

## Curb your enthusiasm, just a little

Watch our global team of economists give their thoughts on how things can only get better in 2021 in 2 minutes, 21 seconds. But as our December economic update shows, we've still got an awful lot to worry about... today's US jobs figures weren't exactly spectacular. And don't get Rob Carnell started on negative interest rates; it's our podcast pick this week

### In this bundle

#### Video

#### **Watch: 2021 in 2 minutes, 21 seconds**

We're promising better times ahead. Find all the details and analysis in our Global Outlook here  
By Carsten Brzeski, James Knightley and James Smith



#### **December Economic Update: Pre-Christmas excitement**

Vaccine progress boosts 2021 optimism, but Covid rules, EU politics, and slow rollouts mean recovery will take time. A better, not quieter, year ahead.

By Carsten Brzeski, James Knightley and 4 others

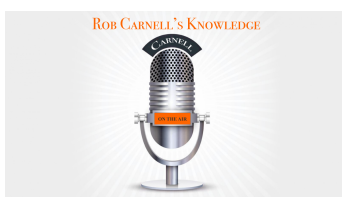


#### United States

#### **US: Weakening jobs market enters critical phase**

A disappointing payrolls number could give way to even weaker figures over the next couple of months as the pandemic worsens and containment measures...

By James Knightley



#### **Listen: Negative rate nonsense**

Some esteemed economists suggest that the way to solve weak economic growth and "low-flation" is substantially negative interest rates. Here are...



Energy

**OPEC+ comes to a deal**

OPEC+ have finally come to a deal. The group will ease cuts starting in January 2021, although the easing will be less than originally planned. While the...

By Warren Patterson



**ECB preview: One final move**

Extending the current level of stimulus rather than significantly increasing the stimulus seems to be the ECB's preferred option next week.

By Carsten Brzeski



**Reappearing Libor: And for my next trick ...**

The end of 2021 we were told. No going back, Libor was finished. Well, yes, no, and it depends. In the case of GBP, JPY, EUR and CHF Libor, there is...

By Padhraic Garvey, CFA



India

**The pandemic will cost India its ascent over the last half decade**

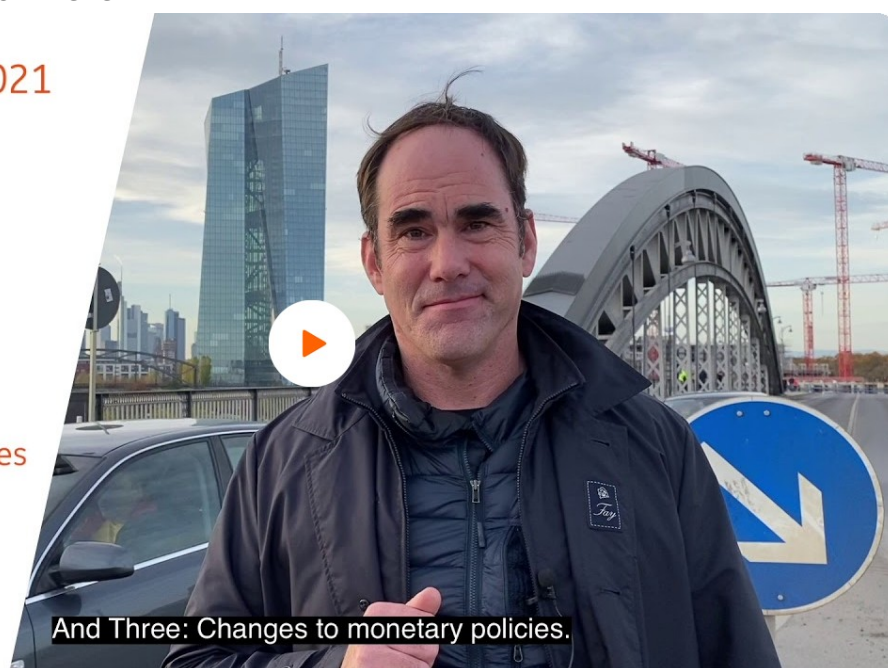
The pandemic has pushed the Indian economy off the cliff. The fall is so bad that it will cost the ascent India made over half a decade. With long-lasting...

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### themes for 2021

1. digital
2. changes to fiscal rules
3. changes to monetary policies



### 2021 in 2 minutes 21 seconds

From London to Singapore, New York to Amsterdam, ING's top economists look ahead to what we can expect next year. We're pretty sure that better times are ahead

[Watch video](#)

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Article | 3 December 2020

## December Economic Update: Pre-Christmas excitement

Positive vaccine news leaves little doubt that 2021 will be much brighter than 2020. But with mass vaccination programmes likely to take time, tight Covid-19 restrictions still in place and political drama ongoing in Europe, the global economy is not out of the woods just yet <https://think.ing.com/cp/index.php?/cp/publish/edit/entry/11653#>



Source: Shutterstock

Wishful thinking, herd behaviour or just swarm intelligence? Professional crystal ball watchers broadly seem to agree that 2021 will be far better than 2020, at least for the economy. Admittedly, it requires a lot of imagination to believe that next year could be worse than this. The UK's decision to approve a Covid vaccine and expectations that the US will soon follow are clearly the strongest drivers behind this optimism. As illustrated in [our Global Macro Outlook](#), we share this confidence and have, for the first time in a long while, tilted the risks to our growth outlooks to the upside.

Does a broad consensus on economic improvement in 2021 now mean that we can finally lean back, relax and enjoy the Christmas season? Not entirely. We liken it to a football club which invests heavily in promising new players at the start of the season: you know the golden future will come but you're also prepared for some nail-biting and

disappointing matches before the investment really pays off. The eurozone knows all about this.

Most countries are still mired in a second lockdown and while there will be some easing of the restrictions for the Christmas break, this is likely to be followed by new lockdowns in January, suggesting the double-dip will be extended into the first quarter of 2021. The US is holding up relatively well and hopes for fiscal stimulus have improved growth prospects for 2021, while at the same time the Thanksgiving period could still lead to new lockdowns in the coming weeks. Only Asia seems to be going strong.

Europe faces a particularly dramatic period before it can ease down for Christmas. The Brexit negotiations and the complex package of the EU's multi-annual budget, the rule of law mechanism and the Recovery Fund are still undecided and, to say the least, complex. Our base case is still that there will be two typical European fudges on both but not before several nightlong discussions and not without the risk of failure. Europe also seems to be running behind the US and the UK when it comes to the approval of the vaccine. Here, a first announcement by the European Medicines Agency is only expected at the very end of December, potentially delaying the rollout of the vaccine. So keep a close eye on Europe in the coming days and weeks. This should be the place of pre-Christmas action and excitement.

If swarm intelligence is right and 2021 is the year of the first synchronised global recovery in a long while, more structural economic topics should re-emerge very quickly.

Think of the economic power shift from the West towards Asia, the need to tackle climate change and accelerate sustainability and digitalisation. Discussions on the eurozone's Japanification and implications for government debt will be very hot topics as well. The only constant next year should be central banks whose only real role will be to accompany and support the economic recovery and fiscal stimulus. More monetary stimulus is hardly possible and would have very little impact on the real economy anyway while premature normalisation would run a high risk of choking off the recovery.

In the end, we think 2021 should clearly be a better year but not necessarily a quieter year. Therefore, let's enjoy the Christmas break as long as it lasts. Merry Christmas.

## □ US: One last hurdle

US output has rebounded strongly, but the recovery seems set to lose steam over the next couple of months. Rising Covid cases are putting hospitals under pressure and containment measures are increasingly being introduced across the nation. This will inevitably have economic implications, but the scale of the impact is uncertain. Right now, restaurant, bar and gym industries are bearing the most stringent regulations, and the increase in initial jobless claims suggests jobs are being lost.

