ECB forced by economic data to announce new stimulus

10 September 2019

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The ECB Governing Council meeting on 12 September will be a very delicate one.

Economic data failed to provide any evidence of the significant improvement that would have been necessary to avoid new stimulus measures. We think **staff growth and inflation forecasts**, higher at present than our own and than consensus estimates, **are likely to be trimmed again**. Therefore, **new measures will inevitably be announced.** But what will they be?

The accounts of the July meeting strengthened expectations for a package of measures that would include both official rate cuts (depo rate, non the refi) and a reopening of net asset purchases under the APP. The top ECB officials did nothing to cool such expectations, which suggests that they are rather solidly grounded.

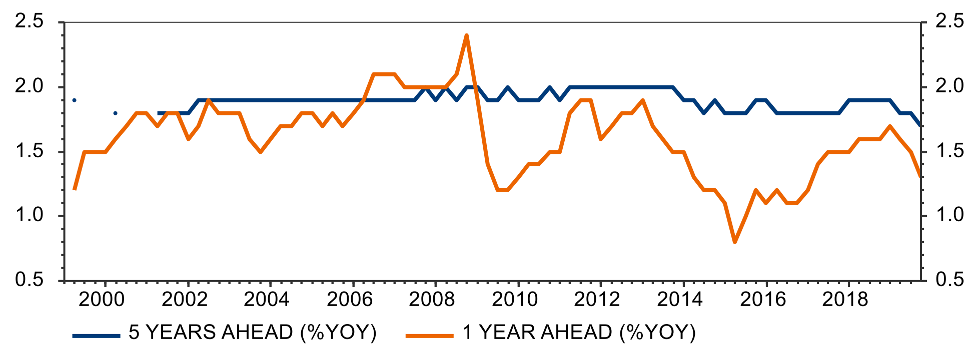
A rate cut, even in the order of 20bps, should not meet with strong opposition. Nor should there be too much resistance against confirming an easing bias on rates, perhaps enhanced by the perspective of mitigating measures on the cost of excess reserves.

However, reopening the APP in the absence of a real threat of deflation, and with the economy still on a growth path, would mark an important change in monetary policy strategy, and would come as the outgoing president's mandate is coming to an end. Some critical voices were heard at the end of August, but it is not clear to what extent they are shared within the Council.

Should a compromise need to be reached, the resumption of net purchases may be delayed and made data-dependent, perhaps accepting a larger rate cut.

For all the ECB's activism, **scepticism on the effectiveness of monetary policy in controlling inflation is mounting** in Europe, as well as in other areas.

Eurozone: professional forecasters are less sure that the ECB will hit its inflation target



Source: ECB, Survey of Professional Forecasters

Based on information available up to 10 September 2019

A heated debate seems likely at the ECB Governing Council meeting on 12 September. Over the past few months, the central bank has fuelled expectations for a loosening of monetary policy on several fronts, rates and size of its balance sheet included. The ECB board showed no reaction to the consolidation of expectations on the market for a package of measures including a rate cut and a resumption of net asset purchases under the APP, also supported by economic data outlining lingering weakness in the manufacturing sector. Reactions from Governing Council (GC) members opposed to this approach only started to emerge at the end of August, but were considered little more than a rear-guard battle by market participants. However, reopening the APP in the absence of deflation risks would represent a far from negligible change in monetary policy strategy. Let's summarise how this point was reached.

Official stance outlined in July

The GC meeting held on 25 July ended with the statement that "if the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act", adjusting "all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner".

The accounts of the monetary policy meeting of 25 July mention the idea of presenting the various intervention options "as a **package**, i.e. a combination of instruments with significant complementarities and synergies", which a part of the Council believes would be "more effective than a sequence of selective actions". In particular, reference is made to a "combination of rate cuts and asset purchases". However, the accounts stress that "the choice of instruments and the design of a possible package should reflect the relative effectiveness of different instruments in addressing future contingencies".

