

Overview: In this week's showCASE our experts discuss the impacts of the ECB's mixed messaging regarding quantitative easing. CASE also weighs in on the recent referendum in Italy and analyses how a "no" vote could feed into the recent wave of populism in Europe.

A dovish Draghi prevails over confused financial markets

By: [Paul Lirette](#), Senior Economist, CASE

The European Central Bank (ECB) sent mixed messages to financial markets yesterday, with an announcement that contained both hawkish and dovish tones.

On December 8th, the ECB revealed that it will extend its monetary stimulus to the Eurozone by 9 months, or beyond, if necessary, but that the pace of monetary stimulus will be lowered from € 80 billion to € 60 billion starting in April.



European Central Bank, Frankfurt am Main (CC)

The mixed messages appeared to surprise currency markets, where the euro/USD witnessed a spike, which failed to sustain, and subsequently moved sharply lower (dropping from a high of 1.0874 to a low of 1.0637). Meanwhile, benchmark German 10-year bund yields rose nine basis points to 0.44 percent but finished the day at 0.38. The pan-European Euro Stoxx 600 index also dropped immediately following the announcement, but recovered to close the day up by 1.23%.

The financial market volatility that was created by the ECB announcement was eased during a regularly scheduled press conference with ECB president, Mario Draghi, who reassured investors that the aim was not an outright winding-down of quantitative easing and that easy monetary policy will remain intact throughout 2017.

It is believed that the decision to extend the accommodative stance hinges on weak inflation, which is only [forecasted to come close to its target range in 4-5 years](#), as well as the fact that many EU members, [including France](#), are set to hold general elections in 2017, which often plays a role in financial market uncertainty.

Meanwhile the U.S. dollar rose 0.9 per cent against a basket of major currencies, as the ECB news comes just one week ahead of the U.S. Federal Open Market Committee meeting to discuss possible rate hikes (which many are expecting a hawkish outcome given the relatively more robust growth in the U.S. economy). Meanwhile, the S&P 500 closed at an annual high on December 8th, prolonging its recent strong bullish trend.

For the ECB, an extension of accommodative monetary policy appears to be the right move, especially given that a number of Eurozone economies continue to struggle. However, a high degree of political instability in the EU, such as the recent referendum in Italy, and lingering debt overhang make it clear that monetary policy is only one piece of the puzzle.

The Italian referendum and Europe's growing wave of political uncertainty

By: [Katarzyna Mirecka](#), Economist, CASE

Italy has become yet another country to take steps towards populism, a change that has been much feared in Europe over the past few months.

On December 4th, a referendum, which aimed to introduce constitutional changes that [the \(soon-to-be ex-\) Prime Minister Matteo Renzi](#) has been promoting since the very beginning of his mandate, faced a resounding “No” by Italian voters (59.1 per cent of total votes). It would appear that investors were prepared for the outcome of the referendum, with [little signs of it generating financial market turmoil](#).



The goal of the referendum was to transform the Senate (which, currently, shares many similarities with the Chamber of Deputies – the “*bicameralismo perfetto*” - a system considered to be the reason for numerous [political gridlocks](#)), by reducing the institution's overall size, costs, influence, and composition (from one composed of directly elected senators to one composed of appointed senators).

In the lead-up to the vote, Mr. Renzi promised to resign in the event of a “No” vote, which is perhaps a signal that the referendum was more of a plebiscite for his government than a question of legitimate constitutional change. Nonetheless, Mr. Renzi's resignation could lead to an early election, possibly taking place as early as next year.

This could open the door for the most popular opposition party in the polls, the populist and anti-establishment Five Star Movement (M5S), who is calling for [an immediate election](#). Given M5S's questioning of Italian membership in the EU, and their strong opposition to participation in the euro zone more generally, this has raised many concerns for the EU's third largest economy, as it adds to the country's laundry list of problems (e.g. [financial problems](#) in the banking sector, the [second-largest debt-to-GDP ratio](#) in the EU at 133 per cent of GDP, instability faced by industry, and a continuous shrinking of the economy since the beginning of the crisis in 2008).

It is clear that, if elected, M5S would only further solidify the global rise in populism and increase political uncertainty in Italy. While the populist wave in Europe recently faced pushback, with the rejection of Austrian far-right presidential candidate, Norbert Hofer, the result of the election (with 48.3 per cent voting for Mr. Hofer) was far from reassuring. Whether or not this new movement will materialize in Italy remains to be seen when an election date is decided. For now, the next big test will be the upcoming elections in the Netherlands and France.

At a glance



According to the Central Statistical Office, Q3 GDP increased in real terms by 2.5% year over year, which comes in much lower than expectations. While private consumption has been increasing (+4.2% yoy), due in large part to accelerating wages and higher welfare spending, investment activity remains subdued imports (-7.3% yoy), weighing on growth expectations. Moreover, growth of imports has been more vivid than growth of exports dragging down current account balance. CASE experts forecast 2016 growth at 2.8% and anticipate that the economy may accelerate slightly in 2017. However, high deficit levels caused by inflated social spending could likely lead to deficits exceeding three percent threshold, and together with increasing policy uncertainty, may hamper future GDP growth.

