BANCA IMI

Macroeconomic Outlook

Research Department
June 2017

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INTESA SANPAOLO

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Quarterly

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The global economy is doing better than expected

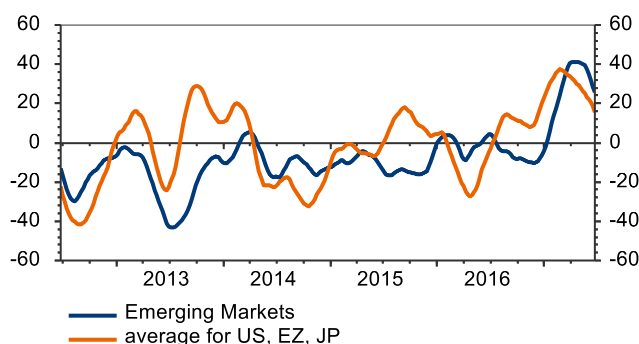
Luca Mezzomo

Those who were expecting the global economy to strengthen this year were spot on, judging by the events in the first half of 2017. Even the political risk in Europe has fallen sharply. However, we are not expecting global growth to put on another significant surge in 2018, after the uptick in 2017. First the Fed, and now the ECB is preparing to embark on the path of normalisation, although it will be undertaken very slowly, in our view. The biggest risks come from the speculative excesses in China and the unpredictable nature of the Trump administration.

The perception of political risk changed dramatically during the second quarter. After the UK's referendum on the EU, there had been widespread fears that the Brexit victory might galvanise eurosceptic movements in continental Europe into action. Conversely, the elections in the Netherlands, France and the UK showed a strengthening of pro-EU and pro-euro forces in continental Europe, especially in France, while the British Conservative party emerged from the early elections in June in a much weakened position. At the moment, opinion polls suggest that the eurosceptics will also be defeated in Germany (24 September) and probably in Austria too (15 October), where only a few months ago, they were on the verge of victory in the countries' coming elections.

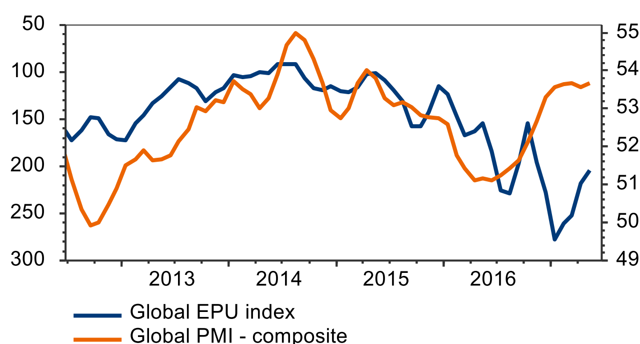
With signs that the European economy is strengthening, together with the release of the new tranche of financing to Greece, the Euro zone has largely stopped being seen as a significant source of uncertainty. Such a conclusion might be a little premature, given that the economic and monetary union is still beset by structural weaknesses (partly arising from the imbalances that member states brought with them when they joined), which could come to the fore again in a less favourable cyclical phase. But there is no doubt that the situation is now more positive than it was a year ago, and that it will stay so at least until autumn. In contrast, political risk has increased in the US, where the Trump administration, which is suffering from a serious reputational crisis, is running into many problems in implementing its domestic programme and is acting very unpredictably in the international arena. Expectations of fiscal stimulus have largely evaporated, although in our view, a tax cut is still likely to be approved by the majority in time for the 2018 mid-term congressional elections. However, measures of uncertainty regarding economic policy seem to have become disconnected from the performance of the economic cycle in recent times (see Fig. 2 on this page).

Fig. 1 – Positive economic surprise indices



Source: Chart based on IHS Markit, Thomson Reuters-Datastream

Fig. 2 – Measures of uncertainty regarding economic policy decorrelated from growth



Source: EPU, Thomson Reuters Datastream, IHS Markit

Economic data has mostly provided positive indications in the last few months, relating to both emerging countries and major advanced economies. Relatively speaking, the situation has been worse for the United States and for China, which is again showing signs of slowing. Overall, however, global economic growth has been widespread and sustained, with global trade also accelerating sharply (see Fig. B on page 5), driven by the pick-up in demand from emerging

economies after two years of weakness. Thus, global growth should actually be stronger than in 2016, just as expected at the beginning of the year. Thanks to the easing of uncertainty and the favourable data, consensus forecasts of global growth have risen by 0.1% since January for the entire two-year period 2017-18, with more substantial upwards revisions for the Eurozone and Japan. We have also upgraded our estimates, mainly on the back of the Eurozone's outlook.

Going forward, it is difficult to see how growth could accelerate much further. Fiscal policies are set to become restrictive overall in 2018, although the US could buck the trend if, as it seems likely, a tax cut is eventually approved. Monetary policies will remain accommodative, albeit less so than in 2016, and the interest rate level will generally be higher. Moreover, consumer spending will no longer benefit from improvements in purchasing power, while the rebound in commodities-exporting countries will come to an end. However, investment should be more robust in many advanced countries.

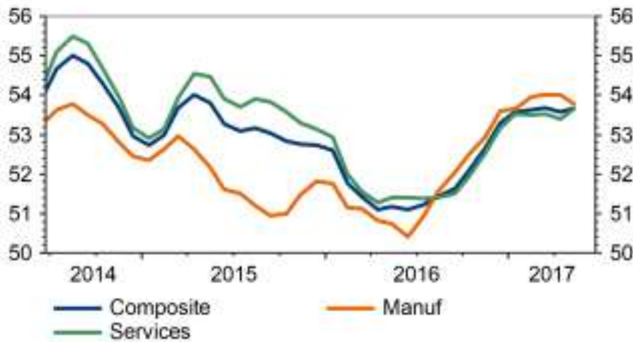
What could threaten this otherwise very rosy scenario? Firstly, energy commodity prices could resume their decline due to excess supply, again creating problems for exporting countries. This development could certainly support domestic demand in importer countries, but its destabilising effects could gain the upper hand; however, it is difficult to see how a fall in oil prices triggered by supply factors could, on its own, derail the growth phase. A much more serious risk is associated with the signs of speculative excesses in China; this relates to a credit gap (the deviation of credit growth in the non-financial private sector away from the long-term trend) of over 24% of GDP at end-2016 according to BIS estimates. These imbalances could worsen and lead to a financial crisis, for example if the economy were to slow further, triggering real (via Chinese exports) and financial transmission channels, and finally impacting confidence levels. It is likely, however, that in the short term the authorities will have the tools to stave off a full-blown crisis, which makes it impossible to assess when this risk might actually materialise if the precautionary measures were to fail. Lastly, it is possible that the Trump administration's difficulties will lead to dangerous tit-for-tat measures in the international arena or, conversely, that the tax cuts next year will be more aggressive than forecast.

It is, however, unlikely to be monetary policy that spoils the party. No-one harbours any doubts about the Bank of Japan's intention to continue with the current stimulus measures. Although the Federal Reserve has picked up the pace of rate hikes and is also preparing to scale back its policy of reinvesting maturing securities, it has nonetheless demonstrated several times that it does not want to surprise the markets and feels there is no particular urgency to complete the normalisation process. Therefore, although a further movement by the end of the year is not beyond the realms of possibility, the markets could be right in expecting a long hiatus in the series of rate hikes and, even if they were proved wrong, the margin of error would only be around 25 bps. By contrast, the markets are already expecting the ECB to announce the gradual closure of its Asset Purchase Programme (APP) by the end of the year; we think the programme will be scaled back until it is abandoned, perhaps by the end of 3Q18. However, the ECB has reiterated its intention not to raise rates until after the end of the APP, and we do not think this sequence of events will change. If, however, the markets factor in a very slow path of rate hikes, the issues will not need to be addressed until 12-18 months into the future.

In the face of such limited monetary policy interventions, exchange rates will not have any powerful drivers. In theory, monetary policy trends are likely to continue to diverge between the United States, on the one hand, and the Euro zone and Japan on the other; consequently, we think that interest rate spreads between the euro and the dollar will become even more unfavourable to the euro in the next few months. However, it is not clear whether this will be enough to offset the greater attractiveness of the European equity markets or the stimulus generated by the ECB's monetary policy announcements.

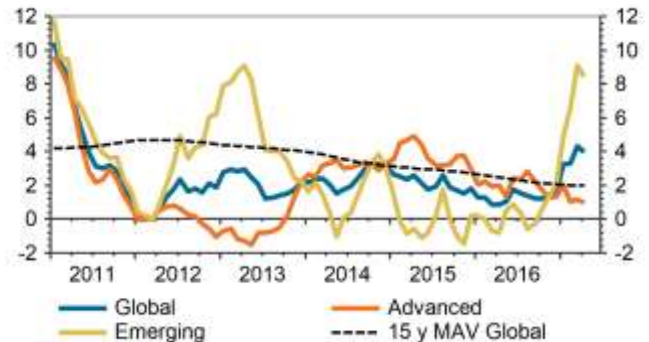
Global economic trends in 10 charts

Fig. A – Global PMIs



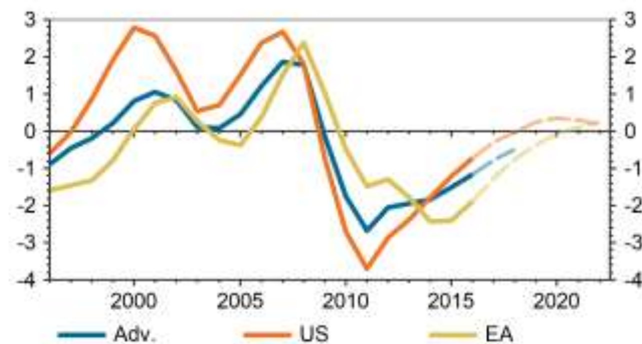
Source: Chart based on Markit Economics, Thomson Reuters-Datastream

Fig. B – Growth in imports, yoy



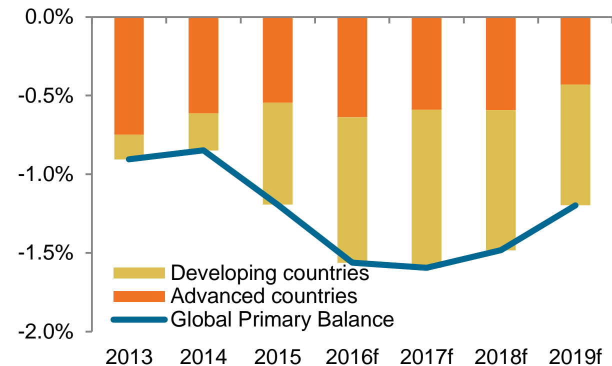
Source: Chart based on CPB World Trade Monitor, Thomson Reuters-Datastream

Fig. C – Output gap (IMF estimate)



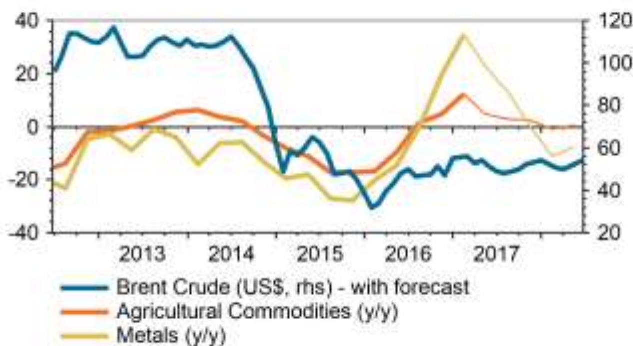
Source: Chart based on Thomson Reuters-Datastream and IMF

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



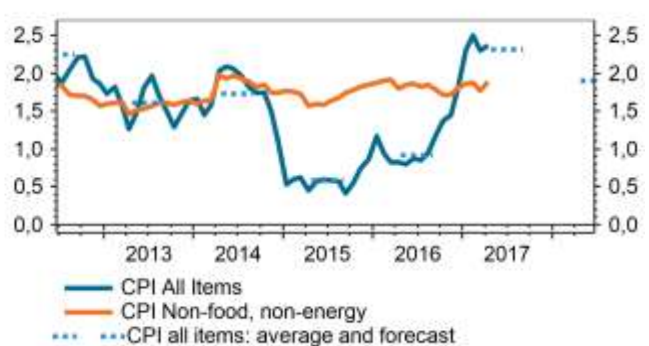
NB: based on 11 major advanced countries and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



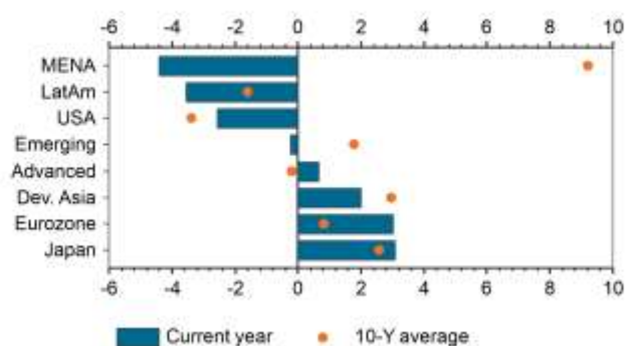
Source: Chart based on Thomson Reuters-Datastream and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



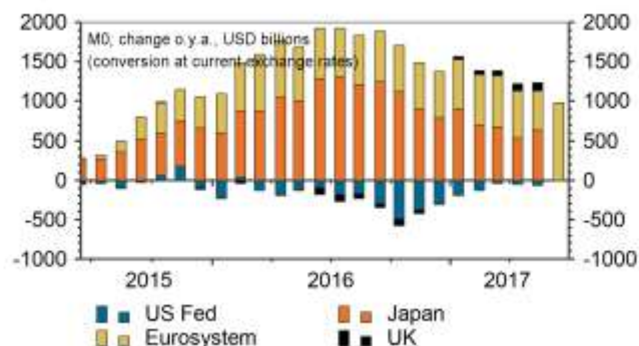
Source: Chart based on OECD, Thomson Reuters-Datastream

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



Source: IMF data and estimates, chart based on Thomson Reuters-Datastream

Fig. H – Monetary base, G3 (change, USD Bn)

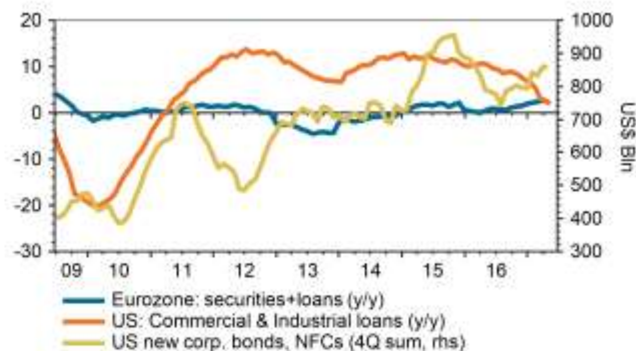


Source: Chart based on Thomson Reuters-Datastream, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average

N.B.: The aggregate includes 44 advanced and emerging countries. Source: Chart based on Thomson Reuters-Datastream and Oxford Economics

Fig. J – Lending to non-financial companies



Source: Chart based on Thomson Reuters-Datastream, ECB, Federal Reserve

Tab. 1 – Economic growth by geographical region

	2015	2016	2017F	2018F	2019F
United States	2.6	1.6	2.1	2.5	2.3
Japan	1.1	1.0	1.2	0.9	0.7
Euro area	1.9	1.7	2.0	1.7	1.5
Eastern Europe	-0.1	1.3	2.0	2.4	2.7
Latin America	-0.8	-1.0	1.9	3.0	3.2
OPEC	1.0	0.8	1.2	3.3	3.5
Eastern Asia	6.9	6.7	6.5	6.1	6.0
Africa	7.5	7.9	7.4	7.6	7.4
World	**3.2**	**3.0**	**3.6**	**3.8**	**3.7**

Source: Thomson Reuters Datastream; forecasts: Intesa Sanpaolo.

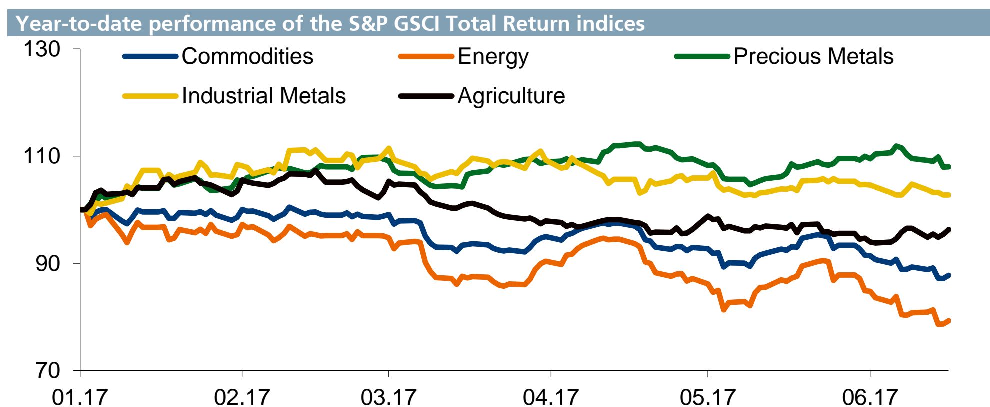
Commodities: risk-off

Daniela Corsini

The macroeconomic scenario is still favourable, and the supply and demand fundamentals for many commodities, especially the industrial segment, are still positive. However, at the moment we see risk aversion as the main brake on the segment: the financial markets are maintaining a risk-off stance on commodities due to the recent deterioration in oil fundamentals, political risks in Europe, the US and Brazil, and the escalation of geopolitical risks in the Middle East.

In the second quarter, nearly all the commodities lost ground, with only the precious metals segment recording positive returns; this was driven up by gold, on the back of strong demand for safe haven assets, and palladium, due to expectations of a growing deficit.

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



Source: Intesa Sanpaolo chart based on Bloomberg data

The worst sector was energy, which was adversely affected by fears that growth in non-OPEC countries' supply could more than offset the OPEC cuts, and by the continuously high level of global stocks.

Industrial metals suffered from the more negative market sentiment towards China: some macroeconomic figures, which were less brilliant than expected, and the first Moody's downgrade since 1989, fuelled speculation that the economy could slow and that the reforms will not be enough to stave off an increase in debt. Although the apparent consumption of metals has remained at satisfactory levels in China, and the fundamentals for some metals have even strengthened in the second quarter, prices have decreased due to profit-taking and greater risk aversion by investors.

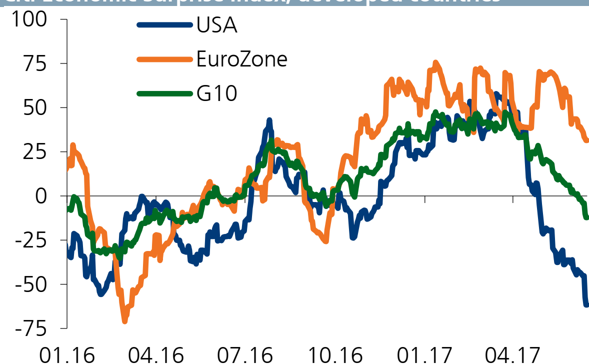
The prices of agricultural commodities have fallen for various reasons: abundant global stocks (cereals); a temporary but sharp increase in supply by Brazilian producers to take advantage of the devaluation of the Brazilian real against the US dollar (coffee, soybeans, orange juice); the devaluation of the UK sterling (cocoa); and the generally good weather (wheat).

However, the macroeconomic environment is still favourable for commodities: global growth is expected to accelerate and will be driven by emerging countries, which tend to have economic models based on a more intensive use of commodities. Meanwhile, pro-cyclical fiscal policies will be maintained and the infrastructure in India and China will be further developed and, lastly, global liquidity will remain plentiful thanks to the continuation of accommodative monetary policies.

As the Citigroup economic surprise indices show, momentum has sharply deteriorated in the last few months, but several indexes remain positive in both the emerging countries and the developed

countries (with the significant exception of the US). In China, the macroeconomic data have, so far, confirmed a scenario of an overall stabilisation of the economy.

Citi Economic Surprise Index, developed countries



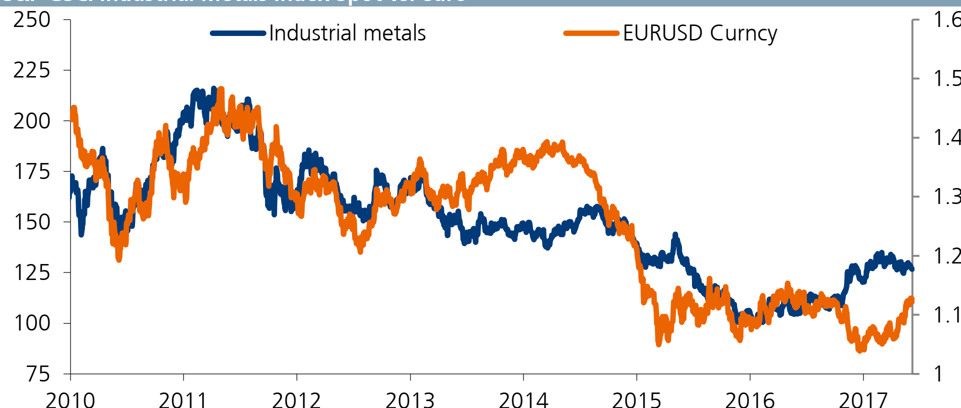
Source: Intesa Sanpaolo chart based on Citi Bloomberg data

Citi Economic Surprise Index, emerging countries

Source: Intesa Sanpaolo chart based on Citi Bloomberg data

Lastly, in our baseline scenario, we are sticking with our forecast of a slight weakening of the US dollar in the second half of 2017. Any upside risks to the dollar, which are mainly concentrated in the middle of the year, are due to the temporary divergence of monetary policy between the US and Europe and the risk of a higher demand for safe haven assets.

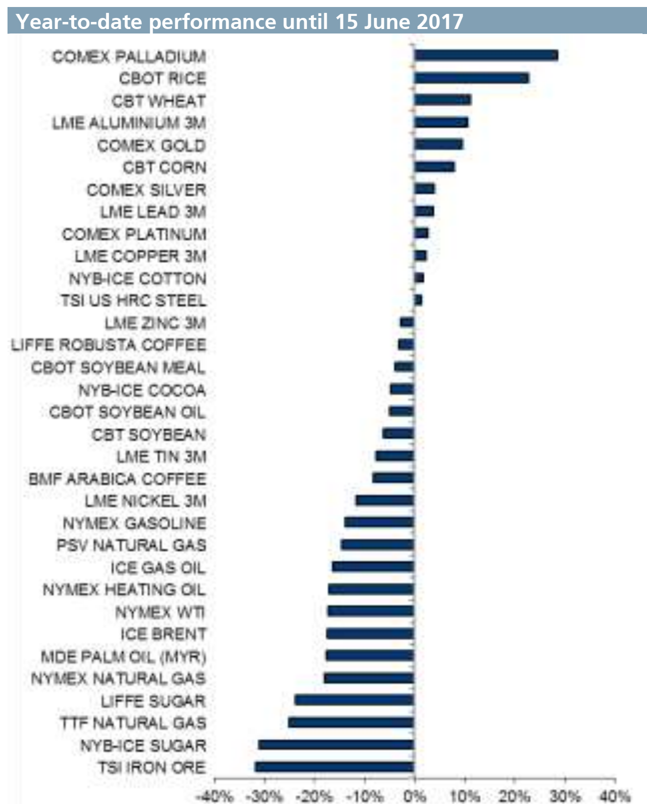
S&P GSCI Industrial Metals Index Spot vs. euro



Source: Intesa Sanpaolo chart based on Bloomberg data

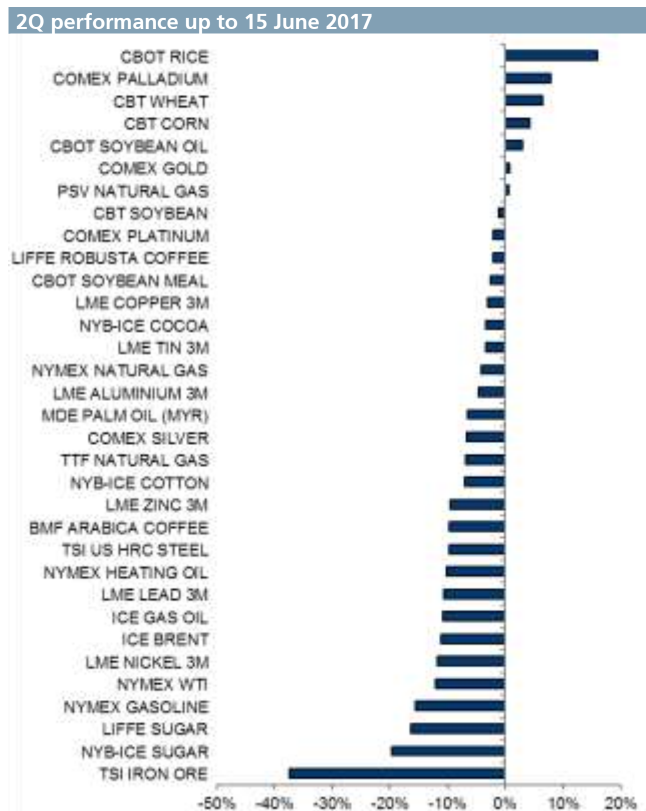
In this favourable macroeconomic scenario, however, we currently see risk aversion as the main brake on the segment: the financial markets are maintaining a risk-off stance on commodities due to increasing negative sentiment regarding crude oil, political risks in Europe, the US and Brazil, and the escalation of geopolitical risks in the Middle East. In addition, the high correlation between commodities and inflation is triggering a vicious circle that is stoking pessimism towards the sector.

Year-to-date performance until 15 June 2017



Source: Intesa Sanpaolo chart based on Bloomberg data

2Q performance up to 15 June 2017



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts for the commodities universe

In our baseline scenario, global economic growth will remain satisfactory, and the main emerging economies will continue to require increasing volumes of commodities, including some for allocation to strategic reserves, in order to take advantage of the relatively low prices. We assume that liquidity will remain plentiful and the US dollar will weaken slightly over the next two years. There will be no sharp deterioration in international relations and the US will not make any significant changes to current trade policies or diplomatic relations. Meanwhile the US will implement an expansive fiscal policy.

With regard to crude oil, our scenario takes the following assumptions into account: a) OPEC will meet the production target without difficulty, at least until early 2018, b) production from Libya and Nigeria will increase in line with expectations and total non-OPEC production will not be revised upwards again, despite the expected growth in shale oil supply, and c) global demand will not miss estimates. In this scenario, oil prices will struggle to exceed USD 60 per barrel, but will not stay below USD 40 per barrel for long, unless OPEC decides to abandon any ambitions it has to monitor its cumulative supply. We forecast that Brent crude oil will stay, on average, within an interval of USD 45-50 per barrel for most of the next quarter, boosted by robust seasonal consumption.

In the rest of 2017, industrial metals are likely to record price rises. Demand and supply fundamentals are still very positive and the macroeconomic scenario is favourable. The main downside risk is the financial markets' risk-off stance on commodities and a negative sentiment regarding China.

Gold is likely to benefit more than any other commodity from the demand for safe haven assets as protection against the numerous elements of risk and uncertainty weighing on the global scenario. Moreover, we expect a significant rise in demand on the physical market, especially in India. We confirm, therefore, that gold could reach our target of USD 1,300 in the fourth quarter of 2017.

With regard to agricultural commodities, the impact of weather conditions on the main cereals seems to have been positive so far, boosting their cultivation. Barring unforeseen events, we expect the commodities most exposed to Brazil (coffee, soybeans and, consequently, vegetable oils) to pick up, and virtually zero returns for maize and wheat, whose prices will be curbed by extremely high global stock levels.

Price forecasts for the main commodities

	3Q17	4Q17	1Q18	2Q18	2017	2018	2019
ICE BRENT	49.0	53.0	51.0	53.0	51.9	53.5	59.0
NYMEX WTI	46.0	51.0	49.0	51.0	49.2	51.5	58.0
NYMEX NATURAL GAS	3.15	3.50	3.50	3.10	3.23	3.25	3.00
COMEX GOLD	1,280	1,290	1,285	1,275	1,262	1,265	1,250
COMEX SILVER	17.8	18.3	18.3	18.1	17.7	18.2	18.5
COMEX PLATINUM	900	890	880	870	926	865	850
COMEX PALLADIUM	810	790	780	770	795	765	750
LME COPPER 3M	5,650	5,750	5,850	5,900	5,735	5,950	6,125
LME ALUMINIUM 3M	1,905	1,950	1,975	2,000	1,905	2,000	2,050
LME NICKEL 3M	8,980	9,055	9,200	9,500	9,400	9,600	11,000
LME ZINC 3M	2,600	2,700	2,750	2,775	2,665	2,775	2,850
LME LEAD 3M	2,155	2,170	2,180	2,200	2,190	2,210	2,250
LME TIN 3M	19,800	20,000	20,150	20,300	19,930	20,425	20,750
SGX IRON ORE	60	60	60	60	67	60	60
TSI US HRC STEEL	600	600	605	610	611	610	620
CBT CORN	364	368	375	380	367	385	400
CBT WHEAT	440	445	450	450	436	450	475
CBT SOYBEAN	940	950	950	960	965	965	1,000
MDE PALM OIL (MYR)	2,800	2,910	2,950	3,000	2,880	3,025	3,100
NYB-ICE ARABICA COFFEE	136	140	147	150	138	151	155
LIFFE ROBUSTA COFFEE	2,110	2,150	2,150	2,175	2,111	2,175	2,250
CBT SOYBEAN MEAL	305	310	312	314	313	314	320
CBT SOYBEAN OIL	33.0	34.0	35.0	35.0	33.2	35.0	36.0

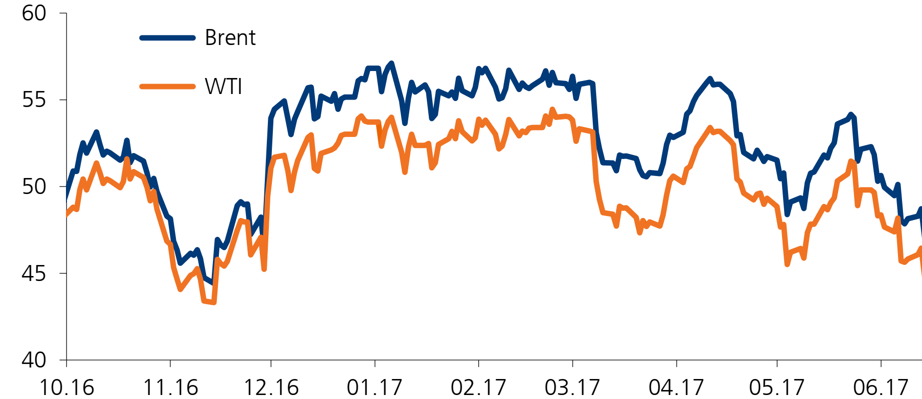
Source: Intesa Sanpaolo estimates. Iron: one-month futures contract quoted on the Singapore stock exchange and based on a basket of reference prices published by the Steel Index. Steel: The Steel Index: index calculated as the weighted average price paid for US hot-rolled coil steel trades

Oil: OPEC cuts, but shale oil continues to grow

OPEC's promise to maintain the current production cuts until March 2018 or later, if necessary, was not enough to shore up crude oil prices: the threat of continuously expanding US supply, together with global stocks that are still extremely high, are fuelling a very negative market sentiment towards the segment. The recent flare-up of tensions in the Middle East fuels geopolitical risks, making the scenario very unstable.

A nine-month extension to the current production cuts was confirmed at the long-awaited meeting of 25 May between OPEC members and its non-OPEC allies held in Vienna. The door was also left open to renew the agreement again if, in March 2018, global reserves have still not returned to their five-year average. Nigeria and Libya are still exempt, while Iran, which has been allowed to increase its supply following the removal of international sanctions, may keep its production target unchanged. Oil prices fell after the announcement, as the market was hoping for an even stronger message, such as an extension of the cuts and perhaps the removal of exemptions.

Oil prices: rally after the 30 November announcement, reversal after the 25 May announcement



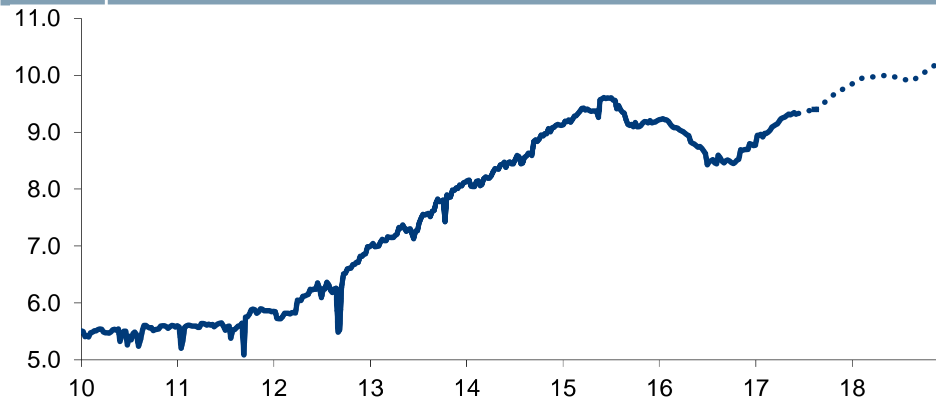
Source: Intesa Sanpaolo chart based on Bloomberg data

In our view, the reassurance that the group will do whatever it takes to bring inventories into line with the predefined target is commendable. The unity between OPEC members and Russia – all apparently behind a uniform energy policy and united in the desire to erode surplus global stocks – also seems encouraging.

However, **there are many factors that justify a cautious attitude** and are preventing prices from rising markedly:

- **growth in US production**. Non-OPEC supply will continue to expand thanks to the increase in US production of shale oil. US production is likely to breach the 10 mb/d ceiling as early as the first quarter of 2018, shattering the previous record of 9.6 mb/d set in 1970. Moreover, the first estimate of the 2018 supply and demand fundamentals, published by the International Energy Agency (IEA) on 14 June, shows that next year, for the first time since 2014, non-OPEC supply will grow more than global demand: +1.5 million of barrels per day (mb/d) vs. +1.4 mb/d. Unless OPEC's cumulative supply records a year-on-year contraction in 2018, it will be impossible for the market to remain in balance. Conversely, there is a risk that excess supply could become extremely relevant.

