INTESA SANPAOLO

Macroeconomic Outlook

Research Department

December 2017

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December 2017

Quarterly

Intesa Sanpaolo
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Based on information available up to 15 December 2017

Please read carefully the important disclosures at the end of this publication

An almost surreal scenario of tranquillity for 2018

Luca Mezzomo

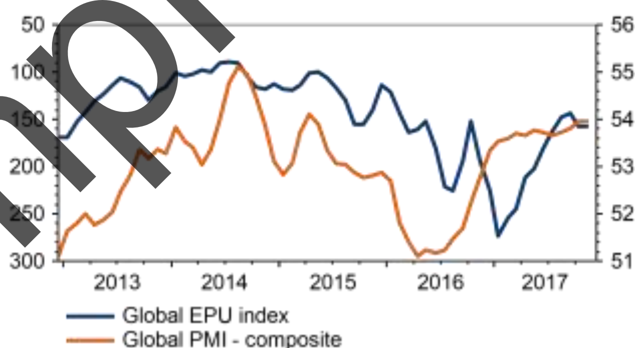
The phase of moderate but widespread economic growth in 2017 seems set to continue into 2018. For some areas, prospects have even improved compared with a few months ago. Monetary restriction could pick up the pace a little: even though inflation will remain modest, some signs of excessive financial vigour are starting to appear. However, the risks of a downturn are still negligible. A surprisingly calm scenario, for the time being, which, it seems, only unexpected geopolitical developments could upset in 2018.

In the last three months, consensus estimates of economic growth in advanced countries were again revised up: by 0.1% for the US, UK and Japan, and by 0.3% for the Euro zone. The revisions reflect the positive surprises provided by the continued flow of economic data from the advanced countries and from emerging economies in recent months, as well as signs from the economic surveys that manufacturing activity is strengthening. Inflation forecasts have also risen – by 0.2% to 2.1% for the US, and by 0.1% for the Euro zone. These estimates incorporate a modest slowdown in growth and broadly stable inflation compared with 2017.

Fig. 1 – Positive economic surprise indices everywhere

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

Fig. 2 – Measures of uncertainty about economic policy have returned to normal



Source: EPU, Thomson Reuters Datastream, IHS Markit

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A comforting aspect of this phase is that expectations seem to be firmly rooted and are subject to much less risk than usual. However, the **markets** have taken the Fed's **monetary restriction** in their stride, while concerns about the risks of financial instability in China have eased as the economy has strengthened. A large part of the global economy is now growing, making it less vulnerable to local shocks. The **emerging countries**, many of which experienced a slowdown or recession in 2016, have seen growth accelerate to over 4% in 2017, and this trend of strengthening economic growth should continue next year.

The outlook for **fiscal policies** also seems to be still working in favour of growth. In the Euro zone, a mild tightening of fiscal policy is on the cards, although this is not enough to worry about, while the tax reform currently being approved in the US could cause growth to rise by a few tenths of a percentage point in 2018 and, perhaps, again in 2019.

One question that might arise is whether the pick-up in global economic growth, which now includes the emerging countries to a greater extent, and the achievement of full employment in some advanced countries such as the US and Germany, could bring with it the risk of a rise in **inflation**. Indeed, industrial metals prices have been much more buoyant over the last year, and oil prices are higher than we expected. However, wage trends are still fairly modest, even in countries where unemployment has reached what we might now consider to be frictional levels. Moreover, the changes currently taking place in commercial distribution, notably the growth of e-commerce, are squeezing profit margins. Pockets of excess capacity still exist despite the

measures adopted by China to rebalance the steel and coal markets. As mentioned at the start, the 2018 inflation forecasts therefore remain modest and in line with the trend for 2017.

In addition, there seem to be no threats of financial instability on the horizon that could endanger the continuation of the growth phase. There are, of course, speculative excesses, and risk premiums are probably too tight. However, this has not translated into unusual lending patterns, which greatly reduces the destabilising potential. The latest BIS data on credit gaps, relating to 2Q17, still suggest that this excessive lending might only constitute a problem in some emerging countries (including China), while in the advanced countries a similar problem might only materialise in Canada, or perhaps France or Japan in the future. Lending is still very moderate in the Eurozone as a whole.

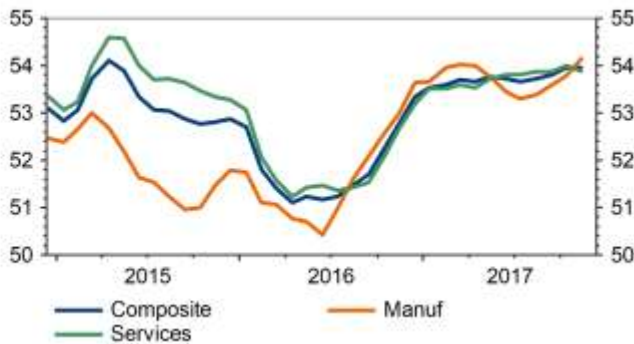
But what about geopolitical risks, which significantly influenced perceptions of the economic situation and the markets in 2016 and 2017? The situation is undoubtedly complex. The two crisis hotspots are North Korea (due to its proximity to various economic growth drivers) and the Persian Gulf (due to the rivalry between Saudi Arabia and Iran). However, the conflict between the US and North Korea would only escalate if there were serious errors of judgement by one of the two parties, while the friction between Saudi Arabia and Iran is unlikely to progress from a proxy war to direct conflict. In Europe, after the French elections, the other countries' elections did not have the same destabilising potential, and indeed there were no negative effects on economic activity at all (except, at purely local level, the tensions connected with the referendum on Catalan independence). The Italian elections might be associated with some increase in country risk premiums, but not to such an extent as to affect economic activity. For the time being, therefore, corporate confidence does not seem to have been adversely affected. The impasse in the process of forming a new German government is further complicating Eurozone reform, but it is the differing opinions on the priorities for action that constitute the real obstacle to the process. Paradoxically, a surprise agreement involving too abrupt a discontinuity in the prudential treatment of banks' sovereign exposures would be worse, and would probably trigger more volatility in the short term.

In conclusion, the 2018 scenario currently looks quite calm. Our forecasts do not vary greatly from the consensus estimates mentioned at the start. In general, we have revised our growth forecasts slightly up, especially for Euro zone countries. We expect global growth to be broadly unchanged on 2017, but higher on a year-on-year basis. Turning to monetary policy, we expect three official rate hikes by the Fed and the gradual closing of the ECB's securities purchases programme by the beginning of 2019 – with no official interest rate rises in 2018. The change of tack for US monetary policy could curb the appreciation of the euro for a bit longer, although in due course a rise over 1.20 could be justified.

Sample

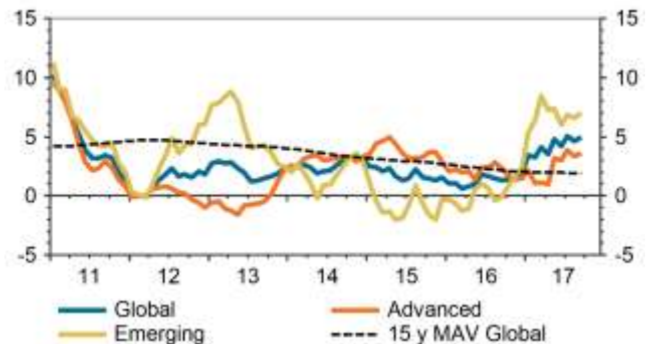
Global economic trends in 10 charts

Fig. A – Global PMIs



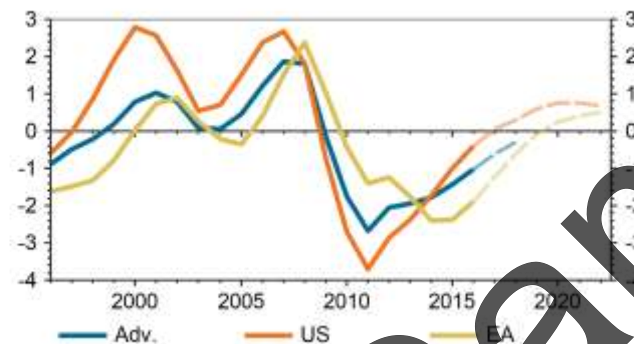
Source: Chart based on Markit Economics, Thomson Reuters-Datastream

Fig. B – Growth in imports, yoy



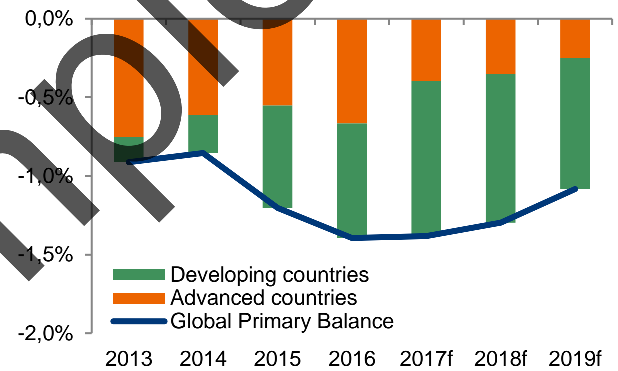
Source: Chart based on CPB World Trade Monitor, Thomson Reuters-Datastream

Fig. C – Output gap (IMF estimate)



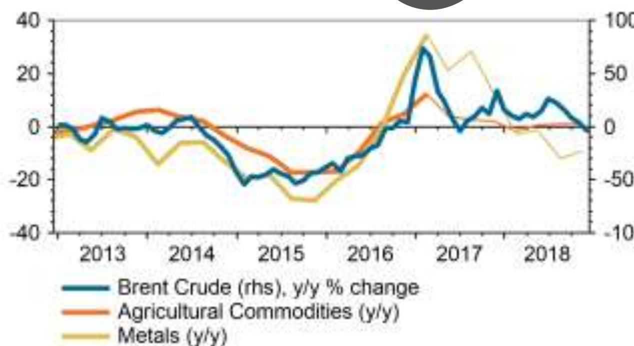
Source: Chart based on Thomson Reuters-Datastream and IMF

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



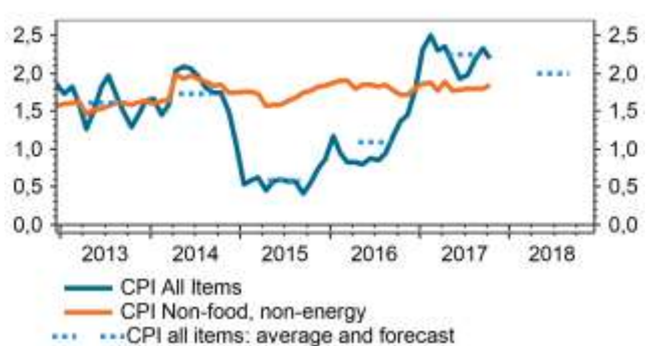
NB: based on 11 major advanced countries and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



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

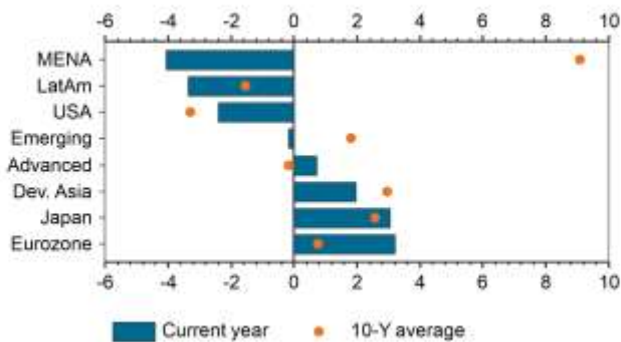
Fig. F – Consumer price indices for OECD countries



Source: Chart based on OECD, Thomson Reuters-Datastream

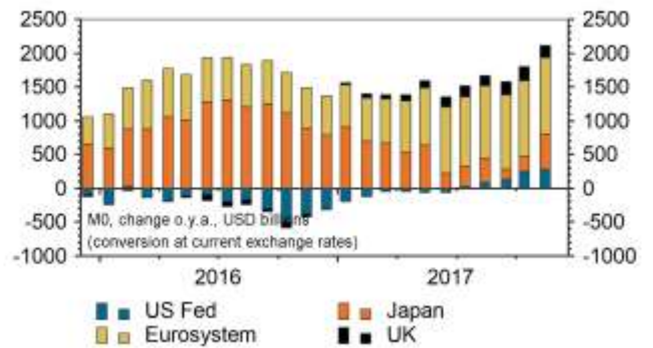
Sample

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



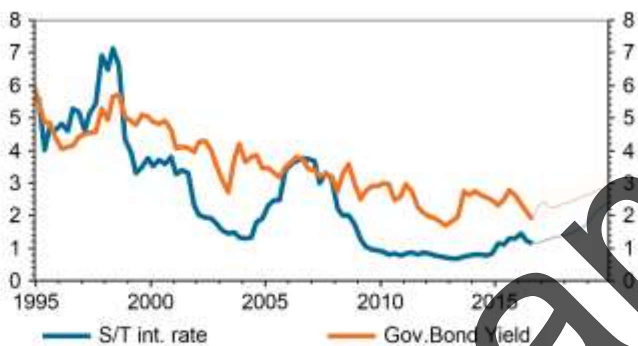
Source: IMF data and estimates, chart based on Thomson Reuters-Datastream.

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



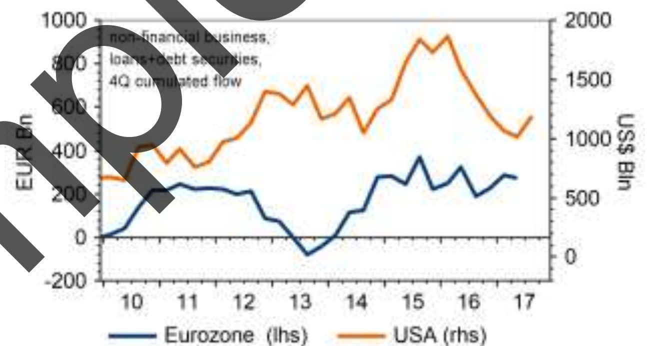
Source: Chart based on Thomson Reuters-Datastream, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



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

Fig. J – Lending to non-financial companies



Source: Chart based on Thomson Reuters-Datastream, ECB (integrated sector accounts), Federal Reserve (Flow of Funds)

Sample

United States: new challenges for Goldilocks in 2018

Giovanna Mossetti

Twenty-seventeen comes to an end with a set of positive outcomes: above-potential growth, low inflation, markets on the rise, low volatility, and no signals of financial instability, although the recovery is now very mature (the third-longest in the post-WWII period). Based on CBO estimates, **the output gap is officially closed,** after a recovery process which lasted around nine years, whereas the **unemployment gap has been negative since 2016**, consistently widening. Inflation is moderate, and for the time being has not responded to the reduction of slack, allowing a gradual exit from the aggressively accommodative monetary policies implemented over the past decade.

What does 2018 have in store? It will be hard to improve, given the almost perfect starting point of the economy, which is neither too cool nor too hot. Net of the tax reform, forecasts would be for moderate growth of 2.3% in 2018, and 2.1% in 2019, supported by widespread expansion of domestic demand, in particular consumption and fixed corporate investments, with a gradual increase in core inflation towards (but still below) the 2% threshold by the end of 2018. **The main uncertainty weighing on the scenario stems from the tax reform**, the details of which are yet to be defined, but which will probably have expansionary effects on the economy in the next two years, estimated in very rough terms at 0.3 pp per annum, with a possible impact on long-term growth of around one tenth. This prompts us to revise up our forecasts for **GDP growth, to 2.6% in 2018 and +2.4% in 2019, subject to changes once the details of the Tax Cuts and Jobs Act will have been defined. The scenario net of the tax reform is reassuring and solid,** and the apparent flattening of the Phillips curve could limit the fallout of potential excess demand on inflation. As the changes to corporate and personal income tax are still in the making, uncertainty is very high. For now, though, **risks to the US scenario are limited and, at least in the H12018, balanced.**

On the one hand, the likely implementation of the tax reform, with expansionary effects on an economy that is already at full employment levels, could generate an overheating starting in the second half of 2018, with upward pressures on rates between the end of 2018 and early 2019, and late-cycle risks. On the other, the effects of the reform are uncertain, and could be modest, whereas persistently weak inflation could slow the uptrend in interest rates (a scenario all the less likely the more expansionary the reform will prove to be). Lastly, the **change at the helm of the Fed**, although fraught with some uncertainty, should guarantee continuity and caution, with ongoing gradual removal of stimulus, subject to the evolution of inflation and to the cyclical effects of the tax reform.

Economy at full employment with no inflation. Growth is solid and widespread, supported by all components of **domestic demand. Consumption** should increase by **2.7% in 2018 and 2.5% in 2019**, supported by a labour market at full employment, ongoing net wealth growth, and by a (likely) tax reduction. In 2018, the wage trend should accelerate moderately. Job gains should remain on a downtrend (Fig. 2), compatible with more moderate corrections of the unemployment rate compared to the post-crisis period**. Consumption fundamentals remain solid, although two hitches should be pointed out**: 1) the ongoing drop in the savings rate, which is now at 2008 levels, at just above 3% (well below the post-crisis average, of around 6%, Fig. 8); 2) the new uptrend in household debt. **If the tax reform is approved,** in 2018-19 **the boost to spending should be limited by the regressive nature of the measures,** and by the uneven effects among the lower income classes. In the Senate's version, **tax cuts for households will expire in 2025,** adding uncertainty to its impact on consumption.

Non-residential investment has been recovering lately (Fig. 3), after proving highly volatile due to oil price fluctuations in previous years, also thanks to stronger domestic and global demand. Businesses should be the first in line to benefit from the tax reform, with measures lowering the corporate tax rate, reducing the tax burden for pass-through businesses, and introducing full expensing of machinery for five years. The effect of the reform on investment, however, will depend on the share of extra-profits that will be poured into higher spending, with an economy at full employment. We forecast solid growth in non-residential investments (**5.4% in 2018 and**

Sample

4.9% in 2019), despite uncertainty due to the historical precedents that show their muted reaction to stimulus addressed to businesses. **Residential investment** should recover starting at the end of 2017, and mark moderate increases in the next biennium.

The great unknown in 2018: inflation. In 2017, despite accelerating growth, the trend of core prices has slowed (Fig. 10), in part due to temporary factors (mobile phone fees, healthcare services), but also for structural reasons (weak inflation expectations, "Amazon effect", stronger competition). The flattening of the Phillips curve would suggest forecast inflation at 1.9%, with an unemployment rate of 2.5% (St Louis Fed, on Blanchard estimates). We expect **inflation to rise slowly in 2018**, albeit at such a pace as to allow the FOMC to implement the three hikes it currently envisages. However, **downside risks persist.**

Fiscal policy: focus point in 2018. The reform Congress is working on aims to simplify the tax system, rationalise and cut corporate taxes and, to a lesser extent, the taxation of households, at a "static cost" of 1.4 trillion dollars over 10 years. While rationalisation and a widening of the tax base have been necessary for some time, a **significant reduction in the tax burden is probably inappropriate in a full employment phase**, unless it is accompanied by measures aimed at stepping up potential growth. The reform, if approved, should increase **the cumulated deficit by around one trillion dollars in 2018-27** (dynamic estimates of the Joint Committee on Taxation on the Senate's version of the bill), with permanent effects on debt, and a 0.8% increase in GDP compared to the unchanged legislation scenario. As many measures are transitory, the effects will decrease over time, and should be marginal in the following periods.

The new Fed faced by an increasingly mature cycle. Twenty-seventeen ends with a **change at the helm of the Fed**. The new chairman, J. Powell, should keep monetary policy on the path outlined so far, with a gradual removal of stimulus, taking a very cautious approach. While Powell is a "continuity chairman", greater uncertainty stems from the appointment of another four board members, who will in all likeliness be more hawkish than their predecessors. 2018 will present **new challenges for the Fed**. The 2017 Goldilocks economy could be rocked on two fronts. The likely approval of a **tax reform** could threaten the current "quasi-steady-state", creating bouts of excess demand, impacting inflation and financial asset prices. On the other hand, the effects of the reform could be limited, and **inflation could remain weak for structural reasons**. The risks to these two scenarios, at least in H12018, are almost balanced, leaving the FOMC waiting for information and with highly dispersed opinions internally on the precise path of interest rates. Another aspect to monitor is the opening of a discussion on the definition of the **price stability mandate,** with a potential shift to targeting the level rather, than the change, of prices. We expect **three rate hikes in 2018,** with a pause in 1Q and a regular path from 2Q onwards, subject to the trend of inflation and to the effects of the tax reform.

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Macro forecasts	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.5	2.3	2.6	1.5	1.8	2.0	2.2	2.3	2.6	2.8	2.7	2.5	2.5
q/q annual rate				2.8	1.8	1.2	3.1	3.3	2.6	2.3	2.5	2.6	2.7
Private consumption	2.7	2.7	2.7	2.8	2.9	1.9	3.3	2.3	2.7	2.5	2.8	2.8	2.9
Fixed investment - nonresid.	-0.6	4.7	5.4	3.4	0.2	7.2	6.7	4.7	6.8	5.0	4.6	5.3	5.2
Fixed investment - residential	5.5	1.1	2.1	-4.5	7.1	11.1	-7.3	-5.1	1.9	5.8	4.3	3.5	3.6
Government consumption	0.8	-0.1	0.3	0.5	0.2	-0.6	-0.2	0.4	0.5	0.2	0.3	0.2	0.2
Export	-0.3	3.3	3.7	6.4	-3.8	7.3	3.5	2.2	6.0	3.6	3.1	3.5	3.1
Import	1.3	3.4	3.6	2.7	8.1	4.3	1.5	-1.1	5.8	4.5	4.2	3.4	3.3
Stockbuilding (% contrib. to GDP)	-0.4	-0.1	0.0	0.1	1.1	-1.5	0.1	0.8	-0.3	-0.1	0	-0.1	0.0
Current account (% of GDP)	-2.4	-2.5	-2.8										
Federal Deficit (% of GDP)	-5.0	-4.3	-4.1										
Gov. Debt (% of GDP)	127.1	124.3	123.2										
CPI (y/y)	1.3	2.1	1.9	1.1	1.8	2.5	1.9	2.0	2.1	1.7	2.0	2.1	1.8
Industrial production (y/y)	-1.2	1.8	3.1	0.2	0.2	0.4	1.4	-0.1	1.1	1.1	0.6	0.5	0.6
Unemployment (%)	4.9	4.4	4.2	4.9	4.7	4.7	4.4	4.3	4.3	4.2	4.2	4.1	4.1
Fed Funds	0.5	1.1	1.8	0.5	0.5	0.8	1.0	1.3	1.3	1.5	1.8	1.8	2.0

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

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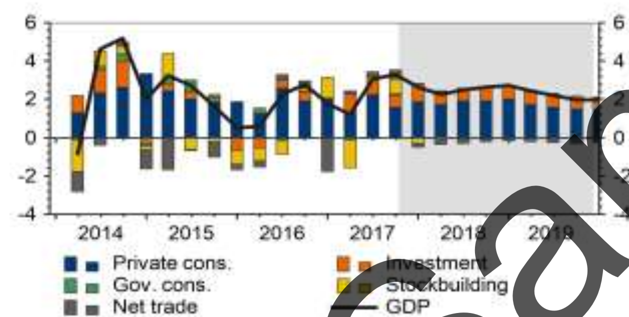
Fig. 1 – All components of domestic demand are forecast to grow at a moderate pace

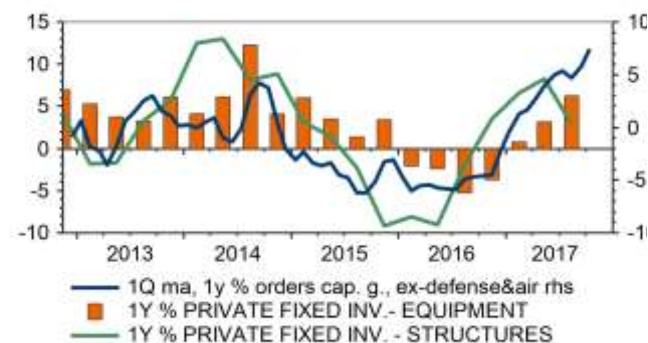


Source: Thomson Reuters-Datastream. Previsioni Intesa Sanpaolo

Fig. 2 – Surprise!

CESI: Citigroup economic surprise index. Source: Thomson Reuters-Datastream

Fig. 3 - Orders point to stronger non-residential investment, even before tax reform



Source: Thomson Reuters-Datastream

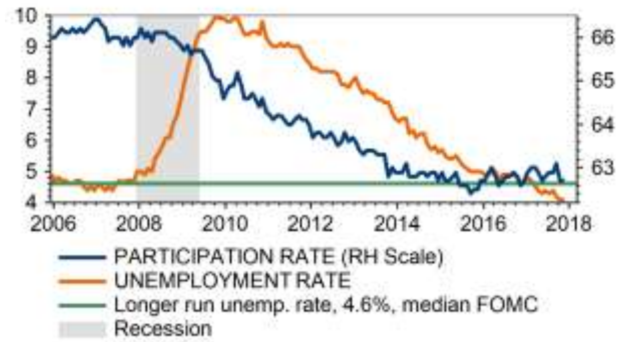
Fig. 4 – There's something new in the air: slowing employment trend, rising productivity

Source: Thomson Reuters-Datastream

Fig. 5 – NFPs still close to +180k per month

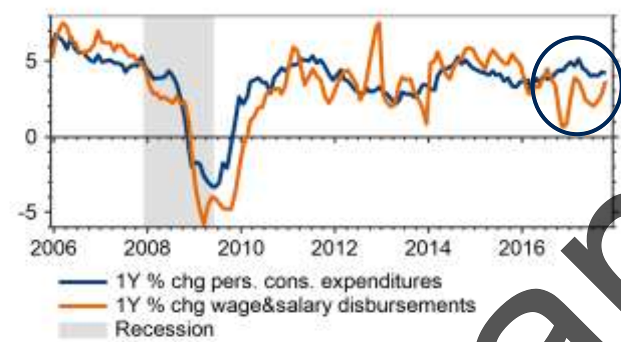
Source: Thomson Reuters-Datastream

Fig. 6 – Unemployment on a downtrend, participation stable



Source: Thomson Reuters-Datastream

Fig. 7 – I consumatori non sono stati fermati dalla dinamica retributiva debole…

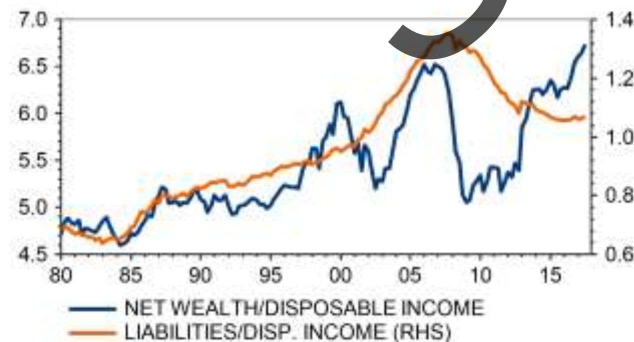


Source: Thomson Reuters-Datastream

Fig. 8 – …ma hanno di nuovo messo mano al risparmio per finanziare la spesa

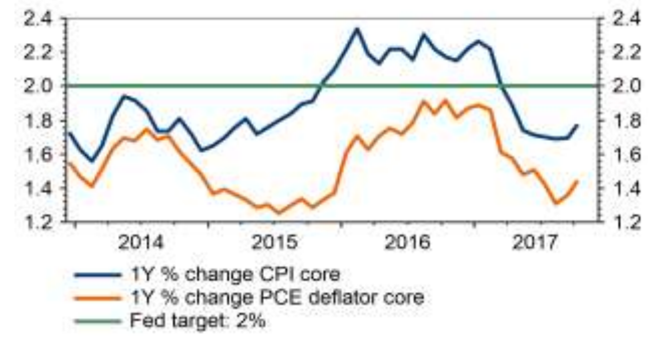
Source: Thomson Reuters-Datastream

Fig. 9 – Household net wealth through the roof



Source: Thomson Reuters-Datastream

Fig. 10 – Inflation still low, in part due to temporary factors



Source: Thomson Reuters-Datastream

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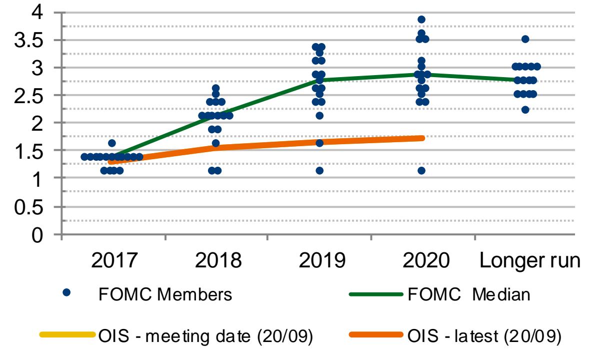
Fig. 11 – The goals of the Fed's mandate are diverging, but should gradually re-align

Source: Thomson Reuters-Datastream

Fig. 12 – FOMC participants' interest rate projections still highly dispersed for 2018-20



Note: projections of the Federal Reserve Bank Presidents, and of the members of the Board of Governors, 13/12/2017. Source: Intesa Sanpaolo elaborations on Federal Reserve Board and Thomson Reuters-Datastream data

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Euro zone: fairy-tale economics. ECB, the end of QE is in sight

Anna Maria Grimaldi

Euro zone economy continues to outperform expectations

Euro zone economy is steaming. In 2017, growth is seen closing at 2.3%, around one point higher than the consensus and ECB estimates of a year ago and well above potential (1.5% in the European Commission's autumn estimates). Growth has been accelerating since end-2016, and includes the recovery in global demand and exports, which drives manufacturing activity. In the services sector, the recovery in retail trade and construction continues apace, shored up by domestic demand. Confidence surveys in October and November pointed to an acceleration of 0.7% qoq in GDP growth at the end of the year (see Fig.1). However, industrial output's lacklustre end to the summer quarter, together with the fall in retail sales in October, suggest a more conservative estimate (0.6% qoq). Recent figures leave little doubt that the Euro zone's underlying economy is far stronger than we expected even in September. Growth rates of around 0.5% qoq would seem to be sustainable in the first half of 2018 too. We have therefore revised up our 2018 growth forecasts from 1.7% to 2.1%. 2018 will be a year of consolidation of the growth phase in all the main Euro zone countries and the growth gap between central Europe and the peripheral countries is expected to narrow further.

