1 December 2014 | 84 pages

Global

# Global Economic Outlook and Strategy

## Prospects for Economies and Financial Markets in 2015 and Beyond

- In this "*Prospects*" edition, Citi's research team presents updated forecasts for economies, interest rates, FX rates, commodity prices and sovereign ratings around the world for 2015 and beyond. We also present Overview essays on the drift into secular stagnation, whether globalization is stalling, political issues for 2015, emerging market strains, advanced economy "low-flation" and long-run projections for the size of major economies.
- We are cutting 0.1 percent off our global growth forecast for 2015 and 0.2 percent off for 2016, and expect only a slight pickup in global growth, to about 3.1% YoY in 2015 from about 2.7% in 2014 (at current FX rates). The improvement from 2015 is likely to be led more by advanced economies rather than emerging markets. Growth in the US and UK is likely to stay around 3% in 2015-16, and we forecast modestly higher growth for the euro area and Japan. EM growth will probably again outpace AE growth in 2015, but the EM-AE growth gap is likely to be the lowest since 2000. Indeed, we expect China's official data to show real GDP growth slowing slightly below 7% in 2015, the lowest since 1999 — and the economy's underlying momentum may well be even softer. By contrast, we highlight India, Mexico, Spain and Ireland as likely reform-driven outperformers.
- Economic divergences are likely to prompt sizeable divergences in monetary policies in 2015-16. We have pushed back our forecasts for the start of Fed and BoE tightening, but still expect that shrinking slack will prompt both central banks to hike rates in late-2015. Conversely, the prospect of persistent low-flation is likely to prompt the ECB to follow the BoJ and launch a major QE program soon. We also expect widespread nearterm monetary easing across emerging markets. In turn, we expect further major USD appreciation, breaching €1.10/$ and ¥125/$ in 2015, with levels of €1.00/$ and ¥135/$ likely over the next 2-3 years.
- Key downside risks center on China's domestic economy (especially if monetary easing is delayed or ineffective); continued underperformance in the euro area and Japan; and the weakening political support for global economic integration. Key upside risks center on the boost for consumers from falling commodity prices alongside loose monetary policies, especially in advanced economies.

**Figure 1. Currency and Interest Rate Forecasts, as of 1 December 2014**

| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | 2Q 16F |
|---|---|---|---|---|---|---|---|
| United States: Federal Funds | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.75 |
| 10-Yr. Treasuries (Period Ave.) | 2.21 | 2.70 | 2.85 | 2.90 | 2.95 | 3.00 | 3.05 |
| Euro Area: US$/€ | 1.24 | 1.16 | 1.12 | 1.09 | 1.07 | 1.05 | 1.02 |
| Euro Repo Rate | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| 10-Yr. Bunds (Period Ave.) | 0.70 | 0.65 | 0.85 | 1.00 | 1.15 | 1.25 | 1.25 |
| Japan: ¥/US$ | 118 | 121 | 124 | 126 | 128 | 130 | 132 |
| Call Money | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 10-Yr. JGB (Period Ave.) | 0.44 | 0.45 | 0.45 | 0.55 | 0.55 | 0.60 | 0.60 |

F: Forecast. Note: All forecasts are for end of period, unless specified. Source: Citi Research

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

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**Figure 2. Forecast Highlights and Changes**