The accounts provide no indication on how strong support for this position is within the GC, and report no dissent. Mention was made of "broad agreement" on the adjustment of the forward guidance and the initiation of preparatory work on two fronts, (a) mitigating measures and (b) "options for the size and composition of potential new net asset purchases". That of the package is a "view" the support for which was not specified. However, evidence of some **internal opposition to very aggressive measures** emerged from ECB central banker interviews and speeches over the past few weeks (see Table C on page 9). **Knot** (Holland) and **Lautenschläger** (Executive Committee) said noted the APP is the right instrument to use when faced with the risk of deflation, which is off the radar at present. **Weidmann** (Germany), who did not vote at the July meeting, opposes a loosening of the limits imposed on the APP; furthermore, he does believe further stimulus measures are necessary in the present phase, also considering they would be less effective and their side effects would increase. Another critical voice, in this case on the negative rate regime as well, was that of the new Austrian Governor, **Holzmann**, who promised in an interview to be critical of further monetary easing. Weidmann also said he would not consider appropriate implementing significant changes to monetary policy strategy before the new president Christine Lagarde takes office, and also contested the view that the inflation target is symmetric.

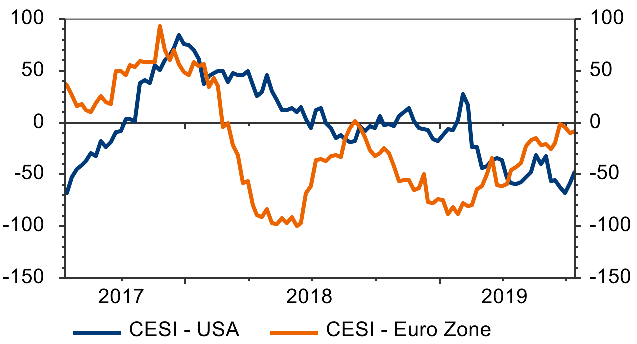
Only the Governor of the Finnish central bank, **Rehn**, spoke on 19 August of the intention to "overshoot" expectations with stimulus, rather than to proceed gradually

Others simply reasserted the official stance announced on 25 July, i.e. that monetary policy will have to remain markedly accommodative and that new measures will be announced in the absence of significant improvements.

Evolution of the economic situation since 25 July

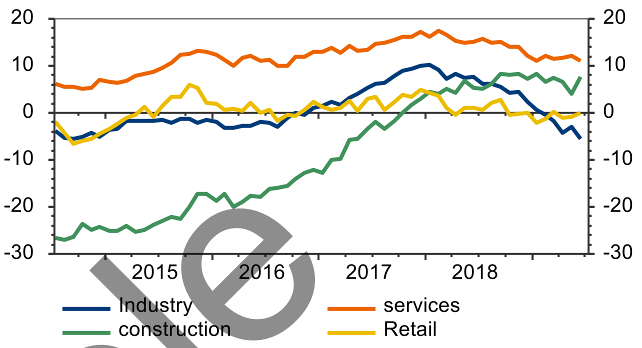
There is no room for doubt: the data released between the end of July and August offered no grounds to believe that inflation is more likely to converge towards the target rate. The condition laid out in July in order *not* to act has not been met. Let's examine the economic situation in greater detail.

Fig. 1 – Economic surprise indices



Source: Refinitiv

Fig. 2 – European Commission, confidence indices by sector



Source: European Commission

Manufacturing activity continues to contract, nonetheless balanced for the time being by construction and services

In general, the manufacturing sector is still contracting, due to a number of sector-specific issues (auto, chemicals) and to the decline of international trade. Initial data on July industrial output are being released now, and following the contraction recorded in Germany (-0.8% m/m) and Italy (-0.7%), despite the increase in France, Netherlands and other smaller economies the euro area aggregate is likely to come in negative, consistent with a drop in 3Q equal to, or sharper than, the one seen in 2Q. Monthly surveys do not point to a significant rebound in the near term, and remain consistent with a further decline of output.

