Italian Cabinet Set to Reach Deal on IMU Tax Today

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Economics

Western Europe

Industrialised G7 Countries

Summary

Italy: Cabinet meeting likely to approve changes to IMU property tax — a council of ministers scheduled for this afternoon is expected to finalise a deal that envisages scrapping the first instalment of the tax (due in June, postponed to September, worth around €2.4bn) and substituting it with a new and broader service tax from 2014. Comment: this will likely lead to yet another relaxation of the fiscal stance vs. 2013 targets. We expect the government deficit to rise to 3.5%.

ECB's Asmussen says modest recovery matches ECB central scenario — the recovery would be very slow and would improve next year. He indicated that President Draghi would explain the policy stance, noting that next week was a *"potential policy decision"*. Comment: slow recovery does not mean that the ECB will adjust its stance much. We believe that the *"potential policy decision"* remark aims to remind investors that the ECB never pre-commits and reserves the right to alter the policy stance when appropriate.

ECB's Coeuré on urgent need for banking union — the main challenge is the *"ability of the financial system in the euro area to withstand higher interest rates"*. He added that policy makers should have reacted more quickly to identify weakness on bank balance sheets as US policy makers did, noting the issue had been *"collectively underestimated"*. He stressed that *"banking union is necessary and absolutely urgent"*. Comment: the urgent need to fix the banking system illustrates concerns that balance sheet repair has been insufficient, leaving the system vulnerable.

French PM presents pension reform proposal — the number of years' work required to obtain a full state pension will rise to 43 years by 2035. But the minimum legal retirement age stays at 62 and there are no changes to remove the inflation indexation of pensions. Employers and employees will contribute by 0.15 percentage points (pp) extra in 2014, and 0.05pp extra in 2015-17. Comment: this reform plan ticks minimum boxes: it should help balance the books, but little else.

Dutch government agrees €6bn austerity package — Details of the expenditure cuts and tax increases will be presented on September 17 in the 2014 budget.

Spain: downward revisions to 2011-12 GDP, large fall in house mortgages — the usual semi-annual revisions of national accounts showed GDP was 0.2pp lower in 2012 on the back of lower domestic demand. But the largest revisions affected nominal GDP: the 2011 estimate stands at +0.1% (vs. 1.4%) and 2012 at -1.6% (vs. -1.3%). New residential mortgages fell to 14,053 in June, 42.2% lower than in June 2012. Comment: annual GDP revisions will be reflected in new quarterly data to be released this week. We expect some reshaping of the quarterly profile too.

Portugal: public sector redundancies could amount to 5K-15K in 2014 — the government is working on a programme for termination of contracts under *"mutual agreement"* of some 15K public sector employees to be completed by September.

Recent Research

Sweden — FSA To Safeguard Financial Stability

Swedish government announces that the Financial Supervisory Authority (FSA) will have main responsibility for introducing new macro prudential measures, and says at same time that several new financial stability measures will be introduced at the beginning of 2014.

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Euro Economics Weekly — Enhanced Forward Guidance, ECB-Style

The euro area economy is recovering but we do not expect any meaningful acceleration because of persistent euro-area specific headwinds. Having dropped our long-held call for a 4Q-13 refi rate cut, we now look for unchanged rates at the September 5 ECB meeting (and beyond), penciling in a first hike in 4Q-16.

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Central Europe Macro View — Is

Slovakia — Economic sentiment indicator improves for second month in August.

Slovenia — Economic sentiment indicator remained unchanged in August.

Norway — Poll confirms conservative-led government in lead ahead of Sep 9 Election.

