BANCA IMI

Macroeconomic Outlook

Research Department
September 2017

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Index

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Based on information available up to 2 October 2017

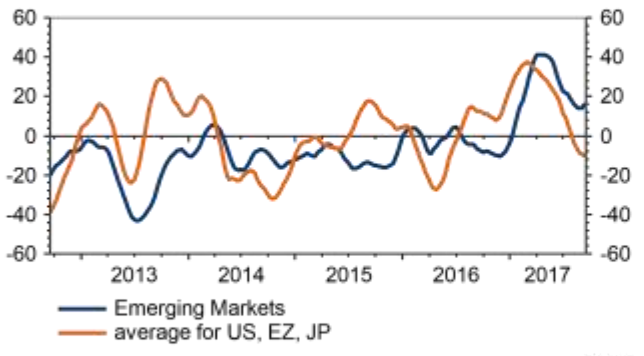
The global economy? Neither too hot, nor too cold

Luca Mezzomo

The trend of the global economy has remained positive in 3Q 2017, sometimes beating expectations. Our assessment of the outlook for 2018 is largely unchanged compared to three months ago: the expansion phase will continue, only marginally affected by the reduction in monetary stimulus and realignments on the currency markets. Low inflation and moderate credit trends allow central banks to take a gradual approach to the normalization phase.

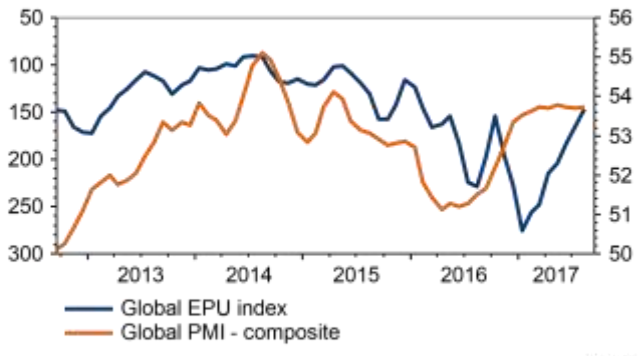
The global economy is bringing the third quarter of the year to another positive close. The latest sets of monthly survey data have outlined unchanged or accelerating growth compared to the second quarter. Global GDP is still accelerating, although growth rates remain moderate: based on the global PMI, we forecast growth to level off at 2.8% in 3Q 2017, with a possible further acceleration to 3% by the end of 1H 2018. Real data confirm the positive indications provided by sentiment surveys, pointing to widespread recovery in industrial output and international trade volumes. The latter are also supported by the stabilisation in oil prices, that have already resulted in reversal of the negative import trend in oil producer countries. The assessment of residual political risks has also become more balanced.

Fig. 1 – Economic surprise indices positive



Source: IHS Markit, Thomson Reuters-Datastream Charting

Fig. 2 – Measures of economic policy uncertainty de-correlated from growth



Source: EPU, Thomson Reuters-Datastream, IHS Markit

Consensus forecasts for growth in 2017-18 have already risen significantly over the past three months, although the United States and the United Kingdom have been left out of the process. However, in recent months data have continued to surprise on the upside only in emerging countries, whereas in advanced economies forecasts now seem to have already adjusted to the more aggressive growth path. Furthermore, confidence surveys are starting to stabilise, indicating that the acceleration phase is now coming to an end. Growth seems unlikely to accelerate significantly next year. The phase in which forecasts are revised upwards may also be in its closing stages.

As already noted in the past, the support offered by economic policies could turn less positive in the quarters ahead. On the other hand, the restrictive impact seems too modest to jeopardise the economic expansion. The reversal of **fiscal policies** is proving shy, and therefore should not significantly hold back growth in advanced countries: the improvement in the primary balance in 2018 is mostly explained, in fact, by the cyclical recovery in fiscal revenues. Furthermore, tax cuts in 2018 are becoming an increasingly likely prospect in the United States, and could lead to a looser fiscal stance overall.

For what concerns **monetary policies**, on the other hand, the change in direction is clear, and is involving an increasing number of advanced countries. More in detail, the tightening of monetary conditions is intensifying in the United States, with modest rate increases and a gradual reduction of the Fed's balance sheet through an only partial reinvestment of assets upon maturity. In the euro area, the ECB is removing monetary stimulus by reducing the expansion of its balance sheet, although it still seems distant from considering policy rate hikes, and the tightening of financial conditions is mostly taking place via the exchange rate. The Bank of England seems to be closer to hiking the bank rate, whereas Canada has already started to step up policy rates. The situation is diverse in the emerging countries, although the cooling of inflation measures and the slow pace at which the ECB and Fed are tightening, could result in a more accommodative trend of monetary policies even among emerging markets.

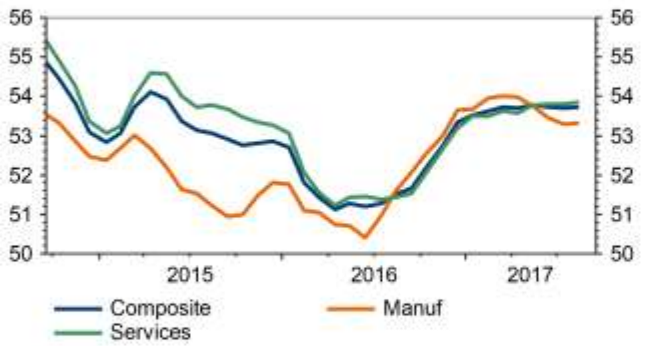
The present monetary tightening phase is effectively proving quite gradual, both in terms of market expectations (the 3m Euribor rate implied by the future contract maturing in December 2021 maturity is a mere 0.63%), and of the forward guidance provided by the central banks themselves: the Federal Reserve is indicating the point of arrival for the present rate hike cycle at <3.0%. Persistently accommodative monetary policies can be kept in place thanks to the modest nature of inflation pressures, which are struggling to pick up even in countries where the labour market seems to have reached full employment levels (United States, Germany). We do not expect significant changes on this front. Central banks are also being aided by the fact that credit trends remain generally moderate: credit gap measures as drawn up by the BIS are now in the norm in all the advanced countries, with the exception of Canada and, to a lesser extent, Japan. This aspect of the recovery could strike as being very surprising, considering the intensity of monetary stimulus (interest rates at zero or negative, building up of large excess reserves, launching of massive financial asset purchase programmes, etc). However, it is less surprising when considering how much stricter banking sector regulations have become following the financial crisis. Much tighter risk control put in place in the financial system could ease the burden typically placed on the shoulders monetary policy makers.

Another interesting aspect of the present phase of the economic cycle is the **realignment of currencies** to the detriment of the dollar, which seems to have begun in 2017, after a false start of sorts to 2H 2016. For the time being, the size of the adjustment is modest: the dollar remains well above its average values for the past five years in terms of the index weighted by trade flows, whereas the euro is just above average levels. Besides, the movements observed so far are consistent with the rebalancing of the global economy, and do not seem excessive for now. Besides, the sensitivity of trade flows to the exchange rate could be structurally lower today than in the past.

In conclusion, our assessment of the economic outlook has changed very little over the past few months. We have marginally revised up our growth forecasts compared to June, mostly for the euro area. By contrast, inflation projections are generally lower than they were in June, for the United States in particular.

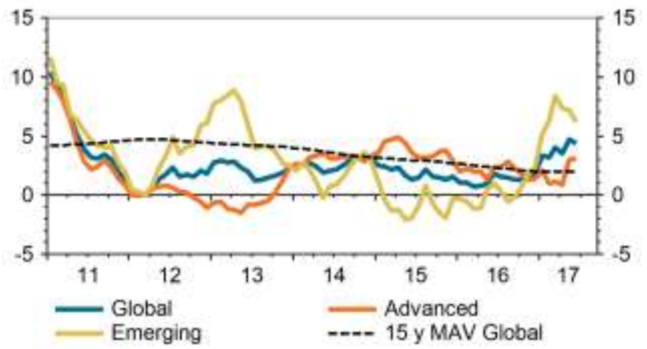
Trends of the global economy in 10 charts

Fig. A – Trend of global PMIs



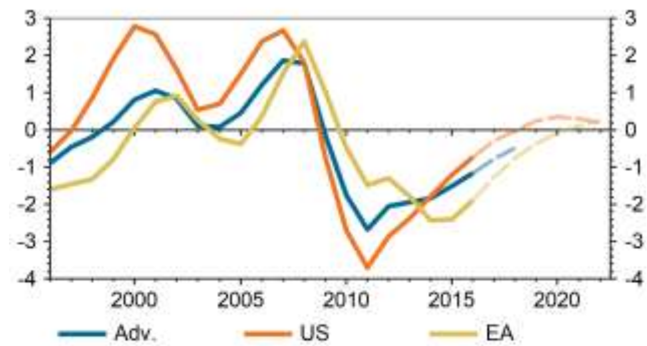
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Import growth, y/y



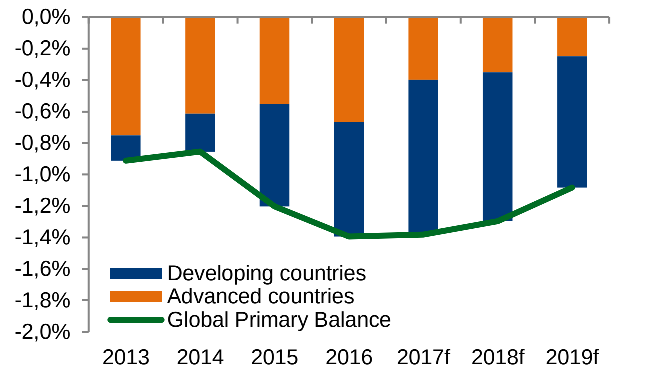
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



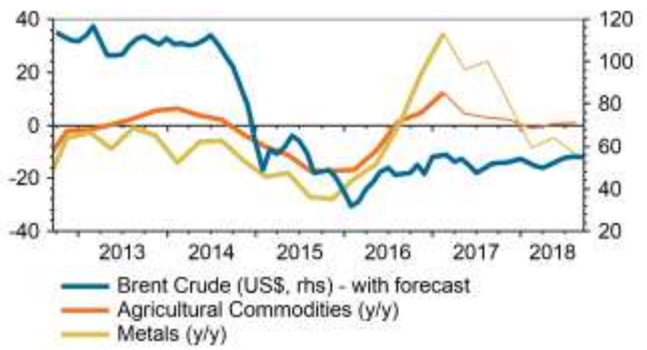
Source: Thomson Reuters-Datastream Charting and IMF

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



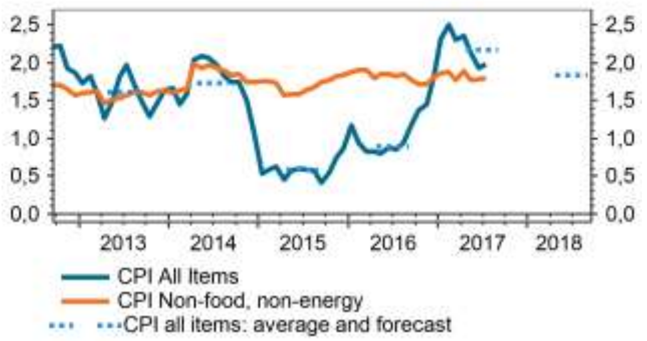
Note: based on the 11 major advanced countries and the 8 major emerging countries. Data aggregates at current exchange rates. Source: Intesa Sanpaolo elaborations

Fig. E – Commodity prices



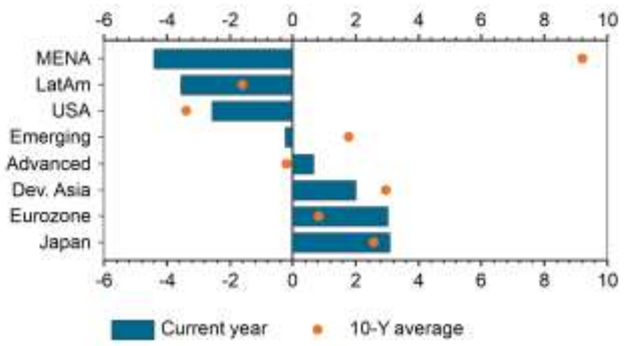
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



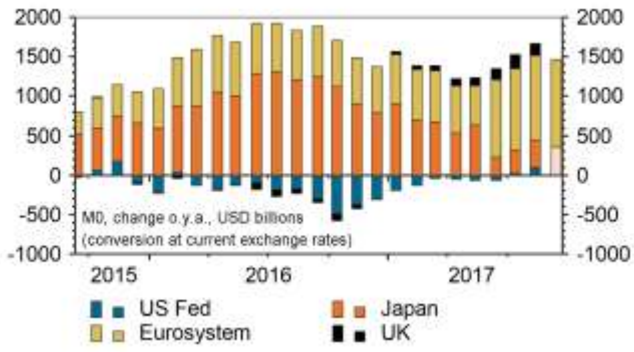
Source: OECD, Thomson Reuters-Datastream Charting

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



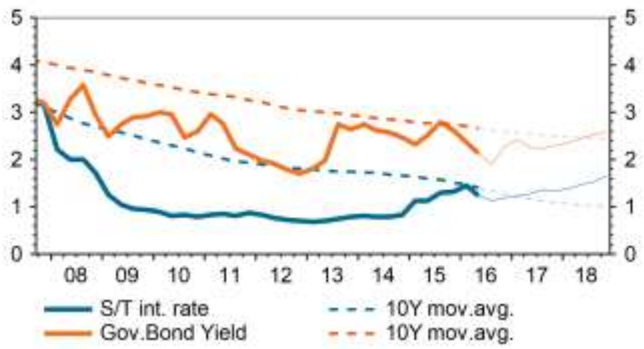
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

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



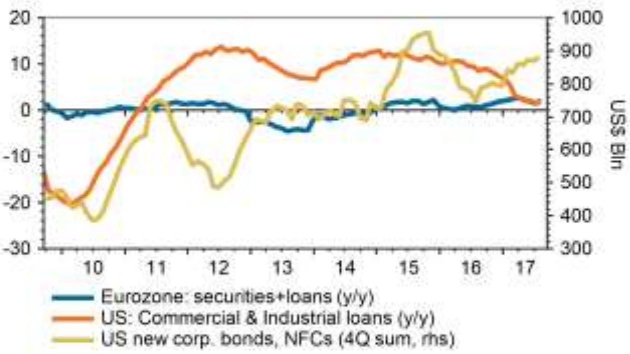
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



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

Fig. J – Credit to the non-financial sector



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

Economic growth by geographical region

	2015	2016	2017	2018	2019
United States	2.9	1.5	2.2	2.4	2.0
Japan	1.1	1.0	1.5	0.9	0.9
Euro Area	1.9	1.8	2.2	1.7	1.5
Eastern Europe	0.0	1.3	2.9	2.4	2.2
Latin America	-0.8	-0.9	1.2	2.4	3.0
OPEC	1.1	2.2	0.7	2.5	3.7
China	6.9	6.7	6.7	6.3	6.0
India	7.5	7.9	6.4	7.2	7.4
World	3.2	3.2	3.6	3.7	3.6

Source: Intesa Sanpaolo elaborations

United States: output gap at zero, low inflation, and gradual rate hikes

Giovanna Mossetti

The US economy continues to grow, and the prospects for this already very mature growth phase (the third-longest since 1854) are that it will extend further. The duration of the current recovery is based on two factors: widespread moderation and low inflation, which have so far managed to stave off aggressive interventions by the Fed. In mid-2017, the unemployment gap was in positive territory and the output gap around zero (CBO and OECD estimates), but inflation remained close to 1.5% and wages at around 2.5% yoy. The Phillips curve is probably still alive and well, but is very flat: slack keeps falling without any significant pressure on prices. The forecast is for the scenario of the last few years to continue, with average growth just above potential in 2017-19: 2.2% in 2017, 2.4% in 2018 (with the tax reform) and 2% in 2019.

1. Macroeconomic outlook: moderation. Average growth in 1H was around 2%. The second half of the year will be impacted by the Hurricanes Harvey and Irma; this will probably curb demand at end-3Q/early-4Q, and then drive activity from mid-4Q, with positive repercussions in early 2018 too. After Hurricane Katrina, GDP growth slowed, especially in the fourth quarter, in the wake of weak consumer spending and investment, followed by a rebound in these two items in early 2006 (Fig. 2). The information currently available suggests that consumer spending will be weak in August and September, and then recover late in 4Q. Aside from temporary volatility, the outlook for GDP is a path of moderate, just-above-potential growth, without excesses.

Consumer spending is still supported by favorable fundamentals: a solid labor market, higher net wealth, expansionary financial conditions and high confidence. The recent revision of the national accounts significantly reduced the savings rate, with higher consumption in 2016. The savings rate has now stabilized at around 3.5%, with less scope for a potential recovery in future spending. However, the achievement of full employment, which will probably also extend into 2018-19, is a solid basis on which to forecast average consumption growth of 2.5% in 2017-19, slowing gradually until it reaches the "steady-state" rates of: 2.7% in 2017, 2.5% in 2018 and 2.3% in 2019. One variable currently difficult to forecast is the effect of the still-uncertain tax reform (see below) in terms of both the total reduction in federal government revenues, and most importantly, the distribution between income classes. For now, we incorporate a modest increase in fiscal stimulus, but this is fraught with uncertainty.

Non-residential fixed investment is showing a moderate and widespread rise. Volatility in mining has dropped as oil prices have normalized. Signs from the manufacturing and orders surveys are positive, apart from probable post-hurricane fluctuations. Expectations of moderate growth in domestic and global demand combined with the weakness of the dollar and the ongoing expansionary financial conditions have bolstered business confidence, even before we have seen details of the potential tax reform. Business fixed investment is expected to grow by **4.5% in 2017, 4.2% in 2018 and 2.9% in 2019.** The forecast for residential investment is for further weakness in early 2H17, followed by a recovery, partly driven by post-hurricane building work. Residential investment growth looks set to be **2.2% in both 2017 and 2018**.

Inflation continues to be the most uncertain variable in the US economic scenario. In 1H, various factors put the brakes on the core indices (mobile phone services, healthcare, hotel services, rental rates, cars), causing a sharp slowdown in monthly variations. August's core CPI rose by 0.24% mom: will this be the new trend? Some of the restraints seen in the last few months are temporary, but other factors could continue to curb the recovery of prices: structural changes to price formation, as Dudley suggested (the Amazon effect, for example), increasing competition (telecoms), saturation of demand (cars, rents) and/or entrenchment of low expectations after five years of inflation persistently below 2%. The cut in mobile phone fees in March 2017 will continue to curb year-on-year growth in core prices until 1H18; annual inflation may also continue to fall further until February, potentially affecting expectations. The impact of the hurricanes increases forecasting uncertainty: however, the rise in gasoline prices in August and September and the scarcity of some goods and services in high demand for rebuilding could put upward pressure on both headline and core indices. In conclusion, the return of inflation to 2%

is still uncertain and, in our view, may lead the Fed to adopt a more cautious attitude to raising rates.

2. Fiscal policy: much ado about nothing? Nine months in from Trump's inauguration, there is still no trace of the promised reforms. The few actions taken in Congress (suspension of the debt ceiling, extension of the appropriation bill, funding for post-hurricane rebuilding) were approved on a bi-partisan basis, thanks to a move by the President which bypassed the Republican leadership. The autumn will be crucial: apart from the possibility of an eleventh-hour agreement on health reform, the **focus will be on the budget and on tax reform. Our forecast is that a reform will be approved, will be expansionary and perhaps more effective than expected,** and will also provide for a lower tax burden for the lower-middle income classes. The central scenario, albeit highly uncertain, is that taxes will be reduced, perhaps retroactively (which may therefore have relatively significant expansionary effects in 1H18) in order to drum up support for the Republicans in an election year. It is not possible, at the moment, to incorporate the effects of a reform that has not yet been announced; however, our forecast of a modest upturn in growth in 2018 reflects the expectation that in the next few months proposals will be discussed and probably approved by late 2017 or very early in 2018.

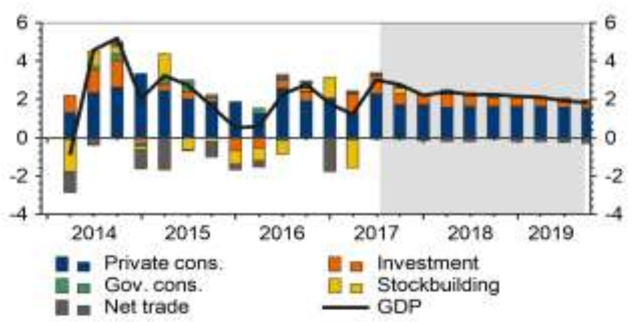
3. Monetary policy: full steam ahead with normalisation. In September, the FOMC announced that it will launch its programme to reduce reinvestment in October, as indicated in June. The reinvestment caps will be "automatic" and progressive (USD -10Bn per month in autumn, increasing gradually to USD -50Bn per month in 2018 and thereafter). The balance sheet will not be an active tool of monetary policy, which will be managed through interest rates. The FOMC has indicated, in this regard, that the healthy performance of the economy justifies the continuation of stimulus reduction. Macroeconomic projections are still positive, with the unemployment rate at two- to three-tenths below the equilibrium rate (4.6%) over the whole forecast horizon, just-above-potential growth, and inflation at 1.9% in 2018 and 2% in 2019 and thereafter. Against this optimistic backdrop, rates are expected to rise, but on a slightly lower and flatter path than in June. Projections are for a further rise in December, followed by three hikes in 2018, two in 2019 and one in 2020. The neutral interest rate has been reduced by 25 basis points to 2.75%, from 3% in the previous projections. The FOMC emphasised that the expected volatility in autumn's macroeconomic data caused by the hurricanes is not likely to change underlying economic trends. **Core inflation is still the crucial variable affecting interest rates:** signs of further weakening could lead to a revision of the forecasts in the next few months.

Forecast Table

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.5	2.2	2.4	1.2	1.5	1.8	2.0	2.2	2.2	2.2	2.6	2.4	2.3
q/q annual rate				2.2	2.8	1.8	1.2	3.0	2.8	1.9	2.6	2.2	2.3
Private consumption	2.7	2.7	2.5	3.8	2.8	2.9	1.9	3.3	2.5	2.1	2.6	2.4	2.4
Fixed investment - nonresid.	-0.6	4.5	4.2	3.3	3.4	0.2	7.1	6.9	4.4	3.7	4.9	3.9	2.9
Fixed investment - residential	5.5	2.2	2.2	-4.8	-4.5	7.1	11.1	-6.5	1.8	2.5	3.0	3.0	3.5
Government consumption	0.8	-0.2	0.4	-0.9	0.5	0.2	-0.6	-0.3	-0.5	0.3	0.6	0.8	0.7
Export	-0.3	3.5	3.3	2.8	6.4	-3.8	7.3	3.7	4.6	2.7	3.3	2.6	3.5
Import	1.3	3.8	3.3	0.4	2.7	8.1	4.3	1.6	3.0	2.9	4.0	3.4	3.1
Stockbuilding (% contrib. to GDP)	-0.4	-0.2	0.1	-0.7	0.1	1.1	-1.5	0.0	0.3	0.0	0.2	0.0	0.0
Current account (% of GDP)	-2.4	-2.4	-2.6										
Federal Deficit (% of GDP)	-5.1	-4.5	-4.5										
Gov. Debt (% of GDP)	127.4	126.1	125.7										
CPI (y/y)	1.3	2.1	1.8	1.0	1.1	1.8	2.5	1.9	2.0	1.9	1.4	1.9	2.1
Industrial production (y/y)	-1.2	1.8	2.3	-0.2	0.2	0.2	0.4	1.4	0.1	0.7	0.7	0.5	0.4
Unemployment (%)	4.9	4.4	4.2	4.9	4.9	4.7	4.7	4.4	4.3	4.3	4.2	4.2	4.1
Fed Funds	0.5	1.1	1.8	0.5	0.5	0.5	0.8	1.0	1.3	1.3	1.5	1.8	1.8
Effective exch. rate (1973=100)	91.7	93.9	95.4	89.6	90.2	93.7	94.4	93.0	93.8	94.4	94.8	95.4	95.6

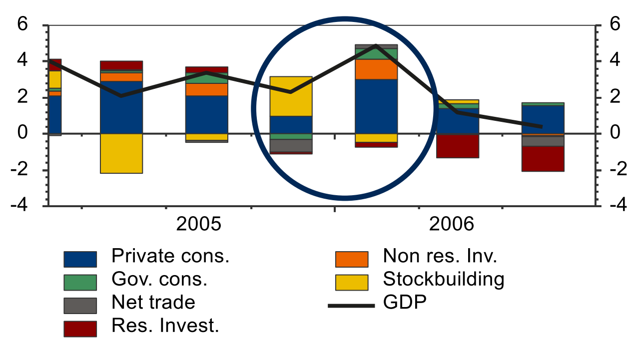
Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

Fig. 1 – Forecasts of moderate growth for all components of domestic demand



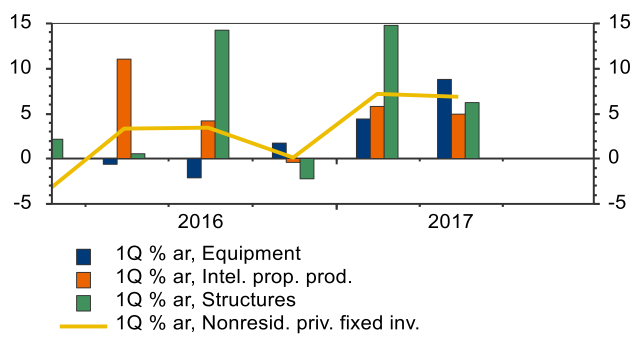
Source: Thomson Reuters-Datastream IMF forecasts

Fig. 2 – GDP and Katrina: temporary effects on consumption and investment disappeared after two quarters



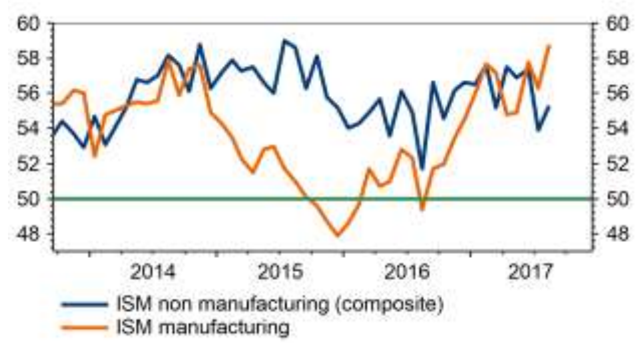
Source: Thomson Reuters-Datastream

Fig. 3 – Non-residential investment: balanced growth



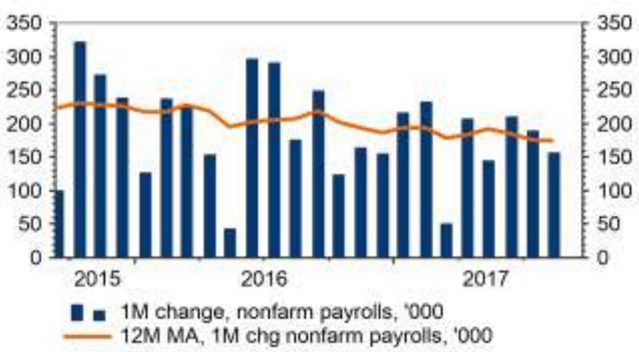
Source: Thomson Reuters-Datastream

Fig. 4 – ISM: positive indications from all sectors



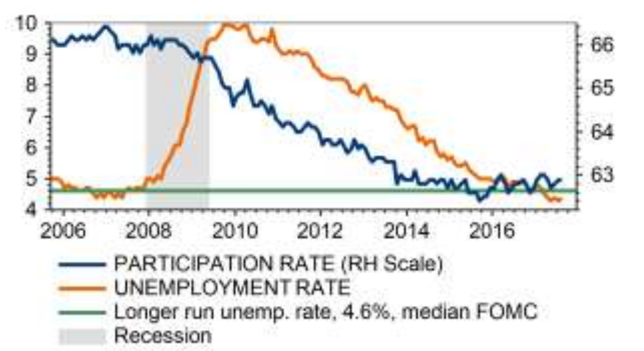
Source: Bloomberg, Thomson Reuters-Datastream

Fig. 5 – New jobs still close to 180,000 per month



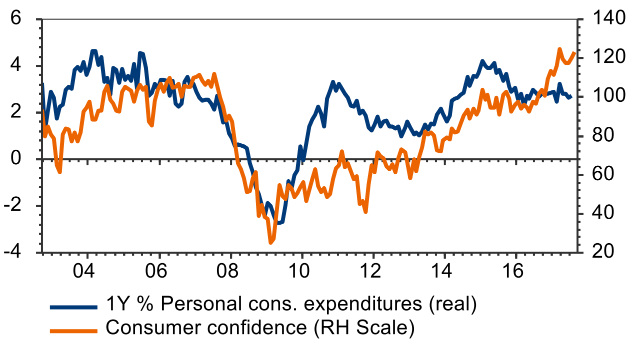
Source: Thomson Reuters-Datastream

Fig. 6 – Unemployment still falling



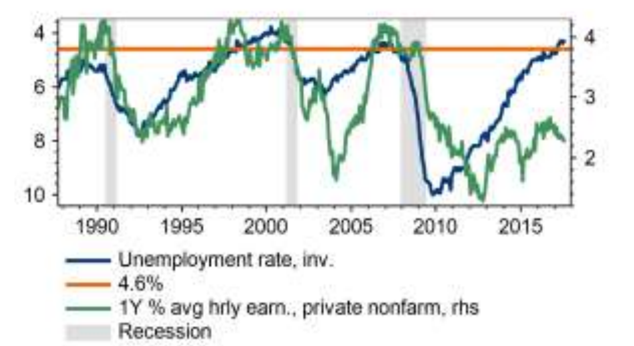
Source: Thomson Reuters-Datastream

Fig. 7 – Consumers are optimistic



Source: Thomson Reuters-Datastream

Fig. 8 – Wage growth still very moderate



Source: Thomson Reuters-Datastream

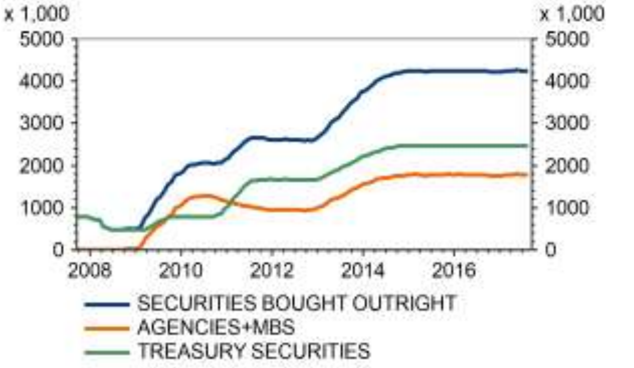
Fig. 9 – Inflation low, partly due to temporary factors

Source: Thomson Reuters-Datastream

Fig. 10 - Objectives of the Fed's mandate differ, but this should be a temporary phenomenon

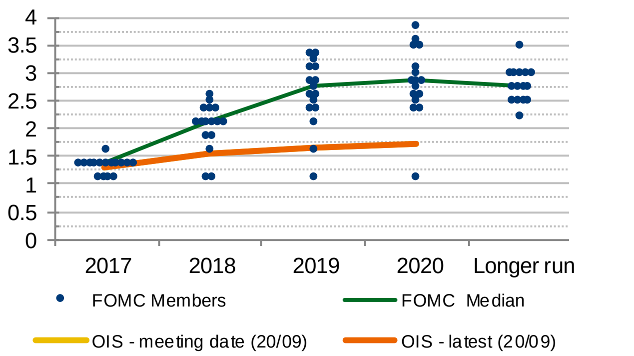
Source: Thomson Reuters-Datastream

Fig. 11 – Fed's balance sheet before QExit



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

Fig. 12 – Rate projections of FOMC members: consensus for the short term, widely differing opinions for the medium term.



N.B.: Projections of presidents of the Federal Reserve Banks and members of the Board of Governors, 20/09/2017. Source: Intesa Sanpaolo chart from Federal Reserve Board and Thomson Reuters-Datastream data

Eurozone: the economy is booming. European politics: everything coming up roses?

Anna Maria Grimaldi

The Eurozone's economic growth phase is continuing at even stronger rates than our forecasts of three months ago, which were already above consensus. We have revised up our 2017 forecast from 2.0% to 2.2%. This phase of acceleration may now have peaked. GDP will grow at a slower pace, but still above trend, from the second half of this year until end-2019. The appreciation of the effective exchange rate (+6% since early April) will not derail the recovery, because it is partly endogenous and is happening in an economy that is doing better than expected. We therefore confirm our 2018-19 growth estimates of 1.7% and 1.5%.

The cyclical recovery is associated with solid job creation and the lowest unemployment rate in over nine years. The stronger economic growth has so far not generated inflationary pressure on domestic prices, and we forecast inflation of around 1.6% at end-2019, up from an expected 1.3% in 2018.

The uncertainty surrounding the rise in core inflation, exacerbated by the appreciating exchange rate, justifies the ECB's ultra-accommodative rhetoric and its commitment to normalise monetary policy in an extremely cautious manner. We think that QE will continue until autumn 2018 and rates will remain on hold until early 2019.

Positive developments in the political landscape are also fuelling greater optimism about the Eurozone economy. The outcome of the Dutch and French elections show that the risk of a populist drift has been stemmed. The Austrian elections on 15 October are not likely to hold any surprises, given the resurgence of the Christian Democrats. However, the Italian elections next spring are a much riskier matter.

The combination of an extremely rosy macroeconomic outlook, Macron's victory at the French presidential elections and the confirmation of Angela Merkel in Germany, creates a unique opportunity to re-open the dialogue on the process of monetary union reform and strengthen citizens' trust in European democratic values, after years in which growth and social cohesion in the Eurozone have been almost exclusively supported by the ECB's policies. But expectations must be managed: the German establishment and public opinion are opposed to giving up tax sovereignty and resolute about managing any future crises based on market processes.

Forecast Table

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.8	2.2	1.7	1.7	1.7	1.9	2.0	2.3	2.3	2.1	2.0	1.7	1.6
- q/q change				0.3	0.5	0.6	0.5	0.6	0.5	0.4	0.4	0.4	0.3
Private consumption	2.0	1.8	1.5	0.3	0.3	0.6	0.4	0.5	0.4	0.4	0.4	0.3	0.3
Fixed investment	4.3	2.8	4.4	2.7	0.1	1.3	-0.3	0.9	1.0	0.9	1.2	1.2	1.1
Government consumption	1.7	1.2	1.2	0.2	0.2	0.4	0.2	0.5	0.3	0.3	0.3	0.3	0.3
Export	3.2	4.4	3.5	1.3	0.4	1.5	1.3	1.1	0.8	0.8	1.0	0.8	0.8
Import	4.6	4.1	3.7	1.8	0.5	2.0	0.4	0.9	1.0	0.8	0.9	1.0	0.7
Stockbuilding (% contrib. to GDP)	-0.1	0.0	-0.3	-0.3	0.2	0.1	-0.1	-0.1	0.0	-0.1	-0.1	0.0	-0.2
Current account (% of GDP)	3.3	3.2	3.0										
Deficit (% of GDP)	-1.5	-1.4	-1.3										
Debt (% of GDP)	91.3	90.3	89.0										
CPI (y/y)	0.2	1.6	1.4	-0.1	0.3	0.7	1.8	1.5	1.5	1.6	1.2	1.5	1.6
Industrial production (y/y)	1.4	1.9	1.4	1.1	1.0	2.2	1.3	2.7	2.4	1.2	1.2	0.9	1.4
Unemployment (%)	10.0	9.2	8.7	10.1	9.9	9.7	9.5	9.2	9.1	8.9	8.8	8.8	8.8
3-month Euribor	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
EUR/USD	1.11	1.13	1.19	1.13	1.12	1.08	1.06	1.10	1.18	1.16	1.17	1.19	1.20

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

Is stronger-than-expected growth an opportunity to re-open the dialogue on monetary union reform?

