12 July 2013 | 16 pages

Western Europe

Euro Economics Weekly

On Italy's Fiscal Woes and Euro Area's Dismal Labour Market

- The unexpected downgrade by S&P this week has redrawn attention to Italy's fiscal woes, amid a more relaxed stance from international bodies, the government and markets in last few months. Continuing with fiscal consolidation is a necessary (albeit perhaps not sufficient) condition, in our opinion, to avoid concerns on debt sustainability resurfacing, as we estimate a 5% primary surplus is needed to set the public debt on a mild downtrend from 2015. Given little room within the government to agree on spending cuts, we think the probability of further rating downgrades has increased (Giada Giani, see page 2).

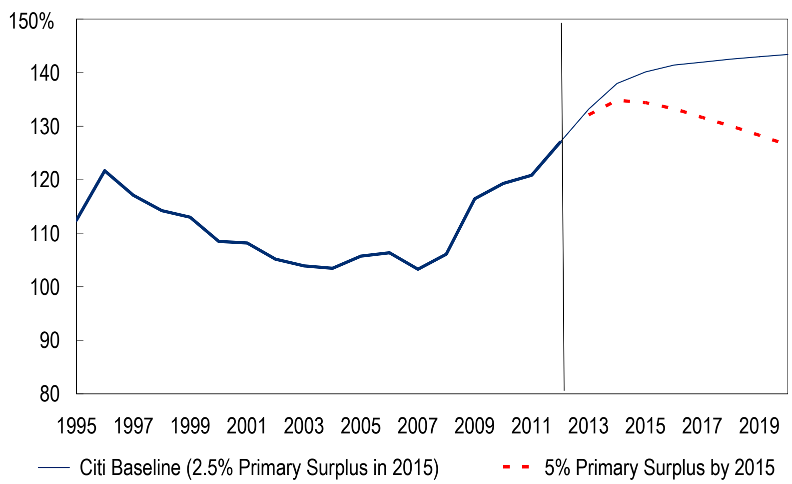
- The euro area isn't working, quite literally. Unemployment is at a record-high in the euro area. We consider recent labour market reforms and argue that labour market rigidities still remain pervasive in the euro area. More significantly, labour market reforms have little hope of solving the job crisis in the near-term (Ebrahim Rahbari, see page 7).

Figure 1. Citi Market Forecasts

	$/€	Euro Repo	10-yr Bunds	£/€	U.K. Bank Rate	10-yr Gilt-Bund	SKr/€	SEK Policy Rate	NOK/€	NOK Policy Rate	SFr/€	CHF Policy Rate	CHF Spread vs Bunds
4Q 13	1.36	0.25	1.50	0.86	0.50	66	8.80	0.75	7.76	1.50	1.26	0.00	-75
2Q 14	1.37	0.25	1.50	0.86	0.50	86	8.71	0.75	7.62	1.50	1.27	0.00	-90

Source: Citi Research

Figure 2. Italy — General Government Debt (Pct. of GDP), 1995-2020F



Sources: Eurostat, Haver Analytics and Citi Research

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Giada Giani

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Italy's Re-Widening Fiscal Deficit

S&P rating downgrade contrasts with the recent more relaxed stance on Italian fiscal issues

The surprising Italian downgrade by S&P this week is a stark reminder of Italy's still-worrying fiscal situation. It strikingly contrasts with the much more relaxed stance from the Italian government, international bodies and markets on Italian fiscal accounts in recent months, after reducing the deficit to 3% of GDP in 2012. The downgrade is a timely move to warn the Italian government about the risks of relaxing the fiscal stance, amid persistent calls from within the ruling coalition for deficit-increasing measures. Moreover, we argue, deficit-increasing measures under discussion (mostly reversing planned tax hikes) are more likely to be saved than spent by financially-strained Italian households and businesses, limiting their positive impact on growth. S&P has linked its next decision on the Italian rating to fiscal developments: given the scarce possibility, in our view, of the current government compromising on credible spending cuts, we reckon that the probability of further downgrades in the next 12-18 month is quite high.

S&P says further rating cuts likely if fiscal deficit widens again

S&P downgraded Italy by one notch to BBB this week, bringing the rating in line with Moody's, one notch below Fitch, and two notches away from the sub-investment grade status. The outlook is still negative, implying a one-in-three chance that another downgrade occurs in the next 12-18 months. Although the main rationale behind the rating cut was further weakening of growth prospects (due to Italy's well-known structural rigidities and the *"impaired monetary transmission mechanism"*), the rating agency re-drew the attention to fiscal developments. They stated they may cut the rating again if *"the government cannot implement policies that would keep fiscal indicators from deteriorating beyond our current expectations"*. S&P projects the 2013 government deficit at 2.9% of GDP and at 2.5% in 2014 — projections that we think are likely to be missed (see below).

IMF and EU Commission much more relaxed in recent months, after Italy's 3% deficit target was met in 2012

Pressures on Italy to stick to its fiscal consolidation path have significantly eased over the past few months, more than we would have expected[1]. In its Article IV report, the IMF called for Italy to move "beyond austerity" and focus on structural reforms to support growth. The EU Commission proposed (and the EU Council in June approved) the exit of Italy from the Excessive Deficit Procedure (EDP), on the back of a deficit ratio below 3% of GDP in 2012 and expectations that this limit is not surpassed again in 2013-14. The Commission last week also announced a new rule which excludes certain public investment expenditures (the national co-financing of EU funds) from the official deficit calculations for countries not under the EDP. Since only Germany, Finland, Luxemburg and Estonia, beyond Italy, are the only EA countries that are not under the EDP at present, the decision looks to have been tailored to give some additional fiscal space to Italy. The government estimated the new rule may imply additional spending leeway of €7.5bn (0.5% of GDP) in 2014 (even though we remain skeptical about this estimate, given Italy's low absorption rate of EU funds). And back in May the Commission had approved Italy's fast repayment of some of €40bn (2.5% of GDP) in government arrears, with an estimated lifting effect on 2013 deficit of 0.5% of GDP.