Today's News in Detail

Italy – Cabinet meeting likely to approve changes to the property tax (IMU) today. Despite the recent negative news flow on the Italian political situation, some coalition agreement has reportedly been reached on the divisive issue of the property tax (IMU) on first residences. A council of ministers scheduled for this afternoon is expected to finalise the deal, which reportedly envisages scrapping the first instalment of the tax (originally due in June, already postponed to September, worth around €2.4bn) and substituting it with a new and broader service tax from 2014. The new service tax is likely to be part of the 2014 Budget and to start in January. It remains unclear whether the final instalment of IMU – due in December and worth another ca. €2bn – is also to be scrapped. The ongoing political debate is focusing on the possible financial coverage for stopping the December IMU instalment, with PdL calling for complete abolition of the tax and the centre-left PD arguing that any available resources should be used to finance other, more socially-sensitive, budget items (eg, jobless claims). Comment: Scrapping IMU (introduced only last year by the Monti government) has been the main electoral battlefield of Silvio Berlusconi's centre-right PdL party. Major political divisions persist between the two main governing parties, but an agreement on the very divisive IMU would be a key result for PM Letta and his attempt to keep the government coalition together. However, even if partially compensated by other deficit-reducing measures, the decision to scrap IMU on first residences (worth around 0.3% of GDP in government revenues) will likely lead yet to another relaxation of the fiscal stance relative to targets in 2013. We expect the government deficit to rise to 3.5%.

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ECB's Asmussen says modest recovery matches Governing Council's scenario – Executive Board member Jörg Asmussen said on Tuesday that *"second-quarter GDP data confirms the scenario that we have in the ECB that we will have a very slow recovery in the euro area, which will improve next year"*, arguing that the ECB's scenario was a *"realistic one"*. He added that monetary policy would remain expansive for as long as necessary, acknowledging the risks associated with rates being too low for too long. He noted that President Draghi would explain the policy stance after the meeting, nothing that next week was a *"potential policy decision"*. He warned that the fact that the catastrophe scenario of the euro zone breaking up had decreased did not mean the crisis was over, stressing that parts of the euro area faced years-long adjustments. Comment: the slow recovery scenario does not mean that the Governing Council will adjust its stance much just yet, although the balance of risks with respect to economic activity might be changed, as argued in our ***Euro Economics Weekly***. We would not read too much into the remark about the September 3 meeting being a *"potential policy decision"*. We believe that the remark is designed to remind investors that the ECB never pre-commits and reserves the right to alter the policy stance whenever appropriate.

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ECB's Coeuré on the urgent need for banking union – Executive Board member Benoit Coeuré said on Tuesday in Gothenburg that ECB interest rates *"will remain at the current level or lower for an extended period of time"*, but noted that the *"ECB will raise rates when risks to medium-term price stability*

Germany really so important for CEE?

We look at foreign trade links between Central Europe and Germany. While the region's sensitivity to German domestic demand shocks has risen over time, it is in fact smaller than the sensitivity to shocks from outside Europe. We believe this means that if the German economy 'rebalances' (accelerates mostly thanks to domestic demand and at the cost of weaker net exports) the CE4 could benefit less than simple historical correlations of business cycles would suggest.

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Germany — Is the Current Coalition Heading For Four More Years?

The parties of the current German ruling coalition, CDU/CSU and FDP, have been gaining in recent polls of German voting intentions ahead of the general election on September 22. Their combined share is now at 46% according to the Citi Polling Trend (Figure 1), leaving them slightly ahead of the joint share of the opposition parties (the centre-left SPD and Greens and the far-left Linke party) at 45%.

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UK Economics Weekly — Is Guidance Failing?

We do not believe the recent rate sell-off means that guidance is ineffective. Rather, guidance has coincided with a dramatic improvement in the UK's growth prospects. If the MPC had not begun guidance, market expectations probably would have risen even more. We doubt the MPC will seek to micro-manage market rates. Nevertheless, Carney's upcoming speech will probably stress the "low for longer" message and may also signal the MPC's willingness to reinforce guidance with asset purchases.

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UK — GDP Revised Up

The ONS revised the QoQ gain in Q2 GDP up from 0.6% to 0.7%, with GDP now up 1.5% YoY from the depressed figure of Q2-2012 (when activity was temporarily depressed by the Queen's

materialise". He indicated that the main challenge would be about the *"ability of the financial system in the euro area to withstand higher interest rates"*. Talking about the crisis, he remarked that European policy makers should have realized more quickly the extent to which what they saw as a sovereign debt crisis in Europe was also a banking crisis. He added that policy makers should have reacted more quickly to identify weakness on bank balance sheets in the way US policy makers did, arguing that the issue had been *"collectively underestimated"*. He stressed that *"the banking union is necessary and absolutely urgent"*. Comment: Mr. Coeuré is reiterating that the period of low interest rates will be long, but will eventually end when upside risks to the ECB's medium-term price stability mandate reappear. His remarks about the urgent need to fix the banking system illustrate persistent concerns at the ECB that balance sheet repair has been insufficient to date leaving the system vulnerable, and the fact that politicians' are now focusing more on the nascent recovery than on the need for more work to address capital shortfalls in the banking system.

