Macroeconomic Outlook

Research Department

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INTESA SANPAOLO

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Index

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Euro area enjoys unexpected support from the oil market

Luca Mezzomo

The plunge in oil prices will raise economic growth in importing countries by 0.3-0.4% in 2015, with possible, albeit uncertain, second-round effects that could extend into 2016. At the same time, the shock is prompting a downwards revision of inflation estimates for 2015. But will all this be enough to foster sustainable growth in Europe and Japan?

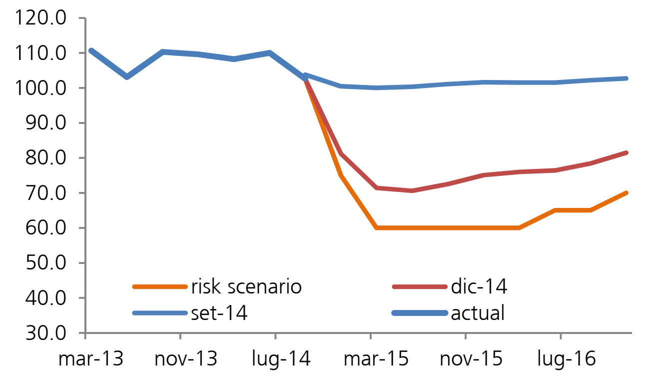
The downside is the higher risk of financial instability in countries which are most dependent on oil exports, on top of many other existing risk factors.

The trend of macroeconomic data in recent months has shown a widespread prevalence of negative surprises in most of the advanced countries, as well as in some major emerging countries. Outside the United States, the pace of growth has been bland compared to long-term averages, and global trade growth has remained stuck at disappointing levels. Several international crisis hotbeds are still active and remain a cause for concern.

Widening regional divergences have strengthened expectations that monetary policies will continue to be influenced by the same trend in the coming months, and has accentuated volatility on the currency markets. The relative strength of the US economy has propelled the dollar to multi-year highs in terms of its effective exchange rate, whereas heightened monetary accommodation in Japan and in the euro area has accelerated the depreciation of the yen and of the single currency.

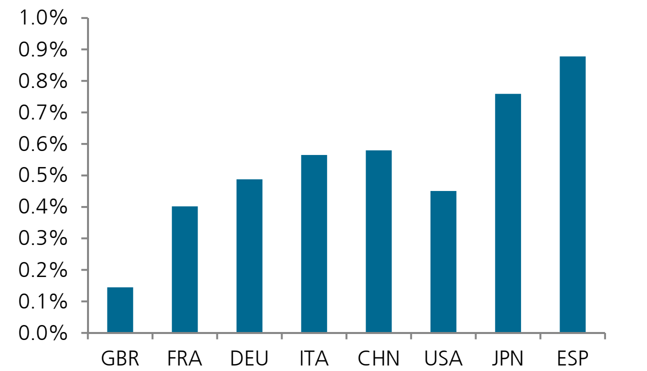
This is the picture within which the major global shock of the autumn of 2014 is panning out, namely the sharp and violent drop in oil prices, which is taking shape as one of the most important factors in driving the 2015 scenario.

Fig. 1 – Changes to our oil price forecasts (USD/barrel)



Source: Intesa Sanpaolo

Fig. 2 – Drop in oil prices: estimated direct impact on the trade balance (% of nominal GDP)



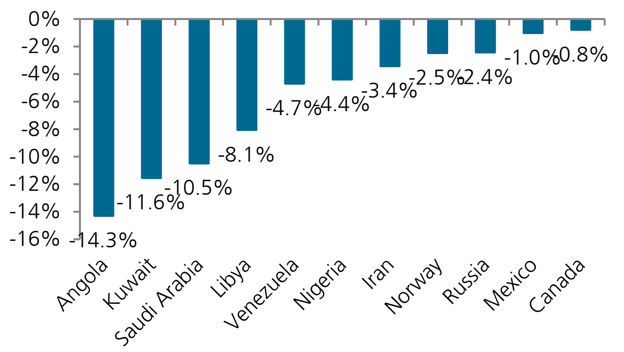
Note: savings on net oil imports, calculated based on 2013 volumes
Source: Intesa Sanpaolo elaborations

Direct impact on energy prices

The downtrend began in July, but picked up momentum in the fourth quarter of this year. The "surprise" compared to the September scenario, when prices were forecast to remain broadly stable at the levels recorded in 2014, amounts to a 28.3% drop in average 2015 terms. But the alternative scenario of a deeper fall, involving prices of $60, seems more and more likely by the day – at least for the first half of 2015. When considering net oil imports in 2013, such a drop implies savings on imports at current prices of 0.4-0.6% of GDP for the main advanced countries, rising to 0.6-0.8% in the $60 scenario. Globally, the lower transfers to oil-exporters consistent with our baseline scenario exceeds 410 billion USD, and over 600 billion in the alternative scenario with oil prices at $60 in 2015.

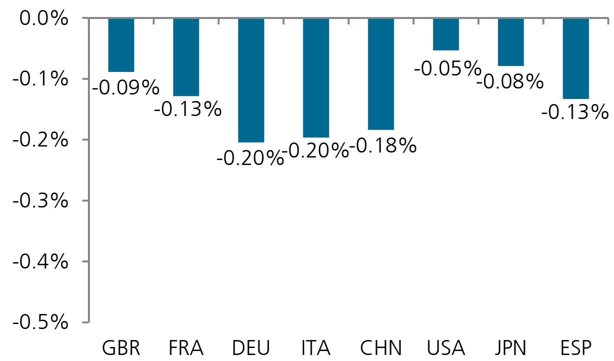
The actual impact on GDP will be smaller, due to the likely contraction of exports to producer countries, conservatively estimated at 0.1-0.2% of GDP. The net effect resulting from the drop in oil prices alone (i.e. without taking into account potential delayed effects on natural gas prices), will therefore amount to 0.3-0.4% for the three major economies of the euro area, for the United States, and for China, and could prove marginally stronger for Spain and Japan. On the other hand, the benefit will only be marginal for the United Kingdom, given the country's small net imports of oil.

Fig. 3 – Decrease in oil exports consistent with the baseline scenario (% of GDP)



Source: Intesa Sanpaolo, based on OPEC and World Bank data

Fig. 4 – Estimate of the impact on exports to oil-exporting countries, baseline scenario (% of GDP)



Note: the calculation is based on the elasticity of total imports of goods by oil-exporting countries observed in the 2008-09 shock, and on the current shares of exports going to such countries. Source: Intesa Sanpaolo from IMF-DOTS data

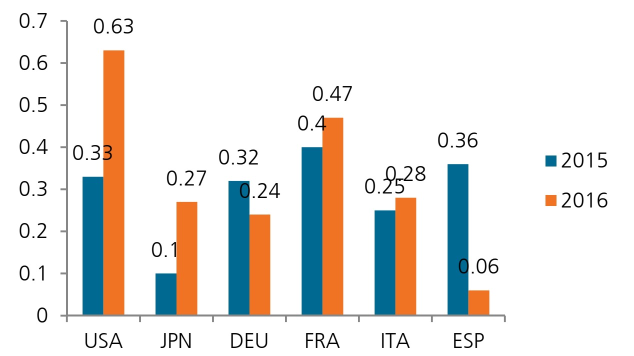
Second-round effects on domestic demand

The domestic advantage tied to less burdensome energy imports initially consists almost exclusively of stronger savings for households (lower fuel expenses) and enterprises (smaller intermediate costs, higher profit margins). The decline in imports will translate in part into stronger nominal GDP growth, and in parte into lower consumption at current prices.

Combined with the improvement of profit margins for businesses, however **the freeing of purchasing power could activate positive second-round effects on domestic demand, with consumption and investments at the fore**. Obviously, due to the normally high tax rates on fuels, the effect of the decline in quotations is diluted in terms of final prices: in 2009, for instance, the price drop transfer amounted to 30-40%. For what concerns consumption, assuming a similar transmission this time around, and considering the share of the consumer goods basket accounted for by fuels, the purchasing power of households could in any case increase by approximately 0.3-0.5% of disposable income, i.e. 0.2-0.3% of GDP.

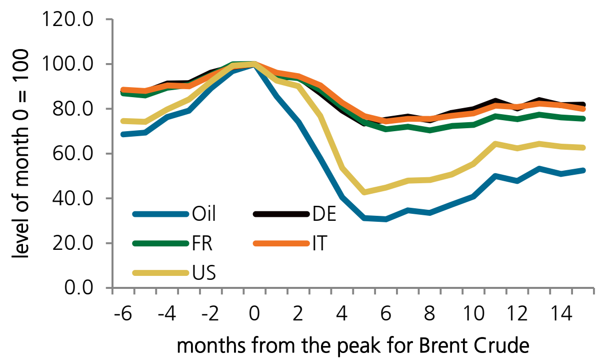
Such second-round effects may be estimated by running structural econometric models. According to the Oxford Economics model, for instance, the revision of oil price projections produces a positive impact of 0.3-0.4% in 2015, followed however by a string of significant second-round that extending into 2016, especially strong in some counties countries – such as the United States, where taxes on fuels are low and the elasticity of retail prices to oil prices is higher (see fig. 6).

Fig 5 – Estimated effects on GDP growth based on the OE model



Difference in GDP growth rate projections tied to the revision of oil price projections (USD -28.3 on the 2015 average and -23 on the 2016 average).
Source: Intesa Sanpaolo elaborations based on the OE model

Fig. 6 – Transfer of the 2008-09 shock to fuel prices

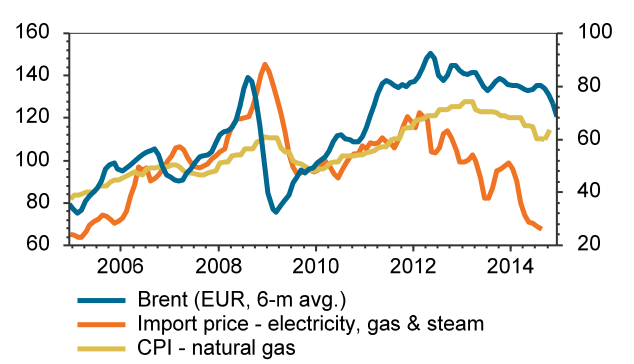


Source: Intesa Sanpaolo elaborations on national statistics sources

The actual materialisation of stronger domestic demand as an indirect consequence of the oil shock, however, depends on the context (confidence levels among households and businesses, the need to cut excessive debt, etc.). The limited effectiveness hitherto displayed by monetary policy management in encouraging enterprises to invest advises against expecting to see especially positive effects on capex spending, as savings could be used to strengthen the balance sheets of companies or to cut prices while keeping profit margins unchanged. The effect on consumer spending through the reallocation of purchasing power, on the other hand, should prove significant – although nominal figures may look disappointing at first sight because of the drop in the energy component of the consumption basket.

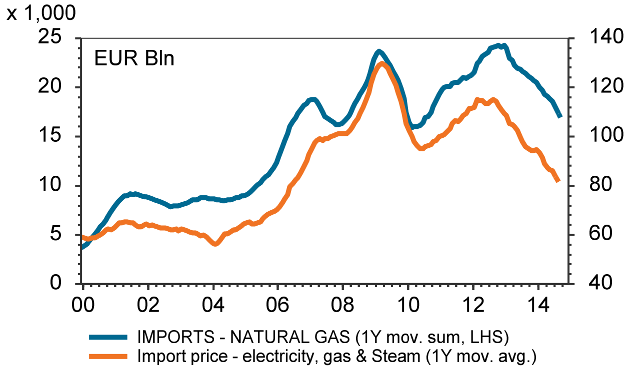
The delayed effects on domestic demand could be enhanced by developments in the market for natural gas. In Europe, the import price index for natural gas is highly correlated to past and smoothed oil prices (see fig. 7 for an example); therefore, it is likely that the steep decline in oil prices will also translate into lower gas prices in 2015. Such developments would be particularly relevant for Italy, the relies on natural gas for heating and electricity generation relatively more than other countries. By the way, the value of Italian imports of natural gas has already dropped by EUR 8Bn since 2012 (fig. 8), partly because of lower demand and partly because of lower prices.

Fig. 7 – Oil prices and the price of gas in Italy



Source: Intesa Sanpaolo elaborations on ISTAT and Thomson Reuters data

Fig. 8 - Import of natural gas have been falling since 2012



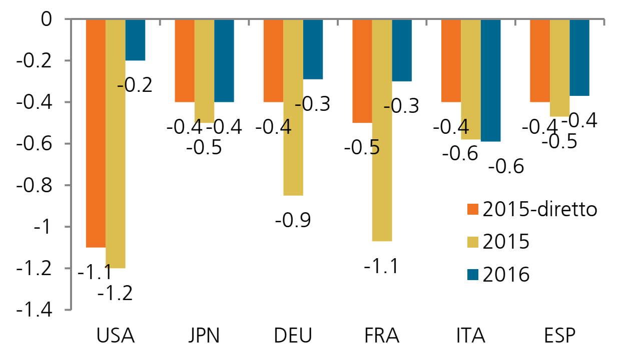
Source: Intesa Sanpaolo elaborations on ISTAT data

Oil, consumer prices and monetary policies

The activation of second-round effects on domestic demand is closely linked with the impact on energy price indices, which may result in the subsequent decline in the prices of manufactured goods and non-energy services, through the transfer of savings on producer costs. The direct impact on consumer price indices tied to the fuel component alone amounts to 0.4-0.5% in Germany, France and Italy, and to 1.1% in the United States, where the tax wedge is lower. The simulation run using the Oxford Economics model, which also attempts to estimate second-round effects, points to a reduction in overall inflation of between 0.5% and 1.2% in 2015 under the baseline scenario, with a tail-end in 2016 and a subsequent rebound in 2017. Our forecast of the average inflation rate in the euro area has therefore decreased to 0.5% in 2015; the estimate for the United States, where the CPI change could turn negative in early 2015 based on the new EIA forecasts for fuel prices, which is close to our $60 scenario, has undergone an even stronger revision.

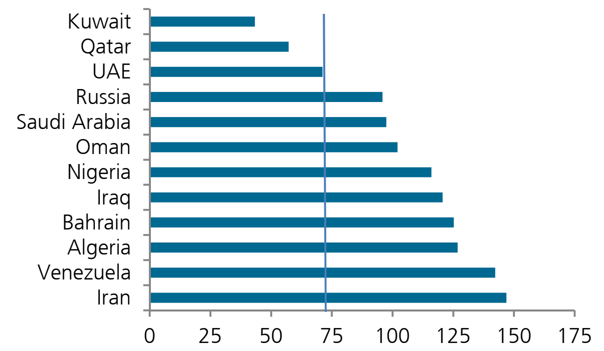
In general, all the above is a positive supply-side shock and the resulting potential reduction in the overall price index should not be countered by monetary policy. What's more, the effects on inflation tend to be transitory and easily reversible, advising against hasty monetary policy responses. The drop in oil prices, therefore, would not justify the postponement of a monetary policy restriction justified by a reduction in unutilised resource in the economy. As a result, the Federal Reserve is still likely to hike fed funds rates in the course of 2015. In the euro area, however, the drop in oil prices may accelerate the decline of inflation expectations, which at present represent the main source of concern for the ECB. For this reason, despite the support provided to aggregate demand by lower energy tariffs, the decline in the price of oil could prompt the ECB to put in place new monetary stimulus measures in the months ahead.

Fig. 9 – Estimated impact on inflation



Note: direct impact estimated based on the share of the consumer price index accounted for by fuels. The other estimates are yielded by simulations using the Oxford Economics model, and do not necessarily reflect the change in our forecasts. Source: Intesa Sanpaolo elaborations

Fig. 10 – Fiscal break-even oil prices



Note: the vertical line shows our baseline forecast for 2015 oil prices.
Source: IIF

Risks of financial instability?

The downside is the violent deterioration of the terms of trade for oil exporters, whose economies are often scarcely diversified and dependent on oil exports for a major share of their imports of goods and services, as well as for the solidity of their public accounts. Figure 3 summarises the impact on the major oil-exporter countries in percentage terms on GDP. Some countries have built large reserves out of retained oil-revenues, and can count on currency reserves within their central banks or on revenues from sovereign wealth funds to withstand the impact of the crisis. In some countries, the reduction of oil revenues could generate problems in safeguarding social cohesion, or force governments to accept debt growth or a drain of currency reserves built up over previous years (where available). In some cases, it may amplify the financial fragility of the country. As figure 8 shows, some countries based their budgets on oil prices well above the likely level for 2015 – double our current forecast in the case of Algeria, Iraq and Nigeria. The reliance of the budget on oil revenues exceeds 70% of total government revenues for Libya, Iraq, Saudi Arabia, Kuwait and UAE, and ranges from 40 to 60% for Russia, Venezuela, Iran, Nigeria and Algeria[1]. The situation of Russia is further weakened by the impact of the sanctions imposed as a result of the annexation of Crimea and of the military involvement in the uprise in eastern Ukraine, and has already resulted in a balance-of-payment crisis.

Will aid from oil producers be enough?

As a result of lower oil prices, the scenario for 2015 could effectively price in the modest acceleration in global growth, from 3.2% to 3.6% that the deterioration of monthly economic data was about to compromise. The United States and Asia will continue to act as the main drivers of global growth, although Asia is expected to experience a further deceleration of the pace of economic activity. Also as a result of the depreciation of the euro and of the yen, growth should strengthen both in the euro area and in Japan. However, the pace of growth will remain modest in both regions.

Potential risks are still numerous and serious: failure to solve the Ukrainian crisis, the increasing hardships incurred by the Chinese economy, the implications of a strong dollar for the emerging countries, problems tied to the process of cutting debt in the euro area – given the context of slow nominal growth and deep disagreement over economic policy strategies. Lower oil and gas prices may help finding a negotiated settlement for the Russian-Ukrainian crisis; however, sooner or later, some of these risks could materialise. Therefore in Europe and in Japan the support stemming from the energy market and from the realignment of exchange rates will be in vain unless domestic demand picks up in the coming quarters.

Economic growth by geographical region

	2011	2012	2013	2014E	2015E
United States	1.6	2.3	2.2	2.2	3.2
Japan	-0.4	1.5	1.5	0.3	0.8
Euro area	1.7	-0.7	-0.4	0.8	1.1
East Europe	4.0	2.4	1.5	1.4	1.0
Latin America	2.8	2.7	2.4	1.3	2.2
OPEC	4.0	4.9	2.6	2.4	1.0
East Asia	7.4	5.9	6.6	6.0	5.8
Africa	3.4	3.1	3.7	3.2	4.1
Global growth	4.1	3.4	3.3	3.2	3.6

Source: Intesa Sanpaolo research

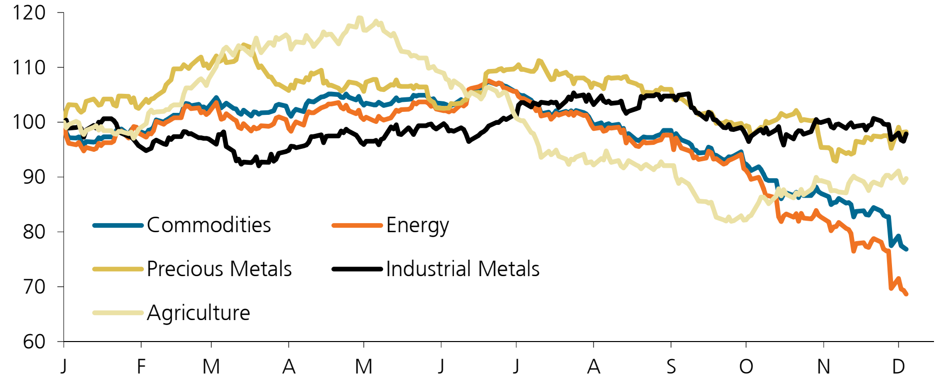
[1] IIF, *After the fall – consequences of lower oil prices*, December 2014, chart 17 di p. 7.

Commodities: oil drags the sector down

Daniela Corsini

Low oil prices are exerting negative pressure on much of the energy sector, but also on industrial metals and agricultural products – due to cheaper energy inputs – and on precious metals due to a further fall in inflation estimates. Next year, for most key commodities only surprises of a significantly tighter market could trigger price rises.

S&P GSCI Total Return Indices (100=31.12.2013)



Source: Intesa Sanpaolo chart based on Bloomberg data

Oil prices, which started falling in the summer months on fears of oversupply, slumped to their lowest in four years when OPEC announced an unchanged production target, thereby abdicating responsibility for rebalancing the market through a cut in its cumulative supply.

At the time of writing, the latest estimates indicate that the 1H15 oil market surplus will be about 1.5-2.0 million barrels a day (mbd), which is roughly 2% of global demand. This, in itself, is not an excessive amount, given that the global economy is recovering and the major emerging Asian nations would increase their strategic reserves of crude oil and oil products.

At the moment, what particularly concerns the markets is that low prices will intensify competition between oil producing countries, thereby fuelling persistent excess supply. In fact, without a common strategy of coordinated cuts, no producer would like to be the first to reduce its production and lose market share to its competitors.

So we expect it to take several quarters of low prices before market forces cause excess production to be re-absorbed and supply growth estimates to be downgraded. In the coming months, prices should stabilise at levels considered to be close to the marginal costs of the most dynamic supply component: shale oil and oil from unconventional sources. We stress that any estimate of the marginal cost of shale oil production is necessarily an approximation: each shale formation is geologically different from the others and each well has its own features, thereby creating a wide range of marginal production costs. Moreover, in North America, the production costs from unconventional sources are slowly but steadily falling, thanks to technological advances, new techniques such as pad drilling (which allows more wells to be drilled simultaneously from a single platform on the surface) and the renegotiation of tariffs with service companies.

In the 2H15, despite a gradual decline in marginal costs, oil could find support from accelerating global demand and expectations of slower expansion in supply caused by the cancellation or postponement of projects aimed at expanding and developing new production capacity.

Downward pressure from stronger dollar and weakness of oil, neutral geopolitical risks

Overall, in the next quarter we expect the sector to come under further severe downward pressure from: a stronger dollar on the back of a solid recovery in the US economy and expectations of an imminent rate hike; the risk of below-potential growth in Europe and China; negative market sentiment and low oil prices.

In particular, low oil prices will weigh on much of the energy sector, especially oil products and natural gas. Specifically, liquefied natural gas (LNG) will experience competition from oil, while various development projects for new infrastructure could be delayed. We will also continue to see negative pressure on natural gas in Europe, where a good proportion of the gas traded is indexed to oil and the demand outlook remains extremely negative. We exclude from our baseline scenario the possibility of future disruptions to the flow of Russian gas in transit via Ukraine, given the recent resolution of the trade dispute between the two countries.

Conversely, the impact of low oil prices on US natural gas is far less clear because the end result will depend on how individual producers respond to the erosion of their margins. In fact, as several wells with very high marginal costs produce both gas and liquids, there might be a reduction in the supply of both oil and natural gas in the coming months. Amid a strong seasonal demand, US gas could come under upward pressure.

The impact on metal prices should be unequivocally negative in the short term. Industrial metals prices are set to be driven down by cheaper energy inputs in the production process; this is especially significant for the refining and processing of metals and for aluminium production. Precious metal prices are likely to be depressed by the lack of inflationary pressure, which is especially harmful to gold and silver.

All major agricultural products will see lower input costs in energy production. Corn and vegetable oils will suffer further downward pressure as oil derivatives become more competitive on the fuel market.

At the moment, we see short-term geopolitical risks having a broadly neutral impact on the main commodities: commodity supplies from Russia (energy and industrial metals) and Iraq (crude oil sold by both the central government and the Kurdistan Regional Government) should be broadly stable, whereas we expect supplies of energy commodities to remain volatile in Libya – albeit consistently below 1 mbd – and Nigeria, where tensions could worsen approaching to the February's presidential elections. We expect supplies of precious metals from South Africa to gradually normalise, after this year's lengthy strikes.

Our forecasts for the commodities universe

Our baseline scenario for oil shows prices stabilising in the 1H15 at around 70 dollar for Brent and 65 dollar for WTI, then recovering moderately to a target of 80 dollar for Brent and 75 dollar for WTI by end-2016.

The main downside risks to our baseline scenario are: further downgrades to global growth estimates; a stronger-than-expected dollar (the minimum low is currently seen at 1.18 against the euro) and a less conducive financial environment for investments in commodities; weaker-than-expected supply and demand fundamentals; and perceived lower geopolitical risks. In our worst-case scenario out to 2Q16, Brent and WTI are stable at around 60 dollar and 58 dollar respectively.

We think upside risks are far more important than downside risks to our baseline scenario at the moment. In particular, we expect a good recovery in oil consumption, based on expectations of high price elasticity of demand. Furthermore, many geopolitical tensions remain unresolved and could lead to deep changes in global supply. An eye should be kept on the Middle East (Iran's nuclear programme, ISIS in Iraq and Syria, civil war in Libya), Nigeria (oil theft and sabotage of pipelines in the Niger Delta region and social tensions) and Russia (conflict with Ukraine and the political response to low oil prices).

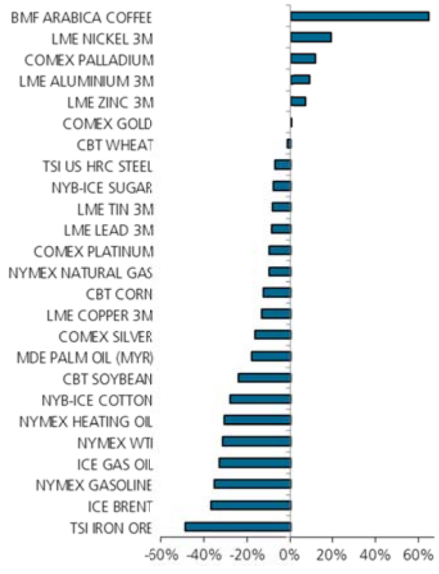
In the long run, geopolitical risks and low prices will reduce investment in new production capacity in the energy sector and consequently they will drive down estimates of future production. For this reason, each of our scenarios shows a gradual increase in prices over the forecast horizon.

With regard to precious metals, we expect the persistent weakness in investment demand and the strengthening of the dollar to continue to weigh on gold, which should fall to its lowest for nearly five years in 1H15. Our target is 1,100 dollar by mid-2015. On the contrary, silver prices will likely consolidate at around 17 dollar in the next few months before gradually rising on the back of recovering global demand. We remain positive on platinum and palladium, which should benefit from the recovery in demand in the automotive and industrial sectors.

We expect industrial metals prices to be broadly stable in the next quarter and stage a moderate recovery during 2015. In the short term, metals should continue to trade close to their current lows due to cheaper energy inputs, the strength of the dollar and the uncertainty weighing on the major emerging markets. Specifically, the segment will mainly be influenced by macroeconomic data to be published by China in the next few months. Our forecast of an overall recovery in prices during the year is based on the expectation that the Chinese economy would surprise on the upside.

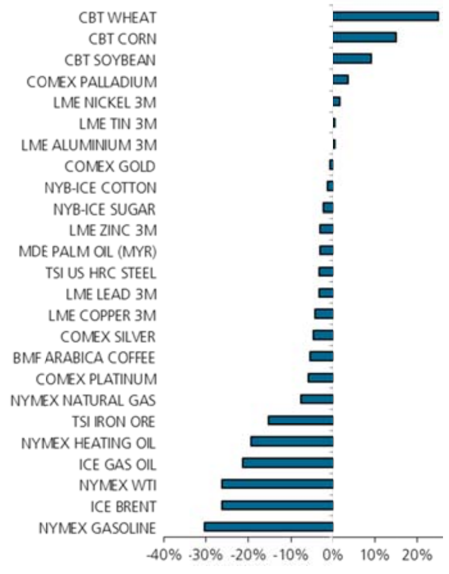
With regard to agricultural commodities, weather conditions will be the key determinant of prices, given that the supply and demand fundamentals remain particularly weak for many agricultural goods – above all cereals – and falling energy prices could exert further negative pressure, primarily on vegetable oils.

Performance since beginning of year to 03.12.2014 (spot prices)



Source: Intesa Sanpaolo chart based on Bloomberg data

Performance in 4Q (from 30.09 to 03.12.2014)



Source: Intesa Sanpaolo chart based on Bloomberg data

Oil: an unchanged target has changed everything else

It will take several quarters of low prices before market forces cause the current level of excess production to be re-absorbed and supply estimates to be downgraded. In the short term, concerns centre around the weakness of global demand and the dollar's strength.

Some clear key points arose from OPEC's 166th meeting and the subsequent press conference:

- We are facing an "extremely well supplied market", given the weakness of the current macroeconomic situation and the expectation of a surplus expanding in the next few quarters.
- This leaves the invisible hand of the market to adjust balances through prices. Indeed, OPEC's decision to maintain its production target at 30 mbd "is the response" of the group to the boom in non-OPEC production. OPEC says that the current oil market surplus originates from non-OPEC producers, who should therefore participate in the effort needed to rebalance supply and demand;
- The group does not have a target price, and any level is considered appropriate as long as it does not affect global economic growth and, at the same time, allows producers to receive a decent income and to invest to meet future demand.

