

What's happening in Australia and around the world?

The odds of an election in the UK have risen. Boris Johnson can still win it, but it won't be easy. Key factors will be Scotland, Lib Dem marginal seats and Farage's Brexit party. And all of this obviously means more pressure on the pound. Across the pond, the risks of a recession have increased as a weak ISM manufacturing survey offers bad news for US jobs too

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Brexit: UK election chatter grows as Parliamentary battle recommences

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Source: Shutterstock

Britain's Prime Minister Boris Johnson speaks outside 10 Downing Street in London.

Election chatter builds as lawmakers return

As Westminster braces for an almighty battle this week, there is a growing sense that prime minister Boris Johnson could be on the verge of calling a general election on 14 October.

This poses a major conundrum for the Labour Party, who will need to give consent to an election. While an election would give them an opportunity to seize power, failure would put the Conservative government in a stronger position to pursue Brexit on its terms later in October - including potentially leaving the EU without a deal.

But a general election also poses challenges for the Conservative party, who will need to win over leave-supporters in Labour-held seats to offset potential losses in Scotland and Southern England. If the party fails to convert their current lead in the polls into a working majority, then a Labour-led government could be formed, particularly given their wider pool of potential partners in the House of Commons, if the party falls short of an outright majority.

The bottom line is that an election would be extremely difficult to call, which in turn would make the job of putting probabilities on the different Brexit outcomes much harder. But given that Conservatives currently lead in the polls, an election will almost certainly increase the perceived risk of 'no-deal' within financial markets in the weeks leading up to 14 October.

As our FX team notes, this only means further [pressure for the pound](#).

The logic behind Mr Johnson's election push

On the steps of Downing Street on Monday evening, Mr Johnson said that he did not want a general election.

But minutes later, a government source confirmed to the press that the government is prepared to trigger a national vote if legislative efforts to block 'no deal' gain momentum today. It's easy to see why an election is tempting for the government, and the reasons appear two-fold:

Firstly, the Conservative-led government is operating with the thinnest of working majorities in the House of Commons. Whatever happens over the next few weeks, an election could give Mr Johnson an opportunity to boost his standing in parliament and assume greater authority as prime minister.

Secondly – and perhaps more importantly – a pre-Brexit election could (if successful) theoretically aid the government's [reported](#) plan to run down the clock towards the end of October, something that is under threat as lawmakers kick-off their efforts to avert a 'no deal' Brexit.

A pre-Brexit election could aid the government's plan to run down the clock towards the end of October

Today, MPs will attempt to seize control of the House of Commons agenda - the first step on the road to passing a bill that would ultimately force the prime minister to ask for another Article 50 extension, if he fails to agree to a deal with the EU.

This legislative route is fraught with roadblocks (e.g. will Speaker John Bercow allow MPs to seize control using an emergency debate today, something that is unprecedented?). But MPs appear cautiously confident that they have the numbers to get the anti 'no-deal' legislation passed over the next few days.

For Mr Johnson, this risks losing control of the Brexit process altogether - both in negotiations with the EU (he believes his negotiating leverage would decrease) and within parliament.

In short, this is why the government appears prepared to trigger an election for 14 October. This carries an enormous amount of risk, but if Mr Johnson can convert his current lead in the polls into an election victory, he would enter the final days of the Brexit process with greater control.

The government may have greater clout to try and force a deal through parliament - although as the newspaper [The Daily Telegraph](#) notes, there is so far little sign of progress towards a compromise. An election victory could also move the prime minister much closer to a 'no-deal' exit should he wish to take that path.

A pre-Brexit election would be a gamble for the Labour party

An election before the 31 October Brexit deadline poses a major conundrum for the Labour party, who don't forget will need to sign up to an election if it is to go ahead. Under the fixed-term parliament act, two-third of MPs need to approve a motion calling for the country to go to the polls (although we'd note there is talk that Mr Johnson may be able to [circumvent this requirement](#)).

On the face of it, this is a dream opportunity for Labour leader Jeremy Corbyn. He and his party have been pushing hard for a general election over recent months.

But Mr Johnson's proposal is also inherently risky for the opposition. While the election would likely take place before 31 October, signing up to this before the legislative efforts have completed would mean there would be no legal mechanism in place to force an Article 50 extension. Don't forget that the government will presumably not be allowed to continue negotiations during the election campaign, making it even less likely that a revised deal would be in place by the mid-October European Council.

So while an election would give Labour an opportunity to seize power, if they fail, then the risk of 'no deal' could increase substantially.

According to [some reports](#), Mr Johnson also retains the ability to change the date of an election by proclamation after it has been called. Some lawmakers are wary that he could call an election for before 31 October, but subsequently change the date to November, by which time the UK would have left the EU without a deal.

If Labour rejects calls for an election this week, and legislation subsequently passes to force the prime minister's hand when it comes to an Article 50 extension, then this would also undoubtedly deal a blow to the government. An election is still very likely at some stage this year, and if legislation ultimately forces the government to ask for another Brexit delay, then this could complicate Conservative efforts to stem the tide of the Brexit party when/if the nation heads to the polls.

An election is also a massive gamble for the Conservatives

Having said all of that, a 14 October election is also an extremely risky option for the Conservatives, although it's also true that an election on these timescales could also be a reasonable strategic choice for Mr Johnson.

While conventional wisdom suggests that Mr Johnson needs to get Brexit 'done' before going to the polls, an election immediately after a 'no deal' exit would be incredibly risky given the potential for severe disruption.

A mid-October election would allow Mr Johnson to campaign on a tough Brexit stance, without risking the economic impact of a pre-election 'no deal'. It would also allow him to tell voters that he didn't want this election, and attack the opposition for trying block Brexit altogether.

But while the Conservatives have maintained a solid lead in the polls, there are a number of headwinds that could prevent the party from converting this into an outright majority at an election.

In Scotland, the Conservatives may well lose seats to the Scottish National party. The Tories hold 13 Scottish seats, all but one of which voted to remain and in many cases, the SNP were only narrowly defeated by the Conservatives at the last election. Meanwhile, in England, the resurgent Liberal Democratic party pose a risk to Conservative-held seats in the South-West and London. To make up this deficit, Mr Johnson will need to attract leave-supporting voters in Labour-held seats. Here, the Conservatives face two dilemmas.

