BANCA IMI

Macroeconomic Outlook

Research Department
March 2017

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INTESA SANPAOLO

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Macroeconomic Outlook

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Quarterly

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Heading towards a cautious withdrawal of monetary stimulus

Luca Mezzomo

Following the Federal Reserve, the time is also approaching for the ECB to reduce monetary stimulus. For the moment, the response has been modest and orderly, thanks partly to signs of stronger global growth that have emerged in the last few months. In addition, there is a good chance that monetary restriction will be very gradual, due both to structural factors and the uncertainty surrounding the political environment.

The strengthening economy and rising inflation are increasing the pressure to remove monetary stimulus

The maturing of the phase of global economic expansion, which last year overcame a temporary period of slowdown led by emerging countries, is forcing various central banks to review the stance of their monetary policies: the process of dismantling the extraordinary monetary measures introduced in the years following the great financial crisis seems to have got under way. As it did not have to grapple with the debt crisis that hit the Euro zone in 2010, or with the structural problem of government debt sustainability of Japan, the Federal Reserve is a step ahead on this path. The financial assets purchase program was suspended as early as 2014, after preparing the markets for the event since the year before, while the official rates have already been hiked three times (December 2015, December 2016 and March 2017). The European Central Bank will reduce the monthly volume of purchases under its Asset Purchase Programme (APP) in April, but has not yet announced what will happen from January 2018. The targeted longer-term refinancing operations (TLTROs) programme has not been renewed, while the forecast that official rates would be maintained at or below their current level well past the end of bond-buying was reaffirmed in March. However, the markets started to factor in a rise in official rates (particularly the deposit rate, which when implemented as part of a full allotment policy is the real guide rate) as early as end-2017/beginning of 2018; some central bankers have also expressed doubts on the sequencing of monetary policy normalisation suggested so far. If the forecasts of continuing economic growth and if the moderates win the French political elections, it is likely that monetary stimulus in the Euro zone will also be reduced in the next 12 months.

Market expectations on the size of the monetary tightening are still modest

Whereas Ben Bernanke's announcement in 2013 that the Federal Reserve was about to discontinue the purchase programme threw the financial markets and the currencies of emerging countries into turmoil, in this case, expectations seem to have been managed without any problems. The differing response could be due to greater confidence in the resilience of the global economy, supported by signs that the global economy is strengthening, which have emerged in recent months. Moreover, more attention is being paid to the specific fundamentals of countries rather than of the global economy, which has also resulted in lower correlations between asset classes, sectors and geographical areas[1]. This increase in uncertainty around economic policy has taken on an expansive "tone" in the US, where equity investors quickly got hold of the idea that the new administration would reduce corporate taxes. But one last and, until now, decisive factor is the fact that expectations of rate hikes remain very moderate. Fed funds futures will just skim 2% in 2020, thus remaining below the lowest estimates provided by FOMC members. In the Euro zone, 3-month Euribor futures remain extremely flat, factoring in rates lower than 0.5% right up until the end of 2020.

This could be explained by the low level of global inflationary pressure

There could be an explanation for the moderation in expectations of interest rate hikes. There could be an acceleration in monetary restriction in the face of threats to price stability or signs that the overly accommodative monetary conditions are putting financial stability at risk. With regard to the second issue, however, it is not universally held that the response should be to

[1] See *BIS Quarterly Review*, March 201, pp. 2 *et seq.*

tighten monetary policy, if there are macro-prudential control tools available that could keep financial excesses at bay. In respect of price inflation, it is likely that the rebound in oil prices from their lows of a year ago will lead to some recovery in underlying inflation in the next few months. However, there are excellent reasons to believe that inflation will remain moderate for some time to come. Firstly, barring any unexpected negative supply shocks, oil prices do not look likely to rise much in the next two years. The impetus from energy costs will therefore be neutral on average. Secondly, globalisation has created excess global production capacity and reduced the significance of domestic factors in generating inflation, providing more opportunities for producers to replace them with imported inputs. The link between inflation measures and those of global slack seems to depend on imports and exports of intermediate goods. Similarly, in industry, it is more difficult for workers to exploit the shortage of manpower to obtain better wage conditions, but also for producers of intermediate goods to increase their sales prices. On the goods markets, at least, inflationary pressure will struggle to take hold. Lastly, there is still considerable uncertainty in the international political arena.

Uncertainty surrounding economic and political developments is still high, although Europe is defusing the immediate most extreme risks

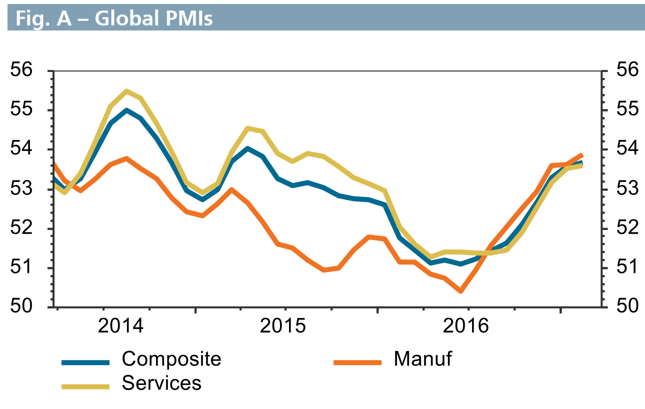
In the United States, the Trump administration has failed to overcome its first parliamentary hurdle, that of healthcare reform. The episode demonstrated that it will be far from easy to implement the divisive policies of the electoral campaign, including that of slashing taxes. In Europe, the picture is even more fluid. The Dutch elections confirmed that modest gains have been made by the Eurosceptics, but the latter are not in any way crucial for forming the next government. Opinion polls on the French elections continue to show the National Front leader losing against centrist Macron at the presidential election ballot box. However, the Eurozone has other critical issues to confront in the next few months; one is the political elections in Italy at the start of 2018, which could result in a hung parliament made up of a huge number of parties clamouring, albeit with varying levels of conviction, to exit monetary union. On the other hand, front-line candidates in both France and Germany (Macron, Schulz) show that they have understood the need to come up with new solutions to the Euro zone problem; their presence indicates that the risks are not only to the downside or destructive.

Our forecasts have changed very little since December, just like the consensus estimates

Our GDP growth projections have been tweaked slightly compared with December, while the 2017 inflation forecasts have risen significantly. We continue to expect more widespread growth and a modest increase in the pace of global expansion, as well as a partial climbdown from the recent rise in inflation rates. The consensus estimates have also remained broadly the same in the last few months, with a slight uptick in 2018 growth and 2017 inflation, but predominantly downward revisions to US growth in 2017. This last phase of divergent monetary policies could also perhaps produce one last temporary strengthening of the dollar. The events of recent weeks suggest that the markets might already have entered the next phase, which is potentially more favourable to a recovery in the euro, but the situation is still fairly fluid and expectations on interest rates can still move favourably to the dollar in the course of the year.

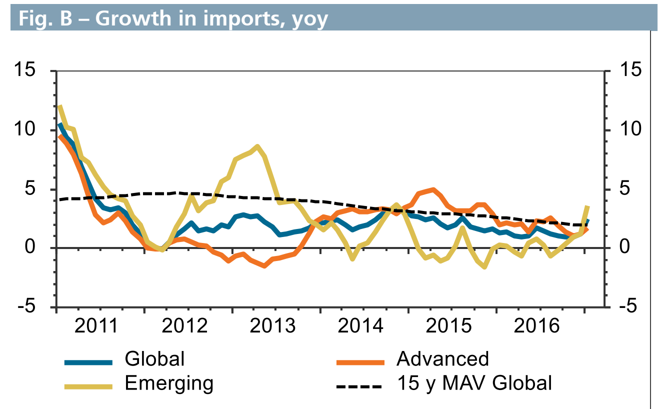
Global economic trends in 10 charts

Fig. A – Global PMIs



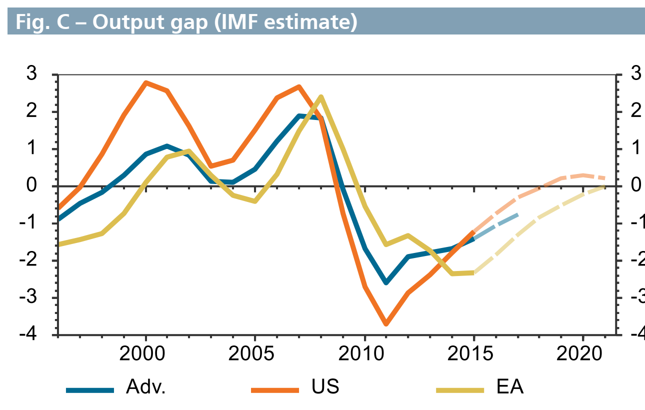
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Growth in imports, yoy



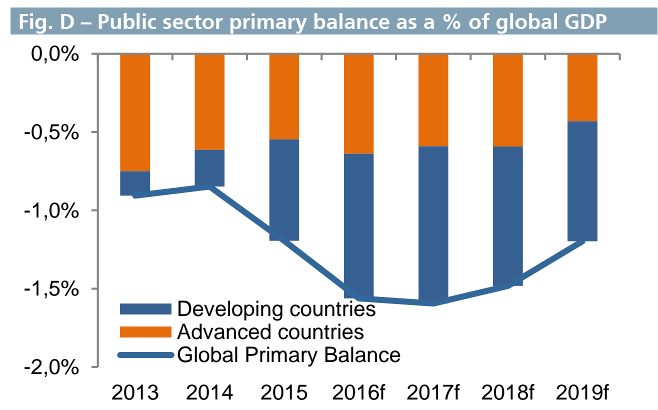
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



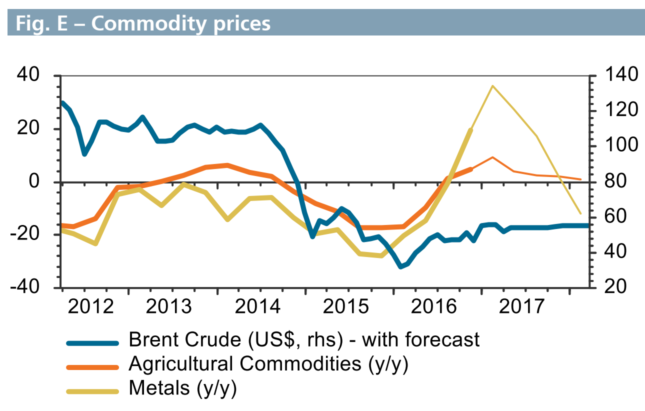
Source: Thomson Reuters-Datastream Charting and IMF

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



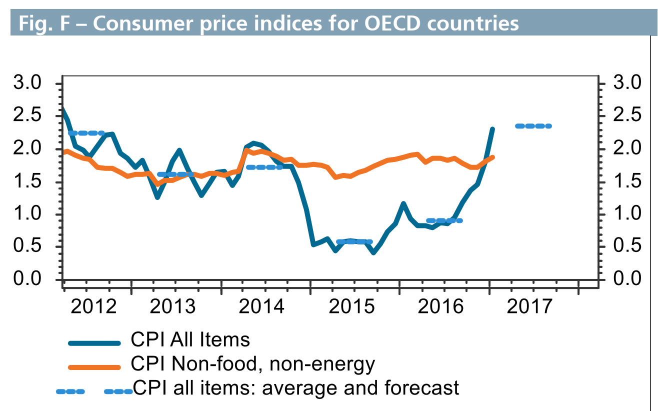
NB: based on 11 major advanced countries and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



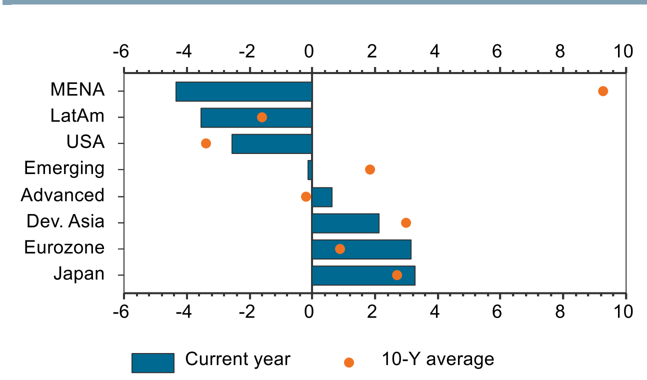
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



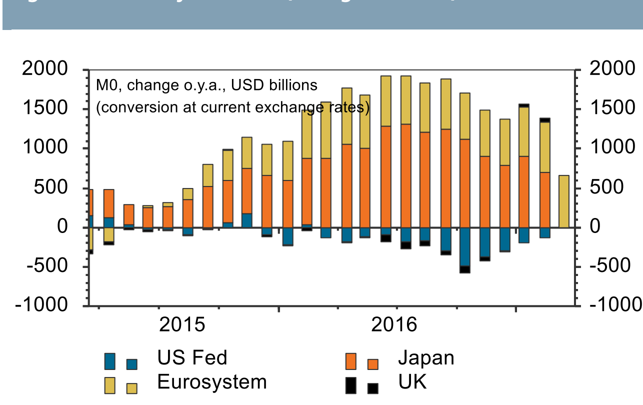
Source: OECD, Thomson Reuters-Datastream Charting

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



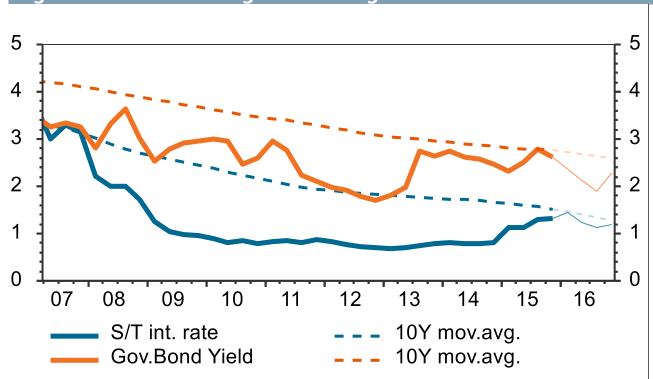
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting.

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



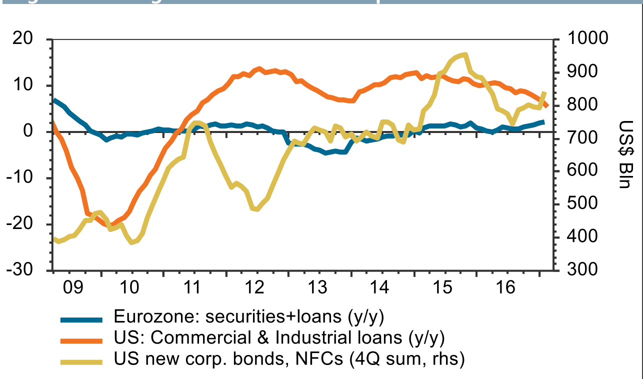
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



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

Fig. J – Lending to non-financial companies



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

Tab. 1 – Economic growth by geographical region

	2015	2016	2017	2018	2019
United States	2.6	1.6	2.1	2.5	2.3
Japan	1.2	1.0	1.1	1.0	0.7
Euro Area	1.9	1.7	1.7	1.6	1.6
Eastern Europe	-0.5	1.1	2.1	2.2	2.1
Latin America	-0.8	-1.0	1.2	2.7	3.2
OPEC	2.6	1.7	2.6	3.8	4.0
China	6.9	6.7	6.4	6.1	6.0
India	7.4	7.5	7.2	7.4	7.3
World	**3.2**	**3.0**	**3.4**	**3.7**	**3.5**

Source: Intesa Sanpaolo data

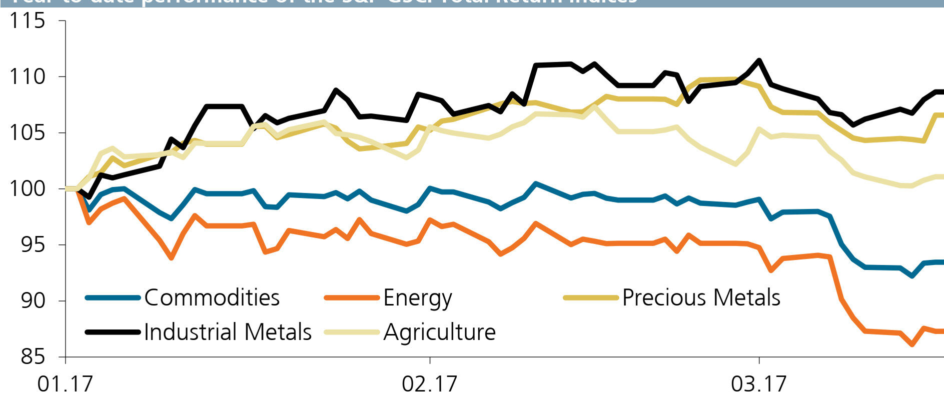
Commodities: macroeconomic environment is favourable

Daniela Corsini

The macroeconomic outlook is still favourable for commodities: global growth is healthy and will be driven by emerging countries, fiscal and monetary policies look set to remain accommodative, momentum in both developed and emerging countries is exceptionally strong, and the risk of excessive appreciation in the US dollar has fallen significantly. We expect this highly positive environment to continue to fuel upside pressure on the segment, but, in our opinion, supply and demand fundamentals will be the biggest driver of the performances recorded by individual commodities.

Stripping out the energy sector, 2017 began on a positive note for the main commodity indices: industrials and precious metals are well above 2016 closing levels, while agricultural products are broadly unchanged.

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

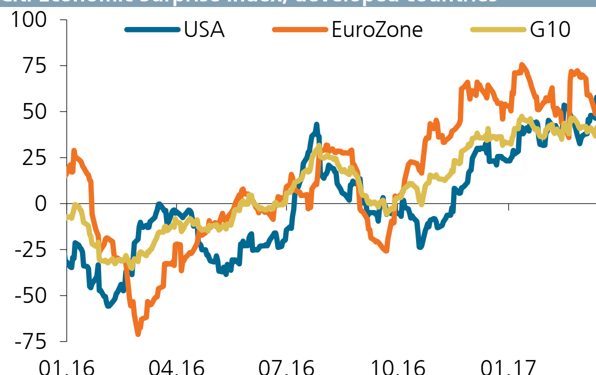


Source: Intesa Sanpaolo chart based on Bloomberg data

The macroeconomic outlook is still favourable for commodities: global growth is expected to accelerate, and in our view, will be driven by emerging countries, which tend to have economic models based on more intensive use of commodities. Meanwhile, pro-cyclical fiscal policies have been announced and new infrastructure development projects outlined, with the largest ones being in India and China, and lastly, liquidity is still plentiful thanks to the continuation of accommodative monetary policies. For example, even the Federal Reserve, when it raised interest rates in March, hastened to reassure the markets, using such persuasive words and dulcet tones that gold also gained after the meeting (even though gold prices are normally negatively correlated with US interest rate levels and the strength of the dollar).

As the Citigroup economic surprise indices show, momentum is exceptionally strong in both developed and emerging countries. Moreover, the indices considered most important for assessing demand for industrial commodities (industrial output, manufacturing PMIs) were strong. In China, the negative surprises in early March were partly due to problems with seasonal adjustments and should not significantly change the scenario of overall stability.

Citi Economic Surprise Index, developed countries



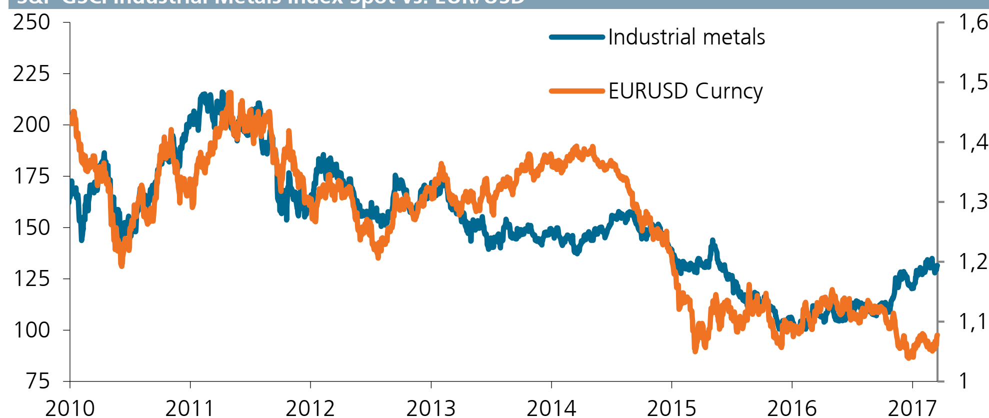
Source: Intesa Sanpaolo chart based on Citi Bloomberg data

Citi Economic Surprise Index, emerging countries

Source: Intesa Sanpaolo chart based on Citi Bloomberg data

To round off this particularly favourable macroeconomic outlook for commodities, we highlight the reduced risk of excessive appreciation in the US dollar. The US currency's strength at the end of 2016 was explained by expectations of a more restrictive US monetary policy than previously forecast and economic growth boosted by investment in infrastructure and expansionary fiscal policies. At the time of writing, both aspects seem to have virtually run their course: the market is completely in line with the Fed's scenario of three rises in 2017, while the Trump administration has not yet announced details of the promised tax stimulus measures and investment plans. In our baseline scenario, we are therefore sticking with our forecast of a moderate weakening of the US currency in the second half of 2017. We think that upside risks for the dollar are mainly concentrated in the second quarter and explained by a possible rise in demand for safe-haven assets coinciding with the French elections.

S&P GSCI Industrial Metals Index Spot vs. EUR/USD

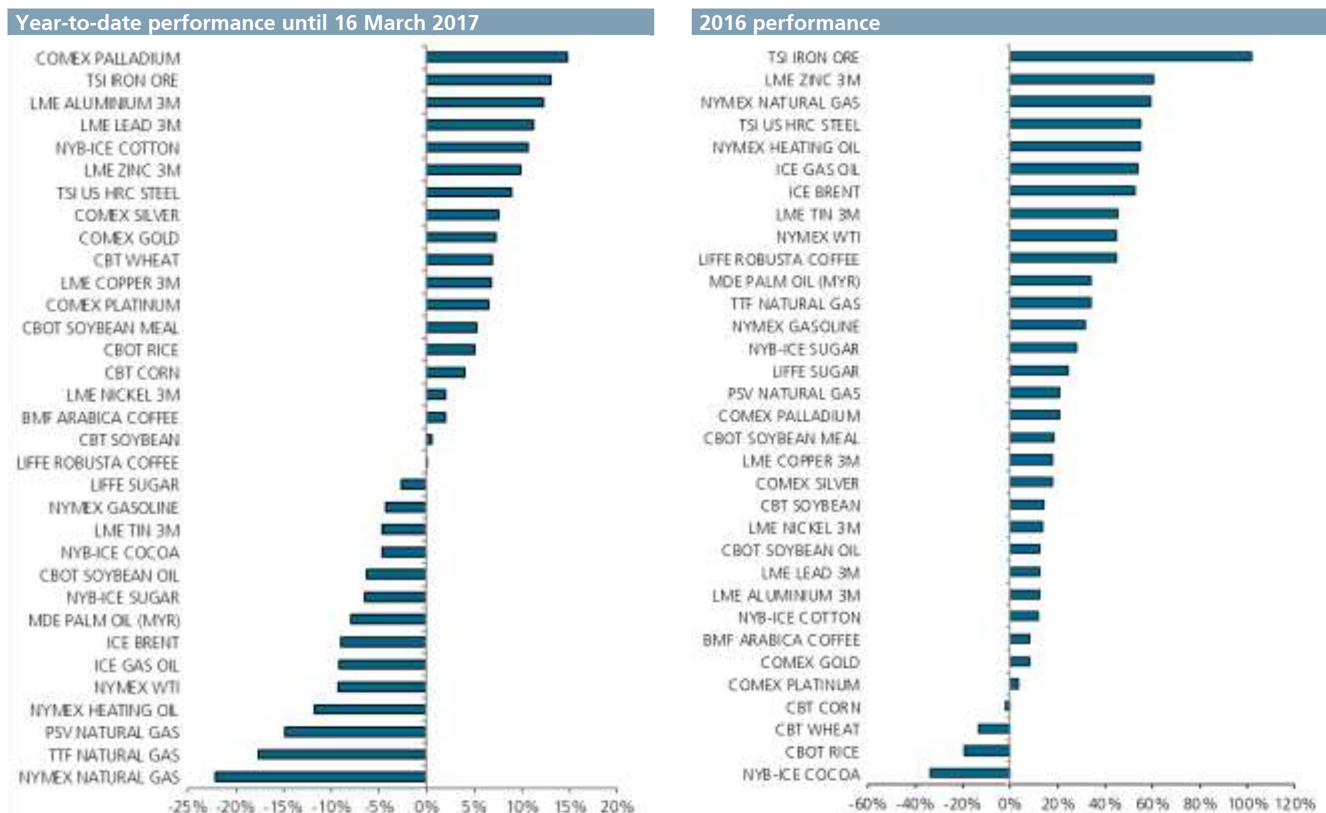


Source: Intesa Sanpaolo chart based on Bloomberg data

This rosy macroeconomic scenario has supported the rise in metal prices, whose physical markets have become tighter overall due to the strength of industrial demand and several limitations to supply (strikes in Chile, mine suspension in the Philippines, proposed limits to production capacity in China); it has also, to date, prevented prices from falling in the agricultural sector, which has weaker fundamentals due to the high level of accumulated stocks.

These favourable macroeconomic conditions have not, however, benefited the energy sector, given the pervasiveness of serious concerns about the weakness in demand (especially obvious in the natural gas market, which was adversely affected by weather conditions that were overall warmer than their historical average in both the US and Europe) and plentiful supply (the sell-off

recorded in the oil market in March has been triggered by strong growth in the US production of shale oil and high levels of domestic stocks).



Source: Intesa Sanpaolo chart based on Bloomberg data

Source: Intesa Sanpaolo chart based on Bloomberg data

We take a positive view of this heterogeneity of returns recorded year-to-date: the commodities asset class is regaining its potential for diversification. We believe that it is now a particularly attractive proposition to include commodities in an investment portfolio, as its correlation with other asset classes is falling, given that the impact of the commodities super-cycle, financial crisis and liquidity bubble is now coming to an end. The pairwise correlations (or correlation between couples of commodities) are also decreasing, after years of high values. We are finally getting back to "normal": supply and demand fundamentals have returned to being the main drivers of prices.

Forecasts for the commodity universe

Our baseline scenario for oil is formulated based on the following assumptions: a) OPEC will effectively meet the production target for around a year, again imposing limits on supply in 2H, b) total non-OPEC production will not excessively surprise to the upside, despite the active hedging policy by some producers and the difficulties in monitoring compliance from countries pledging to share with OPEC the burden of cutting their cumulative supply, c) global demand does not disappoint estimates. Specifically, the main risks are associated with a possible slowdown in both the process of accumulating strategic stocks, mainly in China, and growth in consumption in emerging countries due to the recent partial removal of fuel subsidies and the increasing use of biofuels, especially in South-East Asia. In this scenario, we expect the oil markets to stay in trading range; prices will struggle to exceed the USD 60 per barrel level on a stable basis, but will not fall below USD 45 per barrel, unless OPEC decides to give up any

ambition to monitor its own supply. We forecast that Brent and WTI will stay, on average, within an interval of USD 50-55 per barrel for most of the next quarter.

In 2017, industrial metals are likely to record a positive performance year-on-year, but we fear a correction in the short term. Industrial metal prices have in fact risen too much and too quickly, pushed up partly by temporary factors such as strikes, suspensions of some mineral export permits and proposals for more stringent environmental legislation. We therefore think it likely that prices will dip when these temporary curbs on supply disappear. However, we think that these highly positive supply and demand fundamentals coupled with the favourable macroeconomic scenario point to an increase in upside risks for the segment in 2H.

In our baseline scenario, gold is likely to benefit from a rise in demand for investment as a hedge against inflation risks, and from a recovery – albeit slow – in demand on the physical market. The main downside risks are a more restrictive than expected US monetary policy and a stronger than forecast US dollar.

With regard to agricultural commodities, the impact of weather conditions on the main cereals seems to be positive, boosting their cultivation. As a result, we have kept our end-of-year targets unchanged, which are now close to current market prices.

Oil: an extremely fragile equilibrium

With global demand not shaping up to be particularly outstanding, the two unknowns to keep an eye on in the next few months are OPEC production levels and the resulting reaction of non-OPEC supply to prices. We think that OPEC will try to adjust its production with the aim of reducing the extremely high levels of global stocks, while limiting as much as possible the impact on prices in order to curb growth in production from unconventional sources. For this reason, we expect oil prices to stay in trading range for a long time yet.

OPEC members' compliance with the agreement signed at the end of November has been exemplary: in the first two months of the year, the group implemented 98% of the promised cuts, according to IEA (International Energy Agency) estimates. The same cannot be said for non-OPEC countries: in the same period, these producers only implemented 37% of the agreed cuts, according to IEA estimates. Estimates by OPEC's monitoring committee are much more optimistic and put compliance with the agreement at around 65% in the first two months.

In the next few months, the two biggest concerns will be: compliance with the agreements by OPEC and non-OPEC members, and the production levels of the two OPEC members that are exempt from the cuts, namely Libya and Nigeria. In our view, if Saudi Arabia wants to protect the agreement signed in November and strengthen OPEC's credibility, it must continue to play the role of "swing supplier", i.e. offset any temporary breaches of the production ceiling by other OPEC countries. Moreover, it must pay close attention to communication: any discrepancies between the production estimates reported by the government (direct communication) and those prepared by OPEC's secondary sources must be avoided as much as possible or at least promptly explained. In OPEC's monthly report for March, the discrepancy between the direct communication figures (+263,000 barrels per day, mom) and those from secondary sources (-68,000 barrels per day, mom) accelerated the ongoing sell-off and fuelled major concerns about the ability and willingness of Saudi Arabia and OPEC to respect the agreement. We think that as long as the Saudis continue to benefit from the current deal, they will do their best to make it work.

In our baseline scenario, we assume that OPEC will continue making cuts in 2H; it will probably adjust volumes to take into account changes in supply and demand fundamentals, and will

probably also discuss production limits for Libya and Nigeria. Conversely, we think that non-OPEC countries will not renew their commitment to making cuts, but could undertake to freeze production at January or February levels, at least to demonstrate support for OPEC's efforts. The issue once again hangs on a purely political decision taken by Russia, which will weigh up whether or not it wants to maintain a cooperative relationship with the Middle-Eastern producers.

Supply and demand fundamentals

Generally speaking, all the major forecasters think that the rebalancing is well under way and are expecting a temporary deficit in 3Q. If OPEC were to maintain the average production of 32.0 mb/d (according to reports by OPEC secondary sources) recorded in February, for the whole year, the global market would, on average, record a deficit in 2017 and global stocks would be eroded. The change would vary in terms of significance depending on the estimates of fundamentals formulated by the various forecasters, and would range from an average contraction of 0.4 mb/d for OPEC to a (very optimistic) fall of 1.2 mb/d for IEA.

Supply and demand estimates published by OPEC, IEA and EIA for 2016

Estimates for 2016 published in March 2017 in mb/d	Total demand	Non-OPEC Supply	OPEC	Total demand
OPEC	95.1	57.3	6.1	31.9
Y/Y change	1.4	-0.7	0.2	1.9
IEA*	96.6	57.7	6.7	32.2
Y/Y change	1.6	-0.8	0.2	2.2
EIA	96.6	58.2	6.5	31.8
Y/Y change	1.6	-0.6	0.2	1.8

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA; * IEA figures at February 2017

Supply and demand estimates published by OPEC, IEA and EIA for 2017

Estimates for 2017 published in March 2017 in mb/d	Total demand	Non-OPEC Supply	OPEC LNG Supply	"Call on OPEC Crude"
OPEC	96.3	57.7	6.2	32.4
Y/Y change	1.3	0.4	0.1	0.7
IEA*	98.0	58.0	6.8	33.2
Y/Y change	1.4	0.5	0.1	0.8
EIA	98.2	58.7	6.8	32.6
Y/Y change	1.6	0.5	0.4	0.6

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA; * IEA figures at February 2017

Clearly, with global demand not shaping up to be particularly outstanding, the two unknowns in this equation are OPEC production levels and the resulting reaction of non-OPEC supply to prices. For example, in March, the US Energy Information Administration (EIA) estimates that supply of crude from both OPEC and non-OPEC producers will continue to increase, and thus forecasts that the market will struggle to remain in balance over the year; it will therefore be impossible to make a real dent in the high levels of global stocks. On the contrary, the EIA forecasts an average increase in stocks of 0.1 mb/d in 2017 and 0.2 mb/d in 2018.

Supply and demand estimates published by US EIA in March 2017

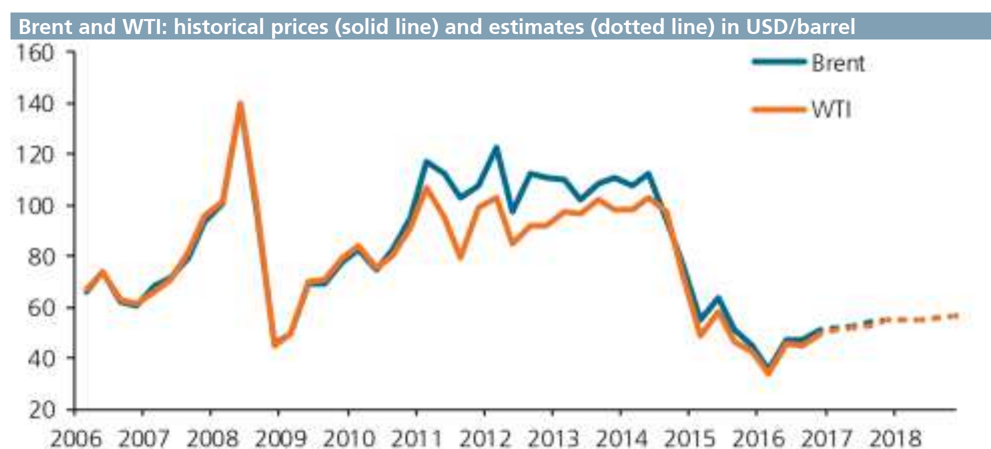
Estimates published in March 2017 in mb/d	World Demand	Non-OPEC Supply	US Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market Balance**
2016	96.6	58.2	8.9	6.5	32.5	32.0	0.5
Y/Y change	1.6	-0.6	-0.5	0.2	0.8	2.0	
2017	98.2	58.7	9.2	6.8	32.7	32.6	0.1
Y/Y change	1.5	0.5	0.3	0.4	0.2	0.6	
2018	99.7	59.7	9.7	7.0	33.2	33.0	0.2
Y/Y change	1.6	1.0	0.5	0.2	0.5	0.4	

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

OPEC is well aware that the increase in the production of US shale oil is the main threat to its efforts. As a result, we think that the group will try to adjust its supply to keep the market in balance or in deficit, while limiting the impact on prices. Excessive upside pressure on prices would stimulate production from unconventional sources, thereby increasing total supply and subsequently explaining any fall in prices.

For this reason we expect oil prices to stay within A trading range for a long time yet: Brent is likely to trade at between USD 47 and USD 60 per barrel for most of the period. We forecast an average price of USD 54 in the two central quarters of the year and a slight rise in 4Q, explained by the prospects of stronger global demand in 2018. The gap between WTI and Brent is likely to narrow as soon as domestic stocks start to be eroded (we will probably see a tighter market as early as 2Q), and could close by the end of the year if at least some of the fiscal stimulus measures promised by the Trump administration are implemented, boosting crude exports and fueling consumption.

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



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

Price estimates for Brent

Al 20.03.2017	1Q17	2Q17	3Q17	4Q17	2017	2018	2019
ICE BRENT	54.5	54.0	54.0	55.0	54.4	55.8	60.0
Median, Bloomberg	54.5	55.0	57.0	59.0	55.8	62.0	63.5
Forward Curve	54.6	52.1	52.4	52.4	52.9	52.0	51.8

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

Al 20.03.2017	1Q17	2Q17	3Q17	4Q17	2017	2018	2019
NYMEX WTI	52.0	52.0	53.0	55.0	53.0	55.8	60.0
Median, Bloomberg	53.0	54.0	55.3	57.0	54.8	60.0	61.5
Forward Curve	51.9	49.8	50.4	50.5	50.6	50.3	50.0

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: a positive outlook in 2017, but reforms are still up in the air

Giovanna Mossetti

The **political upheaval** experienced in the US in the autumn has the potential to dramatically change the economic scenario, with a potential combination of structural reforms and other measures (reform of the tax system, a rise in spending on infrastructure and defence, expansion of the federal deficit, protectionism and deregulation). **The broad spectrum of measures** on the administration's agenda is still **extremely vague in terms of the details and timescales** of implementation, partly because, in many cases, action needs to be coordinated with Congress.

For now, therefore, the economic scenario must be assessed on the **moderate positive growth path inherited from the pre-Trump era, while awaiting more information** about the form of the measures and their effects. Details of the reforms (e.g. level of tax rates, possible border adjustment for corporate taxes, method of financing the higher spending on infrastructure and protectionism) will emerge during the year, but need time to be defined and approved, before influencing the economic scenario.

Our 2017 scenario remains broadly unchanged compared with the one we formulated in December: we forecast **growth of 2.1% in 2017, 2.5% in 2018 and 2.3% in 2019**, with an expected return towards potential growth from 2020 onwards. **Inflation's** expected rise above 2% in the middle of 2017 is likely to be temporary, before it returns towards 2%, based on our forecasts for commodities, the exchange rate and the economic cycle. The scenario is based on **two assumptions**: 1) the potential reforms will not be approved before autumn 2017 and will have **economic effects from mid-2018**; 2) the **overall net effects are likely to be moderately expansionary** (+0.5-0.6 bps over two years), with probable extensive redistributions between sectors for companies and between income classes for consumers, but potential downside risks (protectionism, progressive tax reductions, decrease in the immigrant workforce).

With regard to **monetary policy**, the Fed is likely to continue with the **gradual removal of stimulus measures (another two hikes in 2017),** before taking stock of the next economic scenario based on the reforms and the fiscal policy and deregulation measures.

1. Macroeconomic outlook: recovery is old but still kicking. The current recovery is old but, unlike what happened at the end of previous cycles, there are no obvious signs of wear and tear: growth is widespread, at around potential, the output gap is almost closed, and inflation is moderate. In 2017, GDP is likely to be sustained by growth in all components of private domestic demand.

Consumer spending will be boosted by the positive trend in employment income, with solid employment growth and a moderate acceleration in wages. The **labour market** is driving household spending. Solid **jobs** growth, at an average of around 200,000 new jobs per month in 2015-2016, is set to slow in 2017, bringing it back to levels consistent with a stabilising unemployment rate (Fed estimate: 65,000-125,000). The participation rate is likely to resume its downward path from the second half of the year, taking the **unemployment rate** below equilibrium and triggering a further modest acceleration in wages. **Consumer spending growth** is forecast to be **stable at 2.7% in 2017, rising to 2.8% in 2018**, followed by a slowdown.

Non-residential investment resumed growth during 2016, thanks to the reversal in the extraction sector associated with oil prices, and the recovery in manufacturing and foreign orders. It is forecast to **accelerate to +3% in 2017 (from -0.5% in 2016) and +4.6% in 2018, but is** subject to considerable uncertainty. On the one hand, current indicators point to a moderate scenario (e.g. industrial and commercial loan growth slowing). But on the other, details of tax reform will specifically affect this item (rates, accelerated depreciation and the border adjustment). In the short term, uncertainty surrounding the tax situation could also curb corporate decision-making while companies wait for details of the reform.

Residential investment looks set to expand at a solid pace (+4.6% in 2017), while **exports** are likely to make a negative contribution to growth (-0.6 bps).

2. Administration's policies: actions on many fronts, effects from mid-2018, moderate net stimulus and considerable redistribution. The government's actions are wide-ranging and cover several areas: 1) healthcare, 2) taxes, 3) reallocation of discretionary spending (more for infrastructure and defence, less for other items), 4) deregulation, 5) immigration, 6) delocalisation and international trade. The first three issues require **coordination with Congress** to be enacted into law, and will probably involve measures with a net expansionary effect on

growth. The other three issues are in **executive**'s hands, and have potentially negative implications for domestic and global growth, in light of the Administration's strong **protectionist bias**. The executive orders issued so far do not have direct consequences on growth, but leave the door open to risks of trade wars and of slower labor force growth.

Healthcare reform has just dealt a significant blow to both the republican leadership and the president. The healthcare bill was pulled from the House discussion due to the unwavering opposition of the House conservative group. The impossibility of a deal within the republican party on healthcare puts in jeopardy the timing and size of any future reform, in particular tax reform. The expected increase in **infrastructure spending** will provide a modest boost from 2018, although it is unclear by how much, given the lack of information on its details and its financing.