The implications for the market are clear: the market will be characterised by oversupply because OPEC's production target (call on OPEC crude) is higher than the amount of oil the group would need to supply to balance the markets. According to the same estimates published in the OPEC's Monthly Oil Market Report in November, the call on OPEC crude is expected to be 28.4 mbd in 1Q15 and 28.5 mbd in Q2, a good 1.5 mbd below the target of 30 mbd. In addition, the target is not binding and there are no penalties for overproduction. Consequently, OPEC supply is often higher than the official target (e.g. OPEC production has been estimated at 30.25 mbd in October and 30.48 mbd in September).

In its November Short Term Energy Outlook, the US Energy Information Administration (EIA) estimated that OPEC's spare capacity, which is mainly in Saudi Arabia, was expected to rise to an average of 2.7 mbd in 2015 from 2.1 mbd on average in 2014 and 2013. Moreover, these estimates do not include the additional capacity that may be available in Iran but which is currently not accessible due to international sanctions restricting Iranian exports.

Supply and demand estimates by OPEC, IEA and EIA for 2014

November 2014 estimates, in million barrels	Total Demand	Non-OPEC Supply	OPEC LNG supply	"Call on OPEC Crude"
OPEC	91.2	55.9	5.8	29.5
vs. 2013	1.1	1.7	0.2	-0.8
IEA	92.4	56.4	6.4	29.6
vs. 2013	0.7	1.8	0.1	-1.3
EIA	91.4	56.0	6.1	29.8
vs. 2013	0.9	1.9	0.0	-0.1

Source: Intesa Sanpaolo chart from data published by the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA)

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

November 2014 estimates, in million barrels	Total Demand	Non-OPEC Supply	OPEC LNG supply	"Call on OPEC Crude"
OPEC	92.4	57.2	6.0	29.2
vs. 2014	1.2	1.2	0.2	-0.3
IEA	93.6	57.7	6.7	29.2
vs. 2014	1.3	1.3	0.3	-0.4
EIA	92.5	57.0	6.3	29.7
vs. 2014	1.1	-0.1	0.2	-0.1

Source: Intesa Sanpaolo chart from data published by the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA)

Given the large volume of spare supply and the absence of any announcements of upcoming production cuts, it will be left to the market to adjust its balance through new equilibrium prices, which will be well below the average levels recorded in the last three years. It will take several quarters of low prices before we see products at higher marginal costs removed from the market and cancellations of planned investments announced, thereby downgrading supply growth estimates. Moreover, there are various reasons why a large number of producers will not respond immediately to the low prices; these include low operating costs, ability to bear short-term losses, contractual obligations, and the hope that other producers will cut first to improve the market balance.

The International Energy Agency (IEA) estimates that about 2.6 mbd of oil currently comes from production with a breakeven price of more than 80 dollars a barrel. Specifically, just over 4% of US production of light, tight oil and about 8% of deepwater production would not be cost-effective. However, the IEA also points out that government participation in a number of projects with higher marginal costs of production decreases the price elasticity of this supply component.

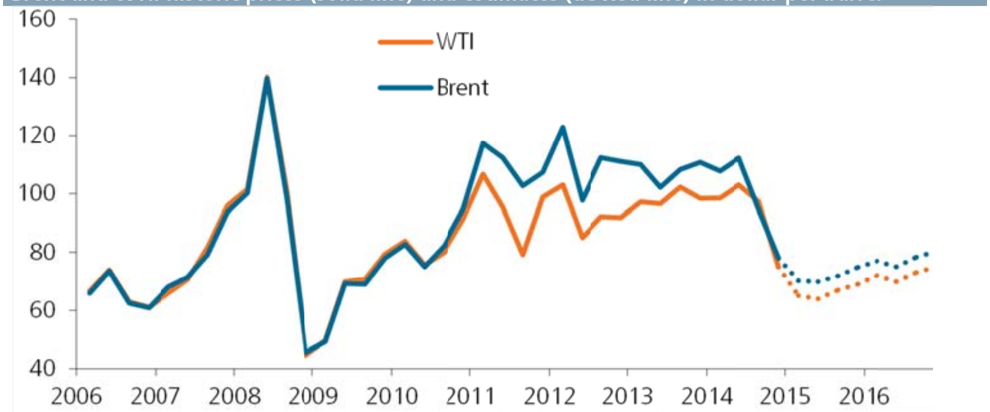
Forecasts

Our baseline scenario forecasts that oil prices will remain weak for a long time to come. This expectation is based on the deterioration in market fundamentals and the fear that macroeconomic factors (weak global economic growth and strong dollar) will exert fresh downward pressure on prices. We have downgraded our estimates from the previous quarter's forecast because of the change in business strategy by major OPEC members, led by Saudi Arabia, and the disappointing data published in Europe and China. Our estimate for the average price of Brent is 70.2 dollar in 1Q15 and 71.7 dollar for the full year 2015. We expect that Brent will remain steadily above the level of 75 dollar per barrel only after clear signals of a reduction in supply on the physical market. Our estimate for the average price of WTI is 65.0 dollar in 1Q15 and 66.3 dollar for the full year 2015. The spread between Brent and WTI should average about 5.5 dollar in 2015, but it will remain volatile with a tendency to narrow during fresh downward pressure on prices.

We are currently incorporating a very low geopolitical risk premium in our estimates for 2015 because in the short term, the conflicts under way in Ukraine and the Middle East are unlikely to cause significant reductions in supply. In our view, Libyan production will remain highly volatile. Conversely, we are starting to price in the risk that the second half of the year could see higher supply from Iran, should there be a gradual easing of the sanctions weighing on the energy and financial sectors if negotiations with the P5+1 powers (United States, United Kingdom, France, Russia, China and Germany) reach at least a partial agreement on Iran's nuclear development programme. Given our optimistic estimates, we must stress that the main upside risks include the possibility of an unexpected worsening of geopolitical tensions.

As regards our long-term forecasts, we think that the crisis in Iraq and the low oil prices have irreparably damaged Iraq's potential to develop its oil production capacity, and have therefore slashed our estimates of future production. For this reason, we are maintaining a fair value for the longer maturities of the forward curve at around 95 dollar per barrel for Brent.

Brent and WTI: historic prices (solid line) and estimates (dotted line) in dollar per barrel



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

Price estimates for Brent

03.12.2014	4T14	1T15	2T15	3T15	4T15	2015	2016	2017
Estimates	78.0	70.2	69.9	71.8	74.9	71.7	77.7	85.3
Bloomberg Median	87.0	90.0	90.0	94.0	95.0	91.0	97.5	96.0
Forward Contracts	79.5	71.4	73.2	74.6	75.7	73.8	78.5	81.7

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

03.12.2014	4T14	1T15	2T15	3T15	4T15	2015	2016	2017
Estimates	75.0	65.0	64.0	67.0	69.0	66.3	72.5	80.2
Bloomberg Estimates	82.0	83.5	84.5	89.0	91.0	86.0	91.8	95.0
Forward Contracts	76.0	67.7	68.2	68.6	69.3	68.5	71.1	73.8

Source: Intesa Sanpaolo chart based on Bloomberg data

USA: the economy is “normalized”, now it's the Fed's turn

Giovanna Mossetti

- The recovery seems to have firmed, now that growth in private domestic demand is finally "normal". We forecast **growth of 3.2% in 2015 and 3.1% in 2016**, with balanced risks.
- **Consumer spending** will be the growth driver in 2015-16. The anticipated upturn in consumption (to 3% in 2015, from 2.3% in 2013-14) will largely be due to factors born of the long adjustment process over recent years: household finances are recovering, the labour market is improving continuously, incomes are rising, and interest costs are at historic lows as a percentage of disposable income. The labour market is returning to equilibrium, and in mid-2015 unemployment should be within the FOMC's estimated rate for longer term unemployment, at 5.3%. The output gap is expected to close by the end of 2016.
- Two important factors are likely to affect 2015 growth: **dollar** appreciation and falling **oil prices**. The strengthening of the dollar, under way since mid-2014, will dampen growth by approximately 0.4 percentage points in 2015. But stabilisation of the oil price at around USD 70/barrel should add about 0.5 percentage points, providing particularly strong stimulus to consumer spending at end-2014/early 2015. If oil prices fall below USD 70/barrel, the impact will be bigger and consumer spending could keep accelerating throughout 2015.
- The fall in oil prices since the first half of 2014 of approximately USD 30/barrel and the stronger dollar will put a brake on **inflation**, which could come in at around 0.5% yoy in the first half of 2015.
- 2015 should be the year the **Fed reverses policy**, and we expect the first rate hike in mid-2015, although this forecast is subject to risks. The Fed will base rate adjustments on data: looking at the forecasts for 2015, there could be a conflict of interests between the central bank's two targets. The labour market will be very close to equilibrium, while inflation could be quite a way off the 2% target, particularly in the middle of the year. The Fed has stated that in the event of a conflict between its targets, it will adopt a "balanced approach". This implies a high degree of uncertainty in the lead up to policy reversal, and the markets could be highly volatile. But monetary policy is set to remain highly expansionary in 2015-16.

Macro forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (1996 US$,y/y)	2.2	2.2	3.2	1.9	2.6	2.4	2.1	3.5	3.1	2.9	3.2
q/q annual rate				-2.1	4.6	3.9	2.0	3.4	3.2	3.1	3.0
Private consumption	2.4	2.3	3.0	1.2	2.5	2.2	2.8	3.5	3.1	2.9	2.9
Fixed investment - nonresid.	3.0	6.1	6.4	1.6	9.7	7.1	5.1	6.5	6.4	6.2	6.0
Fixed investment - residential	11.9	1.7	6.3	-5.3	8.8	2.7	6.5	5.5	7.0	8.0	8.5
Government consumption	-2.0	-0.2	0.3	-0.8	1.7	4.2	-2.2	0.1	0.3	0.3	0.4
Export	3.0	3.2	5.2	-9.2	11.0	4.9	3.8	5.1	4.9	5.3	5.0
Import	1.1	3.5	3.8	2.2	11.3	-0.7	2.1	5.1	4.0	4.3	4.5
Stockbuilding (% contrib. to GDP)	0.0	0.0	0.0	-0.3	0.3	0.0	-0.1	0.0	0.0	0.0	0.0
Current account (% of GDP)	-2.4	-2.1	-1.4	-2.4	-2.3	-2.2	-1.7	-1.5	-1.4	-1.3	-1.4
Federal Deficit (% of GDP)	-4.2	-3.7	-3.4								
Gov. Debt (% of GDP)	122.1	122.1	120.7								
CPI (y/y)	1.5	1.7	1.1	1.4	2.1	1.8	1.4	0.8	0.5	1.2	1.8
Industrial production (y/y)	2.9	4.0	4.0	3.9	5.6	3.1	3.1	4.0	4.7	4.6	3.9
Unemployment (%)	7.4	6.2	5.5	6.7	6.2	6.1	5.8	5.7	5.6	5.5	5.3
Fed Funds	0.25	0.25	0.48	0.25	0.25	0.25	0.25	0.25	0.25	0.58	0.83
Effective exch.rate (1973=100)	75.9	78.3	84.3	76.9	76.4	77.8	82.3	84.3	85.2	84.4	83.1

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

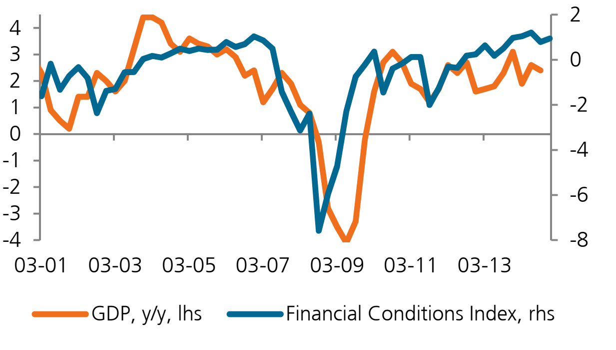
The American consumer is back, and set to spend at full throttle!

2014 began with a nasty surprise (contraction of GDP in 1Q, -1.9% qoq ann.), but is expected to close with a bang, with economic growth normalised and stable at above 3% and supported by solid fundamentals. Domestic demand is expanding, although not excessively, household finances have improved and the outlook for fiscal policy is broadly neutral over the next two years. The labour market is reabsorbing unused resources, and wages are also gradually beginning to pick up. We forecast growth of 3.2% in 2015 and 3.1% in 2016, supported by a 3% expansion in consumer spending and satisfactory demand in non-residential capital investment. Although we expect the output gap to close and wage growth to recover, inflation will remain low, thanks to falling import (strong dollar) and oil prices. The new forecast for WTI of around USD 70/barrel implies a net energy contribution to growth of at least 0.4 percentage points in 2015.

Fiscal policy should be marginally expansionary, with positive contributions at state and local levels. The debt ceiling will be reset in the spring but, despite conflict between the Administration and Congress, the pre-election climate should mean that crises will be avoided. Financial conditions are extraordinarily expansionary, and will remain so for a long time. 2015 should be the year that monetary policy reverses. Although the Fed will proceed very cautiously, there will be periods of heightened volatility, owing to uncertainty about the timing of the first hike and the size of subsequent rises. The forecast of limited inflation (owing to the dollar and oil) will give the Fed room for manoeuvre through cautious rate rises, even though unused resources on the labour market are gradually reducing.

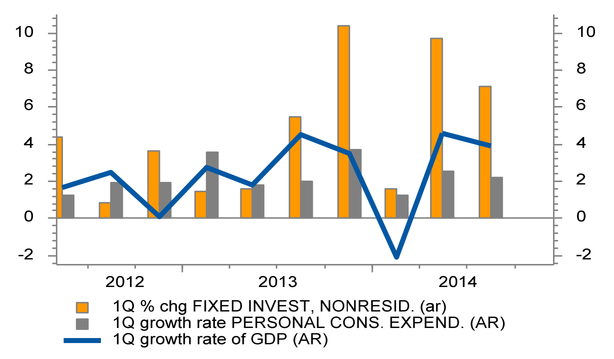
In our view, the risks to the outlook are balanced. The main downside risks are the reversal on US rates and global economic weakness. Both these factors have equally strong implications for the dollar. The strengthening of the dollar, which began in mid-2014, will prune about 0.3-0.4 percentage points off growth in 2015 (incorporated into our forecast). Further appreciation could slow the recovery. There is also a risk of weaker than expected global growth. Conversely, there are upside risks. We project solid growth in consumer spending, but we are pretty conservative, as consumption could be stronger, given the many positive factors for household spending, and the substantial contribution expected from falling petrol prices. The correction in energy prices should have a net positive effect on growth, with the consumption boost largely outweighing slowing investment in the energy sector. If inflation is even lower than anticipated (owing to the exchange rate and, above all, oil), the Fed hikes could start later and/or rise more gradually than expected. The reversal in long-term yields could be a long time coming, leaving financial conditions more accommodative than we currently forecast. Overall, therefore, our growth forecast of 3%+ in 2015-16 looks balanced.

Fig. 1 – Financial conditions still ultra-expansionary



Source: Bloomberg

Fig. 2 – Recovery supported by private domestic demand



Source: Thomson Reuters-Datastream

Labour market – The adjustment in the labour market is key to forecasts. **All indicators are positive**: level and duration of unemployment, employment, labour flows. We forecast that around 230,000 jobs a month will be created in 2015 (we are pretty conservative here). With an average of 230,000 new jobs a month (2014 average) and a stable participation rate of 62.8%, unemployment would reach 5.3% (the middle of the equilibrium range estimated by the FOMC) in May 2015. Only wages are behind on the labour market dashboard that the Fed monitors, but there are signs that they are about to pick up (see figs 2-4). **Sustained labor income growth and falling petrol prices will be the main drivers of consumer spending in 2015.**

Consumer spending – The recovery in 2015-16 will be driven by consumer spending, which is seen accelerating from the end of 2014. The many factors supporting consumer purchasing power in 2015 will take consumer spending growth well above the average in 2013-14 of 2.3%. **Employment** is growing rapidly at around 2% yoy, **wage income** growth is about 5% yoy, **interest costs** as a percentage of disposable income are at an all-time low, net wealth is rising, debt has started to grow again (marking the end of deleveraging), and the fall in **petrol prices** represents a giant transfer. Even before the correction in oil prices, the forecast was for consumer spending growth of between 2.5% and 3%. The release of extra purchasing power, together with a petrol price firmly below USD 3/gallon (as forecast by the IEA, see fig. 10), could add at least 0.4 percentage points to consumer spending in the fourth quarter and in 2015. **Growth forecast for consumer spending is 3% qoq ann. (with risks to the upside)**.

Non-residential fixed investment – Corporate investment picked up in 2014, with higher utilisation of production capacity. A Philadelphia Fed survey shows that 62.6% of companies have plant capacity utilisation or more than 75-80%, while 29% of companies expect to invest more in software and machinery in 2015. The fall in oil prices will cut investment in facilities in the energy sector's most dynamic segment (shale oil). We cautiously forecast **a moderate expansion in non-residential investment, in line with 2014** (forecast 2015: +6.4%).

Residential investment – Residential construction should pick up in 2015, supported by an improving labour market, healthy household finances, positive household formation growth and a drop in available properties. **Residential investment is expected to rise by 6.3% in 2015**, from 1.7% in 2014.

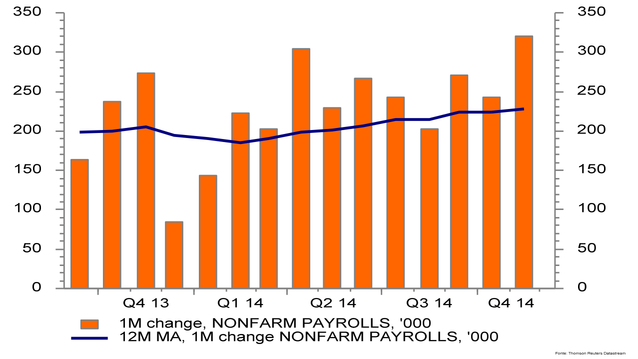
Net exports – The strengthening dollar and higher oil production are having contrasting effects on the trade balance. Despite the strong dollar, the increase in the export and production of oil products is supporting exports and reducing imports. At the end of 2014, net imports of oil products (including crude) are forecast at 4.8 Mb/d (half the 9.4 Mb/d in 2010). **We forecast growth of 5.2% in exports and 4.3% in imports.**

Inflation – Consumer price inflation is being dampened by the dollar's appreciation and falling oil prices. The strong **dollar** is expected to slow inflation by approximately 0.2pp in 2015. The Department of Energy's forecasts for **energy prices** in 2015 (as of Nov 12) are for an average of USD 77.70/barrel for WTI in 2015 (from USD 95 in 2014), USD 2.94/gallon for petrol (from USD 3.40 in 2014), and USD 3.25/gallon for heating fuel (from USD 3.72 in 2014). **Headline inflation is expected to trend sharply downwards from the end of 2014 to mid-2015**, if energy prices stabilise current levels. The December CPI is expected to rise by 1% yoy, and then fall to a low of 0.4% yoy in mid-2015 (2015 average from 1.7% to 1.3%). Inflation measured with the **consumption deflator** is expected to **come in at just above zero in mid-2015**. We expect core CPI to be much more stable, falling to 1.6% yoy in mid-2015, then rising to 1.8% yoy at end-2015. The **core deflator** is on average two-tenths of a point below core CPI. There are two crucial points for **monetary policy**: 1) with energy prices broadly stable in 2015, the rise in inflation is likely to be temporarily interrupted, then pick up again from mid-2015; 2) medium-term inflation expectations could fall in both market measures and surveys. This increases the uncertainty regarding the timing of the first Fed hike, creating **a conflict between the targets of price stability and full employment**.

Monetary policy: the year of the exit – 2015 will be marked by the liftoff of Fed rates. Sustainable growth and the gradual closure of the output and unemployment gaps are likely to push the Fed towards the exit, despite the probable fall in inflation. The Fed says that the drop in oil prices is a positive supply shock, with temporary effects on inflation. The Fed has updated its optimal control model, and the new estimates indicate that the Fed funds rate should already tighten to 0.3% by the end of 2014[2]. The actual policy rate (including non-conventional measures) has been negative since July 2009, and fell continuously to an estimated low of -3% in May 2014, before stabilising at around -2.8% in the fourth quarter[3]. The FOMC has stressed that the rate lift-off is data-dependent, and that in the event of a conflict between its two mandates on prices and employment, it will adopt a "balanced approach". In our view, progress on the labour market front should prevail over a temporary drop in inflation. Wages will be key.

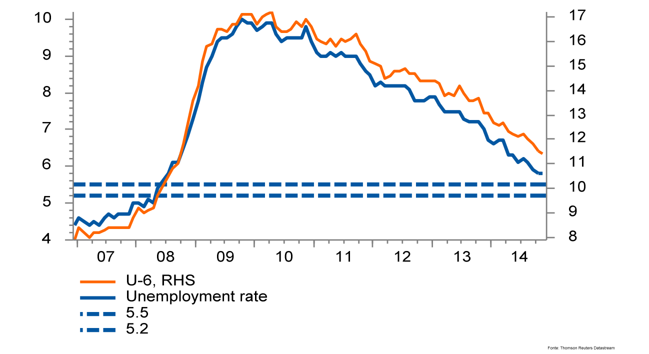
We maintain our **forecast of the first rise in June 2015, with rates of 1%-1.25% at end-2015, 2.5%-3% at end-2016, and around 3.75% at end-2017. Uncertainty over the timing and size of rate hikes will generate volatility.**

Fig. 3 – New jobs keep rolling in



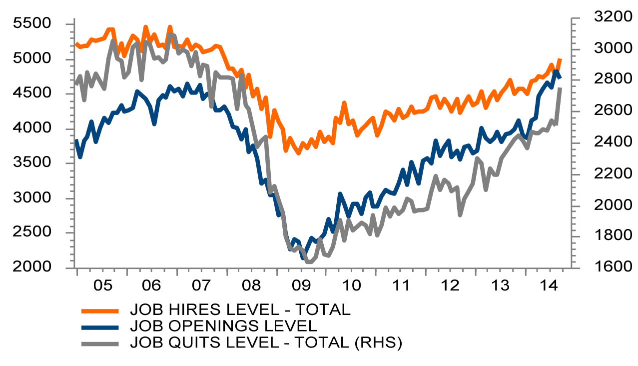
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment very close to equilibrium



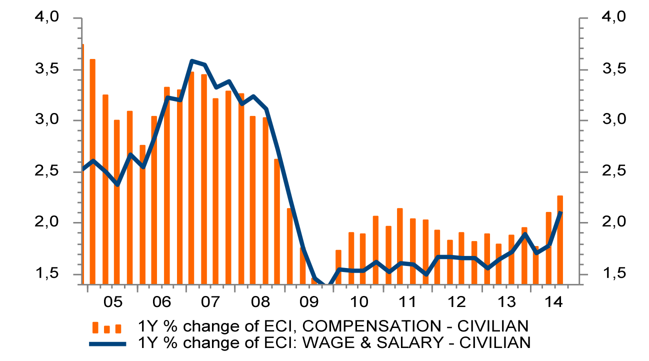
U6 = Unemployment rate, plus discouraged workers, workers marginally attached to the labour force, and workers in part-time employment for financial reasons. 5.2-5.5%: estimated equilibrium unemployment rate, FOMC. Source: Thomson Reuters-Datastream, Fed

Fig. 5 – Job openings, quits and hires



Source: Thomson Reuters-Datastream

Fig. 6 – Employment Cost Index finally rising



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

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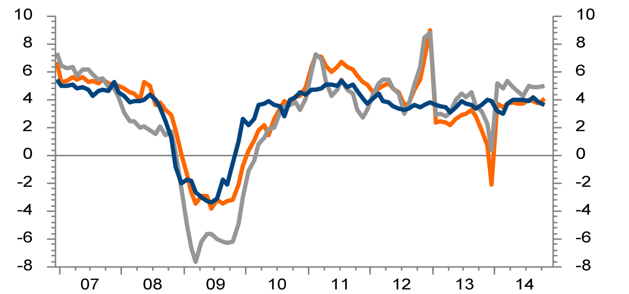
[2] F. Brayton et al., Optimal control monetary policy in the FRB/US model, Feds Notes, 21 November 2014.

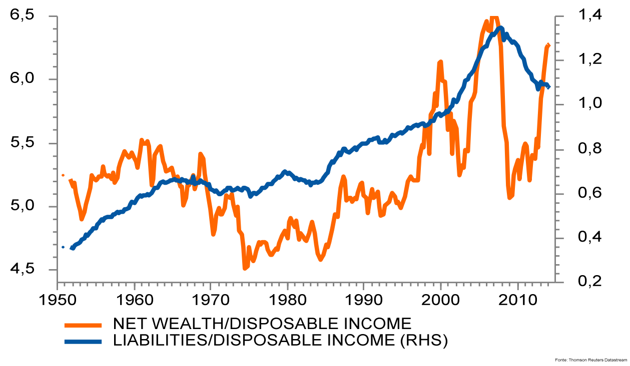
[3] V. Wu-Xia Shadow Federal Funds Rate, Atlanta Fed, https://www.frbatlanta.org/cqer/researchcq/shadow_rate.aspx

Fig. 7 – Personal disposable income, labor income and consumer spending



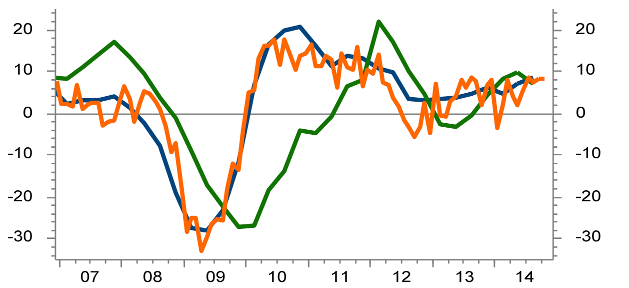
Source: Thomson Reuters-Datastream

Fig. 8 – Household finances in order



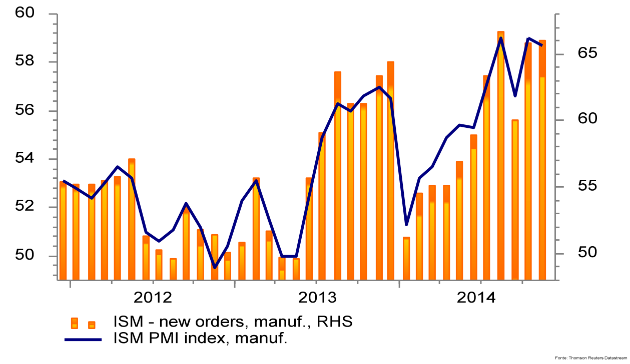
Data in thousands of units (ann.) Source: Thomson Reuters-Datastream

Fig. 9 – Positive trend in fixed non-residential investment



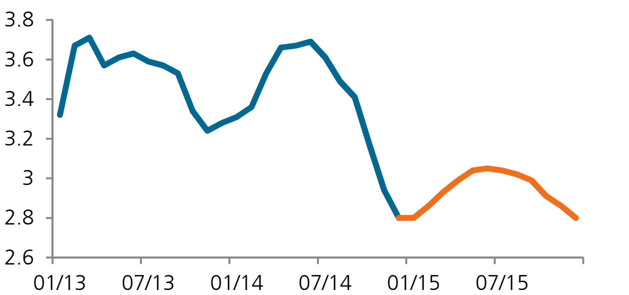
Source: Thomson Reuters-Datastream

Fig. 10 – Manufacturing ISM and new orders point to solid growth



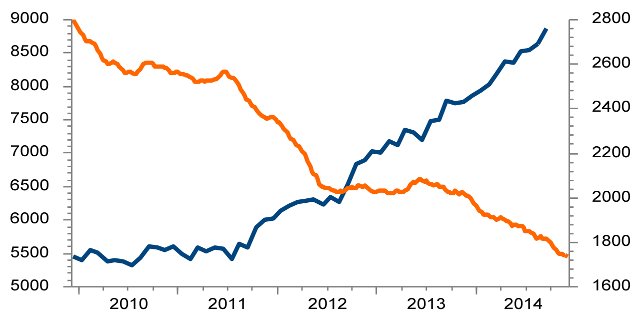
Source: Thomson Reuters-Datastream

Fig. 11 – A lasting correction in petrol prices?