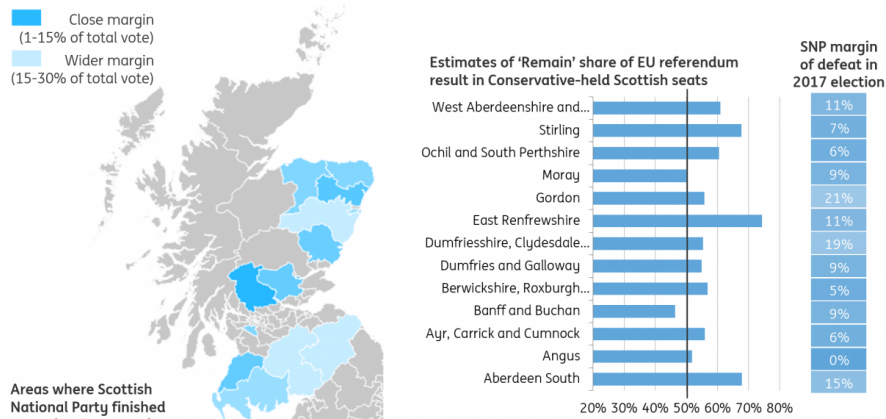
A mid-October election would be impossible to call. But given the Conservatives currently lead in the polls, the prospect of an election means markets will become more nervous about the possibility of a 'no deal' exit.

Firstly, as politics professor [Matthew Goodwin](#) noted, Mr Johnson will have to strike a very fine balance in his calls for a 'no-deal' Brexit. 'No-deal' does not have universal support among the electorate - a [Mail on Sunday/Deltapoll](#) survey found only 28% of voters would prefer to leave without a deal if necessary. Calling outright for a 'no-deal' could hit the party in the polls, but equally watering down the threat risks fuelling further losses to the Brexit party.

Secondly, Mr Johnson will need to win Labour voters over on key economic policies. Surveys have shown that Labour and Conservative leavers often share views on cultural issues - that's partly why the government is pushing hard on plans to tackle crime but differ on economic interests. Assuming the Labour party fight hard on issues such as nationalisation and public spending, this would pose a challenge for the Conservative campaign.

In short, a mid-October election would be impossible to call. But given the Conservatives currently lead in the polls, the prospect of an election means markets will become more nervous about the possibility of a 'no deal' exit.

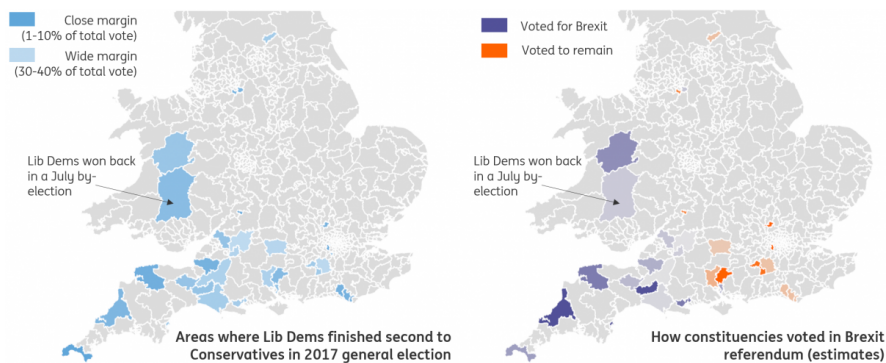
Conservatives face challenges in Scotland



Source: UK Government, Dr Chris Hanretty Brexit by constituency estimates, ING

Margin = seats difference between Conservative and Lib Dems, as a proportion of the total votes cast

Conservatives vulnerable to Lib Dem advances in England



Source: UK Government, Dr Chris Hanretty Brexit by constituency estimates, ING.

Margin = seats difference between Conservative and Lib Dems, as a proportion of the total votes cast

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

US: The rising risk of recession

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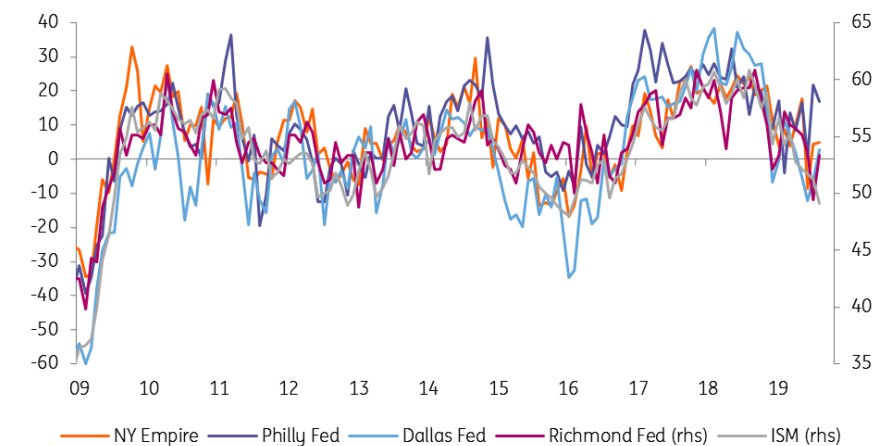
Source: Shutterstock

49.1 Manufacturing ISM index
Weakest reading in over three years

Another manufacturing miss

The ISM manufacturing index has come in at 49.1 for August versus 51.2 in July. This is the first sub-50 reading (the expansion/contraction boundary) since August 2016 and is the weakest figure since January 2016. The consensus had expected a slight rise based on the regional surveys already published and as the chart below shows, this is a clear disappointment that will provide further fuel to the market and President Trump's desire for further Federal Reserve interest rate cuts.

The ISM is worse than what the regional indicators are suggesting



Source: Bloomberg, ING

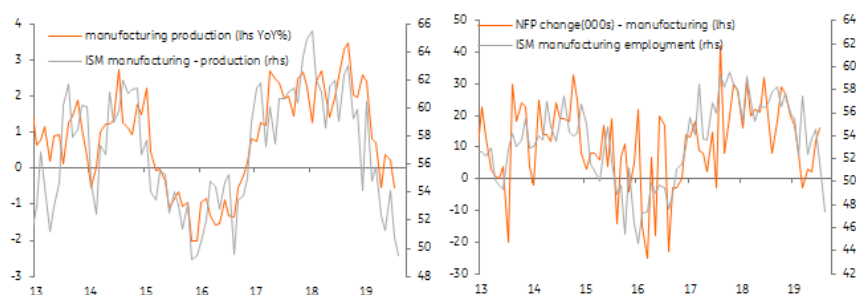
More weakness ahead...

Production, new orders and the employment components all fell into contraction territory and suggest the sector is feeling broad-based pain. Just 17% of America's manufacturing industry is seeing orders rise with just 22% experiencing higher production. Unsurprisingly new export orders were particularly hard hit through a combination of weaker global demand, the stronger dollar and retaliatory tariffs from China. This component fell to 43.3 - the weakest reading since April 2009 and it will almost certainly fall further.