Exchange rate effect less significant than in the past

The **appreciation in the effective exchange rate** (+5.8% from April to December 2017) has had little visible effect so far, but it typically takes between six and nine months for the impact to be felt. In any case, the **impact will be less pronounced than the standard elasticities would suggest** (GDP growth and inflation will be 0.3% and 0.4% lower respectively after a year), since the pass-through exchange rate on import and final prices could be lower than in the past due to 1) structural reasons, including greater integration in the production processes at global level, and 2) cyclical reasons (companies that export to the Euro zone will probably be able to keep their sale prices stable in this phase of high global demand). In addition, as explained by the ECB, the impact of the shock varies depending on its nature. In this case, as the shock is partly external, i.e. it reflects more solid fundamentals and an improved macro-economic outlook, the effects on growth are less significant. For the time being, there are no signs that exports are slowing. The global PMI, excluding the Euro zone, continues to point to resilient exports in the next few months. We therefore forecast continuing solid export growth in 2018: 4.2%, from 4.8% this year. Imports are expected to grow at a more sustained pace than exports. The contribution of foreign trade will therefore go from being positive to slightly negative.

We expect only a modest slowdown in exports in 2018

Consumer spending surprises due to its resilience

According to our estimates, **domestic demand will still be the main growth driver** (+2.1%). Consumer spending is holding up better than expected and, in 2018, will grow at around the same pace as this year (1.8%). Growth in real disposable income will benefit from a temporary fall in inflation and the pick-up in employment, against a background of still-modest growth in nominal wages (see below). The news that gives us most confidence in the sustainability of the Euro zone's growth phase is that **the corporate investment cycle seems to have kicked off at last (see Figs 5-8)**. The European Commission's six-monthly survey points to a pick-up in expansion investment in 2018, justified by the high use of existing plant; stable, positive earnings growth; and more certain demand conditions. Moreover, the latest credit survey showed increased demand for loans to finance investment in machinery. In 2018, we expect investment in manufacturing to grow by over 5%, from an expected 3.8% in 2017. **Construction** activity is also faring better than expected (+0.7% qoq in spring after strong growth at the start of the year). Our indicator points to a continuation of the expansionary phase in the next six months, with growth of around 1.0% qoq.

Corporate investment has finally embarked on a livelier cycle

Construction: sound growth

Sample

Expansion may also continue in 2019, albeit at a less frenetic pace, given the decreasing support of monetary policy

We think that above-potential growth will continue in 2019, although at a slightly softer pace (1.8%), due to the reduced monetary policy stimulus. According to the ECB, the measures adopted between December 2015 and December 2016 may have boosted GDP growth by 1.7% in the period 2015-18[1]. The extension of the programme until September 2018 should support Euro zone growth and inflation by some 0.2% again in 2019. The contribution of fiscal policy will be neutral or slightly restrictive. The European Commission's autumn forecasts show the structural primary balance worsening by 0.2%. According to the European Commission's assessment of the 2018 draft budgets, many countries are at risk of non-compliance with the regulations of the Stability and Growth Pact, including Italy, France, Belgium and Portugal. These countries could therefore be required to implement additional tax measures. The Commission also notes that the countries that have done best in meeting their medium-term budgetary targets are likely to increase investment spending.

The cycle is not yet mature

The recovery that started in mid-2013 is not yet mature and this at least partly explains the feeble rise in inflation, particularly on core prices. The output gap will not close before the end of this year, if not early next year (see Fig. 9). There is no evidence of increased borrowing by families and/or companies: loan growth accelerated in October, but is still below pre-crisis levels. Some parts of the system are still in the phase of gradually reducing debt, including, of course, the public sector. **Employment market shows that there is still considerable, but varied, excess supply within the Euro zone** The European Commission's quarterly survey suggests that employment is starting to become a break on output; both manufacturing and services companies have indicated an increase in hiring intentions in the last few months. Confidence surveys are consistent with jobs growth of close to 1.9% in 2018 (from 1.6% this year) and a further fall in the unemployment rate from 9.1% in 2017 to an average of 8.4% next year. Despite the improved labour market conditions, wage growth remains modest: 1.9% yoy in the middle of this year, up from 1.5% in the previous six months but still well below rates in the pre-crisis period. We do not expect a significant change of pace in 2018. The inertia in nominal wages is partly because excess resources in the labour market are much greater than the level and trend in the ILO unemployment rate would suggest. The expanded unemployment rate, U-6 (which includes involuntary part-time workers, people seeking work but not available to start immediately, and discouraged inactive workers), fell to 16.5% in 2Q17 from a peak of 20.2% at end-2014, but is still higher than pre-crisis levels (12.1% in 2005-08). It is therefore possible that the upturn in wages and domestic prices will occur later than in previous cycles[2].

Sample

The rise in inflation towards the target will remain slow until well into 2019, but the risk of deflation has completely disappeared

Inflation will be directionless, as also indicated by the ECB: it will fall slightly below 1.0% in early 2018, from an estimated 1.5% for November, due to a negative base effect from the energy component, and then rise to 1.5% from mid-2018. Inflation should continue to rise gradually towards the ECB target in 2019 (on average by 1.6%). However, the profile will still be dependent on an upturn in core inflation to 1.6%, from 1.0% this year. The contribution from energy will also be paltry next year since we are not expecting significant rises in the crude price in the next two years. Although the rise in core inflation is modest, the **risk of deflation has, without a doubt, completely disappeared**. Price expectations derived from confidence surveys point to a gradual rise in domestic prices in the next few months. Market inflation expectations derived from 5-year forward contracts are also rising moderately but steadily, although they are still below 2%.

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[1] See also ECB Working Paper no. 1956, 2016: *The ECB's asset purchase programme: an early assessment*. The study estimates that purchases equating to 11% of GDP will have a maximum impact of 0.4% on inflation and 1.0% on growth after two years.

[2] Only in Germany, where the labour market operates with constraints on production capacity, will there be more pronounced wage rises as early as 2018 (IG Metall has called for 6% wage increases for 2018-19, and although the demand is unlikely to be met, it is quite likely that wage growth will be higher than the average 3.5% conceded in the two preceding years).

Franco-German axis for European governance reform? Maybe, but expectations must be kept low

There is no shortage of political and other risks at global and European level. It must however be recognised that **political risk in the Euro zone has waned since a year ago**. Populist winds are still blowing, but with the outcome of the French elections, the worst has been avoided. The political impasse in Germany is not necessarily a bad thing for the Euro zone if it leads to a new "grand coalition": SDP leader Martin Schulz has made it a condition that, before reopening negotiations with the Christian Democrats, reform efforts must be made that take on board the proposals put forward by Macron. However, Germany, the Netherlands and other Nordic countries are very reluctant to accept more burden sharing within the Union. It is not therefore reasonable to expect any major advances in the European governance reform process. From early next year, the political elections in Italy (which will be held before the end of May) will attract the markets' attention. However, euroscepticism, the bugbear of investors, is not fashionable any more among political parties. Moreover, the Catalan issue in Spain is still unresolved: separatists will be forced to take a more cautious approach than before, but they are not giving up their pro-independence stance.

2018 will mark the end of QE

Given the improvement in the scenario, we think it inevitable that the ECB will exit the purchases programme by early 2019. We think the ECB will want to prepare the markets in 2018 to avoid having to tighten the financial conditions around the time of next September's meeting. Changes to the guidance on purchases will most likely be introduced before next summer. In the meantime, the ECB will seek to keep short-term expectations anchored and hence could leave the guidance on rates, especially the reference to "well past the horizon of the net asset purchases" until end-2018. For the time being, the ECB has managed to limit the effect on market rates of the approaching end of ultra-expansionary policies. The markets are factoring in unchanged rates for the whole of 2018. We think that if the scenario of solid growth is confirmed by the figures, the ECB could raise the deposit rate by 30 basis points by September 2019, but it is not impossible that the first hike in the prime rate may not happen before 2020, after the end of full allotment. **2018 will therefore mark the end of the ECB purchases programme.** Between 2015 and end-2018, the ECB will have purchased public and private securities worth EUR 2,580 billion, assuming that it makes purchases at a rate of 10 billion per month in 4Q18, bringing its total balance sheet to EUR 4.8 trillion, over twice the size that it was at end-2014 (see Fig. 12). The asset management policy will probably continue to make reinvestments until 2021 (in the US, the Fed started to taper its purchasing three years after the end of QE). We think that monetary policy will still support the cycle in 2019 since the effects of extending QE until the end of 2018 will not be felt until later, and rates will also stay close to zero.

Sample

Macro forecasts

	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.8	2.3	2.1	1.7	1.9	2.0	2.3	2.5	2.4	2.4	2.2	2.0	1.9
- q/q change				0.4	0.6	0.6	0.7	0.6	0.5	0.5	0.5	0.4	0.5
Private consumption	2.0	1.8	1.7	0.4	0.5	0.4	0.5	0.4	0.6	0.4	0.4	0.3	0.3
Fixed investment	4.5	3.9	5.1	0.1	1.5	-0.2	2.0	1.2	0.9	1.3	1.4	1.2	1.0
Government consumption	1.7	1.2	1.2	0.2	0.4	0.2	0.5	0.2	0.3	0.3	0.3	0.3	0.3
Export	3.3	4.8	4.2	0.6	1.5	1.3	0.9	1.3	1.1	1.1	1.0	0.9	0.9
Import	4.7	4.6	4.2	0.5	1.9	0.4	1.5	1.3	1.1	1.1	0.9	0.7	1.0
Stockbuilding (% contrib. to GDP)	-0.1	0.1	-0.3	0.1	0.1	-0.1	0.1	0.1	-0.1	0.0	-0.1	-0.2	0.0
Current account (% of GDP)	3.3	3.1	3.0										
Deficit (% of GDP)	-1.5	-1.1	-0.9										
Debt (% of GDP)	91.1	89.3	87.2										
CPI (y/y)	0.2	1.5	1.4	0.3	0.7	1.8	1.5	1.5	1.4	1.1	1.5	1.6	1.6
Industrial production (y/y)	1.5	2.5	1.9	1.0	2.3	1.3	2.7	3.6	2.5	2.5	2.0	1.5	1.6
Unemployment (%)	10.0	9.1	8.5	9.9	9.7	9.5	9.2	9.0	8.8	8.7	8.5	8.5	8.4
3-month Euribor	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
EUR/USD	1.11	1.13	1.19	1.12	1.08	1.06	1.10	1.17	1.17	1.16	1.18	1.20	1.22

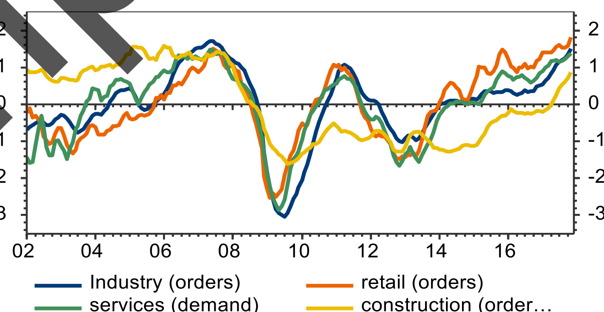
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Sample

Fig. 1 – Confidence surveys continue to point to a pick-up in growth

Source: Chart based on Thomson Reuters-Datastream

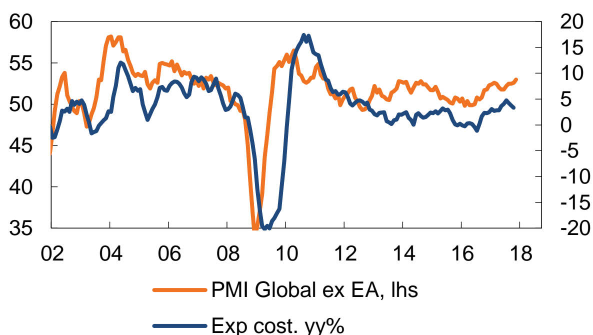
Fig. 2 – Demand is at pre-crisis levels in all sectors



N.B.: the figures are shown in standard deviations from the long-term mean.

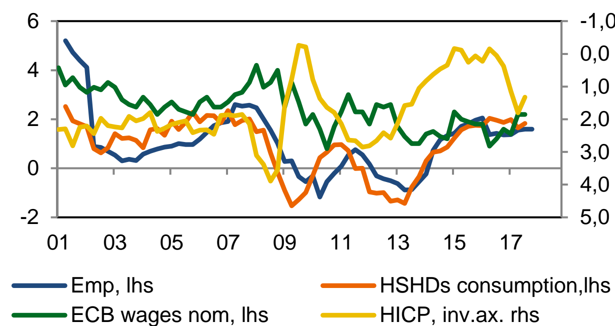
Source: European Commission sector confidence surveys. Intesa Sanpaolo chart from Thomson Reuters-Datastream

Fig. 3 – Exchange rate has limited impact Global demand has greater effect on exports



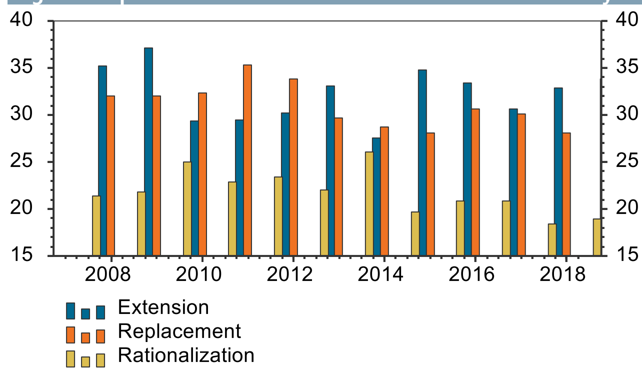
Source: Chart based on Thomson Reuters-Datastream

Fig. 4 – Consumer spending boosted by employment growth



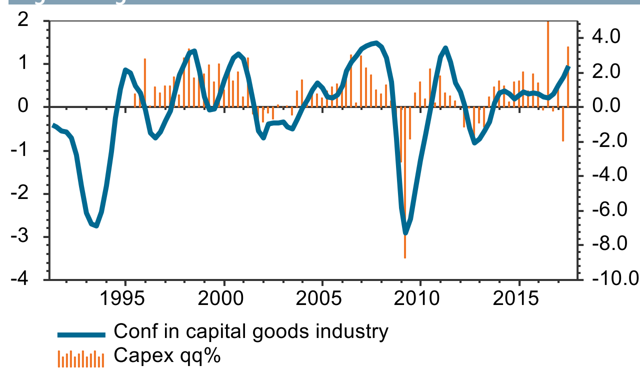
Source: Chart based on Thomson Reuters-Datastream

Fig. 5 – Corporate investment has embarked on a more solid cycle



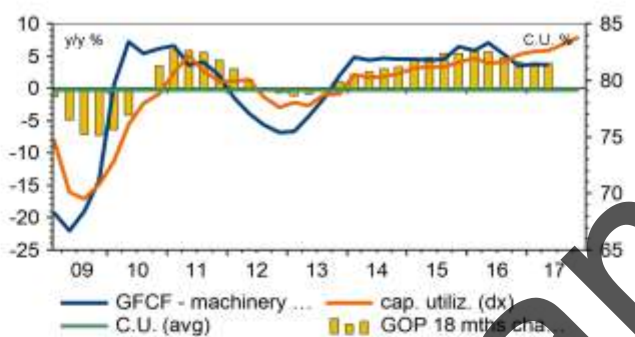
Source: Chart based on Thomson Reuters-Datastream

Fig. 6 – Higher confidence and …



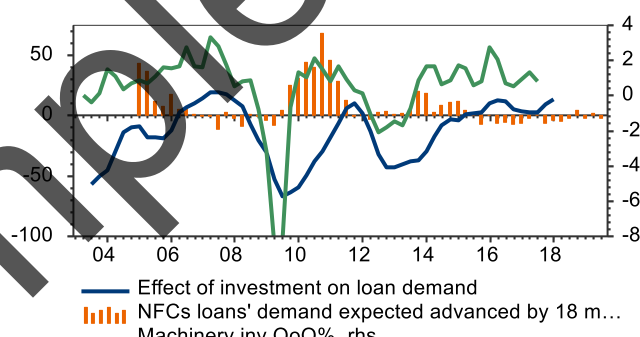
Source: Chart based on Thomson Reuters-Datastream

Fig. 7 – …use of existing plant above the historic norm justifies a rise in spending on machinery



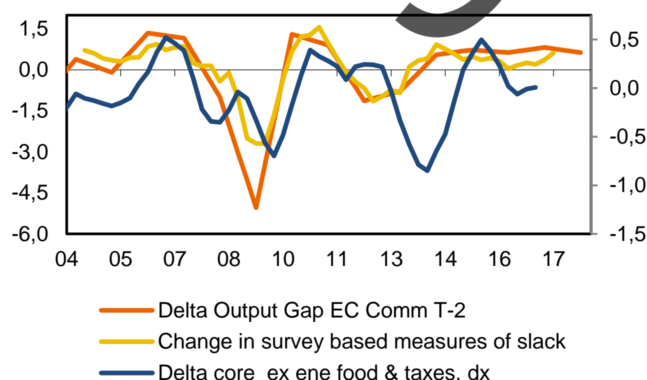
Source: Chart based on Thomson Reuters-Datastream

Fig. 8 – Signs of recovery also seen in demand for loans to finance investment



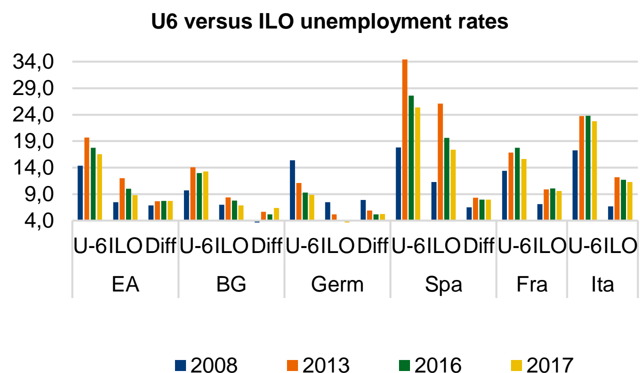
Source: Chart based on Thomson Reuters-Datastream

Fig. 9 – Output gap will close at end-2018 but core inflation is expected to rise slowly



Source: Chart based on Thomson Reuters-Datastream

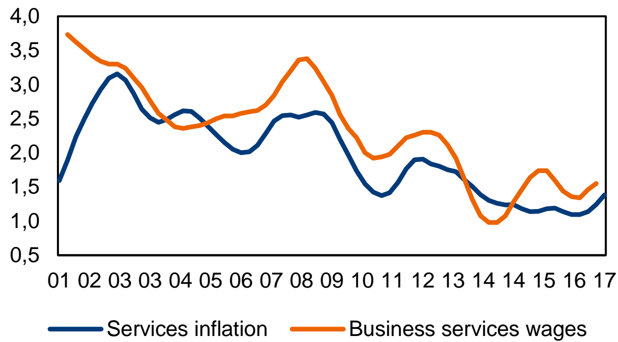
Fig. 10 – Slack in the labour market is still greater than ILO unemployment rate would suggest



Source: Chart based on Thomson Reuters-Datastream

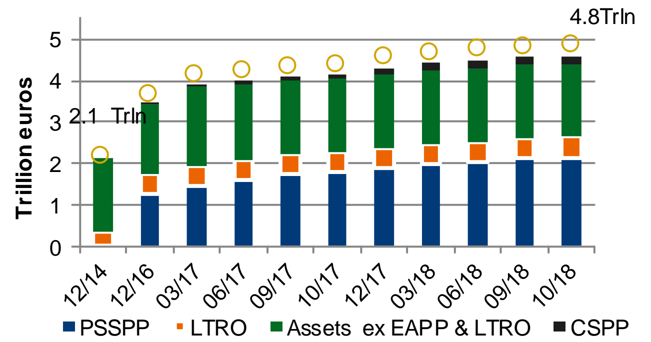
Sample

Fig. 11 – Services salaries still dragging behind



Source: Chart based on Thomson Reuters-Datastream

Fig. 12 – 2018 will see a peak in the ECB's balance sheet



N.B.: estimates assume that the ECB will purchase EUR 10bn per month in 4Q18. As a reminder, the Fed's balance sheet quadrupled between 2008 and 2013.

Source: Chart based on Thomson Reuters-Datastream

Sample

Germany: at full employment for the foreseeable future. Merkel at a crossroads

Anna Maria Grimaldi

Failed talks between the CDU, FDP and Greens have created a totally new crisis for post-war Germany. The country, which is seen as an example of political stability, risks being without a government until the spring. The popularity of the CDU and Merkel has been eroded by the growing support for the extreme-right party, the AfD. To avoid new elections, President Steinmeier has asked Schulz's SPD to consider governing again together with the CDU. Last Monday, after consulting with the party congress, Schulz proposed a *KoKo* (coalition with the conservatives) cooperation government instead of a *GroKo* government (acronym for *grosse koalition - grand coalition*). The goal of SPD leaders is to restore the party's position of strength in view of the fact that cooperation with the CDU in the last legislature is seen as one of the reasons for the precipitous fall of SPD in the recent elections[3]. Schulz set as an essential condition for moving talks forward the creation of the "United States of Europe" by 2025 and accepting Macron's proposals for reform. The fact that reforms of European governance are again the focus of the German political agenda is positive. But expectations need to be reasonable, since several members of the CDU and CSU (the Bavarian branch of the Christian Democrats) along with a large part of the German establishment are against greater risk sharing. Quickly forming a new government in Germany is essential for Europe, because nothing will happen without it. At home, Merkel's biggest challenge is to succeed in consolidating the country's democratic identify faced with growing support for the AfD, which is shifting to more extreme positions as witnessed by the re-election of Alexander Gauland as its leader[4].

A stable government guided by Merkel is urgently needed

Despite this first crisis for German politics, there will be minimal repercussions on the economy, and the fundamental momentum of the German economy remains quite strong. The expansionary phase above potential (1.4%) seems unstoppable. IFO and PMI confidence indexes hit new highs in the fall, pointing to growth of close to 0.7% qoq at year-end, after an increase of 0.8% qoq in the summer months. Industrial output and retail sales had a weak start in the fourth quarter, but despite the monthly volatility of data, the underlying trend continues to be strong. Once again, data suggest that estimates could eventually be revised upwards. Cruising speed in 2018 will be 2.3%, down from 2.6% this year. The expansion may also continue in 2019, when growth will stay close to 1.9%. The output gap will pass the one-and-a-half percent mark by the end of 2018. Manufacturing was a driving force (see fig. 3) due to strong export growth since the end of 2016, and especially to emerging markets, China and Eastern Europe (see fig. 4). In October, trade balance figures showed a decline in exports, which should still turn out to be temporary in view of the figures from confidence surveys and continued strong order growth (see fig. 5). For now, the appreciation of the effective exchange rate (+5% since April) has had a paltry effect on changes in export and import prices. Thus, it can be confirmed that the pass-through is milder than in the past[5]. However, it was not only manufacturing that supported growth; services seemed headed toward a new upswing following the end of the year, based on PMI figures. **Domestic demand will continue** to drive growth over the forecasting horizon, with an average contribution of 1.7% in 2018, which is nearly unchanged from 2017. Instead, the **contribution from foreign trade will stay negative**. Exports will continue to grow at a

Cruising speed: a point above the potential for the foreseeable future

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

[3] In addition, German public opinion is not in favour of a return of GroKo according to a survey taken on 7 December. See www.Tagesschau.de.

[4] Gauland is one of the party's founders and was its leader until 2015. He replaced Frauk Perry, who left to become an independent member of the *Bundestag*. Gauland's appointment strengthens the party's anti-immigration and nationalist wing.

[5] A study by the ECB in 2016 (see working paper no. 1955) illustrates that the pass-through of exchange rate movements into German prices and the braking effect on exports are much lower than in other Euro zone countries, as German companies are managing to hold sales prices steady due to greater specialisation and less elastic demand.

Sample

steady pace (4.4%), but less than in 2017 (4.9%), while imports will rise by 5.4%, given the high import content of German production. The domestic demand cycle is maturing, with the main driver coming from corporate investments that picked up dramatically from -0.3% yoy at the end of 2016 to 6% in the third quarter of this year. The high, and growing, use of production capacity, the very modest slowdown in foreign orders, steady profit performance and amply supportive financial conditions suggest that the expansion may continue (see figs. 7 and 8). For 2018, we forecast average growth of close to 4.9%, up from 4.4% in 2017. In **construction**, the recent trend in orders suggests more normal growth rates of close to 2.7% in 2018, down from 5% this year (see fig. 10). **Household consumption will also continue to grow at a strong pace in 2018 at 1.7%, down from 1.9% for 2016-2017.** No significant upswing in real employment income is projected. Contractual wages will grow at a rate closer to 2.6%, up from 2.2% over the last two years[6], but purchasing power will be partly eroded by the increase in inflation to 2.0% at the end of 2018. No incremental push from employment will be seen as compared with recent growth rates (1.5% in the summer, 2.3% for jobs subject to social security contributions). The labour market has reached full employment, and job creation cannot maintain this pace, partly because new flows of migrants from the rest of the EU could become more controversial. The constant decline in salaries as a percentage of GDP (see fig. 12) is worrying for social cohesion. It is well known that the country is operating with surplus private and public savings, as reflected in the high current account surplus. The new government will benefit from a primary surplus above one percentage point of GDP: perhaps the SPD will force the CDU to agree to **more generous tax policies** through a mix of expenditure cuts and revenue reductions. However, it is not likely there will be significant deviations from the *schwarze null* (black zero) imposed by German national rules.