To date, the trend of the construction and services sectors is still strong enough to guarantee positive growth of the European economy, which seems destined to record **modest GDP growth in monthly terms in 3Q as well.** The models based on monthly survey data point to changes of 0.2-0.3% q/q and 0.8-1.1% y/y, at least using data available up to August, implying a low probability of a recession in the near term (Fig. 3). For what concerns fiscal policies, 2020 should bring an easing of the structural balance: the ECB's June estimates pointed to two tenths of a percentage point of GDP, but they could be more if Germany decides to further loosen fiscal policy in the coming months. In addition to the automatic stabilisers, this should counter the effects of the contraction in manufacturing activity.

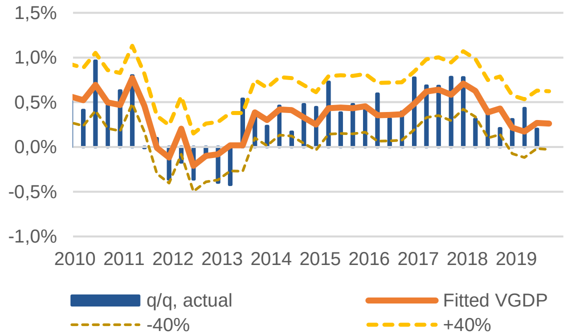
However, business confidence could start to worsen outside the industrial sector as well, if the latter stays weak for too long. In the construction sector, views on the evolution of activity are less positive than they were at the beginning of the year: data (in addition to confidence indices, building permit applications and production data) are potentially consistent with investment growth in the construction sector grinding to a halt.

Furthermore, several risk factors are materialising (USA-China trade war, Brexit), although Italy risk is now off the radar following the change in the government majority. In the UK, the Johnson government seems set on leading the country out of the European Union on 31 October, despite the attempt made by MPs to prevent this by passing an anti no-deal law. This means that the end of 2019 could be marred by further weakness, and that foreign demand addressed to continental businesses will be affected in 2020 by a potential recession in the

United Kingdom. Furthermore, these factors will make private investment even less likely to prove reactive to a potential loosening of financial conditions.

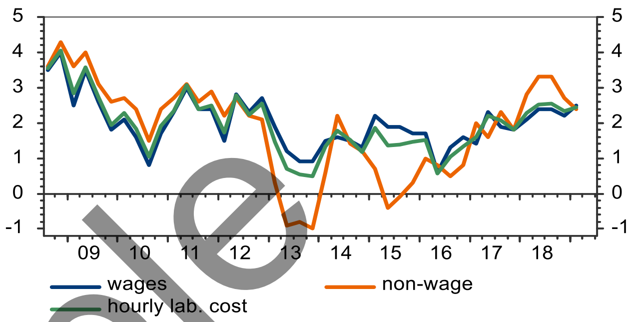
Consequently, **the ECB staff's new forecasts will have to include some downward revisions,** as the scenario contemplating a recovery in 2H no longer applies. Consensus GDP growth forecasts decreased in August to 1.1% and 1.2% for 2019 and 2020 respectively, compared to the ECB's estimates of 1.2 and 1.4%. **Our internal forecasts are slipping towards 1.1 and 1.0%,** as we are now inclined to think that the German economy will not reaccelerate before 2020.

Fig. 3 - Growth still positive in 3Q



Source: Intesa Sanpaolo estimates on Eurostat and IHS Markit data. The estimate presented here is based on the levels and changes of PMI indices

Fig. 4 – Cost of labour reaccelerating (y/y % chg.)



Source: Eurostat

Wages, margins and prices: the broken chain

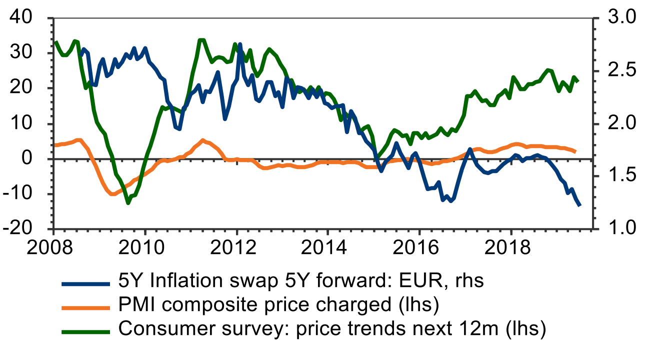
August data failed to show significant changes in price and wage dynamics. Overall, tendency is being confirmed towards a **gradual acceleration of wages,** consistent with the reduction of the unemployment rate; however, the rise in wages is not translating into an acceleration of producer costs, nor of consumer prices. **The trend of the underlying HICP** (excluding fresh food and energy prices) **has remained essentially unchanged for three years**.