Just 17% of America's manufacturing industry is seeing orders rise with just 22% experiencing higher production

The charts below suggest that we are going to see much weaker industrial production and employment figures in upcoming releases. Manufacturing output is already down 1.6% year to date with output 5% below the November 2007 peak. It offers bad news for Friday's US jobs report too with today's ISM employment component pointing to a 10,000 contraction in manufacturing employment - this would be the first negative manufacturing jobs growth for three years.

ISM points to weaker output and employment



Source: Macrobond, ING

Implications for interest rates

With new tariffs having taken effect on Sunday and with more to come in October and December the risk is that the surveys move lower again in the months ahead. It is important to remember that the Institute of Supply Management suggests that a reading above 42.9 “generally indicates an expansion of the overall economy”, and given the clear strength of the consumer sector the US economy appears to be some way off a recession for now.

However, the attritional nature of the US-China trade tensions and the weakening global growth outlook is hitting sentiment while higher tariffs are putting up costs and hurting supply chains. The result is that corporate profitability is deteriorating and there is already evidence, as acknowledged by the Federal Reserve, that this is leading to weaker investment spending. There is the risk that employment growth softens more broadly (not just manufacturing) too.

Given the potential for the slowdown to spread to other sectors (weaker equity markets hurting consumer sentiment, negative yield curve curtailing credit supply from the banks, for example) and the fact other major central banks are moving in the direction of policy loosening, which is pushing the dollar higher, we look towards the Fed to offer more support to the US economy.

We expect 25bp interest rate cuts at both the September and the December FOMC meetings.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

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Source: iStock

Where we are now?

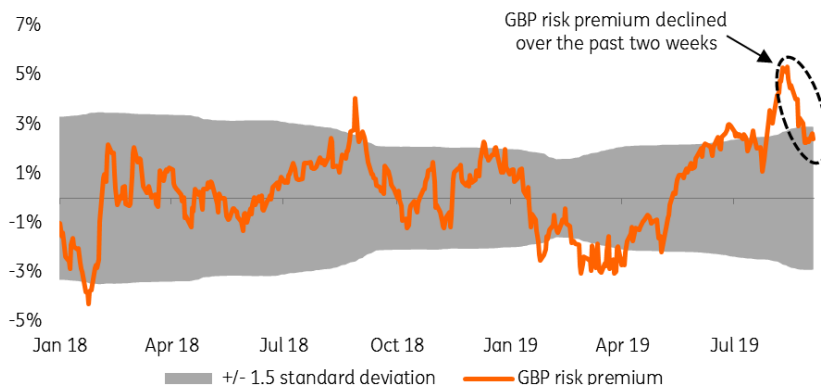
Despite the rebound in the UK pound in the last few weeks, the short term **sterling risk premium isn't extreme**.

We estimate it to be worth around 2.5 % in EUR/GBP (vs 5% this August), with EUR/GBP still within its 1.5 standard deviation band as can be seen in figure 1. This means that more risk premium can be built into sterling. Our financial fair value model is based on short-term drivers of currencies such as rate spreads, yield curves and a gauge for risk appetite.

[Read all about Brexit and the UK government's decision to suspend parliament here](#)

Figure 1: More scope for GBP risk premium to rise

The estimate of EUR/GBP risk premium. A residual between EUR/GBP short-term financial fair value and the spot.

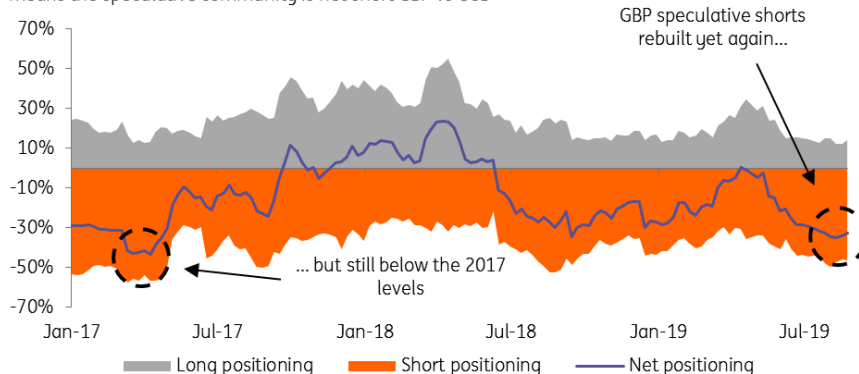


Source: ING

The build-up of **speculative GBP/USD shorts** paused in recent weeks. Although elevated, they are still below the 2017 extremes (33% of open interest currently vs 43% back then – as can be seen in figure 2). In the case of the rising probability of a no-deal Brexit and/or early elections, the shorts can rise further.

Figure 2: Speculative positioning elevated but below the 2017 levels

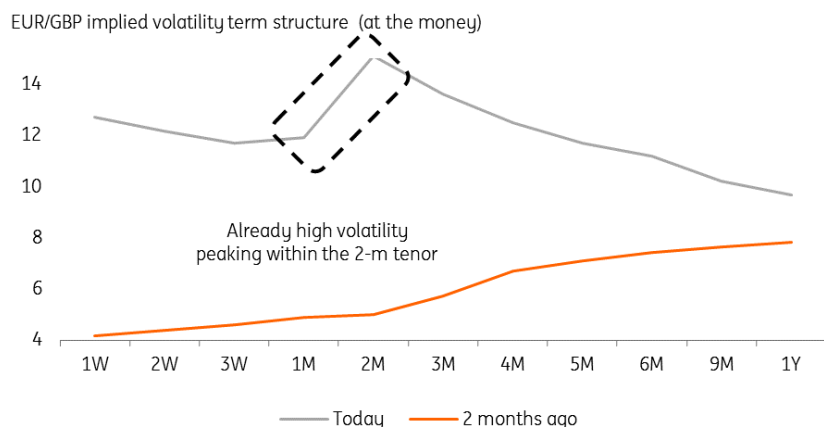
GBP/USD speculative positioning, as % of open interest (as of 27th August 2019). Negative number means the speculative community is net short GBP vs USD



Source: ING

The **options market clearly shows signs of stress**. The EUR/GBP implied volatility curve (the term structure) is kinked around the deadline data as can be seen in figure 3 and GBP volatility premium is the highest in the G10 FX space (figure 4). Still, EUR/GBP risk reversals can rise further (figure 5)