The positive growth phase of the European economy continues at even stronger rates than we had forecast three months ago. We have revised up our estimate for 2017 to 2.2%, from 2.1% previously. However, the acceleration phase is now over. Starting in the second half of this year, and until the end of 2019, GDP will grow at less livelier rates, albeit stronger than the trend. The appreciation of the effective exchange rate will not derail the recovery, as it is in part endogenous in nature and is taking place in an economy that is performing better than expected. We confirm our estimate for 2018 at 1.7%.

The Eurozone cycle continues to outperform expectations. We have revised up growth for the current year but are keeping our 2018-19 forecasts unchanged

Already in June, we expressed a more positive view on the outlook for the Eurozone, in part in light of the evolution of the political picture. Over the summer months, macro data confirmed a stronger than expected underlying trend of the economy. From 0.6% growth q/q (2.3% y/y) in 2Q, up from 0.5% q/q (2.1% y/y) at the beginning of the year, GDP is expected to increase by 0.5% q/q in the summer months as well. The European Commission Sentiment Indicator has reached a new high at 113, well above the average of the previous six months (109); instead, the composite PMI dropped by half a point compared to June, although at 56 on average it indicates growth of at least 0.5% q/q (Fig. 2). However, the weak trend of industrial output at the start of 3Q prompts us to confirm our forecast of 0.5% q/q. In light of the indications provided by data, we have revised up again our estimates for 2017, to 2.2% from 2.0%. Recent data and indications would lead us to revise up our GDP growth forecast for 2018 as well, but for the time being we have opted to confirm our June estimates, of 1.7% in 2018 and 1.5% in 2019.

The appreciation of the exchange will not derail the recovery, as the solid underlying trend of the euro area economy, and the ECB's persistently very cautious approach to adjusting extraordinary measures

Given the stronger than expected macro picture, over the summer months the increase in the external value of the euro consolidated (+6% since the beginning of April, Fig. 4). The standard elasticities of the macroeconomic models suggest that a 5% appreciation of the exchange rate holds back GDP growth by 0.4% after one year. However, as Draghi noted in his press conference last September, the intensity of the negative effect of the exchange rate on growth depends on the nature of the shock. If the shock is endogenous, the impact on growth and inflation is blander, as it reflects more solid fundamentals. Furthermore, the transmission of the exchange rate[1] to import prices and end prices may have decreased compared to the past, for: 1) structural reasons, mostly tied to the stronger integration of production processes at the global level, and 2) for cyclical reasons: businesses which export to the euro area are probably proving able to keep prices unchanged in the present phase, characterised by strong demand. The integration of production processes, and the high import content of European exports, results in the trend of exports being more influenced by the evolution of global trade than by the exchange rate (Figs. 5 and 6). Undoubtedly, in the present phase **the appreciation of the euro is taking place in an economy displaying a stronger than forecast underlying trend,** mostly thanks to resilient domestic demand. It should also be considered that the impact of the exchange rate on inflation and growth is not insulated form monetary policy conduct. The **ECB could opt for a slower exit from the asset purchase programme** (EAPP), extending it until the autumn of 2018. Consequently, the first policy rate hike would not take place before 2019[2]. Therefore, we believe the movement of the exchange rate may weigh on 2018-2019 growth by up to 0.2%, offsetting the stronger than expected underlying trend.

Nothing new on the fiscal policy front

ECB's monetary policy will continue to act as the main driver of the recovery in the course of next year as well. On 20 June 2017, the European Fiscal Board indicated as adequate a neutral

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[1] See Coeuré: *The transmission of monetary policy in standard and non-standard times*, September 2017.

[2] Coeuré, on 11 September 2017, said that the policy-relevant horizon is likely to be longer, muting further the pass-through to the economy of any exchange rate appreciation.

fiscal policy stance for the euro area in 2018, and suggested differentiated policies within the area, which would imply an easing in Germany and the Netherlands. However, the recommendations of the June European Council meeting reasserted that the use of flexibility to stimulate domestic demand is allowed only in respect of MTO targets (structural balance adjustment of 0.5% per year for the countries distant from the target), which suggests a marginally restrictive rather than neutral fiscal policy stance.

The recovery is solid and self-sustaining

One of the characteristics of the present growth cycle, the longest since the introduction of the single currency, is that the recovery is confirmed as widespread throughout the area, and over the next two years the gap between core and peripheral countries should tighten further (Fig. 7), which would make the recovery more solid. GDP growth is still being driven largely by domestic demand, which makes it more sustainable. The surprising recovery in global trade (4.7% in 2017) from 1.6% in 2016, has fuelled euro area manufacturing in the course of 2017. However, in the next two years we expect foreign demand addressed to the euro area to stabilise at around 3.5%, broadly in line with the global growth trend. Therefore, exports should slow to 3.5% in 2018, from 4.7% this year, whereas imports will continue to expand at livelier rates. The positive contribution of foreign trade will gradually drop to zero.

Foreign trade will stabilise at more normal growth rates in 2018-2019

Investments in machinery replacing consumption as the main driver of domestic demand

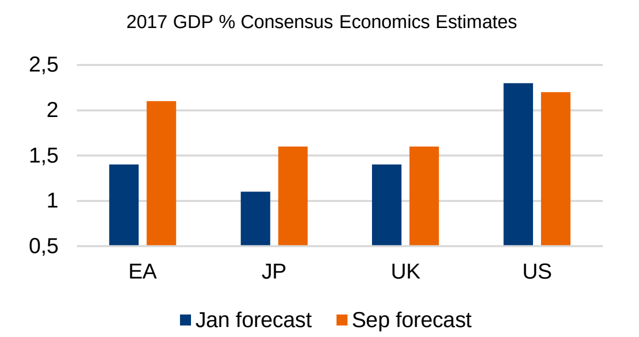
The breakdown of domestic demand growth will see a progressive shift in weight from households' consumption to investments in machinery. Recent data indicate that corporate spending has set out sure-footedly on a more expansive cycle, given the high level of production capacity utilization, the solid financial position of businesses (Fig. 9), the low cost of obtaining financing through bank loans, and more solid demand conditions. Average growth this year (1.7%) will be penalised by the decline at the beginning of the year, whereas we expect an expansion of close to 4.0% in 2018. Activity in the construction sector is also performing better than expected (+0.5% q/q in the spring months, after a surge at the beginning of the year). Our index points to ongoing positive growth in the coming months, of around 1.0% (Fig. 10). In the course of 2017, households' consumption proved more resilient than expected, growing on average by 0.5% q/q (1.7% y/y), thanks to the accelerating employment (1.6% y/y, from 1.4% y/y in 2016) and wages (1.9% y/y from 1.3% y/y in 1Q), which balanced in part the increase in inflation (1.5% in August from 0.2% in 2016). However, **households' spending is estimated to have peaked (Fig. 11),** purchasing power will be further eroded by the rise in inflation to 1.9% in 2019, and the job trend will remain solid (1.3%-1.4%), albeit less so than in 2017 (1.6%). At the same time, wages are unlikely to accelerate markedly from 1.7% y/y in 2Q this year, given the persistent and ample excess supply (Fig. 12).

There is no reason to expect a "quantum leap" in European reforms in the next parliamentary term.

This solid growth phase creates an opportunity to re-open the political dialogue on the process of reform needed to complete the architecture of monetary union. In a recent survey by Politico (23 August 2017), after a period in which confidence in Europe fell, European citizens stated that they are now more favourable to cooperation and integration policies (see. Fig 16). As President Juncker stressed in his annual speech to the European Parliament on 15 September, there is an urgent need to rethink the process of monetary union. Macron's victory in the French presidential elections and the confirmation of Angela Merkel after the polls on Sunday 24 September have led to a sharp fall in political risk in Europe, and paved the way for a new Franco-German partnership. Germany's position in European politics will only become clear after the government coalitions have been formed. But expectations must be managed: the German establishment and public opinion are opposed to giving away tax sovereignty and resolute about managing any future crises based on market processes. Leaving aside Germany's position on the reform of monetary union, political risk has not completely disappeared. Whereas the Austrian elections on 15 October are not likely to hold any surprises, given the resurgence of the Christian Democrats, there are still the more problematic Italian elections, which will be held in spring 2018 at the latest. 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

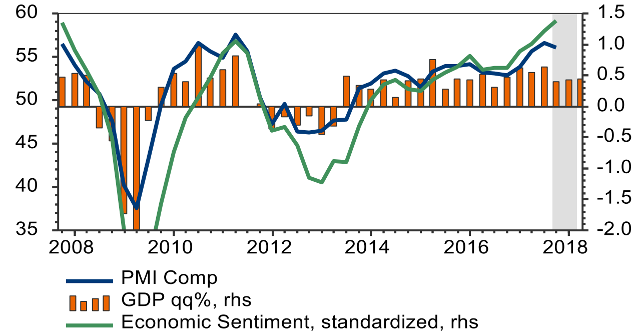
Political risk has faded for now but has not disappeared government coalitions. Even in the event of an uncertain outcome to the Italian elections, however, the institutional landscape will probably be more robust than in 2011.

Fig. 1 – Global growth estimates have been revised up: Eurozone biggest surprise among advanced countries



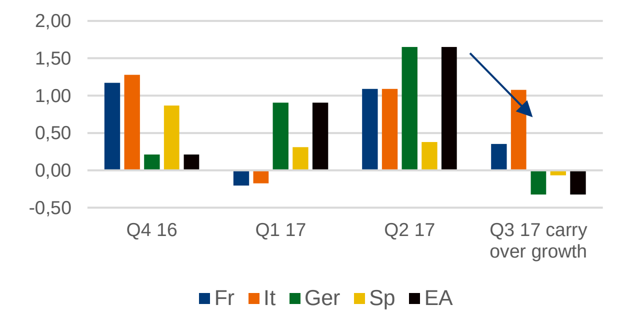
Source: Consensus Economics and Intesa Sanpaolo elaborations

Fig. 2 – Confidence surveys suggest upside risks to our growth estimates of 0.5% q/q in the summer months.



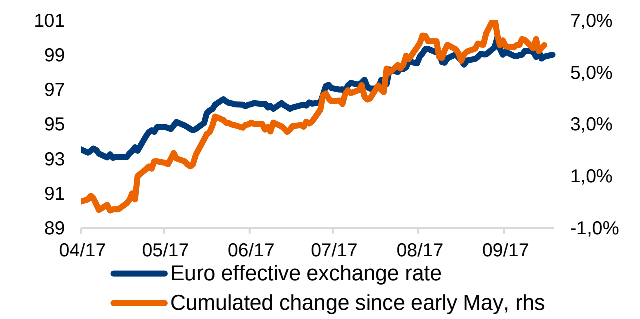
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 3 –However, the weak entry of industrial output into the summer quarter advises caution in assessing the cycle



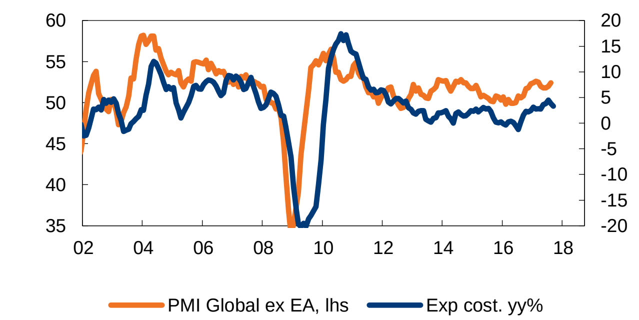
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 4 – Euro exchange rate stronger by 6% since April



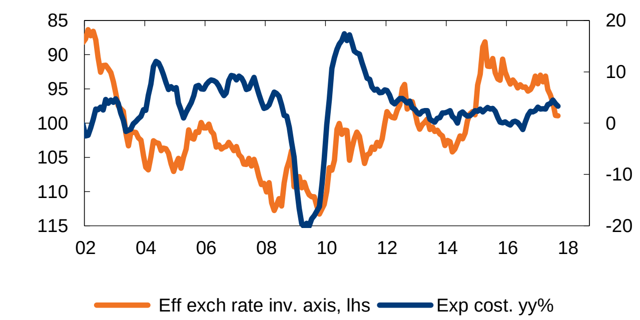
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 5 – Exports responding more to global demand than to…



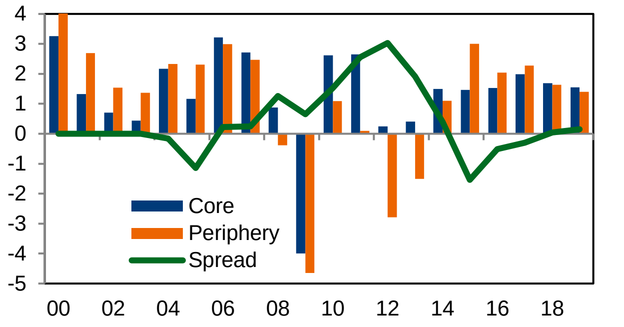
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 6 – …the exchange rate



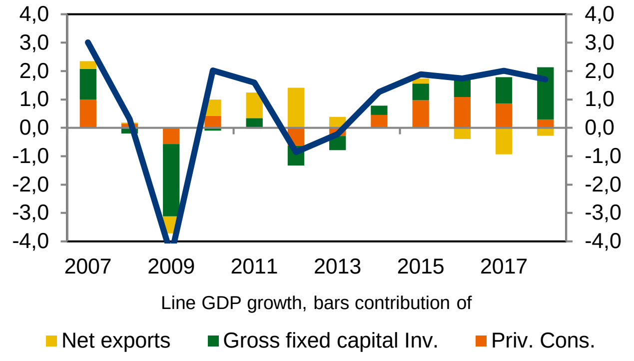
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 7 – Widespread recovery throughout the area. Gap vs. the average narrowing across the board



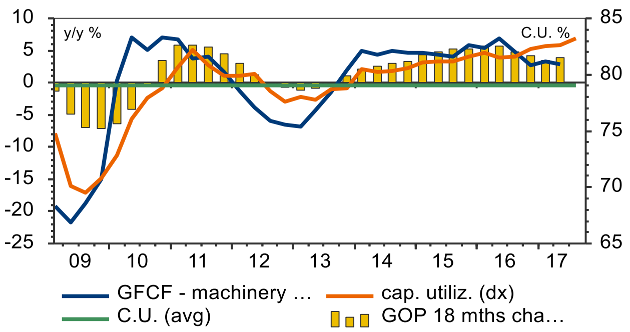
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 8 – Growth baton passing from private consumption to investments



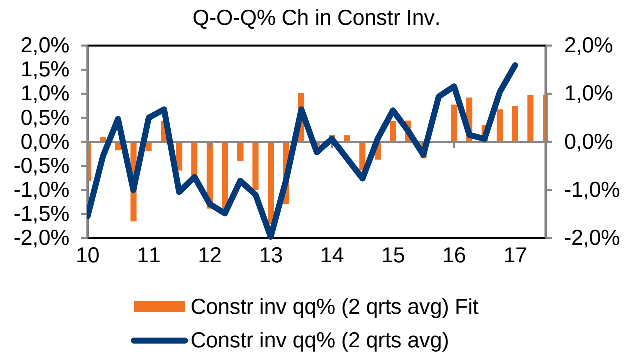
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 9 – Corporate investments have set out on a livelier growth path at last, on solid fundamentals



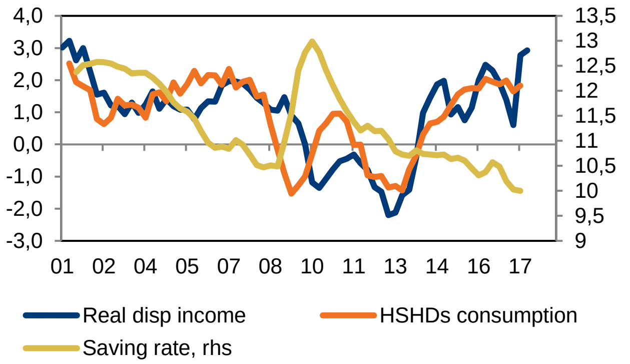
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 10 – Investments in construction to grow at sustained rates



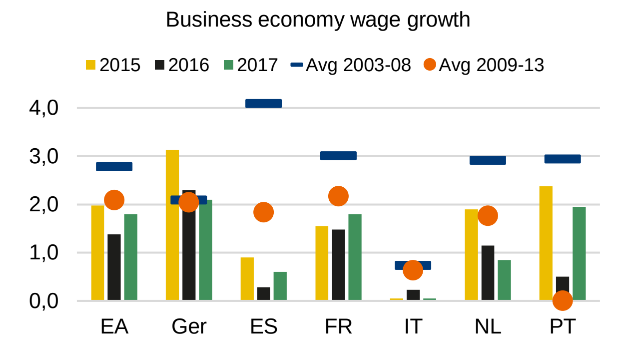
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 11 – Consumption trend stronger than expected in the spring months, thanks to resilient earned income (solid employment growth of 1.6% y/y and acceleration in wages)



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 12 – Wages accelerated in the spring quarter, although average growth remains slower than in the pre-crisis period



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Inflation's return to target more uncertain

Anna Maria Grimaldi

Inflation in the Eurozone remains far from the ECB target. After peaking at 2.0% in February, consumer price inflation returned to 1.3% in June, before rising again to 1.5% in August and September. The volatility of inflation is due to the trend in energy prices and a favourable comparison effect versus the same period of 2016. Core inflation has moved slowly upwards, from 0.8% in November 2016 to 1.3% in August. 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 the next few months, inflation is expected to remain at recent levels, before falling to 1.0% in February 2018, again slowed by the negative statistical effect of energy. Our oil price assumptions have changed little since June (USD 54 in 2018, rising to USD 57 in 2019). The new development compared with three months ago, is the appreciation of the euro (+6% since the beginning of April). The rally is, however, probably almost over; over the forecast horizon, we estimate a further increase of 1.5%. We have marginally revised our inflation forecasts down compared with June, from 1.4% to 1.3% in 2018, and from 1.7% to 1.6% in 2019.

We have revised down our inflation forecasts by two tenths of a point owing to the stronger exchange rate

According to our estimates, as in ECB and consensus forecasts, inflation's rise towards 1.6% in 2019 still depends on the core inflation trend, which is set to accelerate, on average, to 1.5% in 2018 and 1.5% in 2019, from 1.3% in August. Core inflation estimates have been subject to huge uncertainty over the last few years. Underlying consumer price inflation remains surprisingly slow in response to the period of economic growth experienced by the Eurozone, which began more than three years ago. The inertia of core inflation is not an underlying characteristic of the Eurozone economy, but represents a puzzle for economists and central bankers. In the case of the Eurozone, a plausible explanation is that the surplus labour supply is larger than that recorded by standard unemployment measures. The U6 expanded unemployment rate is approximately double the ILO rate[3] (9.1%). More time could therefore be needed before we see an upturn in wages and domestic prices. The rise in labour cost growth to 1.8% in spring from the previous 1.3% suggests that something is beginning to change. However, the appreciation of the euro introduces a new factor of uncertainty for domestic price inflation, and requires, as indicated by the ECB, careful monitoring. In September, the ECB was forced to revise down its forecasts for inflation by a tenth of a point in 2018 to 1.3% and by two tenths to 1.5% in 2019. The models generally suggest that an appreciation of the effective exchange rate of 5% will curb inflation by 0.2-0.3% after a year. The impact could, however, be less pronounced. In the last few years, exchange rate transmission to import prices seems to have weakened (see Fig. 5) partly owing to structural factors: import and export prices increasingly reflect cost trends relating to globally integrated production chains, which slows the transmission. The correlation between the exchange rate and production prices is higher for intermediate goods and practically zero for consumer goods (see Fig. 6). This means that transmission to consumer prices is very slow (12-18 months). It should also be considered that the exchange rate's final effect on prices will depend on the nature of the shock. As Mario Draghi explained at September's press conference, in this phase the exchange rate movement mainly reflects positive endogenous trends, so the impact on consumer prices is likely to be weaker, and not more than 0.2% in 2018-2019. For the moment, the exchange rate trend has not changed the market's inflation expectations, which remain broadly unchanged at around 1.7%, still far from the ECB target. Price expectations emerging from confidence indices have also remained broadly stable in the last few months, and continue to indicate that the deflation risk has completely disappeared, although at the same time there are no pressures on domestic prices.

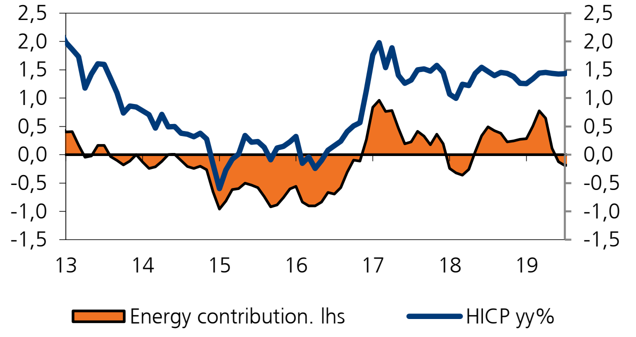
The return of inflation towards the target remains dependent on core inflation, which remains sluggish compared with previous cycles

The exchange rate represents a further element of uncertainty for domestic price inflation, but the braking effect is expected to be less significant than in the past

The deflation risk has however now disappeared completely

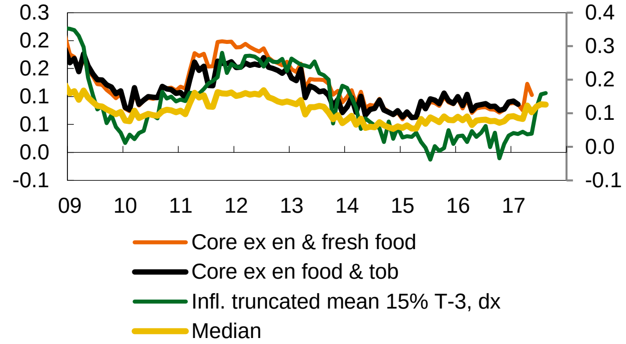
[3] See ECB Economic Bulletin, issue 7/2016 *Exchange rate pass through into euro area inflation*

Fig. 1 – The volatility of inflation is mainly due to the trend in energy prices. The return of inflation to the ECB target still depends on the underlying trend



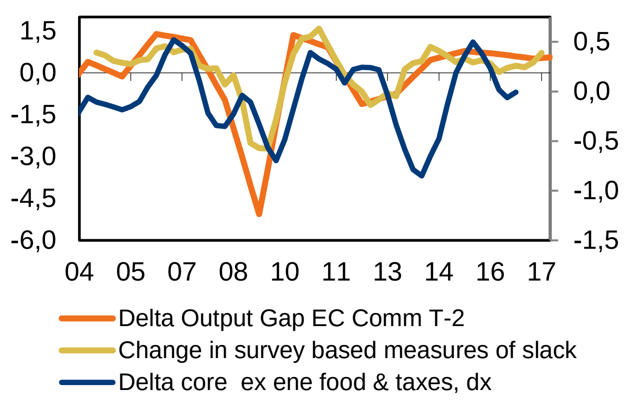
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream estimates

Fig. 2 – Core inflation has risen slowly in 2017



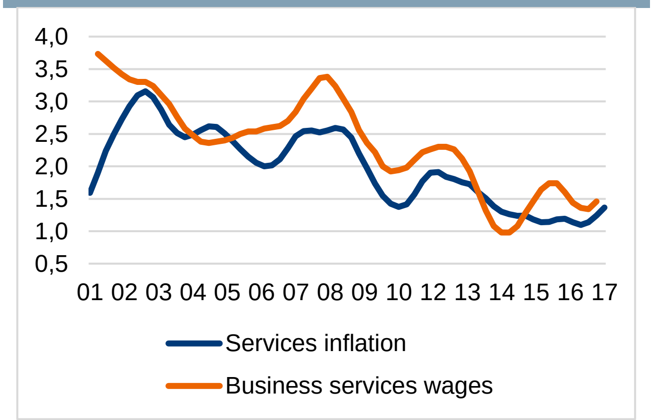
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – Core inflation has reacted less to changes in the output gap than in the past



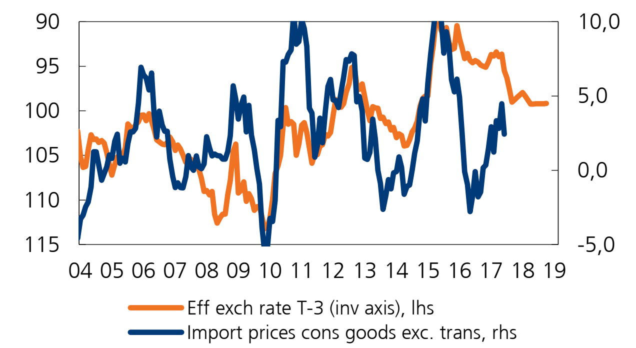
N.B.: Output gap European Commission, change on the previous year. Measures of excess supply from surveys are based on the question posed in the European Commission's quarterly survey: "Is demand a limit to production?" for industry, construction, services and retail. The series are normalised and aggregated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

Fig. 4 – Timid increases in wages in the Spring



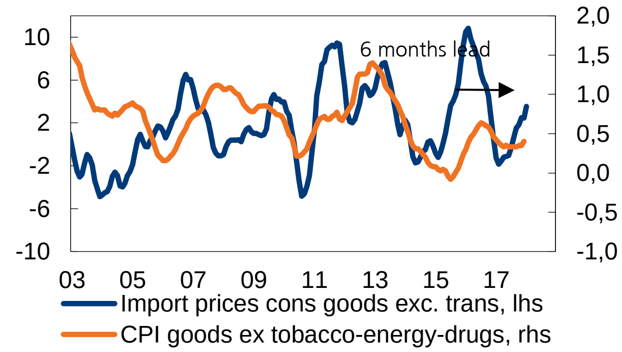
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – But the stronger euro introduces risks for inflation. The impact will be less significant than in the past. Exchange rate transmission to import prices is weaker



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 6 – Transmission from import prices to consumer goods prices is incomplete and requires more time (around 18 months)



Source: Intesa Sanpaolo chart based on Eurostat data

Monetary policy: exit will be very gradual. Rates unchanged until 2019

Anna Maria Grimaldi

In September, the ECB maintained its ultra-accommodative tones and made no significant changes to the introductory press statement. The ECB **confirmed its intention of continuing with net monthly purchases at the current rate of 60Bn per month until the end of December 2017 or beyond, if necessary,** and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. Nor did the ECB change its guidance on purchases, reiterating that it "stands ready to expand the programme if financial conditions become inconsistent with a return of inflation towards 2%". The ECB deferred its decision on the calibration of monetary policy instruments beyond the end of the year to its meeting on 26 October. In the meantime, the ECB **renewed its commitment to keeping rates unchanged well past the horizon of the net asset purchases.**

With the underlying economic trend, more solid than staff expectations suggested in June, several members of the Council recognised that the movement of the effective exchange rate (+4.7% from mid-May, when the June forecasts were closed) had brought about less accommodative financial conditions in the last few months and the need to leave monetary policy unchanged. The press release expressly stated that the recent **exchange rate volatility** represents a source of uncertainty which should be kept under observation in view of its potential implications for the medium-term outlook for price stability. Note that the ECB is not in any hurry to tighten monetary conditions; **the central bank's staff have downgraded inflation estimates by one-tenth of a point** to 1.2% in 2018 and 1.5% in 2019, due to the stronger exchange rate. The revisions to the inflation forecasts are entirely due to the weaker underlying trend (net of energy and food) compared with June. The core inflation estimate was reduced to 1.3% for 2018 and 1.5% for 2019. If the movement in the currency were entirely due to external factors, its impact on inflation would be higher (0.5% for the two years, according to Draghi's statements[4]), but the currency's performance is partly due to the improvement in the economic and political landscape. Growth forecasts have been revised up to 2.2% in 2017, from 1.9% previously, while estimates for the next two years are unchanged at 1.8% and 1.7% since, according to the ECB's assessment, the underlying economic trend will be more robust than estimated a few months ago and this will offset the stronger exchange rate effect. Moreover, monetary policy will partly offset the braking effect of the euro's appreciation. The **downgrade to the core inflation estimates for the next two years and, specifically, the forecast of 1.5% for 2019, sends a strong signal, which reduces the urgency for the ECB to exit its purchases programme.**

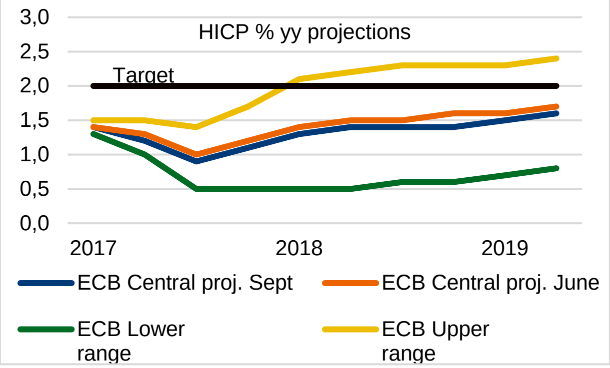
Tab. 1 – Main ECB macroeconomic forecasts versus Intesa Sanpaolo and Consensus Economics

	BCE settembre 2017 previsioni in [ ] previsioni di giugno				ISP & ( ) Consensus forecasts, maggio 2017			
	2016	2017	2018	2019	2016	2017	2018	2019
PIL %	1.8	2.2 [1.9]	1.8 [1.8]	1.7[1.7]	1.8	2.2 (2.0)	1.7 (1.7)	1.5
HICP a/a %	0.2	1.5 [1.7]	1.2 [1.6]	1.5 [1.7]	0.2	1.6 (1.5)	1.3 (1.4)	1.6
HICP *core* y/y %	0.8	1.1 [1.1]	1.3 [1.4]	1.5 [1.7]	0.9	1.2	1.4	1.6
Giu 17 Ipotesi BCE su EUR	1.11	1.13 [1.09]	1.18 [1.09]	1.18 [1.09]	1.11	1.12 (1.15*)	1.19 (1.15*)	1.20 (1.16*)
Giu 17 Ipotesi BCE su BRT	43.1	51.8 [51.6]	52.6 [51.4]	53.1 [51.5]	45	52 (51.3*)	53 (52.9*)	57 (56)

* Estimates of Consensus Economics for the EUR exchange rate and oil prices are for December 2017, August 2018 and August 2019. Intesa Sanpaolo forecasts are annual averages
Source: ECB, June and September 2017 estimates, Intesa Sanpaolo September 2017 forecasts and Consensus Economics August 2017

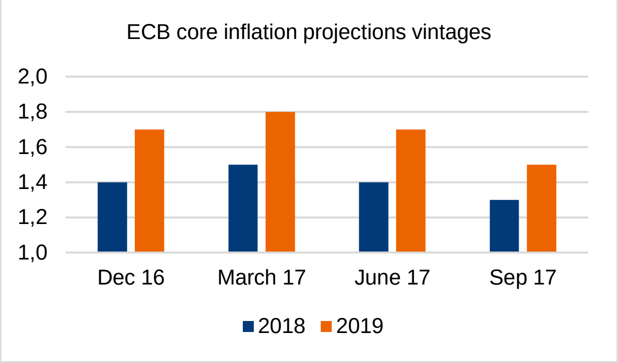
[4] See Introductory Statement to the ECB's meeting on 7 September 2017 https://www.ecb.europa.eu/press/pressconf/2017/html/ecb.is170907.it.html

Fig. 1 – The ECB's inflation estimate was downgraded in September



Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 – The ECB's choices depend on a lasting rise in core inflation across the whole Eurozone But in September, the ECB downgraded its estimates for 2018 and 2019



Source: Intesa Sanpaolo chart based on ECB June and September 2017 forecasts

What can we expect from October onwards?

The ECB's tones at the September meeting, which were even more dovish than expected, together with the cut in the 2019 core inflation estimates, indicate that the movement of the exchange rate could weigh on the timing of the exit from the asset purchase programme. During the press conference, Draghi stated that the bulk of the decisions on extending the APP (asset purchase programme) will be taken at the 26 October meeting. The Council has assessed alternative scenarios for duration and volumes of purchases, but is awaiting information from various working groups.

The September press release implied that the programme would be extended until next year and talked of a calibration rather than a gradual tapering. We think, therefore, that the ECB will announce a very gradual exit from the purchase programme and adopt a flexible formula, without giving a final closing date for the programme, while reserving the right to calibrate purchases from meeting to meeting, or after several months. In reality, the tapering of purchases started last December and will continue throughout 2018. The final decision on the timing of the exit will depend on the political balances within the Council and the economy's performance, rather than on restrictions governed by the scarcity of bonds since, under the conditions currently in force, the ECB might have to make replacement purchases as early as the beginning of 2018.

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

1. In October, there will be changes to the guidance on purchases which, on the one hand, will give the Council greater flexibility to intervene in "both directions", as stated in the minutes of the July meeting, and, on the other, will reassure the markets that the programme will continue beyond December 2017 and will prevent a further tightening of financial conditions. However, it is possible that the ECB might not announce either volumes or an exit timetable for the programme in October, but that it will merely propose a general recalibration of purchases in 2018 in conjunction with changes to the medium-term inflation outlook. Note, in this regard, that the ECB will publish its initial estimates for 2020 in December and might, therefore, want to wait for the staff estimates before taking a final decision on volumes of purchases for next year, as it did in December 2016.

2. The ECB will have to advise the market of the amount it intends to purchase, at least in 1Q18, by December. We do not rule out the possibility of the ECB deciding to announce changes to the volume of purchases on a meeting by meeting basis, without explicitly giving a final date – a scenario that would become more likely if core inflation were to rise at a lower rate than expected. This flexibility would enable it to respond more quickly to errors of judgement regarding the markets' reaction. The announcement that would most tie in with

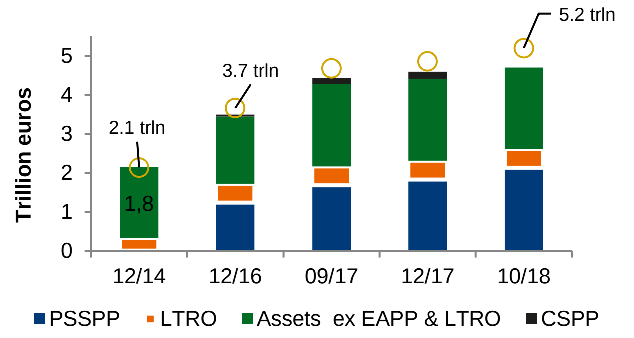
the recent *modus operandi* would undoubtedly be an extension of fixed volumes for a period of at least six months, followed by a new announcement shortly before the end of this period. We tentatively assume a reduction in purchases to EUR 40Bn in 1Q18 and then a further reduction to EUR 20Bn until October 2018, amounting to total purchases of EUR 320Bn.

Turning to the **official rates, at the moment it is reasonable to expect that the first hike will not happen before 2019.**

The issue of what is significant for the financial conditions – whether the stock or the flows of bonds are purchased from a central bank – remains to be seen. The ECB's objective is to keep financial conditions broadly unchanged at least for the whole of 2018, going by the press release in September, which again emphasised that the recovery will continue to depend on accommodative conditions. Monetary policy will therefore continue to support growth in 2018, although this will be at a slower pace. According to our central scenario, the ECB will expand its balance sheet by another EUR 240Bn between January and June 2018, compared with a half-yearly rate of increase of EUR 360Bn last year. In October 2018, the ECB's balance sheet will probably exceed EUR 5,000Bn (see Fig.3), up from EUR 2,100Bn at end-2014. Note that the Fed quadrupled its balance sheet between 2008 and 2013.

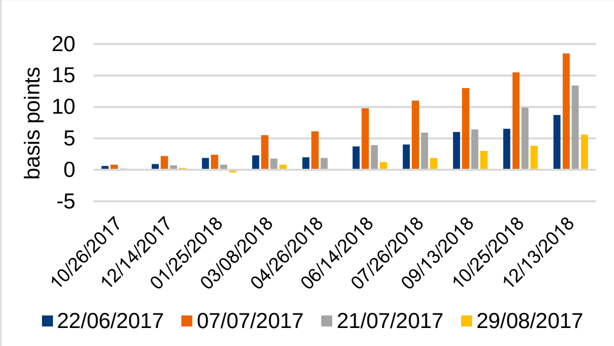
The effect on yields depends not only on the reduction in monthly volumes but also on its timing and how it ties in with changes in net supply on the market. The benefit of a tapering scenario for autumn 2018 (with a reduction in the volume of purchases in the first half of 2018) would smooth out increased supply in core countries over the year and reduce net supply by nearly 50%, 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' level of preparation for the tapering of monetary stimulus. Note that, according to ECB estimates, an increase of around EUR 1Trn in the balance sheet would equate to a reduction of approx. 100 basis points in interest rates[5] . However, it is difficult to extrapolate the effect of a change in the volume of purchases to an increase in yields.

