

## In case you missed it: Trade truce withering away

Will the trade truce between the US and China give way to renewed conflict, peace or drawn out simmering tension? February could be the turning point. And with a dovish Bank of England slashing growth forecasts amidst the uncertainty, next week will be another week, another vote in Brexit Britain

### In this bundle



#### February Economic Update: Stick or twist?

A substantial softening in the Federal Reserve's rhetoric on monetary policy, coupled with encouraging signals from the US-China trade talks have...



#### United Kingdom

##### Bank of England slashes forecasts amid Brexit uncertainty

There's plenty of short-term negativity in the Bank of England's latest predictions, but there is still the subtlest of hints that...

By James Smith



#### US State of the Union: Building walls, not bridges

The President's State of the Union address spoke about bi-partisanship, but the government shutdown and a lack of policy thrust highlight the...

By James Knightley



## Sweden

### Riksbank preview: February blues

We expect little change from the Riksbank next week, but the outlook has clearly taken a turn for the worse and a further dovish shift in the policy...



## Canada

### Canada: What wage growth concerns?

When it comes to the story of sluggish wage growth, the Groundhog Day we've been seeing since June last year has finally changed its tune. January saw...

By James Knightley



## India

### India: RBI's surprise rate cut appears premature

The Reserve Bank of India (RBI) has ignored the inflationary consequences of the fiscal splurge and eased policy in support of the government's...



## Italy

### Italy: Falling deeper

Poor December industrial production data adds to the risk of another GDP contraction in 1Q19, and pushes our average GDP growth forecast for 2019 down to...

By Paolo Pizzoli



## Corporate Sector Coverage

### Construction goes digital

Construction companies are going digital, helping to boost productivity in the sector after years of stagnation. At the same time, however, investment in...

By Maurice van Sante

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## February Economic Update: Stick or twist?

A substantial softening in the Federal Reserve's rhetoric on monetary policy, coupled with encouraging signals from the US-China trade talks have boosted market risk appetite, but we are approaching key dates that will be critical for the global economic outlook. Read more in our latest economic update



Source: Shutterstock

A dramatic softening in the Federal Reserve's rhetoric on monetary policy, coupled with encouraging signals from the US-China trade talks have boosted market risk appetite, but we are approaching key dates that will be critical for the global economic outlook. Will President Trump stick with what he has won already or will he gamble for a bigger victory to take to the electorate for the 2020 election? The odds of the latter are rising. If we do see an escalation of trade tensions, the global growth story will deteriorate, having broad-based implications for financial markets and currencies.

The US economy remains in good health with the government shutdown having ended,

employment rising strongly, pay picking up and the Federal Reserve signalling that they are in no hurry to tighten monetary policy further. This Goldilocks story has boosted both US equities and bond markets. Assuming a benign global trade story, the prospects of a Fed rate hike remain strong.

Even though this is our official base case for now, we are increasingly considering a more negative trade scenario. If President Trump chooses to move more aggressively he could win additional concessions from both China and the EU but this is likely to come at the cost of weaker near-term growth. If this scenario were to come true, it is possible that US interest rates have already peaked for the year.

The Eurozone continues to grow, albeit at a more subdued pace. A reversal of some one-off effects could bring slightly higher growth in the second quarter, but risks to the downside remain. US tariffs on European cars could yet be another brake on growth, in addition to the Brexit uncertainty. We don't see inflation picking up much, so there's little need for monetary tightening. On the contrary, we believe the ECB is likely to decide on new longer-term liquidity operations to avoid a tightening of credit conditions.

The Brexit impasse in the UK shows no signs of breaking. The EU is refusing to budge on the Irish backstop, while Prime Minister May is still reluctant to push for a cross-party solution. One way or another, an extension to the Article 50 negotiating period looks increasingly inevitable, which would prolong uncertainty for businesses.

The Chinese economy is weakening on several fronts and not just due to the US-China trade war. In response, the government is looking for ways to boost consumption. Tax cuts may not be enough, to avoid a softening in the labour market. Even worse, the People's Bank of China has continued to let USD/CNY follow the dollar index, and a stronger yuan could end up offsetting some of the stimulus.

We have identified a change in rates market psychology; it shows that rates are peering down, but we'd prefer to bet against this as a tactical view. Structurally there will indeed be rate cuts at some point down the line. But to accelerate towards this, a deeper deterioration would be required. It's worth remembering the current risk-on mood is implicitly pushing against this too.

The Fed pause and the US: China trade truce has improved the external environment and allowed under-valued currencies to recover. As long as the trade truce holds, we expect this positive environment to continue and the dollar to stay gently offered. However, a serious risk event this month is the threat of US tariffs on auto imports. If they materialise, EUR/USD would retest the 1.12 lows.

