

Polls Continue to Suggest Close German Election Result

Summary | Today's News in Detail | Recent Research | Latest Issues of Euro Area Sovereign Debt Crisis Update | Macroeconomic Forecasts

Summary

Germany: A new Forsa poll showed 40% of voting intentions for Merkel's CDU/CSU, and 5% for her present coalition partner FDP, while the opposition centre-left SPD and the Green Party reached 23% and 14%, respectively. Together with the far-left Left party, these three opposition parties would gain 44% of votes, broadly similar to the link-up of CDU/CSU and FDP. Both the anti-euro AfD and the Pirate party were at 3%, below the 5% needed to enter parliament. Comment: with a likely very close result from the ballot boxes, our base case remains a Grand Coalition of CDU/CSU and SPD, although the chances for a continuation of the current coalition have risen. Chances for the AfD to enter parliament are limited, in our view.

Germany – IMF praises policy and economic performance, but argues that a slightly looser fiscal stance may be appropriate if the recovery disappoints. The IMF also called for further structural reforms to raise growth potential and encouraged Germany to move further on financial reforms and euro area integration.

Italy – GDP falls by 0.2% QQ in Q2, but FinMin says “recession is over” as economic indicators suggest Q3 and Q4 GDP will post a positive reading. Comment: we doubt that decently positive growth rates necessary to bring down the unemployment rate and stabilise the government debt ratio will materialise in the next few quarters, given still widespread structural weaknesses.

Greece – Government tries to dispel fears of new belt-tightening measures, amid speculation about the troika's next visit in September. Separately, two German coalition MPs argue that Greek debt is not sustainable and that more debt relief will be necessary, together with additional austerity in Greece. Comment: We believe discussion on further debt relief for Greece is just postponed until after the German election.

Spain should work on a social pact to cut private wages, EU Commissioner Olli Rehn said, backing last week's IMF proposal. The IMF estimated that a 10% cut in nominal wages would lift GDP growth by 5pp and reduce unemployment by 6-7pp by 2016, by boosting competitiveness.

German industrial orders rise on the back of aircraft-related orders. German new orders rose by 3.8% MM in June (from an upwardly revised -0.5% MM (-1.8% YY in May). Net of large-items orders, they fell by 0.7% MM.

French business confidence weakens from 96 to 95 in July, against the trend of surprisingly positive data from the euro area countries.

Portuguese banks' borrowing from the Eurosystem broadly stable in July at around €50bn, but it increased as a share of banks' total assets (to 9.4% from 8.7% in February) amid shrinking banks' balance sheets.

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Economics
Western Europe
Industrialised G7 Countries

Italy — Q2 GDP Still Down, H2 Unlikely to Show Much Rebound

Western Europe

Italian GDP declined by 0.2% QQ in Q2 – less negative than generally expected (consensus and Citi: -0.4% QQ). This was the seventh consecutive quarterly decline, although it was the smallest since Q3 11. Italian GDP is now 8.8% lower relative to the pre-crisis peak in Q1-08. Output losses since the inception of the financial crisis have been the largest of all euro area countries except for Greece and Ireland (where GDP is down more than 20%), very similar to Portugal (see Figure 1 on page 2).

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ECB — One Dovish Hint, But No Change In Rates, Guidance Or Minutes

Western Europe

The ECB left its key interest rates unchanged and took no further non-standard measures, as expected. It also maintained its forward guidance, noting that the Governing Council (GC) expects 'key interest rates to remain at present or

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Today's News in Detail

Polls continue to suggest a close election result in Germany: *Handelsblatt* reports on two latest indicators of voting intentions. In a Forsa poll for the magazine *Stern*, 40% of respondents indicated that they would vote for Chancellor Merkel's CDU/CSU, and 5% for her present coalition partner FDP. The centre-left SPD and Green Party arrived at 23% and 14%, respectively, which implied that together with the far-left Left party, these three opposition parties would gain 44% of votes, 1pp short of the link-up of CDU/CSU and FDP, but the difference is well within the margin of error for these polls. Both the anti-euro AfD and the Pirate party were at 3%, below the 5% needed to enter parliament. In the *Handelsblatt* 'Prognosebörse' (projection exchange), which allows users to enter trades on the potential election outcome with fictional money, the performance of the AfD has weakened considerably recently but, at an implied vote share of 12.5%, remains far above its performance in any of the standard polls. The higher performance of the AfD on this exchange compared to the standard opinion polls comes at the expense of all major parties (the CDU/CSU and FDP score 35% and 6.2% of voting intentions, and the SPD and Greens 21.8% and 11.5%, respectively). Comment: As we have stressed repeatedly, German election results are likely to be pretty close. Our base case remains a Grand Coalition of CDU/CSU and SPD, but the chances for a continuation of the current coalition have risen. Given the lack of momentum in recent polls, it looks unlikely for the AfD to enter parliament.