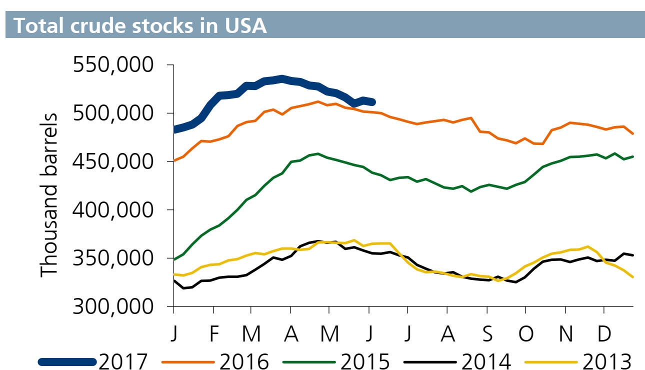
US crude production in mb/d. Dotted line: US EIA estimates



Source: Intesa Sanpaolo chart based on US EIA data

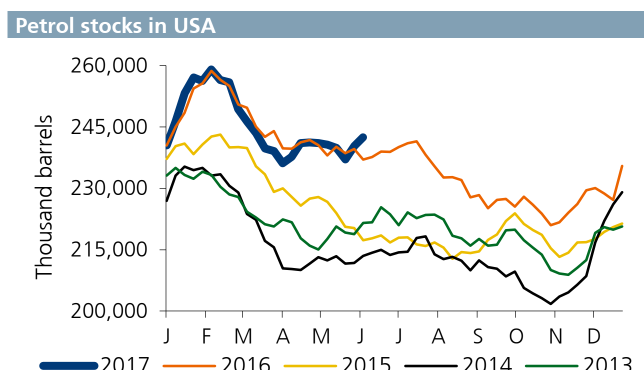
- **Extremely high stocks**. Despite the efforts of OPEC and its non-OPEC allies, OECD stocks will remain above the five-year average for many months to come, and US stocks of oil and derivative products, which are monitored weekly by both the US Department of Energy (DOE) and the American Petroleum Institute (API), are still close to their seasonal highs.

Total crude stocks in USA



Source: Intesa Sanpaolo chart based on US EIA data

Petrol stocks in USA



Source: Intesa Sanpaolo chart based on US EIA data

- Risk of lower-than-expected compliance with their agreement by OPEC and non-OPEC allies. OPEC has so far shown exceptional levels of compliance. We have no reason to believe that compliance is likely to worsen, at least as long as the main players, Saudi Arabia and Russia, have an interest in keeping the agreement in place. We believe that both countries are interested in stabilising the oil market, by encouraging the gradual erosion of global stocks, and in benefiting from relatively stable prices that would be higher, on average, than could reasonably be expected without production cuts. Added to this is the planned IPO of Saudi Aramco in 2018 (5% of the Saudi Arabia government oil company is to be listed with the first capitalisation estimates showing a range of USD 1-2 trillion: it will be the largest IPO of all time), while Russian presidential elections will also be held.

- Geopolitical tensions that might lead to the collapse of the agreement. During his first State visit to Riyadh (19-21 May), US president Donald Trump made a historic speech that endorsed a sharp change in US foreign policy. Iran is considered to be the main funder of, and therefore instigator of, Islamic terrorism, and Middle-Eastern countries are being invited to play a more active part in the war against terrorism in exchange for stronger relationships (including, and most importantly, economic relationships) with the US, and less interference in the management of domestic matters (i.e. form of government and civil rights). The first developments in this new change to the status quo have already been seen:

  - On 5 June, Saudi Arabia, the United Arab Emirates, Bahrain, Egypt and other small allied countries announced the suspension of diplomatic relations with Qatar and of many economic relationships (including the closing of land and other borders, as well as a ban on vessels flying the Qatari flag from docking at their ports) in retaliation against alleged support for terrorist groups. This unprecedented decision could mark the start of a new political phase in the Middle East. The support of the new US administration, led by President Trump, so far enjoyed by the Saudi Arabian government, could encourage the kingdom to take a more aggressive attitude towards countries or groups that maintain good relations with Iran and whose policies are less aligned with its foreign policy.

  - On 7 June, Tehran experienced terrorist attacks claimed by ISIS Jihadists for the first time in many years. Various parties in Iran immediately attributed moral responsibility for the attacks to Saudi Arabia. The message given by Iranian President Hassan Rouhani, a moderate, who was re-elected with a large majority on 22 May, underlines the importance of national unity and regional and international cooperation to fight the common threat of Islamist terrorism. However, there is still a serious risk that an escalation of tensions between the two main powers in the region (Saudi Arabia and Iran) could become so severe that it would endanger any possibility of cooperation, including the coordination of energy policies, and thus lead to the collapse of the OPEC agreement.

Supply and demand fundamentals

In its monthly update published on 6 June, the US Energy Information Administration (EIA) revised its supply and demand estimates, including, for the first time, the extension of the agreement between OPEC and Russia. Assuming good compliance and the maintenance of OPEC cuts until end-2018, the fundamentals will inevitably strengthen considerably. The market is therefore likely to record a deficit in 2017 (-0.2 mb/d) and could return to a modest surplus in 2018 (+0.1 mb/d). The extremely high global stocks look set to reduce this year, but will start growing again, albeit slowly, next year.

Supply and demand estimates published by US EIA in June 2017

Estimates published in June 2017 in mb/d	Global demand	Non-OPEC Supply	US Supply	LNG OPEC Supply	Crude OPEC Supply	Call on OPEC crude*	Market Balance**
2016	96.69	58.2	8.9	6.5	32.5	32.3	0.3
2017	98.5	59.1	9.3	6.9	32.3	32.5	-0.2
Y/Y change	1.5	0.9	0.5	0.4	-0.2	0.2	
2018	100.1	60.3	10.0	7.1	32.8	32.7	0.1
Y/Y change	1.6	1.2	0.7	0.2	0.5	0.2	

NB:* "Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply"; ** "Market balance = OPEC crude supply - Call on OPEC crude" Source: Intesa Sanpaolo chart on US EIA data

Growth in US shale oil production (+0.5 mb/d in 2017 and +0.7 mb/d in 2018) represents the main threat to OPEC's efforts. In addition, as mentioned earlier, the scenario outlined by the IEA is even more negative because it forecasts still higher growth in non-OPEC supply than in global consumption.

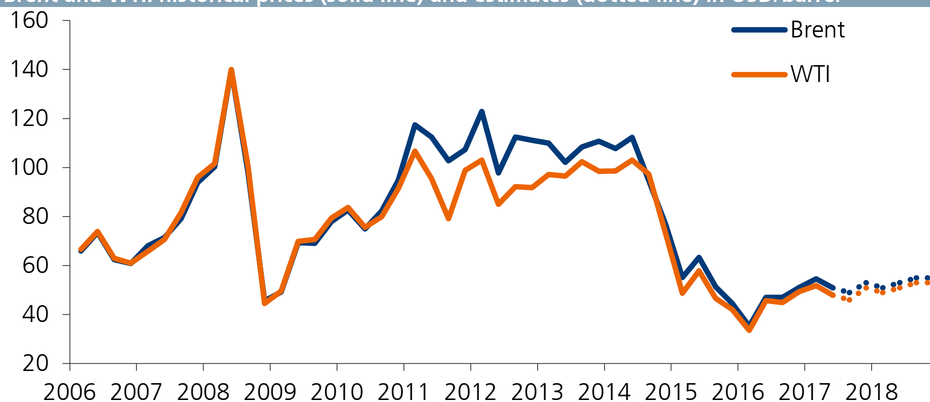
Forecasts

We believe that Brent oil will continue to trade in a relatively narrow range, at around USD 51 on average in the second half. At the moment, we see downside risks as more likely in the third quarter due to the marked deterioration in the expected fundamentals for 2018. In our baseline scenario, we do not think that crude could trade at above the USD 60 threshold, unless there are positive demand-side surprises or serious shocks to supply; this is because high prices would further stimulate production from unconventional sources, and hence increase total supply, which would justify a fall in prices thereafter. Assuming continued negative market sentiment, explained by the fact that US stocks are at all-time highs for this period of the year, we see the level of USD 40 as a significant support level for Brent.

In our baseline scenario we have included a Brent-WTI spread of around USD 3 in the third quarter of 2017 and then USD 2 until end-2018, in the expectation that, contrary to what was promised, the US administration will not change import and export taxes and it will therefore take longer for US stocks to be eroded than had been previously expected.

Lastly, it seems that many OPEC members also expect that the potential for crude prices to rise in the medium-term is limited. According to comments by the Nigerian and Iranian energy ministers, the most appropriate price range to return stability to the crude market, stimulate investment in the sector and, at the same time, support global consumption would be between USD 50 and 60 dollars per barrel.

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



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

Price estimates for Brent							
Al 15.06.2017	3T17	4T17	1T18	2T18	2017	2018	2019
ICE BRENT	49.0	53.0	51.0	53.0	51.9	53.5	59.0
Median, Bloomberg	56.0	58.0	59.0	59.0	55.5	60.2	62.0
Forward Curve	47.6	48.4	49.0	49.4	50.4	49.5	50.6

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI							
Al 15.06.2017	3T17	4T17	1T18	2T18	2017	2018	2019
NYMEX WTI	46.0	51.0	49.0	51.0	49.2	51.5	58.0
Median, Bloomberg	54.0	55.0	56.0	56.5	53.6	57.5	60.0
Forward Curve	45.2	45.9	46.4	46.8	47.8	46.9	47.8

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: the economy is in balance: what's next?

Giovanna Mossetti

The US economy is still doing "very well", as Janet Yellen said in June. Growth is just above potential, the labor market is at full employment, inflation, albeit moderate, is on track to reach 2% in a year or so. This "Goldilocks" situation is ideal, but it introduces an element of uncertainty: **what's next**? Alan Greenspan reminded us in 1997 that "there is no evidence that the business cycle has been repealed" and this still holds true: reaching a state of equilibrium, however rare, is inevitably followed by either an overheating or cooling of the economy. Herein lies the doubt that surrounds the positive assessment of the US scenario. At the end of 2016 the risks were mainly to the upside, with expectations of reflation driven by fiscal policies. Today, the risks are balanced and the fiscal reforms are more uncertain. Barring any external shocks, the economy looks set to proceed along a moderate path in 2017-18, without any excessive fluctuations, but also without a clear sense of direction, leaving it more vulnerable to both upside and downside risks. In our view, **risks of a cyclical reversal (reflationary or recessive?) will appear in 2018**.

Despite the strong increase in political uncertainty, we maintain a **positive outlook with growth forecast at 2.1% in 2017 and 2.5% in 2018**, falling unemployment, and inflation gradually rising towards 2% in 2018. The **Fed is likely to proceed along a path of normalising monetary policy**, continuing to gradually raise rates and launching a phase of reducing reinvestment in maturing securities by the end of 2017. The risks are balanced and, for the time being, mainly political.

1. Macroeconomic scenario: moderate, widespread growth. Despite moderate growth in the first quarter (+1.2% qoq, ann.), the scenario for 2017 is unchanged: GDP is set to increase at a rate of just above 2%, with moderate growth in all components of domestic consumer demand. The Atlanta Fed's **nowcasting estimate** for the second quarter puts GDP growth at 2.9% qoq ann., bolstered by consumption and non-residential fixed investment. The demand components are seen as "rotating", which will keep growth close to potential – neither too hot nor too cold.

After slowing at the beginning of the year, **consumption** is taking off again, shored up by employment income, with solid employment expansion and moderate wage growth. In 2017-2018, the contribution of durable goods to household spending growth should moderate, giving way to services and non-durable consumer goods. Thanks to the solid fundamentals of both the labour market and the public finances, **consumer spending is likely to rise by 2.5% in 2017 and 2.8% in 2018.** The **labour market** is still driving household spending. Solid **jobs** growth, at an average of around 200,000 new jobs per month in 2015-2016, slowed in 2017 (to 162,000, 1.5% yoy in May) but, as this is higher than workforce growth (+0.7% yoy), the unemployment rate fell by five-tenths of a percentage point between January and May 2017, to 4.3%.

Non-residential investment is slowing after the early-year rise, driven mainly by mining (see Fig. 3). Manufacturing surveys are still in expansionary territory. The ongoing recovery and improvement in the global cycle underpin the expected moderate growth in corporate investment, albeit in the face of considerable uncertainty regarding future tax reform. The forecasts for 2017 and most of 2018 had, however, already been formulated without considering whether the pre-election promises would be implemented, and we maintain a framework of growth in non-residential fixed investment of 4.8% in 2017 and 4.6% in 2018. **Residential investment** in 2Q is showing signs of retracement, with barely positive growth after the double-digit rises seen between end-2016 and early 2017. The forecast for this year therefore remains moderately positive (5.4%). **Net exports** are likely to make a negative contribution to growth (-0.4pp).

2. Political turmoil has stopped the reform path. Six months on from President Trump's inauguration, the only political progress made so far is in the direction of a possible launch (albeit very distant and uncertain) of an impeachment procedure against the President. Progress on the reforms has been derisory. A version of the **health reform** has been approved by the House of

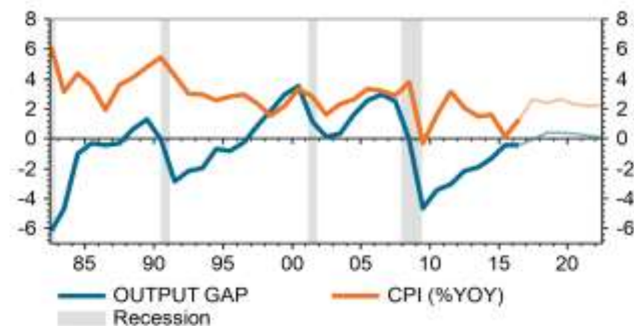
Representatives and is being discussed in the Senate. The Republican leadership is pushing for the early approval of a modified version by the Senate so that a text can be sent to the House to vote on before the Congressional summer recess at the end of July. This passage into law will still be controversial, but we think that there could be a favourable vote by the end of July, primarily due to sheer exhaustion and so that Congress can deal with **tax reform** in September when it reconvenes. On this front, time is scarce to reach a consensus on an agreed framework that will enable a law to be passed by the end of 2017. The Republicans are under pressure to achieve results: if they do not have a clear plan by the end of the year, the likelihood of a tax cut before the mid-term elections will fall dramatically. Furthermore, the issue of the **debt ceiling**, which was reached several months ago, will come to the fore again; action will be required by early September. The conservative fringe is still inflexible, and the risk – very low but not zero – of a government shutdown might have to be faced. **What has stalled the reform process?** Apart from the well-known internal split in the Republican party, the political furore over the investigation into the Trump campaign's links with Russia, and the shift of Congress' focus onto the President's role, have been significant. Trump's involvement in Russiagate increased after the sacking of the FBI director and the appointment of Special Counsel Robert Mueller. Trump's probable (although unconfirmed) inclusion in the investigation due to possible obstruction of justice has not only weakened the President's ability to lead the reforms, but could constitute the basis for the launch of an impeachment process. However, the "judicial" consequences of Russiagate are fairly uncertain and remote. Even if the outcome of the investigation by Special Counsel Mueller were to have criminal implications, this would not incriminate the President, according to accepted case law. If culpability were to be established, this would shift the focus onto the political process of impeachment. However, to launch this process a simple majority of the House is required, and this has never happened when the President's own party has had a majority. Moreover, a majority of two-thirds of the Senate would be needed to remove the President, something which is almost impossible to achieve. Even in the worst-case scenario for Trump, it is highly unlikely that an impeachment procedure would be opened before the 2018 elections. In the meantime, **the Republicans are playing things by ear, and the path of reforms will be slow and unambitious**.

3. Monetary policy: full steam ahead with normalisation. At its June meeting, the FOMC raised the Fed funds rate to 1-1.25% and announced that the programme to reduce reinvestment would be implemented "this year". The economic scenario should still justify "gradual increases" in rates: the median forecast for the next few years is for a further hike in 2017 and three in each of the two years after that. The forecast that the normalisation of rates will be "well on its way" in the next few months shifts the focus onto **balance sheet policy**. The programme outlined by the FOMC projects gradual, predictable reductions in reinvestments. Initially, repurchases will be reduced by USD 10Bn a month (USD 6Bn of Treasury bonds and USD 4Bn of agency bonds and MBS). Each quarter the reduction will increase by USD 6Bn for Treasury bonds and by USD 4Bn for agencies, until it reaches a regular pace of total reductions of USD 50Bn a month. There are still **two important details missing**: the **start date** and the **balance sheet end point**. On the desired final level of the portfolio, the FOMC only says that this will be above the pre-crisis level and "appreciably below levels seen in recent years". In conclusion, the Fed confirmed its desire to continue with monetary policy normalisation to ensure that it will be in a position to react to any cyclical reversal in the future. We forecast another **rate hike and the start of tapering** by the end of 2017. The inflation figures will affect the order of these events: the central scenario for now is for a rate hike in September and tapering in December, although if inflation is still weak in the summer, the order could be reversed.

Macro forecasts	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.6	2.1	2.5	1.3	1.7	2.0	2.0	2.4	2.0	2.1	2.4	2.4	2.5
q/q annual rate				1.4	3.5	2.1	1.2	2.7	2.2	2.3	2.4	2.6	2.7
Private consumption	2.7	2.5	2.8	4.3	3.0	3.5	0.6	2.9	2.5	2.5	3.0	2.8	3.0
Fixed investment - nonresid.	-0.5	4.8	4.6	1.0	1.4	0.9	11.4	4.4	4.5	4.0	4.5	5.1	5.0
Fixed investment - residential	4.9	5.4	5.3	-7.8	-4.1	9.6	13.7	2.5	4.2	6.5	6.2	4.9	4.7
Government consumption	0.8	-0.1	0.7	-1.7	0.8	0.2	-1.1	0.3	0.4	0.5	0.9	0.7	0.8
Export	0.4	2.3	2.2	1.8	10.0	-4.5	5.9	1.3	0.9	1.5	2.5	2.6	3.0
Import	1.1	4.3	4.4	0.2	2.2	8.9	3.8	3.7	3.9	4.2	4.6	4.6	4.5
Stockbuilding (% contrib. to GDP)	-0.4	0.0	0.1	-1.2	0.4	1.0	-1.1	0.3	0.2	0.2	-0.2	0.1	0.0
Current account (% of GDP)	-2.6	-2.6	-2.7										
Federal Deficit (% of GDP)	-5.0	-4.8	-5.6										
Gov. Debt (% of GDP)	127.6	127.4	127.2										
CPI (y/y)	1.3	2.3	2.1	1.0	1.1	1.8	2.5	2.0	2.4	2.1	1.8	2.3	2.2
Industrial production (y/y)	-1.2	2.1	2.9	-0.2	0.2	0.2	0.4	1.3	0.7	0.6	0.8	0.7	0.6
Unemployment (%)	4.9	4.6	4.6	4.9	4.9	4.7	4.7	4.5	4.5	4.6	4.6	4.6	4.6
Fed Funds	0.5	1.2	1.8	0.5	0.5	0.5	0.8	1.0	1.3	1.5	1.5	1.8	1.8
Effective exch.rate (1973=100)	91.7	94.0	95.5	89.6	90.2	93.7	94.4	93.1	94.0	94.5	95.0	95.5	95.8

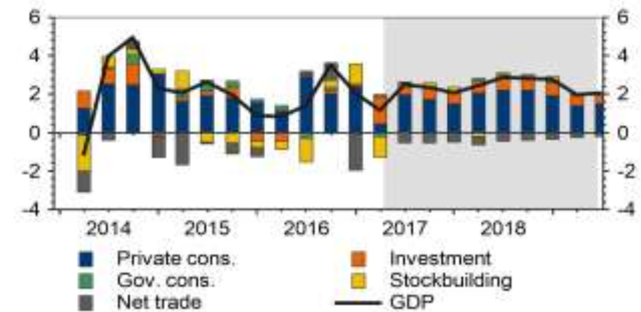
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – US economy in equilibrium: how long will this last?



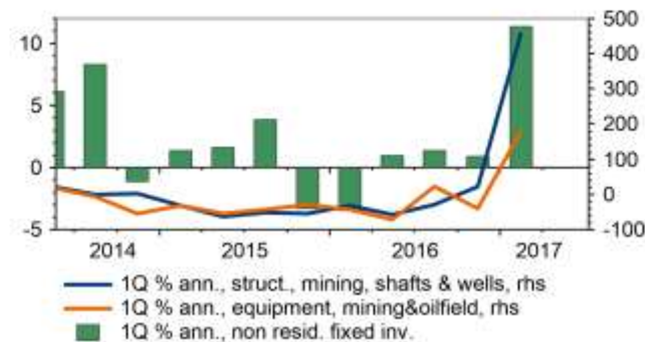
Source: Thomson Reuters-Datastream. IMF forecasts.

Fig. 2 – Forecasts of moderate growth for all components of domestic demand



Source: Thomson Reuters-Datastream

Fig. 3 – Non-residential investment rising



Source: Thomson Reuters-Datastream

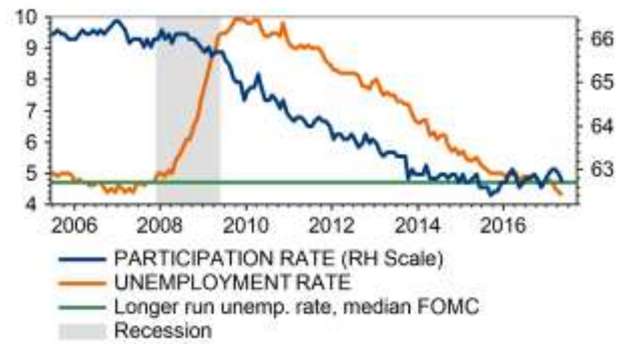
Fig. 4 – ISM: positive indications for growth

Source: Bloomberg, Thomson Reuters-Datastream

Fig. 5 – New jobs: trend remains above "normal" job creation, estimated at around 60,000 positions

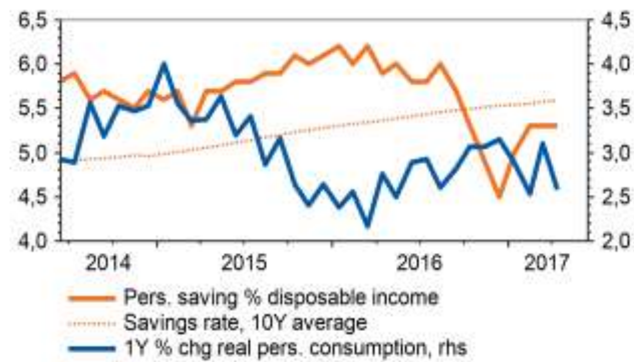
Source: Thomson Reuters-Datastream

Fig. 6 – Slack drying up in the labour market



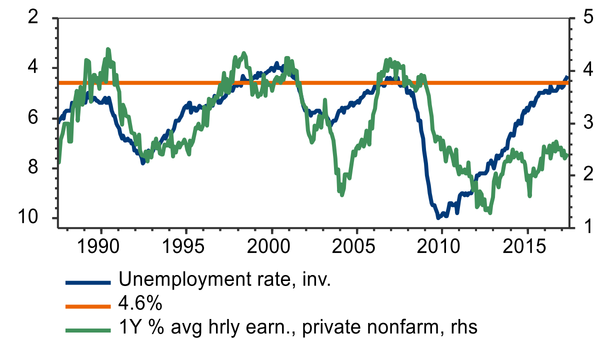
Source: Thomson Reuters-Datastream

Fig. 7 – Consumption and saving on a sustainable path



Source: Thomson Reuters-Datastream

Fig. 8 – Wage growth still very moderate

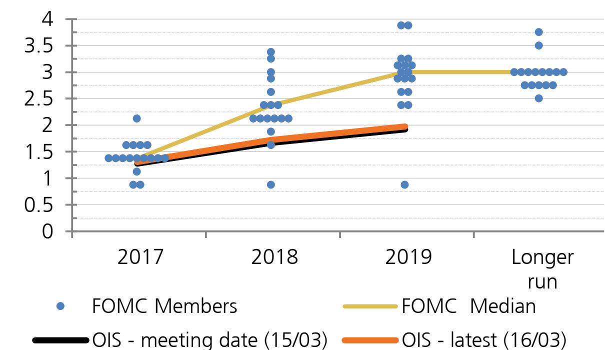


Source: Thomson Reuters-Datastream

Fig. 9 – Inflation still below 2%

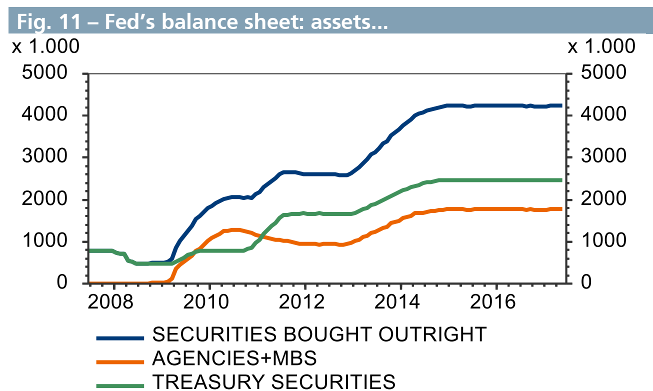
Source: Thomson Reuters-Datastream

Fig. 10 – The market still does not believe the FOMC



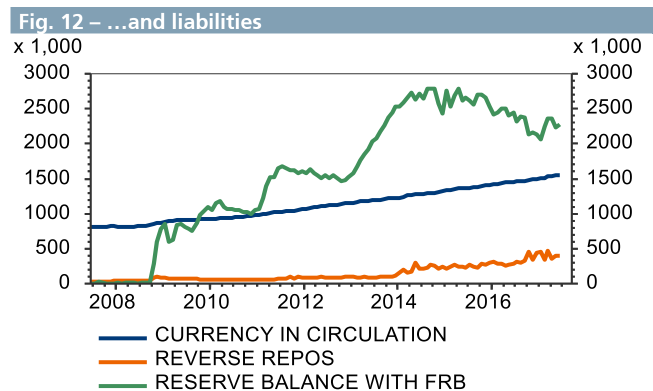
Source: Thomson Reuters-Datastream

Fig. 11 – Fed's balance sheet: assets...



N.B.: Figures in USD Bn. Source: Thomson Reuters-Datastream

Fig. 12 – ...and liabilities



N.B.: Figures in USD Bn. Source: Thomson Reuters-Datastream

Euro zone: it's almost goldilocks, partly thanks to lower political risk

Anna Maria Grimaldi

We are more optimistic about the Eurozone, not only because of the positive surprises from the data, but also due to the reassuring outcomes of the French and Dutch elections. Thus, we have once again revised our growth forecasts for 2017 to 2.0%, from 1.7% three months ago. The cycle is likely to peak between the spring and the summer, but the above-trend growth phase, which started in mid-2014, will extend to 2018 (1.7%) and 2019 (1.5%), making the current expansion the longest in the history of the single currency.

The recovery is widespread across sectors and across countries. Germany (2.0%), Spain (3.3%) and the Netherlands (2.3%) are leading, but the gap with the average is closing for France (1.5%) and Italy (1.2%) and. The pickup global trade has also given fresh impetus to industrial activity, while services and retail trade seem to have peaked. Despite the recovery in exports, domestic demand will remain the main growth driver, supported more by capex than by private consumption, set to moderate compared with the previous two years.

The recovery has been "job rich" and confidence surveys suggest that job creation will remain solid. Yet, there is some leeway before we reach full employment. The enlarged U6 unemployment rate is double the size of the ILO rate (9.5% in April) and this partly explains sluggish wages growth and, indirectly, the weakness in inflation (especially core inflation), which, in our view, will only rise more convincingly towards 1.7% in the autumn of 2018.

Political risk and, in particular, the risk of drift towards populism has fallen sharply, although it has vanished. While the German elections on 24 September are not expected to hold any surprises, the results of the elections in Austria (15 October) and Italy (early-2018) are more uncertain.

We think growth will continue to be supported by monetary policy. Oil and the exchange rate will shave off GDP growth 0.2% each this year. According to the European Fiscal Board, fiscal policy should be neutral in 2018, but the Stability Pact imposes a restriction of 0.2% of GDP.

The uncertainty around core inflation estimates justifies the ECB's ultra-accommodative rhetoric and its commitment to normalize monetary policy very gradually. The ECB will complete QE at the latest by September 2018 and will start raising the deposit rate only at the end of next year.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.7	2.0	1.7	1.6	1.8	1.8	1.9	2.1	2.1	2.0	1.9	1.8	1.7
- q/q change				0.3	0.4	0.5	0.6	0.6	0.4	0.4	0.4	0.5	0.4
Private consumption	2.0	1.6	1.5	0.4	0.4	0.4	0.3	0.5	0.4	0.3	0.4	0.4	0.3
Fixed investment	3.4	4.6	4.2	1.2	0.0	3.4	1.3	-0.1	0.5	1.1	1.5	1.1	1.0
Government consumption	1.8	1.2	1.2	0.3	0.1	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Export	2.9	4.1	3.8	1.2	0.4	1.7	1.2	0.5	0.9	1.1	1.1	0.9	0.8
Import	4.2	5.8	4.3	1.6	0.3	3.8	1.3	0.4	0.9	1.0	0.9	1.5	1.1
Stockbuilding (% contrib. to GDP)	0.0	0.5	-0.1	-0.1	0.1	0.4	0.1	0.2	0.0	-0.2	-0.3	0.2	0.1
Current account (% of GDP)	3.4	3.3	3.2										
Deficit (% of GDP)	-1.5	-1.4	-1.3										
Debt (% of GDP)	91.3	90.3	89.0										
CPI (y/y)	0.2	1.5	1.4	-0.1	0.3	0.7	1.8	1.5	1.3	1.3	1.0	1.4	1.5
Industrial production (y/y)	1.4	1.9	1.3	1.1	1.0	2.3	1.5	2.2	2.5	1.4	1.4	1.3	1.3
Unemployment (%)	10.0	9.1	8.7	10.2	9.9	9.7	9.4	9.2	9.0	8.9	8.7	8.7	8.7
3-month Euribor	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2
EUR/USD	1.11	1.09	1.13	1.13	1.12	1.08	1.06	1.10	1.09	1.11	1.12	1.13	1.13

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

Euro zone: a long expansionary cycle, even stronger than expected

This is the longest expansion since the launch of the single currency. But the economy is not yet at full employment

The first half of 2017 was surprisingly positive both in terms of economic data and on the political front. We think GDP will grow at 2.0% this year, around a half-point higher than in last December's estimates (1.5%). Confidence surveys are pointing towards a more marked expansion in the current quarter, but we maintain an estimate of 0.6% qoq[1] as in Q1 (see Fig.1). The other positive aspect of this growth phase is that the recovery is widespread across the whole area, albeit with differing degrees of intensity (see Fig. 5) and is therefore more sustainable.

Foreign demand is stronger than expected but the outlook for 2018 remains uncertain

The fresh impulse to growth is coming from **foreign trade**, which accelerated at the end of 2016 / early 2017, supporting manufacturing activity, but growth in services and retail is also continuing (see Fig. 2). Industrial output is heading for an increase of over 1.0% in June, thanks to a particularly solid trend in France and Germany (see Fig. 3). Global demand has surprised to the upside thanks to the recovery in emerging markets (see Fig. 4), and, according to global PMI indications, the trend is set to continue in the next few months (see Fig. 4). Short-term indicators suggest **more solid growth (3.5%) in foreign trade in 2017-18 compared with our forecasts three months ago** (3.0%) although still weaker than the pre-crisis period. Growth estimates for global demand in 2018 are still subject to uncertainty as the international geopolitical environment remains fragile. Recent movements in the **oil price** and new estimates for demand and supply in 2017-18 suggest a more modest rise compared with our forecasts of three months ago (expressed in euro +13% in 2017 and +2.0% in 2018). **Rising oil prices will curb GDP growth by 0.2%** this year and 0.1% next year. The **exchange rate could shave 0.1%-0.2%** from growth over the forecasting horizon. The effective exchange rate is likely to rise by around 2% by the end of 2018.

According to the European Fiscal Board, the appropriate fiscal stance in 2018 is neutral. But the SGP imposes a correction of 0.2%

Monetary policy will again provide the biggest impetus to growth, and to domestic demand in particular. In June, the ECB removed the easing bias on rates and formally started the normalization of monetary policy. Sluggish core inflation and the persistence of a negative output gap until the end of 2018 (see Fig. 12) justify a very cautious exit. In our scenario, the ECB will keep rates unchanged until end-2018 and the ending of the purchases programme by September 2018 (see the section on monetary policy), the ECB will continue to support the economy, albeit less so than in the two previous years. [2] In our view, **fiscal policy will not be able to provide support to growth** in the next few years, at least at national level. After a period of neutrality or modest easing in 2016-17, fiscal policy is likely to be tightened again according to the provisions of the Pact (see Fig.13). On 20 June, the *European Fiscal Board* suggested that a neutral fiscal policy stance would be appropriate for the Euro zone, although its recommendations are not binding. The **European Commission's latest recommendations pave the way to a more active use of flexibility**, and that allowance should be made for the need to strengthen the economy in assessing the "appropriate" structural efforts enacted by Member countries still a long way from the medium-term objective (MTO) (at least 0.5% of GDP).

Net exports to weigh on GDP growth

Foreign trade will make a negative contribution (-0.5%) to GDP growth in 2017 as, despite stronger export growth (4.1%), imports are expected to rise by 5.6% following the fairly strong trend at end-2016/early 2017. In 2018, exports should continue to rise at a sustained pace (3.8%) while imports are expected to slow to 4.3%.

[1] As we highlighted in our quarterly outlook for March 2017, to same levels for confidence indices correspond lower GDP growth compared to the pre - crisis period, due to a structural break in the series, which partly reflects lower expectations of potential growth. The European Commission has provided details on what is being defined as the "new modesty" in the 2017 Winter Forecasts.

[2] According to the ECB, the measures adopted between December 2015 and December 2016 are likely to have boosted GDP growth by 1.7% in the period 2015-18 (Draghi, press conference, 9 March 2017). See also ECB Working Paper no. 1956, 2016: *The ECB's asset purchase programme: an early assessment*. The study estimates that purchases amounting to 11% of GDP will have a maximum impact of 0.4% on inflation and 1.0% on growth after two years.

Domestic demand will continue to drive growth. The stimulus to growth will now come from corporate investment and construction spending

The **main growth driver** will still be **domestic demand** (see Fig. 6), which remains stronger than expected. While we expected a slight slowdown in domestic demand three months ago, we now forecast a stabilization at 2.0% as in 2016, and an increase of 1.8% in 2018. The **more solid growth in domestic demand rests on investment in machinery**, which finally seems to have embarked on a more dynamic cycle (see Fig. 7). Corporate spending in Germany, France and, especially, the Netherlands (+12% qoq in 1Q), accelerated sharply at the end of 2016 and early 2017. Spending on machinery in the Euro zone as a whole increased by 3.1% qoq at the end of 2016 and by a more normal 1.3% in the winter months. A combination of production capacity that is above the historical average, a fall in corporate debt, the resilience of earnings, amply supportive financial conditions and the prospects of higher demand in manufacturing, together with less political uncertainty, should ensure investment growth of 6.3% this year and 3.4% in 2018 (annual averages are affected by the volatility of the data at end-2016/early 2017). **Construction** activity is also outperforming expectations (+1.3% qoq in the winter) thanks to the contributions from Germany, Spain and the Netherlands. Our construction spending indicator points to a continuation of the expansionary phase and to an average growth in the next two quarters of close to 1.0% (see Fig. 8). **Private consumer spending**, however, looks to have peaked. Household spending could come in at 1.5% in 2017, from an average of 1.9% in the previous two years. The slowdown (see Fig. 9) is the result of the loss in purchasing power deriving from higher crude oil prices and the rise of inflation to 1.5% from 0.4% last year. Rising inflation has not been offset by wage acceleration (see Fig. 10). In early 2017, labour costs grew by a meagre 0.3% and real disposable income slowed to 1.3% from 1.9% in the previous six months. We expect labour costs to rise by 0.9% in 2017, while we may see more generous increases in 2018 as the recovery consolidates. However, **there is still considerable excess supply in the labour market**. Unemployment returned to 9.3% in April from 12.1% in 2013, but it is still above the NAIRU (see Fig. 11). The expanded unemployment rate U-6 stands at 18%, double the ILO rate. The resilience of consumption therefore depends on employment growth remaining solid, and at the same levels as in 2016 (1.4%), which we think is possible given the cyclical context.