The main issue, though, is **corporate and personal tax reform.** The Ryan Plan is the starting point. a) **Corporate tax**: taxation on cash flow, with a border adjustment (excluding imports and exports), lower rates for all businesses, expansion of the tax base, repatriation of profits from abroad, immediate write-off of investment. b) **Personal tax**: reduction in the level and number of income tax and capital gains rates, repeal of estate and gift taxes, lower deductions. The net impact on the cumulative deficit over ten years would be an increase of USD 2.4Trn (static estimate) or between USD 0 and around USD 400Bn (dynamic estimate). See Table 1. An agreement will prove difficult, even within Congress, due to the considerable redistribution effects between industrial sectors and income classes. The border adjustment (BA) is crucial as it will generate revenues of around USD 1.1Trn over ten years and "finance" other parts of the reform (tax rates, depreciation), as well as provide an incentive for production to relocate and stamp out tax avoidance by multinationals. At the moment, it is difficult to predict which aspects of the Ryan Plan will survive the negotiations, but the advent of mid-term elections in 2018 suggests a **high probability that an agreement on the reform will be reached by mid-2018**. In our view, the combination of the reform's features will give rise to considerable redistribution effects, which will be higher than the expansionary effects, and act as a moderate spur to growth in 2018-19.

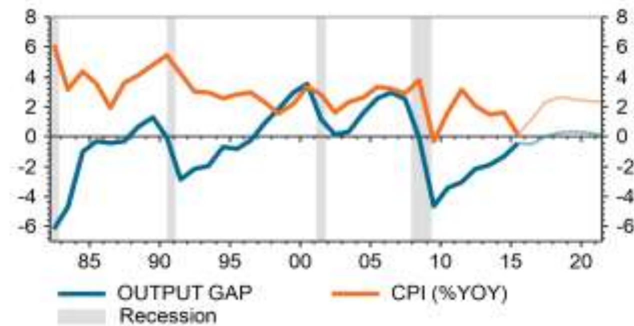
3. Monetary policy: gradual rises towards neutrality. The Fed has achieved its objectives of maximum employment and inflation of around 2% and now aims at a neutral monetary policy: estimates of the short-term real neutral rate are around zero, and the forecast is that the rate will gradually rise towards 1% in the longer term. The reinvestment policy is likely to continue at least until mid-2018; the portfolio duration is continuously falling (six years, from 7.5 in 2013), which, according to Janet Yellen, is equivalent to two hikes in the fed funds rate in 2017. **Two more tax hikes likely in 2017, but the path will depend on the data and policies of the new administration.**

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.6	2.1	2.5	1.3	1.7	1.9	2.2	2.3	1.9	2.0	2.1	2.4	2.6
q/q annual rate				1.4	3.5	1.9	2.1	1.7	1.9	2.1	2.8	2.9	2.8
Private consumption	2.7	2.7	2.8	4.3	3.0	3.0	2.6	2.2	2.5	2.2	3.0	3.2	3.2
Fixed investment - nonresid.	-0.5	3.0	4.6	1.0	1.4	1.3	3.5	4.4	4.5	4.0	4.5	5.1	5.0
Fixed investment - residential	4.9	4.6	5.8	-7.8	-4.1	9.6	6.2	6.2	6.9	6.5	6.2	4.9	4.7
Government consumption	0.8	0.3	0.7	-1.7	0.8	0.3	0.3	0.3	0.4	0.5	0.9	0.7	0.8
Export	0.4	0.9	2.2	1.8	10.0	-4.0	-0.3	1.3	0.9	1.5	2.5	2.6	3.0
Import	1.1	4.2	4.4	0.2	2.2	8.5	3.5	3.7	3.9	4.2	4.6	4.6	4.5
Stockbuilding (% contrib. to GDP)	-0.4	0.1	0.1	-1.2	0.4	0.9	0.1	-0.2	-0.2	0.2	0.2	0.1	0.0
Current account (% of GDP)	-2.7	-3.1	-3.2										
Federal Deficit (% of GDP)	-5.0	-5.1	-5.7										
Gov. Debt (% of GDP)	127.6	127.3	126.9										
CPI (y/y)	1.3	2.6	2.3	1.0	1.1	1.8	2.6	2.4	2.8	2.6	2.2	2.4	2.3
Industrial production (y/y)	-1.0	1.3	2.2	-0.2	0.4	0.1	0.3	0.6	0.4	0.6	0.7	0.6	0.4
Unemployment (%)	4.9	4.6	4.6	4.9	4.9	4.7	4.7	4.6	4.6	4.6	4.6	4.6	4.6
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	95.3	97.3	89.6	90.2	93.7	94.5	94.8	95.7	96.3	96.7	97.2	97.5

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

Fig. 1 – US economy in balance

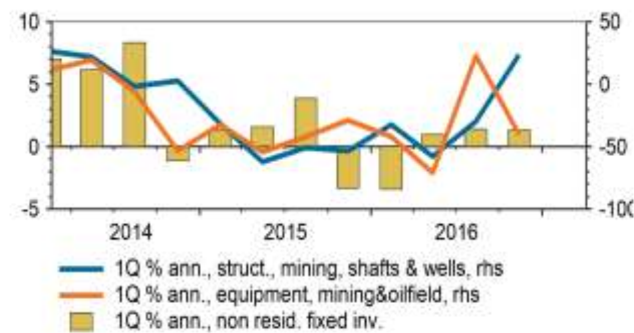


Source: Thomson Reuters-Datastream

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

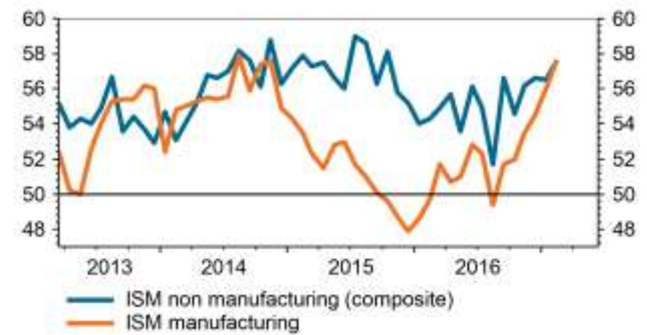
Source: Thomson Reuters-Datastream

Fig. 3 – Non-residential investment on a moderate upward trend



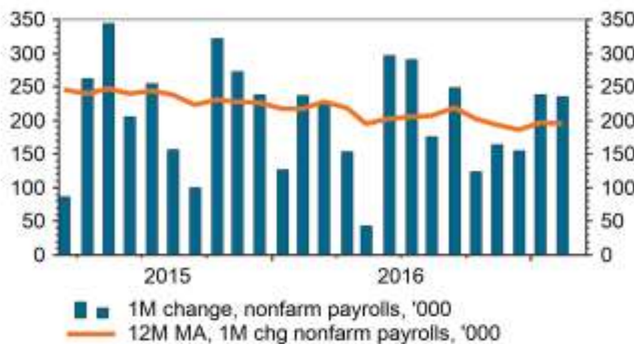
Source: Thomson Reuters-Datastream

Fig. 4 – ISM: positive indications for growth



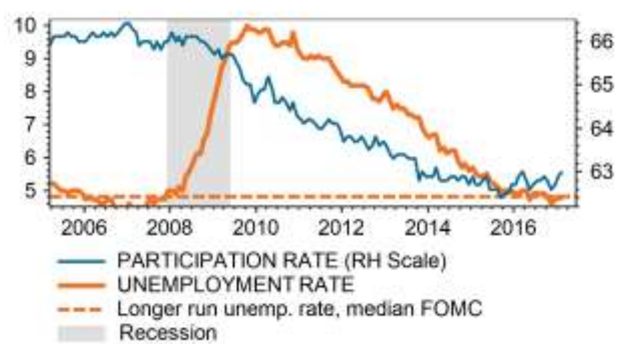
Source: Bloomberg, Thomson Reuters-Datastream

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



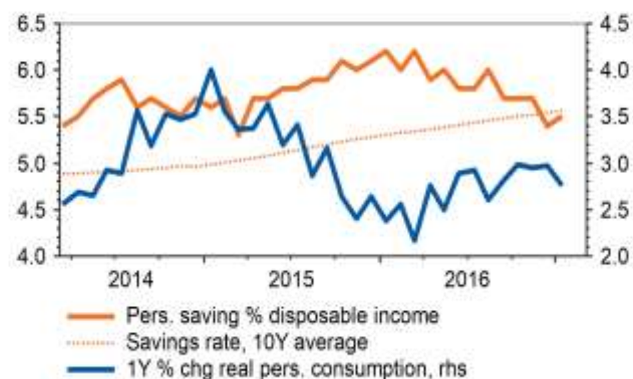
Source: Thomson Reuters-Datastream

Fig. 6 – Unused resources drying up in the labour market



Source: Thomson Reuters-Datastream

Fig. 7 – Consumption and saving: sustainable equilibrium

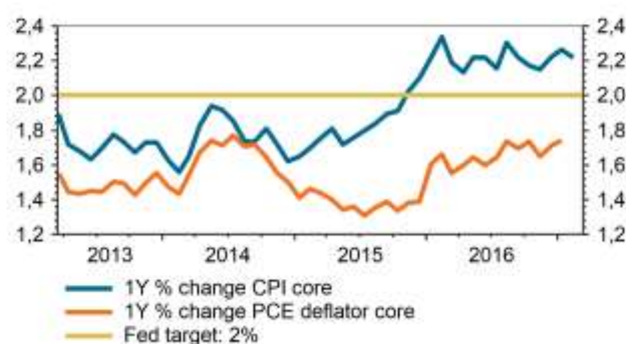


Source: Thomson Reuters-Datastream

Fig. 8 – Wages reflect scarcity of available resources

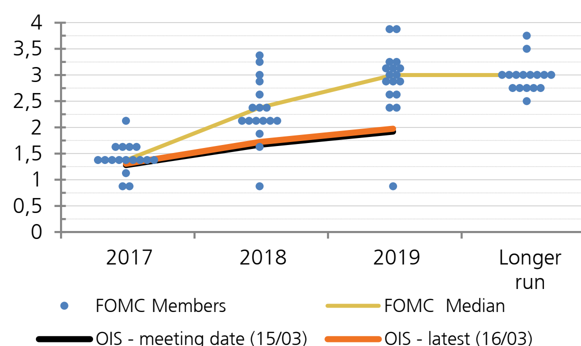
Source: Atlanta Fed, wage growth tracker

Fig. 9 – Inflation is close to 2%



Source: Thomson Reuters-Datastream

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



Source: Thomson Reuters-Datastream

Table 1 - The arithmetic of the Ryan Plan

Ryan plan impact (2016-25) – alternative estimates

Tln USD	TF static	TF dinamic	TPC static	TPC dinamic
Revenues	-2.4	-0.2	-3.1	-3.0
Households	-0.981	-0.566	-2.0	
Corporations	-1.197	-1.324	-0.891	
Of which				
- immediate expensing &non deductibility of interest costs	-1.042	0.293	-0.447	
- Border Adjustment	1.069	0.936	1.179	
- tax rate at 20%& cancellation of AMT	-2.161	-0.429	-1.844	
GDP (%)		9.1		1.0

N.B.: TF=Tax Foundation; TPC= Tax Policy Center. Static = with no macroeconomic feedback; dynamic = with macroeconomic feedback. "-" sign =>reduction in revenue,"+" sign => increase in revenue. Source: Intesa Sanpaolo chart based on Tax Foundation and Tax Policy Center data

Euro area: the recovery accelerates against high political risk

Anna Maria Grimaldi

- We are more positive on Euro zone growth than we were three months ago: the signs of recovery from foreign trade have firmed up and support exports and manufacturing activity. Services are still growing at a sustained pace and construction has started moving towards a more expansionary phase. Confidence surveys indicate that GDP is accelerating (0.5% qoq from 0.4% in the second half of last year). The recovery is widespread across the whole area, although with varying degrees of intensity. We have, therefore, upgraded our 2017 forecast again, from 1.5% previously to 1.7%. For 2018 we expect only a slight recovery, to 1.6%.
- Foreign demand is stimulating GDP growth more than we had expected three months ago, but domestic demand remains the main engine of growth, thanks to the support of the ECB policies. Household consumer spending will continue to grow at a sustained pace (1.4%), but less so than in the two previous years, since employment growth (+1.4%) will not be enough to offset the loss in purchasing power associated with the rise oil prices. Investment in machinery is likely to accelerate, but risks are to the downside given the looming political uncertainty (see below).
- The ECB's expansionary policies are still the only support to the Euro zone economy. Fiscal policy will be only marginally expansionary and there is a risk that it will be tightened again in 2018.
- The expansionary phase has continued above potential (1.3%) since mid-2014. However, the cycle is not yet mature: the considerable excess supply will only be reabsorbed by the end of 2018. Unemployment has fallen back to 9.6% from 12.1% in 2013, but is still above NAIRU, and the difference between the various countries is still fairly considerable, continuing to put pressure on wages and domestic prices.
- Inflation returned to 2% in February, but this is likely to have been only a temporary surge, generated by the rise in oil prices. For a sustainable rise, we will need to wait for an increase in core inflation, which currently remains stuck at 0.9%, where it has been since 2013.
- Although less than they were three months ago, the risks to the scenario are still tilted to the downside and are mainly political. A populist victory has been averted in the Netherlands. The next test will be the French presidential elections (April-May), followed by the German elections (24 September). Last, we should not overlook the risk of early elections in Italy.
- Low core inflation and the high degree of political uncertainty are the reasons for the ECB's caution. However, as the recovery gathers strength, the end of the super stimulus (negative interest rates and QE) approaches. Formal announcements on the asset purchase programme will probably only be made after the German elections. Meanwhile, at its June meeting, the ECB could modify its rates guidance in a more symmetrical way and indicate that the sequencing of exiting from the unconventional measures could be revised.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.7	1.7	1.6	1.6	1.8	1.7	1.6	1.8	1.7	1.7	1.7	1.7	1.6
- q/q change				0.3	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Private consumption	1.9	1.6	1.5	0.3	0.3	0.4	0.4	0.4	0.4	0.3	0.4	0.4	0.3
Fixed investment	2.5	3.8	5.4	1.2	-0.7	0.6	1.6	1.3	1.2	1.0	1.5	1.5	1.4
Government consumption	1.8	1.3	1.1	0.3	0.1	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Export	2.7	3.4	3.0	1.3	0.3	1.5	0.9	0.5	0.6	0.8	0.7	0.9	0.7
Import	3.4	4.2	4.3	1.4	-0.1	2.0	1.0	0.9	0.8	0.8	1.1	1.4	1.1
Stockbuilding (% contrib. to GDP)	-0.1	0.0	-0.1	-0.2	0.2	0.1	-0.1	0.1	0.0	-0.1	0.0	0.0	0.0
Current account (% of GDP)	2.8	2.0	2.6										
Deficit (% of GDP)	-1.7	-1.4	-1.4										
Debt (% of GDP)	91.5	90.4	89.2										
CPI (y/y)	0.2	1.7	1.5	-0.1	0.3	0.7	1.9	1.7	1.6	1.5	1.1	1.4	1.7
Industrial production (y/y)	1.4	2.1	1.5	1.0	1.0	2.2	1.9	2.4	2.5	1.5	1.1	1.4	1.7
Unemployment (%)	10.0	9.3	8.9	10.1	9.9	9.7	9.5	9.4	9.3	9.1	9.0	8.9	8.8
3-month Euribor	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.2
EUR/USD	1.11	1.07	1.11	1.13	1.12	1.08	1.06	1.06	1.08	1.09	1.09	1.10	1.11

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

Euro zone: the pace of the recovery picks up, political risk notwithstanding

Euro zone GDP rose by 0.4% qoq in the second half of last year (1.8% yoy). The acceleration in growth signalled by business surveys since last October was not reflected in GDP growth figure, which was stable at 0.4% qoq at end-2016, as in the summer. The composite PMI and economic confidence index improved further in 1Q, returning to the highs of 2011 (55.2 from 53.9 previously and 109 from 106.8 previously, respectively). In our estimates, Euro zone GDP is likely to accelerate to 0.5% qoq (see fig. 1). Note that, for the same confidence surveys levels, GDP growth is lower than it was before the crisis due to a structural break in the series, which partly reflects lower expectations of potential growth. The European Commission has provided details on what is being defined as the "new modesty" in the 2017 Winter Forecasts[2]. January industrial output left the quarterly dynamic on track for a slight slowdown in economic growth compared with the end of 2016 (see fig. 2). However, industrial sector surveys suggest that the expansionary phase in industry will continue into February and March (see fig. 3). Global demand has surprised to the upside thanks to the recovery in emerging markets (see fig. 4), and, according to global PMI indications, the trend is set to strengthen in the next few months (see fig. 5). Growth in services and retail continues. The other positive aspect of this growth phase is that the recovery is widespread across the whole area, albeit with differing degrees of intensity, and thus seems more sustainable (see fig. 6).

We have, therefore, upgraded our 2017 forecast again, from 1.5% previously to 1.7%. For 2018 we expect only a slight recovery, to 1.6%. The expansionary phase has continued above potential (1.3%) since mid-2014. However, **the cycle is not yet mature: the considerable excess supply will only be reabsorbed by the end of 2018.** Unemployment has fallen back to 9.6% from 12.1% in 2013, but is still above NAIRU, and the difference between the various countries remains considerable. Excess supply is even larger if we look at the expanded unemployment rate, which includes the economically inactive (see figs. 11 and 12).

Recovery in foreign demand confirmed, but outlook remains uncertain

The recovery in global demand (see fig. 5) suggests that export growth will be more vigorous than we estimated in December. However, we maintain our **forecast of a cautious upturn in foreign trade with the Euro zone** (3.0% in 2017-18, from 2.1% this year and below 3.4% in 2012-2014). The trend in global demand, especially in 2018, is shrouded in uncertainty. President Trump is currently maintaining an aggressive stance on international trade and immigration policies, but concrete measures are few and far between. The debate on fiscal reform is still to be defined. The effect of the new administration on both US and international growth therefore remains uncertain. The **rise in the oil price (22% expressed in euro) will hamper growth** to the tune of at least 0.4% of GDP, with a stronger impact in the first half of the year since the bulk of the increase has already occurred and there are unlikely to be any significant changes from recent levels over the next few months. The **exchange rate could shave one- or two-tenths of a percentage point** off growth in the current year. The modest appreciation looks set to strengthen in the next few months with the euro/dollar exchange rate rising to 1.10 after 12 months and 1.15 after 24 months; the effective exchange rate is likely to remain broadly stable.

Oil will to weigh on growth. Exchange rate broadly neutral

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[2] See European Commission Winter Forecasts, Box I.2: *A "new modesty"? Level shifts in survey data and the decreasing trend of "normal" growth* pp. 52-54. In the pre-crisis period, a European Commission economic confidence level of 100 equated to a GDP growth rate of 2%, while more recently, the same level has been consistent with a growth rate of just over 1%. Note that the long-term average of the confidence indices should reflect what economic operators consider to be a normal level of economic activity. The fact that given levels of confidence are associated with variable growth rates – in this case, decreasing over time – suggests that economic operators are adapting their perception of what is normal to recent events.

Monetary policy will again provide the biggest impetus to growth, and to domestic demand in particular. According to the ECB, the measures adopted between December 2015 and December 2016 are likely to have boosted GDP growth by 1.7% in the period 2015-18. As the recovery gathers strength, the start of the exit from the monetary super stimulus approaches (see section on monetary policy below), although ultra-accommodative conditions for governments and companies will likely prevail until at least mid-2018. **Fiscal policy will be unable to pick up the baton if European rules must be complied with.** After a period of neutrality or modest slowdown in 2016-17, fiscal policy is likely to be tightened again in 2018 (see fig. 13) in at least six countries (Italy, France, Spain, Portugal, Belgium, Slovenia and Finland) by a total amount of between 0.3% and 0.6% of average Euro zone GDP (see fig. 14). Even if some relaxation of fiscal policy will be agreed, it is unlikely to happen before the German elections on 24 September.

Monetary policy to remain the main growth booster this year and next

Negligible support from fiscal policy. Any progress unlikely before the French and German elections

With regard to the composition of growth, we forecast that, in line with estimates of foreign demand directed to Euro zone, exports will accelerate to 3.4% in 2017 and slow to 3.0% in 2018. Livelier export growth will be offset by import growth of over 4.0% in 2017-18. As a result, the **contribution of foreign trade** will be **negative both this year and next**. The **main growth driver** will still be **domestic demand** (+1.6%), although less so than in the previous two years (1.9%-2.0%). **Private consumption** is again expected to maintain a solid pace (1.6% in the current two-year period), but less so than in the last two years (1.9% on average), partly due to the loss of purchasing power associated with higher oil prices and **inflation rising** to 1.7%, from 0.2% this year. Nominal wage growth slowed more than expected in 2016, although it rose to 1.9% yoy at the end of 2016. In 2017, we do not expect wages to rise significantly, partly because there is still **considerable excess supply in the labour market** (see **figs 11 and 12**). **Risks of negative second-round effects on wages, however, seem to have decreased compared to three months ago,** due to the rise in energy prices (see section on inflation) and rebound in selling prices 'expectations. The resilience of consumption therefore depends on employment growth remaining solid and close to 1.3%, as per our estimates. The slight increase in the **savings** rate in 1H16 should provide a cushion against adverse shocks (see Fig. 7). **Fixed investment** picked up (+0.6% qoq at the end of 2016, after -0.7% qoq) on the back of the recovery in construction, according to country data. On the other hand, investment in machinery slowed (+0.6% qoq), but it could be a hiatus after the strong growth in the middle of 2016 (+2.8% qoq). The combination of resilient earnings, high production capacity utilisation (see fig. 8) and ongoing expansionary financial conditions is likely to boost company spending on machinery during 2017-18. Construction activity seems to be stabilising at modest growth rates (see fig. 3) according to information obtained from companies. Our indicator for **construction spending[3] estimates growth of 0.5% qoq in early 2017** (see fig. 9). Spain and Germany are driving this expansionary phase (+2.1% in 2017, from 2.3%).

More vigorous exports will be offset by accelerating imports

Domestic demand will continue to drive growth. Private consumer spending has now peaked, while investment is expected to accelerate

The risks to the scenario are to the downside and are mainly political. Uncertainty reigns supreme, with the imminent negotiations for the UK's exit from the EU, together with political elections in France (presidential in April-May; parliamentary in May-June), followed by Germany (September) and perhaps Italy. Marine Le Pen is consolidating her popularity in the polls at around 26%, and it is assumed that she will lose in the second round against either Macron or Fillon. But if, in circumstances that are currently unforeseeable, Le Pen were to win, the new President's powers would be limited as she would struggle to wrest a parliamentary majority from the traditional parties (currently the Socialists). In the absence of support from Parliament, Marine Le Pen would be unable to trigger the dreaded Frexit, but the effects of victory by her would spook the markets, confidence and investment much more than the UK vote did. But there could also be positive surprises along with the negative ones. In Germany, under Schultz's

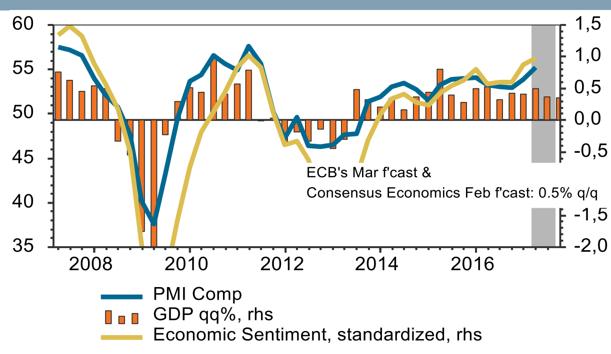
Risks to the downside have only partially eased and are mainly political

But there could also be positive surprises: a Macron-Schultz axis could push for more pro-Europe reforms

[3] See the *Weekly Economic Monitor* of 20 May 2016

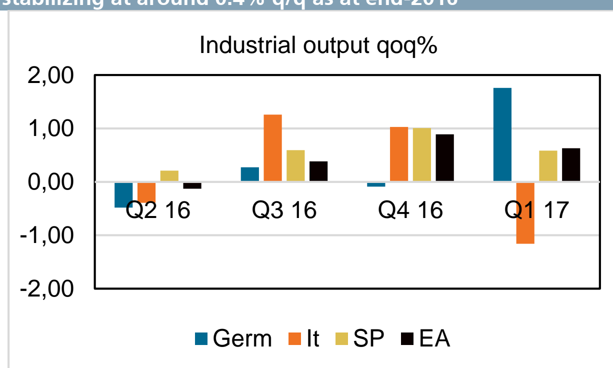
leadership, the Social Democratic Party (SDP) have gained around 12 points in the surveys and are only two points (32%) adrift from the CDU (34%). We cannot rule out the possibility that if Schulz manages to consolidate his upturn in popularity in the next few months, there could be a CDU/SPD coalition where Schultz rather than Angela Merkel is in charge at the chancellery. With Macron at the helm in France and Schultz as the German chancellor, the debate on European reforms and a Europe running at different speeds (for security and defence) could make significant progress in 2018.

Fig. 1 – GDP is expected to accelerate to +0.5% qoq in early 2017, but confidence surveys suggest upside risks



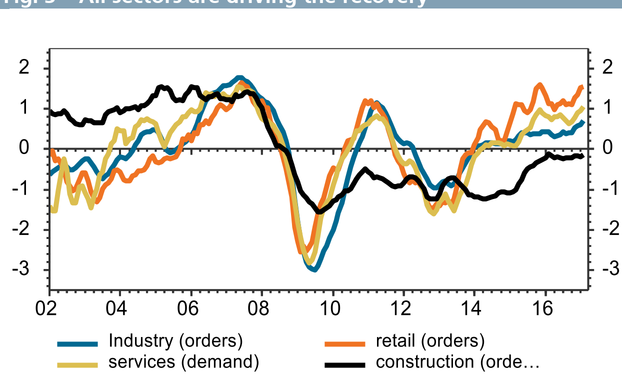
Source: Consensus Economics February forecasts, ECB March 2017 estimates, Intesa Sanpaolo chart from Thomson Reuters Datastream data

Fig. 2 – Positive trend in Euro zone industrial output in early 2017, but, for the moment, consistent with GDP growth stabilizing at around 0.4% q/q as at end-2016



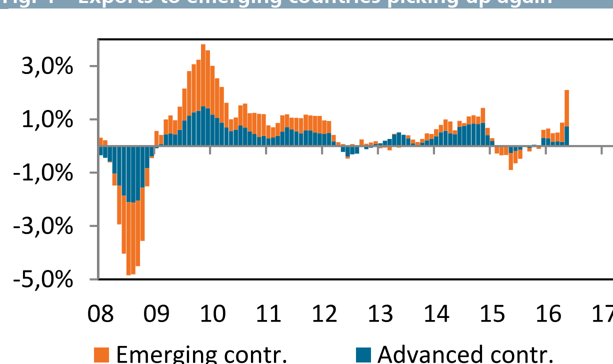
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – All sectors are driving the recovery



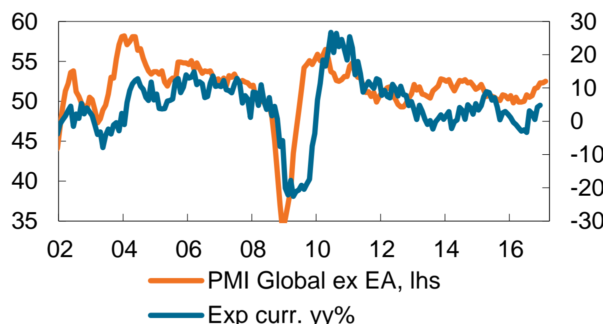
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 4 – Exports to emerging countries picking up again



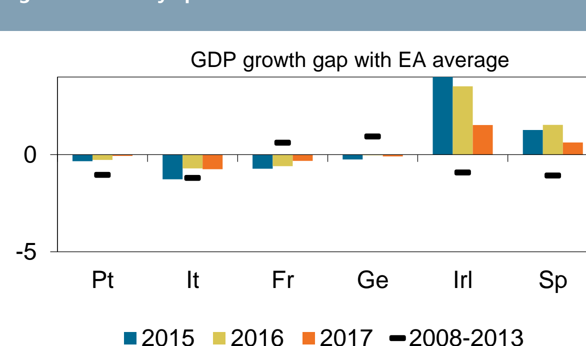
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 5 – Global trade recovery set to continue in the next few months



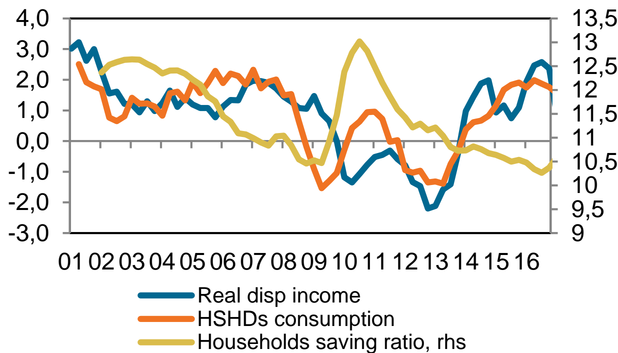
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – Recovery spread across the whole euro area



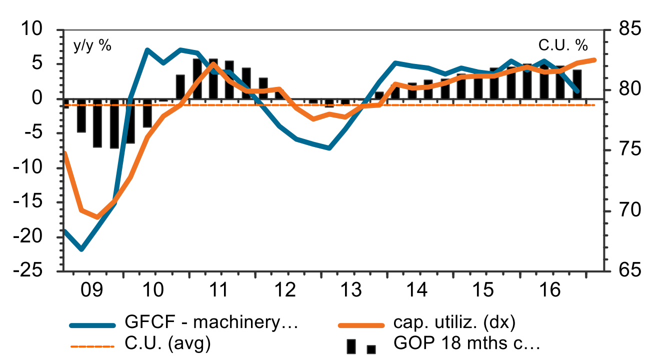
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Global demand will continue to grow at a sustained pace, but consumer spending has now peaked. Savings rate might only partially offset fall in disposable income.



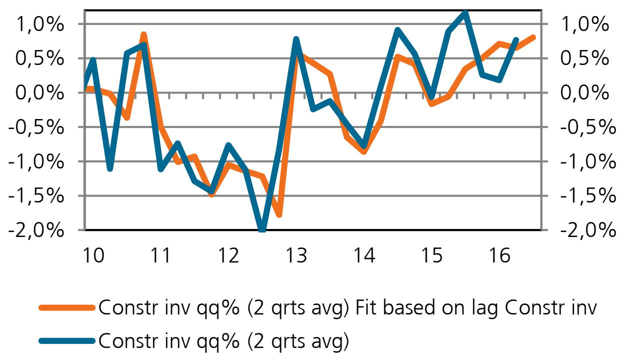
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 8 – Investment on the brink of livelier growth?



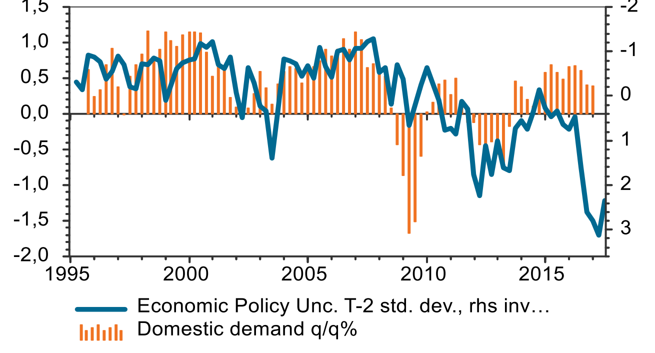
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 9 – Construction has embarked on a path of moderate expansion



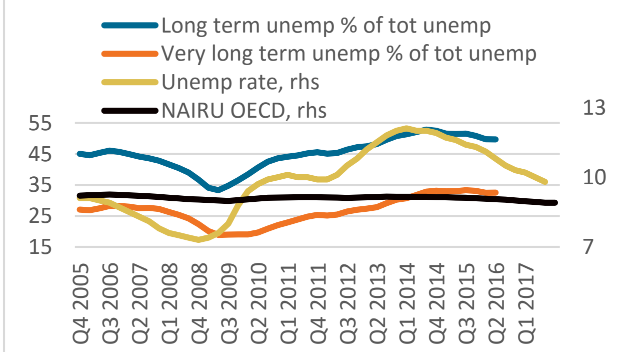
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig 10 – Political uncertainty still the sword of Damocles hanging over the Euro zone



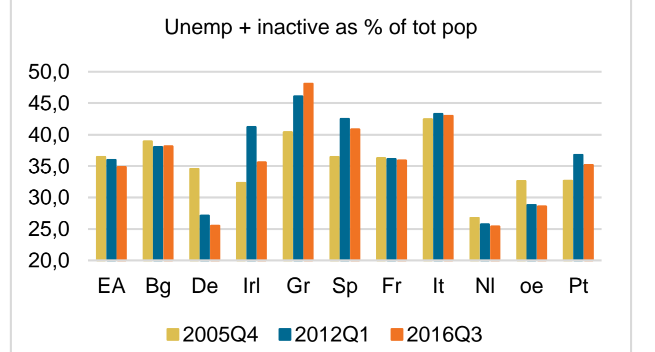
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig 11 – Cycle not yet mature, but a strongly expansionary monetary policy will no longer be easy to justify after 2017



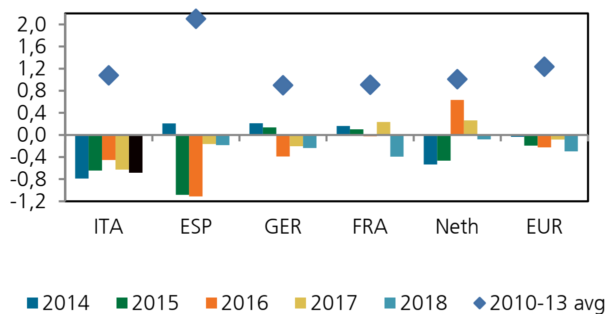
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig 12 – Expanded unemployment rate has fallen less than the unemployment rate



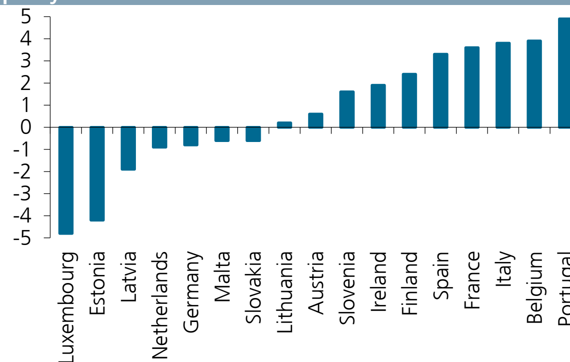
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 13 – Fiscal policy in the Euro zone is only slightly expansionary



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

Fig. 14 – Scope for loosening (-) or the need to tighten (+) fiscal policy for the various Euro zone countries



Source: "Towards a Positive Euro Area Fiscal Stance", EU Commission Issue 20, 23 November 2016

Inflation: appearances are deceptive. What counts is the underlying trend

Anna Maria Grimaldi

Euro area inflation rose to 2% in March, a level it hadn't reached in four years, half a point higher compared to ECB staff's December forecasts (Fig. 1) and *Consensus Economics* estimates (in February, average forecast inflation among analysts was 1.6% in 1Q 2017). The surge of inflation by close to two points between August and February is explained by the rebound of the energy component (+9.4% y/y, from -6.7% y/y in July), combined with rise in oil prices and a favourable statistical base effect. The response of energy prices to the rebound in the oil price was stronger than we expected. It is also true that the price of oil averaged around 55.6 dollars per barrel between December and February, slightly above the prices implied by futures in November; furthermore, the exchange rate was marginally weaker. Net of energy, fresh food, and tobacco prices, inflation was stable at 0.9% in February, the same level as at the end of 2013. The median calculated on the various measures of inflation actually decreased in February (Fig. 2), despite two and a half years of above-potential growth. In light of developments over the past few months, we have revised up our estimate for 2017 to 1.6% from 1.2%. We expect **inflation to drop to 1.5% in 2018, and the price trend should only return more stably towards the ECB target in 2019**. Our estimates are roughly in line with consensus, and with the latest ECB forecasts (IPCA: 1.7% in 2017, 1.6% in 2018, and 1.8% in 2019).

Headline inflation grew more than expected at the beginning of 2017, driven by energy. But core inflation was stable at 0.9%

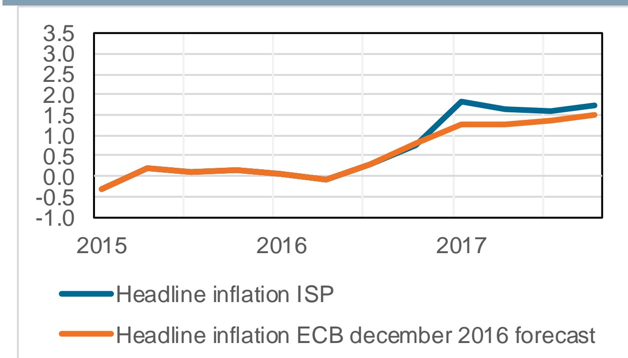
The return of overall inflation towards target still depends largely on the trend of core prices (Fig. 3), as we expect, in line with ECB's March assumptions, little changed oil prices (56 dollars per barrel in 2018, 55 dollars in 2019) and a broadly stable effective exchange rate. This explains the shift in the ECB Council's focus to the trend of domestic prices. In March, the ECB revised up by one tenth its estimate of core inflation in 2019, to 1.8%, while stressing that there is still significant uncertainty on the size of excess supply[4] and/or on the reaction speed of underlying inflation. Specifically, the ECB has placed emphasis on the wage trend, which is still struggling to accelerate. In 4Q 2016, the cost of labour rose to 1.6% from 1.4% previously, and nominal wages increased by 1.6% from 1.5%. The rise in wages was driven by Germany and Ireland, as opposed to a slowdown in Spain (0.2% y/y from 0.6% y/y), a still sluggish, albeit no longer negative, trend in Italy (0.1% y/y from -0.2%), and a stable course in France (1.5% y/y from 1.7% y/y a year earlier). The sluggish trend of cost of labour, in peripheral countries in particular (Fig. 5), is at odds with the rather strong decline in the unemployment rate observed in 2016, to 9.6%, a low since 2009. Going forward, pressures exerted by the cycle on the trend of wages and domestic prices will ease: if GDP growth stabilises at a pace in line with 2016 (1.7% in 2017-18), the reduction of excess aggregate supply will be smaller than in the 2014-15 period (Figs. 6 & 7). The failed acceleration of the wage trend could reflect a slower response to cycle conditions than in the past, probably due the size of excess supply on the labour market, that has built up in recent years. However, it may also be that the reforms implemented during the crisis years in many euro area countries have reduced the reactivity of wages to the trend of energy prices, as well as to the reduction of excess supply. Risks to the trend of core inflation explain how the doves within the ECB Council have managed to have the level of monetary stimulus kept high. However, it should be acknowledged that downside risks to euro area inflation have eased in part compared to last December, as the recovery is consolidating and is widespread throughout the area. The trend of price expectations, as inferred from business confidence surveys, suggests that the risk of deflation has not been overcome (Fig. 8), although producer prices in the consumer good segment have reversed (Fig. 9). Furthermore, the rise in oil prices has reduced the risk of negative second-round effects (Fig. 10).