[>> Back to the Top](#)

IMF praises German policy and performance: In its annual Article IV report, the IMF painted a broadly positive picture of German economic performance and policy. It expects growth in Germany to be 0.3% in 2013 (with growth in H2 still below potential), and 1.3% in 2014. The report points to continued high uncertainty as a major drag on the German economy, particularly for investment, and argues that the outlook is heavily dependent on a gradual recovery in the rest of the euro area and a reduction in uncertainty. While the report highlighted prudent economic management which preserved "*strong domestic fundamentals, healthy balance sheets and financial system soundness*", it stated that a slightly looser fiscal stance may be appropriate if the expected recovery disappoints, and encouraged Germany to move further on financial reforms and euro area integration, noting that "*a clearly-communicated longer-term vision for closer economic and financial integration among EMU member countries would provide a crucial anchor to the expectations of households, firms, and the financial system*". The IMF also urged further structural reforms in Germany to raise the economy's growth potential and "*promote a more balanced economy*", including the pan-European integration and harmonization of energy and transportation networks, improving productivity in the service sector, and broadening the sources of funding for firms. Comment: The IMF's projections are quite close to our own views and the report was fairly short of news. We agree with the IMF that structural reforms could support a rebalancing process in Germany, as the prospects for net external growth diminish amid deteriorating competitiveness.

[>> Back to the Top](#)

Italy – GDP falls by 0.2% QQ in Q2, but FinMin says "recession is over". Italian Finance Minister Saccomanni said yesterday that economic indicators suggest Q3 and Q4 GDP will post a positive reading, after a less-negative-than-expected Q2 print of -0.2% QQ. Saccomanni also mentioned a Bank of Italy indicator on the probability of a cyclical upturn signalling almost 100% chances for a recovery at present. However, the FinMin also acknowledged that improvements in the labour market will not follow immediately. Comment: Survey-based indicators have been improving significantly in recent months, but their levels remain consistent with close-to-zero GDP growth for the time being. We doubt that a proper recovery – i.e., decently positive growth rates necessary

lower levels for an extended period of time'. In relation to forward guidance, President Draghi noted that 'the expectations of rate hikes in money markets are unwarranted' and that 'it would take much better data for the ECB to change guidance'. This statement has left the door open to further easing, in particular if money market conditions tighten further, but left the potential instruments of easing unspecified.

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Euro Economics Weekly — Low(er) ECB Rates: For How Long?

Western Europe

We expect no change in key ECB rates in August or in the assessment of risks to economic activity and inflation. Hence, the ECB is likely to reiterate its downward bias on rates and that its monetary policy stance will remain accommodative for as long as necessary. This note focuses on forward guidance, on the long-term outlook for rates, as well as the July bank lending survey and changes to its collateral framework.

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Scandi Economics Update —

Western Europe

Sweden — Political support for increasing the job tax deduction for a fifth time. July borrowing requirement to be published today. German environmental requirements of Vattenfall.

Norway — We expect a rebound in June manufacturing production, out at 9.00 UK time today.

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to bring down the unemployment rate and stabilise the government debt ratio – will materialize in the next few quarters, given the still tight credit conditions and still poor competitiveness position of the Italian economy (see [Italy - Q2 GDP Still Down, H2 Unlikely to Show Much Rebound](#))

[>> Back to the Top](#)

Greece – Government tries to dispel fears of new belt-tightening measures.