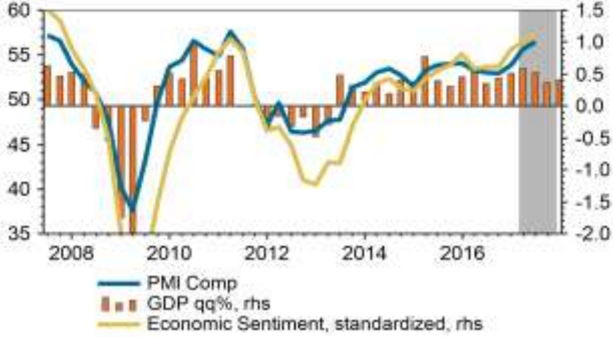
The considerable excess supply in the labour market will continue to exert downward pressure on wages

The risks are now balanced. The political turnaround in the Netherlands, and especially France, has changed the landscape dramatically

The risks to Euro zone growth have abated considerably compared with three months ago and are now balanced. The trends in the data have certainly been encouraging, but some of the change is due to the easing of political uncertainty. The results of the elections in the Netherlands, and especially in France, are better than could have been hoped for. For now, the populist drift in Europe seems to have been stemmed. In autumn, it will be Germany's turn (24 September) followed by Austria's on 15 October. In Germany, the polls suggest that the Christian Democrat-led government will be re-elected with the support of the SPD, while the populist Alternative fur Deutschland is losing ground, but will still enter Parliament. In Austria, the risk of a victory by the populist FPÖ party has fallen, although it is still one of the country's three largest political forces. It remains to be seen whether, after the German elections, the Franco-German partnership will succeed in promoting a reform process for the European Union that is consistent with the German government's speech[3] in January. The political risk will intensify again in early 2018 when Italy goes to the polls. The Five Star Movement is vying for pole position with the Democrats, and the proportional representation voting system could make it very difficult to form government coalitions. Even if the Italian elections produce an uncertain result, however, the context is more robust than in 2011. Today, a country can access ESM-funded support programmes and possibly the ECB's Outright Monetary Transactions (OMT). Moreover, Italy’s GDP growth is above trend, foreign investors have already reduced exposure and the country is a showing a substantial current account surplus, which is rapidly improving its foreign net financial position.

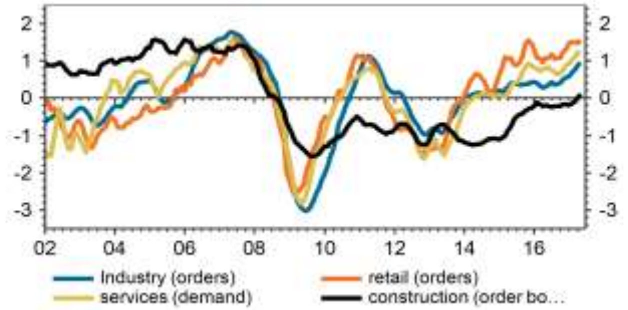
[3] See: https://en-marche.fr/article/meeting-macron-berlin-discours

Fig. 1 – Surveys point to further acceleration in GDP growth in the Spring



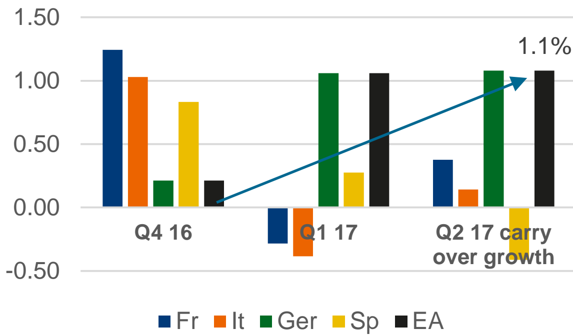
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 2 – All sectors are driving the recovery



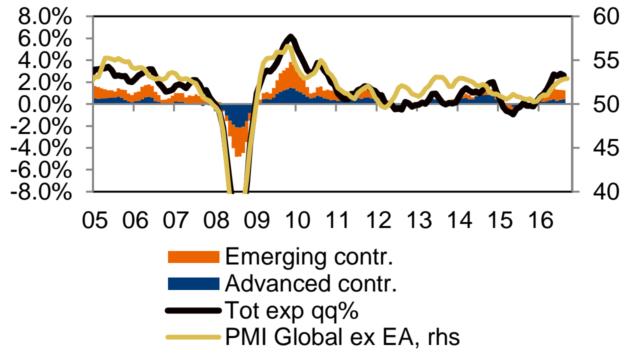
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – Manufacturing activity has stabilized at much more solid growth rates than at end-2016. The impulse comes…



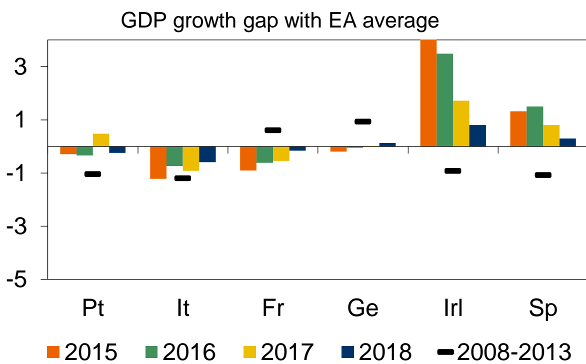
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 4 – …from exports, which should continue growing at a sustained pace in the summer



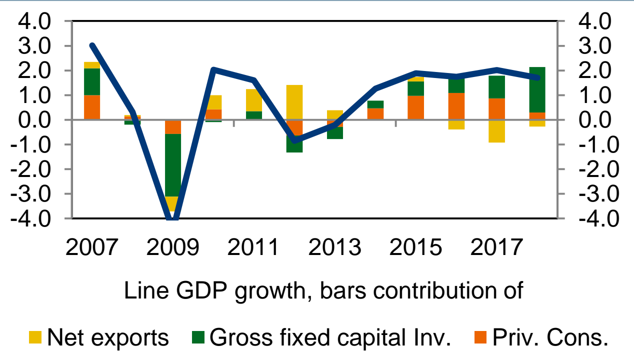
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – The recovery is widespread across countries and for many the gap with the average is closing



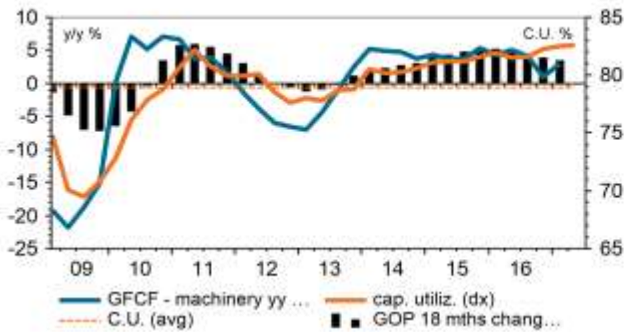
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – Growth rotates from consumption to investment



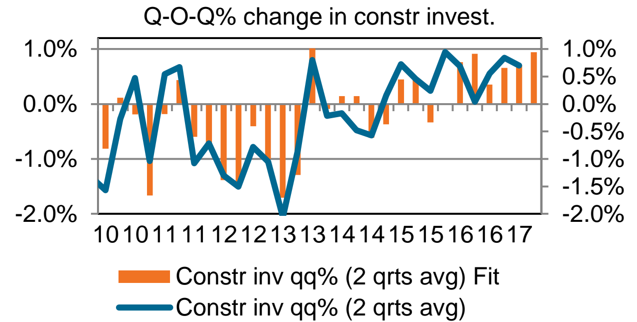
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Corporate investment has finally embarked on a livelier cycle given the solid fundamentals



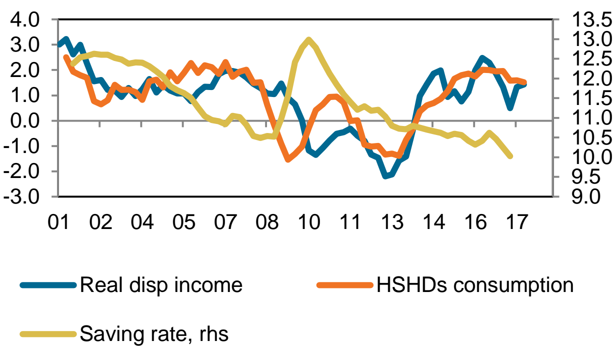
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 8 – Construction investment will also grow at a sustained pace



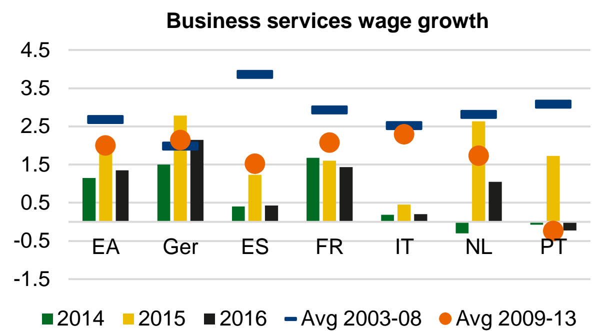
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 9 – Consumer spending has now peaked. Savings rate might only partially offset disposable income moderating due to the rise in inflation and …



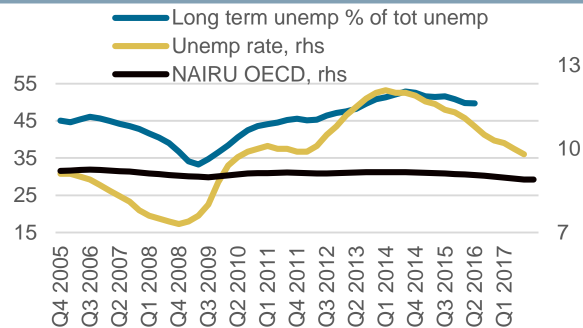
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 10 – …the inertia of wages and salaries (at least so far)



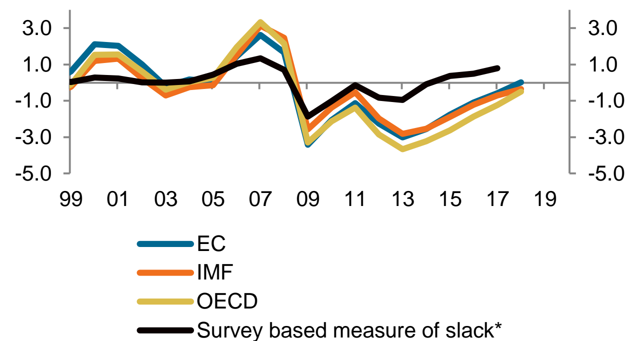
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 11 – Ample slack in the labor market partly explains wage inertia



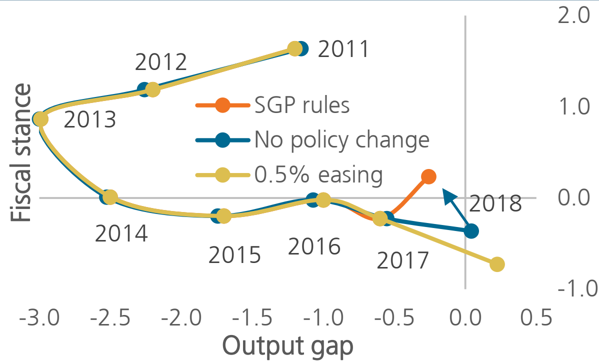
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 12 – The output gap will not return to positive territory until early 2019



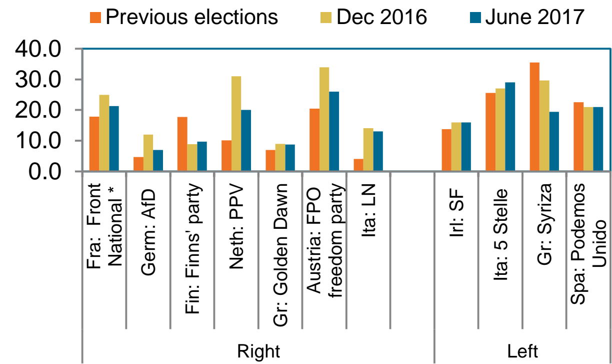
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 13 – According to Stability Pact rules, fiscal policy should turn restrictive I 2018



NB: Changes in the cyclically-adjusted primary balance. Source: Intesa Sanpaolo chart from European Commission Spring 2017 Forecasts

Fig. 14 – Populist drift has been avoided in Northern European countries



*The result for the *Front National* is that of the first round of the presidential elections
Source: Intesa Sanpaolo chart based on Wikipedia

Inflation: slow and shaky return towards target

Anna Maria Grimaldi

Consumer prices shot up to 2% in March and then fell back to 1.4% in May (see Fig. 1). The recent volatility is due to the late timing of Easter, which pushed up leisure services prices (especially in Germany) and then curbed them in April. We have trimmed our inflation forecasts by 0.1% compared with last March to: 1.5% in 2017, 1.4% in 2018 and 1.6% in 2019. Our estimates are in line with the ECB's June forecasts (revised down from 1.6% to 1.4% in 2018 and from 1.8% to 1.6% in 2019). Energy contribution will be modest over the forecasting horizon and, at the margin, could even be lower than the estimates of three months ago. We have downgraded our estimates for crude oil prices by around USD 3 per year (from USD 52 this year to USD 53 per barrel in 2018 and USD 58 in 2019). The exchange rate will curb inflation since the effective rate is expected to rise by around 1.5%. The contribution of food prices is estimated to be close to 0.2-0.3% per year, in line with the historic average.

The return of inflation towards the target depends on core inflation rising to 1.7% at the end of 2019

In our estimates, as in ECB and consensus forecasts, the inflation's rise towards 1.6% in 2019 still depends on the underlying trend, which is set to accelerate, on average, to 1.4% in 2018 and 1.6% in 2019. Core inflation is expected to rise to 1.4% at end-2018 and to 1.7% in 2019. However, core inflation estimates are still beset by great uncertainty, since although Euro zone growth has been above potential for four years now, core inflation is still stagnant. After the spike to 1.2% in March, price inflation excluding energy, food and tobacco was back to 1.0% in May, not much above its post-crisis lows (0.7%). The median average, which is calculated on a greater number of measures of underlying inflation, has also remained broadly the same as a year ago (see Fig. 2). In our estimates, core inflation will be curbed by unfavourable base effects towards end-2017 (see Fig. 3), but should gradually rise to 1.6% from September 2018.

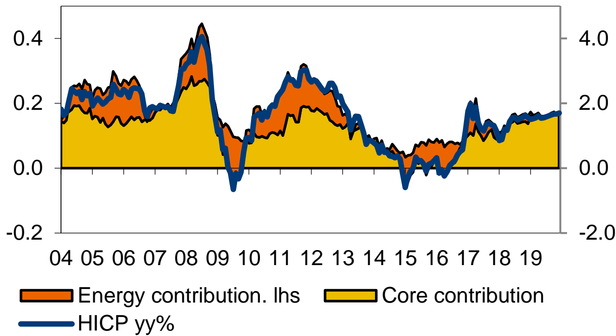
The slow rise of core inflation could be due to languishing wages, which in turn could be explained by the fact that the U-6 unemployment rate is twice the of the ILO

The ECB has regularly underestimated core inflation in the last four years, and again cut its estimates in June (from 1.5% to 1.4% in 2018 and from 1.8% to 1.7% in 2019). The causes and implications of low inflation during 2012-2016 were comprehensively explored in a recent study by the ECB[4], which concluded that the Phillips Curve model is still appropriate for explaining recent trends. Low core inflation may, in part, be due to sluggish wage growth, a surprising trend when compared with the employment figures. Around five million jobs were created from mid-2013 to end-2016, while wages grew by 1.4% in 2016, compared with 1.5% in 2015 and 1.3% in 2014, or half that seen in the period 2005-2008. One explanation is that excess labour supply is higher than that measured by the unemployment rate. It is no coincidence that the ECB has started to look at the U6 unemployment rate [5], which the Fed monitors, to understand how much potential manpower reserve is likely to be reabsorbed before we see more solid wage growth and salaries become the main driver of services inflation (see Fig. 5). The expanded unemployment rate is 18%, around double the ILO's figure (see Fig. 6). The rise in wage and core inflation may simply lagging behind. Although we recognise the uncertainty surrounding core inflation forecasts over the forecasting horizon, the risk of deflation has disappeared. Macro data show that the recovery is more solid than expected. Furthermore, the trend in price expectations, derived from confidence surveys, show that the risk of de-anchoring expectations – along with the risk of deflation – has fallen. This explains wht the ECB removed the *easing bias* on rates at its June meeting.

But downside risks are fading

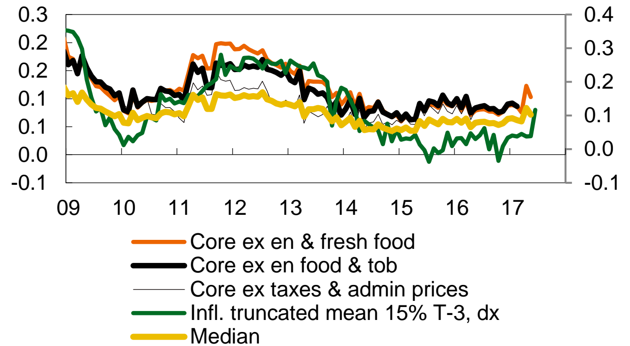
[4] See: *Low inflation in the euro area causes and consequences*, ECB occasional paper No. 18, January 2017. The study shows that over-prediction of core inflation in the last four years has cast doubt on the ability of the forecasting models to capture the impact of new structural factors that could affect domestic price inflation (e.g. demographic factors, technology innovation, e-commerce).
[5] See ECB Economic Bulletin, issue 3/2017 *Assessing labour market slack* pp. 31

Fig. 1 – The rise of inflation towards the ECB target still depends on the underlying trend



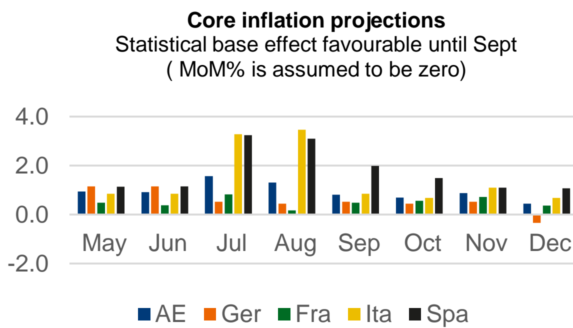
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream estimates

Fig. 2 – Core inflation still stagnant



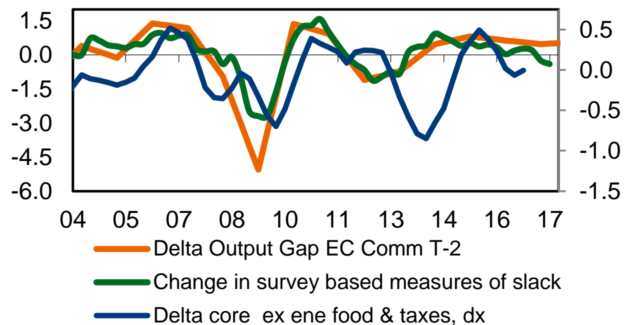
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – Core inflation will be boosted by a favourable base effect in the Summer. From September; genuine rises in domestic prices will be necessary



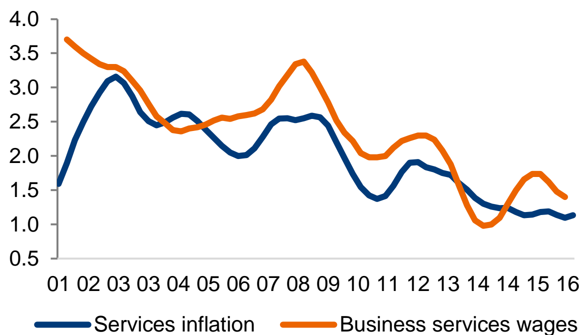
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – Core inflation has reacted less to changes in the output gap than in the past



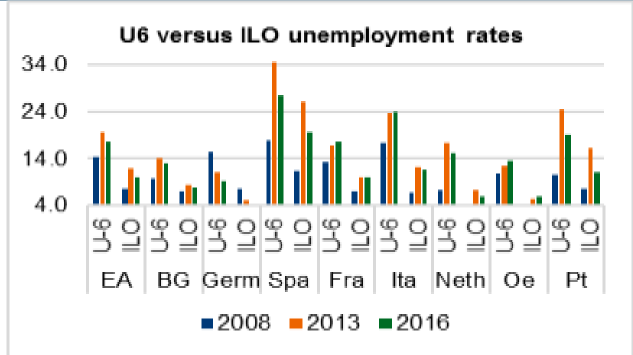
N.B.: Output gap European Commission, change on the previous year. Measures of excess supply from surveys are based on the question posed in the European Commission's quarterly survey: "Is demand a limit to production?" for industry, construction, services and retail. The series are normalised and aggregated by industry value-added weights.
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – Wages, still one of the main causes of services inflation, are not rising at the moment but…



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 6 – … it may only be a matter of time. The U6 unemployment rate is twice the size of the ILO, and even the ECB has started to monitor it



N.B: Expanded unemployment rate U6 = ILO unemployed + Eurostat potential workforce (under-unemployed + marginally attached to the labour force) as a percentage of the active population in the 15-74 age band + potential workforce
Source: Intesa Sanpaolo chart based on Eurostat data

.Monetary policy: slowly but surely exit is approaching

Anna Maria Grimaldi

In June, the ECB took its first cautious step towards normalising its unconventional monetary policies. The reference to keeping rates "at lower levels" has been dropped from its statement. Governing Council member Ardo Hansson clarified that this was a "homeopathic" change, yet an acknowledgement that the risk of deflation has completely disappeared as the recovery has strengthened and **risks to growth are now broadly balanced** and no longer to the downside

Aside from the tweak on "lower rates", the ECB's stance remains ultra-accommodative. The Council has confirmed its commitment to continue its purchases programme until December 2017, since the return of inflation towards 2% in the medium term still depends on *"a very substantial degree of monetary accommodation for underlying inflation pressures to build up"*. In addition, **the ECB has maintained what Draghi defined as an easing bias on purchases**, which is defined in the following sentence: *"if the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation,* ***we stand ready to increase our asset purchase programme in terms of size and/or duration****"*.

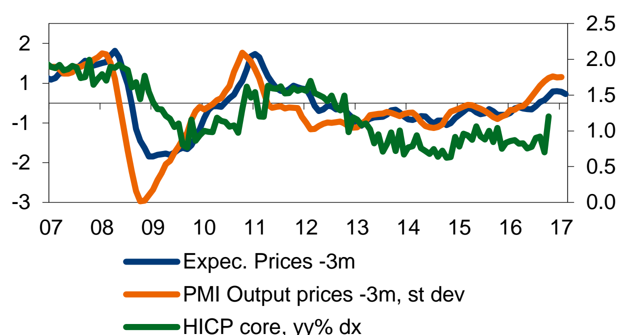
The **sequencing for exiting the unconventional measures has not changed since the Council expects rates to remain at current levels well past the end of bond-buying.**

Draghi explained that the easing bias for the APP purchases is part of the ECB reaction function, which links ECB's choices on monetary policy to the evolution of prospects for inflation in the medium term. The *easing bias* **on rates was an expectation on rates related to tail risks and notably the risk of deflation**.

The real question concerns purchases and how quickly the ECB will exit the programme

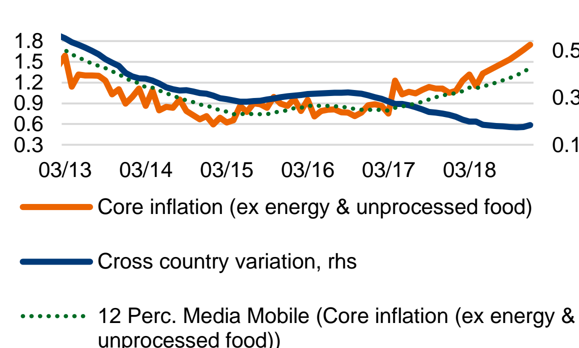
The ECB has clarified that before starting to gradually normalise measures, it wants to be certain that core inflation: 1) has embarked on a path consistent with the ECB's target in the medium term; 2) that the increase will be self-sustaining; and 3) that it is widespread across the Euro zone.

Fig. 1 – Risk of deflation has now disappeared



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 – The ECB's choices depend on a durable rise in core inflation across the whole Euro zone, which we think will happen from 2018 onwards



Source: Intesa Sanpaolo chart based on Eurostat data

As regards the timing of the next moves, we think that:

1. **The ECB will remove the easing bias on purchases in September,** provided that the macro scenario is confirmed.
2. The Council will give **broad indications about the Asset Purchase Programme (APP) at its October 2018 meeting after the German elections.**
3. **The ECB is unlikely to announce the pace of purchases for 2018 before December**, when it may also announce the last date for exiting the programme. In our **central scenario**, we assume **a reduction in purchases to USD 45Bn in 1Q18, and to USD 30Bn in Q2 and to 15bn in Q3.**

We do not rule out that the ECB might decide to announce by three months in three months the pace of purchases without committing to a final date. We think it unlikely to be later than September since Euro zone core inflation should have embarked on a stable rise towards 1.7% by then.

We think that decisions on the remaining term of the purchases programme after December 2017 will only be partly affected by constraints due to the scarcity of bonds in Germany, and in Portugal and other minor countries, since these constraints could turn out to be stringent given the parameters for implementing purchases in force at the end of 2017 (when the ECB will hold 41% of German debt, 37% of Luxembourg debt and 32% of Portuguese and Cypriot debt) and the ECB will therefore have to make replacement purchases.

In any case, monetary policy will continue to support growth in 2018, albeit at a slower pace. In our central scenario, the ECB would expand its balance sheet by another EUR 195Bn between January and June 2018, compared with an increase of EUR 360Bn last year.

The effect on yields does not only depend on the reduction in monthly volumes but also on the timing and how it ties in with changes in net supply on the market. The benefit of a tapering scenario by the end of September 2018, as highlighted by our interest rate analysts (see **Interest Rate Strategy of 30 May 2017: Considerations on ECB tapering**), would be to smooth out increased supply in core countries in 3Q and, generally, to reduce net supply by nearly 50% over the year, which the market will have to absorb, limiting the impact on rising yields. The impact on rates of reducing purchases also depends on the ECB's statements and the markets' preparation for the tapering of monetary stimulus. Note that, according to ECB estimates, an increase of around EUR 1Trn in the balance sheet equates to a reduction of approx. 100 basis points in interest rates. But it is difficult to extrapolate the effect of a change in the volume of purchases to an increase in yields.

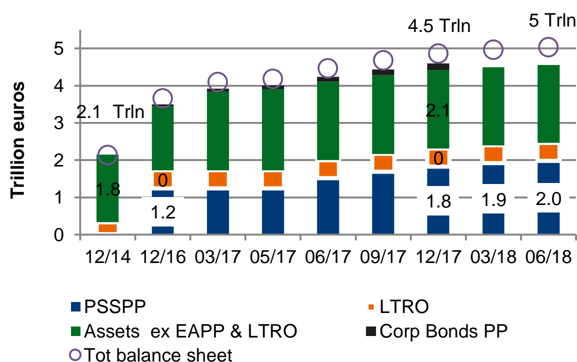
Tab. 1 – Main ECB macroeconomic forecasts versus Intesa Sanpaolo and Consensus Economics [Click to Type]

	ECB June 2017[a]				ISP & ( ) Consensus forecasts, May 2017			
	2016	2017	2018	2019	2016	2017	2018	2019
GDP %	1.7	1.9 [1.8]	1.8 [1.7]	1.7[1.6]	1.7	2.0 (1.7)	1.6 (1.6)	1.5
HICP y/y %	0.2	1.5 [1.7]	1.3 [1.6]	1.6 [1.7]	0.2	1.6 (1.6)	1.5 (1.4)	1.7
HICP *core* y/y %	0.9	1.1 [1.1]	1.4 [1.8]	1.7 [1.8]	0.9	1.0	1.5	1.7
June 2017 assumptions on EUR	1.11	1.08 [1.07]	1.09 [1.07]	1.09 [1.07]	1.11	1.09 (1.075*)	1.13 (1.079*)	1.17 (1.099*)
June 2017 assumptions on BRT	43.1	56.4 [51.6]	56.5 [51.4]	55.9 [51.5]	45	54.2 (53.4*)	55.8 (54.9*)	60

* Estimates of Consensus Economics for the EUR exchange rate and oil prices are for July 2017, July 2018 and July 2019. Intesa Sanpaolo forecasts are annual averages. (a) March 2017 forecasts in brackets.

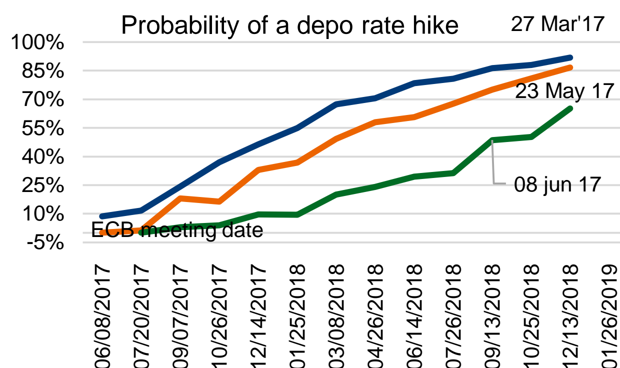
Source: ECB, March and June 2017 macroeconomic estimates, Intesa Sanpaolo May 2017 forecasts and Consensus Economics May 2017

Fig. 3 – ECB's balance sheet will exceed EUR 5Trn in June 2018 (45% of GDP), from around EUR 2Trn at end-2014 (21% of GDP)



N.B.: We assume purchases will be extended to June 2018 at a rate of EUR 40Bn per month in 1Q and EUR 25Bn in 2Q. NB: The Fed balance sheet quadrupled between 2008 and 2013. Source: Intesa Sanpaolo chart from ECB data

Fig. 4 – Probability of rate hike lower after June meeting



Source: Bloomberg and Intesa Sanpaolo estimates

Germany: it's the economy, stupid![6]

Anna Maria Grimaldi

Germany is heading towards the Bundestag elections on 24 September on a very solid macroeconomic footing. The **phase of above-potential growth** (1.4%), **which started in mid-2014, is continuing at a more sustained pace than was expected a few months ago**. The IFO and composite PMI returned to pre-crisis levels in May and point to growth of at least 0.7% qoq in the Spring, up from 0.6% qoq in 1Q (see Fig. 2). We have therefore revised up our growth estimates by two-tenths of a percentage point to 2% this year (or 1.7% net of calendar effects) and 1.8% next year. The output gap will return to positive territory as early as the middle of this year and will pass the one-and-a-half percent mark by the end of 2018. The stimulus to growth in this phase is coming from manufacturing, which will benefit from the recovery in global trade. After increasing in April, industrial output is *en route* for growth of 1.4% in June and in the winter months. Growth in services and retail also continues, although confidence indicators have fallen below their mid-2016 peaks (see Fig .3). **Domestic demand will continue** to drive growth over the forecasting horizon with an average contribution of 1.7%, which is a slight slowdown on the figure of 2.2% in 2016. The **contribution from foreign trade will be broadly neutral, after accounting for 0.3% last year.** Exports have grown at a more sustained pace since end-2016, thanks to increased demand from both emerging economies and other more advanced countries. The recent trend in capital goods orders and expectations for exports, as shown in the IFO and global PMI surveys, points to exports continuing to support growth until the summer (see Figs. 4 and 5). Exports are expected to accelerate from 2.2% in 2016 to 4.3% in 2017 and then moderate to 3.7% in 2018; this is, however, a slower pace of growth than in the pre-crisis period[7]. However, imports will also grow at a more sustained pace (4.9% this year and 4.4% in 2018), since German exports have a high content of imported goods and components. **Domestic demand will progressively be driven more by corporate investment** than **private consumption** (see Fig. 6), which was the main growth engine in the previous two years. Corporate investment has already accelerated by 1.1% qoq in 1Q, and we expect it to grow by 1.3% qoq on average in the rest of the year. A combination of production capacity utilisation that is well above the historical average, expectations of resilient orders and production, solid earnings, and amply supportive financial conditions (see Figs. 7 and 8) should ensure **growth** in **investment in machinery** of 3.2% this year and 2.9% in 2018. **Construction investment growth** is expected to accelerate to 3.2%, from 2.5%, and then moderate towards 2.8% in 2018. The recent trend in orders and permits points to only a modest slowdown in building activity in the next few months (see Figs. 9 and 10) after the boom at the start of the year. The expansionary cycle of residential building will continue to be boosted by the large inflow of workers from other EU countries. **Household consumption will continue** to grow **at a sustained pace** (1.4-1.5%), **but less than in the previous two years** (1.9%), when it benefited (for 0.6% of disposable income) from falling crude oil prices and ultra-accommodative financial conditions. Real disposable income is expected to slow to 1.8% in 2017-18, from 3.1% in 2016. This will be affected not only by the rise in inflation (see below) but also by softer job creation (from 1.4% in 2016 to 1.0% in the current two-year period), which the wage trend will fail to offset. Confidence surveys point to still-solid employment growth, but the labour market is at full employment and new jobs cannot continue to be created at the pace seen at end-2016/early 2017 (1.5% yoy for total jobs, and 2.3% yoy for jobs subject to social security contributions). The **unemployment rate** fell again to 5.7% in May, **a new record low, and is close to the NAIRU** (5.3% according to OECD estimates). The workforce is mainly created via immigration from other EU countries, which has helped **mitigate pressure on salaries and wages**. Most wage agreements for 2017 include modest rises that are close to those of 2016 (2.2%), given that they were signed last year when inflation was low and prospects for the industrial sector

[6] Phrase coined by J. Carville for Bill Clinton's presidential campaign in 1992.

[7] Germany is losing market share within the Euro zone. Exports will suffer from the fall in demand from the UK and, to some extent, from the shift in Chinese demand from capital goods to consumer durables.

still modest. The next round of agreements in 2018 is likely to introduce larger increases in wages (closer to 2.7%) as firms will perceive more solid demand ahead de. **Inflation** is expected to increase from 0.4% in 2016 to 1.4% in 2017-18 – hence below the ECB target – given the modest pressure from wages (see above) and energy prices.

Although the labour market is at full employment, wages are still under control. Inflation will remain below the ECB target until end-2018

Schäuble's rigorous administration and the much-opposed negative rates regime will ensure that **a large budget surplus is maintained in both nominal and structural terms**, equating to 0.6% of GDP in 2017, from 0.8% in 2016. The debt/GDP ratio is expected to fall to 63% in 2018, from 68% this year. It is possible that, after the elections, a portion of the budget surplus will be used to increase investment spending and reduce taxes. In 2017, the revenue/GDP ratio is forecast to remain unchanged[8], while spending, especially on taxes and child care, should rise.

