20 June 2014 │ 20 pages

Developed Markets
Western Europe

Euro Economics Weekly

A Great Rotation towards Eurozone Portfolio Assets?

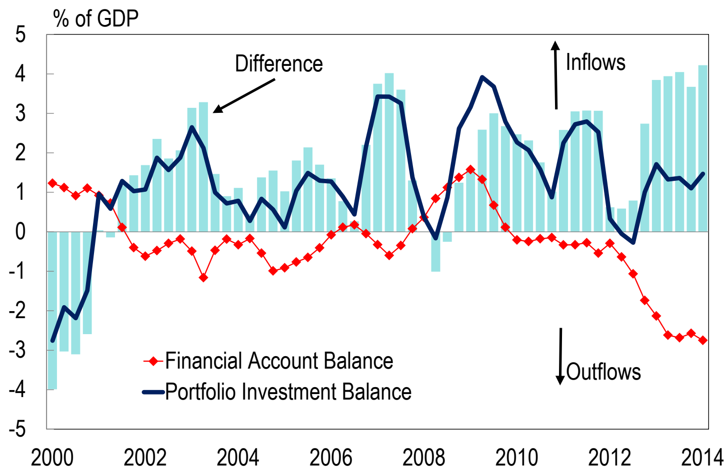
- The Eurozone is experiencing record net capital outflows, yet at the same time portfolio inflows are positive for both debt and equity portfolio investment, notably into the Eurozone periphery, and the difference between overall capital outflows and net portfolio inflows is at a record high currently. One way to rationalise these flows is that foreign investors are more optimistic about the expected risk-adjusted returns of bonds and equities in the Eurozone or are reducing underweights in those areas, whereas they have been keen to reduce their deposits in Eurozone banks.
- Another, complementary, interpretation is that Eurozone residents are choosing to invest their large foreign savings by paying back foreign loans and deposits rather than investing in foreign equities or bonds or increase outward FDI. This is similar to Japan's experience in most of the last two decades before the Great Recession, when large net capital outflows coexisted with sizable net sales of equities.

Figure 1. Citi Forecasts

	$/€	Euro Repo	10-yr Bunds	£/€	UK Bank Rate	10-Yr Gilt-Bund	SKr/€	SEK Policy Rate	NOK/€	NOK Policy Rate	SFr/€	CHF Policy Rate	CHF Spread vsBunds
3Q 14	1.38	0.10	1.60	0.80	0.50	142	9.11	0.50	8.06	1.50	1.24	0.00	-65
1Q 15	1.35	0.10	1.70	0.79	1.25	183	9.18	0.50	7.97	1.50	1.25	0.00	-68

Source: Citi Research

Figure 2. Euro Area — Financial Account Balance and Portfolio Investment Balance (% of GDP, 4Q Sum), 2000-2014



Note: Positive values signify inflows.
Sources: ECB and Citi Research

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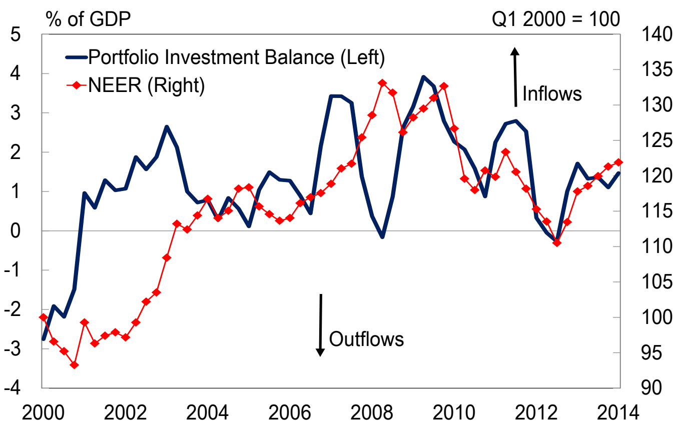
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

A Great Rotation into EA Portfolio Assets?

Capital flows matter — both their overall size and their composition.

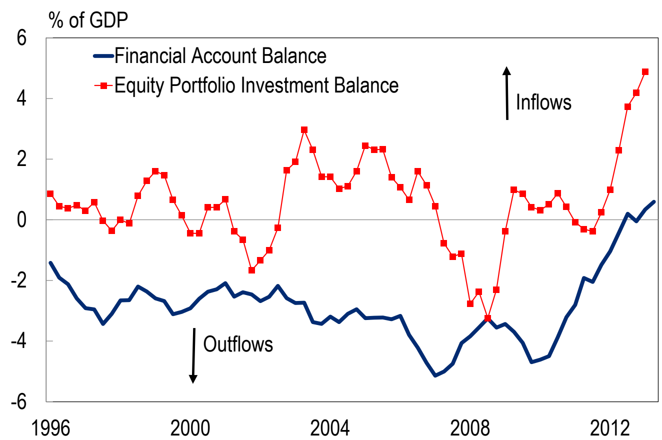
Cross-border capital flows matter, including to fund activity and to lower the *cost* of funding. In addition to their aggregate size, the composition of capital flows also matters. 'Hot money', such as short-term portfolio investment or bank debt can create heightened risks of a painful sharp reversal ('sudden stops'), but may sometimes also be an early indicator of a reversal of fortunes for the better. Inward foreign direct investment (FDI) may transfer useful knowledge and skills, is harder to reverse and may for that reason be a more powerful signal of corporate confidence in a region. It has also been suggested that portfolio flows (rather than capital flows as a whole) can affect, or at least be associated with, exchange rate movements (see Figure 3).[1]

Figure 3. Euro Area — Portfolio Investment Balance (4Q Sum, % of GDP) and Nominal Effective Exchange Rate (Q1 2000=100), 2000-2014



Note: NEER is nominal effective exchange rate.
Sources: ECB and Citi Research

Figure 4. Japan — Financial Account and Equity Portfolio Investment Balance (4Q Sum, % of GDP), 1996-2014



Note: Positive amounts signify inflows.
Sources: Bank of Japan and Citi Research

The Eurozone is running a record financial account deficit, but there are still net portfolio inflows of 1.5% of GDP

In the Eurozone, its large current account surplus virtually implies a large (2.7% of GDP in Q1 2014) financial account deficit, i.e. large net capital *outflows*. At the same time, the Eurozone currently enjoys net portfolio (debt and equity) *inflows* of 1.5% of GDP and the discrepancy between net portfolio inflows and total net outflows is at a record-high (see Figure 2 on the Front Page).[2] This observation is consistent with an interpretation that there had been a 'rotation' of net capital inflows into the Eurozone towards equity and to a lesser extent bonds and bills, notably in the Eurozone periphery and 'soft core', and an even larger move by the rest of the world (RoW) to reduce loans and deposits in the Eurozone in particular. This rotation could be driven by foreign investors either being more optimistic about the prospects of Eurozone equity and debt portfolio assets than Eurozone investors or the RoW reducing their underweights for these assets. An alternative – and perhaps complementary – interpretation would be that Eurozone investors are preferring to invest their foreign savings in 'other investments' (more precisely by reducing foreign liabilities of this type, in particular deposit and loan liabilities of banks), while selling more equities and bonds to the RoW than they are buying from them. Such a pattern of large foreign saving and net selling of at least equities at the same time is reminiscent of the norm for Japan for most of the last two decades before the Great Recession (see Figure 4), whereas the mirror image (consistent foreign borrowing but net equity outflows have been the norm for the UK and US outside of crisis periods).

