to accelerate. In future, only the annual data for net indirect taxes for the calculation of GDP at factor cost will be published, while quarterly data for GDP at value added and at market prices will be published in line with international practice.

- After the improvement in 2Q14, which lasted until the end of the year, the data for the first few months of 2015 have shown signs of a slight slowdown. Industrial output recovered at the end of the year from the lows reached in 3Q, thanks to the improved performance of capital goods output, but suffered a fresh slowdown in January (2.6% yoy vs 3.2% yoy in December); this was due partly to the fall in mining output and partly to the slowdown in the manufacturing sector. Consumer goods production improved tentatively but continues its downward trend (-1.2% yoy in January). Production of energy commodities also slowed significantly. All this is in line with the three-point fall in the PMI index between December and February, and the even more pronounced drop in the orders component (from 57.9 to 51.9). According to data from the Ministry of Commerce and Industry, both the number and value of investment proposals submitted for approval have been rising since the turn of the year. However, the Reserve Bank of India's (RBI) Industrial Outlook Survey shows a fall in confidence in 1Q, after three quarters of continued increases (Fig. 3), as well as in expectations for the next quarter. Businesses are showing a modest slowdown in both internal and external demand, with orders falling and stocks increasing. This is supported by the Dun & Bradstreet survey. Foreign trade data indicate a significant fall in both imports and exports of oil, due to falling oil prices. Exports net of oil have fallen, although by much less (-5.7% yoy in February; Fig. 5), while imports net of oil have slowed compared with 3Q but remain positive (+11.7% yoy), partly due to an increase in machinery imports. While the trend for passenger traffic is up, international cargo traffic is slowing and at a faster rate than domestic traffic. Prospects for the services sector remain good (the PMI is up for the third month in a row, to 53.9 in February), although mobile phone subscriptions remain stable and tourist arrivals have slowed. Auto sales continue to pick up, while consumer confidence remains in line with 2012 highs in 4Q but registered a slight fall in expectations.

- Consumer price inflation (new base year 2012) rose to 5.4% in February from 5.2% in January due to seasonal food price increases before the south-west monsoon season, and an increase in the price of electricity and other types of fuel. However, core inflation remained moderate at 4.2% and wholesale price inflation fell for the fourth consecutive month (-2.1% yoy in February), dragged down by the falling price of oil and raw fibrous textiles. There is no upward pressure from demand, and moreover the base effect will remain favourable until August. The expected fall in the first part of the year will be limited by the recovery in the price of oil and utilities. Inflation is expected to head back up in the second half, averaging 4.8% for the year.

- The fall in inflation has allowed the RBI to make two rate cuts of 25bps each (in January and in March), taking the repo rate to 7.5%. The central bank believes that an economic recovery is under way, although it highlights the discrepancy between the new national accounts data and the continuing weakness in the monthly data for the real economy and the further slowdown in lending, particularly in the non-food sector, which fell from 11.1% yoy in November to 9.7% yoy for all sectors. In contrast, the trend for personal loans remains stable.