Return of inflation to 1.8% on average in 2019 depends on the underlying trend

Downside risks to core inflation have eased somewhat compared to three months ago

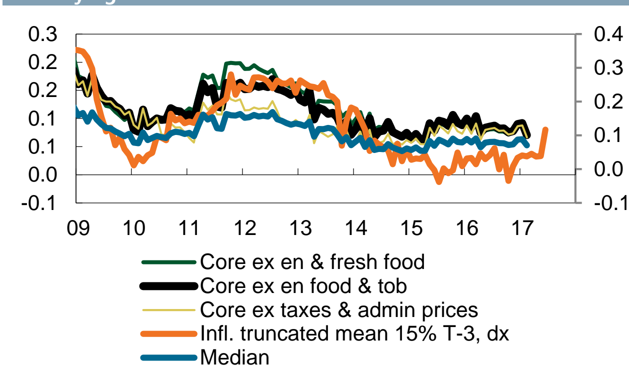
[4] See ECB working paper No. 1966 *An inflation-predicting measure of the output gap in the euro area.*

Fig. 1 – Euro area inflation at the beginning of 2017 up more than forecast by the ECB



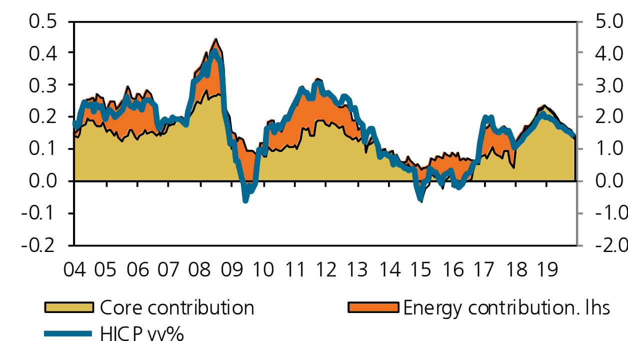
Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 2 – The contribution of energy will be roughly neutral between now and the end of 2018. Resurgence of inflation towards the ECB target dependent on the acceleration of the underlying trend



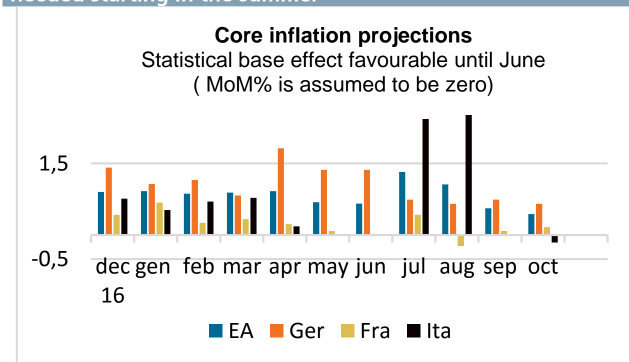
Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 3 – Core inflation still at historically low levels, median back down in February. Only the truncated mean at 15% leaves hope for an increase in the coming months



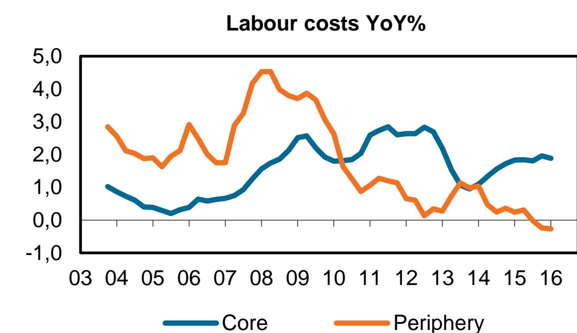
Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 4 – Core inflation will be helped by a favourable base effect in the spring, but genuine domestic price increase will be needed starting in the summer



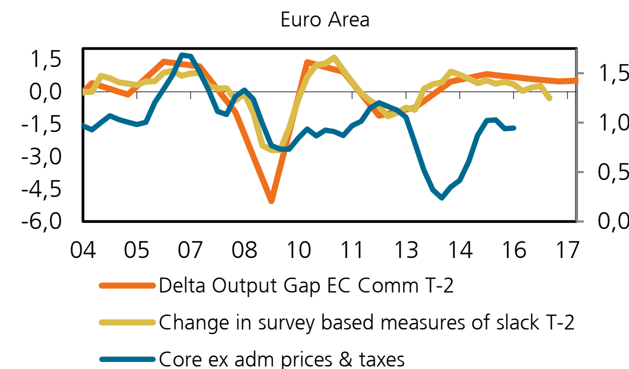
Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 5 – Cost of labour still not accelerating in peripheral Europe



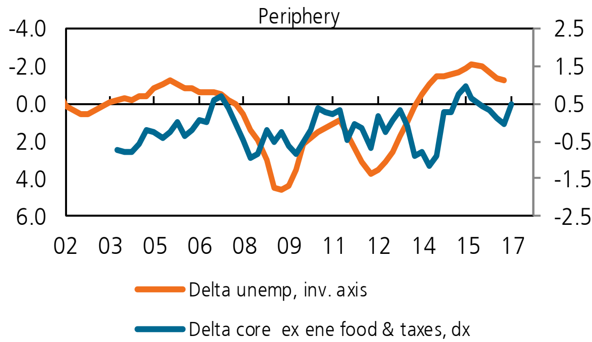
Note: Periphery = ITA+SPA+GR+PT+IRL; Core = GERM+FR+NL+BEL. Countries aggregated based on euro area IPCA weight. Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 6 – Support from the cycle will not be as strong. The pace of the narrowing of excess supply will slow in 2017



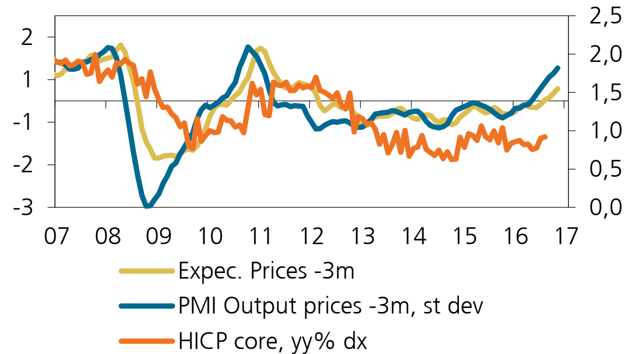
Nota: EU Commission output gap, chg. vs. previous year. The measures of excess supply derived from the surveys are based on demand as per the EU Commission's quarterly survey: "is demand limiting output?" industry, construction, services, and retail sales. The series are normalised and aggregated based on the weights of individual sectors on value added. Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 7 – Unemployment is expected to drop at a slower pace in the next few quarters compared to 2016



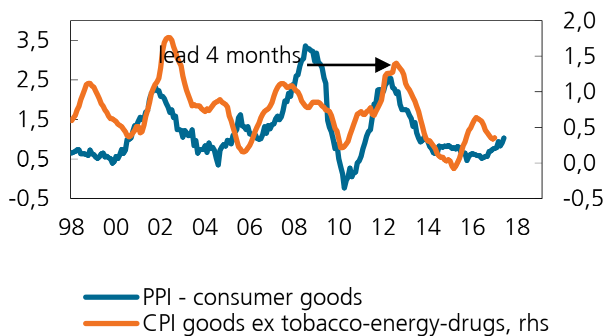
Nota: Periphery = ITA+SPA+GR+PT+IRL; Core = GERM+FR+NL+BEL. Countries aggregated with euro area IPCA weight, and country labour force weights based on the change in the unemployment rate. Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 8 – Businesses signal that the risk of deflation has now been averted. Sales prices based on confidence surveys are back at their highest since 2009



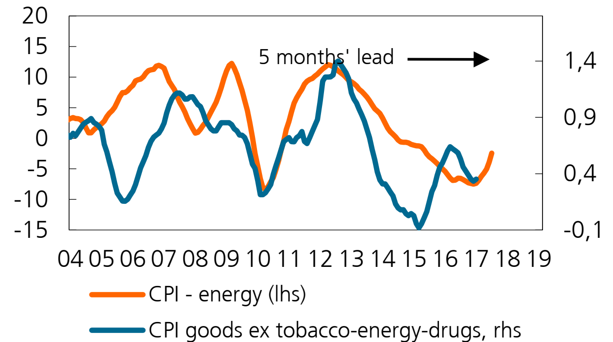
Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 9 – Consumer goods producer prices have reversed



Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 10 – The rebound in the energy component indicates a smaller risk of negative second round effects on domestic prices



Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

ECB: preparing markets for "the end of the super stimulus"

Anna Maria Grimaldi

In March, despite positive indications about Euro zone growth and the surprise headline inflation data, the Council maintained the *status quo* on unconventional measures (negative rates and asset purchase programme), and left its statement virtually unchanged, retaining and inflation bias. The ECB's caution is justified by the inertia in core inflation and by the political uncertainty surrounding Europe's busy electoral calendar and, in particular, the French presidential elections coming up in the next few months (first round on 23 April; second round on 7 May). But the ECB will want to prepare markets in due time that exit from unconventional measures is nearing. During the press conference, Draghi pointed out that the measures adopted by the ECB between March 2015 and March 2016 should drive growth and inflation by about 0.55% per year in the period 2016-2018 (see Table 1 below). The removal of interest rate stimulus and the end of purchases must be managed with careful communication to avoid an abrupt and unwarranted tightening in financial conditions, which could hurt growth in 2018H2 and beyond.

The debate on exit has already started and currently revolves around the guidance on rates

At the end of January, Ewald Nowotny (Austria) was the first to indicate June as a possible date for starting the formal debate on asset purchases after December 2017. Council members have clearly already started to discuss the timing and methods of ending the unconventional measures; for the moment, the subject being debated is the guidance on interest rates. The Council has to decide the timing and methods of ending not only quantitative easing (QE) but also the negative rate policy. The ECB's guidance has, in a sense, outlined the sequencing for exiting the unconventional measures by indicating that "rates will stay at present or lower levels well past the horizon of net asset purchases". In late February, Yves Mersch[5] and Jens Weidmann spoke in favour of changing the guidance on rates to make statements more symmetrical. On 20 February, Ignazio Visco (Bank of Italy) said that the negative interest rate policy was the real unconventional measure adopted by the ECB, while the active management of the central bank balance sheet, to increase the monetary base and stimulate the real economy, was not so unheard of[6]. As such, it is certainly a possibility that the ECB may decide to remove the more unorthodox measure, i.e. negative interest rates, before ending asset purchases. Nowotny, on 16 March, said that "the ECB could raise the deposit rate earlier than the refi rate" and stressed that ending asset purchases before raising interest rates is "the US model" and that the ECB still needs to assess whether this would the best path for Europe too. Draghi, during the March press conference, explained that guidance on interest rates is an expectation and the probability of that expectation could change. Visco (20 March) said that the expectation that "rates would be negative beyond the end of purchases could be interrupted". Guidance on rates, said Visco, is part of a package of measures (QE and interest rates) which could be modified when the ECB considers the time is ripe to reduce the super monetary stimulus. We do not expect any announcements at the April meeting about exit modalities and timing. However, it is possible that Council members will start to prepare markets in the coming months. We think the ECB will proceed gradually:

"The guidance relating to " rates at current or lower levels until well beyond the end of purchases" is an expectation that can be interrupted" Visco, 20 March 2017

We do not rule out the possibility of the ECB opting to end asset purchases more gradually (September 2018) and starting to raise deposit rates towards zero from the end of 2017

- in our view, **the reference to lower interest rates compared with current levels will be removed from the statement in June at the latest**;
- then, **in September, if the figures continue to surprise to the upside**, and the downside risks to growth and inflation start balancing out, **the ECB could consider changing the guidance to indicate that rates would remain at zero and would no longer be negative well past the end of purchases**;
- we do not expect a statement on tapering of the APP before the German elections and therefore before the October meeting;

[5] Mersch, in particular, seems to have wanted to remove the reference to lower rates compared to current levels back in December.

[6] The Bank of Japan resorted to assets purchases in the second half of the 1990s.

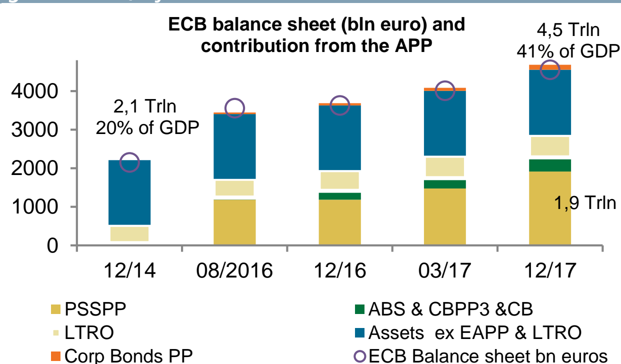
- markets are pricing with a probability of 40% a hike in the deposit rate rising to -0.25% by end-2017 (see Fig. 2). We deem this scenario as not very likely. However, the **Council may start raising the deposit rate already in 2018H1, but the ECB will want to try to contain the restriction of financial conditions by committing to maintain the refinancing rate at zero** well past the end of the asset purchase programme and **opting for more gradual QE tapering**.
- Expanding the purchase program to a rate of EUR 30-40Bn per month up to the third quarter of 2018 would have the merit of extending ultra-advantageous, long-term financial conditions for governments and firms. At the same time, hiking deposit rates before stopping purchases would certainly please players in the financial system in Germany and France who have been complaining for some time about the perverse impact on profitability of negative rates. Note, however, that the decision about the remaining term of the asset purchase programme, after December 2017, is restricted by the scarcity of tradable bonds in Germany, and in Portugal and other minor countries, and this could become tougher given the parameters currently in effect for implementing purchases. At end-2017, the ECB will hold 41% of Germany's debt, 37% of Luxembourg's and 32% of Portuguese and Cypriot debt (see IRS, 21/03/2017 EAPP update).
- There is a not insignificant risk that, starting as early as the middle of this year, the ECB might be forced to prepare for a definitive, if gradual, exit from asset purchases, though some of this risk seems to have been priced in by the market. One thing not priced in is that institutions and European governments could find themselves unprepared for the consequences of ending purchases. Filling the vacuum in European governance has been ruled out in a busy year of electoral events.

Table 1 – The ECB's "super stimulus" package, once completed, will have increased the ECB's balance sheet by 20 percentage points of GDP and likely driven growth and inflation by 1.7 points in 2017-18

	Bln euros
December 2015 – APP announced	1140
March 2016 – APP extended until March 2017	360
March 2016 – Monthly purchase volume increased to 80 bln a month	240
March 2017 - APP extended until December 2017, purchase volume reduced to 60 bln a month	540
Memo: reinvestment policy confirmed	320
Total of purchase programs volumes	**2280**
Memo: nominal GDP	10396
Measures in % of GDP	**21,9%**

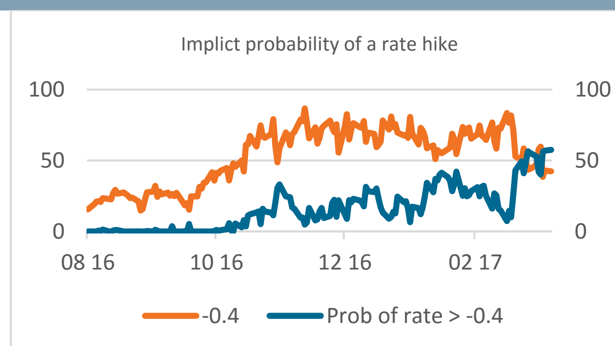
Source: Intesa Sanpaolo chart from ECB data

Figure 1 – ECB balance sheet at End-December 2017 will be twice the size it was in 2014, largely thanks to purchases under the PSPP. We expect the balance sheet to continue growing, again in 2018, by another EUR 300 billion



Source: Intesa Sanpaolo chart from ECB data

Figure 2 – The markets are starting to price in a rate hike before the end of asset purchases



Source: Intesa Sanpaolo chart based on Bloomberg data

Germany: is it still Angela's year?

Anna Maria Grimaldi

Angela Merkel's campaign looks to be more difficult than expected. By standing for re-election as Chancellor for a fourth term, Mrs Merkel has halted the rise of the right-wing populists of the Alternative for Germany (AfD), although they are still the third-largest party in Germany behind the Greens and *Die Linke* (the Left), at 8% (see figs. 1 and 2). The opinion polls indicate that the FDP could also surpass the minimum threshold of 5%. But the real news is that since pro-European Schultz has been at the helm of the SPD, the Social Democrats have jumped by around 12 points in the opinion polls to 31%, only three points behind the CDU (see fig. 2). German moderates perceive Schultz as an alternative to the current leadership, which *Der Spiegel* described as "tired" after 11 years in power. It remains to be seen whether Schultz will be able to build on the successes of the last two months and meet the demands for a democratic revival. In May, the elections in Schleswig-Holstein and especially in Rhineland will be a major test: the press suggest that in the latter case, there could be a coalition between the FDP and SPD, which would send a message throughout Germany. We think that, based on the opinion polls (see Fig. 2), an SPD/CDU coalition is the most likely scenario, but all is still to play for in the race for the chancellorship. If the PSD were to consolidate its successes of the past few months, Schultz could become an alternative to Merkel. A Schultz leadership would very probably push towards more pro-Europe policies and a less stringent interpretation of the tax rules, which would be positive for both Europe and Germany. A more expansionary fiscal policy would help curb – at least in part – the rising current account surplus (8.7% of GDP in 4Q, well above the limits set by the Macro Imbalance Procedure (MIP). For now, the current government is committed to maintaining, via the 2017 budget, a structural surplus of 0.8% of GDP, as in 2016, and to bringing the debt down to 62.4% in 2018.

Mrs Merkel will seek to maintain consensus Schultz (SPD) is shaping up to be a possible alternative Chancellor

Schultz would give fresh impetus to the creation of more pro-European policies

IFO and PMI confidence surveys (see fig. 6) indicate that GDP growth will accelerate from +0.4% at end-2016 to +0.6% qoq in early 2017. However, industrial orders and retail sales lead us to maintain a more cautious forecast of 0.5% qoq. Quarterly volatility aside, the German economy remains extremely solid, given the absence of any significant internal imbalances, along with financial conditions that provide considerable stimulus for households, companies and the government. We expect average growth of 1.6% for 2017 (1.5% net of calendar effects), slowing from 1.8% in 2016. For 2018, we forecast growth to stabilise at 1.6%. The above-potential growth (1.3%) phase started in 2014, and excess supply will have been absorbed by early 2018.

The economy is still solid

Livelier exports, but growth is still driven by domestic demand

Over the forecast horizon, we expect a more pronounced contribution from exports, which already picked up at end-2016 (+1.8% qoq in real terms). Export and import data show an across-the-board recovery in trade flows to the rest of the Euro zone, and to non-Euro zone countries, especially the US (due to the euro's depreciation against the dollar), China and Japan, while exports to the UK have fallen (due to the depreciation in sterling) and Russia. In 2017-18, we estimate that growth in exports will accelerate, from 2.4% in 2016, to 3.4%, which is still lower than the pre-crisis growth rate (8.3% in 2000-07). After the rally at end-2016 (3.1% qoq), imports will grow at more normal rates, and by 4.2% on average in the next two years. Consequently, foreign trade will return to making a negative contribution and growth will continue to be driven by domestic demand (see fig. 3). Household consumption will remain the main driver, although it is likely to have peaked (1.3%, from 1.8% in the last two years) despite the ultra-accommodative financial conditions and fiscal support measures (public subsidies, reduced social security contributions and adjustments to minimum pensions). Growth in real labour income is expected to slow to 1.3% in 2017, from 2.5% in 2016, due to the erosion in purchasing power associated with the higher oil prices (-0.3% of disposable income) and the rise in inflation to 1.7%, from 0.4%. Employment growth again outperformed expectations at end-2016 (total employment was up by 1.3% yoy and jobs subject to social security contributions were up by 2.3% yoy, a slight improvement on last summer). The positive trend is expected to continue in the next few months, with IFO and PMI surveys indicating an increase in hiring intentions. The ratio of vacancies to jobless numbers is at an all-time high (26.0%). We

Consumer spending growth has now peaked Disposable income will slow in 2017-18

think it unlikely, however, that employment will continue to grow at the same pace as in 2016 (1.3%).

Employment cannot keep up the pace of 2016 The labour market is at full employment

The **unemployment rate** fell again in January to 5.9%, **a new historic low**, with a jobless total of 2.65M. The **labour market is almost at full employment** (NAIRU: 5% according to the OECD) with the workforce created mainly via immigration from other EU countries. Participation in the labour market by the national workforce in fact fell by another half point in 2016 to 54.6%, while the contribution to growth in the workforce by recent refugee inflows remains low[7]. Despite the excess demand in the labour market, **growth in contractual wages slowed** by one-tenth of a percentage point on average to 2.1%[8] in 2016 (1.9% at end-2016). One possible explanation is that companies are giving their employees other benefits instead of salary increases. **For 2017, agreements signed so far show that wage growth is only slightly stronger** (2.5%). The rise in **inflation** to 1.7%, from 0.4%, will therefore partly erode households' purchasing power. Nevertheless, savings rose to 9.7% in 2016 (see fig. 8) and could act as a buffer against any shocks. Investment in **residential construction** picked up (1.6% qoq) at end-2016 after the cumulative fall of 2.0% qoq in the middle of last year. Quarterly volatility aside, we expect the more sustained growth rate to continue into 2017, in view of the recent performance of orders, permits and confidence in the construction sector (see fig. 9). **Investment in machinery** was still **weak** (see fig. 10) at end-2016, after falling in 2Q and 3Q. This has probably been slowed by uncertainty – firstly surrounding global demand in the middle of 2016 and then, more recently, relating to domestic and foreign policy (see fig. 11). Fundamentals continue to provide strong support.

Residential construction: expansion is still solid

Corporate investment: curbed only by uncertainty

Risks to the outlook are broadly balanced. Investment could pick up after the elections, once the uncertainty has been allayed. Moreover, if Schultz were to emerge from the September elections as Chancellor, the government would likely adopt a softer fiscal policy stance. The risks to foreign demand, at least for this year, seem balanced.

Macro forecasts

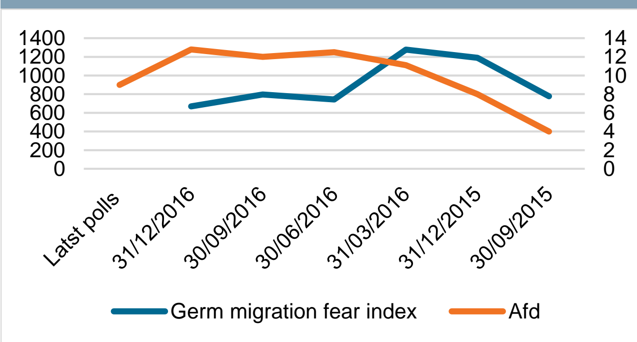
	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y) *	1.7	1.5	1.6	1.8	1.7	1.8	1.5	1.5	1.7	1.7	1.6	1.6	1.6
- q/q change				0.5	0.1	0.4	0.5	0.4	0.4	0.5	0.4	0.4	0.3
Private consumption	1.8	1.3	1.4	0.2	0.2	0.3	0.3	0.4	0.3	0.4	0.4	0.3	0.3
Fixed investment	2.1	2.4	3.1	-1.5	-0.2	0.8	1.1	0.9	0.6	0.8	0.7	0.9	0.6
Government consumption	4.0	2.2	1.4	0.9	0.2	0.8	0.7	0.4	0.4	0.4	0.3	0.3	0.3
Export	2.4	3.7	3.4	1.2	-0.3	1.8	1.1	0.9	0.4	0.8	1.1	0.8	0.8
Import	3.6	5.5	4.0	0.1	0.4	3.1	1.6	1.0	0.8	0.6	1.5	1.0	0.4
Stockbuilding (% contrib. to GDP)	-0.1	0.5	0.0	-0.1	0.3	0.3	0.1	-0.1	0.1	-0.1	0.1	0.1	-0.3
Current account (% of GDP)	8.7	8.3	8.0										
Deficit (% of GDP)	0.6	0.5	0.4										
Debt (% of GDP)	68.2	65.5	62.9										
CPI (y/y)	0.5	1.7	1.6	0.0	0.2	0.6	1.5	1.3	1.4	1.3	1.2	1.2	1.3
Industrial production (y/y)	1.0	2.7	1.8	0.4	0.8	1.2	0.8	2.7	3.6	3.7	2.3	1.9	1.6
Unemployment (%)	6.1	5.9	5.8	6.1	6.1	6.0	5.9	5.9	5.9	5.9	5.9	5.8	5.8
10-year yield	0.10	0.37	0.87	0.12	-0.12	0.11	0.24	0.30	0.39	0.54	0.70	0.83	0.93

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

[7] According to the Bundesbank, in 2016, only 55,000 out of some 700,000 new jobs that are subject to social security contributions were taken by refugees and/or immigrants from non-EU countries.

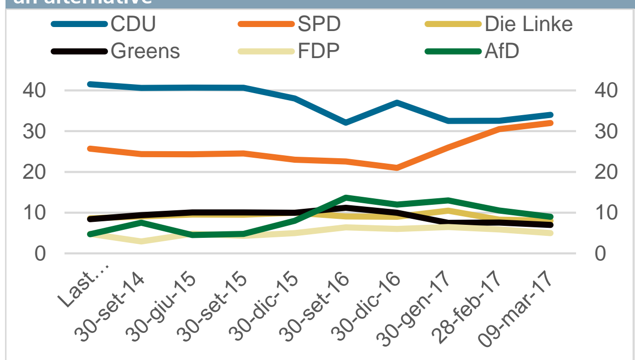
[8] Although actual wage growth, at 2.5%, is higher than the figure for contractual wages, it is nevertheless slower than a year ago.

Fig. 1 – Support for AFD is waning as fears about immigration are allayed



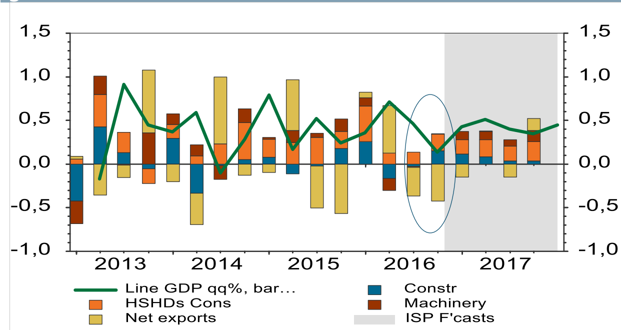
Source: Intesa Sanpaolo charts based on Baker, Bloom & Davies migration fear indices via Bloomberg, and opinion pools on the forthcoming parliamentary elections from Wikipedia

Fig. 2 – A CDU/SPD coalition would again have the majority, but a left-wing CDU/*Die Linke*/Greens/FDP coalition could be an alternative



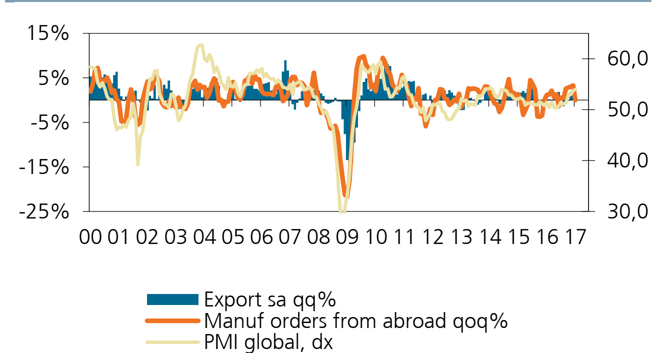
Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 3 – Foreign trade will make a less negative contribution in the next few quarters Consumption and investment: stable growth rates



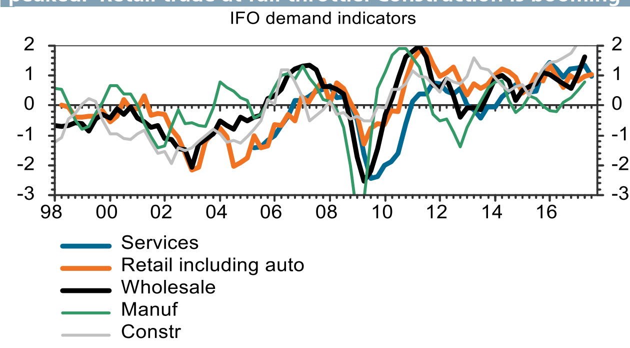
Source: FSO via Thomson Reuters-Datastream

Fig. 4 – Exports supported by demand from the rest of the Euro zone, falling to other advanced countries Global PMI indicates that the livelier trend in trade will continue



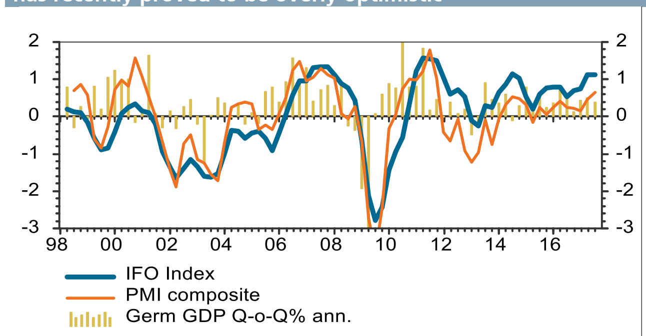
Source: FSO via Thomson Reuters-Datastream

Fig. 5 – Industry has locked in the recovery. Services have peaked. Retail trade at full throttle. Construction is booming



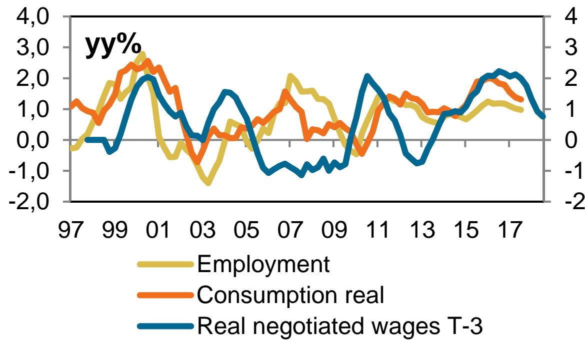
Source: FSO via Thomson Reuters-Datastream

Fig. 6 – GDP growth accelerating to 0.5% qoq, although the IFO has recently proved to be overly optimistic



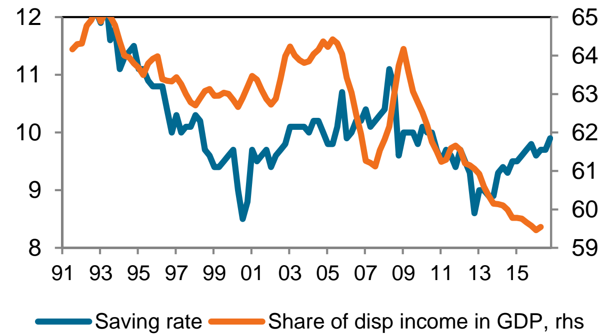
Source: FSO via Thomson Reuters-Datastream

Fig. 7 - Private consumer spending has now peaked. Financial conditions will continue to be highly expansionary, but employment and real salaries are expected to slow



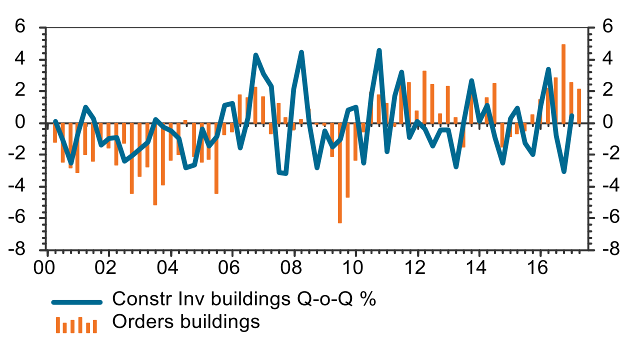
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – The rise in the savings rate is likely to provide a buffer in the event of shocks



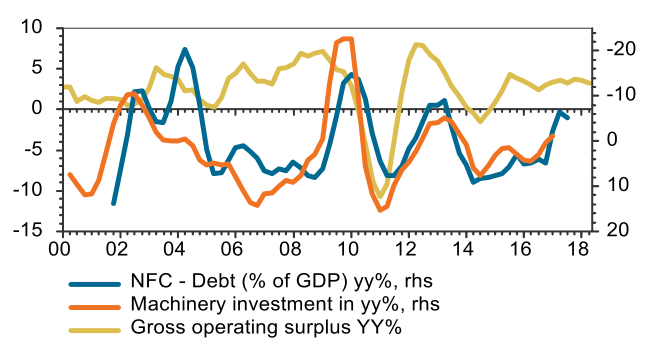
Source: Thomson Reuters-Datastream

Fig. 9 – Construction, orders and confidence indicate solid growth



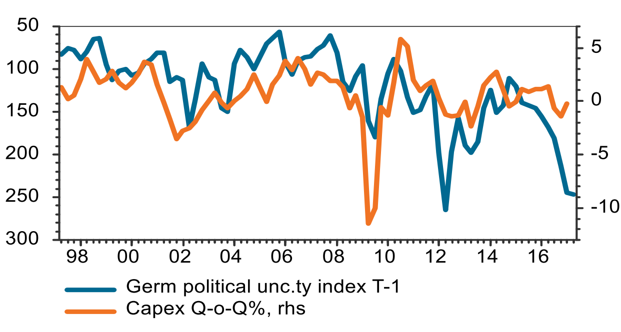
Source: FSO via Thomson Reuters-Datas

Fig. 10 – Fundamentals consistent with a more buoyant trend in investment spending



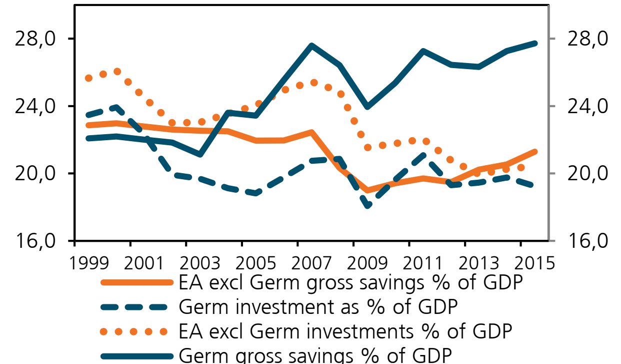
Source: FSO via Thomson Reuters-Datastream

Fig. 11 – The real brake on investment is "the great uncertainty"



Source: FSO & Economic Policy Uncertainty Institute via Thomson Reuters-Datastream

Fig. 12 – Post-election challenges: rebalancing the trade surplus, generated by the excess aggregate savings excess



Source: Eurostat via Thomson Reuters-Datastream

France: a crucial passage for Europe

Guido Valerio Ceoloni

This year, France will experience a decisive round of elections not only for the country, but for Europe as a whole. On **23 April** the first round of the vote will take place **to elect the eighth President of the Fifth Republic.** While the eurosceptic Marine Le Pen is very likely to win access to the second round ballot, the baseline scenario, based on the latest voting intention polls, still points to a victory for Emmanuel Macron.

This year, the presidential elections are attracting much more attention than usual for the tail-end scenarios which could materialise in the event of Marine Le Pen coming out on top, given her declared intention to take France out of the monetary union. There are four main participants in the race: **François Fillon** for the moderate right (Les Republicains), **Marine Le Pen** for the far right (Front National), **Benoit Hamon** for the socialists (Parti Socialiste), Jean-Luc Mélenchon for the Left, and **Emmanuel Macron** with his party *En Marche!* founded last summer. However, it should not be overlooked that after the presidential elections, **the legislative elections for the renewal of the National Assembly will follow on 11-18 June**. Both will be crucial in establishing the new balance of political power.

The new element introduced by the forthcoming presidential elections is that, for the first time since 1965, there is a strong chance of none of the main parties that have historically alternated at the helm of the country managing to reach the ballot stage. Furthermore, both the favourite finalists (Macron and Le Pen) lack a long record in terms of political experience. As regards the Front National, in 2002 Jean Marie Le Pen, Marine's father, reached the second round of the presidential elections only to be overwhelmingly defeated by Chirac, whereas Macron was briefly part of the Hollande cabinet. Nonetheless, Le Pen and Macron have managed to set up electoral campaigns that are proving more efficient than the socialists' and the republicans', marred from within by inner currents and conflicts, the former as a result of the prickly heritage of François Hollande, whose decision not to run for re-election inevitably weakened the governing party, and the latter following the scandal which is involving Fillon and his decision not to pull out and be replaced by Juppé, who is forcing him to run without the support of the Republican Party's élites.

Focus: how does the French electoral system work?

Apart from the temporary adoption of a proportional system in 1986, since the Fifth Republic was born (1958) France has always voted with a **two-round, majoritarian first-past-the-post system** (French style majoritarian) to elect the **577 National Assembly members**. Unlike the election of the President of the Republic, the system for the election of the members of the National Assembly is not written in the Constitution, and therefore may be modified by simply introducing new legislation. At present, there are 577 electoral constituencies which each yield an MP. If a candidate obtains already at the first round an absolute majority of votes representing at least **25% of electors**, he or she wins the parliamentary seat; otherwise, a second round of voting takes place, accessed by all the candidates that have obtained at least **12.5% of valid elector votes.** If only one or none of the candidates make the cut, the two most voted at the first round access the ballot. The candidate with the most second-round votes is elected. **The majoritarian system tends to limit the representation of minorities;** furthermore, it plays to the advantage of the parties which win by a slim margin in many constituencies, over those which win in only a few constituencies with a strong majority; it penalises parties with a strongly delocalised electorate, and aids locally-rooted parties with a concentrated electoral base. **The majoritarian sector also tends to encourage electors to express a sincere vote at the first round, as opposed to a strategic one at the second round**, especially in the event of a three-way ballot, with none of the candidates pulling out and pledging support to another. Furthermore, **the French-style majoritarian system historically tends to favour centrist parties, or the moderate wings over the extremist factions**.

What do the surveys say?

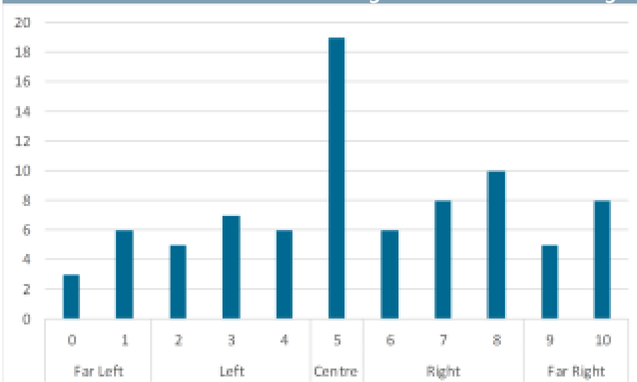
Once it became clear that Hollande was not going to run for re-election, voting intention polls singled out **Fillon** as the hot favourite in January, supported by a solid, determined party with strong popular consensus (over 25%). The scandal which hit Fillon in February, and that will seep into the remaining part of the electoral campaign, has already cost him over six per cent in consensus ratings, and survey data now award him **third place with a share of around 19%. Marine Le Pen**, on the other hand, immediately emerged as the force to beat at the second round, **with 25% of consensus,** a share that is proving resilient, despite the fact that she is also under the scrutiny of French magistrates for the Front National's use of public funds: according to simulations conducted by various sources, **the probability of Le Pen reaching the ballot stage is estimated at 90%.** According to the voting intentions surveyed so far, 80% of her electors are firm in their choice. **Macron, on the other hand, must count on a much more volatile consensus** (only 48% of his electors are firm in their choice), but his ascent has been consistent, fuelled on the right by the outbreak of the Fillon scandal, on the left by Hamon's manifesto, and at the centre by the support offered by Bayrou: for a couple of weeks now, **voting intention polls have seen Macron neck-and-neck with Le Pen at 25-26%. Hamon** is the weakest of the four at present, as survey data assign him a share of around **14% of the vote**, with 55% of electors' firm in their choice. He may even slip to the fifth place behind Mélenchon. By the way, the left has squandered the opportunity to compete for the ballot by running with two candidates instead of agreeing a common ticket, as the Greens suggested at one stage.

If on the one hand the volatility of Macron's electors leaves open the possibility of the candidate winning fewer votes than expected at the polling stations, on the other it confirms that the votes of the undecideds are unlikely to be directed to Le Pen's extremist positions, as they belong to moderate electors, of both right and left wing provenance, that may be disappointed by the candidates presented by the main parties, but who nonetheless do not intend to embrace extremist positions. Therefore, at the ballot stage, even in the event of Macron failing to get through, those votes would strategically be channelled to Le Pen's opponent, whether it be Fillon or Hamon. **Furthermore, we expect the turnout to be even higher this year than in the past, both at the presidential and legislative elections, which will play to the advantage of Le Pen's adversaries. Statistically, the presidential elections in France are an important appointment for electors**, who take part in mass: the average turnout since 1974 has been around 81.5% (Fig. 6): this should in part moderate, but not rule out, the risk of "polling station surprises".