# ING global forecasts

	2017					2018F					2019F					2020F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
<b>United States</b>																				
GDP (% QoQ, ann)	1.8	3.0	2.8	2.3	2.2	2.2	4.2	3.4	2.6	2.9	1.6	2.0	2.0	2.0	2.3	1.7	1.7	1.7	1.9	1.8
CPI headline (% YoY)	2.6	1.9	2.0	2.1	2.1	2.3	2.6	2.6	2.2	2.4	1.6	1.9	1.9	2.1	1.9	2.3	2.2	2.1	2.1	2.2
Federal funds (% eop) <sup>1</sup>	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3-month interest rate (% eop)	1.15	1.30	1.35	1.55	1.55	2.30	2.35	2.45	2.65	2.65	2.75	2.90	2.90	2.90	2.90	2.90	2.90	2.90	2.90	2.90
10-year interest rate (% eop)	2.40	2.30	2.30	2.40	2.40	3.00	3.00	3.00	2.80	2.80	2.80	3.00	2.90	2.80	2.80	2.70	2.70	2.60	2.60	2.60
Fiscal balance (% of GDP)					-3.5					-4.0					-4.7					-5.0
Fiscal thrust (% of GDP)					0.0					1.2					0.5					0.8
Debt held by public (% of GDP)					76.1					77.4					80.2					83.3
<b>Eurozone</b>																				
GDP (% QoQ, ann)	2.7	2.8	2.7	2.7	2.5	1.6	1.8	0.7	0.7	1.9	1.1	1.6	1.4	1.4	1.2	1.1	1.2	1.0	0.9	1.2
CPI headline (% YoY)	1.5	1.3	1.5	1.4	1.4	1.3	1.7	2.0	2.0	1.8	1.4	1.2	1.2	1.5	1.3	1.6	1.6	1.7	1.7	1.7
Refi minimum bid rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
3-month interest rate (% eop)	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	-0.32	-0.30	-0.30	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
10-year interest rate (% eop)	0.45	0.40	0.45	0.42	0.42	0.50	0.30	0.40	0.24	0.24	0.20	0.30	0.30	0.40	0.40	0.40	0.40	0.40	0.40	0.40
Fiscal balance (% of GDP)					-0.9					-0.6					-0.9					-0.8
Fiscal thrust (% of GDP)					0.2					0.0					0.1					-0.2
Gross public debt/GDP (%)					89.2					87.6					85.9					84.9
<b>Japan</b>																				
GDP (% QoQ, ann)	1.9	2.3	1.6	1.3	1.9	-1.3	2.8	-2.5	1.3	0.7	2.6	-0.6	5.8	-5.8	1.0	2.9	1.6	1.1	1.6	0.8
CPI headline (% YoY)	0.2	0.4	0.6	0.6	0.5	1.3	0.6	1.1	0.9	1.0	0.4	0.6	1.0	1.9	1.0	2.4	2.2	2.1	1.0	1.9
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.0
3-month interest rate (% eop)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.05	-0.05	0.05	0.05	0.00	0.00	0.00	0.00	0.10	0.10	0.10	0.10
10-year interest rate (% eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Fiscal balance (% of GDP)					-4.8					-4.1					-3.6					-3.0
Gross public debt/GDP (%)					221					223					224					226
<b>China</b>																				
GDP (% YoY)	6.9	6.9	6.8	6.8	6.9	6.8	6.7	6.5	6.3	6.6	6.2	6.2	6.3	6.3	6.3	6.3	6.2	6.2	6.2	6.2
CPI headline (% YoY)	1.4	1.4	1.6	1.8	1.6	2.2	1.8	2.3	2.5	2.2	2.5	2.5	2.6	2.6	2.6	2.6	2.6	2.5	2.4	2.5
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.45	2.50	2.50	2.55	2.55	2.55	2.55	2.55	2.50	2.50	2.45	2.45	2.45	2.40	2.40	2.35	2.35	2.35
10-year T-bond yield (% eop)	3.29	3.57	3.61	3.90	3.90	3.75	3.48	3.63	3.30	3.30	3.25	3.20	3.15	3.10	3.10	3.10	3.05	3.05	3.00	3.00
Fiscal balance (% of GDP)					-3.7					-4.5					-4.5					-4.0
Public debt, inc local govt (% GDP)					50.0					88.0					102					103
<b>UK</b>																				
GDP (% QoQ, ann)	1.3	1.0	1.9	1.6	1.5	0.3	1.7	2.5	0.6	1.4	1.3	1.5	2.0	1.6	1.5	1.5	1.7	1.2	1.1	1.6
CPI headline (% YoY)	2.1	2.7	2.8	3.0	2.7	2.7	2.4	2.5	2.3	2.5	2.1	2.0	1.8	1.8	1.9	2.0	1.9	1.8	1.7	1.8
BoE official bank rate (% eop)	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.50	1.50	1.50
BoE Quantitative Easing (Ebn)	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445	445
3-month interest rate (% eop)	0.35	0.35	0.35	0.50	0.50	0.60	0.80	0.80	0.80	0.80	0.85	0.85	1.05	1.05	1.05	1.30	1.35	1.60	1.65	1.65
10-year interest rate (% eop)	1.15	1.10	1.35	1.20	1.20	1.45	1.50	1.55	1.30	1.30	1.50	1.70	1.85	1.85	1.85	1.90	2.00	2.10	2.20	2.20
Fiscal balance (% of GDP)					-2.5					-1.4					-1.5					-1.5
Fiscal thrust (% of GDP)					-0.5					-0.4					-0.4					-0.3
Gross public debt/GDP (%)					87.0					84.0					83.0					81.5
<b>EUR/USD (eop)</b>																				
USD/JPY (eop)	1.08	1.12	1.20	1.20	1.20	1.20	1.17	1.15	1.12	1.12	1.12	1.12	1.15	1.20	1.20	1.22	1.25	1.28	1.30	1.30
USD/CNY (eop)	6.89	6.78	6.65	6.51	6.51	6.28	6.67	6.87	6.88	6.88	6.74	6.85	6.85	6.75	6.75	6.70	6.60	6.70	6.70	7.10
EUR/GBP (eop)	0.87	0.88	0.94	0.89	0.89	0.88	0.88	0.89	0.90	0.90	0.87	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85
<b>Brent Crude (US\$/bbl, avg)</b>																				
	55	51	52	61	55	67	75	76	69	72	65	68	69	73	69	70	74	76	74	74