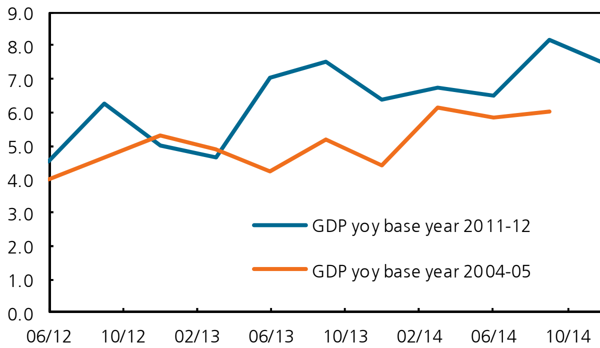
- The RBI has recently negotiated a framework agreement with the government regarding monetary policy, which defines inflation objectives more clearly as well as responsibility if these targets are missed. The RBI is committed to reducing inflation to below 6% by January 2016 and to keeping it within the range of 4%+-2% for FY 2016-17 (April-March). The December guidelines on monetary policy, which saw the Central Bank ready to loosen policy only if inflation showed a clear downward trend and if the target of consolidating the public accounts was maintained, remain unchanged, although further cuts will depend on the data. We think it likely that the RBI will make at least one more cut of 25bps in 2Q – and a subsequent cut if the data remain weak – before pausing.
- The Government has presented its budget for FY 2015-16, including a very optimistic forecast for GDP growth of between 8% and 8.5%. The budget contains increased investment in infrastructure, an improvement in social welfare programmes and support for the manufacturing sector. It also contains an increase in defence spending, a proposal to reduce corporate tax rates from 30% to 25% from the next fiscal year, as well as further deductions and allowances for average income taxpayers in the current fiscal year. The government forecasts a deficit/GDP ratio for FY 2015-16 of 3.9%, which is lower than the 4.1% estimated for FY 2014-15, and 3% in FY 2017-18, with the process of consolidation twelve months longer than that proposed last year. However, all this is compensated, as the RBI has observed, by higher-quality spending and by greater participation of local government. In line with devolution objectives already announced, from this year the percentage of federal tax receipts transferred to local governments will increase by 42%, although details of this are yet to be specified.
- The fall in the price of oil and the subsequent drop in imports with, and, at the same time, exports holding steady, have significantly improved the trade deficit and the current account, which fell to 1.4% of GDP in 2014 vs 2.6% in 2013. The recovery of exports and the continuing low price of oil should favour a further reduction in 2015, putting a brake on exchange rate depreciation.
- The approval of some reforms at the end of the year, the government's commitment to reducing bureaucratic restrictions and supporting investment and the accommodative monetary policy continue to support consolidation of growth in 2015. We forecast a moderate rise in GDP, using the new base year, to 7.5% in 2015 with an increase to 7.8% in 2016; this is supported by strong consumer spending and the recovery in investment, as well as by a positive contribution from foreign trade.

Forecasts

	2010	2011	2012	2013	2014	2015	2016
Gross Domestic Product*	11	6.2	4.4	6.4	7.2	7.5	7.8
Private Consumption	8.6	7.3	7.2	5.2	5.8	6.9	7.1
Public Consumption	8.4	7.9	5.5	8.5	5.5	8.3	7.9
Total Fixed Investment	17.5	6.2	-1.3	5.2	2.5	5.5	7.6
Exp. of Goods and Serv.	15.5	18.3	11.2	2.9	3.8	6.8	8.6
Imp. of goods and serv.	18.2	18.4	11.8	-6.7	-2.2	2.7	7.2
Industrial production	9.7	4.8	0.7	0.6	1.4	4.9	7.8
Inflation (CPI)	10.3	9.6	9.7	10.1	7.2	4.8	6.0
Unemployment rate (%)	6.1	5.8	5.6	5.6	5.6	5.5	5.4
Average wages	19.4	13.5	20.2	11.2	10.7	10.3	9.7
3- month Mibor (%)	6.3	9.5	9.5	9.3	9.1	8.5	7.8
Exchange rate USD/INR (average)	45.74	46.69	53.47	58.57	61.04	63.04	62.06
Current account balance (bn INR)	-2498.0	-2945.1	-4893.2	-2779.6	-2033.0	-954.2	-1874.9
Current account balance (% of GDP)	-3.4	-3.4	-5.1	-2.5	-1.7	-0.7	-1.2
Government balance (% of GDP)	-3.8	-6.8	-5.5	-5.5	-4.3	-4.3	-4.0

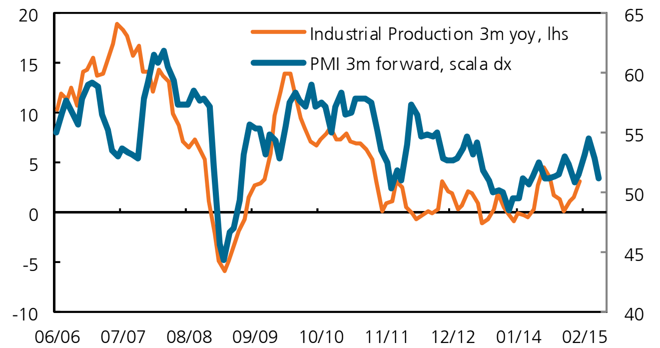
NB: Percentage changes versus previous period - except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo and Oxford Economic Forecasting