The most striking development is actually the interpretation given by market participants of the inflation outlook. While consumers are more inclined to expect the price trend to pick up (strongest expectation levels since 2012, in fact), and the selling-prices PMI remains above the 50-point mark, 5Y5Y forward inflation has continued to drop, increasingly diverging from the expectations of businesses and households. Nor does the promise of new stimulus seem to have reaped any positive effects. This has prompted a debate within the ECB Governing Council. The latest to comment on the matter was De Guindos: like others before him, he stressed that the GC must rely on a multitude of information, and not only on financial markets prices. In general, several Council members expressed doubts on the reliability of the financial markets as an indicator of the inflation outlook. The accounts of the 25 July meeting note that the drop in long-tern inflation expectations effectively reflects a lower risk premium, rather than a change in expectations.

Monetary policy surveys are also revealing increasing scepticism among participants on the effectiveness of monetary policy to shift the level of inflation. In the past, inflation forecasts incorporated great confidence in the central bank's ability to ensure achievement of the goal; in more recent times, however, long-term forecasts have shifted downwards: the July SPF survey, for instance, found that long-term inflation had dropped to 1.7% (see chart on front page). This means that **the idea is starting to take hold that the inflation trend is becoming structurally more moderate than in the past,** despite monetary policy activism. That should not surprise: in Japan, decades of ultra-accommodative monetary policy have failed to raise inflation. This evolution of expectations should prompt caution in assuming that upward revisions of the inflation target would make any difference; furthermore, it also undermines the effectiveness of announcements like the one made in July on the symmetry of the inflation target.

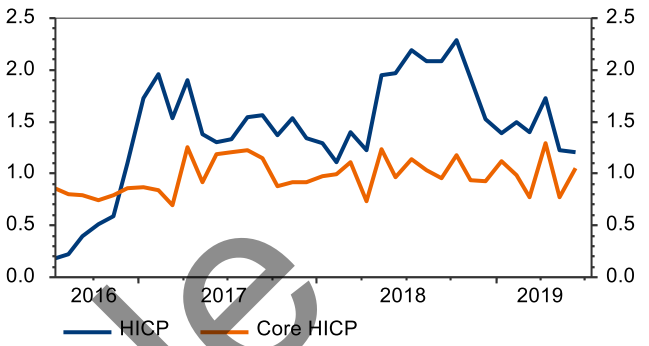
Consensus forecast for 2020 are lower than the ECB's by two tenths (see Table B), and by four tenths in the case of underlying inflation. In our view, in light of the slowdown under way and of the limited chances of an increase in oil prices, inflation is likely to remain at modest levels in 2020. In this case as well, therefore, **we expect a downward revision of staff's forecasts.**

Fig. 5 – Inflation: market expectations diverging increasingly from consumer expectations



