Sunday Wrap

Happy Sunday,

This is Marco Valli from Milan, the UniCredit Chief European Economist. It has been an eventful week. The Fed followed up on the ECB's stimulus package and lowered the target range for the federal funds rate by 25bp. However, the dot plot was less dovish than expected, with only 7 of the 17 FOMC members forecasting another 25bp cut by the end of the year, and no one penciling in further cuts through 2022. We remain convinced that the Fed's GDP estimates are too optimistic, and, therefore, current "insurance cuts" will be followed by further easing well into next year as the US growth outlook deteriorates.

Interestingly enough, the Fed's liquidity policy, not rate policy, was the main theme in US financial markets, as tension in the repo market forced the first Fed intervention since the financial crisis. Some stress had been expected because of corporate tax payments and a fairly large amount of Treasury settlements coming due in the present environment of the Fed unwinding its massive post-crisis support. However, aggregate liquidity in the banking system is abundant and the inter-bank market had been expected to function well enough to cap the effect on overnight rates, even though excess liquidity is heavily concentrated in a relatively small number of large banks. In the event, banks with excess liquidity did not step in to lend sufficient amounts overnight to other banks to prevent rates from skyrocketing.

Reportedly, the Fed is now investigating why the interbank market does not function normally. NY Fed Sr. VP Lorie Logan was quoted in the FT saying that "the excess reserves relative to the minimum level each bank is demanding is concentrated, and the key question is how those reserves, as the level was coming down, would get redistributed, and how smooth that redistribution process would be." Meanwhile, the NY Fed announced that it would expand its interventions beyond overnight loans to also include two-week loans this coming week, with operations scheduled on Tuesday, Thursday and Friday.

We take comfort in the fact that this is a market in which it is very easy for the Fed to intervene, and that they are doing so. A standing repo facility would provide a permanent tool for Fed intervention and would probably solve the issue. But something is obviously not working right in the US banking system, so we are watching this issue carefully.

Marco Valli
Head of Macro Research
Chief European Economist
(UniCredit Bank, Milan)
+39 02 8862-0537
marco.valli@unicredit.eu

Bloomberg: UCGR, UCFR
Internet: www.unicreditresearch.eu

On Brexit, hopes for a deal have increased thanks to three important developments. First, the UK government was reported to be seriously working on a plan for an all-island economy for agri-food and electricity, as an alternative to the backstop, with other checks carried out away from the border. And the UK has, finally, submitted some (as yet unpublished) ideas in writing to the EU. Second, the leader of the Northern Irish DUP party said she is "prepared to be flexible and look at Northern Ireland-specific solutions". Third, European Commission President Jean-Claude Juncker said on Thursday that the latest UK proposals were the "starting and arrival point" for a deal. However, according to a leaked European Commission document, the UK proposals "fall short" in 1. avoiding a hard Irish border and 2. preserving the integrity of the EU single market. The path to a deal was never going to be easy and it will very likely require the UK to accept a Northern Ireland-only backstop (probably in all but name). We continue to expect either a deal or an extension of Article 50, thereby avoiding a no-deal Brexit on 31 October.

In Germany, the climate cabinet decided on a package of measures to reduce greenhouse gases over the long term. The package is worth a cumulative EUR 54bn (or 1.5% of GDP) by 2023; it still needs parliamentary approval and is, therefore, amendable. If we assume that the fiscal multiplier for this package is 1, the additional growth impulse would amount to nearly 0.4pp per year. However, the deal also foresees measures that will dent the purchasing power of companies and private households, hence reducing the package's net impact on growth. For example, the core part of the new agreement is a pricing system on carb-dioxide emissions for traffic and buildings, whose costs will be passed on to the private sector via higher energy prices. Importantly, Chancellor Merkel and other leading politicians from the grand coalition made clear once again that a balanced public budget, the so-called "black zero", remains a primary goal and that a rise in public indebtedness is not planned.

Given that Erik is not available this weekend, today I will take the opportunity to elaborate on two topics:

- **Oil prices on a roller coaster as investors assess the impact of geopolitical tensions in an oversupplied market.**
- **The Italian budget process enters a crucial stage and investors are relaxed – rightly so. We expect a constructive dialogue with the EU, while Renzi's breakaway from the PD is not a threat to government stability in the near term.**

1. Oil investors caught between geopolitics and excess supply

Oil prices have reacted with large swings to last week's drone attack that disrupted about half of Saudi Arabia's oil production, de facto lowering global oil supply by approximately 5%. At 5.7mb/d, this was the worst supply disruption in history; hence, it was not shocking to see oil prices jump 20% at market opening on Monday. But the price decline that followed the encouraging news on Aramco's timeline for full recovery in output tells a lot about the contrasting forces that are currently driving the oil market. Brent prices are now trading at around USD 65/bbl, some 7-8% higher than the level just before the strike.