| | |
|---|---|
| **Global** | We continue to trim our 2015 global growth forecasts, cutting 0.1 percent off this month (the fourth consecutive downgrade). The downgrades are led by emerging markets, and in all we have cut our 2015 EM growth forecast by 0.6 percent (to 4.4% from 5.0%) in the last three months. |
| **United States** | Above-trend US growth in the near term is likely to give way to slower underlying GDP growth from mid-2015 onward. Incipient downside risks stem from slow global growth and weakening of domestic demand drivers. As the unemployment rate declines toward the natural rate by end-2016, this implies modest below-Fed-target inflation through most of 2017. Consequently, we forecast the first policy rate increase for December 2015, followed by a moderate pace of rate increases. |
| **Euro Area** | Persistent low-flation, an uneven recovery and an explicit target of balance sheet expansion mean that the ECB will likely have to deliver additional monetary policy accommodation in 2015. We expect a full QE programme including government bond purchases to be launched in Q1-15, with a preference for the Jan 22 meeting. Given the large output gap, we believe that the ECB will have to rely on a much weaker euro (and maybe more QE) to stop inflation expectations from falling further. |
| **China** | Growth is likely to remain below potential for a couple of years with excess capacity and high leverage constraining investment. We maintain our growth forecast of 7.3% for 2014 and 6.9% for 2015, but we are cutting our average inflation forecast from 2.1% to 2.0% for 2014, and from 2.2% to 1.9% for 2015. We continue to expect downside growth and inflation risks to lead to two benchmark rate cuts (25bps each) by mid-2015. |
| **Japan** | The economy is likely to maintain above-trend growth in the years to come, in part thanks to lower oil prices and postponement of the consumption tax hike. However, we expect core inflation will undershoot the BoJ bullish forecasts in 2015 and believe this will probably prompt policymakers to implement additional easing measures next summer. |
| **United Kingdom** | The UK economy is likely to grow solidly in 2015, fuelled by strong growth in consumer spending and business investment. We have again pushed back the start of MPC tightening, and now expect the first rate hike in Q4-15, by which time the jobless rate is likely to be close to the MPC's estimate of equilibrium. Key risks centre on the 2015 election. |
| **Canada** | Expectations of moderate growth and sub-target inflation next year, as well as global uncertainties, suggest that resumed BoC tightening is unlikely until 1Q 2016. |
| **Australia** | The key drivers of the economic outlook this year are likely to remain in play again in 2015. As a result, economic growth next year is unlikely to be materially different to this year's growth of around 3%. With underlying inflation expected to be in the bottom half of the 2%-3% target, the RBA is probably on a similar tightening timetable to the Fed. |
| **Emerging Asia (ex-China)** | EM Asia growth prospects in 2015 continue to be undermined by challenging global growth. Persistent 'low-flation' is likely to allow further monetary easing in Korea, India and Thailand, and allow others to stay on prolonged hold. Domestic-driven and commodity-importing economies of India, Philippines and Sri Lanka should do relatively better than others. |
| **CEEMEA** | 'Commodities importers' vs 'manufactured goods exporters' will remain an important theme in CEEMEA next year as the region's commodity economies – chiefly Russia, Nigeria, South Africa – face challenges, not just from falling commodity prices but also from their relative lack of effort to improve the investment climate in these economies. Manufacturing-based economies – Turkey, Central Europe, for example – are likely to be in a relatively stronger position. |
| **Lat Am** | 2015 is unlikely to be a memorable year for Lat Am. In Brazil, low growth will couple with the need for fiscal consolidation and additional monetary tightening as inflation is likely to surpass the upper bound of the CB's target. The lack of coherence in macroeconomic policy-making, together with sizeable external shocks, suggests that the recession will worsen in Argentina and Venezuela. Both countries face important elections in 2015. Mexico is amongst the few countries within the region for which we see a promising 2015, as growth should accelerate further while inflation is likely to stay in check. |

Source: Citi Research

**Figure 3. Selected Countries — Industrial Production Forecasts (Pct.), 2014-2016F**

| | 2014F | 2015F | 2016F |
|---|---|---|---|
| World | 3.3 | 3.2 | 3.7 |
| United States | 4.2 | 3.8 | 3.0 |
| Japan | 1.6 | 0.2 | 2.7 |
| Euro Area | 0.6 | 0.7 | 2.5 |
| United Kingdom | 2.3 | 1.8 | 2.0 |
| Canada | 3.2 | 1.8 | 1.5 |
| China | 8.3 | 7.4 | 7.1 |
| India | 3.9 | 5.9 | 7.0 |
| Korea | 0.7 | 2.4 | 3.4 |
| Brazil | -2.7 | 0.5 | 2.0 |