[1] In an emerging markets context, see e.g. IMF (2010), "The Impact of Capital and Foreign Exchange Flows on the Competitiveness of Developing Countries", IMF Working Paper

[2] Throughout, we will quote all financial flows as 4Q sums unless noted otherwise.

The Eurozone's Financial Account Deficit

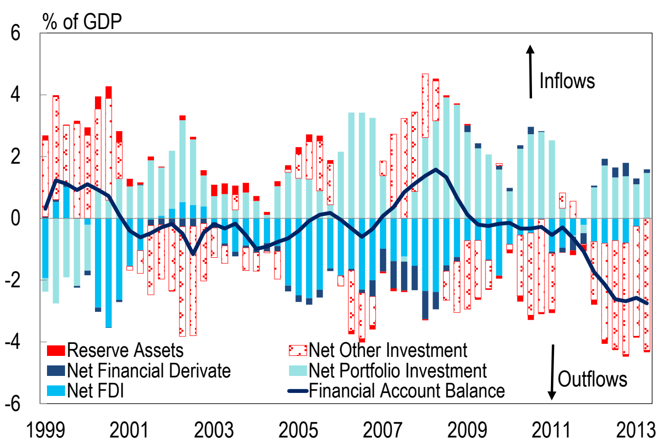
The balance of payments identity requires that the sum of current account, capital account and financial account sums to zero

The balance of payments identity implies that the current account, the financial account and the capital account have to sum to zero. As the capital account (which mostly includes transactions of non-financial and non-produced assets) tends to be small in advanced economies most of the time and the Eurozone's current account surplus was 2.6% of GDP in Q1 2014, its financial account would need to show a large *deficit*. The deficit was 2.7% of GDP or €265bn of *net capital outflows* in Q1 2014, compared to being roughly in balance in the pre-crisis period and in 2010-12.

Net outflows are exclusively driven by 'other investments' — mostly reductions of Eurozone banks' loan and deposit liabilities

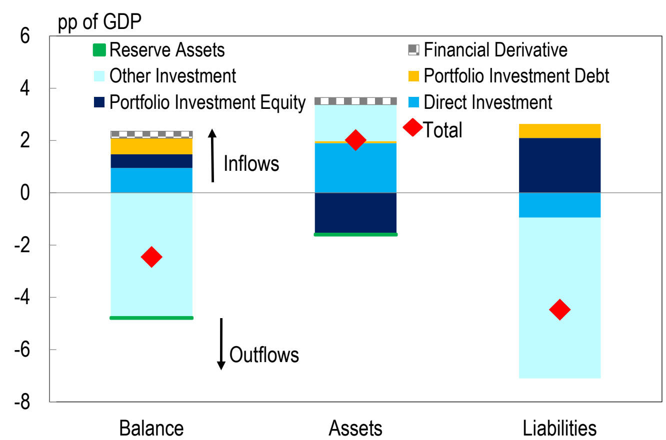
Figure 5 shows that net outflows were almost exclusively driven by 'other investments' which stood at -4.3% of GDP in Q1 2014. Other investment flows are mostly flows of bank loans and deposits, on both the asset and liability side, even though they also include loan and deposit flows of the non-financial private sector, the general government and the Eurosystem. Foreign direct investment (FDI) was roughly in balance and portfolio investment registered 1.2% of GDP of net *inflows*.

Figure 5. Euro Area — Financial Account Balance (4Q Sum, % of GDP), 1999-2014



Note: Positive values signify inflows.
Sources: ECB and Citi Research

Figure 6. Euro Area — Decomposition of Change in Financial Account Balance (4Q Sum, pp of GDP) between Q1 2012 and Q1 2014



Note: Assets and liabilities are from the perspective of Eurozone residents. Positive values here signify inflows, including for liabilities. Net balances on reserve assets and financial derivatives are added to the asset side.
Sources: ECB, Eurostat and Citi Research

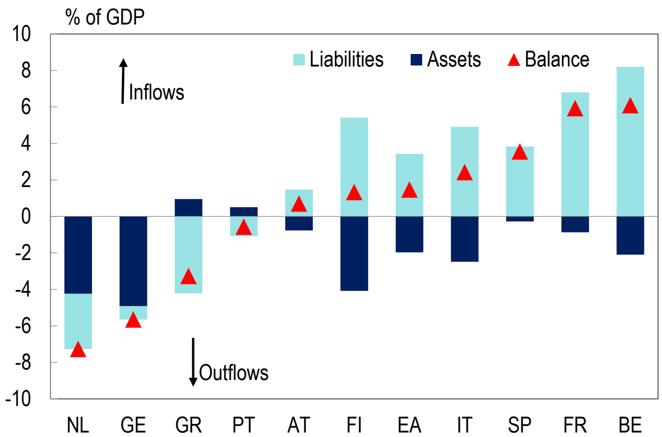
A change in the flows of other investments has also accounted for most of the change in the financial account balance in recent years

External deleveraging by Eurozone banks is a key part of the narrative behind other investments outflows

Compared to Q1 2012 when the financial account was still close to balance, net outflows of other investment have increased by almost 5% of GDP (see Figure 6). This is mostly as Eurozone banks (and to a lesser extent non-banks) reduced their loan and deposit liabilities to the RoW, at a rate of almost 4% of GDP in Q1 2014, whereas such liabilities were still rising (implying inflows) by 2.3% of GDP in Q1 2012. At the same time, Eurozone residents reduced their loans to and deposits in the RoW by only around 0.5% of GDP in Q1 2014 (so a small inflow), compared to reductions of almost 2% of GDP still in Q1 2012. External deleveraging by Eurozone banks thus seems to be a major part of the narrative behind the large other investments outflows. According to the latest data, Eurozone monetary-financial institutions (MFIs) have reduced their external liabilities (which also include non-Eurozone portfolio and FDI liabilities) by €1.7trn since the peak in 2008 — more than three times the Eurozone's cumulative financial account deficit since 2009 (the local peak). That is, Eurozone residents have paid back external loans and the RoW (including the US, UK, Japan and offshore financial centers) reduced Eurozone deposits to a large degree. In aggregate, Eurozone residents have thus decided to use their foreign savings to reduce loan and deposit liabilities when they could have bought foreign equities, bonds or engage in more outward FDI instead.