Italian government has been trying in many ways to relax its fiscal stance

The new Italian government — in a quite risky strategy, in our view — has tried to make the most of the more relaxed stance from international observers and the improved market conditions. As one of its first policy actions, the Letta administration suspended the payment of the first installment (50%) of the much-contested IMU property tax (albeit only on first-residence real estate) and promised an overall reshuffle (read, reduction) of the IMU real estate tax by the end of the summer. Later in June it delayed the planned VAT rate hike by 1pp due to enter into force on 1 July. The government has pledged to make up for the ensuing budget shortfalls with alternative measures and to re-introduce the VAT rate hike in

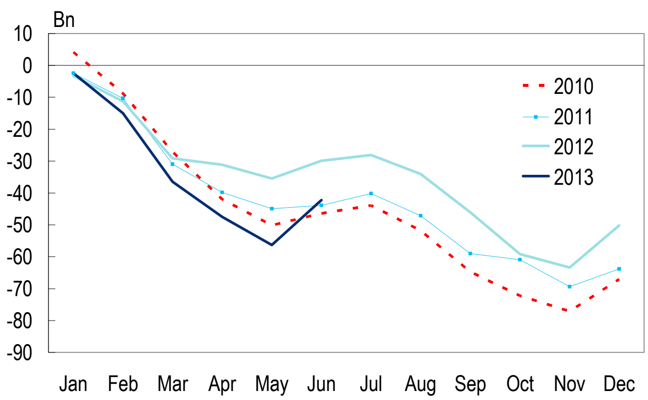
[1] See "Euro Economics Weekly: Italy and Spain — "We Will Die of Austerity Alone"", 3 May 2013, Citi Research.

October. However, we note that persistent pressures from the centre-right coalition party (PdL) to scrap completely the tax hikes and the absence so far of meaningful discussions on credible spending cuts make it quite unlikely that the fiscal slippage is contained by the end of the year in order to meet the deficit target of 2.9% of GDP.

The state cash deficit is widening, although due to one-off factors

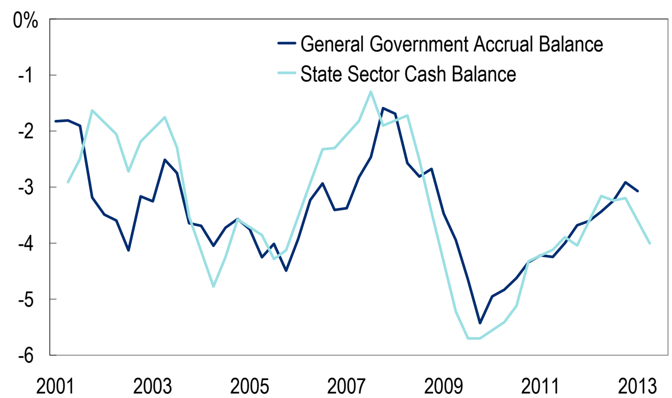
What is more problematic is that the reversal of some tightening measures introduced by the previous government is adding to an already deteriorating fiscal position. Monthly data on the state sector cash balance up to end of June show a higher deficit to the tune of €12bn relative to the same period of 2012. True, H1 13 has been affected by several one-off measures (eg, EIB capital increase of €1.6bn, ESM capital increase of €2.8bn, a bank recap of €2bn) while H1 12 saw one-off factors of the opposite sign. When these temporary effects are taken into account, the state cash balance in H1 13 is similar to the one recorded in the same period of 2012 (see Figure 3)[2].

Figure 3. Italy — State Sector Cash Balance (Cum. YTD), 2010-Jun13



Sources: Italian Treasury, Haver Analytics and Citi Research

Figure 4. Italy — Government Balance (4Q Sum, Pct. of GDP) 2001-Q113



Sources: Italian Treasury, Haver Analytics and Citi Research

Accrual-basis government deficit data clearly show a bigger deficit in Q1 13

However, more accurate, albeit less timely data, on the general government fiscal accounts (accrual basis, consistent with the official deficit figures) show a less benign picture in Q1. The fiscal deficit stood at €27.4bn in Q1 13, against €25.1bn in Q1 12 (equivalent to a deficit-to-GDP ratio of 7.3% in annualised terms, compared with 6.6% in Q1 2012). As a more meaningful measure of the underlying trend, the four-quarter sum of the fiscal balance showed a deficit of 3.1% of GDP in Q1 13, wider than 2.9% recorded in Q4 12 (see Figure 4). This marked the first deterioration in the four-quarter moving sum of the government's fiscal balance since Q4 09. The primary balance (net of interest payments) worsened from a surplus of 2.5% of GDP in Q4 12 to 2.3% in the four quarters ending in Q1 13.

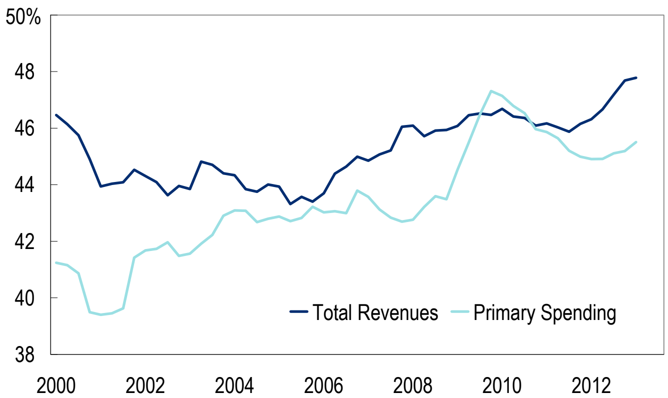
Revenues are weakening, but primary spending also seems less under control than in the recent past

The Q1 breakdown details showed that the deep recession last year is taking its toll on revenues, despite the broad-based tax hikes introduced by the Monti government. Q1 total revenues were unchanged relative to Q1 12, after growing by an average of 2.5% YY in 2012. Falling indirect tax revenues (down by 1.9% YY) mostly accounted for the weakness, reflecting the sharp drop in domestic demand. But control on spending also seems to have eased relative to the recent past. Primary expenditures rose by 2.1% YY in Q1 13, in a clear inversion of trend relative to the mild downward trajectory in primary spending observed since 2010 (see Figure 5). Q1 13 public sector wage bill showed the first YY positive growth

[2] In 2010, the general government deficit came at 4.5% of GDP and in 2011 at 3.8% of GDP.