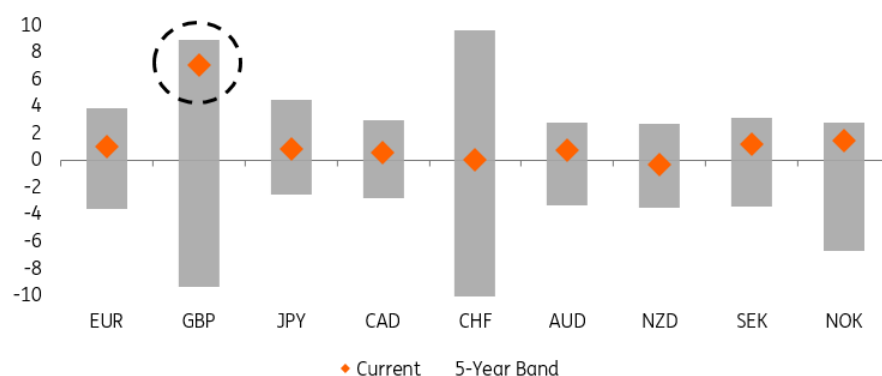
Figure 3: The GBP volatility curve already heavily kinked around the Brexit date



Source: ING, Bloomberg

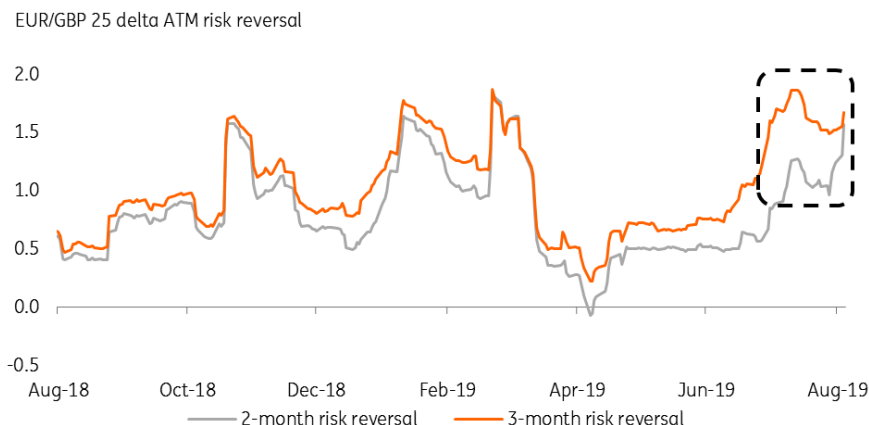
Figure 4: Sterling volatility risk premium remains high

3-month G10 FX Volatility premia vs USD (calculated as implied volatility - realised volatility). Note that USD/CHF implied vol 5-y band exceeds the scale, but we reduced the scale for visual simplicity



Source: ING

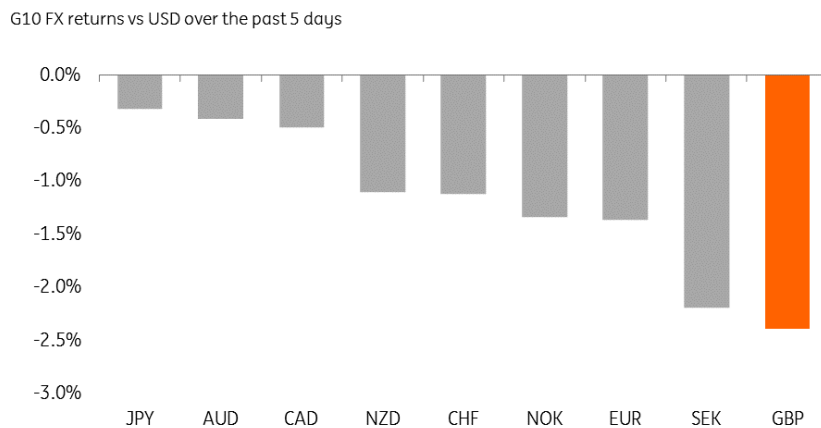
Figure 5: Risk reversals already at stressed levels but can get stressed even more



Source: ING, Bloomberg

The recent decline of the pound over the last few days has turned sterling into the **G10 FX underperformer yet again** (figure 6) but we **don't expect the Bank of England to provide any help** to the struggling pound, with dovish market pricing to firmly remain in place (figure 7). Currently, more than one full 25bp rate cut is priced in within six months.

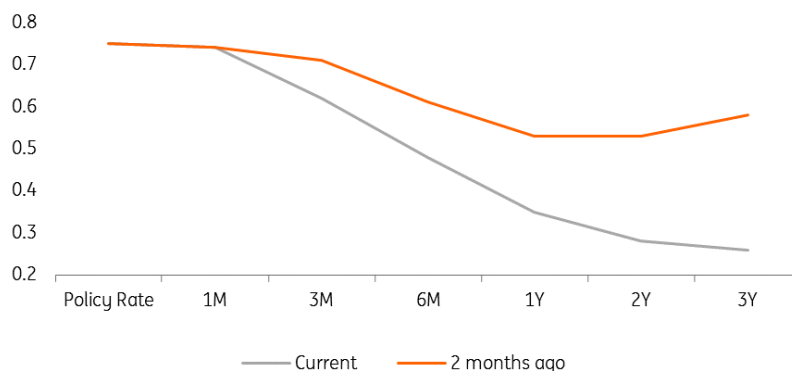
Figure 6: GBP turning into a G10 FX underperformer yet again



Source: ING, Bloomberg

Figure 7: Market pricing Bank of England rate cuts

Market implied policy curve for the BoE policy rate



Source: ING, Bloomberg

What to look for?

If parliament moves a step closer to legislating against no-deal Brexit today by seizing control of the parliamentary agenda and prime minister Boris Johnson subsequently and successfully calls for early elections (likely in mid-October), we would see this as GBP negative given that (a) the Conservative party under PM Johnson's leadership will likely run on the ticket of a divisive stance vs EU ("no ifs or buts"), (b) the alternative option of a Labour government under Jeremy Corbyn may not be seen as an overly positive for market participants.

As [we've written before](#), we view early elections as negative for GBP and continue to see downside risks to sterling. This is consistent with our forecast of EUR/GBP 0.95 within 1-3 months and [GBP/USD falling to 1.17](#).

[Read our detailed view on currencies here - FX Talking: Currencies move to the frontline of the trade war](#)

India: Where has all that stimulus gone?

A 6-year low of 5% GDP growth in 1Q FY2020 provides more reasons for the government and central bank to remain in policy-easing mode over the rest of the...



Source: Shutterstock

5% GDP growth in 1Q FY2020

Worse than expected

6-year low GDP growth...