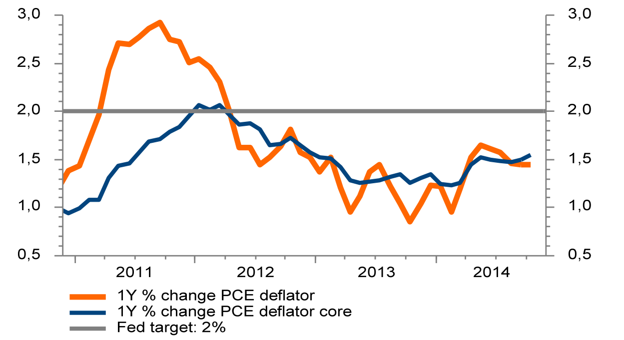
Source: Energy Information Administration. Forecasts from November 2014 to December 2015. Forecasts updated to 12 November 2014

Fig. 12 – The energy boom is reducing the trade deficit



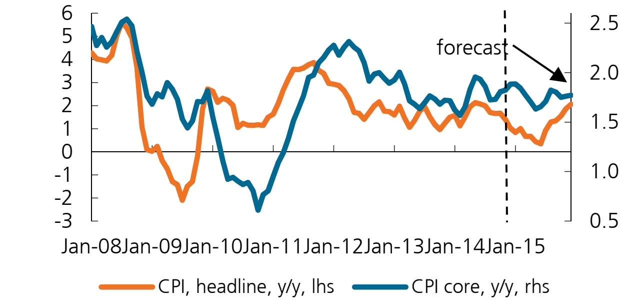
Source: Thomson Reuters-Datastream

Fig. 13 – Consumption deflators



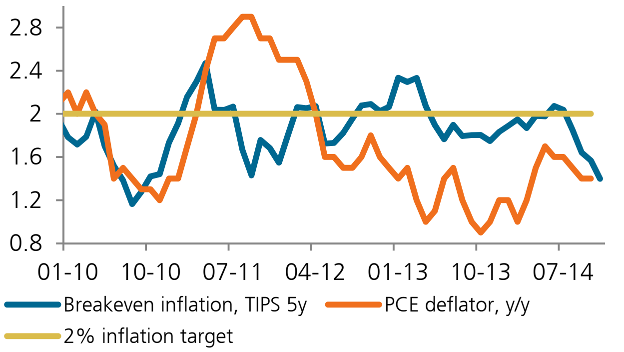
Source: Thomson Reuters-Datastream

Fig. 14 – Falling energy prices will push inflation towards zero in mid-2015



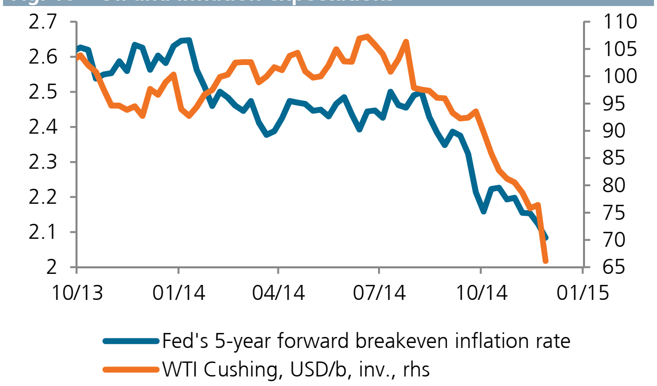
Source: Thomson Reuters-Datastream. Forecasts Intesa Sanpaolo, for energy: Department of Energy

Fig. 15 – Inflation still below 2%



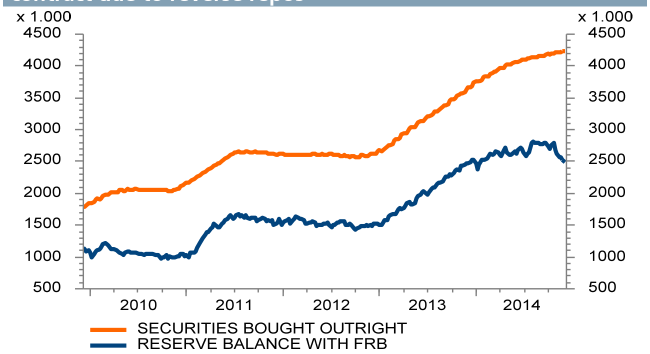
Source: Bloomberg

Fig. 16 – Oil and inflation expectations



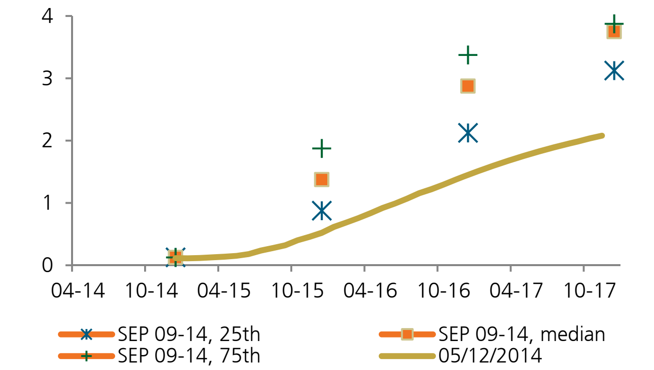
Source: Bloomberg

Fig. 17 - A sea of liquidity, but reserves are beginning to contract due to reverse repos



Source: Federal Reserve Board of Governors, Tab. H.4.1. Figures in USD million

Fig. 18 – The market is (too) cautious on the fed funds' future path



Source: Bloomberg, Intesa Sanpaolo, Federal Reserve Board. Solid lines: Fed funds futures; SEP = summary of economic projections, September 2014

Euro zone: 2015 - still the year of the tortoise?

Anna Maria Grimaldi
Paolo Mameli

- Euro zone seems to be caught in a trap of modest growth and low inflation. Next year, we do not expect any significant acceleration compared to 2014, when the estimates proved too optimistic, especially for Germany and Italy. We confirm our forecast of 1.1% growth for 2015, which was below consensus three months ago but is now broadly in line with it.
- The exchange rate depreciation in 1H15 was (up to 1.24) already priced into our September estimates. Falling oil prices could push Euro zone GDP growth up by 0.3%-0.4% by the end of 2015/early 2016, but will have a negligible effect on the 2015 average, since the summer data suggest an underlying trend that is clearly weaker than previously expected.
- Growth will continue to vary greatly between Euro zone countries. We expect a growth rotations towards peripheral countries (Spain, Portugal and Ireland), which should benefit from the fiscal devaluation process of the last few years. German growth will be more or less in line with trend (1.1%), while France and Italy will hover below average (0.7% and 0.4%), hampered by domestic structural problems.
- We think that the risks to growth are broadly balanced: currency and commodities prices are likely to be supportive while geopolitical factors continue to represent an element of uncertainty. 2015 is an election year in Greece, Portugal and Spain, and a drift towards populist positions is a substantial risk factor.
- Euro zone inflation is expected to be stable at 0.5% in 2015 then rising again to 1.0% at end-2016 on the back of our revised oil price scenario (USD 70 on average in 2015 and back up to USD 83 in 2016). Alternatively, if the oil price were USD 60, inflation would remain below 1.0% until end-2016. Risks to inflation are still skewed to the downside as the longer inflation expectations remain below the ECB's target, the higher the risk that medium-term expectations drift away for the central bank target and trigger second-round effects which may also impact the core trend.
- 2015 will be the year of quantitative easing in Europe. The probability that the ECB will extend its asset purchase programme to government bonds is now significantly higher than 50%. In terms of timing, we think it is most likely to happen at the March meeting, but we do not rule out a pre-announcement January. The decision will, however, depend on the economic data becoming available between now and March. The real question is how will the debate on economic policies in the Euro zone shape up during the year.

Macro Forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	-0.4	0.8	1.1	1.1	0.8	0.8	0.7	0.6	0.9	1.2	1.6
- q/q change				0.3	0.1	0.2	0.1	0.2	0.4	0.5	0.5
Private consumption	-0.6	0.9	1.2	0.2	0.3	0.5	0.2	0.3	0.3	0.3	0.3
Fixed investment	-2.4	0.7	1.1	0.3	-0.6	-0.2	0.0	0.4	0.5	0.8	0.7
Government consumption	0.2	0.9	0.7	0.1	0.3	0.3	0.2	0.1	0.1	0.2	0.1
Export	2.1	3.5	4.2	0.4	1.4	0.8	1.2	0.9	1.1	1.1	1.1
Import	1.2	3.5	4.3	0.4	1.3	1.2	1.2	1.0	1.2	0.6	1.3
Stockbuilding (% contrib. to GDP)	-0.1	-0.1	-0.1	0.1	-0.1	0.0	-0.1	0.0	0.1	-0.1	0.2
Current account (% of GDP)	2.0	2.2	2.7	2.2	2.4	2.2	2.1	2.7	3.0	2.7	2.4
Deficit (% of GDP)	-2.9	-2.5	-2.3								
Debt (% of GDP)	93.1	94.4	94.6								
CPI (y/y)	1.4	0.5	0.5	0.7	0.6	0.4	0.3	0.1	0.5	0.5	0.9
Industrial production (y/y)	-1.0	0.8	1.1	0.4	-0.3	-0.3	0.2	0.3	0.6	0.6	0.5
Unemployment (%)	12.0	11.6	11.3	11.8	11.6	11.5	11.5	11.4	11.3	11.3	11.2
3-month Euribor	0.22	0.21	0.07	0.29	0.30	0.16	0.08	0.07	0.07	0.07	0.07
EUR/USD	1.33	1.33	1.21	1.37	1.37	1.33	1.25	1.21	1.19	1.21	1.24

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

Crude oil and the weaker euro will offset negative surprises on the cycle

Anna Maria Grimaldi
Paolo Mameli

- 2014 will close with average Euro zone growth of barely 0.8%, worse than the consensus expectations of a year ago, largely due to a more disappointing performance in Germany and Italy. Geopolitical tensions have played a substantial role in recent cyclical trends, not only via exports, but also indirectly, as the rise in uncertainty caused by such tensions has weighed on, and continues to weigh on consumer decisions, especially regarding investment.

- Since the summer, national confidence surveys and the composite PMI have moved along a path consistent with a falloff around three-tenths of a percentage point in the 2015 estimate, owing to the now almost-certain stagnation in GDP growth in Germany at the turn of the year, the potential double-dip recession in France and the ongoing weakness in Italy.

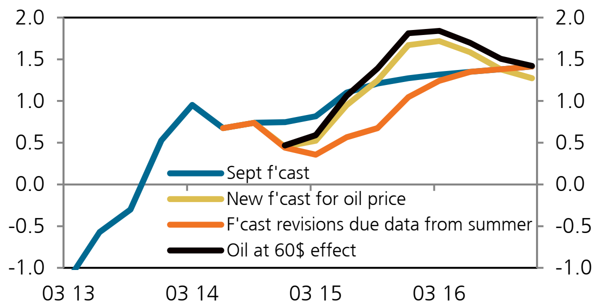
- There are no significant changes to fiscal policy, which is expected to remain broadly neutral on average in 2015, according to the European Commission's forecasts on the cyclically-adjusted primary balance, with a slight tightening in spring next year. Monetary policy is likely to become more accommodating during 2015. The completion of the asset quality review (AQR), together with the ECB's measures, are likely to support credit growth. However it is by no means certain that the ECB will manage to halt the rise in real rates, even though it is open to QE. In any case, it is difficult to assess the impact of the ECB's measures on domestic demand.

- The exchange rate depreciation was to a large extent (up to 1.24 in the first half of 2015) already priced into our September estimates; we now expect it to fall to 1.21, which implies an effective exchange rate depreciation of just under 2%. Following OPEC's decision not to cut production in order to maintain market shares, we significantly downgraded our oil price forecasts in 2015-16; from USD 100/bbl to USD 72/bbl in 2015 and from USD 101/bbl to USD 78/bbl in 2016, with a target of USD 82/bbl at end-2016, up from USD 70/bbl at end-2015. This represents a 28% fall in 2015, reducing to 23% in 2016, versus September's base scenario.

- Below, we attempt to assess the impact of the fall in crude oil prices on growth forecasts. The immediate impact of the fall in oil prices will be savings for net oil and fuel importers, both in terms of their trade balance and cheaper imported energy bills. This impact is counteracted by a fall in exports to OPEC countries. Considering the net level of crude imports in 2013, this price change reduces imports by 0.4%-0.6% of GDP for the main Euro zone countries. The impact on GDP is lower because of the probable contraction in exports to producer countries, which is cautiously estimated at 0.1%-0.2% of GDP. The net effect due to the fall in oil prices alone (i.e. without considering the delayed effects that could become apparent on natural gas), is therefore equal to 0.3%-0.4% for the three largest Euro zone economies, and could be slightly bigger for Spain. The potential significance of the shock could be increased by the freeing up of households' purchasing power. The effect of the 2009 fall on final prices was dampened, in particular, by the tax on fuels: the transfer was therefore equal to 30%-40%. Assuming that the transmission is the same and considering the size of the contribution of fuel to the basket of consumer goods (see fig. 2), households' purchasing power could be 0.3%-0.5% of disposable income, i.e. 0.2%- 0.3% of GDP. Together with the improvement in companies' profit margins, this could trigger positive secondary effects on domestic demand - although this cannot be taken for granted in the current climate of uncertainty. In the most prudent scenario, lower energy imports would be almost entirely offset by an increase in savings by households and consumers. This is clearly a partial assessment and does not take account of the interaction between variables that would be set off following the shock, but gives a preliminary measure of the potential impact. A more complete assessment can be obtained by looking at the elasticity of the macroeconomic models.

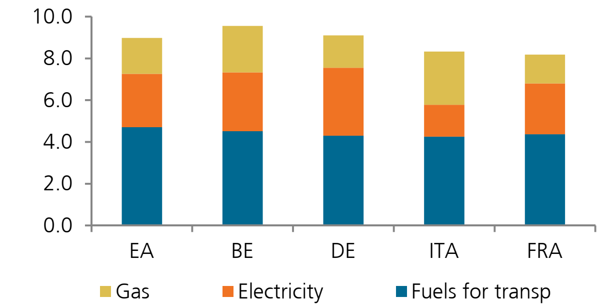
- In 2015, consumer spending is expected to accelerate slightly, to 1.3%, after 0.9% in 2014, thanks to the resilience of real salaries (0.5%) and employment growth (we estimate 0.4% in line with 2014). The wealth effect is likely to be positive but is less significant than in the US.
- The real crux of the economic outlook is the weakness of machinery investment. Companies' capex spending is particularly weak compared with similar cyclical recovery phases in the past, generating record lows for investment in machinery and construction in relation to GDP. After the rebound (+3.2%) in 2014, investment in machinery and fittings could run out of steam in 2015, growing by barely 2.7%. Low profitability, under-utilisation of production capacity and persistent uncertainty weigh on the economic and fiscal outlook. We expect other investment (mainly construction) to stagnate after seven years of contraction: the property sector is not only in recession in France and Italy but is expected to slow in Germany too.
- Lastly, foreign trade will also contribute positively to growth in 2015, due both to the weak euro (see above) and the pick-up in global demand (we estimate growth of 5.1% in the demand index of the Euro zone's major trading partners). We estimate that both export and import growth will accelerate to 4.1%: in both cases this would be the highest level since 2011.

Fig. 1 – Support to growth should come from the dynamic of oil and exchange rate



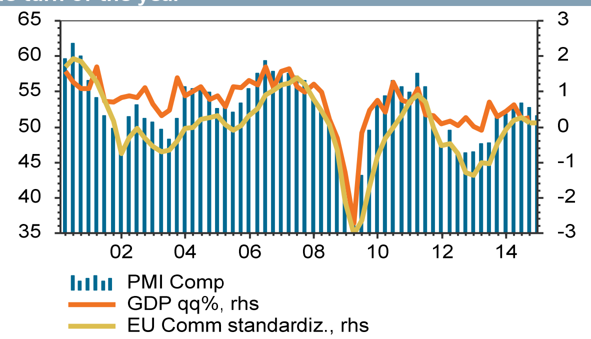
Source: Eurostat and Intesa Sanpaolo simulations with Oxford Economic forecasting

Fig. 2 – Weight of gasoline, gas and power consumption for households



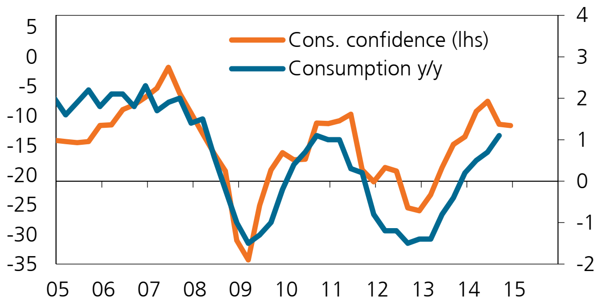
Source: Thomson Reuters Datastream

Fig. 3 – Business surveys suggest a stagnation in EA GDOP over the turn of the year



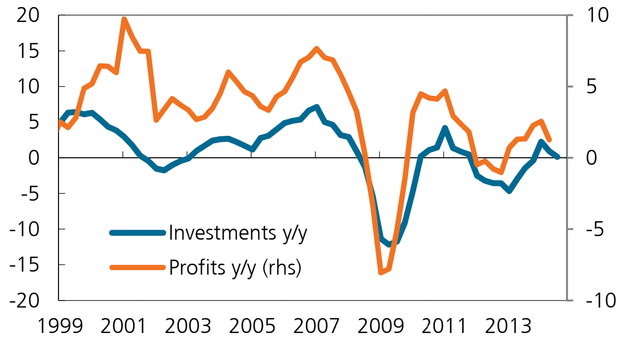
Source: Thomson Reuters-Datastream

Fig. 4 – Depressed morale does not anticipate a turn in consumption



Source: Eurostat

Fig. 5 – Capex dampened by low productivity…

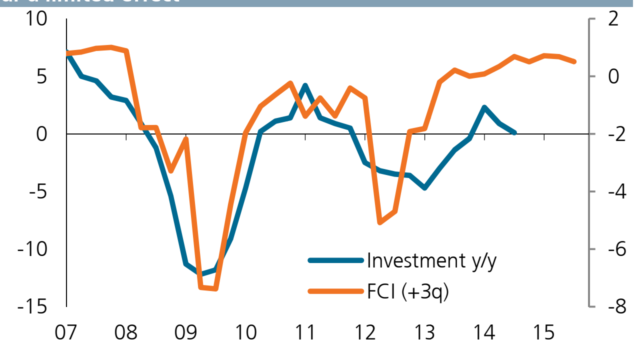


Source: Eurostat

Fig. 6 – … but also by uncertainty

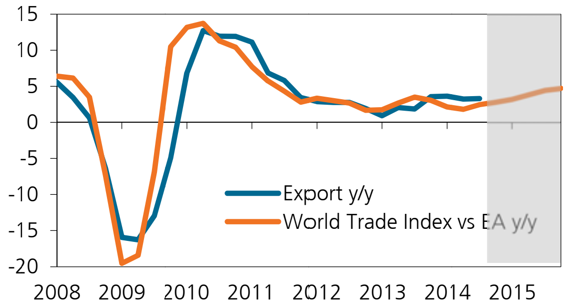
Source: Eurostat, www.PolicyUncertainty.com (Scott Baker, Nicholas Bloom and Steven J. Davis)

Fig. 7 – The more accommodative financial conditions had so far a limited effect



Source: Eurostat, Bloomberg Financial Conditions Index

Fig. 8 – Exports should be supported by the exchange rate and the (expected) pick-up in global demand



Source: Eurostat and Intesa Sanpaolo simulations with Oxford Economic forecasting

The Oil price effect? Indefinite disinflation

Anna Maria Grimaldi

- Euro area inflation dropped again in November, to 0.3% y/y, returning to the September level. Core inflation stopped at 0.7%, a new low since 1998. The decline in inflation since June (0.5% y/y) is almost entirely explained by the trend of energy prices, with core inflation only accounting for 0.1 of the movement. It is by now evident that euro area inflation will stay at significantly lower levels than we were estimating up to two months ago, when we expected a rate of around 0.6% at the end of the year, and well below the ECB's 0.7% forecast for 4Q 2014.

- The most recent trend in euro area inflation is largely explained by the sharp drop in the prices of energy commodities since July, and only marginally by the decline in domestic prices (v. Fig. 5). However, it should be said that the ECB has overestimated euro area inflation in 2014 by over half a point. The drop in core inflation is still explained mostly by the trend of non-energy goods prices, affected by external factors, more than by services which tend to respond more to internal demand dynamics. The percentage of non-energy industrial goods showing price changes of less than zero in October was back at its highest since 2009. The percentage of services with price changes below zero stabilized in the past few months, whereas the percentage with price changes lower than 1 has risen to new highs (v. fig.1).

- The ECB and OECD interlink models suggest that the impact of a 10% drop in the price of oil generates an effect on the annual trend of consumer prices of between 0.2% and 0.3% after four quarters, whereas a 5% depreciation of the effective exchange rate should push euro area inflation up by two or three tenths after one year. Therefore, the models suggest that euro area inflation will be lower by around one point after one year as a result of the 30% drop in the price of oil, and by 0.1-0.2% due to the depreciation of the effective exchange rate.

- The simulations with Oxford Economic Forecasting suggest that the impact is strongest after one year, amounting to around 0.6-0.7 (Fig. 3). Overall inflation would therefore average 0.5% in 2015, from 0.9% previously in 2015 and return to 1.0% in 2016 from a previous estimate of 1,3%. The impact of the shock is particularly strong for France (-1.0%) and Italy (-0.5). In Italy, inflation will stay very close to zero, whereas in France, based on the indications yielded by the model, inflation could fall into negative territory. The impact on Italian inflation of a drop in crude oil prices of around 30% does not differ greatly from the one suggested by the elasticities of the OECD's Interlink model (+/-0.5 inflation per +/-25% price of oil), although the impact seems a little too strong in France's case. Therefore, we have revised our forecast for French inflation to 0.4% from a previous rate of 0.7%.

- Core inflation is not expected to stray significantly from current levels (0.7%-0.8%) on the forecasting horizon, as we do not expect the output gap to close significantly before mid-2016. Our models suggest that a one-point change in the output gap has an effect on core inflation of around one tenth after two quarters. Therefore, the impact of stronger growth on the core trend will be very modest. Risks to the core trend, however, are still skewed to the downside, as a lasting drop in the price of oil could prompt a downward revision of inflation expectations, with possible second-round effects also on core dynamics. An analysis of the evolution of inflation expectations as measured by the EU Commission's survey and by the composite PMI shows that they are influenced by the trend of the price of oil (v. Fig. 4-6). Inflation expectations implied in swap contracts also emerge as being influenced by the trend of oil prices. The decline in the price of crude oil was not so important in 2009 for the evolution of price expectations probably because the starting point of core inflation was higher (over 2% at the end of 2008), and the shock was perceived as temporary. There is no need to stress the fact that a decline in medium-term inflation expectations would trigger an increase in real rates, offsetting the supportive effect on growth of a weaker price of oil.

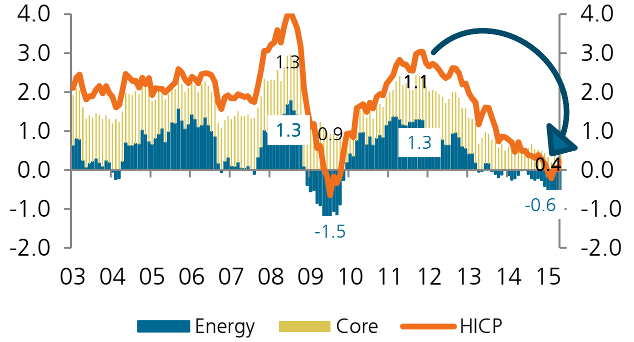
- With oil prices at 60$ per barrel, the euro area would experience deflation in 2015, and below 1.0% inflation also in 2016.

Tab. 1 – EA and countries inflation estimates

	NLD	EST	ITA	ESP	BEL	IRL	DEU	FRA	EA	FIN	PRT	MLT
2013	2.6	3.2	1.3	1.5	1.2	0.3	1.6	1.0	**1.4**	2.2	0.4	1.0
2014	0.3	0.6	0.2	-0.1	0.6	0.2	0.8	0.6	**0.5**	1.2	-0.1	0.7
2015	1.2	1.6	0.2	-0.2	1.0	0.4	0.9	0.4	**0.5**	0.9	0.3	-0.1
2016	1.9	1.5	1.2	1.1	1.0	1.0	1.0	1.0	**1.0**	0.8	-0.3	0.8

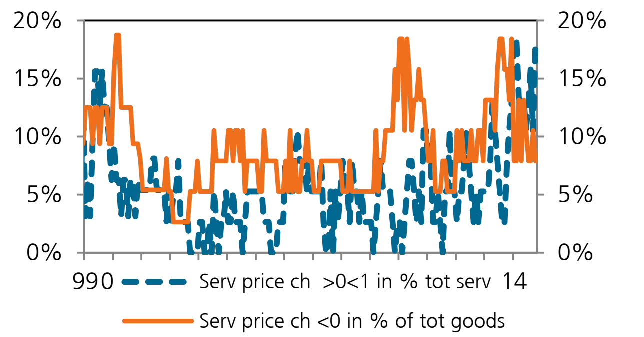
Source: Eurostat and Intesa Sanpaolo forecasts

Fig. 1 – AE inflation will lack drive on the forecasting horizon, but the core trend will also represent a drag



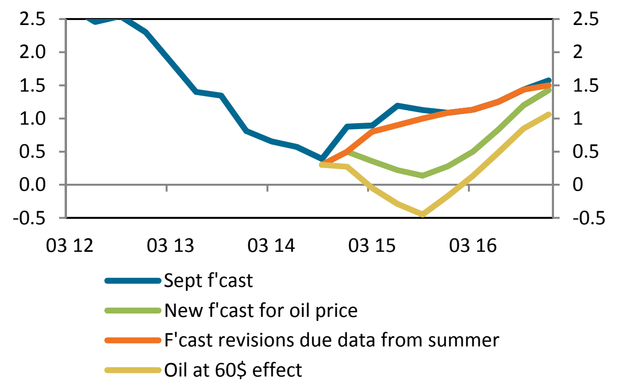
Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 2 – Percentage of goods showing negative price changes at its highest



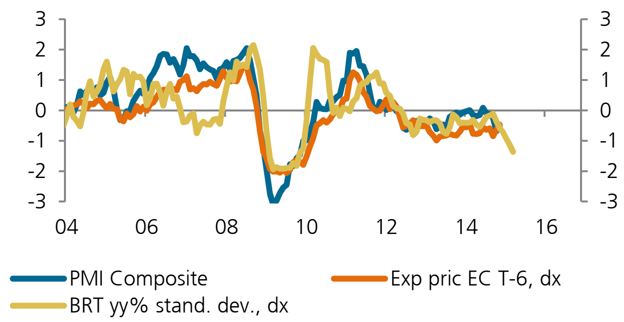
Source: Eurostat and Intesa Sanpaolo elaborations

Fig. 3 – Based on updated oil price forecasts, inflation would return to 1.3% at the end of 2016. A price of USD 60 per barrel would keep inflation at 1.0% at the end of 2016



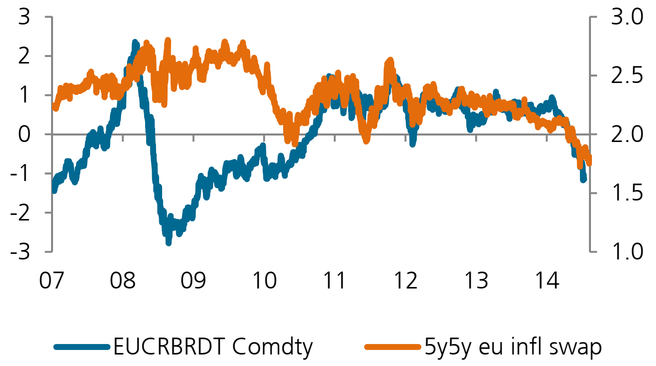
Source: Eurostat and Intesa Sanpaolo simulations with Oxford Economic forecasting

Fig. 4 – A sharp decline in oil prices (> 1 st. dev.) tends to influence price expectations as derived from business surveys…



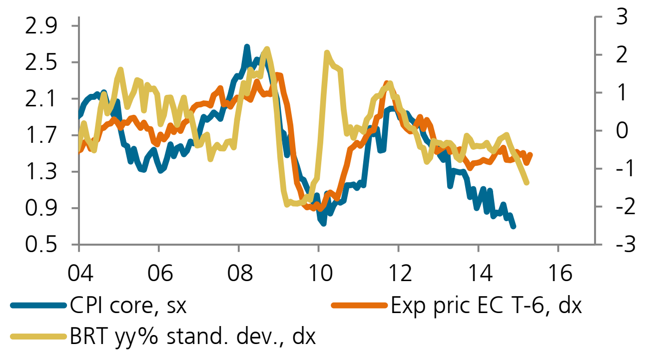
Source: Eurostat and Intesa Sanpaolo simulations with Oxford Economic forecasting

Fig. 5 – …and by the market



Source: Bloomberg and Intesa Sanpaolo elaborations

Fig. 6 – Core inflation influenced by the trend of price expectations



Source: Eurostat; Bloomberg and Intesa Sanpaolo elaborations

QE on government bonds is the ECB's only option

Anna Maria Grimaldi

The ECB has exhausted all the measures available to counter the fall in medium-term inflation expectations and halt the rise of real rates in the Euro zone. In line with our March 2014 expectations, the ECB has 1) cut the refi rate to zero; 2) brought the deposit rate into negative territory; 3) announced new long-term refinancing operations (TLTROs), conditional upon the supply of new loans to households and companies; 4) launched a new covered bonds purchase programme (CBPP3) in October and an ABS purchases programme at the end of November. But despite these measures, Euro zone growth and inflation continue to surprise to the downside.

The ECB's intention is to bring its balance sheet back to the 2012's peak level. But with the measures in place it is mission impossible

The ECB with the December introductory statement stressed that it now expects that the measures introduced in June and September will have a sizeable impact on the ECB balance sheet, "which is intended to move" towards the dimensions it had at the beginning of 2012. Draghi stressed that "intended" means somewhere in between an expectation and a target. We estimate, under very optimistic assumptions, that with the measures announced in June and September the ECB may at best a balance sheet expansion of 450 billion euros.