■ NBP MPC Base rate unchanged at 1.5%

Real GDP forecast (%)	2016	2017
CASE	2.8	3.4
IMF WEO	3.1	3.4
OECD	2.6	3.2



Recent OECD forecasts show that Russia is expected to return to growth in 2017, following two years of recession. Primarily, this reflects higher real wages, which are expected to boost private consumption, as well as lower interest rates capable of supporting investment. However, the Russian unemployment rate reached 5.4% in Q3 and is expected to continue growing, reaching 5.7% in Q4, which will play a role moving forward. The strength of the recovery also depends on government's ability to unclog structural bottlenecks in the economy (which have hindered diversification) as well as whether or not oil prices rebound. Further, some degree of political uncertainty remains for the Russian economy, particularly issues relating to Western sanctions.

■ Nov CPI unchanged from previous month at 0.4%

Real GDP forecast (%)	2016	2017
IMF WEO	-0.8	1.1
OECD	-0.8	0.8



The latest Bundesbank report presents a positive picture of the German economy, in line with OECD's upward revision of its Real GDP Forecast from 1.6% to 1.74%. Positive expectations for economic growth are underscored by increase in capacity utilisation and order intake in the manufacturing sector, industry's higher export expectations, a lively construction sector and favourable labour market conditions. Outlook for employment remains positive, despite weak growth in jobs between June and August, associated with social security contributions and a drop in low-paid part-time work. Prices are following a steady but sluggish growth path (CPI y/y 0.80%), with suppressed wage inflation and low energy prices stifling inflationary pressure from a weather-related spike in food prices and rise in rents.

↑ Nov Services PMI up to 55.1 from 55.0 in October.

■ Nov Manufacturing PMI stable at 53.7.

Real GDP forecast (%)	2016	2017
IMF WEO	1.7	1.4
OECD	1.74	1.65

At a glance



On December 8th, the National Bank of Ukraine (NBU) announced that it will keep its discount rate unchanged at 14%, in an attempt to mitigate inflationary pressure in the economy. In October, headline inflation stood at 2.8% m/m, while in November inflation slowed to 1.8% m/m, gradually converging to the NBU's targeted path. The slowdown in inflation has been primarily due to a slowdown in unprocessed food prices, but has been counterbalanced by higher fuel prices. NBU's projections for economic growth over 2016 remain moderate, with real GDP forecasted to grow by 1.1% y/y, while for 2017 and 2018 growth is expected to reach 2.5% y/y and 3.5% y/y respectively.

Real GDP forecast (%)	2016	2017
IMF WEO	1.5	2.5
OECD	-	-



The Czech economy experienced an economic growth slowdown in Q3 2016, expanding 0.2 percent q/q or 1.9 y/y. Although this has been expected by the Czech National Bank (CNB), the slowdown has been more preannounced than forecasted by 0.6 pp in both year-on-year and quarter-on-quarter terms. The Czech economy is suffering from an increasing outflow of funds from foreign owned companies, which according to the latest report prepared by the Czech Government own a significant share of businesses in some of the most profitable sectors of the economy. Nonetheless, economic growth in 2017-18, as forecasted by the OECD, is expected to remain stable, reflecting solid labour demand, which is expected to push down unemployment and drive up wages.

↓ Retail sales growth slows to 2% from previous 4.7%

Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.5

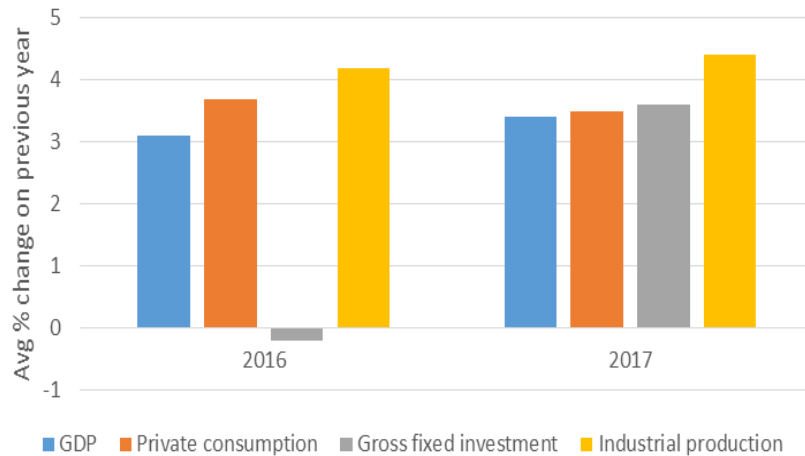


Recent OECD forecasts expect Hungarian growth to pick up in 2017, reaching 2.5%, as a new cycle of EU structural funding should give rise to new infrastructure projects. Growth in 2017 will also benefit from increased bond ratings, from Ba1 to Baa3, and declining government debt burdens coupled with significant overall reductions in external vulnerabilities. Meanwhile, inflation continues to remain below the 3% Central Bank target with little signs that it will increase above target levels in 2017, a reality which could incite further rate cuts in the near future (although none are currently planned). Moving forward, the economy should benefit from growing business capital accumulation, inward FDI and increasing demand.