While there is the imminent prospect of an approved vaccine, the logistics of distributing it to more than 300 million people means that containment measures are unlikely to be fully relaxed for several more months. We cannot rule out the possibility of a negative GDP reading in 1Q, reflecting

weakness in the December-January period.

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*We cannot rule out the possibility of a negative GDP reading in 1Q, reflecting weakness in the December-January period but expect the US to have recovered all the lost pandemic output in late 3Q/early 4Q.*

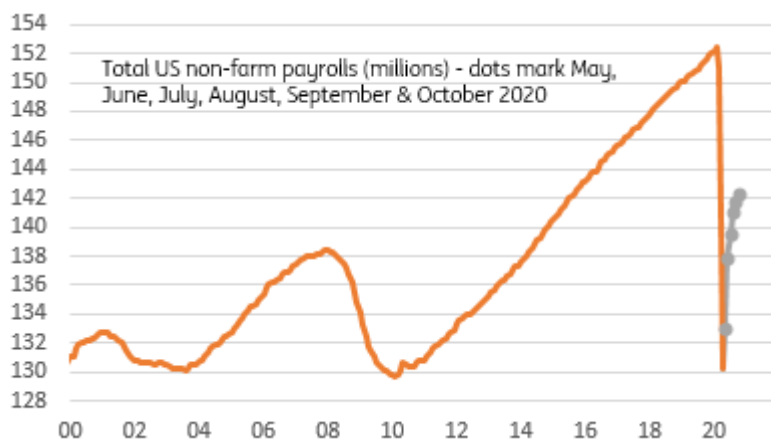
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Nonetheless, once the vaccination programme has reached a critical mass, perhaps in late 1Q, we should see a vigorous period of economic activity. The combination of pent up demand and travel, hospitality and entertainment industries fully reopening and hiring workers plus a fiscal stimulus of the order of \$1 trillion under President Joe Biden should be a heady mix. We expect the US to have recovered all the lost pandemic output in late 3Q/early 4Q.

There will be [questions over when we will see fiscal policy consolidation](#), but this seems doubtful for 2021, particularly with former Federal Reserve chair Janet Yellen set to become Treasury Secretary. Next year is all about growth and recouping the lost jobs.

One risk is that structural changes brought about by the pandemic lead to supply constraints that could generate more inflation (reduced flight, hotel, restaurant/bar and car hire capacity). This could prompt talk of earlier rate hikes than 2024 as the Fed currently projects, plus a steeper yield curve.

## US jobs: Still a mountain to climb



Source: ING, Macrobond

## □ Eurozone: More stimulus on the way

The new lockdown measures in the eurozone are now reflected in economic data, with the economic sentiment indicator markedly declining in November, corroborating our expectations of negative growth in the fourth quarter. As some confinement measures will last until mid-January the growth pick-up in 1Q21 is likely to remain modest. But we still see a significant acceleration

from 2Q on the back of the vaccine rollout.

While the Recovery fund is currently blocked by both Poland and Hungary over a dispute regarding the interpretation of the rule of law provisions, we expect the German EU presidency to find a compromise, freeing the necessary budget stimulus in 2021. On top of that, the European Central Bank is likely to expand its monetary stimulus further in December.

We're looking for an additional €500 billion of quantitative easing in the form of the pandemic emergency purchase programme and €40 billion of monthly purchases under the public sector purchase programme until further notice, as well as a lengthening in time of the generous TLTRO interest rates for banks. Banks will probably also see a greater part of their excess liquidity exempt from the negative deposit rate.

## □ UK: Brexit crunch time... again

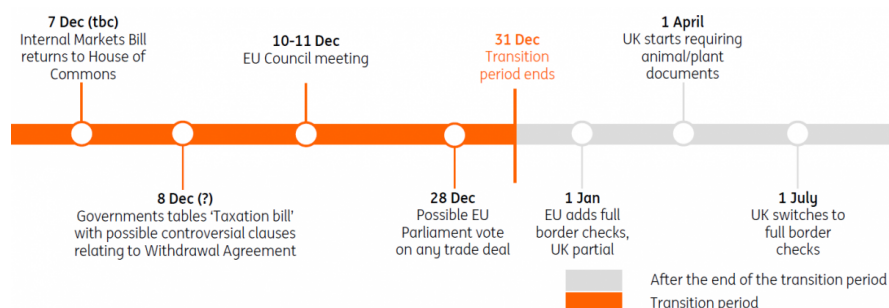
UK-EU negotiations have been going around in circles for weeks, or at least that's how it seems on the surface. Fishing continues to be flagged as the major division, although we suspect level playing field is the bigger challenge.

Either way, time is running out to break this deadlock, although neither side wants to be the one seen to end talks. Brussels is reportedly preparing for the European Parliament to ratify any deal just days before 31 December.

Ultimately it will come down to UK politics. While Covid-19 and polling on Scottish Independence could push the government towards a deal, it will face steep opposition from some pro-Brexit UK MPs.

Deal or not, there will be disruption at the start of 2021, although unprecedented volatility associated with Covid-19 potentially means we won't see negative 1Q GDP. And while the sharp change in trade terms will weigh on the recovery and jobs, this should be offset by a rapid vaccination programme due to start within days. The hope is that this can foster a sustained rebound in GDP through 2021, albeit we don't expect the economy to reach pre-virus levels for at least a couple of years.

## Brexit timeline



Source: ING

## □ China: Default risk rising

Onshore bond market default risk in China is accelerating. Companies that are on the brink of default or have already defaulted include both state-owned enterprises and private-owned enterprises and stretch across many different industries.

Condensing the available data, we group these companies into two main groups. The first group is related to incident cases that have lasted for years and would already have defaulted if there had been no pandemic or the trade war, as the economic response to these shocks has delayed deleveraging reforms. The second group runs businesses inefficiently with over-expansion strategies and over-borrowing over many years. It is quite clear that this current wave of defaults is intentional by the government to continue its deleveraging reform.

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*We will certainly see more defaults but not from firms that are too big to fail*

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As it is part of the reform, the government still plays a role even though it would like the market to determine the key parameters of default, e.g. terms of restructuring, or the percentage of haircut required. The government does not want to create a reform-driven default crisis. The central bank has injected short term liquidity into the market to calm sentiment. And the central government may delay a default which they view as posing a systemic risk.

We will certainly see more defaults but not from firms that are too big to fail.

## □ Japan: Third time lucky?

In Japan, the recent news on Covid-19 has been worrying. While few countries in Asia have levels of Covid-19 comparable to those in Europe and the US, the hurdle for restrictive social distancing measures is almost certainly lower. So we are watching the numbers in Japan closely in case we have to shift Japan and some other Asian countries to our second scenario setting.

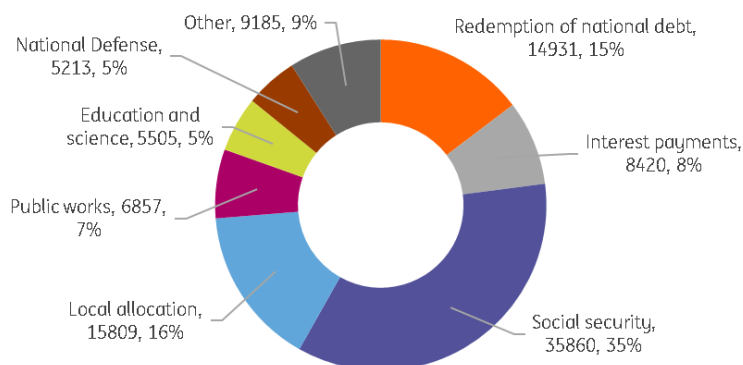
Although the unhelpful pandemic figures dominate the outlook, there are some positive underlying factors too. Japan has in place substantial fiscal support, which is keeping most of the economy intact pending vaccine rollouts. GDP will probably not return to pre-Covid levels until the end of 2022, but this is in line with what we expect for other G-7 economies. That means that the deficit, which is close to 12% this year, will likely remain well above 5% next year.

