

## Italy: Lega Less Aggressive on the Budget

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**Italy: Salvini aims for a 2% deficit-to-GDP target in 2019** – *La Stampa* reports the right-wing leader wants to avoid triggering a negative market reaction, risking FinMin Tria's resignation, only few months ahead of the crucial EU elections in May 2019.

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**Italy: Lega becomes by far the largest party in first post-summer polls** – Lega clearly overtakes M5S amid a more vocal confrontational stance on immigration.

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**Italy: Jan-Aug 2018 state sector budget deficit narrows by €11.8bn (0.7% of GDP) vs. 2017** – Net of bank recap costs, 2018 overall budget deficit-to-GDP set to decline slightly relative to the 2017 result of 1.9%.

With thanks to Ann O'Kelly

**Germany: AfD gains in recent polls again** – Following anti-immigrant street protests in Chemnitz, right-wing populists inch closer to record high in polls.

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**Spain: Sanchez in favor of a vote in Catalonia, but not on independence.**

**UK: budget in October?** – *The Times* reports that the Chancellor may try to avoid the crunch phase of Brexit talks and ratification.

**UK: construction sector cools sharply in August** – Adds to manufacturing slowdown and raises slowdown likelihood, but much larger services sector could provide better news tomorrow.

**Switzerland: stable 1.2% inflation in August** – Headline CPI inflation and core (0.5%) in line with expectations in August. With inflation below target and the Franc below the former minimum exchange rate, no pressure on SNB to change policy for now.

**Euro Area: Why the Upswing is Not About to End:** We argue that the current cycle has every chance of extending at least into 2020. Even with real GDP growth remaining slightly above trend in coming quarters, the ECB is unlikely to start hiking interest rates before the end of summer 2019. We answer some frequently-asked questions (length and magnitude of the cycle, private sector leverage, potential for wage acceleration, risk of domestic policy errors, likelihood of Italian government embarking on large scale fiscal easing, the risk of No-Deal Brexit, etc...) and we look at the probability of trade wars and EM contagion, as bilateral tensions between the US and China have global ramifications.

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## Today's News In Detail

**Italy: Salvini aims for a 2% deficit-to-GDP target in 2019** – Italian daily *La*

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*Stampa* reports that the leader of the right-wing governing party Lega, Matteo Salvini, will argue for setting the 2019 budget deficit/GDP target at 2% during today's meeting of Lega's highest ranks. FinMin Tria has recently said the government will target a deficit of 1.5%. According to *La Stampa*, 1.5% was agreed by the government in early August to be the starting point of the negotiations with Brussels. Note that the previous government had committed to reduce the 2019 deficit to 0.8% of GDP, from 1.6% in 2018. Salvini reportedly wants to avoid triggering a negative market reaction with excessive fiscal loosening, risking FinMin Tria's resignation, only few months ahead of the crucial EU elections in May 2019. Yet, the more Eurosceptic figures within Lega are calling for a much higher deficit and a more confrontational clash with Brussels.

**Comment:** Lega's disincentives against a too confrontational stance with Brussels and markets are indeed significant and this is the main reason why we expect the government to seek only a modest fiscal loosening in the 2019 budget. Even so, that would require significant negotiations with the EU, given the Italy would be required to tighten the fiscal stance by 0.6pp of GDP each year in 2019 and 2020.

**Italy: Lega becomes by far the largest party in first post-summer polls** – The first SWG poll on Italians' voting intentions (fieldwork: 29 Aug- 3 Sep) shows right-wing Lega at 32.2% vs. its coalition partner M5S at 28.3%. In the previous SWG poll at the end of July, Lega was ahead of M5S by only 0.6pts, at 30.3% vs. 29.7%. The two governing parties jointly would obtain 60.5% of the votes, vs. 50.1% in the 4-March election. Centre-left PD remains the third party, roughly stable since July (and since the election) at 17.7%, while centre-right Forza Italia loses further support to 6.9%, from 8.6% in July and from 14% in March. Another poll by Lorien (fieldwork: 27 Aug) also sees Lega ahead of M5S, by 4.9pp (31.7% vs. 26.8%). **Comment:** Lega's confrontational stance towards the EU, mainly on immigration, is clearly paying off in voting intentions. Joining forces with anti-establishment, more left-leaning, M5S does not seem have negatively affected Lega's support, while this may not be true for M5S. This reduces the incentive for Lega to pull out of the current coalition government and force a snap election, at least not until the important European election in May 2019.

**Italy: Jan-Aug 2018 state sector budget deficit narrows by €11.8bn (0.7% of GDP) vs. 2017** – The state sector budget posted a surplus of €1.3bn in August, vs. a deficit of €1.1bn in Aug-17, data showed on Monday. In the first 8 months of 2018, the state sector borrowing requirement stood at €29.5bn, some €11.8bn (or 0.7% of GDP) lower than in the same period of 2017. Net of expenditures in support of banks (which amounted to €8.9bn in the first 8 months of 2017), the state budget sector still improved by ~€3bn (0.2% of GDP). Net interest spending by the state sector (data available only up to July) was €0.6bn higher in Aug-18 than in Aug-17, but over the May-Aug period (when yields have spiked higher), interest spending was still €0.8bn lower than in the same period of 2017.