Fig. 1 - The revised GDP series takes growth higher



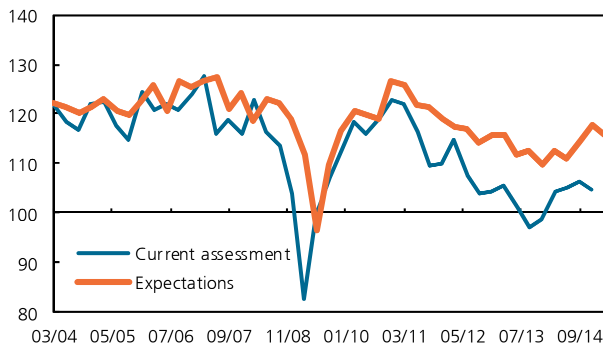
Source: CEIC

Fig. 2 – Total Orders are falling



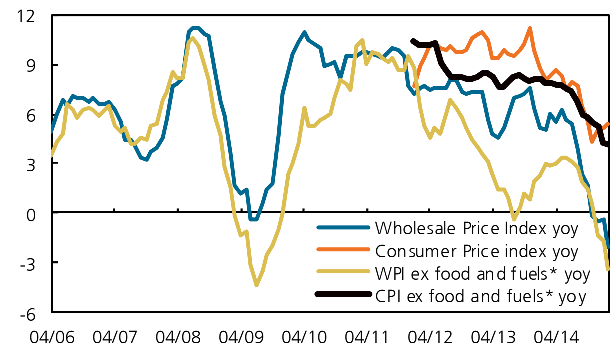
Source: Markit-HSBC, CEIC

Fig. 3 - Business confidence dipping slightly



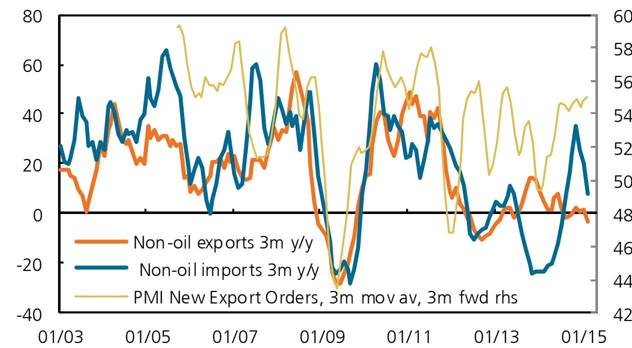
N.B.Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 - Inflation is falling