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



N.B.: We assume purchases will be extended to October 2018 at a rate of EUR 40Bn per month in 1Q and EUR 20Bn from July to October 2018. NB: The Fed balance sheet quadrupled between 2008 and 2013.
Source: Intesa Sanpaolo chart from ECB data

Fig. 4 – Even before September's meeting, the markets had ruled out the possibility of a rise in 2018



Source: Bloomberg and Intesa Sanpaolo estimates

[5] See ECB Working Paper no. 1956, 2016: *The ECB's asset purchase programme: an early assessment*.

Germany: great economy, Merkel seeks government allies

Anna Maria Grimaldi

Tentative steps in forming new government

The results of the parliamentary election on 24 September show that fragmentation is now entrenched also in German politics like in the majority of European countries (see Focus below). Creating a governing coalition will require lengthy three-way negotiations. The most likely scenario after the vote is that of a 'Jamaica' coalition between the Christian Democrats (CDU), the Greens and the liberal FDP. But dialogue will not be an easy task for Merkel given the divergence in opinions, particularly with the Greens. At least, the new government will be able to rely on very strong macro outlook.

The recovery is solid, supported by both manufacturing and services. The strong currency will have little impact in 2018-19 (-0.2%) given the low elasticity of German exports to the exchange rate

The economy is solid and latest data clearly indicate that thee above-potential growth phase (1.4%) continues unabated. Over the summer months, the IFO improved further, reaching new all-time highs in July-August, and then retreating in September. The composite PMI fell on average to 56.1 from 56.8, a level consistent with slightly lower growth than the 0.6% qoq seen in the spring (see Fig. 1). The data on industrial orders, production (see Fig. 2) and retail sales also suggest some deceleration during the summer: consequently, we forecast GDP growth of 0.5% qoq for the second half of 2018. Growth is supported in particular by an upswing in manufacturing, which is benefiting from the recovery in world trade as well as heightened demand in the rest of the Eurozone and from services activity, stabilising at still-high growth rates. Until now, the stronger euro seems to have had a limited effect on German GDP growth. A study by the ECB in 2016 (see working paper no. 1955) illustrates that the pass-through of exchange rate movements into German prices and the braking effect on exports are much lower than in other Eurozone countries, as German companies are managing to hold sales prices steady due to greater specialisation and less elastic demand. Based on this, we feel the stronger exchange rate could impact prices by -0.2% in 2018-2019, offsetting a stronger-than-forecast underlying economic trend. Compared with June, we have revised up our 2017 growth estimates to 2.1% given the strong signals emerging from the data. We confirm our GDP growth estimates of 2.1% for this year and 1.8% for 2018. 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 will come from manufacturing, which is benefiting from the recovery in global trade, and mainly in trade with emerging economies and Eastern Europe (see Fig. 4). The recent movement in exports is about in line with global PMI indications (see Fig. 5), which suggests a slightly weaker trend compared to the Spring, nearing 0.8% qoq. Imports, however, will continue to grow at around 1.2% qoq on average over the next few quarters, given the high import content of German exports. Foreign trade will shave some 0.1% off GDP growth in 2017-19. Domestic demand will continue to drive growth over the forecasting horizon with an average contribution of 1.7%, down from 2.2% in 2016.

Household consumption is expected to slow to 1.7% from 1.9% in 2016-17. Real disposable income is expected to grow at a little over 1.5%, falling short of the 2.4% average in 2016, due to rising inflation (to 1.7% from 0.5% in 2016), which is only partly offset by higher salaries, which rose 2.0% in June after the 2.5% posted in March. The reason why wage growth is low in a labour market that is close to full employment (see below) is because most of this year's agreements were signed in 2016 when inflation was low. The strong influx of immigrant workers from other EU countries was part of the reason why wages came under pressure. The next round of agreements in 2018 is likely to close with salary increases near to 2.5%. In mid-2017, employment surprised on the upside once again, climbing 1.5% yoy (2.3% yoy for employees subject to social security contributions). But the labour market is almost at full employment and job creation will not be able to keep up this pace. The unemployment rate has been parked at 5.7% since May: a hard fall is unlikely since unemployment is near the structural level (5%, according to the OECD). The workforce is primarily created via immigration from other EU countries, which could slow when the economic recovery reaches these areas. Inflation is expected to fall to 1.5% in 2018, down from 1.7% this year, and then climb to 1.6% in 2019. It will, therefore, remain below the ECB target, partly because of the modest contribution of energy prices in euro. Salaries will pick up slightly in the current two-year period. Consumer spending could receive support from fiscal measures in the next few years, but we should not expect anything major (see below).

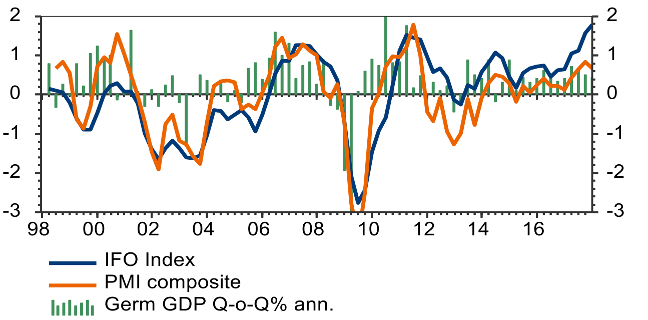
After a strong start to the year (2.1% yoy), corporate **investment in machinery** continued to grow at a sustained pace in the spring (+1.1% qoq). The combination of production capacity utilisation that is well above the historical average, only a modest slowdown in foreign orders at the end of summer, almost steady earnings, and amply supportive financial conditions (see Figs. 7 and 8) should ensure growth in investment in machinery of 3.3% this year and 3% 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. **Construction** will thus likely see growth of 3% in 2018, down from 5% this year.

Fiscal policy continues to run along the same lines as usual. The budget surplus reached EUR 18.3Bn in the first half of 2017. In annualised terms, the German public sector is expecting a budget surplus of 1.1% of GDP, well above the "*schwarze null*" *(black zero)* imposed by German regulations and fiercely defended by Schäuble. The new government has ample room to apply fiscal policy more actively. But none of the programmes of the CDU, FDP or Greens, potential members of the Jamaica coalition, advocate a significant easing of fiscal policy. The **CDU** backs raising the top tax rate (42%) from EUR 56,000 to 60,000 at a cost of EUR 15Bn (0.5% of GDP) covered in part by the reduction in the solidarity tax from 2020 (the CDU wants to bring it down to EUR 4Bn). The CDU's proposed tax reform includes other major changes to the tax rates, while the Greens want to raise the top tax rate and the minimum tax exemption. The FDP is calling for a tax cut of some EUR 30Bn. **As for spending, the CDU wants to introduce measures** to support spending equivalent to 0.5% of GDP relating to defence expenditure, subsidies for first-time home buyers and research, while the FDP envisages a significant boost to education spending (2 points of GDP to bring Germany in line with the other OECD countries) but less investment in infrastructure (EUR 2Bn for road-building and maintenance). The Greens are in favour of increasing spending on renewable energy and digital infrastructure.

Forecast Table	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y) *	1.8	1.9	1.8	1.9	1.9	1.9	1.9	2.1	2.3	2.3	2.1	1.9	1.7
- q/q change				0.5	0.3	0.4	0.7	0.6	0.5	0.4	0.5	0.4	0.3
Private consumption	1.9	2.0	1.6	0.2	0.4	0.6	0.4	0.8	0.4	0.4	0.4	0.3	0.3
Fixed investment	2.9	4.1	3.4	-1.2	0.5	-0.1	2.7	1.0	0.9	0.9	0.8	0.9	0.6
Government consumption	3.7	1.7	1.7	0.7	0.2	0.5	0.2	0.6	0.5	0.4	0.3	0.5	0.4
Export	2.4	4.0	3.5	1.3	-0.2	1.3	1.6	0.7	0.8	0.8	1.1	0.8	0.8
Import	3.8	4.9	4.4	-0.2	0.7	2.5	0.4	1.7	1.4	0.9	1.0	1.3	0.4
Stockbuilding (% contrib. to GDP)	-0.1	0.0	0.1	-0.2	0.4	0.4	-0.7	0.2	0.2	0.0	-0.1	0.2	-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	1.8	1.7	0.0	0.4	1.0	1.9	1.6	1.7	1.8	1.7	1.9	1.8
Industrial production (y/y)	1.2	2.5	1.3	0.6	1.0	1.4	1.1	3.3	2.9	2.9	1.4	0.6	1.6
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	0.33	0.61	0.12	-0.12	0.11	0.25	0.31	0.37	0.41	0.49	0.56	0.65

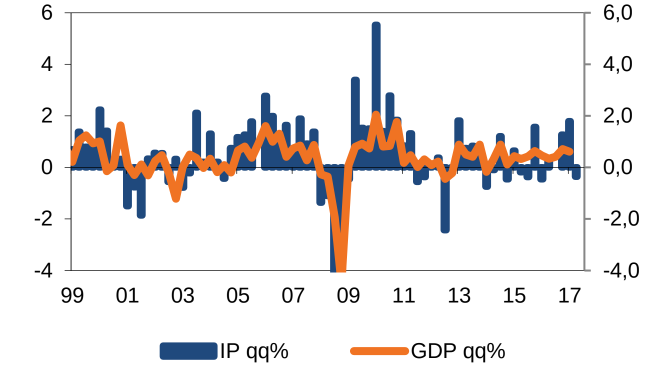
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Fig. 1 – The IFO shows growth accelerating again in the summer months the composite PMI, more in line with recent GDP performance, points to 0.5% qoq growth in 2H17



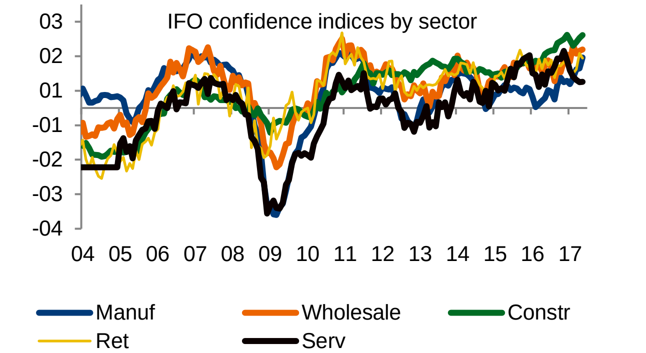
Source: Intesa Sanpaolo chart from Thomson Reuters data

Fig. 2 – Industrial output started the summer on a weak footing



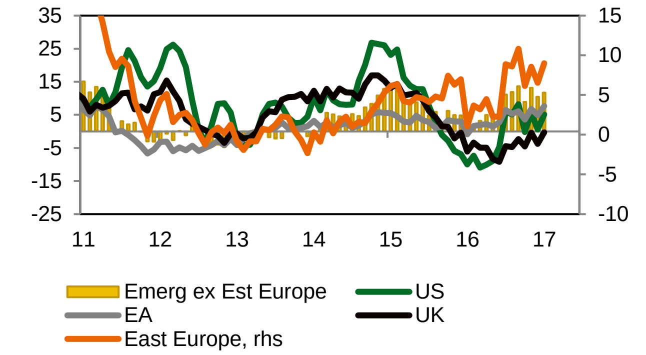
Source: Intesa Sanpaolo chart from Thomson Reuters data

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



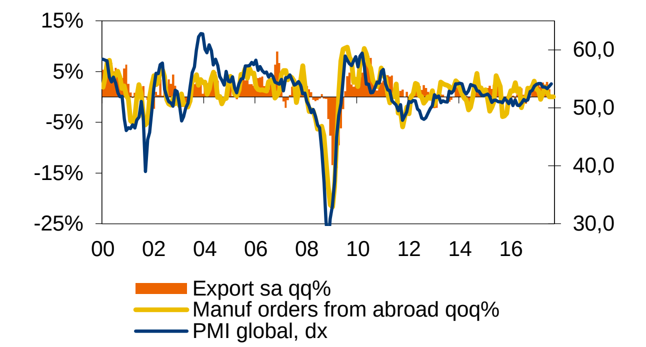
Source: IFO via Thomson Reuters-Datastream

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



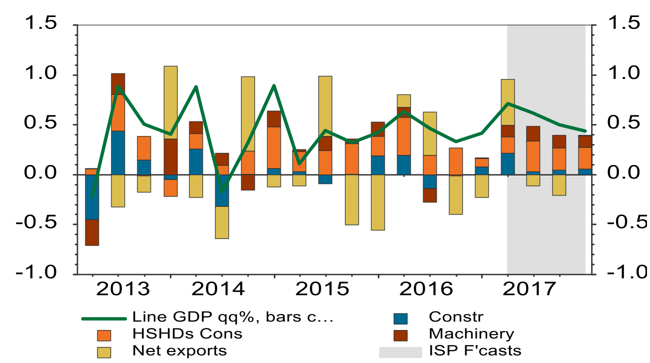
Source: FSO via Thomson Reuters-Datastream

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



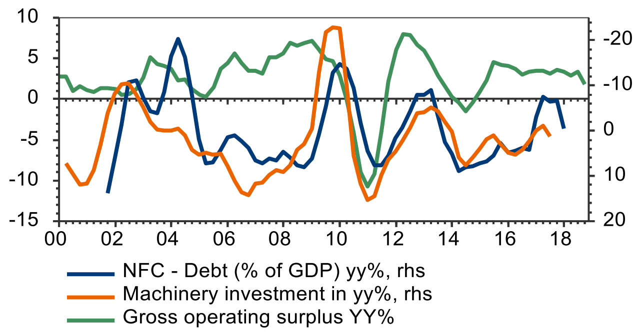
Source: FSO via Thomson Reuters-Datastream

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



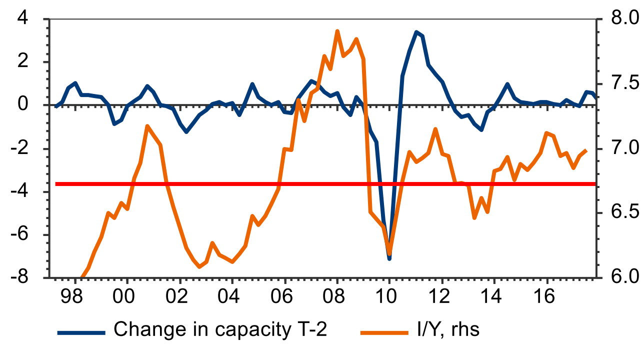
Source: FSO via Thomson Reuters-Datastream

Fig. 7 – Fundamentals and...



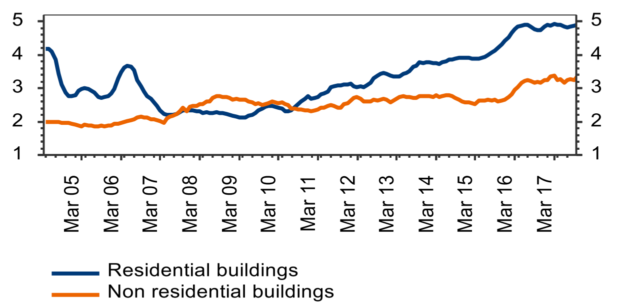
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – ...the high use of production capacity point to a more buoyant trend in investment spending



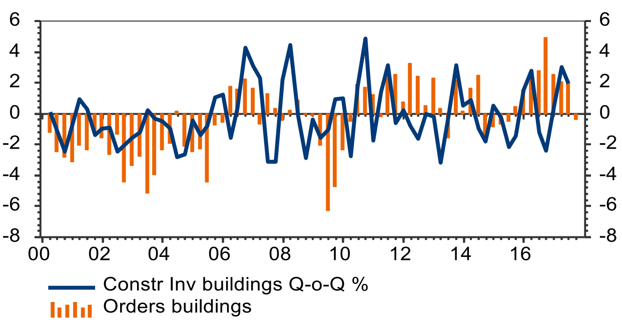
Source: FSO via Thomson Reuters-Datastream

Fig. 9 – Trend in permits and...



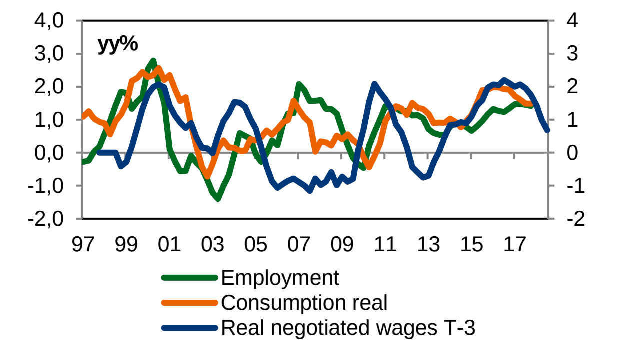
Source: FSO via Thomson Reuters-Datastream

Fig. 10 – …orders suggests resilient construction investment



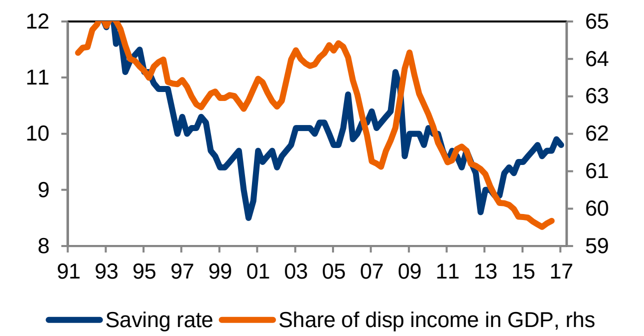
Source: FSO via Thomson Reuters-Datastream

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



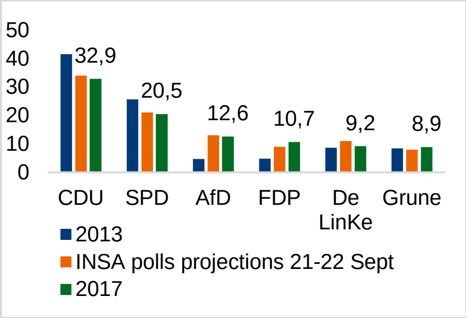
Source: Thomson Reuters-Datastream

Germany's shift to the right presents a new hurdle for the monetary union reform process

The elections in Germany on Sunday, 24 September had some surprises in store **The Christian Democrats (CDU), led by Angela Merkel, are still the largest party, but with 32.9% of votes, they are sharply down on 2013 (41.5%)** and did worse than predicted in the final opinion polls, which had suggested they could get 34%-36% of the votes. The Chancellor acknowledged that the result was not as good as she had hoped for. The larger turnout (76.2% versus 71.5% in 2013) shifted support away from the traditional parties. **The SPD Social Democrats, led by Schulz, took a beating**, garnering just 20.6% of the votes, down from 25.7% in 2013, although fairly close to the results of the opinion polls in the last few weeks. SPD leader Schultz stated that a confrontation is now needed in Germany's political culture, and that **it is time to move on the opposition**. **Both the CDU and the SPD had their worst result since 1949, showing that support for the traditional parties is being eroded**. *Der Spiegel* noted that this fragmentation is due not only to the emergence of hot-button issues such as the debt crisis or immigration, but probably also because the country has been governed for (too many) years by a coalition catering to broad public interests, which has made the two largest parties look too alike in the eyes of the electorate.

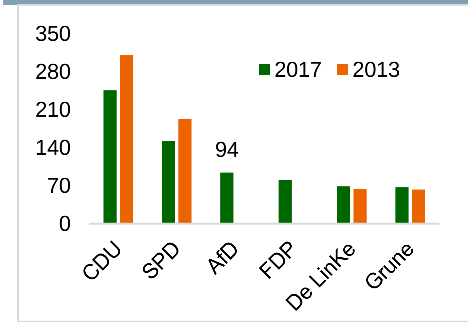
The **emerging force** from this round of elections is the far-right populist party **Alternative für Deutschland (AfD)**, which garnered 13% of the votes, surpassing most opinion polls' predictions. The AfD has now become the country's third largest party, whereas in 2013 it did not even reach the 5% threshold for entering the Bundestag. It's the first time since the Second World War that a far-right party has entered the German parliament. The liberal **FDP** party is also returning to the *Bundestag* with 10.7% of the vote after losing all its seats in 2013. The **Greens** increased by one percentage point (8.9%), while the far-left party, **Die Linke**, rose to 9.2% from 8.6% in 2013. Voter turnout was a good 75.6%, well above the 71.5% in 2013, a sign that the radical right had managed to capture the attention of previously discouraged voters.

Fig. A – The traditional parties lost ground compared with 2013. The far-right party, AfD, got 13% of the votes



Source: Intesa Sanpaolo chart from Bundesamt für Statistik data

Fig. B – Distribution of seats in the Bundestag



Source: Intesa Sanpaolo chart from Bundesamt für Statistik data

Building a governing coalition will not be easy: the process will take a couple of months at least.[6] An agreement between the CDU-CSU and SPD, as in the outgoing government, is fairly

[6] In principle, all the parties can negotiate with one another – when a probable coalition starts to emerge, a formal discussion then starts two to three weeks after the vote. A coalition agreement is then approved by the member parties. The Federal President nominates the coalition leader, the Chancellor, who must be elected with an absolute majority; if no absolute majority is reached, another vote can be held in the 14 days following.

unlikely after Schulz's statement. Playing the role of the largest opposition party could be important for the SPD to regain its role as the alternative to the Christian Democrats. The main opposition party could gain some visibility: the Bundestag's budget committee is generally led by the main opposition party. Moreover, the opposition party can intervene in government matters at any time by establishing a dedicated committee.

The **most likely scenario** based on the outcome of the vote is what is being called a **Jamaica coalition** based on the symbolic colours of the parties in such a coalition - black for the CDU, yellow for the FDP and the Greens. Reaching an agreement will not be easy; if the liberals are ready to talk, the Greens' position will need to be assessed. Moreover, Merkel will need to try to maintain a dialogue with the CSU party, her more conservative ally in Bavaria. The AfD's victory could further widen the divide between the CDU and Bavarian ally, CSU. Bavaria will hold their regional vote in 2018, and leader Horst Seehofer could step up his conservative stance. Merkel has already governed with the FDP, in 2009-13, but the liberals came out weaker as a result and will fight to maintain their own identity. The Greens are faced with the same problem.

Immigration and defence played a prominent role

The issue which dominated the electoral campaign was **immigration** policy, given the indignation aroused in part of the electorate when one million refugees were admitted in 2015. The AfD set the tone of the election campaign by calling for the immediate closure of Germany's borders, taking advantage of the discontent among low-income voters who felt threatened by the influx of low-cost immigrant workers, including some from other European Union countries. Immigration policy will remain a key topic on the new government's agenda. Merkel continues to resist pressure from Bavarian sister party CSU to introduce a yearly cap of 200,000 political refugees. The Greens want to maintain a very open door policy, while the FDP would like a more Canadian-style system to attract skilled labour.

FDP much more rigid on European reforms

The parties diverge widely in their stance on European policies. The pro-business liberal FDP is much more rigid than the CDU with regard to European issues. The FDP is in favour of strengthening the "no bailout" clause and applying sanctions for the infringement of fiscal regulations. The party is openly against OMT (outright monetary transactions), preferring a market solution in the event of a debt crisis (FDP leader Christian Lindner has publicly supported the restructuring of Greek debt). The FDP backs the risk weighting of sovereign bonds in banking portfolios and would be open to renegotiating the treaties for allowing member states an "ordinary" exit from the Eurozone. The party is open to a multi-speed Europe, but against creating a mini European budget. However, the Greens are on the exact opposite side of the fence from the liberals on many issues: as well as making it harder to manage a government coalition, it could also bring about more balanced positions or simply paralyse each high-level political initiative in Europe. In our opinion, therefore a Jamaica coalition in the next legislature may not be positive for either domestic or Europe-wide policies.

France: the economy continues to grow, but an eye needs to be kept on the public accounts

Guido Valerio Ceoloni

Owing to a significant improvement in confidence levels and renewed export buoyancy, from the autumn, the Macron presidency's agenda should move forward in a favourable economic scenario. The second quarter ended with GDP up by 0.5% qoq, at the same pace as the previous quarter. The year-to-date growth has therefore reached 1.3%. This time, growth was due to a greater-than-expected contribution from exports, which rose by 0.6% thereby perfectly offsetting the 0.6% decrease in the previous quarter, while the contribution of domestic demand was about in line with the previous quarter (+0.4%). Thus, for the current and next quarter, we confirm our forecast of an increase of 0.4% qoq, which was slightly off the pace for the first half. If confirmed, annual growth in 2017 is likely to rise to 1.6% from 1.1% and then slow somewhat to 1.5% in 2018. For next year, risks to the forecast will be to the upside in light of the sharp improvement in the country's sentiment.

GDP growth of 1.6% in 2017 and 1.5% in 2018

After a very positive 2016 (2.3%), household consumption slowed in 2017, stabilising around a pace of 1.0% yoy in the first two quarters mainly due to sales of cars and household items; thus, we project that consumption will rise at the same pace in the current quarter, while at the end of the year and in 2018 there could be a slight uptick. Household confidence continues to improve with the INSEE index at 103.8 in the current quarter, up from 103.4 in the previous quarter (at the peak of the cycle in 2007 it reached 108). The household confidence index issued by the European Commission is also pointing to an improvement. During the two-year forecast period, consumption will remain the main growth driver.

Household confidence is up considerably with positive, stable consumption over the two-year period

Investments slowed in the second quarter from 1.3% qoq to 0.7% qoq, due to the fall in investment in manufacturing (from 1.9% qoq to 0.7% qoq) and residential investment (from 1.3% qoq to 1.0% qoq). Meanwhile public investment rose for the second consecutive quarter at a fairly strong pace (from 1.5% qoq to 2.5% qoq). For the rest of the year, we project that investments will stabilise around 0.7% qoq, resulting in a rise in average growth this year to 3.0% from 2.7% in 2016, and then a slowdown to 2.3% in 2018.

Stable investments supported by the return of public spending

According to the INSEE, business confidence continues to improve, with the manufacturing confidence index now around 109.7, up from 108.7 in the previous quarter, and at its highest since 2011; the services index is now at 105, up from 103.0, while construction is at 104.7, up from 102.0, which is comfortably above the historical average (from an average of 96.0 in 2016). PMI indicators are also strong: the PMI composite index is hovering around 55.4 with manufacturing at 55.4 and services at 55.5. Industrial output is expected to slow to around 0.5% qoq during the current quarter after a rise of 1.1% qoq in the previous quarter, providing a contribution of about half a tenth of a percentage point to the formation of GDP. Industrial capacity utilisation is marginally moving past 84% in the current quarter, up from 83.3% in the previous quarter. As an annual average, industrial output is heading for an increase of 1.7% yoy compared with 0.3% yoy in 2016, and we forecast a further marginal increase for next year. In the second quarter, construction expanded at the same pace as in the first quarter (+0.2% qoq), slowing from the end of 2016, but rising in comparison with the same period in 2016 (+1.1% yoy).

Better confidence in manufacturing than services; continued recovery in construction

Regarding foreign trade, exports jumped by 2.5% qoq in the spring (from a decrease of 0.9% qoq) thanks to the capital goods segment, but should slow to below 1% in the current and next quarters owing to the stronger euro. Specifically, based on an analysis of summer trade flows, we should see an actual slowdown in non-EU[7] exports in the transport equipment and chemical

Exports exceed expectations in the first half, but the contribution of exports to GDP will still be negligible

[7] This is equal to about 40% of total French exports.

products segments. However, for the time being, the appreciation of the exchange rate does not represent a significant threat. Thus, as an annual average, exports are expected to grow at a rate of 2.8% in 2017 and around 3.2% in 2018, up from 1.9% in 2016. **Imports**, which were supported by lively consumption in 1Q, slowed in 2Q to +0.4% qoq, from 1.1% qoq, but are expected to strengthen in the autumn; as an annual average, we expect they will grow by 3.8% this year and 3.2% in 2018, up from 4.2% in 2016. Thus, on the whole **the contribution of net exports to the formation of GDP will be slightly negative this year and broadly neutral next year.** Starting in 2018, we expect it to return to a positive contribution due to exports and the stabilisation of domestic consumption. The **trade deficit** will continue to increase this year and next, reaching 11% of GDP, from 8.8% in 2016.

Inflation will hover around 1% this year and next

Price-related data show that **inflation**, after reaching an annual high of 1.2% in the spring, will gradually slow to an annual average of 0.9% on the national index (1.0% on the harmonised index). For next year, an unfavourable statistical effect should keep it just above 1%. The **core index**, net of food, energy alcohol and tobacco, now stands at 0.5%, and the annual average should slow marginally to 0.3% this year from 0.5% in 2016, and then rise again to 0.9% in 2018. Thus, inflationary pressures will remain moderate until the end of 2018 thereby bolstering household purchasing power for at least another year.

Unemployment declining this year to 9.5% from 10.1%; employment rising steadily, also in construction

In keeping with the trend in the Eurozone, **unemployment** is now on a downward path also in France, with the first drop below the 10% threshold at the beginning of 2017; this continued in the spring with a further fall of one-half of a percentage point to 9.5%. The annual average is now poised for a decline of six-tenths of a percentage point to 9.5% from 10,1%, the largest change since 2008. It is expected to fall to 9.1% in 2018, but this could be even greater if the second part of the labour market reform is approved quickly without too much watering down. Macron has committed to bringing unemployment below 7% by the end of his term. The **employment** scenario shows a further 81,000 new jobs were created in the second quarter (+0.3% qoq, +1.2% yoy), the 11th consecutive quarter in which employment has risen at a strong pace: the participation rate now stands at 65.3%, the highest since the end of 2008. In particular, it is encouraging to see that employment over the last two quarters has started to grow again in construction (+0.4% qoq, from +0.6% qoq), which has experienced continual falls since 2008.

Public finances will need to be monitored closely. In 2018, the deficit could again go below -3%

In 2017, the **deficit** could fall by a tenth of a percentage point more than was announced to -2.9%, from -3.4% in 2016. This was mainly due to the better-than-expected GDP numbers; the recapitalisation of France's state-owned nuclear company Areva is already included in the adjustment and should have an impact of two-tenths of a percentage point. Next year, the government budget could indicate a further reduction to -2.6% from the previous estimate of -2.7%; in 2019, it is likely to drop below -3% if corrective measures are not announced[8]. At the same time, the cuts for 2018 could be about EUR 4Bn lower than the EUR 20Bn announced in July. However, the exact figures projected by the government will only be announced when the 2018 budget is presented. Thus, the **structural effort** in 2018 will likely only be +0.1% compared with the +0.5% forecast; moreover, **public spending is expected to increase over the two-year period** as a result of the end of the public sector pay freeze, higher spending in the education sector and the increase in investments promised by Macron. **Thus, controlling the public finances continues to be the main focus** for the country scenario. **Public debt** will again increase by around half a percentage point this year to 96.5%, from 96.0% in 2016, and will continue to rise in 2018.

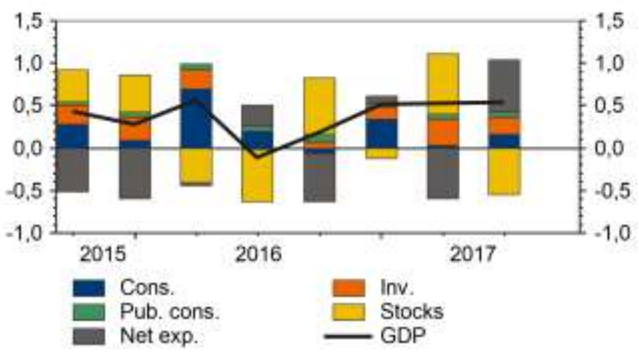
[8] This is due to a cost adjustment in the CICE (competitiveness and employment tax credit) for 2018 that will be "offloaded" onto the public accounts in 2019, in an amount of about EUR 3.3Bn.