Macro forecasts

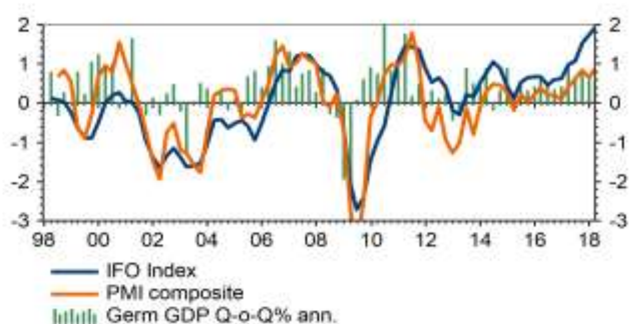
	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y) *	1.8	2.3	2.3	1.9	1.9	2.1	2.3	2.8	3.0	2.7	2.5	2.1	2.0
- q/q change				0.3	0.4	0.9	0.6	0.8	0.7	0.6	0.5	0.4	0.5
Private consumption	1.9	2.4	1.6	0.4	0.6	0.8	0.9	-0.1	0.8	0.4	0.3	0.3	0.4
Fixed investment	2.9	4.4	3.7	0.5	-0.1	2.8	1.5	0.5	0.9	0.9	1.1	0.8	0.7
Government consumption	3.7	1.1	1.3	0.2	0.5	0.2	0.2	0.0	0.4	0.3	0.5	0.4	0.4
Export	2.4	5.0	5.2	-0.2	1.3	1.7	1.0	1.7	1.6	1.2	1.2	1.0	0.9
Import	3.8	5.3	5.0	0.7	2.5	0.4	2.4	0.9	1.4	1.5	1.0	0.4	1.4
Stockbuilding (% contrib. to GDP)	-0.1	-0.1	0.0	0.4	0.4	-0.8	0.3	0.4	-0.2	0.1	-0.2	-0.3	0.2
Current account (% of GDP)	8.6	8.2	7.7										
Deficit (% of GDP)	0.8	0.9	1.0										
Debt (% of GDP)	68.1	64.8	61.2										
CPI (y/y)	0.4	1.7	1.6	0.4	1.0	1.9	1.6	1.7	1.5	1.4	1.7	1.7	1.7
Industrial production (y/y)	1.2	2.9	1.6	1.0	1.4	1.1	3.4	4.2	3.0	1.7	1.0	1.1	2.5
Unemployment (%)	6.1	5.7	5.6	6.0	6.0	5.9	5.7	5.7	5.6	5.6	5.6	5.5	5.5
10-year yield	0.10	0.33	0.82	-0.12	0.11	0.25	0.31	0.40	0.39	0.59	0.75	0.90	1.02

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

Sample

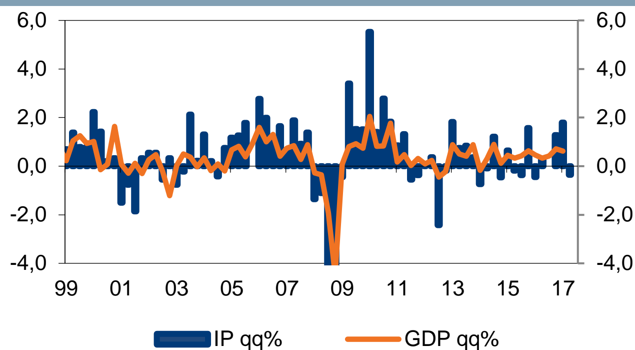
[6]Contractual wages are projected to rise at a rate of 2.7% at the end of 2018, up from 2.2% at the end of 2017. Agreements signed to date for the next two years should ensure salary growth of around 3%, compared with the 2.3% projected by the agreements signed in 2016 under low inflation conditions.

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



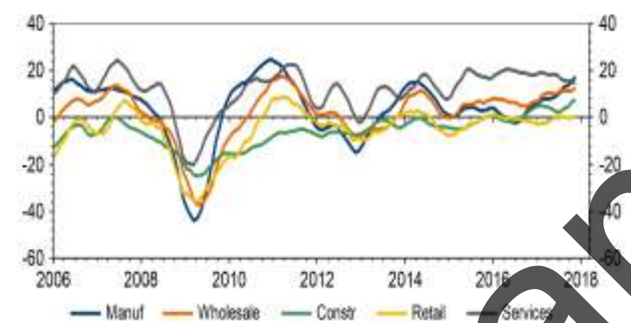
Source: Intesa Sanpaolo chart from Thomson Reuters data

Fig. 2 – Industrial production got off to a weak start in the autumn quarter



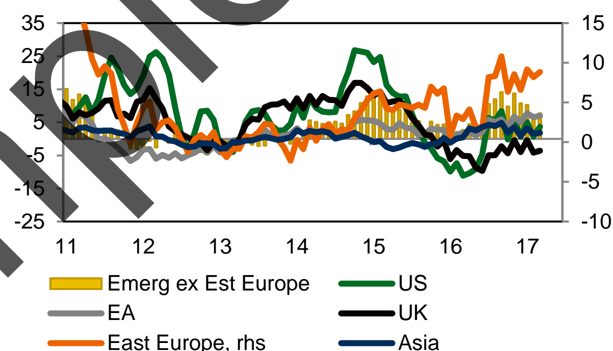
Source: Intesa Sanpaolo chart from Thomson Reuters data

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



N.B.: Six-month moving average. Source: IFO through Thomson Reuters-Datastream

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



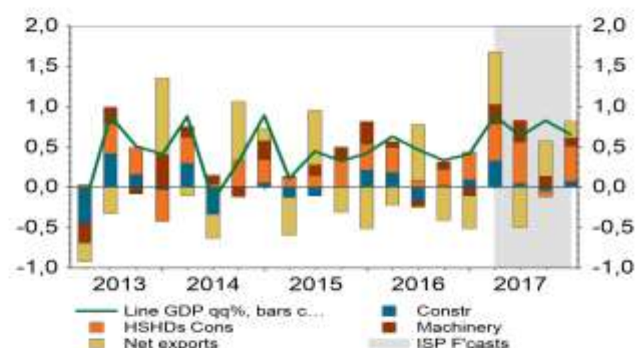
Source: FSO through Thomson Reuters-Datastream

Sample

Fig. 5 – Surveys point to positive growth in exports in Q3

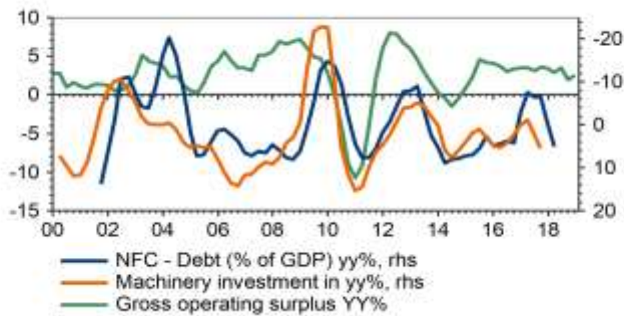
Source: FSO through Thomson Reuters-Datastream

Fig. 6 – Growth over the forecast horizon will still be driven by domestic demand, but corporate investment will gain importance relative to private consumption



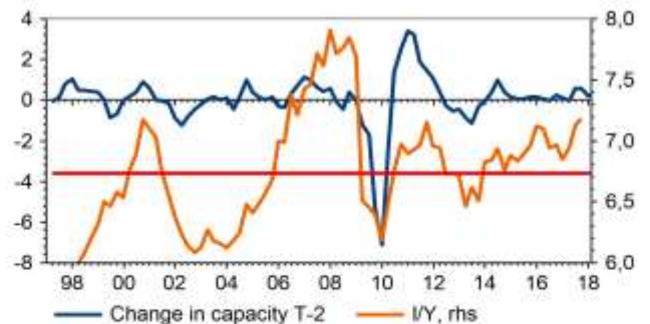
Source: FSO through Thomson Reuters-Datastream

Fig. 7 – Fundamentals and...



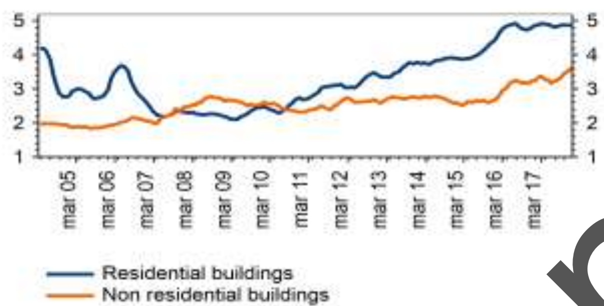
Source: FSO through Thomson Reuters-Datastream

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



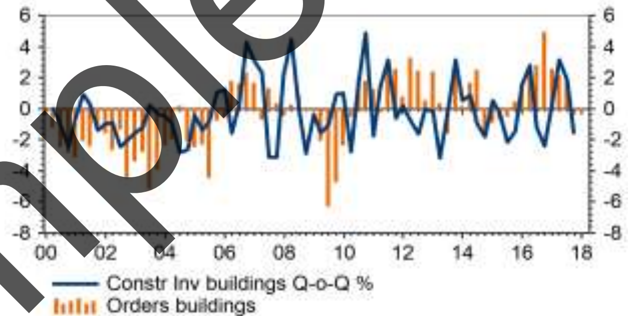
Source: FSO through Thomson Reuters-Datastream

Fig. 9 – Trend in permits and...



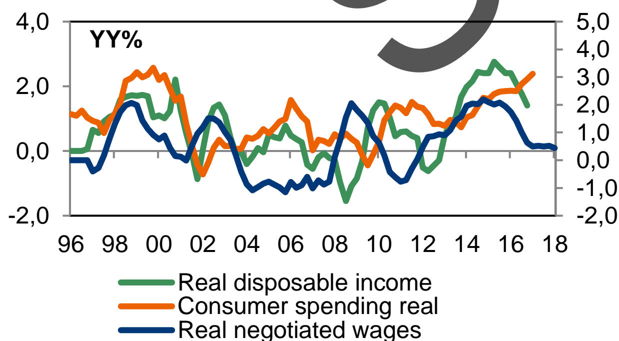
Source: FSO through Thomson Reuters-Datastream

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



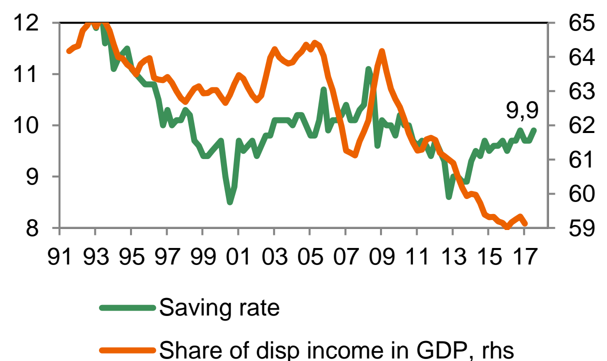
Source: FSO through Thomson Reuters-Datastream

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



Source: FSO through Thomson Reuters-Datastream

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



Source: Thomson Reuters-Datastream

Sample

France: expansionary phase continues, unemployment falls

Guido Valerio Ceoloni

1.8% GDP growth for 2017-18

The third quarter closed with GDP growth of 0.5% qoq, in line with consensus estimates. The economy recorded slightly slower growth than in the second quarter due to a more negative contribution from net exports than expected. With growth of 1.7% so far, we expect that GDP will advance by another 0.5% qoq in the last quarter of the year, adding one-tenth of a percentage point to the annual average and thus bringing it to 1.8%, from 1.1% in 2016. For next year, we expect GDP to continue to grow by 1.8% on the back of higher domestic demand. Tax cuts already introduced for companies and families, together with the labour market reforms in the pipeline, should boost households' purchasing power and hence stoke consumer spending; risks to the forecasts remain to the upside.

Consumer spending still solid but starting to stabilise

Consumer spending forecasts remain upbeat, but household spending could slow slightly at the end of the year: the consumer confidence index stood at 101.3 in October and November, from an average of 102.8 in 3Q, and spending intentions, while still positive, have moderated. The spending correction in October shaved around 1% off consumption; as an annual average, consumer spending will grow by 1.2%, from 2.1% in 2016, and then slightly increase by a couple of tenths of a percentage point in 2018.

Investment shored up by the return of public spending

Investment will likely remain sustained at the end of the year and then start to slow from 2018. The end of government incentives in mid-2017 should lead to a natural slowdown in investment in **manufacturing** in 2018, when we expect to see a deceleration to around 3.5%, from 4.2%. **Residential** investment is also likely to slow next year to 1.7%, from 4.1% this year. From 2018, the recovery in **public** investment growth (to 0.7% yoy, from -1.1% yoy), after the slowdown in the election year of 2017, will help keep the overall performance of investment positive, which we confirm at 2.5% in 2018, from 3.5% this year.

Industrial output positive; services booming

Business confidence has continued to improve, with the INSEE index for manufacturing rising from 110 in the third quarter to 112 in October and November. It also confirms a general progression, from 106 in January to ten-year highs at the end of the year. **Industrial output** could visibly accelerate to 2.5% qoq in 4Q, from +0.6% qoq in 3Q, and thus make a positive contribution to GDP growth, which is on course for annual average growth of 2.3% in 2017, compared with 0.3% in 2016. We forecast an equally positive scenario for next year, with growth potentially at around 2.8%. Morale in the **services** sector also continues to improve, with confidence indicators showing new highs (INSEE services index at 108, from 106 in 3Q and the services PMI at a record high of 58.9, from 56.0 in 3Q). In **construction** too, after a fresh increase of 0.2% qoq in 3Q, morale is high, and the sector has embarked on a new expansionary phase after five consecutive quarters of growth.

The trade deficit is widening in the wake of increased consumption

Growth in **imports** is likely to slow from next year, in line with consumer spending, falling from an expected 4.8% for 2017 to an estimated 4.2% for 2018. Imports could, however, start to moderate as early as the last quarter of this year, in the wake of a correction in consumer spending. **Exports**, however, will improve both this year (from 1.9% on 2016 to 3.0%) and next (to 3.4%) against a backdrop of favourable global demand. As a result, exports are expected to make a less negative contribution next year than in 2017. The **trade deficit** will be 11% of GDP this year, from 8.8% in 2016, stabilising at around this level in 2018.

Inflation at 1% in 2017 and 1.4% in 2018

After accelerating at the start of the year, **inflation** gradually slowed and will come in at an annual average of 1.1%, from 0.2% (national index). For next year, we expect that an unfavourable statistical effect from the energy component will help keep the CPI in check during the first half of the year. After that, it is set to resume a moderate growth path, resulting in an annual average of 1.4%. From 2019, pressure on the labour market could help trigger a more marked acceleration in inflation. The **core** index, excluding food, energy and tobacco, will this year stay broadly in line with its 2016 level (at 0.4%, from 0.5%) and then pick up again to over 1% in 2018.

Sample

The latest quarterly figures from the labour market show an unexpected rise in **unemployment** of some two-tenths of a percentage point to 9.7% in September, due to the ending, last June, of government incentives to companies for fixed-term hirings. In the last quarter of the year, unemployment could fall again by a tenth of a percentage point, but the annual average would only decrease by half a percent to 9.6%, from 10.1% last year. According to the European Commission's autumn estimates, unemployment will fall to 9.3% next year. The improvement is due to the rise in employment and the stable participation rate.

Unemployment falling from 10.1% to 9.6% this year, and to 9.3% in 2018

The **nominal deficit** is expected to fall to 2.9% this year, reflecting stronger growth and expenditure consolidation measures totalling around EUR 4Bn[7]. For 2018, the deficit is expected to remain stable at 2.9% due to the compensatory effect of expansionary measures such as the gradual reduction in taxes on housing, changes to savings taxes, and new investment, on the one hand, and the higher income raised from the ecotax and the rise in tobacco duties, on the other. The **structural deficit** is expected to worsen by three-tenths of a point in 2018, from 2.4% to 2.7%. Lastly, **debt** will rise by four-tenths of a point this year to 96.9% and then stabilise at 97.0% next year. The risks to the scenario remain to the upside, as the positive effects of growth start to filter through to the labour market, and the public accounts gradually move closer to European parameters.

The excessive deficit procedure will finally come to an end in 2018

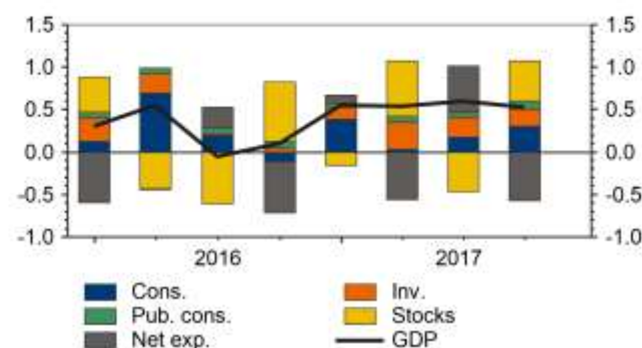
Sample

Macro forecasts

	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.1	1.8	1.8	0.9	1.2	1.1	1.8	2.2	2.1	1.9	1.8	1.7	1.7
- q/q change				0.1	0.6	0.5	0.6	0.5	0.5	0.4	0.5	0.4	0.4
Private consumption	2.1	1.2	1.5	-0.2	0.7	0.1	0.3	0.6	0.4	0.4	0.4	0.4	0.4
Fixed investment	2.7	3.5	2.5	0.2	0.6	1.5	1.1	0.9	0.6	0.5	0.5	0.5	0.5
Government consumption	1.3	1.6	1.4	0.4	0.3	0.4	0.4	0.5	0.4	0.3	0.3	0.3	0.3
Export	1.9	3.0	3.4	0.8	1.3	-0.7	2.2	1.1	0.6	0.7	0.7	0.8	0.9
Import	4.2	4.8	4.2	2.6	0.9	1.2	0.3	2.8	0.9	0.8	0.8	0.8	0.7
Stockbuilding (% contrib. to GDP)	-0.4	0.4	0.2	0.6	-0.2	0.6	-0.6	0.4	0.1	0.0	0.1	0.0	0.0
Current account (% of GDP)	-2.4	-2.8	-2.9										
Deficit (% of GDP)	-3.4	-2.9	-2.9										
Debt (% of GDP)	96.5	96.9	97.0										
CPI (y/y)	0.3	1.2	1.6	0.4	0.7	1.5	1.0	0.9	1.3	1.2	1.7	2.0	1.6
Industrial production (y/y)	0.3	2.3	2.8	-0.4	0.3	0.5	1.7	2.7	4.2	4.3	3.4	3.0	0.6
Unemployment (%)	10.1	9.6	9.3	10.0	10.0	9.6	9.5	9.7	9.6	9.4	9.3	9.2	9.1

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

Fig. 1 – Contribution to the GDP



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

Fig. 2 – GDP and confidence indicators

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

[7] The consolidation of Areva, France's state-owned nuclear company, has been excluded from the calculation as Eurostat has not yet decided how to record it.

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

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

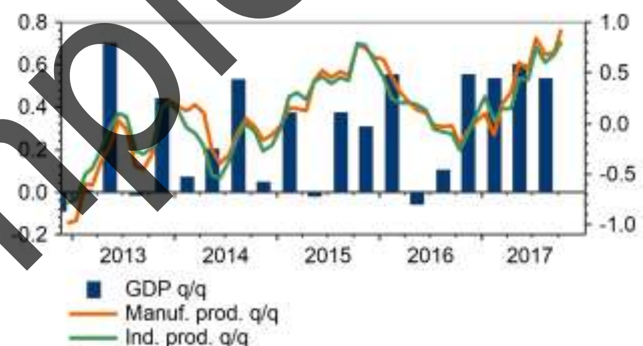
Fig. 4 – Retail sales and household confidence

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

Fig. 5 – Residential investment and construction activity

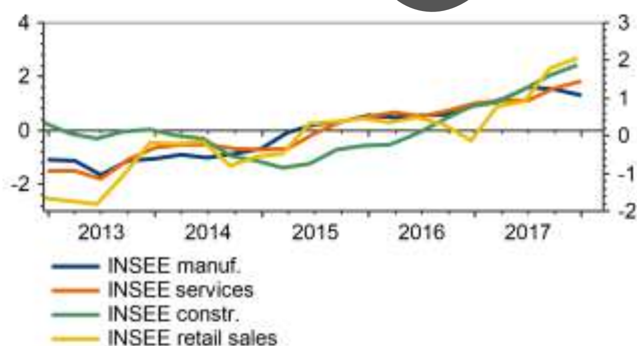
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



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

Fig. 7 – Activity indices in the production sectors



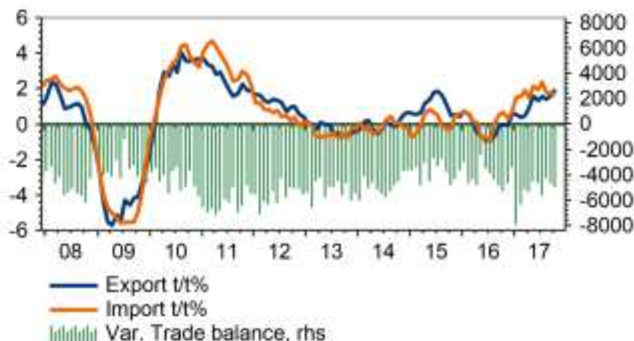
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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

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

Sample

Fig. 9 – Trade balance



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

Fig. 10 – Expected and structural unemployment

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

Italy: growth to remain sustained in 2018 (despite political risk)

Paolo Mameli

Based on our estimates, the recovery in economic activity in Italy could continue in 2018, albeit at a slightly slower pace than in 2017: we forecast GDP growth at 1.3% next year, from 1.5% this year. Compared to three months ago, we have revised up our estimate for 2017 by one tenth, and our estimate for 2018 by two tenths. Quarterly growth could slow slightly at the end of 2017, reaccelerate at the beginning of 2018, and decelerate again subsequently. **In 2018, final domestic demand should grow at a pace very close to the 1.5% rate recorded in the past three years**. We confirm a possible slowdown in consumption (albeit not as sharp as we expected three months ago), as opposed to still upbeat investments (on a stronger uptrend than estimated last September). Foreign trade could resume making a slightly positive contribution (after holding back growth in 2014-16 and making a neutral contribution in 2017), whereas inventories could continue to represent a slight drag.

Sample

Households' consumption is holding out better than expected…

Consumption proved more resilient than expected in 2017, keeping up a growth rate of 1.5%, in line with 2016 (after the 2% peak recorded in 2015), despite a slowdown in the real disposable income of households (our estimate: 0.4% in 2017 from 1.6% in 2016). Therefore, propensity to save decreased (to 7.5% from 8.7%). Consumption held out thanks to both resilient employment (1.1% from 1.3% in 2016), and the unexpected recovery in consumer confidence, which starting in mid-year became gradually brighter on the outlook for the economy (and on the employment trend as well). Once again, the main driver was the consumption of durable goods, which kept up a growth rate of close to last year's 5%. In 2018, employment could slow further on the one hand, in our estimation to 0.7% from 1.1%, and on the other the purchasing power of households could rebound, to 1.4% from 0.4%. Therefore, **we are less cautious today on the evolution of household spending** than we were three months ago: we expect only a marginal slowdown in national accounts consumption, to 1.3% in 2018 from 1.5% del 2017 (therefore in line with the trend of GDP). However, we expect a slowdown in purchases of durable goods (tied to the rise in interest rates, as gradual as it may be), as opposed to a possible reacceleration in non-durable goods.

…and investments in machinery seem to have picked up firmly at last

In any case, we confirm our view that the baton of the recovery has now been passed on from household consumption to business investments, i.e. the component of demand that has surprised most on the upside in recent weeks. In particular, investments in machinery and equipment, after crashing at the beginning of 2017, anomalously in our view, due to the fact that orders of capital goods were brought forward on uncertainty on whether or not the incentives offered by the "Industry 4.0" scheme would be confirmed, subsequently picked up strongly in the course of the year, as we had expected, marking an all-time high in the Summer quarter since the statistical series began (+6% q/q). The recovery is materialising in step with the

rise in capacity utilisation. The obsolescence of machinery (investments are still 24% short of pre-crisis levels), expectations for a further recovery in demand, and still accommodative financial conditions (albeit less so than a year ago), will support a further strengthening in investments, and for investments in machinery in particular (fuelled, as mentioned above, by the renewal of the government incentive scheme). On the other hand, after an initial phase in which businesses have remained very cautious in their investment decisions, despite enjoying a recovery in profitability, the gap between profit rate and investment rate is now gradually narrowing. In a nutshell, **investments in 2018 could confirm the 3% growth rate recorded over the past two years**. However, we estimate the breakdown to be different, with investments in machinery accelerating sharply (to 4.6% from 1.7% in 2017: this would mark a high since 2006), as opposed to slower trends for means of transport (+6.6%, after expanding at rates of over 20% for three years on the run), and construction (which would in any case achieve positive growth for the third year, in our estimate of 0.8% in 2018, from 1.2% in 2017 and 1.4% in 2016).

The foreign channel in 2018 could resume contributing positively to GDP…

In its initial phase (during the whole 2014-16 three-year period), the recovery was driven by domestic demand, whereas foreign trade made a negative contribution to GDP. This situation has now changed and, far from representing a drag, **foreign demand has resumed making a decisive contribution to growth.** Furthermore, for the time being at least, our view is being confirmed that the negative impact of the strong euro on growth could prove smaller than indicated by the main macroeconomic models (i.e. than seen in the past), for both structural reasons (increased invoicing of imports in local currency, higher import content of exports), and cyclical (the role played by domestic demand in this recovery). However, some negative effect going forward in 2018 cannot be ruled out, as exports show a tendency to feel the impact at a lag of even one year (the Italian effective exchange rate, after depreciating by almost 4% in 2015, appreciated by 0.7% in 2016 and by 1.1% in 2017: a movement which, based on our estimates, should continue in 2018, by 1.3%).

…despite a slowdown of trade flows in both directions

In a nutshell, **we expect a slowdown in trade flows in both directions next year compared to this year, but more so for exports** (to 3.3% from 5.1% estimated in 2017) **than imports** (to 3.2% from 5.5%), held back by less upbeat domestic demand. In fact, in our view global demand addressed to Italy, after booming in 2017 (+5.7%, a high since 2011), could stay rather sustained in 2018 (+4.7%), as GDP growth is forecast to decelerate slightly in the Eurozone, and to change little for the other trade partners. Therefore, we estimate a slight drop in exports, both towards the rest of the euro area (from +6.4% in worth in the first nine months of 2017), due to the moderate slowdown in growth, and towards the United States and the United Kingdom, as a result of exchange rate effects (in 2017, sales to the US grew by 9.6% in the first 10 months of the year, and sales to the UK by 2.3% in the first nine months). In the United States' case, the acceleration in demand should balance the exchange rate effects. Against this backdrop, the emerging countries, which were among the main target markets in 2017 (China +24%, Russia +22%, Mercosur +17%, and ASEAN countries +13% in the first 10 months of the year), should contribute positively in 2018 as well (with the possible exception of OPEC).

Fiscal policy is roughly neutral for now

We confirm our view that the impact of fiscal policy on growth in 2018 will be marginal. Barring corrections required by the EU next spring (in any case limited to 0.2% of GDP at worst, as was the case last year), fiscal policy in 2018 will be broadly neutral (slightly restrictive based on the change in the structural balance, but marginally expansionary considering the cyclically-adjusted change in the primary balance). While criticalities still exist, with particular reference to the financing of some Budget Law items, positive aspects are the avoidance of the safeguard clauses kicking in, a repeat of the "Industry 4.0" incentives, the unblocking of the public service labour contract, and the new forms of contribution cuts offered on the permanent hiring of youths. However, we think there are still upside risks to the government's deficit and debt forecasts for next year, respectively of 1.6% and 130% of GDP.

