

# In Case You Missed it: This is just the beginning

A US-China trade war edges closer, the Fed hikes again, China's central bank gets a new boss and a post-Brexit transition period finally seems in sight. Here's our thinking

## In this bundle



### China

#### China: losing patience on US trade protectionism

China has sent a strong message by announcing its own tariffs following the latest US\$60bn tariff plan from Washington. What are the implications?



### United States

#### One down, three more to come?

The Fed raises rates by 25bp and indicates more hikes ahead



### United Kingdom

#### Four questions following the latest Brexit breakthrough

After months of bumpy discussions, negotiators have reached an agreement on a post-Brexit transition period. But will it be long enough for businesses to...

By James Smith



### China

#### How will China's new central bank governor run the new central bank?

With more responsibilities to regulate the banking and insurance sectors, how will Yi Gang - the new central bank governor run the People's Bank of...



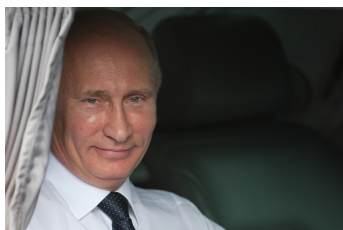
#### United States

### Why the US 10-year should settle in the 3% to 3.5% range

Has the US 10-year Treasury yield peaked? We're not convinced and think it's likely to breach 3%, possibly within the next few weeks

By Padhraic Garvey, CFA

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#### Russia

### Russia: Vladimir Putin 4.0

The elections were an easy win for President Putin, but the promised success of his very ambitious economic programme will certainly be more challenging

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### The structural decline in the Eurozone's growth potential

The euro crisis had a negative effect in some member states that lasts to this day, with potential economic output in a structural decline

By Peter Vanden Houte and Bert Colijn

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# China: losing patience on US trade protectionism

China has sent a strong message by announcing its own tariffs following the latest US\$60bn tariff plan from Washington. What are the implications?



Source: Shutterstock

The Ministry of Commerce of China has announced imports tariffs of 15% or 25% for a concrete list of items imported from the US.

Nuts and fruits, wine, modified ethanol, American ginseng and steel pipes will all face a 15% import tariff. Pork related items and scrapped aluminium will face a 25% import tariff. These items' export value in total was close to US\$3billion in 2017.

This reply to US trade tariffs sends a strong message to the US, even if the export value is relatively small.

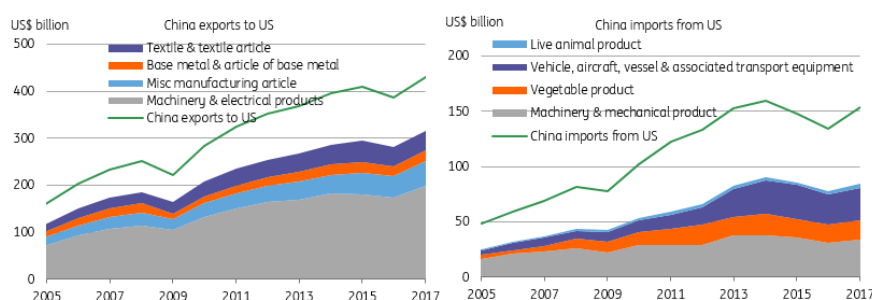
## Retaliation is on the cards

Compared to the US plans to put tariffs of US\$60billion of imports from China, the US\$3billion plan in China looks small, but it has big implications.

First, China indicates clearly that it can retaliate.

Second, the retaliation starts with tariffs on major export items namely: vegetable products, pork and scrap metal.

Third, China's embassy in the US has stated that China will fight these tariffs strongly, which implies that the list announced on 23 March may not be exhaustive and could be expanded if the US continues to impose tariffs on China's exports. This could include stopping US companies from operating in China.



Source: ING, CEIC, Bloomberg

## A trade war could ensue

Any further reaction by China will depend on what the US does now.

Let's assume the US targets the largest chunk of China exports to the US - machinery and electrical products. Then China could react similarly by imposing tariffs on the largest chunk of US exports to China (either machinery and mechanical products or transport equipment).

We believe that China will choose transport equipment, because if there were import tariffs on China's exports of machinery and electronic products to the US, then those imports from the US would also shrink (there is a complicated two-way supply chain in this sector). Taking this into account, the largest remaining import sector from the US is transport equipment.

Therefore a trade war is more likely to affect China's machinery and electronics sector and the US's transport equipment sector.