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French PM presents pension reform proposal – French PM Jean-Marc Ayrault announced that the government would extend the number of years of work required to obtain a full state pension to 43 years by 2035, up from 41.5 years by 2020 according to the current system. Mr. Ayrault maintained the minimum legal retirement age of 62 and rejected proposals to remove the inflation indexation of pensions. Employers and employees will see their contributions increase by 0.15 percentage points in 2014, and by 0.05 percentage points in 2015-17. The plan aims to raise €7.3bn by 2020 to compensate a €7.6bn projected deficit. The government ruled out an increase of the CSG (general social contributions) tax on all incomes and revenues and announced that it would lower social charges related to families that employers pay on salaries to ensure that the cost of labour does not increase in 2014. Other measures to save money include shifting the inflation pension adjustment from April to October and reforming – for better-off retired parents – the 10% pension bonus for the parents of three or more children. The reform would also allow the launch in 2015 of a points-based system for strenuous jobs allowing workers to retire earlier. Comment: the pension reform plan is largely in line with what had been reported in the press since the start of the week. Employers are not particularly happy about higher contributions and some trade-unions are rejecting the need to increase the contribution period, maintaining a day of demonstrations scheduled for September 10. From an investor standpoint and for the European Commission, this reform plan ticks the minimum of boxes in the sense that it should help balance the books and increases the number of years of contributions, but little else.

French unemployment rises to record high, again – France's number of registered jobless rose by 6,300 (0.2% MM, 10% YY) in July. This 27th successive monthly increase took the total number to a new all time high of 3,285,700. The Labour ministry indicated in a statement that the number of jobless youths fell for the third month in a row – partly due to 50,000 state-subsidised job contracts that have so far been signed under a government programme to cut youth unemployment. Comment: the pace of jobless increase might be easing, but President Hollande's pledge to lower the number of unemployed by year-end will be an arduous task given the still negative rate of job creation expected during the second half of 2013.

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Dutch government agrees €6bn austerity package – Finance Minister Jeroen Dijsselbloem told reporters on Tuesday that the government had agreed €6bn of budget measures to help meet the 3% of GDP budget deficit target in 2014. Details of the expenditure cuts (pay freeze for public sector workers, and a 1% reduction in spending across the board according to *De Telegraaf*) and tax

Jubilee holidays). We estimate that real GDP per head is now 1.3% above the mid-09 low but 7.0% below the pre-crisis peak (Q3-2007). By contrast, real GDP per head was 6-10% above the pre-crisis peak at this stage (ie after 23 quarters) of the recession/recovery cycles of the 1970s, 1980s and 1990s.

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Scandi Economics Update —

Western Europe

Sweden — Manufacturing and consumer sentiment seen improving in August — NIER releases updated economic forecasts.

Norway — Poll confirms conservative-led government in the lead.

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increases (scrapping the inflationary increase in the basic tax band) will be presented on September 17 in the 2014 budget. Deputy PM Lodewijk Asscher declined to go into any details. A poll released on Sunday by pollster Peil.nl indicated that the government coalition (PM Rutte's centre-right Liberal Party and the leftist Labour Party of Mr. Dijsselbloem) would lose its majority in the 150-member parliament if elections were held now. At the same time, populist parties on the left and right have gained momentum. Comment: this package took the best part of three months to be agreed, and will probably not be enough to hit the 3% target next year after a likely 3.9% outcome in 2013, according to calculations made by the government think-tank CPB, given the poor dynamic of the Dutch economy where the recession continues. There is the added problem of the government not having a majority in the upper house.