Table 1 – One-trillion euro expansion: realistic expectation or "mission impossible"? An assessment based on existing measures

	14-nov-14	As % of assets	End 2016	As % of assets
Expected change in balance sheet at the end of 2016 based on existing measures			454	
Total assets	2028		2482	
Total non-standard measures	567	29	1021	34
Net liquidity creation through LTROs			195	
LTROs	368	20	563	13
LTROs in 2012	285		0	
TLTRO I	83		83	
TLTRO2 ISP frcst			180	
Mar 15-Jun 16 TLTROs ISP frcst:+ 50Bn at each auction			300	
Net liquidity creation through asset purchases			259	
Portfolio assets from purchase programmes	199	10	458	21
SMP *	144		29	
CBPP1*	29		6	
CBPP2*	13		3	
CBPP3 ISP frcst: +2Bn on avg. per week for 2 years	12		212	
ABS ISP frcst: +2Bn on avg. per week for 2 years	0		208	

Note: our assumption is that 80% of the SMP portfolio and CBPP1 and CBPP2 will reach maturity by the end of 2016. February 2013, when the ECB disclosed the breakdown of government securities purchased under the SMP, the average residual life of the portfolio was indicated at 4.5 years. Source: ECB and ISP forecasts

The decision to pull the trigger will depend on fresh new info on the business cycle and not only form the oil prices

Should data on growth and mostly on domestic demand surprise further on the downside between now and February, the ECB would be left with not man other options but sovereign QE. In December, the ECB cut significantly its GDP growth projections to 0.8% in 2014, 1.0% in 2015 and 1.5% in 2016, from 0.9%, 1,6% and 1,9% in September. The estimate for 2015 inflation came down to 0,7% from a previous 0,9% in 2016 and the estimate for 2016 was cut by only 0,1 to 1,4 on average in 2016 and at year end. The impact of the recent further drop in oil prices on growth and inflation is not included in the December staff's projections, as the cutoff date was in mid-November. The technical assumptions are for the oil price is 88.5 $ September a barrel in 2015 -16, compared to 105$ and 102.7$ in and 1.25 for the EUR from 1.34 in September. Draghi highlighted that the impact of the lower oil price (-16%) was in the order of 0,4pp on inflation in 2015 and 0,1pp in 2016. Thus, if the oil price was to be confirmed at current levels, the ECB will cut inflation in March to close to 0.0% in 2015 and to 1.0 -1,1% in 2016. The ECB will need to assess both the direct and indirect impact of the lower oil prices on inflation and GDP growth in the coming months. Draghi clearly stated that the impact on growth is positive but he stressed that *the ECB will not tolerate significant deviations of inflation from the ECB's target to the extent that if this feeds into medium term inflation expectations, it would, at the zero bound, lead to a tantamount increase in real interest rates*. We think that at these low levels of inflation and ample output gap the ECB will weigh more the negative impact of the oil shock on inflation than the positive effect on growth.

Ultimately the decision on whether to act or not will depend on the fresh news on the business cycle and whether there are further negative surprises from the data in the coming months.

The decision may be taken with a majority and not by unanimity

Draghi stressed that "*QE is not illegal, but not pursuing the ECB mandate, with all possible measures, would be illegal*". Draghi also made clear is that he is working towards a consensus but that the decision to expand the purchases of assets to govies, if needed, would be taken also with a majority, which he should be able to secure. In the meanwhile the ECB is stepping up preparatory work for QE and discussed several options of asset purchases.

Regarding the likely timing of the announcement, there were rumors, soon after the meeting, that the ECB could pre – announce a package already in January. We think March is more likely as the ECB will want to reassess its growth and inflation forecasts with more than a couple of data points. In addition, Constancio repeated there are implementation difficulties due to the fact that there is no single bond to buy.

The ECB will likely buy govies jointly with corporate and/or supranational bonds, in order to limit the purchases of sovereigns 300-350 billion euros (see tab. 3 and 4)

In our view, if the ECB extends asset purchases, it would also buy corporate bonds, which according to ECB data amounted to 900 billion euros in July 2014, as well as bonds issued by the EFSF/ESM (194 billion euros) and the EIB (441 billion euros). These would be the amounts of government securities to purchase in order to achieve the desired expansion of the balance sheet. Assuming the ECB purchases 10% of each asset class, for instance, between April 2015 and June 2016 it could buy:

1) 70 billion euros in corporate bonds (10% of the total outstanding);

2) 20 billion euros in EFSF securities, and 40 billion in EIB bonds;

In this scenario, the targeted one-trillion euro expansion of the balance sheet would require around 300 – 350 billion euros in government bond purchases. As most of the securities held in the SMP portfolio will reach maturity by the end of 2016, government bond purchases amounting to around that sum would keep the weight of sovereign bonds on total assets limited. Should the ECB intend to keep the share of government bonds unchanged, to smooth the decision-making process within the Council, it would have to act very aggressively on other bond classes, in order to reduce government bond purchases to around 210 billion euros. However, in this case the percentages of EIB, EFSF, and ESM bonds to purchase would become very high, and possibly implausible.

Tab. 2 – Assets the ECB may include in its shopping list for March 2015

Covered Bonds (bln euros) 2014	483
Issued in euros	1741
Issued in euros & regulated in the EA	690
70% ISIN	483
Supranational	443
EFSF bonds	194
70% ISIN	135
European Investment Bank Bonds	440
70% ISIN	308
Government bonds (excluding Bills)	5789

Source: National central banks and Intesa Sanpaolo elaborations

Tab. 3 – Possible balance sheet expansion at the end of 2016 in billion euros, with new measures in place

Unconventional measures announced between June & Sept.	450
Corporate bonds	70
EFSF bonds	20
European Investment Bank Bonds	40
Government bonds (excluding Bills)	350
New measure which could be announced in 2015	480
Total unconventional measures	930

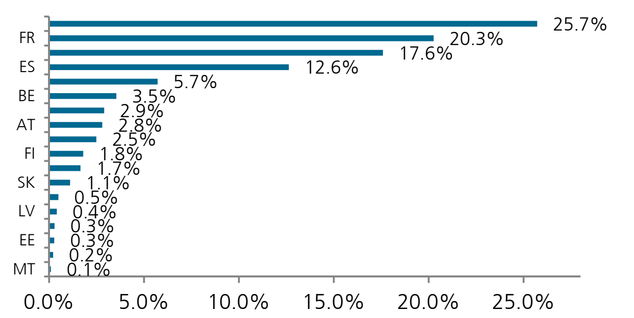
Source: Bloomberg and Intesa Sanpaolo elaborations

Furthermore, Constancio said that if the ECB were to purchase government bonds, it would do so based on the stakes held by each country in the ECB capital: a rule of this kind would play to the advantage of countries with a large interest in the ECB capital, combined with low debt and better ratings, therefore making the composition of the portfolio less expose to risk than the SMP portfolio. Whether or not the markets will deem the measure appropriate is another story.

Presumably, however, allocation based on ECB capital keys would be subject to adjustments to avoid severely draining liquidity on the smaller markets and to contain distortive effects. Assuming a programme worth 200 billion euros with no adjustment measures, for instance, the ECB would purchase only 4% of Italy's outstanding debt, and 5% of Spain's, whereas it should unreasonable percentages of the debt of small states such as Estonia, Latvia, Cyprus, and Luxembourg (v. fig. 2).

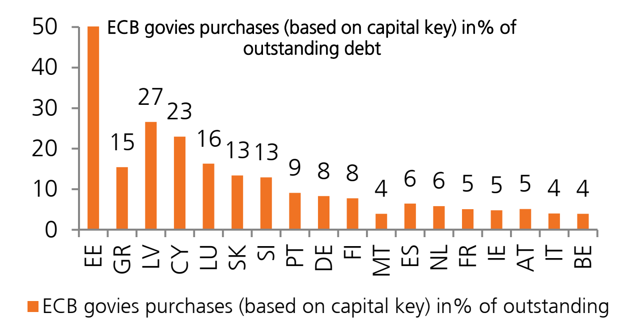
Another issue is whether or not the markets will consider sufficient a package of measures providing for government bond purchases for 300 - 350 billion euros. Reasonably, the ECB will want to indicate that the pace of the purchases may be stepped up if needed, i.e. based on the evolution of inflation expectations and of the macroeconomic scenario. The ECB may indicate that the program will run for at least two years and that it will communicate ex post how much it has bought of each asset class, over the previous week, as it does for the CBPP3 and the ABSPP and as it was the case for the SMP.

Fig. 1 – Countries' keys in ECB capital



Source: ECB and Intesa Sanpaolo elaborations

Fig. 2– Sovereign QE for 350 billion euros based on ECB capital keys



Source: ECB, Bloomberg and Intesa Sanpaolo elaborations. Note Estonia is out of scale as purchases based on capital keys for 350 billion euros would

Focus: towards a rotation of voting rights at the euro tower

Anna Maria Grimaldi

From January 2015, the frequency of ECB Governing Council monetary policy meetings will change to six-week cycle. In addition, the accession of Lithuania will trigger a system under which NCB Governors will take turns holding voting rights within the Council. Euro area countries are ranked according to the size of their economies and their financial sectors. The Governors from the first main countries Germany, France, Italy, Spain and the Netherlands – share four voting rights. The President of the Bundesbank will vote monetary policy decisions meeting in 2015 with the exception of the October meeting.

With Lithuania's accession to the monetary union at the start of 2015, the number of euro area member states will reach 18. The size of the ECB Governing Council will also increase, and the voting system will change. To date, each member of the Council has had both a voice and a vote at the Council's monthly meetings. Starting next January, a rotation system will be introduced. Member States will be divided into groups.

The rotation system of voting rights was approved in 2002, and should have been launched in 2008 when the size of the euro system reached 16 Member States. However, in 2008 the Council decided to postpone the introduction of the new system until the number of Member States reached 18. The Treaties provide for no possibility of further postponing the change in regime.

The total number of votes is set at 21, of which 6 for the members of the Executive Committee, and 15 for Member States.

The six members of the ECB Executive Committee, i.e. President Draghi, Vice Presidente Constancio, Chief Economist Praet, Coeure, Sabine Lautenschlaerger, and Mersch, will retain right to one vote per member, also with the new system.

For the other Member States, the new system provides for a division into groups based on the relative weight of the single economies on the euro area total, and on the development of their financial sectors (relative weight of the banking system of the individual country on the euro system total). Transition to the new voting rights rotation system will be made in two stages:

Stage 1: up to 22 Member States, there will be two sub-groups totaling 15 votes

As long as Member States number between 18 and 21, two groups will be formed.

The first group will include the governors of the central banks of the five "largest" countries, currently Germany, France, Italy, Spain, and Holland, which will share four voting rights.

The other countries (14 once Lithuania will have entered) will form the second group, and share 11 voting rights.

Voting rights will be rotated on a monthly basis in both the first and second groups. The governors of the central banks of the countries that do not vote in the month, will in any case take part in the meetings and in the discussions within the Council.

Decisions affecting ECB capital and reserve assets, and/or the distribution of profits, will in any case be taken by means of a weighted vote, according to each voter's capital share in the European Central Bank.

Phase 2: above 22 member countries 3 groups will be formed

Once euro area member countries will be 22 or more the ECB regulation foresees that the countries will be divided in 3 groups.

Member of the 1st group will continue to share 4 voting rights out of 5 members

Members of the 2nd group will share only 8 voting right as they will have to give 3 voting rights to the smaller countries ranked in the 3rd group.

On July 3 2014, the ECB Governing Council decided that meetings dedicated to monetary policy will be held every six weeks instead of once in a month starting in January 2015. As a consequence, the maintenance periods will be extended to about six weeks as well. The new calendar aligns the start of maintenance periods with possible implementation of monetary policy decisions. At the same time the ECB starting from January 2015 will publish regular accounts of the Governing Council's monetary policy meetings.

On July 16th the ECB GC published indicative calendar for Governing Council Meetings and reserve maintenance periods in 2015. In the table below we have highlighted in orange the date of monetary policy decisions meeting and who votes at each of those meetings.

Table 1 - Who votes when in 2015?

Governing Council Members - Group 1		22 Jan	Feb	5 Mar	15 Apr	May	3 Jun	16 Jul	Aug	3 Sept	22 Oct	Nov	3 Dec
President, Deutsche Bundesbank	Jens Weidmann	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓
Governor, Banco de España	Luis María Linde	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓
Governor, Banque de France	Christian Noyer	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗
Governor, Banca d'Italia	Ignazio Visco	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓
President, De Nederlandsche Bank	Klaas Knot	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓
Governing Council Members - Group 2													
Governor, Nationale Bank van België/Banque Nationale de Belgique	Luc Coene	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗
Governor, Eesti Pank	Ardo Hansson	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Governor, Central Bank of Ireland	Patrick Honohan	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Governor, Bank of Greece	Yannis Stournaras	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓
Governor, Central Bank of Cyprus	Chrystalla Georghadji	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓
Chairman of the Board, Lietuvos bankas	Vitas Vasiliauskas	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓
Governor, Latvijas Banka	Ilmārs Rimšēvičs	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓
Governor, Banque centrale du Luxembourg	Gaston Reinesch	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓
Governor, Central Bank of Malta	Josef Bonnici	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓
Governor, Oesterreichische Nationalbank	Ewald Nowotny	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓
Governor, Banco de Portugal	Carlos Costa	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓
Governor, Banka Slovenije	Boštjan Jazbec	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓
Governor, Národná banka Slovenska	Jozef Makúch	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗
Governor, Suomen Pankki - Finlands Bank	Erkki Liikanen	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗

Note: Monetary policy decision meetings are highlighted in orange Source: ECB

Who sits on the ECB Executive Board and for how long?

Source: ECB

Germany: 2015, Adagio

Anna Maria Grimaldi

GDP growth surprised one the downside in 2014, more than in other countries. After a dazzling start to the year (+0.8% qoq), partly owing to the exceptionally mild weather[4], GDP contracted by 0.1% qoq in 2Q, and grew by an anaemic 0.1% qoq in the summer. Economic surveys suggest that the period of weakness, particularly in the manufacturing segment, could continue around the turn of the year. The IFO fell continuously from June to October, before recovering slightly in November to 104.7, still below the long-term average, and to levels significantly lower than in the previous six months (109). The composite PMI stood on average at 52.3 in the 4th quarter, from 54.5 in the previous six months. The German economy was affected more than expected by the Russia-Ukraine crisis from the summer onwards, both through the export channel (with a drop in exports towards Russia of more than 20%) and indirectly, as political uncertainty likely contributed to the decline in investment over the summer quarter (-1.4% qoq). In light of recent cyclical developments, we would cut our 2015 GDP growth forecast from 1.5% to 1.1%. However, the sharp drop in oil price forecasts (-28% in 2015 and -23% in 2016) will support growth from the spring, and should add 0.2% to GDP in 2015-2016. We have therefore revised down our growth forecast by two tenths of a point to 1.3%, from 1.5% previously. Germany will therefore grow at just above potential (1.1% for the Bundesbank[5]). We expect growth to pick up to 1.9% in 2016, assuming an upturn in global demand and in particular in the rest of the Euro zone (Germany's most important trading partner, absorbing 28% of exports).

Domestic demand should also support growth, and we expect it to grow by 1.4%, thanks to an upturn in consumer spending (+1.6%, from 1.2% previously), and the recovery, albeit still weak compared with previous cycles, of corporate investment. Foreign trade is only expected to offer a moderately positive contribution (+0.2%), since imports should pick up by 5.3% (from 3.6% previously), driven by consumer spending and investment acceleration and considered the high import content of exports and industrial output. Trade flows are expected to register an upturn at the beginning of the year, according to indications from the global PMI excluding the Euro zone, and will be sustained over the year by the depreciation of the euro. After stagnating in 2Q, consumer spending grew by 0.7% qoq over the summer, and retail sales figures only point to a slight slowdown at year-end. In 2015, consumer spending will be supported by growth in real disposable income of around 2.0% courtesy of sustained growth in nominal wages of 2.6%, (even if slowing from the 3.3% in the opening months of 2014, associated with the negotiated pay rise at the beginning of the year). The IFO index points to a drop in hiring intentions, and a probable slight fall in employment at the beginning of 2015, so overall growth in the number of people employed could slow from 0.8% this year to 0.4% next year. Unemployment fell to 6.6% in October, but we do not expect significant movements in 2015, since the unemployment rate is already at its structural level. We may see a small rise in unemployment in the first half of 2015 following the introduction of the minimum wage[6]. The savings rate is expected to rise marginally from 9.3% in 3Q to 9.6% at end-2015.

… 1.7% growth in consumer spending in 2015, sustained by the trend in disposable income

[4] The Bundesbank estimates that 0.3% qoq of GDP growth in the first quarter was due to the exceptionally mild weather.

[5]The Bundesbank recently revised its potential growth estimate to 1.1%, from 1.4% previously, to take into account the cut in the retirement age on the workforce, particularly on participation. See *Outlook for the German economy – macroeconomic projections for 2015 and 2016,* pp. 12-14.

[6] According to a CESIFO study, the minimum wage could destroy around 900,000 jobs, particularly those known as "mini-jobs".

The period of expansion in residential construction could come to a halt at the end of 2014 / beginning of 2015, following the recovery in the summer, according to indications from orders and output figures. However, the outlook for the sector remains positive: building permits are still trending upwards, sustained by immigration and highly favorable financial conditions. In 2015, we will see average growth of investment in construction of 0.4%, from 3.1% in 2014, partly offset by an unfavorable base effect and a weak start to the year. Investment in machinery is expected to remain weak around the turn of the year, according to indications from order and output figures. In addition, the greater utilization of production capacity slowed in the middle quarters of the year, although remains in line with the historical average. The fall in real medium- to long-term rates should be at an end, but uncertainty could continue to rein this in. We expect a modest upturn to 3.7% yoy at end-2015.

Slowdown in residential construction likely

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

Inflation fell by more than expected in 2014, to 0.5% in November, from 1.6% a year previously, owing to the smaller contribution from the energy component, as well as the slowdown in service prices from 1.1% the previous year to 0.1%. German inflation could continue to fall, slowed by the energy component and reaching a low of -0.1% in February 2015. Revisions to our oil price expectations bring down the average 2015 figure from 1.1% to 0.7%.

Public finances - We confirm our forecast of a balanced budget in 2014 and 2015. Fiscal policy is expected to be neutral in both 2015 and 2016, despite there is ample room for manoeuvre to ease taxes on income and profits and stimulate domestic demand. Public finances will continue to benefit, over the forecast horizon, from a fall in interest expenditure, which will offset the increase in spending on pensions following the recent reform. Public debt is expected to fall to 72.2% next year.

Neutral fiscal policy

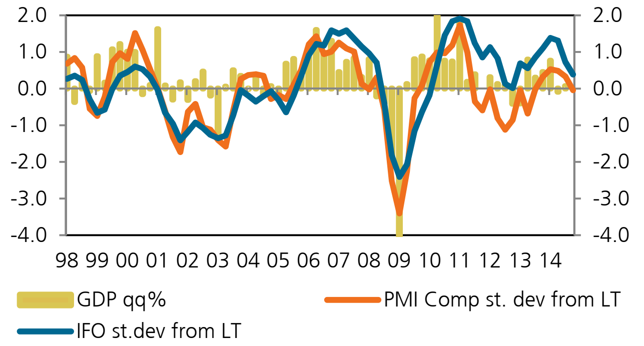
The risks to the outlook are still to the downside, and could result from either ongoing geopolitical uncertainty, with a negative impact on the trend in exports, or the failure of the Euro zone to stage a more pronounced economic recovery. Another short-term risk factor is the failure of domestic demand to take off. Despite solid fundamentals and the stimulus effect of the fall in oil prices, we cannot rule out that households and companies will remain cautious in their spending plans.

Macro Forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (1995 prices, y/y)	0.2	1.4	1.3	2.3	1.4	1.2	0.8	0.3	0.8	1.4	2.0
- q/q change				0.8	-0.1	0.1	0.1	0.2	0.4	0.6	0.7
Private consumption	0.9	1.1	1.4	0.5	0.1	0.7	0.2	0.2	0.3	0.5	0.4
Fixed investment	-0.5	2.9	0.7	2.8	-1.8	-0.9	0.2	0.4	0.4	0.9	0.8
Government consumption	0.7	1.2	1.4	0.2	0.4	0.6	0.3	0.3	0.3	0.3	0.3
Export	1.7	4.1	4.7	-0.2	1.2	1.9	1.6	0.4	1.1	1.4	1.0
Import	3.2	3.8	5.4	-0.1	1.1	1.7	1.9	1.4	1.2	0.0	1.9
Stockbuilding (% contrib. to GDP)	0.1	-0.3	0.0	-0.1	0.0	-0.5	-0.1	0.3	0.1	-0.5	0.5
Current account (% of GDP)	6.9	7.5	8.4	7.2	7.1	7.6	8.2	8.2	8.4	8.9	8.5
Deficit (% of GDP)	0.1	0.2	0.3								
Debt (% of GDP)	76.9	74.5	72.1								
CPI (y/y)	1.5	0.9	0.8	1.2	1.1	0.8	0.7	0.6	0.8	0.9	1.0
Industrial production (y/y)	0.1	1.2	1.5	1.1	-1.1	-0.3	0.2	0.6	1.0	1.0	0.1
Unemployment (%)	6.9	6.7	6.9	6.8	6.7	6.7	6.7	6.8	6.9	7.0	7.0
10-year yield	1.61	1.25	1.00	1.72	1.42	1.06	0.81	0.85	0.94	1.02	1.20
Effective exch.rate (2005=100)	99.6	100.0	98.3	100.8	100.5	99.7	99.0	98.3	97.7	98.2	99.1

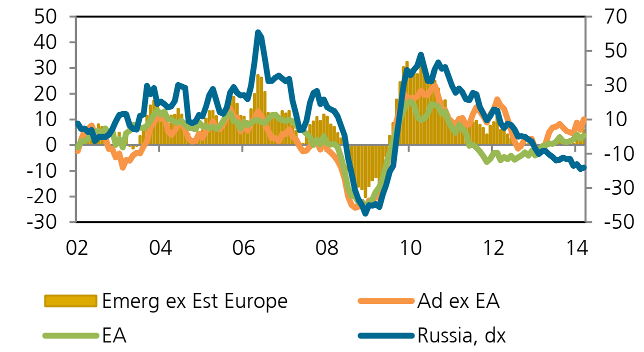
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

IFO and PMI confidence surveys are consistent with stagnating GDP in Germany over the turn of the year



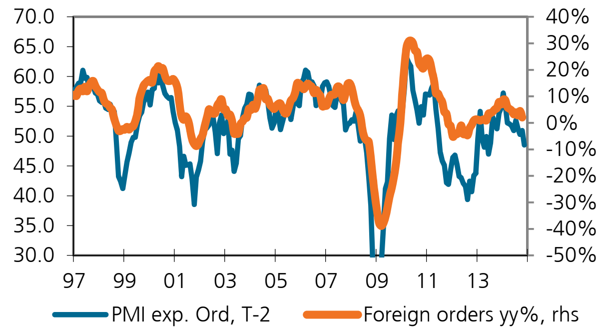
Source: Intesa Sanpaolo chart from FSO data

The slowdown in Russia has had a fairly significant effect on cyclical trends in Germany



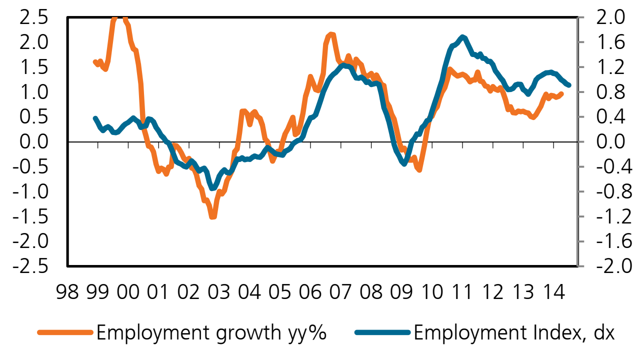
Source: Intesa Sanpaolo chart from Markit, IFO and FSO data

The manufacturing PMI points to a further drop in foreign demand around the turn of the year



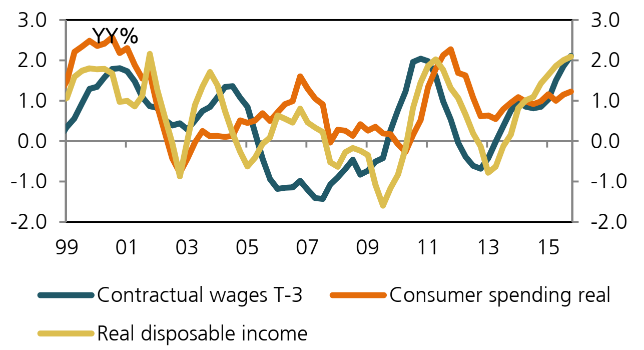
Source: Intesa Sanpaolo chart from Markit and FSO data

The employment index suggests a slowdown in job creation going forward



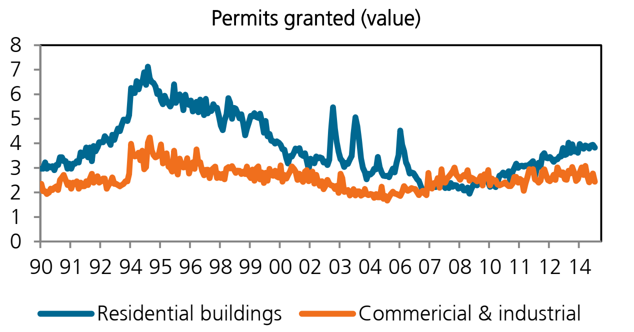
Source: Intesa Sanpaolo chart from IFO and FSO data

Nominal wages to grow by 27% in 2015, with inflation at 0.7% and disposable income growth of around 2%



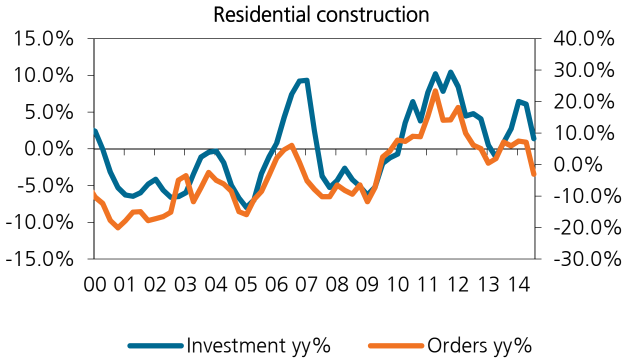
Source: Intesa Sanpaolo chart from Markit and FSO data

Permits still trending upwards, suggesting that the slowdown in residential construction could be a temporary phenomenon



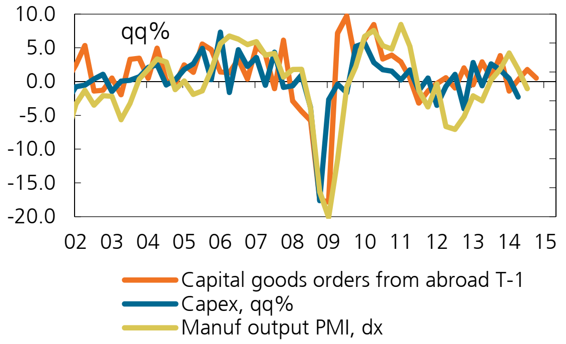
Source: Intesa Sanpaolo chart from FSO data

Residential construction - probable slowdown under way according to data on orders on …



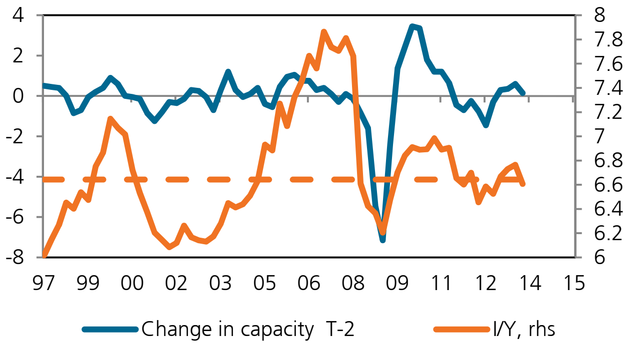
Source: Intesa Sanpaolo chart from FSO data

Orders and PMI do not point to a turnaround in investment in machinery at the turn of the year



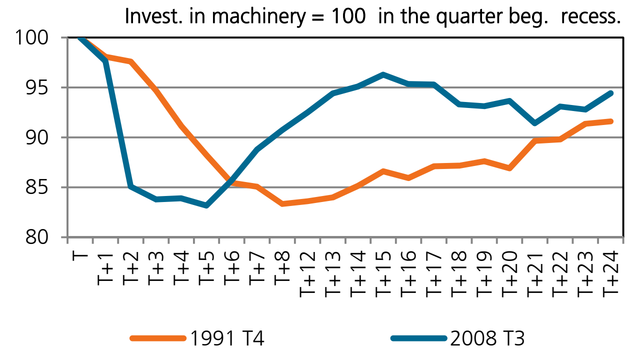
Source: Intesa Sanpaolo chart from FSO data

The utilisation of production capacity seems to have reversed



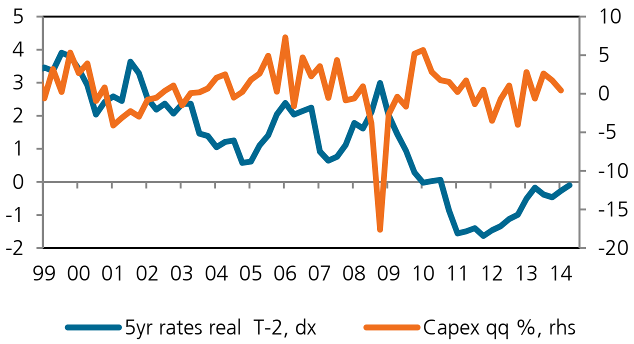
Source: Intesa Sanpaolo chart from FSO and European Commission data

Recessions compared in investment in machinery This cycle is not particularly unusual



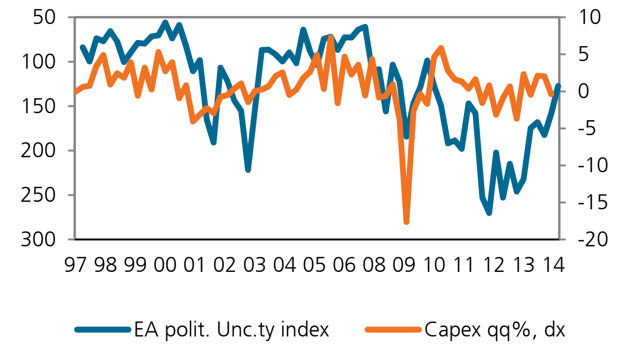
Source: Intesa Sanpaolo chart from Deutsche Bundesbank and FSO data

Financial conditions remain extremely favourable



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

Uncertainty could weigh on corporate investment



Source: Intesa Sanpaolo chart from FSO data

France: structural problems and crisis of confidence still hold the economy back

Luca Mezzomo

- As 2014 comes to a close, the French economy is in a diminished state, with its prospects for 2015 far from brilliant. While GDP growth was better than expected in the third quarter (+0.3% qoq and 0.4% yoy), confidence indices, which worsened between April and August, have only partly regained lost ground. Levels on the PMI (below 50 for both manufacturing and services) and on the Insee and Banque de France confidence indices continue to indicate a scenario characterised by stagnation or marginal growth. As for the building industry, confidence remains at very low levels, to the point of being worse than in the first half of 2014, and work on residential building sector is in decline, albeit more slowly than in the spring. The economic is being kept going by private and public consumption, while the growth in imports more than outweighs declining exports.