Apart from a clearly positive economic framework, Germany is heading towards the elections with no particular internal imbalances. Although criticised by many as a sign that the fiscal and economic policies are not expansionary enough, and indirectly damaging to the rest of the Euro zone, the excess in public and private savings, reflected in the high current account surplus (still at 8.5% of GDP in March 2017), actually constitutes a buffer in the event of adverse shocks. The solid macroeconomic framework and continuous flow of positive surprises on the data front help explain, at least in part, the recovery made by Mrs Merkel's CDU; on 13 May, the party pulled off an overwhelming victory in the local elections in North Rheine Westphalia, the most densely populated German state and historically an SPD stronghold. The euphoria surrounding Schulz, who was appointed leader of the Social Democrats in January, has dissipated. Support for the SPD has fallen from a 30% peak in mid-February to 25%, ten points behind the CDU (see Fig 1). There are still two months to go before the elections, but it is quite likely that Mrs Merkel will be reconfirmed as Chancellor and will still govern with a CDU-SPD grand coalition[9]. It remains to be seen whether Mrs Merkel will succeed, in this fourth term, in shifting the German government's focus from fiscal rigour to reforms of the EU targeted at consolidating the process of economic and political integration – and accepting the proposals of the newly-elected French president.

It is no surprise that Mrs Merkel has regained support

Macro forecasts

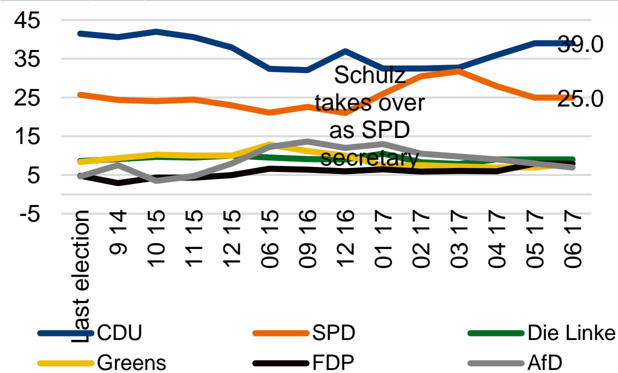
	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y) *	1.8	2.0	1.8	1.8	1.7	1.8	1.7	1.9	2.3	2.3	2.2	1.9	1.7
- q/q change				0.5	0.2	0.4	0.6	0.7	0.5	0.4	0.5	0.4	0.3
Private consumption	1.9	1.4	1.5	0.4	0.5	0.2	0.3	0.4	0.4	0.4	0.4	0.3	0.3
Fixed investment	2.0	3.0	3.4	-1.4	-0.1	0.4	1.7	0.9	0.9	0.9	0.8	1.0	0.6
Government consumption	4.0	1.7	1.7	0.7	0.1	0.3	0.4	0.6	0.6	0.4	0.3	0.5	0.4
Export	2.5	4.3	3.7	1.1	-0.3	1.7	1.3	1.2	0.8	0.8	1.1	0.8	0.8
Import	3.7	4.9	4.4	0.2	0.6	2.5	0.4	1.7	1.4	0.9	1.0	1.3	0.4
Stockbuilding (% contrib. to GDP)	-0.1	0.3	0.1	0.0	0.3	0.4	-0.4	0.3	0.2	0.0	-0.1	0.1	-0.3
Current account (% of GDP)	8.5	8.3	8.0										
Deficit (% of GDP)	0.8	0.5	0.3										
Debt (% of GDP)	68.3	65.8	63.3										
CPI (y/y)	0.4	1.4	1.3	0.1	0.5	1.1	1.9	1.6	1.4	1.2	1.1	1.3	1.4
Industrial production (y/y)	1.2	3.3	1.9	0.6	1.0	1.4	1.2	3.6	4.3	4.2	2.6	1.7	1.7
Unemployment (%)	6.1	5.8	5.7	6.1	6.1	6.0	5.9	5.7	5.7	5.7	5.7	5.7	5.6
10-year yield	0.10	0.34	0.81	0.12	-0.12	0.11	0.25	0.30	0.33	0.48	0.65	0.80	0.90

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

[8] The lower revenues from the changes in tax deductions are likely to be offset by the progressive increases in the tax bands.

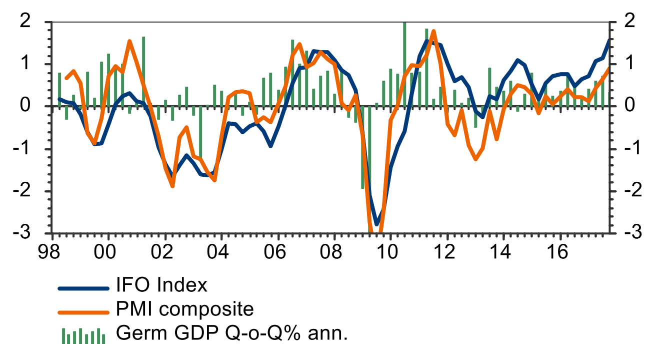
[9] In recent weeks, the FDP's climb to 9% (in the 2013 elections the Free Democrats failed to meet the 5% minimum threshold), combined with the Greens sitting at around 7%, has prompted speculation of a CDU-FDP-Green coalition, known as a "Jamaica coalition" because of the colours of the three parties.

Fig. 1 – CDU again in the lead in the opinion polls... "It's the economy, stupid!"



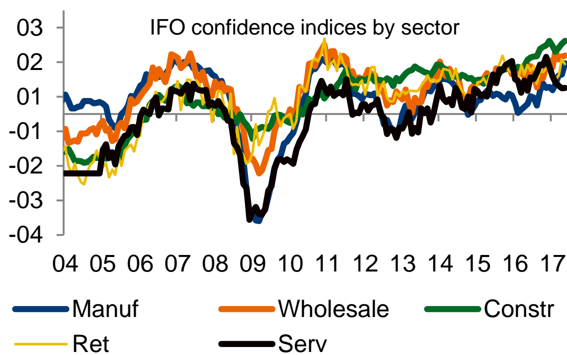
Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 2 – Confidence surveys show an acceleration of GDP growth to at least 0.7% qoq in the Spring



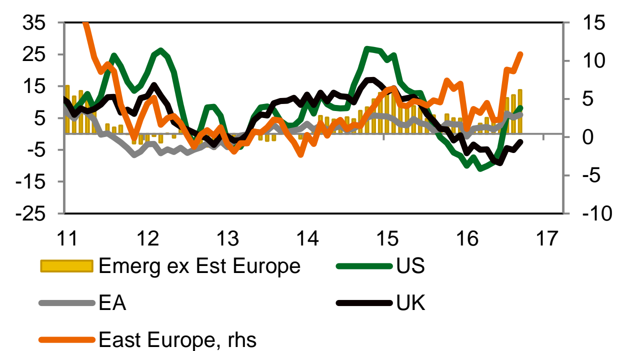
Source: Intesa Sanpaolo chart from Thomson Reuters data

Fig. 3 – Growth in this phase is being driven by manufacturing, which is benefitting...



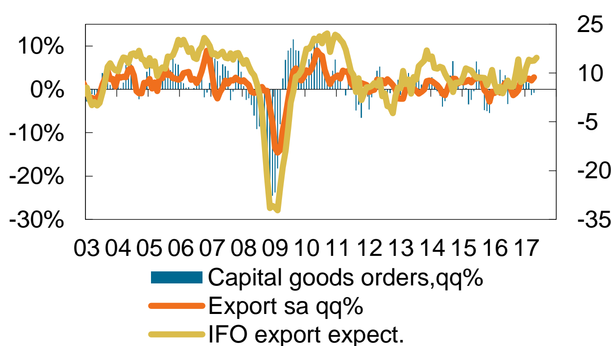
Source: IFO via Thomson Reuters-Datastream

Fig. 4 – ...from the recovery in exports, especially to emerging economies



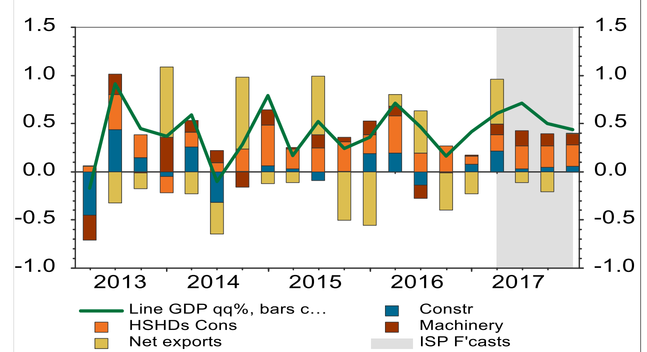
Source: FSO via Thomson Reuters-Datastream

Fig. 5 – Surveys point to further sustained growth in exports in the summer



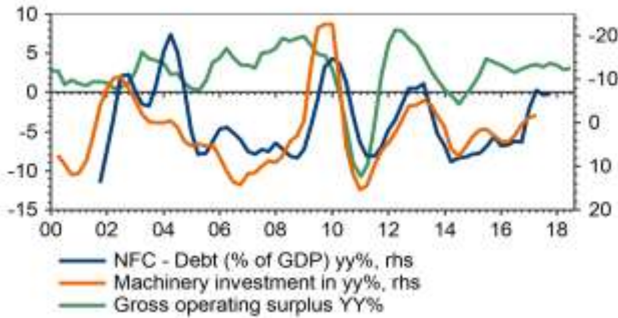
Source: FSO via Thomson Reuters-Datastream

Fig. 6 – Growth over the forecast horizon will still be driven by domestic demand, but the baton will pass from consumption to corporate investment



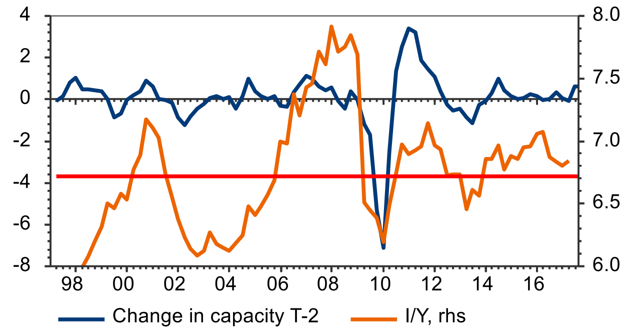
Source: FSO via Thomson Reuters-Datastream

Fig. 7 – Stable if not raising profit growth, falling corporate debt and...



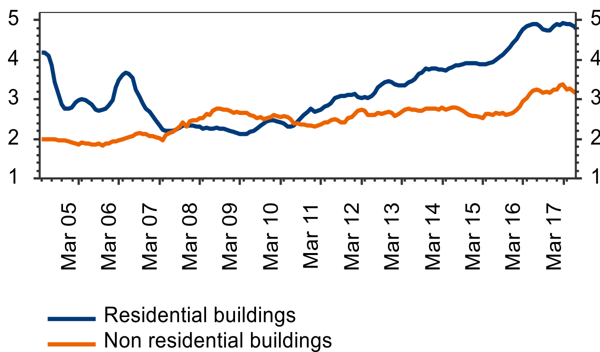
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – ...high manufacturing capacity utilizations are consistent with more buoyant investment spending



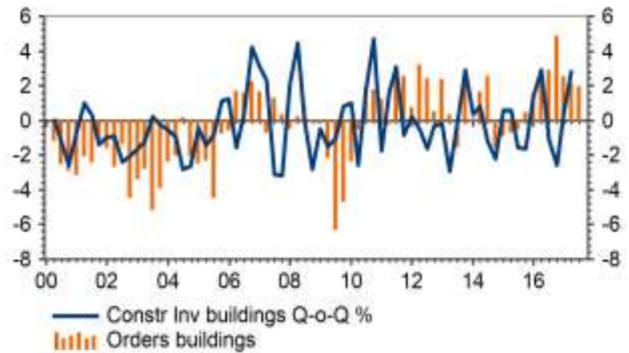
Source: FSO via Thomson Reuters-Datastream

Fig. 9 – Trend in permits and...



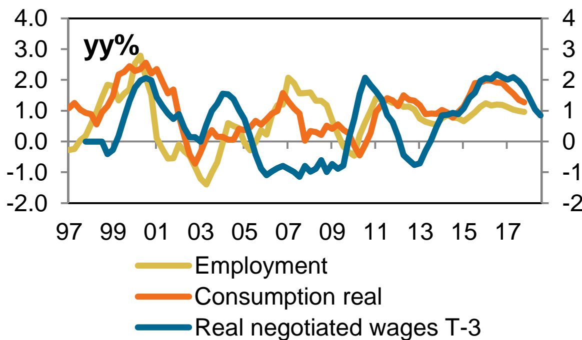
Source: FSO via Thomson Reuters-Datastream

Fig. 10 – ...orders suggests resilient construction investment



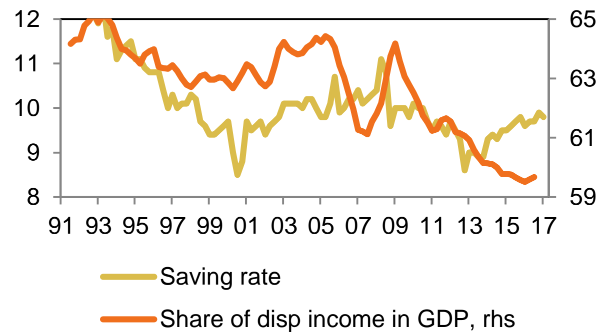
Source: FSO via Thomson Reuters-Datastream

Fig. 11 – Private consumer spending has now peaked. Financial conditions will continue to be highly expansionary, but employment and real salaries are expected to slow



Source: FSO via Thomson Reuters-Datastream

Fig. 12 – The rise in the savings rate is likely to provide a buffer in the event of shocks



Source: Thomson Reuters-Datastream

France: *en marche!*

Guido Valerio Ceoloni

The scenario that has emerged from the long 2017 electoral cycle could not have been better for the country. **The populist threat from the *Front National* has been stemmed for the time being, and President Macron has even won an absolute majority in the National Assembly**, which, on paper, gives him free rein to implement his reform programme. The conditions thus created are unique in enabling the country to complete the structural reforms it needs to become fully competitive again in the next five years.

Having outperformed expectations in 1Q, GDP growth is set to accelerate from 1.1% to 1.6% this year

As for economic performance, after a better-than-expected Q1 (0.5% qoq), in line with Banque de France's forecasts, we expect the economy to maintain a similar pace (0.5% qoq) in Q2. In H2, **GDP** growth will edge down (0.4% qoq, 1.7% yoy). In the whole of 2017 GDP will rise 1.6% (we have revised up our estimate by two-tenths of a point compared with three months ago). For 2018, we forecast a similar pace to that of 2017 (1.4-1.5%); risks to the forecast will be to the upside in light of the sharp improvement in the country's morale, operators' confidence at the end of the election cycle, and an improvement in the labour market.

Consumption, although positive, will slow compared with 2016

Household consumption stagnated in the first quarter, but is expected to accelerate from Q2; for the whole of 2017, consumer spending is seen up by just 1.2% yoy on average after a very positive 2016 (2.1%), partly in the wake of the correction to purchasing power (around 0.6% yoy in 2017, from 1.9% yoy in 2016) due to an increase in nominal wages which is not keeping the pace of inflation. However, household confidence is rising: the INSEE index of consumer confidence has remained above 100 since the beginning of the year, and could return to 2002 levels (109) around the end of this year.

Industrial output accelerating this year, as is construction

Business confidence is also on the upturn, with the INSEE index of manufacturing confidence at an average of 107 since the start of the year, an improvement on the figure of 103 in 2016. PMI indicators, which are all well above the breakeven threshold (2017 averages: composite 56, manufacturing 53.8 and services 56.2) point to a widespread increase in activity, with the services sector continuing to drive the economy this year. **Industrial output**, after edging down in the first quarter (-0.3% qoq from 1.2% qoq), is expected to rebound at around 0.2-0.3% qoq, and to accelerate by around 1% yoy on average (from 0.3% in 2016). **Capacity utilisation** is now over 84.5%, up on last year's figure of 83.2%, which should be positive for business investments. After declining for four years, **construction** resumed growth in 2016 (0.4% yoy). In 1Q17, activity slowed again (to 0.1% qoq, from 0.3% qoq), but we expect it to pick up from the second half of the year (annual average growth at 0.7%).

Investment accelerating this year, supported by the manufacturing segment

Investment in manufacturing also picked up this year (growth at 1.2% qoq in 1Q from 0.7% qoq previously). The fairly positive developments in the political landscape will help support continued investment growth. However, we expect it to slow in the current quarter (to 0.9% qoq, from 1.2% qoq) as the March figure was partially distorted by the strong contribution of the auto sector, but this should fall from June. In terms of the annual average, however, we expect total investment to grow at 3.0% yoy, slightly up from the figure of 2.7% in 2016. **Household investment** is still weak and is expected to slow this year to growth of 1.9%, compared with 2.4% last year.

Net exports will make a negative contribution to GDP this year

Foreign trade made a negative contribution of -0.8% to GDP in the first quarter (with an offsetting contribution by inventories). **Exports** recorded a sharp fall of -0.7% qoq (from +1.1% qoq) resulting from the correction in the aeronautics segment after the rally at the end of 2016, while growth in **imports** accelerated to 1.2% qoq, from 0.6% qoq. In the current quarter, we expect exports to rise (+0.4% qoq), partly thanks to the naval sector, which will trigger de-stocking, but also imports (to 1.6% qoq, from 1.2% qoq): the combined effect of this should therefore keep the contribution of net exports to GDP in negative territory. As an annual average, we expect

exports to maintain a similar pace to that of 2016, at 1.7%, thanks to the expansion in global trade, while we forecast that growth in imports will accelerate to 4.9%, from 4.3% on the back of the rise in investment: the net contribution of exports to GDP should therefore remain slightly negative. The **trade deficit** is likely to continue to increase this year, exceeding 11% of GDP, from 8.8% in 2016.

Inflation confirmed at around 1%

After accelerating at the start of the year, **inflation** slowed again in April and is set to remain below 1% for the rest of the year, due, in particular, to the price weakness in manufactured products and the slowdown in energy prices after the early-year surge. Over the 2017-2018 forecasting horizon, annual average CPI is expected to be 1.0% this year (from 0.2% in 2016), and 0.9% in 2018. The **core index** will remain fairly weak at 0.4% this year, from 0.5% in 2016, and then rise to 1.0% in 2018. Inflationary pressure will therefore remain moderate until end-2018.

The Macron reforms are expected to hasten the fall in unemployment

Unemployment recorded its first significant fall in the the first quarter of this year, from 10.0% to 9.6% qoq, dropping below 10% for the first time since 2012. In the rest of the year, we expect a fall of around one-tenth of a percentage point per quarter, resulting in **an annual average of 9.6%, from 10.1% in 2016**. For 2018, if the new presidential reforms are launched quickly, unemployment could drop below 9% (Macron's commitment was to bring it below 7% by the end of his term). Overall, some 130,000 new jobs were created in the first quarter (+0.2% qoq), more than double the quarterly average in 2016. We forecast that **employment** is set to grow at a broadly similar rate for the current year, taking the level to 65.2% in 2017, from 64.7% in 2016.

2017 will be the year that the deficit drops below 3%

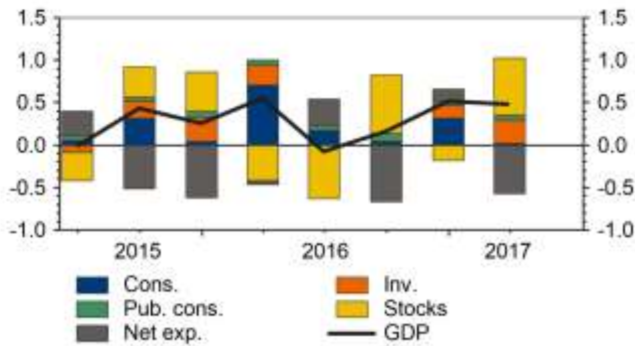
In 2017, the **deficit** is likely to drop to 3.0%, from 3.4% in 2016. The new government's focus on restoring the country's fiscal credibility in the eyes of the Euro zone, together with the economic upturn and new ecotaxes should help put the public accounts in order; however, the recapitalisation of France's state-owned nuclear company Areva (0.2% of GDP), the end of the public sector wage freeze in 2016, and fresh government investment could hamper the achievement of this objective. In any event, the **structural deficit** is expected to correct by two-tenths of a point this year from 2.5% to 2.3%, but in the absence of any corrective intervention, it will increase again in 2018, though remaining below 3%. **Public debt** will increase by around half a percentage point this year to 96.5%, from 96.0% in 2016, and will continue to rise even in 2018.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.1	1.6	1.6	1.2	0.9	1.2	1.1	1.7	1.9	1.7	1.6	1.5	1.5
- q/q change				-0.1	0.2	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Private consumption	2.1	1.2	1.4	0.3	0.0	0.6	0.0	0.5	0.3	0.4	0.4	0.4	0.4
Fixed investment	2.7	3.0	2.3	0.1	0.1	0.7	1.2	0.9	0.7	0.6	0.5	0.5	0.5
Government consumption	1.3	1.3	1.2	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	1.9	1.7	3.8	0.3	0.7	1.1	-0.7	0.5	1.0	1.2	0.9	0.9	0.9
Import	4.2	4.9	3.6	-0.7	2.8	0.6	1.2	1.6	1.0	1.2	0.7	0.7	0.7
Stockbuilding (% contrib. to GDP)	-0.4	0.8	-0.1	-0.7	0.6	-0.2	0.6	0.3	0.0	0.0	-0.1	-0.1	-0.1
Current account (% of GDP)	-2.1	-2.4	-2.4										
Deficit (% of GDP)	-3.4	-3.0	-3.2										
Debt (% of GDP)	96.0	96.4	96.7										
CPI (y/y)	0.3	1.2	1.1	0.0	0.3	0.5	1.2	1.0	1.2	1.2	1.1	1.4	1.6
Industrial production (y/y)	0.3	0.9	1.4	0.5	-0.5	0.3	0.7	1.0	1.4	0.7	1.4	1.4	1.5
Unemployment (%)	10.1	9.4	9.0	10.0	10.0	10.0	9.6	9.7	9.3	9.2	9.1	9.0	8.9

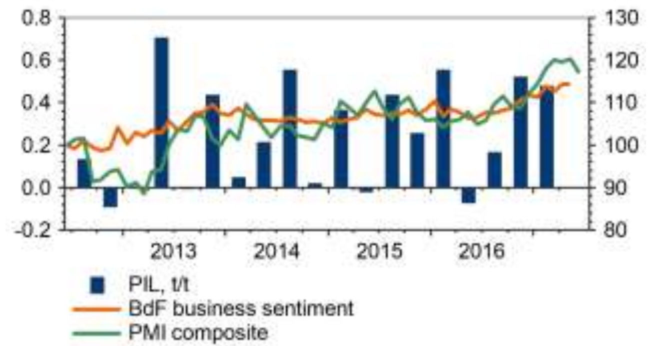
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to the formation of GDP



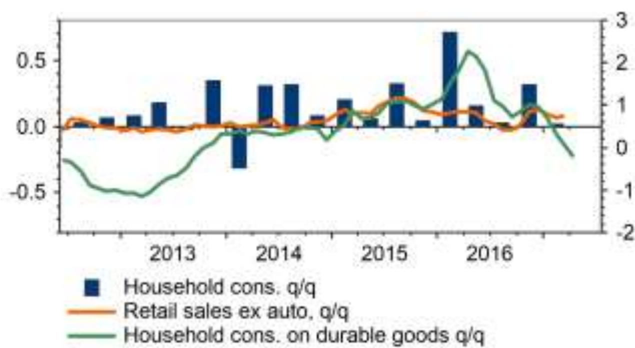
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – GDP and confidence indicators



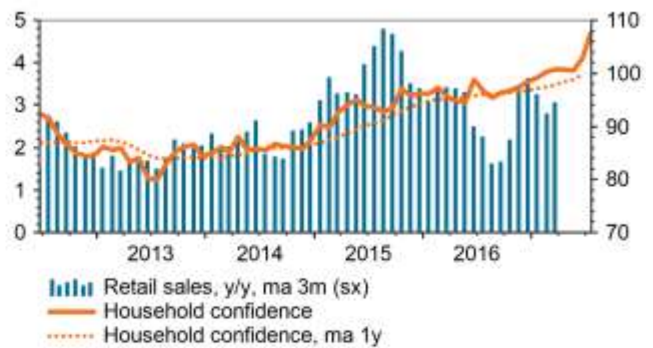
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending, purchases of durable goods and private consumption



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

Fig. 4 – Retail sales and household confidence

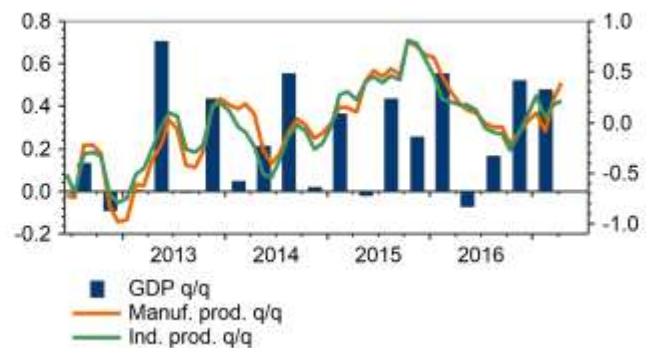


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment and construction sector activity

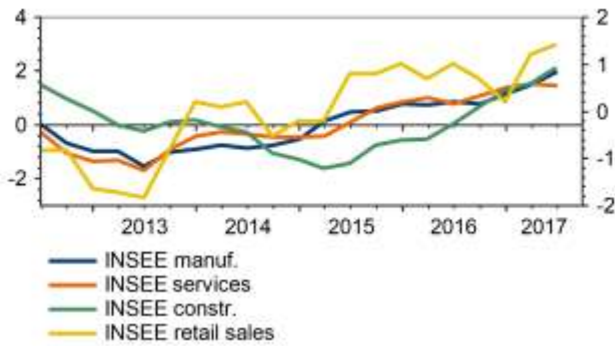
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



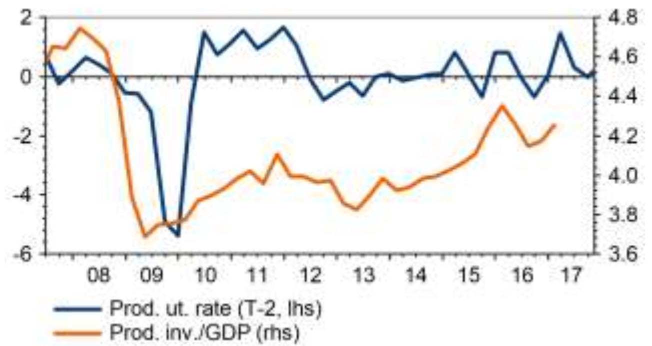
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



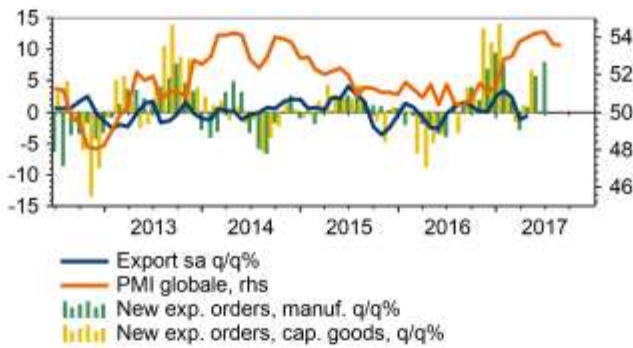
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Production capacity utilisation and level of investment as proportion of GDP



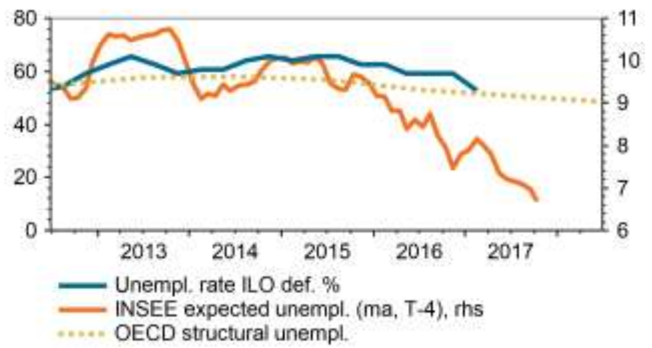
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



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

Fig. 10 – Expected and structural unemployment



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

Italy: 2017 is better than expected. Uncertainty is all political

Paolo Mameli

We have revised upwards our estimate of Italian GDP growth in 2017, in light of both the positive trend of survey data, and of the recent revision of national accounts data at the turn of the year, released by Istat. However, we remain cautious, by implementing only a marginal revision (to 1.1%), although we acknowledge upside risks to our forecast. This is because we cannot rule out a slowdown in growth in the Spring quarter, after a strong start to the year that was "anomalous" in some ways. The composition of demand in the remainder of 2017, and into 2018 as well, will also change compared to the situation seen at the beginning of the year: investments and foreign trade will resume driving growth, as opposed to a loss of steam for consumption, construction, and inventories. At the same time, we have also revised down our forecast for growth in 2018, given the need for fiscal consolidation (unlikely to be smaller than 0.3% of GDP), and the uncertainty tied to the outcome of the next political elections (expected to be held next Spring).

We are more optimistic on 2017 growth, due to the positive trend of surveys and to the revision of past national accounts data released by Istat

After having signalled already three months ago the existence of upside risks to Italian growth this year (and, if any, downside risks to growth in 2018), **we have now revised up our forecast of GDP growth in Italy in 2017**, for two main reasons:

1) The **positive trend of forward-looking indicators** observed between the closing months of 2016 and the first months of 2017: in effect, confidence surveys did worsen slightly in May, but only after having hit their highest level in almost 10 years in April, both in terms of the composite index published by Istat and of the manufacturing sector taken alone (as regards the construction sector, the May reading marked a nine-year high);

2) The **revision of national accounts data** announced by Istat on 1st June, which brought an upward revision of GDP growth not only for the beginning of 2017, but also for the end of 2016 (implying a positive rollover effect on this year as well): economic activity is now estimated to have grown by 0.4% q/q at the beginning of the year (from an initial reading of 0.2% q/q); the 4Q 2016 reading was revised up to 0.3% from a previous 0.2% q/q. As a result, year-on-year growth has been revised by a hefty four tenths, to 1.2% from a previous estimate of 0.8% (and from 1.1% at the end of 2016). This is the strongest growth rate in almost six years (since 2Q 2011). As a result, the growth gap compared to euro area average is tightening (close to a six-year low).

However, an "anomalous" Q1 calls for caution: a slowdown in the Spring quarter is possible

However, we have opted to remain cautious, and have only marginally revised up our growth forecast for this year, considering that the **Q1 2017 reading may be considered as rather "anomalous", for a number of reasons:**

1) Growth at the beginning of the year was entirely due to the **volatile inventories component** (contribution: +0.4% q/q), which casts uncertainty on the forecast for the current quarter (our baseline scenario contemplates the possibility of a quarterly slowdown, although in our view both investments and foreign trade may resume contributing positively);

2) The reading may have been influenced by a number of **calendar effects**: a month of March without Easter and a greater number of long holiday weekends in the quarters immediately prior and following, which may have resulted in a concentration of hours worked in particular in the services sector (which, by no chance, contributed most to value added growth in the quarter);

3) It is also legitimate to suspect that **deflators could have been underestimated** (import deflator overestimated, investment deflator underestimated?) resulting in an overestimation of GDP at chained volume measure. In effect, not only the import deflator surged (+2.2% q/q, a five-year high), probably on the energy effect, but the investment deflator plunged "anomalously" (-1.6% q/q for overall investments, -3.8% for the machinery and equipment component: a long-term trough for both); indeed, nominal GDP not only failed to grow in the quarter, but declined by one tenth; as by definition the measurement of national accounts aggregates should be more

accurate in terms of value than of volumes, such a wide divergence between nominal and real GDP should induce caution against an overly optimistic take on data referred to the beginning of the year.

As a result, in the conservative assumption of growth amounting to just one tenth in the spring quarter, and to two tenths in the second half of the year, average GDP change in the year would be 1.1%. In our view, **risks to this forecast are in any case skewed to the upside.**

The composition of demand in the remainder of 2017 and in 2018 will differ from the beginning of this year

We reassert our view that **the composition of demand in the remainder of 2017, and going forward into 2018, will differ significantly from that observed at the beginning of this year** (in this sense as well, therefore, Q1 2017 would in some ways emerge as being "anomalous"). This is because:

1) We confirm our view that **consumption** will not be the main engine of growth in 2017-18 (as was the case, on the other hand, in 2015-16); however, we are more optimistic on the trend of this component of demand as well than we were a few months ago, both in light of stronger than expected household spending at the beginning of year (driven by durable goods, as was also the case at the end of 2016, but also by an acceleration in services), and because of the renewed momentum of job growth, the slowdown in which was largely responsible for the loss in confidence and the drop in consumer spending in the second half of last year. We expect consumption to grow by 1% this year and by 0.6% the next.
2) The more critical evolution of the cycle between the end of 2016 and the beginning of 2017 is due to the disappointing trend of **investments**, and in particular of businesses' capital expenditure in machinery and equipment (-0.3% q/q on average in the past year, -2.2% q/q in real terms and -5.9% q/q nominal in Q1 2017). This trend may be tied to uncertainty over the extension of fiscal incentives (which was then implemented, and strengthened with the "Industria 4.0" package). In any case, the current recovery in business profitability (at least as measured by the share of gross operating margin on value added), also taking into account the incentives mentioned above, seems compatible with an ample margin for a recovery for this component; however, the improvement will mostly be visible in the 2018 average (which could approach 4%), whereas the forecast for 2017 prices in the slow patch at the beginning of the year (0.9%). As regards overall investments, we expect growth to average around 2.5% in the biennium, i.e. a slightly slower pace than the 2016 average.
3) Vice versa, the **construction** sector showed unexpected signs of liveliness in the recent period, albeit much more visible in national accounts data on investments in construction (up by over half a point per quarter on average between 2H 2016 and 1Q 2017) than on monthly data on output in the sector. In any case, we do not expect the sector booming, but we rather see a partial recovery after the epochal crisis incurred in the past decade: the construction sector, after having achieved positive growth in 2016 for the first time in a 10 years, should stabilise at 1.4% this year, and a slowdown to 1% next year cannot be ruled out.
4) The symmetrical contributions of inventories and foreign trade recorded at the beginning of the year should also change in sign, in our view, in the remaining quarters of 2017, and into 2018. **Foreign trade** recovered sharply already in the closing months of 2016, a trend confirmed at the beginning of 2017. However, its contribution to GDP was negative, as imports grew more than exports. Going forward (probably already in the remaining quarters of this year), we believe imports may lose steam as a result of a less upbeat trend of domestic demand, whereas exports could continue to grow at a robust pace (albeit without accelerating from their already high current levels). In light of the trend observed at the beginning of the year, imports may again grow more than exports on average in 2017 (for the fourth year in a row), although in our view this trend could change in 2018 (export on the rise by 3.5%, imports by 2.5%).