## Implications are complex

Would Chinese employment be hurt if US companies manufacturing in China decided to move their production lines to locations outside China? Yes. But this is not likely to happen overnight and may be more of a case of considering alternative locations for future Asian expansion.

Additionally, displaced workers could choose other jobs, likely in the service sector that is booming in China and has low skill requirements.

For transport equipment imports into China, there are always substitutes from Europe and elsewhere. So the overall impact on China may be predominantly through rising prices of these substitutes - this is likely to be considerably less than the US tariffs, however. In short, some increase in prices of transport equipment are likely.

## Usually there are alternatives

The analysis so far has been on from China-US trade and China-US-World trade, and from manufacturing of machinery and electronics to the service sector in China - there are substitutions for production location, trade partners and jobs.

If the US imposes restrictions on sectors that require a joint venture, it would also face the

consequences of investment decisions made by foreign companies.

There are so many alternatives in a globalized world when it comes to decision-making that we are very likely to have left out something critical in our analysis. And this is the point we would like to make - there are choices.

## **Even more complicated: Is this economics or politics?**

Eventually, we need to ask (or answer) the question, is all this protectionism an economic or a political issue? That would make a significant difference to the outcome. If it is the latter, it could get even more complicated.

And if it looks likely that it is the latter, then the US has helped Taiwan on tourism. China finds this as annoying as US hints that it does not agree on One-China policy.

All in all, trade protection actions imposed by the US may not be too damaging for China. We expect some loss of employment in manufacturing but this may be shifted to the service sector and result in higher prices of some imported goods. The more important point we would like to make is that trade protection actions will lead to changes in global production and trade, given today's globalised, complex supply chain.

## One down, three more to come?

The Fed raises rates by 25bp and indicates more hikes ahead



Source: Shutterstock

As expected, FOMC policymakers raised rates by 25bp to a target band of 1.5-1.75%. With dovish members Kashkari and Evans (who opposed the last hike in December) dropping to non-voting status in 2018, there were no dissenting votes.

The statement released alongside the rates decision suggests the committee's assessment of the economic outlook remains upbeat. There are few changes from the January statement, though reflecting the two strong jobs reports since their last meeting, the FOMC now notes that "job gains have been strong in recent months, and the unemployment rate has stayed low".

Growth forecasts were revised upwards again, to 2.7% in 2018 and 2.4% in 2029 (from 2.5% and 2.1% respectively), likely on account of stronger near-term momentum and incorporating the further fiscal boost from the additional spending package agreed by Congress in February.

The projection for inflation also strengthened slightly, to 2.1% in 2020 on both the headline and core inflation measures (from 2.0% previously). This is a small change but significant because it means the Fed is now projecting inflation a touch above target, strengthening the case for more rate hikes.

# 2.1%

## Fed projection for core inflation in 2020

Above target

Some FOMC members have also shifted their projections of future interest rates upwards, indicating they expect rates rise somewhat faster and further than previously anticipated. The median dot now in 2018 still indicates two further hikes this year, but the projection now indicates three hikes in 2019 (up from two) and two full hikes in 2020. The median expected long-run rate has shifted up from 2.8% to 2.9%.

The dispersion of the dots has also increased, with one committee member now indicating a preference for rates near 4% in 2019 and 5% in 2020. That means we now have a hawkish counterpart to Kashkari's persistently dovish stance. And given at least two of the lower dots belong to non-voters (Kashkari and Evans), the committee is likely to tilt a bit more towards the hawkish camp in 2018 than indicated by the dots alone.

To us, all this indicates that more rate hikes are likely on the way. The US economy continues to grow strongly and fiscal stimulus will boost the expansion further. With inflation set to pick up towards the summer, we think three more rate increases in 2018 is the base case. Should momentum remain strong into 2019, there is a chance that we could see another three hikes in 2019.

That said, we see two key risks that could prompt the FOMC to reassess the outlook, which Chairman Powell is likely to be asked about in the upcoming press conference. The first is renewed market turmoil: while the Fed appears fairly sanguine about the VIX episode in early February, a more severe and sustained bout of volatility that led to a tightening of financial conditions could give the Fed reason to pause. The other risk is an escalation of tensions around the US' aggressive tariff policy into a full-blown trade war, which could cause the global economy to slow down pre-maturely.



# Four questions following the latest Brexit breakthrough

After months of bumpy discussions, negotiators have reached an agreement on a post-Brexit transition period. But will it be long enough for businesses to...