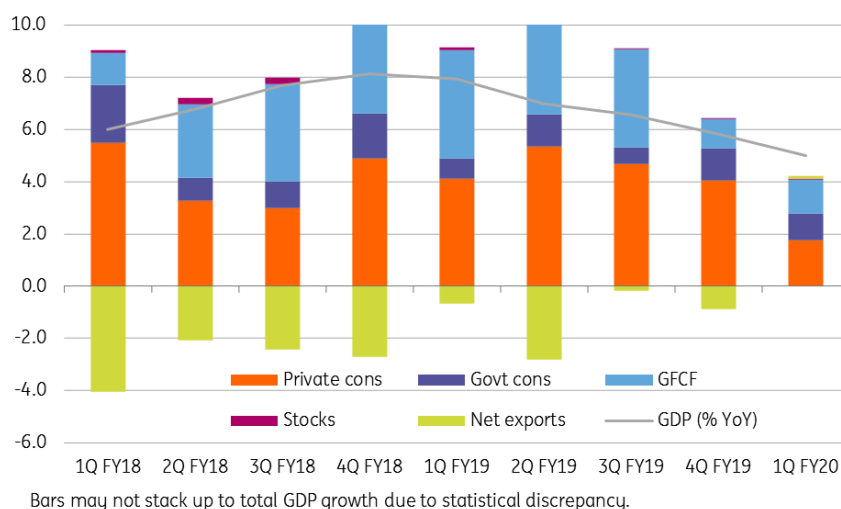
Contrary to the consensus of just a tick-down in growth, GDP in the first quarter of FY2020 (started in April this year) posted a sharp slowdown to 5% year-on-year from 5.8% in the previous quarter. The consensus median was 5.7% growth as against 5.8% in the previous quarter. We were more optimistic with our 6.0% forecast, which rested on the massive stimulus the authorities, both the government and the central bank, unleashed earlier this year in the election drive to boost growth.

Among the spending components, private consumption stood out to be the main source of GDP slowdown. 3.1% consumption growth more than halved from 7.2% in the previous quarter, implying a 2.3 percentage point hit to GDP growth. There was also a sharp slowdown in government consumption (to 8.8% from 13.1%), which is at odds with fiscal stimulus. Growth of

fixed capital formation improved slightly (to 4.0% from 3.6%), thanks to the aggressive policy rate cuts by the Reserve Bank of India (RBI).

Firmer exports were reflected in an improved net trade contribution to GDP growth (albeit zero overall), though these failed to sustain manufacturing as a source of GDP growth from the industry side, while services growth also slowed in the last quarter.

Weak private consumption dents growth



Source: CEIC, ING

... paves way for more stimulus

Data suggests that all the stimulus that has gone into the economy this year -- as part of a surge in the election spending as well the RBI taking advantage of low inflation by slashing policy rates -- has failed to boost growth. The latest data also reflects significant policy lags (pointed out by an RBI policymaker in the latest policy minutes) with less than 40% of the rate cuts so far being transmitted to the banking system. The 110 basis point RBI policy rate cut this year was by far the most aggressive easing by any central bank in the world this year.

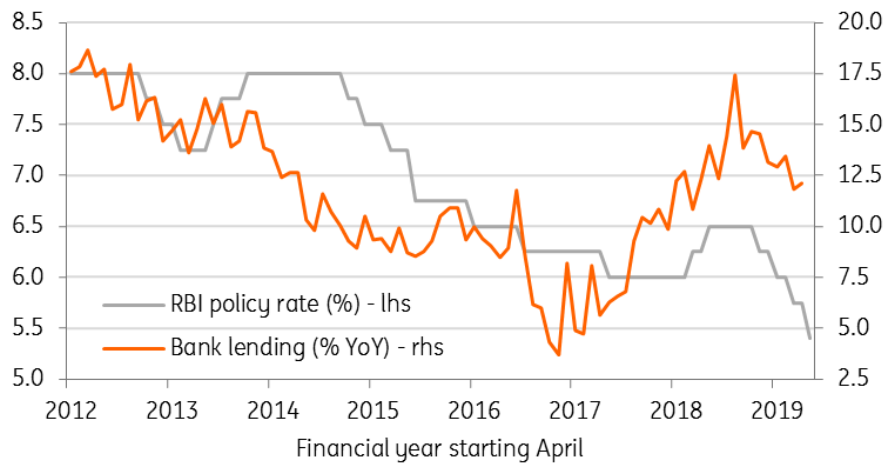
The question is: should the RBI pause easing and allow the rate cuts implemented time to filter down into the economy? We think so, though we are sceptical that they will actually do so now that growth has dipped well below the RBI's 6.9% growth forecast for the full FY2020 (revised recently from 7.0%).

We retain our forecast of an additional 50bp of rate cuts over the rest of the year, taking the repo rate to 4.90%, the lowest in a decade and just shy of the 4.75% record low reached during the 2009 global financial crisis.

Furthermore, taking advantage of a \$24 billion windfall received from the RBI this year, the government unveiled additional stimulus just prior to the GDP release. We don't see it stepping off the stimulus pedal just yet.

However, we continue to caution about the inflationary implication of such massive policy accommodation. We retain our view of inflation accelerating above the RBI's 4% policy target by the end of the year. So continued easing now may lead to considerable policy awkwardness later.

Monetary easing failing to stimulate bank lending



Source: Bloomberg, CEIC, ING

Canada: We're looking for a rate cut in October

Canada's economy performed well in 2Q19, but it is heavily exposed to global growth and trade, which hints at weaker activity ahead. The central bank...



Bank of Canada Governor, Stephen Poloz

Some encouragement on the domestic front...

At the July monetary policy meeting, the Bank of Canada suggested there was little prospect of any near-term policy change. Officials highlighted the improvements to the domestic story we've seen since the weakness in 4Q18 and 1Q19 with the economy described as growing at potential. Today's 2Q GDP report underlined that strength with the economy growing by a very robust 3.7% annualised versus the 3% consensus figure. It is this decent domestic performance that has so far left the BoC reluctant to follow the crowd of other central banks signalling dovish intentions. We think that will change at the next policy meeting on September 4.

After all, if you dig a little deeper into the GDP we find the growth story isn't as positive as the headline suggests. Exports contributed hugely by growing 13.4%, largely due to the re-starting of oil fields whereas consumer spending grew just 0.5% annualised - the slowest since 2012 - despite

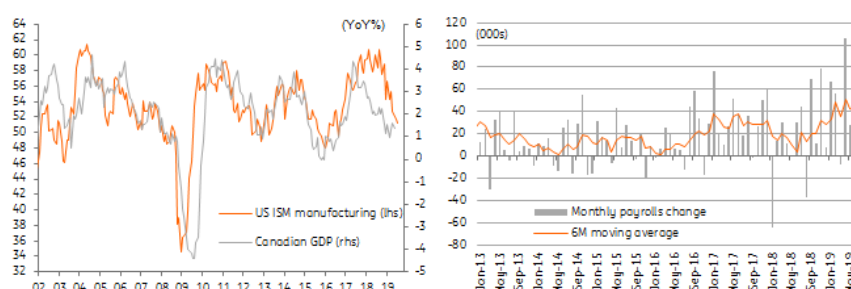
healthy income gains. Non-residential business investment actually contracted 16% annualised while residential investment rose for the first time in six quarters.