**Comment:** despite the large fiscal pledges of the new government, the underlying fiscal position continues to improve mirroring the recovery in nominal GDP. Modestly rising wage growth will also provide a boost to government revenues in coming months. The 2017 overall general government budget deficit stood at 2.3% of GDP, but net of bank recap costs it was 1.9%. Monthly data up to August suggest the 2018 deficit is likely to come in at around this same level if not slightly lower (current target for this year is 1.6%).

**Germany: AfD gains in recent polls again** – In the wake of anti-immigration street protests in the east German city of Chemnitz following the alleged killing of a German citizen by asylum seekers, the right-wing populist AfD has gained a percentage point in several recent polls. It now stands at 17% in three of the seven most important polls and at 16.3% in our 5-poll trailing average, up 1.5pp over the last three weeks. The party is closing in on its all-time high of 16.7% in mid-July this year. The gains came almost entirely at the expense of Chancellor Merkel's CDU, which also runs the state of Saxony, in which Chemnitz is located.

In all east German states (except Berlin), the AfD is currently polling between 20-25%. **Comment:** The AfD is currently gaining each time a major crime or alleged major crime of asylum seekers against Germans occurs. Especially in east Germany, where the two major non-mainstream parties AfD and Linke (Left party) have voting shares of up to 40% combined, it will get increasingly difficult for the traditional parties to avoid alliances with the right-wing and left-wing parties. However, even in West Germany, the governing CDU and SPD look set for disappointing results in the regional elections in Bavaria (14 October) and Hessen (28 October), which may increase tensions within the government again.

**Spain: Sanchez in favor of a vote in Catalonia, but not on independence –**

The new Socialist PM said in an interview on Monday that the solution to the Catalan situation should pass through a vote. However, he said that would not be a vote on self-determination, like the 2017 illegal Catalan referendum, but rather a vote on a new regional statute – the legal framework covering the rights and obligations of the citizens of Catalonia, as well as the region's financing, political institutions and competences. Sanchez however sounded firm in re-stating that Article 155 of the Constitution (allowing Madrid to overtake power in the region) is still a possibility were the local government to push again for self-determination. Sanchez also refused to interfere with the judicial process against 9 Catalan politicians imprisoned last year in the aftermath of the illegal referendum.

**Comment:** the more conciliatory stance of the new Socialist government in Madrid, relative to its conservative predecessor, could ease tensions with the separatist region, although it is unlikely to solve the problem any time soon.

**UK: budget in October? –** *The Times* reports that the Chancellor may unveil the budget in late October rather than the more usual November date, in order not to clash with the finalization of the Brexit talks and the potential ratification process of any treaty. However, Treasury sources also told the *Times* that it remained possible that the budget presentation would take place in December. **Comment:** Having moved the budget from the spring (and thus only a month before the fiscal year starts) to the autumn (and thus 4 months before the fiscal year starts), the Chancellor has ample flexibility to move the announcement, and with it the crucial votes, to the politically most opportune moment.

**UK: construction sector cools sharply in August –** The UK construction PMI fell to 52.9 in August (Consensus 54.9, Citi 55.0), from 55.8 in July. We and consensus had expected a correction after the big July gain, but not quite this sharp. Markit highlights that despite the broad slowdown in August, new business and employment increased solidly, with the volatility largely reflecting fluctuations in current output. **Comment:** The release adds to the disappointing manufacturing PMI published yesterday and lends support to our call for a growth slowdown in H2 as the Brexit deadline approaches and uncertainty increases. However, it is too early for a verdict on August growth as manufacturing and construction together weigh less than a third of the private services sector's share in total GDP. The services PMI will be published tomorrow (July: 53.5, Citi forecast: 53.8).

**Switzerland: Inflation Stays At Post-Crisis Peak –** Headline CPI inflation was unchanged at 1.2% YY in August, in line with Citi and Consensus expectations. Core inflation 1 (excluding seasonal products and energy), was unchanged at 0.5% YY, also in line with Citi expectation. Goods inflation was unchanged at 2.2%, largely reflecting energy inflation (which has peaked, as expected). Services inflation was marginally lower at 0.5% (-0.1pp compared to July). There was some volatility in the details, which much higher clothing inflation, offset by lower food & drinks inflation. **Comment:** We expect headline inflation to stay at above 1% until spring 2019 and then fall back below 1% as the energy base effects drop from the annual comparison. Inflation is currently running a bit higher than the SNB's June forecast. However, with the Franc well below the 1.20 former minimum exchange rate to the euro, the SNB is under no pressure to

deviate from its policy and is unlikely to hike rates before the ECB, in our view.

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