Macro forecasts

	2016	2017	2018	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.1	1.7	1.6	1.2	0.9	1.2	1.1	1.8	2.0	1.9	1.7	1.6	1.6
- 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	1.0	1.4	0.4	-0.1	0.6	0.0	0.3	0.3	0.4	0.4	0.4	0.4
Fixed investment	2.7	3.2	2.3	0.0	0.3	0.6	1.4	0.9	0.7	0.6	0.5	0.5	0.5
Government consumption	1.4	1.3	1.2	0.3	0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Export	1.9	2.8	3.2	-0.1	0.9	1.2	-0.8	2.4	0.6	0.6	0.7	0.7	0.8
Import	4.2	3.8	3.2	-1.0	2.7	0.8	1.2	0.3	0.9	0.9	0.8	0.8	0.8
Stockbuilding (% contrib. to GDP)	-0.4	0.3	0.0	-0.7	0.6	-0.2	0.7	-0.6	0.1	0.1	0.0	0.0	0.0
Current account (% of GDP)	-2.1	-2.4	-2.4										
Deficit (% of GDP)	-3.4	-2.9	-3.2										
Debt (% of GDP)	96.0	96.5	98.0										
CPI (y/y)	0.3	1.1	1.0	0.1	0.4	0.7	1.5	1.0	0.9	0.9	0.6	0.9	1.3
Industrial production (y/y)	0.3	1.7	1.8	0.5	-0.5	0.3	0.7	1.8	2.5	1.8	2.5	1.8	1.7
Unemployment (%)	10.1	9.5	9.1	10.0	10.0	10.0	9.6	9.5	9.4	9.3	9.2	9.1	9.0

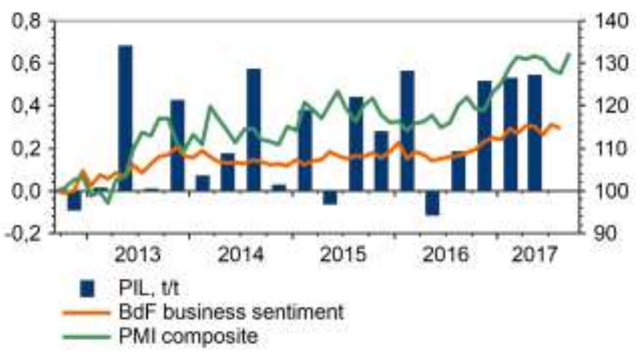
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to the formation of GDP



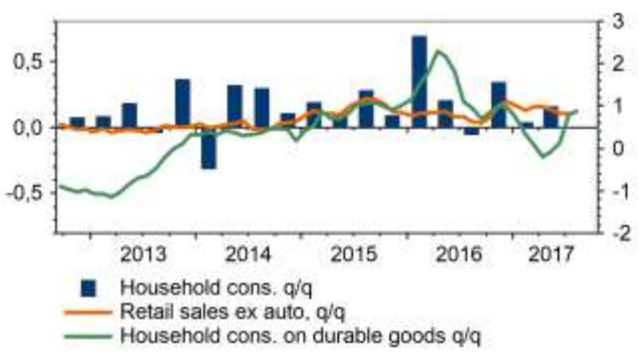
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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

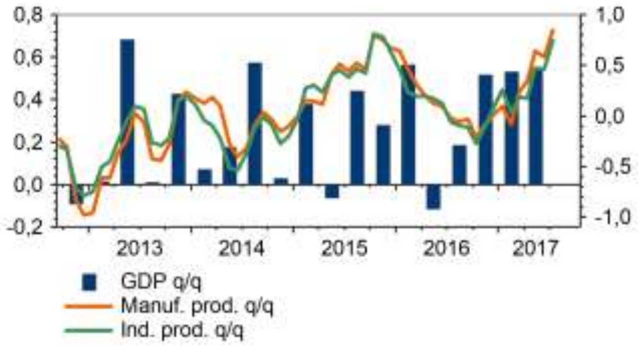
Fig. 4 – Retail sales and household confidence

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

Fig. 5 – Residential investment and construction sector activity

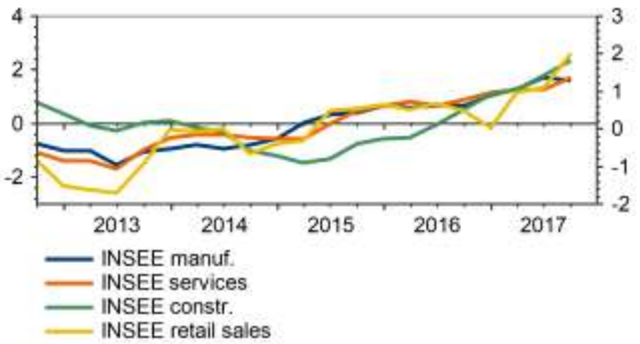
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



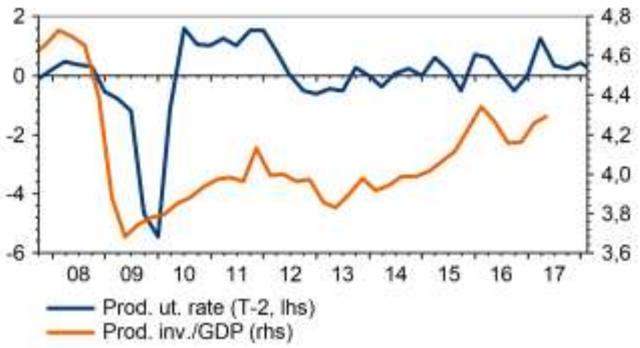
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



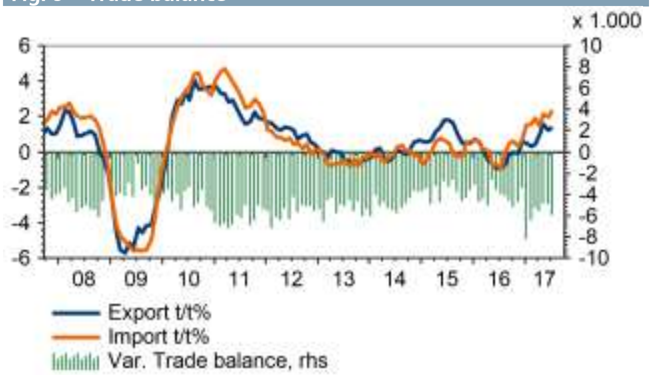
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Utilization rate and level of investment as a proportion of GDP



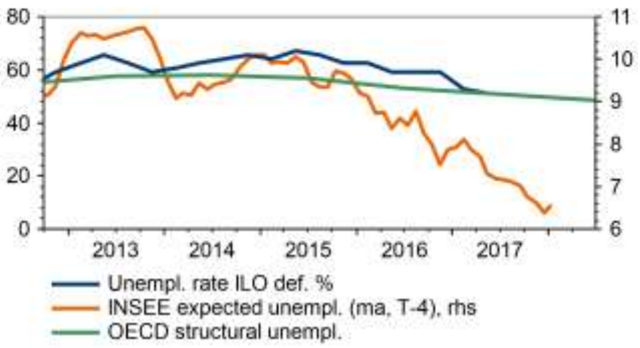
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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: full steam ahead, at least in the near term

Paolo Mameli

Compared to three months ago, **we have revised up our forecast of Italian GDP growth in 2017, to 1.4%** from 1.1% previously. We have done so for two main reasons:

We have revised up our growth forecast for 2017, on better than expected national accounts and the positive trend of survey data

1) **Data on the recent trend of GDP beat expectations**, outlining 0.4% q/q growth in the past three quarters (the reading at the end of 2016 has been revised up by one tenth, and the spring quarter proved stronger than we had expected), and 1.5% year-on-year in mid-2017: both readings mark **new records since 2010**;
2) **The still positive trend of forward-looking indicators:** not only has **business confidence** kept improving, reaching levels close to its 10-year high in the manufacturing and construction sectors, **consumer confidence** also scored a surprise rebound after hitting a low in May, rising back over the following four months (a higher level than the September reading was only recorded in July last year).

Even after the revision, risks to the 2017 forecast are skewed to the upside

Even after the revision, we continue to see **upside risks to the 2017 growth forecast**. This is because our estimate for the second half of the year is not particularly optimistic, as it prices in GDP growth of 0.3% q/q, i.e. down slightly compared to the previous three quarters.

Compared to three months ago, we are less pessimistic on consumption and less optimistic on exports

For what concerns the components of growth, **we are less pessimistic** than we were three months ago **on the evolution of consumption, whereas we are less optimistic on the trend of exports**. Lastly, we continue to believe that, despite the very disappointing trend seen at the beginning of the year, investments in machinery and equipment have a significant margin for recovery. More in detail:

1) **Private consumption**, after slowing in the closing months of last year, picked up again at the beginning of 2017, also on the surprise rebound in households' real disposable income (+0.8% in 1Q 2017, from -0.5% q/q at the end of 2016); the recent recovery in consumer confidence is also explained by the further drop in unemployment (at its lowest levels in four and a half years, at 11.2% between April and June, although it rose back by one tenth in July). Going forward, we continue to expect a slowdown in consumption, although not as sharp as we expected three months ago (1.2% in 2017 and 0.8% in 2018); the point is that the employment trend, after slowing between the autumn of 2016 and the spring of 2017, also due to the definitive removal of de-contribution incentives on new unlimited hiring, has at least in part recovered: the impression today is that, once the impact of the removal of hiring incentives will have disappeared, the job trend could stay upbeat thanks to the liveliness of the economic cycle (in line with the strong hiring intentions signalled by business confidence surveys);
2) We stick to our view that **investments in machinery and equipment** have a significant margin for recovery, in the wake of the "anomalous" decline incurred at the beginning of 2017, after performing better than expected in 2016 (+2.1%, a high since 2007). The decline early this year may be due to capital goods orders being brought forward to the closing months of 2016, on uncertainty over the removal of the incentives offered by the "Industry 4.0" package (by no chance, the quarterly change in investments in machinery in 4Q 2016 was revised significantly upwards by Istat, from an initial +0.4% q/q to +1.6% q/q); this would explain (at least in part), the -4.5% q/q contraction recorded at the beginning of 2017, which remains "anomalous" nonetheless, and was not fully reabsorbed in 2Q (+0.6% q/q). As a result, average total investment growth will slow this year compared to last year (to 1.8%), in waiting to reaccelerate in 2018 (to 2.4%). In any case, the very optimistic outlook of businesses on the trend of demand, the current recovery in profitability (to the point that, for the time being, investments are largely being financed using own means), and the tangible possibility of "Industry 4.0" incentives being renewed, lead us to think that investments may prove to be the component of demand from which to expect the strongest growth margins in the second half of 2017 and in the course of 2018.

3) Lastly, compared to three months ago, we are slightly less optimistic on the pull effect generated by **exports**. This is because foreign trade flows recovered at a very lively pace between the closing months of 2016 and the first half of 2017, slowing moderately only in June and July (the last month for which data are available), after pealing in the spring months. However, the recent appreciation in the exchange rate leads us to be a little less optimistic on the contribution of this component of demand: in all likeliness, in average 2017 terms as well, foreign trade is not expected to contribute to GDP (after having held it back over the previous three years), and foreign demand may probably start moderately supporting growth only in 2018 (with flows in both direction slowing, but imports more so than exports).

Risks to the outlook may affect 2018 more than 2017: strong exchange rate, unwinding of QE, and political risk

In a nutshell, the near-term outlook for the Italian economic cycle seems positively set. **What risks is this outlook exposed to?** In our view, risks are mostly regarding the medium term, rather than the near term, and are the following (in order of increasing importance):

1) **STRONG EXCHANGE RATE**: the most immediate risk to the growth scenario stems, in our view, from the recent strengthening of the exchange rate, which since the beginning of April has appreciated by around 12% against the dollar and 6% in terms of the effective exchange rate. However, **we believe the effective impact may prove more limited (probably around two or three tenths), both for structural reasons**: (imports increasingly invoiced in local currency, higher import content of exports) **and cyclical reasons:** (stronger role of domestic demand in the current recovery).

2) **UNWINDING OF PSPP**: estimates of the macroeconomic impact of the stimulus measures put in place by the ECB in recent years are uncertain. The analyses conducted show that the impact on growth in Italy may have been stronger than the euro area average (0.5% in 2015 and 0.8% in 2016, according to the Bank of Italy[9], although the exchange rate effect would contribute by around two thirds). In any case, even by introducing into the *Oxford Economics Forecasting* model a 20bps shock to long-term rates per quarter in the course of 2018, stemming from a gradual unwinding of the PSPP, the resulting impact on average GDP growth in 2018, at like-for-like conditions, would amount to less than one tenth. To sum up, we believe the effect of the termination of QE on GDP should consist of slower growth by one tenth at most.

3) **POLITICAL RISK**: there are still doubts on whether the approval will be possible of a new electoral law capable of both harmonising the two systems currently in force for the two houses of Parliament, and of reducing the risk of ungovernability ahead of the new legislature. The Democratic Party has submitted a new draft bill to the Constitutional Affairs Committee, the so-called "modified *Rosatellum*", which assigns just over one third of the seats on a single name per constituency basis, and the remainder proportionally (with a 3% minimum threshold). To date, it is not clear whether this proposal will be approved by the main parties. Moreover, the new bill proposed does not seem capable of deleting at all risks of ungovernability. The likeliest date for the next election seems to be March 2018. The outcome may well make the formation of a new government difficult, nor can the event of this outcome generating volatility on the financial markets be ruled out, and thus damage growth. However, the evolution of the global cycle will be crucial: if the context remains expansionary (as per our baseline scenario), even potential difficulties in forming a government in the immediate wake of the elections could be viewed less unfavourably by the markets.

[9] Questioni di Economia e Finanza (Occasional Papers) No. 270, *"Il programma di acquisto di attività finanziarie per fini di politica monetaria dell'Eurosistema"* by Pietro Cova e Giuseppe Ferrero (April 2015)

The net budget for 2018 should be tight, but with limited effects on GDP

In this context, we believe **the Budget Law will not be decisive (neither in a negative nor positive sense) on growth**. The 2018 Budget will be growth-supportive by 0.6% of GDP when taking into account provisions for safeguard clauses, but slightly restrictive (by 0.3% of GDP) net of the clauses (which are not priced into the expectations of economic operators). The gross budget, in addition to almost 16 billion euros to prevent the increase of indirect taxes, and around one and a half billion in spending under existing policies, should also include **stimulus measures** worth 4-5 billion (such as new forms of de-contribution on new unlimited hiring, probably limited to young adults; renewal of the "Industry 4.0" incentives and of the civil service contract). **Funding** should amount to around 10 billion euros (the government has explicitly mentioned a new spending review process, to generate further savings through the rationalisation and centralisation of PA purchase of goods and services, and new measures against tax evasion; press sources do not rule out a reopening of voluntary disclosure options, or of the "scrapping" of Equitalia tax bills at a discount; at the present stage, however, the aim of raising funding of at least 10 billion euros from these measures seems challenging). However, as mentioned above, the budget would be restrictive (net of clauses) by three tenths of GDP, although its composition (which presents a high multiplier on the stimulus measures side and, vice versa, a low multiplier on the funding side) seems such to justify a negative impact on GDP limited to one tenth at the most (neutral effect according to the government). In any case, we believe the government's deficit and debt forecasts for next year, respectively of 1.6% and 130% of GDP, are exposed to upside risks.

We expect a moderate slowdown in growth in 2018

Considering the effects of the appreciation of the exchange rate, and of less accommodative economic policies, and taking into account the deceleration of the cycle in the euro area as a whole priced into our baseline scenario, our expectation, shared by the majority forecasters, is for a **moderate slowdown in Italian growth in 2018**, to 1.1% from 1.4% this year. The estimate for next year is unchanged compared to three months ago. Yet, whereas risks to the 2017 forecast are skewed upwards, we see downside risks weighing on 2018, especially depending on the political risk described above materialising, and to what extent.

Forecast Table

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.4	1.1	0.8	0.9	1.2	1.2	1.5	1.5	1.4	1.3	1.1	1.0
- q/q change				0.1	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.2	0.2
Private consumption	1.3	1.2	0.8	0.5	0.3	0.2	0.5	0.3	0.2	0.1	0.2	0.2	0.2
Fixed investment	3.1	1.8	2.4	0.1	1.7	1.8	-1.6	0.7	1.0	0.5	0.6	0.6	0.4
Government consumption	0.6	0.8	0.5	-0.3	-0.1	0.6	0.5	-0.1	0.1	0.2	0.1	0.1	0.2
Export	2.6	4.5	2.5	2.3	0.4	1.9	1.6	0.6	-0.3	1.0	0.8	0.6	0.6
Import	3.1	5.5	2.1	2.3	1.1	2.3	1.6	0.7	0.6	0.5	0.5	0.5	0.5
Stockbuilding (% contrib. to GDP)	-0.4	0.4	-0.1	-0.2	0.0	-0.1	0.3	0.1	0.3	-0.1	0.0	-0.1	-0.1
Current account (% of GDP)	2.6	2.5	2.1										
Deficit (% of GDP)	-2.5	-2.2	-1.9										
Debt (% of GDP)	132.0	132.6	132.3										
CPI (y/y)	-0.1	1.5	1.5	-0.3	-0.1	0.2	1.3	1.6	1.4	1.7	1.2	1.4	1.7
Industrial production (y/y)	1.9	2.6	1.9	0.6	1.7	3.4	1.8	3.2	3.2	2.1	2.6	2.1	1.5
Unemployment (%)	11.7	11.3	10.9	11.6	11.6	11.8	11.6	11.2	11.2	11.1	11.1	11.0	10.8
10-year yield	1.48	2.17	2.82	1.48	1.19	1.77	2.15	2.17	2.08	2.28	2.61	2.80	2.89

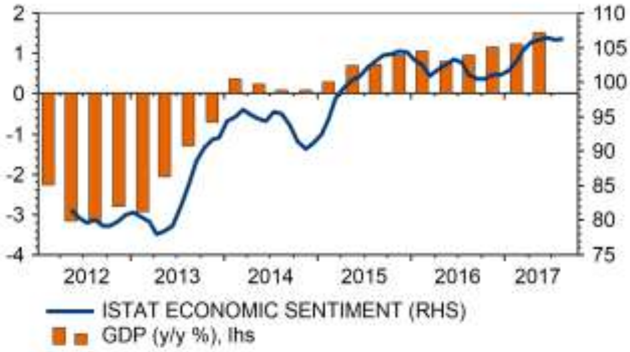
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Tab. 1 – Quantification of risks to GDP growth in 2018

	Min	Max
Exchange rate appreciation	-0.2	-0.3
Fiscal policy	0	-0.1
End of QE	0	-0.1
Political risk	?	
TOTAL	-0.2	-0.5

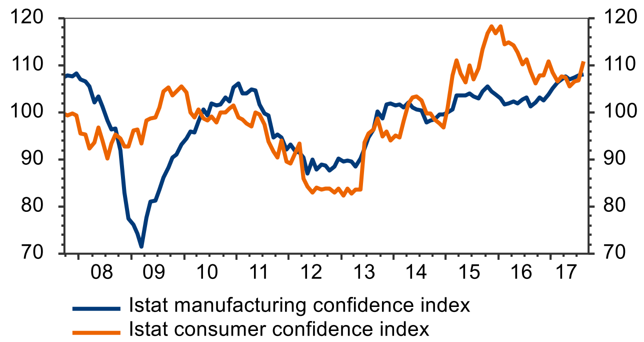
Note: effects on % y/y GDP growth in 2018. Source: Intesa Sanpaolo

Fig. 1 – Forward-looking indicators, however, point to lively ongoing growth at least for the remainder of 2017



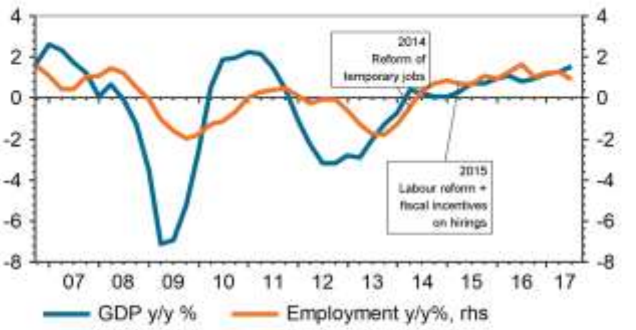
Source: Thomson Reuters-Datastream Charting

Fig. 2 – Business confidence still recovering, surprise rebound in households' confidence



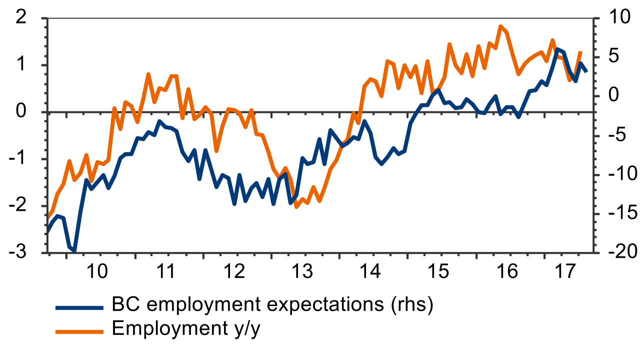
Source: Thomson Reuters-Datastream Charting

Fig. 3 – Elasticity of the employment trend to GDP has decreased compared to the first phase of the recovery…



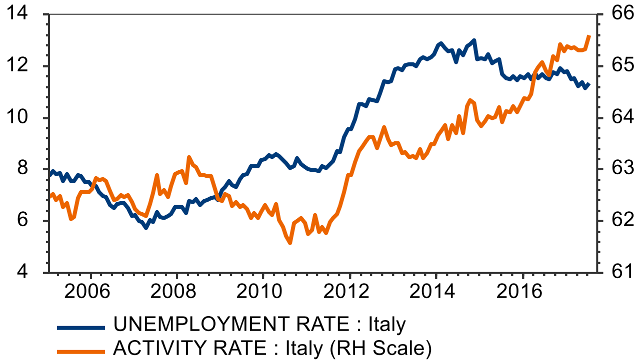
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 4 – …however, job growth should continue, in light of businesses' strong hiring intentions



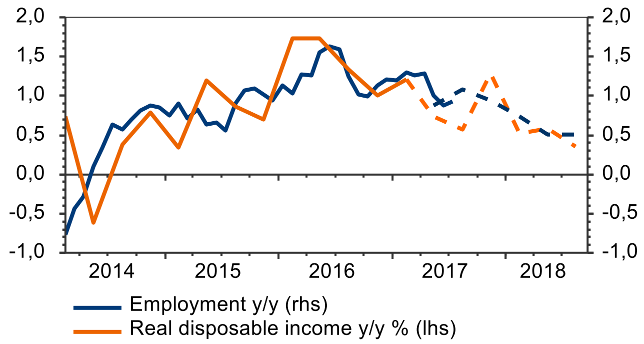
Source: Thomson Reuters-Datastream Charting

Fig. 5 – In any case, unemployment will continue to drop at a slow pace, held back by the ongoing increase in the activity rate



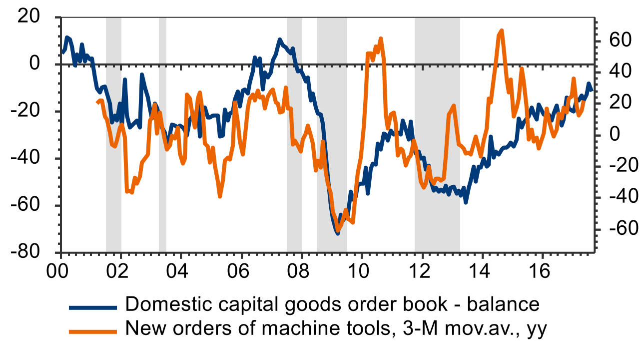
Source: Thomson Reuters-Datastream Charting

Fig. 6 – Employment and disposable income growth will continue, although it has probably peaked



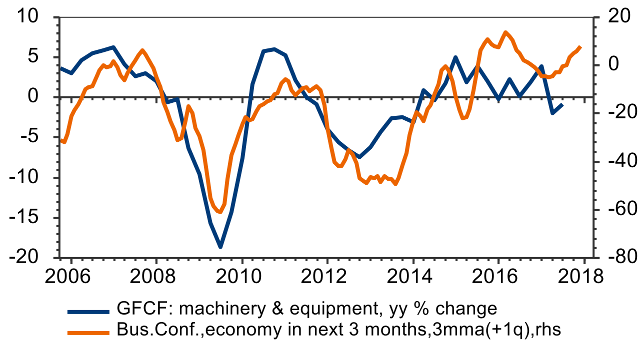
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo forecasts

Fig. 7 – The resurgence in orders of capital goods outlined by both surveys and orders data could be due to "Industry 4.0" incentives



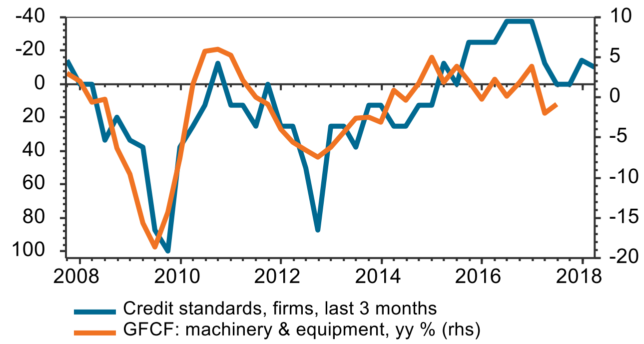
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo calculations

Fig. 8 – As well as by incentives, the recovery in investments will be supported by optimistic business expectations for demand…



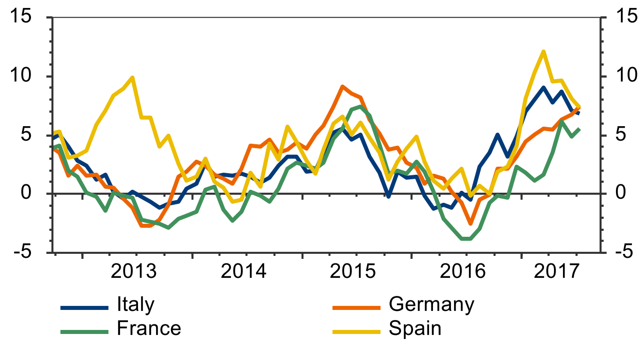
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo calculations

Fig. 9 – …and by still accommodative financial conditions



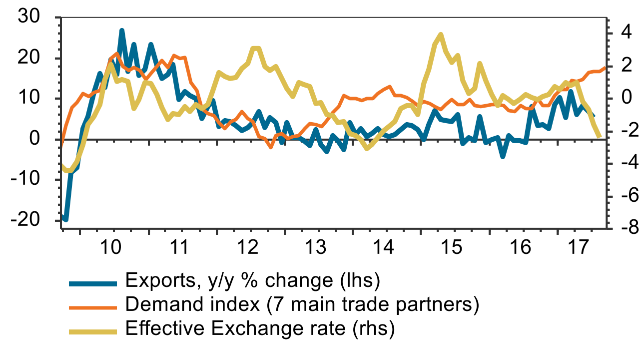
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo calculations

Fig. 10 – Italian exports currently growing at the same pace as the German and Spanish exports



Source: Thomson Reuters-Datastream Charting

Fig. 11 – The recent movement in the effective exchange rate is relevant, but balanced by the acceleration in global demand addressed to Italy



Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo calculations

Spain: the Catalan question reignites

Anna Maria Grimaldi

We are revising our forecasts up again for 2017

The Spanish economy continues to grow at a super healthy pace. Following growth of 3.2% in 2016, which outperformed our expectations and consensus estimates, we have again revised our growth estimates up for the current two-year period to 3.0% (from 2.8%) in 2017 and 2.3% (from 2.0%) in 2018. Recent signals from the PMI and economic confidence surveys (Fig. 1) suggest that growth is slightly slower than it was during the spring months (0.8% qoq). Manufacturing activity had already eased off by the start of the summer, suggesting GDP growth of around 0.6-0.7% qoq in the second half of the year. The country seems to be moving towards a phase of more moderate growth: the peak impact of the fall in oil prices and the ultra-accommodative financial conditions has already been experienced; from the end of the year, the appreciation of the exchange rate will make itself felt and, from next year, fiscal policy will be tighter. Internal political matters and the exacerbation of the stand-off with the Catalan independence movement have induced Madrid to delay approval of the 2018 budget by a week. So the spotlight is again on politics. But there is no ignoring the fact that the country needs to continue with the reform process, given that the high level of external debt, unemployment falling but still at socially unsustainable level.

Exports and consumption produced surprises. But the peak has already been seen

The rising expectations in the first six months of 2017 was due to exports outperforming (by an average of 2.5% qoq between the end of 2016 and June this year) the Eurozone average, while imports saw a lower rise (on average by 1.5% qoq). Foreign trade therefore made a broadly positive contribution. Recent figures for foreign orders from the PMI and the global PMI surveys suggest that demand for Spanish exports will not grow further (see Fig. 3). From Q4, the appreciation of the exchange rate will begin to weigh on exports. The effect on imports and exports of a strengthening exchange rate (see Fig. 4) tends to be greater in Spain than in the rest of the Eurozone[10]. It is, however, the case that most of the improvement in the goods balance was with the rest of the Eurozone (see Fig. 6), which leads to the hope that the exchange rate effect might have less impact than in the past (an appreciation of the effective exchange rate reduces Spanish growth by around 0.5% after one year). We expect export growth to moderate to 1.0% qoq over the next 18 months. Annual average export growth is expected to slow from 6% in 2017 to 4%, while imports are expected to decelerate less: foreign trade will therefore continue to make a positive contribution to growth of 0.2%. Growth will continue to be driven by domestic demand, which we expect to rise by 2.0 % next year, compared with 2.3% for this year. Household spending was better than forecast in the first half of 2017, growing by 0.7% qoq. However, consumption in the last six months has in part been financed by running down savings (see Fig. 8). Thus, it is possible that consumption will continue to slow towards 2.0% in 2018, from 2.3% this year and 3.2% in 2016.

Less stimulus from employment

Real wages still negative Unemployment will fall further, although excess supply on the labour market will keep contractual wages under pressure next year

Although jobs growth is solid and better than the figures reported in confidence surveys (2.8% yoy in the spring) (see Fig. 9), it does not offset the fall in real wages (see Fig. 10) associated with the rebound in inflation to 2.1%, from the figure of -0.2% last year, due to continued low increases in contractual wages. **Over the forecasting horizon, we anticipate a moderation in jobs growth of 2.0%.** Growth in real wages will remain negative. **Inflation is expected to fall slightly to 1.7% in 2018**, due to the dampening base effect provided by energy. However, the considerable excess supply in the labour force will continue to exert downward pressure on contractual wages. **The unemployment rate fell by 9% to 17.1% in July from a peak of 26.2% in 2013 and, according to our predictions, could fall to 16.8%** over the forecasting horizon. The expanded unemployment rate is much higher at 26% – easily the highest in the Eurozone – and is approaching a structural level that is unacceptably high for an advanced economy and that is probably masking, at least in part, under-employment.

[10] See ECB Working Paper no. 1955, September 2016

Domestic demand will receive more support from investment in machinery next year. Even so, however, it is reasonable to expect a slowdown from the 8.9% of 2016 and the 5% of 2017: we estimate growth of close to 4.0% in 2018. The rise in the use of production capacity has, to some extent, stopped (see Fig. 12) and the opportunities provided by low interest rates seem to have been fully exploited.

Construction is in a new expansionary cycle: at the start of 2017, residential investment was 2.7% qoq, up from 0.9% qoq in the previous 18 months, while the spring months saw growth of 1.0%. Confidence in the sector will remain sustained. In comparison, growth in residential construction should be 7% in 2017, although we expect this to slacken to 4% in 2018. Our estimate for non-residential construction growth is an average of 2.5% in 2017-18. The contribution of value added has returned to pre-crisis levels (see Fig.11). The expansionary cycle may continue but, hopefully, will slow in 2019, as otherwise new excesses would be forming.

Capex: it is reasonable to expect a slowdown after growth of 9% in recent months

Spain will remain in the corrective arm 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. The improvement in the nominal balances is largely due to the contribution of the economic cycle. Last spring, the European Commission assessed the structural balance adjustment for 2018 as being insufficient (0.0% compared with the required 0.5% of GDP, based on the rules of the Growth and Stability Pact). When announcing the 2018 budget, the Government targeted a deficit of 2.2% in 2018. Measures to contain spending (cuts to intermediate consumption and subsidies), totalling 1% of GDP, should more than offset the EUR 2 billion in tax cuts. Receipts are expected to fall from 38.5% of GDP to 38.4%. The uncertainty about what will happen to the balances stems from both the impact of the taxation 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% is more cautious, partly due to the uncertainty surrounding the revenues from privatisations (estimated to be around 0.2% of GDP next year).

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

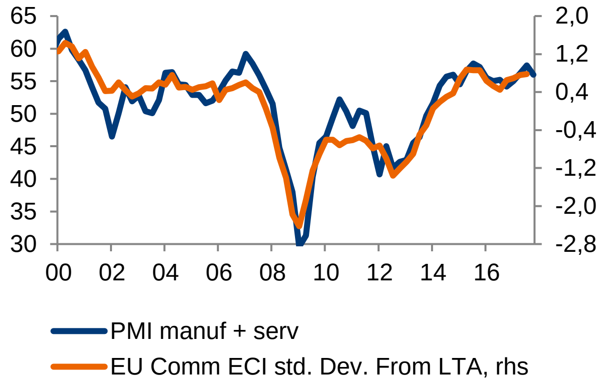
Risks to the macro scenario are broadly balanced. However, the Catalonia situation has reopened the question of the relationship between the central government and local autonomy, and this could have repercussions for spending decisions by businesses and for the management of the public finances. The way the crisis in Catalonia is managed will have consequences for the relationships with other regions that have separatist tendencies (see the focus below).

Forecast Table

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	3.2	3.0	2.3	3.4	3.2	3.0	3.0	3.1	3.0	2.9	2.7	2.4	2.3
- q/q change				0.8	0.7	0.7	0.8	0.9	0.6	0.6	0.6	0.5	0.5
Private consumption	3.2	2.3	2.0	0.7	0.6	0.8	0.4	0.7	0.5	0.5	0.5	0.5	0.4
Fixed investment	3.1	3.8	3.0	1.4	-0.1	0.5	2.1	0.8	0.3	0.8	1.0	0.6	0.8
Government consumption	0.8	1.1	0.9	-0.6	0.5	-0.2	0.8	0.2	0.3	0.1	0.3	0.2	0.2
Export	3.7	6.6	3.2	0.8	0.4	1.4	2.7	2.4	0.4	0.9	0.8	0.5	0.5
Import	3.3	4.9	3.8	2.6	-2.0	1.8	3.1	-0.2	1.2	1.0	0.8	1.0	1.2
Stockbuilding (% contrib. to GDP)	0.1	0.1	0.2	-0.1	0.1	0.1	-0.1	0.0	0.3	0.1	-0.1	0.0	0.2
Current account (% of GDP)	1.6	1.8	1.6										
Deficit (% of GDP)	-4.5	-3.2	-2.6										
Debt (% of GDP)	99.4	99.2	98.5										
CPI (y/y)	-0.3	2.2	1.8	-1.0	-0.3	0.8	2.7	2.1	2.0	2.2	1.3	2.2	2.0
Unemployment (%)	19.6	17.3	16.8	20.1	19.3	18.7	18.2	17.0	16.9	16.9	16.9	16.8	16.8

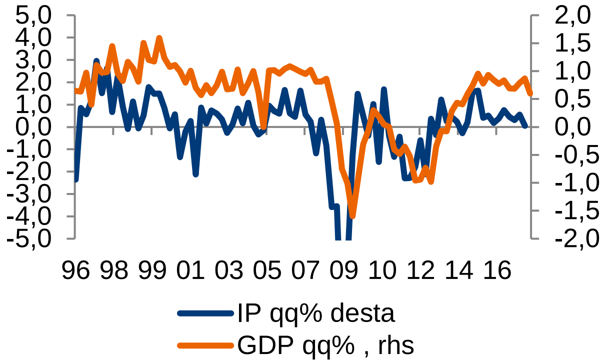
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – The composite PMI indicates that the peak has probably been reached



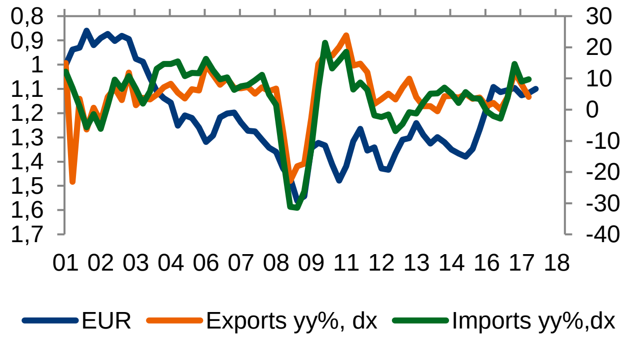
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. Fig. 2 – Manufacturing activity had already begun to slow in the summer



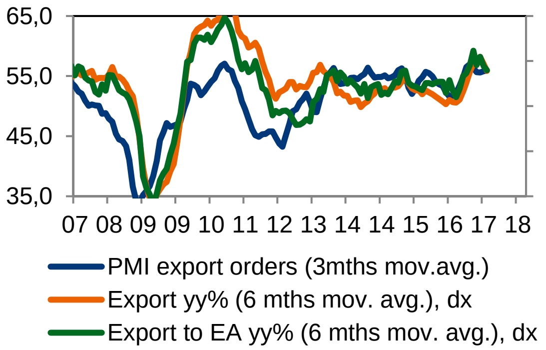
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – The exchange rate is weighing more heavily on exports…



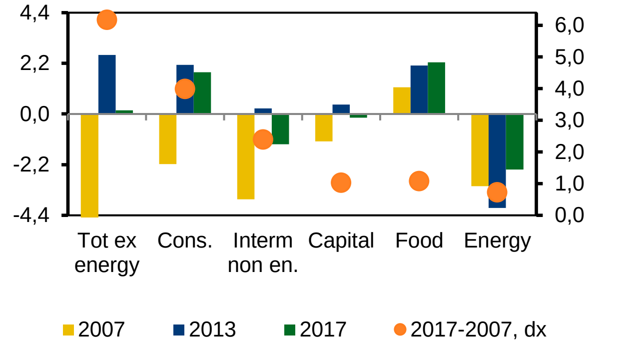
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 4 – …than the trend for global demand



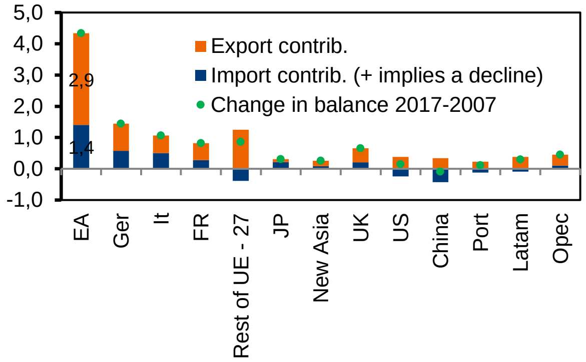
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – The goods balance has worsened since 2013 due to the intermediate goods balance. But the energy balance is improving.



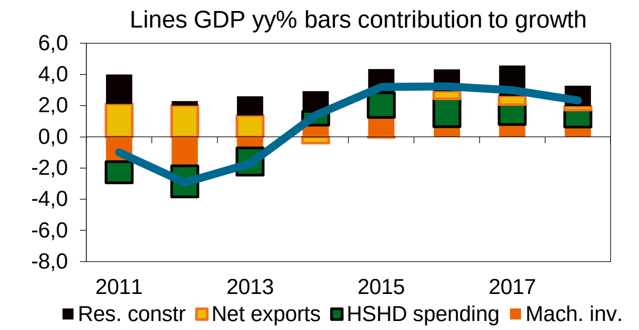
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – The trade balance with the rest of the Eurozone is continuing to improve.