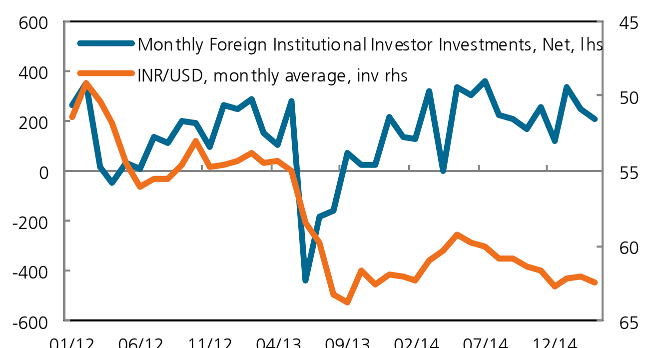
*Intesa Sanpaolo estimates Source: CEIC

Fig. 5 - Exports down, despite foreign orders holding up



Source: Bloomberg, Markit

Fig. 6 – Rupee depreciation remains moderate



Source: CEIC

Currency markets: waiting for the Fed tightening cycle

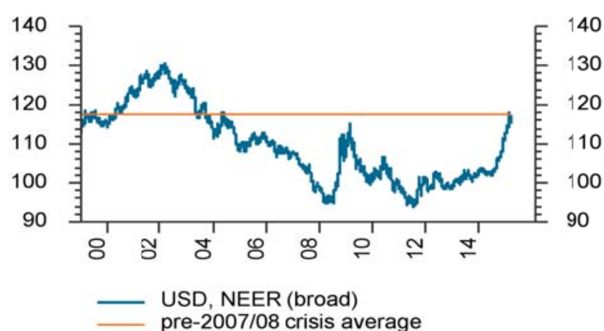
Asmara Jamaleh

The second quarter will be the last quarter before the Fed's first rate increase. The highest currency volatility should therefore be seen in this quarter, where uncertainties are greater more or less everywhere. The main uncertainty concerns the precise timing of the effective reversal of Fed rates: June, July or September? This is now the central issue in all exchange rates.

DOLLAR

The dollar started 2015 with a considerable and rapid appreciation across the board, which also lifted it above its pre-crisis levels of 2007-08. At around the time of the FOMC on March 18, however, it retreated, because the Fed, despite having paved the way, in legal terms, for a first increase in June, in fact sowed seeds of doubt that the first rise might not be in June but rather in July or September. The implied probability of rate rises, in fact, lessened, and the greenback's climb was interrupted. The current retracement is not, however, a downwards reversal, but only a pause in the trend, which should resume in the run-up to the Fed's first actual increase. At that point, rate/yield spreads will widen, both because Fed Funds are starting from zero rates (where they have been for six years) and because the other central banks will start to normalise their monetary policy after the Fed, and, generally speaking, not before next year.

Dollar: nominal effective exchange rate



Source: Thomson Reuters

Euro: nominal effective exchange rate

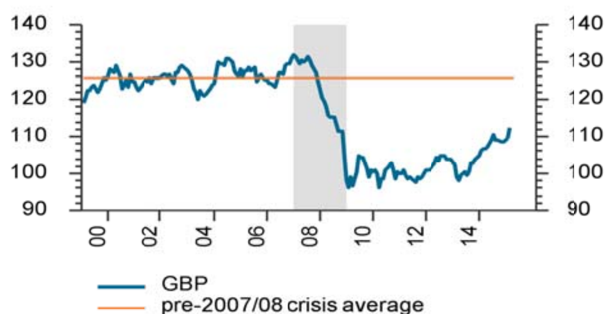
Source: Thomson Reuters

EURO

This downward trend by the dollar was particularly marked against the euro; it tumbled 14% between January and March (from 1.21 to 1.04 EUR/USD). In this case, the fall was exacerbated by the ECB's launch of QE which, by pushing yields as far down as possible (and in many cases even making them negative), further widens spreads with the US. Although the euro bounced back a few days after the March FOMC towards 1.10 EUR/USD, renewed downward pressure from the first Fed increase could again push it below 1.05 EUR/USD, with downside risks near/just below parity. Not until much later, towards the end of the year, with QE in progress and Fed normalisation under way, will the downward exchange rate phase (which started in the middle of last year) come to an end, potentially making way for a period of stabilisation, with an improvement in Euro zone fundamentals, before the start of a moderate upward trend in 2016. In the second quarter, fluctuations could remain significant, staying mainly in the 1.05-1.10 EUR/USD range, with greater upward risks in the short term, given that the US figures will generally be weaker compared to the recent past because of unfavourable one-off factors and on account of a direct comparison with the preceding month, which were particularly positive. Technically, 1.05 EUR/USD represents the normal level of retracement compared with early year values of around 1.20 EUR/USD, the 1.0875-1.1000 corridor potentially opens an upside front