Fig. 1 – Voting intentions at the first round of the presidential elections: Macron is closing in on Le Pen and is very likely to be her opponent at the ballot stage

Source: Ifop-Fiducial, Ipsos, Elabe, BVA, OpinionWay, Cevipof, Kantar

Fig. 2 – Elector self-perception in terms of political belonging: scale from 0 to 10, where 0 is "left" and 10 is "right". A 30% share of electors is centrist or belongs to the moderate wings

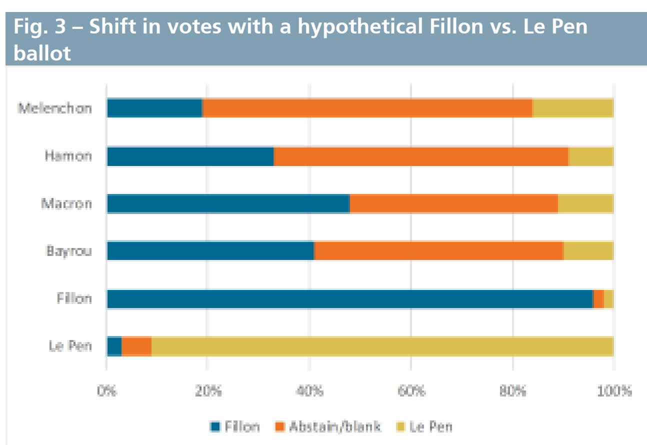


Source: Opinionway

Data (fig. 2) gathered by the numerous surveys confirm that **the most substantial part of the electorate is of centrist belief:** around 20% declare themselves to be centrists, 10% have a slight

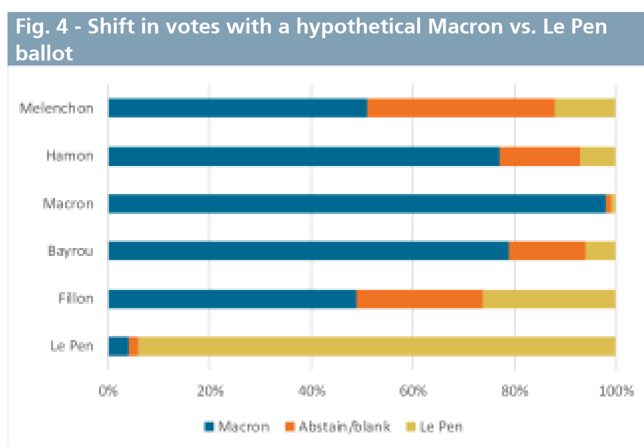
propensity for right/left wing positions, and another 14% declare themselves as of non-radical right/left positions. The real challenge, therefore, will be to win the consensus of the 30% of moderate electors, who may ultimately vote for Macron, Fillon, or even Hamon, but are very unlikely to support Marine Le Pen, based on most survey data and opinion polls published since January. Other surveys also confirm that at the second round of the presidential elections, a **ballot between Fillon and Le Pen** (Fig. 3) would see Fillon prevail with around 40% of the votes of the other candidates, whereas the residual voters would abstain *en masse*, and Le Pen would win less than 10% of her adversaries' votes.

Fig. 3 – Shift in votes with a hypothetical Fillon vs. Le Pen ballot



Source: Ifop-Fiducial

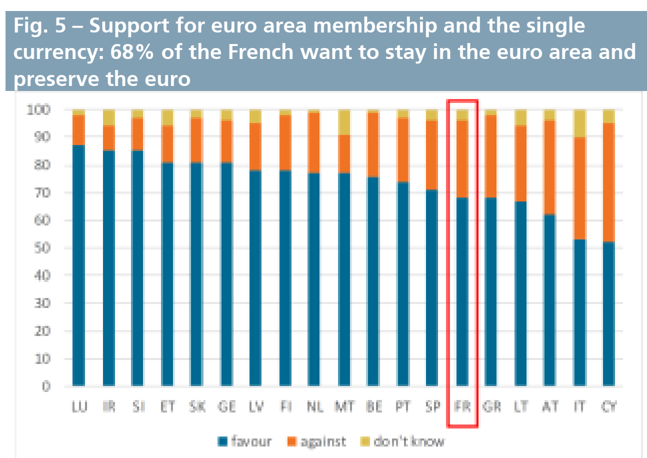
Fig. 4 - Shift in votes with a hypothetical Macron vs. Le Pen ballot



Source: Ifop-Fiducial

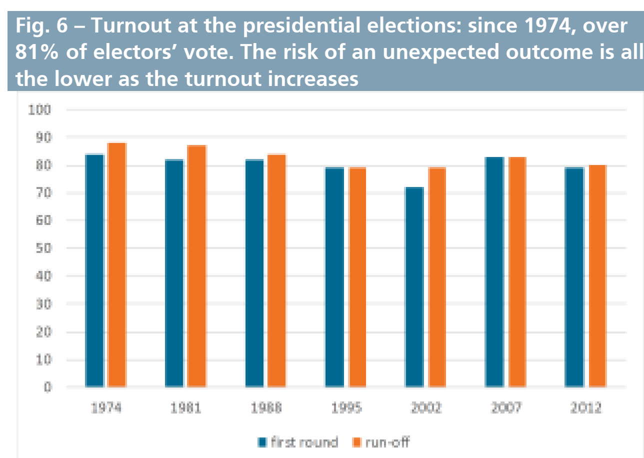
Should Macron get through to the ballot stage (fig. 4), the scenario would be similar: he would attract almost 70% of the votes of the other candidates, with left wingers at the fore, as opposed to only a 10% share, in this case as well, for Le Pen. Under both scenarios, therefore, we think Le Pen is highly unlikely to win the ballot.

Fig. 5 – Support for euro area membership and the single currency: 68% of the French want to stay in the euro area and preserve the euro



Source: Eurobarometer

Fig. 6 – Turnout at the presidential elections: since 1974, over 81% of electors' vote. The risk of an unexpected outcome is all the lower as the turnout increases



Source: Republican Constitutional Council

What do the candidates intend to do? The manifestos of the main contestants in a nutshell

All the candidates have by now unveiled, more or less exhaustively, their electoral manifestos. On some hot topics, such as the pension and labour market reforms, the manifestos of Le Pen and Hamon seem to overlap in many ways, with Fillon on the opposite front and Macron in between, with proposals that seem to take up Hollande's heritage. The impact of the proposals made by Le Pen, Hamon and Mélenchon would be markedly negative for public accounts, the former for the project of exiting the euro area (with all the connected complications), the latter

because massive public spending plans would cause public debt to surge. Left and Right also share the distrust for EU policies on trade and for the fiscal compact. Fillon, on the other hand, suggests to cut spending and the number of public sector employees with unusual force, starting in 2018 (although this will be hard to implement, given the French state sector's historical resistance to change). Macron's manifesto strikes a middle ground between these two extremes, and aims to respect (alone out of the four) the 3% deficit limit already this year. The GDP growth projections set forth by Le Pen and Fillon are a little too optimistic (at between 2% and 2.5%) in our view, whereas Macron's are more cautious; Hamon has not yet disclosed clear forecasts, and is vaguer than his adversaries on a number of specific manifesto points, possibly because he was the last to unveil his plan (Tab. 1).

Marine Le Pen: exit from the euro, less EU, immigration and border controls, measures in support of income, lowering of the retirement age, taxes on imports.

A radical review of the euro area (double currency franc/euro) or a definitive abandonment of the euro and a return to the franc. GDP growth of 2.0% in 2018 and 2.5% in 2022. The deficit would be allowed to increase as far as 4.5% in 2018, but then be cut to 1.3% in 2022; 1.7% cut in public spending to 53.4% of GDP. Proposed fiscal stimulus worth 40 billion euros (20 in tax cuts and 20 in measures to support purchasing power, such as a 5% reduction in gas and electricity tariffs, increase in pensions of less than 1,500 euros), reduction of spending addressed to the EU, to health care and *securité sociale*, reformulation of the institutional setup and fight against tax evasion to generate savings of 60 billion euros in total over five years; fixed 3% tax on imports; the national defence budget would be expanded to 2%[9] of GDP in 2018, and to 3% in 2022. According to the FN, public debt would amount to 89% in 2022. The FN proposes that the Treasury be directly financed by the Banque de France, and supports border control and a reduction of immigration; confirmation of the 35-hour work week and lowering of the retirement age to 60; creation of a fund for the re-industrialisation of the country, de-taxation of overtime work, special rates on loans to SMEs. The FN intends to remove France from NATO, as well as from the EU.

Benoit Hamon: exploding weight of the State, citizen's income, review of deficit and public debt constraints imposed by Europe.

Deficit of 3.5-4.0% in 2017-2018, on the decline to 2.7% in 2022. Universal income measure worth 35 billion euros a year[10], to be reduced to 25 net by recouping 10 billion euros in funds appropriated for responsibility pact and CICE (worth 1.2% of GDP per year), which will integrate the income of 19 million French citizens; special tax on companies which automate processes and lay off staff, which will be channelled to a fund addressed to finding new jobs for the unemployed. Allocation of 50% of public contracts to French SMEs and to the *Made in France* sector in general, super tax on the profits of banks and strengthening of the role of workers in private companies, inspired by the German model. Re-discussion at the European level of the 3% ceiling on the debt/GDP ratio, European investment plan worth 1,000 billion euros, cancellation of the debt accumulated up to 2008 for the most indebted euro area countries.

François Fillon: public accounts in order starting in 2019, a smaller state sector, with half a million civil servants to be laid off, corporate tax cuts, and the pension reform.

Average growth estimated at over 2%, deficit above 3.0% until 2019 (3.7% in 2017, 3.5% in 2018, 2.9% in 2019), 110 billion euros in public spending cuts over five years. Abolishment of the 35-hour week, which would be raised to 39 in the public sector; raising of the pensionable

[9] Currently at 1.5%
[10] Around 1% of GDP per year

age to 65, reduction of unemployment to 7% by the end of 2022. On the fiscal front, significant reduction of public debt, with an easing of fiscal pressure, in particular by cutting the ISF[11] to 30% starting in 2018; fiscal detractions of 30% on SME investments, 25 billion euros less in labour tax and transformation of the CICE tax credit as of 2018 into a permanent reduction of the contributions imposed on businesses, a reduction of the corporate tax rate to 25% by the end of 2019; in part, these measures would be financed by means of a 4% VAT increase. New reform of the labour market and of contract renewal negotiations.

Emmanuel Macron: 3% deficit starting in 2017, digital transformation and green economy, 50-billion-euro investment plan, reduction of state sector employees, reformulation of the 35-hour week.

Deficit at 2.9% starting in 2017, reduction of public debt to levels in line with the euro area average, state spending cuts worth 60 billion euros over five years by reducing the wage bill and of social communities, investment plan worth 50 billion euros over five years, end of the 35-hour week for young adults, abolishment of contributions of unemployment benefits, CSG[12] hike, abolishment of the RSI, transformation of CICE tax credits into a permanent reduction on labour taxes, minimum wage increase, reform of the ISF and its transformation into a tax on property alone, with tax cuts on the main dwelling, construction of 80k social housing units, tax regulation stability, five thousand new teachers, enhanced security, defence budget of 2% of GDP, preservation of Schengen, creation of a European border police force, creation of a euro area Finance minister, reduction of diesel vehicles, renewal of the existing stock of vehicles via a 1,000 euro incentive, reduction of the use of nuclear power.

Tab. 1 – Comparison of candidate manifestos

	Fillon	Le Pen	Hamon	Macron
GDP growth	>2% average	2% in 2018, aim for 2.5%	n.a.	1.4% 2017, aim for 1.8% in 2022
Deficit and debt	-3.7% 2017; -3.5% 2018; -2.9% 2019	-4.5% 2018; aim for -1.3% in 2022; debt of 89% by 2022	n.a.	< -3.0% from 2017; debt in line with European avg. at 91% by 2022
Fiscal stimulus[13]	50Bn over 5 years	40Bn over 5 years	n.a.	+20Bn over 5 years
VAT hike	+2% on the marginal rate	No	No	No
New investments	n.a.	60Bn over 5 years	Social housing, urban renewal plan, stronger spending on R&D to 3% of GDP, energy renovation plan	60Bn over 5 years
Public spending	-100Bn over 5 years, -500k public sector employees	-60Bn over 5 years	Sharp increase in spending	-60Bn over 5 years, -120k max public sector employees
Net effect on public spending	Spending cuts worth 0.5% of GDP per year	Higher spending worth 0.4% of GDP per year		Higher spending worth 0.2% GDP per year
Net effect on consumption	Uncertain/restrictive	Expansionary	Expansionary	Expansionary
Unemployment	5% in 2022	n.a.	n.a.	7% in 2022
Labour market: 35h-week	Abolishment	Confirmation	Reduction to 32 hours	Abolishment only for the young
Pensionable age	Raised to 65	Lowered to 60	Confirmed at 62	Confirmed at 62
European issues	Stronger integration, common budget, common defense	Exit from the euro	Renegotiation of Maastricht constraints, stronger integration, debt mutualisation	Stronger integration, common budget, common borders surveillance

Source: electoral manifestos as set forth by individual candidates in interviews, speeches, press, conventions, TV debates, planning documents

[11] *Impôt de solidarité sur la fortune*
[12] *Contribution sociale generalisée*
[13] Net of the VAT hike

The scenarios after the presidential and legislative elections: "cohabitation" likely

Barring a last-minute comeback (unlikely, based on survey data) by Fillon, **the likeliest scenario will be the election of a President of the Republic not supported by a clear majority in Parliament** (so-called "presidential majority"). Whether Le Pen or Macron win, neither of them can hope to govern without reaching an agreement with other parties. In these cases, the French system contemplates **cohabitation**, by which the President elect governs alongside a Prime Minster who is not appointed exclusively by the president's party: typically, the former manages foreign policy, and the latter domestic policy. This would be the fourth such outcome in the history of the Fifth Republic.

If Marine Le Pen wins

We believe the National Front is unlikely to win the presidency, and even more unlikely to obtain a majority at the June legislative elections. Even only living up to pre-election voting intention polls would be an extraordinary result, considering that at past elections the actual votes obtained at the first round consistently fell well short of expectations, and crashed at the ballot stage (Tab. 2). The only exceptions to this rule were the European and regional elections, at which, however, a proportional system was used**. The two-round majoritarian system has always represented an insurmountable barrier for the FN**. We expect this to be the case once again. Also, in the spirit of cohabitation that is characteristic of the French system, which historically opposes extremisms, "strategic" second-round electors who may have played a part in handing over the presidency to Le Pen would not add to the FN's number of parliamentary seats, but would support the more moderate parties, therefore guaranteeing equilibrium in managing the powers of the State. **In case of victory, Marine Le Pen would then have to cohabit with a government probably led by the Republicans**. They would ask to appoint the Prime Minister, also based on the cohabitation principle, and therefore we believe they would also attempt to significantly water down Le Pen's populist manifesto, on the exit from the euro in particular. At this point, the possible turn of events would be uncertain. The President may even dissolve the National Assembly, as would be in her powers, but new elections would be unlikely to yield very different results, unless the electoral law is changed.

In any case, **all survey institutions indicate that over 68% of the French are firmly in favour of preserving the euro** (Fig. 5), therefore, of all the controversial points included in Le Pen's manifesto, **exit from the euro remains the most complex to implement, either via a parliamentary vote or a popular referendum.** However, there would undoubtedly be negative consequences for the European integration process and for the reform of euro area government structures.

Tab. 2 – In the past, voting intention polls have always overestimated the FN's actual consensus

Election	Polls	First round	Second round	Seats obtained
Legislative 2007	6-7%	4.3%	0.1%	**0**/577
Legislative 2012	14-17%	13.6%	3.6%	**2**/577
European election 2014[14]	21-25%	24.9%		**24**/72
Departmental election 2015	26-33%	25.2%	22.2%	**62**/4,103
Regional election 2015[15]	21-30%	27.7%	27.1%	**358**/1,910

Source: Assemblée Nationale, Ministère de l'Intérieur

[14] It should be pointed out that, unlike all the other elections, that are based on a majoritarian system, the proportional system is used at the regional and European elections.

[15] The departmental election held in March 2015 using the first-past-the-post system resulted in 62 seats for the FN (1,5% of the total); on the other hand, the regional election held in December 2015 using the proportional representation system resulted in 358 seats for the FN (18,7% of the total).

If Emmanuel Macron wins

Even in the event of Macron coming out on top, the cohabitation scenario seems very likely. Barring an explosion of *En Marche!* at the legislative elections as well, **Macron will need the support of centrist Bayrou, of Lagarde's UDI, and of a part of the Socialist Party.** Even an alliance with the Republicans has not been ruled out by Macron. In the first case, a centre-left coalition would take shape with the exclusion of the less moderate wing of the socialists, whose candidate is Hamon. In this case, the situation could be similar to that which came about with the Giscard d'Estaing presidency (1974-1981), a centrist supported by the Gaullist right with Jacques Chirac as Prime Minister, which required ongoing negotiations between the President and his government, to the detriment of any reformist momentum. The government's programme would have to mediate between competing proposal, but we would expect a strong pro-Europe impulse, a curbing of the deficit to just under 3%, smaller public spending cuts than the promised 60 billion over five years, an investment plan, no VAT hike, confirmation or only partial removal of the 35-hour week, partial reform of the pension system, while keeping the retirement age at 62.

Household consumption slowing slightly this year

In essence, based on current voting intention polls, **the baseline scenario is still a second-round ballot between Marine Le Pen and Emmanuel Macron, with the latter prevailing**. François Fillon's bid now seems irreparably compromised by the scandal he is involved in. Although consensus for the Front National is increasing briskly, the two-round majoritarian system, and the French people's support of the single currency (at close to 70%, based on survey data) should also prevent the far-right party from winning a large number of parliamentary seats at the forthcoming legislative elections in June. **Therefore, a cohabitation scenario is taking shape**, last seen during Jacques Chirac's presidency (1997-2002).

Economic outlook: central scenario is for a Macron victory

2017 GDP set to accelerate by 0.3 to 1.4% from 1.1%

In our central scenario, **we expect GDP to accelerate by three-tenths of a percentage point from 1.1% to 1.4% this year.** 2016 ended in line with expectations and the economy closed with solid growth of 0.4% qoq. We expect activity to slow in 1Q by one-tenth of a percentage point (0.3% qoq) and then pick up again in 2Q (0.5% qoq), approaching the Euro zone average and taking growth in 1H to 1.1%.

Household consumption will slow slightly due to the erosion of purchasing power as consumer prices rise. In 2016, purchasing power increased by 1.9%, providing considerable support to consumption (1.8% yoy at end-2016), while this year we expect purchasing power to be eroded by the price effect (0.7% yoy), which will lead to a hiatus in consumption (1.3% yoy) and hence a lower contribution to GDP. We therefore forecast that consumption will slow from 0.6% qoq in the current quarter to 0.2% qoq, and then pick up slightly in the next quarter, partly thanks to the positive effect that electoral campaigns traditionally have on household confidence.

Industrial output accelerating this year, as is construction

The business climate remained positive at the turn of the year, with all sectors slightly above the historical average. The recent improvement in confidence has been driven in particular by the manufacturing sector, where the confidence index reached the highs of 2011, thanks to the boost given to foreign orders by recovering global demand. We therefore expect **industrial output** to pick up this year from 0.2% to over 1% yoy, thanks particularly to the contribution of manufacturing (expected to be 0.8% yoy, up from 0.3% yoy). After two years (2014-2015) of decline, **construction** also resumed growth in 2016 (0.7% yoy); we expect the segment to grow by 0.3% qoq in 1Q and then accelerate in 2Q (annual average: 1.5%).

Another positive factor in 1H will be companies' **investment in manufacturing**, which will continue to benefit from the additional depreciation mechanism guaranteed by the French government until mid-April. After a stagnant 3Q, investment in manufacturing bounced back in the last quarter (0.8% qoq) driven by car sales. Economic surveys are set fair in relation to both services and manufacturing, and we therefore expect another solid gain in the current quarter (0.9% qoq) and a slowdown in the next quarter (0.7% qoq). **Household investment** should maintain a good pace after expanding by 0.7% qoq in 4Q (2.5% qoq; annual average of 2.0%), especially in early 2017 (0.8% qoq), driven by the real estate sector, as indicated by the number of building permits.

After pronounced expansion in 2016, investment in manufacturing slowing from 2Q

Exports accelerated at the end of the year to 1.3% qoq, shored up by global demand and major deliveries in the aeronautics sector. We therefore forecast a structural slowdown to 0.4% qoq in the current quarter, followed by an acceleration to 1.0% qoq in spring on the back of new deliveries of ships. Imports for the year are set to accelerate to 3.0%, from 1.1% in 2016. **Imports** will continue to be dynamic in the first two quarters, but not enough to prevent foreign trade from making a slightly positive contribution of around one-tenth of a percentage point to GDP in 1H. As an annual average, imports are expected to slow to 2.9%, from 3.8% in 2016. The **trade deficit** will continue to increase during 2017 to -10.5% of GDP (-8.8% in 2016).

Trade deficit set to widen again in 2017

French **inflation** accelerated sharply at the beginning of the year, to 1.2% from 0.6% at the end of last year, due to a combination of rising energy prices, an unfavorable statistical effect and higher tobacco duties. We expect inflation to stabilize at around 1.2% in the next few months (2017 annual average of 1.3%, up from 0.2% in 2016); **core inflation** is likely to remain stable at around 0.5% this year, as in 2016.

Inflation likely to return to above 1% this year

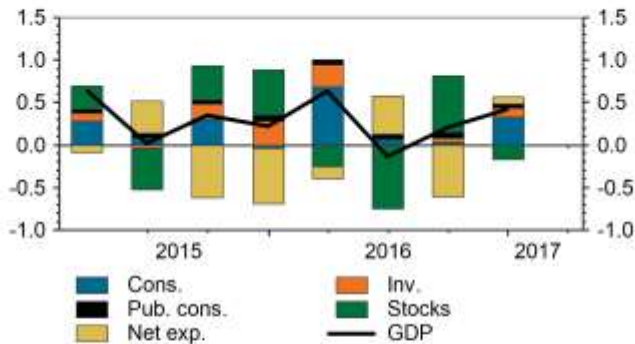
On the labour market, over 210,000 private sector jobs were created in 2016, the highest since the start of the crisis in 2007. This figure was boosted by temporary work (+12% yoy) and growth in the services sector (+1.2% yoy), while jobs were cut in the industrial sector. Jobs were also shed in construction, although fewer jobs were lost in 2016 than in 2015 (-0.8% yoy). For the current year, we expect the rate to settle at around 190,000 new jobs on the back of the stabilization in the services sector. We therefore forecast that **employment growth** will slow by a couple of tenths of a percentage point, from 0.8% yoy to 0.6% yoy. Consequently, total **unemployment** is expected to improve this year by around four-tenths of a percentage point from 10.1% in 2016 to 9.7% (9.4% in metropolitan France) and is already heading for a fall of nearly two-tenths of a point in the current quarter.

Unemployment expected to drop back below 10% this year; employment likely to improve only slightly

The current year could see the deficit eventually fall below 3% (from -3.3% to 2.9%) for the first time since 2007 if the government manages to recover the extra EUR 0.8Bn budgeted for defense, security and adjustments to public sector employees' salaries, which had been frozen until 2016. The measures to be taken by the new government are not, of course, included in these estimates. The structural deficit is also likely to improve by two-tenths of a percentage point from -2.5% to -2.3%. The risks are tilted to the downside as the calculation excludes the recapitalization of Areva, which is still to be tackled; this could weigh on GDP by up to 0.2%. In 2018, in the absence of any specific measures, the deficit will increase again to over 3%, due to the deferral of this year's spending to next year. Lastly, public debt is expected to grow by around three-tenths of a percentage point to 96.7%.

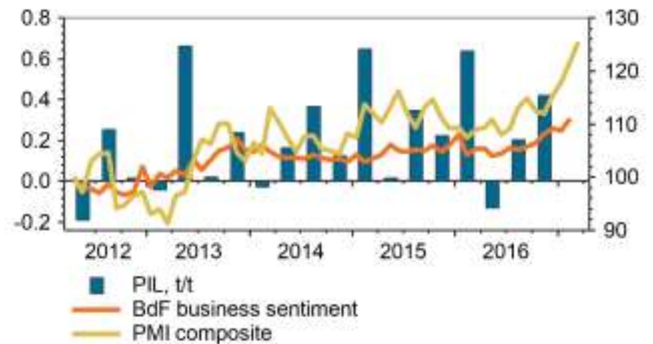
2017 should be the year that sees deficit fall below 3%, but it could rise again in 2018

Fig. 7 – Contribution to GDP



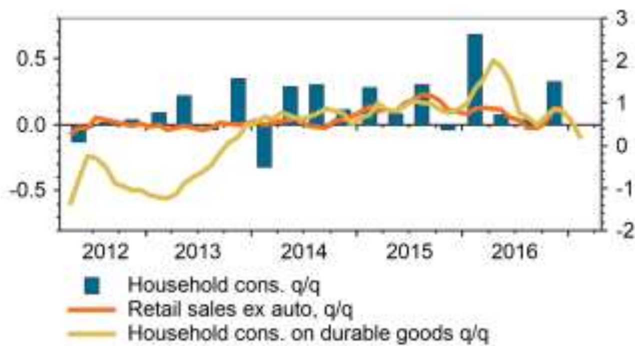
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – GDP and confidence indicators



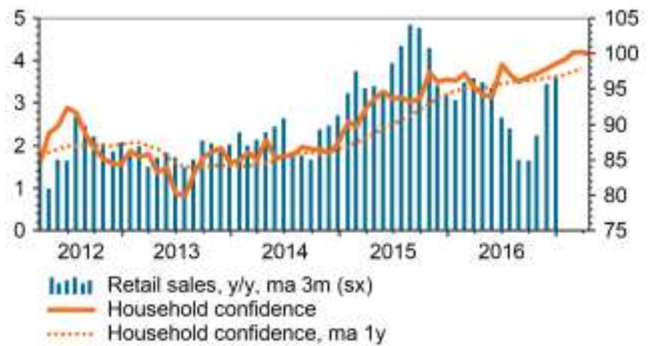
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Household spending, purchases of durable goods and change in consumer spending



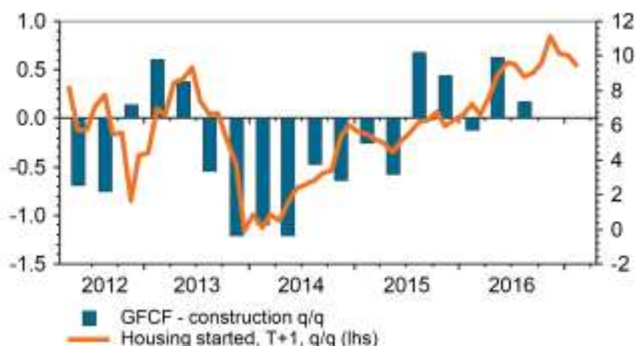
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Retail sales and household confidence



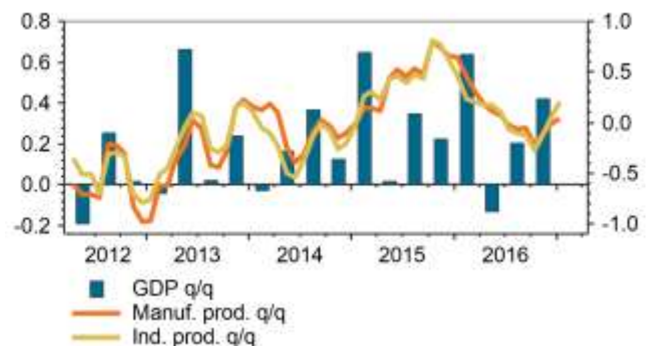
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 11 – Residential investment and construction sector activity



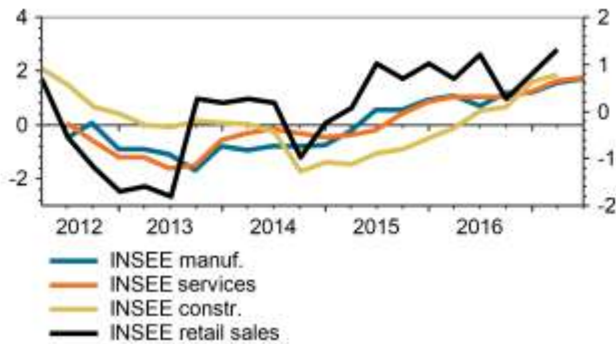
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 12 – Industrial output and GDP



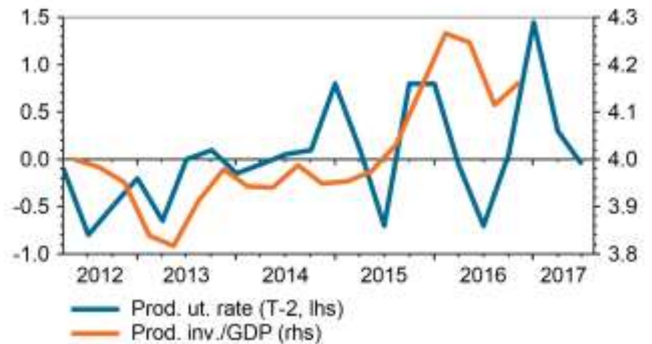
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 13 – Activity indices in the various production sectors



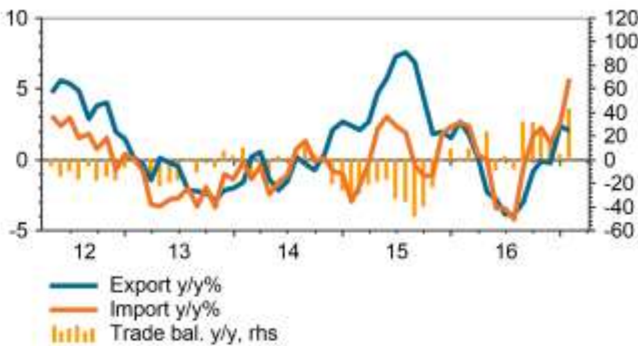
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 14 – Capacity utilization and level of investment as percentage of GDP



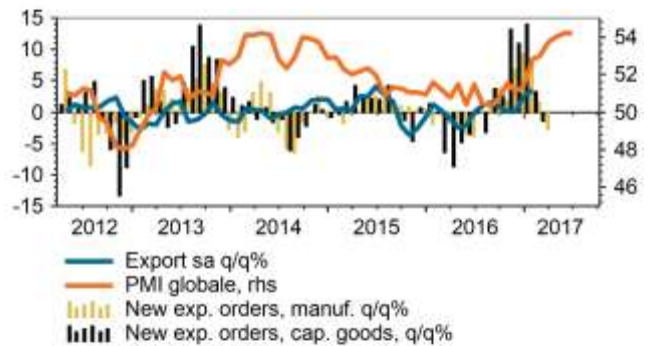
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 15 – Trade balance



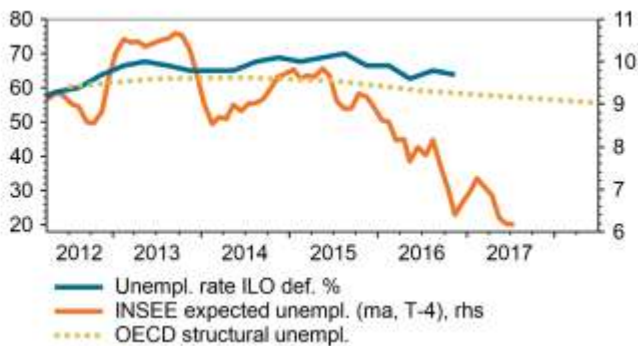
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 16 – Exports, export orders and global PMI



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

Fig. 17 – Expected and structural unemployment



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

Fig. 18 – Employment

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

Italy: less uncertainty on 2017, risks pushed back to 2018

Paolo Mameli

The opening months of 2017 could bring a quarterly slowdown in GDP, although survey data point to a reacceleration in the course of the year

Macroeconomic data for the opening months of 2017 outlined: 1) a recovery in business confidence, in the manufacturing sector in particular (as unanimously recorded by all the main indicators, i.e. Istat, PMIs, EU Commission); **2) a recovery in foreign trade** (in particular with non-EU countries), which, contrary to the situation at the end of 2016, saw exports grow more than imports; **3) a further loss of steam in the consumption trend**, also and especially as a result of the slowdown in employment (as well as of rising inflation, which pushed real wages back down into negative territory for the first time in four years).

After the slight quarterly slowdown in GDP at the end of 2016 (to 0.2% q/q from 0.3% q/q in the summer months), **economic activity may have slowed further at the beginning of 2017**, to 0.1% q/q. The main reason is the removal of the positive contribution of the industrial sector, which was the main driver of growth in the second half of 2016. However, in our view this is a temporary slowdown, as the plunge in industrial production recorded in January seems tied to issues pertaining to adjustment for working days, given the particular distribution of festivities between December and January (in this sense, we expect a rebound in output as soon as in February). Also, **the industrial sector's slowing may be balanced by the contribution, positive at last, of foreign trade**, which once again at the end of 2016, despite accelerating flows in both direction, had held back growth as had been the case almost consistently over the past three and a half years. However, the evident recovery in confidence surveys in the manufacturing sector between the end of 2016 and the beginning of 2017 signals a reacceleration in both industrial output and GDP in the course of the year: **we believe GDP may pick up again, to 0.3% q/q, in the remaining quarters of 2017**.

Downside risks to keeping up a cruising speed of close to 1% have decreased on the forecasting horizon

This scenario is compatible with 2017 average growth at very similar levels to 2016 (0.9% in unadjusted terms, 1% adjusted by working days). Some **downside risks** still seem to weigh on this baseline scenario, **albeit less than we envisaged three months ago**. We also confirm our view that, in the 2017-18 biennium, compared to the situation last year, a cruising speed of around 1% may be kept up despite a **probable slowdown in domestic demand** (we expect consumption to decelerate in 2017 and investments in 2018). The reasons are the following: 1) the significant drag caused by inventories (-0.4% in 2016) should gradually wane; 2) the contribution of foreign trade could turn from slightly negative to slightly positive (given the narrowing of the growth differential between domestic and foreign demand).

However, we continue to expect a slowdown in domestic demand, and in consumption in particular…

The expected slowdown in private consumption already seems to be under way, in line with the significant deterioration in consumer confidence observed over the past year and more. **In our view, consumer spending may grow by 0.7% in the 2017-18 biennium, ie at half the pace observed over the previous two years**. There are two main reasons for this:

1) For almost a year now (i.e. from the peaks hit last spring), **the trend of the labour market has been losing steam:**

   a. The **unemployment rate,** after repeatedly hitting a low of 11.5% between the summer of 2015 and the same period of 2016, subsequently rose back to 11.9% at the turn of the year, although the main reason was increased labour force participation (in the months between August 2016 and January 2017 the jobless rate increased by four tenths, the activity rate by six tenths);

   b. The year-on-year growth rate of **employed** workers slowed to +236k (+1%) y/y in January 2017, after peaking at +412k (+1.8%) last May;

c. Employment growth remains limited to the **older age brackets** (+4.4% y/y for over-50s, as opposed to -1.3% y/y for 35-49 year-olds, and zero growth among under-35s), although this trend is blander when considered net of the demographics component (+2.5% over-50s, +0.7% for the intermediate class, and +0.9% for the younger adults);

d. Lastly, there are signs of a worsening of the "quality" of employment: **permanent employment** slowed (+57k y/y in January 2017, from a peak of +321k hit in February 2016), due to the removal of government incentives.

2) **The current resurgence of inflation, against the background of a stagnant wage trend** (0.4% y/y in January, a long-term low, and new lows could be hit in the coming months in the absence of renewals), **drove real compensation into negative territory** already at the end of 2016, as had not been the case in almost four years; this trend will accentuate in the first part of 2017.

As a result, we believe the significant recovery in real disposable income seen in 2016 (2.3% on average), which translated into an increase of the savings rate (from 8.4% to 9.1%), as consumption in the year actually slowed (to 1.3% from 1.6% in 2015), will not be replicated in 2017-18: this year we expect a decline from 2.3% to at least 0.9%. This is because we forecast a deceleration in the number of employed workers (to at least 0.7% from 1.3% previously), and a little changed unemployment rate (11.6% from 11.7% in 2016). As a result, **we expect consumption to slow to 0.7% in 2017 from 1.3% in 2016.**

… whereas there is still room for an acceleration in investments in machinery

Vice versa, the recent revision of national accounts data outlined a **stronger than expected trend of investments** in 2016: total fixed investments accelerated to 3.1% (from 1.6% in 2015), and the improvement touched not only spending on means of transport (up by more than 20% per year on average for three years in a row), but also spending on machinery and equipment, as well as construction (which achieved the first year of positive growth in a decade). Spending on **machinery and equipment** has aligned somewhat more with the indications of a recovery that had emerged from survey data, accelerating to 2.1% in 2016 (from 1.9% in 2015), as opposed to a previously forecast stagnation. We believe there is further room for a recovery in 2017, as we expect an acceleration to 2.8%, in the wake of an additional increase in business profitability. The main risk is policy uncertainty; also, a slowdown cannot be ruled out next year as a result of the removal of government incentives. Also, we believe the boost from investments in **means of transport** is still not entirely over, which could come in at over 20% this year as well (although a slowdown is possible next year). Vice versa, signals are more mixed for the **construction** sector, which we forecast to decelerate from 1.4% to 0.9%; however, the recovery in business confidence in the sector is still not fully reflected by output data, probably due to persistently high excess supply.

The contribution of foreign trade is expected to turn positive again

Lastly, as mentioned above, an important engine of growth in 2017-18 should also be foreign trade. Already at the end of 2016, trade flows in both directions rebounded significantly, with imports outpacing exports. In our view, the current recovery may continue in 2017 (and probably in 2018 as well). **Our forecast for this year points to similar percentage growth (of around 4%) for both exports and imports**, which will be enough to result in foreign trade making a slightly positive contribution to GDP (+0.1%, which should increase to +0.3% in 2018), after averaging -0.2% in the 2014-16 three-year period. For what concerns foreign sales, means of transport will continue to spearhead growth, joined by machinery (whereas pharmaceuticals could gradually lose steam). Some emerging countries (Russia, OPEC and Mercosur), which had contributed negatively on aggregate to Italian exports by an average of -0.6% over the 2014-16 three-year period (with a direct impact on GDP of -0.2% a year), are now experiencing a marked recovery in sales (which in our view should continue in the course of the year). Furthermore, after the semi-stagnation observed in 2016, we expect sales to the United Sates to reaccelerate (as a result of both the depreciation of the euro against the dollar in

the second half of last year, and of a possible acceleration of the US economy), taking over as the main driver of growth for Italian exports.

The April DEF and the Autumn budget should plan fiscal consolidation in 2018, which nonetheless could be watered down by the approaching elections

For what concerns public finances, **in 2016 the government met both its goals in terms of the deficit** (2.4% of GDP from 2.7% in 2015, a low since 2007) **and of debt** (which at 132.6% of GDP was two tenths lower than targeted, albeit up by six tenths compared to the previous year). However, as has also been the case in recent years, the objectives were not achieved thanks to an improvement of the primary balance (up only marginally, from 1.4% to 1.5% of GDP, in line with the two previous years), but on lower interest expenditure. **In 2017**, taking into the account the 0.2% of GDP correction required by the EU Commission in the course of the year (to be detailed by the end of April), **we expect the deficit to improve modestly, to 2.3%**, albeit once again on lower interest expenditure, as the primary surplus is forecast to drop slightly, to 1.4% of GDP. **Debt could hit a new high** of 132.8% of GDP (also due to the challenging objective laid out in terms of privatisations, and to the issues aimed at supporting the banking sector). The most critical aspect will be the budget for 2018, the policy framework of which should be outlined in the April DEF. Based on the difference between the structural deficit estimated under current legislation by the EU Commission in its winter economic forecasts (-0.5% worsening), and the correction that would be required by European rules (+0.6%), the gap to bridge would amount to a hefty 1.1% of GDP (19 billion euros). Even applying the maximum flexibility of half a point, **the budget would have to be worth 0.6% of GDP (over 10 billion euros)**. However, the impending political elections could induce the government to use a lighter hand, resulting in a budget that would probably be restrictive in net terms (it may be risky to strive for less than 0.3-0.4% of GDP), as opposed to a gross budget which could contain some growth-supportive measures (there is talk of a reduction of the "fiscal wedge" and of taxes on labour, which may be financed, however, through partial recourse to VAT hikes).