... is increasingly being offset by a weaker global backdrop

Looking back at the July policy meeting, the BoC also recognised the threat posed by global trade tensions, which in turn risks curbing manufacturing activity, weakening investment and dampening commodity prices. These trade tensions have escalated in recent weeks while the global slowdown shows little sign of abating. Together with a softer tone seen in US manufacturing data, the newsflow all points in the direction of fading Canadian economic momentum. In any case, the surge in export growth due to oil seen today is not sustainable.

The Canadian economy is relatively open with trade accounting for more than 30% of economic activity versus little more than 10% for the US. It is also more dependent on commodities for a significant proportion of its output with mineral extraction and agriculture representing more than 10% of the economy. Given these exposures and with little prospect of an imminent easing in trade and global growth concerns we expect that Bank of Canada to use next week's policy announcement to pave the way for a rate cut in 4Q19.

Softer US manufacturing and weaker Canadian payrolls point to BoC rate cut



Source: Macrobond, ING

The BoC likes surprises

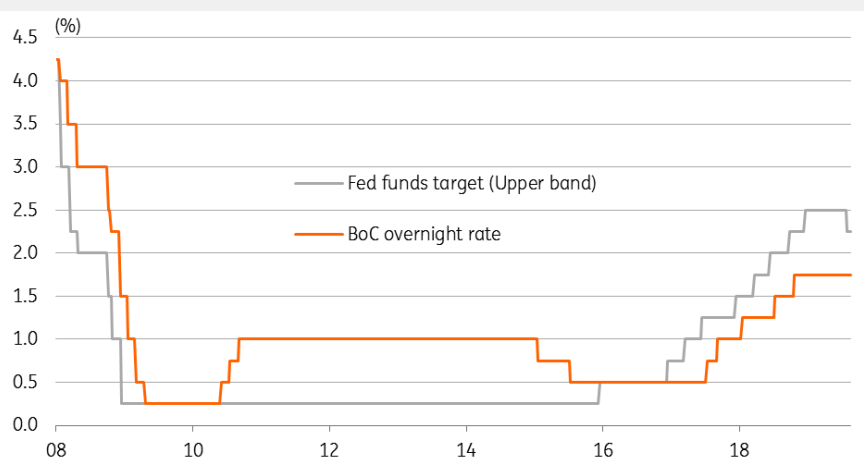
These expectations will build if we see a further slowdown in labour hiring. Canada has already experienced two consecutive months of falling payrolls and, with business confidence coming under pressure given the global backdrop, we may see more losses in the months ahead. A rate cut at next week's meeting is an outside possibility, but the imminent federal election (October 21st) and election campaigning getting into full swing make that doubtful. At the moment the market is pricing in around a two-thirds probability of a rate cut in October, whereas the latest survey of analysts by Bloomberg continues to peg stable rates through this year and next.

Given the BoC's tendency in the past to move swiftly after signalling a change, we are now forecasting a 25bp rate cut at the October 30 meeting. In this regard think back to 2015 when the BoC rapidly changed its tune and cut rates in response to plunging oil prices and the fears for what it might mean for the broader economy. We also remember 2017, when it surprised with a September hike after already hiking rates in July. Swift, but modest action seems to be the BoC's mantra.

One and done

For now, we have just this one rate cut in total pencilled into our forecasts, characterised as an insurance move. But given the uncertain global and trade situation there could be more in early 2020. How the US-China dialogue plays out will be critical. For now though we would point out that the BoC was far less aggressive in hiking rates than the Federal Reserve over the past couple of years. As such, there is arguably less need for a significant corrective move lower in rates.

Canada didn't hike rates as aggressively as the Fed, so less need to cut...

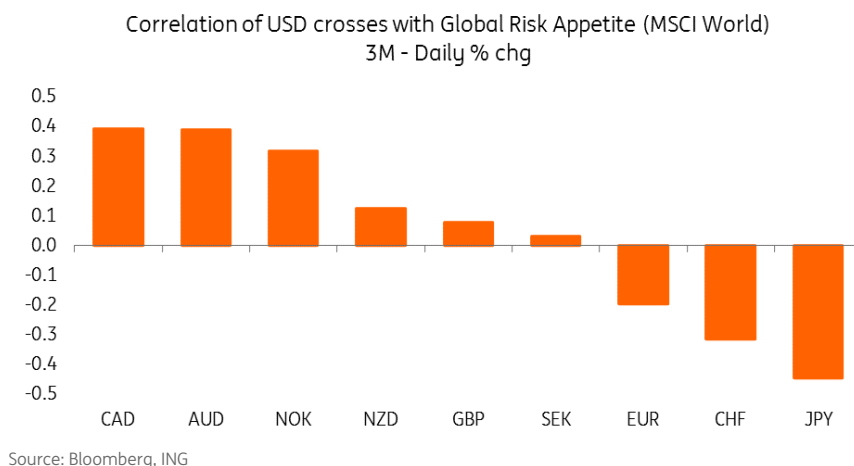


Source: Macrobond, ING

CAD: Still weak in the short-term, but close to the bottom

Trade tensions seems to be the root of all evil for the Canadian dollar given its negative impact on the three main drivers of the currency:

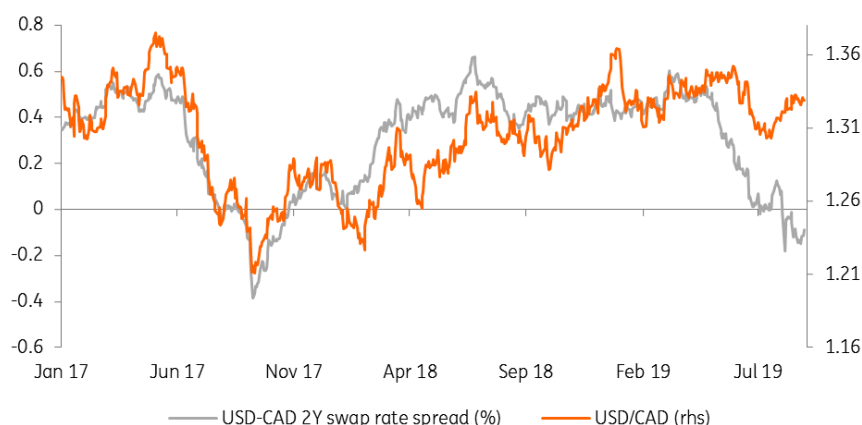
1. Global risk appetite: in the past three months, only the USD/JPY has been more sensitive than USD/CAD to swings in global risk sentiment (as measured by the correlation with the MSCI World stock index). A high-yielding activity currency such as CAD is naturally hit by rising risk aversion, and the extraordinary rally seen in June and July is now presenting the bill.
2. Oil prices: despite OPEC+ efforts to revive the battered oil market, trade tensions are fuelling fears of a global slowdown on the demand side, keeping crude prices on the back foot. On the internal side, the state of Alberta has extended its output gap, but this has done little to help CAD.
3. Rate outlook: BoC rate expectations have been under pressure as trade wars escalated and markets are currently pricing in one rate cut by the end of the year.