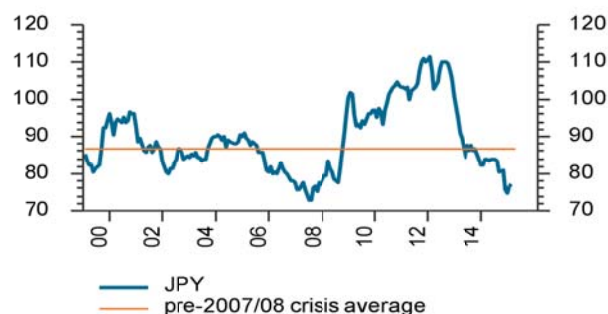
towards 1.20 EUR/USD, and the 1.0125-1.0000 range a downside front towards 0.90 EUR/USD (a hypothetical minimum in case of extreme scenarios that would be highly unfavourable for the Euro zone). The other domestic issue, which could again penalise monetary policy, is the question of Greece, which has only been partially and temporarily resolved. Except in the extreme case of an exit from EMU, this should not, however, determine the underlying exchange rate trend, but only accentuate the prevailing trends.

Sterling: nominal effective exchange rate



Source: Thomson Reuters

Yen: nominal effective exchange rate



Source: Thomson Reuters

STERLING

At the other extreme of the Euro zone is the UK. This, however, is not always reflected in an equally clear-cut divergence in exchange rate trends. Sterling alternates between phases of positive and negative correlation with the euro - in comparison with the dollar. In contrast to the ECB, the BoE should be the first to raise rates after the Fed, because growth is still very robust. In the past few weeks, however, the BoE, like the Fed, has taken a more cautious stance as to the timing of the first hike. Specifically, it once again raised the issue of the dampening effects of a strong currency on inflation. As a result, sterling weakened, dropping below 1.50 GBP/USD (with a low of 1.46), and retracing from recent new highs against the euro of 0.70 EUR/GBP. The central scenario remains an initial rise this year, in the fourth quarter, but the probability of such an event is reduced. In the short term, therefore, sterling could stay below 1.50 GBP/USD, with downside at 1.45-1.44, partly because of electoral uncertainty. The elections will take place on 7 May. May will also be important, however, because the BoE is due to publish the inflation report (13 May) with updated growth and inflation forecasts. The new inflation forecast for this year will be particularly important, because it will give a clearer measure of the BoE's position on the timeliness of a first bank rate hike this year. If this assumption holds, in the run-up to the rate reversal, sterling would probably resume its rise against the dollar, heading towards the 1.55-1.60 GBP/USD range, and hitting new highs against the euro of between 0.70 and 0.65 EUR/GBP. Against the single currency, however, this could happen even sooner, because although sterling is in a downwards phase versus the dollar, it is likely to fall by less than the euro. All in all, the sooner the Fed begins to raise interest rates, the greater the possibility that the BoE will also do the same this year.

YEN

The yen also declined against the dollar, but less than other currencies, as it was starting from a lower base. The USD/JPY exchange rate is thus meeting resistance in breaking through the 120 mark, but the central scenario remains one of further depreciation this year. The yen's new downward trend is expected to start with the Fed's first hike and would be exacerbated if the BoJ were to decide to extend QQE to prevent the pursuit of the inflation target from being

postponed further. The expected fall in the yen would thus take it towards the 125-130 USD/JPY range.

SWISS FRANC

After the SNB discontinued the 1.20 EUR/CHF floor in January, the Swiss franc settled in a new fluctuation range of around 1.05 EUR/CHF. At these levels, the SNB reiterated that the franc is still too overvalued, and that the expected path will hence be one of depreciation. The central scenario is therefore one of a gradual fall towards 1.10-1.15, within a 12M-24M timeframe. In the next few months, in particular, the lower the EUR/USD exchange rate, the more slowly the franc will slide against the euro. The SNB therefore confirmed that it will continue to intervene on the currency markets to avoid another undesirable appreciation of the franc. At the March meeting, it revised both growth and inflation, halving the former to just under 1% this year, and cutting the latter to -1.1% in 2015 and -0.5% in 2016, and forecasting a return to above zero (+0.4%) only in 2017.