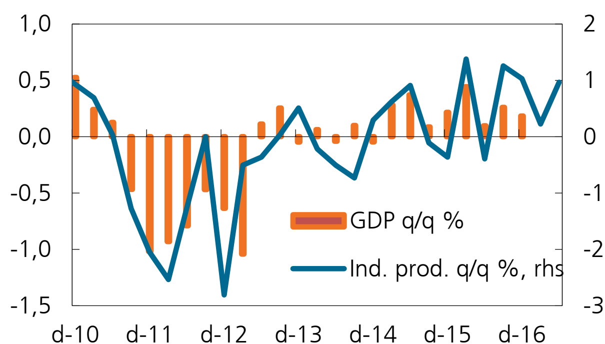
The political elections should take place upon the natural end of the legislature, but could lead to ungovernability, unless changes are made to the electoral law

The picture of public finances intertwines with political developments. The possibility of early elections in 2017 has recently waned, therefore **the likeliest scenario is that the vote will be scheduled as expected in the opening months of 2018** (February or March at the latest). In the meantime, the Gentiloni government, which will probably last longer than initially prospected, could find greater legitimacy in carrying on the reform agenda undertaken by the previous government (completion of the PA reform, approval of the law on competition, review of the civil and criminal legal processes, land register reform). **The risk, as the end of the legislature approaches, is that the outcome of the vote could lead to ungovernability**: on this front, a correction would seem advisable for the electoral law, which in its current form would risk yielding such a level of fragmentation to make forming a government after the vote a challenging feat. As we write, this undertaking is in no way taken for granted objective, as the main parties have still not begun a serious discussion on reforming the voting system. An inconclusive outcome of the election could trigger a resurgence of tensions on the financial markets, with a potentially negative fallout on the real economy. In any case, **for the time being the risk seems to have been pushed back to 2018.**

Macro forecasts	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.0	1.2	0.8	1.0	1.0	0.7	0.9	1.0	1.2	1.3	1.2	1.1
- q/q change				0.1	0.3	0.2	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Private consumption	1.3	0.7	0.7	0.5	0.2	0.1	0.2	0.2	0.1	0.1	0.2	0.2	0.2
Fixed investment	3.1	3.2	2.0	0.4	1.5	1.3	0.5	0.6	0.5	0.5	0.6	0.5	0.4
Government consumption	0.6	0.5	0.5	-0.3	-0.2	0.6	0.1	0.1	0.1	0.2	0.1	0.1	0.2
Export	2.6	4.0	3.2	2.2	0.3	1.9	0.7	0.7	0.9	0.8	0.8	0.8	0.7
Import	3.1	4.1	2.5	2.2	1.0	2.2	0.6	0.6	0.5	0.5	0.8	0.6	0.6
Stockbuilding (% contrib. to GDP)	-0.4	-0.2	0.0	-0.3	0.1	-0.2	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	2.8	2.6	2.5										
Deficit (% of GDP)	-2.4	-2.3	-2.5										
Debt (% of GDP)	132.6	132.8	132.7										
CPI (y/y)	-0.1	1.6	1.6	-0.4	0.0	0.1	1.4	1.7	1.6	1.8	1.4	1.5	1.6
Industrial production (y/y)	1.9	2.5	1.2	0.5	1.9	3.3	2.1	3.5	2.7	1.6	1.5	1.1	1.1
Unemployment (%)	11.7	11.6	11.2	11.6	11.6	11.9	11.8	11.6	11.5	11.4	11.3	11.2	11.1
10-year yield	1.48	2.32	2.78	1.48	1.19	1.77	2.15	2.22	2.38	2.53	2.67	2.79	2.81

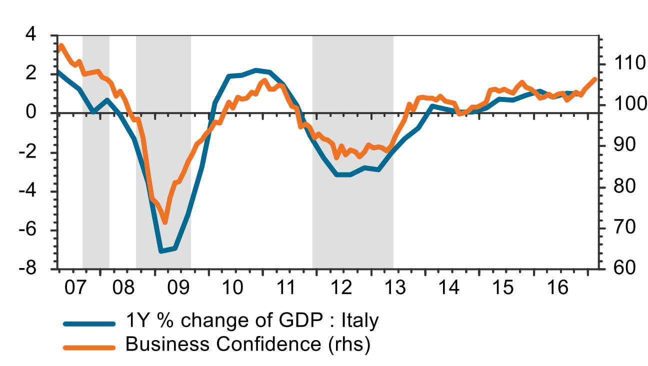
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – The recovery lost steam in quarterly terms between the end of 2016 and the beginning of 2017, but should pick up again already starting in the spring quarter



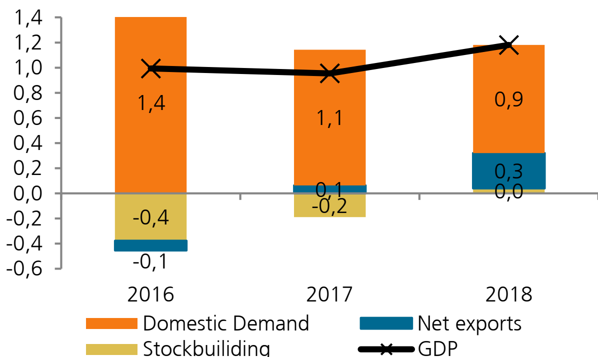
Source: Intesa Sanpaolo elaborations and forecasts on ISTAT data

Fig. 2 – Leading indicators are consistent with a possible year-on-year acceleration in the remainder of 2017



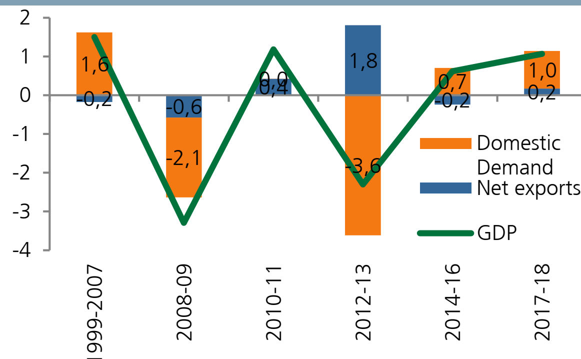
Source: Thomson Reuters-Datastream

Fig. 3 – Growth in 2017-18 could be driven less by domestic demand and more by foreign trade (as well as by inventories no longer representing a drag)



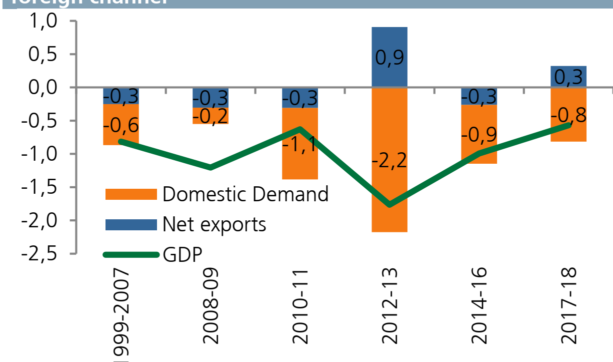
Note: GDP and contributions to GDP, avg. annual % changes. Source: Intesa Sanpaolo elaborations and forecasts on ISTAT data

Fig. 4 – This would be the second biennium in a row of positive growth, after the brief cycles of the past decade



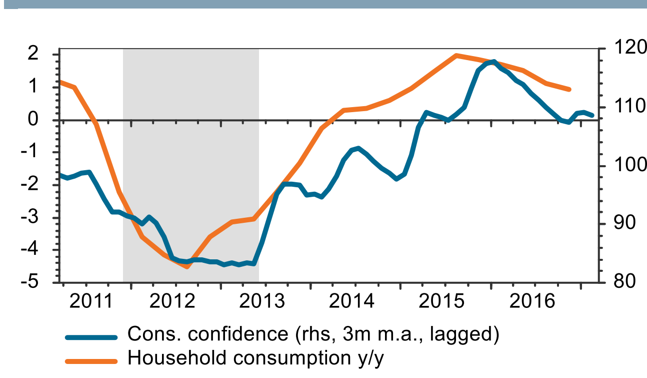
Note: GDP and contributions to GDP, avg. annual % changes. Source: Intesa Sanpaolo elaborations and forecasts on ISTAT data

Fig. 5 – The growth gap compared to the area euro average could narrow thanks to the stronger contribution of the foreign channel



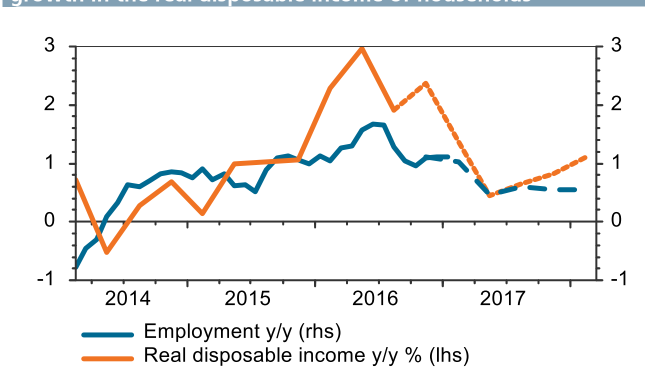
Note: differential between GDP and contributions to GDP (avg. annual % changes) Italy vs. Eurozone avg. Intesa Sanpaolo elaborations and forecasts on ISTAT, Eurostat data

Fig. 6 – On the domestic demand front, the current slowdown in private consumption should continue



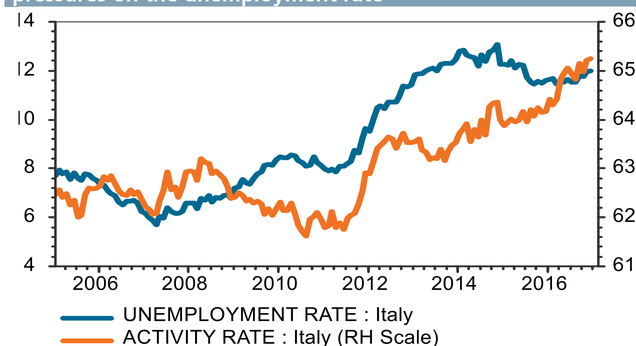
Note: y/y % chg. in investments in machinery and equipment and earnings (gross operating result). Source: Intesa Sanpaolo elaborations and forecasts on ISTAT data

Fig. 7 – The slowdown in the employment trend will aid slower growth in the real disposable income of households



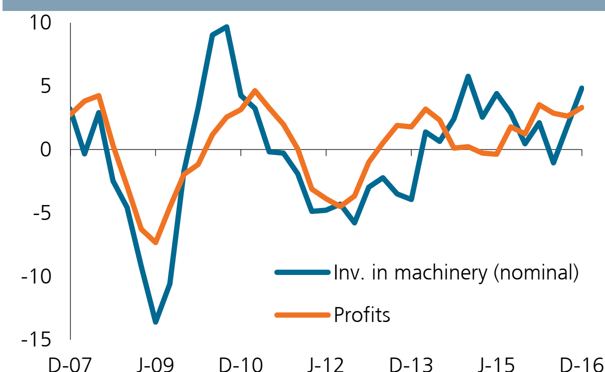
Source: Thomson Reuters-Datastream, Intesa Sanpaolo forecasts

Fig. 8 – Stronger participation will continue to exert upward pressures on the unemployment rate



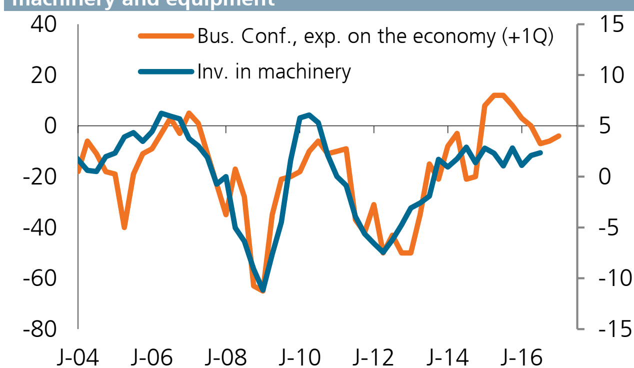
Source: Thomson Reuters-Datastream

Fig. 9 – An investment cycle seems to be shaping up at last, also thanks to improved business profitability



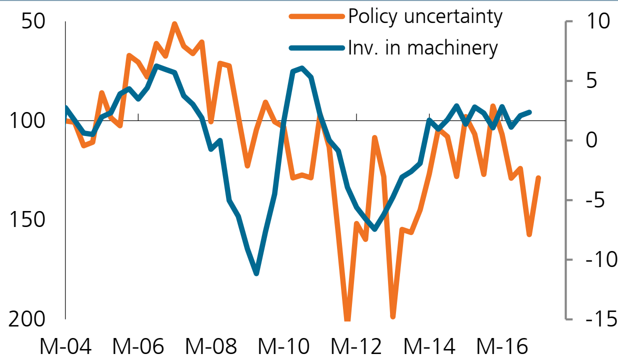
Note: y/y % chg. in investments in machinery and equipment (nominal) and earnings (gross operating result). Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 10 – The expectations of businesses for the economy are compatible with a further improvement in investments in machinery and equipment



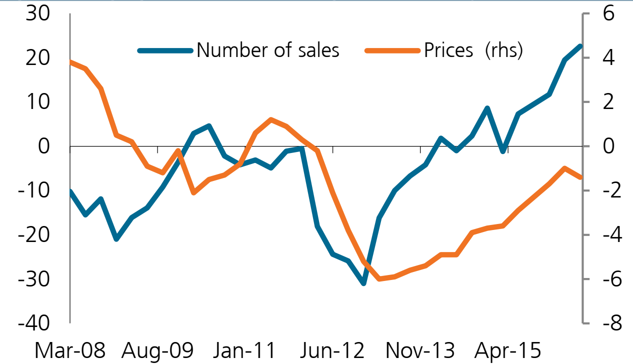
Note: y/y % chg. in investments in machinery and equipment (real). Source: Intesa Sanpaolo elaborations on ISTAT data

Fig. 11 – One risk is policy uncertainty



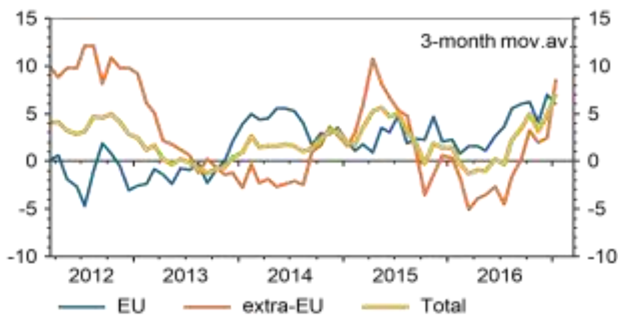
Note: y/y % chg. in investments in machinery and equipment (real). Source: ISTAT, www.PolicyUncertainty.com (Scott Baker, Nicholas Bloom and Steven J. Davis)

Fig. 12 – On the real estate market, transactions are still picking up, although prices remain in negative territory



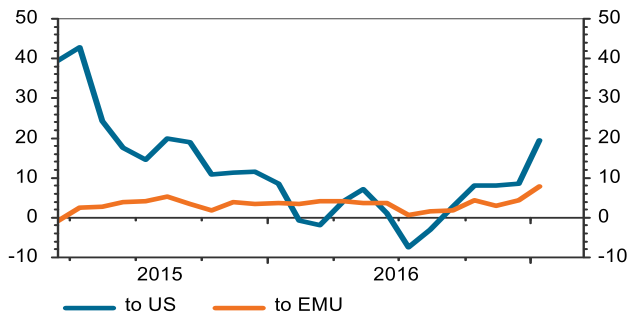
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 13 – Exports to non-EU countries are the driving force in the present phase



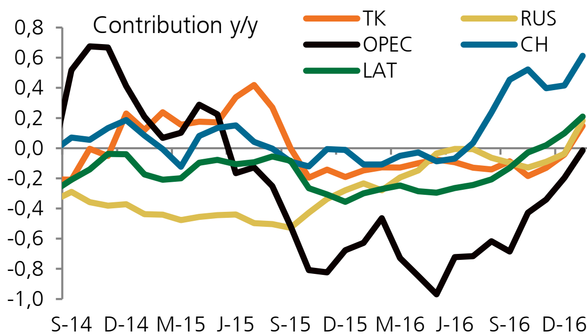
Source: Thomson Reuters-Datastream

Fig. 14 – Sales to the US are reaccelerating (as opposed to a less lively trend of sales to the euro area)…



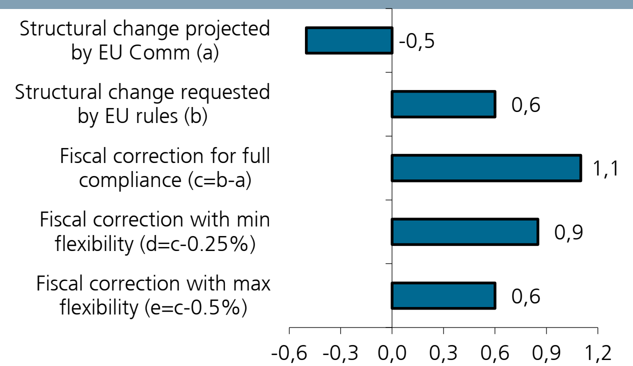
Source: Thomson Reuters-Datastream

Fig. 15 – …and the contribution to growth of sales to several emerging countries is turning positive again, after previously holding back exports



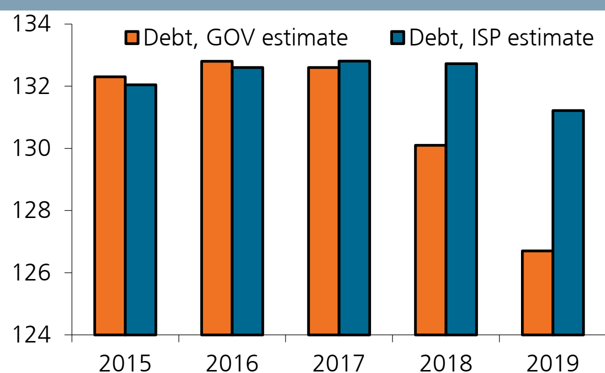
Note: contribution to the annual % growth of Italian exports (3m moving average). Source: Intesa Sanpaolo elaborations on Istat data

Fig. 16 – In theory, the 2018 budget should be restrictive by at least 0.6% of GDP (over 10 billion euros)



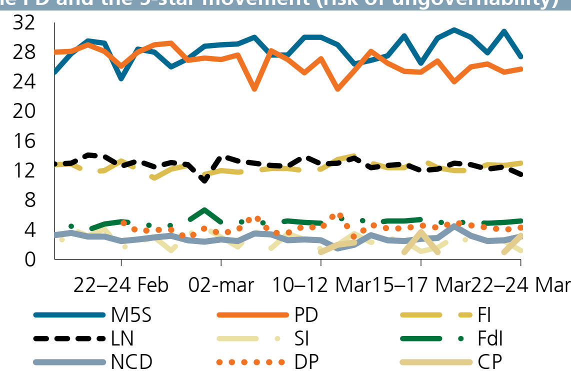
Source: Intesa Sanpaolo elaborations on EU Commission data

Fig. 17 – The overly sluggish reduction of public debt will once again be at the heart of the debate with the European authorities



Source: MEF and Intesa Sanpaolo forecasts

Fig. 18 – The evolution of the Italian political scenario will remain under the spotlight as the elections near. To date, voting intention polls point to a neck-and-neck race between the PD and the 5-star movement (risk of ungovernability)



Source: CISE, Datamedia, Demopolis, Demos&Pi, EMG, EP Election, Epoké, Euromedia, IPR, Ipsos, Ixé, Lorien, Piepoli, Quorum, ScenariPolitici, SWG, Tecnè

Spain: expansion continuing, currently without excesses

Anna Maria Grimaldi

The Spanish economy continues to grow at a sustained pace, outperforming expectations. Growth in 2016 closed at 3.2%, half a percentage point above *Consensus Economics* mean forecast from a year ago, while the surprise for the Euro zone was barely one-tenth of a percentage point. Recent signals from the PMI and economic confidence surveys suggest that economic growth was showing resilience at around 0.7% qoq at the start of 2017: we have therefore upgraded our **estimates for the current year to 2.5%,** from 2.3% previously. In 2018, GDP should slow to 1.9% as financial conditions become less expansive, while fiscal policy is likely, according to the regulations of the Stability and Growth Pact, to narrow by at least 0.5% of GDP.

Growth will remain solid in 2017-18, but has now peaked

The outlook for **exports** is for more sustained growth, in line with the signs of recovery in foreign orders (see Fig. 3). Exports were already accelerating sharply at the end of 2016 (3.1% qoq at current prices, +2.0% qoq in the national accounting data), having stagnated in the middle of the year. We expect average growth of 4.6% in 2017, which is not much more than last year. It must be borne in mind that although Spanish exports fared better than the rest of the Euro zone in 2014-16, thanks to geographical diversification and improved cost competitiveness, there has been no further progress to suggest exports will significantly outperform the Euro zone average. In 2017, we should see a rise in salaries and wages rise and, for the first time in years, a recovery in labour costs. **Imports** are expected to grow by 4.0% given that the amount of internal demand met by imported goods has been much lower in recent months than in the past. **The contribution of foreign trade will be moderately positive over the forecast horizon (0.2%)**. During 2016, the goods balance varied marginally by destination (see Fig. 4), due to the ongoing improvement in the energy balance, but the other categories of goods deteriorated (see Fig. 5). We think the energy balance will start expanding again in 2017, given the high dependency of energy on foreign markets. The anticipated slowdown in internal demand should limit expansion of the goods balance in the next few years (see Fig. 6). The current account balance is expected to narrow to 1.5% in 2018, from 1.8% last year.

Foreign trade will make a marginally positive contribution to growth

As elsewhere in the euro zone, we think **internal demand** will remain the main growth driver in the two-year period 2017-18, but it has probably peaked: we are expecting growth to average 2.0% yoy in 2017, down from 2.8% in the previous two years. **Household consumption** is expected to slow to 2.6%, from 3.0% in 2015-16, due to the implicit oil price rise in our estimates, less robust growth in employment (see below), modest growth in nominal salaries of

Internal demand is growing solidly, but at a less sustained pace than in 2015-16

around 0.7% yoy and only modest acceleration compared with the previous two years (see Fig. 9). We expect household purchasing power to be partly eroded by a rise in inflation from -0.2% to +2.5% in 2017, and by reduced fiscal policy stimulus.

Employment growing at a sustained pace, but no longer in line with GDP

Employment continued to outperform the indications from confidence surveys in 2016 H2, growing by 2.5% yoy. However, job creation has already slowed compared to2015 (3.0%). The confidence surveys are indicating further moderation to 2% in the coming months. In the latter months of 2016, more jobs were created in industry (+4.7% yoy) than in services and construction. The unemployment rate fell to 18.2% at the start of 2017 from a peak of 26.3% at the start of 2013. Unless the participation rate increases and active labour policies can influence the natural unemployment rate, we think that unemployment will fall more slowly in the coming years, to a maximum of 17.5% by end-2018. The participation rate started to fall during 2016, to 59.4%, due to an increase in the economically inactive, and is still lower than in 2012-13 (60.5%). The unemployment rate is still at unacceptable levels for social cohesion, and reducing it remains one of the main challenges for the next government.

Unemployment rate heading towards smaller falls. At 18.2%, it remains at a socially unacceptable level

Residential construction and investments in machinery: the recovery will continue at a more moderate pace

Residential construction has turned the corner[16]. The contribution of value added has returned to pre-crisis levels (see Fig. 11). The expansionary cycle may continue, but more slowly (1.5%) than in 2016. Investments in machinery should slow in 2017-18 to 3.0% from 5.0% (quarterly growth has been weighing on annual averages since the start of 2016), as quarterly growth has been much higher than the change in production capacity (see Fig. 12).

Despite the fact that the pace of growth is more solid (3.3% in 2015-16) and well above the Euro zone average, the country continues to face challenges. The unemployment rate, despite recent falls, remains at extremely high levels (see above). The high foreign debt position requires further effort to rebalance internal imbalances: the private sector has done its bit, but the same cannot be said of the public sector. Spain will remain in the corrective grip of the Growth and Stability Pact until 2018. Its deficit is not expected to return to 3% – and debt stabilise at 100% – until 2018. Although the country will miss the nominal deficit target in 2017 (the Commission estimates it will close at 3.6%, compared with the 3.1% planned), the structural adjustment for 2016-17 is considered sufficient. The Commission's estimates put the correction at 0.7% of GDP, thanks to the measures adopted in early December by the new government (mainly revenue measures: corporate taxation, increase in alcohol and tobacco duty, expansion of the taxable base for social security contributions). In theory, under the rules of the Pact, Spain is required to make a structural correction of at least 0.5% of GDP in 2018. The Commission sees particular uncertainty around the structural balance trend due mainly to measures on the revenue side taken in recent years.

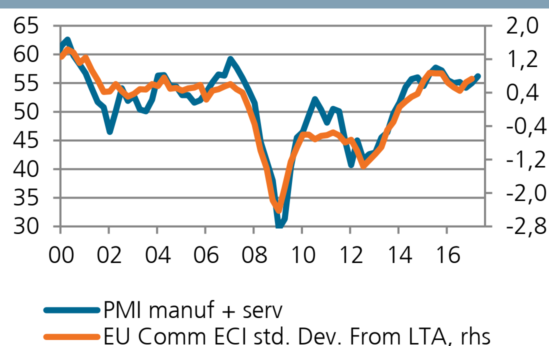
The scenario is subject to moderate downside risks from weaker-than-expected international demand and a faster rise in oil prices, given the country's high dependency on foreign energy. Moreover, the financial conditions could be affected if the risk premium widens in the event of increased uncertainty in other countries in the area.

[16] The contribution of residential construction to GDP fell to 5.4% in 2015, after peaking at 11% in 2007, and is now broadly in line with the Euro zone average.

Macro forecasts	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	3.2	2.5	1.9	3.4	3.2	3.0	2.9	2.7	2.4	2.1	1.9	1.8	1.9
- q/q change				0.8	0.7	0.7	0.7	0.6	0.4	0.4	0.6	0.4	0.5
Private consumption	3.2	2.6	2.1	0.7	0.6	0.8	0.7	0.6	0.5	0.5	0.6	0.6	0.4
Fixed investment	3.1	2.3	2.1	1.4	-0.1	0.5	0.8	0.5	0.6	0.3	0.6	0.7	0.5
Government consumption	0.8	0.7	0.9	-0.6	0.5	-0.2	0.3	0.3	0.3	0.1	0.3	0.2	0.2
Export	3.0	1.7	1.6	0.8	0.2	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Import	3.3	4.2	4.1	2.6	-2.0	1.8	1.5	1.0	1.2	1.0	0.8	1.0	1.2
Stockbuilding (% contrib. to GDP)	0.1	0.3	-0.1	-0.1	0.0	0.2	0.1	0.1	0.0	0.0	-0.1	-0.2	0.3
Current account (% of GDP)	1.8	1.7	1.6										
Deficit (% of GDP)	-4.9	-3.5	-3.1										
Debt (% of GDP)	99.9	101.0	99.7										
CPI (y/y)	-0.2	2.5	1.7	-0.9	-0.2	1.0	2.9	2.8	2.2	2.0	1.1	1.6	1.9
Unemployment (%)	19.6	18.4	18.3	20.1	19.3	18.7	18.4	18.4	18.4	18.4	18.3	18.3	18.3

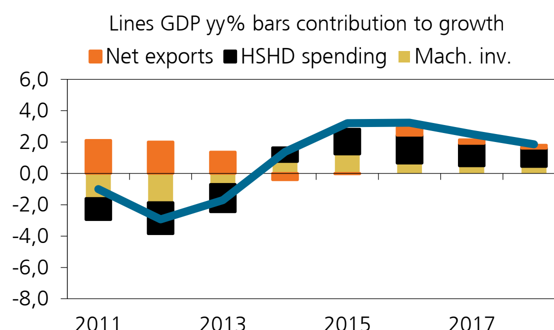
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contrasting signals from composite PMI and confidence surveys. The peak has very probably been reached



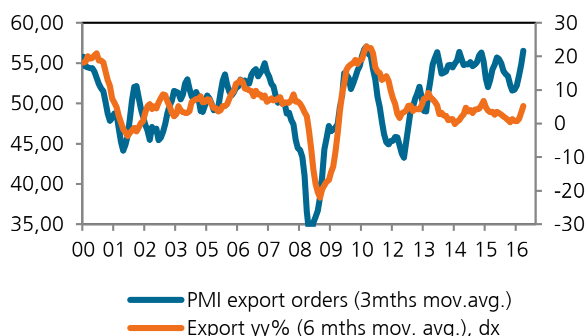
Source: Intesa Sanpaolo chart from Markit PMI and EU Commission

Fig. 2 – The recent pace of consumption is unsustainable. The cycle of investment in machinery seems to be mature. Foreign trade should make a positive contribution



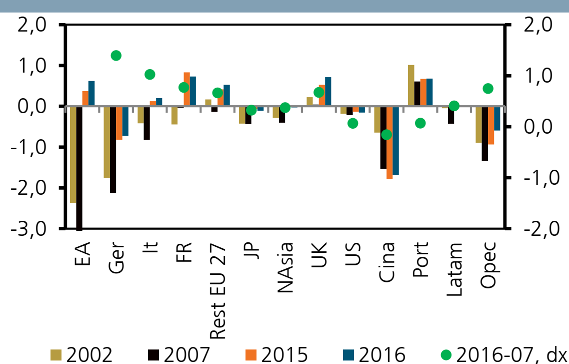
Source: Intesa Sanpaolo chart from INE and Eurostat data

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



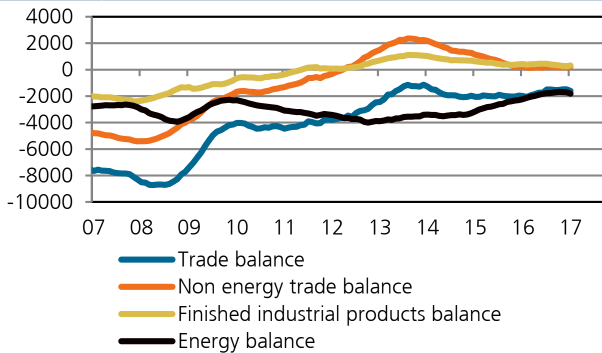
Source: Intesa Sanpaolo chart from Eurostat and INE data

Fig. 4 – The goods balance is stable or improving



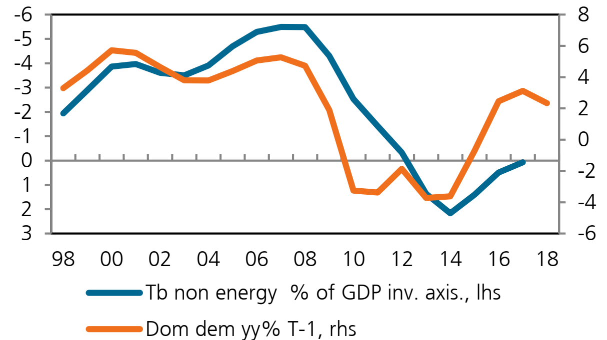
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 5 – The goods balance will hold as long as the energy balance stays in the black



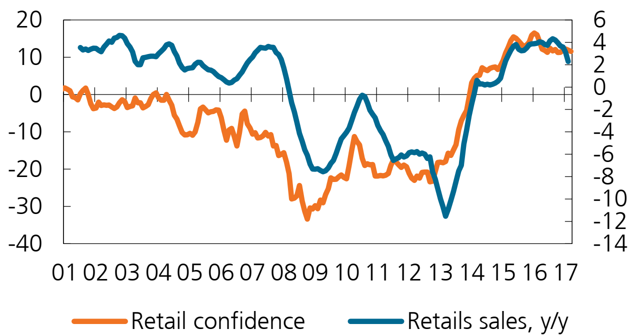
Source: Intesa Sanpaolo chart from Bank of Spain data

Fig. 6 – There is a risk that the return to sustained growth of domestic demand will widen the current account deficit



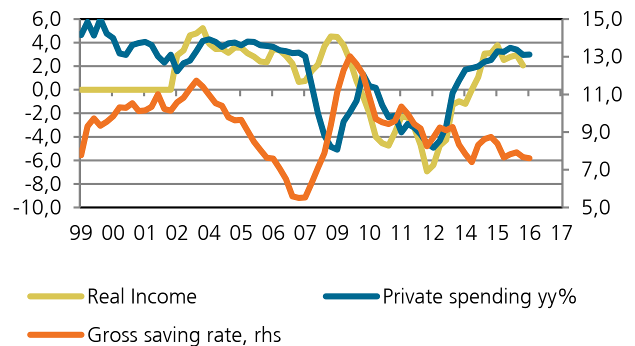
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 7 - Private consumer spending may have peaked. But growth will remain solid



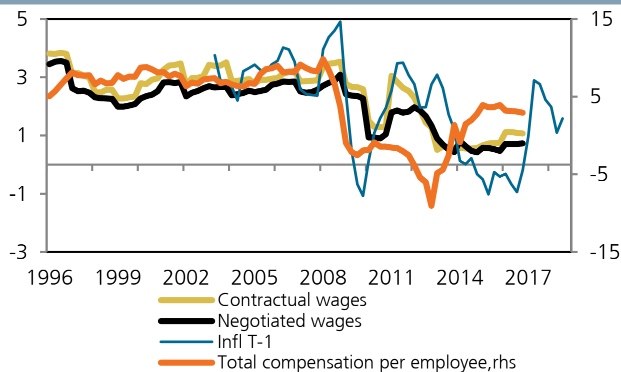
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Consumption is keeping pace with income. The low savings rate will provide limited support when real income slows due to…



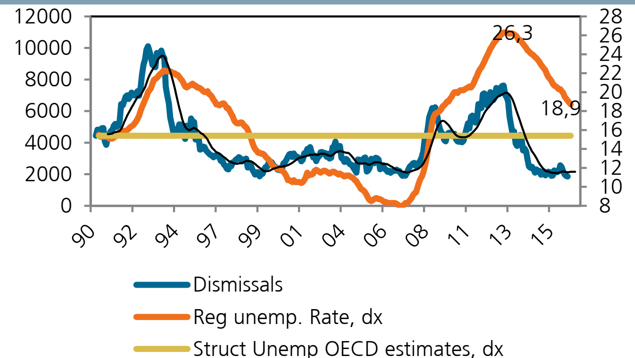
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – …rising inflation. Salaries will remain stagnant due to the reforms in 2012



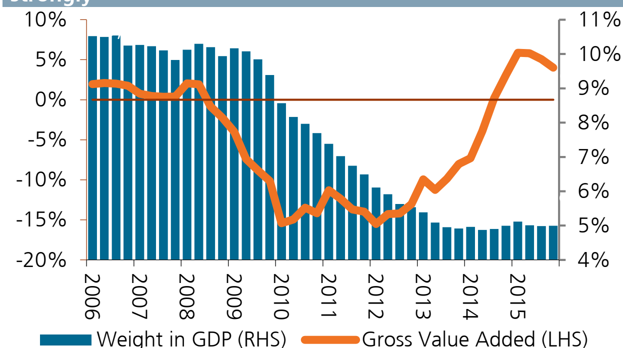
Source: Intesa Sanpaolo chart from INE data

Fig. 10 – Employment growth is solid. Unemployment has fallen by almost 8 points but remains at socially unacceptable levels



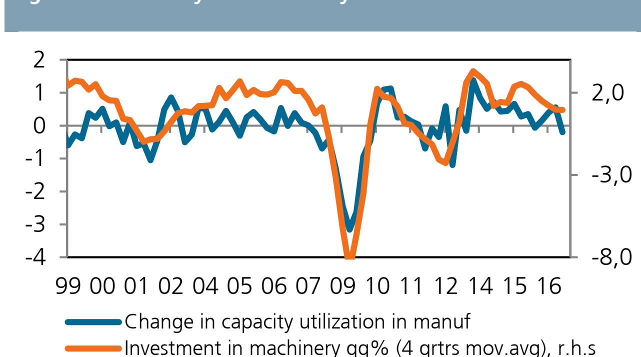
Source: Intesa Sanpaolo charts from UE Commission and INE data

Fig. 11 – Value added in residential construction again growing strongly



Source: Intesa Sanpaolo chart from INE data

Fig. 12 – Machinery investment cycle is mature



Source: Intesa Sanpaolo charts from INE and European Commission data

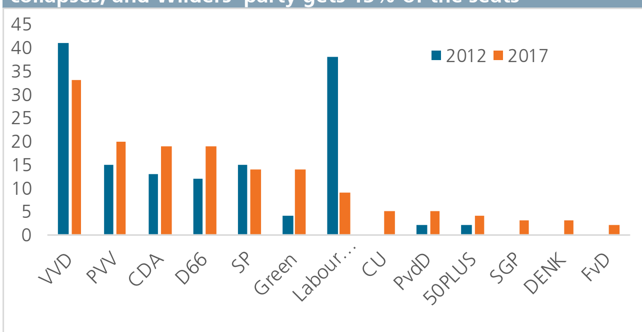
The Netherlands: with the elections over, the economy will continue to grow

Guido Valerio Ceoloni

The new parliament is more fragmented, but Rutte will remain prime minister

The elections saw the victory of the current prime minister, Mark Rutte, who, as predicted by the opinion polls in the last few weeks leading up to the vote, recaptured ground from the populist party of Geert Wilders. Rutte's VVD will be the largest party in the new parliament with 33 seats (five less than before), followed by Wilders' PVV with 20 seats (five more than before) and the D66 and CDA (both with 19 seats, in total 13 more than before). The outgoing defeated left will no longer be part of the government coalition with Rutte, following a huge slump in the number of seats held by the Labour Party (down 29, to nine) and the socialists holding firm on 14 seats (one less than previously). Looking at the breakdown of the distribution of votes, the strength of Rutte is confirmed, as the proportional representation system provided him with the relative majority in almost 75% of constituencies, on a much higher than usual turnout (81.4%). The political landscape is now, however, more fragmented than before, and a government majority will have to incorporate at least four parties. The most likely option is an alliance between the VVD and its natural allies, the CDA and D66 (71 seats): Rutte could seek the five seats of the Christian Union (CU), rather than the 14 seats of the Greens. These elections demonstrated that the electorate did not like the right-left cross-party alliance. The Greens may in this regard also prefer to only offer Rutte external support. Besides, a left-wing government is highly unlikely, because they would not have enough seats to guarantee a majority. In any case, the systemic risks for the Euro zone arising from the Dutch elections have been averted, and the pro-European stance of the previous government is likely to remain intact, although perhaps with less support to further integration or new bailouts (Greece).

Fig. 1 - The new Parliament: Rutte holds, the Labour Party collapses, and Wilders' party gets 13% of the seats



Source: https://www.tweedekamer.nl/

Tab. 1 – Possible new coalitions: centre-right coalition again led by Rutte the most likely

Coalitions	Parties	# of seats	Fiscal stance	Views on EU
Centre-right	VVD, CDA, D66, CU	76	Little expans.	Mixed
Centre-right	VVD, CDA, D66, CU, others	76+	Little expans.	Mixed
Centre-left	VVD, CDA, D66, Green	85	Little expans.	Pro EU
Left	D66, Green, Socialists, Labour party, other	70	Expansionary	Mixed

Source: Intesa Sanpaolo table on https://www.tweedekamer.nl/ data

GDP growth slows this year from 2.1% to 1.9%

In this scenario, we forecast that the economy will grow unperturbed for the rest of the year. **In the current quarter, we expect GDP growth to slow to 0.3% qoq, from 0.6% qoq,** mainly due to a hiatus in consumption, before picking up to around 0.4% qoq in the spring. In annual average terms, the slowdown in domestic demand (1.7% yoy) after two years of strong expansion (2.0% in 2016 and 2.7% in 2015) is expected to moderate **GDP growth, from 2.1% to 1.9%.** We then expect it to stabilise at 1.6% from 2018 when the cycle is mature and the effects of Brexit start to become more apparent than they have been so far.

Consumption slowing on the back of rising prices after two extremely positive years, but disposable income will continue to grow

In February, **consumer confidence** was at 14, at its highest for more than nine years, well above the historical average (8), and supported in particular by the improved economic outlook and strong household purchasing intentions; disposable income increased by 0.3% qoq in December, down from 0.6% qoq in the third quarter; we forecast that for the rest of the year, it will continue to support consumption, with average growth of around 0.3% qoq in the first half. We therefore expect that **consumption** will continue to move in the right direction (on average +0.2% qoq in the first two quarters of 2017), making a positive contribution to GDP. Private spending is expected to grow on average by 1.6% yoy in 2017, from 1.7% yoy last year, and will also be bolstered by the package to support purchasing power and lower incomes that the government will launch in the near future, worth 0.1% of GDP.

Positive but slowing investment, dynamic property market

After experiencing average growth of 7.4% in 2015-16 while emerging from the crisis, and acting as the main growth driver, **fixed investment** is expected to slow this year to an average of 3.3%. Business confidence surveys remain extremely upbeat, however, with indices in February at their highest since 2008; the **property market** is well-placed. **House prices** were 6.4% higher in January than in 2016, but are nearly 10% lower than their peaks at the time of the bubble in 2008; prices are not however showing an upturn from the 2016 average; transactions increased by almost 40% yoy in January, indicating that the property market is still very dynamic and is partly offsetting the consolidated losses suffered by consumers in their securities portfolios during the crisis. We therefore expect fixed investment to slow markedly in the first quarter after surging in the fourth (to 0.7% qoq, from 4.4% qoq), before recovering in the spring. In annual average terms, we forecast a substantial slowdown, however (from 9.9% yoy to 4.9% yoy).