<sup>1</sup>Lower level of 25bp range; 3-month interest rate forecast based on interbank rates

Source: ING

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# Bank of England slashes forecasts amid Brexit uncertainty

There's plenty of short-term negativity in the Bank of England's latest predictions, but there is still the subtlest of hints that they'd still like to tighten policy further if they can. That says to us that a 2019 rate hike shouldn't be ruled out just yet, although as ever it all depends on Brexit



Source: Shutterstock

## A big cut to 2019 growth forecasts

With just 50 days left until Brexit, it shouldn't come as much of a surprise that the Bank of England has taken a more dovish stance amid all the uncertainty. Policymakers unanimously opted to keep rates unchanged, and the statement is littered with references to intensified uncertainty.

That said, the extent of the downgrade to 2019 growth – from 1.7% to 1.2% – is much sharper than we had expected. The Bank now looks for just 0.2% in both the first and second quarter of 2019 and only a marginal improvement in the third.

This partly reflects the weaker global backdrop, but we suspect it may also reflect the growing risk that the Brexit deadline could need to be extended, prolonging the uncertainty well beyond March. We agree that there is a real risk that business investment stays subdued for some time, as firms remain awake to the 'no deal' risk.

## A hike still seems some way off, but it's too early to rule it out this year

The upshot is that the Bank is highly unlikely to tighten policy again through the first half of this year, and indeed the chances of a rate hike at all in 2019 have receded – although we think it's too early to write one off completely.

Despite all the caution in the February report, we still get the sense that the Bank has a preference to tighten policy at some point if it can. Wage growth has been particularly strong recently and the Bank continues to see this rising at a rate close to 4% in 2021. This has been central to the Bank's previous rationale for hiking rates, and policymakers gave the subtlest of hints again that it thinks rates may eventually need to rise further than markets expect.

## A lot depends on Brexit

Of course, all of that relies heavily on Brexit. Most paths now lead to an extension of the article 50 negotiating period, but if (and it's still a big if) the government can secure a cross-party consensus for a particular deal – for instance one that commits to a permanent customs union – then this may well be followed up with a Bank of England rate hike relatively swiftly.

A lot depends on the global outlook too, and some are questioning whether the Bank of England would still opt to hike rates at a time where the Fed is easing off and the ECB is moving only very gradually. However, it's important to remember that the Bank of England is much further away from a neutral stance than the Fed. So with the economy running close to full capacity, policymakers may still conclude that some catch up is required.

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Article | 5 February 2019

## US State of the Union: Building walls, not bridges

The President's State of the Union address spoke about bi-partisanship, but the government shutdown and a lack of policy thrust highlight the problems he faces with a divided government