A debt-to-GDP ratio of more than 250% now already sounds alarming. But with virtually zero debt service costs of recently issued debt to finance this support, recent increases to support spending pose little additional burden to government finances.

Inflation is also not an imminent problem and is currently slightly negative, and likely to remain close to zero through 2021. We don't anticipate any significant change in policy from the Bank of Japan in response.

[Read our comprehensive outlook for Japan for more analysis](#)

## Japan FY20 expenditure with two supplementary budgets (JPY bn)



Source: Ministry of Finance, Japan

### □ Rates: Paving the way to 1%

It's psychologically important – that 1% handle for the US 10-year.

And we've made some strides in that direction in the past few weeks. In fact, ever since the “vaccine moment”, the central underpinning has been for a test higher in market rates. It's been quite a bumpy ride, but at 90 basis points, the US 10yr is poised for at least an attempt to mark 1%, a level that was broken to the downside back in February as the stark realities of Covid-19 dawned, in fact well before the World Health Organization declared it a pandemic.

The last time the German 10yr was at 1% was well over five years ago, and with the US now at 90bp, the German 10yr continues to languish in the -50bp area. We expect the 140bp spread between the two to widen to 175bp in the coming months as the US continues to lead hopes for a material reflation process as we progress through 2021.

The ECB remains all-in, and it needs to be. The eurozone maintains a stressed market discount, as evidenced by rich valuations in the belly versus the wings – a classic sign that rates here remain anchored.

### □ FX: Reflation narrative plays out in a weaker dollar

Nowhere has the powerful reflation narrative been felt more than in global foreign exchange markets. The powerful combination of a Biden win and vaccine progress has driven yield curves steeper, pushed investors out along the credit curve – and out of the dollar. We forecast another 5-10% dollar decline through 2021 as the Fed allows the US economy to run hot.

## *Given our conviction call of a dollar decline in 2021, EUR/USD looks well on its way to our 1.25 target*

We have detailed much of our thinking on this subject in our [2021 FX Outlook: Back on Track](#). And November's 15bp steepening in the 2-10 year Treasury curve has seen the FX reflation playbook work well. Big winners have been the high beta currencies on global growth, particularly the commodity currencies of Norway's krone, the New Zealand dollar and the Brazilian real.

The broad trade-weighted dollar has fallen about 3% since the start of November and is on its way to retracing about two-thirds of the Trump trade war rally – a move which started in early 2018.

It is probably about now we will start to hear the phrase from a former US Treasury Secretary that the dollar is 'our currency, but it is your problem'. These words will be resonating in Frankfurt as the ECB meets on 10 December. The good news for the ECB, however, is that because of the broad nature of the dollar decline – including against Asia – the trade-weighted euro has barely budged.

Given our conviction call of a dollar decline in 2021, EUR/USD looks well on its way to our 1.25 target.

### US Nominal Trade Weighted Broad Dollar Index



Source: ING, Macrobond

### □ EMEA: Old habits die hard

Bright days lie ahead. After the tough 2020 and a challenging winter, most Central and Eastern Europe, Middle East and African economies should stage a meaningful rebound from 2Q21 onwards, in line with eurozone trends. Driving this post-Covid-19 recovery will be both domestic and external demand. Russia should remain the growth laggard while Poland should steam ahead.

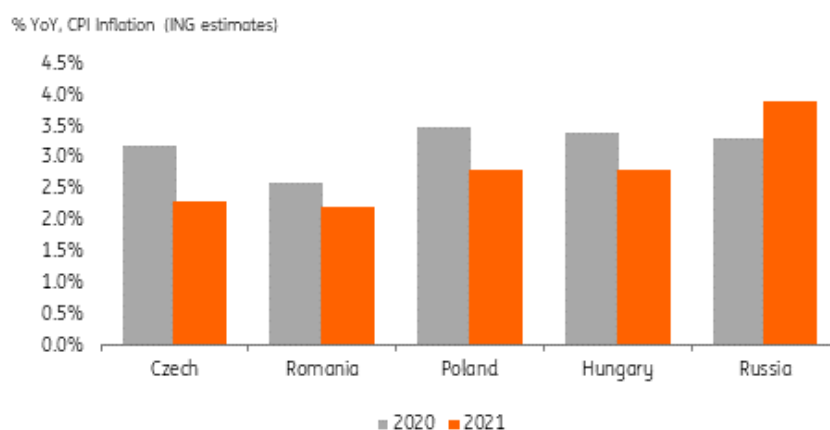
In contrast to developed markets and most emerging market Asia peers, 2021 inflation in the region is expected to fall, not rise. This is mainly due to CEE countries having entered the Covid-19 crisis with elevated CPI levels and tight labour markets. Hence, any reflation theme in the region will largely focus on rising growth levels, rather than CPI increases.

The post-Covid-19 rebound should allow for a return of the monetary divergence. The Czech National bank is to reclaim its position as the ultimate hawk in town, while central banks in Poland and Hungary are to stay behind the curve. Turkey's central bank is expected to keep the very restrictive policy in place until mid-2021, while the Central Bank of Russia is to finalise its multi-year easing cycle with some last cuts.

The fiscal stance in the region will stay supportive in 2021, but less expansionary than in 2020. Those countries facing Parliamentary elections next year (the Czech Republic and Russia) will keep fiscal policy looser than otherwise might have been the case.

2021 should therefore see old habits die hard. Russia will return to being a growth laggard, the CNB should regain its mantle as the hawkish outlier and those countries in election years will require greater spending capacity. In fact, CEEMEA should break the Covid-19 stranglehold quite quickly.

## EMEA Inflation



Source: ING, Macrobond

[For our full analysis and look-ahead to 2021, please read our full Economic Outlook published in November](#)

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# US: Weakening jobs market enters critical phase

A disappointing payrolls number could give way to even weaker figures over the next couple of months as the pandemic worsens and containment measures intensify. The need for fiscal support is only going to become more pressing



**245,000** Increase in jobs in November

Worse than expected

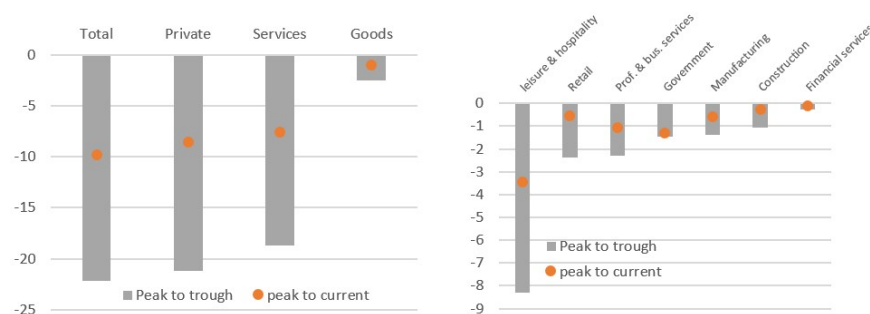
## Lost momentum

The US jobs report is a disappointing read throughout. The establishment survey shows US payrolls rose just 245k versus 460k consensus, while the household survey, which is used to calculate the unemployment rate, actually showed employment falling 78,000. These figures are substantially weaker than other labour surveys had indicated and leaves us in a troubling situation with more Covid cases, hospitalisations and movement restriction coming day by day.

The details show private payrolls rising just 344k and government employment falling 99k, primarily due to census collection workers ending their terms. Private goods producing jobs increased 55k, split evenly between manufacturing and construction, while services rose 289k. The number of retail jobs actually fell 35k with leisure and hospitality posting a gain of just 31k and business services increasing only 60k.