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Spain – 2011-2012 real GDP revised lower by 0.3pp and 0.2pp, respectively. The usual semi-annual revisions of national account data released yesterday showed GDP was 0.2pp lower in 2012 on the back of lower domestic demand. Private and public consumption were revised down to -2.8% from -2.1% and to -4.8% from -3.7%, respectively, while gross fixed investment dropped less strongly (-7.0% instead of -9.1%). Both exports and imports were revised lower, leaving the same contribution to GDP growth from net trade (+2.5pp). The largest revisions actually affected the level of nominal GDP: 2011 nominal GDP growth is now estimated at just +0.1% compared to a previous estimate of +1.4%, and 2012 nominal GDP seen falling by 1.66% (from -1.3% previously). Overall, the 2009-2012 revisions imply nominal GDP at the end of 2012 was 2% lower than previously estimated. Annual revisions will be reflected in the new quarterly data to be released this week on Thursday, when the final Q2 13 data are published. Expect some reshaping of the quarterly profile too.

Spain – large fall in number of house mortgages in June. New mortgages constituted on houses fell to 14,053 in June, 42.2% lower than in June 2012, falling back to the sharpest rate of contraction in mortgages observed in 2011-Q2 12. Mortgage transactions are now close to one tenth of the average in 2007 (above 100K per month). The new downward acceleration reflects a similar trend in bank lending, where the fall has been accelerating in the past few months. Strict lending standards amid banks trying to clean up their balance sheets, poor income expectations and still rock-bottom expectations on house prices are contributing to bring new house lending almost to zero.

Spain – Cataluña approves extension of 2012 Budget, envisaging €2bn budget cuts for 2013. The Cataluña government adopted the fiscal deficit target of 1.58% of GDP, as requested by the central government, and approved budget cuts for €2bn (0.2% of national GDP) to be introduced in the second half of this year to reach the target. After the approval, the Catalan economic minister said the spending cuts are excessive and unjust and accused the central government of having set too narrow a deficit target. Comment: the late approval of the Catalan budget testifies the difficult task for the central government to apply fiscal discipline at the regional level.

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Portugal – public sector redundancies through *"mutual agreement"* could amount to 5K-15K in 2014. *Diario Economico* newspaper reports that the government is working on a programme for termination of contracts under *"mutual agreement"* of some 15,000 public sector employees which will be completed by September. Redundancy payments, reportedly estimated at €500mln, will not be made until January next year. Comment: the road to achieve a more sustainable structural primary balance is still long in Portugal, in our view, with significant additional fiscal tightening still in the pipeline.

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Slovakia – Economic sentiment indicator improves for second month in a row in August, but industry disappoints. Overall sentiment improved owing to better sentiment in retail and services, however, industrial and consumer confidence worsened after July gains, while the construction sector remains just above long-term lows. Industrial confidence suffered from higher inventories and lower export order-books (the lowest since March this year), which kept total order-books and production expectations stable, but weak. Given that expectation of recent production decreased back to the level seen in April this year, we keep our forecast of further deceleration in industrial production to 0%-1% YY, which we expect during 3Q13 after a probably deceleration to 2.3% YY in 2Q13 from 6% in 1Q13. By contrast, combined trade and consumer confidence improved in August, which eased our concerns about the recovery in retail sales (ex. cars), which we have seen during 1H13 to 0.7% YY in 2Q13 from -1.1% in 2012. Overall, we expect Slovak GDP to increase by 0.3% cumulatively in 2H13 after 0.3% QQ in 2Q13, which is likely to slow GDP growth to 0.8% in 2013 from 2% in 2012 (we assume weaker export and industrial activity owing to strong base effects and weaker fixed investment owing to lower utilization of production capacities reported in July) before its recovery to1.8% growth next year reflecting a better outlook for foreign demand.

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Slovenia – Economic sentiment indicator remained unchanged for third month in row, but consumer and construction confidence improved. Industrial confidence improved only slightly in August owing to worse production expectations and higher inventories, but order-books (also export) improved after dropping in July. This still suggests the recovery of export growth to 5%-7% YY in the short term from 2.1% in 2Q13. This is supportive for our forecast of mild recovery in industrial production to 0.2% YY growth in 3Q13 after -1% a quarter ago. Improved construction confidence, which is at its long-term average, suggests that an abrupt easing in contraction in construction output to -2.6% YY in June from an average -20% in the previous five months and -17% in 2012 was not only a one-shot. The contradictory data came from the tertiary sector as consumer confidence improved in all segments, however, plans for major purchases and a drop in retail confidence probably do not suggest any further stronger gains in retail sales or private consumption. For the time being we keep our forecast of GDP at -1.9% YY in 2013 after -2.2% in 2012, followed by -0.2% in 2014 assuming recovery in foreign demand, while the ongoing credit crunch is unlikely to support recovery in domestic demand. The 2Q13 GDP will be published this Friday, we expect -0.2% QQ and -2.5% YY swda after -0.7% and -3.3% respectively in 1Q13 (owing to better data from construction and retail sector .