Source: Shutterstock

### A hint of an olive branch...

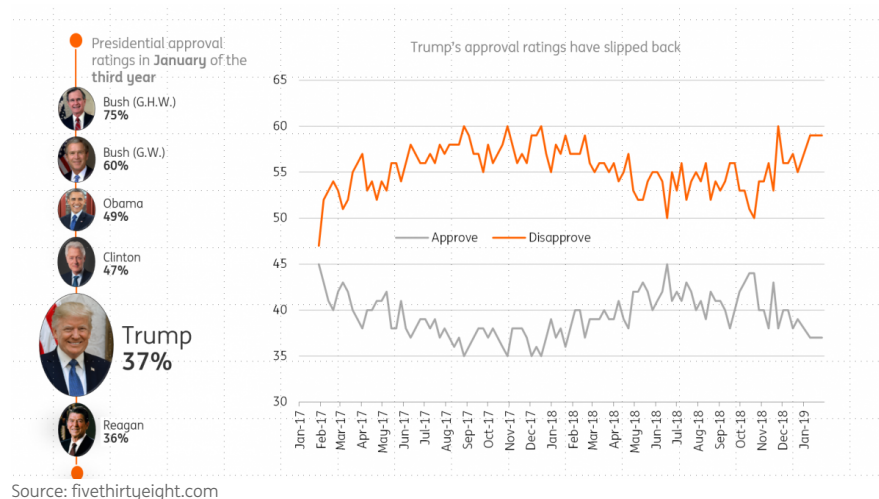
President Trump's 82 minute speech to Congress spoke of a need for the Republicans and Democrats to come together for the good of the American people. He talked of efforts to reduce drug prices and repeated his calls for bi-partisan cooperation on infrastructure investment, although there was next to no detail on what that may involve. The President also repeated calls for support for the border security wall with Mexico, but stopped short of saying he would declare a national emergency and get it built himself should that support not come. Obviously the potential for such action remains firmly on the table.

He was even more vague on US-China trade policy, merely stating that "I have great respect for President Xi, and we are now working on a new trade deal with China. But it must include real, structural change to end unfair trade practices, reduce our chronic trade deficit, and protect American jobs."

However, in a warning shot to Europe and their car exports to America, he made the plea to

Congress, “I am also asking you to pass the United States Reciprocal Trade Act, so that if another country places an unfair tariff on an American product, we can charge them the exact same tariff on the exact same product that they sell to us.” Europe charges a 10% tariff on American made cars while America charges only a 2.5% tariff on EU made car imports. On this front, we are focused on the US Commerce Department’s report (due 17 February) on whether the import of cars is a threat to US national security, which could trigger a stepping up of US-EU tensions.

## Popularity isn't everything...



## It could be worse

Given tensions in Washington, the Democrats were always going to be blasted somewhere along the line. President Trump criticised them for the way they have acted since winning control of the House by stating “we must reject the politics of revenge, resistance and retribution”. But this is the world we live in and buoyed by their perceived “victory” in the government shutdown debacle the Democrat policy of “resistance” is set to continue.

Given this backdrop we are worried about the potential for another government shutdown – though not necessarily after the deadline of getting Democrat support for funding the border security wall in mid-February as Trump can indeed declare a national emergency and fund it himself. Potentially more significantly, 1 March sees the reintroduction of the government debt ceiling and given the national debt is already above this level, there could be a major battle here.

Trump so far is getting most of the blame for the discord on Capitol Hill as can be seen in his slumping approval ratings with less than two years to go before the 2020 Presidential election. But it is important to remember that all is not lost. Looking at the “modern” comparisons, only Ronald Reagan was in a weaker position at this stage in his Presidency, yet he won 58.8% of the popular vote at the 1984 election, carrying 49 of the states. Conversely, George HW Bush had an approval rating of 75%, yet lost the election the following year. A strong economy, a deal with North Korea and the potential for an attritional and contentious set of Democrat primaries ahead of that 2020 election make these current polls pretty meaningless.

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## Riksbank preview: February blues

We expect little change from the Riksbank next week, but the outlook has clearly taken a turn for the worse and a further dovish shift in the policy stance at the next meeting in April looks increasingly likely



Source: Shutterstock

### Worsening outlook

We expect the Riksbank's February meeting to be largely a non-event. The central bank is unlikely to shift policy meaningfully so soon after the December meeting when the policy rate increased to -0.25% but the interest rate forecast was revised down (a very dovish hike), and forecasts for growth and inflation were revised down (again).

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*We expect the Riksbank's February meeting to be largely a non-event*

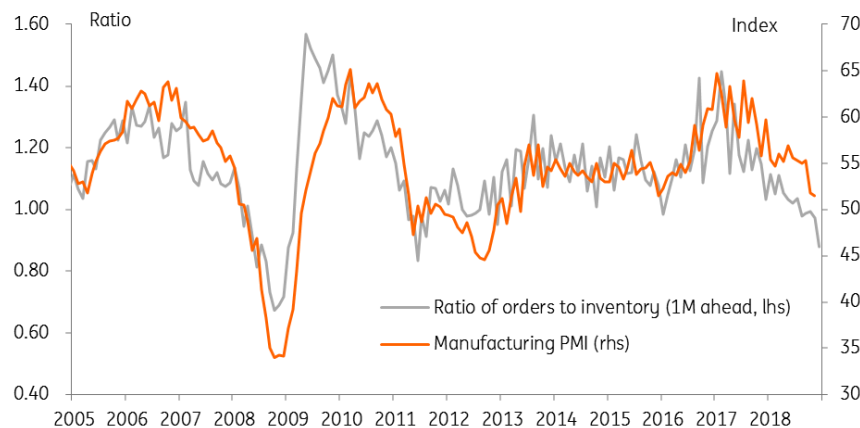
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Since then, the outlook for the Swedish economy has worsened further, both due to domestic factors and a now clearly a slowing global economy. Survey data points to a marked loss of momentum in the domestic economy, both due to the export sector suffering from lower growth in trading partners and the housing market slowdown in Sweden. The manufacturing PMI has fallen to 51.5, and the ratio of orders to inventory suggests we are likely to see the PMI fall below 50 in

coming months, indicating a contraction in the manufacturing sector.