Source: Shutterstock

## 1 What has been agreed?

Following lengthy negotiations over the weekend, Michel Barnier and David Davis announced on Monday that both sides have finally reached an agreement on a post-Brexit transition period. The deal, which will be formally agreed at the EU leaders summit later this week, will create a period of time from the end of March 2019 (when the UK formally leaves the EU) until December 2020 where the UK's relationship with Europe will remain virtually unchanged. This will allow for the completion of talks on the final Brexit deal, as well as giving businesses time to adjust.

During this time, both sides have agreed that citizens “who arrive in the UK during the transition period will have the same rights as those arriving before”. And in what appears to be a win for the government, the UK will be able to negotiate trade deals with non-EU countries during the transition (to come into effect afterwards). UK ministers have often cited the ability to sign third-country trade deals as a key advantage of Brexit.

But in what appears to be a fairly big concession on the UK's part, both sides have agreed the need



for a 'legal backstop' option should the final Brexit deal fail to address concerns over the Irish border. This would effectively keep Northern Ireland within a customs union, which has previously raised concerns in the Democratic Unionist Party (DUP) over barriers to trade within the UK's internal market. Theresa May said herself only a couple of weeks ago that "no UK prime minister could ever agree" to such a backstop.

It's worth remembering that technically none of this is legally binding until the full withdrawal agreement is ratified later in the article 50 process. But the strong commitment this deal brings will remove a fairly big layer of uncertainty for firms, and should be enough to discourage firms from enacting contingency plans for a no deal 'cliff edge'. What's less clear, however, is quite how much investment will be unlocked as a result of the agreement, particularly as there are still several question marks hanging over the ultimate Brexit deal.

## 2 Will a 21-month transition be long enough?

Perhaps not. According to EU negotiators, the goal is to agree on a high-level political declaration on the future relationship before the UK formally leaves in March next year, leaving the finer details to be thrashed out during the transition period. As Michel Barnier said himself at the press conference, that's a "short period of time to do so". Remember the EU-Canada deal took seven years to agree and sign-off.

But even if a deal can be swiftly negotiated, that still begs the question of whether there will be enough time for businesses and government departments to adjust. For businesses, many of whom rely on supply chains that see goods move multiple times between the UK and EU before hitting the single market, it will take time to re-orchestrate operations.

For the government, logistics will be an important factor. Is there enough time to train new border staff? David Davis has previously said between 3000 and 5000 new staff will be needed. It will also take time to develop new IT processes, as well as physical customs infrastructure.

## 3 Could the transition period be extended?

Possibly. Whilst there are economic and practical arguments that suggest a longer transition may be necessary, the current timeframe largely reflects political factors. From the EU's perspective, the decision to end the transition in December 2020 coincides with the end of the current budget period.

A longer transition would almost certainly require the UK to contribute to the EU budget after 2020, something that would be politically challenging for the UK government to accept at this stage. It's also worth bearing in mind that the next UK election is scheduled for 2022, and a longer transition could leave the government vulnerable to suggestions it hasn't brought the UK entirely out of the EU.

From Monday's agreement however, it's not immediately clear whether the EU would ultimately be open to an extended transition period. European Officials initially floated the possibility of a transition lasting as long as three years, earlier on in the negotiations. But in the latest deal, there is reportedly no legal wording that would leave the door open to a possible extension – something which, [according to the FT](#), the UK had been pushing for over recent days.

That said, if negotiations were to take longer than expected, it is unlikely that governments on

either side of the debate would be too keen on walking away and triggering a possible "cliff edge" Brexit in 2020, given the threat to the economy and jobs (and having worked hard to avoid such an outcome this time around).

## The 2018 Brexit timetable



Source: European Commission, ING

## 4 What comes next?

Now that a transition has been agreed, the immediate focus will turn to finding a practical solution to avoiding a hard border with Ireland. [As we noted last week](#), neither of the potential options put forward by Theresa May earlier this month (new technology or a 'customs partnership') appear to have alleviated concerns in Brussels and Dublin.

Away from the negotiations, markets will also be paying close attention to the Bank of England when it meets this Thursday. In principle, the agreement on the transition period bolsters the Bank's assumption that the adjustment to the post-Brexit world will be "smooth". That, combined with the stronger momentum we've seen in wage growth over recent months, makes it all the more likely that policymakers will hike rates in May. We may see the Bank make subtle hints at this in its statement this week, perhaps by echoing some of its language from December that the latest progress is "likely to support household and corporate confidence".

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# How will China's new central bank governor run the new central bank?

With more responsibilities to regulate the banking and insurance sectors, how will Yi Gang - the new central bank governor run the People's Bank of...