Source: Eurostat, Refinitiv Datastream Charting and IHS Markit

Fig. 6 – Underlying inflation unchanged since 2016

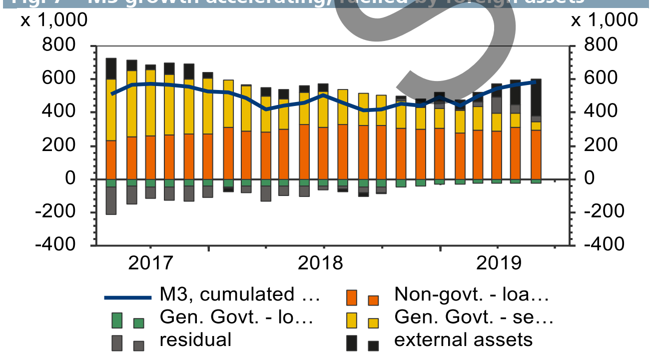


Source: Eurostat

Financial conditions are even more accommodative than before

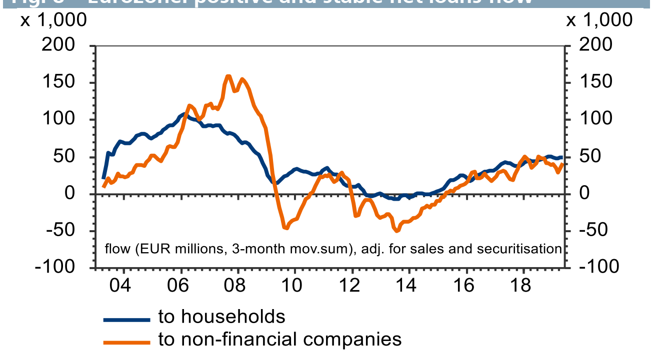
The July announcement resulted in a further loosening of financial conditions, even before the actual implementation of any measures. Monetary market rates decreased across maturities, anticipating a 10-20bps rate cut. Swap rates dropped by a minimum of 10bps on the 2-year maturity and by up to 23bps on the 10-year segment, which resulted in a flattening of the interest rate curve. Some profit taking has only taken place in the last few day, raising the 10-year Bund yield from -0.715% to -0.56%. Furthermore, the euro weakened against the dollar by around 1%. These movements would be reabsorbed in part if the measures announced by the ECB fall short of expectations.

Fig. 7 – M3 growth accelerating, fuelled by foreign assets



Source: ISP elaborations on ECB data

Fig. 8 – Eurozone: positive and stable net loans flow



Source: ISP elaborations on ECB data

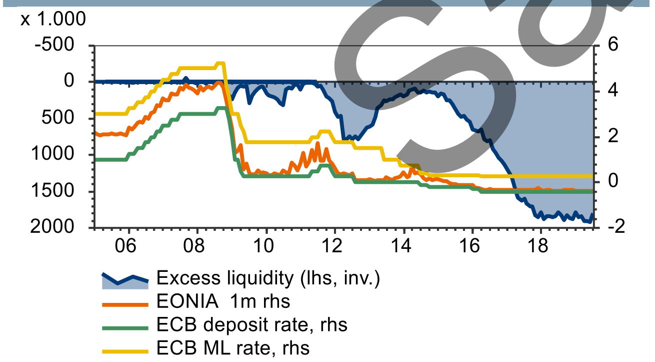
Monetary market data outlined a **stronger than expected** acceleration in the **pace of growth of the M3 aggregate,** to 5.2% y/y, driven by the record-breaking M1 trend (7.8%) as opposed to stable trends for the M2-M1 aggregates (+0.1% y/y) and to a smaller decline of the M3-M2 (-1.2%). Among counterparts, the ECB has signalled that the pace of lending growth is almost unchanged, both in terms of loans to enterprises (3.9%) and to households (3.4%). M3 growth is increasingly a reflection of the **growth of net foreign assets,** which account for 2.9 percentage points compared to 3.2 accounted for by loans to the private sector.

What will the ECB announce on 12 September?

Despite the dissenting voices mentioned above, which seemed aimed at cooling market expectations somewhat, **a large majority of analysts and investors are taking for granted that the ECB will cut rates** (Reuters consensus: 10bps) **and resume net purchases under the APP already in October** (Reuters consensus: 30 billion euros per month). The markets are pricing in an immediate deposit rate cut to -0.6%, followed by a further reduction in 2020 to -0.8%; the evolution of yield curves signals that some reopening of APP net purchases has also been priced in.