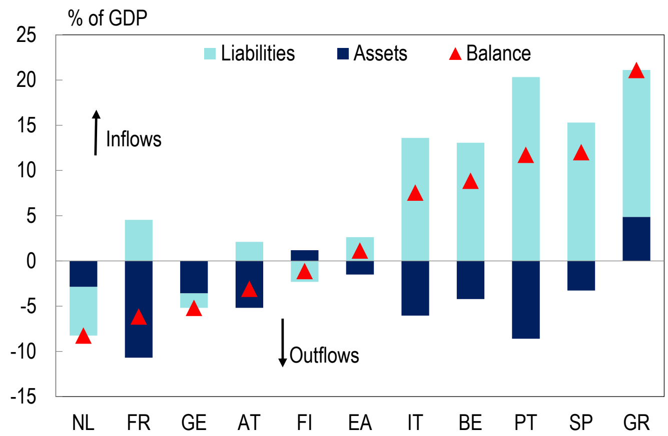
The Return of Portfolio Inflows

Figure 7. Selected Countries — Portfolio Investment Balance (4Q Sum, % of GDP), Latest



Note: Assets and liabilities are from the perspective of the country's residents. Positive values here signify inflows, including for liabilities. Latest is Q1 2014 for the euro area, France, Germany, Italy and Spain and Q4 2013 for the remainder.
Sources: ECB and Citi Research

Figure 8. Selected Countries — Change in Portfolio Investment Balance (4Q Sum, % of GDP) Between Q1 2012 and Latest



Note: Assets and liabilities are from the perspective of the country's residents. Positive values here signify inflows, including for liabilities. Latest is Q1 2014 for the euro area, France, Germany, Italy and Spain and Q4 2013 for the remainder.
Sources: ECB and Citi Research

Net portfolio inflows are at a record-high relative to overall financial inflows in the Eurozone

As noted above, despite the net outflow of capital from the Eurozone, net portfolio inflows have been positive, to the tune of 1.5% of GDP in Q1 2014. Even though the net portfolio inflow is only in line with the 2001-2007 average (relative to GDP), it is notable in at least two respects: first, it comes after net portfolio flows were (slightly) negative at the height of the Eurozone crisis in mid-2012. Second, net portfolio flows are at the highest level relative to total Eurozone net capital flows (see Figure 2 on the Front Page). That means that, taking total net capital flows as given, the RoW are choosing to invest in Eurozone portfolio assets and reduce (even more strongly) their Eurozone bank loans and deposits (with net FDI close to balance), whereas it is the other way around for the Eurozone residents.

Portfolio inflows are exclusively in the Eurozone periphery

Across countries, portfolio inflows are concentrated exclusively in the periphery and the soft core, with the largest net portfolio inflows into Belgium and France in Q1 2014 (at around 6% of GDP), followed by substantial net inflows into Italy and Spain (see Figure 7).[3] Netherlands and Germany, but also Greece, are registering large portfolio net *out*flows. In all countries with net portfolio inflows, portfolio liabilities are rising (i.e. there are higher inflows) rather than that foreign assets are falling, whereas in the Netherlands and Germany net outflows are driven both by rising foreign portfolio assets and falling portfolio liabilities.[4] And Figure 10 shows that the change in net portfolio investments since Q1 2012 has been even more dramatic for the Eurozone periphery (but also Belgium), as these had been registering very large net portfolio outflows at the time.

Net equity inflows account for the bulk of portfolio inflows

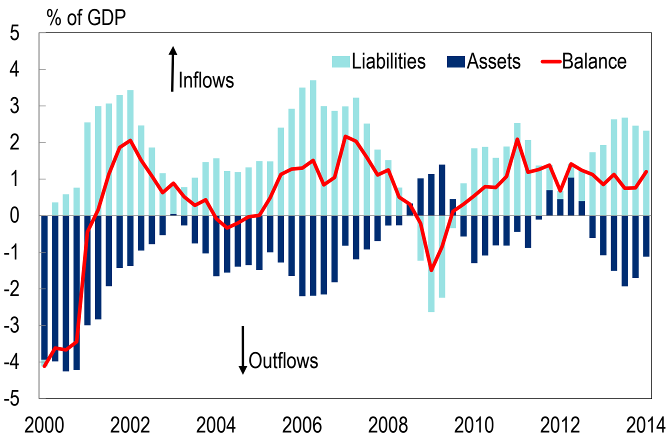
Net equity portfolio inflows, at 1.2% of GDP in Q1, account for the bulk of net portfolio inflows and equity inflows are also at record-highs relative to total Eurozone net inflows. Net inflows into portfolio debt (which include flows into the marketable debt of banks, the non-bank private sector and the public sector) are still

[3] For Belgium, we note the possibility of a 'Euroclear' effect whereby the location of the clearing house could distort financial account data, just one example of the potential for misinterpretations of financial account data due to financial intermediaries and financial centers.

[4] The difference between net portfolio inflows and total net capital flows is high in historical comparison in the entire Eurozone periphery and the 'soft core', even though it is at record-highs only in Italy.

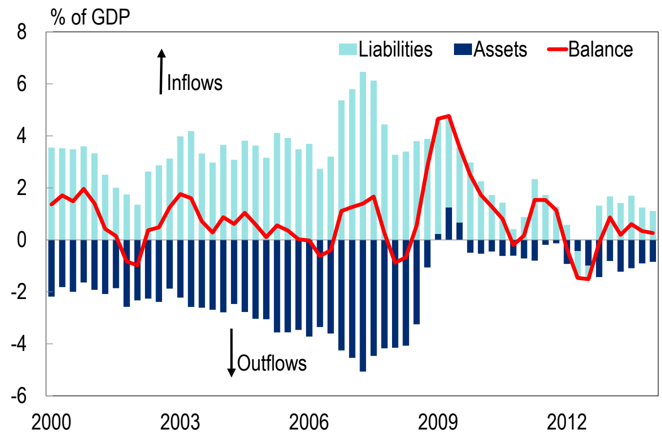
positive but small at 0.3% of GDP (and even though they are high relative to total net inflows, they have not yet again reached the 2008-09 highs). On the other hand, relative to the crisis peak it is in fact net debt portfolio flows that have recovered more, after registering sizable net outflows in 2011-12 as Eurozone residents both increased foreign holdings of portfolio debt and the RoW reduced Eurozone holdings. Net equity portfolio investment flows have by contrast been relatively stable, as in 2011-12 when sales to foreigners dried up (even though foreigners did not actually reduce their holdings), Eurozone investors sold foreign equities.

Figure 9. Euro Area — Equity Portfolio Investment Balance (4Q Sum, % of GDP), 2000-2014



Note: Assets and liabilities are from the perspective of Eurozone residents. Positive values here signify inflows, including for liabilities.
Sources: ECB and Citi Research

Figure 10. Euro Area — Debt Portfolio Investment Balance (4Q Sum, % of GDP), 2000-2014



Note: Assets and liabilities are from the perspective of Eurozone residents. Positive values here signify inflows, including for liabilities.
Sources: ECB and Citi Research

Net equity inflows are relatively high

As Figure 9 shows, net equity flows are relatively high (but not at extreme levels) compared to the historical average, as foreign purchases of equity are quite high, and Eurozone purchases of foreign equity remain close to historical norms. By contrast, both Eurozone purchases of foreign portfolio debt and the RoW's purchases of Eurozone debt have fallen dramatically since 2008-09 and remain low in historical comparison (see Figure 10).