The slowdown in consumption should stimulate net exports in 2016

In the first few months of the year, **foreign trade** continued the period of expansion seen at the end of last year: exports grew by 5.7% yoy in January, supported in particular by foreign orders of machinery, commodities and chemical products, while imports advanced by 4.0% yoy. In the current quarter, we forecast that net exports will contribute a few tenths of a percentage point to GDP, from 0.5% previously. **Exports** are expected to post growth of 0.6% qoq after 1.4% qoq in the current quarter, but we foresee the annual average to be around the same level as that recorded in 2016, at 3.6% yoy. **Imports**, however, will be affected by the slowdown in consumption, and are seen growing by 0.9% qoq, from 1.1% qoq in the current quarter, and by around 3.3% yoy, from 3.8% yoy, for 2017. During the year, the Brexit negotiations could have an impact on foreign trade flows, given that the UK is the Netherlands' second largest trading partner. **The trade balance** closed 2016 at 7.5% of GDP: we expect a slight contraction of approximately two tenths of a percentage point a quarter, before it closes the year at 6.7%.

Inflation above 1% in 2017

After rising from 1.0% to 1.7% in January, **inflation is expected to accelerate this year at an annual average of 1.4%, from 0.3%,** on the national index (HCPI at 1.4%, from 0.1%), supported by a favourable base effect for energy prices and duties on energy consumption, as well as the increase in hourly wages. **The core index** is expected to increase this year from 2016, by two or three tenths of a point (to 0.7-0.8%), but risks are to the upside, mainly due to pressures on input prices in the manufacturing sector, which in January reached their highest since 2008 (+9.5% yoy).

Employment above pre-crisis levels, unemployment not yet

The number of unemployed fell over the last quarter at a rate of 9,000 a month, while approximately 13,000 new jobs per month were created: **employment** rose by 0.5% qoq in December, and is on course for a further rise of 0.3% qoq in March, to 66.2%; the rate is now higher than pre-crisis levels. With around 473,000 people out of work, **unemployment** fell in February by another tenth of a point to 5.3%, from 5.4% at the end of 2016. In annual average terms, it is expected to fall this year by a further six-tenths of a point, from 6.0% in 2016 to 5.4%, thereby also nearing pre-crisis levels (5%).

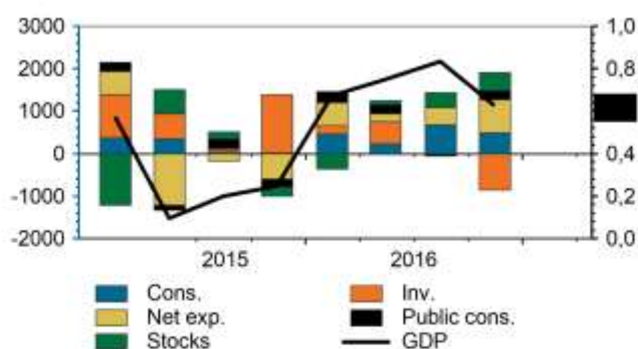
Maastricht criteria fully met

The **deficit** in 2016 is expected to fall sharply, from -1.9% to -0.1% on the back of higher tax revenues, and we should see a surplus this year. Meanwhile, the **structural balance** should already show a surplus for 2016, of 0.2%; **public debt** also fell, by nearly three points to 62.2%, and we expect it to fall to 60%, in line with Maastricht criteria. Given the fairly positive public accounts position, an easing of fiscal policy of around 0.2% of GDP is on the cards for 2018-21, following the tightening of 0.6% in the last four years.

With the elections behind us, the risks to the scenario are now balanced

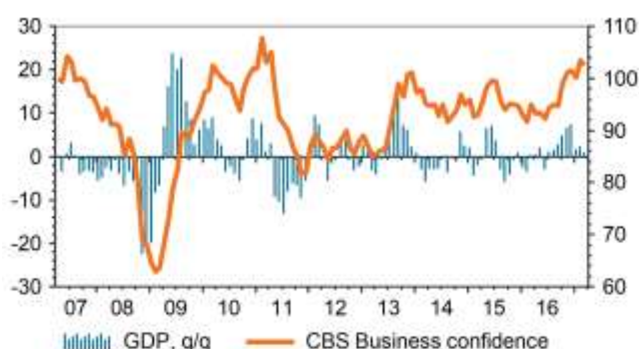
With the elections behind us, **the risks to the scenario are balanced**: the forming of the new government could generate some uncertainty among economic operators, but they remain positive about the state of the economy and the job market; household debt is falling, but is still higher than the European average. External risks could come from a move towards protectionism in global trade driven by the Trump administration and by unfavourable developments in the Brexit negotiations, to be launched at the end of March.

Fig. 2 – Contribution to GDP



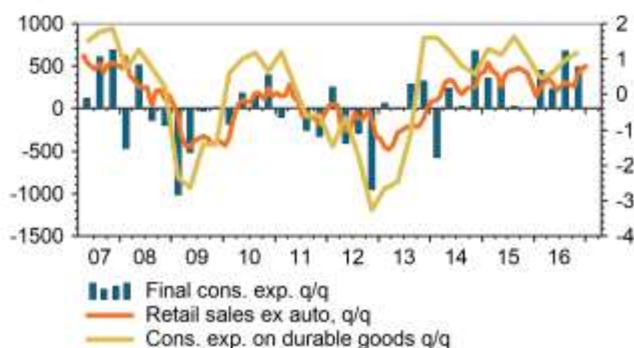
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Economic confidence and GDP



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

Fig. 4 – Household spending, purchases of durable goods and changes in consumer spending

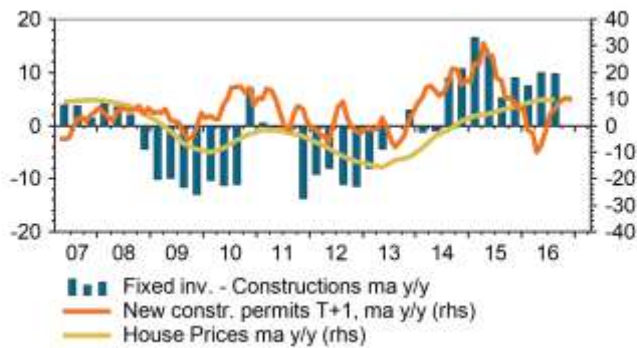


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Retail sales and household confidence

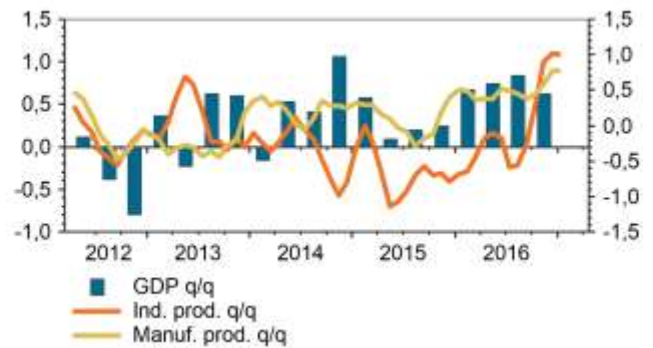
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Residential investment, construction sector activity and house prices



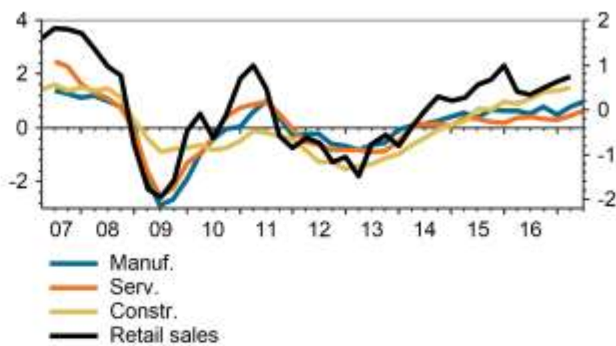
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Industrial output and GDP



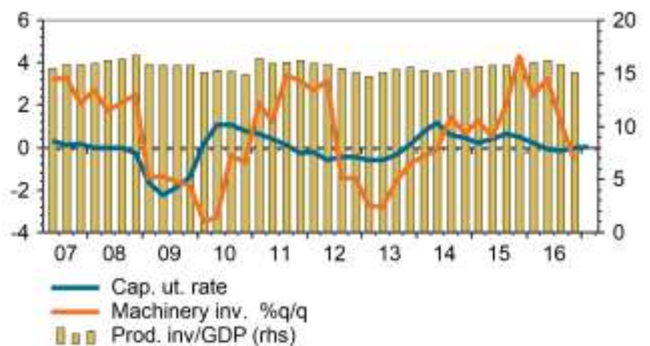
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Activity indices in the various production sectors



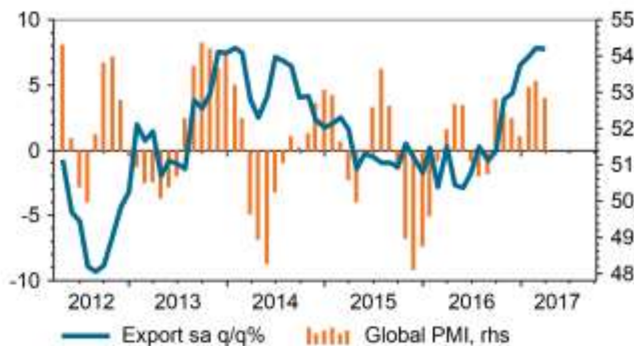
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 –Capacity utilisation and level of investment as percentage of GDP



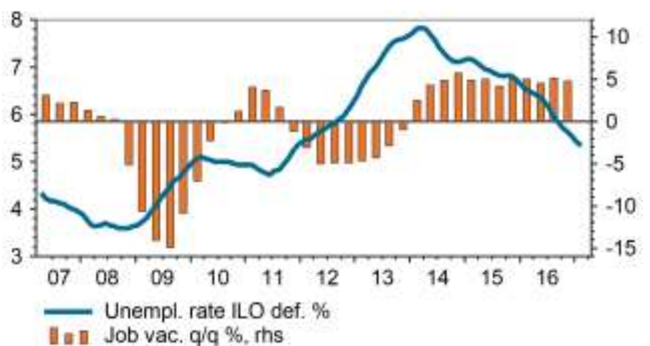
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Exports, export orders and global PMI



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

Fig. 11 – Unemployment and job vacancies



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

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	2.1	1.9	1.6	1.9	2.5	2.9	2.5	2.1	1.5	1.3	1.4	1.5	1.7
- q/q change				0.7	0.8	0.6	0.3	0.4	0.3	0.4	0.4	0.4	0.4
Private consumption	1.7	1.6	1.2	0.3	1.0	0.7	0.2	0.2	0.2	0.3	0.2	0.4	0.3
Fixed investment	4.8	3.7	3.0	1.5	0.0	-2.5	3.4	1.4	1.0	1.2	0.5	0.5	0.5
Government consumption	1.0	1.0	1.0	0.6	-0.1	0.6	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Export	3.3	3.3	2.9	0.3	1.0	0.9	0.6	0.9	0.9	1.0	0.7	0.6	0.4
Import	3.6	2.6	2.5	0.2	0.9	0.4	0.6	0.8	0.8	0.9	0.5	0.5	0.5
Stockbuilding (% contrib. to GDP)	0.0	-0.7	-0.4	0.1	0.2	0.2	-0.6	-0.3	-0.3	-0.3	-0.1	-0.1	0.2
Current account (% of GDP)	7.7	8.1	8.6										
Deficit (% of GDP)	-0.8	0.1	0.2										
Debt (% of GDP)	62.6	60.0	58.5										
CPI (y/y)	0.1	1.0	1.8	-0.2	-0.2	0.5	1.5	1.1	1.0	0.5	0.7	1.4	2.2

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

Greece: further tensions expected this summer

Guido Valerio Ceoloni

Clouds are gathering on the horizon for Greece. The second review of its third economic adjustment programme began in December: five months on, no concrete progress has been made. The Eurogroup meeting of 20 March passed uneventfully; the next convenient juncture for finalizing the review or a new **Memorandum of Understanding** (MoU) will be the Eurogroup meeting in May (the April meeting will be dedicated to Brexit). **GDP dropped again in the fourth quarter, by 1.2% qoq** (revised down from -0.4% qoq[17]), after two positive quarters, reflecting a decline in exports of 1.9% qoq, compared with a rise of 3.6% previously, and a decrease in domestic demand, due to slowing public sector consumption (down 2.1% qoq, from +0.1% qoq) and the uncertainty connected with the aid programme, which has weighed on investment (down 6.4% qoq). Overall, household consumption rose by an annual average of 1.4% in 2016, the best figure since 2008, and industrial output accelerated by 2.2% yoy, from 1.1% yoy; the contraction in public spending continued (down 2.1%, slower than the average decrease of 3.1% since 2008); while the contribution from foreign trade took 0.6% away from GDP due to weak exports. **Growth was therefore a negative 0.1% in 2016, making it almost impossible to meet the Commission's official target of 2.7% for 2017, which will once again be a year of fiscal consolidation.** We estimate that GDP will bounce back by 0.8% qoq in the first quarter, before slowing in the second quarter, as tensions rise in connection with the bond issue set to mature this summer. **We expect output to increase by around 0.9% this year. The issue of the primary surplus target of 3.5% of GDP from 2018**, which the IMF continues to criticize and which remains an obstacle to its involvement, appears to remain unresolved. To ensure that the target is reached, corrective fiscal tightening of at least 2.0%[18] of GDP has been called for in the event that the intermediate budgets of 2017 and 2018 are not achieved. At the end of 2016, the primary surplus should have exceeded the target of 0.5% of GDP by two-tenths of a percentage point[19]: however, the result was achieved not due to a structural position of fiscal solidity but to extraordinary measures, given that 50% of taxpayers are currently exempt from paying income tax under a pension system that is still "generous" and not aligned to revenue. **Public debt may stabilize this year at around 180% of GDP**, the level recorded at the end of

2016 GDP forecast revised downwards; the official estimates for 2017 are unrealistic. Further tensions are expected this summer due to debt of EUR 6Bn maturing in July

[17] Given the downward revision of fourth-quarter GDP growth from -0.4% qoq to -1.2% qoq, further downward revisions of GDP, taking the figure further into negative territory, cannot be ruled out. Extensive revisions of the components may also be necessary, now that the shadow economy accounts for 20% of GDP.

[18] Broken down into 0.75% of GDP in new taxes that lower the minimum exemption threshold, 0.75% in pension cuts and 0.5% in as yet unspecified measures. The measures will take effect from 2019.

[19] For the purposes of the programme, the primary balance is net of extraordinary bank recapitalisation costs.

2016 (179.7%), before beginning to fall from 2018; debt servicing is also expected to decrease from 2018, due to old loans maturing and the start of the new line of ESM aid at lower interest rates. The ten-year rate fell on average in 2016 to 8.2%, from 9.7% in 2015, and fell further over the past three months, to 7.2%, despite market fears. The current stalemate on the completion of the second review and the disbursement of the associated funds has made the payment of the maturing EUR 6Bn uncertain: but it may now be more complicated to reach an agreement among the international partners, as the IMF might, under pressure from the new Trump administration, duck out of new disbursements to Greece and take a harder line, including at the European level, in light of the outcome of the Dutch elections and the expected outcome of the German elections.

The risks to the scenario therefore remain to the downside, mainly due to the possibility that an agreement that includes the IMF will not be reached, or that fiscal consolidation or the safeguard clauses to be approved in parliament might dampen the recovery, triggering street protests and further confrontations between the government and its international partners. Completion of the second review could certainly lead to greater optimism among operators, unlocking new private investment.

Portugal: a sprint finish to 2016 and a (possible) exit from the corrective arm

Guido Valerio Ceoloni

The uptick in investments and the more positive than expected 2016 tourist season resulted in an **upward revision of year-end GDP growth from 0.3% qoq to 0.6% qoq**, raising the 2016 annual average by more than one-tenth of a percentage point, to 1.4%. The growth driver was domestic demand, and consumption in particular, which ended 2016 with more rapid growth of 3.1% yoy (2.3% annual average). For **2017,** we expect the increase in inflation to affect, to some extent, the purchasing power of households, which on the other hand are seeing an improvement in the labour market, with unemployment falling to 11.1% from 12.6%, higher minimum wages and slight increases in minimum pensions. We therefore expect a **moderate slowdown in consumption this year, to around 1.5% from 2.2%.** By contrast, investment, which had been weak for much of the past year due to the end of the European programmes and a credit crunch, surged at the end of the year (up 4.6% qoq) and is expected to stabilize in 2017 (at 3.2%, compared with -0.2% in 2016), before accelerating again in 2018 thanks to new European funding. **Foreign trade remained weak last year**, taking 0.1% from GDP in total, due to strong imports driven by consumption. In the first half of the year, net exports should contribute positively to GDP due to the **acceleration in exports**, sustained by the recovery in global demand, and a slowdown in imports, but overall in 2017 we expect a contribution of approximately zero. **Therefore, for the current quarter we confirm a normal slowdown in GDP growth to 0.4% qoq**, followed by a stabilization of activity in the following quarter at just under the Euro zone average, although there might be some upside surprises in the short term, according to the European Commission's economic sentiment indicator, with the ESI improving in the current quarter from 108.5 to 110 (on pre-2008[20] levels), particularly in manufacturing, services and retail, while morale in construction remains stagnant. **We are revising our previous estimated 2017 annual average upwards by one tenth of a percentage point to 1.7%, from 1.4% in 2016, which is one tenth of a percentage point higher than the Commission's official forecasts.** During the year, conditions on the **labour market** should continue to improve, with unemployment, despite being above the European average, down another point to 10.2% from 11.2%, while **inflation** will return to more than 1% from 0.6% in 2016, in the wake of another rise in the core index and the energy component.

Year-end was better than expected, 2017 GDP growth of 1.7%, up from 1.4%, with slowing consumption, stabilizing investment and listless net exports

[20] However, GDP growth has remained 4% below pre-crisis levels.

As the 2016 deficit target has been reached, Portugal should have been released from the Commission's corrective measures

The 2016 deficit will be confirmed as less than the 3% threshold, at -2.3% from -4.4%, in line with official estimates, due to higher than expected revenues for 0.25% of GDP, resulting from the amnesty on taxes and unpaid contributions[21] and the reduction in public investments, which offset lower tax revenue in 2016. Now that the structural effort has been successfully completed (+1.6% GDP) **the excessive deficit procedure imposed on the country should have ended in December**, although in 2017 it will remain under "observation" for one year. The structural effort in 2017 will be close to zero (-0.1% GDP) compared with an initial Commission forecast of +0.6%: however, the shift of 0.5% would be under the tolerance threshold of the European rules. The nominal deficit is expected to correct by another three tenths of a percentage point, to -2.0%[22] this year. **Public debt should fall, but only marginally** in 2017, to 129.0% from 130%. Meanwhile, in February, DBRS confirmed Portugal's sovereign rating with a stable outlook, but the spread also suffered the effects of the uncertain climate in the Euro zone, rising close to the highs of 380 bps recorded in March.

Although, financially speaking, the public accounts will be protected throughout 2017, thanks to the extension of the ECB's Asset Purchase Programme, **the risks to the scenario remain to the downside, due the persistent burden of high government and private debt and problems in the financial sector** (with non-performing loans representing more than 16% of the total): the country therefore remains substantially exposed to external shocks in a politically sensitive year for the entire Euro zone.

[21] Limited to all debt positions until end-2015 for individuals and businesses.

[22] Thanks to the recovery of the state guarantee granted to BPP Bank, which amounts to 0.25% of GDP. However, CGD is also expected to be recapitalised this year.

Asia

Japan: 2017 - stars lining up to support growth

Giovanna Mossetti

The economic outlook in Japan for 2017-18 is positive: widespread growth, expansionary economic policies and, unlike in other advanced countries, no forthcoming electoral events or risks of political instability. In the next two years, **economic growth** should continue at a moderately faster pace than potential, and is forecast at 1.2% in 2017 and 1% in 2018. The estimate of potential growth has been revised up to 0.9% by the Cabinet Office and to 0.5% by the BoJ. According to the BoJ, the output gap is virtually closed. Core **inflation** remains close to zero, and should move up only gradually in 2017-18, while remaining well below 2%.

In 2016, growth was supported by a combination of mutually supportive factors: improvement in the **global cycle, weakening of the yen,** and expectations for **fiscal stimulus**. These elements should stay in place in 2017 and support economic expansion through a **solid trend of domestic and foreign demand**. Fiscal stimulus should accelerate this year, and the recovery in corporate investments is expected to push up wages and consumption. Net exports are forecast to make a positive contribution in 2017, for the third year in a row. **Monetary policy will increasingly take a back seat** in guiding the cycle, also in light of both the stealth tapering of purchases the BoJ is (unwillingly) implementing, and of the difficulty in pursuing its control of the yield curve. Still, the central bank is managing to keep real rates in negative territory.

1. Macroeconomic outlook: widespread growth The fundamental factor in boosting growth in 2016 was the weakening of the yen, "imported" via the reversal of the dollar, rather than prompted by the BoJ's monetary policy. The upward shift of manufacturing and of net exports has triggered a virtuous circle consisting of a recovery in corporate earnings and in **non-residential fixed investments** (Figs. 1-2). Business surveys remained positive at the beginning of 2017: in February the manufacturing PMI hit its highest level since March 2014, and reported a further acceleration in overall and foreign orders, signalling capex spending growth in 2017 as well **(forecast: +2.8%**). The higher business profitability translates not only in higher investment, but also in a stronger labour market, which should have a positive fallout on wages and consumption.

For years now, the **labour market** has been experiencing excess demand due to demographic factors. Business surveys point to stronger job demand, which should result in wage increases at the **spring negotiations,** also supported by the recent minimum wage increase. By the Spring, the government will unveil the **details of the labour market reform**, which should reap effects for higher female participation, reduced labour market segmentation (with positive consequences for average wages and total compensation), limits on overtime work, labour productivity, and on other operational details. The Prime Minister chairs the Committee charged with drafting the reform, and has committed to reach agreements with unions and businesses by the spring.

Despite the recovery in real wages and compensation growth, **consumption** is still being held back by higher propensity to save, ahead of the implementation of a new consumption tax hike by the end of 2019. At the end of 2016, consumer spending remained broadly unchanged on a quarterly base, and the savings rate continued to increase (Fig. 8). Inflation expectations remain stable, and the trend of core inflation has only recently reversed into marginally positive territory. However, we expect the ongoing improvement in corporate earnings and investments to result in moderately higher wages in 2017, sufficient to support an acceleration in consumption from 0.4% in 2016 to 0.7% this year. In 2018, the consumption tax will be back in the limelight, as it is currently expected to be hiked again in 2019.

Net exports are benefiting from the weakening of the exchange rate and from the recovery in global demand and trade flows (Fig. 10). Data on the first months of 2017 point to stronger

exports, based on the trade balance as well as on export orders. The recovering export trend is fuelled by stronger global growth in the second half of 2016 and by the depreciation of the exchange rate, whereas imports should be cooled by the stabilisation of the price of oil. In 2017. Net exports are expected to contribute 0.3pp to overall growth, from 0.5pp in 2016.

2.Fiscal policy to stay expansionary in 2017. Fiscal policy should contribute more strongly to growth in 2017, as the public spending hikes approved in 2016 come into force, mostly through **labour market reform** and support to R&D investment. Capital spending was little changed in recent quarters, but should accelerate thanks to the extra stimulus added to the 2016 FY budget.

3.Monetary policy and inflation: BoJ has a hard time hitting the 2%. target Inflation remains distant from the 2% goal. The index ex-fresh food and energy fell throughout 2016, and gave timid indications of a reversal only at the beginning of 2017, possibly the start of a modestly positive path. The revision of the BoJ's projections in December 2016 signals a gradual rise in inflation ex-fresh food between FY 2017 and FY 2018, from 1.5% to 1.7%, still likely overoptimistic. The upward revision of potential growth (Cabinet Office to 0.9%, BoJ to 0.5%) implies that inflationary pressures are still contained, despite accelerating growth and the closing of the output gap. The depreciation of the exchange rate and the forecast acceleration of consumption should result in a modest uptrend in prices, albeit not sufficient to allow the BoJ to reach the 2% goal on the forecasting horizon which, for now, extends to FY 2018.

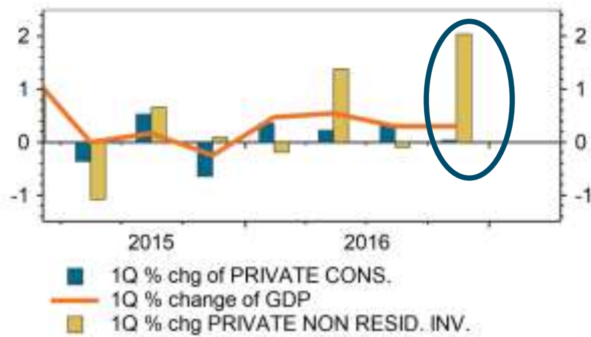
In the present phase, **monetary policy** must meet the challenge of maintaining **curve control in a context of rising global yields**. At the end of February, the BoJ did not specify any indicative estimate of JGB purchases in March, simply signalling that purchases would be conducted "in a flexible manner, taking account of market conditions, aiming to achieve the target level of a long-term interest rate specified by the guideline for market operations". Up to January, the indication on the size of purchases specified a range of 8-12 trillion yen per month, subject to market conditions. In the course of 2017, JGB purchases are likely to slow compared to the previous years' level of around 80 trillion yen. The conflict between keeping 10Y yields targeted at around zero, and of making predetermined purchases, imposes a choice between the two instruments. We expect the BoJ to explicitly shift its **focus on the curve objective later in the year**, leaving purchase volumes as a residual. However, keeping real rates negative, in a context in which real rates are increasing in the rest of the bond markets, contributes in any case to loosening financial conditions and supporting private demand growth.

Macro forecasts

	2016	2017f	2018f	2016			2017				2018		
				2	3	4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.0	1.1	1.0	0.9	1.1	1.6	1.3	1.1	1.0	1.0	1.0	0.9	0.9
q/q annual rate				2.2	1.2	1.2	0.6	1.2	1.1	1.0	0.6	1.0	1.1
Private consumption	0.4	0.7	0.9	0.9	1.4	0.2	0.5	0.9	1.0	1.0	0.7	0.8	0.9
FI - private nonresidential	1.5	2.8	1.2	5.7	-0.4	8.4	0.9	1.8	2.2	2.3	0.6	0.6	0.3
FI - private residential	5.6	2.0	0.7	13.8	10.1	0.5	-0.4	-0.7	0.7	0.8	0.8	0.8	0.8
Government investment	-2.9	3.1	1.4	4.1	-3.6	-9.5	12.0	12.0	1.5	-0.3	-0.4	2.0	1.5
Government consumption	1.5	1.1	1.3	-4.2	1.0	1.0	1.6	1.6	1.6	1.6	1.6	0.8	0.8
Export	1.2	3.1	1.6	-4.6	8.5	11.0	0.3	0.6	1.2	0.9	0.5	3.0	2.7
Import	-1.7	2.1	2.0	-3.9	-1.0	5.3	2.6	2.4	2.2	2.0	1.9	1.9	1.8
Stockbuilding (% contrib. to GDP)	-0.3	-0.3	0.0	1.2	-1.3	-0.7	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.1
Current account (% of GDP)	3.8	4.1	4.1										
Deficit (% of GDP)	-5.0	-6.1	-5.6										
Debt (% of GDP)	219.5	222.4	223.8										
CPI (y/y)	-0.1	0.8	1.2	-0.4	-0.5	0.3	0.2	0.9	1.0	1.1	1.2	1.2	1.1
Industrial production	-0.5	3.6	1.6	-1.7	0.6	2.6	4.3	4.6	3.6	2.0	1.8	1.6	1.5
Unemployment (%)	3.1	2.9	2.6	3.2	3.0	3.1	3.0	2.9	2.8	2.8	2.7	2.6	2.6
JPY/USD	108.8	115.1	118.5	107.9	102.4	109.6	113.7	114.5	115.8	116.6	117.6	118.3	118.8

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

Fig. 1 - Non-residential fixed investment picked up in 4Q16



Source: Thomson Reuters-Datastream

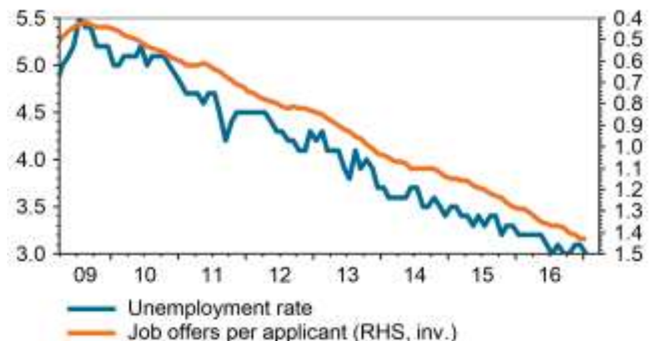
Fig. 2 – Businesses are starting to invest again, encouraged by the rise in corporate earnings boosted by the weak yen

Source: Thomson Reuters-Datastream

Fig. 3 – Reuters Tankan manufacturing: up with the weak yen

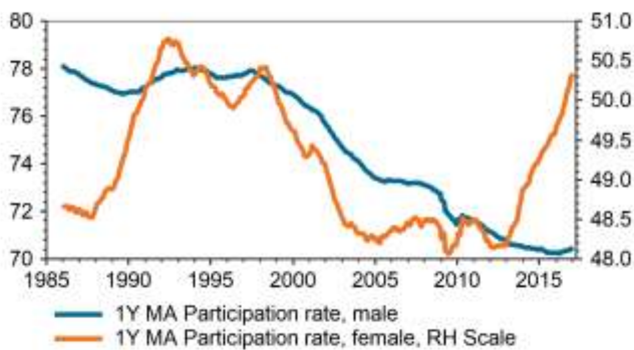
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment still declining



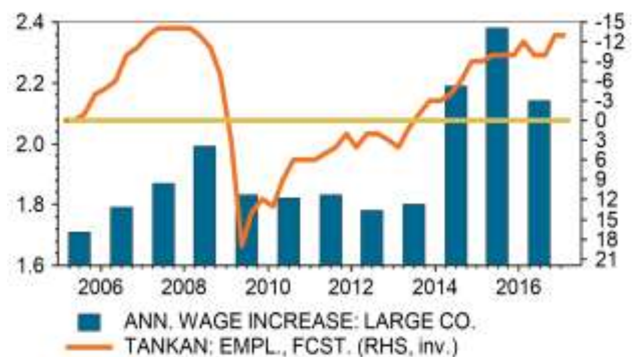
Source: Thomson Reuters-Datastream

Fig. 5 – Female participation in the labour market increasing



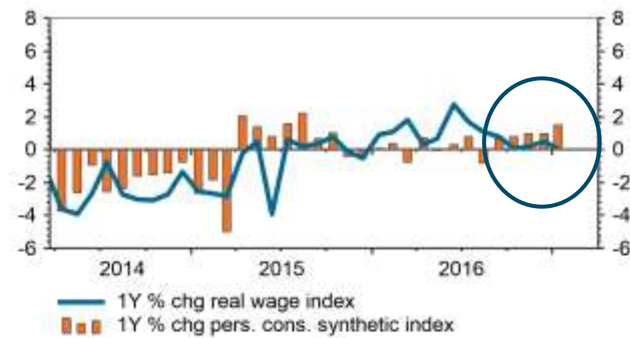
Source: Thomson Reuters-Datastream

Fig. 6 – Contract-based annual wages gradual recovery since 2014



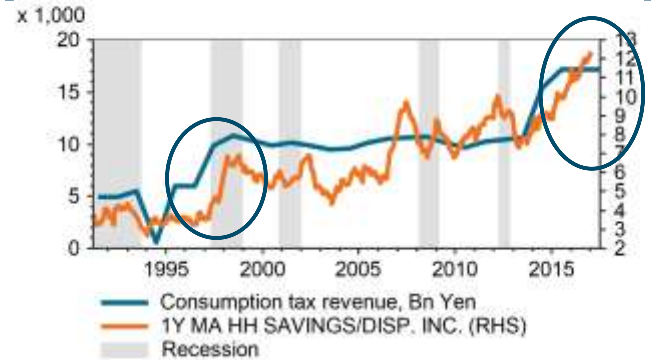
Source: Thomson Reuters-Datastream

Fig. 7 – Weak consumption despite the accelerating wage trend…



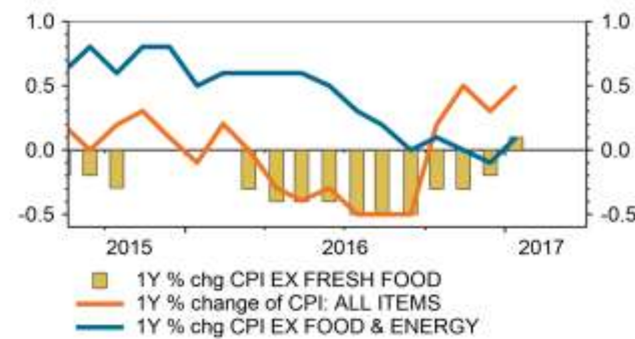
Source: Thomson Reuters-Datastream

Fig. 8 – … with propensity to save consistently on the rise since the consumption tax hikes



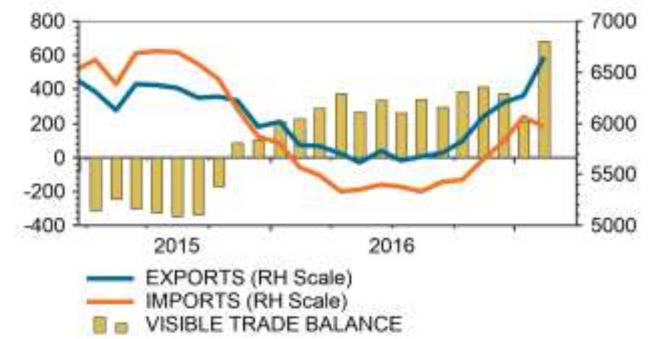
Source: Thomson Reuters-Datastream

Fig. 9 – Core inflation does not budge



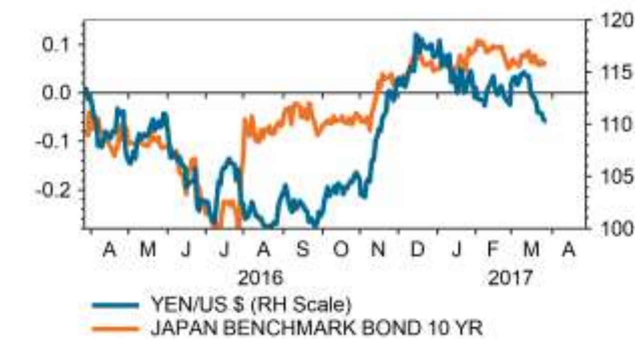
Source: Thomson Reuters-Datastream

Fig. 10 – Trade balance surplus at last



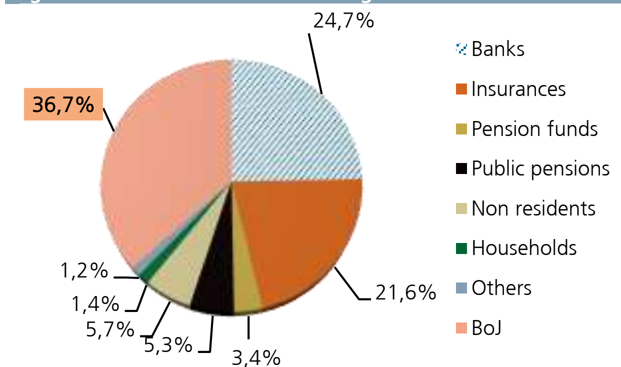
Source: Thomson Reuters-Datastream

Fig. 11 – Yen: where the BoJ failed, Trump has succeeded!



Source: Thomson Reuters-Datastream

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



Note: data as at the end of September 2016; total JGBs: 971.1 trillion yen
Source: Ministry of Finance

China: stable growth and less accommodative monetary policy

Silvia Guizzo

- Fourth-quarter GDP jumped 6.8% yoy, just above the 6.7% recorded in the first three quarters, thanks to accelerating growth in services, in particular transport, freight and storage, and hospitality and catering. This put annual growth at 6.7%, two-tenths of a percentage point below 2015's result but within the government's range target. Although quarterly growth was 1.7% qoq, slightly below the third quarter's 1.8% qoq, **data between December and February**, which should be viewed with caution due to volatility induced by the Chinese new year celebrations, **have confirmed the improvement currently under way in economic activity.**

- During the presentation of the Government Work Report at the annual spring meeting of parliament, premier Li Keqiang officially confirmed the trend that had already emerged in the last quarter of 2016 – that **financial risk control** is once more the **priority** over accelerating economic growth. On the economic front, **growth stability** and **job creation** are of "**prime importance**", with a growth target of "about 6.5%, or higher if possible", just below the 6.5-7.0% range for 2016, and a target for new jobs up from 10 to 11 million.

- **The desire not to fuel further economic and financial imbalances** is reducing room to manoeuvre in terms of fiscal and monetary policy compared with 2016. **Fiscal policy**, which is described as "**proactive and effective**", encompasses a deficit/GDP target ratio unchanged at 3% for 2017 and a general provision of **reducing costs and creating space to cut taxes**, a fundamental measure to reduce costs for companies and increase their competitiveness. The **monetary policy** stance has been defined as **"prudent" and,** for the first time, **"neutral"**, signalling that it will be **less accommodative** than in the last two years. This signal, which had already been sounded when the money and bond markets reversed at the turn of the year, has been confirmed by the People's Bank of China (PBOC) with two hikes of 10bps on refinancing operations. The underlying rationale is more the desire to stabilise credit growth and reduce financial risks than to contain inflation or depreciate the currency; in our view, these are not prime objectives at the moment and are achieved more effectively (using capital controls).

- Less accommodative monetary policy will end up **slowing credit growth, which will reduce support to investment.** We still think that the resilience in investment in public infrastructure and services – which the government is keeping in its sights – will fail to entirely offset a fresh slowdown in investment in real estate and manufacturing. **We therefore maintain our scenario of economic growth slowing moderately to 6.4% in 2017 and to 6.1% in 2018.**

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	7.8	7.8	7.3	6.9	6.7	6.4	6.1
Private consumption	9.6	7.9	8.2	8.1	8	7.3	7.2
Public consumption	6.2	5.1	3.7	7.8	10	6.5	4.7
Fixed investment	8.7	9.3	6.9	7.3	6.3	4.7	4.7
Exports	5.8	7.9	8.6	0.6	2.1	3.5	4.5
Imports	6.7	10.6	8.7	1.5	5.8	4.2	5.6
Industrial output	8.4	8	7.4	6.2	6.1	5.7	5.2
Inflation (CPI)	2.6	2.6	2	1.4	2	2.4	2.6
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.0	4.0	4.0
Average salaries	14.4	11.8	10.8	9.5	8.3	7.7	7.5
90-day interbank rate (average) (%)	4.2	4.9	4.8	3.8	3	4.2	4.1
USD/CNY exchange rate (average)	6.31	6.15	6.16	6.28	6.64	6.95	7.08
Current account balance (CNY Bn)	1360	912	1713	2077	1395	1173	1113
Current account balance (% of GDP)	2.5	1.5	2.7	3.0	1.9	1.4	1.2
Budget balance (% of GDP)	-1.6	-1.8	-1.8	-3.4	-3.8	-4.8	-4.8

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

Real growth and inflation

Fourth-quarter GDP jumped 6.8% yoy, just above the 6.7% recorded in the first three quarters, thanks to accelerating growth in services, in particular transport, freight and storage, and hospitality and catering. This put annual growth at 6.7%, two-tenths of a percentage point below 2015's result but within the government's target range. Although quarterly growth was 1.7% qoq, slightly below the third quarter's 1.8% qoq, data between December and February, which should be viewed with caution due to the volatility linked to the Chinese new year celebrations, have confirmed the improvement currently under way in economic activity.

The first two months of the year saw a slight acceleration in nominal fixed investment (+8.9% yoy vs 8.1% for 2016 as a whole) and industrial output (+6.3% yoy vs 6% in 2016). Investment growth was affected by the upturn in private investment, particularly in agriculture and services, which were driven up by the rebound in investment in water, utilities and health management. However, total investment is still being driven by transport infrastructure and real estate and by stabilising investment in manufacturing. Construction, conversely, dropped sharply (-37.3%), mainly due to the private sector, whereas industrial output was boosted by the state sector. In general, the improvement in economic activity is confirmed by higher consumption of electricity, higher PMIs (both stable at around 51 points since October), above all for large companies (53.3 vs 50.5 for medium-sized and 46.4 for small companies), orders (especially domestic) and corporate confidence.

Investment in real estate climbed to 8.9% yoy in the first two months of 2017, most probably driven by non-state sectors and, above, all non-residential buildings. The property entrepreneurs' confidence index series, which was discontinued in January, stabilised in the latter months of 2016 after a first-half rebound. Sales growth remains high (+22.7% for residential buildings), despite a downturn due to an unfavourable base effect, and was accompanied by an increase in floor space started but a slowdown in average sale prices.