Source: Shutterstock

Yi Gang, the newly appointed governor of the People Bank of China has been part of the bank for a considerably long time and is likely to continue the ongoing reforms laid out by governor Zhou Xiaochuan which should help smooth the takeover and minimise any uncertainties on interest and exchange rate markets.

Currently, there are three policies governed by the PBoC, namely, the monetary and exchange rate policies along with capital controls and the first two are under reforms.

## Interest rate liberalisation

In the recent months, the central bank increased five basis points on the PBoC 7D reverse repo (2.5%), the medium lending facility (1Y 3.25%), the standby lending facilities (1M 3.35%) when the Federal Reserve raised interest rates last year. And since 2015, the PBoC hasn't changed its benchmark deposit and lending rates which sent a strong signal that not only is it liberalising deposit and lending rates, which should invite competition among banks but also changing policy rate tools to short-term interest rates.

We believe Mr Yi is likely to continue this interest rate liberalisation, and will finally name a single short-term interest rate as the policy interest rate. In the meantime, we believe the 7D reverse repo is the key policy interest rate to watch.

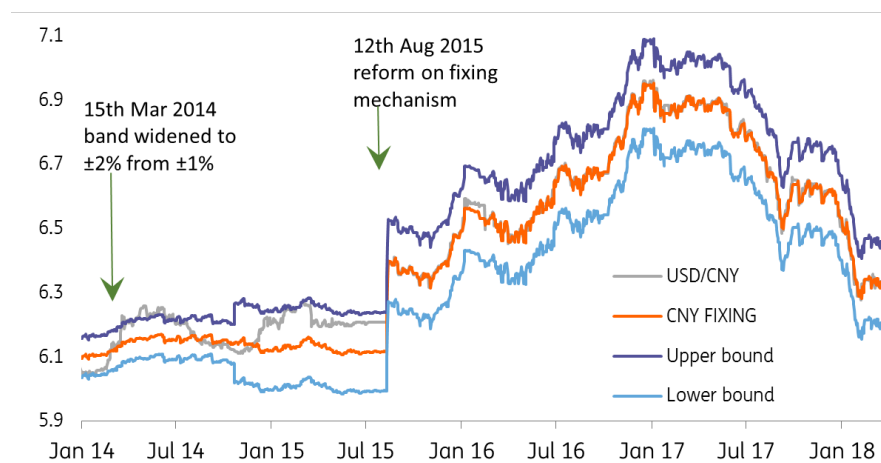
## Exchange rate liberalisation

Another ongoing reform is the liberalisation of the exchange rate mechanism. The recent policy of resetting the counter-cyclical factor in the yuan fixing formula is a step towards exchange rate liberalisation, but this is still a very long road ahead for Mr Yi.

The central bank has claimed that the market is taking charge of the intraday momentum of USD/CNY, which should increase the volatility of the exchange rate. If this is true, it is still to be tested by major market movements. Since the depreciation of the yuan on 11th August 2015, the exchange rate liberalisation has moved backwards. The spot rate has stuck with the fixing, which means it does not touch the daily trading bands.

Yi Gang faces a tough job to allow the spot rate to move away from the fixing after the 11th August 2015 incident. If the spot doesn't show volatility, then there is no point to further widen the daily trading band.

## USD/CNY has yet to experience genuine volatilities



Source: ING, Bloomberg

## Capital controls

The PBoC, it is not independent of the government and this is crucial to understanding how the central bank tune the tightness when it implements capital controls.