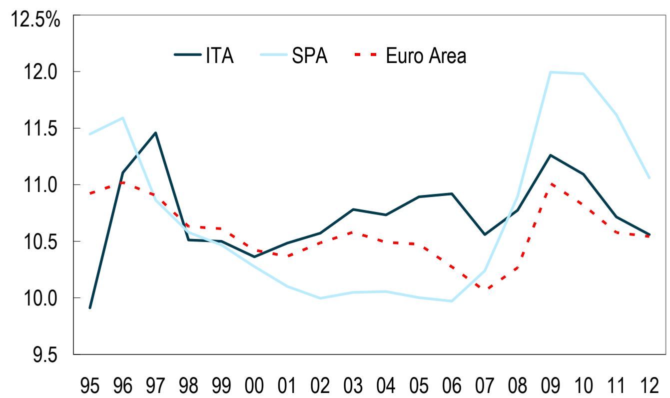
rate since Q3 08, although from a level as a percentage of GDP that is broadly in line with the euro area average (see Figure 6). Spending on cash benefits (mainly pensions) as a percentage of GDP increased by 0.8pp in the past 2 years, as nominal GDP falls and pension expenditure keep rising at some 2.0-2.5% annual rate. The fall in interest spending — helped by the reduction in government's funding costs relative to last year — partly offset the rise in primary spending.

Figure 5. Italy — General Government Revenues and Primary Spending (4Q Sum, Pct. of GDP) 2000-Q113



Sources: ISTAT, Haver Analytics and Citi Research

Figure 6. Selected Euro Area Countries — Government Wage Bill (Pct. of GDP), 1995-2012



Sources: AMECO, Haver Analytics and Citi Research

2013 deficit likely to exceed again the 3% of GDP threshold…

In the second half of the year, these trends are only likely to get worse as the economy remains in recession (we expect another fall to the tune of 0.3-0.4% QQ in Q2 13) and hence fiscal revenues will continue to soften, especially if the planned tax hikes are not reinstated or substituted with alternative deficit-reducing measures. We reckon there is enough evidence to suggest that the deficit is on a re-widening path and it is likely to move again above the threshold of 3% of GDP.

…possibly reigniting concerns on public debt sustainability

Some may argue that this is not too worrying, given that Italy's fiscal deficit is among the lowest in the euro area and its primary surplus is as high as Germany's. But, we argue, Italy is nowhere near the stabilization of its debt ratio, which we see rising to around 133% of GDP by the end of this year. Without either faster growth or a higher primary surplus (or a combination of the two), it remains doubtful whether the Italian public debt is sustainable. Resuming growth by policy actions is likely to be harder, at least in the short term, than cutting the deficit further, in our view, especially for a country that has been trying to introduce growth-enhancing structural reforms for the past fifteen years. We very much agree with S&P assessment (and Bank of Italy's view) that financial fragmentation and a tight credit environment represents the major drag on GDP growth[3]. Fixing the credit crunch is something pretty much beyond the scope of the national government, unless if it embarks on large-scale bank recapitalisation efforts.

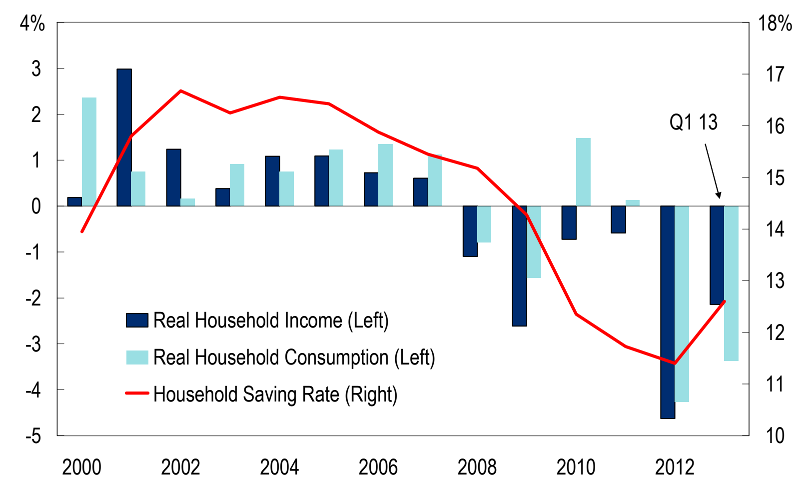
Deficit-expanding measures are unlikely to provide any boost to GDP growth

Trying to engineer a growth spurt by relaxing the fiscal stance is, in our view, a risky and likely ineffective strategy for Italy. Any fiscal easing is more likely to be saved than spent at this stage by the financially-strained Italian private non-financial sector. Sector account data released this week seem to support this: the household saving rate jumped to 12.6% in Q1, its highest level since 2010, amid disposable income growing by 1.0% QQ in 1Q (-0.1% YY from -3.1% YY in Q4 12). While details on the income components are not available on a quarterly basis, the rise

[3] See "Euro Economics Weekly: Italy's Credit Crunch", 12 April 2013, Citi Research.

probably did not stem from improved labour income, as wage growth was broadly unchanged in Q1 relative to 2012 at around 2% YY, and the employment contraction got worse (-1.4% YY in Q1 from -0.9% YY in Q4 12). We suspect the gain in disposable income reflects the reduced fiscal drag on households' balance sheet. Probably because the saving rate had reached undesirably low levels — after almost a decade of declines — the modest increase in disposable income was more than offset by a rise in savings while consumption continued to contract (-0.5% QQ and -3.4% YY in real terms) (see Figure 7). We believe a higher level of household saving rate (higher profit margins for the business sector) is probably required to compensate for the compression in savings (profits) of the last few years before gains in disposable income (value added) are translated into a higher consumption (investment) pattern.