Source: Citi Research

# 2015 — Drifting Into Secular Stagnation?

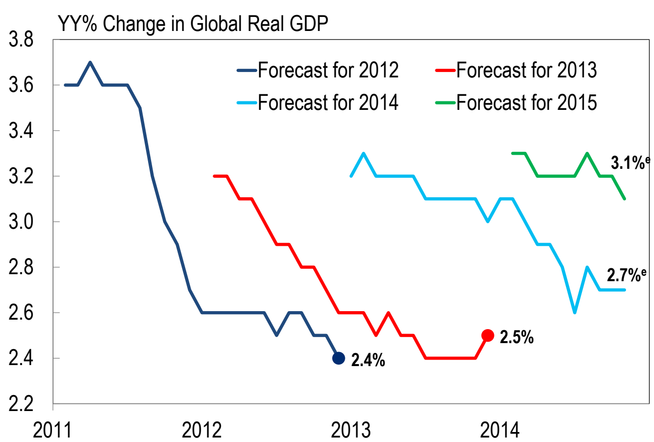
**Guillermo Mondino**

**Willem Buiter**

The past few years have probably established a record of disappointments for economic forecasters of global GDP growth. Every year, since at least 2011, forecasts have been systematically proven optimistic forcing a downward revision. Rather surprisingly, these backward-looking downward revisions were invariably accompanied by a forecast of a meaningful pick-up in growth (from the downward revised current levels) for the following period (see Figure 4). The logic of forecasting models, one imagines, is that business cycles and growth mean-reversion are powerful forces. However, these effects seem to have lost some of their strength.

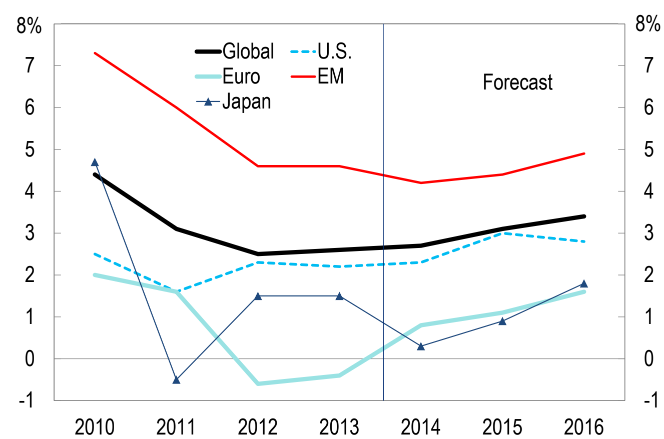
We find that an increasingly appealing interpretation of the frustrating economic performance in advanced economies (AE) is “Secular Stagnation.” The version of that hypothesis that we favor holds that the economic recovery is extraordinarily weak because there is an endemic excess of savings over investments that only a spontaneous eruption of animal spirits boosting domestic consumption and/or capital formation, a major boost from external demand or aggressive expansionary policies can resolve. In a world with such limited growth and ample resource underutilization, low inflation is likely to emerge. Low-flation, in turn, contributes to prolonging the period of low growth when nominal policy rates are near the zero lower bound, limiting the effectiveness of traditional policies. Low global activity leads to low commodity prices. Note, however, that the recent weakness in oil prices is not just driven by a reduction in oil demand caused by a lower global GDP growth and by policies that promote a less commodity-intensive, energy intensive and carbon-intensive composition of production and demand, but is to a large extent the reflection of a technological disruption that led to a large (distributional) global shock. These three themes marked the second semester of 2014 and, we think, will continue to shape economic and political outcomes in 2015.

**Figure 4. Consensus expectations of growth have proven to be consistently optimistic leading to systematic downward revisions**




Note: Dots = data for 2012 and 2013, last available forecast for 2014-15. Sources: Consensus Forecasts and Citi Research based on a graph by Gavyn Davis: http://blogs.ft.com/gavyndavies/2014/10/12/its-the-new-mediocre-not-a-global-recession/

**Figure 5. Global growth has been mediocre and, although we are forecasting a small rebound, it is set to continue at a moderate pace, at best**