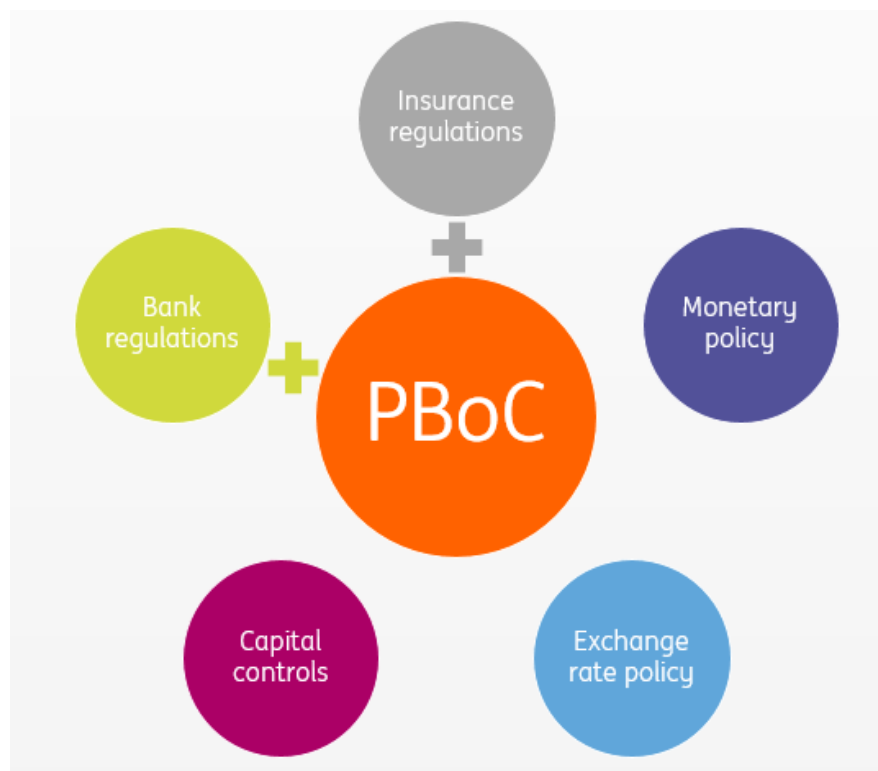
When Xi Jinping would have had a very long tenure, and Wang Qishan becomes the vice president of China, the anti-corruption campaign might become at least as fierce as in 2017. But for now, it's possible we see a fresh round of capital flight from the new political environment, which means we might see a tighter implementation of capital controls. The expected appreciation of the yuan (forecast USDCNY at 6.1 by the end of 2018) should attract inflows, which should counter-balance the outflows.

Still, it is Mr Yi's job to skillfully manage the value of capital controls so that foreign companies don't complain they couldn't make outward remittances when required and given that Mr Yi was

previously the head of SAFE, the body to control capital flows, he is well placed to do so.

## Impact on financial markets now that the central bank is a financial market regulator

The central bank now has to take care of banking and insurance regulations - two new functions that will prevent Mr Yi from simply following the footsteps of Zhou Xiaochuan.



Source: ING

When financial products offered by banks and insurance companies could create credit risk, liquidity risk and market risk in the interbank it is reasonable to assume that the central bank to have better say on the regulations of banks and insurance companies.

The apparent impact is that there would be more controls on shadow banking, e.g. regulating issuance and underlying assets of wealth management products and insurance products. This would extend to capital and liquidity requirements of banks and insurance companies. We can think of a few results. 1) With decreasing number of wealth management products in the market banks may start to raise deposit rates. 2) PBoC would continue to tighten liquidity in the interbank to drive out poor credits as underlyings of wealth management products, which would directly push up short-term interest rates. 3) For banks, fewer product sales could mean lower fee income, and banks would turn to look for increase interest income to stabilise bottom line, but deposit costs are on the rise. The central bank might need to react to the dynamic changes because that could incur higher credit risks.

This is positive for the long-term growth of China's financial system as we see this as part of the financial deleveraging reform. But these functions are not only new to the central bank but also brand new to Yi Gang. We expect the central bank to be on the cautious side, i.e. to minimise the risks we mentioned when it comes to regulating banks and insurance companies. However, over-

regulating the two sectors would create slow growth and innovation in financial products and the financial market.

We stick to our forecast that the PBoC is likely to follow the Fed's footsteps to hike four times but each at five basis points to keep the interest rate spread between China and US stable. We also believe that the yuan will continue to appreciate to attract inflows counterbalancing outflows. We hold our USD/CNY forecast at 6.10 by the end of 2018.

We believe Mr Yi will continue the reforms laid out by Zhou. But the new functions mean he has new challenges, and we think he will start with caution to minimise the risks.



# Why the US 10-year should settle in the 3% to 3.5% range

Has the US 10-year Treasury yield peaked? We're not convinced and think it's likely to breach 3%, possibly within the next few weeks



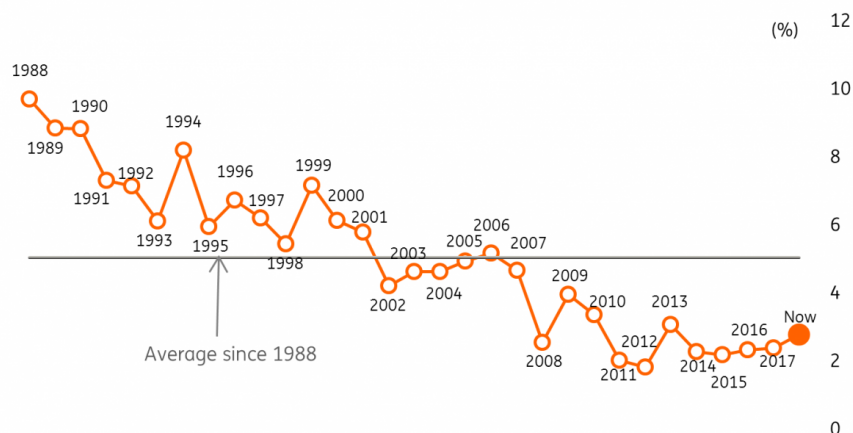
Source: Shutterstock

Getting a good steer on the US 10yr Treasury yield is important, for a few reasons.