The Eurozone periphery has seen large net inflows of debt, but the destination of equity net inflows is less obvious

As we noted above, net portfolio investment in the Eurozone has been concentrated in the periphery and soft core most recently. For debt flows, data on the composition of portfolio flows available from national sources bear this out quite clearly: net portfolio debt inflows into Italy, Spain and France have recently been running at 4-6% of GDP (and are mostly driven by increases in holdings of foreign investors rather than reductions in foreign holdings of domestic residents, Figure 11), Portugal has had modest net inflows, and Germany has large outflows (with no data available from most of the other Eurozone countries). For equity, however, the data leave somewhat of a puzzle: foreign inflows into equity were positive as of the latest data (Q1 2014 except in Portugal and Ireland where it was Q4 2013), but the net balance was still negative in Italy, Portugal and Spain and (marginally) Germany, with a very small net inflow in France. Only in Ireland were net equity inflows positive and large.

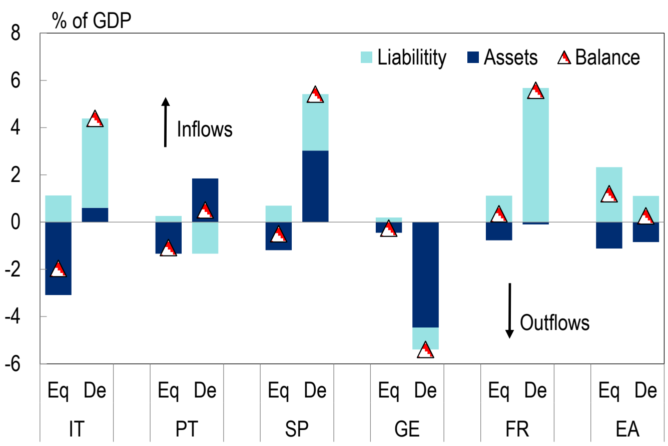
Where Do The Portfolio Inflows Come From?

US residents are investing in Eurozone portfolio assets again, but mostly in debt

No data are available on the origin of portfolio inflows for the Eurozone and to our knowledge only Germany and Portugal produce such data among the individual Eurozone countries. Even conceptually, such bilateral flow data (based on residence principles) are tricky, as financial flows are often routed through financial

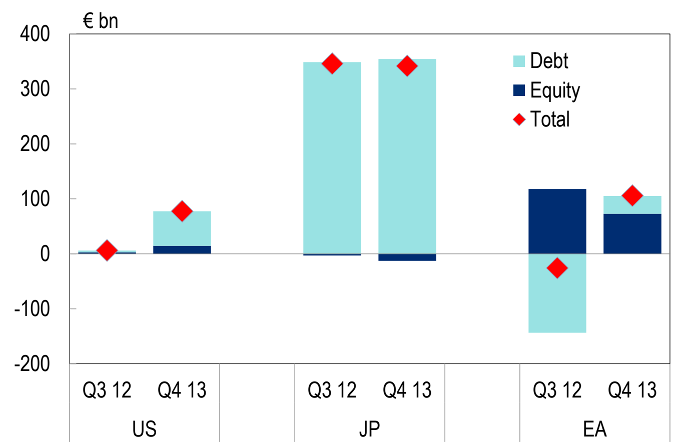
centres (including e.g. the UK, Switzerland or the Cayman Islands outside of the Eurozone or Luxembourg or Ireland within it) which can obscure the location of ownership, with similar complications created by the location of clearing houses, such as Euroclear in Belgium. Subject to these caveats, s*ome* information on the geographical composition of portfolio inflows may be gathered by looking at the asset side of non-Eurozone countries that provide a geographical breakdown of portfolio outflows. Data from the US and Japan indeed suggest that net portfolio flows to the Eurozone have been positive and large recently, even though once more the overwhelming majority of the flows was in debt.[5] These data suggest also suggest a notable pickup of US net flows from the period in 2011-12 when net portfolio flows to the Eurozone dried up (even though they did not turn negative), whereas net portfolio inflows from Japan were large even in 2011-12.

Figure 11. Selected Countries — Debt and Equity Portfolio Investment Balance (4Q Sum, % of GDP), Latest



Note: Positive values here signify inflows, including for liabilities. Latest is Q4 2013 for Portugal and Spain and Q1 2014 for the remainder.
Sources: ECB and Citi Research

Figure 12. US and Japan — Debt and Equity Portfolio Investment Balance into the Eurozone (4Q Sum, % of GDP), latest



Note: Positive values signify inflows. Latest is Q4 2013 for Japan, Q1 2014 for US.
Sources: ECB and Citi Research

Inward FDI remains subdued

Inward and outward FDI in the Eurozone are now balanced, but due to a fall in outward FDI in recent years

Above we noted that the Eurozone's net FDI balance is almost in balance, increasing from a deficit (net outflows) of -0.9% in Q1 2012 and moderate net outflows throughout much of the euro area's existence. But as Figure 13 shows, the increase in the net FDI balance is not due to rising levels of inward FDI but rather to more to gradual reductions in outward FDI. Net FDI balances into Portugal and Greece (and, marginally, Spain) have recently been positive and they have been driven more by inward FDI than reductions in outward FDI. Net FDI balances have also risen moderately in recent years in Spain, Portugal and Greece, having been negative in 2011. However, there is no sign of a surge in inward FDI in the Eurozone periphery (or the Eurozone overall). Levels of inward FDI into Italy, Portugal, or Spain have been stable or modestly declining since 2011, with a very modest pickup in Greece (they are also relatively stable but very large in Ireland). In Italy, net FDI balances in fact remain negative.

Will the Great Rotation to Portfolio Inflows Continue?

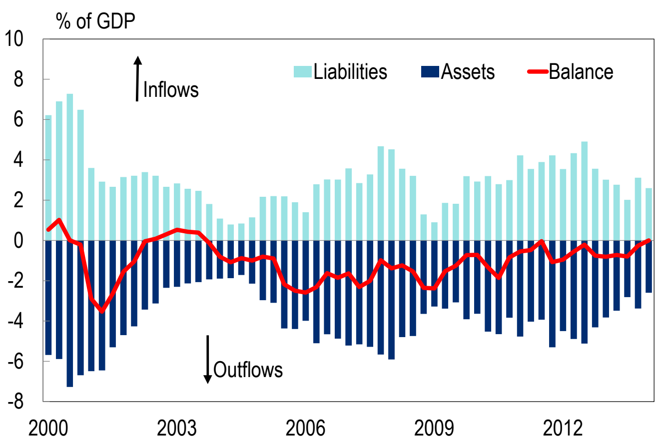
The drivers of capital flows are quite complex

The different elements of the balance of payments are of course jointly determined along with the relevant asset prices, but we have written before that we expect the

[5] A large share of the net debt flows from Japan were destined to Luxembourg, which is yet another example of the financial center effect, but even excluding Luxembourg net flows to the Eurozone were positive and large in 2011-12 as well as most recently.