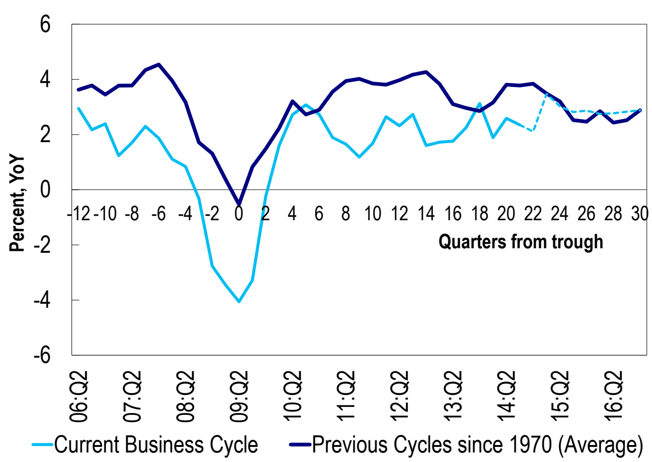

Source: Citi Research

## Secular stagnation gains traction

The world economy grows at a modest pace. For 2015, our forecasts still exhibit some tendency to mean-revert, but the forecast level is quite mediocre (see Figure 5). Even positive stories like the US, are only the result of an early pick up in Q1 to above 3%, with growth likely to then revert back to the high 2s. Japan and Europe are expected to deliver close to 1% growth and China is forecast to decelerate to below 7% (6.9% is our actual forecast for officially reported GDP). In all these cases, except for the US, even these modest growth rates are based on the assumption that there will be further expansionary policy support. And the repeated disappointment of recent years suggests that risks probably lie mainly to the downside of our forecasts for 2015-16.

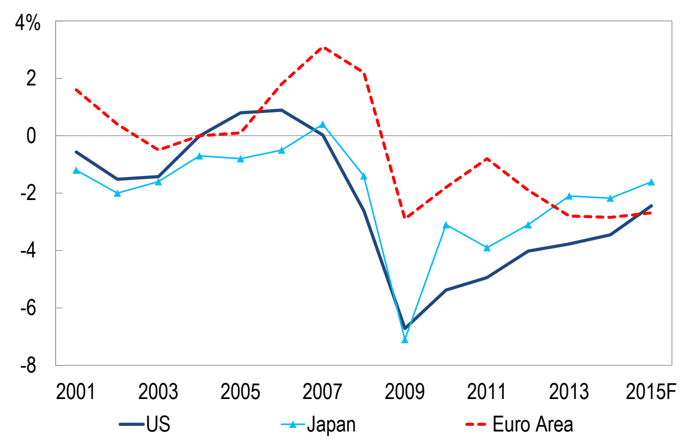
Growth is insufficient and output gaps remain wide open despite some gains in labor market conditions. The global financial crisis (GFC) is gradually fading in memory, yet the pace of economic recovery leaves much to be desired. Take for instance the case of the US, where growth has run since 2010 at an average annualized pace of 2.16% (see Figure 6). At that pace and given most estimates of potential growth (CBO estimates 2% on average for 2010-2014) the output gap has closed only marginally in those years and remains quite significant. Our forecasts for US growth in 2015 imply some further closing of the output gap, but it remains large even after a year of 3.0% growth. Using IMF estimates of potential growth, Figure 7 illustrates that the problems in Europe are more acute given the shabby recovery (an average growth rate of 0.68%) which remains roughly similar to the 0.7% potential growth that the IMF estimates (a number we deem too pessimistic, even without reforms in Italy, France and Germany). In Japan, the relatively speedy growth of actual output immediately following the crisis and the very modest rate of potential output growth (the IMF estimates 0.4% while Citi pencils down 0.5%), resulted in a narrower output gap, yet the poor growth performance in 2014 has kept the gap from closing further. Notice too that despite our forecasts for policy actions, output gaps in all three regions are expected to remain large towards the end of 2015. Is prolonged cyclical stagnation about to become secular?

**Figure 6. US Global Financial Crisis cycle and previous cycles. Even if potential growth were 2%, the recovery fails to close the output gap**




Sources: IMF and Citi Research

**Figure 7. Output gaps in Advanced Economies are still wide open. IMF estimates, adjusted with the latest Citi growth forecasts**