My colleague Edoardo Campanella convincingly argues that troubled geopolitics should be assessed in tandem with the fundamentals of the oil market, with the latter pointing to a problem of oversupply, not shortage. This happens because traditional producers are pumping too much and have ample spare capacity, while commercial inventories are at a high level amid weak global demand, which reflects subdued economic activity. In this environment, temporary supply shocks tend to be reabsorbed fairly quickly. You can find Edoardo's note here: Oil Update: Heightened geopolitical tensions amid powerless OPEC+

However, equilibrium prices are now likely to be higher than those prevailing before last weekend's attacks, as the market will price in some geopolitical risk premium for a number of reasons. First, investors have likely reassessed the probability that oil infrastructures of Saudi Arabia and of other key producers might be exposed to new attacks in the future. Second, the chances of rapprochement between the US and Iran are now slim, as shown by the decision of the Trump administration to impose additional sanctions on Iran. At least for the time being, the 2mb/d of Iranian oil exports that were withdrawn when the US adopted the strategy of maximum pressure on Tehran are unlikely to come back. Finally, the likelihood of skirmishes between the main regional powers in the Strait of Hormuz, which is the most important global chokepoint, remains high.

In the current weak macro environment, the 7-8% increase in oil prices from last week is an unwelcome development for energy importers such as the euro area, but the impact on inflation and growth will be small. As a rule of thumb, when (euro-denominated) Brent prices jump 10%, the eurozone inflation rate rises by 0.2pp within a month after the shock, compared to a counterfactual scenario where oil prices remain stable. This reflects the fast pass-through to the price of oil products, which represents the bulk of the CPI response, while a smaller, delayed impact occurs **1.** when the price of other forms of energy products start to respond, especially natural gas; **2.** if indirect effects materialize on the prices of food, services and non-energy industrial goods, and **3.** if second-round effects on wages start to emerge.

In terms of growth, the increase in oil prices works its way through the economy mainly via lower purchasing power of households and a compression of corporate profits, which negatively affect private consumption, fixed investment and employment. However, the GDP response to an oil-price shock is usually more uncertain than that of inflation, potentially due to non-linearity (the impact on growth might be larger when oil prices rise, lower when they decline), threshold effects (the impact increases when oil prices rise above a certain level) and also evidence pointing to a larger impact at times of heightened macroeconomic uncertainty. In our estimates, a 10% increase in oil prices subtracts 0.1pp from eurozone real GDP growth, but in the current circumstances it is possible that the drag will be somewhat larger.

Given the small magnitude of the impacts we are discussing here, it is clear that the recent oil shock will not trigger any fresh policy response by the ECB, especially so shortly after the bold package of measures announced on 12 September. However, it is interesting to simulate a scenario where geopolitical uncertainty in the Middle East escalates and Brent prices jump to, say, USD 100/bbl (a 50% increase from the current level). In such an environment, eurozone inflation would rapidly accelerate and fluctuate in a 2.0-2.5% range through most of next year, while average GDP growth for 2020 might slow to a range of 0.0-0.5%.

This is not the type of inflation that anyone wants, because it erodes growth and does not lead to a sustainable increase in inflation expectations. Unless indirect or second-round effects prevail over the widening of the output gap and start driving core inflation higher – which seems unlikely, given the stickiness of core prices in recent years – the shock to headline inflation would fade after a year as a large base effect kicks in. This would allow the ECB to look through the (temporary) jump in inflation. If anything, downside risks to inflation might even prevail over the medium term, as rising slack weighs on underlying price pressure. In such environment, the ECB's call for bolder fiscal action would probably intensify.

2. The Italian budget and Renzi's breakaway

In the upcoming week, the Italian government will start to unveil its plans for the 2020 budget law. By Friday, they are expected to publish the new projections for the key macro variables and fiscal targets (the latest update was in April), while more detailed information on individual measures will become available in mid-October when the draft budget law will be sent to the European Commission. Loredana Federico, our Chief Italian Economist, covers this and much more in a note that you can find here: Italy`s government faces new economic challenges

The path for the government is narrow, amid looming downward revisions to the outlook for real and nominal GDP growth, and, especially, the need to prevent triggering the large VAT hike envisaged by current legislation, which accounts for revenues worth up to 1.3% of GDP. We should also add to this list about 0.2% of GDP in resources needed to finance expenditures that cannot be deferred, and, obviously, a package of measures that would allow the government to begin the implementation of some of its economic agenda, starting with a cut in the tax wedge to the benefit of workers.

Some relief – which we quantify is about 0.3% of GDP – will mainly come from lower-than-expected spending on pensions (reflecting a smaller take up of the "Quota 100" early retirement scheme), and much lower interest rates as the BTP curve shifted down spectacularly since the April forecasts.

When all this is taken into account, Loredana estimates that the government's deficit target for 2020 will likely be set at or just above 2% of GDP, hence basically unchanged from the outcome expected for this year. This target assumes that the package of fresh stimulus measures will be relatively small, probably no more than 0.5% of GDP, and implies a meaningful effort by the government to retrieve resources for at least 1% of GDP, as well as a decent dose of flexibility from the EU within current budget rules. However, this composition should be taken with caution because it is just our own attempt to quantify measures for which visibility remains very low, also given that all the numbers will have to be fined-tuned in light of the updated macro framework.