Figure 7. Italy — Household Income (YY) Consumption (YY) and Saving Rate, 2000-Q1 13



Sources: ISTAT, Haver Analytics and Citi Research

Credible and sizable spending cuts are required, but unlikely to be agreed upon by the grand-coalition government

Therefore, the continuation of the fiscal consolidation efforts is a necessary (albeit perhaps not sufficient) condition to restore debt sustainability, although at a somewhat reduced path compared with 2012 massive tightening. Most of the fiscal tightening last year was done via increased taxes, making Italy's tax burden one of the highest in the euro area. This leaves little alternative other than tackling public spending as a way to reduce the deficit going forward. Between 2010 and 2011 some efforts were already made to reduce public expenditure, for example by freezing public sector wages and reducing the public sector headcount. But Italy still has the highest share of GDP spent on public pensions (social benefits amount to 40% of total spending and to some 20% of GDP) although recent pension reforms have set this ratio on a downward trajectory in coming years. Unless another pension reform is considered, this high ratio requires large reductions to other part of total expenditure to make a significant dent into the overall budget. This has proven politically very difficult to implement even by the technocratic government led by Monti. The difficulty of finding a compromise within the current grand-coalition government makes these changes even less likely in the near future, in our view.

At current levels of expected nominal GDP growth and primary surplus the public debt is probably not sustainable

We expect nominal GDP growth to average around zero in the next three years, assuming that the primary surplus is maintained around the current level of 2.5%. We calculate that Italy needs to reach a primary surplus of around 5% of GDP by 2015 (similar to the level prevailing in the mid-Nineties) to set the debt ratio on a mild downtrend from 2015 onwards (see Figure 2 on the Front Page). Actually, this

primary balance target may not even be sufficient, because the additional fiscal tightening required to achieve it may generate a much more negative GDP dynamic than our baseline scenario, keeping the debt ratio on the rise. The return to fiscal sustainability may not be just a matter of political willingness: this is why we maintain our long-held view that some form of debt restructuring may eventually be required to reduce the debt burden. But pursuing a reversal of some of fiscal tightening already achieved in 2012 looks a very risky strategy, in our view, as it takes Italy even further away from public debt sustainability. We suspect at some point either rating agencies or market participants, or both, will re-focus their attention on this issue.

The Euro Area Isn't Working

Unemployment is at record highs in the EA as well as Greece, Italy, Portugal, Spain, Slovenia, and Cyprus – and likely to remain high for many years

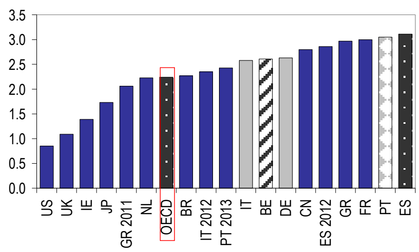
The euro area (EA) is quite literally not working. The unemployment rate in May 2013 stood at 12.2% of the labour force, a record high. Unemployment was also at a record high in all GIIPSSC countries (Greece, Ireland, Italy, Portugal, Spain, Slovenia, and Cyprus) except Ireland (Figure 9), even though employment and labour force participation were quite low in some of these countries even before the crisis. In Global Economics View - The euro area isn't working – labour market reforms in the euro area and why they won't solve the euro area job crisis, we consider the region's reforms and rigidities. Here, we provide a short summary.

(Un)employment matters greatly. In addition to its high social costs, unemployment makes it harder to repair the public finances, leads to skill degradation and creates the risk of greater social dislocation and social unrest. Long-term unemployment and youth unemployment — probably the most economically and socially harmful forms of unemployment — are particularly high in many EA countries.

In recent years, a substantial number of labour market reforms were passed in the EA, particularly in Greece, Portugal and Spain, often mandated by troika programmes. In these three countries, severance pay has been cut substantially, severance regulation eased somewhat, bargaining more decentralised and restrictions on the renegotiation of wages and the non-wage terms of employment eased. Sizable cuts in public sector employment and wages, driven by fiscal consolidation motives, probably also helped to anchor modest wage expectations in the private sector. Italy has reformed less, but also faced less intense rigidities to start with after a succession of minor reforms over the last two decades (Figure 8).

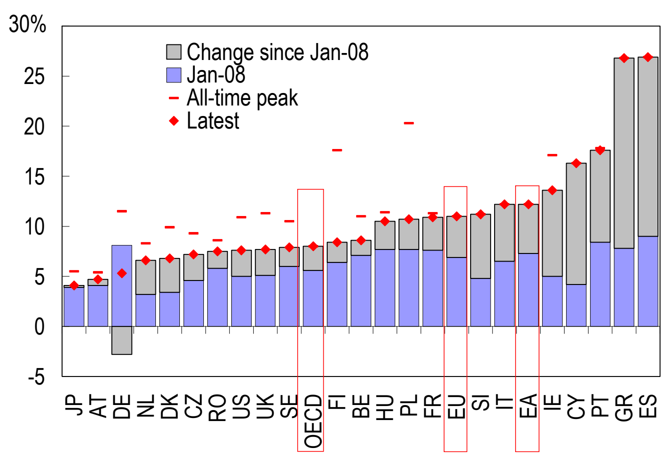
However, these reforms will not solve the EA job crisis, in our view, and we expect unemployment to remain very high for a long time — still above 10% at the end of this decade for the euro area as a whole, and twice that in Spain (Figure 10).