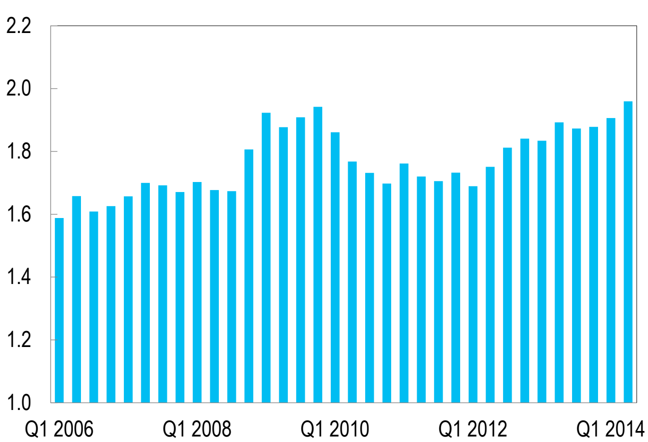

Sources: IMF and Citi Research

In some cases, it may be natural to blame fiscal consolidation and private deleveraging, for the lack of final demand. However, except in Japan, 2014 was hardly a year of additional fiscal tightening and, furthermore, private sector

deleveraging has slowed almost everywhere. Monetary policy accommodation remains extensive across the board (less so in the euro area, EA), and real policy rates are negative in AEs, except in parts of the EA periphery where actual deflation has taken hold. Nevertheless, once policy rates are near the lower bound, the transmission mechanism relies more on wealth and liquidity effects which seem to have lost some of their punch. In the US, for instance, household wealth increased in value by nearly $15 trillion since the launch of QE3 (roughly 8% per annum) yet consumer spending has only grown a modest 2.5%, in contrast with the pre-crisis high propensity to spend out of wealth. There are two obvious explanations for the apparent fall in the US marginal propensity to spend out of wealth. The first is that the increase in wealth since the GFC is likely to have been more unequally distributed than in the past. If the marginal propensity to spend out of wealth falls with the level of wealth, this would account for a weaker wealth effect on consumption. The second is that since the GFC, household wealth increases, especially those associated with higher home prices, have not been leveraged to the same degree as prior to the crisis as mortgage equity withdrawal has been more limited.

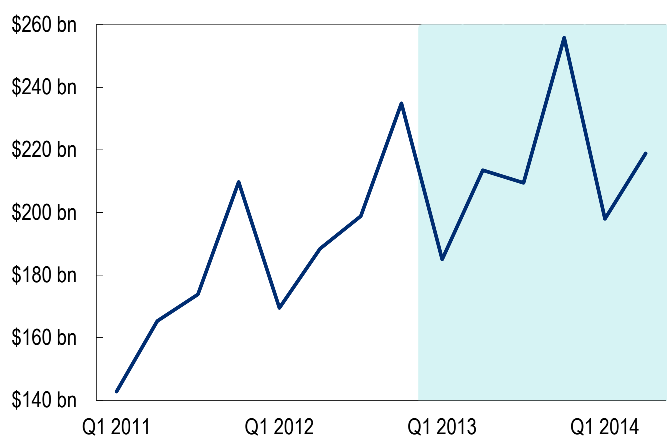
Investment in the AEs has been disappointing, despite the low level of real interest rates. The same way that consumers sport a lower marginal propensity to spend out of wealth, corporates with still fairly healthy balance sheets are reluctant to engage in capital expenditure. Remarkably, at least in the US, corporate balance sheets started to deteriorate at the time of QE3 with some corporate re-leveraging (see Figure 8). However, the higher leverage has been mostly used for other purposes, including equity buy-backs, extraordinary dividends, mergers and acquisitions, etc. rather than to support increased capex (see Figure 9). Perhaps the simplest, and most convincing explanation of the low capex is the weakness of the recovery and the persistence of large negative output gaps (which inhibits the 'accelerator'). With output constrained by effective demand, the weakness of the recovery is itself in no small part due to the weakness of capex.

**Figure 8. US Corporate leverage on the rise. Median leverage ratio (total) for industrial corporates.**




Note: Median of total debt over LTM EBITDA at issuer level
Sources: Steve Antczak at Citi Research and Bloomberg

**Figure 9. Little of that leverage is going to investment. Total capex for IG industrial corporates.**




Sources: Steve Antczak at Citi Research and Bloomberg

A prolonged period of low growth may lead to lower potential growth. With nominal policy rates close to the zero lower bound (ZLB), a contractionary demand shock (an ex-ante glut of saving over investment) drives the short-term real risk-free

interest rate consistent with full employment (the short-term neutral risk-free real rate) into negative territory. This negative 'neutral' risk-free rate of interest cannot be achieved because the nominal interest rate is at the ZLB and inflation (and expected inflation) is lowered by the negative demand shock. Without either an external boost to demand or an exogenous boost to domestic demand, full employment cannot be restored. The resulting negative output gap and underutilization of labor reduce investment and lower the effective supply of labor: short-term unemployed turn into long-term unemployed and ultimately drop out of the labor force altogether. So the path of potential output may be lowered by a persistent negative output gap. Cyclical stagnation becomes secular stagnation.