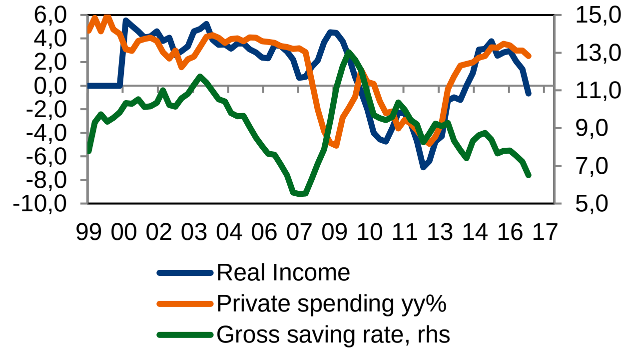
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Consumption has now peaked but growth will remain sound (2.2%). The cycle of investment in machinery seems to be mature. Residential construction will stabilise at more typical growth rates



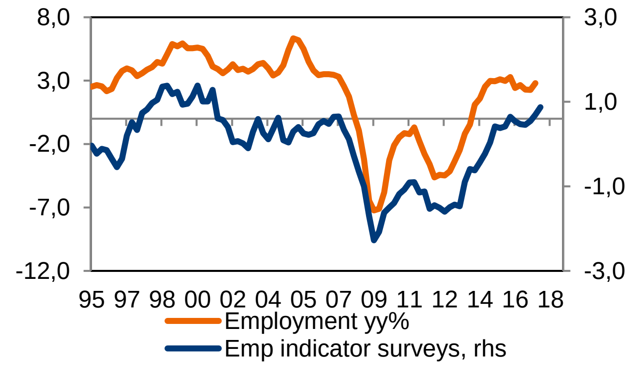
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 8 – Consumption is growing faster than disposable income. The savings rate is continuing to fall and is not far from the lows seen in 2007.



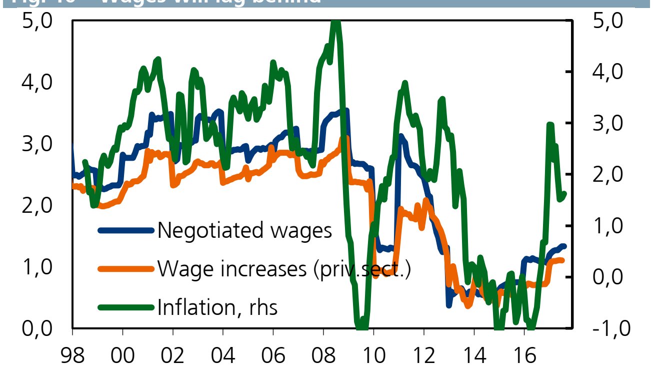
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – The trend for employment continues to surprise



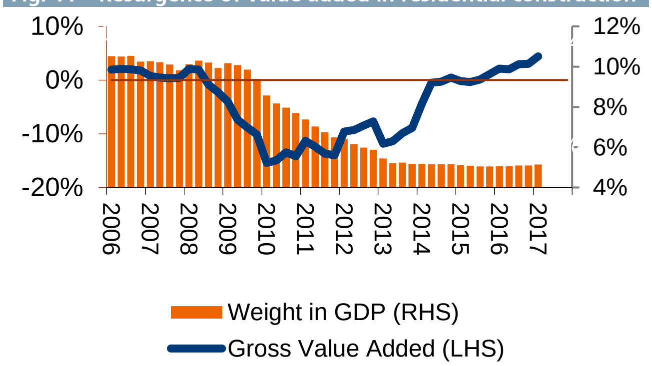
Source: Intesa Sanpaolo chart from INE data

Fig. 10 – Wages will lag behind



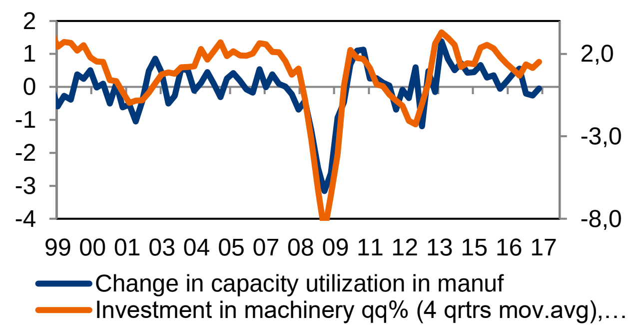
Source: Intesa Sanpaolo chart from INE data

Fig. 11 – Resurgence of value added in residential construction



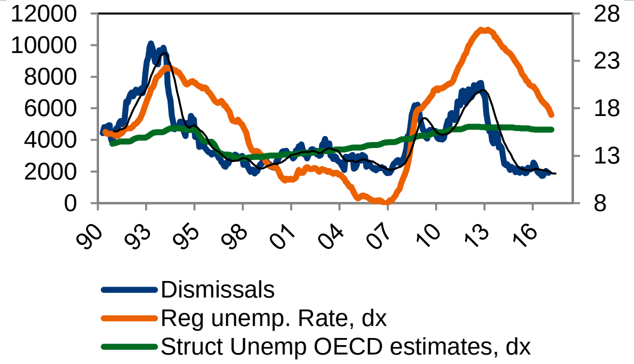
Source: Intesa Sanpaolo chart from INE data

Fig. 12 – Machinery investment cycle is mature



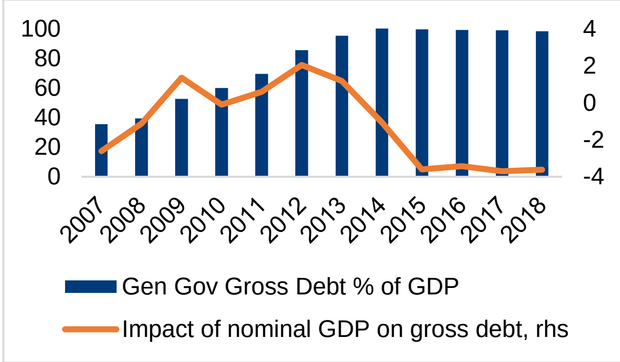
Source: Intesa Sanpaolo charts from INE and European Commission data

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



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

Fig. 12 – Public sector debt expected to fall from this year, mainly thanks to sound growth



Source: Intesa Sanpaolo chart from European Commission data

The Catalan question is a European question

Anna Maria Grimaldi

There has been an escalation of tensions between Madrid and the Barcelona authorities over the independence referendum, on October 1st. According to the Catalan government 2.2 million voted on Sunday, which is about 42% of the eligible people, indeed a low representation threshold for a referendum that has been pushed through not only against Spanish Constitutional provisions but also without the approval of the Catalan Parliament. Out of 2,2 million voters, 90% were in favour of independence. The central government's intervention, on Sunday, has made the voting process non - transparent and unverifiable. Nonetheless the Catalan government pledgees that the "Yes votes", only 38% of the total eligible, are enough to press ahead with the declaration of independence without any pause of reflection and negotiating with the central government. This act is likely to lead to a new escalation of the clash with Madrid. Rajoy stated that if he does not have the full support of the parties (including the Socialists) to handle the Catalans threat to declare unilateral secession, he will call early elections.

The Catalan question is not just relevant to Spanish national unity – it also has a European dimension. In the days ahead of the referendum, the European Union gave cautious support to the position of the Spanish Government: Margaritis Schinas, the spokesperson for the Commission, has confirmed that Brussels "respects the constitutional law of Spain, as is the case for all Member States, and it is in this spirit that all these matters can and must be dealt with".

The Catalan separatist drift, even though it is the manifestation of a strong cultural identity rarely seen in other regions, could revitalise the separatist tendencies present in other Member States. The crisis could make it even more difficult to reach agreement on the main issues on the European political agenda. If the referendum and the independence vote are passed, the spotlight could once again be cast on the possibility of leaving the single currency.

Something needs to be clarified. It is not unheard of for a country to agree to a political and territorial separation. This happened in 1992, when Czechoslovakia split into two separate states called the Czech Republic and Slovakia. However, in this case, Czechoslovakia was not part of the European Union, which the two countries only joined in 2004. Any secession by Catalonia would pose much more complex problems associated with the new state's participation in the single market and Monetary Union. We can visualise, on the one hand, a negotiated and consensual pathway preserving access to the single market and Monetary Union for both states but, on the other hand however, a unilateral declaration of independence that would prejudice access to the European Union.

A little bit of history

Tension between the Madrid Government and Barcelona has very long-standing origins. We should remember that Spain is a relatively young country and is still nationalist in character. In the case of Catalonia, the independence movement has always been stronger than in other regions apart, perhaps, from the Basque Regions. As an historic nation, Catalonia had already obtained a high level of autonomy during the transfer from Francoism to democracy, after decades of repression of Catalan identity during the dictatorship. However, the 1978 Constitution did not specify the competencies of the autonomous regions. In the 1990s, Catalonia was granted greater autonomy in tax matters thanks to the support of the coalition of nationalists and conservatives (CIU). In 2016, under the socialist government led by Zapatero, a new statute of autonomy was passed. Rajoy's Popular Party has always considered the statute to be a danger to the unity of the country. In 2010, the Constitutional Court in Madrid declared a large number of the statute's articles to be unconstitutional. This ruling has fed independence sentiment, which was strengthened in 2012 when the region, during a full-blown financial crisis, was forced to request financial help from the central government. This was presented as the inevitable result of the unfair policies of the central institutions. Local politics has, in part, been driven by nationalist sentiment in recent years and, since the 2015 elections, a coalition has emerged between Jxsi (United for "Yes"), led by Artur Mas, and the radical left of the CUP, in favour of independence.

What does Catalonia have to lose?

Catalonia is the second-most populous region of Spain with 7.5 million inhabitants out of a national total of 48 million and a per capita income of around EUR 29,000, above the national average of EUR 24,000. With a GDP of over EUR 200 bln, it has an economy the size of Austria's, and is the region that makes the greatest contribution to GDP. The region's deficit was 2.6% of GDP in 2014, only slightly above the average for local governments (1.7% of regional GDP). The stakes are therefore fairly high and it is understandable why Madrid and Prime Minister Rajoy have been seeking to keep separatist tendencies at bay.

The cost of a unilateral declaration of independence could be quite high, if not fatal, for the financial stability of the region and for its growth prospects. We believe that this cost would be much higher than any potential benefits arising from greater legislative and administrative autonomy over higher tax revenues (40% according to the Catalonia *Generalitat* in 2011, although, in reality, tax revenues for Catalonia in July 2015 amounted to 21% of the total). The negative consequences that would be associated with a "Yes" victory would include:

- Exclusion from the European Union In the event of a non-consensual secession, Catalonia would become a new state, and would have to apply from scratch to join the European Union, showing that it met specific economic and political requirements. At the same time, it would not automatically be granted access to the single market.

- Significant financing difficulties on capital markets Catalonia manages to finance itself on capital markets despite its "junk" rating, thanks to transfers from the central government that amounted to EUR 50 bio in 2012-15. Catalonia currently has a debt of EUR 75 billion, which represents 40% of regional GDP (and 27% of the total debt) If the region was unable to repay this debt, then clearly access to capital markets would be more or less impossible.

- Discontinuity in the monetary system. Catalonia would be thrown into a monetary nightmare. It would be obliged to choose between its own currency (possibly supported by being pegged to the euro) and using the euro - without having any control over the monetary base. In the second scenario, local banks would have no lender of last resort (a role that could not be performed by the Bank of Spain), so a new system would also have to be set up to settle interbank payments in Catalonia (unless an agreement could be reached with Eurosystem to use the existing system). The figure for the balance of payments would determine the trend for money supply. Any central bank set up in Catalonia would not be able to participate in the Eurosystem, given that the new state would not even be a member of the European Union. There would be a risk of a *corralito* (the freezing of bank accounts or financial assets) in the event of a "Yes" victory, to avoid any bank runs. Banks would be severed from liquidity funding from the Eurosystem, and catapulted into a regulatory limbo that would compromise their creditworthiness and access to capital markets.

The consequences for Spain and for Europe

If the re-opening of the Catalan question damages the Spanish Government, which, we should remember, is a minority administration, this will also create problems for Europe. On the one hand, Catalan separatist tendencies are a manifestation of a strong cultural identity and not a rejection of European policies: quite the contrary, Catalonia wants to remain part of the European Union and the Monetary Union. However, if the independence movement were successful, this could revitalise separatist tendencies in other countries. Indirectly, the crisis could also make it more difficult to reach agreement on the main themes on the European political agenda, and cast the spotlight back onto the risk of the Monetary Union breaking up.

The Netherlands: a second exceptional quarter drives GDP in 2017 to 3%

Guido Valerio Ceoloni

GDP accelerated this year from 2.1% to 2.9%, thanks to an exceptional second quarter

Q2 GDP, which increased by **1.5% qoq**, outperformed all expectations with the **strongest increase since 2007**. The data are explained by a sharp, widespread increase in the components of domestic demand: private consumption jumped from 0.2% qoq to 0.9% qoq and public consumption from -0.1% qoq to +0.7% qoq (its strongest since March 2016), while investments slowed from 4.5% qoq to 0.8% qoq. As a result, domestic demand contributed +0.7%, following on from +1.1% in the winter quarter. Foreign trade also made a positive contribution, rising from -0.1% to +0.7%, with exports accelerating from 1.6% qoq to 1.8% qoq and imports slowing from 2.0% qoq to 1.2% qoq. **Year-to-date growth was 2.9%** at the end of the second quarter. For the current quarter, we forecast the economy to correct by -0.2% qoq, before closing the latter part of the year in positive territory. **We are therefore upgrading our previous estimate for the current year** by six-tenths of a percentage point **to 2.9% yoy** (best figure since 2007) and downgrading GDP in 2018 by one-tenth of a percentage point to 1.7%. The risks to the forecast over the forecast horizon remain balanced.

Consumption accelerates for the third straight year; household confidence at a maximum

Consumption is proving to be extremely robust for the third year in a row. In Q2, it accelerated by a further 0.9% qoq, which will push up the annual average from 1.5% in 2016 to 1.9% in 2017. The data currently available indicate that household spending in July accelerated to 2.8% mom, setting consumption up for a further increase during the summer. We think consumption will slow in 2018 to 1.3%, as government tax incentives run out. Thanks to fiscal stimulus and the positive outcome at the spring elections, **the confidence of Dutch households is at an all-time high**: the European Commission's Economic Sentiment Indicator (ESI) shows it averaging 17.0 in the current quarter, up from 15.0 in the previous quarter (and at 16.0 in the first eight months of the year, up from 4.6 on average for 2016), which is well above the Eurozone average of -1.5. The continued improvement in real estate markets and rising house sales continue to support household portfolios, which in the past have been rather exposed to equity market crises.

Investment still growing after two years of expansion, buoyed in part by the return of public spending

Capital investment slowed in Q2 from 4.5% qoq to 0.8% qoq, due in part to a foreseeable slowdown in machinery, given its 11.6% qoq growth over the winter. In the first eight months of the year, economic confidence, based on the European Union's ESI index, was stable at around 109. However, we expect expansion to slow in the next few months, bringing the annual figure down from 5.3% yoy in 2016 to 4.8% yoy. **2017 will be the third consecutive year of strong investment growth**. We expect this to slow to 2.2% in 2018 (partly offset by the return of public investment after years of contraction). Activity in the **real estate market is showing no signs of slowing**, with prices continuing to rise month after month (in July, they rose by 7.6% yoy, after an 8.0% yoy increase in June). Although the pace appears to be starting to slow, it is still 6% above the high in 2008, the year of the real estate crisis. **As a result, the dynamics of the real estate market remain a potential source of risk that requires monitoring**.

Industrial output stabilising between 2017 and 2018

Industrial output grew between June and July, thanks to electronics and transport, but is expected to slow between August and September, mainly due to pharmaceuticals and refining. Output should bounce back in the closing stages of the year. In annual terms, industrial output is expected to increase by 1.5% yoy this year and next, compared with 2.1% yoy in 2016, driven by the close ties between Dutch and German manufacturing. Production capacity utilisation is stable and at its highest since 2009.

Net exports will make a positive contribution to GDP this year, but will turn neutral again from 2018

With **exports** growing further in Q2, from 1.6% qoq to 1.8% qoq, and imports slowing from 2.0% qoq to 1.2% qoq, net exports made a strong contribution to growth of +0.7. In the rest of the year, we think that foreign trade will continue supporting growth by about one-tenth of a percentage point per quarter, with exports accelerating over the summer months by about 7%

yoy (driven by cars and household appliances) and looking to rise from 4.2% to 4.9% in 2017 on average. We are expecting a slowdown from next year to around 3.5%. **Imports**, stimulated by consumption and investment in machinery, will accelerate from 4.0% in 2016 to 4.4% this year, then slow to 3.4% in 2018. The contribution of net exports next year should therefore return to about neutral. At the moment, the summer's foreign trade data are showing no appreciable impact from the stronger euro. But given the Dutch economy's degree of openness, we cannot rule out the possibility of a prolonged period of unfavourable exchange rates hurting the contribution of net exports down the line. Growth in the **trade balance** should exceed 7% of GDP, next year as well.

Inflation is expected to slow to 1.3% in 2017 and to 1.5% in 2018

After its new year surge, **inflation** has been slowing and is now expected to come in at around 1.3%. We expect prices to remain broadly stable over the remainder of the year, with a slight slowdown keeping the annual average at 1.3%, up from 0.1% in 2016 (harmonised index). Inflation in 2018 should accelerate moderately, by at most a couple of tenths of a percentage point, to 1.5%. **Core inflation** should accelerate from 0.6% to 0.8% this year, before easing to 0.7% in 2018.

The labour market has virtually returned to pre-crisis conditions and continues to improve

The **labour market** continues to improve: the **participation rate** has risen by three-tenths of a percentage point from 67.1% to 67.4% but remains below pre-crisis levels (69%). The number of hours worked in Q2 increased by 4.2% qoq, the highest since 2007, and **employment** increased by more than 51,000 jobs in Q2, compared with 56,000 in the previous quarter. The labour market figures are therefore the best in a decade, and the outlook over the forecast horizon remains positive, as is also confirmed by business surveys, which are showing a continuous propensity to hire. **Unemployment**, therefore, is expected to fall from 6.0% last year to 5.0% this year and by another four-tenths of a percentage point to 4.6% in 2018, which is one of the lowest levels in the Eurozone.

Spending on the up (in relative terms), but public finances still exemplary

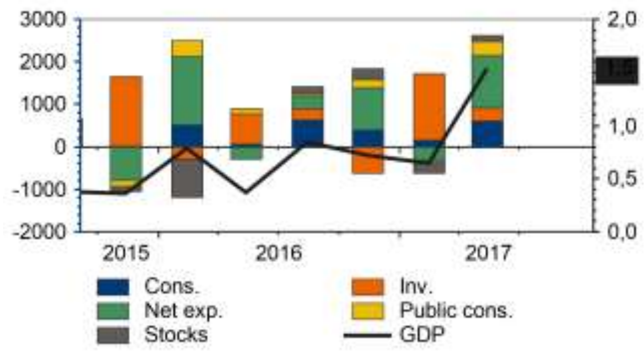
Public finances remain **exceptionally positive**. In 2017, the impact of a package of tax incentives will be EUR 4.1Bn or around 0.6% of GDP. In the next budget law for 2018, the People's Party for Freedom and Democracy (VVD), led by Mark Rutte, is planning a new package of fiscal stimulus measures for companies and households. Over the two-year period, we expect control of public finances to be relaxed. This year, the **headline surplus** should improve from +0.4% to +0.5%, but the **structural surplus** is expected to fall from +0.7% to +0.2%, then stabilise next year. The current forecasts for public finances are nonetheless fraught with uncertainty because the government has failed to form a coalition since the March elections. **Public debt** will fall further in the two-year period, from 62.3% in 2016 to just below 60%, in line with the Maastricht targets.

Macro forecasts

	2016	2017	2018	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	2.1	2.9	1.6	1.9	2.4	2.7	2.6	3.8	2.7	2.4	2.2	1.1	1.7
- q/q change				0.4	0.8	0.7	0.6	1.5	-0.2	0.4	0.5	0.4	0.4
Private consumption	1.5	1.8	1.3	0.1	0.9	0.6	0.2	0.8	0.0	0.3	0.4	0.4	0.4
Fixed investment	5.2	5.0	2.3	2.0	0.8	-1.8	4.5	0.8	0.3	0.6	0.6	0.6	0.5
Government consumption	1.1	1.0	1.0	0.3	0.1	0.5	-0.1	0.8	0.3	0.2	0.3	0.3	0.3
Export	4.1	4.9	3.4	0.2	1.0	1.2	1.6	1.8	0.5	0.7	1.0	0.8	0.8
Import	3.9	4.4	3.4	0.4	0.9	0.6	2.0	1.2	0.5	0.7	1.0	0.9	0.8
Stockbuilding (% contrib. to GDP)	-0.5	-0.1	-0.1	0.0	0.1	0.1	-0.2	0.1	-0.3	0.0	0.0	0.0	0.0
Current account (% of GDP)	8.2	7.6	7.2										
Deficit (% of GDP)	0.4	0.5	0.7										
Debt (% of GDP)	62.3	59.8	57.2										
CPI (y/y)	0.1	1.4	1.7	-0.2	-0.2	0.5	1.3	1.0	1.6	1.7	1.8	1.9	1.6

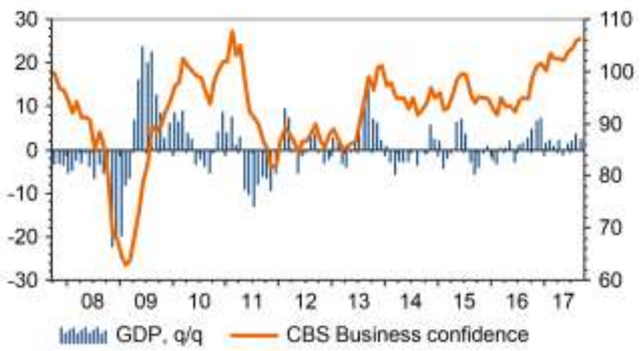
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to the formation of GDP



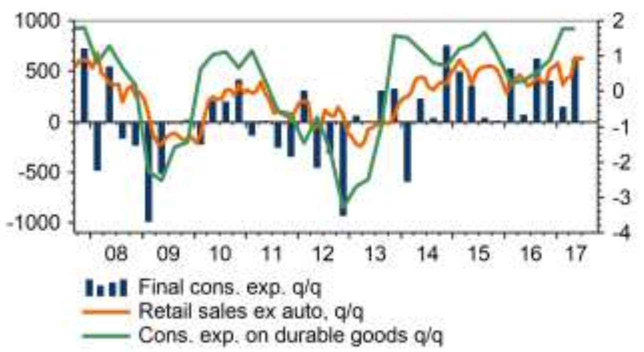
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – Economic confidence and GDP



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

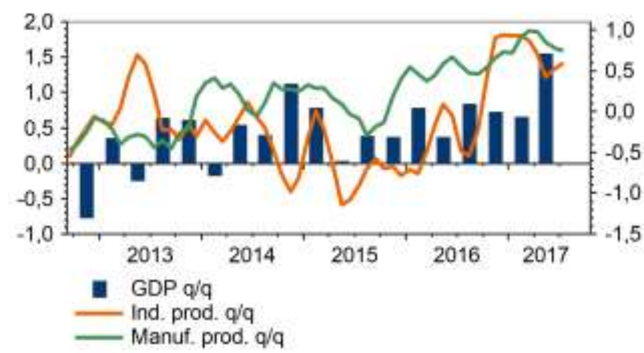
Fig. 4 – Retail sales and household confidence

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

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

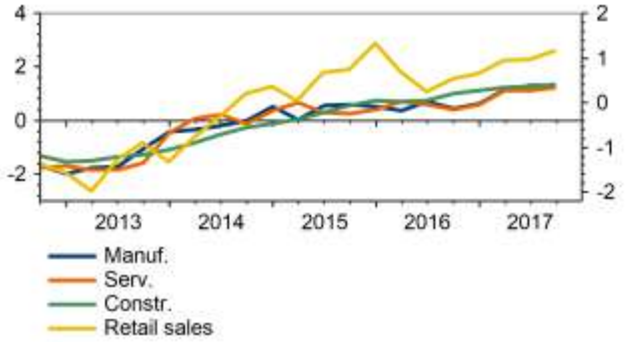
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



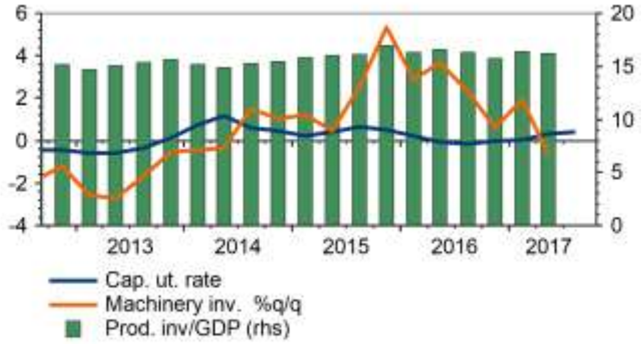
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



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

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

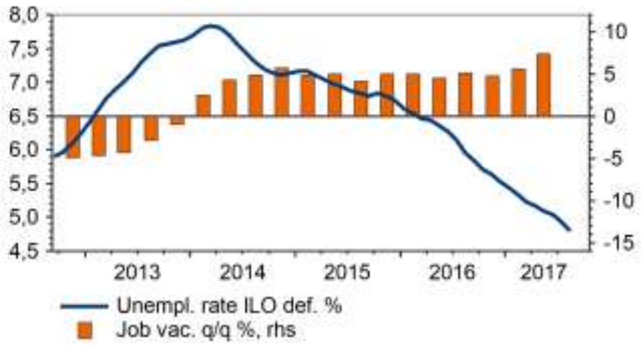


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Exports 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

Portugal: the return to investment grade marks the end of the crisis

Guido Valerio Ceoloni

The scenario is looking better than expected, with a well-set economy and a visible improvement in market confidence due to the exit from the excessive deficit procedure and the rating upgrade by S&P's.

The second quarter saw growth of just 0.3% qoq, from 1.0% qoq, which disappointed consensus expectations, although this figure is in line with our forecasts. However, annual growth is 2.2%. The scenario remains positively set for this country, which, benefiting from the economic recovery of the Eurozone and the progressive easing of risk factors (particularly debt), will emerge from the excessive deficit procedure this year. We therefore confirm our previous estimate of average annual GDP growth of 2.5% for 2017, up from 1.4% for 2016, while for 2018 we expect a slowdown in output of about 1.6% (the latest European Commission estimates are 1.8% and 1.6% respectively for 2017 and 2018). Forecast risks remain tilted to the upside, with economic confidence indicators improving markedly: the Commission's ESI index now stands at 112.0, precisely in line with the Eurozone average (an annual average of 111.9, compared with 106.4 in 2016), while consumer confidence has also improved to 1.2, higher than the historical average and the Eurozone average (-1.5).

Second-quarter growth mainly reflected a sharp increase in stocks, which contributed +0.8 (from +0.4), while domestic demand stagnated and foreign trade made a negative contribution of -0.4 as a result of a fall in exports (-0.2% qoq from 2.9% qoq), offset by an increase in imports (+0.7% qoq from 1.9% qoq), driven by investments. Consumption corrected by -0.3% qoq after the substantial increase in the spring (+0.9% qoq). For the current quarter, we are expecting a 0.4% qoq increase: a predictable running down of stocks should offset growth in net exports and a rise in consumption, which this year should be up by 2.0% on average and by 1.2% in 2018, buoyed by the rise in the minimum wage and in employment, but partly eroded by rising prices.

Inflation is estimated at 1.5% this year and at 1.6% next year. Investments will register a boom this year (+9% yoy), driven, in particular, by residential construction and public investment contributions, fuelled by EU funds from the 2014-20 programme, which will come into effect from the autumn. We expect the contribution from foreign trade to be around zero or slightly negative, reflecting growth in domestic demand this year, which will fuel imports, despite a good performance by exports and tourism. 2017 will be a positive year for the labour market, with a widespread rise in employment driven by the construction sector, and a stabilisation in the workforce that should lead to a fall in unemployment of more than one point, to 10% from 11.2% in 2016, before it approaches 9.0% in 2018, now in line with the Eurozone average.

The decrease in the spread of the Portuguese 10-year bond has been accelerating in the last few months, touching a minimum since the summer of 2015 of 191bps (a year ago it was close to 350bps); the gradual withdrawal of the APP in 2018 will lead to a natural widening, which could, however, be offset by an improved country risk assessment, which the major ratings agencies are already incorporating into their outlooks; following DBRS, S&P's also recently raised the Portuguese rating to investment grade, on the grounds of the improvement in public finances and the pace of economic recovery. The next major event for the country will be the budget law, which will provide valuable information that will allow for a better understanding of the direction of the public finances in the coming year. However, the deficit is expected to fall again this year, by -1.5%, before climbing back to 2% next year, with public debt decreasing again by around one point a year in 2017-18 from 130.4% in 2016.

Greece: a quiet summer, pending the result of the German elections

Guido Valerio Ceoloni

After passing a complicated second review in June, next year the Greek government is scheduled to close its third bailout in eight years, with no further surprises on the horizon for now. The June agreement stipulated further fiscal tightening in 2019-20 (after the end of the bailout) and a further reduction in social security spending, by a total of 2% of GDP.

The economy shows signs of life, but the post-bailout scenario remains highly uncertain

As the French presidency established itself and Brexit negotiations started, there were no major developments in the Greek situation during the summer, except for the payment of the July tranche of EUR 7Bn and the return of Athens to the market with a five-year bond issue of EUR 3Bn. Discussions between the IMF and the European Union on the restructuring of Greek debt were postponed until after the German elections, and this will be the real opportunity for the country, once it has emerged from the bailout, to durably recover the confidence of economic operators and investors, which, for the time being, remains very volatile.

By contrast with Portugal, the Greek recovery has been slower and more halting: the economy has been more or less stagnant since 2014, and remains 27% below its pre-crisis levels. GDP rose again in the second quarter, by 0.5% qoq (although this was slightly better than consensus estimates). Net exports made the biggest contribution (+2.5%), partially offset by the running down of stocks (-2.0), which was the opposite of what had happened in the previous quarter. Domestic demand contributed +0.8, more than recovering the winter decline of -0.3; however, consumption contracted, albeit slightly, by -0.1% qoq from +0.2% qoq, while investments dropped by -4.5% qoq from -1.0% qoq, perhaps reflecting the climate of uncertainty related to the elections in Europe; the only component of domestic demand to increase was public consumption, which jumped from -1.2% qoq to +6.5% qoq, its highest level in more than a decade. GDP growth is now 0.6%: on the basis of the indications so far available, we expect an acceleration in the summer quarter, partly driven by the good tourist season: annual average GDP will increase by 1.1-1.2%. Unless there are substantial ex-post revisions of the data for the first two quarters, we are therefore revising our previous estimate upwards by two-tenths of a percentage point. We forecast an acceleration to 2% in 2018, in line with the consensus. According to the European Commission's confidence index, household confidence remains very depressed compared with the other Eurozone countries (-68) compared with last year: with the slowdown in employment this year (to 1.4% from 2.0% in 2016), and higher fiscal pressure than last year due to higher excise duties, consumption will slow from 1.5% to 1.0% in 2017, while investments will remain volatile over the forecasting horizon (about -1% this year and +1% next year). Lending conditions for households and companies continue to be adversely affected by the fragility of the banking sector, while investor confidence is still too volatile to generate a strong recovery in investments, as has been the case in Portugal.

Economic confidence as measured by the Commission has improved slightly compared with 2016 (to 95 from 91), but remains weak. Exports will fall less than last year and should rise again next year (+1%), while imports will grow on average (6.2%), mainly due to the burst at the beginning of the year, before slowing in 2018 (to 3% yoy).

With regard to the public accounts, Athens has pledged to keep the primary surplus at 3.5% of GDP from 2018 onwards. For this year the aim is to bring it to 1.75%; this goal is attainable, considering that last year, due to tax cuts, Athens was able to beat the target set, achieving a surplus of 4.0% (after recapitalisations of the banks) and that the tax collection reform in progress and the absorption of European funds should make the task easier. The target for 2018 might be over-ambitious, however. After peaking at 170% of GDP last year, public debt should stabilise just below this threshold this year and start to decline from 2018. The risks to the scenario will remain to the downside as long as debt restructuring is not addressed: although the economic outlook is moderately positive, the country remains more susceptible than most to any external shocks. At present, a new aid package at the end of the current programme cannot be ruled out.

Asia

Japan: above-potential growth, core inflation still close to zero and a growing share of JGBs in the BoJ's portfolio

Giovanna Mossetti

The macroeconomic outlook for Japan remains positive for 2018-19, with above-potential growth, driven by private domestic demand and boosted by the contribution of monetary and fiscal policy and exports. The economy is likely to slow in 2020, caused by the hike in consumption tax to 10%, set for October 2019. **Growth** was also stronger than expected **in 2017**, and the year is set to close with a **1.5% rise in GDP**. In 2018, the trend should moderate slightly, to 0.9%. The most notable absentee in Japan's macroeconomic outlook remains inflation, which is still way below 2% and will remain so for the foreseeable future. As a result, monetary stimulus will continue, boosting the expansive effects of fiscal policy and shoring up investments. The Bank of Japan (BoJ) is the only central bank in the industrialised countries to keep its entire toolkit of unconventional monetary policies, namely bond purchases and zero interest rates, in play for the entire forecasting horizon. Above-potential growth combined with zero inflation will enable the central bank to continue with its efforts to solve the Japanese debt problem: in a few years' time, most JGBs will be in the BoJ's portfolio (currently 40%), and Japan will be the industrialised country with the lowest ratio of debt held by the public/GDP.

1. Macroeconomic outlook: economy running at full throttle. The outlook for the Japanese economy is positive for 2017-18, with above-potential growth forecast: estimated at 0.8% by the Cabinet Office and 0.5-1% by the BoJ. The picture has not changed since June, with growth supported by all components of both domestic and foreign demand. Since the end of 2016, manufacturing activity, investment spending and loans have picked up the pace again (see Figs. 1, 3 and 4) in the wake of the yen's depreciation and a stronger international economy, and the third-quarter signs are positive. **Companies' capital investment** stalled in 2Q, due to the slowdown in some key sectors (transport, chemicals and IT). However, surveys maintain their expectations of activity and capital spending growth; Reuters Tankan has returned to its pre-crisis levels. Investment is forecast to grow by **3.1% in 2017**, thanks to its strong finish at the end of 2016 and moderate trend this year. In subsequent years, corporate investment is likely to grow by an **average of 1-1.5%**, thanks to the continuation of expansionary financial conditions and buoyant domestic and international final demand. **Residential investment**, which was positive in the first half of 2017, will probably now slow (4.5% in 2017 and 1.2% in 2018).

Consumer spending was a major driver of first-half growth (0.4% qoq in 1Q and 0.8% qoq in 2Q), after a generally weak 2016. The forecast for the next few quarters is for more moderate and sustainable growth, averaging around 0.2% qoq in both the second half of this year and in 2018. The **labour market** is supporting household spending: the continuing improvement in employment and the achievement of full employment are underpinning the positive trend in consumer spending, but it is still curbed by **two factors**. 1) On the one hand, **real wage growth is still close to zero** and not accelerating, despite clear excess demand in the labour market. The unemployment rate (2.8% in July) is the lowest since June 1994 and the job-to-applicants ratio (1.52 in July) is the lowest since February 1974, but real wage growth continues to fluctuate around zero (see Figs. 6 and 7). In part, the recent increase in the number of women in the workforce (Fig. 5) and immigration (+40% since 2013, with the foreign population up from 0.6% of the total population in 1990 to 1.8% at end-2016), has helped expand labour supply, reducing salaries accordingly. 2) The second factor prompting continued consumer caution on spending is the expectation of the **next consumption tax hike**, anticipated to be in October 2019. The savings rate rose in response to the last rate hike (Fig. 8) and shows no sign of falling.