As the chart below shows, net employment is still massively down in these sectors and with more restrictions likely to come into place over the next few weeks the December jobs report is likely to show only weak jobs growth. We could potentially see a negative January figure – remember the data collection period is the week of the twelfth every month.

## US jobs lost since the crisis started by sector (millions)



Source: Macrobond, ING

## More challenges ahead

Even after November's 245k jobs gain, total employment still down 9.87mn versus February. Moreover, the employment as a proportion of working age population remains well down on even the worst readings of the Global Financial Crisis and is on a par with the early 1980s when female labour market participation was less. The charts below underline how far away the US jobs market is from a full recovery.

The outlook for jobs growth in December is less positive. Rising covid cases are putting hospitals under real pressure and we are likely to see more containment measures introduced to try and keep the situation manageable. But this comes at obvious economic cost with many businesses likely to struggle with the threat of job losses.

Moreover, we have to remember that the Federal Reserve's Beige Book found four out of 12 Fed districts were already reporting they experienced "little or no growth" in recent weeks. It suggested that "activity began to slow in early November as COVID-19 cases surged" and that business optimism had "waned" as a result. That is not an environment that suggests vigorous hiring.

## Employment tracking (millions in work) & employment as % of working population



Source: Macrobond, ING

## A fiscal support package looks needed more and more

Comments from Federal Reserve officials have underlined their concern about the near-term economic situation. Only on Wednesday, Dallas Fed President Robert Kaplan warned that “growth could stall out” if we see the economy constrained in the absence of fiscal support.

In that regard, we continue to look for signs of a deal on a fiscal package to help households and the broader economy through this latest wave of the pandemic. House majority leader Nancy Pelosi’s endorsement of the \$908bn bipartisan fiscal plan, after having held out for a \$2tr+ stimulus for so long, suggests there is a real chance of a deal being struck in the next week or so. Remember we have recess coming up and a December 11 deadline on a funding bill that could in fact lead to a partial government shutdown.

As a minimum there will be intensifying pressure to extend unemployment benefits that are scheduled to expire at month end and to find money to fund the vaccination roll out. However, Republican Senate leaders continue to sound more cautious... for now...

## But better times are coming

Despite all this near-term uncertainty and anxiety about the economy, we remain upbeat on the prospects for 2021 as a vaccination program allows a full re-opening of the economy with consumers able to fully re-engage with the economy. It also would give businesses the clarity to finally put money to work on investment and hiring (remember there are still 10mn fewer people in work than in February). Throw in a fiscal stimulus of the order of 4% of GDP and we see very vigorous growth from late 1Q21 onwards.

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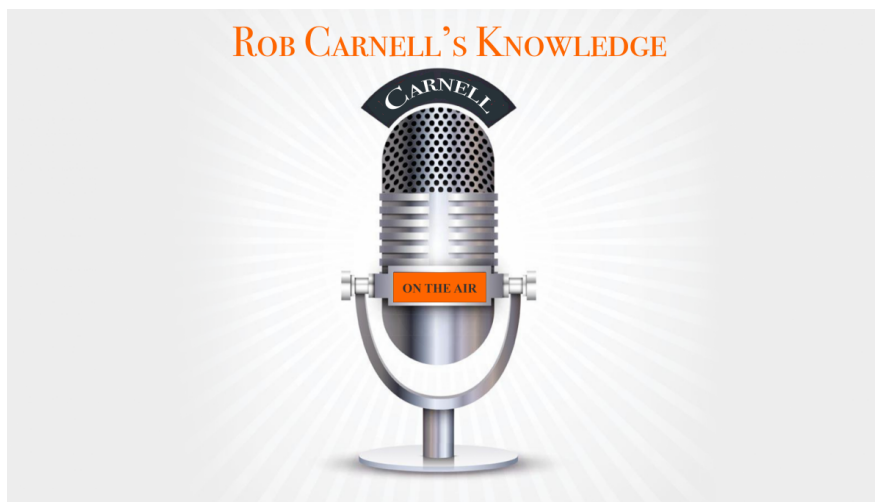
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Podcast | 4 December 2020

## Listen: Negative rate nonsense

Some esteemed economists suggest that the way to solve weak economic growth and "low-flation" is substantially negative interest rates. Here are some commonsense arguments why this is likely to do more harm than good. This podcast is part of the Rob Carnell's Knowledge series



### Why less isn't always more

It sounds simple - growth is weak, inflation "too low", so let's just throw even more monetary easing at it? But like most things in economics, it isn't that simple. That said, it isn't so complicated that some very well known economists should know better.

I'm Rob Carnell, and [here's my personal take](#) on why it might be better for some economies to actually raise rates a little - explained with lots of intuitive examples and a hefty dollop of irreverence.

## OPEC+ comes to a deal

OPEC+ have finally come to a deal. The group will ease cuts starting in January 2021, although the easing will be less than originally planned. While the deal is less than the market was expecting, it should ensure that inventories continue to fall next year



### What was agreed?

It has been a tough week for OPEC+, with the group having to delay its meeting in order to give the group some time to reach a deal. Finally yesterday the group came to a compromise, which will see the group easing production cuts by 500Mbbbls/d from January 2021, which is much less than the 1.9MMbbbls/d that the group would have brought back onto the market had they not come to an agreement. The group will then assess market conditions on a monthly basis and decide whether to allow more supply to be brought back onto the market. Under the deal, the maximum the group can ease per month is 500Mbbbls/d.

While the amount of easing is less than what the group originally planned, it still falls short of expectations that the group would rollover the current level of cuts for an additional 3 months.

In addition, OPEC+ also agreed to extend the period for compensatory cuts through until the end of March 2021.

## What does this mean for the oil market?

The market reacted mildly positive to the agreement, despite it falling slightly short of expectations, with participants likely taking comfort in the fact that the group finally managed to come to some sort of deal.

Prior to the agreement, given the surge that we have seen in Libyan output, coupled with continued uncertainties over the demand outlook, given the latest wave of Covid-19 and lockdowns, the oil market was looking increasingly fragile over the early stages of next year, and faced the very real risk of returning to surplus.

However, while the deal does fall slightly short of expectations, importantly it does look more certain that the oil market will be in deficit over the first quarter of next year, and so the market should continue to draw down inventories.

As a result, we have left our forecasts unchanged, and still expect that ICE Brent will average US\$48/bbl over 1Q21, and US\$55/bbl over full year 2021.

## What are the risks still for the market?

The key risk and uncertainty for the oil market continues to be the demand outlook. Any further waves and lockdowns prior to a wide rollout of a Covid-19 vaccine could easily push the oil market back into a fragile state.

Secondly, while expectations are that we will see a return of Iranian supply, following the outcome of the US election, the big unknown is timing. If Iranian supply started to return to the market in the first half of next year, it would likely be a challenge for the market to absorb these additional barrels, and so could put some pressure on the market. However, if this supply only started to make a return towards the end of the year, the market would be better placed to absorb this supply, given expectations of stronger demand as we move through the year. We are assuming that Iranian supply will start to make its way back onto the market during the 2H21.

Finally, compliance is always a risk, and with the group now moving into easing mode, there is a risk that they become complacent, and that we start to see compliance slipping.

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Article | 3 December 2020

## ECB preview: One final move

Extending the current level of stimulus rather than significantly increasing the stimulus seems to be the ECB's preferred option next week.



Source: Shutterstock

Expectations are high for next week's ECB meeting. At the October meeting, ECB president Christine Lagarde broke with an unwritten communication principle of her predecessor, Mario Draghi, to 'never pre-commit'. Instead, Lagarde de facto preannounced new ECB action next week, calling it a 'recalibration' of all instruments.