CANADIAN DOLLAR

The Canadian dollar also suffered the same general depreciation against the US dollar, but the decline was exacerbated after the BoC, in a completely surprise move, cut rates. The fall in the oil price, in this case, significantly penalises growth, further delaying the economy's return to full production capacity and inflation's return to target, which the BoC expects towards the end of next year. This substantially widens the gap in the timing of when the BoC could follow the Fed in resuming rate hikes. The Canadian dollar should therefore depreciate further towards the 1.30-1.35 USD/CAD range. **The phase of greater weakness of the CAD should coincide with the start of the Fed increases.** At the last March meeting, the BoC hinted that, barring very unfavourable developments, the January cut should be sufficient. Moreover, subsequently, the Canadian economy is expected to again benefit from the positive US growth cycle, which would put an end to the CAD's depreciation phase, paving the way to a gradual trend reversal next year.

AUSTRALIAN DOLLAR

Like the BoC, the RBA also cut rates at the start of the year (February), but in this case the move was not entirely unexpected. The persistent strength of the Australian dollar exacerbates the downward pressure on growth and inflation caused earlier by the drop in commodities. **Unlike the BoC, the RBA has, however, left the door open to a further cut** in rates, if necessary, reiterating that the AUD remains overvalued. As this would happen as the Fed rise approaches, the exchange rate is expected to **further depreciate** to **between 0.75 and 0.70 AUD/USD** in the next three to six months.

NEW ZEALAND DOLLAR

The New Zealand dollar is also expected to weaken further, taking it towards the 0.70-0.65 NZD/USD range. At the January meeting, **the RBNZ, the only one to have raised rates last year, switched from a tightening bias to a neutral bias.** Subsequently, in March, it significantly revised down its inflation forecasts, and only slightly revised up its growth forecasts. **It also reiterated that the New Zealand dollar is still too strong** and that its strength helps keep inflation low. This scenario is consistent with a period of stable rates rather than the resumption of a rate hike cycle. Here too, the approach of the Fed's first rate hike is also unfavourable for the NZD.

SWEDISH KRONA

Having followed the ECB in taking its rates into negative territory, the Riksbank again cut rates in March, in a surprise move, lowering them from -0.10% to -0.25%, and extended the

programme of purchases launched earlier. The Swedish krona corrected immediately, moving from 9.15 to 9.36 EUR/SEK. The Central Bank's move happened at a meeting where policy changes are not normally decided. Last month, the Riksbank had nonetheless warned that it could also intervene between meetings if necessary. In this case, the "necessity" arose after the recent currency rebound, which had taken the exchange rate from 9.68 to 9.05 EUR/SEK in just a month. The central bank pointed out yesterday that inflation is probably already starting to reverse, but it left the door open to further monetary expansion in the coming months if required. The phase of greater Krona weakness should therefore be concentrated in the short term, between 9.40-9.50 EUR/SEK. Afterwards, however, given the positive growth scenario maintained by the Riksbank beyond the very short term, the currency is likely to stage a very gradual recovery, with an expected return to around 9.10-9.00 EUR/SEK in the next year or so.

NORWEGIAN KRONE

The Norwegian krone had depreciated sharply in December, from 8.50 to over 9.50 EUR/NOK, when the Norges Bank had cut rates. The currency subsequently recovered to 8.50 EUR/NOK, and at the March meeting, the central bank left rates unchanged at 1.25%, against consensus expectations for a further cut. In the new Monetary Policy Report, however, it revised down the growth and inflation forecasts, specifying that while developments in early 2015 were broadly in line with the December MPR's forecasts, the scenario for the next few quarters will be a little weaker. It therefore revised down the expected path for official rates, hinting that, barring particular improvements in the scenario, the probability of another cut in the immediate term (7 May or 18 June meeting) remains fairly high. The Norwegian krone thus remains exposed to a downward retracement, especially in the next three months, at just below 9.00 EUR/NOK. Subsequently, it should experience a rebound; initially this is likely to be cautious, but it will then gather steam over the following year, with an expected return towards the 8.50-8.20 EUR/NOK range.

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Appendix

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