House prices have also started falling again, and a large amount of outstanding supply suggests risks remain to the downside. There are also increasing signs that the housing market troubles are affecting households, with consumption in 4Q18 likely to come in lower than 4Q17 as consumers tighten their belts.

## Manufacturing PMIs indicate contraction likely in Q1



Source: Macrobond and ING calculations

## And the exchange rate could become a headache again

On the positive side, the December inflation figure came out in line with the Riksbank's forecast (for only the third month in 2018). In particular, core inflation and the service sector component rose, and we think that at least over the next few months, core inflation will stay largely in line with the Riksbank's forecast, mainly because the forecast has been revised down continuously through 2018. Remember that this time last year the Riksbank was forecasting core inflation to have reached 2% by now, whereas the December reading was only 1.5%. Now, the Riksbank doesn't see core reaching 2% until late 2020.

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*Another key consideration is the Swedish krona has depreciated by around 2.5% since the start of 2019, in contrast to the Riksbank's expectations of a gradual appreciation*

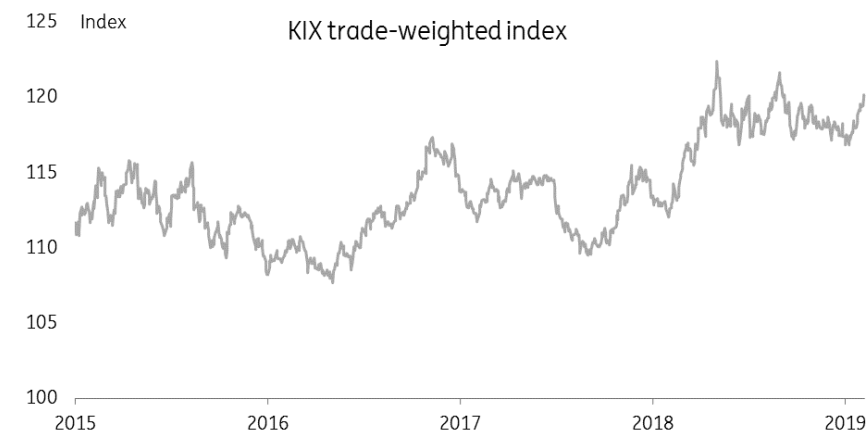
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Another key consideration is the Swedish krona has depreciated by around 2.5% since the start of 2019, in contrast to the Riksbank's expectations of a gradual appreciation. The krona's depreciation is even more remarkable given the bounce-back in risky asset prices globally during January, which would typically be associated with a stronger krona.

While this will mechanically push up a little on growth and inflation in the Riksbank's forecast, the current level of the exchange rate (whether looking at EUR/SEK or the KIX TWI) is close to the levels seen in May and September last year. It's worth bearing in mind that on both those occasions the Riksbank came out with somewhat more hawkish communication, which appeared at least in part

driven by a desire to keep the exchange rate from depreciating further.

## KIX index nearing 2018 lows



Source: Macrobond

### Little change in February, but a dovish shift in April looks likely

Piecing this together, we expect a somewhat more cautious tone in the February statement, though perhaps not as dovish as markets may be expecting given how weak the exchange rate already is. In other words, the Riksbank is likely to mirror the slightly more dovish stance taken by the ECB and Bank of England over the past couple of weeks, acknowledging the deteriorating data but not shifting the policy stance materially.

That said, we anticipate another downward revision to the interest rate forecast in April, as growth is likely to deteriorate further. This would put the next rate hike in 4Q19 at the earliest, and there is a clear and growing risk that the Riksbank proves unable to hike at all this year. We also expect the April meeting will include an announcement that QE reinvestments will be extended to the end of 2020, though probably at a reduced rate.

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## Canada: What wage growth concerns?

When it comes to the story of sluggish wage growth, the Groundhog Day we've been seeing since June last year has finally changed its tune. January saw wage growth finally pick-up for full-time workers, and we don't expect this to just be a temporary relief