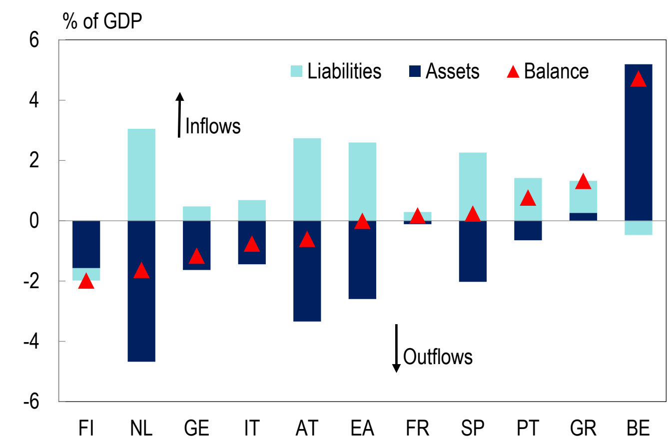
Eurozone's current account to remain large, which also implies a large financial account deficit. Conceptually, the composition of capital flows is determined by complex joint aggregate portfolio decisions of Eurozone and RoW investors. Among the drivers of such decisions are subjective differences across countries in expected risk-adjusted returns (e.g. if RoW investors are more optimistic or less risk-averse about Eurozone equities than domestic investors, net inflows into Eurozone equity may ensue), the desire to correct perceived underweights (RoW investors wanting to correct an underweight in Eurozone bonds would likely trigger a net inflow into Eurozone bonds). The impact of objective differences of returns between, say, Eurozone equities vs US equities on the composition of capital flows is less straightforward. If both Eurozone investors and US investors thought Eurozone equities were undervalued relative to US equities, we should expect the *price* of Eurozone equities to rise relative to US equities, but that could happen without any (gross or net) flows (even though flows are of course not ruled out either in the price formation process).

Figure 13. Euro Area — Foreign Direct Investment Balance (4Q Sum, % of GDP), 2000-2014



Note: Assets and liabilities are from the perspective of Eurozone residents. Positive values here signify inflows, including for liabilities.
Sources: ECB and Citi Research

Figure 14. Selected Countries — FDI Investment Balance (4Q Sum, % of GDP), Latest



Note: Positive values here signify inflows, including for liabilities. Latest is Q1 2014 for the euro area, France, Germany, Italy and Spain and Q4 2013 for the remainder.
Sources: ECB and Citi Research

It is difficult to know if RoW investors will continue to be more optimistic about Eurozone portfolio assets or continue to reduce any potential underweights

The revealed portfolio decisions in recent years suggest that foreign investors were relatively more optimistic about Eurozone equities and bonds (relative to RoW equities and bonds) or more underweight relative to their desired allocation than Eurozone investors, similarly so on Eurozone FDI and the reverse (in more dramatic fashion) for 'other investments'. Whether that will be true in the future is difficult to know, in our view. One factor that may change is that following the conclusion of the ECB/EBA asset quality review and stress test, the uncertainty around the state of Eurozone bank balance sheets may fall and the desire of Eurozone banks to urgently reduce their external liabilities may also moderate (as it seems to have done most recently).

But the example of Japan shows that net equity inflows and overall net capital outflows can coexist for extended periods, particularly in a deleveraging environment

However, in our view it seems plausible that portfolio inflows into the Eurozone will continue, at least for equities, for two reasons. First, Figure 5 shows that portfolio net inflows have been the norm in the Eurozone for most of its existence. Second, the example of Japan – where over most of the last two decades before the Great Recession net equity inflows were positive even though there were overall net capital outflows – shows that countries in 'deleveraging mode' may choose to be conservative in the allocation of their foreign savings. The mirror image also exists – in the UK and US, sizable and persistent net capital inflows have usually coexisted with sizable net capital outflows on the equity side, outside of crisis periods.

Key Economic Indicators (23 June – 27 June 2014)

During the Week		Forecast	Last
07:00	UK: Nationwide House Prices, May		
Monday 23 June		**Forecast**	**Last**
09:00	Euro Area: Manufacturing PMI, Jun Flash	52.5	52.2
	Services, PMI, Jun Flash	53.4	53.2
	Composite PMI, Jun Flash	53.8	53.5
Tuesday 24 June		**Forecast**	**Last**
07:00	Switzerland: Trade Balance, May		
08:30	Netherlands: Producer Confidence, Jun		
09:00	Germany: ifo Business Climate, Jun	110	110.4
09:00	Italy: Contractual Wages, May		
09:30	UK: BBA Mortgage Advances May		
	Spain: Budget Balance, May YTD	€-22.6 Billion	Jan-May 2013: €-26.1 Billion
14:00	Belgium: Business Confidence, Jun	-7.5	-6.8
Wednesday 25 June		**Forecast**	**Last**
07:00	Germany: GfK Consumer Confidence, Jul		
07:45	France: Manufacturing Confidence, Jun	100	99
	Own-Company Production Outlook, Jun	9	4
08:00	Spain: Producer Prices, May		
08:30	Netherlands: GDP Details, 1QF	-1.4% QQ, -0.3% YY	1.0% QQ, 0.9% YY
09:00	Italy: Retail Sales, Apr		
10:00	Italy: Consumer Confidence, Jun	107.0	106.3
11:00	UK: CBI Retail Survey, Jun		
11:00	Ireland: Residential Property Prices, May		
Thursday 26 June		**Forecast**	**Last**
	European Council (to 26 June)		
07:45	France: Consumer Confidence, Jun	85	85
08:00	Spain: Producer Prices, May		
08:30	Sweden: Producer Prices, May		
09:00	Norway: LFS Unemployment Rate, Apr	3.2%	3.3%
17:00	France: Jobseekers – Net Change, May	5.0K	14.8K
	Total Jobseekers, May	3,369.1K	3,364.1K
Friday 27 June		**Forecast**	**Last**
00:01	UK: GfK Consumer Confidence, Jun		
	European Council, continued		
07:00	Germany: Import Prices, May	-0.4% MM, -2.4% YY	-0.3% MM, -2.4% YY
07:45	France: GDP Details, 1Q	0.0% QQ, 0.8% YY	0.2% QQ, 0.8% YY
07:45	France: Consumer Spending, May	0.3% MM, -1.0% YY	-0.3% MM, -0.5% YY
07:45	France: Producer Prices, May		
08:00	Switzerland: KOF Economic Barometer, Jun		
08:00	Spain: HICP, Jun Flash	0.0% YY	0.2% YY
08:00	Spain: Retail Sales, May	-0.6% YY	-0.7% YY
08:30	Sweden: Trade Balance, Apr		
08:30	Sweden: Retail Sales, May	0.5% MM	0.6% MM
09:00	Norway: Registered Unemployment Rate, Jun	2.8%	2.7%
09:00	Italy: Business Confidence, Jun	100.1	99.7
09:30	UK: Balance of Payments, 1Q	£-16.7 Billion, 4.0% of GDP	£-22.4 Billion, 5.4% of GDP
09:30	UK: GDP, 1Q (3rd Release)	0.8% QQ, 3.1% YY	0.7% QQ, 2.7% YY
09:30	UK: Service Sector Output, Apr	0.3% MM, 3.2% YY	0.4% MM, 3.1% YY
10:00	Euro Area: Economic Sentiment, Jun	103.2	102.7
11:00	Ireland: Retail Sales, May		
13:00	Germany: HICP, Jun Flash	0.1% MM, 0.6% YY	-0.3% MM, 0.6% YY
	National CPI, Jun Flash	0.1% MM, 0.9% YY	-0.1% MM, 0.9% YY

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area

Jun 23	***Manufacturing PMI, Jun Flash***	**Forecast: 52.5**	**Prior: 52.2**
09:00	***Services PMI, Jun Flash***	**Forecast: 53.4**	**Prior: 53.2**
London Time	***Composite PMI, Jun Flash***	**Forecast: 53.8**	**Prior: 53.5**

The weakening of the euro and further ECB monetary policy loosening may have supported the expectation components in the PMIs, leading to a partial reversal of the quite large drop recorded in May. However, the PMIs have clearly lost momentum in the past four months, especially in the manufacturing sector, possibly reflecting the slowdown in foreign demand for exports.