On the other hand, we have revised down forecast growth in 2018, due to fiscal consolidation needs and risks tied to political uncertainty

Vice versa, **at the same time we have revised down (also by one tenth) our forecast of GDP growth in 2018** (to 1.1% as well). Our decision was prompted by two sets of considerations:

1) **Need for fiscal consolidation** in 2018: based on European rules, Italy should correct its structural deficit by 0.6% of GDP in 2018 compared to 2017; on 1st June, in the letter delivered by Italian minister of the economy Padoan to the EU Commission, the Italian government proposed a reduction of the structural adjustment, to 0.3%. To date, the Commission has not officially responded to the letter, although some flexibility will probably be allowed, especially if the Budget Law is penned by the current government ie before the next political elections. As the Commission's Spring Economic Forecasts point to a two-tenth worsening of the budget, a three-tenth improvement would imply corrective measures (of a structural nature) worth half a point of GDP (around 8.6 billion); in our view, as elections are approaching, the net budget could result less large (a reasonable figure could be 0.3% of GDP. i.e. around five billion euros); in this case, the impact on the cycle would be negative, but limited to one or two tenths of GDP.

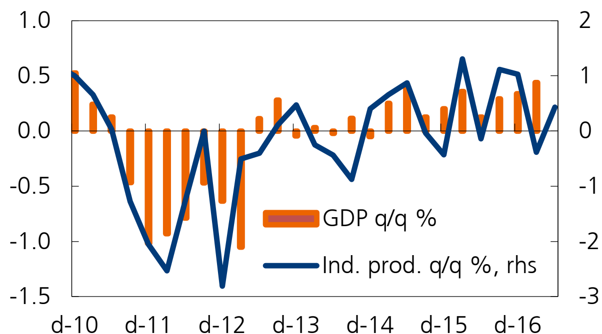
2) The **possibility of tensions on financial markets** in the event of an inconclusive outcome of the next political elections: following the ditching of the agreement reached by the main parties on an electoral reform modelled on the German system, the baseline scenario now contemplates once again elections at the natural end of the legislature (i.e. between February and May 2018); in any case, an electoral law will have to be approved (at least in order to harmonise the voting system for the two houses of parliament), and in all likeliness will be of a proportional nature (possibly with a relatively high election threshold). On the other hand, given the current political scenario, there are no electoral systems (other than a runoff-based French-style system, which does not seem to be an option, following the Constitutional Court's rejection of the *Italicum* model) that would be capable of averting the risk of ungovernability; should a hung-parliament scenario effectively materialise, a resurgence of tensions on financial markets cannot be ruled out (although in no way comparable to the situation in 2011), and may have an impact on the confidence of economic operators, as well as on the credit channel.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.1	1.1	0.8	1.0	1.1	1.2	1.2	1.1	0.9	0.8	1.1	1.2
- q/q change				0.1	0.3	0.3	0.4	0.1	0.2	0.2	0.3	0.4	0.3
Private consumption	1.3	0.9	0.6	0.5	0.2	0.1	0.5	0.0	0.1	0.1	0.2	0.2	0.2
Fixed investment	3.1	2.3	2.5	0.4	1.5	1.2	-0.8	0.9	1.0	0.5	0.6	0.6	0.4
Government consumption	0.6	1.0	0.6	-0.2	-0.2	0.6	0.5	0.1	0.1	0.2	0.1	0.2	0.2
Export	2.6	4.3	3.5	2.2	0.3	1.9	0.7	1.0	1.0	1.0	0.8	0.8	0.7
Import	3.1	5.2	2.5	2.2	1.0	2.3	1.6	0.5	0.5	0.5	0.8	0.6	0.6
Stockbuilding (% contrib. to GDP)	-0.4	0.1	-0.2	-0.2	0.1	0.0	0.4	-0.3	-0.2	-0.2	0.0	0.1	0.0
Current account (% of GDP)	2.6	2.2	2.1										
Deficit (% of GDP)	-2.4	-2.0	-1.9										
Debt (% of GDP)	132.6	134.1	134.0										
CPI (y/y)	-0.1	1.5	1.6	-0.4	0.0	0.1	1.3	1.5	1.3	1.5	1.1	1.3	1.7
Industrial production (y/y)	1.9	1.4	1.2	0.7	1.8	3.3	1.6	2.2	1.5	0.5	1.1	1.2	1.2
Unemployment (%)	11.7	11.2	10.7	11.7	11.6	11.8	11.6	11.2	11.1	11.0	10.9	10.8	10.6
10-year yield	1.48	2.30	3.15	1.48	1.19	1.77	2.15	2.19	2.26	2.59	2.95	3.20	3.28

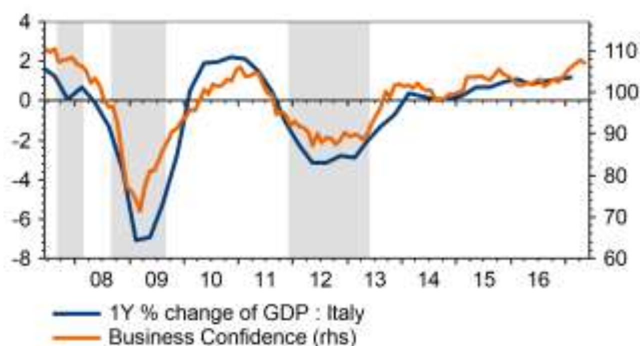
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – GDP accelerated at the beginning of 2017 despite being held back by manufacturing, which nonetheless we expect to have resumed contributing positively already in Q2



Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 2 – Forward-looking indicators compatible with a further year-on-year acceleration: risks to growth in 2017 are skewed to the upside



Source: Thomson Reuters-Datastream

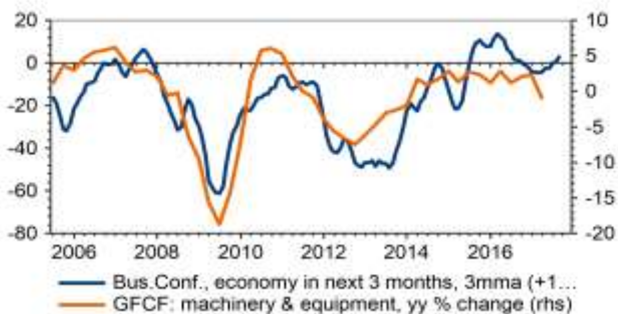
Fig. 3 – Growth gap tightening compared to the euro area average

Source: Thomson Reuters-Datastream Charting

Fig. 4 – Consumption reaccelerated at the beginning of year, but is unlikely to drive growth, given the still depressed trend of household confidence

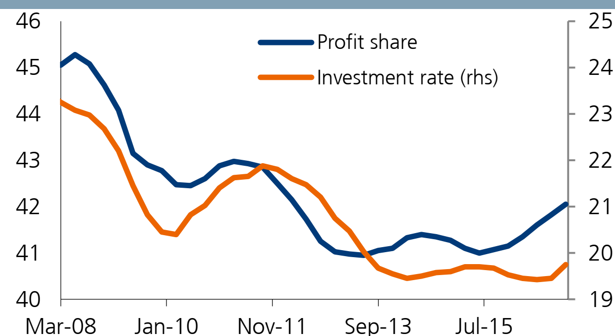
Source: Thomson Reuters-Datastream Charting

Fig. 5 – Based on the expectations of businesses on the economy, there seems to be ample margin for a recovery in investments in machinery and equipment



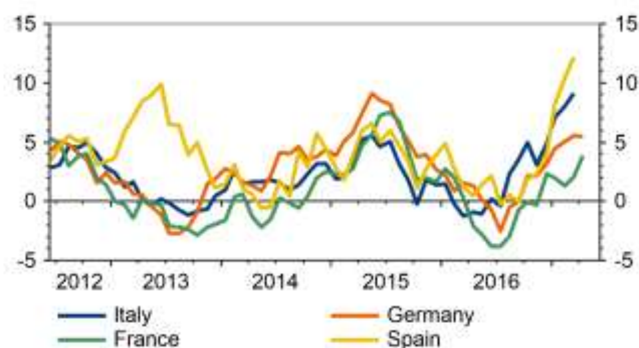
Source: Thomson Reuters-Datastream

Fig. 6 – To date, the improvement in business profitability has only marginally translated into a higher investment rate



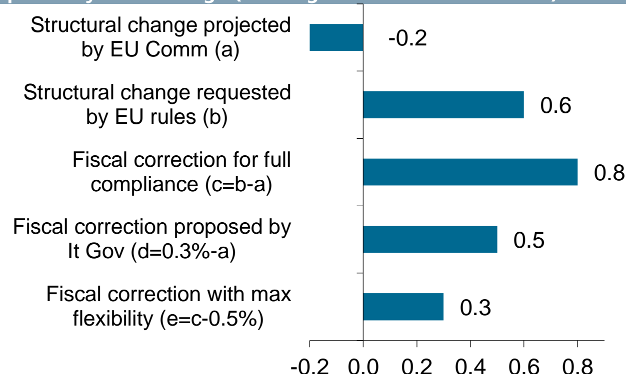
Note: share of gross operating margin and gross fixed investments on value added to the basic prices of non-financial firms. Source: Intesa Sanpaolo elaborations on Istat data

Fig. 7 – Exports recovering sharply (more than in Germany or France)



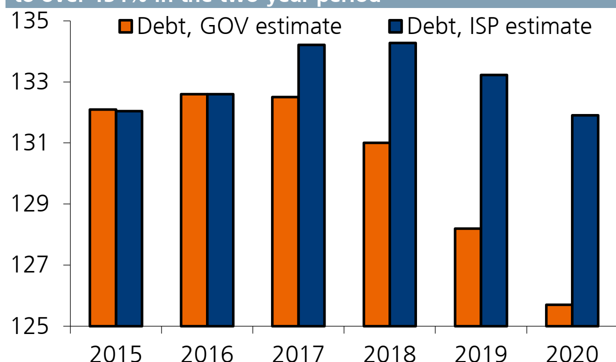
Source: Thomson Reuters-Datastream

Fig. 8 – The 2018 Budget should include, in theory, consolidation worth at least 0.8% of GDP; the adjustment will probably be less large (although no smaller than 0.3%)



Source: Intesa Sanpaolo elaborations on EU Commission data

Fig. 9 – Based on our estimates, and also in view of the blander than expected trend of the GDP deflator, public debt could rise to over 134% in the two-year period



Source: MEF and Intesa Sanpaolo forecasts

Fig. 10 – In the present political situation, a proportional system, even with a high election threshold, is unable to guarantee governability

	Voting intentions %	5% threshold		3% threshold		2.5% threshold	
		N seats	%	N seats	%	N seats	%
Pd	29.3	217	35.1	199	32.2	188	30.4
M5s	28.6	212	34.3	195	31.6	184	29.8
Lega N.	13.0	97	15.7	88	14.2	84	13.6
Fi	12.4	92	14.9	85	13.8	80	12.9
Fdi	4.5			31	5.0	29	4.7
Mdp	3.0			20	3.2	19	3.1
Ap	2.7					18	2.9
SI	2.5					16	2.6
Others	3.9						
TOTAL	100.0	618	100.0	618	100.0	618	100.0
PD+FI	41.7	309	50.0	284	46.0	268	43.4
M5s+LN	41.6	309	50.0	283	45.8	268	43.4

Note: simulation of distribution of House seats; the 12 seats awarded by electors abroad are excluded. Source: LUISS, *Il Sole 24 Ore*, 28 May 2017, Intesa Sanpaolo elaborations

Spain: expansion continues

Anna Maria Grimaldi

The Spanish economy continues to record sustained growth. Following growth of 3.2% in 2016, which outperformed our expectations and the consensus estimates, we have again revised up our growth estimates to 3.0% (from 2.5%) in 2017 and 2.3% (from 2.0%) in 2018. Recent signals from the PMI and economic confidence surveys, together with estimates from the Bank of Spain, suggest resilient economic growth at around 0.9% qoq in the spring, after recording +0.8% qoq.. The largest boost – from low oil prices and ultra-accommodative financial conditions – came between 2Q16 and this spring. Financial conditions will become progressively less expansionary although they will remain supportive. Moreover, expansionary fiscal policy has already become more restrictive this year.

Growth will remain solid in 2017-18

Revised estimates partly factor in better-than-expected export growth. During the period from 2015 to mid-2016, Spanish exports were more resilient than in the rest of the Euro zone, and this seems to have also been the case in the last six months; export indices suggest the recent trend will continue thanks to support from non-Euro zone countries (see Fig. 3). In the first quarter, the **current account balance worsened** (see Fig. 4) as the goods balance net of energy returned to zero. The energy balance is worsening due to the rebound in oil prices, given the high dependency of energy on foreign markets. The expected slowdown in domestic demand is likely to rein in the expansion of the goods balance in the next few years. **The contribution of foreign trade to GDP will be decidedly positive over the forecasting horizon (0.5%)**. After the sharp acceleration to 4% qoq at the start of the year, we expect more moderate growth of 1.0% qoq on average. Exports for the year are forecast to rise by 7.3% in 2017 and to moderate to 4.9% in 2018. **Imports** are expected to grow by 6.6% in 2017 (due to the strong start to the year) and then by 4.1% next year. As with GDP, **we have revised up our growth estimates for domestic demand** by around three-tenths of a percentage point per year for the current two-year period. The revision was triggered by investment growth that was more solid than forecast. **Construction is in a new expansionary cycle**: at the start of 2017, residential investment was at 2.7% qoq, up from 0.9% qoq in the previous 18 months. The strong start to the year means that residential construction is heading for a 7% rise in 2017. In 2018, we expect it to moderate to 4%. Our estimate for non-residential construction growth is an average of 2.4% in 2017-18. The contribution of value added has returned to pre-crisis levels (see Fig.9). The expansionary cycle may continue but, hopefully, it will slow further in 2018, in order to prevent new excesses forming. The figures for early 2017 show an upturn in **investment in machinery** to 3.1% qoq after the hiatus in the previous months. We think, however, that this is an isolated phenomenon and that investment in machinery will slow in the next few quarters since quarterly growth was higher than production capacity (see Fig. 12), confidence in the capital goods segment has fallen in the last few months, and support from the ultra-expansionary financial conditions will progressively lessen. We expect growth of 4% in 2017-18 from 5.0% last year. **Private consumer spending is expected to grow by 2.2% yoy on average**, which is higher than the Euro zone average, but slowing from the figure of 2.8% yoy in the last two years, due to the combination of a 0.2% rise in inflation to 1.8% in 2017 and the slower rate at which new jobs are being created (see below); this will not be offset by the expected rise in contractual wages from 0.7% in 2016 to 1.1% in 2017 (see Fig. 9). Moreover, support from fiscal policy will diminish.

Foreign trade will make a positive contribution to growth

Domestic demand is slowing less than expected and will grow more than the Euro zone average, thanks especially to investment in construction

Investment in machinery: solid growth but less so than in 2016

The **labour market is still a long way from full employment**, despite the progress made in the last three years. The unemployment rate fell by nearly 10% from a peak of 26% in 2017 to 17.8% in April. However, if the unemployment rate is expanded to include the marginally attached and inactive for economic reasons, it would be much higher, at 26%: the highest in the Euro zone in absolute terms. Unemployment again grew at a sustained rate (2.3%) in early 2017; this was better than could have been expected based on firms' stated hiring intentions but less than in 2016 (2.7%) when it had already slowed. Last year, new jobs were only created in the private sector (378,000) while the public sector shed 32,000 jobs. In the last six months, industry (4.2% yoy) and construction (3.2%) saw higher growth than services (1.6%). Confidence surveys indicate

Slowing consumption as inflation rises, wage growth remains sluggish and job creation decelerates

that growth will slow further in the next few quarters, to 1.5% yoy, and hence less than GDP growth. The unemployment rate will fall less over the forecasting horizon than in 2015-16 (-2.4 points) partly because jobs creation will slow but also because labour market participation is declining (58.8% in early 2017 from 59.3% in September 2016), as the number of inactive workers is rising.

Unemployment rate remains at socially unacceptable levels

Spain will remain in the corrective grip of the Growth and Stability Pact. The **deficit** is not expected to return to below the 3% target until 2018, from 4.5% in 2016. In 2017, the deficit is expected to be 3.2% of GDP. The improvement in the nominal balances is largely due to the contribution of the economic cycle. The European Commission, in its spring recommendations, assessed the structural adjustment for 2017 as barely adequate, but, under existing legislation, judged the change in the structural balance for 2018 (0.0%, compared with the required efforts of 0.5% of GDP, based on the rules of the Growth and Stability Pact) to be insufficient. The uncertainty about what will happen to the balances stems from both the impact of the taxation measures approved last December (increase in tobacco and alcohol duty, a broadening of the tax base for social contributions) and cost control measures (the Commission specifically refers to the rule to strengthen the sustainability of the public finances). In the government's estimates, the debt/GDP ratio is expected to fall to 98.8% as early as this year, and to 97.6% in 2018. The Commission's estimate of debt falling to 98.8% in 2018 is more cautious, partly due to the uncertainty surrounding the revenues to be generated from privatisations (estimated to be around 0.4% of GDP this year and 0.2% next year).

Fiscal policy will be tightened. Debt will fall below 100% of GDP, mainly thanks to growth

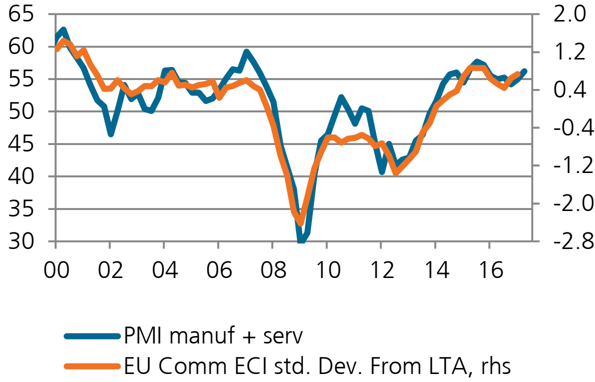
Despite the fact that the pace of growth is more solid and well above the Euro zone average, **the country continues to face a number of challenges ahead**. The unemployment rate is still at unacceptable levels for social cohesion, and reducing it remains one of the main challenges. (see Fig. 11). Private sector debt, although down from its 2007 peak, is still above the Euro zone average (see Fig.12). The high foreign debt position (see Fig.14) remains an element of weakness and leaves the country vulnerable to changes in market sentiment. It is crucial, therefore, that the country maintains its current account surplus and continues with the process of internal deleveraging.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	3.2	2.8	2.3	3.4	3.2	3.0	3.0	2.9	2.8	2.7	2.5	2.4	2.3
- q/q change				0.8	0.7	0.7	0.8	0.7	0.6	0.6	0.6	0.5	0.5
Private consumption	3.2	2.3	2.2	0.7	0.6	0.8	0.4	0.6	0.5	0.5	0.7	0.6	0.4
Fixed investment	3.1	3.0	2.8	1.4	-0.1	0.5	2.0	-0.2	0.5	0.8	1.0	0.6	0.8
Government consumption	0.8	0.7	0.9	-0.6	0.5	-0.2	0.3	0.3	0.3	0.1	0.3	0.2	0.2
Export	3.7	5.0	2.7	0.8	0.4	1.4	2.7	0.4	0.4	0.9	0.8	0.5	0.5
Import	3.3	6.6	4.1	2.6	-2.0	1.8	3.8	1.0	1.2	1.0	0.8	1.0	1.2
Stockbuilding (% contrib. to GDP)	0.1	0.3	-0.2	-0.1	0.1	0.1	-0.1	0.3	0.3	0.1	-0.5	-0.1	0.2
Current account (% of GDP)	1.6	1.8	1.6										
Deficit (% of GDP)	-4.5	-3.2	-2.8										
Debt (% of GDP)	99.4	99.2	98.8										
CPI (y/y)	-0.3	1.9	1.4	-0.9	-0.2	1.0	2.7	1.9	1.4	1.3	0.5	1.5	1.7
Unemployment (%)	19.6	18.3	18.3	20.2	19.3	18.6	18.2	18.4	18.4	18.3	18.3	18.3	18.2

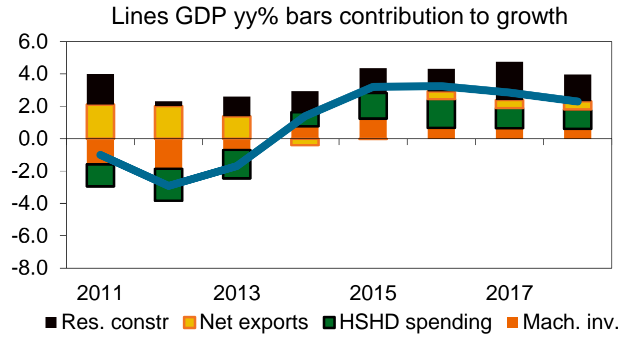
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 - Above trend growth continues but the speed may be declerating [Click to Type]



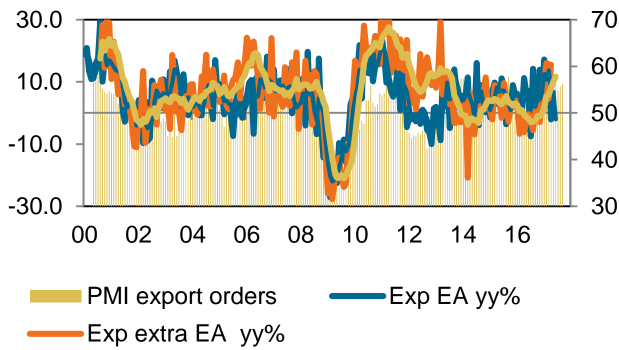
Source: Intesa Sanpaolo chart from Markit PMI and EU Commission

Fig. 2 – Consumption has now peaked but growth will remain solid (2.2%). The cycle of investment in machinery seems to be mature. But residential construction is picking up pace again



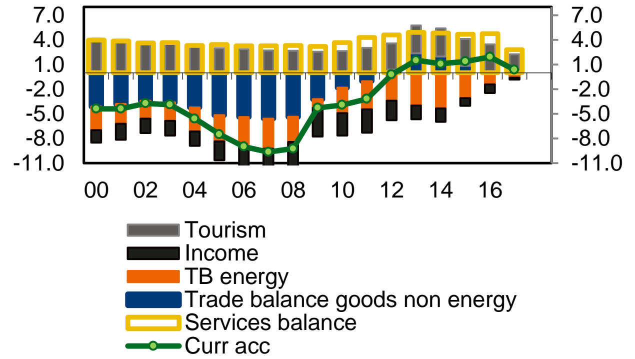
Source: Intesa Sanpaolo chart from INE and Eurostat data

Fig. 3 – Exports have underperformed expectations in the last six months. The uptick in global demand raises hopes of a more marked recovery in 2017



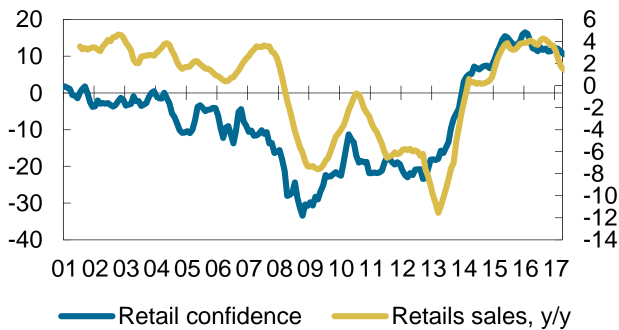
Source: Intesa Sanpaolo chart from Eurostat and INE data

Fig. 4 – The goods balance has worsened, but the energy balance is improving. Services balance falling due to lower tourist inflows



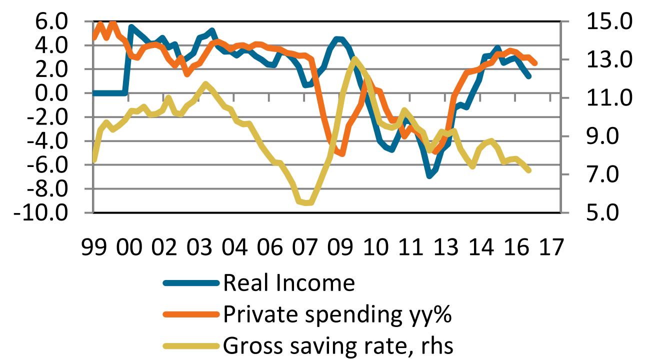
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 5 - Private consumer spending may have peaked. But growth will remain solid



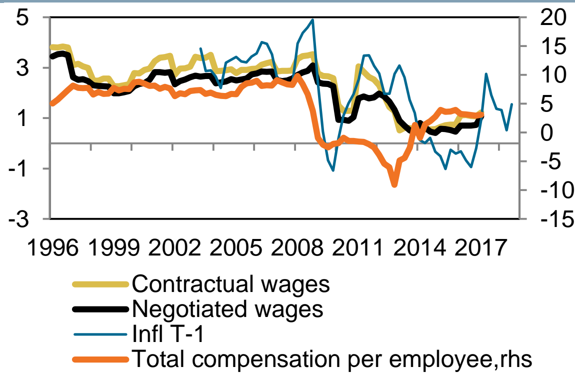
Source: Intesa Sanpaolo chart from INE data

Fig. 6 – Consumption is keeping pace with income. The low savings rate will provide limited support when real income slows due to...



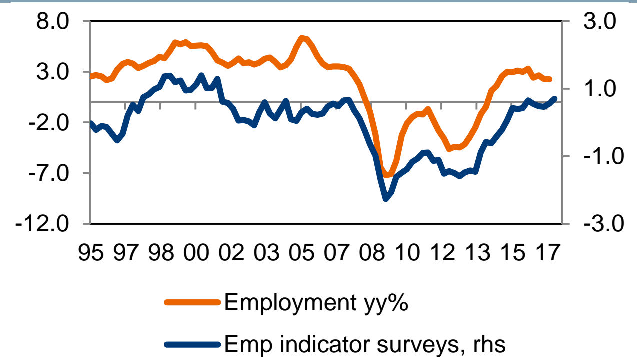
Source: Intesa Sanpaolo chart from INE data

Fig. 7 – …inflation on the rise; sluggish wages



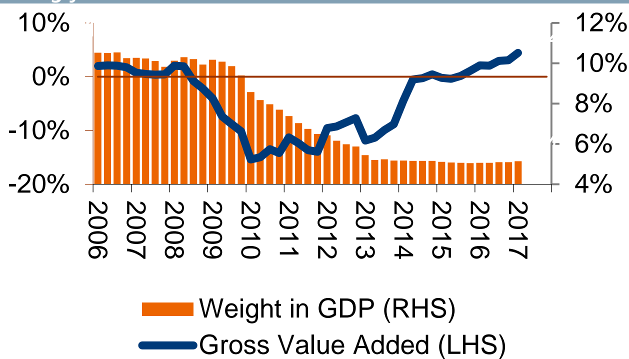
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Employment resilience remains the key to social cohesion



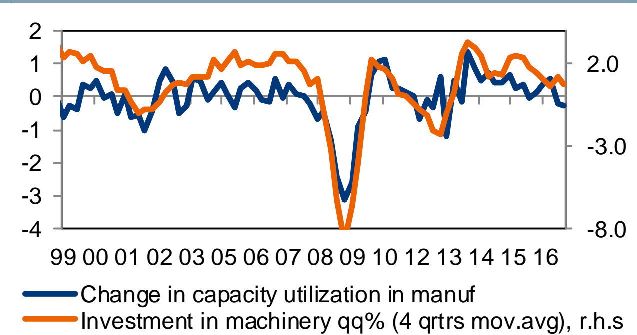
Source: Intesa Sanpaolo charts from UE Commission and INE data

Fig. 9 – Value added in residential construction again growing strongly



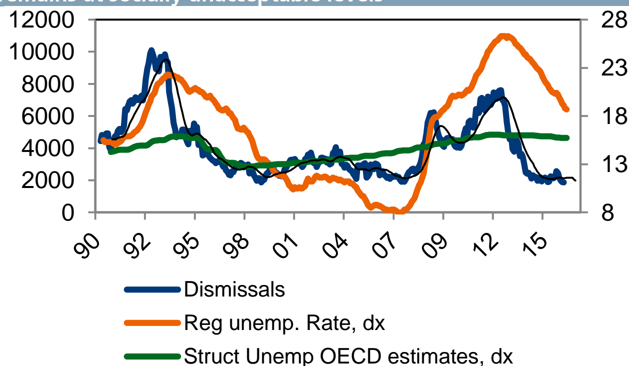
Source: Intesa Sanpaolo chart from INE data

Fig. 10 – Machinery investment cycle is mature



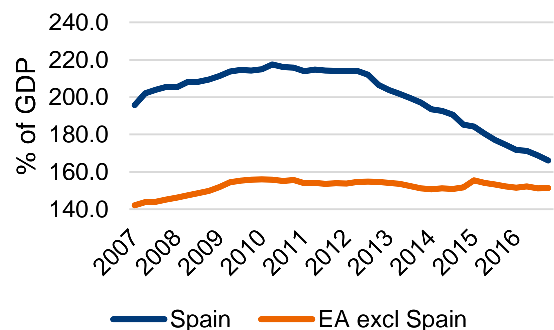
Source: Intesa Sanpaolo charts from INE and European Commission data

Fig. 11 – Unemployment has fallen by almost 8 points but remains at socially unacceptable levels



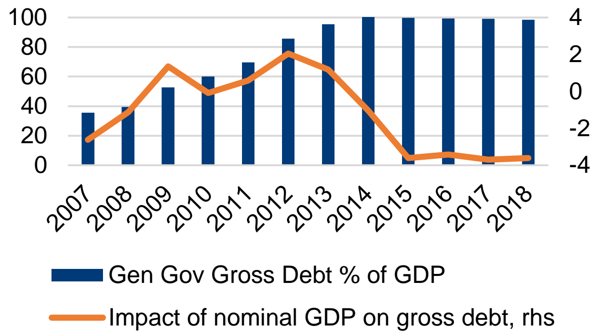
N.B.: the black line shows the 6-month moving average of dismissals
Source: Intesa Sanpaolo chart from INE and OECD data

Fig. 12 – Private sector debt has fallen but is still higher than the Euro zone average



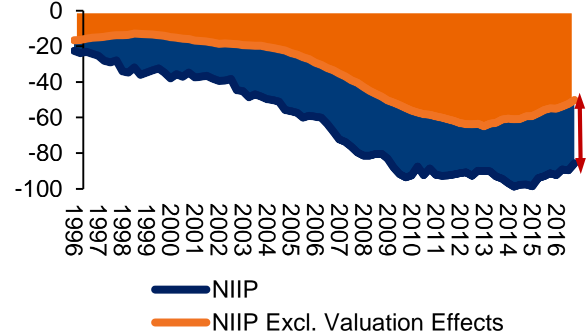
Source: Intesa Sanpaolo chart from ECB and INE data

Fig. 13 – Public sector debt expected to fall from this year, mainly thanks to solid growth



Source: Intesa Sanpaolo chart from European Commission data

Fig. 14 – High foreign debt position remains an element of weakness



Source: Intesa Sanpaolo chart from Bank of Spain data

Netherlands: 2017 - third year of growth above 2%

Guido Valerio Ceoloni

GDP growth still accelerating this year, from 2.1% to 2.3%

After a first quarter in which GDP grew by 0.4% qoq, two tenths of a point below the Euro zone average, we expect an upturn in June to 0.6% qoq, mainly thanks to domestic demand supported by growing disposable income and rising employment. The economy is expected to slow slightly over the rest of the year, with a growth rate of 0.5% qoq, taking the annual figure from 2.1% to 2.3%, above the Eurozone average for the fourth consecutive year. **Again this year, the main growth driver will be domestic demand,** while foreign trade will be less dynamic than in 2016. For 2018, we forecast a slowdown in GDP growth to under 2% (1.8%).

Consumption stabilising this year, but disposable income continues to grow

In March, **consumption** took its first break after four positive quarters, edging down by 0.1% qoq. From Q2 onwards, it should however return to growth, at a rate of 0.3-0.4% qoq, partly thanks to EUR 1.1 Bn fiscal stimulus. The consumer confidence index is well above its historical level and the Euro zone average; in the first five months of the year, it rose sharply compared with 2016 (from 3.6 to 15.8), partly thanks to the positive results of the spring elections, which averted the risk of a victory for the populist parties. **On an annual average basis, growth in consumption is therefore expected to stabilise this year at 1.3%, from 1.7% in 2016.**

Investment to slow slightly in 2017. Buoyant property market and sharp rise in house prices, which however remain below 2008 highs 8

Capital investment posted a record rise in March (+4.6% qoq, from -1.7% qoq), mainly thanks to machinery (+12.6% qoq, from -8.6% qoq). After having grown by 1.1% in 2015 and by 5.3% in 2016 (mainly thanks to the contribution of the residential component), for 2017 we expect a **slowdown** to approximately 5.0%, with **productive investment** picking up the baton from investment in real estate, driven by a marked upturn in the transport equipment, chemicals and refining sectors. Confidence indicators on economic activity remain above the historical average, despite a modest correction in May. The **property market** is showing the first signs of possible overheating, with **house prices up by 7.4% yoy in April**. They were at an all-time high when the bubble burst in August 2008, and current prices are still 8.3% below these highs, but the recent growth rate of almost 2% a quarter, with an increase in transactions of almost 20% in April compared with the previous year, is starting to attract attention. **A recovery in public investment** is also likely to contribute to 2017-18 growth, with an average rise of 1% after two years of contraction.

Industrial output registered a natural decline in the first quarter of 1.36% qoq, after strong growth at the end of 2016, but has posted uninterrupted growth in year-on-year terms for almost 20 months. For the rest of the year, we expect an increase of approximately 0.3% qoq, with an annual average at 1.7% from 2.0% in 2016, driven by machine production and the chemicals industry.

Net exports broadly neutral this year

Exports grew by 0.9% qoq in the first quarter of the year, the same rate as in December: we expect an upturn from the second quarter to 1.2% qoq (particularly thanks to the exports of household appliances and chemical products, mainly to Germany). The rate is then seen stabilising in the second half of the year, with the 2017 annual average at 3.9%, from 3.3%. **Imports** also grew in the first quarter despite the slowdown in consumption, with growth of 1.2% qoq, from 0.5% qoq. In the second quarter, they could improve further before stabilising from the summer, with annual average growth rising from 3.6% to 4.1%. **Foreign trade should therefore be broadly neutral** in terms of contribution to GDP this year. In 2016, the **trade balance** was 7.4% of GDP: we expect a rise to 8.1% in 2017.

Inflation slowing after the surge at the beginning of the year, expected to come in just below 1% in 2017

In Q2, harmonised inflation slowed compared with the first few months of the year. In May, inflation fell significantly, from 1.4% to 0.7%, and is expected to remain below 1% for the rest of the year, mainly owing to the weakness of the core component and the easing of the rise in energy prices. On average, **we see inflation picking up from 0.1% in 2016 to 0.9% in 2017, before stabilising around 1% in 2018**. The **core** index, which in 2016 came in at 0.6%, is this year

expected to slow by a couple of tenths of a point to 0.4%, owing to the lack of pressure on manufacturing prices paid. The gradual absorption of slack in the labour market is likely to put greater pressure on wages by early 2018, which will be reflected in price levels next year.