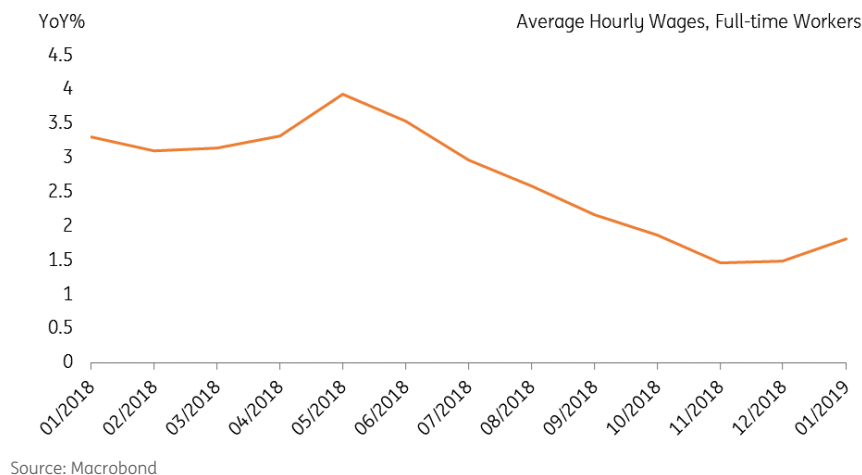
Source: Shutterstock

After the hiring blitz in November (+94,000), there was a much slower pace of job gains in December (+9,300), but Canada is back on track in January creating 67,000 jobs. The unemployment rate ticked back up to 5.8% after sitting at a four-decade low of 5.6% for two months as more people entered the labour market. That said this is still a relatively low unemployment rate and jobs are still being created, so on face value, the picture is pretty positive and won't be too much of a concern for the Bank of Canada (BoC).

### Light at the end of the tunnel

The long-awaited pick-up in wage growth is tentatively beginning to show. For full-time workers, average hourly wages ticked up to 1.8% year on year from its 2018 low of 1.5% YoY. 2019 should see some further upside for wages, given the economy is operating close to full capacity and unemployment is so low. Today's number backs up the view, which was hinted at the central bank's most recent business outlook survey.

## Wage growth heads back in an upward direction



## The full-time hiring reinforces our view the economy is in decent shape

This employment report was reassuring despite the fact the unemployment rate ticked up. Both full-time and part-time positions drove January job gains, reinforcing our view the economy is still in good health given firms now require to hire permanent positions – likely because of the high level of demand (particularly from the US) that is expected to persist in the near-term.

*This employment report was reassuring despite the fact the unemployment rate ticked up*

However, it is worth noting strengths will probably come outside of the energy sector given its deteriorating outlook. The mandatory oil production cuts in Alberta – enforced by the local government have started to hurt employment figures; we've seen declines for two months in a row now – driven by losses in full-time positions, and this could overall start to weigh on employment.

Reducing output has helped to lift oil prices in Western Canada, but it isn't all good news. The reduction in output puts the energy sector's performance below par (and will be for some time), and this was a significant contributor to our downward 2019 growth revisions from 2.1% to 1.8% given Canada is large net-exporter of oil.

[Read for more on Canada's economic slowdown](#)

### Escalation of the risk environment could quickly change things

Nevertheless, if we continue to see wages heading in an upward direction and the job creation momentum carries on, we anticipate household activity should still contribute a decent amount to growth this year. This is despite headwinds such as a housing market

correction and higher rates feeding through into the economy. This would support our view that the central bank could hike rates twice this year – likely in the third and fourth quarter – although the risks are skewed to the downside on this.

The central bank governor Stephen Poloz recently said in Davos that oil prices and global trade tensions would play a large part in determining the timing of the next rate hike. Any escalation of these risks would likely push us into revising down our anticipated number of rate hikes to one or possibly even none.

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# India: RBI's surprise rate cut appears premature

The Reserve Bank of India (RBI) has ignored the inflationary consequences of the fiscal splurge and eased policy in support of the government's drive to boost growth before the elections. We think the markets will view such a policy move as premature and the rupee will be the main victim



Source: Shutterstock

# 6.25%

RBI repo rate

25 basis point cut

Lower than expected

## An RBI rate cut with neutral policy stance

The RBI Monetary Policy Committee voted 4-2 to cut the key policy rate by 25 basis points, taking the repurchase rate to 6.25% and the reverse repo rate to 6.00%. The decision was surprising in that very few, only eight out of 38 participants in the Bloomberg survey anticipated it. As widely expected, there was no change to the banks' reserve requirement rate of 4.00%. The MPC also

switched its policy stance to 'neutral' from 'calibrated tightening', which was a unanimous decision by all members.

What's more amazing though is the sharp swing in the policy perception within the MPC. Until late 2018, all but one member expressed caution on inflation and advocated a tighter stance with stable rates, whereas all favoured a neutral stance and the majority voted for a rate cut today.

## A change in policymakers' thinking

MPC member	Dec-2018 meeting	Feb-2019 meeting
<b>Governor Patel =&gt; Das *</b>	<b>Tight - no change in rate</b>	<b>Neutral - rate cut</b>
Dr. R. H. Dholakia	Neutral - no change in rate	Neutral - rate cut
Dr. Pami Dua	Tight - no change in rate	Neutral - rate cut
Dr. Michael Patra	Tight - no change in rate	Neutral - rate cut
Dr. Chetan Ghate	Tight - no change in rate	Neutral - no change in rate
Dr. Viral Acharya	Tight - no change in rate	Neutral - no change in rate

\* Shaktikanta Das replaced Urjit Patel as RBI governor after the latter resigned in December.