Jun 27 10:00 London Time	***Economic Sentiment, Jun***	**Forecast: 103.2**	**Prior: 102.7**

Economic sentiment probably continued to improve in June, although the level of the index remains only 0.3 sd above its long-term average. We expect a rise in the flash estimate of consumer confidence (and a similar dynamic for the services and retail sectors) while manufacturing may ease slightly.

Germany

Jun 24 09:00 London Time	***Ifo Business Climate, Jun***	**Forecast: 110**	**Prior: 110.4**

The ifo business climate index has trodden water since the start of the year, as strong growth momentum in 1Q was counterbalanced by concerns about tension in Ukraine and Russia. We think this trend will continue in June, and expect a very modest decline. The readings we expect would still leave both the overall index and the individual components at more than 1 std above their long-term averages

Jun 27 07:00 London Time	***Import Prices, May***	**Forecast: -0.4% MM, -2.4% YY**	**Prior: -0.3% MM, -2.4% YY**

German import prices continue to fall as the euro remains strong and food and energy prices (earlier in the year) remained subdued. In May, we expect import prices to fall once more month on month, leaving the YY growth rate at -2.4%.

Jun 27	***HICP, Jun Flash***	**Forecast: 0.1% MM, 0.6% YY**	**Prior: -0.3% MM, 0.6% YY**
13:00	***National CPI, Jun Flash***	**Forecast: 0.1% MM, 0.9% YY**	**Prior: -0.1% MM, 0.9% YY**
London Time			

After the large downside surprise for German inflation in May, we expect it to stabilise in June at this very low level of just 0.6% YY for the HICP and 0.9% YY for the national definition. Even this stabilisation implies a small rebound from the calendar-driven fall in the prices of package holidays that had in part lowered the May inflation reading. We still expect German inflation to slowly increase in 2H, but the next few months will show if low price increases have entrenched themselves in inflation expectations (and therefore price setting) to avert even a moderate pickup in inflation.

France

Jun 25	***Manufacturing Confidence Indicator, Jun***	**Forecast: 100**	**Prior: 99**
07:45	***Own-Company Production Outlook, Jun***	**Forecast: 9**	**Prior: 4**
London Time			

Manufacturing confidence is anticipated to have gained one point to 100 (matching its long-term average) in June, although renewed softness in the manufacturing PMI for May does not bode particularly well for the French industrial sector. We see two main reasons limiting the potential for upside surprises in coming months, keeping France in the camp of underperformers: i) the strength of the euro is hampering efforts to improve competitiveness and profitability, ii) the government is struggling to convince industrialists about the strength of its s reform agenda.

Jun 26 07:45 London Time	***Consumer Confidence Indicator, Jun***	**Forecast: 85**	**Prior: 85**

Household confidence would need to register a three-point gain to 88 in June for the 2Q average to match the 86 recorded in 1Q-14. We think that this is unlikely at this stage and look for an unchanged reading of 85 for the third successive month. Poor unemployment numbers, together with the record high proportion of protest votes at the European Parliament elections in late May should be clear sources of a downward bias in our view. Yet we think that continued softness in headline inflation will support households' perception of future increases in purchasing power.

Jun 26	***Jobseekers – Net Change, May (000s)***	**Forecast: 5.0K**	**Prior: 14.8K**
17:00	***Jobseekers, May (000s)***	**Forecast: 3,369.1K**	**Prior: 3,364.1K**
London Time			

We look for a 5K increase in the total number of registered jobseekers in May, stretching the series of successive upticks to seven. Although surveys of private sector employment intentions continue to improve gradually, suggesting that some jobs will be created in coming quarters, the turnaround in the labour market has been painfully slow. France is the only large euro area member state where the ratio of employment to real GDP growth has been negative over the Q1-08 to Q1-14 period (see *Euro Economics Weekly - Labour Market Slack*). Higher business confidence is the missing ingredient, in our view.

Jun 27 07:45 London Time	***Gross Domestic Product, 1Q F***	**Forecast: 0.0% QQ, 0.8% YY**	**Prior: 0.2% QQ, 0.8% YY**

The final estimate of 1Q GDP is expected to be unrevised at 0.0% QQ. This would amount to the lowest quarterly reading since 3Q-13 (-0.1% QQ), mainly because of a pull-back in private consumption (-0.5% QQ) in the aftermath of the 1 January 2014 VAT rate hike, but also because gross fixed capital formation contracted for a third successive quarter, with a drop in business investment (-0.5% QQ) adding to the trend of falling household residential investment. While export contributions likely added meaningfully to 1Q GDP, we don't expect much in the remainder of 2014. Note that the recent trends in business surveys and composite sentiment indicators point to downside risks to our 0.5% QQ 2Q GDP forecast.

Jun 27 07:45 London Time	***Consumer Spending, May***	**Forecast: 0.3% MM, -1.0% YY**	**Prior: -0.3% MM, -0.5% YY**

Consumer spending is likely to have trodden water in the past couple of months. We look for an uptick of 0.3% MM, largely offsetting the April contraction on the grounds that household and retail confidence was little changed. Anecdotal evidence from car registrations, BdF retail sales and labour market dynamics point to downside risks, although the low inflation reading and discounting probably helped a little. Looking ahead to June, we estimate that 2Q-14 average is unlikely to show a significant rebound, barring an unexpectedly strong June.

Economic Indicators

Netherlands

Jun 25 08:30 London Time — ***Gross Domestic Product, 1Q F*** — **Forecast: -1.4% QQ, -0.3% YY** — **Prior: 1.0% QQ, 0.9% YY**

Dutch economic activity contracted sharply in the first quarter of 2014, with the statistics office reporting that domestic consumption and exports of natural gas had declined sharply due to the mild winter. Nevertheless, despite some negative developments, the Dutch economy is still showing signs of recovering, with gains in investment, manufacturing production and higher demand for temporary workers. Our forecast for the second quarter envisages a rebound of a similar magnitude, pushing the YY GDP rate to 1.0%.