In light of this, trade tensions continue to be a big question mark on the CAD outlook and will inevitably be the key driver for the currency moving on. Nonetheless, it can be noted how most of the negatives for CAD appear to be mostly in the price and that a number of developments may allow the loonie to hold its ground better than its risk-sensitive peers. First, our commodities team tends to exclude more extended downside in crude oil prices, instead forecasting a recovery in the coming months, with the WTI benchmark possibly back to the 60\$/bbl levels in 4Q.

Second, a rate cut in October by the BoC (as we expect) is mostly in the price and may have limited downside impact on front-end rates. By contrast, we also expect the October cut to be a one-off move and this would prompt markets to pare back the expectations for 25bp of additional easing by June 2020 currently embedded in the OIS curve. In addition, the much-awaited ratification of the USMCA (which should materialize in the coming weeks) should offer some support to the Canadian trade outlook and probably give some respite to CAD.

USD-CAD 2Y swap rate spread v USD/CAD



Source: Bloomberg, ING

Trade tensions have been the main factor preventing USD/CAD to recouple with the short-term rate spread that would still suggest a weakening of the pair ahead. We expect the rate differential to prevail as a driver in the longer term and remain in the view that USD/CAD can

explore the below-1.30 area by 1Q20 and maintain a downward-sloping trajectory for the remainder of 2020.

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

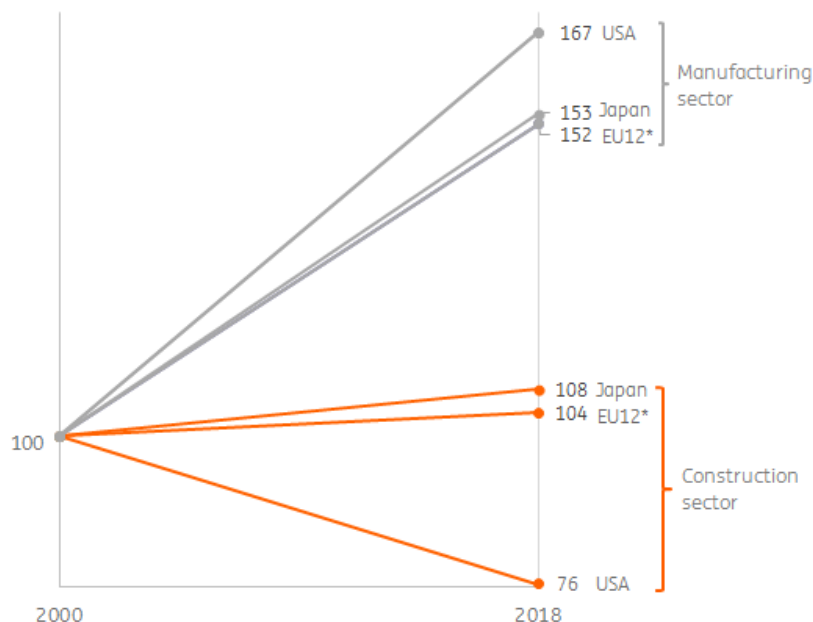
Why construction prices are surging

Labour productivity in the construction sector is growing at a much slower rate than in other sectors such as manufacturing. As a result, higher wages and...



Labour productivity growth in the construction sector is much slower than in manufacturing

Changes in labour productivity in terms of the added value (volume) per employee (index 2000=100)



Source: Oxford Economics & Eurostat, processed by ING Economics Department

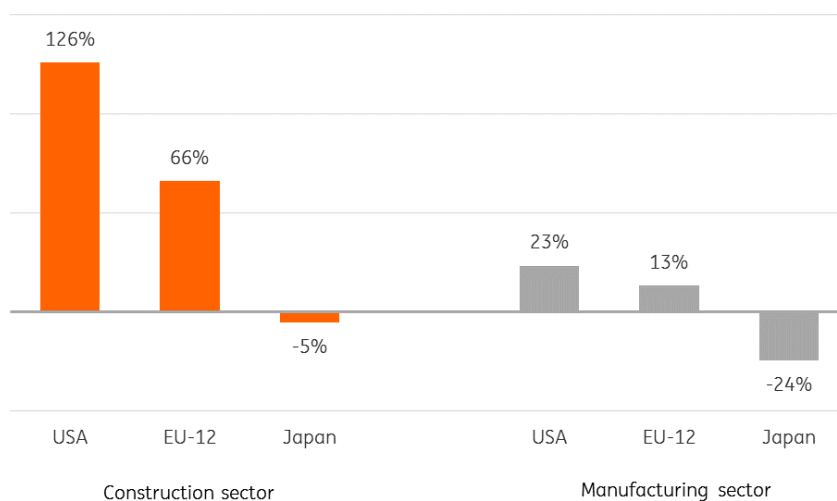
**Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal & Spain

Slower growth in labour productivity in construction sector

In recent years, labour productivity in the construction sector has grown much more slowly compared to the manufacturing sector in the US, Japan and the 12 most important countries in the European Union (the EU12). Growth in the EU12 has been just 3% since 2000, while the region's manufacturing labour productivity increased by 51% over the same period. The trend in Japan has been very similar. In the US, labour productivity in the construction sector actually decreased by almost a quarter while the country's manufacturing sector became much more efficient (with a 67% improvement).