Source: RBI policy statements and meeting minutes, ING Bank

## Benign inflation, strong growth outlook

The [RBI statement](#) began by noting that, "These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 percent while supporting growth". Inflation for the current quarter (the final quarter of FY2019 ending in March) is projected at 2.8%, picking up to 3.2-3.4% in 1H FY2020 and then to 3.9% in 3Q FY2020. This outlook rests on expectations of continued food and fuel price trends, the transitory nature of currently high healthcare and education costs, and moderating household inflation expectations. The upside risks stem from volatile vegetable prices, an abnormal monsoon, and the fiscal boost to aggregate demand.

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*Headline inflation is expected to remain contained below or at its target of 4 percent. - Governor Das.*

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The central bank forecasts an acceleration of GDP growth to 7.4% in FY2020 from 7.2% estimated for the current financial year, supported by strong credit growth, softer crude oil prices, and the lagged impact of the weak currency on net exports.

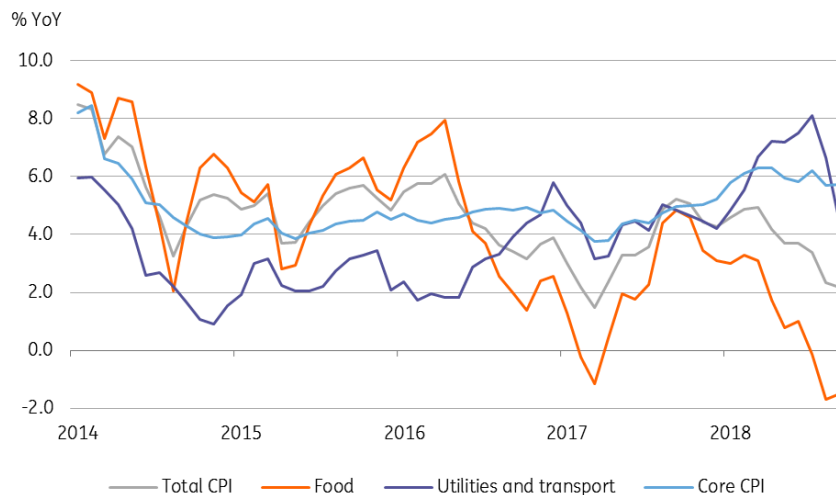
## A premature policy move

It was a surprise that the RBI eased policy on the grounds of inflation continuing to be benign. Indeed inflation is unlikely to hit the RBI's 4% policy mid-point anytime soon. But we expect the underlying pressure to remain upward. Food price inflation has bottomed as the January CPI data is expected to show, while the adverse base effect will likely push it higher going forward. High core inflation, running at about 6% in the current financial year, reflects still elevated inflation expectations. The loose fiscal policy and a weak currency are the other factors likely to push prices up going forward. We expect average inflation of 3.6% in 1H FY2020, rising to 5.4% in 2H 2020.

As such, we consider the decision to cut the policy interest rate premature. The key question it poses is: why do we need a loose monetary policy when the fiscal policy is already supporting growth well above 7%? Maybe a political push from the incumbent government aiming for a second term.

Now that elections are just around the corner, we aren't expecting the RBI to move policy again this year. However, as inflation accelerates above 5%, the tightening pressure will return. We believe the next RBI policy will be a 25 basis point tightening by the end of FY2020.

## CPI inflation by key components



Source: Bloomberg, CEIC, ING

## INR to remain Asia's weakest currency

Government bonds gained and the Indian rupee weakened in a knee-jerk reaction to the RBI's decision.

It's unlikely to be a lasting relief for bonds as the supply overhang to plug a persistently wide fiscal deficit will continue to pressure yields higher. The INR7.04 trillion government borrowing plan for FY2020 announced in the budget a week ago represents an over 30% increase from the revised INR 5.35 trillion borrowing in the current year. This will not only pressure borrowing costs higher but also will cause a significant crowding out of private investment, thereby weighing on GDP growth.

The INR has been the worst performing Asian currency since last year. Despite persistent wide relative interest rate differentials, the lower domestic rates will sustain the INR's underperformance throughout 2019. We maintain our view of the USD/INR rate re-testing 73 in the near-term.