- Turning to the factors driving the outlook for 2015, France will benefit from a significant impulse (0.3-0.4% of GDP) resulting from reduced oil prices and accommodative financial conditions. Evidence of the latter is to be found in the marginal relaxation of lending conditions applied to families and businesses, while net lending flow data show an improvement in lending to businesses (see fig. 12). The change in the structural balance of the budget is estimated at a marginal 0.1% of GDP, but the fiscal stance is likely to put the brakes on domestic demand if France agrees to make the total correction of 0.8% of GDP that was requested by the Eurogroup on 8 December. In any case, the dynamic of public consumption over the past three months appears to be unsustainable, and the growth of domestic demand would be affected were it to return to normal.

- On the private demand front, consumption by families, which has enjoyed marginal growth in 2014, is expected to gain in strength on the back of an increase in real income and a slight decline in the propensity to save. The outlook for capex spending remains negative: while the contraction in investment in machinery is likely to end in 2015, spending on construction will continue to fall. French businesses are still generally being very cautious where demand prospects are concerned, so it is less likely that the increased profit margins resulting from falling energy prices will translate into more substantial investments.

- Outside France, the stronger economic recovery elsewhere in the Eurozone is set to make a positive contribution in 2015. Export performance has improved over recent months, although the marked elasticity of demand for imports when set against overall demand has up to now hampered any improvement in the considerable (EUR 4.6 billion a month) commercial deficit. Trends in external trade flows depend on both structural and economic factors, and these have been barely dented by the Hollande government's tinkering with the labour tax wedge.

- To sum up, we predict an increase in GDP growth from 2014's figure of 0.4% to 0.7% in 2015. These estimates are in line with the European Commission's forecasts and the consensus average. While growth will send employment rates up, it will not be enough to reduce unemployment, which is likely to remain at its present levels in 2015.

- Inflation has steadily fallen from 1.1% in February to 0.4-0.5% in September/October. The collapse in oil prices is now starting to have an effect, bringing about an overall fall of 0.5% in the energy component of the general prices index. The overall impact will in fact be greater, by reason of the fall in both production costs and transport charges. Inflation could fall to a low in the first quarter of 2015, possibly even briefly hitting zero, before returning to near 0.7% by the end of the year. Underlying inflation should again slow down to an annual average of 0.6% in 2015 (compared with 2014's figure of 0.8%), with risks tilted to the downside especially in the first half.

- France's public deficit again increased in 2014, to 4.4% of GDP, three tenths of a percentage point up on 2013. In November, the European Commission said that the deficit could increase further over the coming years, to 4.5% and 5.7% of GDP in 2015 and 2016 respectively, and that it expected a rapid increase in the debt/GDP ratio, to as much as 99.8% in 2016. The deterioration would be attributable solely to cyclical factors in 2015, while 2016 would see a noticeable structural downturn (-0.5%), failing any discretionary – but as yet unspecified – measures provided for by the French financial programme. On 27 October, the government announced measures to add a structural 0.2%, which, together with the sterilisation of the effects of the revision of the country's accounts, took the total correction to 0.3-0.4%. On 8 December, the Eurogroup called on France to take corrective structural action to correct this trend, but without going so far as to reject the 2015 budget. The situation is made thorny by the fact that France was actually meant to have corrected the excessive deficit by 2015. However, the Socialist government is in serious trouble, following the European election débacle in May and a series of major electoral setbacks at the local level. The presidential elections are still a long way off (2017), but this makes it no easier for the government to accept the need for the restructuring of financial policy as a prelude to economic recovery.

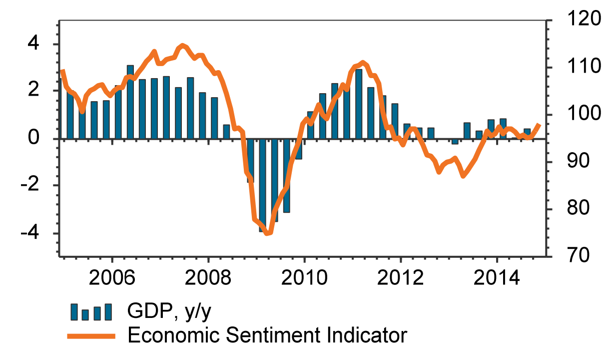
- Political action will therefore continue to focus on **structural reforms**. The National Assembly, which recently approved a thorough and extensive reform of local authorities, continues to push for the reduction of fiscal pressure on labour. There are no plans for further interference in the pensions system after the 2013 reform, which reduced, but did not do away with, the system's forecast deficit in 2020, and the European Commission has expressed regret at the failure to set up mechanisms to ensure the sustainability of the healthcare system. An economic reform bill was presented in December, but we doubt that it will have a significant impact on the economy in 2015, even if approved quickly by the parliament.

Macro Forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	0.4	0.4	0.7	0.8	0.0	0.4	0.2	0.3	0.7	0.7	1.1
- q/q change				0.0	-0.1	0.3	0.0	0.1	0.2	0.3	0.4
Private consumption	0.3	0.4	1.2	-0.4	0.3	0.2	0.2	0.2	0.3	0.4	0.5
Fixed investment	-0.8	-1.7	0.3	-0.7	-0.8	-0.6	-0.3	0.2	0.6	0.6	0.6
Government consumption	2.0	2.0	0.9	0.4	0.5	0.8	0.3	0.1	0.0	0.1	0.1
Export	2.4	2.0	2.5	0.5	-0.1	0.5	0.4	0.6	0.8	0.9	1.0
Import	1.9	2.9	2.8	0.7	0.3	1.1	0.4	0.6	0.8	0.8	1.0
Stockbuilding (% contrib. to GDP)	-0.2	0.3	-0.1	0.4	-0.1	0.3	-0.1	0.0	-0.1	-0.1	0.0
Current account (% of GDP)	-1.3	-1.2	-1.1	-0.9	-1.4	-1.3	-1.1	-1.1	-1.1	-1.1	-1.0
Deficit (% of GDP)	-4.1	-4.6	-5.1								
Debt (% of GDP)	92.2	95.7	98.9								
CPI (y/y)	0.9	0.5	0.3	0.7	0.6	0.4	0.3	0.0	0.2	0.3	0.6
Industrial production	-0.6	-0.8	1.0	-0.5	-0.5	0.5	-0.1	0.2	0.3	0.6	0.7
Unemployment (%)	9.9	9.7	9.8	9.7	9.7	9.8	9.8	9.9	9.8	9.8	9.7
Effective exch.rate (1990=100)	99.7	99.6	97.2	100.7	100.3	99.3	98.0	97.1	96.5	97.1	98.0

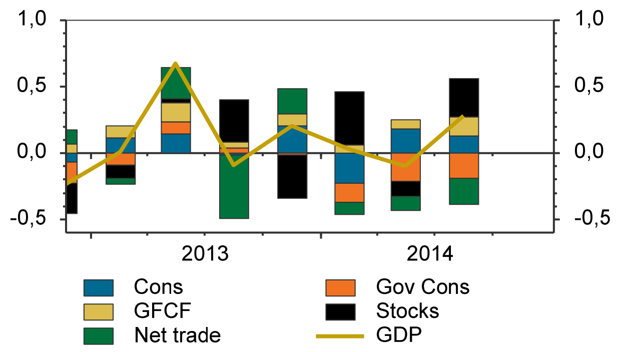
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Economic Sentiment and GDP growth



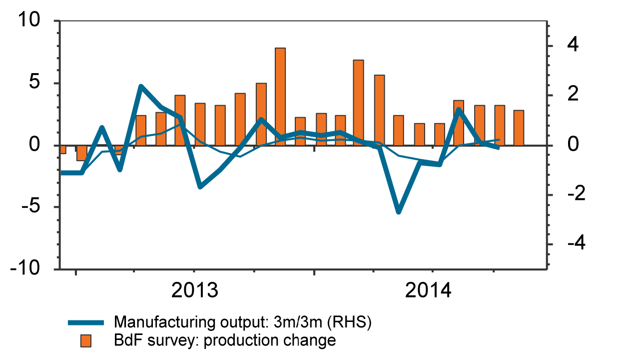
Source: Thomson Reuters-Datastream

Fig. 2 – Contribution to GDP growth



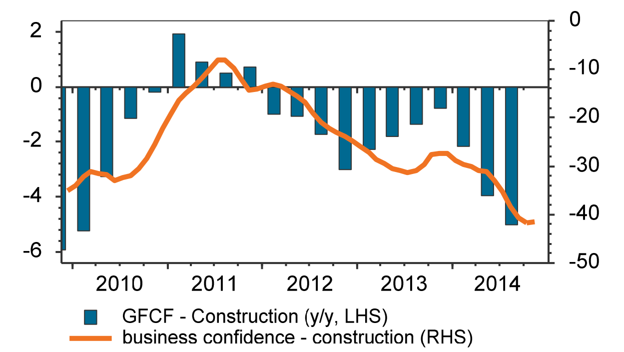
Source: Thomson Reuters-Datastream

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



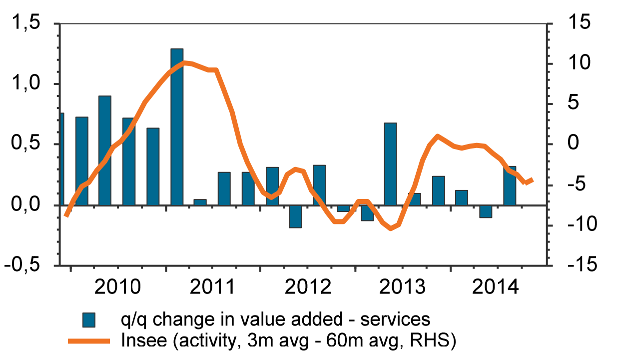
Source: Thomson Reuters-Datastream

Fig. 4 – Investment in construction and business confidence



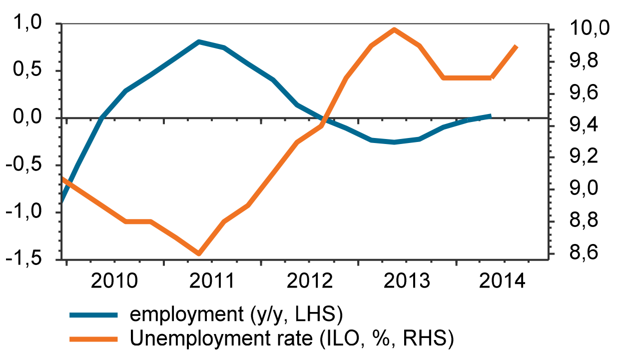
Source: Thomson Reuters-Datastream

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



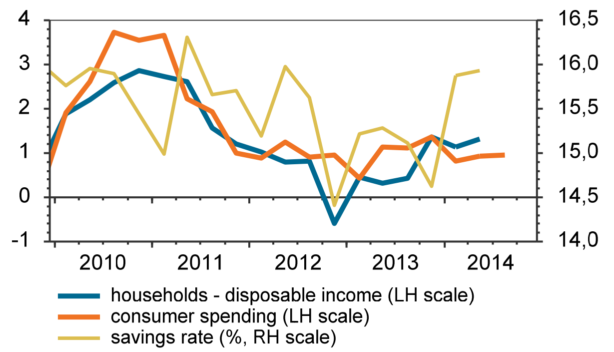
Source: Thomson Reuters-Datastream

Fig. 6 – Employment and unemployment



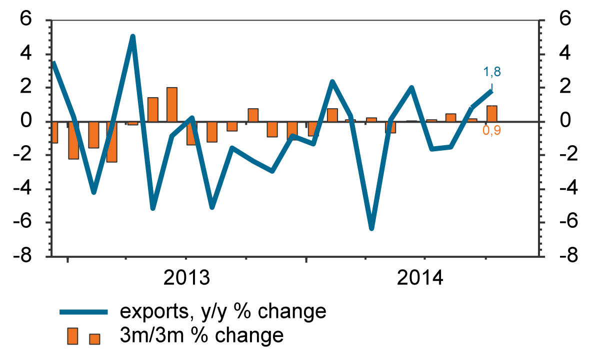
Source: Thomson Reuters-Datastream

Fig. 7 – Income, consumption and propensity to save



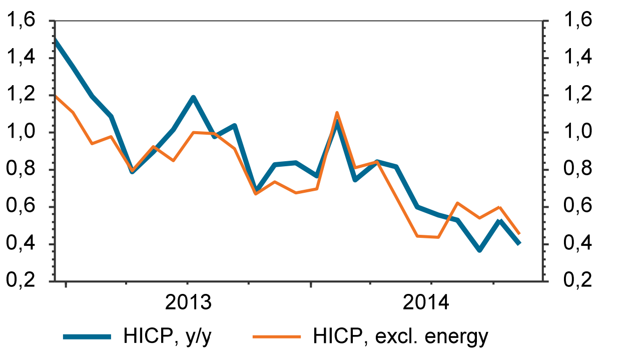
Source: Thomson Reuters-Datastream

Fig. 8 – French export trend



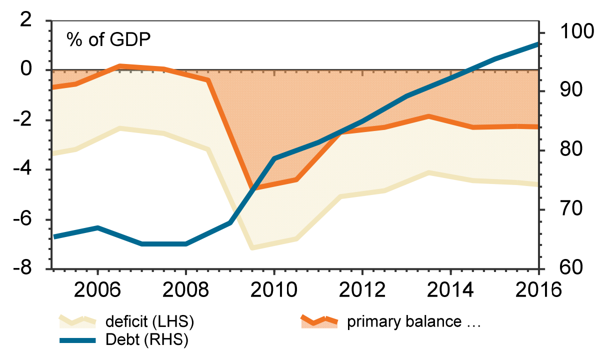
Source: Thomson Reuters-Datastream

Fig. 9 – Consumer price growth



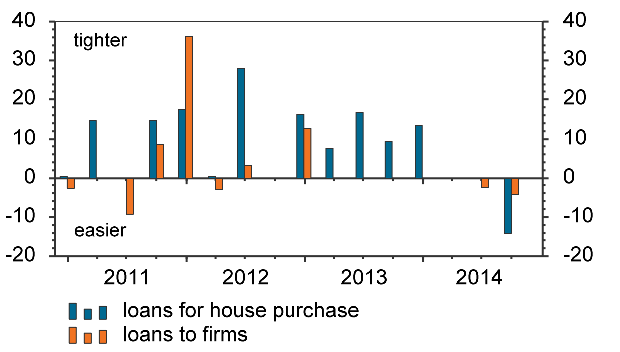
Source: Thomson Reuters-Datastream

Fig. 10 – Government Debt and deficit, with EC projections



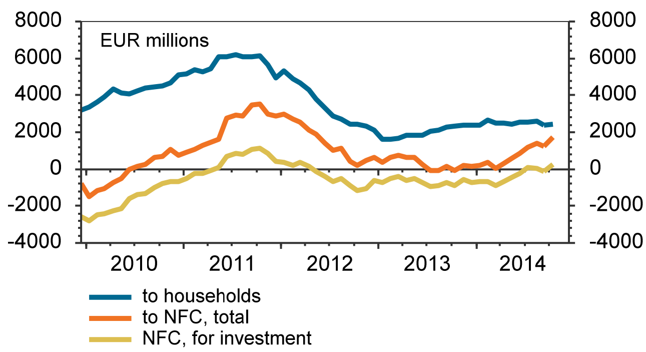
Source: Thomson Reuters-Datastream

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



Source: Thomson Reuters-Datastream

Fig. 12 – Net lending by banks (flow)



NB: 12-month moving average. Source: Thomson Reuters-Datastream

Italy: still waiting for the recovery

Paolo Mameli

- **We are downgrading our estimate of Italian GDP in 2015 by two-tenths of a percentage point** from +0.6% in our September outlook to +0.4%. The downgrade is entirely due to the knock-on effect of **2014 growth that was more disappointing than expected** (GDP fell by 0.4% rather 0.2% as previously estimated). Of the two-tenths of a percentage point downgrade in our estimate, half is due to the revision of the national accounting figures for 2013-2014 reported by ISTAT, and the other one-tenth of a point is due to a downgrade of our forecast for the current quarter. In 4Q 2014 we expected economic activity to return to positive territory, whereas now we think this will not now happen until early 2015 (in the best-case scenario).

- **We have kept our expected quarterly growth profile unchanged for next year,** with a return to slightly positive territory at the start of the year and a gradual strengthening of the recovery during the year. On the one hand, **recent trends in the economic data indicate downside risks** to this scenario, since the performance of both hard data and confidence indices is not yet consistent with a recovery, and indeed would have justified a downgrade of the expected profile for 2015. **On the other hand, however, a number of exogenous factors that occurred in recent months would indicate upside risks to the 2015 estimate**. Specifically, the new EUR/USD exchange rate and oil price profiles will have a positive effect of 0.3% *ceteris paribus* on Italian growth in 2015. This effect could be bigger in 2015 and also extend into 2016 if the recent fall in oil and commodities prices were to worsen: a simultaneous shock of 10% on the exchange rate and on brent crude would have a 0.5% effect on our estimates of average GDP growth after one year (this impact would, however, be almost completely wiped out in the following year).

- In addition to a weak currency and cheaper commodities, the other "potential" factor for recovery, - although we only expect it to make a modest contribution – is **support from economic policies:**

1. **the ECB has made its monetary policy even more accommodative**: after reducing its rates to zero in September, the Frankfurt-based institution embarked on a securities purchase programme, which at the moment affects covered bonds and ABSs, and there is a growing possibility (which we now estimate at over 50%) that in 1Q15 these purchases could be extended to include corporate bonds and/or government bonds. However, a) it is doubtful that the central bank will achieve its stated target of expanding the balance sheet to EUR 1,000Bn (we think it more likely that it will reach around EUR 350Bn), and b) it is by no means sure that the measures announced will be effective in "unblocking" the transition mechanism of monetary policy (yields on both government and corporate bonds are already very low but have not yet been reflected in a marked improvement in the cost and conditions of credit for companies);

2. **in 2015, as in 2014, fiscal policy will be slightly expansionary** thanks to tax cuts included in the 2015 Budget (-0.2% is the change in the cyclically-adjusted primary balance forecast for next year, after -0.3% this year). This is, however, only a modest easing after years of highly contractionary policy; we estimate a "theoretical" impact of two-tenths of a point on GDP, although uncertainty over future fiscal policy could halve the impact to +0.1%.

- This impact could be augmented by the effects of the structural reforms but, most importantly, by the continuing **repayment of public sector arrears**. This process was halted in the middle of 2014 but is likely to resume in the last few months of 2014; some EUR 40Bn in arrears could be paid by the end of 2014 (2.5% of GDP) and EUR 57Bn (3.5% of GDP) by mid-2015. In total, then, EUR 17Bn have been paid in 2013, EUR 24Bn could be paid in 2014 and EUR 17Bn in 2015. In the Bank of Italy's prudent assumption that additional resources for financing new investment came to 12% of the total (and that the remaining portion was split equally between the financing of working capital and precautionary provisions), the most cautious estimate would put the overall impact on the cycle at 0.7% (to be "spread" over the three-year period 2013-2015). The impact on 2015 would be 0.2%. However, this estimate is optimistic given that the uncertainty that seems to weigh on corporates' investment decisions could reduce the portion earmarked for capital spending; in our view, a more realistic estimate would be 0.1%.

- In 2015, **the recovery will once again be highly dependent on other countries.** In fact, net exports could add 0.3% to GDP, after 0.5% in 2014 (this would be the fifth year running in which foreign trade makes a positive contribution to the cycle). Exports are expected to accelerate to 3.3% (1.9% this year) with imports also picking up (+2.5% from +0.4%). As noted, export growth could be accentuated by the currency's movements: in our estimates, a 10% fall in the EUR/USD exchange rate compared with our base scenario would produce a positive effect of 1.5% on exports and 0.4% on GDP (taking account of the feedback effect between exports and imports). As in 2014, we expect foreign sales to be buoyant especially to the Angelosaxon countries, while the rest of the euro zone would not pick up much; we believe that some emerging countries, including eastern Europe and the Middle East, could again be penalised by geo-political tensions, and by lower demand due to the fall in commodities prices. In general, exports to the developed countries are likely to be more vigorous than those to developing countries, and exports to dollar currency areas livelier than those to other currency areas.

- As for domestic demand, **the modest recovery in consumer spending** - the only domestic component in positive territory in 2014 - is set to continue (0.3% in our estimates this year, expected to accelerate to 0.8% in 2015). Household spending, which started to grow again, albeit at a very modest pace (0.1% yoy), over a year ago now (3Q13), could be boosted by the recovery in real disposable income (which we estimate to increase by 0.6% in 2015 after seven years of contraction). **The stabilisation of the IRPEF (personal income tax) bonus** will be a help, although the uncertainty surrounding future fiscal pressure (see the safeguard clause relating to VAT and the risk that tax on homes will increase with the land registry reforms) could lessen the impact. **The main risk comes from the ongoing weakness of the labour market**: the signs of a recovery in employment (which was almost entirely temporary, stemming from, inter alia, the greater flexibility introduced by the Poletti decree last March) have to some extent receded recently and, in terms of their effects on unemployment, are being frustrated by the fall in the inactive population, which has brought the jobless rate to a new historic high of over 13%. We expect unemployment to stabilise rather than fall in 2015.

- The most discordant note in the scenario is the **failure of investments to recover**; they are expected to contract again next year for the seventh year in a row (by 0.3%). Construction is still in recession, with the leading indicators in the sector showing that the recovery has been postponed to 2016 at best. Instead, we expect investment in machinery and equipment to pick up (+1%) as early as next year; for the most part, however, they are likely to be replacement investments, given the degree of plant obsolescence after years of reduced capital spending by companies. The reduction in the employers' tax wedge included in the 2015 Budget will be helpful, as will the various incentives envisaged in a number of legislative measures. Despite this, the situation is hampered by lower profitability, which is frustrating the potentially favourable effect of the cut in interest rates (although the situation has been improving on this front since 2013), excess production capacity and the uncertainty that still surrounds the economic outlook and fiscal policy; furthermore, the more international reach of companies may have loosened the historic link between export growth and corporate investment.

- In summary, we expect **more of a stabilisation of economic activity** in 2015, after years of contraction (the last three in a row, and five of the last seven) **rather than a "proper" recovery**. We will have to wait until at least 2016 before we see anything like a real recovery (around 1%).

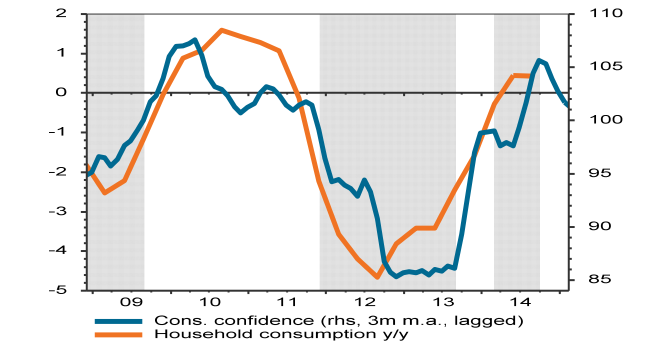
- **Average inflation in 2015 will be very close to the previous year's figure i.e. only just above zero** (we estimate 0.3%, from 0.2% this year). The weak currency and fall in commodities prices will act against each other. The underlying trend in the core components is barely above zero, reflecting the output gap that has opened up in the last seven years. In this scenario, it is possible that CPI could make forays into negative territory during the first half of the year. However, we still think the probability of a real deflation scenario, i.e. that the CPI will stay significantly negative for a long time, is low.

Macro Forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (constant prices)	-1.9	-0.4	0.4	-0.3	-0.4	-0.5	-0.5	-0.3	0.1	0.6	1.1
- q/q change				0.0	-0.2	-0.1	-0.1	0.1	0.2	0.3	0.3
Private consumption	-2.7	0.3	0.8	0.1	0.2	0.1	0.1	0.2	0.3	0.3	0.3
Fixed investment	-5.4	-2.5	-0.3	-1.1	-0.8	-1.0	-0.4	0.1	0.3	0.6	0.5
Government consumption	-0.7	-0.3	-0.2	-0.3	0.1	-0.3	-0.1	0.0	0.0	0.0	0.0
Export	0.9	1.9	3.3	0.2	1.3	0.2	0.7	0.8	0.9	1.0	1.1
Import	-2.6	0.4	2.5	-0.7	0.9	-0.3	0.5	0.7	0.8	0.9	1.0
Stockbuilding (% contrib. to GDP)	-0.1	-0.5	-0.3	-0.1	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0
Current account (% of GDP)	1.0	1.6	2.1	-0.2	1.5	1.7	3.2	0.0	2.3	2.3	3.8
Deficit (% of GDP)	-2.8	-3.0	-2.9								
Debt (% of GDP)	127.9	132.8	135.8								
CPI (y/y)	1.2	0.2	0.3	0.5	0.4	-0.1	0.1	-0.1	0.1	0.4	0.7
Industrial production	-3.1	-0.9	0.0	-0.1	-0.6	-1.1	-0.4	0.0	0.9	0.6	0.2
Unemployment (%)	12.2	12.8	13.1	12.6	12.6	12.8	13.2	13.2	13.2	13.1	13.0
10-year rate	4.31	2.90	1.93	3.64	3.10	2.61	2.24	1.97	1.85	1.85	2.03
Effective exch.rate (2010=100)	99.7	99.9	98.6	100.5	100.3	99.7	99.1	98.6	98.1	98.5	99.2

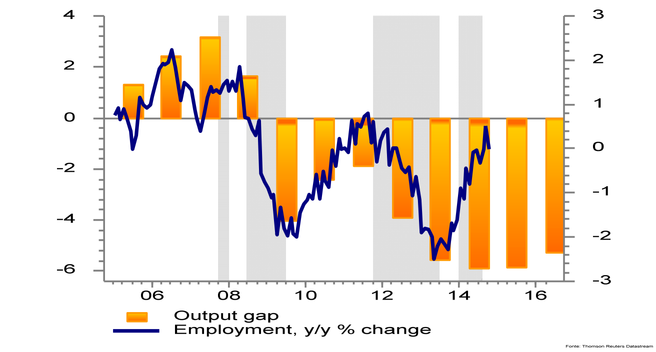
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Consumer confidence is still not pointing to any significant recovery in consumption



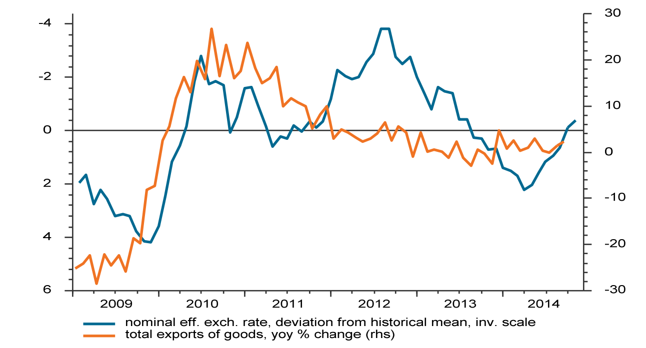
Source: Thomson Reuters-Datastream

Fig. 2 – Employment risks are still to the downside, given the persistence of a wide output gap



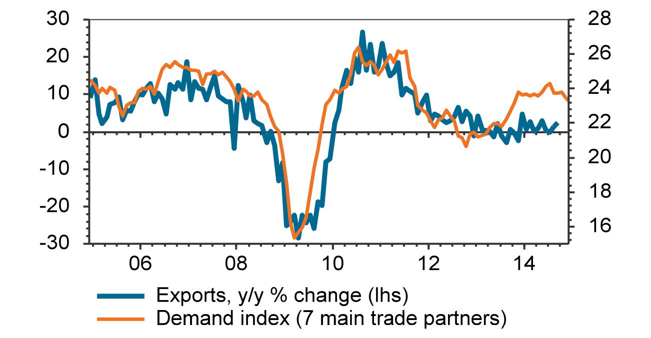
Source: Thomson Reuters-Datastream

Fig. 3 – Exports will not only be boosted by the depreciation of the euro...