Sample

The main risk is political…

2018 will be general election year in Italy. The date of the vote has not yet been set (in May at the latest, most probably in March), nor has the composition of the participating forces been defined. **The new electoral law encourages the formation of coalitions**, which nonetheless, as we write, have not yet been "formalised". In all likeliness, the main competitors will be the traditional centre-right alliance (Forza Italia, Northern League, Fratelli d'Italia), a "new" centre-left coalition (with PD playing the major role, today it is unclear if alone or allied with minor centrist or left-wing parties), the 5-Star Movement, that will run alone, and a formation to the left of the PD (led by former Chairman of the Senate). The latest polls award a lead to the centre-right coalition (with around 35% of the vote, with the centre-left and the 5-Star movement trailing with around 27%), although it is early days yet to attempt to draw definitive indications, given that, as mentioned above, the formations have not yet been defined, and the new electoral system is not entirely proportional (a third of MPs will be elected in single-name first-past-the-post constituencies, and minimum thresholds have been set for parties and coalitions). While we cannot rule out that one of the coalitions (seemingly the centre-right, based on the latest polls) may obtain a majority of seats, the probability of this happening is currently smaller than 50%. **The likeliest scenario at present is an inconclusive outcome of the elections**, followed by weeks of negotiations towards the formation of a government; our main-case scenario is that some kind of government will be formed at the end of the day, probably based on a large coalition grouping the PD, the centrist parties, and Forza Italia (although the direct or indirect contribution of members of Parliament belonging to other political formations could be necessary).

…which nonetheless seems more "manageable" today than a few months ago

In any case, **political risk in Italy seems more "manageable" today, at least from the point of view of the financial markets, compared to a few months ago**, for two reasons: 1) with the sole exception of France, political uncertainty is now weighing on the majority of European countries, currently governed (in some cases successfully) either by broad coalitions, or by minority governments; 2) if, as we think, the economic cycle at the global and continental levels will remain expansionary, economic growth would place the trajectory of public debt on a sustainable path, regardless of any fragilities of the political system.

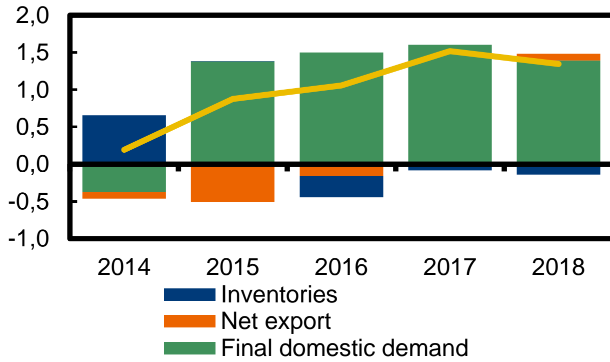
Macro forecasts

	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	1.1	1.5	1.3	0.9	1.0	1.3	1.5	1.7	1.6	1.4	1.4	1.3	1.3
- q/q change				0.2	0.4	0.5	0.3	0.4	0.3	0.4	0.3	0.3	0.3
Private consumption	1.5	1.5	1.3	0.3	0.2	0.7	0.2	0.3	0.4	0.3	0.3	0.3	0.2
Fixed investment	3.0	3.0	3.0	2.1	2.6	-2.2	1.1	3.0	-0.2	0.5	0.7	0.4	0.6
Government consumption	0.5	0.8	0.5	-0.1	0.5	0.4	0.2	0.1	0.1	0.1	0.1	0.2	0.1
Export	2.6	5.1	3.3	0.9	1.9	1.8	0.1	1.6	0.5	0.9	0.8	0.7	0.8
Import	3.3	5.5	3.2	0.8	2.5	0.7	1.6	1.2	1.0	0.6	0.6	0.5	0.5
Stockbuilding (% contrib. to GDP)	-0.3	-0.1	-0.1	-0.4	-0.1	0.1	0.4	-0.5	0.2	0.0	-0.1	-0.1	-0.1
Current account (% of GDP)	2.7	2.4	2.1										
Deficit (% of GDP)	-2.5	-2.1	-1.7										
Debt (% of GDP)	132.0	132.0	131.6										
CPI (y/y)	-0.1	1.3	1.1	-0.1	0.2	1.3	1.6	1.3	1.0	0.7	0.8	1.2	1.6
Industrial production (y/y)	1.9	2.8	2.2	1.6	3.4	1.8	3.3	3.9	2.4	3.1	2.6	1.5	1.7
Unemployment (%)	11.7	11.3	10.8	11.6	11.8	11.6	11.2	11.2	11.1	11.0	10.9	10.7	10.6
10-year yield	1.48	2.06	2.76	1.19	1.77	2.15	2.17	2.09	1.84	2.42	2.80	2.91	2.92

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

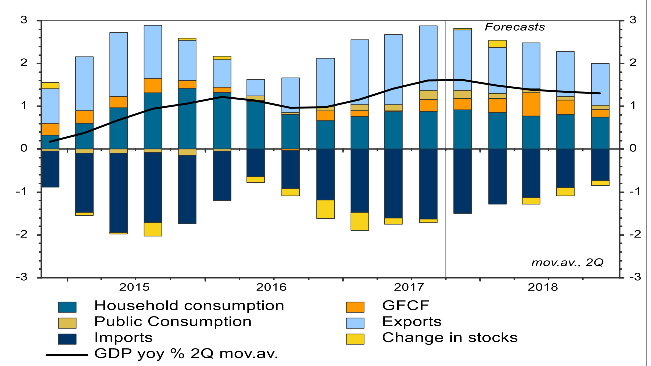
Sample

Fig. 1 – In 2018 we expect an only marginal slowdown in domestic demand (and a slightly positive contribution from foreign trade)



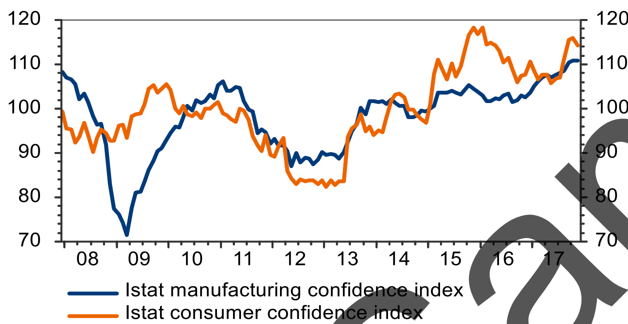
Note: annual GDP % growth rate and contribution of the main components. Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 2 – Investments to make a stronger contribution



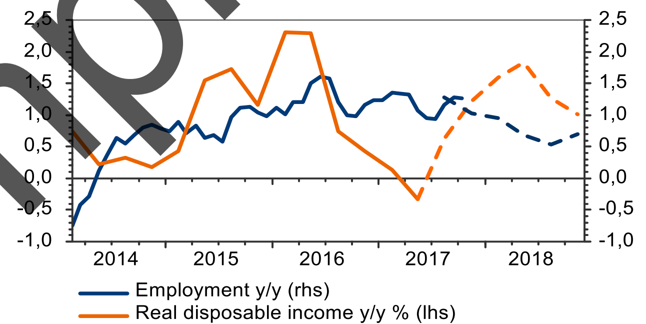
Note: annual GDP % growth rate and contribution of the main components, 2Q moving average. Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts

Fig. 3 – In the past few months confidence has improved not only among manufacturing businesses, but also, unexpectedly, among consumers



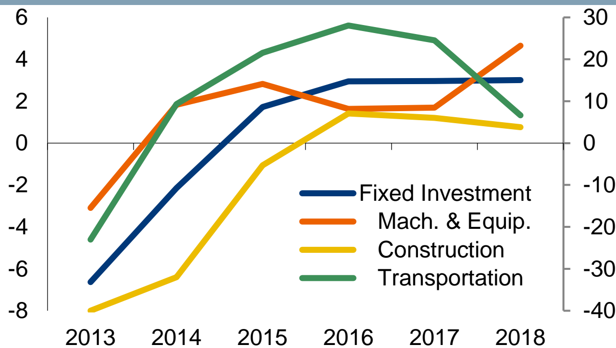
Source: Thomson Reuters-Datastream

Fig. 4 – Households' disposable income could rebound in 2018. Employment will slow, but stay sustained



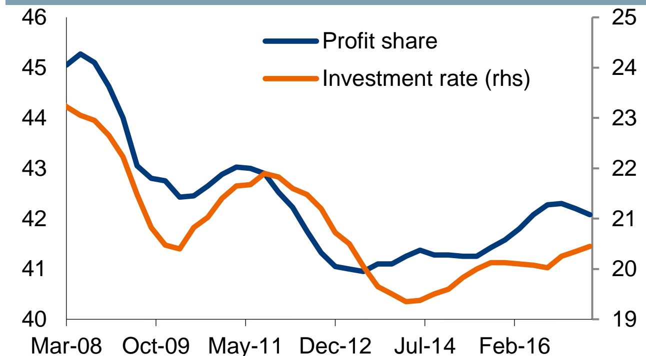
Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts

Fig. 5 – We expect investments in machinery and equipment to accelerate



Source: Intesa Sanpaolo elaborations and forecasts on Istat data

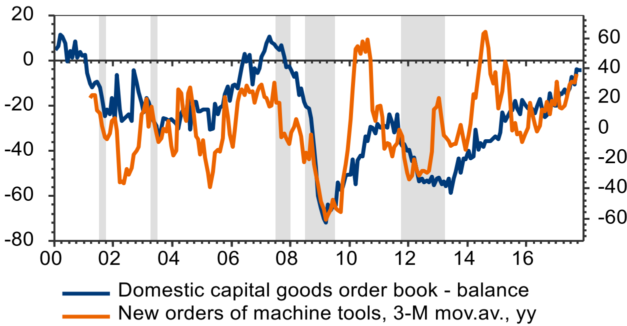
Fig. 6 – Narrowing gap between businesses' profit share and investment rate



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

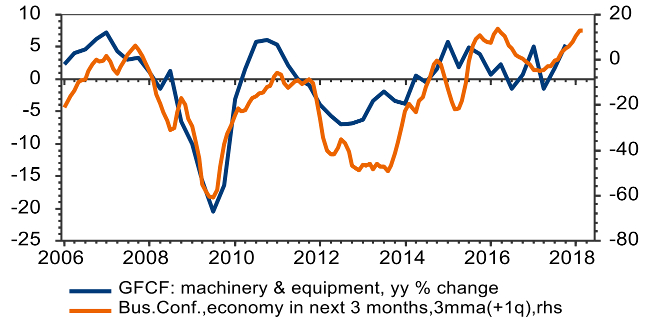
Sample

Fig. 7 – The cycle of investments in capital goods seems to be under way at last, driven by the "Industry 4.0" incentives…



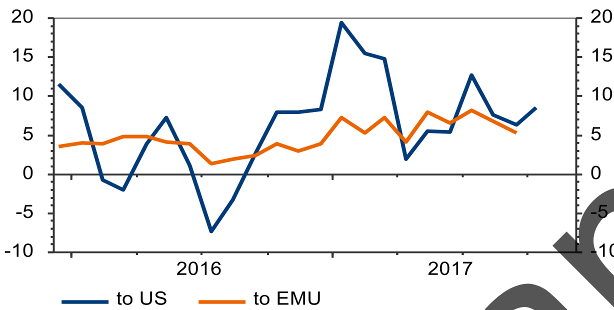
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 8 – …and most importantly by businesses' optimistic outlook on demand



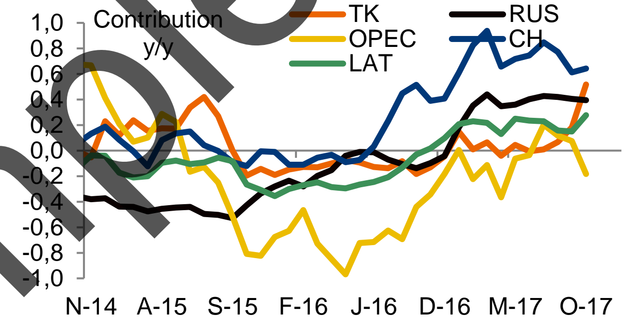
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 9 – Exports to the United States resilient so far, despite the appreciation of the euro against the dollar…



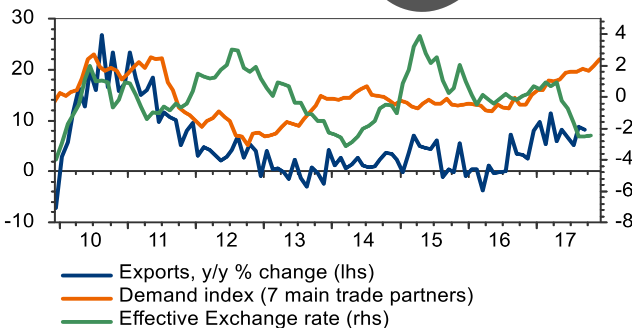
Note: annual % of Italian exports to the United States and the Eurozone (3-month moving average). Source: Intesa Sanpaolo elaborations on Istat data

Fig. 10 – …and the main emerging countries are making a positive contribution (with the sole exception of OPEC)



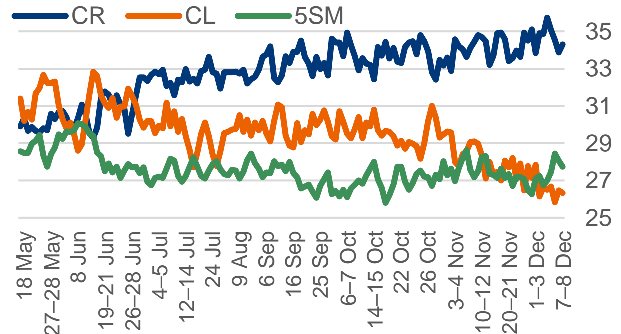
Note: contribution to the annual % growth of Italian exports (3-month moving average). Source: Intesa Sanpaolo elaborations on Istat data

Fig. 11 – The strong exchange rate remains a risk, but is offset by the acceleration in global demand addressed to Italy



Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 12 – Of the three possible coalitions in the election race, the centre-right has recently shown the strongest trend. However, the risk of ungovernability remains tangible



Note: Centre-Right (CR) = Forza Italia + Lega Nord + Fratelli d'Italia; Centre-Left (CL) = PD + AP + CP. Source: CISE, Datamedia, Demopolis, Demos&Pi, EMG, EP Election, Epoké, Euromedia, IPR, Ipsos, Ixé, Lorien, Piepoli, Quorum, ScenariPolitici, SWG, Tecnè

Sample

Spain: solid and better balanced growth

Anna Maria Grimaldi

The output gap will close already in 2017. Growth is less dependent on domestic demand than in the past, and therefore more sustainable

The Spanish economy continues to expand well beyond expectations: growth in 2017 will reach +3.1%, beating Consensus Economics forecasts dating back to a year ago by half a point. After over three years of growth in excess of 3%, and over two points stronger than the potential rate (estimated by the EU Commission at 1.1%), the output gap will return to zero by the end of the year from a low of -8.8 at the end of 2013. The performance of the Spanish economy has significantly outpaced growth in the rest of the euro area (where the output gap will only turn positive again in 2018, according to the Commission) and in other peripheral countries, which nonetheless have also latched on to the recovery. Strong growth over the past few years stems in part from the structural reforms put in pace during the crisis, which include the labour market reform, the de-indexation of negotiation-based wages, and the orderly and timely resolution of banking crises by resorting to the EU assistance programme. Furthermore, Spanish GDP tends to respond more promptly to interest rate declines (given the higher incidence of variable-rate loans) and to lower oil prices, due to the country's high energy-dependency. The crisis triggered a rebalancing of growth from domestic demand to exports (Fig. 1). The country's large foreign debt imposed a competitive devaluation process which allowed a partial recovery in market shares (Figs. 3 and 4) and a return of the trade balance into surplus territory (Fig. 2). However, the price paid to the crisis has been marred social cohesion and a loss of consensus for the traditional parties. The country has experienced deep changes on the political scene in the past two years, with the emergence of the *Podemos* populist movement and of the liberal, anti-establishment *Ciudadanos* party. In 2015-16, it took two rounds of voting to form a minority government led by Mariano Rajoy. The shift in consensus was due in part to the crisis, reflected by the still high unemployment rate, which at 16.4% remains socially unacceptable. Preserving the current, better-balanced growth phase, may help restore consensus for the traditional parties and safeguard the current account surplus, thus reducing the fragilities resulting from Spain's large foreign debt. For the time being, there are no indications that the country is heading for new excesses.

The consequences of the crisis are still visible in the high unemployment rate, which in part explains the drift towards populist positions

Sample

Exports and consumption surprised most on the upside, but have now peaked

Growth is expected to stabilise at blander levels than in the first three quarters of 2017 (0.8% q/q), based on the indications provided by the PMIs and by the EU Commission's ESI (Figs. 5 and 6). In 2018, we expect the expansion of economic activity to continue, albeit at a less sustained pace (2.6%). Political uncertainty tied to the Catalan question could weigh negatively on confidence and financial conditions, although this now seems less likely. Exports, which surprised most on the upside at the end of 2016 and in early 2017, will grow at more moderate rates, averaging 1.0% q/q in the coming quarters, and 3.4% in 2018 (the annual average will be affected by an unfavourable base effects). Foreign demand addressed to Spain is proving resilient, based on the indications provided by the PMIs on the orders trend (Fig. 7); however, the acceleration phase should now be over. Furthermore, we estimate that the exchange rate could slow exports somewhat, albeit less than in the past. Spanish companies have less bargaining power on the market than their German competitors, and may have to revise prices down in order not to lose orders[8]. Imports are expected to slow less than exports, from 3.9% in 2017 to 3.0%. Foreign trade will therefore continue to contribute positively to growth, by 0.3%. The main driver of growth will continue to be domestic demand, which we expect to slow from 2.6% estimated this year to 2.2% in 2018. The consumption is estimated to have peaked, in light of the surprises recorded in mid-year; we expect a slowdown in the quarterly trend to close to 0.6% q/q, as already in the past few months consumer spending has been financed by tapping savings, now at their lowest level since 2007 (Fig. 9). It is unreasonable to expect an acceleration in real earned income. Employment growth has beaten expectations in the past few quarters (2.8% y/y in the central months of 2017, from 2.3% in the six previous

[8] See ECB Working Paper No. 1955, September 2016

months), but we estimate it average around 2.0% y/y starting in 2018. Real wage growth will remain in negative territory despite the **temporary drop in inflation to 1.5% in 2018, from 2.0% this year,** due to energy prices. Significant labour market slack will continue to exert downward pressures on contract-based wages. **The unemployment rate dropped by almost 10 points to 16.4% in October, after peaking at 26.2% in 2013, and based on our forecasts it could decrease to 14.8%** at the end of 2018. The wider measure of unemployment is much higher, at 26%, the highest in all the euro area. **Domestic demand will continue to be supported by investments in machinery** next year. However, in this case as well, it is reasonable to expect a slowdown to 5.0% from 6.2% in 2017. The increased production capacity utilisation has stopped in part (Fig. 12), and the most seems to have been made of the opportunity offered by low interest rates. The **residential construction** sector is experiencing an expansion phase, which may continue in 2018, at a pace of +3.8%, down from 5% in 2017 (average growth in 2018 will be affected in part by the unfavourable comparison with 1Q 2017). For now, the share of value added accounted for by construction is well below the peak hit in 2007 (Fig. 11). Residential mortgage growth remains slower than the trend of home sales. Therefore, the expansionary cycle may continue, although a further slowdown in 2019 would be healthy, in order to avoid new excesses.

Capex: a slowdown is reasonable, following growth of close to 6% in recent months

Construction: expansion to continue at more moderate rates

Spain remains under the corrective arm of the Stability Pact. The **deficit** is expected to drop back to below 3% only in 2018, from 4.5% in 2016. The improvement in nominal balances is largely due to the contribution made by the economic cycle. The structural balance is forecast stable between 2017 and 2019 by the EU Commission. Therefore, the country remains exposed to the risk of failing to meet medium-term objectives. The Commission expects debt to drop to 95.5% in 2019 from 98.4% in 2017, as a result of strong nominal growth and of the closing of the primary deficit.

Public accounts: deficit to drop back below the 3% threshold and debt to decline by around three points to 95.5% in 2019, thanks to strong nominal growth

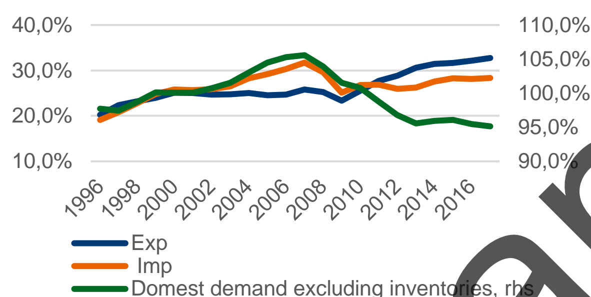
Risks to the scenario are skewed to the downside starting in mid-2018, and stem from the political scene and from a potential deterioration of the Catalan crisis. The outcome of the vote on 21 December is highly uncertain, based on the limited number of voting intention polls available (Figs. 13 and 14). For the time being, confidence has proven resilient, and even at the height of tensions market reactions were very contained and financial conditions only tightened marginally. However, in the event of a re-exacerbation of the crisis, stronger negative repercussions could materialise on confidence and financial conditions. If the front opposed to independence prevails at the elections, or even if the independentist movement fails to obtain the absolute majority, the likely outcome would be the reopening of talks with the central government to obtain a greater degree of autonomy within the framework of the Spanish constitution. A clear victory of the independentist formations would be more dangerous for Spain's economic outlook.

Sample

Macro forecasts	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	3.3	3.1	2.4	3.2	3.0	3.0	3.1	3.2	3.1	2.8	2.5	2.2	2.2
- q/q change				0.7	0.7	0.8	0.9	0.8	0.6	0.5	0.6	0.5	0.5
Private consumption	3.0	2.4	2.1	0.8	0.4	0.6	0.8	0.5	0.5	0.5	0.5	0.5	0.4
Fixed investment	3.3	4.3	4.3	-0.3	0.8	2.5	0.4	0.7	0.9	1.5	1.4	0.8	0.8
Government consumption	0.8	1.2	1.4	0.5	-0.6	0.7	0.5	0.5	0.5	0.3	0.2	0.2	0.2
Export	4.4	7.1	4.9	0.1	2.0	4.0	1.5	0.4	0.7	1.9	1.6	0.7	1.0
Import	2.7	4.6	3.6	-1.7	0.6	4.3	-0.8	1.2	1.0	0.8	1.0	1.2	1.0
Stockbuilding (% contrib. to GDP)	0.0	-0.1	-0.5	-0.1	0.1	-0.1	0.0	0.1	-0.3	-0.3	-0.1	0.1	0.1
Current account (% of GDP)	1.5	1.8	1.8										
Deficit (% of GDP)	-4.5	-3.1	-2.4										
Debt (% of GDP)	99.0	98.4	96.9										
CPI (y/y)	-0.3	2.0	1.2	-0.3	0.8	2.7	2.1	1.8	1.6	0.6	1.4	1.4	1.6
Unemployment (%)	19.6	16.9	15.3	19.4	18.7	18.2	17.3	16.2	15.9	15.6	15.4	15.1	14.9

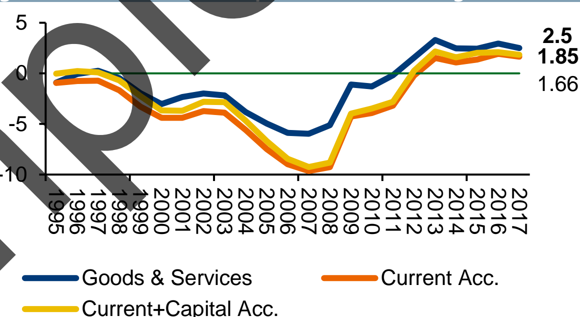
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth less dependent on domestic demand



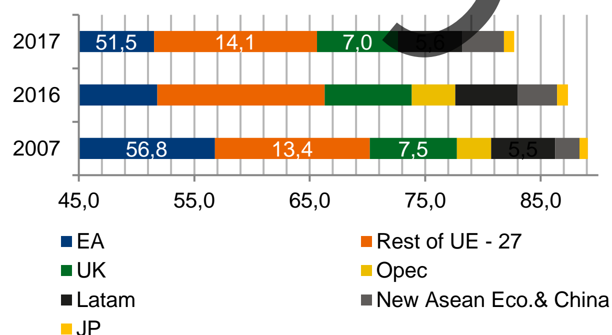
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 2 – Current account surplus achieved through…



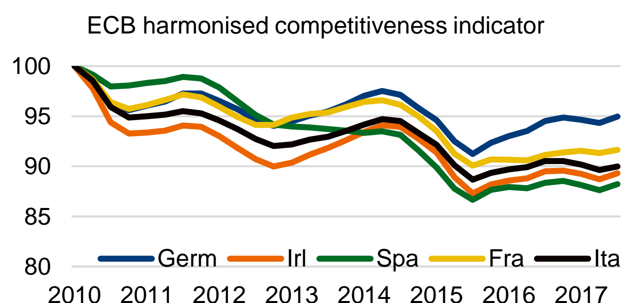
Source: Banco de España and Intesa Sanpaolo elaborations

Fig. 3 – …a diversification of exports, and…



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

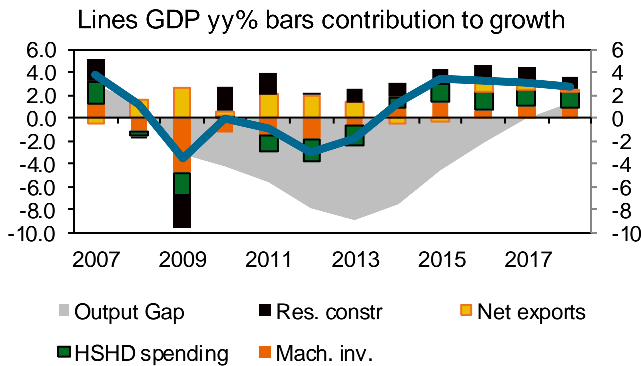
Fig. 4 – …cost competitiveness gains



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

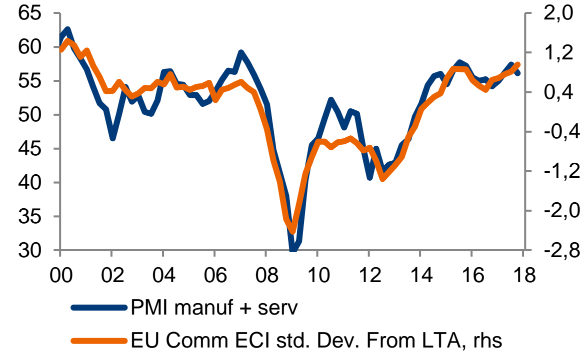
Sample

Fig. 5 – Growth stable: modest slowdown expected in 2018, but still above potential. Output gap to turn positive again already at the end of 2017



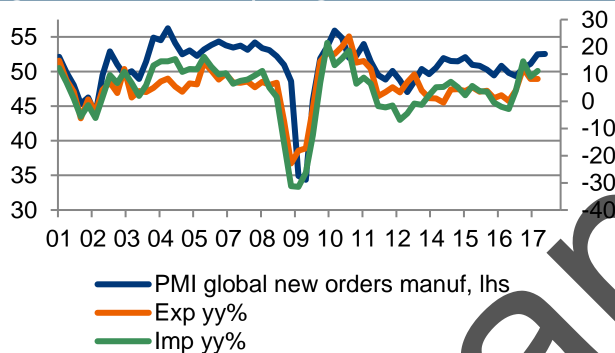
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 6 – Surveys point to a stabilisation of growth at 0.6%/0.7% q/q at the end of the year, from 0.8% q/q in the summer months