It is the global benchmark market rate; movements in it cause reverberations across rates and bond markets extending from core rates to corporates and emerging markets. Crucially, it also provides a long-term nose for where the Fed funds rate may eventually converge towards (compensated by term premium). So, it matters.

The big question is, has the 10yr rate peaked? We're not convinced it has. Currently, 2.98%, we expect it to cross 3% perhaps within the next few weeks, with fundamentals, positioning and technicals as the key drivers. We employ our model for interest rates, to get an unbiased handle on a fair valuation of market rates.

## The US 10-year rates since 1988 – still well below its historical average



Source: Bloomberg, ING estimates

### What our model says?

We start by deciding where the neutral rate should be. Not an easy task, as it changes over time, and the average 10yr rate in the past 30 years at 4.85% is significantly different from current levels (some 200bp below average). We address this through the simple assumption that the US economy at the very least is a zero real rate economy, as Janet Yellen has attested. If that is the case, then the neutral rate must be flat to core inflation, and we expect core inflation to settle in the 2% area or slightly above.

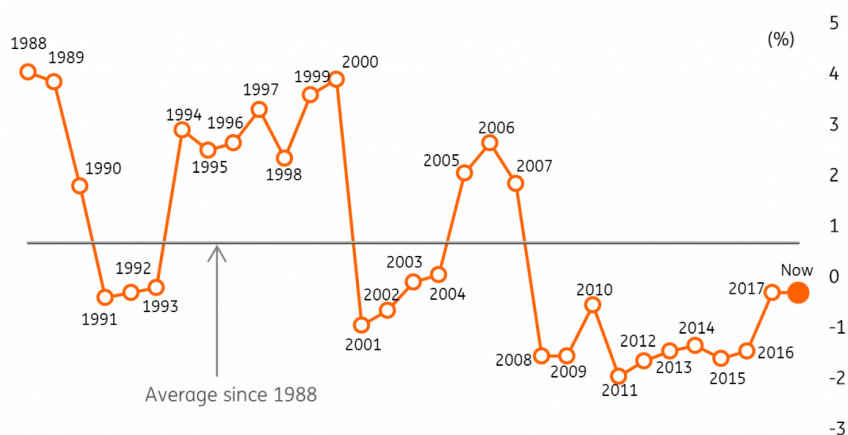
The next thing to do is assess how far we should be deviating from this rate. To do this we look at how a selection of macro variables deviate from normality, and we translate that into a deviation from normality for market rates both based on historical distributions when normally distributed. Long story short, we find that a weighted average of current macro data points to a basis point deviation of +130bp, i.e. market rates should be some 130bp above normal based off contemporaneous inputs. So, with the neutral rate at 2%, we add 130bp to this to give 3.3%. That is then a target fair value for market rates; code for the US 10yr rate.

For the past six to nine months the model has been consistently pointing to an outcome in the range of 2.9% to 3.4% with most of the outcomes in the 3.2% to 3.4% area. At the extremes of this distribution, there is support for the 10yr holding at sub-3%, but the bulk of the distribution points squarely to a break above 3%.

### The caveats to consider

This model is based on current macro data and is agnostic to how we got to where we are and is also ignorant of where we are going. It is just based on where we are right now and doesn't know for example that Donald Trump is the US president. So there is a layer of judgement that is required.