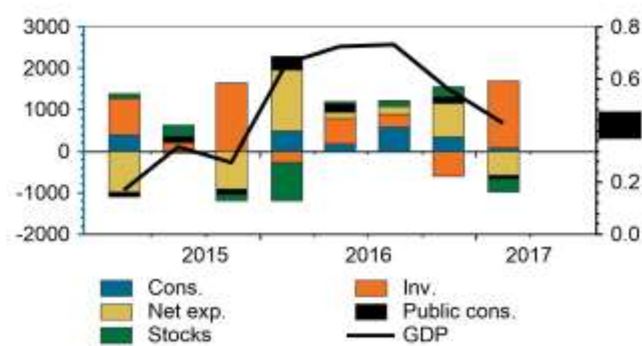
Labour market in excellent health, but the gap between full-time and part-time work is widening

The **labour market** continues to improve: in the first quarter, 56,000 new jobs were created, with approximately half on a temporary basis. In the first quarter alone, recruitment agencies registered an increase in job openings of almost 13,000 (a high since 2007). **Hours worked** increased by 1.4% qoq in March, slowing from 2.1% qoq in December. **Unemployment** fell by three tenths of a point in the first quarter, from 5.5% to 5.2% in March; in May, it fell by a further tenth, to 5.1%: we expect an overall drop of a further two tenths of a point in the rest of the year, spread evenly across the main production sectors, leading to **an average for this year of 5.1%, from 6.0% in 2016, more than four points below the level for the Euro zone**. On the **employment** front, compared with an average of 35,000 new jobs a quarter in 2016 (+0.6% qoq), the rate is expected to slow to approximately half this year (+0.3% qoq), with employment seen rising to 67.5%. The labour market continues to improve despite a participation rate that remains below pre-crisis levels owing to the large pool of labour.

Public finances with budget surplus and deficit below 60%

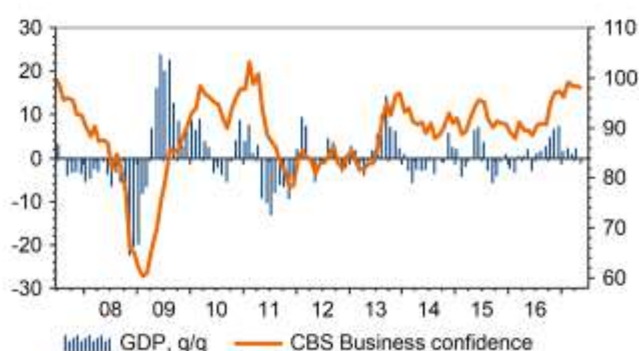
The state of the **public finances** remains **exceptionally positive**. 2016 saw a net improvement in the **budget position**, which now shows a **surplus of 0.4%.** This was thanks to higher than expected revenues, which offset the loss of income from gas extraction. This year, we expect to see a further marginal improvement in the surplus to 0.5%. **The structural surplus is however expected to be partially eroded, from 0.7% to 0.2% this year**. **Public debt is seen falling further to below 60%,** from 62.3% in 2016, fully in line with Maastricht criteria. **The main risk in the current scenario remains political**, with the States General so far being unable to form a government: after the collapse of the four-way alliance between Mark Rutte's VVD, the Christian Democrats (CDA), the D66 and the Greens (GL), a coalition that excludes the Greens and replaces them with the Christian Union (CU) could take the helm, with a slimmer majority (76 seats out of 150). The long time periods and long negotiations are however a feature of Dutch politics, and the new government could be created by the autumn. Another threat could come from a **property market** bubble following that of 2008: for now, however, it remains an issue to take into consideration and not a real risk.

Fig. 1 – Contribution to GDP



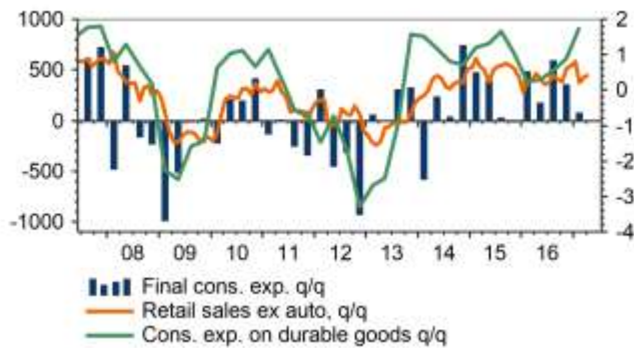
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – Economic confidence and GDP



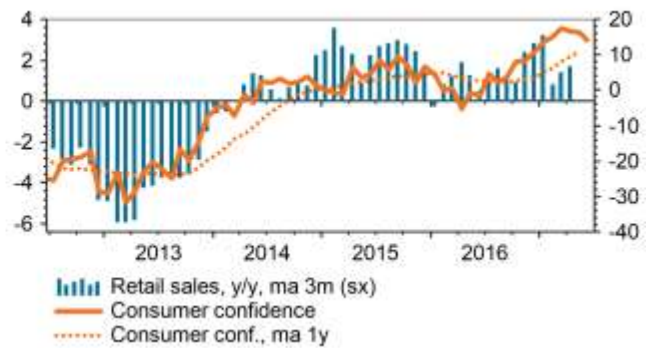
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending, purchases of durable goods and change in consumer spending



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

Fig. 4 – Retail sales and household confidence

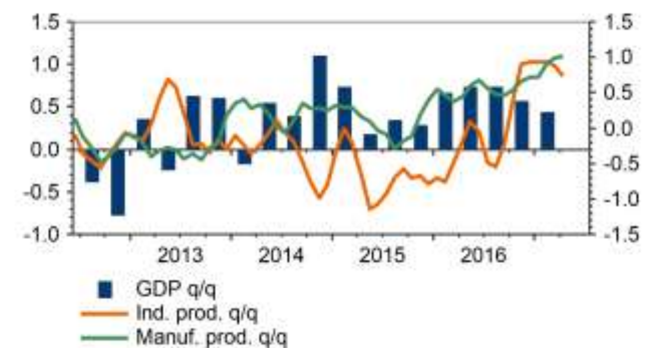


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment, construction sector activity and house prices

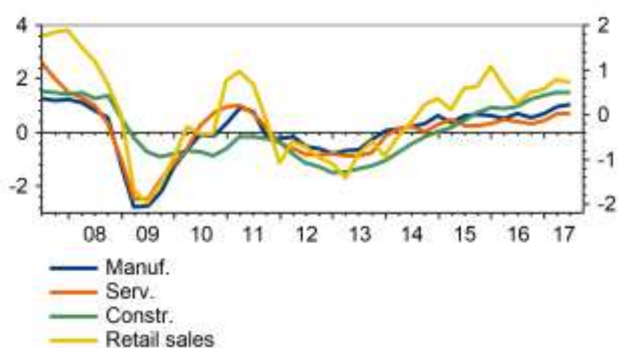
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



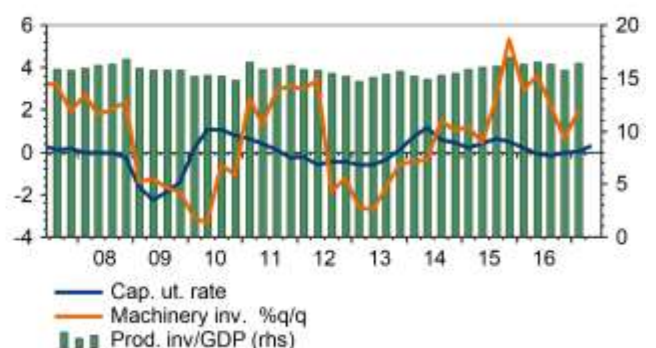
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



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

Fig. 8 – Production capacity utilisation and level of investment as proportion of GDP

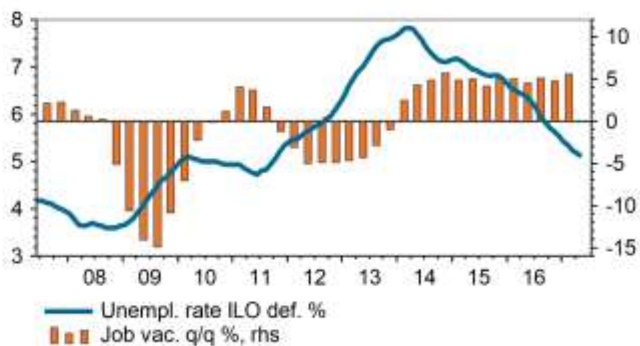


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Exports, export orders and global PMI

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

Fig. 10 – Unemployment and job vacancies



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

Greece: agreement reached at the eleventh hour to meet July's maturity, but there is still no long-term solution in sight

Guido Valerio Ceoloni

The last meeting of the Eurogroup in June achieved some positive results, putting an end to months of speculation and postponements relating to the conclusion of the second review of the bail-out, which had stalled since last year: the agreement clearly boosted GGBs, with 10-year yields dropping by more than 25 bps to an all-time low of 5.4%. According to the terms of the agreement, **EUR 8.5 Bn will be released, enabling Athens to honour the next maturity in July of EUR 7 Bn. Nothing, however, has been agreed to prepare the country for the "post-bailout" period,** apart from the not-very-credible agreement to maintain a primary surplus at 3.5% from 2018 to 2022, and at 2% from 2023 to 2060, and the general forecast of the deferred payment of certain tranches of interest "in the event that this will be necessary"; for its part, Athens has undertaken to cut pensions and widen the tax base from 2019 onwards (with an overall cut in spending of 2% of GDP). **The IMF's position has remained unchanged, pending a concrete debt relief plan**, which European partners have however let it be known they do not want to tackle before next year. The IMF is said to be willing to pay out a further EUR 2 Bn, but only after a restructuring that will make the debt sustainable in the long term. Without approval on the sustainability of the debt from the IMF, the inclusion of Greece in the ECB's QE now seems unlikely before the closure of the purchase programme (and the issues that could be included would in any case be scarce). Europe therefore continued in its usual strategy for Greece of avoiding the imminent danger at the last minute and deferring a long-term solution. 2017 should however now be sheltered from further tension, but in summer 2018, the country is expected to emerge from the bail-out and return to the market (with a debt refinancing cost that is currently around 15% of GDP and which will grow up to 20% in the long term).

Downwards revision of 2017 GDP growth, the economy remains fragile and the terms of the June agreement merely gain time to 2018

As regards the economic scenario, **GDP** surprisingly rose by 0.4% q/q in 2017Q1, after -1.1% q/q in 2016Q4 (fall due to the tightening of public consumption and the slowdown in exports). **Growth in the first quarter was therefore barely 0.1% y/y**, on the back of the weak end to 2016. **For the current quarter, we expect, in line with consensus, an upturn** of around 0.3% qoq thanks to domestic demand. In the second half of the year, GDP is expected to grow at a faster rate, thanks to the end of uncertainty on the status of the bail-out that has been weighing on the country since the last quarter of 2016. We therefore see annual average **GDP growth for 2017 at around 1% following the stagnation of 2016:** in Spring, the European Commission revised down its estimates (from 2.7% to 2.1%), but they remain much more optimistic than consensus. **Consumption** fell back last year by 0.3% yoy, but is expected to recover in 2017 to growth of around 1.5% (particularly from the summer onwards), stimulated by the rise in **employment**, which increased by 1.3% last year and is expected to maintain a similar rate this year; last year, **unemployment** fell to 23.6%, with a further drop expected this year to 22.8% (it was 22.5% in April), but it remains the highest in the Euro zone. Consumer confidence remains well below the historical average: also given the further fiscal consolidation expected this year and the upturn in **inflation** to more than 1%, partly due to the rise in tobacco duties, consumption could be impacted by more than expected. **Investment** could rise by 3.6% this year after growth of 1.6% in 2016: the European Commission's ESI posted a slight improvement in 2Q versus 1Q, coming in at average levels that are higher than in 2016 (from 91.7 to 93.9), but still below the growth threshold; PMIs also still remain below 50. Foreign trade is likely to benefit from the tourism season and growing demand for associated services, with growth in **exports** recovering this year to 2.4% from -1.2% in 2016; meanwhile, **imports** are set to pick up this year (+8.8% from 1.3%), fuelled by rising consumption. Overall, net exports will dampen growth again this year. Turning to the **public finances**, in 2016 Greece beat the targets set[10], with a surplus of 0.7% of GDP and a

[10] However, we should take into account that the primary surplus target of 0.5%, lower than that set for this year and next, was partly reached through one-off measures, such as delayed payments and tax amnesties.

primary surplus of 3.5% (compared with 0.5% agreed in the MoU). **The target for the current year is a primary surplus of 1.75%** (and 3.5% for 2018): given the more disappointing growth prospects than expected, there is a possibility that tax revenues will be lower than expected, and considering that the objective for 2017 is higher than it was for 2016, **there are concrete risks that it will not be met**. We expect public debt to stabilise from this year, falling just a few tenths of a point after having peaked at 179.0% of GDP in 2016; it is expected to fall at appreciable rates from 2018.

Compared with our previous quarterly report, **the agreement to unblock the tranche linked to the second review has not significantly changed the scenario, with risks remaining to the downside**. Even if the worst is now behind us in terms of contraction of activity, GDP remains 27% below pre-crisis levels, the recovery seems rather fragile (with growth estimates revised down) and the Eurogroup's decision to again defer the issue of the debt will again fuel uncertainty about what will happen from summer 2018.

Portugal: 2017 - a positive year under the ECB umbrella

Guido Valerio Ceoloni

After an upturn in the second half of 2016, GDP continued to expand robustly in 1Q, with growth of 1.0% qoq, mainly on the back of net exports. We expect this rate to slow in 2Q to around 0.3% qoq, a pace that should then be maintained until the end of the year; risks to the forecast are to the upside, however. **Growth is already equal to 2.0%**, from 1.4% in 2016. **For the current year, we have therefore revised up our previous forecast from 1.7% to 2.5%**, above European Commission estimates (1.8%), but below those of the Ministry for the Economy and the central bank, which project growth of 3% this year. GDP levels are still more than 3% below pre-crisis peaks, however. The main growth driver is likely to remain **domestic demand**, while we expect a slowdown in foreign trade from this quarter. **Consumption** is seen slowing this year, with growth falling from 2.3% to 1.7%; the removal of the surtax on income and the increase in the minimum wage should offset the effects of rising **inflation** (expected to be 1.4% this year, from 0.6%) on disposable income. The labour market is set to continue to improve, and **unemployment** could fall by more than a point to an annual average of 9.9%, from 11.2% in 2016 (above but close to the Euro zone average). **Employment** is set to increase this year by approximately 0.2% qoq per quarter, mainly thanks to the positive phase enjoyed by the building industry. **Economic confidence indicators** have improved further since the beginning of the year, with the European Commission's ESI at a nine-year high of 112.7, from 110.3 in 1Q, and well up on the 2016 figure of 106.4: indicators suggest that **investment** growth is likely to see a marked upturn, from 0.1% in 2016[11] to 6.4%, on the back of the strong start to the year (8.9% yoy, from 5.2% yoy), driven by construction, the recovery in public investment and EU funds for the 2014-2020 programming period, which should come on stream from the autumn. There are, however, signs of a slowdown in capital goods imports, indicating that the expansionary phase of investment in manufacturing could slow in the future, and hand the baton to construction, which is recovering strongly, partly on the back of foreign investment. **Exports** are set to slow from the summer, while remaining buoyant thanks to tourism, which is this year registering flows that are 10% up on 2016: after the strong start to the year, annual average export growth will rise from 4.4% in 2016 to 7.6%, while **imports** will be supported by the resilience of consumption and the recovery of investment, with growth rising from 4.5% to 5.6%. The country's **public accounts** improved last year, thanks to the amnesty on taxes in arrears, with the **deficit** also set to improve this year, falling by two tenths of a point from 2.0% to 1.8%, mainly thanks to the (one-off) recovery of the state guarantee for bank BPP, equal to approximately 0.25% of GDP. Given the limited impact of fiscal consolidation this year, the **structural deficit** is expected to increase by two tenths of a point to 2.2%, from 2.0% in 2016, while **public debt** is seen falling marginally to around 129% of GDP, after having risen to 130.4% in 2016, owing to the recapitalisation of state-owned Caixa Geral de Depósitos.

The outlook is positive for 2017, with growth forecasts again revised up. Exports and construction extremely dynamic. The end of QE from 2018 could trigger renewed tensions on the public finances

For the current year, buoyant economic activity, the positive trend in the Euro zone election cycle and the ECB's APP will protect the country from risks; however, from 2018, the gradual tapering of the ECB's QE will lead to an increase in the cost of debt, and the market's focus will therefore be on the performance of the country's public finances. After the 2017 hiatus, risks to the scenario will remain to the downside, with clear concerns regarding the weakness of the banking sector and the country's high level of structural debt (both the state and the private sector).

[11] 1Q16 was hit particularly hard by a period of political instability, which depressed investment.

Asia

Japan: growth is solid, but prices and wages struggle to pick up

Giovanna Mossetti

The Japanese economy continues to grow at above potential, driven by the positive contributions of all the main components of aggregate demand. The lack of new restrictive fiscal shocks, and the closing of the output gap, together with the positive thrust of corporate earnings, are supporting investments, the labour market, and consumption. The recovery in international demand is helping keep the trade balance in positive territory. The inability of inflation to rise should prevent the BoJ from starting to plan an exit from the current stimulus programme (QQE + yield curve control) at least until mid-2018, or even beyond. The outlook for growth in 2017-18, therefore, remains positive, and points to GDP growth of 1.2% this year and 0.9% in 2018. Risks to growth are skewed to the upside.

1. Macroeconomic picture: growth above potential, mounting excess demand for labour.

The outlook for the Japanese economy is positive for 2017-18, forecast to grow at above-potential rates, estimated at 0.8% by the Cabinet Office, and between 0.5% and 1% by the BoJ (around 1% in 2016). The economy is now in an excess demand phase, both in terms of production capacity and in terms of labour resources (Fig. 2): the BoJ estimates that the output gap has closed since 2016, and the business surveys signal that firms are finding it increasingly difficult to cover open positions. GDP growth in 1Q 2017 was +0.3% q/q. Final domestic demand accelerated compared to the end of 2016, with consumption rising by 0.3% q/q (after stagnating at the end of 2016) and non-residential investments growing by 0.6% q/q. Public spending also contributed positively (investments +0.4% q/q). Net exports contributed +0.1pp, inventories -0.1pp.

In the remainder of 2017, the trend should remain positive for all components of aggregate demand. **Non-residential investments** should grow at a solid pace (estimated at +3.1%, from 1.4% in 2016). Business confidence surveys remain compatible with an expansion in the manufacturing sector, supported by positive domestic and foreign orders, and are in line with effective industrial output data (Fig. 4), up sharply in 2Q. Furthermore, the high level of production capacity utilization, and the difficulty in filling jobs, should support capital expenditure aimed at increasing labour productivity.

For what concerns **consumption**, the moderation of the trend observed in 2016 (+0.3%) is still tied to the increase of the savings rate (Fig. 8), prompted by the latest consumption tax hike. As labour market prospects keep improving, despite the still subdued trend of wages, consumption should accelerate somewhat in 2017-18 (+0.9% in each of the two years), whereas the savings rate is likely to stabilise around its recent levels.

The **labour market** is the key factor in the Japanese scenario for 2017-18, as it may at last generate an upward thrust in prices and wages. Opposite forces clash on this front: rising demand and decreasing supply (Fig. 6). The unemployment rate dropped to 2.8% in April (a low since May 1994), and the jobs-to-applicant ratio hit 1.48 (a high since February 1974), confirming the increasing excess demand for labour, in line with the findings of business surveys (Fig. 2). To date, this excess has not resulted in higher wages (Fig. 9): in fact, contractual wage growth seems to be slowing, despite the positive employment trend. The evolution of labour force participation is the variable to monitor in order to solve the puzzle which has taken shape in recent years and forecast the future trend of labour compensation. Between September 2012 and March 2016, participation grew by 1.2pp (from 59% to 60.2%), generating a 930k increase in potential workers, in a period in which the population aged between 15 and 64 decreased by around one million. The rise was driven by the female component and by over-65s (Fig. 5). An analysis of the breakdown of individuals not participating in the labour force at the beginning of 2017 shows that reserves to keep participation on the rise are now very limited, and even with active economic policy measures in this direction, by the end of 2017 the labour force trend could slow

significantly. The expected future shortage of workers varies depending on productivity growth. Given the current productivity stagnation, yearly job gains would need to amount to over 1 million to support GDP growth of around 1%; an acceleration in productivity towards 0.5% would require a more feasible increase of around 350k. The labour force picture explains to a large extent the subdued wage growth in 2015-16, and supports expectations for an acceleration in 2017-18. It should also be pointed out that, as an increasing share of senior workers exits the market, the average wage is held back by the entry of young workers at the lower end of the compensation scale.

Net exports should continue to make a modest positive contribution to growth, thanks to the positive export tend, helped by the weak yen and the improving global economic cycle.

2. Fiscal policy still expansionary.

Fiscal policy should support growth in 2017, thanks to full implementation of the public spending hikes decided in 2016.

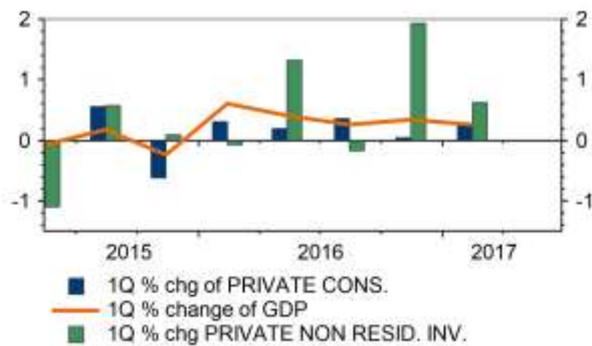
3. Monetary policy and inflation: BoJ playing for time.

Inflation remains distant from the 2% goal. The index net of fresh food (Fig. 11) kept declining throughout 2016, and only sent shy signals of a reversal at the beginning of 2017, although it was held back by the correction of telephone fares. The BoJ still forecasts a return to 2% in the medium term (1.9% at the end of fiscal year 2019), although the path outlined by the central bank's projections remains excessively optimistic: in our view, it will be revised down with the next update in July. In June, the BoJ kept in place **the strategy of QQE and yield curve control,** with unchanged targets on rates (zero for 10Y JGBs, -0.1% for the policy rate on deposits with the central bank) and asset purchases (including the indication of "around 80 trillion yen" for JGBs). In order to reach the rate indicated in the guidelines for curve control, purchases may have to be stepped up, in the event of upward pressures generated by a potential rise in US yields. For now, however, the target on rates prevails over the target on quantities: Kuroda specified that purchases vary on a monthly basis, and that the 80 trillion yen indication is a "guideline". The BoJ reasserted that the current strategy will stay in place "as long as necessary" to reach and stabilise the inflation goal at 2%. Recently, the BoJ was rumoured to be starting to prepare the exit from the current programme. Kuroda stressed that it is early yet to consider an exit, which will involve short-term rates and the size of the balance sheet, as this would generate damaging confusion on the market. However, Kuroda said that ETF purchases are not tied to JGB purchases, and could be adjusted even before the 2% rate is achieved. For now, the central bank seems likely to want to stay on hold: initial indications on **the exit sequence (balance sheet stabilisation or rate hike first?) could come in the closing months of the year**, followed by possible implementation at a later stage, not before the first half of 2018.

Macro forecasts	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.2	0.9	0.9	1.0	1.6	1.3	1.2	1.2	1.1	1.0	0.9	0.9
q/q annual rate				1.6	1.0	1.4	1.0	1.5	1.0	1.0	0.5	1.0	1.0
Private consumption	0.3	0.9	0.9	0.8	1.4	0.1	1.1	0.9	1.0	1.0	0.7	0.8	0.9
FI - private nonresidential	1.4	3.1	1.2	5.4	-0.7	7.9	2.5	1.8	2.2	2.3	0.6	0.6	0.3
FI - private residential	5.5	2.5	0.6	13.2	11.0	0.8	1.1	-0.7	0.9	0.8	0.4	0.5	0.8
Government investment	-2.9	-0.6	1.4	2.7	-5.0	-11.5	-0.6	12.0	1.5	-0.3	-0.4	2.0	1.5
Government consumption	1.3	0.6	1.4	-4.8	0.8	0.2	0.0	2.6	1.6	1.6	1.6	0.8	0.8
Export	1.1	5.6	1.6	-5.6	8.0	14.1	8.7	0.6	1.2	0.9	0.5	3.0	2.7
Import	-2.3	3.1	2.3	-4.4	-0.9	5.3	5.6	3.5	2.5	2.3	2.3	2.1	2.2
Stockbuilding (% contrib. to GDP)	-0.3	-0.3	0.0	1.0	-1.3	-0.6	-0.5	0.2	-0.1	0.0	0.0	0.0	0.1
Current account (% of GDP)	3.7	4.3	4.3										
Deficit (% of GDP)	-5.0	-6.0	-5.6										
Debt (% of GDP)	219.5	223.1	224.9										
CPI (y/y)	-0.1	1.0	1.2	-0.4	-0.5	0.3	0.3	0.9	1.2	1.4	1.2	1.2	1.1
Industrial production	-0.2	5.7	2.5	-1.5	1.0	2.8	4.0	7.6	6.4	4.9	5.2	1.8	1.7
Unemployment (%)	3.1	2.8	2.6	3.2	3.0	3.1	2.9	2.8	2.8	2.7	2.7	2.6	2.6
JPY/USD	108.8	113.6	117.8	107.9	102.4	109.6	113.6	111.1	113.9	115.8	116.6	117.6	118.3

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

Fig. 1 – Growth driven by non-residential fixed investment

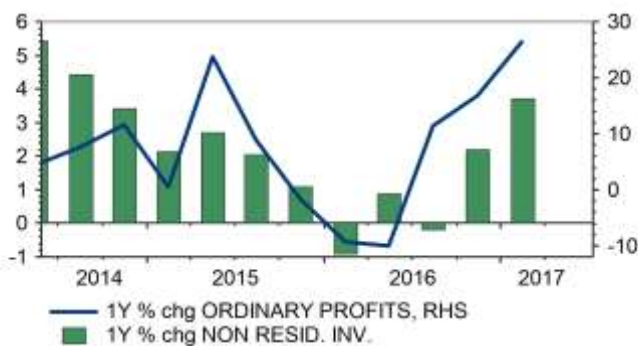


Fonte: Thomson Reuters-Datastream

Fig. 2 – Output gap closed, and excess demand for labour increasing

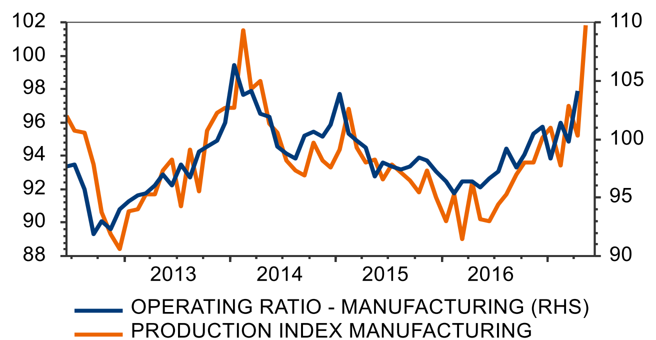
Fonte: BoJ

Fig. 3 – Firms investing again, thanks to stronger corporate earnings



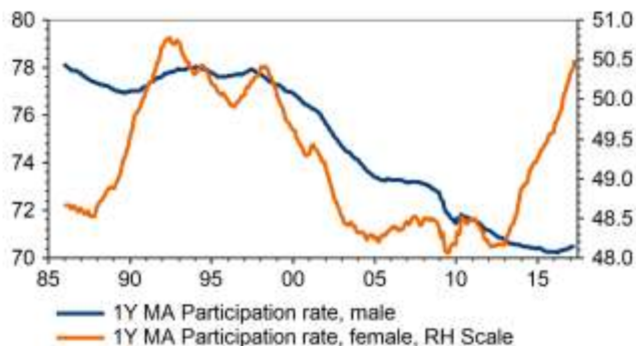
Fonte: Thomson Reuters-Datastream

Fig. 4 – Industrial production up sharply



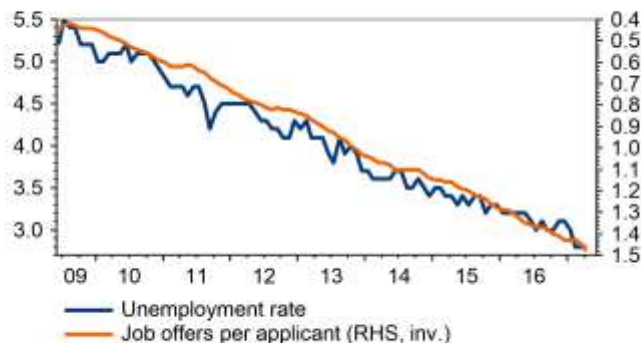
Fonte: Thomson Reuters-Datastream

Fig. 5 - Female labour force participation: a regime shift



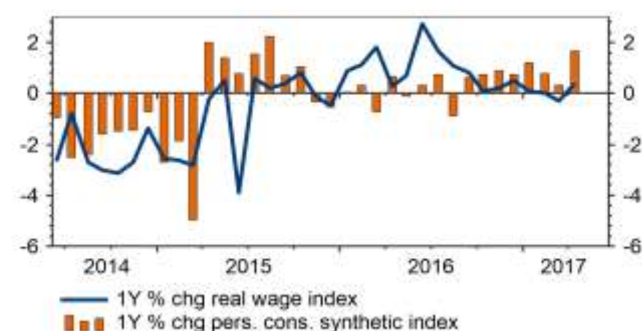
Fonte: Thomson Reuters-Datastream

Fig. 6 – Unemployment down, job openings up



Fonte: Thomson Reuters-Datastream

Fig. 7 – Consumption recovering moderately despite the weak wage trend

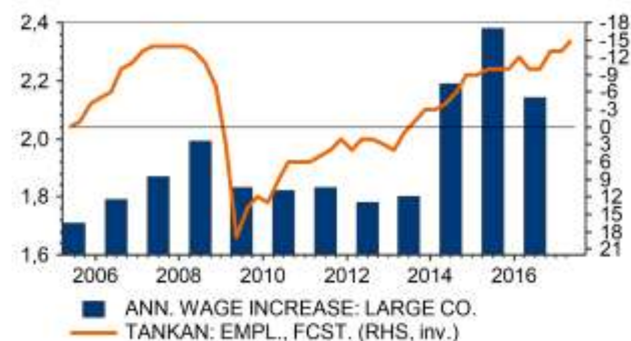


Fonte: Thomson Reuters-Datastream

Fig. 8 – Savings propensity up after the consumption tax hikes

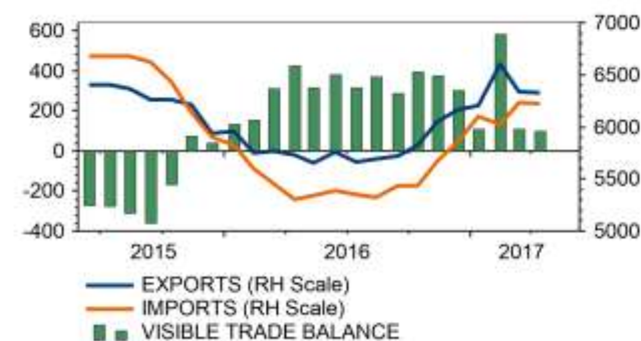
Fonte: Thomson Reuters-Datastream

Fig. 9 – Contractual wages weak, despite excess labour demand



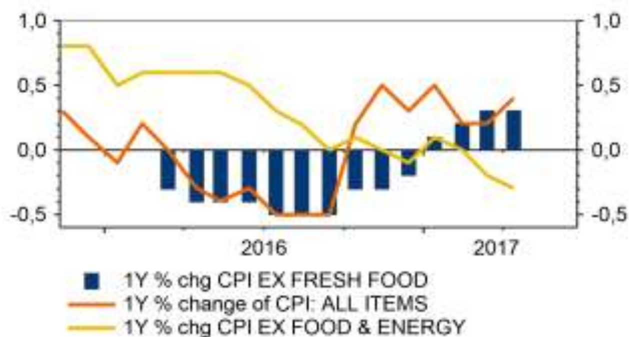
Fonte: Thomson Reuters-Datastream

Fig. 10 - Trade balance positive



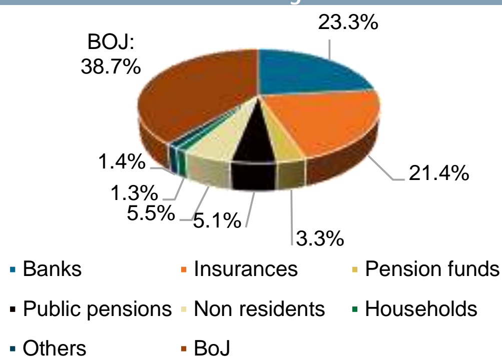
Fonte: Thomson Reuters-Datastream

Fig. 11 – Core inflation: the 2% goal is still far away



Fonte: Thomson Reuters-Datastream

Fig. 12 – The central bank is the largest holder of JGBs



Note: data end of December 2016; total JGB: 958.1 tln of yen
Fonte: Ministry of Finance

China: moderate deceleration and monetary flexibility

Silvia Guizzo

- **GDP rose 6.9% yoy in 1Q**, slightly outpacing the 4Q16 figure of 6.8%. The upswing in the agricultural and industrial sectors has more than offset the contained slowdown in services, which has been driven by transport and storage. On the demand side, consumption has held up well, thanks in part to accelerating public spending, while investments have slowed marginally. Overall, the monthly data point to a marginal slowdown in growth between March and May, with the leading indicators giving off a number of contrasting signals.

- The various regulatory bodies (CBRC, CSRC, CIRC), together with the People's Bank of China (PBOC), have continued to issue **new and tighter regulations on the financial markets and various types of credit** and operators in recent months. The gradual **uptick in rates** on both the money markets and the bond markets, which commenced at the start of the year, continued in 2Q, in the absence of other official rate hikes. The PBOC has confirmed its **neutral stance on monetary policy**, recently defined as "tactically flexible", which demonstrates it is ready to provide the market with liquidity if needs be. With yields rising rapidly, some temporary tension could return, given the high **volume of securities maturing in 3Q17** (about CNY 7,480Bn); **most of this is bank debt**, with the peak concentrated in August and September.

- Our **central scenario** continues to project a **gradual economic slowdown**, supported in part by the authorities' measures to encourage more sustainable growth and limit financial risks, particularly in view of the ticklish meeting of the Communist Party in autumn. Room to manoeuvre in terms of fiscal and monetary policy will be reduced compared with 2016; this will slow credit growth, which will reduce support to investment. We think that the resilience in investment in public infrastructure and services in 2H will fail to make up for a fresh slowdown in investment in real estate and manufacturing. Because GDP growth was higher than expected in 1Q, **we are slightly upgrading our forecasts for 2017, from 6.4% to 6.5%, and are sticking with our scenario of a moderate slowdown to 6.1% in 2018.**

- **The risks to growth remain to the upside in the short term** because support from fiscal policy and less restrictive-than-expected monetary policy could provide a fresh boost to investments. Despite this, the probability of an alternative scenario of a financial crisis and possible sharp slowdown in the economy is far from negligible. The expansion of credit – and in particular non-banking credit – and the increase in the volume of both non-performing loans and local authority debt will remain a growing source of **risk both to financial stability** and economic growth.