Belgium

Jun 24 14:00 London Time — ***Business Confidence, Jun*** — **Forecast: -7.5** — **Prior: -6.8**

Business confidence is likely to have fallen further to -7.5 (-0.2 standard deviation above its long-term average). In the last few months, demand expectations have weakened a little and the uptrend in employment expectations has stopped while price expectations have weakened further. While we estimate that business confidence will likely rebound in the third and fourth quarters in June, in the aftermath of the ECB's decision to cut interest rates and to provide additional monetary policy stimulus, a period of consolidation probably lies ahead, pointing to below trend growth.

Italy

Jun 25 09:00 London Time — ***Consumer Confidence, Jun*** — **Forecast: 107.0** — **Prior: 106.3**

Consumer sentiment has improved significantly since March, mainly because of improved expectations about the general economic outlook. The tax rebates disbursed in the May payslip for all employees earning less than €25K/year should have supported sentiment further in the month of June.

Jun 27 09:00 London Time — ***Business Confidence, Jun*** — **Forecast: 100.1** — **Prior: 99.7**

We expect another small gain in industrial sentiment, as the partial easing of the currency and buoyant equity prices should have positively affected expectations. Recent announcements of growth-supportive measures by the new government probably also helped to offset some of the weakness observed recently in some forward looking indicators.

Spain

Jun 24 — ***Budget Balance, May YTD*** — **Forecast: €-22.6 Billion** — **Prior (Jan-May 13): €-26.1 Billion**

We project the YTD central government deficit to show further modest improvements in May relative to the same period of last year. On a monthly basis, we project a deficit of €8.4bn, down by €0.4bn relative to May 2013. This should bring the YTD deficit figure roughly 13% below the Jan-May 2013 average. We expect the 2014 general government fiscal deficit to come only slightly above the government's target (at 5.8% of GDP vs. target of 5.5%), but still down from the 2013 outcome of 6.6% (net of bank recap costs), amid improved tax revenues on the back of better economic activity.

Jun 27 08:00 London Time — ***HICP, Jun Flash*** — **Forecast: 0.0% YY** — **Prior: 0.2% YY**

We expect the annual HICP inflation rate to slow to zero in June, from +0.2% YY in May. Recent weak dynamics in fresh food prices have likely continued in June, bringing the headline YY rate to the lowest level since 2009. In addition, we expect the YY inflation rate for energy to slow to 2.2% YY from 3% in May, driven by adverse base effects and by some reduction in electricity prices (as households will start being repaid the announced Q1 electricity price rebate). We expect core inflation (excluding fresh food and energy) to remain in negative territory in June and overall inflation to remain subdued throughout 2014.

Jun 27 08:00 London Time — ***Retail Sales, May*** — **Forecast: -0.6% YY** — **Prior: -0.7% YY**

We expect real retail sales growth to slow down in May (0.3% MM), mainly as a payback after the strong rebound in April (1.1% MM). We estimate this will translate into the YY growth rate (WDA) slightly improving from -0.7% in April to -0.6% in May. We continue to expect retail sales to post positive growth in the coming months, on the back of reduced fiscal tightening, marginal improvements in employment and subdued inflation.

Sweden

Jun 27 08:30 London Time — ***Retail Sales, May*** — **Forecast: 0.5% MM** — **Prior: 0.6% MM**

Momentum in the service sector is accelerating, hence offsetting weakness in the manufacturing sector. This is well in line with indications from the services PMI, which has now been above 50 for eleven consecutive months, and with a 58.5 reading in June points to strong growth in the sector. NIER retail sector sentiment has improved steadily since late-2011and stood at the highest level since Dec-10 in May (110.5). In addition, we note that strong clothing and shoe sales in May also bode well for retail sales; according to data from HUI, sales of clothing were up by 3.8% YY and shoes by 3.2% YY in May.

Norway

Jun 26 09:00 London Time — ***LFS Unemployment Rate, Apr*** — **Forecast: 3.2%** — **Prior: 3.3%**

The labour market has stabilized, with the LFS jobless rate on average 3.5% in recent quarters (ticked down to 3.4% in 1Q-14). Employment recovered slightly in the three-month period Feb-Apr, gaining 0.1% compared to the previous three-month period, up from a 0.1% QQ decline in 1Q. Norges Bank, however, tends to put more emphasis on the timelier and less volatile unemployment figures from labour offices; in May, the number of unemployed persons rose by 2,500 to 76,500, the highest level since Dec-15. The year-to-date average registered jobless rate is currently 2.75% (in seasonally-adjusted terms), and compares with the Central Bank's forecast of 3.0% for this year.

Jun 27 09:00 London Time — ***Registered Unemployment Rate, Jun*** — **Forecast: 2.8%** — **Prior: 2.7%**

In May, the number of unemployed persons rose by 2,500 to 76,500, the highest level since Dec-15. The year-to-date average registered jobless rate is currently 2.75% (in seasonally-adjusted terms), and compares with the Central Bank's forecast of 3.0% for this year. In line with the seasonal pattern, we expect the registered unemployment rate to rise by 0.1pp to 2.8% in June.

Economic Indicators

United Kingdom			
Jun 27 09:30 London Time	***Balance of Payments, 1Q***	**Forecast: £-16.7 Billion, 4.0% of GDP**	**Prior: £-22.4 Billion, 5.4% of GDP**
	Recent figures have shown a drop in the deficit on goods and services trade to £5.2bn in 1Q, the lowest since 1Q-2011, from £5.7bn in 4Q. In addition, we expect the current account deficit will be reduced by a rebound in earnings on the UK's direct investment overseas, from the unusually weak reading in 4Q. Note that the current account data are frequently revised markedly and hence this release may also include sizeable changes to data in prior quarters.		
Jun 27 09:30 London Time	***GDP, 1Q (3rd Release)***	**Provisional: 0.8% QQ, 3.1% YY**	**Prior: 0.7% QQ, 2.7% YY**
	It seems quite likely that 1Q GDP growth will be revised up to 0.9% QQ given the recent upward revision to 1Q construction output. The split is likely to show real household disposable income rising about 0.5% QQ and 2% YY, although the YY growth rate is exaggerated by temporary shifts in the timing of income payments a year earlier.		
Jun 27 09:30 London Time	***Service Sector Output, Apr***	**Forecast: 0.3% MM, 3.2% YY**	**Prior: 0.4% MM, 3.1% YY**
	We expect a further solid gain in service sector output in April, and a figure in line with our forecast would put the YY gain at the highest since early 2008. All business surveys suggest that service sector output remains buoyant.		