When there is no boost to aggregate demand from external sources - a spontaneous recovery of animal spirits or an effective fiscal and/or monetary stimulus – the inevitable conclusion is that real interest rates ought to remain low. Both ex-ante and ex-post real policy rates are negative throughout the AEs[1], though the decline in inflation expectations results in an effective reduction in the level of stimulus afforded by nominal rates at or close the lower bound. Another avenue through which non-conventional policies have worked is via super-low longer term real rates. Indeed, 10y real rates in Germany and Japan are negative, as were US real rates before the taper tantrum of mid-2013. However, the magnitude of the output gaps and the slow response of consumption and investment to the non-conventional policy stimulus suggest that real rates will have to stay low for quite some time, capping potential policy normalization actions by central banks.

## Low-flation

Global inflation is running at extraordinarily low levels. Michael Saunders shows in his essay, Will Advanced Economy Low-flation Persist?, that inflation in OECD countries is running lower than at any time in the last fifty years while core inflation has been at or below 2% (YoY) since 2009. The forces behind this phenomenon are linked to large output gaps, slack in labor markets, international linkages and weaker commodity prices. Importantly, expectations of inflation are catching up and now reflect inflation in the long term significantly below the central banks' stated targets: 10y inflation breakevens, which include significant risk premia, are at 1.83% in the US, 1.21% in Japan, 1.06% in Italy and 1.02% in Germany. Such a low level of inflation and expectations can be quite costly and will surely drive central bank policy decisions.

The same logic applies at the global level. Global growth during 2014 is likely to be 2.7% (at market exchange rates). That is below our guesstimate of global potential output growth of just over 3 percent. This means that the global output gap is widening and, thus, global disinflationary pressures have grown. Exchange rate movements merely redistribute this global disinflation from the countries whose currencies are depreciating to the countries whose currencies are appreciating.

Short-term nominal interest rates have been at zero for some time while measured inflation is positive, suggesting real rates are negative. However, Robert Gordon shows that, because of upward biases in measured price inflation, true price stability is consistent with PCE deflator increases of 1.2 or 1.3%.[2] If a similar bias were present in Europe and Japan, both regions would be facing meaningful deflations and the US would be near true price stability today, despite a measured rate of core PCE inflation of 1.48%. In other words, the deflation threshold, once

[1] The negativity of the real policy rates holds for all large economies if we treat the euro area as a single economic entity or nation.

[2] Robert J. Gordon: The Boskin Commission Report: A Retrospective One Decade Later. NBER Working Paper No. 12311. June 2006.

measurement issues are accounted for, would put (core) PCE inflation above 1%, not zero! Therefore, if real rates need to be negative to equilibrate saving and investment at full employment, measured inflation needs to be significantly higher.

Furthermore, there are crucial distributional and economic dislocation consequences that low-flation can have. If an economy has debtors and creditors, and if the levels of pre-existing (nominal, fixed-rate) leverage are significant, the consequences of low inflation can be quite important. There are two main sources of economic costs. (1) Debtors tend to have a higher marginal propensity to spend than creditors (which is how they got to be debtors) and unanticipated low-flation typically implies a transfer from debtors to creditors, reducing the bang-for-the-buck potential of some aggregate demand policies; (2) unanticipated debt deflation increases financial distress and bankruptcy, imposing large deadweight costs.[3]