2. Fiscal policy in 2017-18 is set to be slightly expansionary. In July, the government revised its target for the primary balance in 2020 to 1.3% of GDP, from its previous target of reducing it to zero. The prime minister indicated that the government's main objective is now to reduce the debt/GDP ratio rather than concentrate on the primary balance. The 2017 requirement should be broadly in line with that of 2016, at JPY 34Trn (less than half the BoJ's annual JGB purchases). The Cabinet Office expects to reduce the **debt/GDP** ratio from its current 189.5% to 179.3% in 2020 and 163% in 2025. The prospect of a consumption tax hike in October 2019 is maintained in the current plans, but another postponement has not been ruled out, should the debt/GDP ratio continue to fall.

3. Inflation and monetary policy: no news. Inflation continues to show no signs of life, despite the currency depreciating, full employment being reached and the output gap closing. According to the BoJ, the failure of prices to recover is partly because the expectation that prices and wages will be virtually flat has become "deeply rooted" in the behaviour and decision-making processes of companies and individuals.[11] In July, the central bank downgraded its projections for 2017-18 (by three-tenths and two-tenths of a percentage point to 1.1% and 1.5% respectively); however, it continues to forecast a gradual rise in inflation towards 2% in 2019, driven by the improvement in the output gap and rising medium- to long-term expectations. The reason given by the BoJ is the probable rise in import prices, salaries and companies' sales prices in the wake of the ongoing reduction in unused resources in the next two years. The risks to the prices trend highlighted in the July six-monthly Outlook are, however, to the downside: expectations of stable prices becoming more entrenched, poor response of certain price categories (services, administered prices, rented housing) to the output gap and possible yen appreciation. In light of the expected changes in the activity and prices outlook, the BoJ has kept monetary policy unchanged (and will probably continue to do so) until 2019, with the introduction of "Quantitative and qualitative easing (QQE) with yield curve control". Yield curve control enables it to maintain expansionary conditions by reducing the costs of private investment, limiting the crowding out effects of public spending and improving the public finances. QE continues to reduce the share of JGBs held by the public (by the banks, in particular, freeing up assets to increase lending) and to shift public debt into its own portfolio. In March 2017, the BoJ held 40% of total JGBs. The "qualitative" component of QQE shows the BoJ's willingness to continue monetary expansion. At this rate, the problem of Japanese debt might not be significant in a few years' time, given that each year the BoJ purchases more than double the net issues of the government, which raises funds at zero rates.

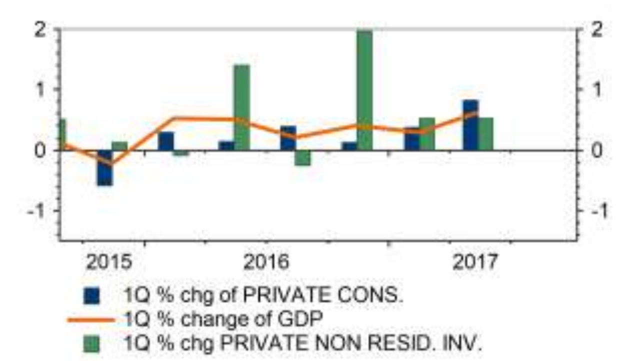
Forecast Table

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.5	0.9	1.0	1.0	1.7	1.4	1.6	1.5	1.4	1.2	0.8	0.8
q/q annual rate				2.0	0.9	1.6	1.2	2.5	0.6	1.2	0.5	0.9	0.7
Private consumption	0.4	1.5	1.0	0.6	1.6	0.5	1.5	3.4	1.0	1.0	0.7	0.8	0.9
FI - private nonresidential	1.4	3.1	1.2	5.7	-1.0	8.1	2.1	2.1	2.2	2.3	0.6	0.6	0.3
FI - private residential	5.5	4.6	1.2	13.5	11.8	0.9	4.0	5.1	1.4	1.2	0.8	0.5	0.8
Government investment	-2.9	2.5	2.1	-2.5	-3.4	-9.2	1.5	26.1	1.5	-0.3	-0.4	2.0	1.5
Government consumption	1.3	0.3	1.3	-5.1	0.9	0.1	-0.2	1.6	1.6	1.6	1.6	0.8	0.8
Export	1.1	5.0	1.4	-3.4	8.7	13.1	8.0	-1.9	1.2	0.9	0.5	3.0	2.8
Import	-2.3	3.5	2.5	-4.6	-0.9	5.5	5.4	5.7	2.6	2.3	2.3	2.1	2.2
Stockbuilding (% contrib. to GDP)	-0.3	-0.4	-0.1	1.4	-1.7	-0.6	-0.5	0.0	-0.5	0.1	0.0	-0.1	-0.2
Current account (% of GDP)	3.7	3.6	3.4										
Deficit (% of GDP)	-4.6	-5.2	-5.6										
Debt (% of GDP)	222.3	225.3	225.9										
CPI (y/y)	-0.1	0.4	0.5	-0.4	-0.5	0.3	0.3	0.3	0.4	0.4	0.1	0.6	0.6
Industrial production	-0.2	3.9	1.6	-1.5	1.0	2.8	4.0	5.8	3.6	2.2	2.4	0.7	1.7
Unemployment (%)	3.1	2.8	2.6	3.2	3.0	3.1	2.9	2.9	2.8	2.7	2.7	2.6	2.5
JPY/USD	108.8	112.2	116.0	107.9	102.4	109.6	113.6	111.1	111.0	112.9	114.6	115.6	116.6

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

[11] https://www.boj.or.jp/en/mopo/outlook/gor1707b.pdf

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



Source: Thomson Reuters-Datastream

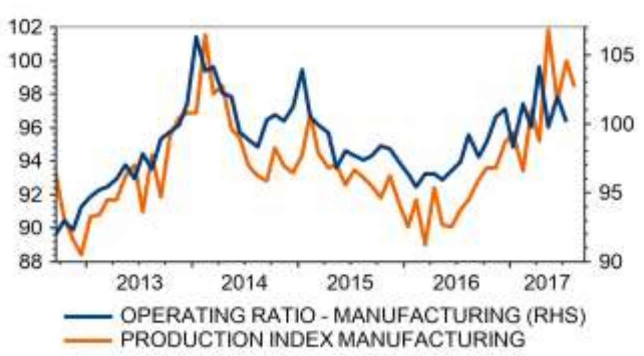
Fig. 2 – Monetary policy pushes up growth, but not inflation

Source: Thomson Reuters-Datastream

Fig. 3 – Business investment up, thanks to increased corporate earnings

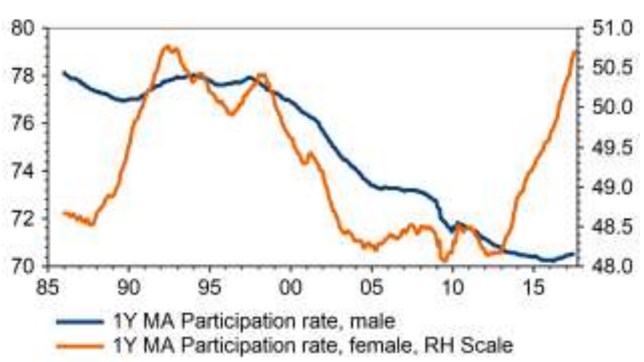
Source: Thomson Reuters-Datastream

Fig. 4 – Industrial output is rising sharply



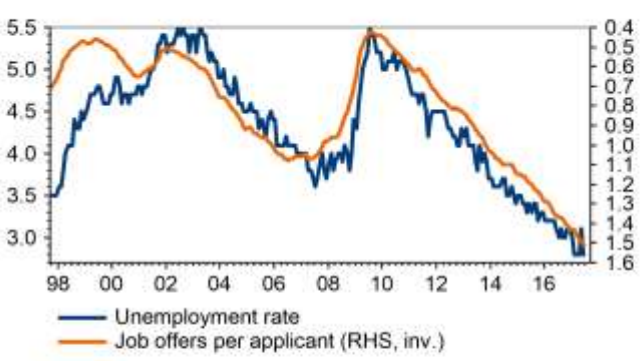
Source: Thomson Reuters-Datastream

Fig. 5 – Women participation skyrocketing



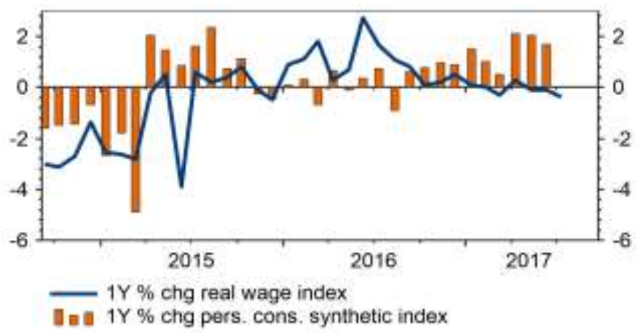
Source: Thomson Reuters-Datastream

Fig. 6 – If this isn't full employment, what is?



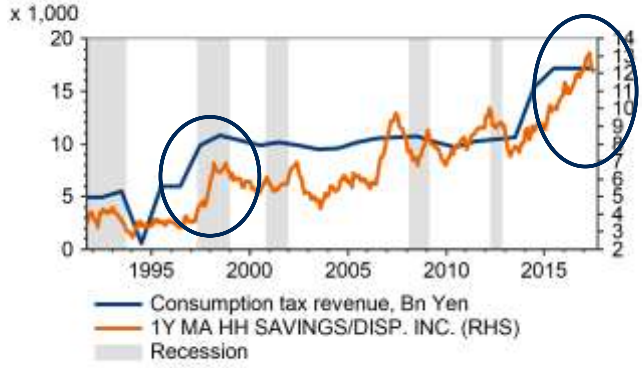
Source: Thomson Reuters-Datastream

Fig. 7 – Moderate recovery in consumption despite weak real wage growth



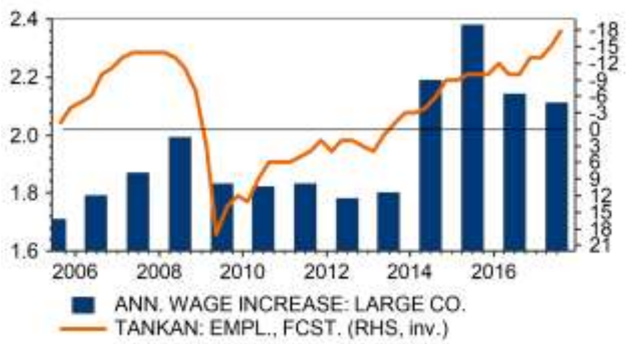
Source: Thomson Reuters-Datastream

Fig. 8 – Propensity to save on the rise after consumption tax hikes



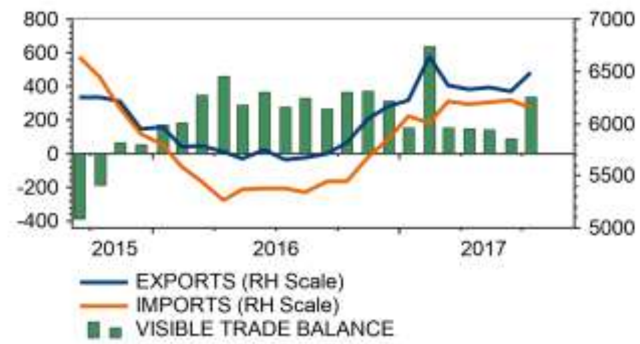
Source: Thomson Reuters-Datastream

Fig. 9 – Contractual wages weak, even with excess labour demand



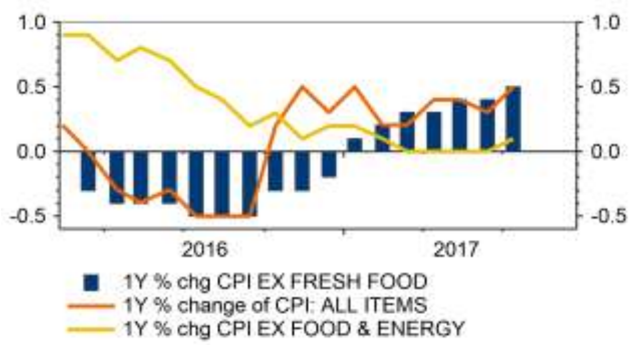
Source: Thomson Reuters-Datastream

Fig. 10 – Positive trade balance



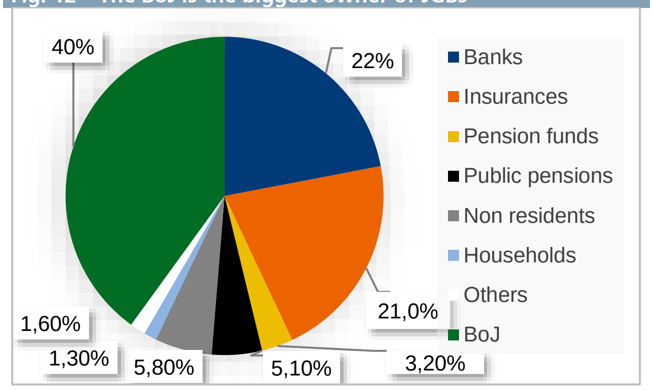
Source: Thomson Reuters-Datastream

Fig. 11 – Inflation: still a long way from 2%



Source: Thomson Reuters-Datastream

Fig. 12 – The BoJ is the biggest owner of JGBs



N.B.: figures at end-March 2017; total JGBs: JPY 967.6Trn. Note: total JGB+Tbill = JPY 1,082.9Trn. Non-residents hold 51.9% of the T-bills. Average life of debt is 8 years and 8 months.
Source: Ministry of Finance

China: waiting for the forthcoming Congress

Silvia Guizzo

- Exceeding our expectations, **GDP rose by 6.9% yoy again in 2Q17,** with quarterly growth of 1.7% qoq. While growth remained stable in the industrial sector and slowed only slightly in the services sector, it rose from 3% to 3.8% in the agricultural sector. In the services sector, transport and storage accelerated, while other segments, especially real estate and financial intermediation, slowed. Company earnings data and the PMIs' performance in the last three months have confirmed that most of the improvement in the industrial sector was again concentrated in the state and large company's sectors. Overall, domestic orders improved and corporate and consumer confidence remained high. The **real data,** however, revealed a **slight slowdown** in economic activity during the summer.

- The authorities' repeated intention of limiting house price rises and, more generally, of containing financial risks, foreshadows higher interest rates in the next few quarters and a slowdown in credit, which will gradually remove investment support. **We are upgrading our growth forecasts** by two-tenths of a percentage point **compared with our June estimates,** in line with a better-than-expected first half**, but we maintain our scenario of a moderate slowdown in the economy, from 6.7% in 2017 to 6.3% in 2018.**

- After fluctuating between 1.5% and 1.4% for three months, consumer price inflation rose to 1.8% yoy in August. **Inflation is expected to rise slightly in the next few months,** especially in the services sector. A favourable base effect, combined with a **fall in some food prices, should, however, help contain consumer price inflation at an annual average of 1.6% in 2017 and limit the increase to 2.3% in 2018.**

- The 19th National Congress of the Communist Party of China will begin on 18 October. In light of the political appointments of officials close to the President in some important provinces (Chongqing, Xinjiang, Beijing, Tianjin, Shanghai, Guangdong) and the recent replacements of senior military personnel (new commanders of the army and air force), the congress is expected to consolidate Xi Jinping's position as core leader and confirm him as party secretary for a second term, providing continuity in the economic policies followed so far.

- The biggest surprise in the summer was the further appreciation of the yuan against the dollar, proportional to the general decline of the greenback, which was more marked against the main currencies. The higher fix of the yuan's rate and the removal of some of the measures imposed in 2016 to support the currency lead us to believe that the Chinese authorities are opposed to a further rise. We expect a **moderate correction of the USD/CNY exchange rate to 6.70 at the end of 2017 and 6.90 in a year's time,** with fluctuations in the 6.50-6.90 range.

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
PIL (prezzi costanti)	7.8	7.8	7.3	6.9	6.7	6.7	6.3
Consumi privati	9.6	7.9	8.2	8.1	7.9	7.4	7.4
Consumi pubblici	6.2	5.1	3.7	7.8	9.2	7.3	4.7
Investimenti fissi	8.7	9.3	6.9	7.3	6.6	5.6	4.7
Esportazioni	5.7	7.9	5.7	0.1	1.8	10.3	4.3
Importazioni	6.7	10.6	7.7	0.7	3.8	9.2	6.1
Produzione industriale	8.4	8	7.4	6.2	6.1	6.1	5.4
Inflazione (CPI)	2.6	2.6	2.0	1.4	2.0	1.6	2.3
Tasso di disoccupazione (%)	4.1	4.1	4.1	4.0	4.0	4.0	4.0
Salari medi	14.4	11.8	10.8	9.5	8.3	7.7	7.5
Tasso interbancario a 90gg (media) (%)	4.2	4.9	4.8	3.8	3	4.5	4.2
Cambio USD/CNY (media)	6.31	6.15	6.16	6.28	6.64	6.77	6.84
Saldo delle partite correnti (md di CNY)	1360	912	1458	1912	1296	1548	1621
Saldo delle partite correnti (% del PIL)	2.5	1.5	2.3	2.8	1.7	1.9	1.8
Saldo di bilancio* (% del PIL)	-3.4	-3.5	-3.6	-4.4	-4.6	-4.7	-4.4

N.B.: Percentage change versus previous period - except where otherwise indicated; *IMF Article IV August 2017. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Real growth and inflation

Exceeding our expectations, GDP rose by 6.9% yoy again in 2Q17, with quarterly growth of 1.7% qoq, up from growth of 1.3% qoq in 1Q. While growth remained stable in the industrial sector and slowed only slightly in the services sector, it rose from 3% to 3.8% in the agricultural sector. In the services sector, transport and storage accelerated, while other segments, especially real estate and financial intermediation, slowed.

The PMIs' performance in the last three months is consistent with a consolidation in the industrial and manufacturing sector. The Markit PMI, after hitting a low of 49.6 in May, rose gradually thereafter, reaching 51.6 in August, moving back into step with the figure of the National Bureau of Statistics (NBS), which has been fluctuating around 51 since October 2016. Both surveys point to a sharp increase in domestic orders. Most of the improvement in the industrial sector was, however, again concentrated in the state and large companies sectors; in the latter, this probably relates to the heavy industry segment, which benefited from both the recovery of the real estate sector in 2016 and 1Q17, and the rise in raw materials prices. The increase in industrial companies' profits was much more pronounced in state-owned and majority state-owned companies, and production was markedly higher in state-owned companies than private companies.

Total industrial output rose by 6.8% cum. yoy in the first eight months of 2017, although in the last three months it slowed to a low of 6% yoy in August; this was the result of the slowdown in private industry, which probably suffered a temporary blip due to the more stringent implementation of environmental regulations on pollutant emissions from the summer, a factor also cited in the Markit survey as a cause of the increase in delivery times. The production of cement, as well as that of steel and iron products, also dropped; this could be associated with the decline in real estate investment compared with the early-year peaks, rather than with the cuts in production capacity in sectors with excess supply (steel production has been accelerating in the operational plants, driven by the rise in raw materials prices). This theory is supported by the slowdown in retail sales in the construction materials, household appliances and furnishings segments.

Overall, retail sales recorded a moderate slowdown (10.1% yoy in August, from 11% in June), partly due to weak car sales. Other segments, such as clothing and cosmetics, continue to show good rates of growth, as do online sales. Although it corrected slightly, consumer confidence remained high, partly thanks to the improvement in the labour market situation. The number of new jobs rose in 2Q and the Manpower survey, after being stable for four quarters, indicated an increase in companies' hiring intentions in 4Q, especially in the services sector.

Capital investment continued to slow (from 8.6% cum. yoy in May to 7.8% cum. yoy in August in nominal terms) across both the state and private sectors. In real terms, the trend is much lower (around 1.5% cum. yoy in August), given the rise in production prices. The transport and storage sector continues to record very high investment growth rates (14.3% cum. yoy in August), although they are falling slightly from their spring peaks. The same trend has also been evident in the manufacturing and real estate sectors. Investment in the construction sector continues to record year-on-year falls (-25.1% cum. yoy in August) while some services segments (water management, environment, education, the arts) maintain a sustained pace of growth. Services sector production remained stable at 8.3% yoy during the summer and, despite a moderate fall in the NBS reading in the same period, the services PMI is still higher than the figure for the manufacturing sector. The real estate sector declined slightly overall: building permits and residential land sales slowed during the summer, and house prices slowed sharply in first-tier cities – the cities most affected by government restrictions – while the situation was better in second- and third-tier cities. The authorities succeeded in their intention to reduce the rate of unsold housing, which, according to NBS data, fell from its peaks of nearly five months in early 2016 to 2.7 months in July. However, IMF analysis, which uses local data, while confirming the fall in the rate for second-tier cities in particular, puts it close to two years at national level, and confirms the higher rate of unsold housing for third-tier cities (nearly three years).

Foreign trade slowed between May and August, partly due to an unfavourable base effect concentrated in August. Imports slowed from 15.3% 3m yoy in May to 13.8% 3m yoy in August, but this was better than the performance of exports (10.4% 3m yoy in May vs 7.9% 3m yoy in August). Seasonally-adjusted monthly figures show that imports stabilised in the last three months and exports fell slightly in both value and volume terms. Volumes of metal imports stabilised. The **foreign orders** component of the manufacturing PMI, although still above 50, recorded varying trends over the last three months depending on the survey: the National Bureau of Statistics showed it falling while the Markit survey indicated a rise. The outlook for foreign demand seems to be one of stabilisation: in Asia, the aggregate foreign orders component gradually rose from its May lows, and then stabilised in July and August due to the fall in India, Japan, Hong Kong, Taiwan, and, in particular, Australia and the Philippines.

After fluctuating between 1.5% and 1.4% for three months, **consumer price inflation** rose to 1.8% yoy in August. The increase is partly due to a highly unfavourable base effect and partly due to the rise in food prices, especially fresh vegetables (+9.7% yoy), and in the prices of medicines and health services (+5.9% yoy), and household utilities (+2.7% yoy). The increase in the price of some foods was caused by temporary factors such as the particularly warm weather and the typhoons that hit the coastal regions in August, and should correct itself. Inflation net of food and energy (2.2% yoy in August) has remained broadly stable within the 2.1-2.2% range since April, and stands at its highest level since the end of 2011. **Producer price inflation,** after three months at 5.5%, rose to 6.3% yoy in August, pushed up by the rise in raw materials prices. Inflation is expected to rise slightly in the next few months, especially in the services sector. A favourable base effect, combined with the fall in some food prices, should, however, help **contain consumer price inflation at an annual average of 1.6% in 2017 and limit the increase to 2.3% in 2018.**

Economic, monetary and exchange rate policy

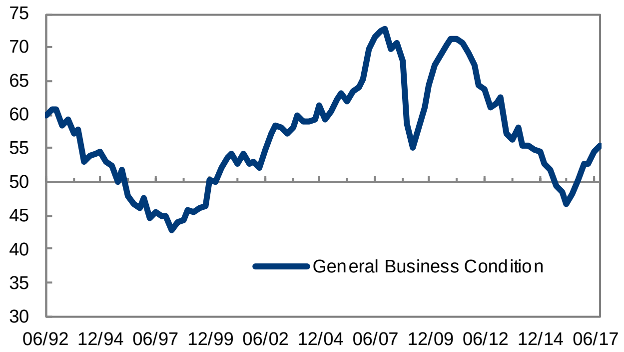
The 19th **National Congress of the Communist Party of China** will open on 18 October. The congress, which meets every five years, is particularly important as five of the members of the Politburo Standing Committee have reached the official retirement age of 68 and could be replaced. In light of the political appointments of officials who are very close to the President in some important provinces (Chongqing in 2017, Xinjiang, Beijing and Tianjin in 2016, Shanghai and Guangdong in 2012) and the recent replacements of senior military personnel (new commanders of the army and air force), the congress is expected to consolidate Xi Jinping's position as core leader and renew his mandate for a second term, providing continuity in the economic policies outlined so far. The shake-up at local level includes the surprising appointment of Chen Min'er, who was named Communist Party chief in Chongqing in July, replacing Sun Zhengcai; the latter was once regarded as one of Xi's greatest rivals and a contender for promotion to party secretary but has recently come under investigation by the Central Commission for Discipline Inspection (responsible for discipline in the party and the military) and the Central Leading Group for Inspection Work (the anti-corruption agency), led by Wang Qishan, main standard-bearer of the anti-corruption campaign launched by Xi. Wang is considered by many to be the most important political figure after Xi and it is by no means certain that he will be replaced. He is the youngest of the Standing Committee members to have reached retirement age. Moreover, at the sixth plenary session of the 18th CPC Central Committee in October 2016, the members of the central committee asked for the methods of promotion to be corrected, based on only one of the four criteria used (votes obtained, assessment of work carried out, GDP growth rates in the regions they presided over and chronological age), paving the way for the unwritten rule to be ignored. The replacement of Wang seems to be a particularly delicate issue; it is thought that if he remains, this would strengthen President XI's position, enabling him to aim for a third term, rather than step down after the customary two terms. In the past year, he, too, along with other politicians, has faced allegations (which have never been formalised) of corruption, by Guo Wengui, a controversial billionaire entrepreneur exiled for some years in the United States and considered to be a megaphone for Wang's opponents. Wengui himself is subject to various allegations and has an international warrant for arrest requested by the Chinese authorities hanging over him. **Wang** is regarded as an excellent politician and competent economist, both in China and internationally, to such an extent that many analysts expected him to become prime minister in 2012; it might not therefore be a complete surprise, albeit not highly likely, if, at this next congress, there is a "government reshuffle", which could see him return in some other role that is more closely related to the economy.

There has been little news on the economic policy front over the summer; the most important news includes the publication of the national plan for the development of Artificial Intelligence by 2025, and guidelines on reducing electricity costs for industry and on standardising the financial management of state-owned companies. There was more activity in the purely financial arena. The Chinese authorities recently reiterated at the National Financial Work Conference, a government conference on finance held every five years, that the **reduction of financial and systemic risks** will continue to be the **main objective** for the next five years. The central bank will therefore play a greater role in the macro-prudential management and prevention of risks. The conference also resolved to create a Financial Stability and Development Committee within the State Council to co-ordinate reforms and regulatory policy for the financial markets and the non-banking financial sector, but the finer details were not provided. The PBOC stated that it is considering including the capital positions of the large-scale online finance companies in its macro-prudential assessment of risks. Meanwhile, during the summer, the authorities repeated their intention and/or issued new regulations and guidelines in the direction of greater openness to foreign investors, including in the banking sector, and on the strict control of speculative and money laundering activities. Controls related to the foreign branches of Chinese banks, foreign investment in sectors such as real estate, entertainment and sport, hotels, and areas not considered to be in line with the country's strategic development, as well as the stringent restriction of the use of digital currencies, which could soon lead to a complete ban.

New bank **lending** rose again in the summer, resulting in only a slight increase in the stock (12.9% yoy in May to 13.1% yoy in August); likewise, the social financing aggregate, although it slowed slightly when local government issues are included. Long-term loans to households, broadly consisting of mortgages, continued to slow, while long-term loans to companies picked up. The slowing mortgage trend seems to be linked to the moral suasion implemented by the authorities, who do not want to trigger a new phase of house price rises. The overnight rate, after rising between end-June and end-August to a high of 2.92%, started falling again, and reached 2.70% in mid-September. Money market rates with maturities of up to one year fell from their mid-June peaks, returning to their previous highs seen in March. The authorities' intention seems to be to keep rate hikes within a limited but higher range than at the start of the year. The range could be raised further in the next few quarters in keeping with the intention to limit house price rises and contain financial risks. We therefore think that lending will continue to slow, thereby gradually withdrawing investment support. **Although we have upgraded our growth forecasts by two-tenths of a percentage point,** in line with a better-than-expected first half, **we maintain our scenario of a moderate slowdown** in the economy, **from 6.7% in 2017 to 6.3% in 2018.**

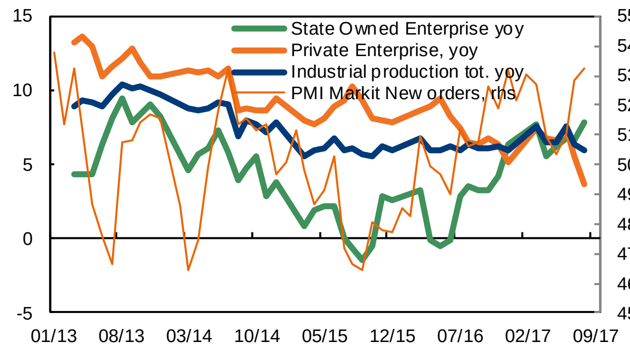
The biggest surprise in the summer was the further appreciation of the yuan against the dollar, proportional to the general decline of the greenback, which was more marked against the main currencies. The USD/CNY exchange rate fell from 6.80 in mid-June to a low of 6.48 on 9 September, following the trajectory of the dollar effective exchange rate, which depreciated by 5.9% in the same period. The yuan was also supported by the improvement in capital flows, which led to an increase in foreign currency reserves. The higher fix of the yuan's exchange rate and the withdrawal, on 9 September, of some of the measures imposed in 2016 to support the currency, such as a reserve ratio of 20% for foreign currency positions and reserve requirements for offshore yuan deposits, lead us to believe that the Chinese authorities are opposed to a further rise. We think the dollar's depreciation (10.1% from the start of the year to mid-September) was excessive and the market is too cautious in discounting (not even wholeheartedly) one Fed hike by the end of 2018. We expect the dollar to partially retrace its steps during 2018 and **the USD/CNY exchange rate to make a moderate correction to 6.70 at the end of 2017 and 6.90 in a year's time,** with fluctuations in the 6.50-6.90 range.

Business confidence



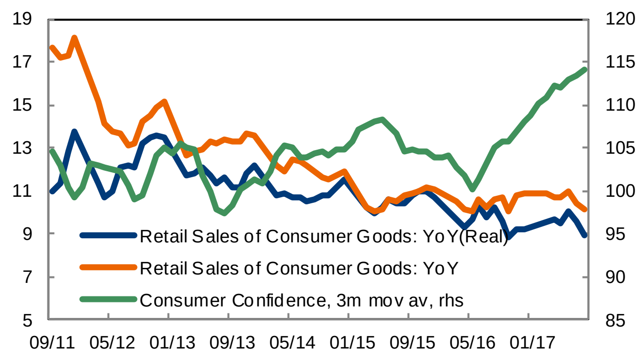
Source: PBOC's Industrial Enterprise Survey by CEIC

Industrial output and orders



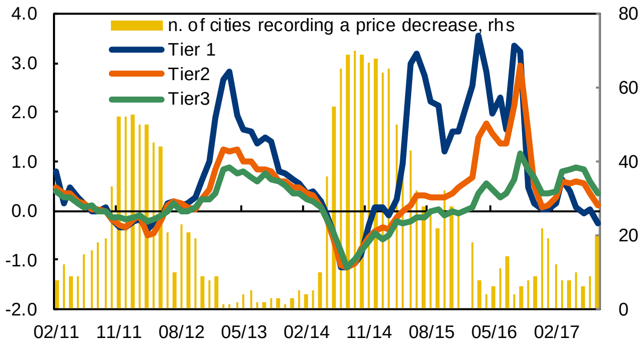
Source: CEIC, IHS Markit.

Retail sales



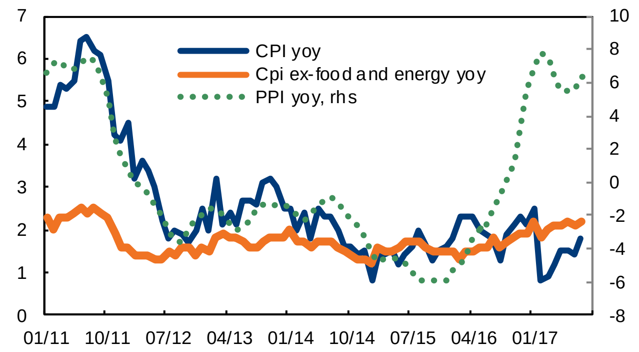
Source: CEIC

Property prices



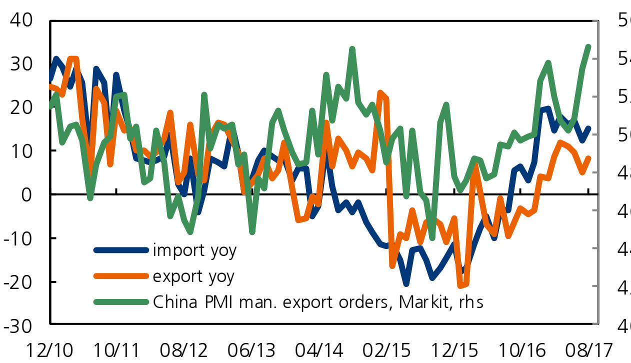
N.B. mom average change 70 cities, primary market. Source: Intesa Sanpaolo chart from CEIC data

Inflation



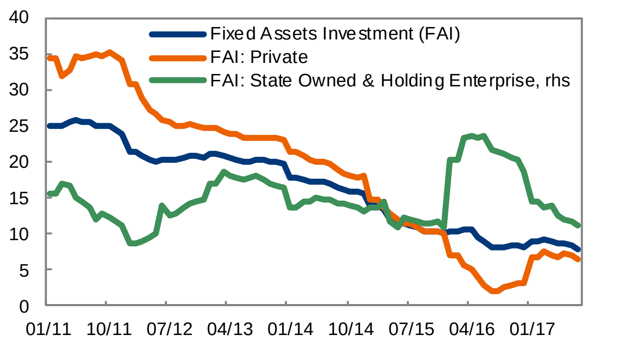
Source: CEIC

Foreign trade



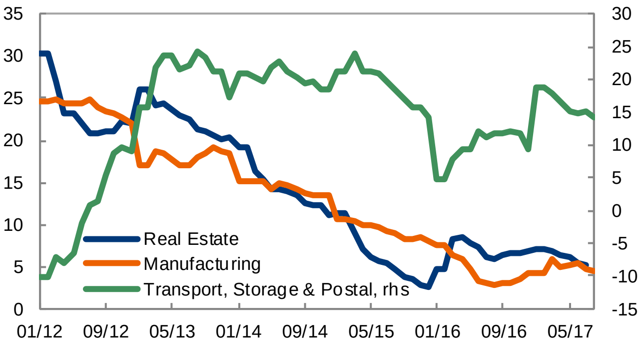
NB: seasonally adjusted data, 2m yoy. Source: Intesa Sanpaolo chart from CEIC and Markit data

Nominal investment, ytd yoy



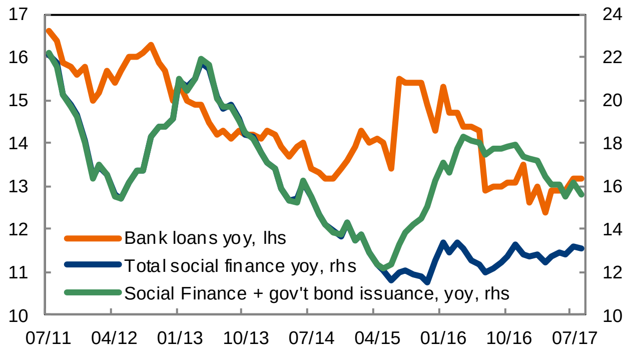
Source: CEIC

Investment by sector, ytd yoy



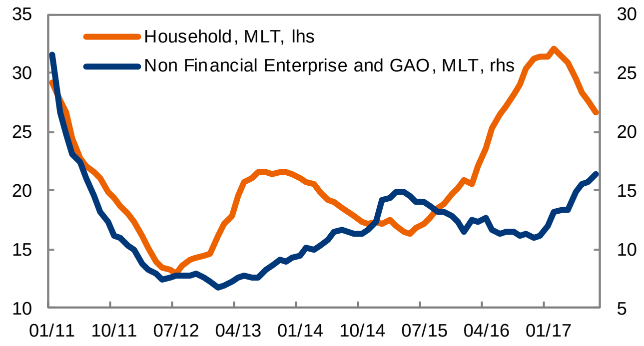
Source: CEIC

Lending is stable



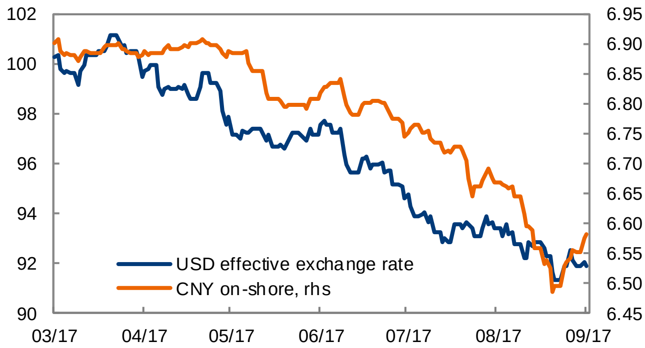
Source: Intesa Sanpaolo chart from CEIC data

Domestic bank loans, yoy



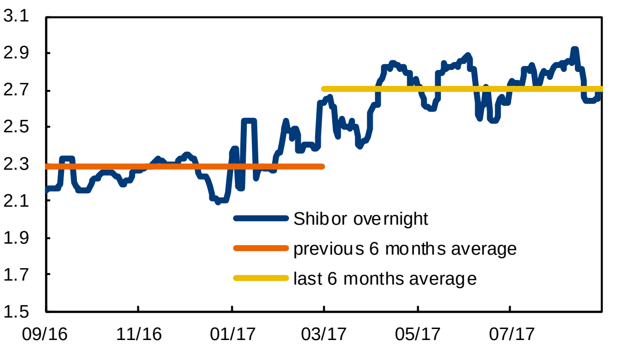
Source: CEIC

The currency is rising



Source: Bloomberg

Money market rates are stabilising



Source: CEIC, Bloomberg

India: a second temporary slowdown

Silvia Guizzo

- **GDP** growth slowed further to 5.7% yoy in 2Q versus 6.1% in 1Q and 7.9% for 2016 overall. Consumer spending, which has so far been the main driver behind growth, decelerated in tandem with a further drop in consumer confidence. The contribution of net exports was negative, while capital investment was up 1.6% yoy, bucking the downward trend in 1Q. On the supply side, the upswing in the services sector was not enough to fully offset the slowdown in the agricultural and industrial sectors, and in manufacturing in particular. Over the summer, macroeconomic data showed a rise in imports, but a **weakening in economic activity**, including in the services sector as well, and consumer confidence declined more sharply than business confidence.