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	7.8	7.8	7.3	6.9	6.7	6.5	6.1
Private consumption	9.6	7.9	8.2	8.1	8	7	6.8
Public consumption	6.2	5.1	3.7	7.8	10	6.6	4.8
Fixed investment	8.7	9.3	6.9	7.3	6.4	4.8	4.3
Exports	5.7	7.9	5.7	0.1	1.8	9.1	4.2
Imports	6.7	10.6	7.7	0.7	3.8	9.5	4.5
Industrial output	8.4	8	7.4	6.2	6.1	6	5.2
Inflation (CPI)	2.6	2.6	2.0	1.4	2.0	2.0	2.4
Unemployment rate (%)	4.1	4.1	4.1	4.0	4.0	4.0	4.0
Average salaries	14.4	11.8	10.8	9.5	8.3	7.7	7.4
90-day interbank rate (average) (%)	4.2	4.9	4.8	3.8	3	4.5	3.8
USD/CNY exchange rate (average)	6.31	6.15	6.16	6.28	6.64	6.92	7.01
Current account balance (CNY Bn)	1360	912	1458	1912	1296	1386	1422
Current account balance (% of GDP)	2.5	1.5	2.3	2.8	1.7	1.7	1.6
Budget balance (% of GDP)*	-1.6	-1.8	-1.8	-3.4	-3.8	-4.9	-4.8

N.B.: Percentage change versus previous period – except where otherwise indicated;
Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Real growth and inflation

GDP rose 6.9% yoy in 1Q, slightly outpacing the 4Q figure of 6.8%. The upswing in the agricultural and industrial sectors has more than offset the contained slowdown in services, which has been driven by transport and storage. On the demand side, consumption has held up well, thanks in part to accelerating public spending, while investments have slowed marginally. Overall, the monthly data point to a marginal slowdown in growth between March and May, with the leading indicators giving off a number of contrasting signals.

Industrial output was stable at 6.5% yoy in April and May, but has slowed from 7.6% in March. This is in line with the manufacturing PMI from the National Bureau of Statistics, which has fluctuated around 51 since the end of the year. It has been stable at 51.2 in the last two months, signalling a strong improvement in conditions for small and medium-sized enterprises, for which the index has risen above 50, but a deterioration for large firms. At the same time, the PBOC's survey of industrial firms has shown an increase in confidence for the second quarter running, especially as regards future expectations, together with an improvement in orders. In contrast, the PMI Markit index has been gradually falling, hitting 49.2 in May; the orders component, although still just above 50, has deteriorated since the start of the year. However, the **services** PMI has increased marginally, in both the April and May surveys, although it has declined slightly on 1Q.

Nominal **capital investment** rose by 8.6% yoy, from a peak of 9.2% yoy in March due to slowing investment in the real estate sector and transport infrastructure, as well as a continued fall in construction investment. Growth in total capital investment is estimated to be much lower (2.9% yoy in May) in real terms. The real estate market is still feeling the impact of anti-speculative measures implemented by various provinces. After the slowdown in monthly price growth at the turn of the year, the last two months have seen an uptick in second-tier and especially third-tier cities, while growth in first-tier cities remains flat and is still negative in the secondary market. Land sales and new starts are both slowing.

Exports have improved rapidly in the last two months, posting double-digit growth rates (+10.9% 3m yoy in May) and approaching the level of import rates (15.7% 3m yoy). In terms of volume, both variables are at their highest since mid-2016. **Imports**, in particular, have benefited from the increase in oil imports and, to a lesser extent, in agricultural products and fibrous textiles. However, the signals from foreign orders of other Asian countries do not yet point to an overall improvement in foreign demand.

Growth in **retail sales** remained high in May (+9.5% yoy in real terms), although slightly slower than in April. The same trend was recorded by consumer confidence, which remains at its highest since 2008. Online sales continue to post stable, double-digit rates and have marginally accelerated (26.5% yoy in May), whereas increased taxes on vehicles continue to hurt car sales, which have been slowing since the start of the year. The employment component of the PMI indices has deteriorated in the last two months and now only remains above 50 in the Markit services survey, whereas the Manpower survey for 3Q, although slightly higher, is at its lowest for the series.

The authorities' desire not to fuel further economic imbalances will reduce room to manoeuvre in terms of fiscal and monetary policy compared with 2016; this will lead to slowing credit growth, which will reduce support to investment. We think that the resilience in investment in public infrastructure and services in 2H will fail to make up for a fresh slowdown in investment in real estate and manufacturing. Because GDP growth was higher than expected in 1Q, **we are slightly upgrading our forecasts for 2017, from 6.4% to 6.5%, and are sticking with our scenario of a moderate slowdown to 6.1% in 2018.**

Our central scenario continues to project a gradual economic slowdown, supported in part by the authorities' measures to encourage more sustainable growth and limit financial risks, particularly in light of the difficult meeting of the Communist Party in autumn. **The risks to growth remain to the upside this year** and next because support from fiscal policy and less restrictive-than-expected monetary policy could provide a fresh boost to investments. Despite this, the probability of an alternative scenario of a financial crisis and possible sharp slowdown in the economy is far from negligible. In fact, **the medium to long-term risks** remain **to the downside.**

The expansion of lending, particularly alternative forms of non-banking finance, the rise in non-performing loans and local authority debt, and uncertainty surrounding growth in the property market remain a growing source of risk to both **financial stability** and economic growth. Similar concerns lay at the heart of the downgrade by Moody's of sovereign debt from Aa3 to A1 (equates to AA- to A+) at end-May and were reiterated in the *Financial Stability Report* by the International monetary fund in April. The IMF point out, in particular, that total assets of the banking system alone are now more than three times GDP and that many financial institutions are overly dependent on wholesale funding compared with deposits. This particularly concerns smaller banks, which also show significant maturity mismatches between assets and liabilities. On top of these imbalances come growing interconnections between the interbank market and non-banking financial products, such as wealth management products.

Consumer price **inflation**, having bottomed out at 0.8% in February, rose to 1.5% yoy in May, partly due to an unfavourable base effect and partly to an uptick in services inflation (+2.9% yoy); increases in goods inflation were more contained (+0.7%) because it is benefiting from a fall in food prices, which started in the new year. Inflation net of food and energy remained stable at 2.1%, while producer price inflation slowed from its March peak to 8.0% yoy. Overall, inflation in the first few months of the year has underperformed our expectations. A favourable base effect (largely in the second half of 2017) will be only partly offset by upward pressure from rising fuel prices and a slight depreciation in the exchange rate. **We therefore expect consumer price inflation to remain contained at 2.0% in 2017 and then return to 2.4% in 2018**.

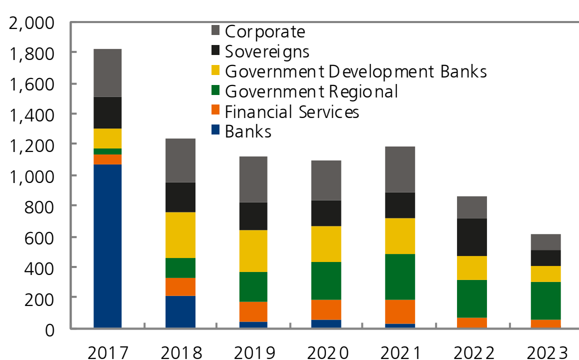
Monetary policy and foreign exchange

New **lending** jumped by 9.7% cum yoy in the first five months of the year, while growth in stocks remained stable at 12.9% yoy in April and May, up slightly from 12.4% in March but lower than at end-2016 (13.5% yoy in December). Long-term corporate lending continues to gradually improve, rising by 14.8% yoy in May from a low of 11.2% in December. At the same time, long-term household loans are slowing (+29.6% yoy) while their short-term counterparts are accelerating. Aggregate social financing remains substantially stable, thanks especially to a sharp increase in new trust loans, which offset the slowdown in other items. Corporate issues in particular were negative on a net basis, having been discouraged by rising yields. On top of this comes a decline in net local government issues, which, although positive in the first five months of the year, were down 60% on the year-earlier period.

In the **money markets**, the gradual upturn in rates that started in the new year has continued: overnight SHIBOR rose by more than 45 bps from mid-March to mid-June to 2.85%, while 1-month SHIBOR hit 4.65% in the same period. The **bond markets** also reversed, with corporate yields on 5-year maturities rising between 21 bps (AAA) and 66 bps (AA). Yields on government securities with the same maturity rose by around 48 bps, while 2-year maturities added 63 bps, with the curve flattening. We think, however, that the inversion of the curve in the 2-10 year and 5-10 year segments is due to liquidity factors and not the pessimism of operators: the volume of 10-year debt in circulation (2027) is CNY 172Bn, which is much less than for 2-year maturities (2019) at CNY 1,145Bn or 5-year maturities (2022) at CNY 1,718Bn. The situation is no better for maturities in 2026 or 2028.

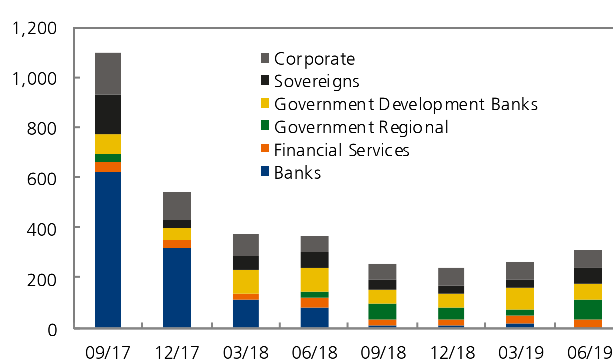
Yields fell in the third week of June. The PBOC injected CNY 430Bn of **liquidity** in the second week of June, the first of this size for months; it was also intended to cover forthcoming maturities of reverse repos (approx. CNY 250Bn a week up to mid-July). Between now and the end of the year, another CNY 370Bn approximately will mature each month via the Medium-term Lending Facility (MLF). The Ministry of Finance also intervened, buying CNY 1.2Bn of 1-year securities to support prices of short-term securities under a programme announced last November to purchase or issue securities in the event of insufficient demand or, in some maturities, excess demand. However, the situation on the market was exacerbated by tax deadlines and regulatory controls and by end-of-quarter risk assessments by the PBOC under the Prudential Macro Assessment framework, which came into effect at the start of the year.

Securities maturing per year (USD Bn)



Source: Bloomberg SRCH, data at 20 June 2017

Securities maturing per quarter (USD Bn)

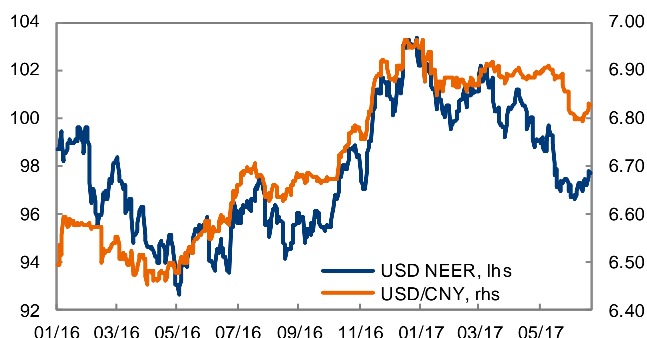


Source: Bloomberg SRCH, data at 20 June 2017

An editorial in the People's Daily recently defined **monetary policy** as **"tactically flexible"** and **"strategically prudent"**[12]. We expect the PBOC to continue its marginally restrictive stance in order to stabilise lending growth and limit financial risks, but the level of normalisation of monetary policy very much depends on how the market evolves. In the absence of liquidity problems or overly sharp reactions by the markets, the PBOC may make further increases in refinancing operations during the year of up to 50 bps in total, without touching benchmark rates. We think that the PBOC will continue to provide all the necessary liquidity, especially in the event of temporary tensions that might re-emerge if yields rise, given the high **volume of securities maturing** in the second half of 2017. In total, around CNY 7,500Bn of securities (about USD 1,100Bn) will mature **in 3Q17, most of which are from the banking sector**. The amount is actually a little more than last year, but yields were lower and trending slightly down at that time. Maturities will peak in August (approx. CNY 2,880Bn) and then in September (approx. CNY 2,695Bn), which is the month in which the US Federal Reserve is expected to make another rate hike.

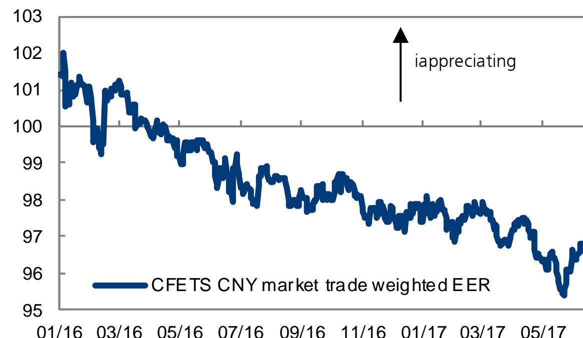
[12] Bloomberg News 20/06/2017: "China's Monetary Policy to Remain "Tactically Flexible": Daily"

The yuan has been less reactive to the dollar effective exchange rate



Source: Bloomberg

CNY effective exchange rate



Source: Intesa Sanpaolo chart based on Bloomberg data

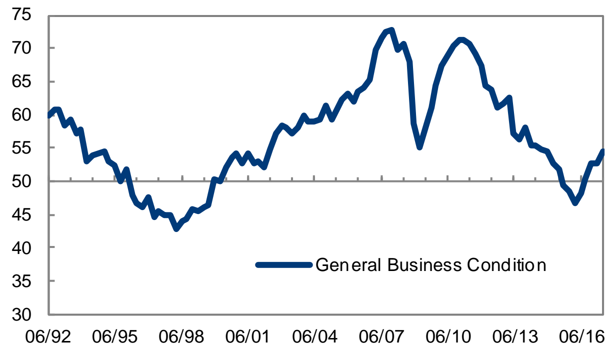
The regulatory entities (CBRC, CSRC, CIRC), together with the People's Bank of China (PBOC), have continued to issue new and tighter regulations on the financial markets and various types of credit and operators in recent months.[13] Furthermore, the governor of the PBOC reiterated at the Lujiazui Forum that China must continue to gradually open up the financial markets. This would also be particularly positive for financial institutions because it would expose them to greater competition and comparison with international standards. The authorities are moving in this direction with the official announcement of the Shanghai-Hong Kong Bond Connect project, which is a channel to acquire fixed income securities, and with the entry, although at a minority percentage, of China A shares in the emerging markets MSCI, which was announced on 20 June and will take effect next year.

At the same time, however, the authorities remain cautious and continue to put the brakes on capital outflows. The Bond Connect programme will initially function only from Hong Kong to China, and the capital flow controls implemented last year will remain in effect; some have even been tightened. These measures, together with rising yields and the general depreciation of the dollar, have helped support the yuan. After a phase of stabilisation at around 6.9 between February and mid-May, the yuan recently rose to 6.79 in mid-June, before dipping back. In the meantime, according to press releases issued at the end of May, the PBOC has announced it has adopted a "countercyclical factor" for setting its central parity rate, in addition to the other factors used (effective exchange rate, market conditions and previous day's closing price). No other official clarifications have been forthcoming. However, since the start of the year, the exchange rate has seemed less reactive to upward movements in the effective dollar exchange rate. Capital outflows have dropped in the meantime, and reserves have risen by USD 55Bn, from their February low, to USD 3,054Bn in May, partly due to valuation effects.

The currency will be increasingly governed by market forces in a regime of controlled fluctuations, but the authorities will continue to support the yuan's stability. **We are sticking with our scenario of contained depreciation of the yuan against the dollar, with a peak of 7.0 at year-end**; the only way this could be exceeded is if there is a sharp upwards revision of Fed rate hike expectations or very negative news on the domestic macroeconomic front.

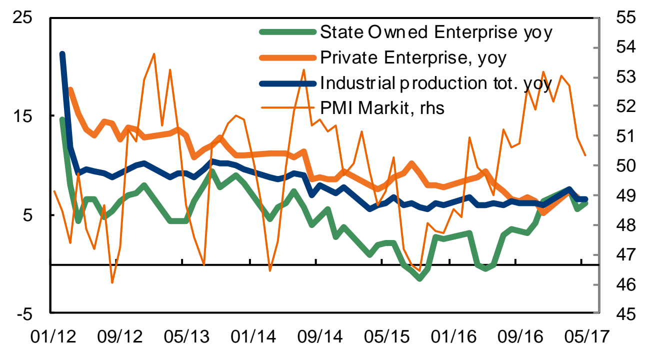
[13] For example, new guidelines have been issued for correctly valuing guarantees and monitoring bank risks, with priority given to those relating to investments in bonds, interbank lending, wealth management products, funding via the internet and real estate. Banks must classify funds obtained through negotiable certificates of deposit as interbank loans, and these may not exceed one-third of assets. Furthermore, from April, new securities with ratings of less than AAA may no longer be used as collateral for repo transactions.

Business confidence is improving



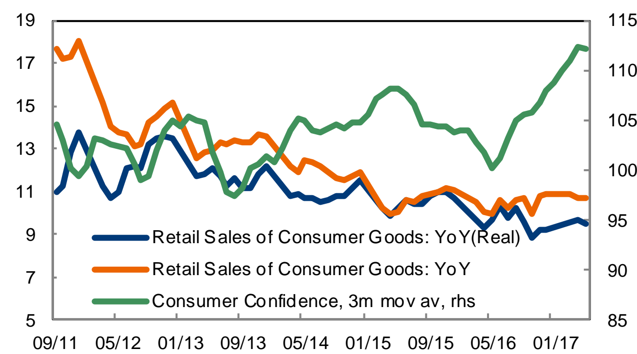
Source: PBOC's Industrial Enterprise Survey by CEIC

Industrial output is stabilising but the PMI is deteriorating



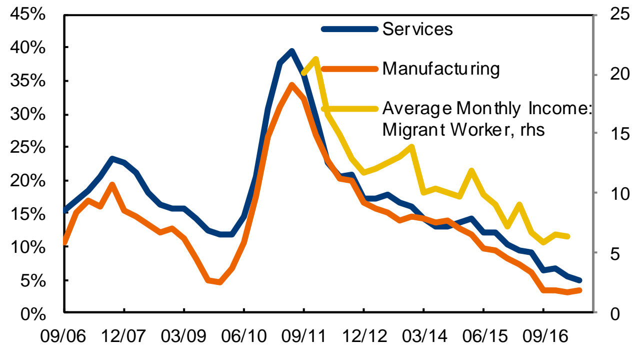
Source: CEIC, IHS Markit

Retail sales



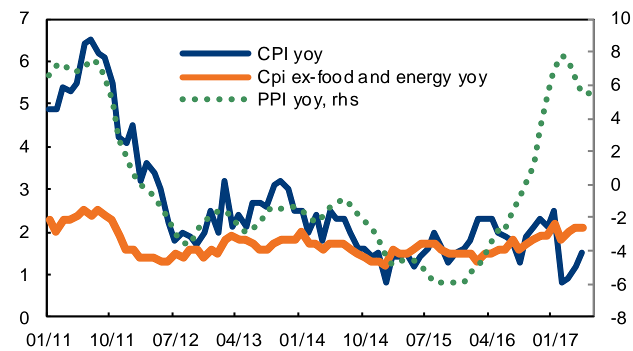
Source: CEIC

Employment: percentage of firms with hiring intentions



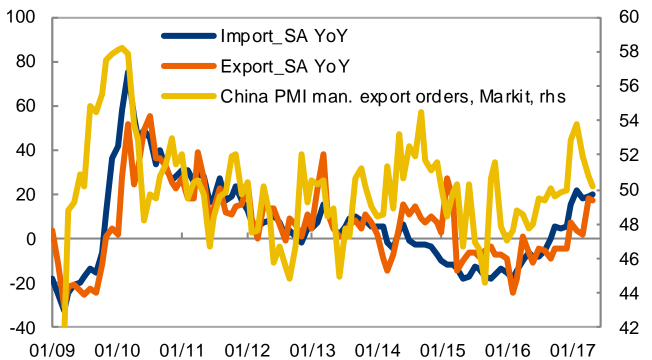
Source: Manpower, CEIC

Inflation



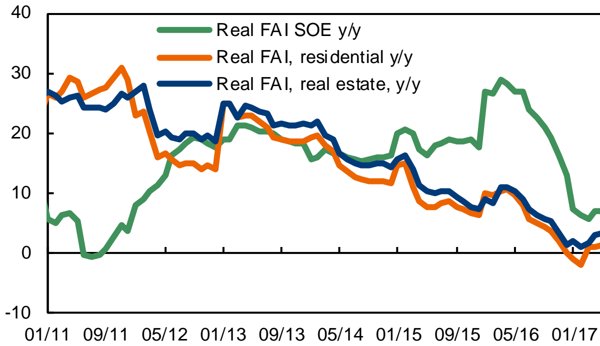
Source: CEIC

Foreign trade



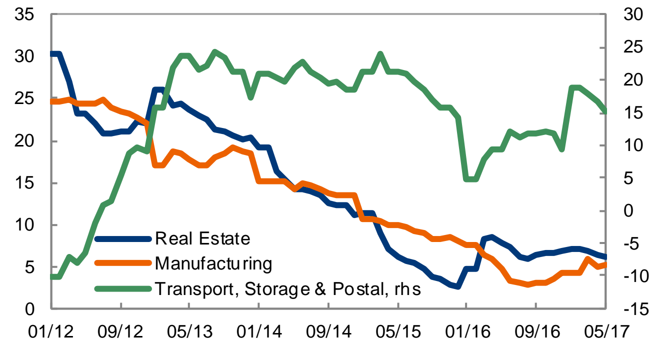
NB: seasonally adjusted data, 2m yoy. Source: Intesa Sanpaolo chart from CEIC and Markit data

Nominal investment, yoy



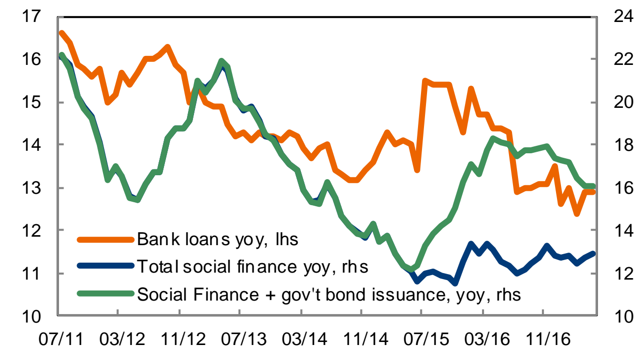
Source: CEIC

Investment by sector, yoy



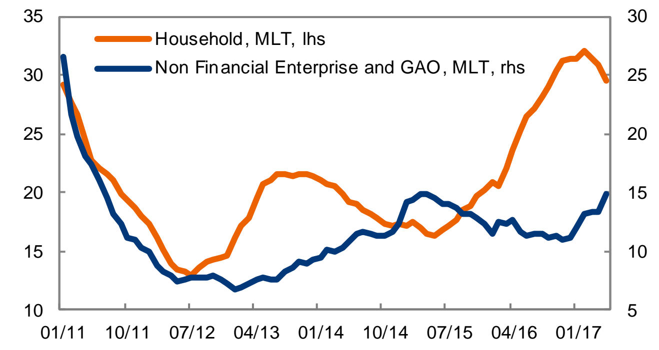
Source: CEIC

Lending is stable



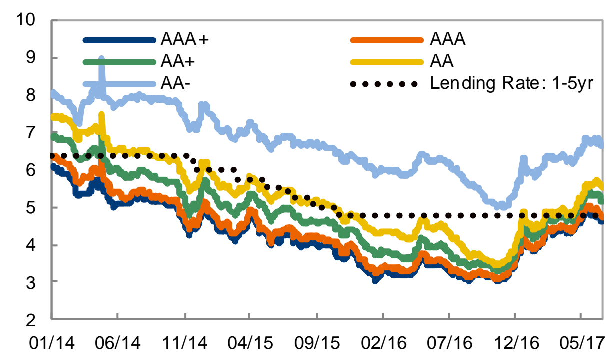
Source: Intesa Sanpaolo chart from CEIC data

Domestic bank loans, yoy



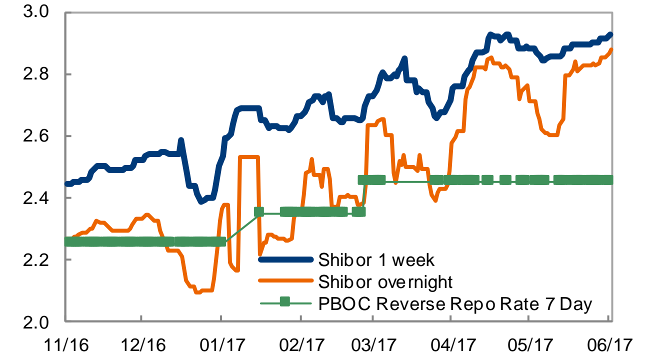
Source: CEIC

Yields on 5-year corporate bonds



Source: CEIC

Money market rates are rising



Source: CEIC, Bloomberg

India: Inflation surprises to the downside but RBI remains cautious

Silvia Guizzo

- **The preliminary GDP estimates** for FY 2016-2017 and 1Q17, which were published at end-May by the Central Statistical Office, **have been upgraded sharply**. GDP growth **in 2016** was therefore **7.9%**, driven mainly by consumption (+10.2%). Growth in gross value added, however, was 7.4% yoy, thanks to an excellent performance by the agricultural sector, which more than offset the moderate slowdown in manufacturing and services.

- **GDP rose by 6.1% yoy in 1Q**, thanks to strong support from public (+31.9%) and, to a lesser extent, private consumption; investments, however, took a downward trend (-2.1% yoy), and the contribution from foreign trade was also negative. The monthly data are signalling a consolidation in consumption and foreign trade. They are also pointing to a modest recovery in investment, in line with a gradual uptick in consumer and business confidence, which had fallen at the turn of the year in what is proving to be a temporary effect of the demonetisation manoeuvre. The outlook for services is still better than for manufacturing.

- **We are revising our inflation forecast for 2017 to 3.2%** from 4% **and for 2018 to 5.0%** from 4.7%. Consumer price inflation actually fell to 2.2% yoy in May, the lowest in the last two years, driven down by falling prices for foodstuffs and fuel. With the base effect still very favourable until July and food and fuel prices slowing further, inflation should continue to drop until midway through the year. The strength of domestic demand, and possible government intervention to prevent an excessive collapse in agricultural product prices, combined with expectations of a modest increase in oil prices in the latter part of the year, will help push inflation up in the second half of 2017 and in 2018.

- Assuming a normal summer monsoon season, consumption should remain solid to the end of the year, supported by the good performance of the agricultural sector and the labour market. At the same time, private investment looks set to continue its modest recovery, driven by public investment, the continuing neutral stance on monetary policy and strengthening exports. **We are therefore adding two points to our growth forecasts, to 7.4% for 2017 and to 7.6% for 2018** (7.6% in FY 2017-18 and 7.8% in FY 2018-19). The **risks** to the forecast **are mainly to the downside**; externally, they come from an increase in protectionism globally and from a sharper-than-expected slowdown in China, and internally from further weakness in private investment.

Macro forecasts

	2012	2013	2014	2015	2016	2017E	2018E
GDP (constant prices)	5.5	6.1	7	7.5	7.9	7.4	7.6
Private consumption	6.5	6.6	6.3	5.6	9.2	7.7	8.6
Public consumption	4.6	2.6	6.9	1.3	15.1	12	8.3
Fixed investment	6.2	2.5	2.5	5.1	5.1	1.4	6.2
Exports	9.9	4.6	6.9	-6.1	1.2	9.3	4.5
Imports	11.2	-5.9	0.3	-6.1	-1.7	11.9	4.3
Industrial output	0.7	1.9	4.6	2.6	5.8	4.7	7.8
Inflation (CPI)	9.4	9.9	6.6	4.9	4.9	3.2	5.0
Unemployment rate (%)	2.0	2.5	2.8	3.0	3.3	3.3	3.3
Average salaries	12.2	11.2	9.8	7.6	8.6	11.1	10.4
3-month MIBOR (average)	9.5	9.3	9.1	8	7.2	6.6	6.7
USD/INR exchange rate (average)	53.47	58.57	61.04	64.15	67.21	65.56	63.34
Current account balance (INR Bn)	-4893	-2780	-1661	-1451	-800	-3978	-3530
Current account balance (% of GDP)	-5.1	-2.5	-1.4	-1.1	-0.5	-2.4	-1.9
Budget balance (% of GDP)	-5.5	-5.5	-4.3	-3.4	-3.7	-3.3	-3.5

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

Real economy and inflation

The preliminary GDP estimates for FY 2016-2017 and 1Q17, which were published at end-May by the Central Statistical Office, have been upgraded sharply. The revision was prompted by the adoption of new series of the industrial production and wholesale price indices, and by increased estimates for agricultural output, which was buoyed by a particularly favourable monsoon season. GDP growth in 2016 therefore came out at 7.9%, four points above the estimate published at the end of February, with private consumption making a very strong, positive contribution of 5.2% and growth in investments remaining stable compared with 2015 (5.1%). Growth in gross value-added was 7.4% yoy, upgraded from 7.1%, thanks to an excellent performance by the agricultural sector, which more than offset the moderate slowdown in manufacturing and services.

GDP rose by 6.1% yoy in 1Q, down from 7% in 4Q, on the back of strong support from public (+31.9%) and, to a lesser extent, private consumption; investments, however, took a downward trend (-2.1% yoy), and the contribution from foreign trade was also negative. On the supply side, the industrial sector continued to slow under the impact of the contraction in construction (-3.7% yoy).

The services sector grew slightly faster in 1Q (7.2% yoy) than in 4Q16 (6.9%), largely due to public services, which offset a deceleration in retail and a sharp slowdown in financial services, real estate and corporates. The effect of demonetisation on the services sector is proving to be temporary. The PMI services index rose in the first half of the year to 52.2 in May. Expectations are stabilising but, despite retreating from a peak in March, remain high, at levels comparable with autumn 2016. Tourism continues to grow at a sustained pace (18% 3m yoy in May), as do related revenues, which are supporting the sector's growth.

The monthly consumption indicators remain positive overall. Motor vehicle sales accelerated, buoyed by demand for new cars in urban areas, while sales of commercial vehicles and three-wheelers contracted, in part due to new emissions standards that came into force on 1 April. However, sales of two-wheeled vehicles – previously the hardest hit by demonetisation – and mobile phones continue to improve. The number of banknotes in circulation is gradually improving, thanks to the issuance of new bank notes and the removal of limits on ATM withdrawals at the start of February. Consumer confidence, which fell sharply in 1Q, rose in 2Q, and the labour market situation remains good, even though both the PMI index in May and the Manpower survey in 3Q are indicating a deterioration in manufacturing.

The new industrial output index has improved its coverage of industrial activities and reclassified weightings and activities (the manufacturing sector has a higher weighting than electricity generation, and a component has been introduced for infrastructure goods), dampening the impact of more volatile components. The trend in industrial output in 2016 is therefore much better (+5.8% yoy) than in the previous series (+0.3% yoy). Industrial output in April rose by 3.1% yoy, only slightly above 1Q (2.9%) but slowing compared with March (3.8% yoy); it is still being driven down by the trend in the production of capital goods and consumer durables. The trend is in line with the manufacturing PMI, which fell to 51.6 in May from 52.5 in the previous two months. The corporate confidence indices diverge with regard to expectations for 2Q: the RBI (Reserve Bank of India) survey jumped to a two-year high while the *Dun&Bradstreet* survey dipped marginally. But both surveys are signalling a sharp improvement in orders expectations, although the orders components of the PMI index, after recovering in 1Q, gradually fell in April and May, while foreign orders dipped below 50. Foreign trade, including net of oil, continued the acceleration triggered at year-end, a path that is confirmed by the freight traffic data. It should continue to grow in the coming months, although less impressively than in 1Q.

Following on from the GDP revision, growth in investments, which was previously negative, turned positive, although worsening, in 2016. This is in line with the increase in industrial projects submitted for approval to the Industry Ministry, which in 2016 rose 14.3% by volume compared

with 8.3% in the previous year and, after falling for years, also rose 33.1% yoy by value. In the first five months of 2017, the number of new proposals was in line with the previous year, while imports are picking up. This re-acceleration and the trend in imports of machinery, which remains sustained, should support a modest improvement in fixed investments during the year, which contracted by 2.1% yoy in 1Q.

However, we still think that the recovery in investments will be modest, unless **lending growth**, which remains at a historical low (4.3% in April) and is falling in construction and real estate, inverts. The increase in non-performing loans continues to impact this negatively; according to the ADB (Asian Development Bank)[14], these rose to 9.1% of total lending in September 2016 from 7.8% the preceding March. This figure rises to 12.3% if restructured loans are also included and to 15.8% in banks and state-owned enterprises. The latter account for the majority of non-performing and restructured loans, which mainly concern lending to the base metal, construction, textiles, food manufacturing and infrastructure sectors. Implementation of the new Insolvency and Bankruptcy Code, which was approved in mid-2016, should make it easier for companies to restructure and gradually lead to an improvement in non-performing loans.

Assuming a normal summer monsoon season (June-September), consumption is likely to remain solid to the end of the year, supported by a good performance by the agricultural sector and labour market. At the same time, private investment looks set to continue its modest recovery, driven by public investment, the continuing neutral stance on monetary policy and strengthening exports. Annual growth, however, will slow from 7.9% in 2016, due to an unfavourable base effect, decelerating public consumption and a marginally negative contribution from exports. **We are adding two points to our growth forecasts, to 7.4% in 2017 and 7.6% in 2018**. Growth is forecast at 7.6% in FY 2017-18 and 7.8% in FY 2018-19.

The **risks to the forecast are mainly to the downside** and come from an increase in protectionism globally and a sharper-than-expected slowdown in China, both factors which would put the brakes on the recovery in global demand. Internally, there is a risk that private investment will weaken further, hampered by a number of factors: corporate indebtedness, the increase in non-performing loans and their impact on the supply of new bank lending, a lack of progress on structural reforms and effects that are less positive than currently expected due to difficulties in implementing the GST tax and the Insolvency and Bankruptcy Code. We think a much higher-than-expected increase in the price of raw materials would then negatively impact terms of trade.

Consumer price **inflation** fell from 3.9% yoy in March to 2.2% yoy, a two-year low, in May. The decline is due to a very favourable base effect combined with a greater-than-expected fall in the price of food, in particular vegetables and pulses; this contrasts with the seasonal trend, which usually increases from May and peaks between July and August. Fuel prices, which rose in March, have adjusted downwards in line with falling oil prices. Stripping out food and fuel, inflation fell to 4.3% in May from 4.9% in March, due to slowing prices in various services segments. The Goods and Services Tax (GST), which is set to enter into force on 1 July, should not have a significant effect on inflation because it replaces a series of other taxes and does not apply to alcohol or, at least initially, oil products. Furthermore, the GST Council, chaired by the Finance Minister, and responsible for the implementation of the tax, has recently dropped the rates on many products.

With the base effect still very favourable until July, and food and fuel prices slowing further, inflation should continue to drop until midway through the year. In any case, the strength of demand, which is buoyed by solid wage growth, and possible government interventions to prevent an excessive collapse in agricultural products (via government procurement and minimum support price), combined with a modest increase in oil prices in 2H, will help push inflation up

[14] Asian Development Outlook, April 2017.