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

Key Economic Indicators (23 June – 27 June 2014)

During the Week		Forecast	Last
08:00	UK: Halifax House Prices, May		
Monday 30 June		**Forecast**	**Last**
07:00	Germany: Retail Sales (ex Cars), May SWDA (by Jun 30)	0.4% MM, 1.9% YY	0.1% MM, 1.7% YY
08:30	Sweden: Household Lending, May		
09:00	Norway: Credit Indicator C2, May		
09:00	Norway: Retail Sales, May		
09:00	Italy: Producer Prices, May		
09:00	Euro Area: M3, May		
09:30	UK: Personal Borrowing, May		
10:00	Italy: HICP, Jun Flash	0.4% YY	0.4% YY
10:00	Euro Area: HICP, Jun Flash		
10:00	Greece: Retail Sales, Apr		
	Spain: Current Account, Apr		
	EU: Greek Presidency ends		
Tuesday 1 July		**Forecast**	**Last**
	EU: Italy assumes Presidency until end-Dec		
07:30	Sweden: Manufacturing PMI, Jun		
08:00	Norway: Manufacturing PMI, Jun		
08:55	Germany: Unemployment, Jun		
09:00	Italy: Unemployment, May		
09:00	Euro Area: Manufacturing PMI, Jun Final		
09:30	UK: Manufacturing PMI, Jun		
10:00	Euro Area: Unemployment Rate, May		
	Italy: Budget Balance, Jun		
Wednesday 2 July		**Forecast**	**Last**
08:00	Spain: Unemployment, Jun		
09:30	UK: Construction PMI, Jun		
10:00	Euro Area: GDP, 1Q Final		
10:00	Euro Area: Industrial Product Prices, May		
Thursday 3 July		**Forecast**	**Last**
07:30	Sweden: Services PMI, Jun		
08:30	Sweden: Riksbank Monetary Policy Outcome		
08:30	Sweden: Average House Prices, Jun		
09:00	Euro Area: Services PMI, Jun, Final		
	Composite PMI, Jun Final		
09:30	UK: Services PMI, Jun		
10:00	Euro Area: Retail Sales, May		
12:45	Euro Area: ECB Meeting Outcome – Press Conference at 13:30		
Friday 4 July		**Forecast**	**Last**
07:00	Germany: Incoming Orders, May		
08:30	Sweden: Industrial Production, May		
08:30	Sweden: Services Production, May		
09:00	Italy: Deficit to GDP, 1Q		

Sources: National statistical offices, central banks and Citi Research

Publication Title	Author	Date
Euro Area — Sovereign Debt Update		
BoI Expects 0.5pp Boost to GDP from ECB Measures	European Economics Team	Jun 20, 2014
Merkel Rejects Calls to Modify the Stability Pact	European Economics Team	Jun 19, 2014
More Flexibility in Stability Pact Under Discussion	European Economics Team	Jun 18, 2014
German Deputy Chancellor Gabriel Favours Easing French Deficit Target	European Economics Team	Jun 17, 2014
ECB's Coeuré: "QE Is Not Needed Now"	European Economics Team	Jun 16, 2014
Euro Area		
Spain - Housing Adjustment: Are We Nearly There?	Antonio Montilla	Jun 13, 2014
Italy - Q1 GDP Details And April Industrial Output	Giada Giani	Jun 10, 2014
ECB - Door firmly open to additional stimulus and QE in late 2014	Guillaume Menuet	Jun 5, 2014
Europe - Monthly Inflation Profiles for Selected Countries	European Economics Team	Jun 5, 2014
Euro Area - Inflation Surprises Once Again to the Downside	Giada Giani	Jun 3, 2014
Euro Area - Economic Sentiment Strengthens, But France Stays Weak	Ebrahim Rahbari/Antonio Montilla	May 28, 2014
Euro Area - Weak M3 but fall in private sector loans eases in April	Ebrahim Rahbari/Antonio Montilla	May 28, 2014
Italy - Q1 GDP Downward Surprise and Political Uncertainty	Giada Giani	May 23, 2014
European Economic Forecast Highlights - May 2014	Ann O'Kelly	May 22, 2014
Euro Area - Q1 GDP Disappoints Probably Due To Exceptionally Mild Winter	Giada Giani	May 15, 2014
Euro Area - No Pickup in NFC Net Borrowing in Q1	Antonio Montilla/Ebrahim Rahbari	May 15, 2014
ECB - Comfortable with a June rate cut (and a negative depo rate)	Guillaume Menuet	May 8, 2014
Euro Area - Strong PMIs Argue Against ECB Rate Cut on Thursday	Guillaume Menuet	May 6, 2014
Spain - A Wider Output Gap Reduces the Need for Fiscal Austerity	Giada Giani	May 6, 2014
Euro Economics Weekly		
Labour Market Slack	Giada Giani	Jun 13, 2014
ECB TLTRO: Ambitious But Probably Not Enough, QE Lies Ahead	Guillaume Menuet	Jun 6, 2014
Negative Deposit Rate: Limiting Risks, Limited Upside	Ebrahim Rahbari	May 30, 2014
Soft Growth, Low HICP And Weak SPF Point To ECB Cut In June	Guillaume Menuet	May 23, 2014
Long Live (s) The Rise of the Current Account Surplus	Ebrahim Rahbari	May 16, 2014
Euro Economics Weekly - How Might QE Affect Financial Conditions?	Giada Giani	May 9, 2014
ECB: Reaction Function Points to Looser Stance Ahead	Guillaume Menuet	May 2, 2014
Private Deleveraging: Picking Up, but Hurting Less	Ebrahim Rahbari	Apr 25, 2014
Portugal: "Clean Exit" or Precautionary Credit Line?	Giada Giani	Apr 17, 2014
France: Will Valls Succeed Where Others Have Failed?	Guillaume Menuet	Apr 11, 2014
The Rise of The Output Gap	Ebrahim Rahbari	Apr 4, 2014
Italy — Some Short-Term Optimism	Giada Giani	Mar 28, 2014
Euro Area: Upside Risks To Q2 GDP	Guillaume Menuet	Mar 21, 2014
The Eurozone Investment Recovery	Ebrahim Rahbari	Mar 14, 2014
Internal Devaluation in the Periphery	Giada Giani	Feb 7, 2014
Chief Economist Publications		
Global Economics View - The Long-Run Decline in Advanced-Economy Investment	Willem Buiter	Jun 12, 2014
Global Economic Outlook and Strategy - May 2014	Willem Buiter	May 21, 2014
Scandi and Switzerland		
Scandi Economics Update	Tina Mortensen	Jun 20, 2014
Norway - NB Delays Rate Hike, Raises Prospects of Near-Term Rate Cut	Tina Mortensen	Jun 19, 2014
Sweden - Strong Labour Market Data in May	Tina Mortensen	Jun 13, 2014
Sweden - IMF: Urgent that Sweden Does More to Address Private Debt	Tina Mortensen	Jun 13, 2014
UK		
UK - Retail Sales and CBI Data	Michael Saunders	Jun 19, 2014
UK - MPC Minutes and BoE Agents Survey	Michael Saunders	Jun 18, 2014
UK - CPI Inflation Falls Further	Michael Saunders	Jun 17, 2014
UK - Carney Speech	Michael Saunders	Jun 13, 2014
UK - Nation of Workers	Michael Saunders	Jun 11, 2014
UK - March of the Makers Continues	Michael Saunders	Jun 10, 2014
UK - REC Survey Suggests Labour Market Still Tightening	Michael Saunders	Jun 6, 2014
UK Economics Weekly		
The "Jobs Miracle" Continues	Michael Saunders	Jun 13, 2014
Implications for the UK of ECB Easing;	Michael Saunders	Jun 6, 2014
Inflation Downtrend Probably Over	Michael Saunders	May 30, 2014
Will Macro-Pru Allow "Low for Longer"?	Michael Saunders	May 23, 2014

Source: Citi Research

Appendix A-1

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