## US Fed funds rate less core inflation – real rate still low and negative



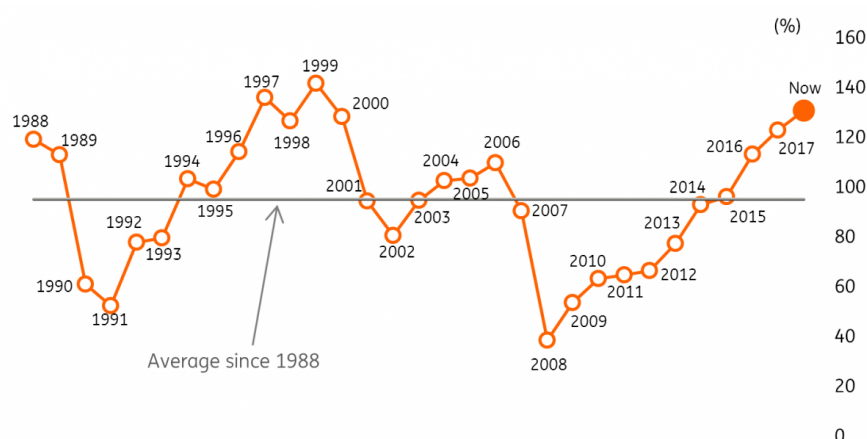
Source: Bloomberg, ING estimates

Also, there is dynamism to take into account. For example, if core inflation were to drift up to 2.5%, that adds 50bp to the central outcome, as it immediately pushes up the neutral rate. The same goes for other macro variable moves. And we've side-stepped the debate as to whether the US is a positive real rate economy or not. If it is a positive real rate economy, that also places upward pressure on the neutral rate. Janet Yellen, for example, has asserted that the US economy will be a 1% real rate economy in the medium term – that immediately brings 3% into play as a future neutral rate.

There is also an important technical issue to consider – the unwinding of quantitative easing (QE). Throughout the third and fourth quarter this year we will move to a point where for the first time in five to seven years central banks will no longer be net buyers of government bonds as the QE is reversed, driven by the (gradual) unwinding of the Fed's balance sheet. The Fed started to effectively de-print money late last year and will continue to do so through the coming five years at least; a persistent removal of support that had been in place through the years of aggressive central banks bond buying. Remember, even if we had a few weak macro datasets the quantitative tapering (QT) process continues relentlessly – an ongoing factor that places upward pressure on market rates.

But in fact, US fundamentals remain very robust. Consumer confidence is literally going off the charts, the last labour report had a jobs growth of 200k in excess of replacement, and survey evidence points to wage inflation ultimately heading towards 3.5%. While holes can and have been picked in aspects of the macro story, the fact remains that there is solidity in play in 2018 at least and well into 2019. We'd assert that the recession risk in the coming 18 months is very low but beyond that things, as always, become a bit fuzzy.

## US consumer confidence – as high as it has ever been



Source: Bloomberg, ING estimates

## This brings us nicely to key medium term considerations

One argument for not breaking above 3% is the likelihood that the US economy could slow, let's say starting in 2020 as prior rises in the Fed funds rate begin to bite. This could occur against a backdrop where the fiscal deficit could be threatening a 5% handle as tax reform hits government revenues. And this added to a growing shortage of savings in the private sector could coincide with the deficit on the balance of payments heading towards a similar big figure. Therein lies the genesis of an imbalance that could well pre-empt a growth recession, likely necessitating eventual mild Fed cuts say from 2021.

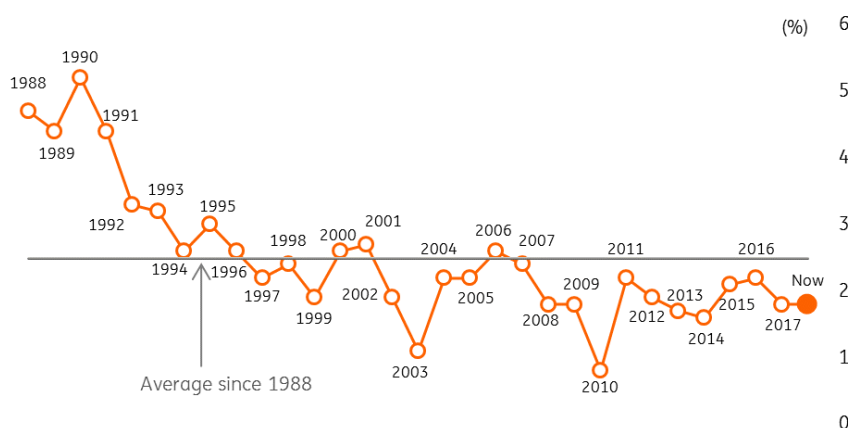
Related to the long term, another item to consider is the long bond (30yr) yield. In days gone by this was the benchmark of the US yield curve, and still garners respect as a back-end anchor for the US curve. The point here is the long bond yield currently sits at 3.15%. By virtue of its tenor, the long bond yield has an ultra-long nose and is suggesting that US rates should not be getting much above 3%. We'd be having a very clear conversation on the logic of the 10yr breaking above 3% if the long bond yield was at 4% for example. Not as straight-forward where it currently is; accepted.