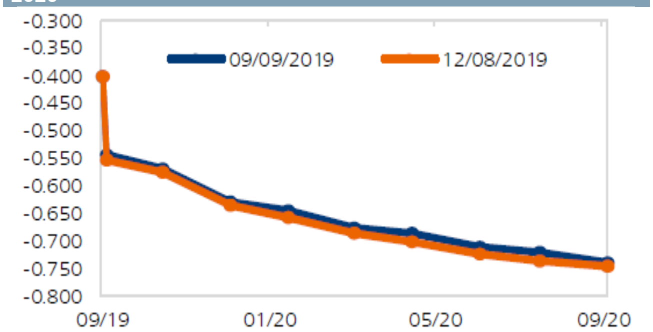
However, as anticipated, despite the widespread persuasion that the ECB *must* do something, surveys show that there is also **strong agreement on the fact that the measures will be ineffective in restoring inflation to target**. The ECB itself is regularly ending its post-monetary policy meeting press conferences meetings by calling upon national governments to use the fiscal space available to them: "all countries should reinforce their efforts to achieve a more growth-friendly composition of public finances", to quote the July press conference. Weidmann also seems to believe that fiscal measures would prove more effective than monetary ones, should it be necessary to act (but he thinks it is *not* necessary, as confirmed by his interview with FAS on 24 August). Ultimately, therefore, **the main factor supporting the introduction of the new measures is that the ECB had promised to act in some way if the situation failed to improve, not that the measures themselves will prove truly effective in achieving their target.** At most, it will raise the fiscal space of government somewhat, and allow them to reduce borrowing costs far into the future. If nothing else, the monetary easing should not worsen the slowdown of the economy. At most, it will increase the future risk of speculative excesses on the financial asset and real estate markets, as well as encouraging an increase in the financial leverage of businesses, which could make a future rate hike more dangerous.

Fig. 9 – ECB: policy rate corridor, EONIA and excess liquidity



Source: Refinitiv Datastream Charting, ECB and Intesa Sanpaolo elaborations

Fig. 10 – The OIS curve is pricing in a 20bps deposit rate cut with a probability of >50%, followed by a further reduction in 2020



Source: Intesa Sanpaolo elaborations on Refinitiv data

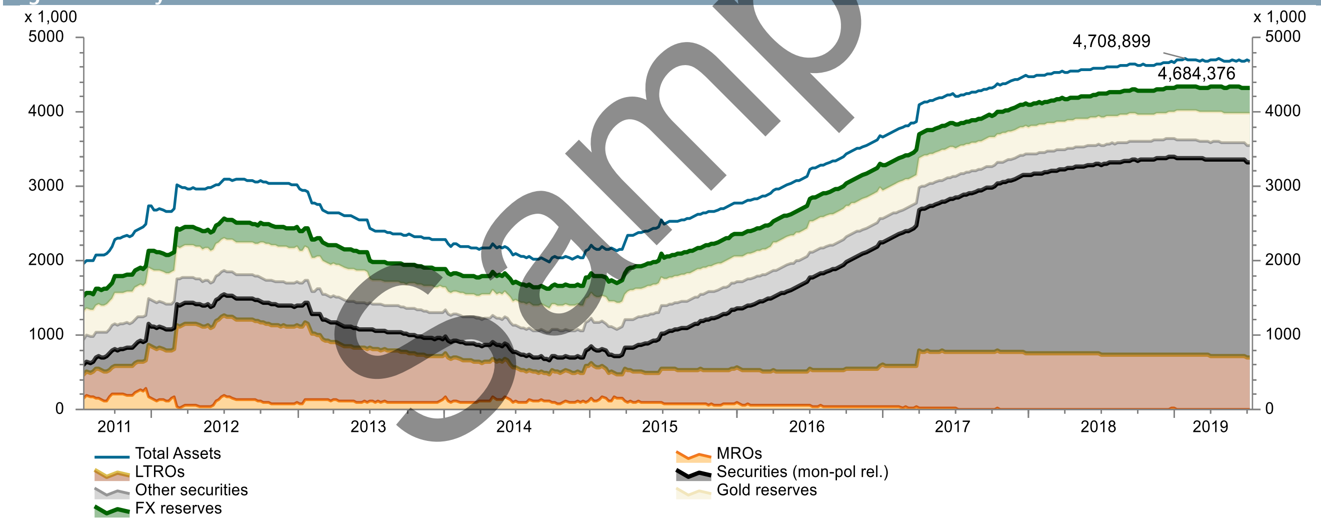
Our expectation is that the announcement will include a **10 or 20bps deposit rate cut**. Changes to the terms of the TLTRO III programme could also be implemented to make it more appealing. Nor can further steps be ruled out towards the introduction of some sort of compensation system for the cost of excess reserves (mostly as a measure to keep alive expectations for further cuts, reinforcing the easing bias, which will be confirmed). As explained by Lane a few months ago, the deposit rate cut is considered important also to keep long-term yields low.