## ING's key economic forecasts for India

India (FY starting April)	FY2015	FY2016	FY2017	FY2018 f	FY2019 f	FY2020 f
Real GDP (% YoY)	8.2	7.1	6.7	7.1	6.8	7.2
CPI (% YoY)	4.9	4.5	3.6	3.5	4.5	5.0
Fiscal balance (% of GDP)	-3.9	-3.5	-3.5	-3.5	-3.4	-3.2
Public debt (% of GDP)	70.0	69.5	71.2	72.5	72.0	71.0
Current account (% of GDP)	-1.1	-0.6	-1.9	-2.6	-3.1	-2.9
FX reserves (mth of imports)	10.2	10.6	10.2	8.3	7.9	7.8
External debt (% of GDP)	182.1	168.2	171.4	160.0	162.2	175.5
RBI repo rate (% eop)	6.75	6.25	6.00	6.25	6.50	6.50
3M T-bill rate (% eop)	7.27	5.82	6.09	6.50	6.80	6.80
10Y govt. bond yield (% eop)	7.47	6.68	7.40	7.50	7.90	7.90
INR per USD (eop)	66.33	64.84	65.18	72.50	68.00	65.00

Sources: Bloomberg, CEIC, ING forecasts

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# Italy: Falling deeper

Poor December industrial production data adds to the risk of another GDP contraction in 1Q19, and pushes our average GDP growth forecast for 2019 down to a miserable 0.1%



Source: Shutterstock

## Industrial production weaker than expected in December

Industrial production data for December 2018, released earlier today by Istat, came in well below consensus, confirming that the soft patch of Italian manufacturing activity continued without any relief until the end of 2018. The seasonally adjusted measure was down 0.8% month on month (from -1.7% MoM revised in November), posting the fourth consecutive monthly contraction. The working day adjusted measure, better suited to follow the trend, turned out a disappointingly weak -5.5% year on year (from -2.6% YoY in November), the steepest yearly fall since March 2013.

A quick look at big aggregates shows that the monthly contraction was marked in consumer goods (-2.9% MoM) and in energy (-1.5% MoM); production was flat on the month for investment goods and marginally positive (+0.1% MoM) in intermediate goods.

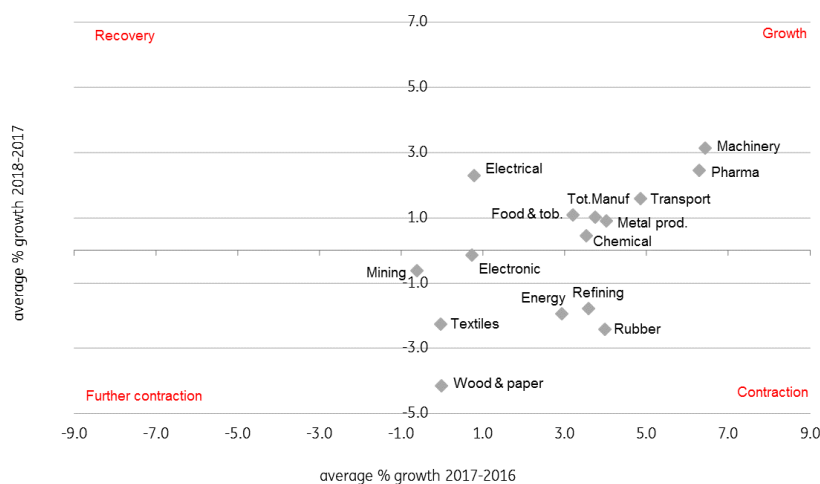
## Average 0.8% production growth in 2018 builds on positive statistical carryover from 2017

Looking at the whole of 2018, average industrial production was up 0.8% on the year, with the manufacturing component up 0.9%. This comes as little consolation as it builds mostly on the



positive statistical carryover of 2017. The sector breakdown shows that machinery and plants (+3.1% YoY) and other manufacturing, installation and repair (+2.8% YoY), more linked to the business investment cycle, were the fastest growing sectors, followed by pharmaceuticals (+2.4% YoY), while sectors more linked to the construction chain such as wood (-4.1% YoY) and plastics and non-metal minerals (-2.4% YoY) confirmed the laggards.

## Production dynamics by sector in 2018 and 2017



Source: Reuters Datastream, ING

## Another quarterly GDP contraction in 1Q19 now more likely

The poor December production release brings the 4Q18 performance down to a disappointing 1.1% QoQ contraction, which leaves a negative statistical carryover to 2019. Based on soft indicator evidence for January, chances of an exit from recession already in 1Q19 look slim. Manufacturing business confidence fell again in January and both the order book and the expected production components were anticipating further declines. This was consistent with the relevant PMI reading, down to 47.8, the lowest reading since May 2013. Confidence was down also among service sector businesses, leaving the onus of growth on households. With both supply and demand indicators anticipating more weakness, and with resuming tensions in BTP-Bund spreads, we expect the first quarter to confirm Italy in recession. Rising political uncertainty is not helping either: with both leaders of the coalition parties in campaign mode for both a round of local regional elections and for the European Parliament ones, re-creating an investment-friendly environment will not be easy in the short run.

## ...leaving our new base case GDP forecast for 2019 at a miserable 0.1%

Our new base case profile pencils in another GDP contraction for 1Q19 and foresees a very gradual recovery thereafter; this would translate into a miserable average growth rate of 0.1% in 2019, with downside risks.

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# Construction goes digital

Construction companies are going digital, helping to boost productivity in the sector after years of stagnation. At the same time, however, investment in machinery remains subdued. Could robotics and 3D printing offer a solution?



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