Figure 8. Selected countries – Employment Protection Legislation Index, 2008



Sources: OECD and Citi Research

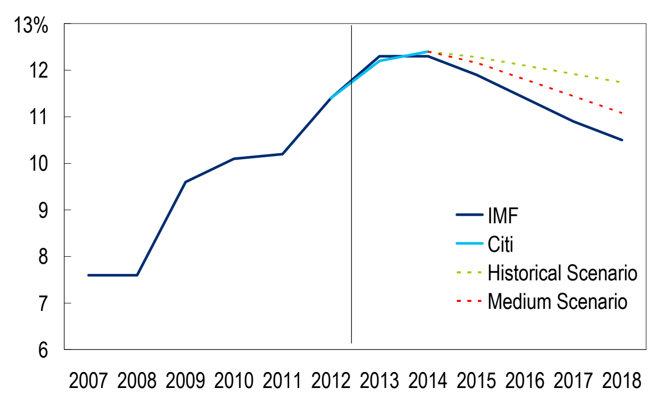
Figure 9. Selected Countries – Unemployment Rate (% of Labour Force), 2008–latest



Note: Latest data are for May 2013 for all countries and regions, except for Japan, Hungary, OECD (April 2013), and Greece and UK (March 2013). All-time peaks since early '90s in Germany, Romania, OECD; late '90s in Slovenia, Hungary, EU (changing composition); '00s in Cyprus, and '80s in the rest.

Source: Eurostat, OECD and Citi Research

Figure 10. Euro Area – Unemployment Rate (% of Labour Force), 2007–2018E

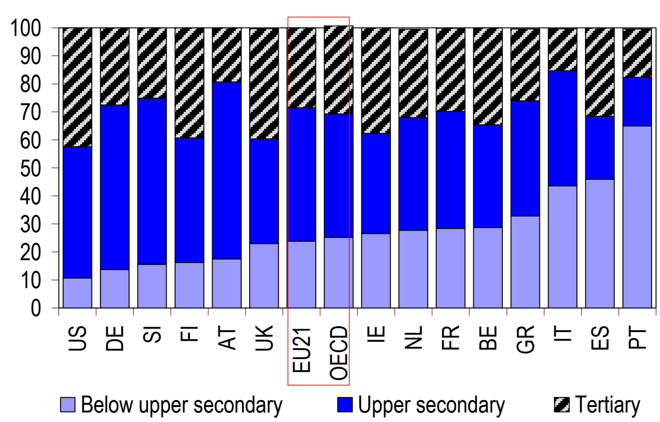


Note: 'Citi' are Citi forecasts until 2014, while 'IMF' is IMF data throughout. In the historical and medium scenarios, the unemployment change from 2015 is given by the change in the output gap (from the IMF) multiplied by the elasticity of unemployment to a change in the output gap (0.6 in the medium scenario, 0.3 in the historical scenario).

Source: IMF and Citi Research

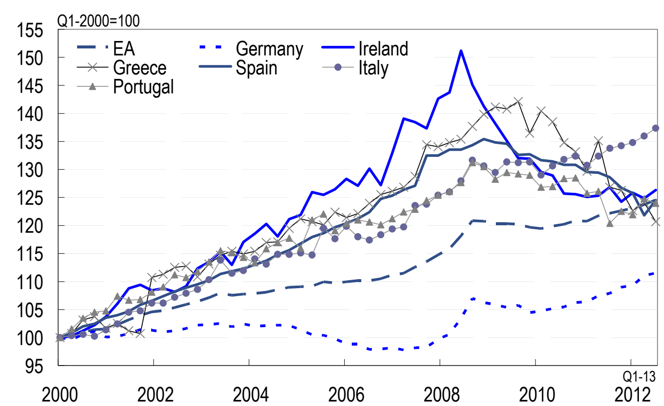
More reforms are still needed in the EA periphery. Unit labour costs in many periphery countries have fallen quite substantially, but much of that is the result of downward pressure on wages from the reserve army of the unemployed and the shedding of low-productivity workers by firms (Figure 12). Labour market rigidities are also extensive in Belgium, France, and the Netherlands – which have yet to reform in earnest – and even in the low-unemployment countries in the EA (Austria and Germany). On average, the major weaknesses in EA labour markets remain: i) high taxes and social security contributions ('tax wedges') on labour, ii) high employment protection, iii) inflexible, excessively centralised and insufficiently differentiated bargaining over wages and other conditions of employment, iv) excessive involvement of courts in labour matters, v) low labour force participation, and vi) high labour market duality. Poor average skill levels in the workforce, and among the unemployed in particular, are another key weakness (Figure 11), which will be difficult to resolve quickly. Extensive active labour market policies (ALMPs) may be needed to get the unskilled/deskilled unemployed back into jobs, which the periphery countries lack the fiscal space for, and EU funds remain 'de minimis'.

Figure 11. Selected Countries – Educational achievement (% of population), 2011



Sources: OECD and Citi Research

Figure 12. Selected Countries – Relative Nominal Unit Labor Costs (2000=100), 2000 – 2013 Q1



Sources: Eurostat and Citi Research

But labour market reforms won't solve the job crisis

Growth of demand is needed and excessive private debt, fiscal austerity, and policy uncertainty are stronger headwinds to growth than structural rigidities currently

But labour market reforms alone will still not solve the EA crisis and have little hope of bringing unemployment down quickly. For job creation to take off, demand growth is needed. With ample idle capacity and deficient demand, caused by excessive private debt, weak banks, fiscal austerity and policy uncertainty, are bigger impediment to growth in the near-term than structural rigidities, in our view. Structural reforms — which need to include product market reforms as well, including opening up closed professions and liberalizing service sectors — will pay off eventually, but the gains usually accrue slowly. Without short-term measures to boost demand, structural reforms could even exacerbate the current demand weakness.

The example of other European countries that implemented extensive labour market reforms in the '80s (Ireland, Netherlands, and the UK), '90s (Denmark), and '00s (Germany) and that saw robust output and employment growth thereafter is only partly encouraging. This is because unlike many euro area countries today, these countries tended to have higher skill levels in the workforce, more flexible product markets, more fiscal space, were more open and usually benefited from a quickly improving external environment.