“There is no issue regarding the lowering of the minimum wage before 2016, nor abolishing of the 13th and 14th salaries,” Ekathimerini reports Labour Minister Yiannis Vrotsis stating, after speculation emerged that additional belt-tightening measures would be required by the troika at their next visit in September. The newspaper reports that the Greek PM’s visit to the US President this month will convey the message that no more austerity is possible in Greece as fiscal tightening has reached its limit. Austerity fatigue is the main risk for the governing coalition, they argue.

Greece – German coalition MPs argue Greek debt is not sustainable, more debt relief will be necessary, Bloomberg reports. Frank Schäffler of the FDP (who has long been critical of eurozone support measures and previous bailouts) said yesterday: *“Because of some legal arguments there will be no proper haircut, but rather a third program in which interest payments are suspended or Greece gets direct support to circumvent the cut. It won’t be called a haircut, but it will have the same effect.”* CDU’s Michael Fuchs reportedly said that *“it’s almost impossible [to make Greek debt sustainable] without great leaps in economic growth”* Fuchs argued that despite the sacrifices already made by Greek people, more is needed in order to restore sustainability. Comment: the discussion about another round of debt-relieving measures for Greece has been put aside for the time being because of the sensitivity of the issue ahead of the German elections. However, the debate will come back in full force in the autumn, when the 2014 budget discussion will start and when additional financing resources for 2014 will have to be found.

[>> Back to the Top](#)

Spain should work on a social agreement to cut private wages, EU

Commissioner Olli Rehn said according to Spanish newspaper *El Pais*. Mr. Rehn is throwing his weight behind the IMF proposal advanced last week according to which the Spanish government should try to forge a social agreement between the unions and the employers, aiming to reduce private sector wages. According to the IMF Article IV report on Spain, a 10% cut in nominal wages accompanied by a reduction in social security contributions by $1\frac{2}{3}$ would be able to lift GDP growth by 5pp and employment by 7pp relative to a baseline scenario. This would reduce the unemployment rate by 6-7 pp by 2016, the IMF concludes. The EU Commissioner acknowledges the political challenge of such a proposal but argues that this agreement would speed up the process of internal devaluation and boost Spanish competitiveness. Mr. Rehn cites Ireland and Latvia as successful internal devaluation cases. Comment: The pressure to reduce private sector wages is mounting on Spanish institutions, after also the Bank of Spain earlier this year had called for such action. Wage growth has already been moderating significantly relative to the recent past – negotiated wages growth stood at 0.5%-0.6% YY in the first half of this year, down from 1.7% on average in 2012 – mainly thanks to the temporary suspension of the indexation clauses. The process of internal devaluation has really just started in Spain and it is likely to take years of low or negative inflation rates.

[>> Back to the Top](#)

German industrial orders rise on the back of aircraft-related orders. German new orders rose by a (seasonally and working-day adjusted) 3.8% MM (4.2% YY) in June (from an upwardly revised -0.5% MM (-1.8% YY in May). Both domestic and foreign orders rose (by 3.3% MM and 4.2% MM, respectively, with euro area

orders rising by 10.0% MM), but the entire increase was due to rises in capital goods orders (+6.8% MM), while intermediate and consumer goods orders fell in June. Compared to the previous year, foreign orders increased, while domestic orders fell. The press release of the German Economics Ministry noted that the June number was heavily affected by orders related to the aviation fair in Paris and that, corrected for large orders, orders fell by 0.7% MM.

[>> Back to the Top](#)

French business confidence weakens: Against the trend of data that have recently been coming in steadily slightly better-than-expected in the euro area, French business confidence weakened slightly from 96 in June to 95 in July (both consensus and Citi had expected a slight increase to 97).

[>> Back to the Top](#)

Portuguese banks' borrowing from the Eurosystem broadly stable in July.

Reliance on ECB liquidity by Portuguese banks stood at €50.4bn in July, up slightly from €49.4bn in June, and broadly in line with the level of the past seven months. However the share of central bank financing on total assets has been trending moderately higher as banks' balance sheets keep shrinking. The percentage of central bank financing has increased from 8.7% of total liabilities in March to 9.4% in July. Comment: In contrast to significant declines in reliance on central bank's liquidity in other banking systems (eg, Spain, Greece, Ireland), the share of central bank financing has been trending higher in the case of Portuguese banks, still denoting their fragility and inability to obtain funding from other sources.