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Norway — Poll confirms conservative-led government in the lead ahead of Sep 9 General Election.

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According to the latest opinion poll (Pollofpolls.no), a four-party Conservative-led government would take 101 seats in parliament compared with 67 seats for Stoltenberg’s Labour-led three-party government (a majority of 85 seats are needed to form government).

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Latest Issues of Euro Area Sovereign Debt Crisis Update

Italian Government Coalition Tensions Persist

Western Europe

Tensions persist in Italy's govt coalition on future of PdL's Berlusconi. Merkel says her govt would not change policy if re-elected, would keep pressure on Greece to

reform. SPD's Steinbrück to make Greece key part of Sep 1 debate with Merkel. ECB's Weidmann on more encouraging data. French pension reform could lower cost of labour, says PM. Greece's FinMin says a 3rd bailout would not be linked to extra austerity. Portugal's state sector budget deficit widens. German IFO higher than expected.

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ECB’s Nowotny Sees Little Need for Rate Cut

Western Europe

ECB's Nowotny sees little need for a rate cut, said discussion ongoing on improving transmission mechanism, particularly to SMEs. German FM Schäuble defends his comments on Greece, sees higher ECB rates at some point. Greece to allow foreclosure on 12K-15K homes. Spain's goods trade deficit at record low in 2Q. Spain's employers' association calls for "hyper-flexibility" in wage contracts. 2nd estimate of German 2Q GDP shows strong investment. German general government surplus in 1H.

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Italian Government at Risk on Berlusconi’s Future in Politics

Western Europe

Tensions escalate after Berlusconi says he will pull down Italy's govt if solution not found to preserve his political career. Agreement closer on Italy's IMU property tax. Buba's Weidmann would welcome publication of ECB Minutes. Belgium's housing market overvalued, says OECD. French employers and small entrepreneurs views on pension reform. German politicians discuss third programme for Greece. Strong reading for euro area flash composite PMI. We lift our forecast for euro area growth.

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Greek Debt Back at the Centre of Political Debate

Western Europe

"There will have to be another programme in Greece", German FinMin Schäuble admits for first time. Merkel calls for EU unity, saying it's "worth fighting for Europe". Oberhausen is German Detroit, says study. France's 2014 budget to be growth friendly, says FinMin. French pension reform to be financed by higher taxes. Strong gains in Belgian and Dutch consumer confidence. Irish property prices see second consecutive annual rise. Slovenia's central govt deficit improves slightly in July.

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Political Uncertainty: Germany and Italy in the Spotlight

Western Europe

Polls show rising likelihood of current German coalition continuing after election. In Italy, crucial Senate vote on 9 Sep could bring down government. Bundesbank clarifies its view of forward guidance, discusses effect of Japanese policy mix on other countries' economies. Spanish NPL ratio hits new high. Greece's current account deficit continues to shrink. French government finalises pension reform and 2014 budget drafts. Dutch budget deficit to exceed 3% EU limit in 2014 says Dijsselbloem.

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Macroeconomic Forecasts

European Economic Forecast Highlights — August 2013

This companion to Global Economic Outlook and Strategy - August 2013 contains detailed quarterly forecasts for the main European countries to end 2014. Tables

20-21 give annual forecasts to 2017 for growth, inflation, short-term interest rates, current balance, fiscal balance and government debt. Table 22 shows the change in our forecasts from last month. Figures 23-25 compare current forecasts for each country.

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Global Economic Outlook and Strategy — August 2013

We cut 0.1% off our 2013 global growth forecast this month (to 2.4%), but lift our 2014 forecast by 0.1% to 3.2%. We highlight four key issues that will shape the economic and market outlook in coming months: Fed tapering, Japan's consumption tax hike choices, the EM slowdown, plus renewed focus on issues of longterm fiscal sustainability in various EMU periphery countries. We pencil in the first Fed hike for 2015, with an even longer period of ultra-low rates likely from the ECB, BoJ and BoE.

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Appendix A-1

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