The counter-argument, however, is that fundamentals are just too bubbly to be ignored, plus the wage inflation/core inflation upside trajectory looks increasingly persuasive. That's where our judgment lands. We are not convinced that the bond market sell-off is over. The long bond yield conundrum is more likely to be squared with the 10/30yr segment inverting at some point later in 2018. An inversion on the 2/10yr segment is less likely in 2018, reflecting a minimal imminent recession risk.

Market positioning is also an important input when it comes to timing and extent of the move. Around the turn of the year the flows data that we track show investors selling long end funds and buying short end funds, in other words they were shortening the duration and positioning for higher rates. That has calmed since, which in part explains why a subsequent break higher in the 10yr yield has not occurred, yet.

We expect this to change, likely to be bullied there by persistently firm fundamentals in the coming quarters. Chicken and egg kind of a situation, but all converging on a likely break above 3%.

## US core inflation – still well below historical average at 2.5%



Source: Bloomberg, ING estimates

### But how high and for how long beyond that?

There is no firm evidence that the 10yr yield should break higher than 3.5%. We find that a material rise in core inflation to 2.5% would be required to make this happen. So not improbable, but not our base view. Hence the notion that the 10yr rate should settle somewhere between 3% to 3.5%. Our point estimate is 3.4%, which also helps project the prognosis that any break above 3% would be sustained for at least a few quarters.

To get above 3% in the first place, there needs to be a market discount where imminent inflation risks trump medium-term growth recession risks. And by the way, we see the Fed funds rate heading towards a terminal value towards 3% on similar reasoning. The end game, in fact, sees the curve flattening out completely with the three handle heavily in play.

Having marked these, subsequent rates moves would indeed then be lower.

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## Russia: Vladimir Putin 4.0

The elections were an easy win for President Putin, but the promised success of his very ambitious economic programme will certainly be more challenging



Source: Shutterstock

### Vladimir Putin wins again!

Nobody expected surprises - but after the preliminary count of votes, the 76.66% result for Mr Putin looks very strong compared to his previous 63.6% result in 2012.

Other candidates stand well behind with Pavel Grudinin (11.80%) taking the second place followed by Vladimir Zhirinovskiy (5.66%) in third. All the others: Ksenia Sobchak (1.67%), Grigory Yavlinsky (1.04%), Boris Titov (0.76%), Maxim Suraykin (0.68%) and Sergei Baburin (0.65%) received 1% or less.

The voter turnout looks cheerful for Kremlin advisers as 67.49% vs 65.34% recorded during the previous presidential elections in 2012.

### Solid outcome despite the reported violations

It's hard to deny the fact that the majority of Russians supported Mr Putin in this "one-man race". Even in Moscow and Saint-Petersburg where people traditionally are more critical of the ruling camp, Vladimir Putin scored better than he did in 2012.



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*We think the economic and financial bloc of the government won't see radical changes, thus providing continuity. But the government needs to work much harder to achieve Mr Putin's socio-economic targets*

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Various violations were reported and documented but the total number looks lower than the previous campaigns even if one checks the data from the independent election-monitoring organisation "Golos". This seems to be down to the fact that the highest possible turnout was the clear target for authorities under lower risks of unintended results.

The bottom line is that these elections could be viewed as a referendum for Mr Putin as they effectively provide him with a mandate for implementation of his preferred external and internal policies mix. And escalating tensions with the West just before the elections seem to have increased his support, once again showing that rising external pressure doesn't shake the political environment and instead helps to sell the "mobilisation story".

## **The real intrigue is how the cabinet will look**

Even though the "external threat" story nowadays is a common political tool around the world, we believe the local economic agenda will be key for Mr Putin to focus on during the next six years. In this respect, we highlight his comments during the press conference yesterday that he will announce new PM candidate and the government only after his inauguration (7 May).

His unclear answer about chances of Mr Medvedev to secure his post and today's comments from the Chair of Federation Council Valentina Matvienko that the gov't needs visible changes leaves room for some reshuffling.

We think that the economic and financial bloc of the government won't see radical changes, thus providing continuity. But the government needs to work much harder to achieve his socio-economic targets.

Otherwise, with no economic progress, risks to domestic political stability may increase thus risking a further shift to "mobilisation" and "isolation" options.

Report | 20 March 2018

# The structural decline in the Eurozone's growth potential

The euro crisis had a negative effect in some member states that lasts to this day, with potential economic output in a structural decline



Source: Shutterstock

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