### New round of macro projections

The reasons for new ECB action are clear: with the second lockdowns the September projections have become outdated and too optimistic. Back then, the ECB had penciled in 3.1% QoQ growth in the fourth quarter. This number will have to be revised downwards significantly. At the same time, the more positive prospects on the back of recent vaccine news could lead to an upward revision of the ECB's growth projections in H2 next year. Overall, we expect downward revisions for the 2021 and 2022 growth projections (5.0% and 3.2% in September).

As regards inflation, the second lockdown has illustrated the current measurement problems, showing prices for goods and services that currently are not available. Given the latest drop in headline inflation, the ECB's expected -0.2% YoY for the fourth quarter could turn out to be

optimistic. Looking ahead, however, a reversal of the German VAT reduction as well as some price increases in the most-hit sectors should lead to a gradual increase in inflation. Overall, we don't expect significant changes to the inflation outlook, which was at 1.0% for 2021 and 1.3% for 2022. An important forecast will be the first release of a 2023 forecast. The distance between this 2023 forecast and 2% will be an important needle in the ECB's compass going forward.

The stronger euro exchange rate will be a complicating factor for the ECB. The latest appreciation only materialized after the cut-off date of the staff projections and will therefore not be reflected in the forecasts. At current levels, the stronger euro could easily shave off another 0.1 percentage point of both the GDP growth and inflation forecasts.

## The case for new ECB action

The eurozone economy needs fresh support to get through the second lockdown and to start a recovery next year. However, this is not a crisis in which monetary policy is the main actor but fiscal policy. The ECB is very well aware of this situation and knows that excessive new monetary stimulus will hardly be a gamechanger for the economy. Therefore, and even if the ECB might formulate it differently, the ECB has in our view two main objectives: (i) provide enough cheap liquidity so that the eurozone recovery can unfold once the vaccine will be rolled out; and (ii) prevent a new euro crisis from unfolding on the back of widening bond yields.

With all of the above in mind and also assessing recent official speeches and interviews, we expect the ECB to decide on the following next week:

- An increase in the PEPP programme by up to 500bn euro to extend this programme until the end of 2021
- An increase of the monthly APP purchases from 20bn euro to 40bn euro, open-ended
- An extension of the generous TLTRO interest rate by six to 12 months
- An increase in the tiering facility to exempt a greater part of the banks' liquidity from the negative deposit rate
- Potentially, including so-called Fallen Angels (corporate bonds downgraded during the crisis) into the corporate bond purchasing programme.

The aim of all ECB measures will be to extend the current very accommodative monetary stance, rather than increasing it. This current crisis is a crisis in which fiscal policy, not monetary policy, can make the difference for the economy. Therefore, while still vague enough to keep the door open, Christine Lagarde will try to signal next week that this new round of monetary action will really be the last one

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## Reappearing Libor: And for my next trick

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The end of 2021 we were told. No going back, Libor was finished. Well, yes, no, and it depends. In the case of GBP, JPY, EUR and CHF Libor, there is indeed the intention for there to be a hard stop. However, the latest out of the US flips that, with an explicit plan to continue with USD Libor through to mid-2023. And then it really ends, we're told



Extension to mid-2023 for USD Libor legacy product, but new business in Libor ends in 2021. That's the plan.

The announcement that USD Libor would have an effective 18-month extension is quite a development. It has certainly made those in varying degrees of preparation mode sit up and listen to the mood music just that bit closer.

As there are important nuances here. Any continuation of references to Libor beyond end-2021 should be purely for legacy product. So accelerated progress should be made through 2021 to get to the point where all discussions on new product are with reference to the new risk-free rates (and not referencing Libor). At the very minimum, all new loans, bonds and derivatives should not reference Libor from 2022 onwards.

In that sense, the end-2021 date still holds for new product. By that time there should be a term rate for SOFR, which could mean that product or players that prefer to employ the term rate could do so. We are of the opinion that an IOSCO-compliant forward-looking term SOFR rate is still probable by mid-2021, on the assumption that sufficient volumes have built in SOFR futures, and wider SOFR derivatives through the first half of 2021.

## Transitioning legacy product smoothly has been a real headache

Tough legacy product is where some room for manoeuvre is needed, and indeed there had always been an explicit possibility that a Libor replica of some description could be posted after the end of 2021 to help tackle product that could not transition. For USD Libor, that would only now be needed post-mid-2023. A central objective here, however, had always been to make this the exception rather than the rule, and this was never intended as a final solution for all such product. But it would help.

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*Large chunks of the legacy marketplace were falling into what could be termed 'outcome un-determinative'*

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Tough legacy had been perceived to be a small resistant element of the marketplace that could be dealt with as a side issue. But it had become increasingly apparent that large chunks of the legacy marketplace were falling into what could be termed “outcome un-determinative”. There were clearly many conversations ongoing, but real action towards transition was seen as next year’s action point. How things would actually pan out through 2021 was tough to call.

The lack of a term SOFR rate was seen in many quarters as a constraint towards real progress, and it would be well into the middle of 2021 before such a term rate became available. Many participants were asking questions like: *'what will we do if there is no term rate in time?', 'how will we transition then?', 'do we need a waterfall methodology or a backstop?',* and if so, *'how to transition from that to future term rates?'*

Clearly far more questions than answers.

While this was a backdrop that required some push from the official sector, it was also a backdrop that provided some unease for the Federal Reserve and the wider regulatory environment. The protection of the system is key, and a rump of un-transitioned loans and bond product is not a desirable outcome. Add to that the requirement to protect the consumer, and the rationale for some timing leeway was there to be pushed on.

What we have now overall is a three-pronged approach to lbor reform. In the eurozone, Euribor continues, so no transition to be concerned with there. The key lbors to be transitioned are GBP, JPY and CHF; with a target transition by end-2021. Then, legacy USD Libor product transitions by mid-2023.

## So what happens for those that signed up to the ISDA protocol?

For derivative players that have signed up for the ISDA protocol, there will be the obvious question as to how this affects them. The fixing of the adjustment spread happens at a point where the respective ibors are deemed unrepresentative at some point in the future. The wording here is vague, so it is not impossible for all adjustment spreads to be fixed at the same time

However, in our opinion, it is unlikely that the SOFR-Libor adjustment spread will be fixed in Q1 2021, as USD Libor does not need to transition at the end of next year. The other Ibors that will transition by end-2021 will have their adjustment spreads fixed as planned. For USD Libor, there could be a separate fixing at some point around the turn of 2022 into 2023, ahead of the transition to coincide with the end of USD Libor by mid-2023.

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*There is absolutely no obligation for players to use the new risk-free rates*

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If the SOFR to Libor spread adjustment is delayed, it could allow the spread adjustment to drift lower towards 20bp, compared with a current spread of 26bp. That would not happen should USD Libor drift higher in the coming quarters. Not huge variability, as it is still within a margin of error of a few basis points, but if the USD adjustment spread is not fixed with the others in Q1 2021, the USD adjustment spread itself becomes that bit less certain.

## Will Libor really go away in the end?

While there will be an extension of sorts for legacy USD Libor product, the plan is for new USD Libor product to be no more from 2022 onwards. New product should reference the new risk-free rates. Note however that this is advisory. There is absolutely no obligation for players to use the new risk-free rates. Should they become the market standard, then players will want to use them, and our central view is that is precisely what happens. We expect dominant market flows to be in SOFR.

At the same time, for as long as a replica Libor persists the notion of continuing with Libor or a proxy Libor beyond these deadlines persists. The challenge for Libor detractors is to make that go away. The extension for USD Libor provides a sensible safety net, but it also gives Libor one more lifeline to cling to, one that could yet morph into something more permanent.