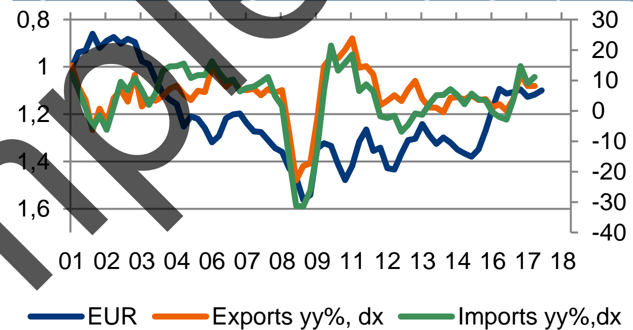
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 7 – Global demand is proving resilient



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

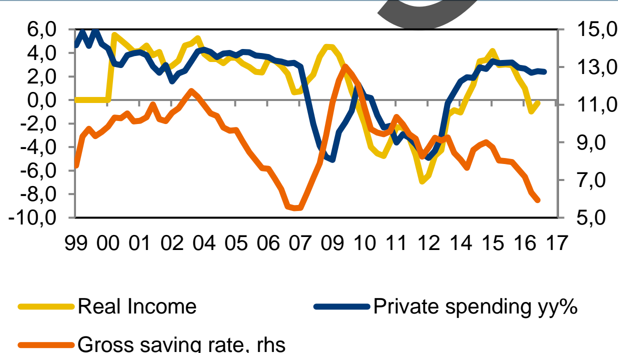
Fig. 8 – But the exchange rate could weight negatively



Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

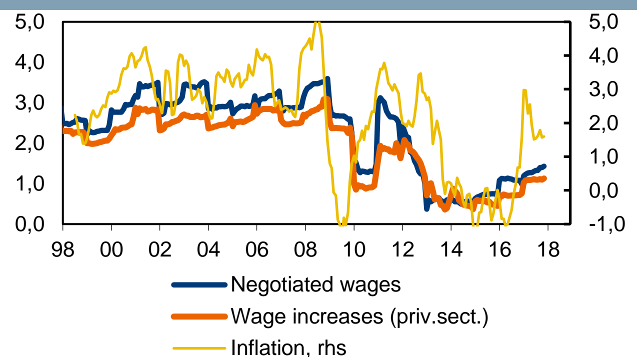
Sample

Fig. 9 – Consumption has now peaked. Households are spending more than they earn. Savings rate still on the decline, not far off 2007 lows



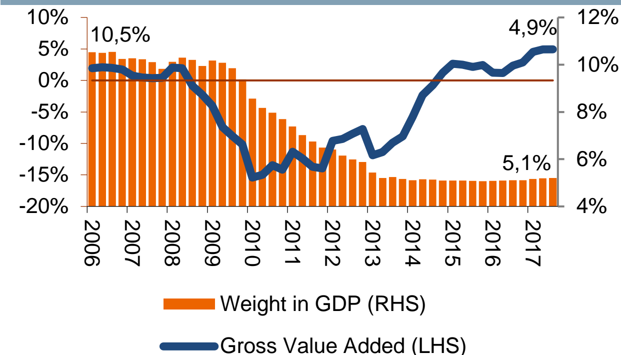
Source: Thomson Reuters Datastream and Intesa Sanpaolo elaborations

Fig. 10 – Real wages have little room to increase significantly



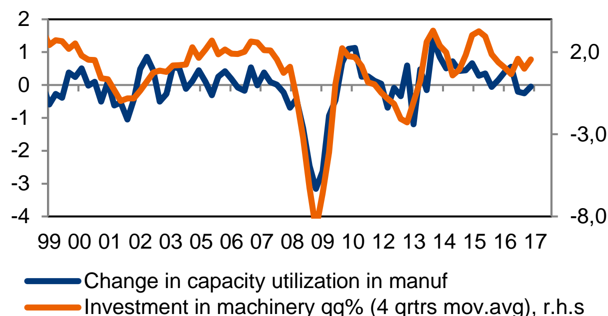
Source: INE and Intesa Sanpaolo elaborations

Fig. 11 – Persistently strong value added growth in residential construction



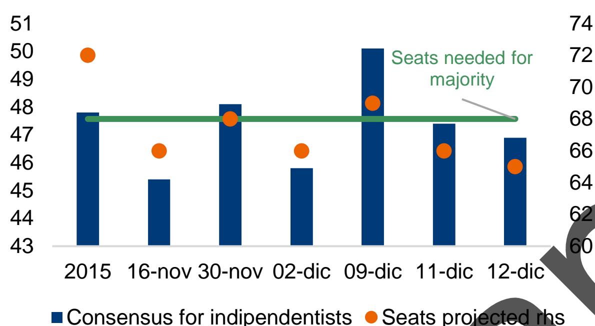
Source: INE and Intesa Sanpaolo elaborations

Fig. 12 – The cycle of investments in machinery is mature



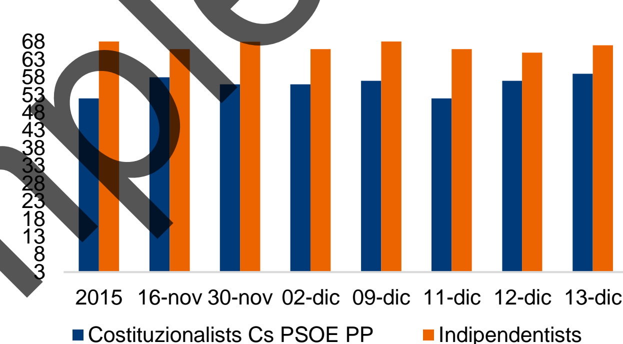
Source: INE, EU Commission and Intesa Sanpaolo elaborations

Fig. 13 – Consensus for the independentists at between 46% and 50%



Source: Wikipedia and Intesa Sanpaolo elaborations

Fig. 14 – High risk of a split Parliament between independentists and constitutionalists



Source: Wikipedia, EU Commission and Intesa Sanpaolo elaborations

Sample

Netherlands: GDP set to reach highest level since 2007

Guido Valerio Ceoloni

GDP growth at 3.0% in 2017 and 2.7% in 2018

After outstanding 2Q figures (+1.5% qoq, +3.8% yoy), **GDP** growth slowed to 0.4% qoq (3.3% yoy), taking YTD growth to 3.0%. We expect growth to pick up again in the last quarter of the year, reaching 0.6% qoq or **3.2%** yoy, compared with 2.1% in 2016. In **2018**, **GDP** growth is likely to decline to **2.7%.** The main growth driver this year and next will be domestic demand, while imports and exports will be weaker yoy in 2018.

Consumption still rising and an exceptional year for the real estate market

Consumption remained very buoyant in the third quarter, and rose 0.6% qoq, compared with 0.9% in 2Q17. We anticipate that consumption will advance by 0.5% qoq in the fourth quarter. Average annual household spending will rise by 2.2% this year (2016: 1.5%) before slowing to 1.6% in 2018. The European Commission's consumer confidence indicators show that household confidence declined slightly in November, but remains close to record-high levels. Now that the Dutch government has announced plans for a new fiscal stimulus package in 2018-19, the uptrend will continue. The ESI index average currently stands at 17.3, up from 16.6 in the third quarter. Given that the package is again intended to benefit private households, we do not expect consumption to return to normal levels until 2019. New public spending programmes will also boost public consumption in the coming year. The real estate market continues to gain ground, with house prices rising again in October. Average house prices are now 22% higher than in

2013.[9] The number of house sales continues to climb, which is good news for residential real estate.

Macro forecasts

	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	2.1	3.2	2.7	2.4	2.8	2.6	3.8	3.3	3.2	3.3	2.5	2.5	2.7
- q/q change				0.9	0.7	0.6	1.5	0.4	0.6	0.7	0.7	0.5	0.8
Private consumption	1.5	2.2	1.6	0.8	0.6	0.2	0.9	0.6	0.5	0.2	0.3	0.3	0.3
Fixed investment	5.2	6.0	3.1	0.6	-1.7	4.6	0.9	2.0	0.6	0.6	0.6	0.5	0.5
Government consumption	1.1	0.9	1.0	0.2	0.4	-0.2	0.7	0.0		0.3	0.3	0.3	0.3
Export	4.1	5.8	4.3	0.9	1.3	1.6	2.0	1.7	1.0	1.0	0.8	0.8	0.7
Import	3.9	5.4	4.5	0.7	0.7	2.1	1.3	1.7	1.3	1.0	0.9	0.8	0.8
Stockbuilding (% contrib. to GDP)	-0.5	-0.2	0.8	0.2	0.1	-0.3	0.0	-0.4	0.3	0.3	0.4	0.2	0.5
Current account (% of GDP)	8.5	8.9	8.9										
Deficit (% of GDP)	0.4	0.7	0.5										
Debt (% of GDP)	61.8	57.7	55.0										
CPI (y/y)	0.1	1.3	1.5	-0.2	0.5	1.3	1.0	1.5	1.3	1.5	1.6	1.5	1.6

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

Sample

Investment up by over 5% for the second year running but growth may slow in 2018

Both **public** and **private investment** are expected to continue to increase. In the private sector, production capacity utilisation has returned to pre-crisis levels, prompting new corporate investment. We predict that annual average investment growth will remain at 5.3%, on a par with 2016, before then slowing to 3.1% in 2018. However, the residential sector is slowing after years of above-average rises. In September, house prices were up 7.3% yoy. After the exceptional 20% gain from 2015 to 2016, this year **residential investment** will advance by "only" 10%, with growth then stabilising at 2.5% in 2018. However, in contrast to the 2013 real estate bubble, this time there does not appear to be any correlation between house price rises and household debt, which remained more or less stable during the period under review.

Strong consumption levels will keep import and export contributions close to zero between 2017 and 2018

Growth in **exports** slowed slightly to 1.7% qoq in the third quarter (2Q17: 2.0%) and may well decline further at the end of the year. However, exports improved significantly over the year, with growth at 5.7% compared with 4.2% in 2016. That said, we expect export growth to slip to around 4.0% in 2018. Exports are seen gradually returning to normal levels over the forecasting horizon as prices and salaries rise, which should have a knock-on effect on competition for goods and services. At the same time, growth in **imports** advanced from 1.3% qoq in the second quarter to 1.7% in the third quarter, boosted by higher volumes of consumption and investment in machinery. We expect them to remain stable at the end of the year, in line with household spending. Consequently, the contribution from **imports and exports** is seen as slightly negative at the turn of the year, but will remain close to zero for 2017 and probably in 2018 too.

Inflation forecast at 1.4% in 2017 and 2.0% in 2018

Consumer prices should remain more or less stable at year-end, with domestic **inflation** coming in at 1.4% in 2017, compared with 0.3% in 2016. After a slowdown in the winter months, we expect inflation to pick up in 2018 and average 2.0% for the year, mainly driven by energy prices. The **core component** is likely to decline from 0.9% in 2017 to 0.6% in 2018. We expect a further rise in 2019 in the wake of the planned increase in indirect taxation.

Labour market edging closer to full employment

With **employment** set to advance 2.1% in 2017 (2016: 1.3%) and the participation rate rising to around 69.7%, **unemployment** is expected to fall for the fourth year running, albeit only slightly. Unemployment should come in at 4.9% in 2017, down from 6.0%, and is expected to drop by around another three percentage points to 4.6% in 2018, putting the Dutch unemployment rate among the lowest in the Euro zone with **close to full employment**. With ever more

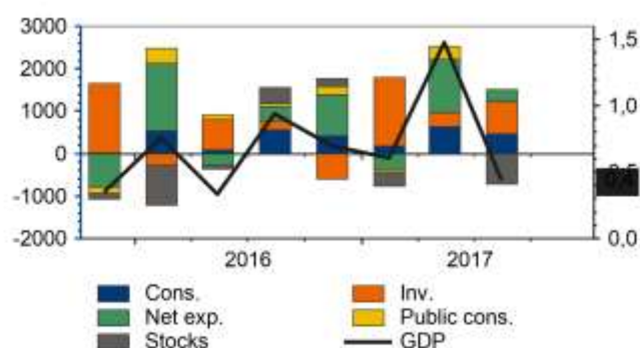
[9] But still 4% below the record prices seen in 2008.

companies hiring, the Dutch labour market is in the best shape that it has been in for a decade, with the employment rate close to record levels at 66.7%.

Budget surplus continues for 2017-18 period, public debt below 60% and falling

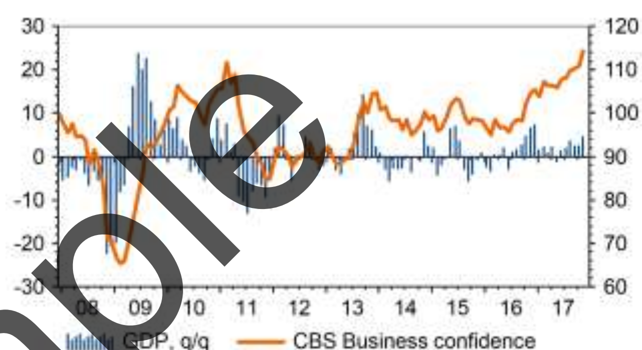
In recent years, the public accounts have benefited from solid growth and consistently improved. **The budget surplus** for 2017 could increase to 0.7% (2016: 0.4%), before then stabilising at around 0.5% in 2018 in response to the new fiscal stimulus measures. Public **debt** continues to decrease year-on-year. In 2017, it is expected to fall just below 58%, down from 61.8% in 2016, and is seen dropping to 55% in 2018. **Risks to the scenario are still positive but moving towards equilibrium**: we feel that the cycle has now peaked, and as of 2018 growth will begin to return to normal levels, as inflation rises and the labour market is at almost full employment.

Fig. 1 – Contribution to the GDP



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

Fig. 2 – Economic confidence and GDP



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

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

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

Fig. 4 – Retail sales and household confidence

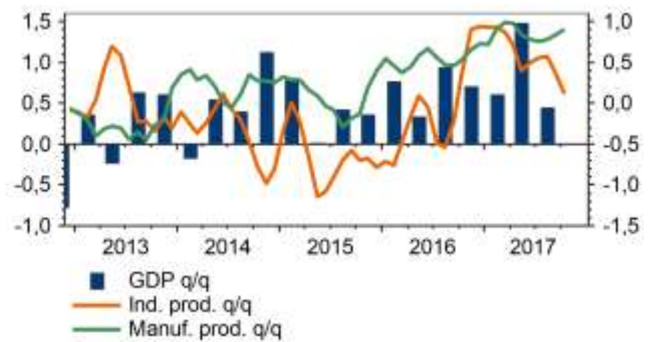
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Sample

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

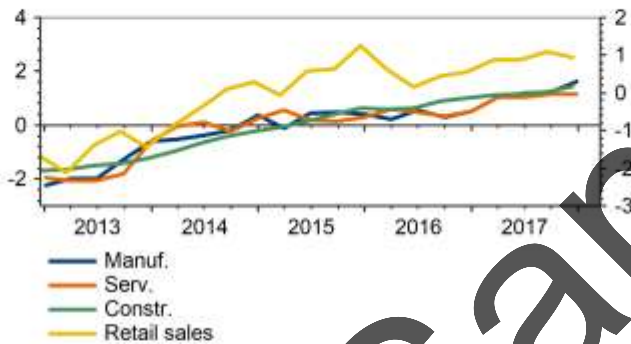
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



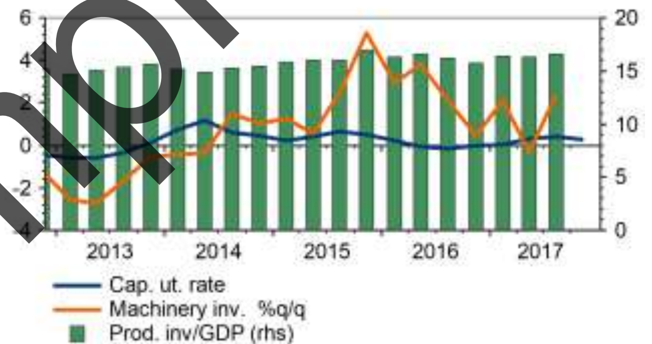
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the production sectors



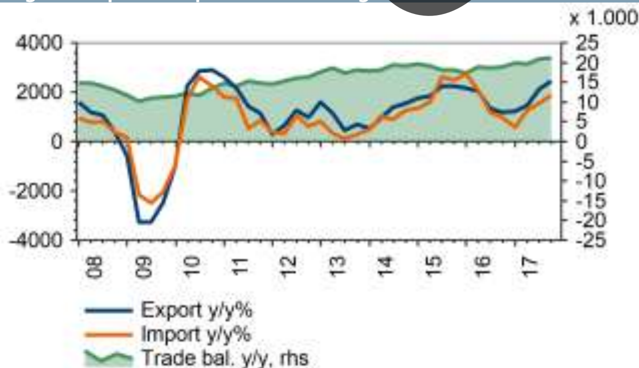
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



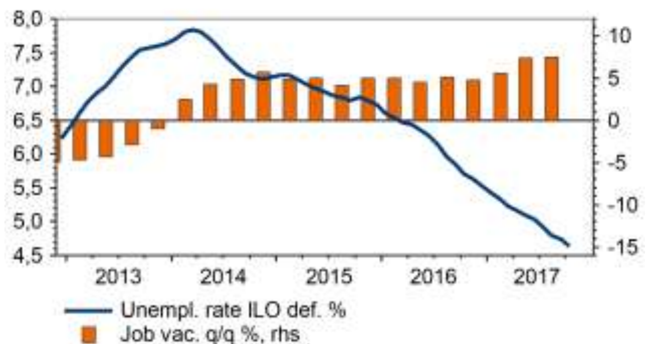
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Exports, export orders and global PMI



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

Fig. 10 – Unemployment and job vacancies



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

Greece: 2017, the mini-recovery arrives, and GDP finally starts to grow again

Guido Valerio Ceoloni

Sample

Second year of GDP growth in a decade: the economic scenario struggles to improve, but it is still not known what will happen after the end of the third bailout.

In the third quarter, Greek GDP rose by 0.3% qoq (1.3% yoy), slowing from the 0.8% qoq (1.6% yoy) in the spring, due to a new slowdown in consumption and a rise in imports (the decline in consumption was partly affected by uncertainty about the end of the second review of the aid programme). Average annual **GDP** is now heading for **growth of 1.5%**, up from -0.3% in 2016. Along with 2014, 2017 will be the **second year of growth in the last decade**. For **2018**, we forecast growth to strengthen with **GDP at 2.1%**. Once uncertainty has dissipated with the second review, after stalling for over six months, household confidence rose. The ESI consumer confidence index went to -53.9 in the current quarter, from -57.4. At the end of the year, we project that improved household confidence will lead to new GDP growth of around 0.8% qoq following the push from **consumption**, which this year is heading for growth of 0.6% yoy (this figure is still weak, but better than the 0.1% yoy in 2016). In 2018, it should strengthen further (+1.0% yoy). The contribution from **public consumption** will also be significant in 2018 (estimated at 2.3% yoy) after a further decline of -1% this year, from -1.4% in 2016. Confidence in the production sectors has not shown a similar improvement, with the ESI index dropping slightly from 99.2 to 98.3 in the last quarter: confidence has only improved in the retail sector, while in manufacturing, services and construction, it has remained stagnant. Nonetheless, **investments** should rise at a higher pace this year than in 2016, at 5% yoy from 1.6% yoy, and then continue with a stronger trend in 2018 (+8% yoy). Bolstered by growing global trade, **foreign trade** was the growth driver in the middle of the year, but in 2017 its contribution will only be slightly positive (having been dragged down by rather strong growth in production investment in the first quarter). In 2018, we expect the contribution of net exports to rise. The labour market is likely to report a fresh fall in **unemployment** from 23.6% to around 21.5%, due to the rise of nearly 2% in **employment** this year, most of which was achieved in the first half. The fall in the number of jobless should also continue next year (20%). **Inflation** will advance to 1.2% this year, driven by the statistical impact on energy prices (seen in many euro zone countries), after stagnating in 2016. A slowdown of around 0.8% is expected in 2018 due to the elimination of this statistical impact. **Risks** will necessarily remain **to the downside**, but less so than in the past; the resumption of growth will also have a positive impact on the public accounts, and thus, on the completion of the bailout plan scheduled for next summer. Based on the latest available data, the improvement in the public administration's arrears and the increase in revenues from social security contributions were better than expected, leading us to believe that the **2017 primary surplus[10] target of 1.75% will be achieved.** For next year, the primary surplus target will rise to 3.5%, and this level will have to be maintained in 2019. The room to manoeuvre will remain very small, but the economic recovery will be a positive factor that did not exist before. Lastly, **public debt** will continue to stabilise this year at just below 180%, down from 180.8% in 2016, and will start falling more strongly in 2018 and 2019. The continuing lack of a government in Germany after the autumn elections has forced the **post-bailout** issue to be postponed in Europe. In the absence of a joint agreement on debt restructuring, the provision of a new package of aid to Athens, subject to some mild form of conditions, could be inevitable to avoid leaving the country largely exposed to external shocks.

Sample

[10] As specified in the MoU, i.e. excluding one-off expenses to recapitalise banks, and revenues from SMP, ANFA and privatisations.

Portugal: 2017-2018, positive cycle and a recovering labour market

Guido Valerio Ceoloni

This has been a very positive two-year period with clear signs of recovery, including in the labour market. However, the country is still exposed to external shocks as a result of debt, which although falling, is still too high.

In the third quarter, growth rose to 0.5% qoq (2.5% yoy) from 0.3% qoq (3.0% yoy) due to the contribution of domestic demand. **GDP** recovered from the disappointing figure in the spring, with growth now at 2.5%. At the end of the year we estimate that the economy will maintain a cruising speed of 0.5% qoq, bringing **the annual average to 2.6%** from 1.5% in 2016. **We forecast a slowdown of around 2.0% in 2018.** Domestic demand was the main driver of the good performance in 2017. Apart from the -0.5% qoq correction in the second quarter, **consumption** continued to grow solidly, and we project that at year-end, it will again rise by 0.3% qoq from 1.5% qoq: in annual average terms, 2017 will be the second year of strong expansion in consumption, at a pace of 2.2%. The European Commission's consumer confidence index indicates that confidence is still set to rise at the end of the year (to 2.8 from 1.5) above the historical average. We are expecting a slight slowdown of around 2.0% in GDP in 2018. Both production and residential **investments** were also a significant growth driver, with average annual growth set to rise to 8.6%, up from 4.6% in 2016. A significant contribution to the year came from the automobile industry where major investments were made by operators to increase production capacity. Now that this extraordinary effect has run its course, we anticipate a slowdown of around 4.8% next year. On the whole, **domestic demand** is expected to remain strong again in 2018. **Foreign trade** produced a negative contribution of 0.2 in September for the second consecutive quarter due to the strengthening euro and strong recovery in consumption in the third quarter: the average annual contribution of net exports will be slightly negative. In 2018, exports, especially in the automobile and tourism industries, should more than offset the impact of consumption on imports: for 2018 we therefore expect a slightly positive contribution from net exports. We confirm **inflation** at 1.5% this year, while in 2018 it could decline marginally to 1.4% due to the statistical repercussions of energy prices in the first nine months of the year. This year, **unemployment** is heading for a significant two-point drop from 11.2% to 9.2%, its lowest level since 2008. The tourism and construction sectors contributed specifically to **employment** growth, which could rise to 3% this year, from 1.6% in 2016. Next year, unemployment will continue to fall, approaching the Euro zone average. Lastly, strong growth and lower-than-expected public investment will facilitate the decline in the **nominal deficit** from 2.0% to 1.4% this year; it will then stabilise around this level in 2018, in the absence of any new consolidation measures. The **structural deficit** should mirror this trend, with a correction of two-tenths of a point this year, falling from 2.0% to 1.8%, and then remaining at this level in 2018. This year, **public debt** will fall from 130.1% to 126.5% after rising in 2016. In 2018, it is expected to drop by around another two points to 124.5%. The Bund spread has continued to decline, including in recent months, and is now around 150 bps, a further 40 bps lower than in September. **Risks to the scenario are now balanced**: against this backdrop of a positive cyclical phase and a labour market in clear recovery, the country is still subject to external shocks, mainly due to heavy debt exposure; moreover, if there is no new round of structural reforms, growth could return to a downward path starting in 2019, as the cycle matures.

Sample

Asia

Japan: the economy on a roll in 2018-19

Giovanna Mossetti

The Japanese economic scenario is looking markedly positive, thanks to a combination of favourable conditions for the domestic and global economies. **Growth** over the next two years should continue at rates well above potential, and is forecast at **1.5% in 2018** and **1.4% in 2019,** driven by solid contributions from domestic demand and net exports, from **+1.5% estimated for 2017. Core inflation** in 2018 should stay below 1%, well off the BoJ's target rate, justifying the central bank's **persistently aggressively accommodative policy,** centred on QQE with yield curve control strategy, albeit with possible adjustments dependent on the evolution of the markets. **Fiscal policy** should be modestly expansionary in 2018 and in most of 2019, before the second tranche of the consumption tax hike is implemented in October 2019. The enforcement of the tax hike in 2019 should pose limited risks for the cycle, as the government has announced that part of the additional revenue will be used to finance significant spending hikes on education.

Risks to the scenario are modest and balanced in 2018. The fundamentals of the economy are positive, both at the domestic and international level, while the mix of economic policies should remain expansionary at least until the end of the year, contrary to the situation in most of the other advanced countries. The expected modest rise in inflation should not prompt changes in monetary policy measures in 2018, save for marginal, possible adjustments to the curve control strategy in the second half of the year. On the **monetary policy** front, the first risk on the horizon is the appointment of the Governor of the BoJ, on expiration of Kuroda's mandate (April 2018). End-of-mandate positions to be renewed include the vice governor (Iwata's term will end in March 2018) and one board member Board (Nakaso, also in March 2018), out of a total of nine members. For the time being, Kuroda seems likely to be reconfirmed, and the Board should stick to its current strategy. For what concerns more strictly **political** topics, the management of the **constitutional reform process,** and of **tensions with North Korea,** may result in bouts of volatility in the next two years, albeit probably not of such scope as to place the recovery at risk. **In 2019 as well, risks should be limited:** the central event will be the **expected consumption tax hike from 8% to 10%**, scheduled for October. The measure should generate large volatility in quarterly growth, but the recovery should survive: the economy is solid and new expansionary measures on education should moderate the restrictive effects of the tax hike this time (recessions started after the previous two consumption tax hikes). **The economy is in excellent health, although the wage trend is still not picking up**. The acceleration of growth in 2017 (1.5% estimated) is supported by consumption, by both public and private investments, and by net exports. In 2018, growth should be widespread across components, and prove to be even more solid than this year. In 2017, the **consumption** trend was positive but volatile. Consumption is forecast to grow by 0.8% in 2018, on the rise to 1.1% in 2019, before the restrictive effects of the consumption tax hike are expected to materialise. The labour market is still under pressure, due to increasing excess demand, which should translate into modestly stronger wage growth over the next two years. In 2017, the strong rise in female participation in the labour market has curbed the uptrend in wages, but significant labour force expansion will be increasingly limited going forward.

Non-residential fixed investment should remain on a solid trend, while slowing modestly from 2017 levels (2.8%), that had also been driven by a very strong exit from 2016. In 2018, supportive financial conditions and ongoing earnings growth, combined with the favourable economic situation both domestically and abroad, should keep average quarterly growth at just under 2%, placing the year-on-year change at 1.8%.

Net exports resumed contributing positively to growth starting in 2015. Net foreign demand contribution is expected to hit 0.5pp in 2017, and a little less in 2018 (estimated at 0.3pp), in the wake of a moderate acceleration in imports (+2.7%) and a 4.3%change in exports, from 6% forecast in 2017.