↑ Q3 GDP revised up to 2.2% y/y from 2.0%

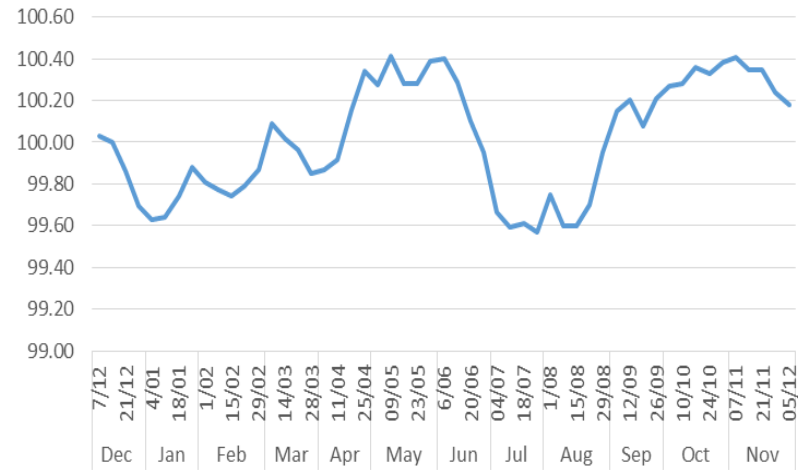
Real GDP forecast (%)	2016	2017
IMF WEO	2.0	2.5
OECD	1.7	2.5

Polish Economy: CASE forecasts



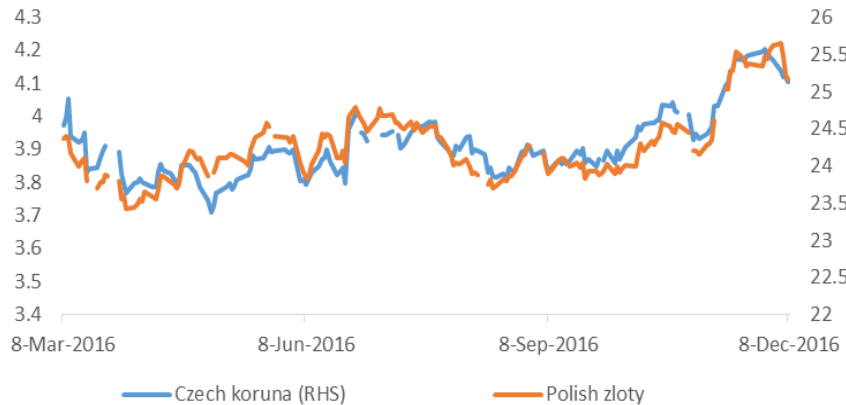
Source: CASE forecasts, updated November 14, 2016

Polish Online CPI



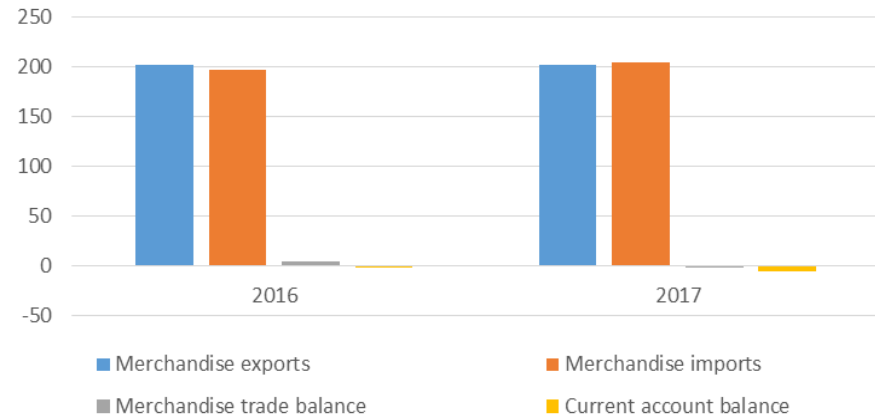
Source: CASE, most recent observation Dec 05, 2016

Czech koruna and Polish zloty
(currency units per U.S. dollar)



Source: IMF, most recent observation December 8, 2016

Polish Trade: CASE forecasts
US\$bn - annual total



Source: CASE forecasts, updated November 14, 2016

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