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# The pandemic will cost India its ascent over the last half decade

The pandemic has pushed the Indian economy off the cliff. The fall is so bad that it will cost the ascent India made over half a decade. With long-lasting wounds and bruises, the climb back will be painfully slow. So, where is the country headed? Certainly, nowhere near prime minister Narendra Modi's \$5 trillion vision in the near-term



Source: Shutterstock

Passengers come out from local trains in Kolkata, India wearing facemasks as a mandatory prevention measure against Covid-19 after the railway station was closed for nearly 8 months

## Key takeaways

- **Covid-19:** India remains Asia's epicentre of the pandemic, as total infections look set to surpass the 10-million mark by mid-December.
- **Growth:** The worst of India's current slump may be over but recovery will be slow. The five most affected Indian states make up for about 40% of the country's GDP, which will hold back growth from a strong rebound.
- **External sector:** A silver-lining is a healthy external payments position, thanks partly to weak domestic demand and low global oil prices. But that won't be enough to move the sovereign from the negative rating watch.

- **Inflation:** CPI has bucked the regional low inflation trend as upward price pressure from supply disruptions and pro-cyclical policies outweigh weak demand due to the high unemployment with the trend to continue going into 2021.
- **Monetary policy:** Central bank policy interest rates are at record lows and the Reserve Bank of India continues to pump liquidity to keep the economy afloat. With all efforts failing to stimulate lending, any additional policy support is likely to be in vain.
- **Fiscal policy:** Over 10% of GDP stimulus package is spending-lite, mainly focusing on structural reforms. Yet, the budget deficit is going to be through the roof in the current fiscal year and will remain elevated in the near term.
- **Politics:** Increased political anxiety amidst a number of state elections in 2021 could prove to be an added whammy for the economy and local markets.
- **Markets:** The RBI's drive to keep market yields and government borrowing costs low has paid off. The currency is benefiting from a broader emerging market rally.

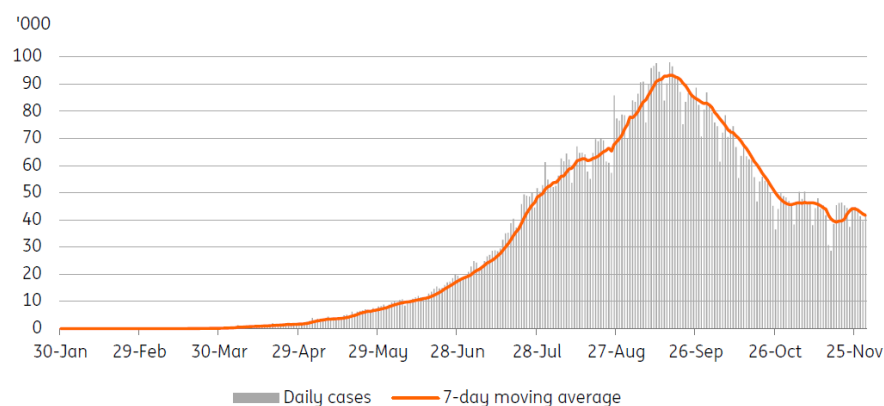
## The fight against Covid-19 continues

India is the world's second-most-populous country, and living up to its name, it has become the country with the second-highest number of Covid-19 cases in the world after the USA, with total cases crossing the 9-million mark recently. The seven-day daily average new cases is currently close to 42,000 and the 10-million mark appears to be around the corner, most likely to be reached by mid-December. So far, more than 137,000 fatalities have been recorded but the official figures remain debatable. The reality could be much worse than what these numbers suggest.

While the infection curve has yet to flatten, the second wave has dampened the prospects of the pandemic being brought under control any time soon with the festive season of Diwali and recent state elections in Bihar as recent key inflection points, sending some regions back into lockdowns and curfews to curb the spread.

The mass labour migration as the first lockdown was announced, surge in joblessness and supply chain disruptions weighed on the recovery from the huge crash induced by the initial closure of the economy, and the second wave of lockdowns are now threatening to delay the recovery further.

## Covid-19 - the second wave is here



Source: Worldometers, ING

Data as of 29 November 2020.

**-15.7%** GDP contraction in 1H20  
Year-on-year

## An economy off the cliff

The Indian economy started battling the pandemic from a position of weakness.

GDP growth has been on a downward drift over the last few years and crashed by a hefty -25% quarter-on-quarter seasonally adjusted rate in the April-June quarter - the first quarter of the financial year which started in April 2020 (FY20), as the nationwide lockdown slammed the brakes on the economy. The gradual easing revived activity, and GDP bounced back by 21% QoQ in 2Q20. Even then, the -15.7% year-on-year contraction in the first half of FY20 was the worst ever and also the steepest in Asia.

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*The slump is broad-based on both the demand and the supply sides of the economy and almost every GDP component has been hit hard*

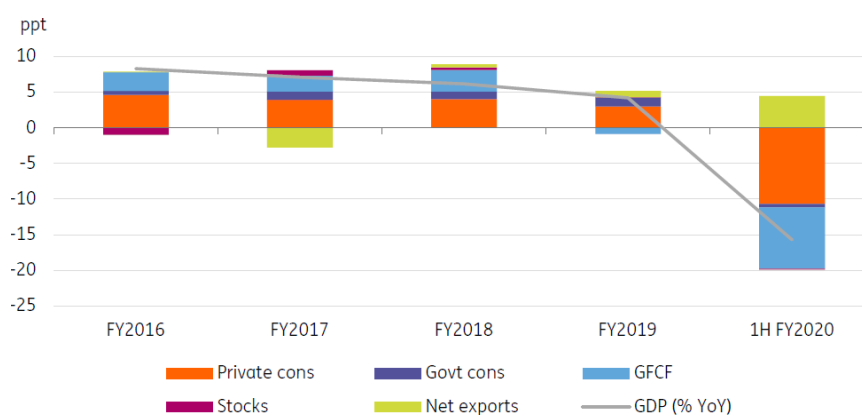
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The slump is broad-based on both the demand and the supply sides of the economy and almost every GDP component has been hit hard, but private consumption and investment have suffered the largest blows. The much-hyped 10% Covid-19 stimulus was nowhere to be seen, instead, government consumption fell by 22% YoY in 2Q20. To be fair, the stimulus wasn't mean to show up anyways, as much of it was of a long-term nature. Exports also suffered from weak global demand, though weak domestic demand dented imports more, leaving net trade as the sole

positive contributor to GDP growth in 1H20.

From the supply-side, services were the biggest drag on GDP, explaining almost two-thirds of the -15.7% contraction, while manufacturing made up for the rest. The agrarian economy remained surprisingly unscathed and managed some growth despite several natural disasters, including flooding and cyclones.

## Explaining the record GDP plunge



Source: CEIC, ING

Bars may not stack up to total GDP growth due to statistical discrepancy.

## Not out of the woods just yet

Like elsewhere in Asia, the worst of India's slump is certainly behind it, however, a large part of the economy continues to be reeling.

The five most affected Indian states at the time of writing are Maharashtra, Karnataka, Andhra Pradesh, Tamil Nadu and Kerala – in that order, which coincidentally make up about 40% of the country's GDP and economic activity in some of these and other states remain partially stalled. In Maharashtra, home to the financial capital Mumbai and with the biggest share in total GDP i.e. 14%, the existing lockdown has now been extended until 31 December 2020.

India's exports plummeted by a whopping 17% YoY in the first 10 months of 2020 – the steepest in Asia and unfortunately it lacks the export support that some of its Asian neighbours have recently started enjoying. The decision to stay out of the Regional Comprehensive Economic Partnership (RCEP) trade deal will also deprive the country of any potential benefits of this intra-regional free trade, although there might not but much to reap here given the existing bilateral trade agreements, which partly reduces incremental benefits. Therefore, the small share of exports in GDP and low exposure to China insulate it from the risk of any trade or technology war.