Sample

Fiscal policy in 2018 will stay on the expansionary path adopted in 2017, focused on investments and aimed at strengthening the economy before the second consumption tax hike is implemented in October 2019. At the end of 2017, an additional mini-budget should be proposed, worth close to one trillion yen, without reaping particularly strong effects. 2018 should be a transition year, ahead of the more important measures announced for 2019. The consumption tax hike from 8% to 10%, expected in October 2019, should be offset in part by increased spending on education (around 2 trillion yen, close to 40% of the additional VAT revenue), aimed at offering free health care for children up to five years of age in low-income families. These measures should support participation in the labour force and limit the restrictive effects of the consumption tax hike, so as to prevent it from being postponed again. The deficit path should be broadly stable, while the ever-increasing share of JGBs held by the BoJ greatly reduces the debt sustainability risks

Inflation and monetary policy. **Core inflation** remains stubbornly close to zero, but the falling trend should now be over. The output gap has closed (Cabinet Office estimate: 0.5%), the unemployment rate is at 2.8% (a 23-year low), labor costs are on the rise for the first time since 2012, consumer expectations have been improving since last spring (fig. 10). Inflation net of fresh food and energy prices is forecast to rise towards 1% between the end of 2018 and the beginning of 2019, fully clearing fears of a fall-back into deflation. Despite the expected increase, inflation net of fresh food prices, as monitored by the BoJ, should remain below the 2% mark, justifying the current monetary policy strategy, based on qualitative and quantitative stimulus with curve control, defined by Kuroda "aggressively accommodative".

The **BoJ has committed to keeping "QQE with yield curve control" in place** until inflation will have overshot the 2% goal. Starting in the second half of 2018, the BoJ could introduce changes to curve control on the long end of the curve, also in light of evolving market conditions. In its November asset purchase operations, the central bank reduced the amounts purchased to counter excess demand. In any case, purchases will continue at a sustained pace ("around 80 trillion yen" in JGBs), roughly twice the government's net issues (43.4 trillion yen in FY 2017). This trend will result in a **gradual easing of risks to the sustainability of public debt**, although it will imply a stalling of the process of cutting the deficit, announced at the beginning of the Abe era. Lastly, risks tied to the **replacement of three BoJ board members**, including the governor and vice governor, by March 2018, should be modest, as Abe has reasserted that monetary policy must remain accommodative, and will probably re-appoint Kuroda. In conclusion, monetary policy in Japan will continue to proceed in the opposite direction compared to the other advanced countries, and **financial conditions will remain markedly expansionary in the next couple of years as well**.

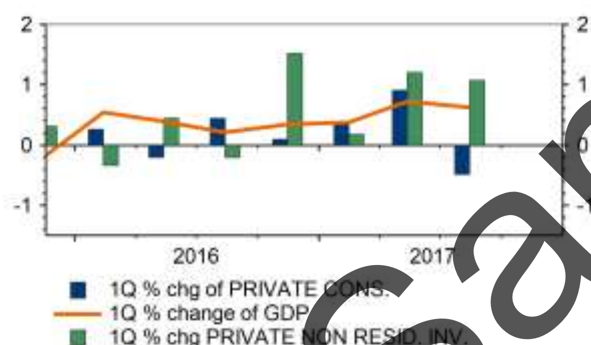
Sample

Macro forecasts	2016	2017f	2018f	2016		2017				2018			
				3	4	1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	0.9	1.7	1.6	0.9	1.5	1.3	1.7	2.1	1.9	2.0	1.6	1.4	1.6
q/q annual rate				0.9	1.4	1.5	2.9	2.5	0.5	1.9	1.6	1.5	1.3
Private consumption	0.1	1.1	0.8	1.8	0.4	1.5	3.7	-1.9	1.0	1.0	1.2	0.9	1.0
FI - private non-residential	0.6	2.9	2.4	-0.8	6.2	0.7	4.9	4.3	2.1	2.0	2.0	1.6	1.6
FI - private residential	5.6	3.8	0.8	12.5	1.0	3.7	5.2	-4.0	2.0	1.6	0.5	0.8	0.8
Government investment	0.1	1.7	5.0	1.2	-9.1	1.4	19.8	-9.2	4.3	7.5	8.4	7.1	0.1
Government consumption	1.3	0.2	1.1	2.0	-1.0	0.7	0.8	0.2	1.6	1.6	0.8	0.8	0.8
Export	1.3	6.0	4.3	8.7	12.6	7.8	-0.5	6.0	4.1	4.9	4.5	4.3	3.8
Import	-1.9	2.6	2.7	0.6	5.2	5.4	5.9	-6.2	3.8	4.6	4.3	2.8	2.1
Stockbuilding (% contrib. to GDP)	-0.2	-0.1	-0.1	-2.1	-0.2	-0.2	-0.1	1.4	-1.0	0.2	-0.2	-0.4	-0.2
Current account (% of GDP)	3.7	3.7	3.7										
Deficit (% of GDP)	-4.6	-5.2	-5.6										
Debt (% of GDP)	222.2	224.6	225.1										
CPI (y/y)	-0.1	0.4	0.6	-0.5	0.3	0.3	0.3	0.6	0.5	0.1	0.7	0.7	0.8
Industrial production	-0.2	4.4	2.1	1.0	2.8	4.0	5.8	4.6	3.2	3.5	1.7	1.7	1.5
Unemployment (%)	3.1	2.8	2.5	3.0	3.1	2.9	2.9	2.8	2.7	2.6	2.5	2.5	2.4
JPY/USD	108.8	112.1	115.6	102.4	109.6	113.6	111.1	111.0	112.8	114.7	115.4	115.9	116.4

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

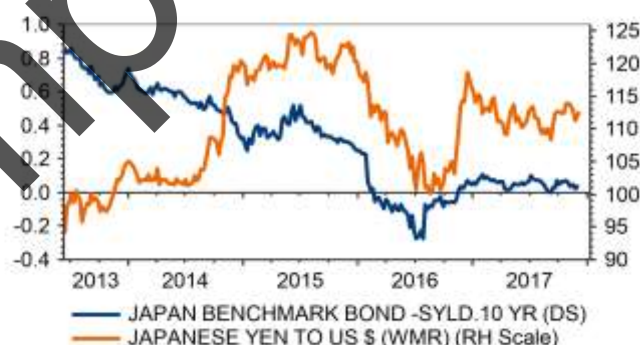
Sample

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



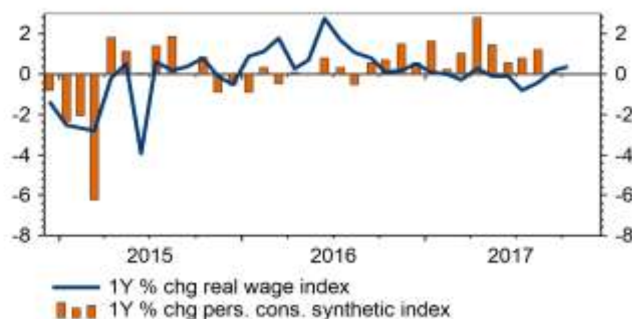
Source: Thomson Reuters-Datastream

Fig. 2 – Monetary policy still active on two fronts: yield curve and exchange rate



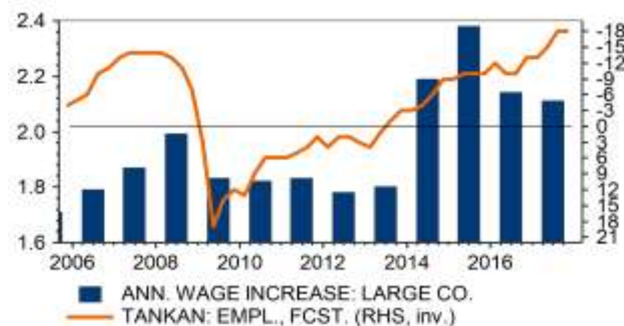
Source: Thomson Reuters-Datastream

Fig. 3 – Moderate recovery in consumption, despite the weak wage trend



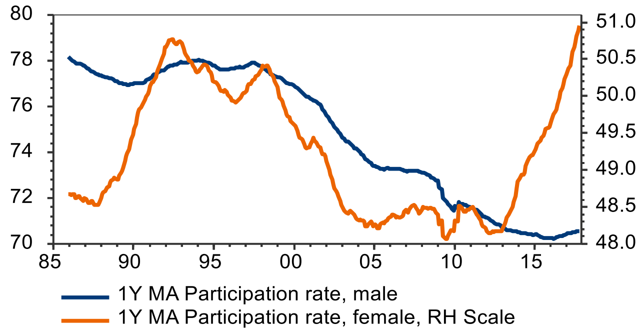
Source: Thomson Reuters-Datastream

Fig. 4 – Contractual wage growth still not materializing, despite excess demand for labour



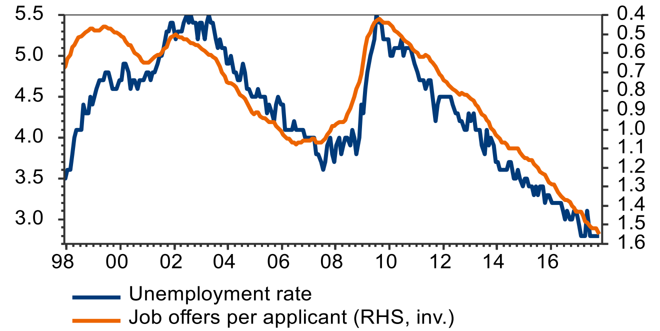
Source: Thomson Reuters-Datastream

Fig. 5 – Higher female participation in the labour force



Source: Thomson Reuters-Datastream

Fig. 6 – More than full employment!

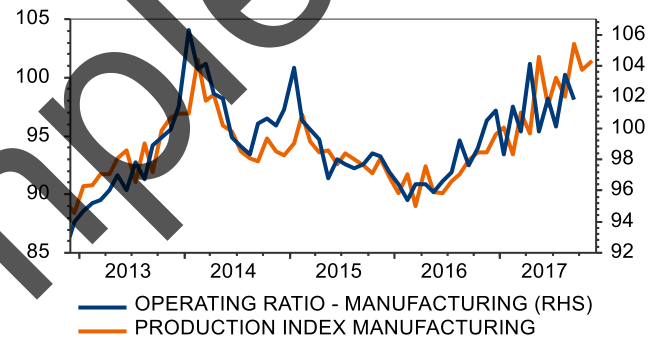


Source: Thomson Reuters-Datastream

Fig. 7 – Businesses have resumed investing, thanks to higher corporate earnings

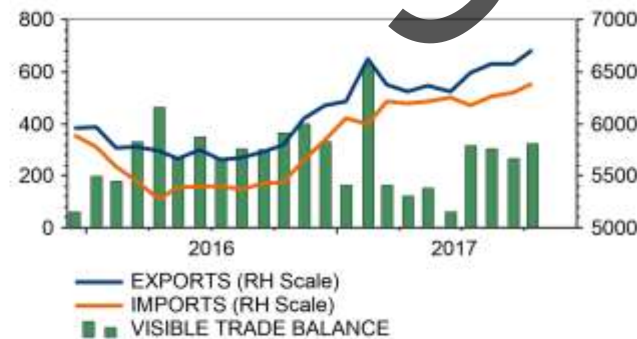
Source: Thomson Reuters-Datastream

Fig. 8 – Industrial output is rising sharply



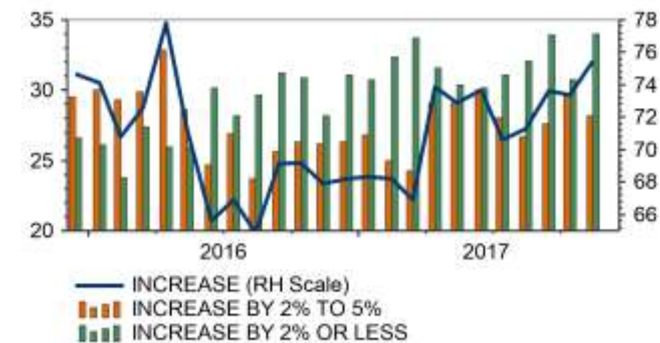
Source: Thomson Reuters-Datastream

Fig. 9 – Trade balance positive: the contribution of the foreign channel should contribute to growth in 2018 as well



Source: Thomson Reuters-Datastream

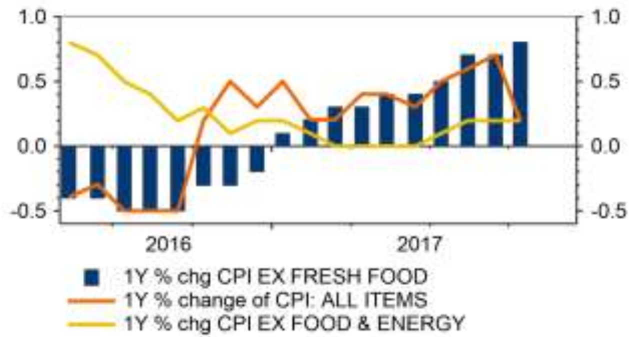
Fig. 10 – Households are starting to believe that prices are on an uptrend



Source: Thomson Reuters-Datastream

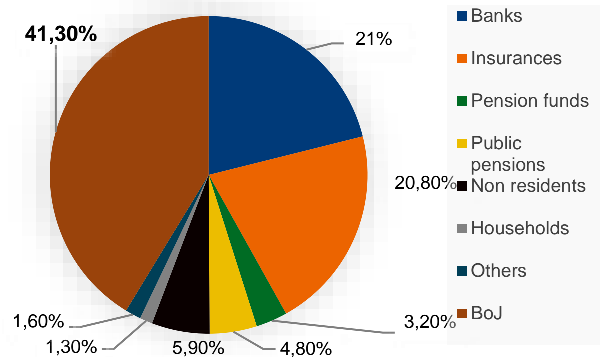
Sample

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



Source: Thomson Reuters-Datastream

Fig. 12 – Increasing share of JGBs held by the BoJ



Note: data as at the end of March 2017; total JGBs: 967.6 trillion yen. Memorandum: total JGBs+Tbills=1082.9 trillion yen. Non-residents hold 51.9% of T-bills. The average life of debt is 8 years and 8 months.
Source: Ministry of Finance

Sample

China: reducing financial risk remains a priority

Silvia Guizzo

- In the third quarter, GDP rose by 6.8%, which was just below the 6.9% reported in the two previous quarters. The upswing in the services sector (8% vs 7.6% in the second quarter) provided the greatest contribution to growth, and together with the resilience in the agricultural sector, offset the slowdown in industry. A breakdown of the supply side shows continued high growth in the transport sector and increasing momentum in the financial services sector, while the property sector continued to languish along with the construction sector. In view of GDP performance, which was higher than our expectations, especially in the third quarter, **we are revising upward economic growth for 2017 from 6.7% to 6.8%**.

- Monthly data showed a moderate slowdown in activity from August to November, with the services sector and new technology related industries still performing better than heavy industry. Business confidence rose further in the third quarter, driven by the increase in profits and sales, but the foreign and domestic order component experienced a modest decline, which was later also reflected in PMI surveys from September to November. The trend for PMI indexes was above 50, but it dropped relative to the high seen in August/September, returning to second quarter levels. Consumer confidence continued to rise, going well beyond the highest levels since 2008, supported by good performance in the labour market and a rise in disposable income.

- The prospects for foreign trade, which were still good over the short term with import growth exceeding export growth (17.5% yoy vs. 6.1% yoy in seasonally-adjusted figures), could decline next year. The recovery in global demand has manifested **in Asian countries** in particular in a **major surge in exports of electronics and technological components**. However, data on microprocessor sales and electronic sector PMIs point to a trend nearing the highs for electronics exports. In addition, the performance of Chinese exports could suffer from an unfavourable base effect and price slowdown, quite apart from other downside risk factors such as an increase in geopolitical risk in the region due to tensions between North Korea and the US and the possible protectionist measures by the latter. President Trump's recent visit concluded on a positive note with the signing of trade agreements totalling USD 250bn, which will, in particular, benefit imports of food products such as soy and meat (in accordance with agreements made in the summer), but also in other sectors such as aeronautics. China further corroborated investor expectations with the announcement of a broader opening for foreign investments in the banking and financial sectors, and a reduction of import duties on 200 consumer goods (including high-tech products) from 1 December. Calculation estimates show that the average duty will drop from 17.3% to 7.7%. The risk of **trade tensions with the US**, which have apparently diminished, **could, however, re-emerge** in the coming months. In addition to the formal opposition of the US to China's recognition as a market economy presented in support of the EU at the WTO in November, there continue to be differences between the two countries in specific sectors. Investigations by the US Commerce Department are still under way into violations of intellectual property rights, forced technology transfers and imports of steel and aluminium and these could lead to the introduction of sanctions or duties in the coming months.

- After reaching a high of 1.9% yoy in October, consumer price inflation came back down to 1.7% in November, driven downward by the decline in food product prices since February. Inflation in the services sector is higher (3.1% yoy in October) than for goods (0.9%), leaving core inflation still stable at above 2% since April. A resurgence in food prices, which is expected especially at the turn of the year, will be countered by a favourable base effect, especially in the services sector, a limited transfer of production prices inflation and an anticipated slowdown in money supply. Thus, **consumer price inflation is only projected to increase modestly from 1.5% in 2017 to 2.2% in 2018 and 2.1% in 2019.**

- At the end of the year, tax revenue growth remained strong, while the growth in tax expenditures slowed, mainly at the local level, due to expenditure frontloading in the first half

Sample

of the year. **Fiscal policy** continued to provide **support for consumption and small and medium-sized enterprises** through measures to reduce consumption taxes and taxes for small and medium-sized enterprises and individual businesses that were recently announced for 2018 and 2019.

- In recent months, the competent authorities have continued to issue new regulations to reduce systemic risk in various areas of the financial, banking and non-banking sectors. In mid-November, the Committee for Development and Financial Stability was also established, which is headed by Vice Premier Ma Kai. Its role is to coordinate monetary, fiscal and economic policies at a ministerial level higher than that of the various competent authorities and the People's Bank of China (PBoC). **Thus, controlling financial risk will again continue to be one of the highest priorities for regulators in 2018**, along with **environmental protection** and the **quality of growth**, meaning the well-being of individuals and distribution of wealth. These objectives, which were presented at the Communist Party Congress in October[11], were recently emphasized by Xi Jinping at the meeting of the Central Committee of the Politburo in December. Thus, the growth target for 2018 could be lowered slightly to around 6-6.5%. The reform of state enterprises and the restructuring of local government debt continue to be just as important, and one of the authorities' main goals.
- The **PBoC** seems to have adopted a **monetary policy stance with a longer time horizon** through the greater use of the medium- and long-term liquidity window with issues shifted to 1-year maturities starting in mid-2017 and the use of 63-day reverse repos. In addition, with the aim of encouraging so-called "inclusive financing" (loans to small and medium-sized enterprises, start-ups, students and the agricultural sector), at the beginning of October it announced a targeted reserve requirement ratio cut for commercial banks that will come into effect in January 2018. The PBoc then lifted rates on refinancing operation by 5bps soon after the Fed hike. We believe that the PBOC will leave its monetary policy stance largely unchanged in 2018, provide an appropriate level of liquidity to the market and maintain rates moderately higher than in the first half of 2017 especially on longer maturities, as reflected in the trend of monetary and government curves since the end of October.
- The repeated intention of various authorities to limit house price rises and, more generally, to contain financial risks, foreshadows higher interest rates in the next few quarters and a slowdown in credit, which will gradually remove investment support. We expect that resilient investment in public infrastructure and services – which the government is keeping in its sights – will not manage to offset a new slowdown in investment in real estate and manufacturing. **We therefore maintain our outlook of a modest slowdown in economic growth to 6.4% in 2018 and to 6.2% in 2019.**

Sample

[11] See ISP report of 21 November 2017: "The party's strategic control in leading China is reaffirmed".

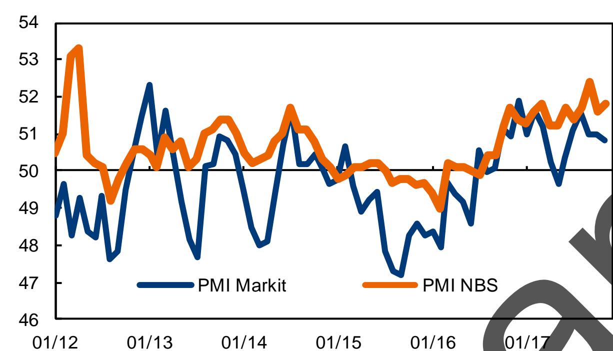
Macro forecasts

	2012	2013	2014	2015	2016	2017	2018
GDP (constant prices)	7.8	7.8	7.3	6.9	6.7	6.8	6.4
Private consumption	9.6	7.9	8.2	8.1	7.9	7.7	7.3
Public consumption	6.2	5.1	3.7	7.8	9.2	7.3	4.8
Fixed investment	8.7	9.3	6.9	7.3	6.6	5.7	4.6
Exports	5.7	7.9	5.7	0.1	1.8	7.2	4.6
Imports	6.7	10.6	7.7	0.8	3.8	9.2	5.8
Industrial output	8.4	8	7.4	6.2	6.1	6.2	5.5
Inflation (CPI)	2.6	2.6	2.0	1.4	2.0	1.5	2.2
Unemployment rate (%)	4.1	4.1	4.1	4.0	4.0	4.0	4.0
Average salaries	14.4	11.8	10.8	9.5	8.3	7.7	7.4
90-day interbank rate (average) (%)	4.2	4.9	4.8	3.8	3	4.6	4.7
USD/CNY exchange rate (average)	6.31	6.15	6.16	6.28	6.64	6.76	6.80
Current account balance (CNY bn)	1360	912	1458	1912	1296	1085	1052
Current account balance (% of GDP)	2.5	1.5	2.3	2.8	1.7	1.3	1.2
Budget balance* (% of GDP)	-3.4	-3.5	-3.6	-4.4	-4.6	-4.7	-4.4

N.B.: Percentage change compared with the previous period - except where otherwise indicated; *IMF Article IV August 2017. Source: Intesa Sanpaolo and Oxford Economic Forecasting

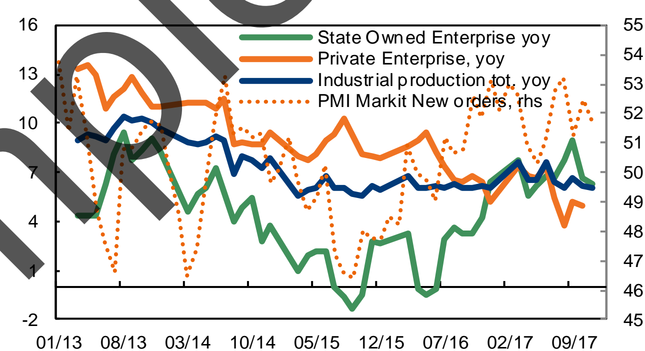
Sample

PMIs for manufacturing



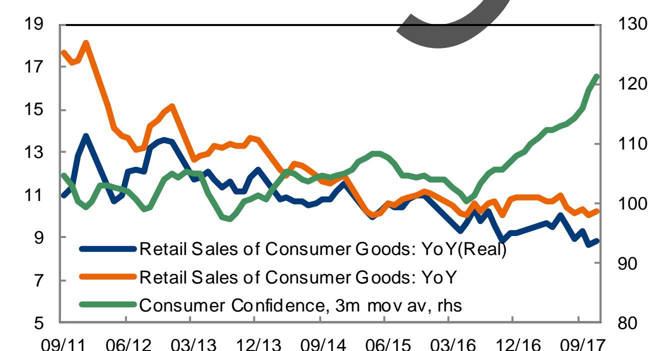
Source: PBOC's Industrial Enterprise Survey by CEIC

Industrial output and orders



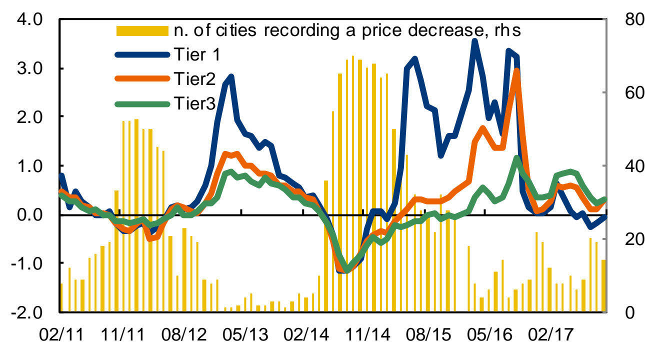
Source: CEIC, IHS Markit.

Retail sales



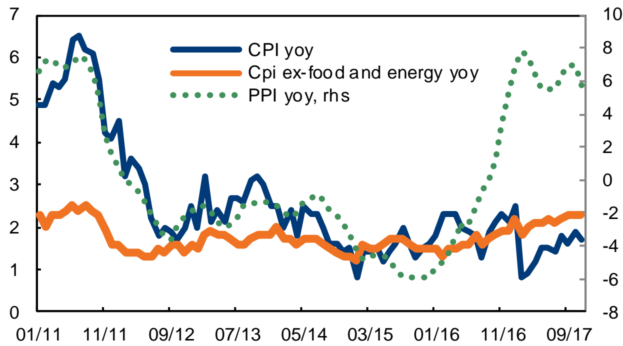
Source: CEIC

Property prices



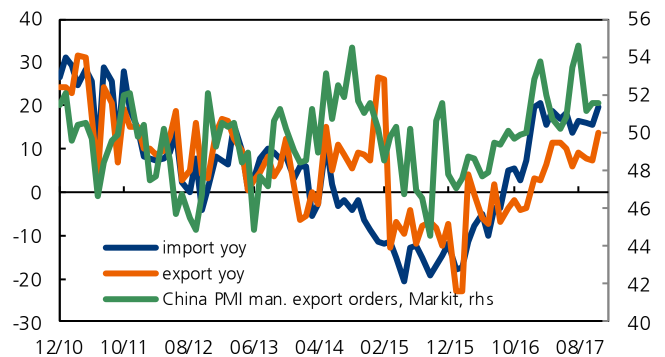
N.B. mom average change for 70 cities surveyed, primary market. Source: Intesa Sanpaolo chart from CEIC data

Inflation



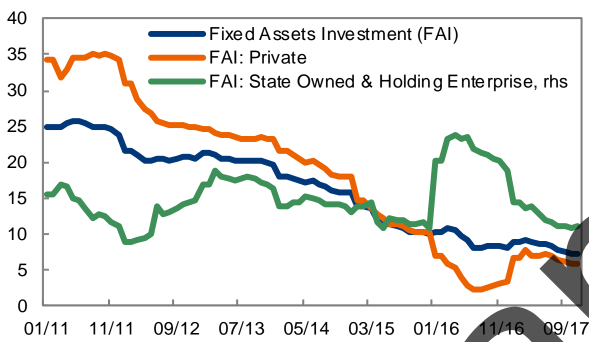
Source: CEIC

Foreign trade



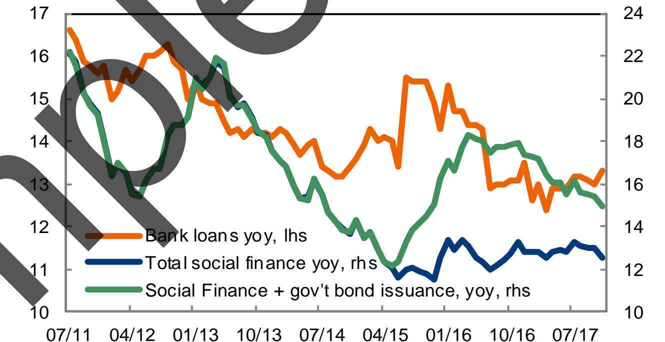
N.B.: seasonally adjusted data, 2m yoy. Source: Intesa Sanpaolo chart from CEIC and Markit data

Nominal investment, yoy



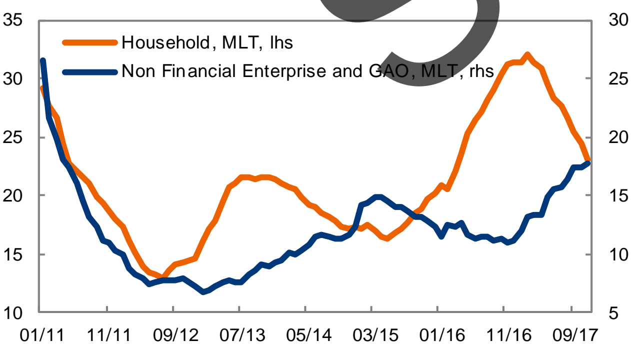
Source: CEIC

Lending is down slightly



Source: Intesa Sanpaolo chart from CEIC data

Domestic bank loans, yoy



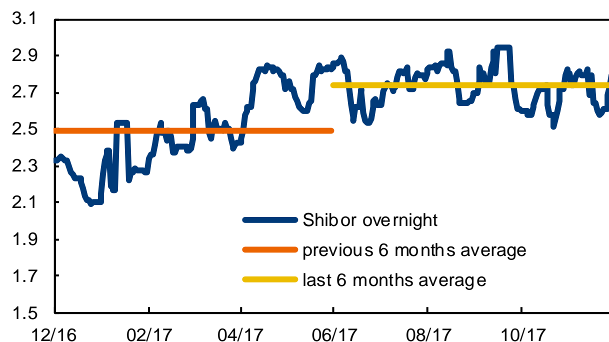
Source: CEIC

The currency is rising

Source: CEIC

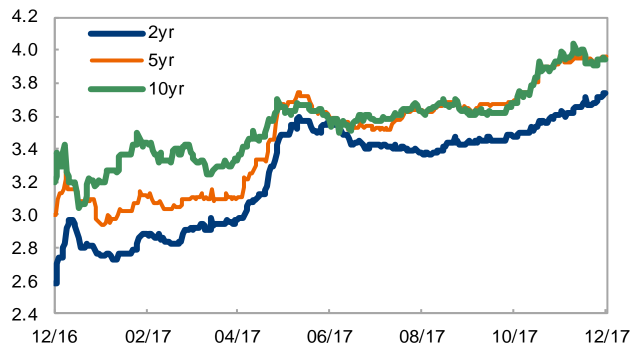
Sample

Rates on very short maturities are stabilising



Source: Bloomberg

Rates rise on the government curve



Source: Bloomberg

Sample

India: moderate acceleration in growth

Silvia Guizzo

- **GDP** was up 6.3% in the third quarter, in line with expectations and higher than the 5.7% in the second quarter. The slowdown in consumption was offset by a moderate recovery in investment and inventory levels. The foreign channel made a negative contribution to growth due to a higher growth of imports than exports. A breakdown of the supply side shows a rebound in the value added of the industrial sector, a slowdown in the agricultural sector, and continued growth (albeit slowing slightly) in the services sector. The monthly macroeconomic data continued to give mixed signals between September and November.