The Council will probably be split on the appropriateness of resuming **net purchases under the APP.** The silence of the top ECB officials as strong expectations mounted for a reopening of the

APP suggests that the intention to proceed in this direction truly exists. The critical voices heard more recently seem nothing more than an attempt to disown a decision that some disagree with, rather than a strategy aimed at guiding expectations. However, the resumption of purchases would not be an innocuous step: net purchases under the APP had originally been presented as the ECB's response to deflation risk, as Lautenschläger noted, but there is no such risk today. Therefore, **reopening the APP would mark a significant change in monetary policy strategy, what's more implemented shortly before the new president takes office**. **There would be good reason to postpone decision to December, rather than announce it on 12 September or 24 October.** Should consensus not be widespread enough to allow for an immediate reopening of net purchases, the press conference and the statement will probably be designed to keep high expectations that this could happen in the months ahead, so as to contain the negative reaction of the markets. This message could be reinforced by a possible easing of the limits imposed on the operative aspects of the programme, although on this front as well the Council will probably be split. Therefore, the meeting seems set to be a highly delicate and very important in this respect.

The search for consensus within a split Council may even impose compromise solutions. Matters of debate will be the size of the rate cut, the size of net purchases under the APP, and the timeline of the latter (possibly data-dependent).

Fig. 11 – Eurosystem: balance sheet assets



Source: ECB and Intesa Sanpaolo elaborations

Table A – Calendar of the Governing Council's next monetary policy meetings				
2019		12/09	24/10	12/12
2020	23/01	12/03	30/04	04/06
	16/07	10/09	29/10	10/12

Source: European Central Bank, https://www.ecb.europa.eu/press/calendars/mgcgc/html/index.en.html

Table B – Staff macroeconomic forecasts and consensus forecasts

	ECB			Consensus Forecasts		
	2019	2020	2021	2019	2020	2021
Real GDP	1.2	1.4	1.4	1.1	1.2	-
HICP	1.3	1.4	1.6	1.3	1.4	-
HICP excl. fresh food, energy	1.1	1.4	1.6	1.1	1.2	-