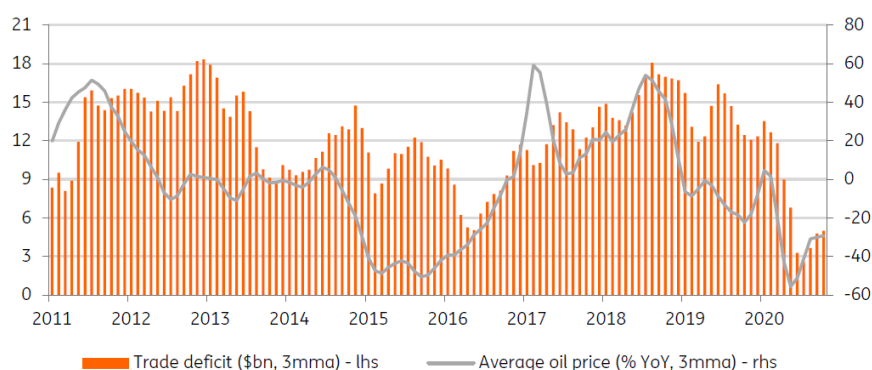
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*Without a material improvement in the underlying economic fundamentals, it's going to be a tough path for the INR going into 2021*

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Meanwhile, weak domestic demand and subdued global oil prices should sustain weak imports and narrower trade deficit trends well into 2021. The current account posted a record surplus of \$20 billion in 1Q20, which with a huge stockpile of foreign exchange reserves of over \$500 billion, the external payments position should continue to be comfortable. However, this hasn't prevented international credit rating agencies from cutting India's sovereign rating outlook on the grounds of slow growth and deteriorating public finances. In turn, the negative rating overhang has been an added whammy to a beleaguered Indian rupee, sustaining it as an Asian underperformer, the status it has held over the last few years. Without a material improvement in the underlying economic fundamentals, it's going to be a tough path for the INR going into 2021 as well.

## Lower oil price, narrower trade deficit



Source: CEIC, ING

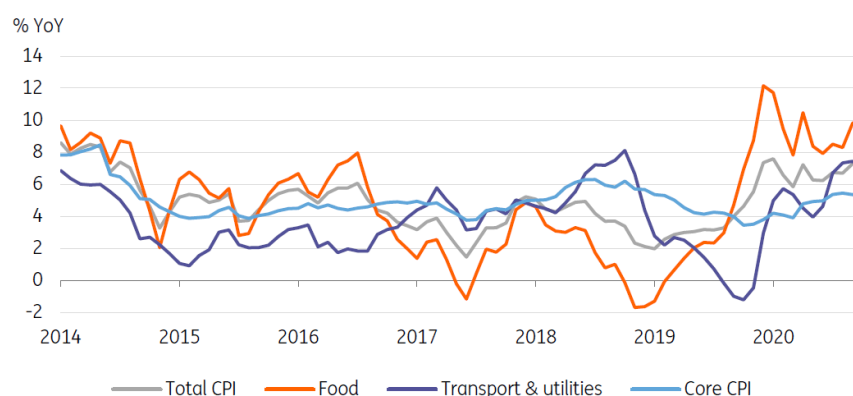
## Rising inflation

The demand destruction due to Covid-19 drove CPI inflation lower in much of Asia.

But not in India, where it has almost doubled this year. The supply disruption during lockdowns and panic buying pushed consumer prices higher, which meant inflation crossed the central bank's 6% policy limit in every month this year except one through to October. Latest data for October puts inflation at 7.6% YoY, bringing the year-to-date FY20 average to 6.9% as against 3.5% over the same period of FY19.

High food and transport prices have been the main problems. Lower global oil prices might have been a godsend from the trade perspective but the transmission of these to domestic prices was pared by pro-cyclical policy such as administrative hikes in retail prices of petrol and diesel. Even as high unemployment and weak consumer confidence continue to play its parts in suppressing demand, the upward price pressure are unlikely to abate anytime soon.

## What's driving inflation higher?



Source: CEIC, ING

## What more can the Reserve Bank of India do?

Policy interest rates at record lows, the banking system is swamped with liquidity and there is commitment to support augmented government borrowing to fund the budget deficit.

The prevailing fiscal policy constraints in helping the economy turn the tide saw the central bank taking the lead in providing stimulus during the pandemic. A significant portion of the 10.5% (GDP equivalent) “total stimulus package” was, in fact, made up of monetary measures.

Besides conventional measures, including a total of 115 basis points of policy interest rate cuts and 100 bps of cut to banks’ cash reserve requirement from March to May, the RBI also resorted to unconventional policy measures in its drive to support financial system liquidity. However, the [central bank’s unconventional easing measures](#) were far from outright quantitative easing or direct deficit financing.

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*The monetary policy guidance in October emphasised the need to see through temporary inflation pressures and also maintain the accommodative stance at least during the current financial year and into the next. - RBI Governor Shaktikanta Das*

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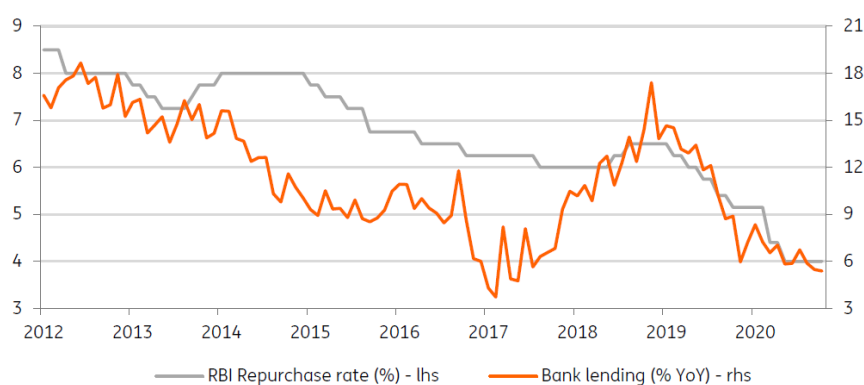
Rising inflation forced the RBI to pause the rate cut cycle at the August meeting, leaving the repurchase rate at 4.00% and reverse repo rate at 3.35%, there is no change to the accommodative policy stance, however, which the central bank has noted to remain “as long as it is necessary to revive growth and mitigate the impact of Covid-19 on the economy while ensuring that inflation remains within the target going forward”. Nor is there any let-up in the RBI’s liquidity boosting operations. The central bank announced more steps towards this in the [last policy meeting in October](#).

While the banking system is flooded with liquidity, high inflation has pushed real interest rates into

negative territory. India's real rates are the most negative in Asia but there are no buyers for cheap funds and bank lending growth continues to slow, which suggests, additional stimulus won't be of much use, as confidence needs to return first.

### [Exploring the depth of Asia's unconventional central bank easing](#)

## Aggressive easing failed to stimulate loan demand



Source: CEIC, ING

## Fiscal stimulus only looks big

In response to the crisis, the Indian government tried to match its macro-policy response with its Asian peers but the stimulus – more than 10% of GDP was more hype than reality. The real (on-budget) spending was meagre and concentrated on structural reforms of critical sectors including coal, mining, power distribution, atomic energy, aviation, and space. The reforms will be beneficial for the economy over the longer-term, but not instantly. And, like everywhere in the region, the investment in sustainability was largely missing in all this, with barely any emphasis on green initiatives or meeting any of the [near-term environmental goals](#).