We have much better visibility in regard to the likely tone of the budget discussion with the EU. As a matter of fact, all the key jobs that require technical dialogue with European peers on this matter are in the hands of PD people with strongly pro-European attitude, namely Economy and Finance Minister Roberto Gualtieri and European Commissioner for economic affairs Paolo Gentiloni. Moreover, when heading the previous government coalition, PM Conte established himself as a guarantor of Italy's compliance with the EU budgetary framework, amid intense pressure to bend the rules coming from within his own cabinet. I would be very surprised if this combination does not lead to a constructive dialogue with the EU, where the two negotiating parties naturally start from different targets, but aim to find an agreement somewhere in between.

Markets have seen this coming as soon as they started to smell a rising probability of a M5S-PD coalition, and have reacted accordingly without waiting to check out the details of the program of the new government. The ECB's open-ended QE added to this feeling of confidence. But now that the Italian government approaches decision time in a context of scarce resources, it is worth having a closer look at its policy agenda. A cut in the tax wedge (i.e. the difference between total labor cost and the net take-home pay of the worker) ranks very high on the list, and rightly so given that taxation on labor is high in Italy compared to European peers – although not higher than in Germany and France.

The tax wedge is typically made up of income taxes and social security contributions (the latter weighing both on workers and employers), therefore, a government can choose between different modalities to trim the wedge. The Italian government has decided to benefit the workers by lowering taxes and social security contributions for low-to-middle-income earners, while, as far as we know today, this specific measure is unlikely to affect firms. By doing so, the government wants to stimulate economic growth via higher private consumption and, hopefully, labor supply, especially among low-skilled workers (and, therefore, low-wage earners) who tend to have higher labor-supply elasticity.

Whether this is the most efficient way to implement a cut in the tax wedge, I don’t know. The majority of literature on fiscal devaluation finds that a reduction in social security contributions for firms tends to generate higher gains in terms of aggregate output and employment than a cut in employees’ income taxes, mainly via the competitiveness channel. However, this result is far from uncontroversial and other studies reach the opposite conclusion, for example in countries where the labor market is characterized by low matching efficiency – arguably Italy’s condition.

Whatever the reality, the decision to benefit workers reflects a clear political priority and, as such, will certainly be endorsed by the European Commission in the very likely event that this measure is implemented within the limits of the European fiscal framework.

Let me close this section with some thoughts on the implications of Matteo Renzi’s breakaway from the PD, which was announced this past Tuesday. It was the speed of the development that caught us by surprise, not the development per se.

First and most importantly, I do not think that Renzi’s departure from the PD will pose a threat to government stability in the near future. With 25 MPs in the Lower House and 15 in the Senate, Renzi’s new party (Italia Viva) has the numbers to potentially cause a government crisis, given that in the confidence vote in the Senate, PM Conte won 169 votes out of an absolute majority of 161. However, we see no incentives for Renzi to pull the plug, because he needs time to assemble and shape up Italia Viva. Preliminary opinion polls indicate that only about 4% of voters would support his party as of now, showing that a lot of work still needs to be done. Moreover, within the PD, Renzi was among the first to call for an alliance with M5S, surprisingly reversing his previous harsh opposition to such an option. His voters would find it difficult to understand a second turnaround within a short period of time.

Second, Renzi’s new challenge is a risky one. It is not clear how much room there is in the middle of the political spectrum, and even if this space does exist, the political offer is not in short supply, given the existence of a few small parties campaigning on rather similar pro-EU, pro-reform agendas, yet so far unable to close ranks and gain critical mass. Renzi’s bet is on the medium term, hoping that the PD increasingly drifting to the left and the center-right clearly skewed towards the hard right would open up good opportunities for a brand-new party à la En Marche. It is possible, but far from clear. It is not too surprising then that several PD MPs who have traditionally been most loyal to Renzi did not follow their leader in his new adventure (at least for now).

Third, I suspect that Renzi might have more power to influence the government’s policies from outside than from inside the PD, where he was being progressively cornered despite controlling the majority of PD MPs. Given the very strained relationship between Renzi and M5S, this probably raises uncertainty on the resilience of the government coalition in the medium term.

That is it for me today. But before I close, let me remind all our non-Bavarian readers that the 186th edition of the Oktoberfest started yesterday. If you cannot participate in person, you should at least make sure you are on top of the key issues of “Oktoberfest economics”. Check out here what my colleague Thomas Strobel has to say on this: Oktoberfest 2019: New record high in beer liquidity?

Best

Marco

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j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

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UniCredit Research* Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Florin Andrei, Ph.D.
Senior Economist, Romania
+40 21 200-1377
florin.andrei@unicredit.ro

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

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