- The resurgence in the industrial sector in the third quarter was driven by the recovery in the mining sector and the renewed acceleration of growth in the **manufacturing sector.** The performance of industrial production did in fact improve (+3.6% 3m yoy in October from 1.2% in July), in line with an increase in the manufacturing PMI since the minimums touched over the summer, in particular for the domestic orders component. The two main business confidence surveys, however, continue to differ on the expectations component, with the Reserve Bank of India (RBI) reporting an increase for the fourth quarter but Dun&Bradstreet a decrease. The latter survey, in particular, reports a fall in expectations for net profits that follows the worsening of profit margins recorded by industrial enterprises in the first half of the year. The performance of credit increased slightly, while that of **credit to industry** remained negative. The short-term outlook remains weak, given that the RBI survey reported businesses' lowered expectations of the availability of finance on both the domestic and the international markets. An improvement is only expected in the second half of 2018, thanks to the supplementary plan to **recapitalise the public banks** announced at the end of October, for a total amount of INR 2.11 trn between the financial years 2017-18 and 2018-19. Part of the funds have already been allocated in the budget, another part will be supplementary and will be raised through bond issues. Implementation of the new insolvency code should make it easier for companies to restructure and, together with the bank recapitalisation plan, will gradually lead to an improvement in non-performing loans.

- The situation is still good (albeit a little less rosy) in the **services sector**. The services PMI, after a modest recovery between September and October, fell again below 50 in November but remained above the August minimum (47.5). Businesses reported rising costs and a still-negative impact on orders arising from the difficult process of implementing the Goods and Services Tax (GST). The increased expectations component, as well as the simplification of some procedures and the lowering of many rates, makes us continue to believe that the impact will be transitory. Tourist sector revenues remain strong, supported by an increased number of tourists, while those for mobile phones slowed slightly.
- The slowdown in consumer spending was caused mainly by the slowdown in **public spending** that continued at the end of the year. In November, the deficit was already 96% of the target for the financial year 2017-18, compared with an average of 70% for the three previous financial years. Total receipts were notably below target (36%) despite the increase in revenues from the disinvestment programme, ranging from INR 200 bn in August to around INR 520 bn in November compared with a target of INR 725 bn. An **overshoot,** albeit marginal, **of the deficit target**, is still probable for financial year 2017-18, and the risks remain for financial year 2018-19, given that 2018 is a pre-election year. The next general election is, in fact, scheduled for spring 2019. The party of President Bharatiya Janata is well positioned to achieve another victory, in the light of its optimism about the outcome in the regional elections held in December in Gujarat and Himachal Pradesh.
- **Consumer confidence** remains pessimistic (below 100). After a brief recovery in May, it continued to fall, reaching 91.1 in October, its lowest level since early 2014. The expectations index showed a similar trend, although it remained at slightly higher levels. Consumers are complaining in particular of a worsening of the general economic situation and the labour market, although spending intentions continue to improve. The employment component of the PMIs has, however, remained above 50 for the past three months, showing an increase for the manufacturing sector and a slight decrease for services, while the Manpower survey of companies' hiring intentions shows a marginal increase on the lows reached in the third quarter. Conditions in the labour market could therefore improve over the next few months, partly supported by the probable implementation of a national labour policy in the budget for the financial year 2018-19.
- **Consumer price inflation** increased from 3.3% yoy in August to 4.9% yoy in September, pushed upward by the rise in food, fuel and electricity prices. Inflation net of food and energy has remained stable, ranging between 4.5% and 4.6% yoy since August, kept high by growth in the housing sector, which is impacted by the payments of rental allowances introduced according to the Seventh Pay Commission recommendation since July. **We expect inflation to average 3.3% in 2017, rising to 5% in 2018**. According to the RBI, the impact of the rental allowances paid by central government should peak in December, although the allowances paid over time by individual States could keep inflation high in 2018. Despite the reduction of food prices expected at the end of the year and the reduction of GST rates on various products, inflation risks remain to the upside. These risks are due to oil prices that we forecast to be higher, on average, than they were in 2017, and to companies passing on costs to end consumers due to worsening profit margins.
- The **current account** balance worsened slightly in the third quarter (1.4% of GDP vs 1.3% in the second quarter and 0.7% in the first quarter), due to a wider trade deficit resulting from imports increasing more than exports, particularly for goods. The continuing weak performance of foreign orders and the expected recovery in internal demand, together with the increase in oil prices, could lead to a further modest rise over the next few quarters, focusing investors' attention on the "twin deficits". In this context and given that inflation is rising, we believe that the **RBI will leave rates unchanged** for the next few quarters, with a rise possible in the second half of 2018, and with further reforms favouring the transmission of monetary policy to bank rates, including the use of an external benchmark rate for calculating the loan base rate applied by the banks.

Sample

- 3Q economic growth in line with our expectations, continuing mixed signals from data for 4Q, as well as downside risks to the performance of the agricultural sector and consumption, lead us to **maintain our growth forecast for 2017 at 6.4%**. However, we believe that the dampening effects of the introduction of the GST will be temporary, as they were for demonetisation. **We therefore maintain our scenario of a moderate acceleration in GDP growth to 7.2% in 2018 and 7.4% in 2019,** thanks to the support from fiscal policy and a gradual recovery of investment engendered by the long-term impact of the reforms implemented in recent years.

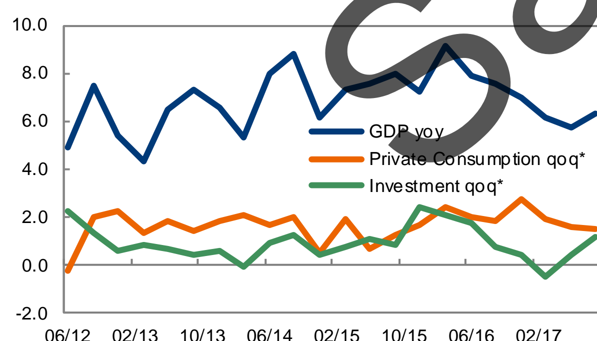
Macro forecasts

	2012	2013	2014	2015	2016	2017E	2018E
GDP (constant prices)	5.5	6.1	7	7.5	7.9	6.4	7.2
Private consumption	6.2	6.6	6.3	5.6	9.2	6.9	7.9
Public consumption	4.4	2.6	6.9	1.3	15.1	15.3	14.2
Fixed investment	6.8	2.5	2.5	5.1	5.1	1.8	3.3
Exports	9.6	4.2	6.6	-5.9	1.2	3.7	4.5
Imports	11.6	-6.3	0	-5.8	-1.7	10.2	3.8
Industrial output	0.7	1.9	4.5	2.5	5.2	3	5.6
Inflation (CPI)	9.4	9.9	6.6	4.9	4.9	3.3	5.0
Unemployment rate (%)	2.0	2.4	2.8	3.0	3.3	3.5	3.9
Average salaries	12.1	11.3	10.3	7.1	8.8	9.5	9.2
3-month Mibor (average)	9.5	9.3	9.1	8	7.2	6.5	6.5
USD/INR exchange rate (average)	53.47	58.57	61.04	64.15	67.21	65.16	63.23
Current account balance (INR bn)	-4,893	-2,780	-1,661	-1,451	-815	-2,471	-2946
Current account balance (% of GDP)	-5.1	-2.6	-1.4	-1.1	-0.6	-1.5	-1.6
Budget balance (% of GDP)	-5.5	-5.5	-4.3	-3.4	-3.7	-3.4	-3.6

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

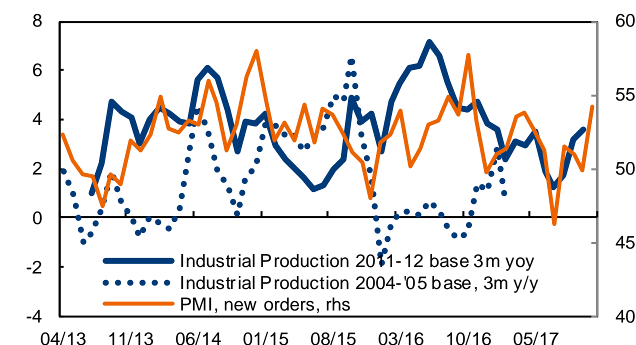
Sample

Growth impacted by slowdown in investments



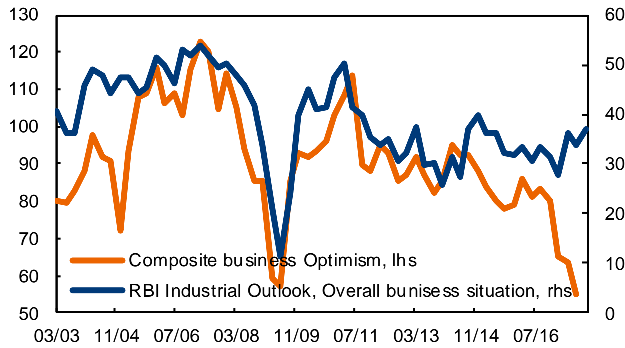
* Four-quarterly moving average. Source: CEIC

Industrial output is slowing



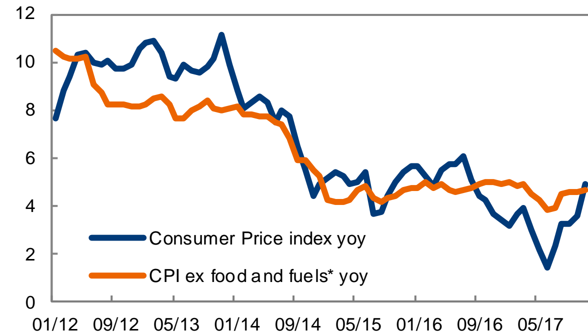
N.B.: Three-month moving average. Source: Markit, CEIC

Business confidence rises only in the RBI survey



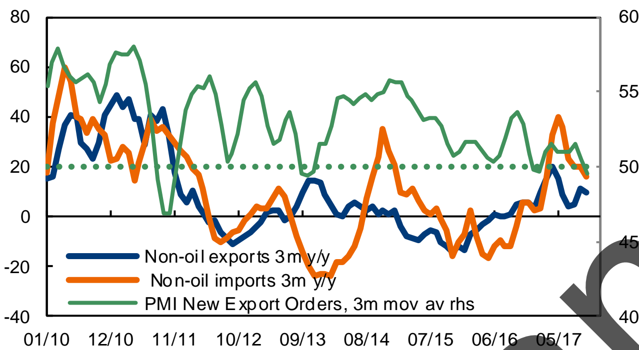
Source: CEIC

Inflation



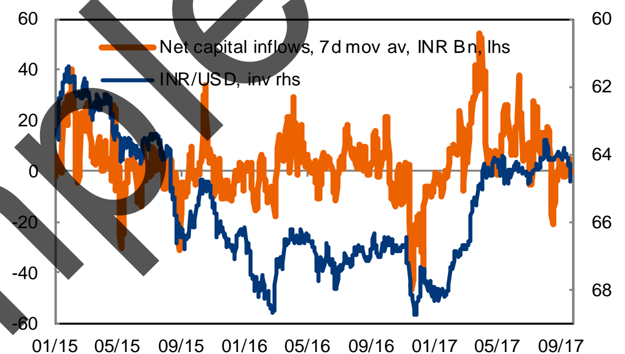
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Foreign trade



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

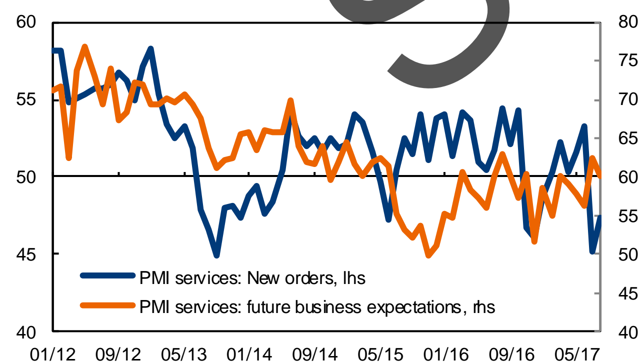
Exchange rate



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

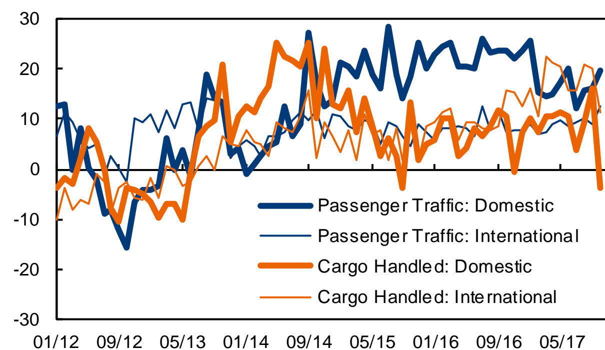
Sample

Services: PMI falling



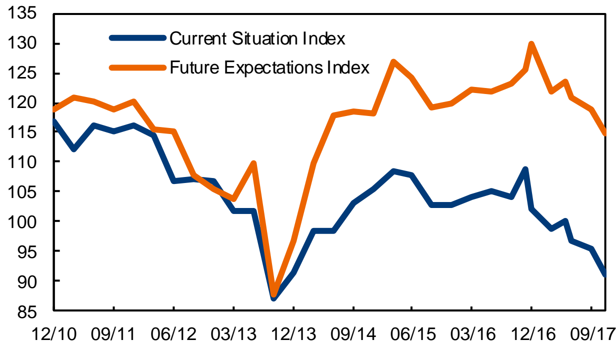
Source: Markit

Passenger and freight traffic



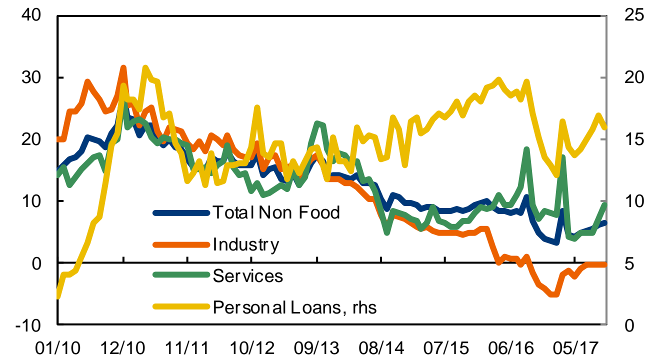
Source: CEIC

Consumer confidence is falling



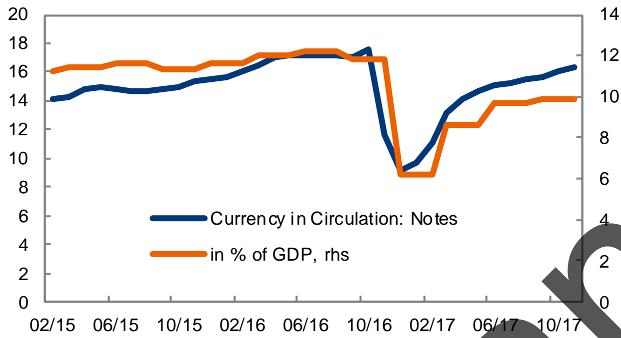
N.B.: Quarterly consumer confidence survey by the RBI Source: CEIC

Loans (% change yoy)



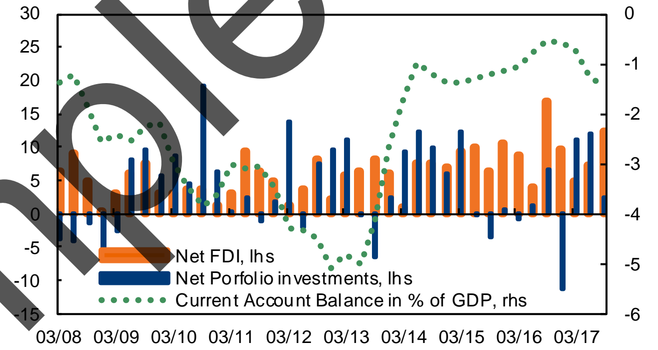
Source: CEIC

Bank notes in circulation (INR trn)



Source: CEIC

Current accounts



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

Sample

Commodities: a favourable framework

Daniela Corsini

In 2018, the macroeconomic conditions should remain favourable for the commodities segment: global growth should remain good, driven by the emerging countries; investment in infrastructure and expansionary fiscal policies have been announced; and global trade growth should remain steady. In China, the world's largest consumer of commodities, the Authorities will continue to focus on the quality of growth, social harmony, environmental protection and fight against pollution. This will translate into growth rates lower than in the past and into evolving consumption trends and flows of commodity imports from the Asian giant.

Energy. This sector is highly exposed to growing geopolitical risks in the Middle East. Gas fundamentals are likely to worsen in the second half of 2018 due to the expected increase in the supply of liquefied natural gas. Although oil fundamentals have improved, thanks to OPEC and Russia's promises to continue cutting production, robust growth in non-OPEC supply is threatening the market balance. We highlight the risk of a price correction by the end of 2017 due to profit-taking, once exhausted the concerns about the unexpected outages in the North Sea, and expect oil prices to be broadly stable in 2018.

Industrial metals. The outlook is strongly favourable to non-ferrous metals, which are more exposed to such themes as urbanisation, increased consumer spending in emerging countries, energy savings and technology developments (e.g. electric cars), but unfavourable to iron and steel (assuming that no major changes are made to the current international trade regulations). We fear there may be profit-taking by the end of 2017. In 2018, we forecast brief rallies, which will be fuelled by collective bargaining in Latin America and resource nationalism in Asia.

Precious metals. We think that the monetary tightening – albeit cautious and gradual – by the main central banks, plus low inflation, will discourage investment in precious metals. We expect better performances by silver and palladium, which are more exposed to industrial demand.

Agricultural products. The risk of the *La Niña* phenomenon occurring in the months leading up to February 2018 could generate volatility and shore up the prices of many agricultural products. Overall, we expect positive performance throughout 2018.

Sample

Price forecasts for the main commodities

	4T17	1T18	2T18	3T18	2017	2018	2019
ICE BRENT	61.4	60.0	59.3	60.0	54.8	60.0	62.0
NYMEX WTI	55.2	55.0	54.7	55.0	50.9	55.0	58.2
NYMEX NATURAL GAS	3.50	3.50	3.10	3.20	3.17	3.25	3.00
COMEX GOLD	1,280	1,285	1,275	1,250	1,259	1,265	1,250
COMEX SILVER	17.0	17.4	17.7	18.0	17.1	17.9	18.5
COMEX PLATINUM	930	950.0	950.0	950.0	950	948	930
COMEX PALLADIUM	975	980	990	1,000	865	998	1,050
LME COPPER 3M	6,800	6,850	6,850	6,900	6,183	6,888	7,000
LME ALUMINIUM 3M	2,100	2,100	2,050	2,050	1,974	2,075	2,075
LME NICKEL 3M	11,500	11,250	11,500	11,500	10,425	11,438	11,500
LME ZINC 3M	3,170	3,100	3,000	3,050	2,881	3,063	3,100
LME LEAD 3M	2,450	2,350	2,300	2,300	2,312	2,298	2,250
LME TIN 3M	19,800	20,500	20,500	20,500	20,004	20,563	20,750
SGX IRON ORE	61	65	62	60	70	62	57
TSI U.S. HRC STEEL	620	610	610	610	622	611	620
CBT CORN	350.0	365	380	390	360	383	400
CBT WHEAT	430	440	450	450	438	450	475
CBT SOYBEAN	980	980	970	970	977	975	1,000
MDE PALM OIL (MYR)	128	135	140	140	2,811	2,688	2,700
NYB-ICE ARABICA COFFEE	1,900	2,000	2,060	2,100	134	140	150
LIFFE ROBUSTA COFFEE	2,100	2,100	2,150	2,200	2,046	2,078	2,250
CBT SOYBEAN MEAL	312	312	314	315	314	314	320
CBT SOYBEAN OIL	33.5	34.0	34.5	35.0	33.3	34.6	36.0

Source: Intesa Sanpaolo estimates

Oil: OPEC and Russia have not disappointed the markets

OPEC and Russia have announced a nine-month extension to the agreement limiting domestic production. The new terms will take effect from January until end-December 2018. The current volume cuts (1.8 million barrels per day) have been confirmed. The main positive surprise relates to Libya and Nigeria, which were previously exempt from the cuts, but which will now be subject to a cap on cumulative production.

If countries continue to exhibit a high compliance to the cuts, the global market will probably stay balanced in 2018, according to data from the International Energy Agency (IEA) and the US Energy Information Administration (EIA). This implies that commercial stocks in OECD countries will remain broadly stable, but the gap with their five-year average will narrow. Conversely, according to figures from the OPEC statistics department, the global market is set to record a large deficit in the second half, with the result that OECD stocks, which are rapidly falling towards the five-year average, would be significantly eroded.

Supply and demand estimates published by US EIA in December 2017

Estimates published in December 2017 in mb/g	Global Demand	Non-OPEC Supply	U.S. Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market balance**
2016	97.0	58.0	8.9	6.6	32.7	32.4	0.3
2017	98.3	58.7	9.2	6.9	32.5	32.8	-0.4
Y/Y change	1.4	0.7	0.4	0.3	-0.2	0.4	
2018	100.0	60.3	10.0	7.0	32.7	32.7	0.1
Y/Y change	1.6	1.7	0.8	0.1	0.3	-0.2	

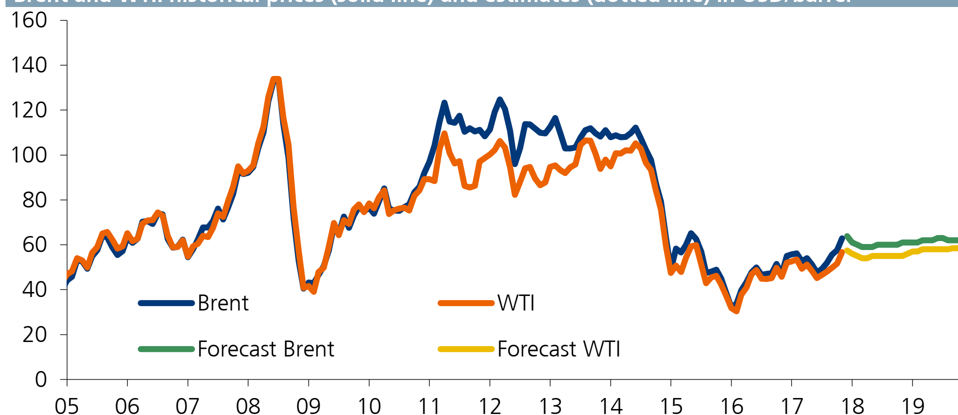
NB:* "Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply"; ** "Market balance = OPEC crude supply - Call on OPEC crude" Source: Intesa Sanpaolo chart on US EIA data

At the next ordinary OPEC meeting, which will be held in Vienna in June 2018, the agreement will be formally reviewed to take account of changes in market conditions. In the meantime, the Joint Ministerial Monitoring Committee, chaired by Saudi Arabia and Russia, will periodically assess adherence to the agreement and analyse changes in the supply and demand fundamentals. The main threats that could lead to revisions of the terms of the agreement are: lower compliance to the agreement by participating countries; an increase in supply from other non-OPEC producers (e.g. shale oil in the United States); uncertainty about the future level of exports from Venezuela; a significant increase in geopolitical tensions in the Middle East. Global demand could also surprise either to the downside, if the winter of 2017-18 in the northern hemisphere turns out to be mild, or to the upside, if demand from emerging countries grows more rapidly than expected.

According to our baseline model, Brent is likely to trade within a wide trading range at an average of around USD 60 per barrel in 2018, due to weak fundamentals: the market will be balanced if, and only if, OPEC and Russia maintain their cuts until the end of the year and supply from other countries does not surprise to the upside. In 2019, the increase in global demand and reduction in OECD stocks will pave the way for a rise to an average of around USD 62 per barrel. The Brent-WTI spread will remain wide. In our baseline model, we forecast an average spread of about 5 dollars, down from the peaks recorded over the past weeks.