Our estimates show that seasonally adjusted foreign trade rose in the first two months of the year, both for imports (+21.1% 2m yoy in February) and exports (+3.7% 2m yoy), in line with the improvement in both domestic and foreign orders (the latter were stronger in the Markit survey, which is more focused on small and medium-sized companies, at 53 vs 50.8 in the National Bureau of Statistics survey) and higher prices for commodities. Services PMIs performance remains good, despite a slight correction in February, in line with the sector's output of 8.2% yoy in the first two months of 2017.

Retail sales slowed, however, in February, both in nominal (9.4% cum yoy vs 10.5% for 2016 as a whole) and real terms, depressed by a dip in car sales, which have faced incentive cuts since the new year. Conversely, consumer confidence has continued the rise, seen since mid-2016, and in February – according to the NBS survey – was at its highest since 2008, buoyed by the good performance of the stock exchange and the improving labour market, especially in services.

The desire not to fuel further economic imbalances will reduce room to manoeuvre in terms of fiscal and monetary policy compared with 2016; this will lead to slowing credit growth, which will reduce support to investment. Despite the improvement in recent months, we think that the resilience in investment in public infrastructure and services – which the government is keeping in its sights – will fail to offset a fresh slowdown in investment in real estate and manufacturing during the year. We therefore maintain our scenario of economic growth slowing moderately to 6.4% in 2017 and to 6.1% in 2018.

Producer prices rose by 7.8% and input prices by 9.9%, to the highest seen since 2008, but seem to be having little impact on consumer prices. Consumer price inflation did, in fact, fall to a low of 0.8% in February, from 2.5% in January, due to a downturn in food and tourism prices

after a seasonal spike linked to the new year celebrations, which this year fell at the end of January. Core inflation, however, only dipped from 2.2% to 1.8% in the same period, back to October's level and buoyed by higher costs for health and medicine, fuel and housing. A favourable base effect (largely in the second half of 2017) will be only partly offset by upward pressure from rising fuel prices and a slight depreciation in the exchange rate. **We** therefore **expect consumer price inflation to** remain limited, but rising **to 2.4% in 2017 and 2.6% in 2018.**

Economic and fiscal policy

The Government Work Report, which was presented by premier Li Keqiang at the annual parliament session (see Focus below), officially confirmed the trend that had already emerged in the last quarter of 2016 – that financial risk control is once more the priority over accelerating economic growth. On the economic front, **growth stability** and **job creation** are of "**prime importance**": the GDP growth target for 2017 is substantially unchanged, reduced slightly to "about 6.5%, or higher if possible", from the 6.5-7.0% range for 2016 and an actual figure of 6.7%; the target for new jobs is up from 10 to 11 million. Creating new jobs and implementing a more proactive labour policy have been described as priority objectives. The investment target, which in 2016 was missed to the downside for the third year running, was lowered from 10% to 9% but is still higher than the actual 2016 growth figure of 8.1%. The M2 and credit targets were also lowered.

Main targets for 2017

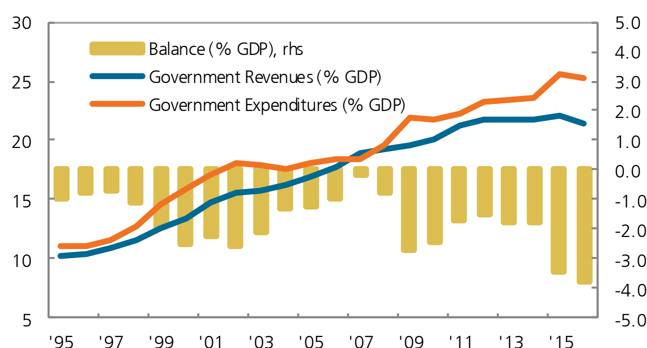
		target 2015	actual 2015	target 2016	actual 2016	target 2017
Macroeconomic variables						
GDP	%	~ 7.0	6.9	6.5-7.0	6.7	~6.5
CPI	%	3.0	1.4	3.0	2.0	3.0
M2	%	12.0	13.3	13.0	11.3	12.0
New employed	Million people	10.0	13.1	10.0	13.1	11
Urban unemployment rate	%	4.5	4.1	4.5	4.0	4.5
Fixed investment	%	15.0	10.2	10.5	8.1	9.0
Foreign trade	%	6.0	-8.1	-	-6.8	
Retail sales	%	13.0	10.7	11.0	10.4	10.0
Social financing	%	-	-	13.0	15.6	12.0
Public deficit/GDP	%	2.3	3.4	3.0	3.8	3.0
Production capacity						
Steel	Million metric tons				-65	-50
Coal	Million metric tons				-290	-150
Environmental Protection						
Energy Intensity	%	-3.1	-5.6	-3.4		-3,4
Carbon dioxide	%	-3.1				-3
Nitrogen dioxide	%	-3				-3
Chemical Oxygen Demand		-2				-2
Ammonia nitrogen emissions		-2				-2
Forests	hectares	666.667		1.000.000		800.000

Source: Xinhua, CEIC

The premier stressed the need to be **extremely vigilant** about the increase in **financial risks**, especially those inherent in non-performing loans, bonds defaults, shadow banking and online finance. He reiterated that all necessary measures would be taken to mitigate these risks because China has "the confidence, the ability and the means to forestall systemic risks". The country, he said, "must not allow the red line to be crossed concerning financial security, people's wellbeing or environmental protection". The government would also have to pay more attention to managing expectations.

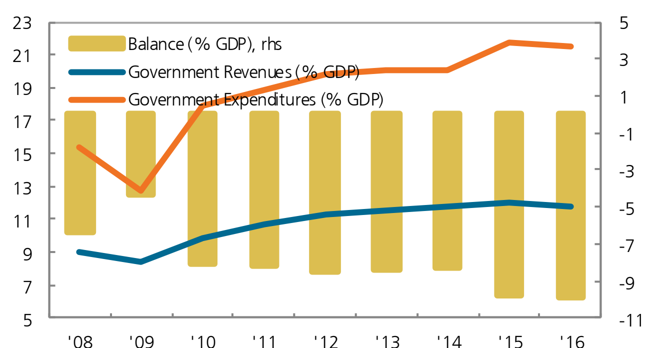
Li Keqiang said that developments at home and abroad required China to be ready to "brace for more complicated and graver" situations. The premier confirmed full support for the One Belt One Road (OBOR) initiative and China's commitment to **facilitating trade and foreign investment**, stressing that globalisation was in the fundamental interests of all countries in a world in which, however, "deglobalisation" and protectionism were growing. China, he said, was therefore ready to promote **economic cooperation** with the ASEAN area by modifying the framework agreement already in place and concluding talks on the Regional Comprehensive Economic Partnership (RCEP) and to advance the development of a free trade area in Asia and the Pacific. He also emphasized the desire to speed up China's development as a **maritime economy**.

Trend in central government...



Source: CEIC

... and local government budgets



Source: CEIC

Fiscal policy, which is described as "**proactive and effective**", encompasses a Debt/GDP target ratio unchanged at 3% in 2017, but it is reasonable to expect it to be missed again, as in the last two years, and come in at around 4%. The budget deficit is expected to be CNY 2,380Bn, up CNY 200Bn since 2015, of which CNY 1,550Bn relates to central government and CNY 830Bn to local government. The premier stressed that while spending would remain the same in some areas, it would have to be reduced in non-priority projects and cut for those not delivering the desired outcomes. General transfer payments to local governments would increase by 9.5% (vs 12.2% in 2016), with the focus on improving access to essential public services and stepping up subsidies for regions facing economic difficulties. Governments at all administrative levels should cut general spending by no less than 5% and not increase spending on official visits. In his closing speech to the Congress, premier Li reiterated that central government should take the lead in **reducing costs and creating space to cut taxes**, a fundamental measure to reduce costs for companies and increase their competitiveness, but also to increase the tax base. Recently, for example, the NDRC published guidelines on levying appropriate taxes on the sharing economy. In any event, the premier gave assurances that China would not deviate from its programme of opening up to foreign investors and markets to encourage domestic companies.

Focus: 2017 Government Work Programme

The Chinese parliament's annual spring session, the **National People's Congress**, met from 5 to 15 March, during which the Government Work Report, which assesses the previous year's results and sets out the following year's targets, and the country's budget were presented. In the ten days prior, a number of major replacements and **new appointments** were made, following on from those in November of Xiao Jie to the Ministry of Finance and Liu Shiyu to the China Securities Regulatory Commission (CSRC): He Lifeng became Chairman of the National Development and Reform Commission (NDRC), Zhong Shan Commerce Minister, Zhang Jun Justice Minister and Guo Shuqing Chairman of the China Banking Regulatory Commission (CBRC); all are considered by analysts to be reform-oriented officials very close to President Xi Jinping. On the political front, interventions, particularly by the premier, have confirmed the core role of Xi Jinping, who was given the title of "core leader" of the communist party; in the past, this title has only ever been bestowed on Mao Zedong and Deng Xiaoping, and then to Jiang Zemin, but not to Hu Jintao.

The most important indications of economic and fiscal policy in the **Government Work Report** mainly concern companies and investment, and should be seen against supply-side reforms and accompanying demand-side support.

Companies. The government anticipates **reducing the tax burden** on companies by about CNY 350Bn and cutting taxes by CNY 200Bn. Income tax will be halved for small companies, with the upper rate of annual taxable income raised from CNY 300,000 to CNY 500,000. For small and medium-sized high-tech enterprises, the proportion of deductible R&D expenses is to be raised from 50% to 75%. Thirty-five administrative charges paid by enterprises to central government will be abolished or suspended, and local governments are encouraged to do the same. The government has also promised to reduce operating fees for businesses; in particular, unauthorised fees charged by intermediaries[23] will be abolished and operating fees levied on businesses in the finance and railway freight sectors will be reduced. Social security contributions paid by companies will also be lowered. A number of these measures had already been proposed by the NDRC or the State Council in previous months, for example the elimination of various services of intermediaries at the end of January and the decentralisation of approvals of large transport projects to provincial governments in February.

The premier has reaffirmed the intention to continue **reforming state-owned enterprises** (SOE) in favour of mixed public/private investment, especially in the electricity, oil, gas, railway, civil aviation, telecommunications and defence sectors. He reiterated the desire for further openness to **foreign direct investment** (FDI), according to the guidelines already outlined at year end by the State Council. In fact, the government intends to review the investment catalogue and make the services industry, and the mining and manufacturing sectors more open to foreign investors, who are encouraged to issue securities in the Chinese market and to take part in national scientific and technology projects. The government has also promised foreign investors the same treatment of Chinese ones, including the possibility of preferential policies under the Made in China 2025 initiative, and financial and fiscal incentives, as well as for land acquisition. Local governments may adopt even more preferential policies to attract investors, and there are plans to open 11 free trade zones. Non-financial foreign direct investment is projected to be the same as in 2016: inflows of USD 126Bn and outflows of USD 170Bn.

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[23] Some large scale projects must have government approval and/or provide some reviews in order to get it, such as, for instance, the energy saving assessment for fixed income investments. Applicants going through these reviews must turn to intermediary agents, either independent or affiliated with cabinet departments, with increasing bureaucratic burdens.

The government will "actively" but "prudently" reduce the high level of **debt of non-financial corporates** through asset securitisation, debt-to-equity swaps, greater equity issuance and more stringent limits on increasing debt, in particular for state-owned companies.

It has promised full support for implementation of the Made in China 2025 and Internet Plus initiatives to promote the development of a digital economy and a **high-end and smart manufacturing sector** that is moving more and more towards the production of medium- and high-end goods. It also intends to support trade in intermediate and assembled goods that are used in production chains of **medium-/high-end products** and its transfer to central and western regions, as well as the import of advanced technology and components. Support was reiterated for technological innovation and accelerating the development of emerging industries in strategic sectors – such as new materials, artificial intelligence, integrated circuits, biopharmaceuticals and 5G mobile communications – with the development of industrial zones.

The government wants to promote the **consumption of services** by launching a series of pilot projects and encouraging the non-state sector to supply education services, care for the elderly, healthcare and other services, such as tourism, leisure and cultural offers. It also intends to support development of the Internet of Things, e-learning and delivery services and to encourage the integrated development of physical stores and online sales. It particularly emphasises the need to support the consumption of **high quality products**, which **need to be produced in greater quantities in China**. Goods for the domestic market need to be produced using the same production lines and to the same standards and quality as goods for export, and measures to combat adulteration and to protect consumer rights need to be stepped up.

The government highlighted the need to promote **environmental protection** and to further combat pollution by strengthening the application of the respective legislation. In addition to targets for combating the main pollutants and fine particulates (PM 2.5), the government aims to combat pollution caused by the use of coal by promoting clean heating systems in the northern regions, replacing coal heating with electric or gas heating for three million families, modernising coal-fired power stations and integrating renewable energy into the electricity grid.

Infrastructure. Investment of CNY 800Bn is earmarked for building railways and CNY 1,800Bn for roads and waterways. Fifteen large water conservation projects will be launched, as well as 2,000 km of metro lines. The central government's budget includes allocations to investments of CNY 507.6Bn, up 1.5% on 2016. But this is much less than the 4.7% in 2015, since the government seems optimistic about private sector investment, in particular within partnership projects. To date, however, this has not yielded the brilliant results hoped for.

Fiscal reform. VAT rates will be reduced from four to three, and the tax reform will be continued. This includes defining the financial powers and spending responsibility of central government and local governments, as well as how tax receipts are distributed. As confirmed by the subsequent announcement by the three main telephony operators, roaming and long-distance mobile telephone tariffs will be abolished from October.

Agriculture. The price of water for agricultural use will be reformed, disaster insurance will be introduced, and the reform of collective ownership rights will continue. Maize cultivation areas will be reduced, high-end agricultural production will be increased, in particular rice and grain, consumption of fertilisers will be reduced, and support will be given to high-end local products.

Households. Six million social housing units will be renovated, and reform of the health and medical services sector will be carried forward. Reform of the hukou resident permit system will continue, with at least 13 million new urban housing units to be registered as permanent. The government proposes reducing the number of poor people in rural zones by 10 million, which includes moving 3.4 million people from inhospitable areas. Central government funds for combating poverty will be increased by 30% and intervention will focus on improving

infrastructure and public services, such as education and health, and promoting the production of local specialities and exporting labour.

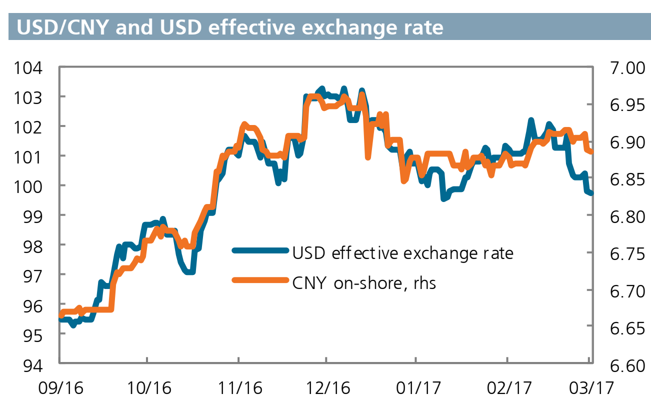
Specifically, mandatory education will be made accessible as a public service for all permanent urban residents, even those without a hukou record, and subsidies for basic health insurance for rural areas and for unemployed urban residents will be increased, with medical insurance cover to be extended to more medicines. Assistance to children of migrant workers will be improved and minimum pensions will be raised. Particular attention is paid to the need to implement policies to increase employment, reallocate ex-military personnel and resolve the problem of late payment of salaries to migrant workers – in the past this has mainly concerned sectors with excess capacity or construction, but there is evidence of this spreading to "new economy" sectors and services[24].

Financial sector. The banking sector must step up support to small and medium-sized enterprises and for modernisation of the agricultural sector and rural areas. Reform of the capital markets and development of the ChiNext market and regional stock exchanges will continue. At end-February, the China Securities Regulatory Commission (CSRC) announced its intention to raise the ceiling for investment in securities brokerage firms by foreign investors, currently set at 49%.

Monetary policy and exchange rate

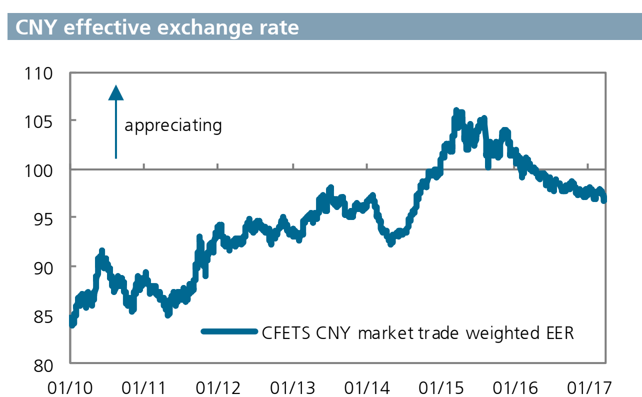
Regarding **financial openness, the exchange rate and monetary policy**, the press statement by the governor of the PBOC (People's Bank of China), Zhou Xiaochuan, at the end of the parliament session was more important. The governor reaffirmed that there was no basis for a sharp depreciation of the yuan or for a competitive devaluation. He attributed the currency's weakness in 2016 to investment flowing out of China and the dollar's strength, and reiterated that the yuan will return to stability on the back of investor confidence in the country's growth outlook. The governor said that reserves were abundant and it would not be a bad thing if they fell – the currency is governed more and more by market forces in a regime of controlled fluctuations, but the authorities would continue to support the yuan's stability. Zhou also defended the guidelines for outbound foreign investment because it was necessary to rein in speculation and the irrationality of some investments, such as in the sports and entertainment industries, because they are of little benefit to the domestic economy and are not welcomed abroad either.

USD/CNY and USD effective exchange rate



Source: Bloomberg

CNY effective exchange rate



N.B. 31/12/2014=100. Source: Intesa Sanpaolo chart from Bloomberg and CFETS data

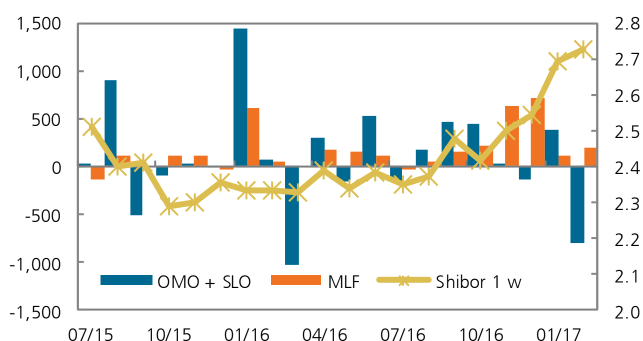
The **CNY/USD exchange rate**, which peaked at 6.96 in early January, fell to 6.84 mid-month before starting depreciating again, in line with the movements of the dollar effective exchange

[24] Hudson Lockett: "China Labour unrest spreads to *new economy*", Financial Times, 2 February 2017.

rate. The yuan, conversely, has remained broadly stable at around 97 since October in terms of nominal effective exchange rate. Since the start of January, the number of currencies in the basket[25] has been expanded from 13 to 24, with falls in the weights of the dollar, euro and yen. The basket now includes currencies such as the South Korean won, which has the highest weight (11%) of the new entrants and is only just below the yen (12%), followed by the South African rand, Mexican peso, Saudi riyal and UAE dirham, at about 2%, and lastly, a number of eastern and northern European currencies and the Turkish lira at weights of about 1%. The expansion of the basket confirms the authorities' intention to stabilise the effective exchange rate. **We are therefore keeping our scenario of limited depreciation of the yuan against the dollar**.

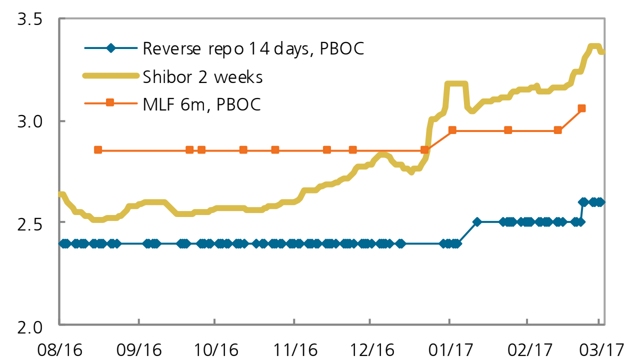
With regard to **capital account liberalisation,** Zhou reiterated that the bond market will be gradually opened up further, but without running after inclusion in international indices. However, the latter received a small boost with the **recent inclusion of onshore bonds in a number of bond indices[26],** in part due to the concession to allow qualified foreign investors to trade in the foreign exchange derivatives market to hedge exchange rate risk in interbank bond market investments from the end of February. The inclusion concerns only a small number of securities and still does not cover global indices, where greater guarantees of the effective option to repatriate capital are required in light of the recent controls introduced. Interest from international investors is, however, growing. **The onshore bond market is the third-largest in the world** after the USA and Japan, with outstanding at end-2016 of CNY 63.7Trn (approx. USD 9.3Trn). According to SAFE (State Administration of Foreign Exchange), foreign investors held CNY 870Bn in bonds at end-2016, just 1.4% of the total but up by 10.6% on 2015. The premier also announced the forthcoming creation of a **Bond Connect programme**, similar to those for the stock market, which will enable foreign investors to buy onshore bonds via a platform in Hong Kong.

The PBOC reduces net liquidity injections (CNY Bn) …



Source: Bloomberg

… and hikes interest rates in refinancing operations



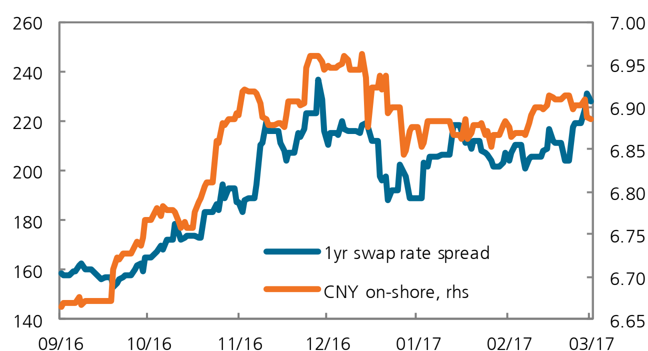
N.B. Government rates – swap rates. Source: Bloomberg

[25] We remind that the PBOC announced the publication of a nominal effective exchange rate index, initially based on 13 currencies, at the end of 2015, in line with the international practice of the other central banks and with the aim to supply the market operators with a better valuation instrument besides the CNY/USD exchange rate.

[26] In early March, Bloomberg announced the inclusion of yuan-denominated bonds (government bonds and state-owned bank bonds) in two new Barclays fixed-income indices – Global Aggregate + China Index (weight of China is 5.31% of the whole index, in fourth place after the dollar, euro and yen) and Emerging Market Local Currency Government + China Index (China's weight is 39.10%) – and the updating of the China Aggregate Index, which was introduced in 2004. A week later, Citigroup announced its intention to include Chinese onshore bonds in its three emerging market and regional government bond indices, Emerging Markets Government Bond Index (EMGBI), Asian Government Bond Index (AGBI) and Asia Pacific Government Bond Index (APGBI). Citigroup also said it will create two new indices, EMGBI-Capped and AGBI-Capped, which will impose caps for country weights.

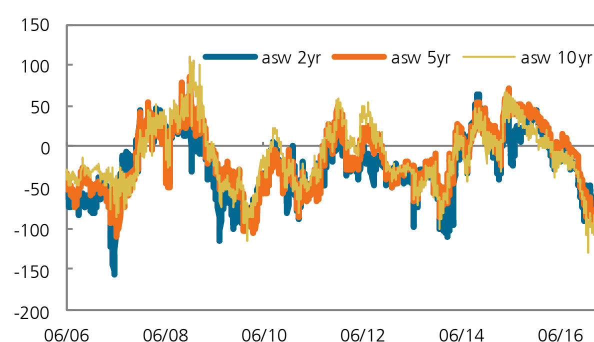
In his speech, Premier Li called the **monetary policy** stance **"prudent" and**, for the first time, **"neutral"**. The governor of the PBOC stressed that an excessive loosing is just as harmful as excessive tightening because it can encourage inflation also in financial assets and conflicts with the supply-side reform policies by incentivising firms to postpone the restructuring required. Deputy Governor Yi Gang then added that leverage needs to be stabilised before it can start to be reduced. The signal, which the markets had already seen at the year end, is therefore of **less accommodative monetary policy** than in the previous two years. Indeed, money market rates started to rise at end November, but the seasonal spike between the year-end and the Chinese new year celebrations did not die down and, unlike in the last two years, the PBOC did not issue large quantities of liquidity at year-end. Whereas maturities between overnight and one week rose by about 10-15bps since early December and mid-March, 1-month and 3-month maturities jumped about 130bps. The PBOC has actually started to act on quantity, reducing short-term liquidity issuance via open market operations at the end of November and those in the long-term window (3 months – 1 year) thereafter. In January, the central bank then hiked rates on short-term refinancing operations by 10bps, followed by another 10bps on 16 March also for medium to long-term operations. The governor then stated that there was no need to over-interpret this type of intervention, which depends on market conditions and does not preclude a rise in benchmark rates.

Differential between US and Chinese rates and exchange rate



Source: Bloomberg

Asset swap spreads are widening



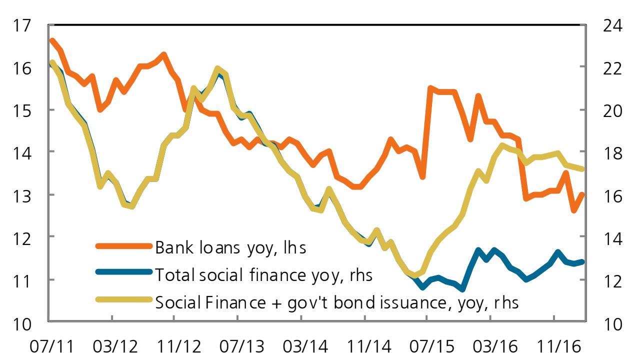
N.B. Government rates – swap rates. Source: Bloomberg

According to press reports, in the second half of December the CBRC ordered banks to adopt a differentiated lending approach to companies with excess capacity in the country's steel and coal sectors, by restricting loans to M&As to encourage the rationalisation of the industry. Moreover, at end January, the PBOC is reported to have ordered banks to limit credit in the first quarter of 2017, especially mortgages, thereby preventing growth from exceeding that in the fourth quarter of 2016. Zhou then spoke about the coordination needed between the various financial regulatory authorities to regulate savings management products. The aims of the draft regulation on this, which has already been prepared, are to clarify to savers that the products do not enjoy a government guarantee, to stop financial institutions from investing income from these products in non-standard asset classes, and to impose a mandatory provision of 10%.

New **bank lending** fell by 1.1% yoy in the first two months of the year, compared with growth of 7.9% for 2016 as a whole. Growth in outstanding loans, at 13.0% yoy, was marginally less in December (13.5%) but substantially stable compared with the autumn months. The positive trend in household loans is continuing, especially mortgages (+36% yoy), while corporate lending slowed marginally, although only because of the short-term component. There was, in fact, a moderate uptick in medium- to long-term corporate loans (+13.3%) compared with the low in October (+11%). Total social financing stock saw stable growth of 12.8% yoy, although the flow slowed in the first two months of the year to 13.0% yoy from 15.6% for 2016 as a whole.

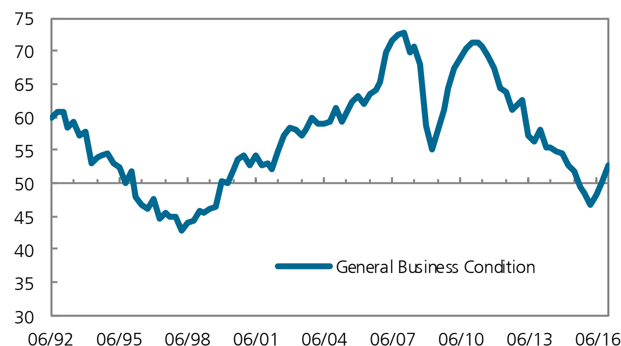
We think that the central bank with continue, together with the other regulators (CBRC, CSRC, CIRC) to regulate the various types of credit and the financial markets and will maintain a **marginally restrictive stance in order to stabilise credit growth and limit financial risks**. At the same time, it will contain the risks of higher inflation from increased commodity prices and limit potential exchange rate depreciation, although capital flow controls are influencing these more. However, we expect the level of monetary policy normalisation to greatly depend on how the market evolves. In the absence of liquidity problems or overly sharp reactions by the markets, as was the case in 2015, the **PBOC will make a total of 50bps of other increases in refinancing operations during the year**, without necessarily touching benchmark rates. In the long term, according to the PBOC's express intention at the start of 2016, the latter have to be replaced by a target rate and a rate corridor.

Lending is stable



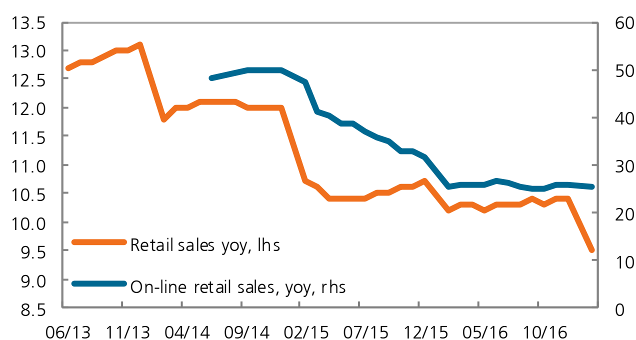
Source: Intesa Sanpaolo chart from CEIC data

Business confidence is improving



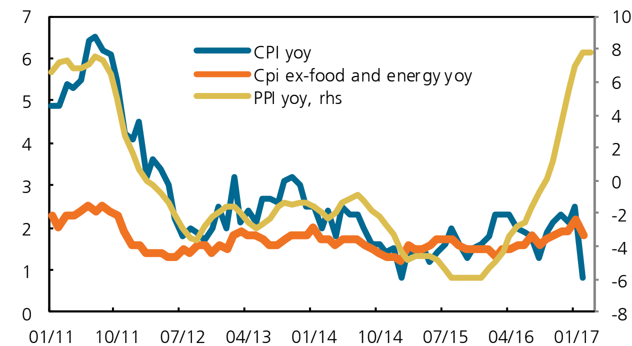
Source: PBOC's Industrial Enterprise Survey by CEIC

Nominal retail sales



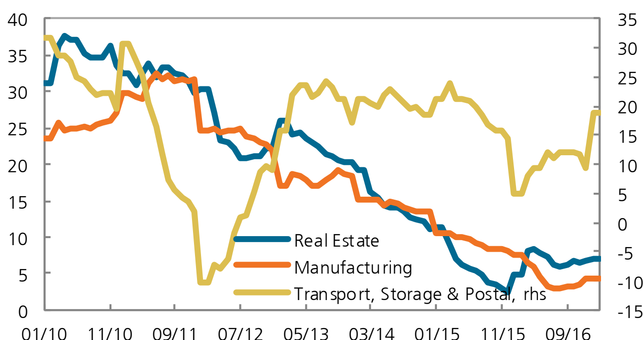
Source: CEIC

Inflation



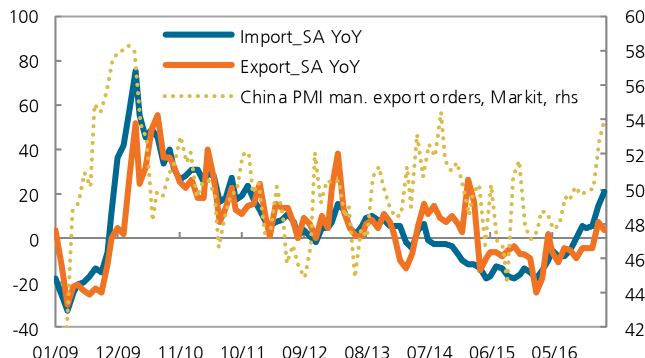
Source: CEIC

Nominal investment



Source: CEIC

Foreign trade



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

India: high growth and upside inflation risks change monetary policy stance

Silvia Guizzo

- Despite expectations of a slowdown as a result of the demonetisation initiative, according to preliminary estimates **GDP rose by 7% in 4Q16**, only slightly less than the figure of 7.4% in 3Q16. **2016 closed with growth of 7.5%, unchanged from 2015,** supported by private consumption, public spending and a slight positive contribution from foreign trade, which offset the decline in investment.

- The resilience of consumer expectations, along with the improvement in orders in January and February, leads us to believe that the **impact of demonetisation on consumption and the services sector is only temporary, and will be mainly limited to 4Q16, and to a lesser extent, 1Q17**. Despite this, given the upwards revision to the GDP time series, **we maintain our estimate of annual growth at 7.5% for 2016.**

- Finance minister Arun Jaitley unveiled the **budget for FY 2017-18** on 1 February, **confirming the government's aim to consolidate the accounts**, albeit at a slower pace (deficit target: 3.2% of GDP and 3% for the next fiscal year), with a continuing focus on **investment in infrastructure, increasing health spending and developing the poorest rural areas**. Consumption is likely to remain solid during the rest of the year, boosted by the good performance of the agricultural sector and the labour market. At the same time, investment looks set to continue along its path of modest recovery, supported in particular by public investment and a neutral monetary policy. Taking account of the upwards revisions to GDP growth in 2015 and a potentially lower-than-expected performance in 4Q16, **we maintain our GDP growth provisions at 7.2% for the calendar year 2017, with a slight acceleration to 7.4% in 2018**.

- Despite the persistence of core inflation, total **inflation** is likely to remain **low** and in line with the RBI's objectives, although it may rise in the second half of the year, surpassing 5% at end-2017. A favourable base effect for much of the year is likely to partially offset a moderate rise in food and fuel prices, bringing average annual consumer price inflation down from 4.9% in 2016 **to 4.0% in 2017 and again up to 4.7% in 2018**. The failure of core inflation to fall and the prospects of a rebound in growth led the RBI **to change its monetary policy stance from accommodative to neutral** at its recent meeting in February, while adopting a wait-and-see attitude to assess the effects of monetisation on inflation and the output gap. Our view is, therefore, that there is no longer any room for a rate cut, as we expected in the first half, and that **the RBI will maintain rates unchanged for the rest of the year**.

Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	5.5	6.2	6.9	7.5	7.5	7.2	7.4
Private consumption	6.7	5.7	7.4	6.2	7.7	6.1	7.5
Public consumption	4.6	2.2	7.1	1.4	13.9	6	14
Fixed investment	2.3	7.4	0.9	7.6	-1.5	3.7	5.6
Exports	10	4.4	7.1	-6.3	0.6	3.8	7.6
Imports	11.3	-6	0.5	-6.3	-1.9	4.5	4.3
Industrial output	0.7	0.6	1.8	3.2	0.3	1.4	5.4
Inflation (CPI)	9.4	9.9	6.6	4.9	4.9	4.0	4.7
Unemployment rate (%)	5.6	5.6	5.6	5.5	5.4	5.5	5.5
Average salaries	19.3	11.1	10.8	10.4	10.3	9.9	9.8
3-month MIBOR (average)	9.5	9.3	9.1	8	7.2	6.6	7
USD/INR exchange rate (average)	53.47	58.57	61.04	64.15	67.21	65.90	62.80
Current account balance (INR Bn)	-4893.2	-2779.6	-1661.2	-1450.6	-1648.7	-4675.6	-3581.2
Current account balance (% of GDP)	-5.1	-2.5	-1.4	-1.1	-1.1	-2.8	-1.9
Budget balance (% of GDP)	-5.5	-5.5	-4.3	-3.4	-3.7	-3.3	-3.5

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

Real economy and inflation

Despite expectations of a slowdown due to the demonetisation initiative, according to the preliminary estimates of the Central Statistical Office (CSO), GDP rose by 7% in 4Q16, slowing only slightly from the figure of 7.4% in 3Q (revised up from 7.3%). The upwards revisions to the GDP time series in January and February, which included figures up to 2012, trimmed growth from 7% yoy to 6.9% yoy in 2014, and increased it from 7.2% yoy to 7.5% yoy in 2015. **2016 thus closed with growth of 7.5%, unchanged from 2015,** supported by private consumption, public spending and a slight positive contribution from foreign trade, which offset the decline in investment. In terms of value added, however, GDP growth was 7.1% in 2016, down from 7.3% in 2015. Growth slowed gradually during the year to 6.6% in 4Q, driven down by the deceleration in services and industry, but supported by the recovery in the agricultural sector.

Industrial output improved in the last three months to 2.7% 3m yoy in January on the back of a surge in the production of capital goods. Excluding the latter, however, it remained fragile, dragged down by the decline in consumer and intermediate goods. However, the improvement in the manufacturing PMI, which climbed to 50.7 in February from a low of 49.6 in December, augurs well for a recovery in the next few months, with reassurance also coming from the increase in orders (especially domestic). Heavy industry production is performing better, supported by energy and cement production. Production capacity utilisation has returned to November levels.

After trending downwards for three quarters, fixed investment returned to positive territory in 4Q (3.5% yoy, or 0.9% qoq, seasonally adjusted, according to our estimates), although it was partly boosted by a highly favourable base effect. Encouraging signs are coming from the industrial investment projects submitted to the industry ministry; in 2016, the number of projects rose by 14.3%, compared with 8.3% in the previous year and, after falling for years, the value of projects also rose by 33.1% yoy. According to the RBI survey, however, business confidence fell in 4Q, both in terms of companies' assessment of the current situation, which is now barely above the lows of 2015, and in their expectations for the next quarter, which fell even more markedly in the Dun & Bradstreet survey. The decline in order expectations has, however, been proved wrong by the rise in the PMI orders component, in both manufacturing and services, from December to February. The RBI survey also records a deterioration in financial conditions for the manufacturing sector in 4Q, with stable expectations for the first quarter of this year; this is borne out by the downturn in lending to the industry, which fell by 5.1% yoy in January. The increase in non-performing loans and Indian banks' recapitalisation problems still point to a slowdown in loans. The prospects for recovery in investment are therefore still weak, although the rebounds in public investment and machinery imports suggest a modest upturn in 2017.

The services sector slowed in 4Q to 6.8% yoy, from 8.2% yoy in the previous quarter, due to the slowdown in financial services, real estate and business services, while the other sectors accelerated slightly. Tourist flows continue to post healthy figures (+14.3% 3m yoy in February) and mobile phone subscriptions have started to accelerate again. After spending three months below 50, the services PMI climbed to just above this level in February.

Foreign trade continued to improve, partly bolstered by the rise in the oil price, which pushed up crude imports by 60% yoy in February. Imports, excluding oil, have also been back in positive territory since November (+3.1% 3m yoy in February), partly supported by the appreciation in the exchange rate (nominal effective exchange rate: +3.5% since June). The buoyant performance of machinery imports (24.5% 3m yoy in February; electronic machinery: +7.2%) is also a reassuring sign that investment might recover. Exports, net of oil, rose by 2.8% 3m yoy in

January, from 5.3% in November, in line with the slowdown in foreign orders, which recorded a low at the end of the year.

Private consumer spending recorded an upsurge of 10.5% yoy in 4Q. Consumer confidence fell slightly in 4Q, returning to just below the level of 4Q15 although, in contrast, expectations have risen to series highs. Car sales fell (-7.0% 3m yoy in February), led by three-wheeled vehicles used in farming regions, which were probably hardest hit by the demonetisation initiative. Domestic passenger traffic continues to be strong, however (+25.6% yoy in January), a sign that consumption will also be healthy in the next quarter.

The resilience of consumer expectations, along with the improvement in orders in January and February, leads us to believe that the **impact of demonetisation on consumption and the services sector will only be temporary, and will be mainly limited to 4Q16 and, to a lesser extent, 1Q17**. We think there could be downwards revisions to the 4Q data in the second publication of national data, due in May, when informal sector estimates, especially for retail, which was hardest hit by the effects of demonetisation, are better factored into the figures. Despite this, given the upwards revision to the GDP time series, **we maintain our estimate of annual growth at 7.5% for 2016, in line with that of the statistics office**.

Consumption is likely to remain solid during the rest of the year, boosted by the good performance of the agricultural sector and the labour market. At the same time, investment looks set to continue along its path of modest recovery, bolstered in particular by public investment and a neutral monetary policy. Taking account of the upwards revisions to GDP growth in 2015 and a potentially lower-than-expected performance in 4Q16, **we maintain our GDP growth provisions at 7.2% for the calendar year 2017, with a slight acceleration to 7.4% in 2018**. Growth in FY 2016-17 (April 2016 to March 2017) is estimated at 6.8% and forecast to accelerate to 7.4% in FY 2017-18.