[>> Back to the Top](#)

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Recent Research

[>> Back to the Top](#)

Latest Issues of Euro Area Sovereign Debt Crisis Update

Greek FinMin rules out another debt restructuring

Western Europe

Greek FinMin rules out another debt restructuring, saying Greece's aim is a fiscal primary surplus. Italy: No clear route to save Berlusconi from jail after PdL meets President Napolitano. IMF sees signs of recovery in France, notes fiscal and structural reform progress. German politicians criticise low ECB rates as bad for German savers. EBA studies banking books of EU banks. Italian fiscal revenues hold up in 1Q13. Italy's Grillo rules out agreement with centre-left PD.

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Italy's Political Tensions Unlikely to Lead to Snap Election

Western Europe

Italy's convicted centre-right leader Berlusconi says the government should continue, however the fragility of the grand coalition remains evident. Germany's SPD want grand coalition only without Merkel. German states run a budget surplus. IMF praises reform progress in Spain but calls for nominal wage reductions. Portugal's government aims to raise 2014 budget deficit target to 5% of GDP. French Government continues to discuss pension reform. Strong readings on July Services PMIs.

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ECB – One Dovish Hint, But No Change in Rates, Guidance or Minutes

Western Europe

ECB provides no more specific forward guidance. IMF's 2013 Spillover Report urges reform, sees exit risks. Tight schedule for EA banking union. Berlusconi's conviction upheld. Brazil changes stance on IMF involvement in Greece. Greek civil servants strike today. Central Bank of Cyprus' progress on bank restructuring. Germany's SPD debates coalition with Left Party. Spain's PM Rajoy rejects allegations of wrongdoing. Spanish unemployment falls in July. French remain pessimistic on economy.

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ECB Meeting Likely Long on Talk, Light on Action

Western Europe

We expect no change today in key ECB rates nor in the assessment of risk to economic activity and inflation. Some European central bankers oppose publishing ECB Minutes. IMF review on Greece. LatAm countries sharply criticise Greek bailout. Two new Greek parties support Grexit. French FinMin says Govt likely to downgrade 2014 growth forecast. Spanish PM Rajoy to appear in Parliament today on party financing scandal.

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Portuguese Government Wins Confidence Vote

Western Europe

Portuguese PM wins confidence vote with clear majority. ECB President Draghi supports publication of ECB Minutes. Estimate of ECB profits from crisis measures. European sentiment indicators improve in July. Spain's state budget deficit widens in June. Berlusconi trial continues. French Govt may freeze tax brackets again. SNB incurs large losses in 1H13. Ireland wrangles over Budget 2014. Lots of euro area data releases. Latest on Slovakia and Slovenia.

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ECB to publish ELA Rules

Western Europe

The ECB decided is to publish the rules for ELA - a welcome step towards transparency. Next Greek bailout tranche was approved yesterday. Bank of Cyprus haircut smaller than expected. Italian business confidence rises more than expected in July. Moody's affirms Italy's sovereign rating. Bank of Italy to extend asset quality inspections of banks. German politicians criticise ECB. Spain's 2Q GDP confirmed at -0.1% QQ, HICP moderates in July.

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[>> Back to the Top](#)

Macroeconomic Forecasts

European Economic Forecast Highlights — July 2013

Western Europe

This companion piece to Global Economic Outlook and Strategy - July 2013 contains detailed quarterly economic forecasts for the main European countries to end 2014, as well as annual forecasts for all European countries to 2017 for GDP growth, CPI inflation, short-term interest rates, current balance, fiscal balance and government debt.

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Global Economic Outlook and Strategy — July 2013

Global, Pan Asia, GEMS, Americas, EMEA, Asia, Australia

Global growth remains a little below its longrun average, with sluggish world trade,

slowing EM prospects and lower investment growth by commodity producers. We are cutting 0.1% off our global growth forecasts for both 2013 and 2014, putting them at 2.5% and 3.1% respectively. We are again cutting EM growth forecasts. This month we have notable downgrades for China, Brazil, Indonesia, Peru and Turkey. Overall, our forecasts are generally below consensus, notably on the BRICs and euro area.

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[>> Back to the Top](#)

Appendix A-1

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