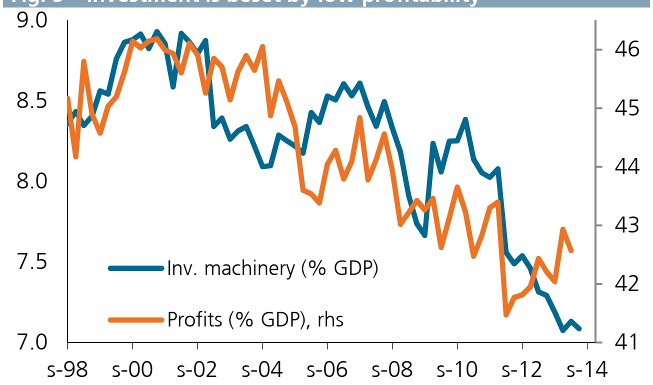
Source: Thomson Reuters-Datastream

Fig. 4 – ...but also by sustained demand from Italy's biggest trading partners



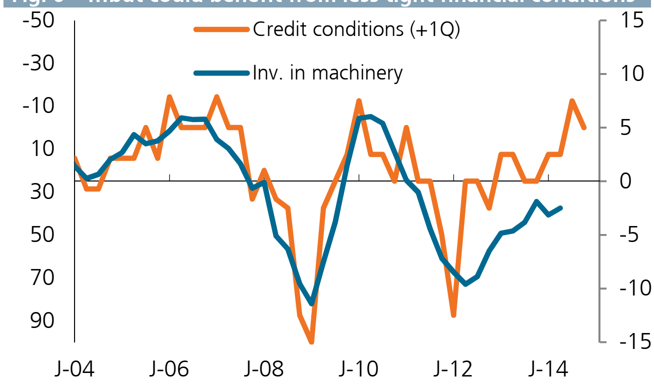
Source: Thomson Reuters-Datastream

Fig. 5 – Investment is beset by low profitability



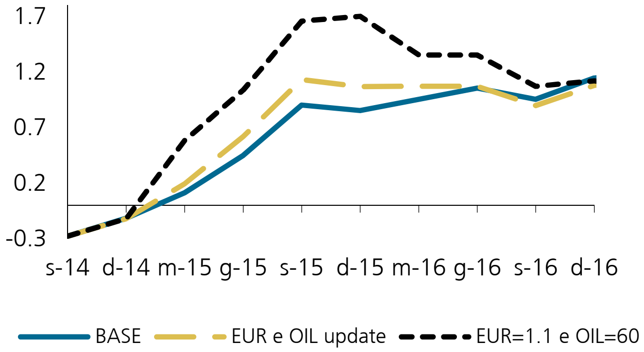
Source: Intesa Sanpaolo chart and estimate from ISTAT data

Fig. 6 – ...but could benefit from less tight financial conditions



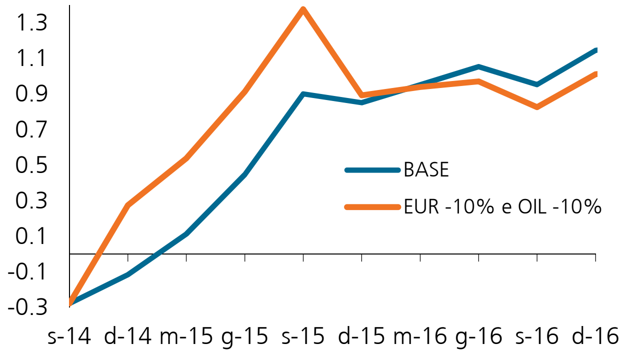
Source: Intesa Sanpaolo chart and estimate from ISTAT data

Fig. 7 – The effect of the changed oil price and EUR/USD exchange rate profile on GDP



NB: Shock compared with the base scenario of September 2014. Source: Thomson Reuters-Datastream

Fig. 8 – The effect of a 10% fall in the oil price and EUR/USD exchange rate on GDP



NB: Shock compared with the base scenario of September 2014. Source: Thomson Reuters-Datastream

Spain: it's party time again, the main risk for 2015 is political

Anna Maria Grimaldi

Overview Spain continued to surprise over the summer and into the autumn. After posting growth of 0.6% qoq in 2Q, GDP advanced by 0.5% qoq over the summer, while stagnating in the Euro zone during the same period (see Fig. 2). The country is clearly reaping the benefits of the reforms implemented in the last few years (see Fig. 1). On an annual basis, GDP grew by 1.7% yoy in the summer, from -1.1% yoy a year previously. Growth is being driven by domestic demand, and no longer by net exports as in 2013. Economic surveys suggest that the economy will hold up even at the close of the year. The composite PMI was on average 54.7 in October and November, from 56 in the summer months, and therefore points to a less marked slowdown in the cycle than in Germany, France and Italy. The composite PMI is still consistent with GDP growth of 0.4-0.5% qoq at the end of 2014 – beginning of 2015 (see Fig. 3). In the previous two quarters, growth in added value in Spain was mainly driven by services, owing to the upturn in domestic demand rather than manufacturing (see Fig. 4). Yet, in October and November, the PMI services index slowed, and the PMI manufacturing index gained ground compared with the third quarter. The trend is all the more surprising if we consider that manufacturing in the rest of the Euro zone is almost in recession. We therefore have to ask ourselves what is driving Spanish industry and if this trend is sustainable. First, we should note that manufacturing has been sustained by a marked upturn in exports to the dynamic economies of Asia and other advanced countries, led by the US (see Fig. 7). It is therefore possible that support to Spanish manufacturing will not completely disappear if the Euro zone continues to slow. PMI export orders suggest a further acceleration in exports in the next few months (see Fig. 6). We may therefore only see a partial slowdown in industry (see Fig. 5). It should however be noted that despite the trend reversal in manufacturing (particularly capital and consumer goods, see Fig. 9), the country is still way behind the Euro zone average, and production remains well below pre-crisis levels (see Fig. 10). In light of the surprises in mid-2014 and the expected resilience of growth over the new year period, we are revising up our growth forecast for Spain by 0.1-0.2% on the 1.8% estimated in September. The impact of falling oil prices will add a couple of tenths of a point to Spanish GDP growth by the end of the summer. Consequently, Spain is the only one of the main Euro zone countries for which we are revising up our growth forecasts for next year. Growth will continue to be driven by domestic demand (+2.0%), while net exports will provide a negative contribution of -0.3%. Consumer spending should continue to register sustained growth in the next few quarters, albeit less so than in the summer, when it jumped by 0.8% qoq. We expect some moderation in household spending growth towards 0.4% qoq per quarter and average annual growth of 1.9% in 2015. Support should be provided by the recovery in purchasing power owing to the fall in inflation and petrol and transport costs, as well as fiscal policy (the tax cuts planned for 2015: a 13% reduction in tax rates for incomes lower than EUR 24,000 and a cut in the maximum rate from 52% to 47% are expected to provide moderate support to growth of around two-three tenths of a point). We expect growth in industrial investment of 3.1% in 2015, from 1.5% this year, thanks to the support of both domestic and external demand, and fiscal policy. Surprises could be on the upside if financial conditions become more accommodative over the year. Furthermore, growth in corporate investment has been greater in the last two quarters than suggested by sector indices and the trend in production capacity (see Figs 11 and 12). With regard to construction investment, the correction in the residential sector looks to be well advanced since the housing/GDP ratio is back below the Euro zone average and close to pre-crisis levels (and employment in the sector is slightly above its end-1980s level). We expect residential construction to stabilize in 2H15.

Positive cycle thanks to diversification of exports and recovery in domestic demand

Impact from oil of +0.2%. We are raising our growth forecast for 2015 from 1.7% to 2.0%, uniquely among large Euro zone countries

Growth will be driven by domestic demand

Exports should expand by 5.4%, from 4.5% in 2014, imports are expected to increase by 6.7% qoq, given the high import content of both exports and Spanish domestic demand,. The current account returned to deficit in 2014, and the gap could widen from -0.4% in September to -1.0% at the end of 2015, since there is a risk that the trade surplus (+1.0%) will close if the

The current account is again in deficit, and this could grow significantly deterioration in the services balance (due to tourism) is also accompanied by a higher goods deficit.

The fall in the unemployment rate is partly a reflection of a lower participation rate. The main challenge remains reducing the structural rate

The recovery has extended to the labour market: the private sector has created 386,000 jobs (mainly fixed-term contracts) (see Fig. 13). For the next few months, economic surveys point to more modest employment growth than in the summer, at only 0.3-0.4% (see Fig. 14). Unemployment has fallen more quickly than we had expected, to 23.7% in 3Q, from a peak of 27% in March 2013. However, the fall is partly due to the drop in the participation rate, from 60.2% to 59.5%, owing to an increase in the inactive population. Over the forecast horizon, we expect a limited drop in unemployment to 22.5% at end-2015. The unemployment rate in Spain remains at its all-time highs, and what is of greater concern for social cohesion (see below), is that it is not far from the structural unemployment rate (21.5% according to OECD estimates). Collective agreements in 2014 resulted in wage increases of 0.4-0.5% yoy in the first nine months of the year, down from 0.6% on average last year. Real salaries have therefore returned to positive territory, thanks to cooling inflation. We anticipate labor cost growth of 0.9-1.1%, which is sharply down on the 4.5% seen in previous growth cycles.

Temporary fall into deflation in 2015 due to oil. Inflation below 2% for the foreseeable future

Spanish inflation is expected to go into negative territory in 2015, owing to the fall in oil prices, to -0.2% on the harmonized measure. Core inflation will remain in positive territory, at +0.5%, unchanged versus the current year. If the cyclical recovery is confirmed, Spanish inflation may just edge into positive territory from the beginning of 2016. A return to recession could also push core inflation into negative territory.

Fiscal policy will provide support in the run-up to the elections at the end of the year

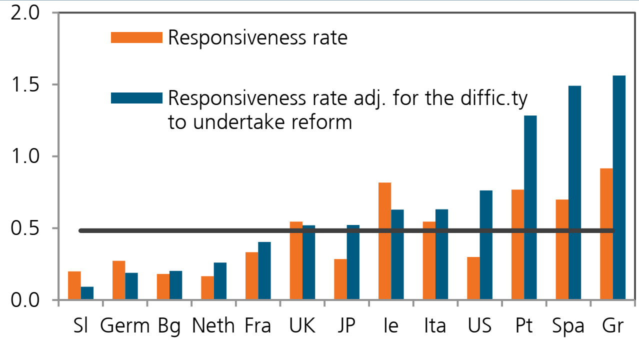
Corrective measures on public finances shelved to 2016

The Spanish deficit should rise to 5.4% of GDP by end of 2014. For 2015, we expect a decline to only to 4.8% of GDP. 2015 is an election year (elections will be likely held in late November) in which the government will undoubtedly seek to regain consensus. Against this backdrop, debt is expected to rise to 102% of GDP and up to 104% in 2016, before beginning to fall from 2017. Furthermore, the European Commission seems to have accepted a break in the process of correcting Spain's public finances. The change in the cyclically-adjusted primary balance will be around zero, according to recent Commission estimates. The cyclically-adjusted balance is expected to rise to -2.8% of GDP in 2016, owing to the expiry of certain measures on the revenues side. To meet its medium-term objective (MTO), Spain needs to implement a structural correction of 2.5% of GDP between 2016 and 2018.

The main risk for 2015 is political

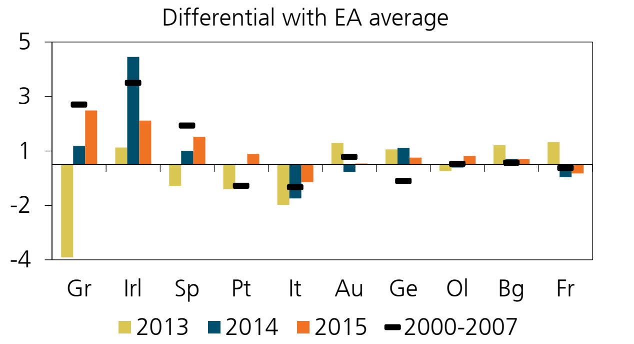
Risks to the forecast While generally positive on the country, we invite to a note of cautiousness; deleveraging must continue, the gains in competitiveness of the last few years having waned somewhat. The risk is that, after the recent surge, demand might again grow less than our estimate (2.0%) and/or that the current account deficit will widen again. The doubt remains that the improvement in recent years is largely cyclical rather than structural, and next year will be the test. Further reforms (in relation to training, politics and employment agencies) will also be necessary to reduce the structural unemployment rate, which remains among the highest within the Euro zone. The high public debt (102% in 2015) is a potential vulnerability if the markets reverse, but the main risk for 2015 is undoubtedly political. The parliamentary elections at the end of 2015 could put at risk the country's international credibility. The latest opinion polls (see Fig. 16) show alarming gains for the anti-euro protest party *Podemos*, to 25%, only two points below the PSOE. There is a risk that the 2015 elections will not result in a majority capable of governing and moving the reforms forward. As regards the situation in Catalonia, there is not a risk of an exit in the short to medium term, but rather, it is evidence of a split, which could intensify, between the central government and the regions.

Fig. 1 – High level of reform has enabled Spain …



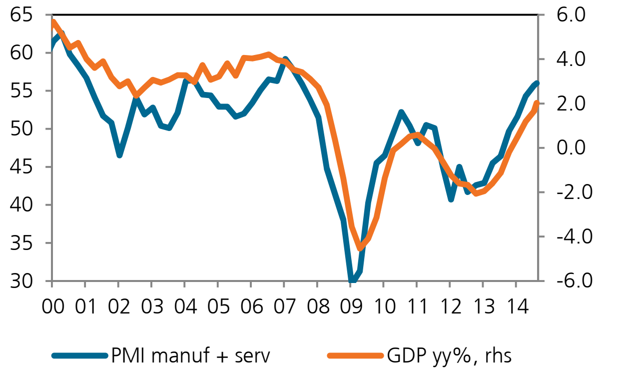
Source: Intesa Sanpaolo chart from OECD data

Fig. 2 - …to return to higher growth than the Euro zone average



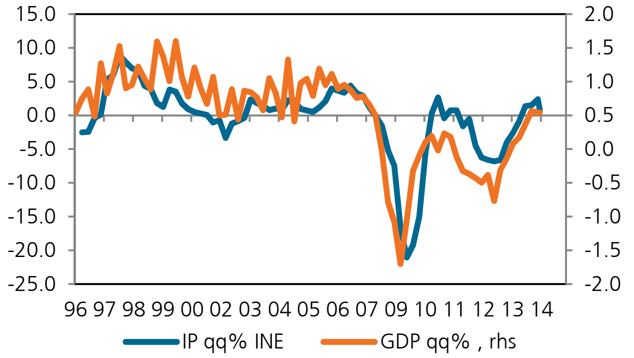
Source: Intesa Sanpaolo forecasts based on Eurostat data

Fig. 3 – While core countries are slowing, the recovery in Spain is for now holding form and gaining ground



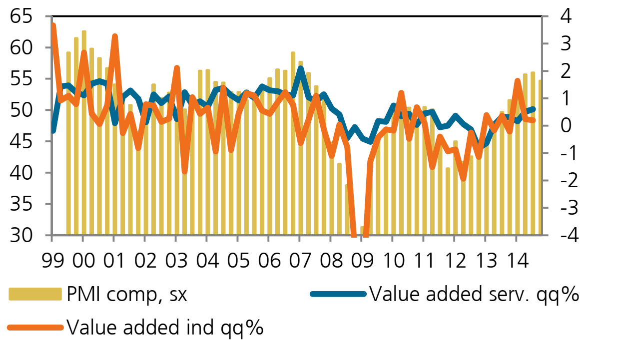
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 4 – Output data suggest slight dip in GDP growth at the end of the year



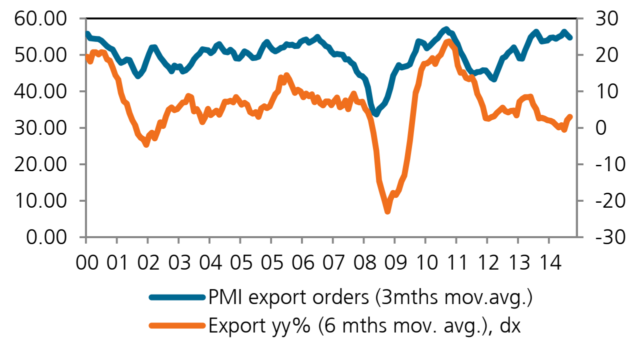
Source: Intesa Sanpaolo chart from INE data

Fig. 5 – Added value creation seems to be coming more from services in this period



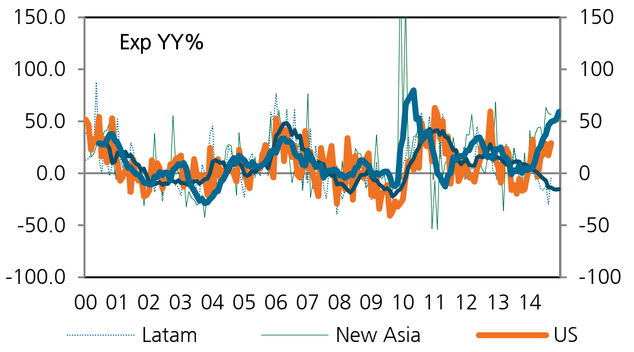
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 6 – Markit PMI pointed to an acceleration in exports that did not occur



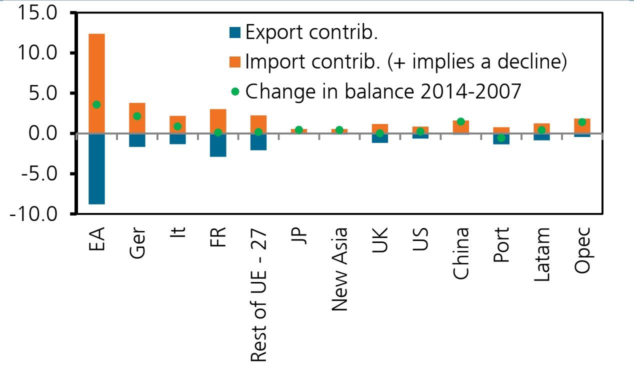
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 7 – Upturn in exports to countries outside the Euro zone, particularly in Asia and the US



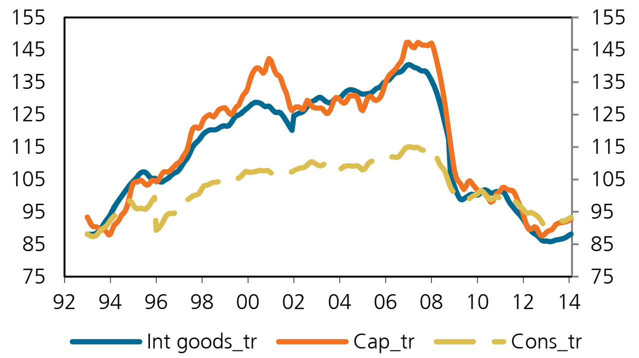
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 8 – The improving goods balance is due almost across the board to imports rather than exports



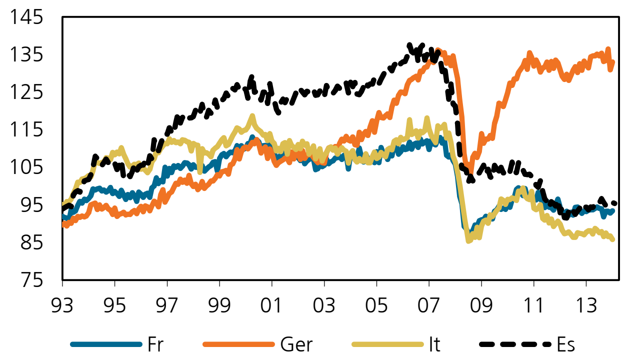
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 9 – The trend has reversed in capital goods and consumer goods



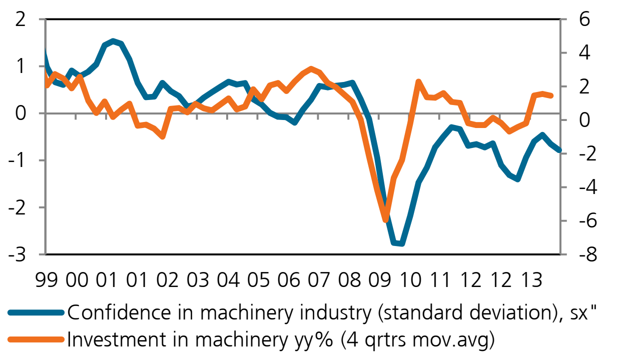
Source: Intesa Sanpaolo chart based on INE and Bank of Spain data

Fig. 10 – Despite the recovery, production remains well below pre-crisis levels, although Spain seems to be doing better than Italy and France



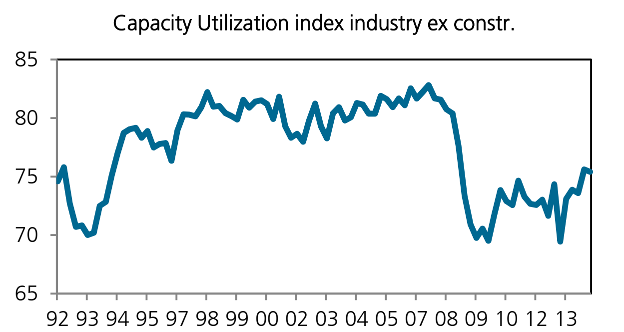
Source: Intesa Sanpaolo chart based on Eurostat data (industrial production indices)

Fig. 11 – Investment in machinery grew faster than suggested by the upturn in confidence and…



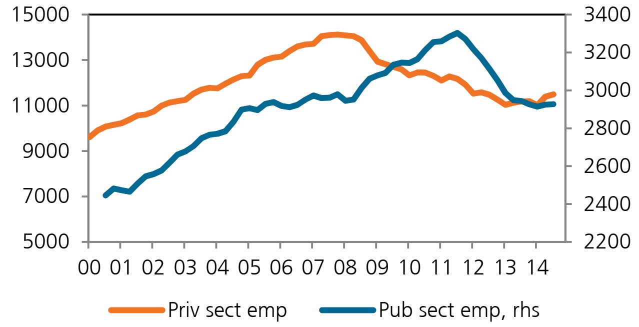
Source: Intesa Sanpaolo chart based on European Commission and Eurostat data

Fig. 12 – … production capacity



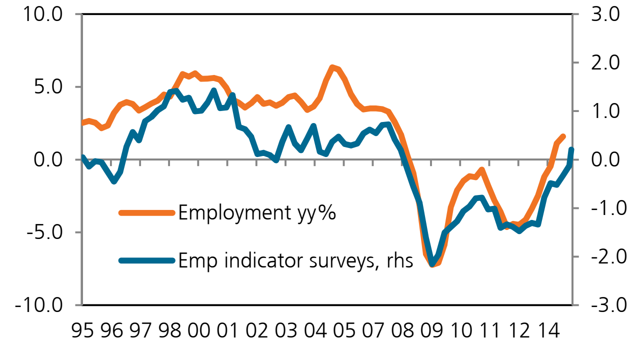
Source: Intesa Sanpaolo chart based on European Commission and Eurostat data

Fig. 13 – Private sector starting to create jobs again



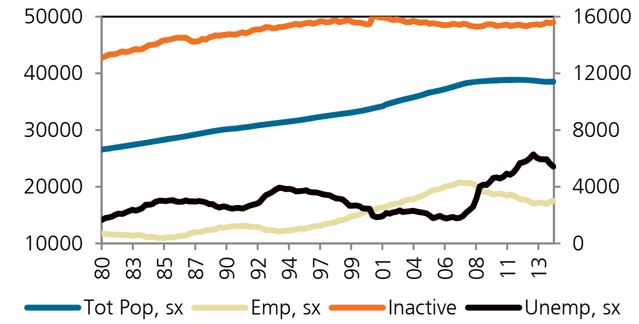
Source: Intesa Sanpaolo chart from INE data

Fig. 14 – But confidence indices suggest more meager growth of 0.3-0.4% in the next few quarters



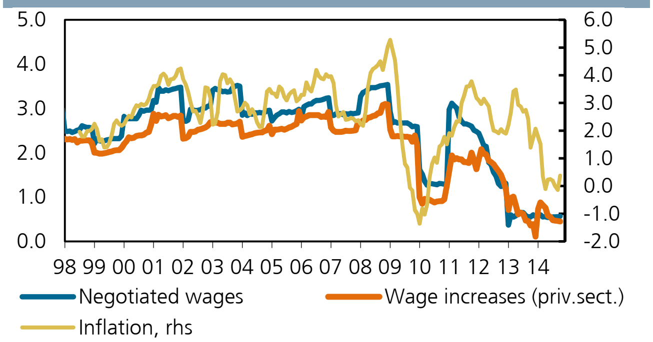
Source: Intesa Sanpaolo charts based on European Commission and INE data

Fig. 15 – Fall in unemployment rate will be modest. The inactive population continues to rise for the time being



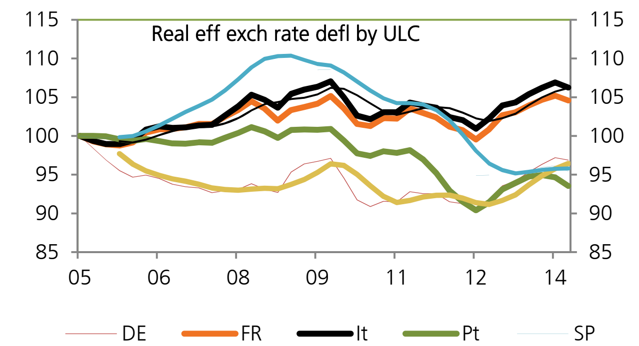
Source: Intesa Sanpaolo chart from INE and OECD (structural unemployment rate) data

Fig. 16 – Wage moderation continues



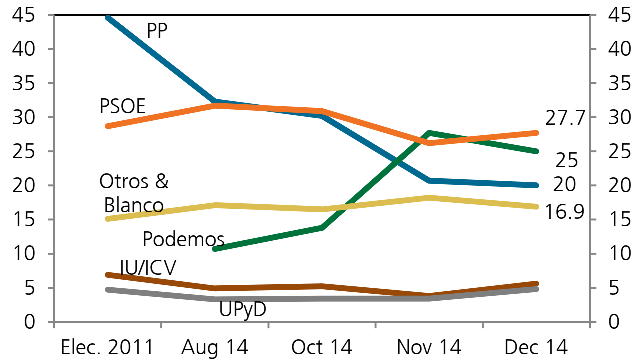
Source: Intesa Sanpaolo chart from INE data

Fig. 17 – But gains in cost competitiveness have waned



Source: Intesa Sanpaolo chart from European Commission data (effective exchange rate deflated for the cost of labour)

Fig. 18 – The main risk is political in the short term



Source: Intesa Sanpaolo chart from INE data

Macro Forecasts	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (constant prices)	-1.2	1.3	2.0	0.5	1.2	1.7	2.0	2.2	2.1	1.9	1.8
- q/q change				0.4	0.6	0.5	0.5	0.5	0.4	0.4	0.4
Private consumption	-2.1	1.9	1.6	0.5	0.7	0.2	0.3	0.4	0.4	0.5	0.5
Fixed investment	-5.1	1.0	2.8	-0.7	0.6	1.9	0.0	0.4	0.8	0.9	1.0
Deficit (% of GDP)	-6.8	-5.6	-4.4								
Debt (% of GDP)	92.2	96.1	101.2								
CPI (y/y)	1.4	-0.1	-0.2	0.0	0.2	-0.3	-0.4	-0.9	-0.4	-0.3	0.7
Unemployment (%)	25.8	24.1	23.5	25.2	24.7	24.1	24.1	23.9	23.8	23.7	23.5
Effective exch.rate (2005=100)	99.7	99.5	98.4	100.1	99.8	99.3	98.9	98.4	98.0	98.3	98.9

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

Asia

Japan: more stimulus on all fronts: BoJ, fiscal policy, oil

Giovanna Mossetti

- After April's consumption tax hike, growth in Japan has been well below forecasts, triggering an aggressive response from the monetary and fiscal policy authorities. We are revising our forecasts down for 2014, slightly less so for 2015, and upwards for 2016, due to the combined effect of the additional stimulus that will be provided by the Bank of Japan, the government and oil. Growth is seen at 0.3% in 2014, picking up to 0.8% in 2015 and 1.9% in 2016. In 2017, we should see a fresh and significant slowdown, due to the planned rise in consumption tax from 8% to 10% in April 2017. Over the whole forecast horizon, the fall in oil prices and weakening exchange rate will give a further boost to reflation, a vital factor in controlling public finance risks. The fall in oil prices should contribute around 0.3-0.4 percentage points to growth in 2015, with upside risks if Brent prices correct further.