Solvency is a challenge in several public and private corners in Europe, high public leverage is a concern in Japan and high private leverage is a concern in EM countries such as Korea and China. Take China, for instance, where the ratio of non-financial private sector debt to GDP reached 200% at the end of 2013 and where the regulated minimum (non-binding) lending rate is now 5.6%. China's inflation objective is 3.5%, yet the latest inflation print is 1.6% YoY. At a time of slow growth, with several sectors mired in excess capacity and low profitability, the resulting increase in real interest rates can be a serious obstacle to growth (and financial stability). Similar difficulties can emerge in Korea where non-financial private sector debt is 234% of GDP and inflation runs at 1.2% YoY. Notice that in both countries large fractions of those debts are internal. Therefore, the contractionary impact of low-flation at the ZLB is most likely to come from the redistribution between borrowers and lenders, with a likely decline in the aggregate marginal propensity to spend, and through the possible insolvencies and bankruptcies associated with this wealth redistribution.

China and Korea, and much of the EM world are also facing deflation in producer prices which may result in imported deflation in the rest of the world, unless countered by EM FX appreciation. Over the last three years, China's PPI has averaged -1.8% YoY and Korea's -1.0%. Singapore, Malaysia and Thailand's PPI deflation is a more recent phenomenon, but still poses a future threat to import prices in the rest of the world. If declining producer prices are compounded with some currency weakness in EM manufacture-exporting countries, the deflationary impact on the rest of the world increases.

When in low-flation, traditional policies lose effectiveness. While it is technically possible to have more negative nominal policy rates in AEs than those observed today, operational constraints make it difficult for central banks to implement them. When facing such constraints, AE central banks aiming to increase inflation are likely to undertake expansionary quantitative and qualitative easing policies. The Bank of Japan recently announced a first expansion of its aggressive QE program, expanding the menu and scope of asset purchases. It is now the turn for the ECB to pursue its own 1trn euros large scale asset purchases, probably in early 2015. Even in those advanced economies where the output gap is closing more materially (the US and the UK, mainly) we now imagine the Fed initiating the zeroexit of the Fed Funds target rate beginning in December 2015, proceeding at a very moderate pace to reach a new normal rate only after 2018. Meanwhile, the Bank of England is

[3] Low-flation can impose costs even if anticipated. Refinancing old debts and recontracting takes time and is costly. Therefore, even if debtors were offered more advantageous borrowing terms, the process will involve a transitional period and a significant amount of renegotiation costs. Furthermore, once an economic agent is highly levered, it is likely that he will not be an attractive credit candidate and, therefore, not eligible for recontracting.

expected to start raising Bank Rate slightly before the Fed's zeroexit, unless uncertainty preceding or following the general elections of May 2015 severely damage domestic demand. Should QE prove incapable of closing the EA output gap, the obvious (and much more effective) alternative — monetized fiscal stimulus in the periphery — would face strong political resistance from Germany.

The divergence among the monetary policy paths of, on the one hand, the US and UK, and the Eurozone and Japan on the other, activates an important transmission mechanism for QE policies: the exchange rate. Divergent policies will impact long-term interest rates, generating spillover effects across countries. Similarly equity and property prices, and lower credit risk premia in the countries implementing the expansionary monetary policies (EA and Japan) are likely to spill over to the rest of the world. However, if the lower marginal propensity to spend out of wealth observed in the US is also present in Europe and Japan, the best hope for a lift in inflation is likely to be through the exchange rate. In consequence, we anticipate further weakness in the Yen, Euro and in EM currencies vis a vis the US dollar. Sterling ought to move like the dollar were it not for the uncertainty generated by the forthcoming general election in May 2015 and the risk of UK exit from the EU.

Emerging markets are far from implementing QE policies, but global disinflation forces and slow growth will likely result in softer interest rate policies. China recently announced a reduction in deposit and lending rates and we anticipate more to come. Korea, Israel, Colombia and India are also likely to cut rates. Others are likely to pursue a less aggressive path than they would have otherwise followed. As a result, EM exchange rates are expected to depreciate against the dollar by 5% or 6% during 2015, including some (moderate) depreciation in China's heavily-managed currency.

### Commodity prices

Low global growth and, in particular, disappointing activity in China are taking a toll on the demand for commodities. However, the overwhelming force impacting the oil and gas markets is, in our view, a large technological disruption that is changing the way the market is organized and works. The shale revolution and the resulting reduction in US demand for oil and gas imports are leading to a change in the behavior of other market participants attempting to preserve market share.