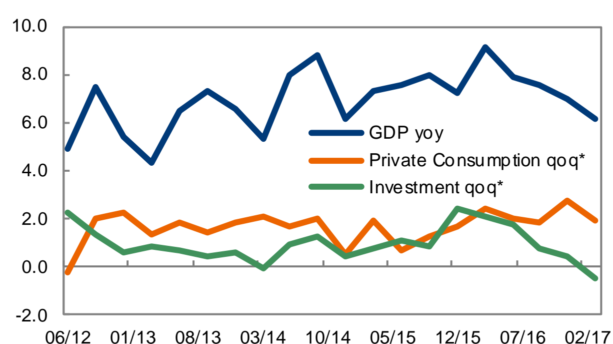
again in the second half of 2017 and in 2018. Given that inflation is lower than we had expected in recent months, **we are downgrading our inflation forecast for 2017 to 3.2%** from 4% **and upgrading our forecast for 2018 to 5.0%** from 4.7%.

Monetary policy and foreign exchange

The risks to inflation are balanced, even though there is considerable uncertainty about how they will develop. The downside risks derive from the much lower-than-expected price of oil (see section on oil). The upside risks derive from applications for farm loan waivers and payments of allowances under the 7th Pay Commission. The waiver of farm loans, initially announced by Uttar Pradesh in April, has now been proposed by Maharashtra and other states after violent protests by farmers, exhausted by years of drought and hard-hit by demonetisation, who are demanding a national amnesty. The RBI, which has not factored in these risks, and barring any rate interventions, forecasts total inflation at 2.0%-3.5% in 2Q17 and 3Q17 and 3.5%-4.5% in the following two quarters. At its recent meeting in early June, the central bank emphasised that monetary policy can only play a more active role once the uptick in investments has strengthened, the main infrastructure bottlenecks have disappeared and the banking sector is in better health. It has confirmed its neutral stance, but will monitor the data closely since falling inflation could prove to have been mainly driven by temporary factors. One member of the committee voted against this. **We are therefore maintaining our forecast of unchanged rates for the rest of the year** with the possibility of moderate monetary tightening in mid-2018.

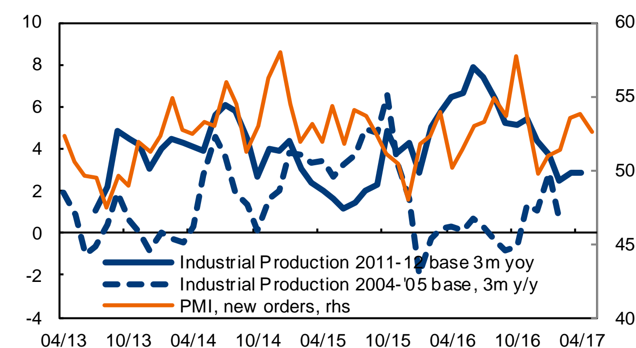
After appreciating by 4.5% in 1Q, the **rupee** stabilised at around 64 to the dollar between April and the first half of June. This year-to-date gain of 5.1% was supported by the RBI's neutral stance, which was announced at its February meeting, a generally depressed dollar, positive news on the internal macroeconomic front and the recovery in portfolio inflows. The effective exchange rate in this period appreciated by 2.7% in nominal terms and by 2.5% in real terms. The reduction in the current account deficit in 1Q17, assisted by a lower trade deficit, together with the improvement in capital inflows, boosted reserves by USD 9Bn in 1Q, and by another USD 8Bn in April and May. This pushed reserves up to USD 355Bn at the end of May from USD 337Bn at end-2016; reserves therefore cover nine months of imports and short-term debt by a factor of four. We think that the **exchange rate will continue to be supported** by the improving macroeconomic forecast and indicators of external vulnerability, as well as the RBI's neutral stance. The exchange rate will, however, be subject to a modest retracement in the second half of the year, given the expected rate hike by the Fed in September.

Growth impacted by slowdown in investments



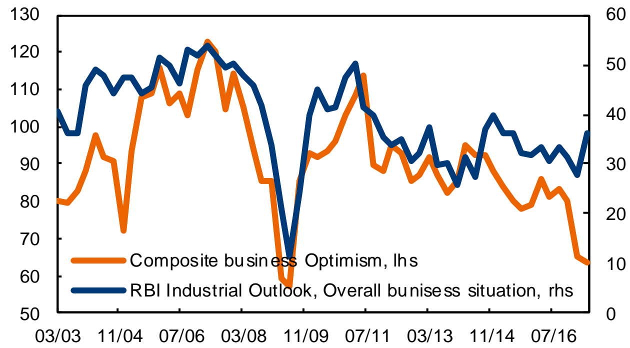
*Four-quarterly moving averages. Source: CEIC

Industrial output stabilises



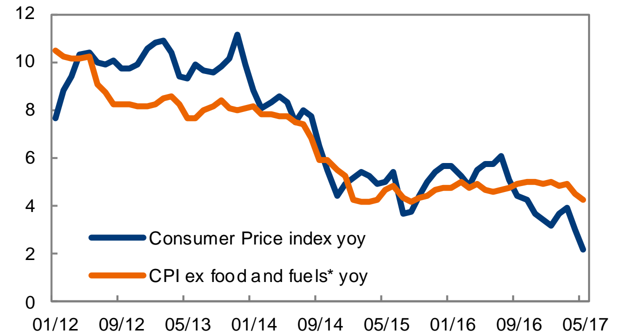
NB: Three-month moving average. Source: Markit, CEIC

Business confidence



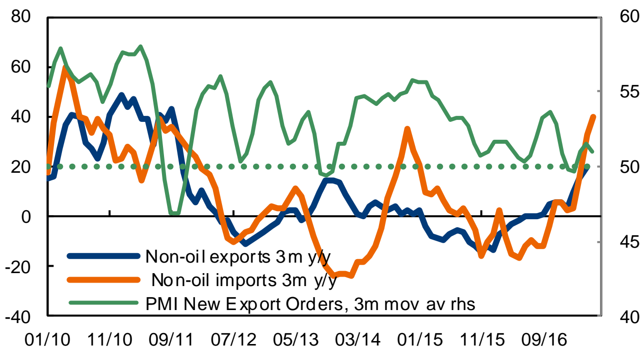
Source: CEIC

Inflation



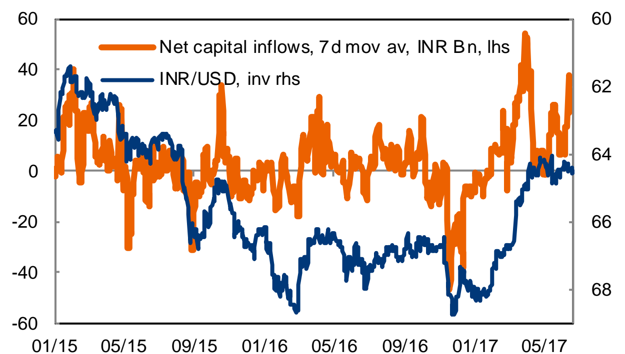
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Foreign trade is improving



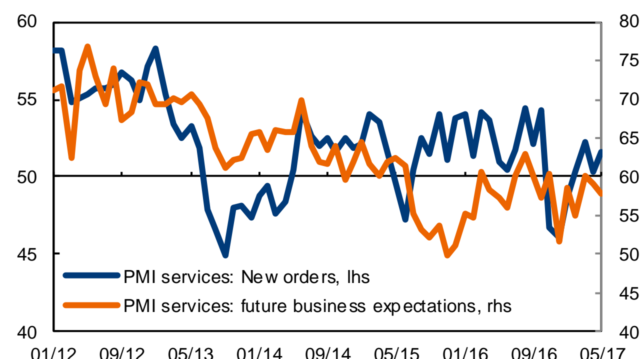
NB: Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Rupee is stabilising



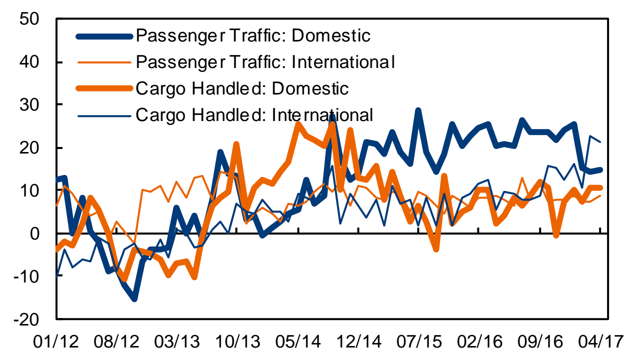
N.B.: (*) Net purchases by foreign institutional investors Source: CEIC

Services are improving



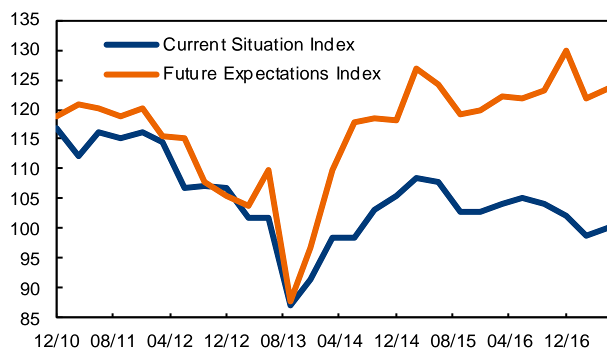
Source: Markit

Passenger and freight traffic



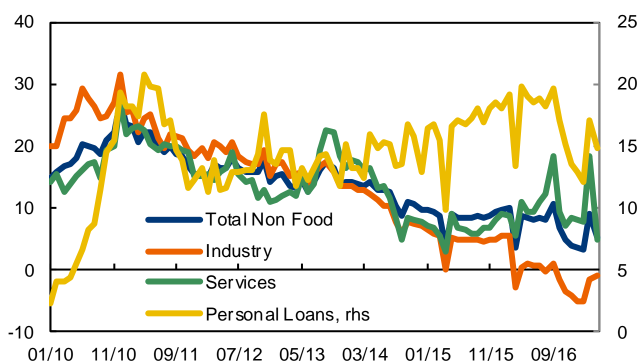
Source: CEIC

Consumer confidence



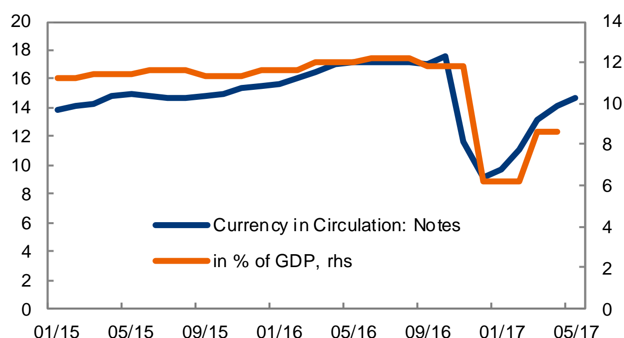
N.B.: Quarterly consumer confidence survey by the RBI Source: CEIC

Lending to industry is falling (% chg. yoy)



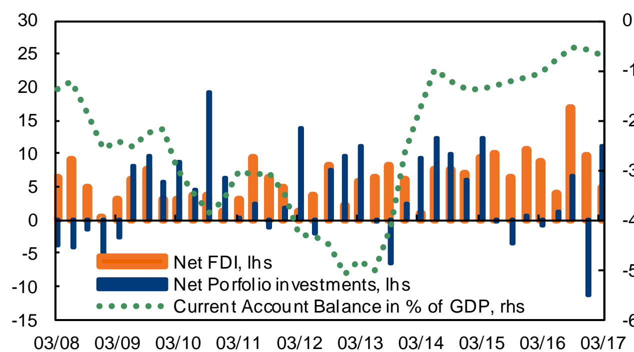
Source: CEIC

Bank notes in circulation (INR Trn)



Source: CEIC

Current account



N.B. Left-hand scale in USD Bn. Source: Intesa Sanpaolo charts from Bloomberg and Thomson Reuters-Datastream data

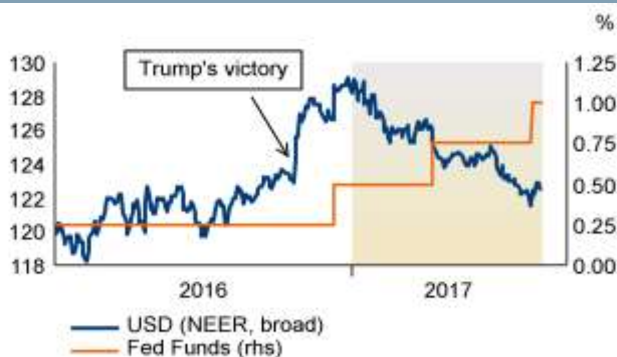
Forex Markets Trump effect reabsorbed, focus back on monetary policies

DOLLAR: Post-Trump victory ascent reabsorbed, focus back on economic developments

Asmara Jamaleh

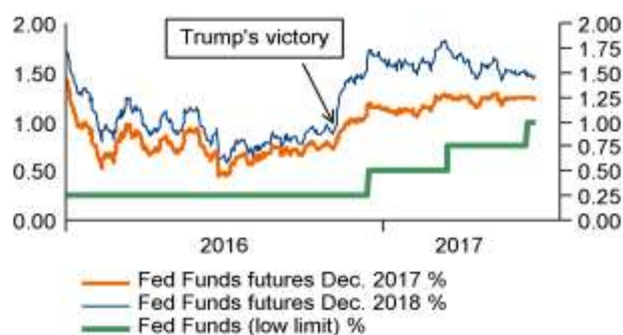
The correction undertaken by the dollar at the beginning of the year continued, and the appreciation which followed Trump's electoral victory has been fully reabsorbed (Fig. 1). The new administration is facing political problems that have significantly reduced the expected size of the fiscal stimulus plan Trump had promised during the electoral campaign, and therefore growth prospects, which remain positive in any case. This is because **the Fed** has been able to stick to the rate increase path announced in December, and **hiked rates** both in March and in June, **confirming the forecast for another move by the end of the year**.

Fig. 1 – Dollar: post-Trump victory appreciation fully reabsorbed



Source: Thomson Reuters-Datastream

Fig. 2 – Market aligned with the Fed scenario for 2017 (another hike this year), but not for 2018 (pricing in one hike rather than three)



Source: Thomson Reuters-Datastream

This prospect should represent the main supportive factor for the dollar in the near term, especially as the Fed will remain the only central bank in all the advanced economies to hike rates this year. However, **support for the dollar on this front seems limited**, as the market has already priced in to a large extent the Fed rate path for 2017 (Fig. 2). Therefore, **US data will become increasingly important**, as they will play a decisive role in guiding the Fed's decisions for next year. **At the moment, the market is pricing in an especially cautious scenario**: fed funds futures with maturity in December 2018 are pricing in a single hike next year, as opposed to three prospected by the Fed (Fig. 2). Any positive surprises from US data could therefore aid a strengthening of the dollar in the near term, albeit modest. On the other hand, a **new weak phase** for the dollar should begin **next year**, when the other central banks will also start to hike rates or to normalise monetary policy. The further recent improvement of the global growth picture supports this scenario, although at the moment the sluggish trend of inflation across the board is prompting these central banks to stay very cautious terms of their communication on the start of the normalisation process, which suggests that the most favourable time window for the dollar is the near term (1m-3m horizon). This is the period in which the next fed funds hike should take place, as towards the end of the year the Fed will put the hike cycle on hold, to start normalising its balance sheet.

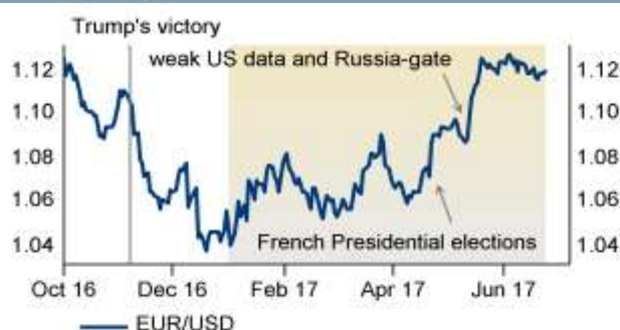
Risks to the baseline scenario are **skewed slightly downwards,** i.e. the dollar could prove weaker than expected in the near term in case of disappointing US data, a further postponement of the fiscal stimulus package, and/or failure to reach an agreement on the debt ceiling (which could push back the expected Fed hike, from September to October.

EURO: the upside reversal has begun, but upside is limited – especially in the near term

In 2Q 2017 the euro built on the rebound initiated in the previous quarter, more than recovering the correction incurred following Trump's election, and rising back from the lows marked at the

start of the year in the EUR/USD 1.03 area, hitting highs between May and June in the EUR/USD 1.12 area. **The upside recovery began towards the end of April, on the outcome of the first round of the presidential elections in France** (Fig. 3), which saw Macron prevail over Le Pen and "definitively" marginalise the euro-sceptic Front National. **The clear reduction of political risk tied to the electoral cycle in Europe allowed the market to focus back on more purely economic developments, which were supportive for the single currency on both sides of the Atlantic**.

Fig. 3 – The euro more than recovered the decline which followed Trump's election



Source: Thomson Reuters-Datastream

Fig. 4 – Speculative market: long euro again after three years' short

Source: Thomson Reuters-Datastream

In the United States, in the first half of May in particular, data fell short of expectations, both in terms of growth and inflation, whereas at the political level the Trump administration started to face mounting tensions over the Russia-gate affair. In the euro area, by contrast, data (albeit only on the growth front) beat expectations (slightly), prompting the ECB to change its assessment of the balance of risks at its meeting on 8 June from "skewed downwards" to "roughly balanced", and to remove from guidance reference to the possibility of lower rates than at present, a first – implicit – step towards initiating the monetary policy normalisation process, which we expect to happen between the end of this year and the start of the next. This is because we believe the ECB – barring an unexpected deterioration of the macro scenario – will provide information on the exit from the QE after the German elections in September, and announce a first reduction in purchases in December.

In correspondence with developments at the beginning of May, the speculative market reversed, turning long euro after staying short uninterruptedly for three years (Fig. 4). In our view, this signals not only a change in sentiment towards the single currency, but also that the upside reversal of the euro may be considered as having begun this year: the movement of the exchange rate, and the repositioning of investors, came at a time when developments both on the economic and political fronts proved favourable for the euro on both sides of the Atlantic. **However, this does not necessarily imply an extension of the uptrend.**

In the near term, the euro should continue to generally range trade, mostly in the medium-low end of the EUR/USD 1.10-1.15 corridor, with the possibility of a temporary drop into the EUR/USD 1.10-1.08 band. Range trading should also be the result of the prospect that **the ECB is approaching policy reversal, although for now it must leave both rates and QE unchanged (thus compressing the euro's upside margin), while at the same time the Fed is preparing to hike rates again (probably in September), but will then put the hike cycle on hold, to start normalising its balance sheet (which will compress upside on the dollar, and therefore the euro's downside margin)**. The possibility of a drop to (just) below the EUR/USD 1.10 mark is kept alive by the risk that inflation in the euro area will further delay returning on course for target: at its June meeting, the ECB – while revising its growth forecasts upwards – revised inflation projections downwards, and not only for this year. Should inflation disappoint, the ECB could postpone the start of the QE exit process.

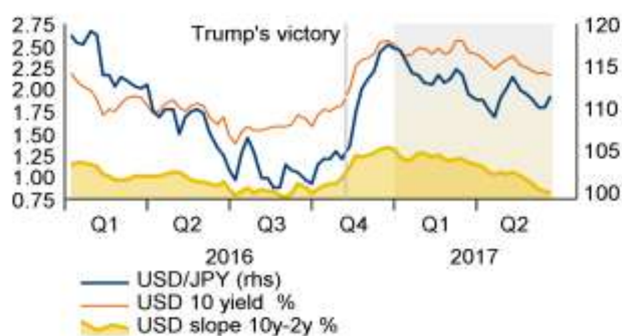
Risks to the baseline scenario are starting to lean upwards, i.e. the euro could prove stronger than expected, especially in the event of negative developments in the United States, as the market has by now effectively priced in the prospect of another Fed hike by the end of the year, and this leaves the dollar more exposed to a further weakening in the near term. However, we stick to our baseline scenario, according to which the euro will not rise to levels higher than last year's (EUR/USD 1.15-1.16) on a one-year horizon to take into account the risks tied to the Italian elections, which will be held by next spring, and because in the course of 2018, while the ECB will exit QE, the Fed will continue to hike rates (it currently envisages three moves, whereas the market is only pricing in one).

Yen: as the BoJ keeps injecting strong stimulus, the dynamics of US interest rates/yields will continue to be the main driver

The yen strengthened against the dollar in the first half of 2017, reabsorbing around half of its post-Trump election correction, and rising from lows in the USD/JPY 118 area to highs in the 108 area. **In this case, the recovery mostly reflects developments on the US front, which overshadowed domestic factors. The exchange rate mostly tracked the trend of US yields, on the long end of the curve in particular, which decreased, replicating the flattening of the US curve** (Fig. 5): the short end tracked the Fed's hikes, whereas on the long end the slowdown in US inflation prevailed.

The underlying trend of the yen, however, should turn downwards again, placing the exchange rate back on a path towards USD/JPY 118 (highs since the beginning of the year) on a 12m horizon. **Given the prospect of another four fed funds rate hikes between now and the end of 2018 (as currently projected by the FOMC),** US yields will have to resume rising on the long end of the curve as well, resulting in an essentially equal widening of differentials, as **the BoJ has confirmed that it will press on – at length – with QQE and its curve control strategy,** keeping the short-term policy rate at -0.10% and the targeted 10Y yield at around zero.

Fig. 5 – The trend of the yen is tracking US (long) yields, replicating the flattening of the Treasuries curve



Source: Thomson Reuters-Datastream

Fig. 6 – Last year's anomaly has reversed: speculative market short yen again

Source: Thomson Reuters-Datastream

While the growth picture is improving, achievement of the inflation target remains a very distant prospect, and in the July update the BoJ will probably lower its inflations projections (which currently point a rise to 1.9% - just short of the 2% target – by the end of fiscal year 2019). Therefore, Governor Kuroda offered reassurances on the need to keep pursuing the strategy currently in place, denying rumours according to which the central bank would soon start preparing the exit from the stimulus programme.

Risks to the baseline scenario are skewed slightly upwards, i.e. the yen may weaken less than expected, mostly due to the persistence of factors that tend to contain inflation pressures, with the effect of – at like for like fed funds rate hikes – the recent flattening of the US curve being reabsorbed only in part. The return to normal of the speculative market's positioning – now

significantly short on the yen again, after anomalously staying long in 2016 (Fig. 6) – may help contain the Japanese currency's downside margin, as also the re-emergence of a number of geopolitical risk hotbeds at the international level.

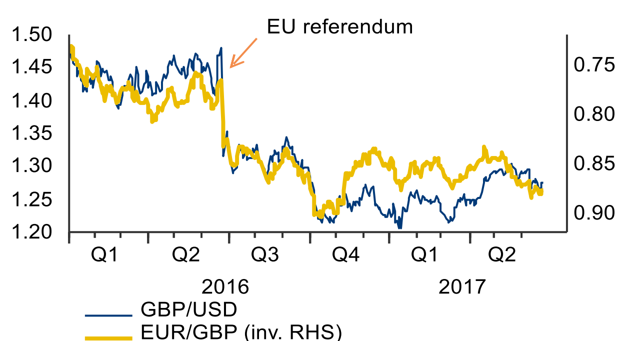
The underlying trend of the yen should be a weakening, against the euro as well, with a return of the exchange rate above the EUR/JPY 130 mark in the course of next year, given the parallel expected strengthening of the EUR/USD.

Sterling – BoE split on the bank rate hikes, although downside risks to growth tied to Brexit should prevail and persuade it not to remove monetary stimulus yet

Despite high uncertainty tied to Brexit, the pound strengthened slightly against the dollar **in the first half of 2017**, rising from a low of GBP/USD 1.19 to a high of 1.30. Against the euro, on the other hand, it generally stabilised, between lows in the EUR/GBP 0.88 area and highs in the 0.83 area, although more recently, between May and June, it has displayed some propensity to drop (Fig. 7). All considered, however, in terms of its effective exchange sterling has managed to level off above its post-referendum lows, and to keep at a safe distance from them. **Sterling has been helped by the fact that the performance of the economy – at least up to a certain point (1Q 2017) – was stronger than expected in the immediate wake of the referendum**. In fact, since November and on a quarterly basis the Bank of England has been revising up its growth projections, while lowering its inflation projections (Figs. 8-9).

Recent data, however, have started to awake some concern. In 1Q, GDP growth disappointed, by slowing more than expected (from 0.7% to 0.2% q/q), due to a sharp slowdown in consumption (from 0.7% to 0.3%), as a result of the rise in inflation triggered by the post-referendum depreciation of the exchange rate, as opposed to very (overly) slow wage growth. All the same, in its May Inflation Report the BoE (Fig. 8) only marginally revised down estimated growth in 2017 (from 2.0% to 1.9%), while revising up its forecast for the 2018-2019 biennium (from 1.6% to 1.7%). And for what concerns inflation (Fig. 9), although it revised up its projection for this year (from 2.7% to 2.8%), it lowered – more sharply – its forecasts for the next biennium (from 2.6% to 2.4% in 2018 and from 2.4% to 2.2% in 2019).

Fig. 7 – Sterling: modest recovery from the post-referendum drop



Source: Thomson Reuters-Datastream

Fig. 8 – Ongoing upward revision of growth forecasts

GDP growth

	IR Nov. 2016	IR Feb. 2017	IR May 2017
2017	1.4%	2.0%	1.9%
2018	1.5%	1.6%	1.7%
2019	1.6%	1.6%	1.7%

Source: Bank of England

However, **the latest data, combined with political developments, suggest a slightly pejorative revision** (downwards for growth, upwards for inflation) – at least for this year – **in the IR due to be published on occasion of the next BoE meeting on 3 August**. This is because inflation has increased more than expected, hitting 2.9% already in May, whereas the BoE expected it to reach 2.8% by the end of the year, which – in the presence of still moderate wage growth – points to a persistently weak consumption trend later in the year, as well. All considered, however, the picture drawn by the BoE is moderately positive, when read in light of the high uncertainty still in

place – and destined to persist – tied to Brexit. **The central bank has made it clear that its analyses are built on the assumption of a "smooth Brexit". At the same time, the BoE expects the slowdown in consumption to be offset by export and investment growth**, which should be supported by the combination of a weaker exchange rate and an improvement of the global growth picture. The expected slowdown in growth in the next biennium will therefore only be marginal (from 1.9% to 1.7%), and would in any case be accompanied by a closing of the output gap, with a rise back in wages that would allow the BoE to resume hiking rates already next year: according to the BoE, the hike path priced in by the market (one increase next year, possibly another in 2019, based on bank rate futures: Fig. 10) is overly cautious.

Fig. 9 – Inflation expected to stay above target throughout the forecasting horizon

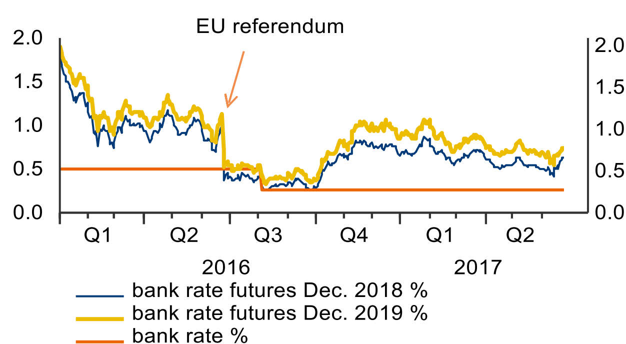
CPI inflation (*)

	IR Nov. 2016	IR Feb. 2017	IR May 2017
2017	2.8%	2.7%	2.8%
2018	2.7%	2.6%	2.4%
2019	2.5%	2.4%	2.2%

(*) year-end (4th quarter) forecasts

Source: Bank of England

Fig. 10 – Market overly cautious on the rate path according to the BoE



Source: Thomson Reuters-Datastream

At the latest BoE meeting in June, three MPC members out of eight (there is currently a vacant seat in the Committee – which usually includes nine members – following Charlotte Hogg's forced resignation), Forbes, McCafferty and Saunders, **voted in favour of an immediate bank rate hike,** on the rise in inflation, and **another member (Haldane)** said he considered doing the same, but ultimately opted to vote for stable rates in light of the slow wage growth trend and of additional political uncertainty – on Brexit as well – following the outcome of the snap election. However, Haldane **has spoken out in favour of a rate hike by the end of the year. However, we believe that – save for swift progress being made on the Brexit front, the number of hawks should not increase,** and that therefore rates will stay put at 0.25% this year. This is because Forbes, one of the three hawks, will end her mandate in June, and be replaced in July by Silvana Tenreyro, who based on the indications hitherto available, will side with the doves. Furthermore, the prevailing line within the BoE at the moment, undoubtedly supported by Governor Carney, seems to be that, **for the time being, above-target inflation is acceptable, as wage growth is slow, and there is still some slack in the economy**, therefore no particularly relevant inflationary pressures are at play other than those created by the exchange rate. As a result, **given the significant level of uncertainty – higher than usual – generated by Brexit in terms of downside risks to growth, the central bank should opt to allow monetary policy to keep offering support to growth.**

This seems even more necessary given the additional uncertainty produced by the outcome of the elections on 8 June, which instead of strengthening Theresa May's leadership, saw the Conservatives lose the absolute majority they had held in Parliament, forcing them – in order to form a new (minority) government – to seek the outside support of the Northern Ireland Unionists of the DUP (Democratic Unionist Party), whose 10 seats, on top of the Tories' 318, would allow May to keep governing, albeit with a very slim majority (only two seats more than the required number of 326). The deal between the Tories and the DUP is a "confidence and supply agreement", where the DUP agrees to support the Government on all motions of confidence, the

Budget, legislation pertaining to Brexit and national security. Support on other matters will be agreed on a case by case basis.

The negative aspect of the outcome of the election – i.e. a much weaker government than before – is probably outbalanced by the favourable one: the fact that May has dissipated the consensus she could previously count on should mean that **the risk of a hard Brexit, or of a no-deal exit,** both of which would be markedly unfavourable scenarios for the British economy, **has decreased significantly.**

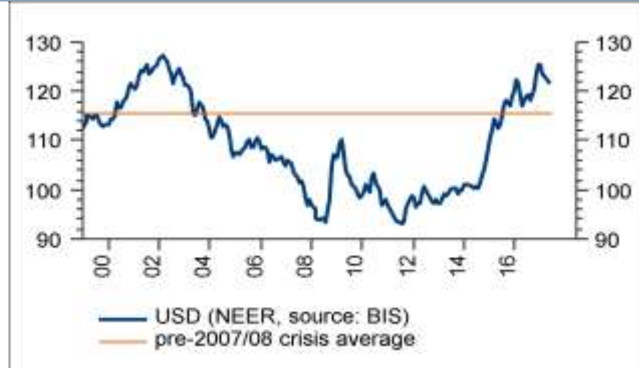
An initial indication in this direction came with the official opening of negotiations with the EU on 19 June, as **the United Kingdom accepted the EU's condition of taking on the issues of the exit bill (estimated at around 100 billion euros) and of the rights of EU citizens living in the United Kingdom, and vice versa, before starting to discuss the terms of future trade relations. Of the two, the exit bill seems to be the prickliest issue,** and will probably not be easy to solve.

While the softening of the United Kingdom's stance on Brexit increases the chances of a positive ultimate outcome of the negotiations, the weakened position of Prime Minister May will leave her more exposed to attacks also from within her own, which could affect the negotiations. In particular, the Chancellor of the Exchequer Hammond stressed the need to make a priority of supporting the economy, by putting in place transition measures to make exit from the EU more gradual, whereas May's main goal still seems to be immigration control. For what concerns the actual parliamentary opposition, a letter signed by over 50 Labour MPs was delivered to the prime minister, calling for the United Kingdom to remain in the single market, an option always ruled out by May.

In the Queen's speech, which formally opened the new legislature, and consisted of the Queen reading the government agenda drawn up by Theresa May, **the new government pledged to work in order to secure the best possible agreement on Brexit. At the same time, however, the list of bills announced per for the next few months includes the bill on immigration control**. Therefore, on the hottest topic, i.e. the terms of access to the single market, uncertainty remains high.

In light of the uncertainty produced by the electoral result, and considering the possibility of the BoE revising down slightly its growth projections in the August IR, while raising its inflation forecasts (at least for this year), the pound could weaken further in the near term. However, downside margin should be limited (mid-upper end of the GBP/USD 1.20-1.25 range, and EUR/GBP 0.88-0.90 band), as easing risk of a hard Brexit and/or a no-deal exit, reduces the negative fallout on the British economy. **Beyond the near term, on the other hand, sterling should gradually start to recover, also supported by the prospect of the BoE starting to hike rates next year,** which could aid a return of the exchange rate to (just) above the GBP/USD 1.30 mark in the course of 2018. By contrast, the pound would strengthen much less against the euro (towards EUR/GBP 0.86-0.85) as a result of the simultaneous expected strengthening of the EUR/USD. **Throughout the forecasting horizon, risks to the baseline scenario would be skewed downwards**, i.e. the pound could prove weaker than expected, especially if Brexit negotiations prove even more difficult than forecast, and/or should yield a negative outcome.

Fig. 1 – Dollar, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate

Source: Thomson Reuters-Datastream

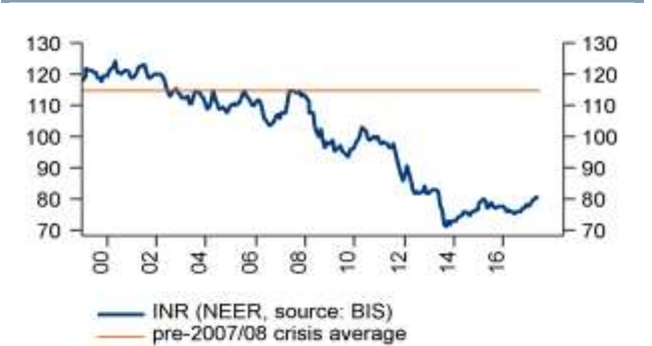
Fig. 4 - Sterling, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 5 – Yuan renminbi, nominal effective exchange rate

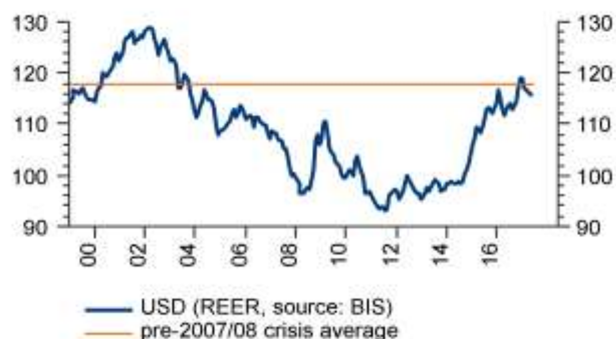
Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 7 – Dollar, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate

Source: Thomson Reuters-Datastream

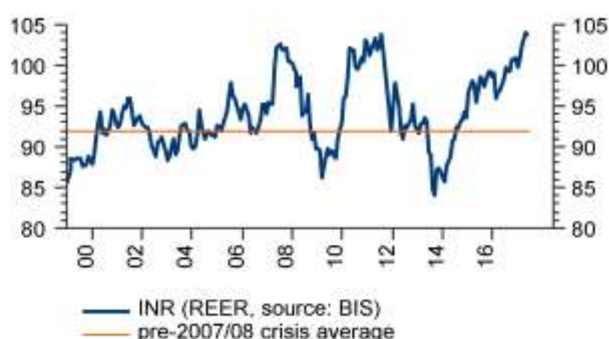
Fig. 10 - Sterling, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate



Source: Thomson Reuters-Datastream

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Appendix

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