- The events of the autumn have radically changed Japan's economic outlook. The publication of very weak preliminary Q3 GDP data caused Prime Minister Shinzo Abe to announce the postponement of the second consumption tax hike (initially planned for October 2015) and call early elections, scheduled to take place on 14 December. Abe's objective is to have his mandate confirmed so that he can continue the reflation strategy by implementing: 1) structural reforms to the labour market and the pensions system; 2) an expansionary fiscal policy in 2015-16; and 3) a further consolidation of public finances in 2017, via a second consumption tax rise. Abe has stated that, if re-elected, he would introduce temporary fiscal stimulus in 2015-16, chiefly to support household income, and has asked the government to prepare a package along these lines. The size and the measures of the package are still uncertain; it should be between JPY 3 and 5 trillion (between 0.8% and 1% of GDP) in 2015.

- In the middle part of the year, domestic demand disappointed more in terms of investment than consumption; this was despite the significant fiscal restriction on households' disposable income and the positive contribution to corporate earnings from the depreciation of the yen.

- After significant first-half volatility, consumer spending has been increasing since the summer, and is expected to pick up further in 2015. Households responded to the rise in consumption tax with a substantial transfer in the timing of consumer spending – the "forced" rise at end-2013/early 2014 was followed by a large correction in the second quarter. The third quarter, however, saw positive growth in real spending, which should accelerate from the end of 2014 onwards. The postponement of the second rise in consumption tax should boost household confidence, driven by expectations of fiscal expansion in 2015. It is particularly difficult to forecast consumer spending as neither the size nor composition of the fiscal stimulus package for 2015 has been announced.

- A key factor for future household spending is the labour market, constantly characterized by excess demand, but wages have not yet adjusted to the new environment of stable, positive inflation. Unemployment, at 3.5%, is at its lowest since the end of 1990s. Real wages are down by 2.8% yoy, after a brief period in positive territory in the first half of 2013. We are unlikely to see a change in pace before the labour contract negotiations in spring 2015. It is thought that large companies are prepared to improve contractual conditions in light of an extremely positive earnings trend triggered by falling yen and oil prices, but small companies will likely remain very cautious. Even with moderate wage growth, the postponement of the tax rise in 2015 and the fall in petrol prices and inflation should send consumption back into positive territory in 2015 at 1%, after contracting by an expected 0.8% in 2014.

- Fixed non-residential investment was extremely volatile in the first half, but is expected to recover steadily, thanks to yen depreciation, moderate export growth and falling energy costs. The postponement of fiscal tightening and the new monetary stimulus will help investment grow by 1% in 2015 and 2.5% in 2016.

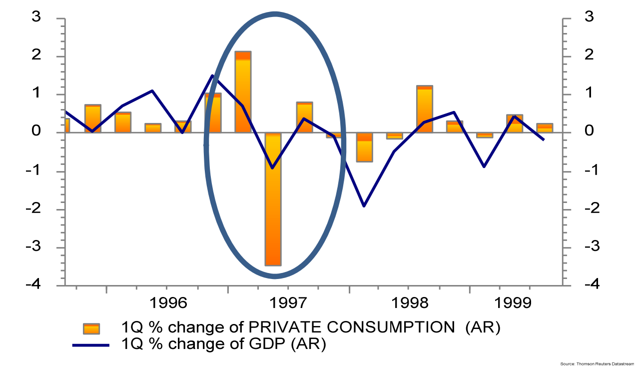
- **Foreign trade** was disappointing in 2014, due to the weak international economy and the boost to energy prices in the first half from the yen's depreciation. In 2015, we should see a positive contribution to growth of around 0.3 percentage points, on the back of a recovery in exports and a significant brake on imports following the fall in oil prices.
- **Monetary policy** provided a positive surprise at the end of October, with the announcement of a significant increase in monetary stimulus and the Bank of Japan's "unshakable" commitment to achieving its inflation target of 2% as soon as possible. The central bank has increased the monetary base target (to JPY **+80 trillion**, from JPY +70 trillion per year), with increases in purchases of all assets, including the riskier types. The BoJ plans to **increase its holdings of JGBs by approximately JPY 80 trillion a year**; it also plans to extend the average maturity of securities purchased to 7-10 years. JGB purchases will therefore be about double net issuance in 2015: the share of JGBs held by the BoJ will continue to rise (20% in November 2014), freeing up the balance sheets of banks, which will be able to shift assets to loans and riskier assets. The size of the new stimulus decided in October is sufficient to stabilise expectations for new BoJ measures in 2015, given as well the government's decision to postpone the tax rise planned for next year. **Inflation excluding fresh food and consumption tax is expected to fall further**, owing to the energy component, but then **stabilise around 0.9% yoy at the end of 2015**.
- Given the postponement of the 2015 consumption tax rise and the introduction of a stimulus package (still to be defined), **fiscal policy will make a positive contribution to growth in 2015**; this compares with previous expectations of a restriction of about 0.4 percentage points. Prime Minister Abe has stated that the fiscal consolidation programme has only been postponed and the target (unlikely to be reached, in our view) is still to close the primary deficit by 2020. Coordinating fiscal and monetary policy in order to reflate the economy is crucial, and to limit the risks of a debt crisis, with a debt/GDP ratio at best stabilizing around 240%.

Macro forecasts

	2013	2014	2015	2014				2015			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.5	0.3	0.8	2.6	-0.1	-1.1	-0.1	-1.3	1.0	1.8	1.7
q/q annual rate				6.7	-7.3	-1.6	2.4	1.6	1.7	1.7	1.7
Private consumption	2.0	-0.8	1.0	9.1	-18.6	1.5	5.6	1.7	1.7	1.7	1.7
FI - private nonresidential	-1.4	5.1	1.0	33.8	-17.9	-0.9	2.5	3.2	3.3	2.5	2.5
FI - private residential	8.8	-3.3	2.4	9.7	-34.3	-24.1	21.6	21.7	0.2	0.2	0.1
Government investment	11.4	4.3	-4.4	-7.7	1.2	8.9	-8.1	-6.4	-6.4	-6.4	-6.0
Government consumption	2.0	0.3	0.5	-0.9	-0.2	1.3	0.4	0.4	0.4	0.4	0.0
Export	1.5	7.1	2.8	28.2	-1.9	5.3	-3.7	4.6	4.9	4.9	4.7
Import	3.3	6.9	2.7	27.3	-19.9	3.1	4.1	4.7	4.9	5.1	4.6
Stockbuilding (% contrib. to GDP)	-0.4	-0.1	0.1	-0.7	1.3	-0.7	0.0	0.0	0.1	0.1	0.1
Current account (% of GDP)	0.7	0.0	0.4	-1.1	0.6	0.5	0.2	0.2	0.4	0.5	0.4
Deficit (% of GDP)	-9.3	-7.7	-5.5								
Debt (% of GDP)	224.7	229.1	230.4								
CPI (y/y)	0.4	2.8	1.4	1.5	3.6	3.3	2.9	3.0	1.0	0.7	1.0
Industrial production	-0.6	2.3	1.9	12.5	-14.4	-7.5	10.4	3.2	3.3	3.3	3.3
Unemployment (%)	4.0	3.6	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.7	3.7
JPY/USD	97.6	105.9	123.5	102.8	102.1	104.0	114.6	121.0	124.2	124.6	124.1
Effective exch.rate (1990=100)	145.2	133.9	118.4	136.3	136.8	136.1	126.5	121.1	118.4	117.3	116.7

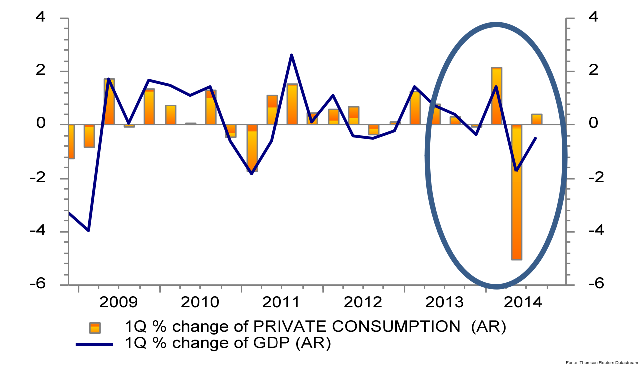
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Average values for the period. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 - GDP and consumption in 1997-98 …



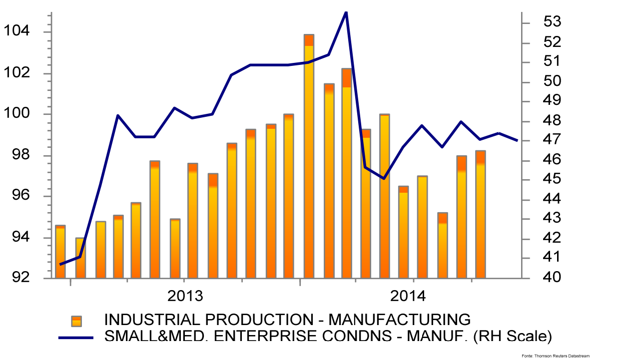
Source: Thomson Reuters-Datastream

Fig. 2 – … and in 2013-14



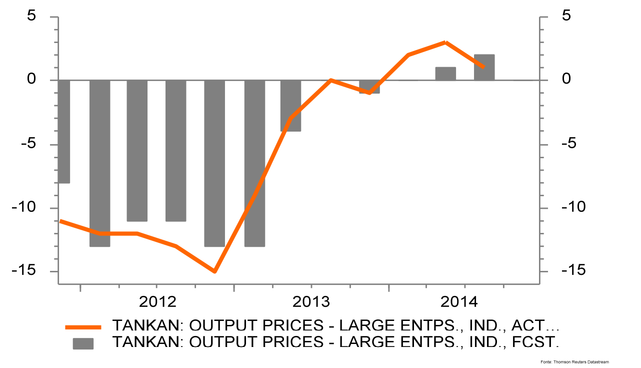
Source: Thomson Reuters-Datastream

Fig. 3 – Companies are recovering…



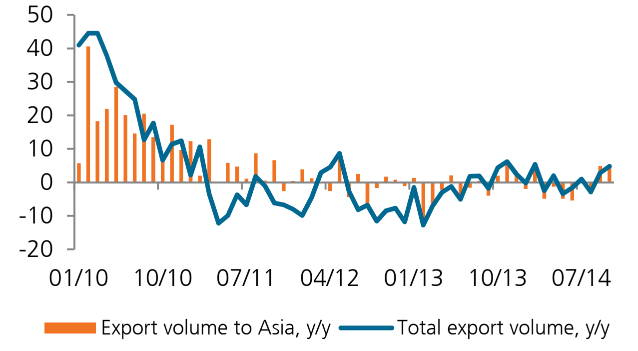
Source: Thomson Reuters-Datastream

Fig. 4 – … and are setting prices in line with a no-deflation scenario



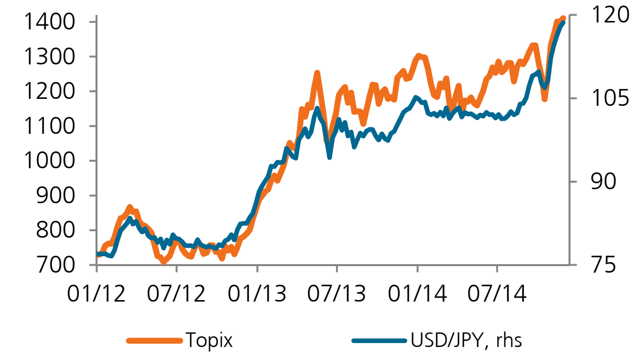
Source: Thomson Reuters-Datastream

Fig. 5 – Exports remain low…



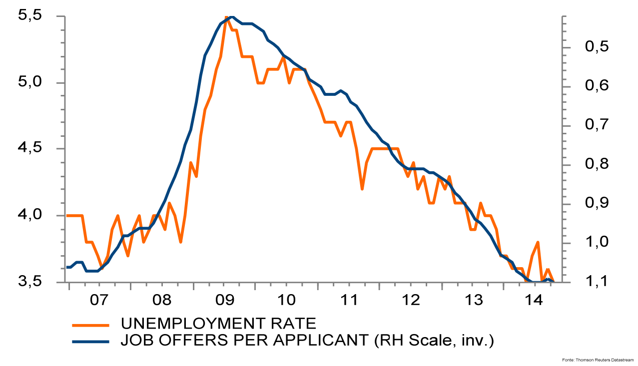
Source: Bloomberg

Fig. 6 – … but the exchange rate is giving the market confidence



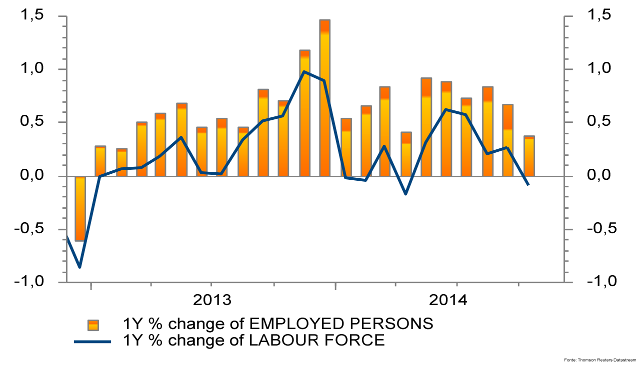
Source: Bloomberg

Fig. 7 – Unemployment rate and jobs-to-applicant ratio



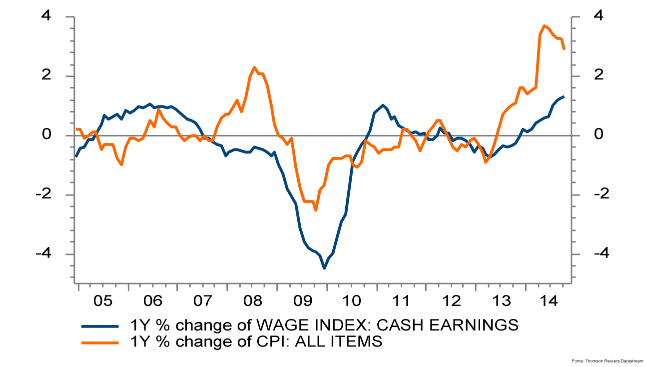
Source: Thomson Reuters-Datastream

Fig. 8 – Number of employed and workforce on rise, albeit largely part-time



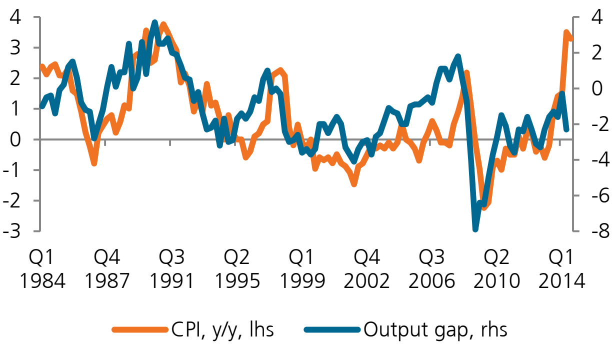
Source: Thomson Reuters-Datastream

Fig. 9 – Wages and inflation



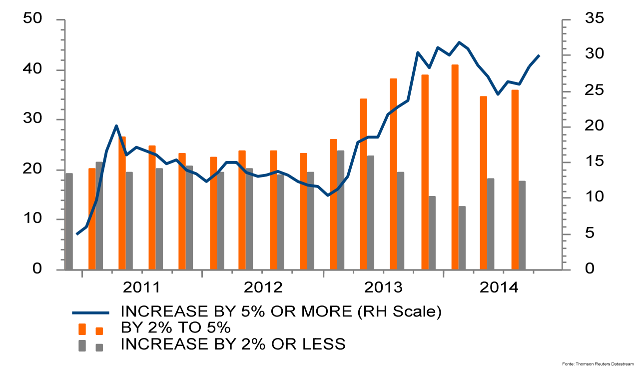
Source: Thomson Reuters-Datastream

Fig. 10 – Output gap and inflation



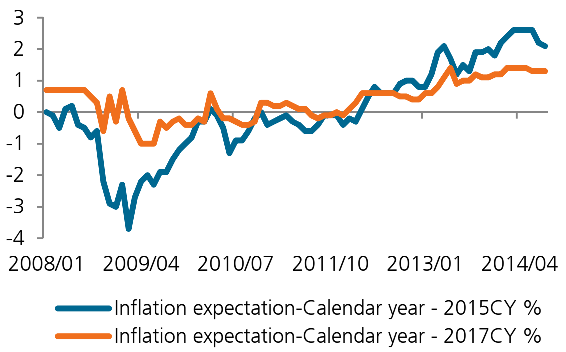
Source: Thomson Reuters-Datastream

Fig. 11 – Household inflation expectations: firmly positive



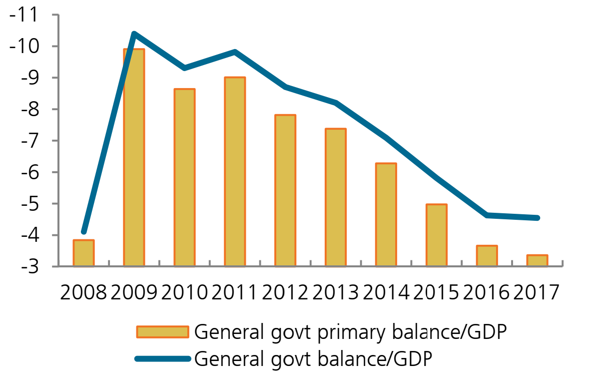
Source: Thomson Reuters-Datastream

Fig. 12 – The market forecasts positive inflation, but less than the BoJ's target



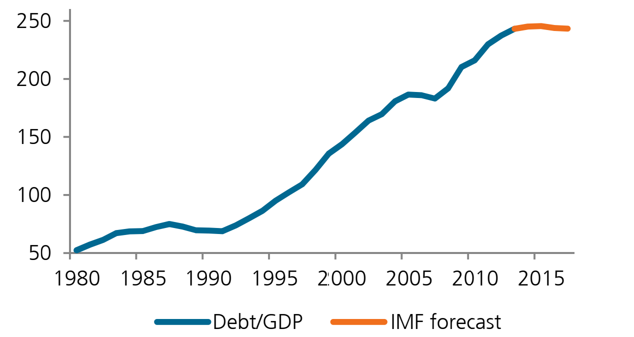
Source: Intesa Sanpaolo chart based on Japanmacroadvisors data. Expectations based on implicit inflation in inflation-indexed JGBs

Fig. 13 – Public accounts will continue to consolidate …



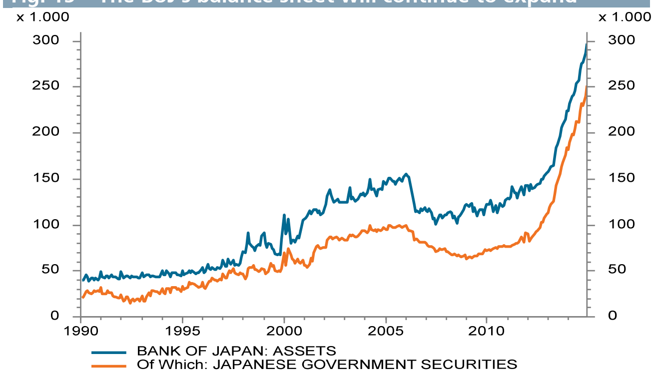
Source: IMF

Fig. 14 –… and debt/GDP ratio likely to stabilise



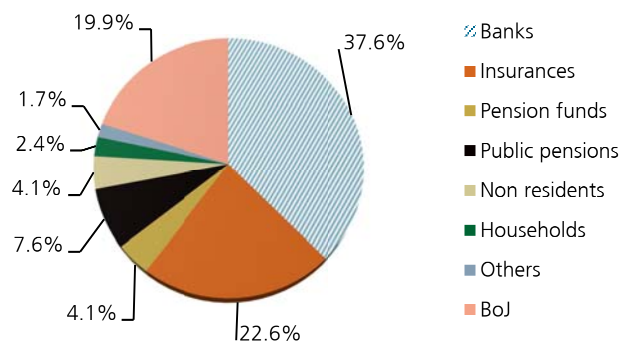
Source: IMF

Fig. 15 – The BoJ's balance sheet will continue to expand



Source: Thomson Reuters-Datastream

Fig. 16 – JGB holders



Source: Ministry of Finance, December 2014

China: monetary policy experiments

Silvia Guizzo

- GDP growth slowed further to 7.3% yoy in 3Q (1.9% qoq), from 7.5% in 2Q (2.0% qoq), bringing the cumulative rate for the first three quarters to 7.4%, in line with the government's target of *around* 7.5%. The weak property market continues to weigh on total investment, reducing its contribution to growth. While net exports rose due to the resilience of international demand, consumer spending slowed to 8.2% yoy vs 8.5% in 2Q. The combination of slowing industrial output and investment in October, the slight fall in the PMI index, including in the orders component, and the stability of real retail sales point to similar trends again in 4Q. We therefore keep our estimate of annual GDP growth unchanged at 7.3% in 2014.

- Even allowing for the problems affecting the over-invoicing of exports (Fig. 4), which the Chinese authorities are still investigating, the foreign trade figures for September and October confirm that foreign demand is performing well and that domestic demand, although still weak, is stable. Exports rose by 12% 3m yoy in October, a slight slowdown on September. Exports to Japan are still trending down, and those to Europe are slowing, while demand from the US and south-east Asia is picking up pace. Imports of goods to be reassembled and exported, which are up 3.2% 3m yoy (Fig. 3), are driving the improvement in total imports (+19.% 3m yoy Fig 3), while imports of ordinary goods are still following a downward path. The latter were anyway partly affected by lower import prices (-1.0% yoy in September) but, most importantly, by the fall in the price of certain minerals such as iron (approx -15% from end-June to end-October) and oil (-24% in the same period). Added to this, nearly all Asian currencies, especially those of the biggest exporters to China (Japan, Korea and Australia) - depreciated against the dollar. In volume terms, however, imports of certain minerals and metals, as well as oil, accelerated over the last few months, in line with the resilience of investment in infrastructure and restocking. Imports of machinery and electronic products continued to improve slightly.

- Growth in nominal urban capital investment continued to run out of steam, recording a cumulative rate of 15.9% yoy, the lowest in the series. While investment in the farm sector accelerated (+26.5% cum. yoy in October vs 23.8% in August), industrial investment continued to slow, dragged down by the minerals and metals sector, as well as the manufacturing sector. Investment in the services sector continued to grow at a stable rate (17.4% cum. yoy in September and October), shored up by investment in transport - particularly railways and roads - and by the attendant recovery in the construction sector.

- Investment in the property sector slowed slightly in September and October (12.4% cum yoy vs 12.5%) compared with the summer months. The slowdown in residential building investment is continuing (11.1% cum yoy in vs. 11.3%), while investment in commercial building and offices is picking up the pace. In October, the prices of residential property continued to fall in all 70 cities covered by the survey, although the monthly decrease was less pronounced than in August (Fig. 6). Sales of residential property in China continued to fall (-9.9% yoy in value) but improved slightly compared to the low of -10.9% yoy in August. After various local governments started, as early as spring, to ease the anti-speculative measures introduced in recent years to cool the housing market, the PBOC decided in September to follow suit with various national measures. Specifically, it changed the terms and conditions for second-home buyers to bring them in line with those for first-home buyers, provided that the latter have completely paid off their first mortgage. The deposit on a second home therefore falls from 60% of the property value to 30% (the percentage required for a first home), and the minimum mortgage rate may fall to 30% of the benchmark, compared with the 10% increase in the rate that applied previously for the purchase of a second home.

- The central bank confirmed only at the beginning of November that it had created a new window (medium-term lending facility, or MLF) for financing operations with terms of over three months, giving credence to the rumours that had circulated around September's financing operations (CNY 500Bn) and October (CNY 289Bn). These loans are available for banks that comply with the requirements for macro-prudential management, and the rates applied will be used as the medium-term reference rate. After some tension on the money markets in mid-November, generated by rumours that the PBOC might also introduce a cash reserve ratio for non-banking financial institutions, on 21 November, the central bank cut the benchmark rate on loans of less than one year by 40bps, and by 25 bps on deposits with the same maturity. The rates cut was applied to all maturities on the curve, with some differences to the two- and three-year maturities, but the deposit rate ceiling was increased from 110% of the benchmark to 120%. The manoeuvre, under the assumption that banks would apply the ceiling to the benchmark – plausible given the competition coming from money management and on-line products – effectively left the deposit rate unchanged except for very short maturities (less than seven days) and maturities of over three years, which even saw the rate increase to 12 bps and 14 bps respectively. The deposit curve slope rose and the banks margin narrowed by up to 40 bps on the one year maturity. This measure is in line with the objective of gradually liberalising rates before introducing insurance on deposits, which seems to be imminent. A draft regulation, in which deposits of up to CNY 500,000 will be insured, was recently published for public consultation, which will last until the end of December.

- The PBOC explained that the recent rate cuts do not constitute a change in the monetary policy stance, which remains prudent. Rather, it is an adjustment operation to drive rates down and realign real rates to a level appropriate for both the economic conditions and the corporate financing conditions, which remain difficult (Fig. 7), especially for SMEs. The average rate applied to commercial loans has remained broadly stable since the start of the year (7.33% in 3Q) but is up by 19 bps compared with 4Q13. The average mortgage rate (6.96% in 3Q), however, rose by over 40 bps in the same period despite the PBOC's moral suasion in the spring. Financing conditions remain anyway highly polarised, especially for property companies; the largest and most financially secure companies are able to access the bond market with its high, albeit reasonable, rates, while, according to S&P's, the cost of financing for the smallest companies, rated B- to B+ is around 12%-13%. A single cut, although helpful to companies, is hardly likely to translate into a significant reduction in the cost of financing, partly because 71% of loans are, in any case, priced at rates that are higher than the benchmark (Fig. 8), and even more so after rate liberalisation and at a time when companies' creditworthiness and banks' margins are deteriorating. In our view, the tapering of the anti-speculative measures and the rates cut, although making it slightly easier, temporarily, for potential buyers to enter the housing market, will not manage to stave off a further slowdown. Demand for homes is still structurally sound for demographic reasons, and the cost of maintaining unsold properties is not that high given that there is no property tax. These factors should therefore prevent a crash, as also suggested by the confidence of property entrepreneurs and the excellent trend in the property component of the Shanghai Composite index. Nevertheless, there will be around 5.5 billion sq. m. of residential surface area (completed area plus area under development) on the market at the end of the year, while residential property of around 1 billion sq. m. is sold per year. The supply and demand ratio is therefore still too big.

- Bank lending stock - together with the broader measure of social financing - is continuing to slow, in line with the authorities' aim of providing less generalised but more limited and targeted support for loans, and of containing and regulating credit outside the banking sector. Given the falling consumer price inflation and product price deflation, we think that the PBOC will make two further rate cuts in 1H15, while keeping the cash reserve ratio unchanged for now.

The increase in non-performing loans (+36% yoy in 3Q or 1.16% of total loans, up from 1% at end-2013) will continue to curb loan growth, including in the event of further rate cuts. We reiterate our forecasts that the economy will slow to 7.1% in 2015, with a further fall to 6.7% in 2016, due to the weakness of investments and decelerating consumer spending. The downside risks to the scenario are unchanged.

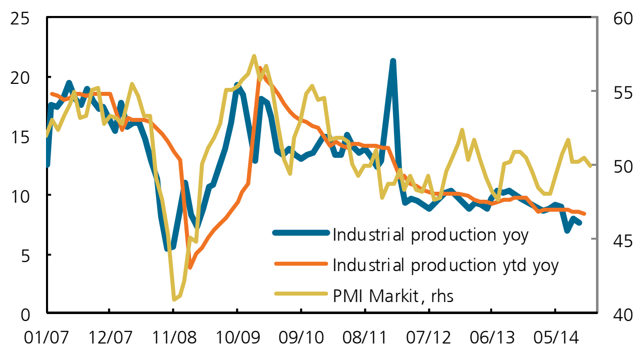
- After appreciating by 0.4% against the dollar in October, the Chinese currency started to weaken again, falling to around 6.14 at the end of November. The currency's relative stability against the dollar, together with the greenback's simultaneous appreciation against all the other currencies led the yuan to appreciate from end-August to end-November; it rose 5.6% against the euro, but more markedly against the yen (12.3%) and the Korean won (9.8%) and to a lesser extent against all the Asian currencies. The effective exchange rate rose by 4.1% in real terms and 4.8% in nominal terms over the same period. On the one hand, this increases internal disinflation, and on the other, it risks penalising exports. As such it has become a cause for concern for the authorities. Foreign currency purchases by financial institutions returned to positive territory in October at USD 10.8Bn. This suggests that either the financial institutions or the central bank are resuming sales of renminbi, which also tallies with the fall in foreign currency deposits since August. Partly in light of the upturn in speculative capital inflows suggested by the over-invoicing of exports to Hong Kong, we think it plausible that the PBOC will intervene again and thus halt the currency's upward trajectory.