Big price increases in construction

Changes in output prices, 2018 compared to 2000



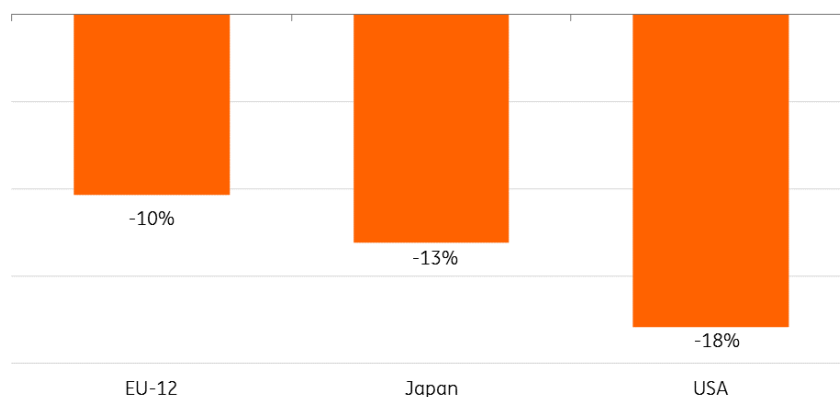
Source: Oxford Economics and Eurostat, processed by the ING Economics Department

Big price increases in construction sector

The slow rate of productivity growth in the construction sector has given rise to significant increases in prices. For example, prices in the US construction sector have increased by 126% since 2000. In the EU12, prices in the construction sector have risen by 66%. In manufacturing, prices in both the EU12 and the US increased much less steeply, by 23% and 13%, respectively. In Japan, prices in the construction sector actually decreased, but prices in manufacturing dropped even more sharply. The slow growth in labour productivity means that increases in costs related to wages and materials cannot be sufficiently covered by simply improving efficiency. Consequently, construction firms need to increase the prices they charge to clients. In manufacturing, on the other hand, significant increases in productivity often allow companies to keep prices down. In the electronics sector, for example, products are becoming cheaper, or better quality products are being made available at the same price.

Sharp drop in construction production in the US in particular

Volume changes in construction production (Added value, 2018 compared to 2000)



Source: Oxford Economics, processed by the ING Economics Department

Overcapacity and reduction in investment

There has been a great decline in construction activity in many regions in the first two decades of the 21st century, and this has had a hugely negative impact on labour productivity growth in the sector. Construction activity in the EU12 in 2018 was 10% below the levels in 2000. The decline was even greater in the US, at 18%. The shrinking market has led to overcapacity in construction firms, which in turn prevents them from deploying their employees efficiently. In addition, this overcapacity and the shrinking turnover has led to the postponement or even cancellation of investments in new and more efficient production processes such as [digitisation and industrialisation](#). This is reflected in the relatively small-scale use of [robots in the construction sector](#). In European manufacturing, there are currently 160 robots in operation for every 10,000 employees compared to 1.2 robots per 10,000 employees in the European construction sector. The number of robots in use in the American and Japanese construction sectors is also relatively small.

Need for flexibility makes innovation difficult

The shrinking construction volume is one issue hindering efficiency in the construction sector, but it is by no means the only factor. Construction personnel the world over have to work in accordance with specific building processes and the demands that these bring. Flexibility is often a requirement, and machines generally don't offer enough of that. This results in a structural slowdown in productivity growth. The following aspects are important factors in this:

- Production is tied to specific location: Every construction project is different, and the construction firms have to move all their expensive machinery to new locations for each project, requiring challenging and time-consuming transportation.
- Specifications and drawings: The design of the building is generally taken care of by architects and structural engineers rather than by the construction firms. Construction firms are therefore constructing different objects in different ways in every new project. It is almost impossible for them to standardise their working methods.
- Volatile market: Construction firms operate within a volatile market, with periods of peak activity alternating with periods of inactivity. Such conditions demand rapid scaling up and

down. This is not conducive to making big investments in efficiency-enhancing means of production.

Author

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Conte 2.0, under the 5SM/PD flag

President Mattarella has mandated Giuseppe Conte to form a new government, backed by the 5SM/PD coalition. Formidable challenges lie ahead, but we expect...



Source: Shutterstock

Italian Prime Minister Giuseppe Conte (R) and Italian President Sergio Mattarella (L) during their meeting at the Quirinal Palace in Rome.

The government crisis which ended the unconventional populist alliance between the anti-establishment Five Star Movement and the far-right League has seemingly found a solution after the centre-left Democratic Party and 5SM agreed to build a new government coalition led, again, by Giuseppe Conte, the outgoing prime minister.

But unlike in Spring 2018, it will be Conte himself managing the division of power between the two stakeholders and will try and strike a balance for a common programme.

President Mattarella will now give PM Conte a few days to work on the government programme and submit the proposed list of ministers. The new government will then have to undergo confidence votes in both branches of the parliament within ten days.

A common incentive to avoid early elections

The solution to the government crisis built on a common incentive for the 5SM and the PD party to avoid a snap election. The genesis of the 5SM/PD new coalition shows that this was contemplated

on the PD front only under the assumption that the new government would aim at completing the legislature (which will end in March 2023). Incidentally, this time horizon would encompass the all-important election of the new Italian president in February 2022 when Mattarella's mandate ends.

Only time will tell if such a long time horizon would be possible.

A different role for PM Conte

In the new political setting, PM Conte is likely to play a different role in comparison to what he did in the outgoing League/5SM government.

If formerly he took office with an unprecedented notarial role, executing the inputs coming from the leaders of the League and of the 5SM, both acting as vice-PM, this time round he is likely to play a more conventional role of a prime minister. As the PM has been indicated by the 5SM, we don't think the scheme of the twin vice-PMs will be re-proposed.

Political divergences exist, but attitude towards Europe should be more constructive

The degree of cohesion of the new coalition is still unknown as both parties had fiercely opposed each other during the last campaign, and their differences remain. But where we do see ample room for improvement is in the relationship with European institutions.

Salvini's confrontational approach would have progressively isolated Italy in Europe, but the new political mix is likely to have a more constructive approach. The 5SM has progressively reneged on its anti-euro calls over the last year and voted in favour of Ursula Von der Leyen as the new president of the EU Commission, like the Democrats. The perceived risk of Italexit threats should clearly reduce under the Conte 2.0 government.

Less disruptive potential in the upcoming budget

But all of this will be tested quite soon in the budget season. Without an official government programme, it is very hard to draw any firm conclusions. However, the conciliatory approach adopted by Conte to European budgetary recommendations during his time in the former government, we believe this would be confirmed.

Cross-checking the lists of priorities spelt out by the 5SM leader Luigi Di Maio and PD leader Nicola Zingaretti, are quite vague, but nevertheless we see less scope for short-term budgetary disruption. There is no mention of costly tax cut exercises such as the introduction of a flat tax system, therefore we think it would be easier to craft a budget, not in collision with European budgetary rules. The lower cost of debt servicing associated with a reduced risk of 'Italexit' should in principle help subsidise the adjustment required.

Big challenges remain, particularly on growth

Having said that, the new government will still face formidable challenges, the first of which will be to agree on pro-growth policies.

The Five Star Movement has so far failed to take a clear stance on this and recently reiterated their inclination to oppose big infrastructural projects, which may lead to conflict

with the pro-growth Democrats. It will be up to PM Conte to distil a viable synthesis, as failing to do so could possibly widen the gap between the North and the South of the country.

To better decipher how difficult this will be, we will have to wait for the agreed government programme and, more practically the discussions over the next budget.

Author

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

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