- A highly favourable base effect and further slowdown in food and fuel prices brought **consumer price inflation** to a low of 1.5% yoy in June. Meanwhile, inflation net of food and energy fell below 4% from June for the first time in over 24 months, paving the way for the RBI's 25bp interest rate cut on 2 August. As these favourable conditions faded, inflation climbed to 3.4% yoy in August, a trend that will continue over the next few months. **The annual average for inflation is expected to be 3.4% in 2017, rising to 5% in 2018.**

- The weakening economy has resurrected the political debate on the need to shore it up through **fiscal policy**. The government is currently considering an **additional stimulus** of some INR 400-500Bn which could, however, raise the deficit for FY 2017-18 above the target of 3.2% of GDP, further deferring the projected path of consolidation. Against this backdrop, and with inflation on the rise, we think that the Reserve Bank of India (RBI) will hold **rates steady** over the next few quarters, with a possible increase during the second half of next year.

- Given that 1H economic growth was lower than we expected and there are downside risks to the performance of the agricultural and consumption sectors, we have **downgraded our growth forecast for 2017 to 6.4% from 7.4%**. We feel that the dampening effects of the introduction of the Goods and Services Tax (GST) will be temporary, as they were with demonetisation. Thanks to the support of fiscal policy, and a slow and moderate recovery in investments, **the economy could resume growth in the next few quarters, leading to GDP growth of 7.2% in 2018**.

Macro forecasts

	2012	2013	2014	2015	2016	2017E	2018E
GDP (constant prices)	5.5	6.1	7	7.5	7.9	6.4	7.2
Private consumption	6.2	6.6	6.3	5.6	9.2	8.2	7.6
Public consumption	4.4	2.6	6.9	1.3	15.1	13.3	6
Fixed investment	6.8	2.5	2.5	5.1	5.1	1.1	4.7
Exports	9.6	4.2	6.6	-5.9	1.2	4.8	7.4
Imports	11.6	-6.3	0	-5.8	-1.7	13.6	2
Industrial output	0.7	1.9	4.6	2.6	5.8	4.3	7.5
Inflation (CPI)	9.4	9.9	6.6	4.9	4.9	3.4	5
Unemployment rate (%)	2.0	2.5	2.8	3.0	3.3	3.7	3.9
Average salaries	12.3	11.1	10.1	7.3	8.8	10.6	10.4
3-month MIBOR (average)	9.5	9.3	9.1	8	7.2	6.3	6.2
USD/INR exchange rate (average)	53.47	58.57	61.04	64.15	67.21	65.02	62.57
Current account balance (INR Bn)	-4893.2	-2779.6	-1661.2	-1450.6	-815.2	-4574.1	-3443.1
Current account balance (% of GDP)	-5.1	-2.6	-1.4	-1.1	-0.6	-2.8	-1.9
Budget balance (% of GDP)	-5.5	-5.5	-4.3	-3.4	-3.7	-3.5	-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

GDP growth slowed further to 5.7% yoy in 2Q versus 6.1% in 1Q and 7.9% for 2016 overall. Consumer spending, which has so far been the main driver behind growth, decelerated in tandem with a further drop in consumer confidence. The contribution of exports was negative, while capital investment was up 1.6% yoy, bucking the downward trend in 1Q. On the supply side, the upswing in the services sector, which was stronger in sectors more closely linked to the use of cash (and hence more hardly hit by the demonetization manoeuvre such as retail trade, restaurants, transport), was not enough to fully offset the slowdown in the agricultural and industrial sectors, and in manufacturing in particular.

A much sharper uptick in imports than exports in 2Q was responsible for the negative contribution made by exports. This trend lasted throughout the summer for the **foreign trade** of goods, particularly for imported goods net of oil, which, although slowing from their May peaks, continued to record double-digit growth (20% 3m yoy in August), with a consolidation in machinery imports (+10.8% 3m yoy in August). Despite a slight dip, the foreign orders component of the PMI also continued to hover around 51 during the last three months, indicating a stabilisation in foreign demand.

The RBI survey of industrial firms recorded a correction in the expectations component of **business confidence** for 3Q, although it is still at its highest for the last eight quarters. In the *Dun & Bradstreet* survey, this fall, which has continued over several quarters, was more pronounced, due to lower profit expectations, while both surveys showed order expectations to be holding up well. Over the summer, **industrial output** also slowed to 1.3% 3m yoy in July, dragged down again by the fall in the production of capital goods, but sustained by non-durable consumer goods, and electricity and gas generation. The implementation procedures for the Goods and Services Tax (GST, in effect since 1 July), particularly the bureaucratic and electronic procedures, were so onerous at the start that many companies postponed their orders. Indeed, the total orders component plummeted to 46.2 in July, but then returned to 51.5, confirming that the impact of the tax was temporary. The impact was greatest in the **services sector** as the PMI remained below 50 for the second consecutive month - although it did improve in August. But as expectations are still high, the sector outlook remains unchanged. Tourist sector revenues are still strong, supported by an ever-growing number of tourists, and mobile phone sales are on the rise as well.

After peaking at the end of 2016, **consumer confidence** continued to fall in 2Q, both in terms of consumers' assessment of the current situation, which had already fallen below the threshold of 100 (indicating pessimism) in 1Q, and their assessment of the outlook, which is a little higher. This decline is mainly due to the worsening of expectations regarding inflation and the labour market, which is partly confirmed by the Manpower survey. Taken all together, weaker confidence poses downside risks to consumer spending this quarter. The pick-up in car sales, particularly commercial and two- and three-wheeled vehicles, however, is a sign that demand in rural areas is recovering; this should also benefit from the farm loan waiver programme for farmers and the rise in agricultural product prices.

Despite the improvement in September, the patchy summer rains pose downside risks to **agricultural sector** performance. The Centre for Monitoring Indian Economy (CMIE) believes, moreover, that agricultural sector growth may have been overestimated thus far. This is because value-added in real terms is calculated using the prices at the height of the sales season. In 4Q16 and 1Q17, however, prices fell substantially, accompanied by the destruction of some crops. Thus we cannot rule out downward revisions to value-added in the agricultural sector once these aspects have been factored in.

The number of **industrial projects** submitted for approval to the Industry Ministry fell in the first eight months of the year compared with the same period in 2016, while the investment amount rose, albeit at a slower rate than in the first few months of the year. **Lending** grew slightly over the summer, but is still low (+5.3% yoy in August for loans to the non-food sector); this activity, which is close to historic lows, is being hampered by the rise in non-performing loans and by risk-averse financial institutions. Prospects for a recovery in **investments** therefore remain slim although the still-upbeat performance of machinery imports augurs well for a modest improvement during the year.

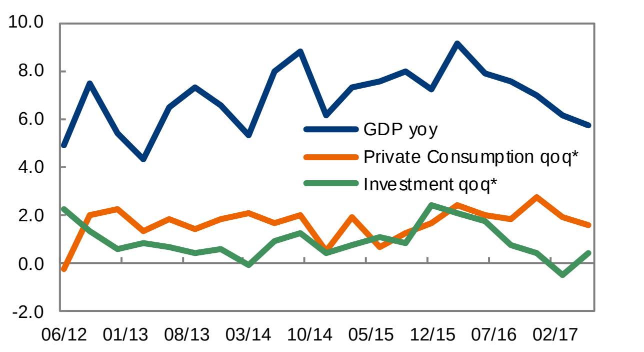
A highly favourable base effect and further decrease in the price of food and fuel brought **consumer price inflation** to a low of 1.5% yoy in June. Meanwhile, inflation net of food and energy fell below 4% from June for the first time in over 24 months, paving the way for the RBI's 25bp interest rate cut on 2 August. As these favourable conditions faded, inflation climbed to 3.4% yoy in August, a trend that will continue over the next few months. **The annual average for inflation is expected to be 3.4% in 2017, rising to 5% in 2018.** The risks to inflation are balanced, although there is considerable uncertainty about how they will develop. The downside risks derive from a much lower-than-expected price of oil. The upside risks come from applications for farm loan waivers for farmers and payments of allowances under the Seventh Pay Commission.

The weakening economy has resurrected the political debate on the need to shore it up through **fiscal policy**. The government is currently considering a further stimulus of around INR 400-500Bn, which should go towards recapitalising the public banks, with the aim of reinvigorating private investment and buoying exports. This measure could, however, raise the expected deficit for FY 2017-18 above the target of 3.2% of GDP, further deferring the projected path of consolidation. Given the uncertainty of receipts expected from indirect taxes in the future owing to the introduction of the Goods and Services Tax, the government seems to be seeking to raise funds from other sources, in particular from privatisations and disinvestments, although in the past they have often failed to meet expectations. The government target for FY 2017-18 is INR 725Bn, and to date it has only collected about INR 200Bn. It is therefore likely that the deficit target will be overshot, if only marginally. Against this backdrop, and with inflation on the rise, we think that the Reserve Bank of India will hold rates steady over the next few quarters, with a possible increase during the second half of next year.

The USD/INR **exchange rate** continued to be supported in the 64 range between April and August, hitting 63 once at the start of August and once in September, thanks in part to the dollar's general depreciation. The exchange rate then corrected, together with the stock market, on news of the additional fiscal stimulus and the possible overshooting of the deficit target. Capital inflows more than offset the current account deficit, which rose in 2Q due to higher imports and lower exports, leading to an accumulation of foreign currency reserves. **In the short term**, the lack of a recovery in exports, negative news on the fiscal front and a correction in the dollar will keep **downward pressure on the exchange rate**, which could return to 65-66 at the end of the year. **In the medium term**, however, the robust performance of the economy, indicators of external vulnerability and unchanged official rates are likely to support **further appreciation** to around 62 by the end of 2018.

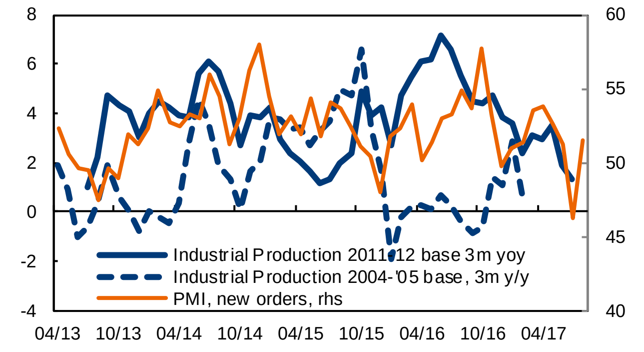
Given that 1H economic growth was lower than we expected and there are downside risks to the performance of the agricultural and consumption sectors, **we have downgraded our growth forecast for 2017 to 6.4% from 7.4%**. We feel that the dampening effects of the introduction of the Goods and Services Tax (GST) will be temporary, as they were with demonetisation. Thanks to the support of fiscal policy, and a slow and moderate recovery in investments, **the economy could resume growth in the next few quarters, leading to GDP growth of 7.2% in 2018** (7.6% for FY 2018-2019).

Growth impacted by slowdown in investments



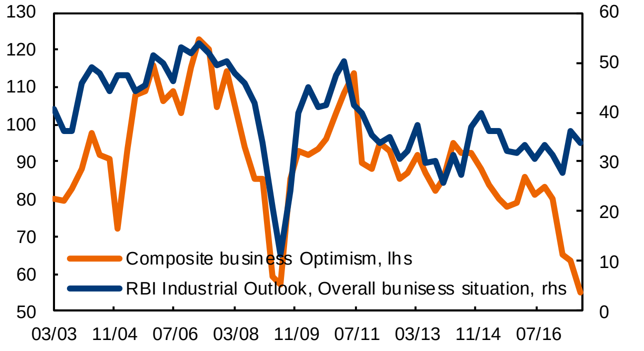
*Four-quarterly moving averages. Source: CEIC

Industrial output is slowing



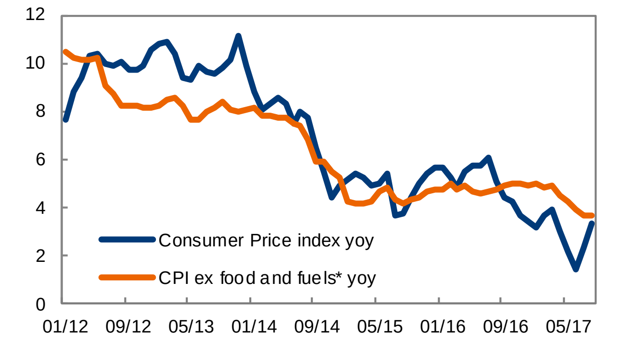
NB: Three-month moving average. Source: Markit, CEIC

Business confidence corrects



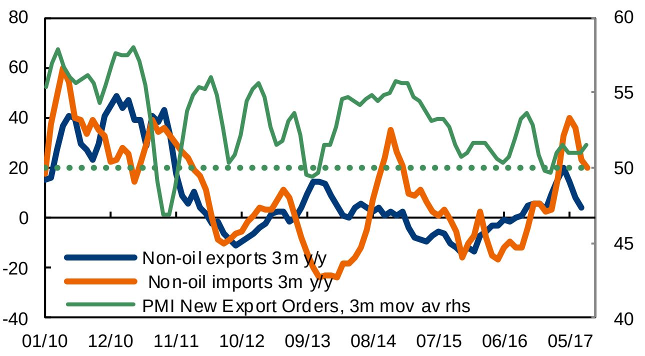
Source: CEIC

Inflation



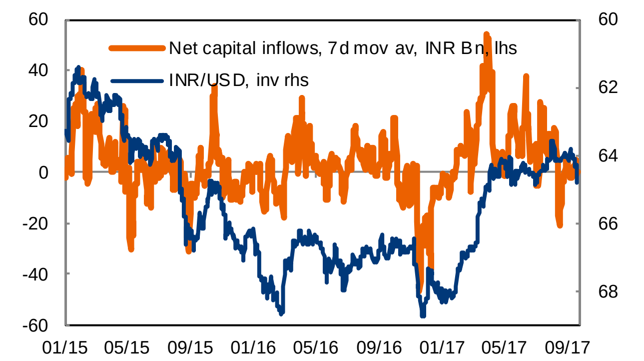
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Foreign trade



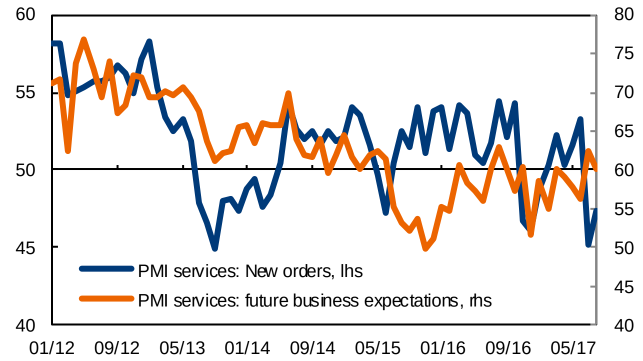
NB: Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Rupee and capital flows



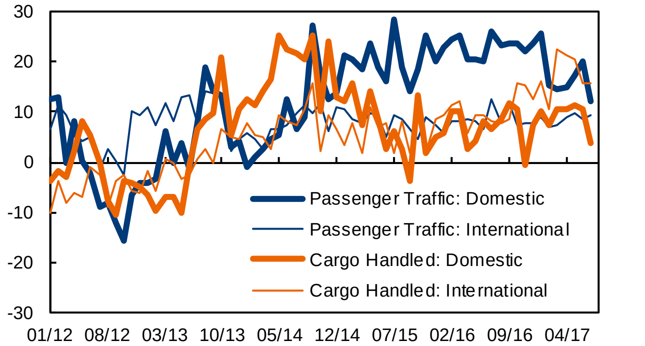
N.B.: (*) Net purchases by foreign institutional investors Source: CEIC

Services: PMI falling



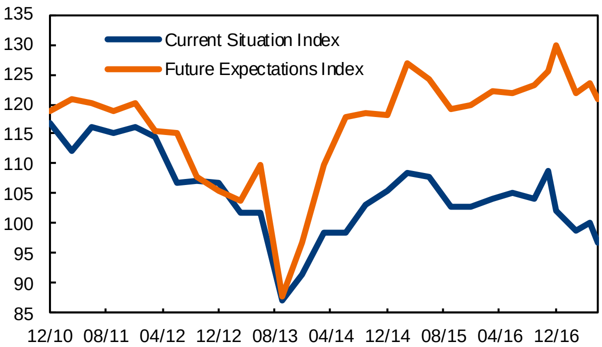
Source: Markit

Passenger and freight traffic



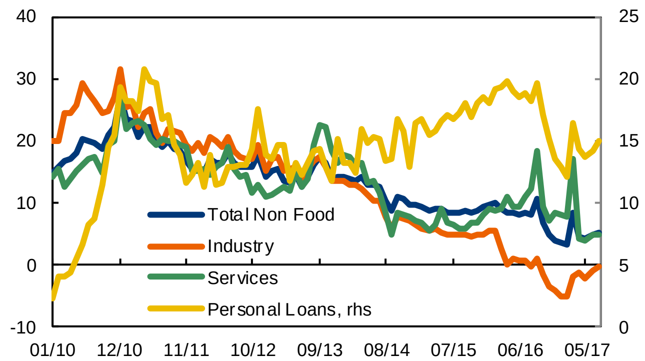
Source: CEIC

Consumer confidence declines



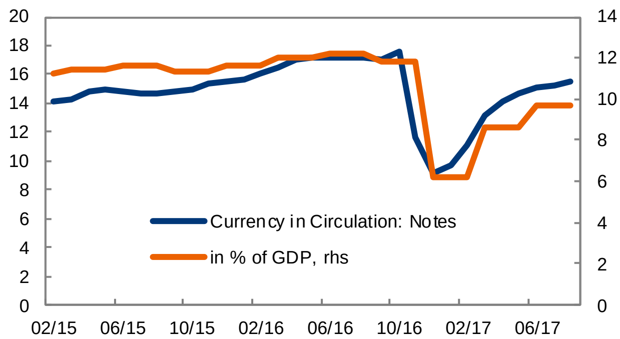
N.B.: Quarterly consumer confidence survey by the RBI Source: CEIC

Loans (% change yoy)



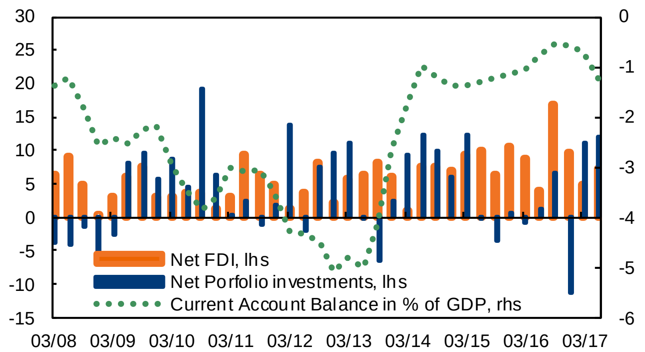
Source: CEIC

Bank notes in circulation (INR Trn)



Source: CEIC

Current accounts



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

Commodities: an autumn rich of potential surprises

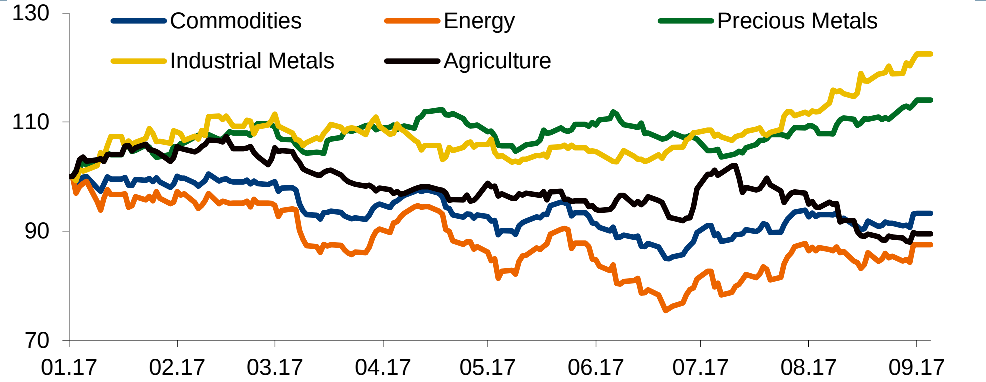
Daniela Corsini

Our macroeconomic scenario of moderate growth, continuing accommodative monetary policies and a relatively weak dollar, is favourable to commodities. We think, therefore, that the prices of the main commodities will mainly be driven by the supply and demand fundamentals. However, we highlight the risk that exogenous events (often with unpredictable consequences) may dramatically affect prices: the serious geopolitical risks in North Korea and the Middle East and the political scandals in the U.S. are just a few examples.

This summer, the high temperatures were accompanied by a rebound in most commodities prices:

- Industrial metals were pushed up by optimism about healthy demand in emerging countries and in some key sectors (e.g. the automotive sector, which is preparing for the rapid market penetration of electric vehicles).
- Prices of precious metals rose due to the resumption of geopolitical tensions, which fuelled demand for safe haven assets.
- In the energy segment, high seasonal consumption and satisfactory compliance with the cuts promised by OPEC and non-OPEC countries have enabled oil and European natural gas to recoup some of the losses recorded since the start of the year.
- The agriculture segment was the only one to record a fall, due partly to seasonal factors and partly to the easing of concerns over supply, especially with regard to certain soft commodities.

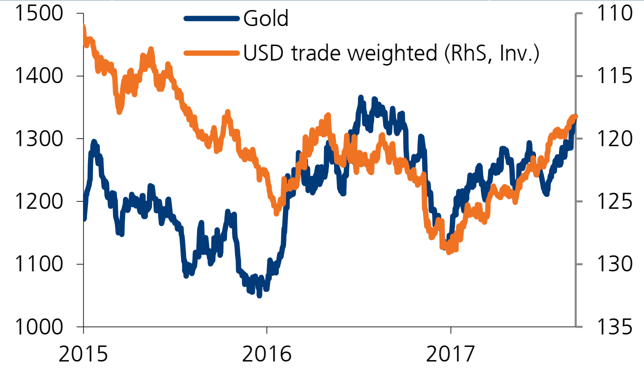
Year-to-date performance of the S&P GSCI Total Return indices



Source: Intesa Sanpaolo chart based on Bloomberg data

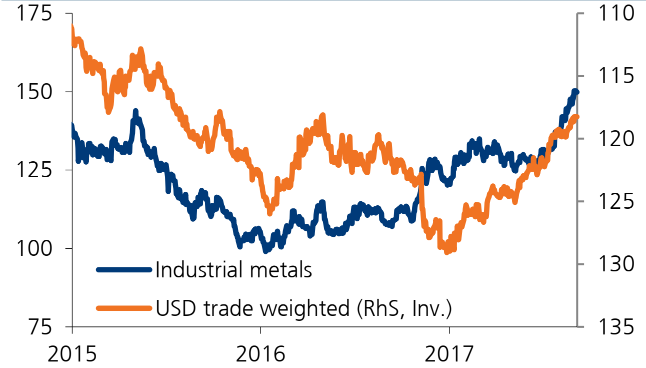
All segments benefited from the depreciation of the U.S. dollar, due to the combined effect of disappointing macroeconomic data in the United States, the Fed's continuing caution in implementing a more restrictive monetary policy, and the Trump administration's lack of success in pushing through the reforms promised in the electoral campaign, accompanied by political scandals and the departure of some key members of the presidential team.

Gold fixing in London and the dollar (trade-weighted)



Source: Intesa Sanpaolo chart based on Bloomberg data

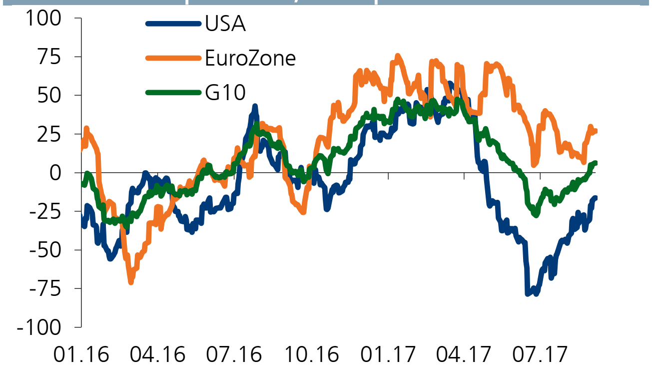
S&P GSCI for industrial metals and the dollar



Source: Intesa Sanpaolo chart based on Bloomberg data

Moreover, as the Citigroup economic surprise indices show, the macroeconomic data have proved to be much stronger than expected in China and the Eurozone in the last few months. In the U.S., the data flow missed expectations but has nonetheless confirmed a reassuring scenario. This has bolstered expectations of robust global demand for commodities.

Citi Economic Surprise Index, developed countries



Source: Intesa Sanpaolo chart based on Citi Bloomberg data

Citi Economic Surprise Index, emerging countries

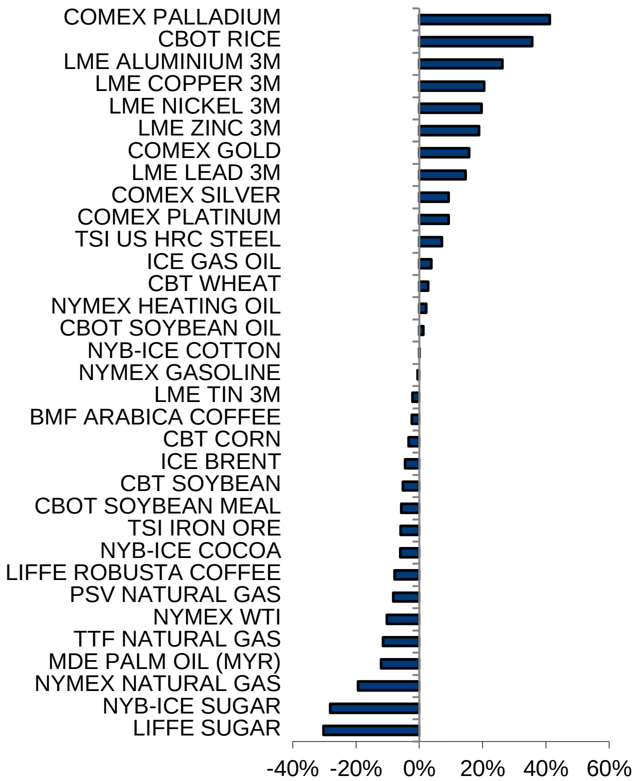
Source: Intesa Sanpaolo chart based on Citi Bloomberg data

Fuelled by good fundamentals and a favourable macroeconomic environment, financial speculation has had a great influence on prices, especially of industrial and precious metals. In fact, we think the prices of some industrial metals have risen well above what could be justified by the actual or expected strengthening of the demand and supply fundamentals, and are mainly supported by an extremely positive investor sentiment. It will therefore be essential, in the next few weeks, to monitor financial flows and assess market sentiment in order to seize early indicators of a possible repositioning of portfolios.

This autumn promises to be full of potential surprises. How will geopolitical tensions develop, with the nuclear threat in North Korea and the civil war in Venezuela acting as catalysts? What new monetary policy measures will be announced by the main central banks? How will the forthcoming reshuffle in the composition of the Politburo, the Communist party's most important body, affect the Chinese economy (and its consumption of commodities)? When will speculators decide to take profits and reduce exposures toward industrial metals? Will OPEC members and their non-OPEC allies abide by their commitments until March 2018, or will we see some countries openly deviate from their production targets?

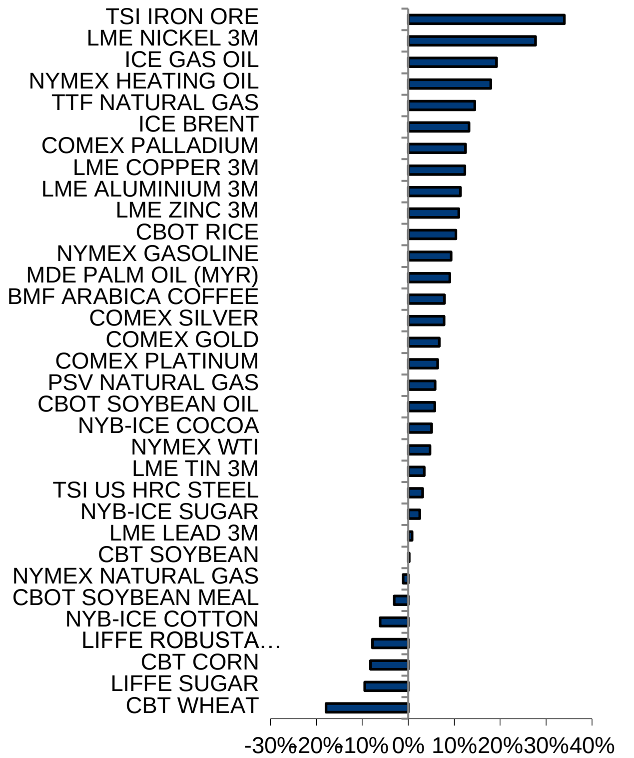
Potentially, each of these issues could dramatically affect the fundamentals of the main commodities markets and hence considerably modify our baseline scenario, which is currently favourable to the commodity segment: global growth is expected to accelerate and will be driven by emerging countries, which 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 enhanced and, lastly, global liquidity will remain plentiful thanks to still accommodative monetary policies.

Year-to-date performance until 12 September 2017



Source: Intesa Sanpaolo chart based on Bloomberg data

3Q performance up to 12 September 2017



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts for the commodity universe

In our baseline scenario, global economic growth will remain satisfactory, and the main emerging economies will continue to require increasing volumes of commodities. Liquidity will remain plentiful and the U.S. dollar will continue to be relatively weak over the next two years. There will be no sharp deterioration in international relations and the U.S. will not make any significant changes to current trade policies or diplomatic relationships. Meanwhile the U.S. will implement an expansive fiscal policy. Open military conflicts will be avoided in both the Middle East and the Far East, by entering into diplomatic negotiations and potentially introducing targeted sanctions.

We think that oil prices will remain entrenched within a relatively wide trading range. On one hand, the extremely high global stocks and the rapid ability to recover shale oil production prevent crude from consistently exceeding USD 60 per barrel. On the other hand, the generally favourable macroeconomic scenario, the readiness of important emerging countries to expand their strategic reserves (when the price deemed as convenient) and Saudi Arabia and Russia's willingness to return stability to the global market should prevent crude from durably going below USD 40 per barrel. We forecast that Brent will stay within the range of USD 48-56 per barrel for most of the next few quarters. In our view, the main risk events that could lead crude oil to break out of the trading range are the failure to renew the OPEC agreement and geopolitical risks.

After rallying over the last few months, many industrial metals have risen well above the fundamentals. We therefore expect prices to be mainly driven by technical factors and speculative flows in the next few weeks. The risk of a considerable sell-off is especially high for the metals that recorded the best year-to-date performance: iron ore, nickel, copper and zinc.

So far, precious metals have been driven by three main factors: demand for safe haven assets, the depreciation of the U.S. dollar and the strengthening of the fundamentals for palladium and platinum. We expect these issues to remain very much in the spotlight. Given the amount of speculative flows into this segment in the last few months, these metals are also vulnerable to reversals of market sentiment and the liquidation of long positions driven by profit-taking.

With regard to agricultural commodities, the impact of weather conditions in the summer was positive, as expected, favouring the cultivation of the main cereals (with the notable exception of rice) and boosting the extremely high global stocks. We expect the prices of some soft commodities (e.g. coffee) to recover due to expectations that production could be lower than the consensus estimates.

Price forecasts for the main commodities

	4Q17	1Q18	2Q18	3Q18	2017	2018	2019
ICE BRENT	53.0	51.0	53.0	55.0	52.4	53.5	59.0
NYMEX WTI	51.0	49.0	51.0	53.0	49.8	51.5	58.0
NYMEX NATURAL GAS	3.50	3.50	3.10	3.20	3.18	3.25	3.00
COMEX GOLD	1,300	1,285	1,275	1,250	1,269	1,265	1,250
COMEX SILVER	17.1	17.4	17.7	18.0	17.2	17.9	18.5
COMEX PLATINUM	980	970	960	950	968	955	930
COMEX PALLADIUM	890	880	875	870	846	873	860
LME COPPER 3M	6,900	6,800	6,850	6,900	6,248	6,875	7,000
LME ALUMINIUM 3M	2,000	2,000	2,000	2,010	1,948	2,010	2,050
LME NICKEL 3M	11,500	11,500	11,500	11,500	10,523	11,500	11,000
LME ZINC 3M	3,000	3,000	2,900	2,800	2,840	2,875	2,850
LME LEAD 3M	2,340	2,300	2,300	2,300	2,282	2,285	2,250
LME TIN 3M	20,500	20,500	20,500	20,500	20,187	20,563	20,750
SGX IRON ORE	65	60	60	60	70	60	57
TSI US HRC STEEL	610	610	610	610	619	611	620
CBT CORN	360	370	380	390	363	384	400
CBT WHEAT	435	440	450	450	437	450	475
CBT SOYBEAN	950	950	960	970	968	965	1,000
MDE PALM OIL (MYR)	2,700	2,700	2,700	2,700	2,812	2,688	2,700
NYB-ICE ARABICA COFFEE	135	140	145	145	135	145	150
LIFFE ROBUSTA COFFEE	2,100	2,150	2,175	2,175	2,085	2,175	2,250
CBT SOYBEAN MEAL	310	312	314	315	314	314	320
CBT SOYBEAN OIL	35.0	35.0	35.0	35.0	33.7	35.0	36.0

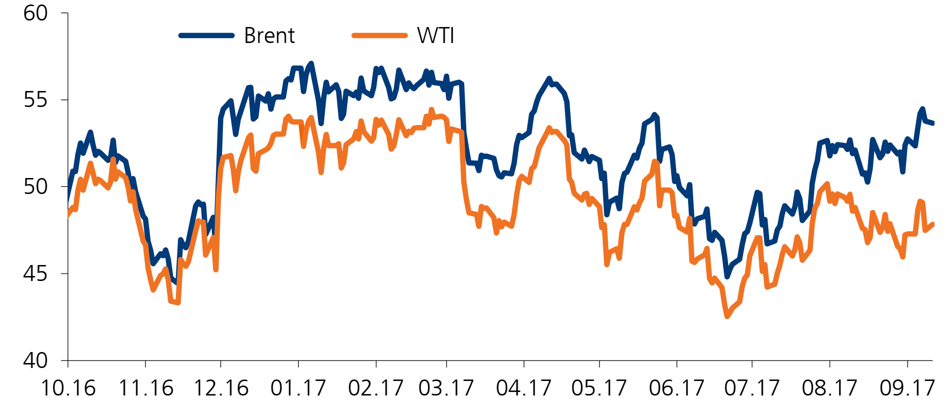
Source: Intesa Sanpaolo estimates. Iron: one-month futures contract quoted on the Singapore stock exchange and based on a basket of reference prices published by the Steel Index. Steel: The Steel Index: index calculated as the weighted average price paid for US hot-rolled coil steel trades

Crude oil: trading range

Supply and demand fundamentals are not strong enough to support a pronounced rise in oil beyond USD 60 per barrel, but nor are they weak enough to justify Brent returning close to USD 40 per barrel. Geopolitical risks and, most importantly, the uncertainty surrounding a possible renewal of the agreement between OPEC members and non-OPEC allies to limit global supply are helping maintain oil within the trading range.