The job crisis raises risks of a 'lost generation', social unrest and austerity fatigue turning into 'debt service fatigue'

The long-running job crisis in the EA also aggravates other risks. It raises the risk that reform efforts stall, even though on balance high unemployment often *increases* the pressure on governments to introduce structural reforms. High unemployment will further boost austerity fatigue, which could eventually turn into political instability and 'debt service fatigue', raising the risk of some form of sovereign debt restructuring/repudation in highly indebted periphery countries. In addition, the risk of a 'lost generation' and of wider social dislocations is material.

Key Economic Indicators (15 July – 19 July 2013)

Monday 15 July		**Forecast**	**Last**
08:15	Switzerland: Producer and Import Prices, Jun		
08:30	Netherlands: Trade Balance, May		
08:30	Netherlands: Retail Sales, May		
09:00	Norway: Trade Balance, Jun		
Tuesday 16 July		**Forecast**	**Last**
07:00	EU-27: New Car Registrations, Jun		
08:30	Sweden: Riksbank Minutes		
09:00	Italy: Trade Balance, May		
09:30	Italy: General Government Debt, May		
09:30	UK: Consumer Prices, Jun	-0.1% MM, 3.0% YY	0.2% MM, 2.7% YY
	CPI Ex Food, Drink, Tobacco, Energy, Jun	-0.2% MM, 2.4% YY	0.4% MM, 2.2% YY
	Retail Prices, Jun	0.1% MM, 3.5% YY	0.2% MM, 3.1% YY
	RPIX – Excludes Mortgages, Jun	0.1% MM, 3.5% YY	0.2% MM, 3.1% YY
09:30	UK: Producer Input Prices, Jun	-0.7% MM, 3.7 %YY	-0.3% MM, 2.2% YY
09:30	UK: Producer Output Prices, Jun	0.0% MM, 1.9% YY	0.0% MM, 1.2% YY
	Excluding Food, Drink, Tobacco, Energy, Jun	0.0% MM, 1.0% YY	0.1% MM, 0.8% YY
10:00	Euro Area: HICP, Final, Jun	1.6% YY	1.4% YY
10:00	Euro Area: Trade Balance, May		
10:00	Germany: ZEW Survey – Current Situation, Jun	6.1	8.6
	ZEW Survey – Economic Sentiment, Jun	34.5	38.5
Wednesday 17 July		**Forecast**	**Last**
09:30	UK: Claimant Count Unemployment, Jun	-5,000 MM, 4.5% Rate	-8,600 MM, 4.5% Rate
	LFS Unemployment, Mar-May	-46,000 QQ, 7.8% Rate	-5,000 QQ, 7.8% Rate
09:30	UK: MPC Minutes		
09:30	UK: BoE Agents' Summary of Business Conditions, Jul		
10:00	Euro Area: Construction Output, May		
10:00	Italy: Current Account, May		
Thursday 18 July		**Forecast**	**Last**
07:00	Switzerland: Trade Balance, Jun		
08:30	Netherlands: Consumer Confidence, Jul		
08:30	Netherlands: Unemployment, Jun		
09:00	Norway: Lending Survey, 2Q		
09:00	Euro Area: Balance of Payments, May		
09:30	UK: Retail Sales Volumes, Jun	0.0% MM, 1.5% YY	2.1% MM, 1.9% YY
Friday 19 July		**Forecast**	**Last**
	G-20: Meeting of Finance Ministers & Central Bank Governors, Moscow		
07:00	Germany: Producer Prices, Jun	0.2% MM, 0.0% YY	-0.3% MM, 0.2% YY
09:00	Italy: Industrial Orders, May		
08:30	Netherlands: Consumer Spending, May		
09:30	UK: Public Sector Net Borrowing – PSNB ex, Jun	£11.8 Billion Deficit	Year Ago: £11.8 Billion Deficit
	Fiscal Year To Date, Apr-Jun	£25.4 Billion Deficit	Year Ago: £8.8 Billion Deficit
	Greece: Current Account, May		

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area

Jul 16 10:00 London Time	***HICP, Jun F***	**Forecast: 1.6% YY**	**Prior: 1.4% YY**

Inflation has rebounded after the temporary dip to 1.2% YY in April to 1.6% YY in June – this reading is likely to be confirmed in the final data. Core inflation also likely to be confirmed stable at 1.2% YY in June. Barring much higher oil prices in the remainder of 2013, June inflation should mark a local peak after which we expect it to fall back to around 1.2% YY by the autumn, and to remain around that level until year-end.

Germany

Jul 16	***ZEW Survey, Current Situation, Jul***	**Forecast: 6.1**	**Prior: 8.6**
10:00 London Time	***ZEW Survey, Economic Sentiment, Jul***	**Forecast: 34.5**	**Prior: 38.5**

We expect the ZEW survey that reflects the assessments of financial market participants to be slightly more downbeat in July. This is because, after a few months during which momentum strengthened, PMIs in Germany have stalled, exports and industrial production were weak in May, and markets have been volatile. Both the current situation and the economic sentiment readings remain above their respective long-term averages, however.

Jul 19 7:00 London Time	***Producer Prices, June, SA***	**Forecast: 0.2% MM, 0.0% YY**	**Prior: -0.3% MM, 0.2% YY**

We expect a slight increase in German producer prices in June after four successive monthly falls. Some of the earlier falls in energy and commodity prices have moderated, while wages are increasing and some supplies are probably restricted by the heavy floods in late May and June.