Macro Forecasts

	2010	2011	2012	2013	2014E	2015F	2016F
GDP (at constant prices)	10.4	9.3	7.7	7.7	7.3	7.1	6.7
Consumer spending	8.2	10.3	9.4	8.5	8.3	7.7	7.1
Public consumption	11.4	12	5.5	7.4	7.1	6.8	6.9
Capital investment	11.3	8.7	9	9.2	6.7	5.6	6.3
Exports	26.1	4.1	3.1	5.8	8.3	7.6	7.7
Imports	19.4	5.3	4.1	7.8	6.2	8.9	7.9
Industrial output	12.3	10.3	7.9	7.8	7.4	6.9	6.8
Inflation (CPI)	3.3	5.4	2.6	2.6	2.1	1.9	2.8
Unemployment	4.2	4.1	4.1	4.1	4.1	4.0	3.9
Average wages	14.1	16.8	14.4	12.2	10.4	9.1	8.7
90-day interbank rate (average)	2.7	5.3	4.6	5	5.1	3.9	3.3
USD/CNY exchange rate (average)	6.77	6.46	6.31	6.15	6.18	6.22	6.16
Current account balance (CNY bn)	1604	874	1360	1124	1801	1712	1624
Current account balance (% of GDP)	3.1	1.7	2.6	2.0	2.9	2.5	2.2
Budget balance* (% of GDP)	-4.0	-1.8	-2.5	-3.6	-3.6	-3.3	-3.2

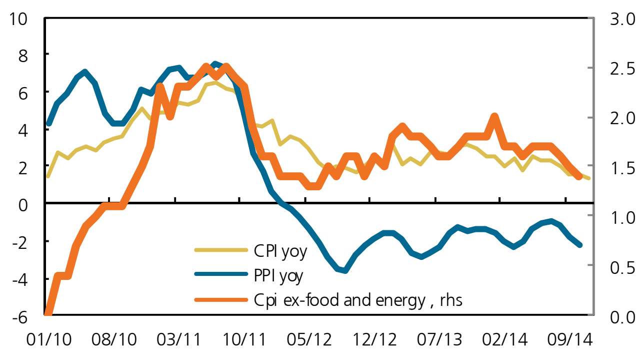
NB: Percentage change versus previous period except where otherwise indicated; *IMF Article IV 2014 estimate
Source: Oxford Economic Forecasting and Intesa Sanpaolo

Fig. 1 - Industrial output is slowing further



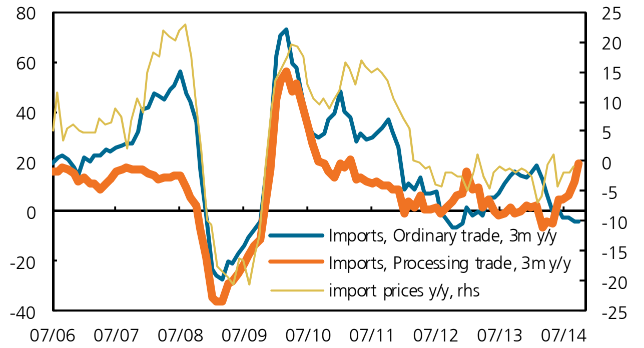
Source: CEIC, Markit

Fig. 2 - Inflation is falling



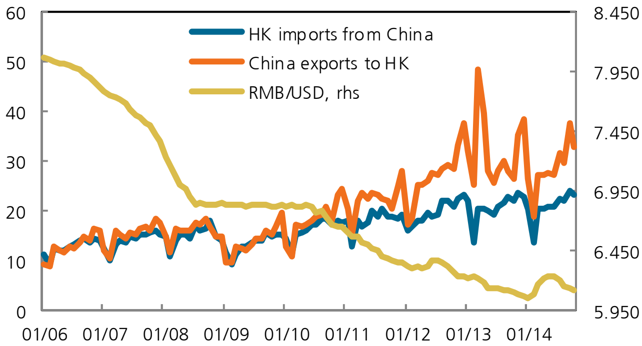
Source: CEIC

Fig. 3 - Only imports of assembling goods are improving



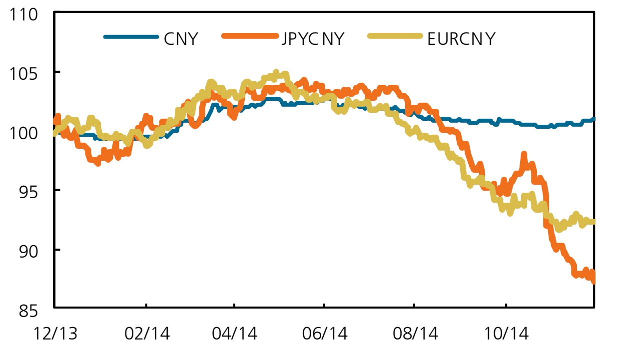
Source: Bloomberg, Thomson Reuters Datastream, Markit

Fig. 4 - Exports to Hong Kong beset by over-invoicing problems



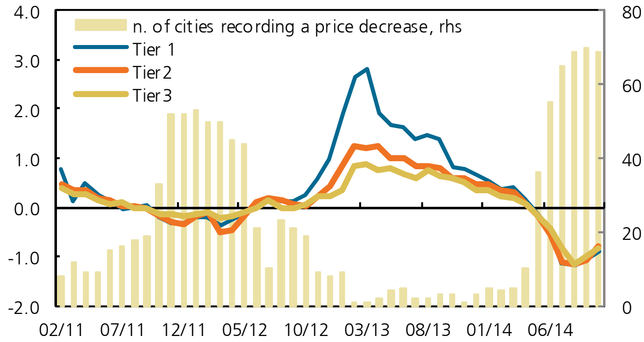
Source: CEIC

Fig. 5 - The yuan is rising markedly against the euro and the yen



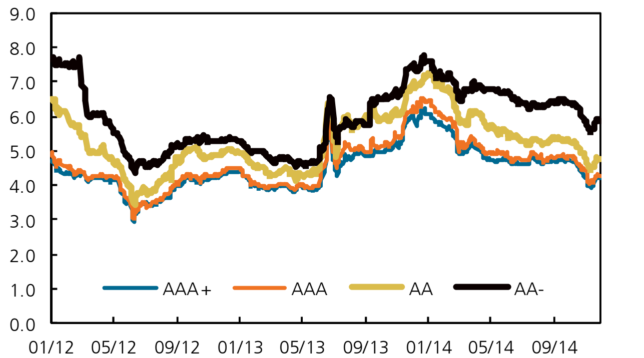
NB: currencies re-based on 01/12/2013 = 100. Source: Bloomberg

Fig. 6 - Residential property prices are still falling



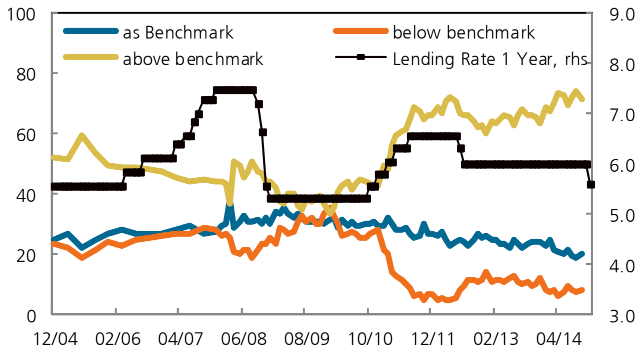
NB: % price change averages mom Source: CEIC

Fig. 7 - The cost of financing for companies remains high



NB: yields on one-year issues. Source: CEIC

Fig. 8 - Price of loans compared with benchmark rate



Note: % of Executed Benchmark Lending Rate. Source: CEIC

India: slow improvement

Silvia Guizzo

- GDP growth was 5.3% yoy in 3Q, slowing from 5.7% in 2Q, but in line with our expectations. The slowdown is in part due to an unfavourable base effect, and on the supply side, to a deceleration in the agricultural and manufacturing sectors, while services picked up, and continue to offer the largest contribution to growth. On the demand side, the marginal upturn in consumer spending was offset by a flat investment trend and a negative contribution from foreign trade, owing to the fall in exports.

- October's data was negatively impacted by three days of holiday more than in the previous year, which makes the figures difficult to interpret. Exports slowed (-0.7% 3m yoy in October), mainly owing to the fall in oil prices. Stripping out oil, they again improved slightly, in line with the increase in the PMI export orders component, which rose to 55.3 in October, and international cargo traffic. At the same time, imports increased (fig. 5), particularly excluding oil (23.6% 3m yoy in October), driven by a rise in the imports of gold, minerals and industrial metals, as well as machinery parts. This could herald an improvement in investment in 4Q, which in our view will still be marginal, however. Despite the increase in government approvals for investment projects, the number of proposals presented is still significantly down (-24.9% yoy in October), also in total value terms (-20.3% yoy).

- The increase in orders, both in the PMI index in October and November and in the Reserve Bank of India (RBI) Q3 Industrial Outlook Survey, points to an improvement in industrial output in the next few months. According to the central bank's quarterly survey, business confidence increased further in the third quarter and in expectations for the fourth quarter (fig. 3), in contrast with the findings of the *Dun&Bradstreet* survey.

- Tourist arrivals continue to grow, thereby supporting tourism industry revenues. At the same time, mobile phone subscriptions continued to increase, and together with the improvement in the services PMI in November, suggest that the sector will also hold up in 4Q. The lower than expected rainfall in the north-east monsoon slowed winter sowing (*rabi*). The next harvests may therefore not be able to compensate for the fall in the autumn harvests (*kharif*), again having an impact on agricultural production and therefore on GDP trends in the next few quarters. In the wake of the election results and the fall in inflation, consumer confidence again rose in the third quarter RBI Consumer Survey. The assessment of the labour market remains positive, as does that on the outlook for incomes, but the improvement in spending intentions on durable goods remains marginal. All this should support consumer spending, which nevertheless remains vulnerable to the slowdown in wage growth in rural areas. We have left our GDP growth forecast for 2014 unchanged at 5.2%.

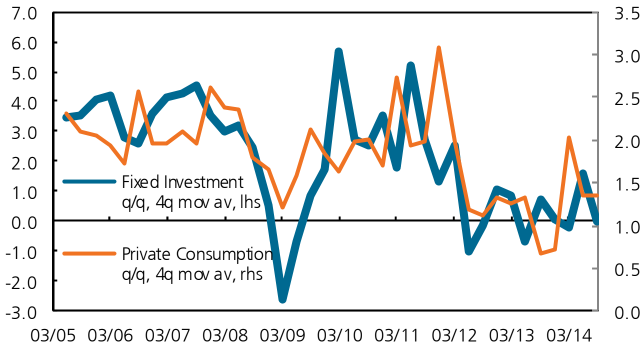
- Consumer price inflation fell more sharply than we expected, to 5.5% in October, from 7.7% in August (fig. 4), partly on the back of temporary effects such as a highly favourable base effect and a slowdown in inflation in the food segment, driven by the seasonal drop in fruit and vegetable prices. In addition, the fall in oil prices and the lack of electricity price rises should be taken into account. The abolition of subsidies and administered prices for the consumption and production of diesel introduced in mid-October in the short term are unlikely to have an impact, given that oil prices are trending downwards, but on other food products (meat, milk), inflation still remains high. Inflation excluding food and fuel held firm at 5.9% in September and October, coming out higher than total inflation, driven by upside pressures on certain segments such as housing, personal care and clothing. The base effect will be unfavourable from December, and inflation is expected to begin to rise again in the next few months, while remaining below RBI forecasts for March 2015 (revised down to 6%, from a previous 8%).

- RBI forecast for March 2016 remains at 6%, with balanced risks. This is based on rain forecasts for the south-western monsoon in line with the historical average, oil prices broadly in line with current prices and no increase in administered prices for fuel, with the exception of electricity tariffs. In December, the RBI stated that it is ready to ease monetary policy in early 2015, even intra-meeting, if the trend in inflation evolves as expected, there is a fall in inflation expectations and public finances remain in line with the consolidation objective. According to this hypothesis, the reversal could be quick and significant, in order to offset the slow speed with which banks have transferred the recent drop in money market rates to customers. We therefore believe that the RBI could take the repo rate to 7% by the end of summer 2015 if the budget for FY 2015-2016 is in line with expectations.
- The recent reforms in energy, the simplifications approved to federal laws on workers' rights and companies' administrative obligations, as well as proposals to make the country more open to FDI, are positive for investment. A more solid improvement in the business climate will however require more time, and will depend on further reforms, also in individual states. The most important at federal level include the easing of regulations regarding workers' rights (a company with more than 100 employees may not currently lay off staff without government approval), waiting to gain parliamentary approval by the end of the year, and of land purchasing procedures. A general tax on goods and services, which would make India a single market (every single state currently has its own taxes and therefore own border controls) would have a big impact on competitiveness, lowing transport times by 20-30% and costs by 30-40%, according to the World Bank.
- The approval of reforms will be partially slowed by certain institutional obstacles (see Macroeconomic Outlook, September 2014) and by unions; they will not therefore have an immediate effect. Owing to these factors, the recovery in investment will be slow and initially limited, also by the trend in lending. We have revised up only slightly our growth forecast to 5.6% in 2015. The introduction of the reforms set out above and the easing of monetary policy will weigh more on the growth trend in 2016, which we see picking up further to 6.0.%.
- The return of capital inflows, the improvement in external vulnerability indicators and the current account balance, further supported by the fall in oil prices, will make the exchange rate less exposed to the effects of Fed rate rises and cuts in RBI rates.

Macro forecasts	2010	2011	2012	2013	2014E	2015F	2016F
Gross Domestic Product*	9.3	7.7	4.8	4.7	5.2	5.6	6
Private Consumption	7.5	10.1	5.7	4	6.2	4.9	6.9
Public Consumption	7.9	6.2	7.6	4.4	7.3	5.4	6.6
Total Fixed Investment	15.2	11.5	2.4	1	1.6	2.9	5.4
Exp. of Goods and Serv.	13.8	20.8	8.3	5.3	6.4	6.7	7.1
Imp. of goods and serv.	17.8	18.2	11.6	-1	1.9	5.3	5.5
Industrial production	9.7	4.8	0.7	0.6	1.8	4.7	6.9
Inflation (CPI)	10.3	9.6	9.7	10.1	7.2	5.6	5.8
Unemployment rate (%)	6.1	5.8	5.6	5.6	5.6	5.7	5.8
Average wages	17.5	15	16.4	11.2	10.6	9.8	8.9
3- month Mibor (%)	6.3	9.5	9.5	9.3	9	8.1	7.5
Exchange rate USD/INR (average)	45.74	46.69	53.47	58.57	60.96	62.85	63.00
Current account balance (bn INR)	-2498	-2945	-4893	-2780	-968	-1268	-867
Current account balance (% of GDP)	-3.6	-3.6	-5.4	-2.7	-0.8	-1.0	-0.6
Government balance (% of GDP)	-4.0	-7.2	-5.8	-5.9	-4.7	-4.4	-4.1

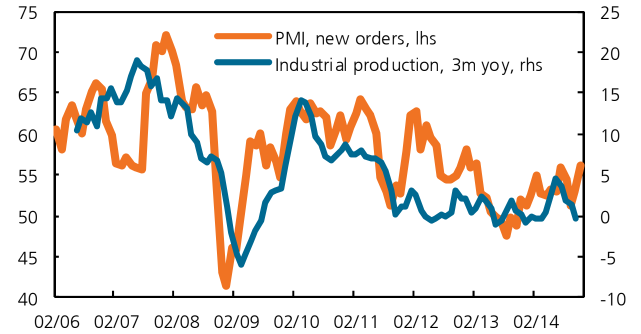
NB: Percentage change versus previous period except where otherwise indicated. * constant prices at factor costs. Figures refer to the calendar year.
Source: Oxford Economics Forecasting and Intesa Sanpaolo

Fig. 1 - Investment is recovering slowly



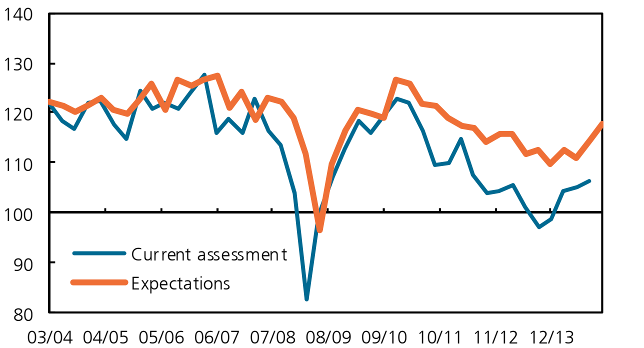
Source: Intesa Sanpaolo chart from CEIC data

Fig. 2 - Tentative improvement in Industrial output



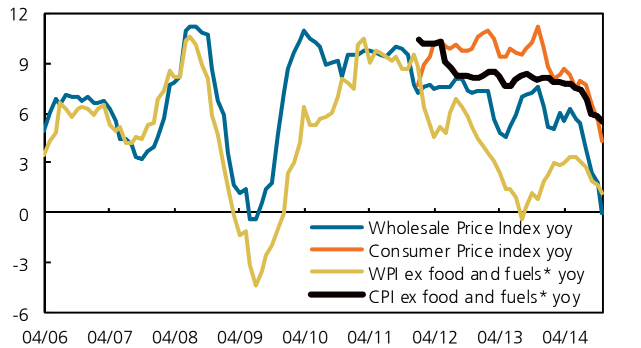
Source: Markit-HSBC, CEIC

Fig. 3 - Further improvement in business confidence*



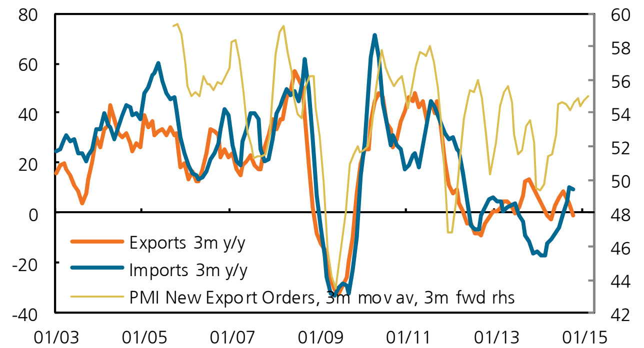
*Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Fig. 4 - Inflation is falling



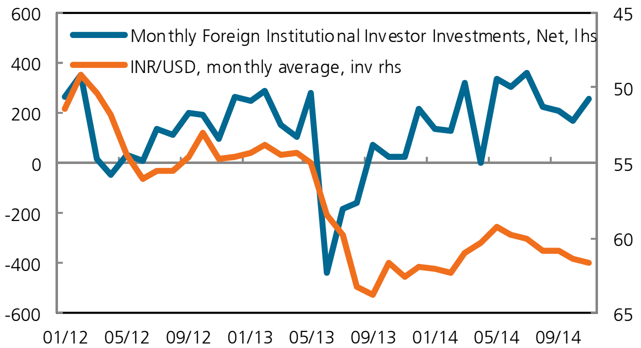
*Intesa Sanpaolo estimate. Source: CEIC

Fig. 5 - Exports remain low



Source: Bloomberg, Markit

Fig. 6 - The depreciation of the rupee remains limited



Source: CEIC

Currency markets: to diverge or not to diverge: that is the question

Asmara Jamaleh

The risks for the euro and the yen are still to the downside, with policy measures of the ECB and the BoJ diverging from those of the Fed. By contrast, the "non-divergence" of the BoE gives sterling another chance to recover.

Euro: the slide is not yet over

- In 2014, the euro made its due correction (see Fig. 1), sliding from a high of nearly 1.40 (1.39 area) to almost 1.20 (low in EUR/USD 1.22 area), in line with the fundamentals. The fall was driven by the simultaneous improvement in the US economic outlook and the deterioration in Euro zone growth and inflation. Expectations of a Fed Funds hike have been increasing, while the ECB has been compelled to resume rate cuts, setting them at (near) zero and launching – six years after the Fed – its own mini QE programme.

- It should be noted that the ECB's role has proved particularly key since Draghi expressly admitted that the exchange rate, although not a policy target, was nevertheless a very important variable that the ECB factors into its monetary policy decisions: an excessive rise by the euro in the context of virtually zero growth and very low inflation can in fact push inflation lower and further away from target. In such a situation, the ECB is permitted to expand monetary policy, and that is what it did this year.

- A major factor that has helped the euro correct is the divergence between the monetary policy cycle of the ECB (which has just ended its rate cut cycle and just started its own mini QE programme) and the Fed (which has ended its QE programme and is now ready to hike rates). This divergence will also continue next year, although the effect could lessen over time. The best approach to 2015 is to divide it into two parts, approximately equivalent to the first and second half. In the first half of the year, policies are set to diverge further as the ECB will increase QE and shortly afterwards the Fed will (definitely) start to raise rates. Downward pressure on the euro will be greatest in this phase, especially at the time of the first Fed Funds hike, given that – and we must not forget this – (1) the starting point is zero and (2) the Fed Funds have been stable for six long years.

- Our estimates of the fair value of the EUR/USD exchange rate (see Fig. 2), with ECB rates at zero and the Fed Funds rising towards 1.00%, put it in the 1.23 region. As our estimates were based on monthly data derived from daily averages, the exact floor consistent with an average level of 1.23 is EUR/USD 1.20. At the moment, however, the risks to the Euro zone are all still to the downside. Moreover, if we consider the possibility of a temporary undershoot, the EUR/USD rate could fall to the 1.20-1.15 range. We would put the expected floor at around EUR/USD 1.18. This level represents significant support because it is the floor reached in 2010 during the Greek crisis, when lack of confidence in the euro due to the threat of a break-up of the Euro zone was at its height. To find a lower floor in the last ten years, we would have to go back to the end of 2005, when the exchange rate fell to 1.16 EUR/USD. At that time, we were effectively still in the phase before the structural break of the 2008 global financial and economic crisis. Nevertheless, the prevalence of downside risks means we cannot rule out *a priori* the possibility of a larger undershoot.

- In the second half of the year, however, the euro could gradually rise to EUR/USD 1.25 at least. The "divergence" effect should then gradually diminish, especially once the ECB has stopped expanding monetary stimulus in light of a resumption of growth and an upturn in inflation. But here, too, the risks are to the downside, especially if the Euro zone outlook worsens again. The probability of this happening does not seem very high, though: among other things, the effects of the euro's recent downward slide – which even Draghi called "considerable" at the ECB's early-December meeting – will start to be felt in the next few months by both exports (hence favouring growth) and inflation. In this case – and we're not punning here – even though the exchange rate is not an ECB "policy target", the effects of the policy measure on the exchange rate will make it easier to achieve the "policy target" (i.e. a rise in inflation).

Yen: 125 – new weaker target

- The divergence issue is also affecting the yen. The hiatus in GDP growth caused by the consumer tax rise has revealed the structural holes in Japanese economic policy. The need to put the public accounts in order is at odds with the target of simultaneously pushing up growth and inflation. The BoJ is now faced with having to further expand quantitative and qualitative easing (QQE), saying that it is prepared to increase the stimulus in the next few months, if necessary. The government, for its part, has postponed the second consumer tax rise – planned for October 2015 – until 2017, and is preparing a new fiscal stimulus package. Prime minister Shinzo Abe has dissolved parliament's lower house and announced early elections in search of fresh approval for the relaunch of the revised and adjusted version of Abenomics.
- In the midst of all this, the yen has plummeted by 13% against the dollar in fewer than three months, from USD/JPY 105 to 121, having been stable at USD/JPY 100-105 for the first two thirds of the year. The yen's depreciation is in line with fundamentals and shows, in a linear way, the divergence in monetary policy between the BoJ and the Fed. The economic policy authorities are worried, however, that the currency will weaken too much and too quickly, which could threaten the credibility of the policy measures. Added to this, the asset allocation reform to the Japanese Government's Pension Investment Fund (GPIF), which opens the doors wide to investments in foreign securities, increases the critical mass of portfolio outflows. The indications for the yen are therefore mostly to the downside, and the pressures will probably increase when the Fed raises rates, especially since, unlike other central banks, the BoJ has no chance of hiking rates for the next two years. However we restrict our forecasts for the yen's decline to around USD/JPY 125 during 2015. There are, in fact, some factors that should help avert any further considerable depreciation of the yen:

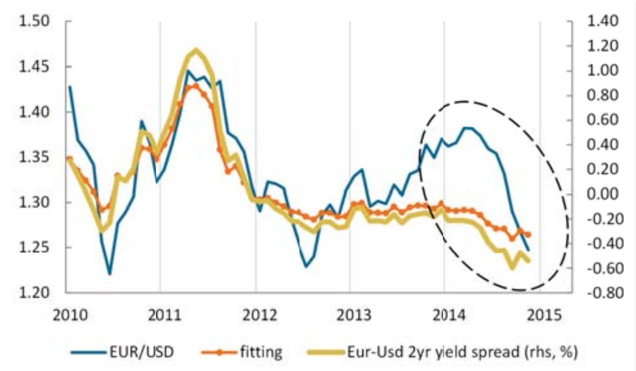
1. the extremely cautious attitude of Japanese economic policymakers to the currency. They think that depreciation in this phase will benefit exports and companies but hurt households and SMEs – due mainly to the higher energy costs caused by a weaker currency. Statements by the economic policymakers expressing their disapproval of an excessive fall in the yen should therefore limit its downside;
2. the implications for the other Asian currencies, on account of trading within the region. The yen's descent – which could be seen as a form of competitive devaluation – has already triggered a depreciation in the other main Asian currencies, but further falls, especially if large, could prove destabilising.
3. the difficulties and (long) timescales for achieving the inflation target. If this turns out lower than expected, real rates prove to be higher, and spreads *vis-a-vis* US rates (which are widening because nominal rates are rising) are narrower, there should be less downward pressure on the yen;
4. knock-on effects on the dollar. In an environment where all the main currencies (euro and yen *in primis*) are falling because the Fed is raising rates and thereby generating divergence in monetary policy, the bullish effect on the dollar is generally accentuated; this may lead the Fed to slow the pace of subsequent hikes. As a result, the greenback could partially correct against the other currencies (including the yen).

Overall, therefore, the risks to the main scenario for the yen are to the downside, as with the euro.

Sterling: complex picture, but we expect new highs against the euro

- The issue for sterling, on the other hand, is "non-divergence". The prospect that the Bank of England will also start to raise rates in 2015, at (approximately) the same time as the Fed will, remains the main driver of sterling's expected strengthening. But following its fall in recent months, it is likely to stage only a partial recovery against the dollar, to GBP/USD 1.60-1.65. The highs seen in the GBP/USD 1.71 region in July would be behind us, because the underlying assumption at those levels was that the BoE might start hiking before the Fed. Now, however, the reversal is expected to happen at more or less the same time. In our view, the BoE could time it for the first half of the year, most likely in 2Q, but with risks of a postponement until 3Q; this is not so much because of the general elections in 2Q as the uncertainty surrounding the macro outlook. However, sterling's expected strengthening against the euro should herald the start of a series of new highs towards EUR/GBP 0.75 or just under. In this case, it is again a matter of divergence between the monetary policies of the BoE and the ECB.
- The considerable acceleration expected in UK GDP growth, from 1.7% last year to around 3.0% in 2014 (the BoE's estimate of 3.5% seems a little optimistic to us), could justify an improvement in the pound's performance, especially considering that it is higher than the US. But here, too, the risks are to the downside, mainly due to the uncertainty around timings and the size of the rise in inflation; in the short term (3-6 months), this could fall further, slipping below the lower limit of the target band, i.e. slightly below 1%. This is, however, likely to be a temporary development, at the most slightly postponing the timing of the first rate rise, which would still be in 2015. By contrast, the outlook for a slowdown in growth from as early as 2015, with the US outperforming the UK in this case, explains expectations that sterling will subsequently recede towards the end of next year.

Fig. 1 – In 2014 the euro made the "due" correction



Source: Thomson Reuters-Datastream and Intesa Sanpaolo elaborations

Fig. 2 – Fair value estimates for EUR/USD wrt EUR and US yields

		US short-term yields (%)			
		0.00	0.25	0.50	1.00
Euro Area short-term yields (%)	0.00	1.3045	1.2859	1.2676	**1.2318**
	0.25	1.3280	1.3091	1.2905	1.2540
	0.50	1.3520	1.3328	1.3138	1.2767
	1.00	1.4013	1.3814	1.3617	1.3232

Source: Intesa Sanpaolo elaborations based on Thomson Reuters-DataStream data

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Appendix

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(2) No direct or indirect compensation has been or will be received in exchange for any views expressed.

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Valuation Methodology

Trading Ideas are based on the market's expectations, investors' positioning and technical, quantitative or qualitative aspects. They take into account the key macro and market events and to what extent they have already been discounted in yields and/or market spreads. They are also based on events which are expected to affect the market trend in terms of yields and/or spreads in the short-medium term. The Trading Ideas may refer to both cash and derivative instruments and indicate a precise target or yield range or a yield spread between different market curves or different maturities on the same curve. The relative valuations may be in terms of yield, asset swap spreads or benchmark spreads.

Coverage Policy And Frequency Of Research Reports

Intesa Sanpaolo S.p.A. trading ideas are made in both a very short time horizon (the current day or subsequent days) or in a horizon ranging from one week to three months, in conjunction with any exceptional event that affects the issuer's operations.

In the case of a short note, we advise investors to refer to the most recent report published by Intesa Sanpaolo S.p.A's Research Department for a full analysis of valuation methodology, earnings assumptions and risks. Research is available on IMI's web site (www.bancaimi.com) or by contacting your sales representative.