Source: European Central Bank and Consensus Economics

Table C – Governing Council member declarations since the last meeting			
Member	Date	Type	Message
Holtzmann (Austria)	01/09	Interview with ORF	Sceptical on negative rates. The probability of monetary stimulus reaping further positive effects is "very slight". On the other hand, "the short- or long-term risks" associated with the risk of a poor allocation of resources. "I will probably voice **a somewhat more critical stance concerning suggestions" about a future loosening of monetary policy.**
Hernàndez de Cos (Spain)	31/08	Speech	Supports inflation goal symmetry. The ECB should undertake a plan to clarify inflation goals and discuss possible alternatives to the current monetary policy strategy. The Council has signalled it is ready to act using all the tools available to ensure convergence with the inflation target.
Lautenschläger	30/08	Interview with Market News	There is uncertainty, but we also see positive trends in the labour market and a resilience of domestic demand. "Based on the current data, **it is much too early for a huge package of measures**". **"The APP should only be used if you have a risk of deflation**; and the risk of deflation is nowhere to be seen now". "I would like to see the September data and whether additional measures are needed [...] Let us not forget that we already have a very accommodative monetary policy". "We need more analysis" on tiering. TLTRO III operations could be re-priced, in particular circumstances. A rate cut of 10 or 20bps is far less important than the forward guidance.
Knot (Holland)	29/08	Statements made to Bloomberg	**The APP is the correct tool to use when faced with deflation risk, which is off the radar at present.** Market expectations are "overdone". **Does not see any added value in launching a package of measures.** The September revision of forecasts will be marginal.
De Guindos	27/08	Speech	Decisions must be based on a multitude of information, covering not only financial markets and experts. The ECB intends to collect more information about consumers and, at the same time, target some of its communication at the general public. The expectations priced into financial assets must be handled with caution. Furthermore, "the more forward guidance we give, the less informative are market signals".
Weidmann (Germany)	24/08	Interview with FAS	"The outlook is particularly uncertain", but there are automatic fiscal stabilisers taking effect and the German government has fiscal leeway, if necessary. "The question is, are new monetary policy measures necessary given our price outlook, especially if the side effects become more significant and the instruments less effective". If the **APP** must be reactivated, there would be room even without changing its **limits** (which he believes **should not be loosened**). Weidmann is **against reviewing the inflation target** and a symmetric interpretation of the current target. **"In my view, any new potential adjustments made to the monetary policy strategy should be decided under the new president"**.
Müller (Estonia)	19/08		"Inflation is far from our target [...] this could mean that the central bank has to further boost the economy. The Governing Council will discuss this at its mid-September meeting".
Rehn (Finland)	19/08	statements	"A significant degree of monetary stimulus continues to be necessary to ensure that financial conditions remain very favourable and to support euro area growth and domestic price pressures". "We are currently examining options, including ways to reinforce our forward guidance on policy rates, mitigation measures related to the negative deposit facility rate and options for the size and composition of potential new net asset purchases". Better to "overshoot" expectations on stimulus.

Source: Intesa Sanpaolo elaborations

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Appendix

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In particular, the description of the measures taken to manage interest and conflicts of interest – related to Articles 5 and 6 of the Commission Delegated Regulation (EU) 2016/958 of 9 March 2016 supplementing Regulation (EU) No. 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest as subsequently amended and supplemented, the FINRA Rule 2241, as well as the FCA Conduct of Business Sourcebook rules COBS 12.4 - between the Intesa Sanpaolo Banking Group and issuers of financial instruments, and their group companies, and referred to in research products produced by analysts at Intesa Sanpaolo S.p.A. is available in the "Rules for Research " and in the extract of the "Corporate model on the management of inside information and conflicts of interest" published on the website of Intesa Sanpaolo S.p.A., webpage https://www.group.intesasanpaolo.com/scriptIsir0/si09/studi/eng_doc_governance.jsp along with a summary sheet on the website of Banca IMI S.p.A. webpage https://www.bancaimi.com/en/bancaimi/chisiamo/documentazione/normative.html. This documentation is available to the recipient of this research upon making a written request to the Compliance Department, Intesa San Paolo S.p.A., Via Hoepli, 10 – 20121 Milan – Italy.

Furthermore, in accordance with the aforesaid regulations, the disclosures of the Intesa Sanpaolo Banking Group's interests and conflicts of interest are available through webpage https://www.group.intesasanpaolo.com/scriptIsir0/si09/studi/eng_wp_studi.jsp. The conflicts of interest published on the internet site are updated to at least the day before the publishing date of this report. We highlight that disclosures are also available to the recipient of this report upon making a written request to Intesa Sanpaolo S.p.A. – Macroeconomic and Fixed Income Research, Via Romagnosi, 5 - 20121 Milan - Italy.

Banca IMI S.p.A., one of the companies belonging to the Intesa Sanpaolo Banking Group, acts as market maker in the wholesale markets for the government securities of the main European countries and also acts as Government Bond Specialist, or in comparable roles, for the government securities issued by the Republic of Italy, by the Federal Republic of Germany, by the Hellenic Republic, by the European Stability Mechanism and by the European Financial Stability Facility.