Sweden

Jul 16 08:30 London Time — ***Riksbank Minutes***

The Riksbank (4:2 split) left the key policy rate unchanged at 1.0% at the July meeting. The Bank also kept its conditional interest rate path unchanged and, in turn, confirmed its near-term easing bias from April (sees a 24% probability of a near-term rate cut), and that gradual increases in the key policy rate are expected to begin during the second half of 2014 (the RB forecasts the repo rate at 2.75% in 3Q 2016). In other words, the Bank keeps an option to cut in September open in case the economy disappoints or inflation declines more than forecast. Even if these factors would support easing, a September rate cut will still be a close call given the strong focus on financial stability considerations among the majority board (unlikely to go away as we see signs of recovery in the housing market). Comment from the two newcomers, Ms Skingsley (voted for stable rate) and Mr Floden (voted for a 25bp cut) will be of particular interest.

Norway

Jul 18 09:00 London Time — ***Lending Survey, 2Q 2013***

The latest bank lending survey showed that household credit demand slipped in the first quarter, contrasting with developments in the monthly credit growth indicator for households. The drop was most noteworthy for first-time buyers, and likely reflected the gain in mortgage rates combined with the ongoing debate on upcoming regulations aimed at addressing the upward trend in house price and household indebtedness (recall the FSA has proposed to raise risk weights on residential mortgages from around 12% to 35% and to restrict covered bond issuance). Meanwhile, banks reported that slightly tighter credit standards in the first quarter had not affected first-home mortgage loans. Although credit standards for households tightened slightly in 1Q 2013, they were nowhere near as tight as at the outset of 2012. With household borrowing continuing to outpace disposable income growth (2.6% YY in nominal terms / 1.3% YY in real terms in 4Q 2012), households' debt levels should rise further from already elevated levels of some 200%. We broadly expect the 2Q lending survey to confirm this picture.

United Kingdom

Jul 16	***Consumer Prices , Jun***	**Forecast: -0.1% MM, 3.0% YY**	**Prior: 0.2% MM, 2.7% YY**
09:30	***CPI Ex Food, Drink, Tobacco, Energy , Jun***	**Forecast: -0.2% MM, 2.4% YY**	**Prior: 0.4% MM, 2.2% YY**
London Time	***Retail Prices , Jun***	**Forecast: 0.1% MM, 3.5% YY**	**Prior: 0.2% MM, 3.1% YY**
	RPIX – Excludes Mortgages , Jun	**Forecast: 0.1% MM, 3.5% YY**	**Prior: 0.2% MM, 3.1% YY**

We expect the YY inflation rates to tick higher, but attach a large margin of error to our forecast. Petrol prices rose by about 1p/litre in June this year but fell last year. The uncertainty mainly concerns the start date of the midyear clothing sales. In 2011 and 2012, sluggish retail sales prompted retailers to begin midyear sales earlier than usual, hence causing the June CPI to markedly undershoot consensus expectations. A full rerun could produce a figure a tenth or two below our forecast, whereas if the sales effect is fully delayed to the July data then the June CPI could well exceed our forecast by a couple of tenths.

Jul 16 09:30 London Time	***Producer Input Prices , Jun***	**Forecast: -0.7% MM, 3.7% YY**	**Prior: -0.3% MM, 2.2% YY**

With sterling a little stronger in June, we expect these data will show input prices falling for the third consecutive month. Nevertheless, base effects from the unusually large drop in input prices (down 2.1% MM) recorded a year earlier probably will cause the YY rate to tick higher. This base effect will unwind in coming months.

Jul 16	***Producer Output Prices , Jun***	**Forecast: 0.0% MM, 1.9% YY**	**Prior: 0.0% MM, 1.2% YY**
09:30	***Output Prices Ex Tax , Jun***	**Forecast: 0.0% MM, 2.0% YY**	**Prior: 0.0% MM, 1.4% YY**
London Time	***Excluding Food, Drink, Tobacco, Energy , Jun***	**Forecast: 0.0% MM, 1.0% YY**	**Prior: 0.1% MM, 0.8% YY**

As with the input price data, we expect that adverse base effects will lift the YY rates for output price inflation despite weak MM readings. Nevertheless, a figure in line with our forecast would leave the level of input prices roughly flat from the February figure, hence implying a considerable loss of momentum in prices during recent months.

Jul 17	***Claimant Count Unemployment , Jun***	**Forecast: -5,000 MM, 4.5% Rate**	**Prior: -8,600 MM, 4.5% Rate**
09:30 London Time	***LFS Unemployment, Mar-May***	**Forecast: -46,000 QQ, 7.8% Rate**	**Prior: -5,000 QQ, 7.8% Rate**

The claimant count has been falling for almost a year and probably will continue to drop this month, with the decline helped by tighter benefit regulations. The LFS measure has been roughly stable for about four years, and probably will be little changed this month, with modest gains in employment matched by the relatively high pace of workforce growth.

Economic Indicators

United Kingdom continued			
Jul 18	***Retail Sales Volumes , Jun***	**Forecast: 0.0% MM, 1.5% YY**	**Prior: 2.1% MM, 1.9% YY**
09:30			
London Time	The retail sales figures have been quite volatile recently, with marked declines in March and April (when the weather was unusually cold) followed by a sharp rebound in May (when the temperature rose sharply and returned to something close to the seasonal norm). We expect little change in the June data but, given the recent volatility, there must again be considerable risks on either side of our forecast.		
Jul 19	***Public Sector Net Borrowing , Jun***	**Forecast: £11.8 Billion deficit, £25.4 Billion Deficit Fiscal Year To Date**	
09:30	***(Figures Exclude Costs of Financial Intervention)***	**Year Ago: £11.8 Billion deficit, £8.8 Billion Deficit Fiscal Year To Date**	
London Time			
	The fiscal data of recent months have continued to be distorted by a range of special factors, including the transfer of interest income from the APF, which has made it hard to discern the underlying trends. For the June data, we expect borrowing to be similar to a year ago, with modest growth in both spending and revenues.		

Sources: National Statistical Offices, National Central Banks, Bloomberg, and Citi Research forecasts.