Positive sentiment reigned on the oil markets over the summer, engendered by optimism over the renewed commitment by Saudi Arabia and Russia to abide by the agreement between OPEC members and non-OPEC countries to reduce global supply; it was also strengthened by satisfactory demand recorded in the main consumer countries.

Oil prices: optimism returned in the summer



Source: Intesa Sanpaolo chart based on Bloomberg data

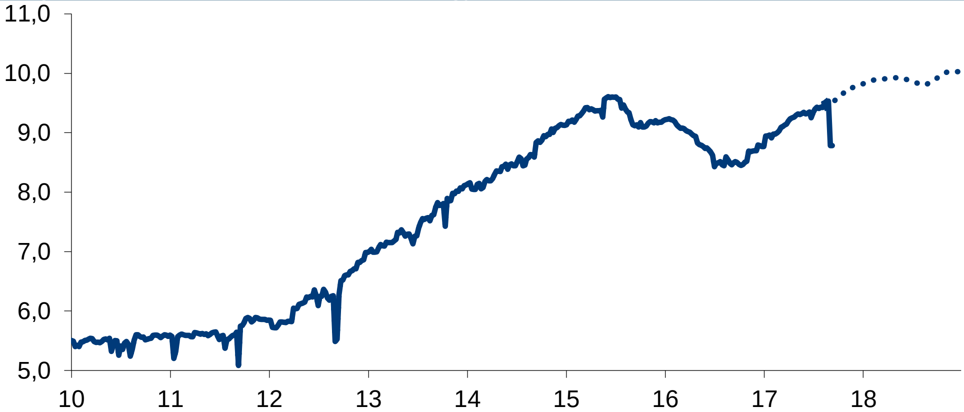
Exceptional weather events, such as the particularly active hurricane season along the U.S. Gulf Coast, pushed up the Brent-WTI spread to a two-year high. Given the temporary nature of these factors, which are associated with the temporary suspension of activities by most of the refineries and some oil wells along the Gulf Coast and in Texas, we should see a narrowing of the spread in the next few weeks, as operations returns back toward their seasonal average levels.

Brent-WTI spread in dollars per barrel

Source: Intesa Sanpaolo chart based on Bloomberg data

Given that the distorting effects of Hurricane Harvey and Hurricane Irma on production and domestic stocks of crude and refined oil products will continue for some more weeks, we think that the market will, in the short term, pay less attention than usual to the weekly reports from the U.S. Department of Energy (DOE) and the American Petroleum Institute (API).

US production in mb/d. Dotted line: US Energy Information Administration (EIA) estimates



Source: Intesa Sanpaolo chart based on US EIA data

In our view, the most important themes in the next few months will be:

- **Developments in the OPEC/non-OPEC agreement.** The current agreement should remain in force until March 2018. The first rumours about the intentions of the main players will probably emerge ahead of the OPEC's November meeting. As global stocks are still a long way from their five-year average, a new agreement will probably be announced ant it will slightly revise the quotas of individual member countries. It may also include Libya and Nigeria, if their production rises above the targets indicated by the national oil companies. In our view, Russia and Saudi Arabia are likely favour an extension of the agreement in order to stave off extreme price fluctuations before the Russian presidential elections in 2018 and the IPO of Saudi Aramco (5% of the Saudi Arabia government oil company is likely to be listed and, with an estimated value within a range of USD 1-2 trillion, it will be the largest IPO of all time).
- **Geopolitical tensions.** Geopolitical risks intensified further in summer: not only were the rifts all over the Middle-East far from being composed, the diplomatic crisis with North Korea could also escalate into military intervention, if the regime steps up its provocations. In addition, the Venezuelan crisis worsened in the summer, and there is still the risk that the oil and refined products trade could be adversely affected. However, we stress that, currently, in our baseline scenario, we do not expect the tensions to erupt into open military conflict or cause disruptions in the production or transport of fossil fuels.

Supply and demand fundamentals

In its monthly update published on 12 September, the U.S. Energy Information Administration (EIA) revised its supply and demand estimates, depicting a much weaker scenario than indicated only a few months earlier. In fact, the market is likely to be broadly balanced in 2017, but could return to a modest surplus in 2018 (+0.3 mb/d). The extremely high global stocks are therefore likely to remain stable this year, but they will start growing again, albeit slowly, next year. Clearly, the surplus of stocks compared with the five-year average should reduce, but this will mainly be due to the progressive increase in the average.

Supply and demand estimates published by US EIA in September 2017

Estimates published in September 2017 (mb/d)	Global consumption	Non-OPEC supply	US production	OPEC supply of LNG	OPEC production of crude	Call on OPEC crude*	Market balance **
2016	96.9	57.9	8.9	6.6	32.7	32.4	0.3
2017	98.3	58.8	9.3	7.0	32.5	32.5	0.0
Y/Y change	1.4	0.9	0.4	0.4	-0.2	0.1	
2018	100.0	60.2	9.8	7.1	33.0	32.7	0.3
Y/Y change	1.7	1.4	0.6	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

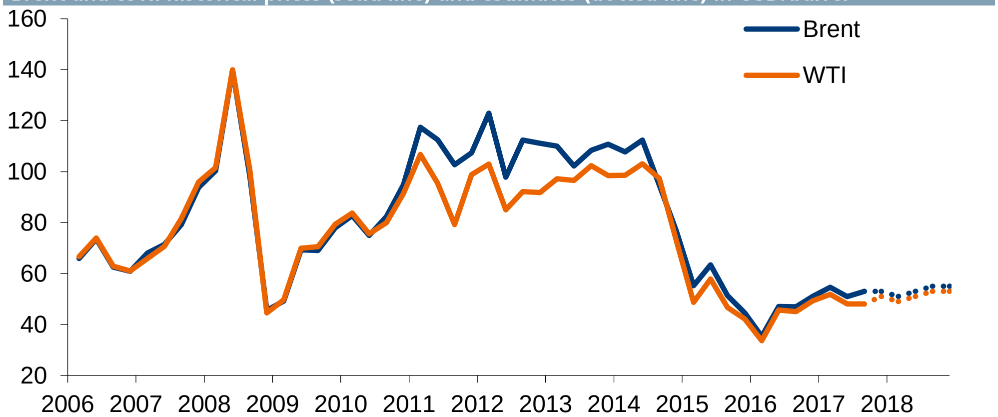
Growth in US shale oil production (+0.4 mb/d in 2017 and +0.6 mb/d in 2018) and the increase in supply from Libya and Nigeria represent the main threat to OPEC's efforts.

Forecasts

We think that Brent oil will trade at an average level of around USD 53 in 4Q. As discussed earlier, as long as OPEC and non-OPEC allies don't make an official announcement about a possible renewal of the agreement to limit global supply, the supply and demand fundamentals will not be strong enough to support a pronounced rise in oil price above USD 60 per barrel, but neither will fundamentals be weak enough for Brent to return close to USD 40. For this reason, we expect oil to stay within a trading range for a long time yet.

We included a Brent-WTI spread of around USD 2 from 4Q17 to end-2018 in our baseline scenario, due to expectations that the distortions caused by the hurricanes will be gradually reabsorbed and the WTI will strengthen accordingly. We do not expect the U.S. administration to change import and export taxes, contrary to what was promised in the electoral campaign.

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							
At 13.09.2017	4Q17	1Q18	2Q18	3Q18	2017	2018	2019
ICE BRENT	53.0	51.0	53.0	53.0	52.4	53.5	59.0
Bloomberg median	54.0	55.0	53.0	56.5	53.0	56.0	61.0
Forward curve	54.0	54.0	54.1	54.2	54.1	54.2	54.5

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI							
At 13.09.2017	4Q17	1Q18	2Q18	3Q18	2017	2018	2019
NYMEX WTI	48.0	51.0	49.0	51.0	49.8	51.5	58.0
Bloomberg median	52.0	52.0	51.0	54.5	50.5	53.0	58.0
Forward curve	49.2	49.9	50.2	50.3	49.0	50.2	50.5

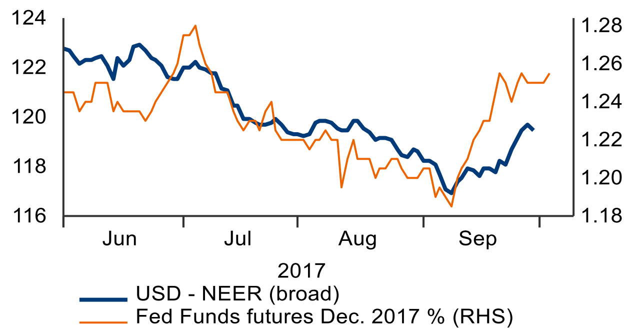
Source: Intesa Sanpaolo chart based on Bloomberg data

Currency markets: dollar held back by smaller monetary policy divergence

Asmara Jamaleh

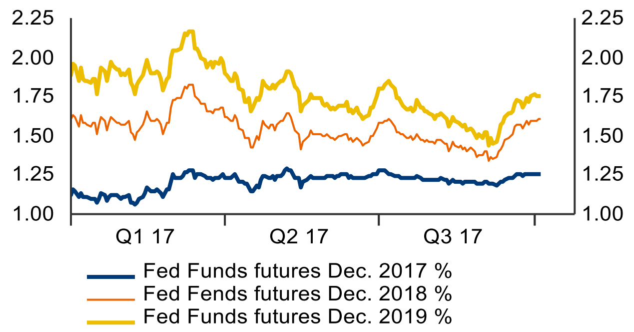
Over the summer months, the dollar deepened the decline under way since the beginning of the year, and hit new lows for 2017, revisiting levels abandoned at the beginning of 2015. The dollar was further weakened – across the board, against the main advanced and emerging currencies – by a combination of factors – of both a political and economic nature – which caused a widespread deterioration in sentiment towards the United States: (i) the ongoing difficulties faced by the Trump administration, which have (had) resulted in a loss in confidence in the US president's ability to deliver on the much-awaited fiscal stimulus package, (ii) the resurgence in tensions at the international geopolitical level (first the Middle East, then North Korea), and (iii) the slowdown in inflation, which has (had) significantly cooled market expectations for a third fed funds rate hike this year (Fig. 1).

Fig. 1 – Dollar down on the cooling of expectations for fed funds hikes



Source: Thomson Reuters-Datastream

Fig. 2 – The market envisages a much more conservative hike path than the Fed



Source: Thomson Reuters-Datastream

September, however, brought positive developments, specifically: (i) on the domestic political front, favourable signals emerged on the progress of the tax reform, which make an implementation of the Trump administration's much-anticipated fiscal stimulus plan more likely (although its size will probably be smaller than prospected during the election campaign); (ii) on the economic front, at the meeting on 20 September (at which the Fed announced that it will start reducing its balance sheet in October), a wide majority of FOMC participants confirmed expectations for a third rate hike by the end of the year (probably in December) – which, by contrast, the markets had started to doubt over the past few months – and also confirmed expectations for three hikes next year. The prospect of another Fed hike before the end of the year is supportive for the dollar, and – barring significant disappointments from data, or negative developments at the (geo)political level – should help it to recover in part between now and the end of the year. However, the Fed's continued focus on the inflation trend could limit the size of the US currency's recovery, as it was probably due to persistently low inflation that it revised down the point of arrival of interest rates.

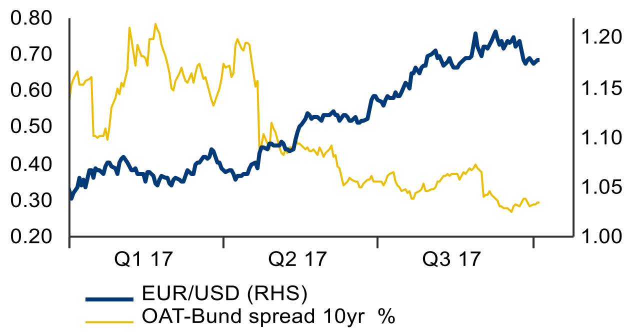
Beyond the near term, in the course of next year, the dollar should gradually weaken back – albeit modestly – because although the Fed will keep stepping up rates, it will no longer be alone in doing so, as the other main central banks will also resume the hike cycle (the Bank of Canada has already done so, in July, and the Bank of England could also make its move before the end of the year), or start normalising monetary policy. The overall size of the dollar's expected weakening should in any case prove to be modest, mostly because the market is pricing in a very conservative upward path for US rates, consisting of only two hikes between 2018 and 2019 (Fig. 2), as opposed to the five envisaged by the Fed at its latest meeting in September. **Risks are skewed slightly to the downside, i.e. the dollar could prove weaker than**

expected, especially in the event of new, serious problems taking shape on the domestic political front.

Euro: retracement against the dollar on the cards, but an uptrend is now under way

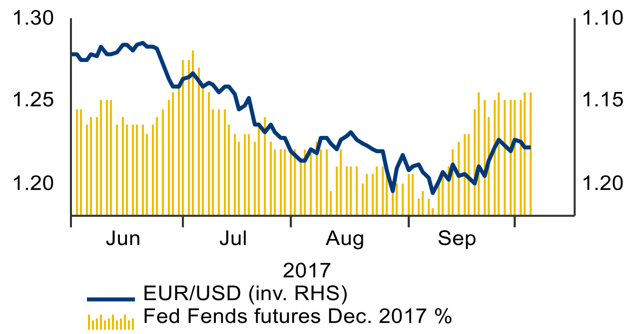
In the course of the summer, the upward trend of the euro, under way already since the beginning of the year, **accelerated: between the end of June and the end of August**, in a matter of two months, **it appreciated from EUR/USD 1.11 to 1.20 – marking new highs for 2017** and revisiting levels abandoned at the beginning of 2015 – therefore by 8%, after having taken three times as long, between January and June, to rise by an equal measure from EUR/USD 1.03 to 1.11.

Fig. 3 – The upswing of the euro began on waning risks tied to the string of elections in Europe…



Source: Thomson Reuters-Datastream

Fig. 4 – … and continued when expectations for the rate hike cycle in the US started to ease back



Source: Thomson Reuters-Datastream

Two main factors have supported this important strengthening: the improvement in the economic and political picture in the euro area, and the simultaneous deterioration in sentiment towards the United States.

In a rough timeframe between now and the end of the year, the prospect of another Fed hike by the end of December should support a downward retracement of the euro, towards EUR/USD 1.17-1.15, also in light of the relative comparison between the forecast performances of the US and euro area economies, which beyond the very near term is skewed to the advantage of the United States. This is because growth is expected to slow down next year in the euro area, and inflation to drop (the ECB also embraces this scenario), whereas US growth should accelerate further in 2018. The size of the expected retracement is modest, as in waiting for the ECB to officially announce the tapering of asset purchases, the market could attach more weight to the fact that the ECB is in any case ready to reverse its policy, which tends to support the single currency.

Beyond the near term, on the other hand, and in course of next year, the euro should gradually rise back, towards EUR/USD 1.22-1.23 between the end of 2018 and the beginning of 2019, **due to the fact that the ECB will gradually taper purchases and ultimately terminate the programme by the end of 2018, and will subsequently resume, in 2019, to hike rates**. The expected size of the exchange rate upswing is limited, both because the ECB normalisation process will be very gradual and monetary conditions will remain accommodative, and because – on the Fed side – the market is pricing in a very conservative upward path for US rates, consisting of a single hike next year, as opposed to the three indicated by the Fed at its latest meeting in September. **Early next year, one event which could interfere** with the trend of the exchange rate **will be the general election in Italy,** in the spring: a potential strengthening of the euro-sceptic forces would have a depressive effect on the euro.

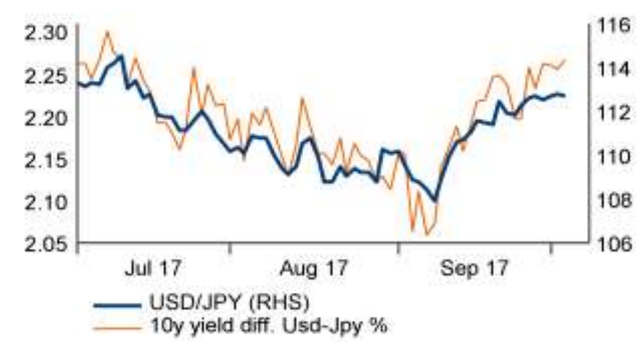
Monetary policy divergence will continue to weigh on the yen

Over the summer months, the yen rose back against the dollar, from lows in the USD/JPY 114 area to new highs for 2017 in the USD/JPY 107 area. The strengthening was entirely explained by the widespread weakening of the dollar, through two channels:

1) Yield differentials, with the drop of US yields expressing a reduction in the market's implied expectations for another fed funds rate hike soon: the correlation between the USD/JPY exchange rate and 2Y US yields has in fact strengthened to over 75%, whereas the correlation with 10Y yields has almost reached 90% (Fig. 5);
2) The rise, in stages, of risk aversion tied to tensions with North Korea (Fig. 6).

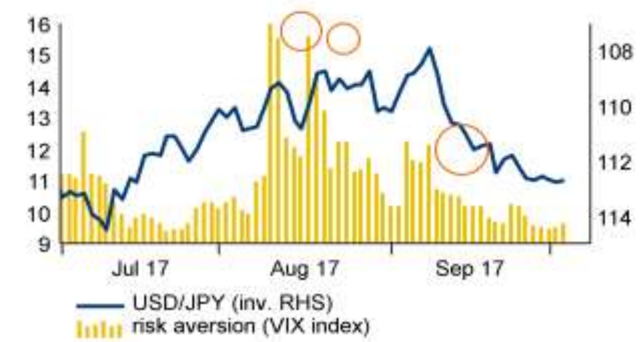
The yen then resumed declining (as far as USD/JPY 113) in September, on the recovery in American yields, supported by strong US data which rekindled expectations for another Fed hike this year, as subsequently effectively confirmed at the latest FOMC meeting.

Fig. 5 – Strong correlation between the USD/JPY and yield differentials vs. the USA



Source: Thomson Reuters-Datastream

Fig. 6 – Yen supported by renewed geopolitical tensions



Source: Thomson Reuters-Datastream

For a rather lengthy period of time, i.e. at least for all of next year – the BoJ will continue to pursue a divergent policy compared not only to the Fed, but also to all the other central banks in the advanced economies (with the exception of the SNB), as it will be the only one not yet in the position to begin normalising monetary policy, neither in terms of rates (still at zero or negative: the short-term rate is at -0.10% and the 10Y rate at a 0%), nor in terms of QE. As the Fed proceeds with its hike cycle, and the BoJ, simultaneously and by contrast, keeps curve control in place, the prospect of yield differentials vs. the US widening further supports expectations for a further decline of the yen against the dollar towards USD/JPY 115-117-118 on a 6m-12m-24m horizon. Risks are skewed slightly upwards, i.e. the yen could depreciate less than expected, in particular if risk aversion mounts back up as a result of the (re-)emergence of geopolitical tensions.

Fig. 7 – Diverging EUR/JPY and USD/JPY trends in the summer months …

Source: Thomson Reuters-Datastream

Fig. 8 – …EUR/JPY tracking the EUR/USD

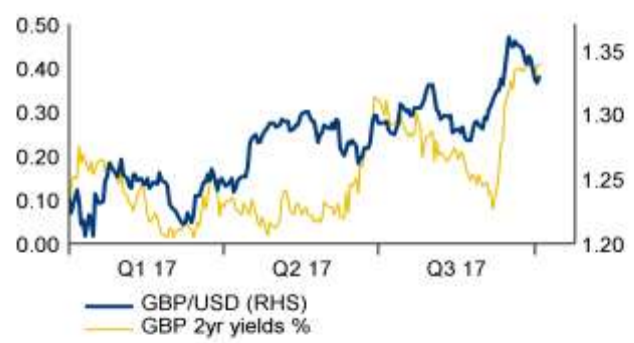
Source: Thomson Reuters-Datastream

Beyond the near term, divergent monetary policy conduct between the BoJ and the ECB should result in a further weakening of the yen against the euro as well, towards EUR/JPY 140-145 on a 12m-24m horizon. In the near term, between now and the end of the year, the Japanese currency could express a partial upward retracement against the euro, in function of a possible – partial – downside retracement of the EUR/USD. Risks to the forecast scenario for the EUR/JPY cross rate are more balanced, as the "disruptive" factors which could push the USD/JPY exchange rate in one direction, would lead the EUR/USD in the opposite direction.

Sterling finding new support in expectations for policy rate hikes

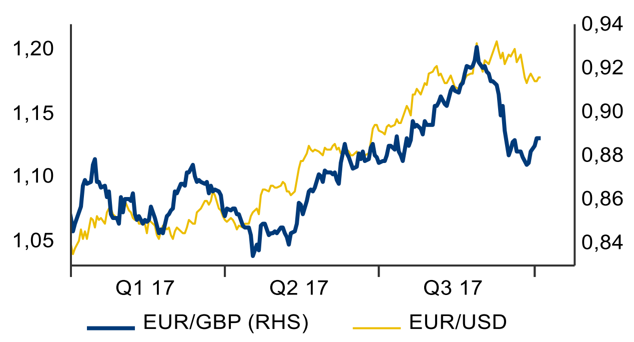
Sterling essentially consolidated against the dollar in the summer months, from GBP/USD 1.28 to 1.30 on average between 2Q and 3Q 2017, while accelerating sharply upwards following the Bank of England meeting on 14 September (Fig. 9), rising as far as GBP/USD 1.36 – and in doing so revisiting the highs abandoned on the day after the Brexit referendum in June 2016.

Fig. 9 – BoE setting the stage for a rate hike, sterling up to new highs against the dollar as a result...



Source: Thomson Reuters-Datastream

Fig. 10 – ...and also recovering against the euro



Source: Thomson Reuters-Datastream

On that occasion, **the BoE hinted that it could start to step up rates** (currently at a historically low 0.25%) **already in the near term**, before previously assumed, explaining that "majority of MPC members judge that, if the economy continues to follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressure… then some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target". In fact, based on the indications provided by the latest data, **(i)** growth should improve, albeit only slightly, after slowing in 1H 2017 (0.2% q/q in 1Q and 0.3% in 2Q); **(ii)** slack is being reabsorbed faster than expected; and **(iii)** inflation has risen a little more than forecast (2.9% in August).

The **probability of the BoE implementing an initial hike already at the next meeting on 2 November** (when the new Inflation Report will be published, containing updated growth and inflation forecasts) **is high,** also considering that **(i)** McCafferty and Saunders already voted for an immediate at the past three meetings, **(ii)** Haldane, despite having hitherto voted for stable rates, said in June that he could change his stance and vote for a hike towards the end of the year, in light of the inflation trend, and **(iii)** Vlieghe, notoriously a dove, said on the day following the September BoE meeting that if the trends outlined by recent data stay in place, it could be appropriate to hike rates already in the months ahead.

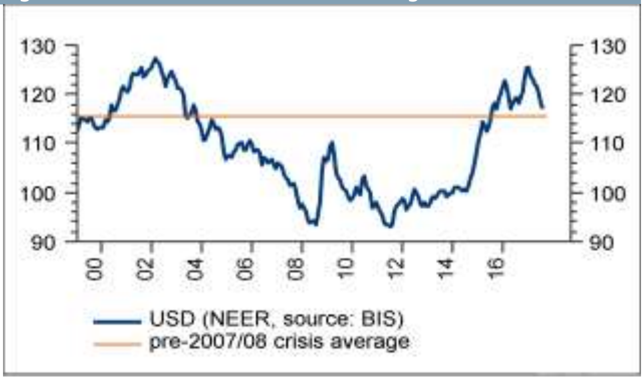
The BoE forecasts growth at 1.7% this year, down marginally due to Brexit to 1.6% next year, and on the recovery again to 1.7% in 2019, the year in which – at the end of March – the United Kingdom will officially leave the EU. For what concerns inflation, it projects a 2.8% rate this year, followed by a decline to 2.5% next year, and to 2.2% in 2019, therefore above target throughout the forecasting horizon, reason for which, if growth does not disappoint, it plans to resume hiking near term rates.

After the BoE meeting and Vlieghe's speech, future rates on the bank rate rose in only two days from 11bps for the December 2017 maturity to 22bps for the December 2019 maturity, pricing in at least three hikes between now and the end of 2019, the first of which already this year. This is a very gradual rate hike path, as the market has correctly interpreted the cautious approach the BoE intends to take in light of the downside risks to growth posed by Brexit, especially given the limited progress made so far in the negotiation process. The first three rounds of talks failed to sufficiently reduce the distance between the two sides on three key issues, namely the exit bill (the prickliest topic), the rights of EU citizens living in the UK and vice versa, and the border with Northern Ireland. It is crucial that at least a compromise agreement is reached on these points, because the EU is firm in its refusal to begin talks on the future trade relations with the United Kingdom before "sufficient progress" will have been made on these priority aspects. The United Kingdom had hoped that talks on the new trade relations could begin in October, ahead of the EU summit in Brussels on 19 October, an unlikely outcome at present. The risk is of a delay until December, when the subsequent EU summit is planned.

In her much-anticipated speech on Brexit on 22 September on Brexit, aimed at overcoming the negotiations deadlock, Prime Minister Theresa **May assured that the United Kingdom will honour the financial commitments** made with the EU until before the referendum, explaining that the UK doesn't wants its EU partners "to fear that they will need to pay more or receive less" in the period covered by the current multi-year budget (2020) as a result of the UK's decision to leave. **For what concerns the rights of EU citizens living in the United Kingdom, May guaranteed that they will be protected even after Brexit**, adding that to this end the UK will take into account the judgements of the European Court of Justice. On the border with Northern Ireland, the PM said that she did not want a return to a "hard border", which could rekindle old tensions. May also expressed the need to plan a post-Brexit transition period of a couple of years, during which EU citizens will be able to freely travel, work and live in the United Kingdom – although a registration system will be implemented – and the hope that access to the one another's markets will be maintained at the current conditions. **The EU's chief Brexit negotiator, Barnier, welcomed May's statements, while stressing the British government must now translate its good intentions into detailed and tangible proposals.**

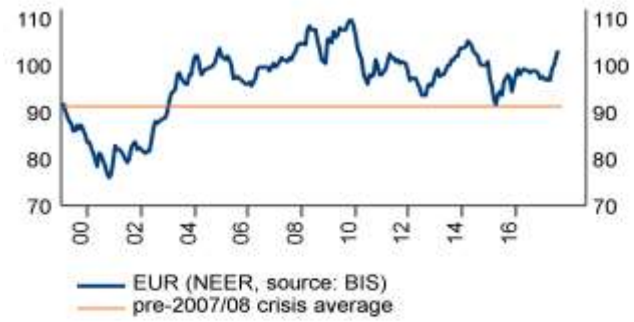
The prospect of the BoE implementing the first rate hike soon should support a strengthening of the pound, against both the dollar and the euro. **However, we forecast a contained and gradual rise,** for three reasons: **(i)** uncertainty over Brexit, given in particular the limited progress made on the negotiation front; **(ii)** the extremely gradual pace at which – therefore – the BoE will proceed with its following hikes; **(iii)** the risks weighing on the macro scenario, which already points to a slowdown in growth, albeit limited, and which could turn modest disappointments into a further worsening of the balance of risks to the downside. Therefore, we expect a gradual strengthening of the pound against the dollar, towards GBP/USD 1.38-1.40 on a 12m-24m horizon. Projections against the euro are less directional, and a trading range should prevail between current levels of around 0.88 and an upside target of up to EUR/GBP 0.85, given expectations for a gradual appreciation of the EUR/USD in the course of next year. Risks to the scenario are rather balanced: skewed upwards, i.e. sterling may prove stronger than expected, in case of an acceleration/positive outcome of the Brexit negotiations, and by contrast skewed downwards if talks with the EU should derail.

Fig. A – Dollar, nominal effective exchange rate



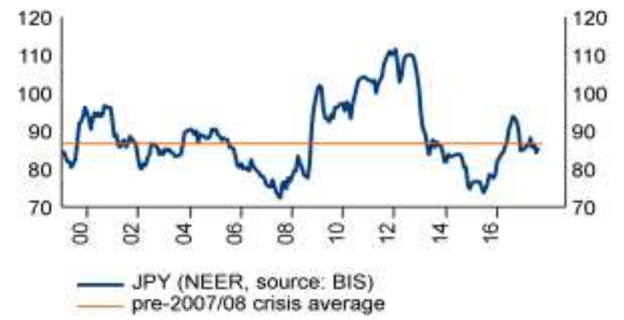
Source: Thomson Reuters-Datastream

Fig. B – Euro, nominal effective exchange rate



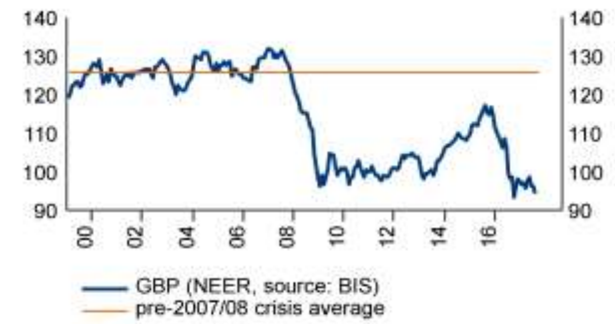
Source: Thomson Reuters-Datastream

Fig. C – Yen, nominal effective exchange rate



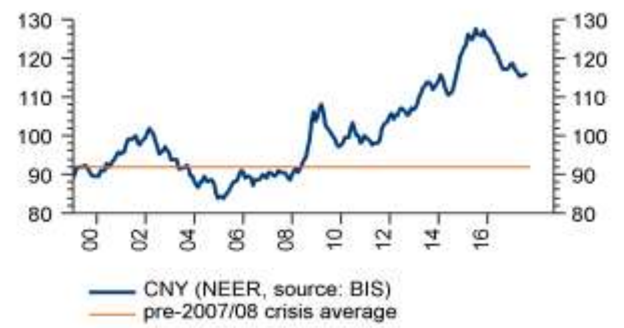
Source: Thomson Reuters-Datastream

Fig. D - Sterling, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. E – Yuan renminbi, nominal effective exchange rate

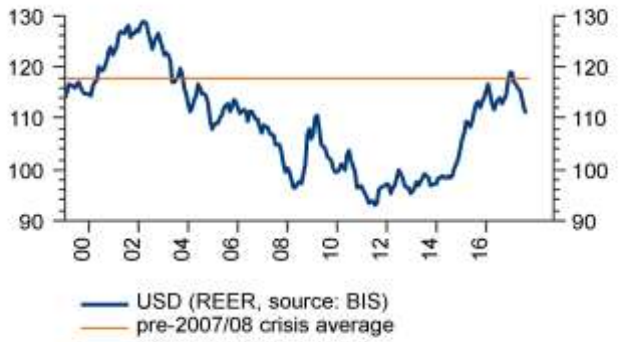


Source: Thomson Reuters-Datastream

Fig. F – Indian rupee, nominal effective exchange rate

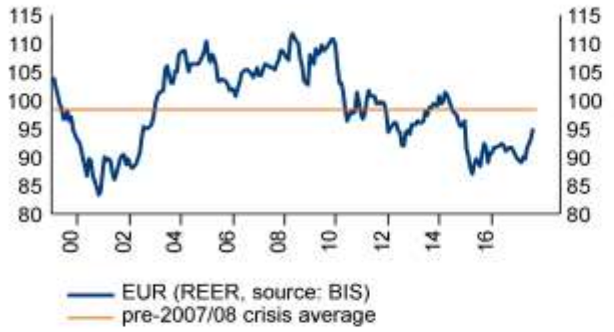
Source: Thomson Reuters-Datastream

Fig. G – Dollar, real effective exchange rate



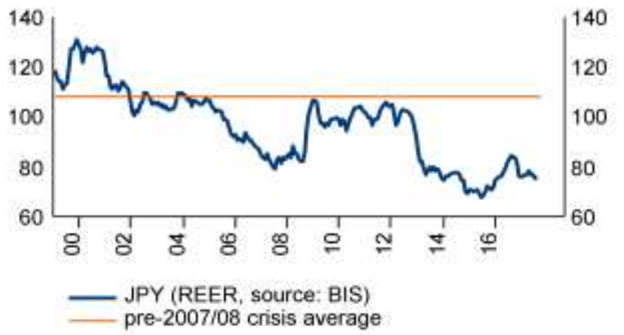
Source: Thomson Reuters-Datastream

Fig. H – Euro, real effective exchange rate



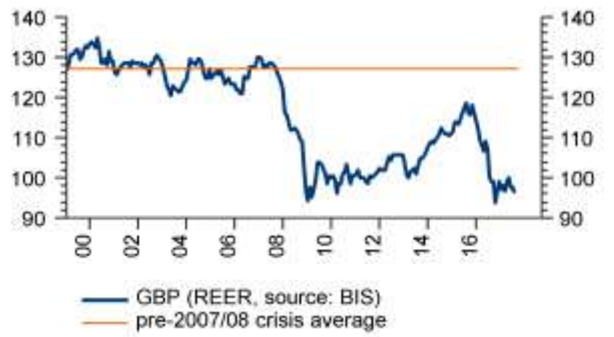
Source: Thomson Reuters-Datastream

Fig. I – Yen, real effective exchange rate



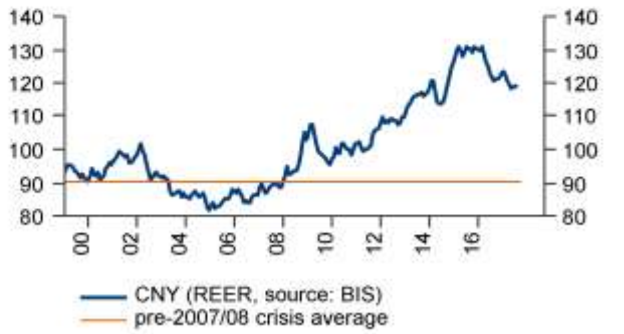
Source: Thomson Reuters-Datastream

Fig. J - Sterling, real effective exchange rate



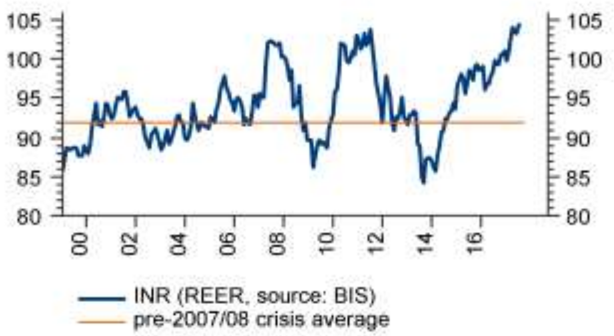
Source: Thomson Reuters-Datastream

Fig. K – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. L – Indian rupee, real effective exchange rate



Source: Thomson Reuters-Datastream

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Appendix

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