Sample

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



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

Price estimates for Brent

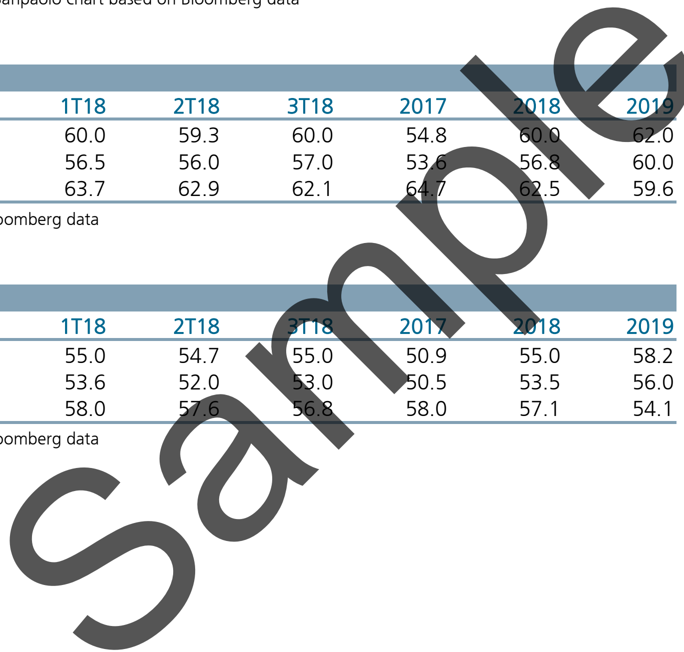
Al 12.12.2017	4T17	1T18	2T18	3T18	2017	2018	2019
ICE BRENT	61.4	60.0	59.3	60.0	54.8	60.0	62.0
Median, Bloomberg	57.7	56.5	56.0	57.0	53.6	56.8	60.0
Forward Curve	61.4	63.7	62.9	62.1	64.7	62.5	59.6

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

Al 12.12.2017	4T17	1T18	2T18	3T18	2017	2018	2019
NYMEX WTI	55.2	55.0	54.7	55.0	50.9	55.0	58.2
Median, Bloomberg	53.5	53.6	52.0	53.0	50.5	53.5	56.0
Forward Curve	55.3	58.0	57.6	56.8	58.0	57.1	54.1

Source: Intesa Sanpaolo chart based on Bloomberg data

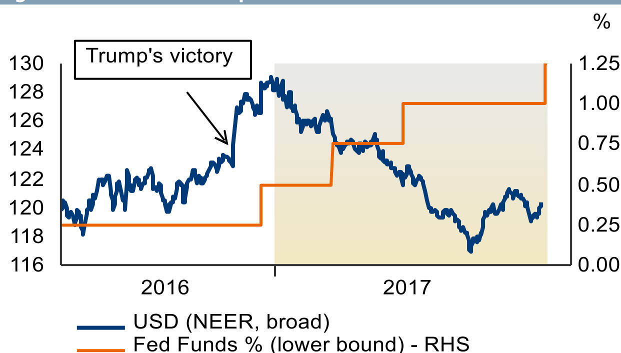


Currency markets: dollar's advantage wearing away

Asmara Jamaleh

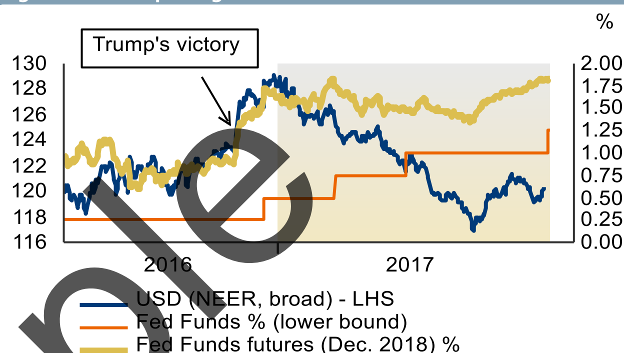
The upward effect on the dollar of the Fed's hikes is buffered by the start of the monetary policy normalisation process, by the other central banks as well. The dollar depreciated in the course of 2017, revisiting lows abandoned at the beginning of 2015. In the past three months, the dollar has recovered, albeit modestly (recovering, albeit only in terms of its peak level, around one third of the correction recorded since the beginning of the year), thanks to the implementation of the third fed funds rate hike of 2017 and the increasingly likely prospect of the much-anticipated tax reform effectively being launched by the turn of the year.

Fig. 1 – Dollar down despite the Fed's hikes



Source: Thomson Reuters-Datastream

Fig. 2 – Market pricing in less than three Fed hikes in 2018



Source: Thomson Reuters-Datastream

Sample

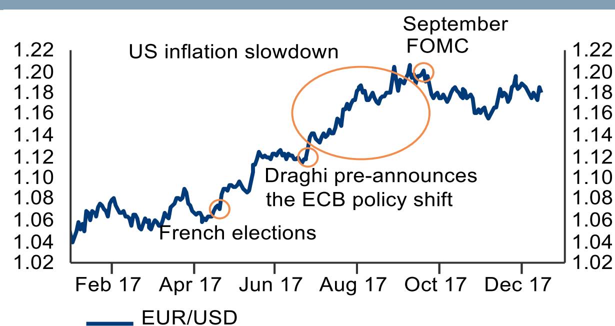
Despite the prospect of the Fed pressing on with its interest rate hike cycle regularly and consistently next year (if all of the three envisaged hikes are implemented, the fed funds rate will close 2018 at 2.00-2.25%), this may not be enough to put the dollar back on an upward course (in particular, it seems unlikely to revisit the highs marked this year). Indeed, between the end of 2018 and the opening months of 2019, most of the other G10 central banks will start – or in some cases continue – implementing their monetary policy normalisation processes, which should compress upside on the dollar, resulting in a mostly lateral trend at the medium/low end of the range observed this year. In the near term, however, or at least until mid-2018, the dollar should continue to benefit from the ongoing Fed hike cycle, also considering that the market is pricing in fewer than the three hikes currently envisaged by the Fed for 2018 (Fig. 2). By contrast, the strength of the dollar should be more contained towards the end of 2018, when the Fed hike cycle will be entering a more mature stage, whereas elsewhere – in most cases – the monetary policy normalisation process will still be at an initial stage, when the upside effect on related currencies (currencies other than the dollar) is usually stronger.

Euro: the ECB's normalisation process is the main factor behind the strength of the euro, although upside should remain contained as long as ECB rates remain stable at zero.

The euro appreciated sharply in the course of 2017, from a low of EUR/USD 1.03 at the beginning of January to a high of 1.20 at the end of August (+17%), **scoring a recovery that marks the start of its upside reversal after the steep drop recorded in 2014,** and the lateral phase experienced in 2015-2016. The recovery began in April, on the clearing of political risk tied to the electoral cycle in Europe, when – in the first round of the Presidential elections in France – the euro-sceptic forces (Front National) were firmly beaten (by Macron's new party). It then consolidated in the immediate wake of economic data outlining the beginning of a recovery in the euro area as well, and at a stronger pace than expected, and finally gained momentum in June, when Mario Draghi preannounced, with a notice of six months, that, thanks to the improvement of the economic and political picture in the euro area, the ECB would be in the position to start normalising monetary policy in 2018 (Fig. 3), a decision then

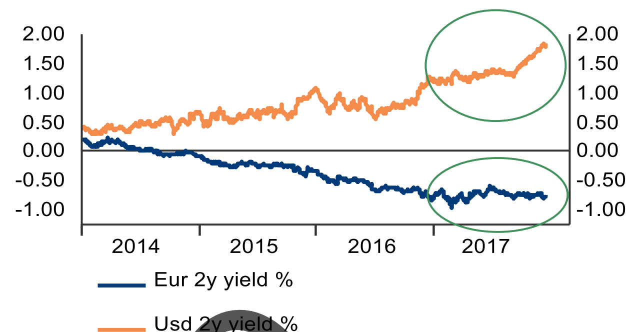
made official at the October meeting (with the announcement of the reduction – halving – of the asset purchase programme between January and September 2018).

Fig. 3 – The stages of the euro's climb



Source: Thomson Reuters-Datastream

Fig. 4 – The divergence between the ECB and the Fed has stopped widening

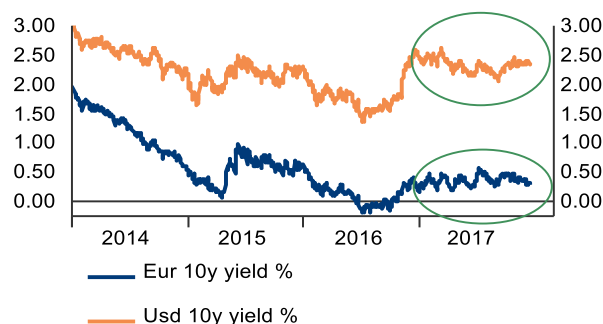


Source: Thomson Reuters-Datastream

In 2018, the start and progress of the ECB's normalisation process should help the euro gradually strengthen from its current levels, not immediately but in the second half of the year, when the ECB will be ready to close its asset purchase programme (by the end of 2018/opening months of 2019) and subsequently, in 2019, to hike rates as well. However, the size of the expected strengthening will be contained, at around EUR/USD 1.22 by the end of 2018 (or in any case close to the middle of the EUR/USD 1.20-1.25 range), as – although the ECB will have set out along the normalisation path – ECB rates (refi) will stay at zero throughout next year, while the Fed currently plans to implement another three hikes, which would mean raising the fed funds corridor to 2.00-2.25% by the end of 2018. The ECB's extremely gradual approach – prone to hiking rates only after the QE programme has ended – is justified by the weak dynamics of euro area inflation. The Fed also has to face a similar problem (Fig. 5), but what makes the difference is growth: in the euro area, while still strong, some deceleration is expected next year, whereas in the United States growth should accelerate further from its already very upbeat levels, also thanks to fiscal stimulus. In the near term, on the other hand, the euro should range-trade, mostly in the medium-low part of the EUR/USD 1.15-1.20 range, as favourable developments should prevail on the US front (ongoing rate hike cycle and implementation of the tax reform), as opposed to the risk of political risk resurging in the euro area in the run-up to the Italian elections, scheduled in the spring.

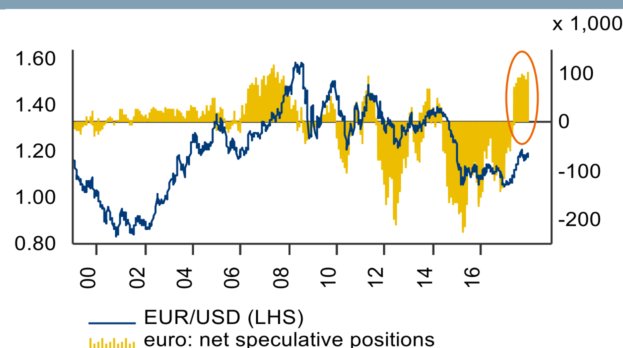
Sample

Fig. 5 – The lateral movement of long-term yields reflects the weak inflation trend both in the euro area and in the US



Source: Thomson Reuters-Datastream

Fig. 6 – Speculative market significantly long euro



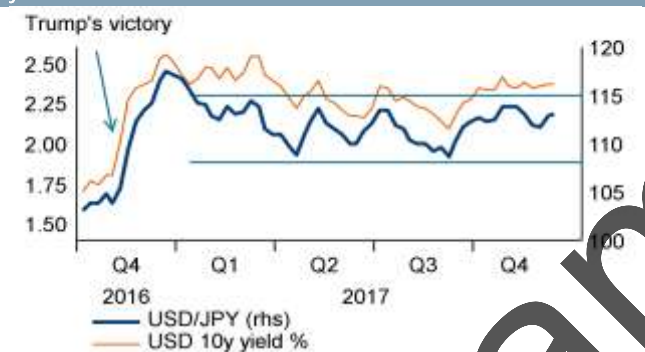
Source: Thomson Reuters-Datastream

Risks to the baseline scenario **are skewed slightly to the downside,** i.e. the euro could prove weaker than expected, for two main reasons: **(1)** the market (fed funds futures) is pricing in less than three Fed hikes next year, which implies that, should the Fed implement fewer hikes than the three expected, the dollar should not be affected, and the euro – consequently – should not benefit. On the other hand, if the Fed hikes rates more than three times, the dollar would benefit and the euro, as a result, would be impacted negatively; **(2)** the speculative market has returned stably on long euro positions this year, at levels close to long-term highs (Fig. 6), which exposes the exchange rate to corrective adjustments on any disappointments in the euro area, both in terms of growth and inflation.

Yen: the BoJ's divergent policy action should help weaken the yen, although the size of the movements against the dollar depends heavily on the dynamics of (long-term) yields in the US.

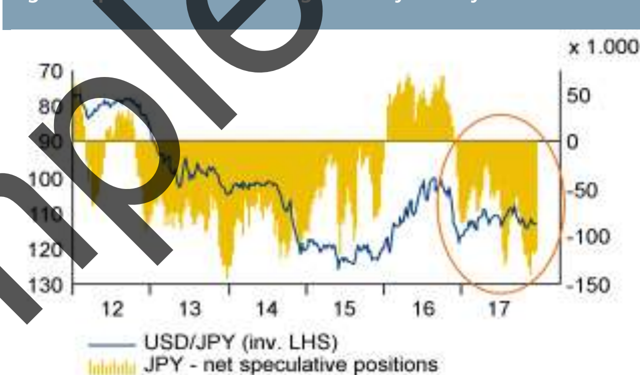
The yen, after having depreciated strongly against the dollar at the end of last year – from USD/JPY 102 to 118 – on Trump's victory, **stabilised over the course of 2017, expressing a lateral trend**, mostly within the USD/JPY 107-115 range.

Fig. 7 – Strong correlation between the USD/JPY and long-term yields in the US



Source: Thomson Reuters-Datastream

Fig. 8 – Speculative market significantly short yen



Source: Thomson Reuters-Datastream

Sample

The yen's failed decline this year should materialise next year, given the prospect of the Fed continuing to hike rates, which should again result in an upward shift of the long end of the US curve, while the BoJ's policy remains ultra-accommodative. The size of the expected decline, however, should be limited, to within USD/JPY 117-118 by the end of 2018, for three main reasons: (1) the forecast increase in 10Y yields in the US is relatively contained; (2) the BoJ has indicated that it could recalibrate policy parameters in a slightly less expansionary mode, in order to both buffer the negative impact on bank balance sheets of persistently very low interest rates, and to take on very difficult market conditions; (3) the speculative market has retuned stably and significantly short on the yen (Fig. 8).

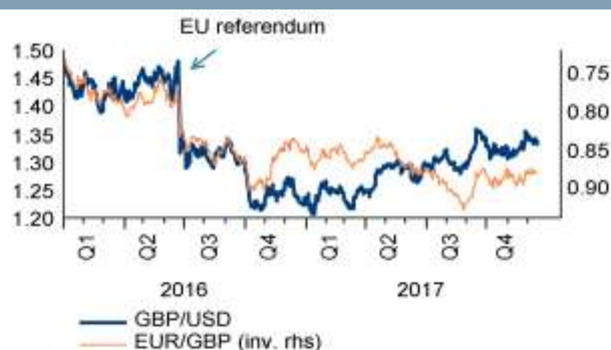
Sterling: The opening of phase two of the Brexit negotiations should help restore stronger exchange rate reactivity to data: if the numbers do not disappoint, sterling should be able to definitively overcome recent lows – barring negative developments on Brexit.

In the course of 2017, the pound gradually recovered against the dollar from its sharp decline in the wake of the Brexit referendum of 2016, rising back from a low of GBP/USD 1.19 to a high of 1.36 (Fig. 9). The recovery was mostly driven by (1) the easing risk of a hard Brexit, and (2) a less negative performance of the British economy than initially feared following the referendum.

Although the opening phase of Brexit negotiations – on the exit bill, the rights of EU citizens residing in the United Kingdom and vice versa, and the Irish border – turned out to be long and complex, a compromise agreement was eventually reached, and at the summit held on 14-15 December the EU declared that "sufficient progress" had been made on the three priority issues laid, so the talks may now move on to the second phase – to define the terms of the transition

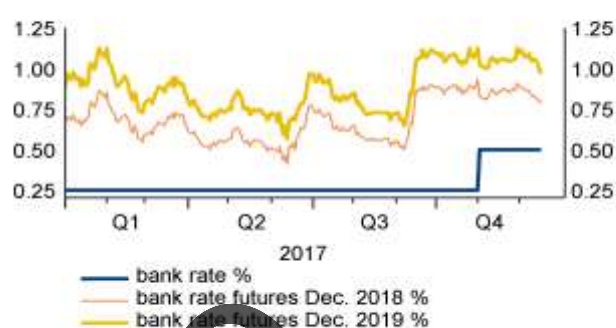
period, and subsequently those of future trade relations between the United Kingdom and the EU.

Fig. 9 – Sterling recovered in part (against the dollar) in 2017



Source: Thomson Reuters-Datastream

Fig. 10 – Upward path of interest rates extremely gradual due to Brexit



Source: Thomson Reuters-Datastream

Sample

The British government stepped up its counterproposal to settle the divorce bill to 40-45 billion euros, considered a near enough figure for now to the 60 billion estimated by the EU. On the other hand, the strongest progress was made on the rights of citizens, whereas the prickliest issue ultimately turned out to be the Irish border, on which the agreement risked falling through. For the time being, in order to prevent the reintroduction of a "hard" border, Northern Ireland has been afforded a special status which provides for alignment with EU rules, *de facto* safeguarding access to the single market for goods. The exact terms of the new formulation of the agreement will have to be defined at a later stage, as the Irish Unionists of the del DUP – the Tories' key ally, without which the government led by Theresa May would be stripped of its majority (following the poor outcome for the conservatives of last June's general election) – have openly rejected this solution, as it undermines the principle of the uniformity of law on the British territory, of which Northern Ireland is part.

The transition period, which will begin immediately following exit from the EU – on 29 March 2019 – should last around two years, at least until the end of the EU's multiyear budget, which expires at the end of 2020, and should maintain the status quo, i.e. access to the single market for the United Kingdom. The key issue, and the most problematic, will be defining the trade agreement. The most popular assumption is that the free trade agreement in place with Canada may be used as a blueprint, although the British government hopes to carry through a totally new formulation, to be designed specifically for the United Kingdom, given the "special" relations entertained over time with the EU: a formulation guaranteeing the country "preferential" access to the single market. This is an ambitious aspiration on the UK's part, and will be the key market theme for most of next year, as – taking for granted that, at least in the near term, exit from the EU will have negative repercussions on the British economy – the better the terms the United Kingdom will manage to secure, the smaller the negative fallout on the economy will be. Therefore, sterling will tend to weaken on negative developments in the talks, and symmetrically to strengthen on positive developments. As a whole, however, barring a significant deterioration of the macro picture, last year's lows should now have been overcome, against the dollar in particular, but maybe also against the euro as well, as the size of the correction incurred in 2016 also reflected the risk of the worst-case scenario materialising, i.e. a no-deal exit from the EU, which now seems unlikely.

While uncertainty remains high on the kind of trade agreement that will eventually be reached, sterling should resume proving more reactive to data. This year, the British economy has slowed (from 1.8% last year to 1.5-1.6%), as a result of weaker consumption due to the rise in inflation

caused by the past depreciation of the pound. In the scenario outlined in the November Inflation Report – based on the assumption of a "smooth Brexit"– the Bank of England does not expect a further slowdown next year, and is forecasting a stabilisation in 2018, at 1.6%, followed by a slight acceleration in the 2019-2020 biennium, to 1.7%. Although this means that the economy will slow compared to the past few years as a result of Brexit, the slowdown will be relatively contained when considering the size of the structural change implied by exiting the European Union. In any case, after the weak patch incurred in the first half of this year, the economy should be fuelled by the global recovery and by the past depreciation of the exchange rate, which should support foreign trade, as well as by markedly accommodative financial conditions which - together with strong global demand - should aid investments. For what concerns consumption, the trough should now be over, and there are already signs of a recovery, albeit gradual. Furthermore, on the fiscal policy front, the BoE has signalled that the measures announced in the November Budget will remove some of the drag on growth resulting from the ongoing fiscal consolidation process, and should translate into stronger growth by 0.3% on a three-year horizon, with inflation 0.1% higher in the same period. As regards inflation, which rose to 3.1% in November, above the upper limit of the target range (2.0% ±1%), the BoE believes the trend is close to its peak, and that – as the effects of the past depreciation of the exchange rate wane – inflation will gradually drop back down towards target, reaching 2.4% by the end of next year, 2.2% by the end of 2019, and 2.1% by the end of 2020.

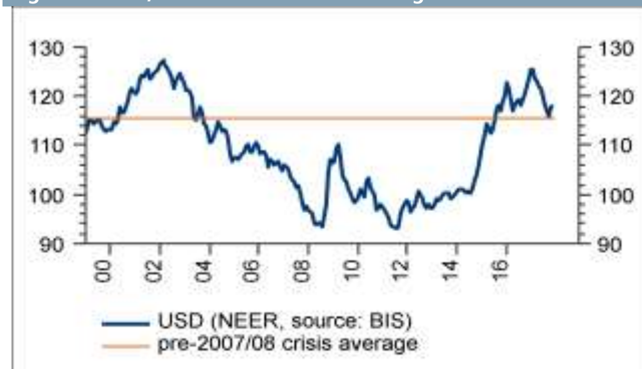
The implications for the interest rate path, after the hike implemented in November (from 0.25% to 0.50%) to counter the rise in inflation, point to an extremely gradual succession of upward moves, indicatively one a year in the next two or three years (the first of which roughly in the second half of 2018 – Fig. 10) due to the exceptional circumstances brought about by Brexit – which pose downside risks to growth – which impose on the BoE to pursue its inflation target with more gradualism than would otherwise be normal, in order not to damage economic activity and jobs.

One important aspect is that at its December meeting the BoE acknowledged the positive scope of recent developments on Brexit (reaching of an agreement on the terms of exit and opening of phase two of the negotiations), observing that this reduces the risk of a "disorderly" Brexit and should support confidence among both households and businesses. The BoE has indicated it will make a more accurate assessment of the related effects at its next meeting in February, as part of the Inflation Report.

Therefore, if data do not disappoint, and generally confirm the BoE's growth and inflation outlook, and assuming the United Kingdom manages to sign a "good" deal with the EU, sterling should be in the position to stabilise and, against the dollar at least, to strengthen slightly over the course of next year, towards GBP/USD 1.38 by the end of 2018. Against the euro, a stabilisation around the EUR/GBP 0.86-0.88 range should prevail, rather than a strengthening, due to the simultaneous appreciation of the EUR/USD. Risks are skewed to the downside, i.e. the pound may prove weaker than expected against both the dollar and the euro, in the event of Brexit negotiations evolving unfavourably.

Sample

Fig. 1 – Dollar, nominal effective exchange rate

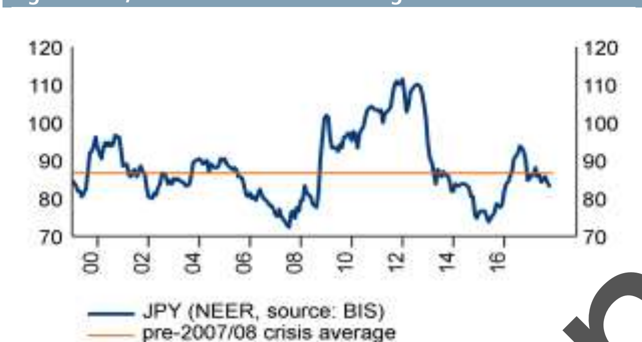


Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate

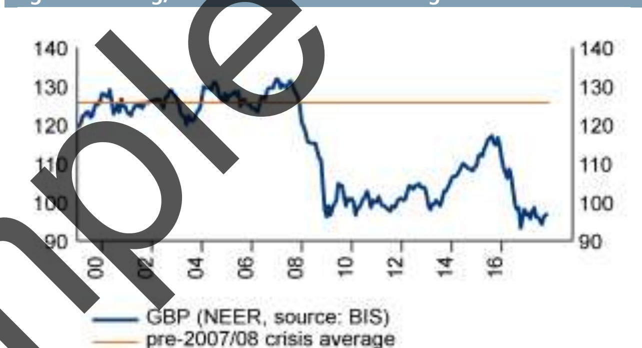
Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate



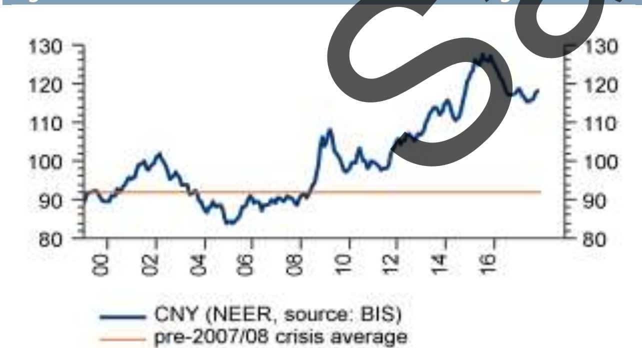
Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 5 – Yuan renminbi, nominal effective exchange rate



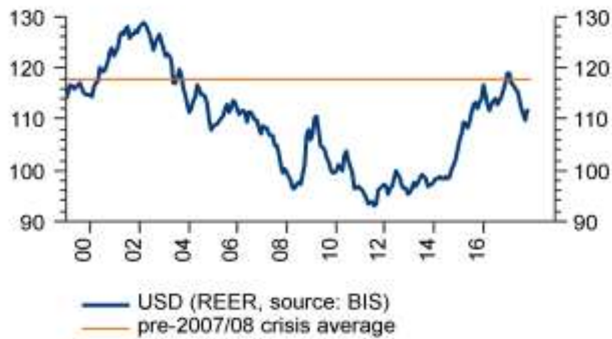
Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate

Source: Thomson Reuters-Datastream

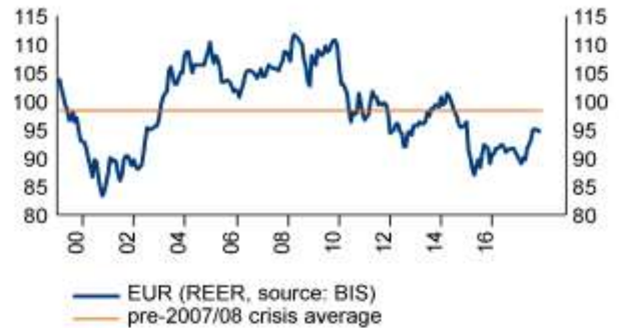
Sample

Fig. 7 – Dollar, real effective exchange rate



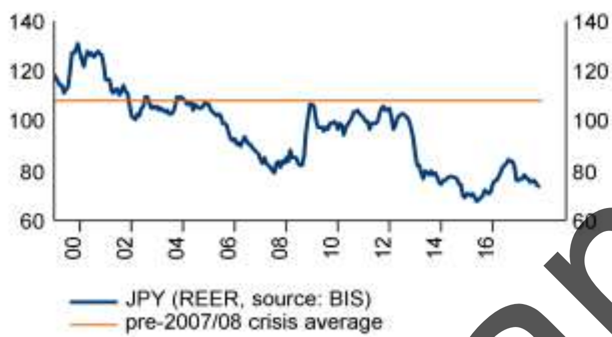
Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate



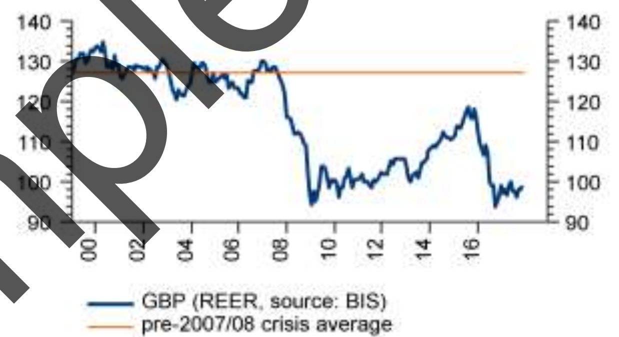
Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate



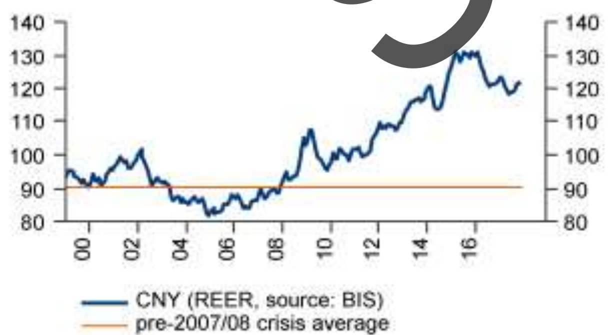
Source: Thomson Reuters-Datastream

Fig. 10 - Sterling, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate

Source: Thomson Reuters-Datastream

Sample

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