Key Economic Indicators (22 July – 26 July 2013)

		Forecast	Last
During The Week		**Forecast**	**Last**
07:00	Germany: Import Prices, Jun (by 29 Jul)		
Monday 22 July		**Forecast**	**Last**
08:30	Netherlands: House Price Index, Jun		
Tuesday 23 July		**Forecast**	**Last**
07:45	France: Industrial Confidence, Jul		
09:30	UK: BBA Mortgage Advances, Jun		
10:00	Euro Area: Government Debt, 1Q		
15:00	Euro Area: Consumer Confidence, Jul Flash		
Wednesday 24 July		**Forecast**	**Last**
08:00	Spain: Producer Prices, Jun		
09:00	Italy: Retail Sales, May		
09:00	Euro Area: PMIs, Jul Flash		
11:00	CBI Industrial Trends Survey – Quarterly Business Confidence, Jul	+8%	Apr: +5%
	Monthly Output Expectations, Jul	+7%	Jun: +10%
	Monthly Order Books, Jul	-18%	Jun: -18%
	Monthly Selling Prices, Jul	0%	Jun: +3%
17:00	France: Jobseekers, Net Change, Jun		
Thursday 25 July		**Forecast**	**Last**
08:00	Spain: LFS Unemployment Rate, 2Q		
08:15	Sweden: Business & Consumer Confidence, Jul		
08:30	Netherlands: Producer Confidence, Jul		
08:30	Sweden: Producer Prices, Jun		
08:30	Sweden: Unemployment Rate, Jun		
09:00	Germany: ifo Business Climate, Jul		
09:00	Italy: Consumer Confidence, Jul		
09:00	Euro Area: M3, Jun		
09:30	UK: GDP, 2Q Preliminary Estimate		
09:30	UK: Service Sector Output, May	0.2% MM, 1.4% YY	0.2% MM, 2.0% YY
Friday 26 July		**Forecast**	**Last**
07:45	France: Consumer Confidence, Jul		
08:30	Sweden: Trade Balance, Jun		

Sources: National statistical offices, central banks and Citi Research

Title	Author	Date
Euro Area – Sovereign Debt Crisis Update		
ECB tries to explain forward guidance	Guillaume Menuet /Giada Giani	Jul 12, 2013
EC presents proposals to revamp bank resolution	Guillaume Menuet /Giada Giani	Jul 11, 2013
S&P downgrades Italy, ECB struggles with its "extended period"	Guillaume Menuet /Giada Giani	Jul 10, 2013
Greece Secures €6.8bn of New Bailout Funds	Guillaume Menuet /Giada Giani	Jul 9, 2013
EU Commission preparing second bailout for Portugal	Guillaume Menuet /Giada Giani	Jul 8, 2013
Euro Area		
The euro area isn't working – labour market reforms in the euro area and why they won't solve the euro area job crisis;	Ebrahim Rahbari and Deimante Kupciuniene	Jul 11, 2013
Taking Stock of Labour Market Rigidities and Reforms in the Euro Area	Ebrahim Rahbari and Deimante Kupciuniene	Jul 11, 2013
ECB - Unanimous Governing Council Enacts Forward Guidance	Guillaume Menuet	Jul 4, 2013
Euro Area - Portugal Political Crisis	Giada Giani	Jul 4, 2013
European Economic Forecast Highlights - June 2013	Ann O'Kelly	Jun 20, 2013
Euro Area - ECB to reassess its monetary policy stance after the summer	Guillaume Menuet	Jun 6, 2013
Euro Economics Weekly		
France a Year On: How Much Progress?	Guillaume Menuet	July 5, 2013
Small steps towards banking union: the ECB should be pleased	Guillaume Menuet	Jun 28, 2013
Slovenia: ESM Assistance for Bank Recap Would Make Sense	Guillaume Menuet	Jun 21, 2013
Spain's External Rebalancing	Giada Giani	Jun 14, 2013
Financial Conditions Neutral, At Best, on Growth	Giada Giani	Jun 7, 2013
ECB: Focus on Collateral Rules rather than Direct Purchases	Guillaume Menuet	May 31, 2013
Removing Grexit from the Baseline Scenario	Giada Giani	May 24, 2013
Watching for Positive Surprises: Favour GIPS over France	Guillaume Menuet	May 17, 2013
Euro Area Disinflationary Pressures	Giada Giani	May 10, 2013
Italy and Spain — "We Will Die of Austerity Alone"	Giada Giani	May 3, 2013
Chief Economist Publications		
Global Economic Outlook and Strategy - June 2013	Willem Buiter	Jun 19, 2013
Ireland		
Ireland - Back in Recession	Michael Saunders	Jun 28, 2013
Scandi		
Scandi Economics Update	Tina Mortensen	Jul 12, 2013
Sweden - Inflation Bang on Riksbank Forecast in June	Tina Mortensen	Jul 11, 2013
Norway - Stable Inflation in June	Tina Mortensen	Jul 10, 2013
Norway - Strong Payback for Mfg Production, but Momentum Stays Strong	Tina Mortensen	Jul 5, 2013
UK		
UK - MPC Set the Stage for Guidance	Michael Saunders	Jul 4, 2013
UK - BCC Survey Shows Better Growth, Plenty of Slack	Michael Saunders	Jul 2, 2013
UK - Stronger PMI, Credit Remains Weak	Michael Saunders	Jul 1, 2013
UK - Update on UK-EU Price Level Disparities	Michael Saunders	Jul 1, 2013
UK - YouGov Report Stable Inflation Expectations	Michael Saunders	Jun 28, 2013
UK Economics Weekly		
The MPC's Declaration of (Monetary) Independence	Michael Saunders	Jul 5, 2013
Carney's Challenge	Michael Saunders	Jun 28, 2013
Selloff Reinforces the Case for Forward Guidance	Michael Saunders	Jun 21, 2013
Growing, But Not (Yet) Really Recovering	Michael Saunders	Jun 14, 2013
A Nation of Workers	Michael Saunders	Jun 7, 2013
Are We Nearly There Yet?	Michael Saunders	May 31, 2013

Source: Citi Research

Appendix A-1

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