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*Our deficit forecasts for the next fiscal year is 5.8%*

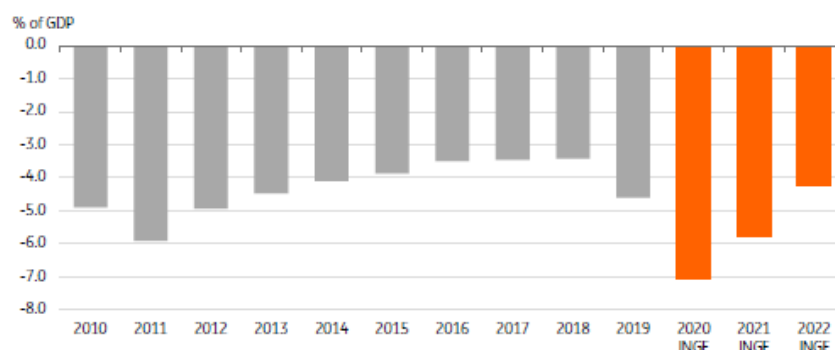
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The government's budget deficit is going to be through the roof in the current fiscal year, wiping out any consolidation over the last few years. The cumulative deficit in the first seven months of the current fiscal year was up 45% YoY and reached 120% of the original budget goal set for the entire year. This comes as revenue took a big hit with a 24% YoY plunge and spending were steady at the year-ago level. We are looking for the full-year deficit of 7.1% of GDP, up from 4.6% in the last year and double the official target of 3.5% for this year.

While it's premature to think about any fiscal consolidation in the next year, the insufficient stimulus is going to hold back recovery and keep the fiscal deficit as a proportion of GDP elevated. Our deficit forecasts for the next fiscal year is 5.8%.

Asia's lamentable green response to Covid-19

## Derailed public finances - fiscal deficit as a percentage of GDP



Source: CEIC, INGF

## Where is stimulus going?

**Total Stimulus 10.5% of GDP: On Budget 2.9%, Monetary 7.5%, Green 0.5%**

Stimulus measures	Rs bn	Stimulus measures	Rs bn
<b>Micro, small, and medium enterprises</b>	<b>5,946</b>	<b>Migrant workers, vendors, and farmers</b>	<b>3,100</b>
Collateral free loans	3,000	Food supply for migrant workers	35
Subordinate debt provision	200	National portable ration card	-
Equity infusion fund	600	Rental housing for migrant workers	-
EPF support for 3 months	25	Interest subvention of 2%	15
Cut in statutory EPF contribution	68	Credit facility for street vendors	50
Special liquidity scheme for investment in NBFCs	300	Housing subsidy for middle-income group	700
Partial credit guarantee for NBFCs	450	CAMPA funds for tribal employment	60
Liquidity injection for power distribution cos	900	Working capital facility for farmers	300
TDS reduction	500	Concessional credit to farmers	2,000
<b>Farming, marine, and dairy infrastructure</b>	<b>1,500</b>	<b>Structural reforms of 8 critical sectors</b>	<b>81</b>
Fund for farm gate infrastructure	1,000	Enhancing coal production	-
Micro food scheme	100	Enhancing private invest in mining	-
Marine and inland fishery	200	Indigenisation of defence production	-
Vaccination of livestock	133	Promoting PPP in aviation	-
Dairy infrastructure	150	Privatisation of power distribution cos	-
Herbal and medicinal plantation	40	Viability gap fund for social infrastructure	81
Bee keeping	5	Boosting PPP in in space sector	-
Operation greens	5	Atomic energy development with PPP	-
<b>Other government measures</b>	<b>2,328</b>	<b>Monetary stimulus - RBI measures</b>	<b>8,016</b>
Rural development scheme (MGNREGS)	400	TLTRO - two auctions of 500bn each	1,500
Enhancing online education	-	100bp CRR cut to 3%	1,370
Exemption of Covid-related debt from IBC	-	Increase MSF from 2% of SLR to 3%	1,370
Increase in borrowing limit for states	-	Financing window for NBFCs	500
Decriminalising companies act	-	Variable repo operation	1,760
Others previously announced (PMGKP)	1,928	Others	1,516

Source: Ministry of Finance, Reserve Bank of India, and newswires

## Political anxiety

Increased political uncertainty amidst a number of state elections next year may well be an overhang on markets. The National Democratic Alliance, the ruling coalition led by Prime Minister Narendra Modi's Bhartiya Janata Party, is currently governing two of five states as the country heads to the polls in April-May 2021.

The recent Legislative Assembly elections in the state of Bihar was a vote of confidence in the Modi administration. Similar outcomes in forthcoming state elections should be market-friendly, though it is difficult to predict the course of Indian politics during the ongoing economic discontent against the government's chaotic handling of the pandemic.

## Underperforming markets

The central bank's drive to keep market yields and government borrowing costs low has paid off.

'Operation Twist' (selling short-term bonds and buying long-term ones), targeted repo operations, special financing window for non-bank finance companies – all helped to mitigate the upward pressure on yields from a record government borrowing issuance. Helping this further was the government's decision to leave its borrowing plan for 2H20 unchanged at the original target of INR 4.34 trillion as against market expectations of about 20% increase over that. The total borrowing for the year is earmarked to be INR 12 trillion.

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*The central bank's drive to keep market yields and government borrowing costs low has paid off*

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However, the bond market appears to be in limbo in a sense that the RBI has been defying investor demands for higher yields to compensate for a supply glut as well as high inflation. The central bank rejected all bids in four consecutive 10-year government bond auctions since August. Clearly, the RBI has gained an upper hand as excess liquidity finds its way into some investment channels and government bonds still remain a safer bet in an uncertain economic environment. The benchmark 10-year yield has been firm in a narrow 5.8-6.0% trading range over the last three months. That said, we expect the latest inflation spike to reassert an upward bias on yields moving into 2021.

Meanwhile, weak growth outlook and worsening public finances have fuelled sovereign downgrade risk. Moody's and S&P have spared no time in placing India's Baa3/BBB- rating under negative watch in June. While the INR has been under pressure from all sides, it isn't entirely ignored by investors in the ongoing emerging market rally. Even so, the INR is still Asia's weakest currency this year with a 3.6% year-to-date depreciation and there are no strong reasons to expect it to move up the ranks over the next year.

As the worst year in the country's history comes towards an end, India's economic situation doesn't look very promising.

*Even though we forecast over 7% GDP growth next year, India's economic situation doesn't look very promising*

The continued Covid-19 spread, lack of additional macro-policy support and persistently weak economic confidence suggest it's going to remain behind the curve in Asia's post-Covid bounce back. Externally, geopolitics, the trade and tech war will be continuous headwinds to the recovery and escalating tensions on the border with China could yet be another dampener. And with several state elections lined up next year, the domestic political risk cannot be ruled out either.

That said, we forecast over 7% GDP growth next year. But that is likely to be a transitory bounce from the favourable base effect rather than underlying economic strength.

## Key economic indicators and ING forecasts

India (FY starting April)	FY18	FY19	FY20F	FY21F	FY22F
Real GDP (% YoY)	6.1	4.2	-10.8	7.5	5.6
CPI (% YoY)	3.4	4.8	6.8	5.5	4.9
Fiscal balance (% of GDP)	-3.4	-4.6	-7.1	-5.8	-4.2
Public debt (% of GDP)	69.6	72.3	83.0	78.9	75.5
Current account (% of GDP)	-2.1	-0.9	1.7	0.8	0.3
FX reserves (US\$ bn)	385	442	540	563	580
External debt (% of GDP)	20.0	19.5	23.0	22.0	21.0
RBI repo rate (% eop)	6.25	4.40	4.00	4.00	4.00
3M T-bill rate (% eop)	6.14	4.23	3.20	3.40	3.60
10Y govt. bond yield (% eop)	7.35	6.14	6.20	6.60	6.90
INR per USD (eop)	69.17	75.39	74.60	73.30	73.00

Source: CEIC, ING forecasts

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