Consumer price **inflation declined gradually** in the second half of 2016 **to a low of 3.2% yoy in January**, due to the fall in food prices, which was exacerbated by the demonetisation initiative. Inflation then **rose again to 3.7% in February**, returning to just below its November level, due to an unfavourable base effect and a surge in fuel prices. Core inflation, which had been stable at 4.9%-5% since September, only fell to 4.8% in February due to a favourable base effect. Although clothing prices fell, prices in other services segments (transport, education) are still rising, which makes it difficult to achieve a more pronounced fall in inflation. Wholesale price inflation is rising markedly (+6.5% yoy) on the back of fuel and electricity price rises. We expect inflation to continue to rise in the second half of the year, passing 5% at end-2017 (but not as an annual average), partly due to a lower starting point than we expected. A favourable base effect for much of the year is likely to partially offset a moderate rise in food and fuel prices, bringing annual average consumer price inflation down from 4.9% in 2016 **to 4.0% in 2017 and again up to 4.7% in 2018**.

Economic and fiscal policy

The Bharatiya Janata party won the local elections in four of the five states in which they were held (Uttar Pradesh – India's largest state – Uttarakhand, Manipur and Goa and were defeated in the Punjab), thus strengthening the position of the coalition government (National Democratic Alliance) in the Rajya Sabha (the upper house of the Council of States). Furthermore, the Bharatiya Janata party, together with the regional parties, now controls 17 of the 29 states and two union territories, and therefore has more scope to continue to implement prime minister Modi's structural reform programme.

Finance minister Arun Jaitley unveiled the budget for FY 2017-18 on 1 February, confirming the government's aim to consolidate the accounts, albeit at a slower pace, with a continued focus on investment in infrastructure, under the banner "Transform, energise and clean India" (TEC India). The target deficit for FY 2017-18 was fixed at 3.2% of GDP, postponing the achievement of the 3% target to FY 2018-19. The deficit target of 3.2% is unchanged on final estimates for FY 2016-17, an improvement on the 3.5% initially forecast by the government due to higher-than-expected revenues (+19.1% versus the FY 2015-16 figure). The government forecasts an increase of 6.6% yoy in revenues and spending, both of which are slowing compared with FY 2015-16. Capital spending, however, is forecast to rise by 10.7%, almost unchanged on the previous year; the bulk of the spending will be on infrastructure, health and developing the poorest rural areas. The biggest increases are earmarked for rail and motorway infrastructure. Another INR 100Bn will be used to recapitalise the public sector banks, a smaller amount than the INR 250Bn allocated in the previous fiscal year's budget.

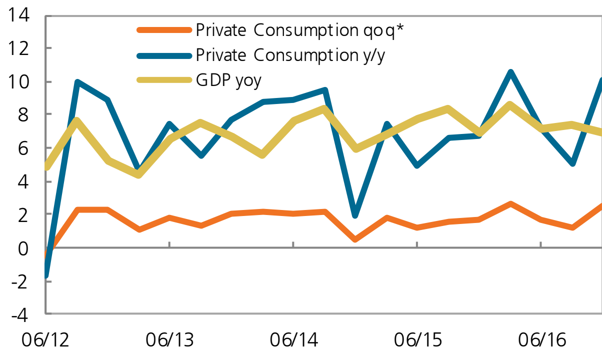
Monetary policy and foreign exchange

The demonetisation initiative caused M1 to plummet by up to 18.7% in December, after positive growth rates of over 15% in the previous months, and M3 to slow moderately, from 10.9% yoy in October to a low of 6.4% yoy in January. Both money aggregates are gradually recovering; the fall in M1 was reduced to 7.7% yoy in the first week of March, while M3 has risen by 7%. Growth in total lending to the non-farm foods sector slowed further, hitting a low of 3.5% yoy in March. The RBI therefore continued to pump liquidity into the markets without creating tensions on the money market.

The Reserve Bank of India (RBI) expects inflation to be within the range of 4%-4.5% in 2Q and 3Q, and 4.5%-5% at the turn of the year, although at its February meeting it emphasised the upside risks arising from stagnant core inflation. Added to this are the risks arising from a higher than expected rise in crude price, depreciation of the exchange rate in the event of an increase in risk aversion on the financial markets, and the effects of the house rent allowance (HRA) granted under the Seventh Pay Commission, which have not yet been factored into the inflation profile. The RBI also expects growth to bounce back during the year, taking it to 7.4% in FY 2017-18, from 6.9% in FY 2016-17, substantially in line with our forecasts. In light of this scenario and the failure of core inflation to fall, the RBI changed its monetary policy stance from accommodative to neutral at its recent meeting in February, while adopting a wait-and-see attitude to assess the effects of monetisation on inflation and the output gap. Our view is, therefore, that there is no longer any room for a rate cut, as we expected in the first half, and that the RBI will maintain rates unchanged for the rest of the year.

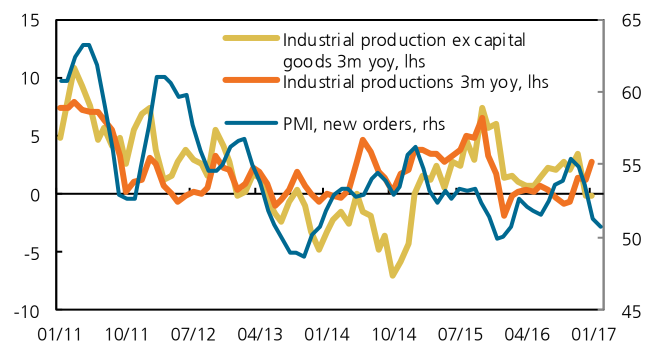
The rupee has more than held its own against the general appreciation of the dollar and, after hitting a high of 68.77 at end-November, continued to appreciate until it reached 65 vs the dollar in mid-March (+3.5% from early January to mid-March), shored up by a combination of the RBI's change in monetary policy stance, solid macroeconomic data, and the outstanding success of Modi's party at the local elections. Net capital inflows from institutional investors, which were negative until January, stormed into positive territory in February, at INR 158.6Bn, and then more than doubled to INR 326Bn in the first 20 days of March. The rupee will still be supported by the good performance of the Indian economy and by a neutral RBI. We also reiterate that the improvement in India's twin deficits and its external position compared with previous years will continue to bolster the exchange rate, limiting the potential for depreciation in the event of another upwards revision of Fed rate hike expectations.

Fig. 1 – Growth still higher than 7%, sustained by consumption



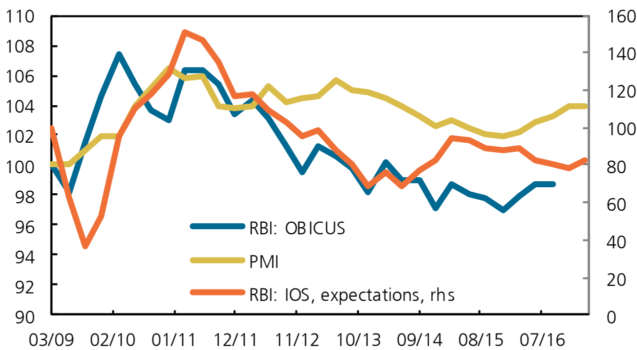
*Four-quarterly moving averages. Source: CEIC

Fig. 2 – Industrial output improves via capital goods



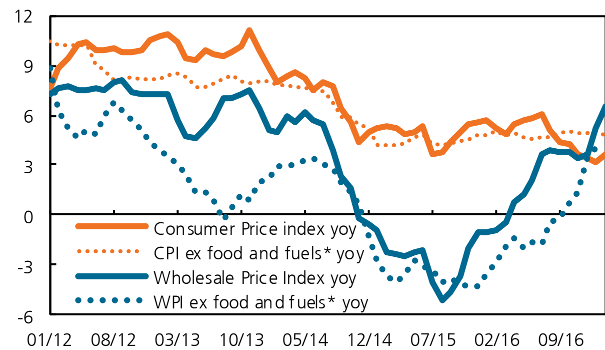
NB: three-month moving average. Source: Markit-HSBC, CEIC

Fig. 3 – Production capacity utilisation



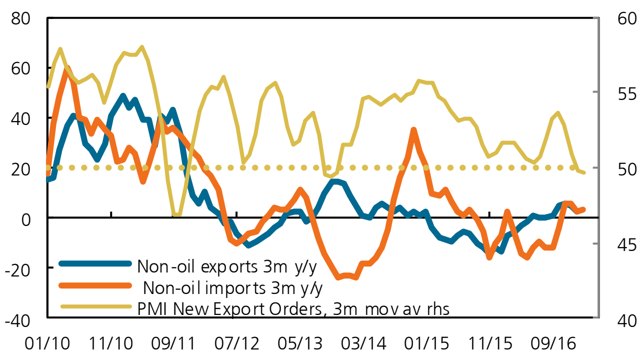
N.B.: (*) Four-quarterly moving averages. 1 qtr. 2009=100. Source: Intesa Sanpaolo chart based on Reserve Bank of India data from CEIC and Markit

Fig. 4 – Core inflation is not falling



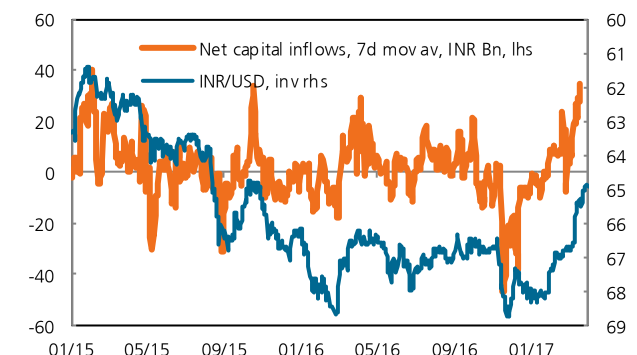
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Fig. 5 – Foreign trade is improving



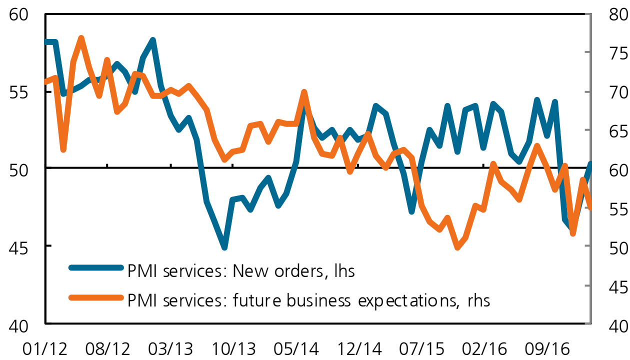
NB: three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Fig. 6 – The rupee recovers from its November lows



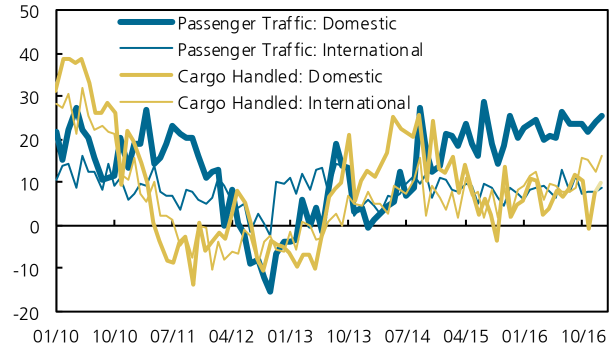
N.B.: (*) Net purchases by foreign institutional investors Source: CEIC

Fig. 7 – Servizi: gli ordini migliorano dopo il crollo di dicembre



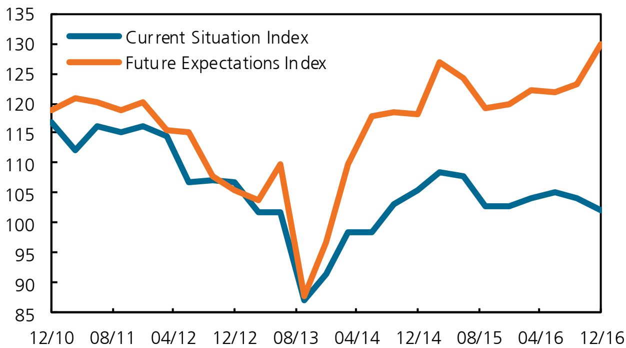
Fonte: Markit

Fig. 8 – Traffico passeggeri e cargo



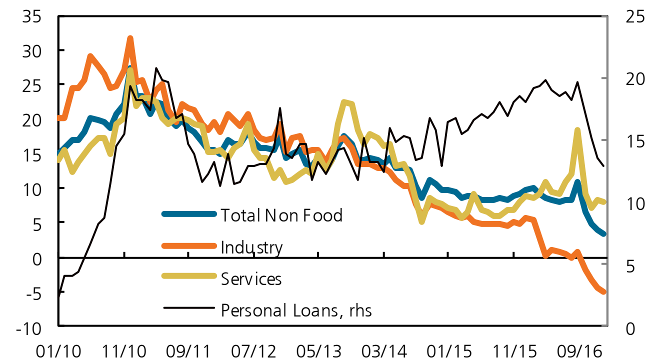
Fonte: CEIC

Fig. 9 – Consumer confidence



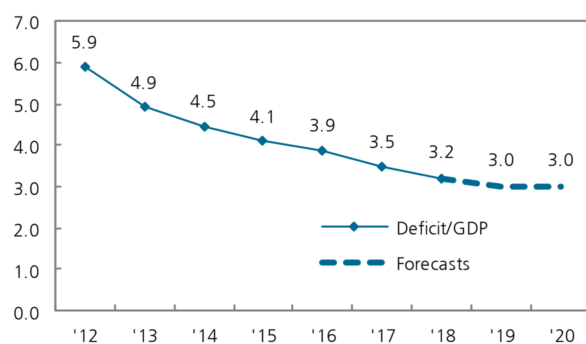
N.B.: Quarterly consumer confidence survey by the RBI Source: CEIC

Fig. 10 – Lending to industry is falling (chg. % yoy)



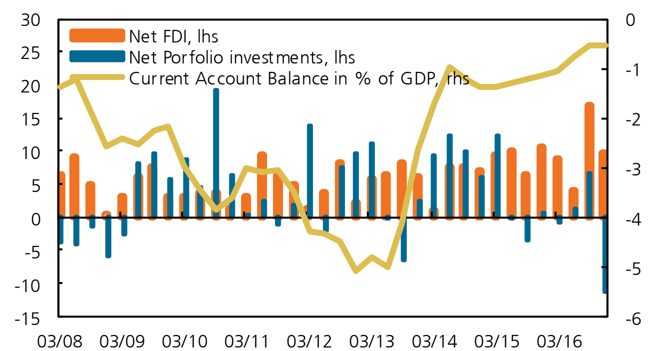
Source: CEIC

Fig. 11 – Public accounts (%)



Source: CEIC, Ministry of Finance

Fig. 12 – Current accounts



N.B. left-hand scale in USD Bn. Source: Intesa Sanpaolo chart based on Bloomberg data

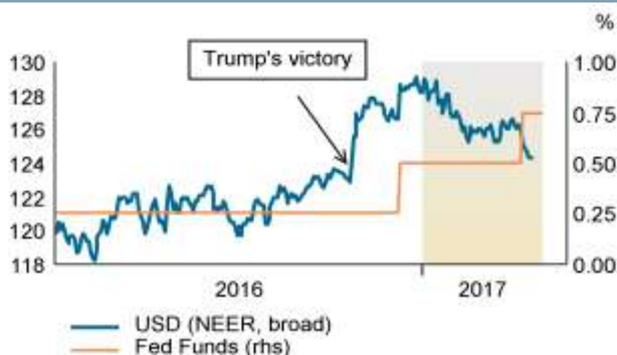
Forex markets: the upsurge of the dollar is shrinking (and this is consistent)

Dollar: any appreciation potentially tied to revisions of expectations on US interest rates in 2018

Asmara Jamaleh

2016 came to an end with the dollar on a sharp appreciation trend, boosted by expectations that Trump's victory would imply the implementation **of a markedly expansionary fiscal policy, and as a result, much stronger growth in the US and a faster upward path interest rates. On the other hand, 2017 began with a partial retreat of the dollar, which reflects the overall cooling of such expectations** (Fig. 1). For what concerns fiscal policy in particular, **the stimulus package will not be announced before the summer**, with the joint implication that the positive effect on growth will not come this year (if not only to an irrelevant extent) but will only be visible starting from the next biennium, and that lacking indications on the size of the budget, the Fed will not be able to speed up monetary normalisation. **At its meeting of 15 March, the Fed did hike rates** (from 0.50-0.75% to 0.75-1.00%) **but left the expected path of subsequent increases unchanged**, confirming the scenario already described in December, i.e. another two hikes this year and three the next. However, it reasserted that the path may change in function of the economic policies implemented by the Trump administration.

Fig. 1 – Dollar: part of the appreciation triggered by Trump's victory has been reabsorbed



Source: Thomson Reuters-Datastream

Fig. 2 – Market aligned with the Fed's scenario for 2017 (another two hikes this year), but not for 2018 (two hikes instead of the Fed's three)

Source: Thomson Reuters-Datastream

For what concerns 2017, the market has embraced the Fed's scenario, with fed funds futures pricing in another two rate increases by the end of December (Fig. 2). **This, to the extent to which the Fed will "stick" to its plans, limits the dollar's upside to within** and not beyond **the highs hit at the beginning of January,** with a trend that will depend on how the next two hikes are distributed in the next three quarters.

In the near term, it should generally level off at the medium-low end of the range outlined this year, as new input capable of generating expectations for more than three rate hikes in 2017 is unlikely to come before the announcement of the budget, i.e. before the summer. **It should then strengthen back in the run-up to the next rate increase,** which if US data remain favourable, could come already in June rather than in September. In the present phase, an external factor which could play to the advantage of the dollar is uncertainty over the outcome of the French elections in April-May: should survey data show an uptrend in consensus for the euro-sceptic front led by Marine le Pen, the euro would again be penalised and the dollar would strengthen as a result. On the whole, **if the Fed "sticks" to its programme of hiking rates no more than twice between now and December, the dollar's upside margin should be limited to within the highs hit at the beginning of the year**.

Beyond the Fed's behaviour, another two factors point in this direction: **(i)** the risk of protectionism, and **(ii)** the prospect of the expansionary monetary policy phase essentially being over, for the other main central banks as well.

(i) For what concerns protectionism, it is no easy task to understand whether it may have a positive or negative final net impact on the dollar. The imposition of tariff barriers on US imports would simultaneously result in higher inflation, a reduction of global trade flows – and therefore weaker demand and growth – and in likely retaliation reactions. Even in the event of the trade partners hit by the protectionist measures devaluating their currencies in response, the resulting appreciation of the dollar would be unwelcome and ultimately damaging for US growth as well. Therefore, even assuming an upside net impact on the dollar, this would probably prove temporary, due to the likely negative final impact on US growth USA.

(ii) For what concerns the monetary policies of the other advanced economies, in this opening part of the year both data and trends at the global level have prompted the other main central banks to express a generally positive view on the evolution of the inflation and growth picture, indicating that the **expansionary phase** of the monetary policy cycle is now **ending**. At the G10 level, therefore, **expectations are now for monetary stimulus not to be further stepped up in the course of the year, and in many cases the normalisation cycle** – rate hikes and/or unwinding of QE – **could begin already net year**. The widening of rate-yield spreads triggered by the current rise in Fed rates should gradually decrease between the end of this year and the beginning of the next, cooling the dollar's upward momentum.

In general, however, risks to the baseline scenario are still generally skewed to the upside, in other words the dollar may prove slightly stronger than expected, mostly in consideration of the fact that the market, while fully pricing in the Fed's three-hike scenario for 2017, has not done the same for 2018, in which it expects only two increases, as opposed to the Fed's forecast of three.

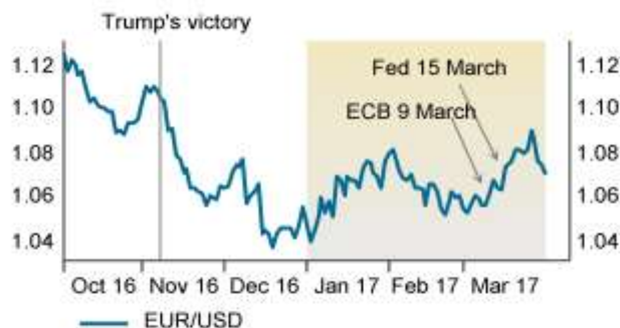
Euro: markets start focussing on the ECB's expansionary cycle coming to an end

The euro opened 2017 on the climb, offsetting – albeit only in part – the decline incurred at the end of 2016, and returning from a low of EUR/USD 1.03 to a high of 1.08 (Fig. 3). **Initially, the recovery was triggered by the cooling of expectations generated by Trump's victory** for much stronger US growth already this year as a result of extraordinarily expansionary fiscal policies (widespread retracement of the dollar: see above), which translated into a visible reduction of speculative short euro positions (Fig. 4).

On this front, a more specific theme has also emerged: the prospect of an ECB reversal. At its March meeting, while leaving monetary policy conditions (rates and QE) unchanged, reasserting that it can still afford to loosen monetary policy further in case of a deterioration of the macro picture, **the ECB remarked that "the risks surrounding the euro area growth outlook have become less pronounced"**.

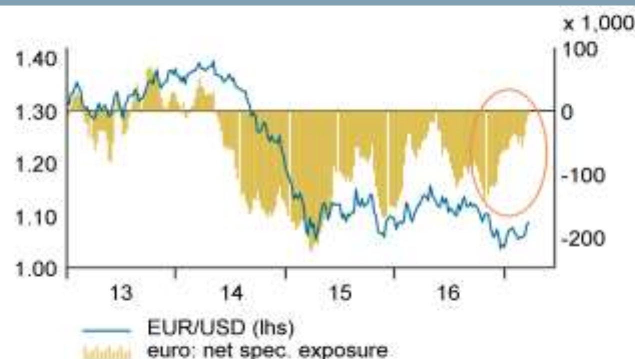
This suggests that if growth and inflation keep recovering – albeit at a slow and gradual pace – as has recently been the case, the necessary conditions should fall in place to start normalising monetary policy, roughly around the turn of the year. Therefore, **the ECB is also preparing to end the present, extended accommodative cycle**. For what concerns growth, the ECB has observed in particular that the latest data suggest that the positive trend should continue consolidating and widening. On the inflation front, on the other hand, it opted to reassert that the recent increase should not be interpreted as signalling a self-sustained rise back to target, as it is almost entirely driven by rising energy prices. In any case, the ECB has revised up its inflation forecasts for both this year and the next.

Fig. 3 – At the beginning of 2017 the euro recovered part of the decline incurred at the end of 2016



Source: Thomson Reuters-Datastream

Fig. 4 – Speculative short euro positions decreasing



Source: Thomson Reuters-Datastream

The prospect of the ECB's expansionary cycle being closed at the end of this year represents the main factor supporting expectations for a gradual recovery of the euro towards EUR/USD 1.10-1.15 on a 12m-24m horizon. We do not assume a 12-month projection for the exchange rate any higher than EUR/USD 1.10, to take into account potential risks tied to the Italian general elections, to be held in the spring of 2018.

In the near term, on the other hand, the exchange rate **could weaken back slightly** (key supports in the EUR/USD 1.05 area) **in function of (1) the fact that at least until the summer the ECB will have to keep monetary stimulus unchanged, whereas in the same period the Fed will keep hiking rates, and (2) uncertainty over the outcome of the French elections in April/May** (risk of the euro-sceptic front led by Marine Le Pen recovering consensus: should the FN leader win the elections, the euro could be hit hard, dropping to levels lower than the trough hit at the beginning of the year in the EUR/USD 1.03 area). The German elections scheduled in September, on the other hand, should not raise concerns of a populist drift, according to polls' evidence.

On the ECB front, the internal debate on how to remove stimulus will focus on several points: removal of guidance on rates, increase of the deposit rate (currently negative) towards zero, tapering and appropriateness (or not) of starting to hike rates before closing the asset purchase programme – as envisaged by Nowotny, whose words offered support to the euro. **The removal of guidance on rates – at least with reference to the option of cutting them further, to lower levels than at present – seems to be the likeliest move to start with,** possibly already at the June meeting (as long as Le Pen does not win the elections in France). In this case, **the euro should benefit instantaneously**. The announcement of a tapering of purchases, on the other hand, should come between September and December.

On the other hand, should the Fed opt to hike rates more than three times this year, the euro would be negatively impacted, but downside should in any case be contained to levels close to the lows set at the beginning of the year in the EUR/USD 1.03 area (support range: EUR/USD 1.03-1.00), as the key factor for the single currency's resilience is the policy cycle stage reached by the ECB (unwinding of the accommodative phase).

Yen: the BoJ's ultra-accommodative policy should weigh on the yen again

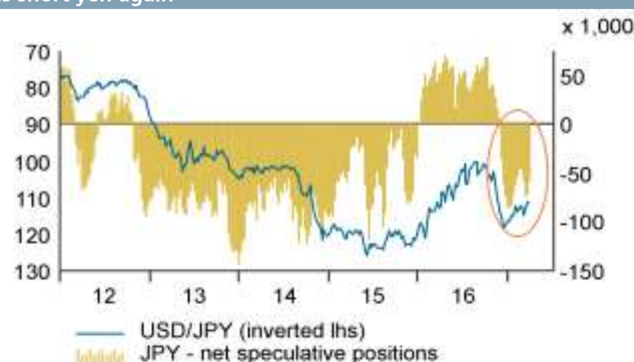
The yen opened 2017 on a modest uptrend (Fig. 5), recovering in 1Q 2016 just under half of the correction incurred at the end of 2016, climbing from USD/JPY 118 to 110, after slipping between October and December last year from 101 to 118 USD/JPY. Most of the recovery was due to the widespread retreat of the dollar on waning expectations for the effects of the new Trump administration's policies.

Beyond the near term, the yen should drop back down, as the BoJ will keep monetary policy extremely accommodative for an extended period, given the persistent difficulties in pursuing the 2% inflation goal. Despite the gradual improvement of the domestic economy, even in his most recent statements Governor Kuroda reasserted that risks to growth and inflation are still skewed to the downside. Therefore, the central bank will keep pursuing the curve control strategy, aimed at keeping 10Y yields at around zero (as opposed to a near term policy of -0.10%) by purchasing government bonds. This suggests that the **underlying trend of yield spreads compared to the US will be a widening**, as the Fed is planning another two rate increase this year, three the next, and further hikes subsequently. Therefore, we continue to forecast an **ongoing decline of the yen** against the dollar, **towards USD/JPY 118-120 on a 12m-24m horizon.** This is a **relatively moderate decline scenario**, when considering that USD/JPY 118 marked a low for the yen between the end of 2016 and the beginning of 2017.

Fig. 5 – At the beginning of 2017, the yen also recovered part of the decline incurred at the end of 2016

Source: Thomson Reuters-Datastream

Fig. 6 – Last year's anomaly reabsorbed: the speculative market is short yen again



Source: Thomson Reuters-Datastream

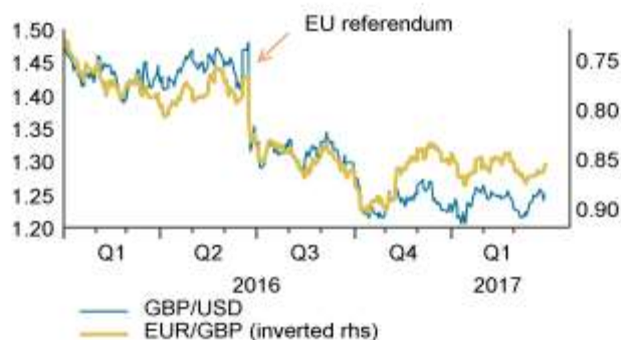
There are two main factors which should help limit the Japanese currency's decline, one tied specifically to the BoJ's action, and the other to the overall market context. For what concerns the BoJ, it is facing hitches in tangibly implementing curve control, as global yields are generally on the rise, and already in the course of this year JGB purchases are likely to fall short of the declared target (around 80 trillion yen), given the impossibility of simultaneously meeting price and quantity goals on the bond market. From the point of view of the market, on the other hand, the fact that a substantial speculative short yen market has built back up – after last year's anomaly, when the market was exceptionally long on the yen – may help ease downside pressures on the yen (Fig. 6).

The yen should weaken against the euro as well, as a result of both monetary policy divergence (BoJ still markedly accommodative while the ECB is preparing to terminate the accommodative monetary policy cycle by the end of the year), **and of the expected strengthening of the EUR/USD exchange rate**. The EUR/JPY should therefore head towards 126-129 on a 6m-12m horizon, subsequently climbing above the 130 mark.

Sterling: downside risks from Brexit persist

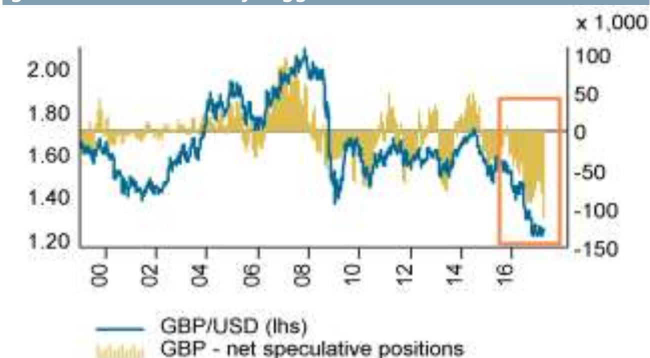
In the first part of 2017 the pound remained stable within the range outlined in the closing quarter of 2016, with fluctuations concentrated in the GBP/USD 1.20-1.25 range (except for a low of GBP/USD 1.19 and a high of GBP/USD 1.27) against the dollar, and in the EUR/GBP 0.84-0.88 against the euro (Fig. 7). Therefore, sterling's **movements have levelled off in the medium-low end of the range observed after last June's referendum on EU membership – which is compatible with the persistent risks tied to Brexit – while at the same time avoiding the setting of new lows – which reflects the ongoing flow of positive economic data from the UK economy, in terms of growth in particular**.

Fig. 7 – Brexit and sterling: sharp depreciation first, followed by a stabilisation



Source: Thomson Reuters-Datastream

Fig. 8 – Speculative short on the pound up to new record highs on the eve of the approval of the bill authorizing the government to officially trigger Brexit



Source: Thomson Reuters-Datastream

The relation between the flow of data and the trend of the exchange rate deserves particular attention, as it could prove somewhat deceptive, in particular when considering the week following the March FOMC. In the past few days, sterling appreciated not only on the widespread post-FOMC retreat of the dollar, but also on a string of data releases on the UK economy which generally surprised on the upside. On closer inspection, **the pound's reaction may have been amplified by exceptionally large speculative short positions (new long-term high, Fig. 8) which built up when the Brexit bill was returned by the House of Lords to the House of Commons following the amendments proposed by the former**. The amendments called on the government to guarantee the rights of EU citizens legally living in the United Kingdom and, most importantly, that the final outcome of negotiations with the EU be voted by MPs, with the specific aim of avoiding an exit without an agreement. This is a very delicate aspect, which, in waiting for the response of the Commons, which ultimately rejected the amendments, may explain the build-up of new speculative short positions, testifying to the risks effectively posed by Brexit, and which may be sometimes overlooked when considering only the data so far available.

For what concerns the Bank of England's assessment of the scenario, the February Inflation Report contained a significant upward revision of growth projections for this year (compared to November), from 1.4% to 2.0% (Fig. 9), which would imply an acceleration from 1.8% last year, a markedly positive outlook when considering that the actual Brexit process is already underway: the British government officially notified its intention to exit the EU, as per Article 50 of the Lisbon Treaty, on 29 March. **For the next two years, on the other hand, the BoE has confirmed its slowdown scenario – entirely due to Brexit** – with projected growth at 1.6% both in 2018 (revised up from 1.5%) and 2019 (unchanged).

Fig. 9 – Strong upward revision of forecast GDP growth in 2017 by the BoE

GDP growth		
	IR Nov. 2016	IR Feb. 2017
2017	1.4%	2.0%
2018	1.5%	1.6%
2019	1.6%	1.6%

Source: Bank of England

Fig. 10 – Inflation should stay above target throughout the forecasting horizon

CPI inflation (*)		
	IR Nov. 2016	IR Feb. 2017
2017	2.8%	2.7%
2018	2.7%	2.6%
2019	2.5%	2.4%

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

Source: Bank of England

At the same time, the BoE revised marginally down its inflation projections (Fig. 10), **while confirming expectations for an increase and a rate above the 2.0% target** throughout the

forecasting horizon: 2.7% at the end of 2017, 2.6% at the end of 2018, and 2.4% at the end of 2019. After averaging 0.7% in 2016, inflation rose above target already in February, climbing to 2.3%, and is expected to rise further in the course of the year. Mounting inflation risks as a result of Brexit prompted one BoE Board member – Kristin Forbes – to dissent from the decision to leave rates unchanged at the March meeting, and to vote for an immediate hike from 0.25% to 0.50%. We do not expect Forbes to be joined by other dissenters soon, as for the time being the shared approach is to maintain a certain degree of caution, in light of the downside risks to growth, which may derive from Brexit both in the near term (uncertainty over the outcome of the negotiations) and in the longer run (loss of access to the single market). The importance of Forbes's dissent as a signal is significantly reduced also when considering that her mandate will end soon, on 30 June.

Furthermore, already within the next few months, **an initial immediate effect of the rise in inflation may be the gradual erosion of purchasing power which, combined with still too sluggish wage growth, should result in a deceleration of consumption.**

Therefore, we confirm our expectations for a modest weakening of the pound in the near term, both against the dollar (towards GBP/USD 1.22-1.20 on a 1m-3m horizon) and against the euro (towards EUR/GBP 0.87-0.88). **In this period, another negative factor could be the uncertainty weighing on the subjects and modalities of the initial phase of the negotiations between the United Kingdom and the EU, which could begin with some delay compared to Theresa May's *desiderata***.

This is because an extraordinary EU summit – due to be held on 29 April - is needed to officially approve the draft guidelines for Brexit negotiations already delivered by the President of the European Council **Donald Tusk to the 27 member states**. As **the negotiations between the United Kingdom and the EU may only begin once the Commission will have laid out the directives**, there is a risk of the talks not beginning in earnest before the end of May/beginning of June, whereas the May government would want to get to work as soon as possible, as the two-year deadline by which to reach an agreement is calculated from the notification date (29 march).

The main object of the negotiations will be to define a new framework of economic and trade relations between the United Kingdom and the EU. However, other issues, on which tensions are already high and to which the EU seems set on awarding a priority, **include: (1) the size of the bill the UK will have to pay to the EU for leaving the bloc in order to cover its past financial commitments under the EU budget** (estimated at around 60 billion euros); **(2) the question of EU citizens living in the UK. The risk is that negotiations may stall at the very beginning on these issues.**

Additional uncertainty is being generated by the request of a new referendum on Scottish independence, to be held between autumn 2018 and spring 2019.

Coming back to the main theme of the negotiations, i.e. the new framework of economic and trade relations with the EU, the negotiations will be far from simple. Loss of access to the single market – inevitable to the extent to which the United Kingdom intends to reacquire full control over immigration (going against the EU principle of free circulation for individuals) – **will be a negative development for the UK economy in net terms**, the impact of which may be buffered, however, by seeking an agreement which minimises the cost of exiting the single market. **The May government aims to reach the best possible agreement, but the EU – at least in the initial phase – cannot show an inclination to make concessions**, as this could create a precedent, involuntarily encouraging other the agenda of countries that may intend to exit the EU in the future. It should also be considered that **even the best possible agreement with the EU will be worse than current conditions**. **Should the United Kingdom fail to reach a satisfactory agreement by the end of the two-year negotiation period, the risk of an exit without a prior agreement would take shape, undoubtedly the worst-case scenario for the British economy**, as

relations with the EU would then be governed by the terms and conditions of the WTO. The May government is working on a contingency plan in case of the risk of an exit without an agreement becoming a realistic prospect.

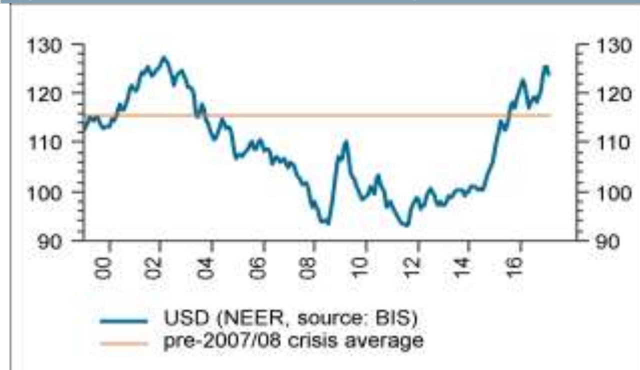
The complexity, uncertainty and duration of the negotiations suggests that risks to the pound will remain skewed to the downside, both this year and the next.

Beyond the near term – assuming an agreement is ultimately reached that limits the damage of losing access to the single market – we continue to expect a gradual recovery of the pound, towards GBP/USD 1.28-1.32 on a 12m-24m horizon. We opt for a modest recovery trend to take into account the risk of tied to the complexity/length of the negotiations – the deadline for which is the end of March 2019 (which coincides with the two-year horizon). Against the euro, this would imply an EUR/GBP exchange rate of around 0.86-0.87 on a 12m-24m horizon, as the EUR/USD scenario in the same period points to a sharper appreciation of the euro (towards EUR/USD 1.10-1.15 on a 12m-24m horizon). **Expectations for a recovery of the pound would in any case be stumped in the event of the United Kingdom ultimately exiting the EU without an agreement**: in this case the pound would correct, probably dropping below its post-referendum lows against both the dollar and the euro.

An aspect the market has still not sufficiently considered are the new trade agreements the United Kingdom will have to reach with non-EU countries. In this case, contrary to the agreement with the EU, better conditions than the present may be achieved. For the time being, however, information on this front is limited, as the United Kingdom cannot officially open negotiations with non-EU countries before it reaches a new agreement with the EU.

Risks to the baseline scenario are virtually symmetrical. **In the event of an exit without an agreement with the EU, the pound would correct, dropping below its post-referendum lows** against both the dollar and the euro. **If on the other hand the agreement with the EU should prove to be better than expected, or be reached sooner than expected, sterling's recovery path beyond the near term would be swifter, with a return to pre-referendum exchange rate levels** (above GBP/USD 1.40 and below EUR/GBP 0.80).

Fig. 1 – Dollar, nominal effective exchange rate

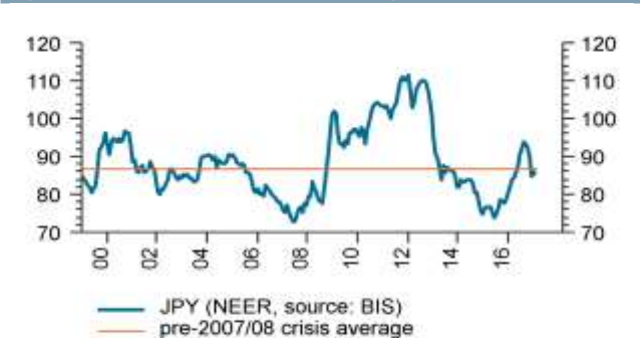


Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate

Source: Thomson Reuters-Datastream

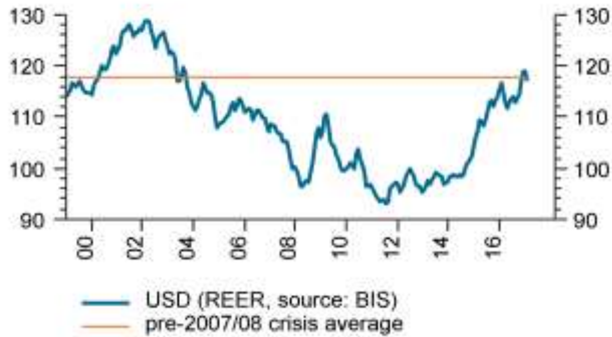
Fig. 5 – Yuan renminbi, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 7 – Dollar, real effective exchange rate

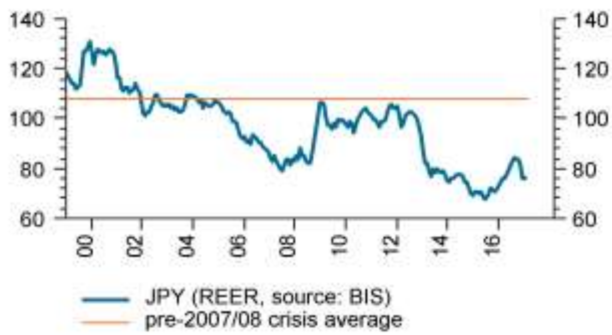


Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 10 - Sterling, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate

Source: Thomson Reuters-Datastream

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Appendix

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