Emerging alternative sources of oil may prove disruptive for a gradually less-powerful price setting cartel like OPEC. Non-OPEC oil production is reducing the market share of OPEC members. According to EIA estimates, OPEC's share of global petroleum and other liquids production is expected to fall from 41.2% in 2012 to 38.7% in 2015. As a result, facing softer demand growth, OPEC needs to cut its own production more to achieve a given impact on prices. Furthermore, the economic weakness of a growing number of cartel members puts them in a very fragile position to withstand a reduction in production. Therefore, the likelihood of a sustainable and credible reduction in OPEC supply is limited, unless the burden of the production cuts shifts towards the financially stronger members of the group.

Lower oil prices have large distributional effects. These effects are significant across nations and within countries. If oil prices decline from an average of $105 as observed in Jan-July 2014 to our forecast average of $80 a barrel in 2015, in a global market with nearly 93mn barrels a day of production, the total income redistribution from oil producers to consumers could be equivalent to nearly $850bn or almost 1.1% of global GDP! If, as is likely to be the case, there is a significant difference in the marginal propensity to consume between consumers and producers of oil, the impact on the level of global aggregate demand could be

meaningful. For the US alone, the decline in gasoline prices could amount to a boost of $100bn a year in disposable income for consumers. Our forecasts for US growth already factor some of this effect for Q4 14 and Q1 15. Notice, however, that these are level effects and are unlikely to maintain a sustained boost to consumption growth later in the year. Should oil prices fall significantly further, the negative effect on investment in shale gas and tight oil production would reinforce the reduction in consumption demand by the oil producers. Investment in oil and gas-using industries could, however, be boosted.

Lower oil prices are likely to result in significant financial and economic distress in a number of countries. Russia, Venezuela, Iraq, Iran, Nigeria, Ecuador, Kazakhstan, Azerbaijan and others are likely to face significant economic hardship. All these countries are dependent on oil for export revenues and some of these countries are large debtors. In those cases, a 25% drop in oil prices may well result in domestic economic and international financial distress. Take the case of Venezuela, for instance, where the drop in oil revenues could amount to nearly $20bn in lost revenue for 2015, twice the amount of maturing principal and coupons on external debt obligations and about half of the non-oil import bill. If the oil price remains at that level, the likelihood of a credit event grows exponentially. In the case of Russia, a credit event is less likely, even if the $420bn reported reserves were to fall rapidly in support of private sector firms. Under normal circumstances, we estimate that a $25 dollar drop in oil prices could result in nearly a 2% drop in Russia's GDP growth within four quarters. In addition, economic and financial sanctions triggered by the Ukraine conflict have isolated Russia's economy and are likely to compound the effect on investment and activity. Russian corporates, many of them oil-related, have $107bn in external debt coming due in 2015 and, because of the sanctions, are unlikely to be able to rollover all of them. The impact can generate distress in the FX market (some of this has already played out) and on investment in those companies. Finally, the decline in oil prices may result in a more complex geopolitical landscape. As a token illustration, the financing to both Iraq and ISIS could dwindle, changing their relative strengths. Or, both Russia and Iran, countries subject to economic and financial sanctions, may find their bargaining power reduced by the weakening of their financial strength.

Summarizing, the combination of the three forces (monetary policy constrained by the ZLB, the reality or imminent threat of secular stagnation in the AEs and a sharp decline in oil prices) discussed above is likely to shape policies and economic/social outcomes. However, despite the significant policy/political developments that may be triggered, we judge that this soggy economic environment is unlikely to result in radical monetary, fiscal, regulatory or structural policy actions. Instead we imagine a muddling-through scenario on a global scale. We do not have a relapse into outright recession as our central scenario; although it is a material risk. We expect that the policy-puts (especially in the euro area and in China) are likely to ensure that is not the case. Neither do we foresee a large-scale crisis in countries with systemic importance, or even a market shattering economic accident. The major fiscal-financial unsustainabilities (in the euro area periphery) and the most threatening credit and asset bubbles (China) are unlikely to reach the point of no return in 2015. Rather, the year is likely to shape up as another mediocre year, much like 2014.

# Why is Globalisation Stalling?

Willem Buiter

Ebrahim Rahbari

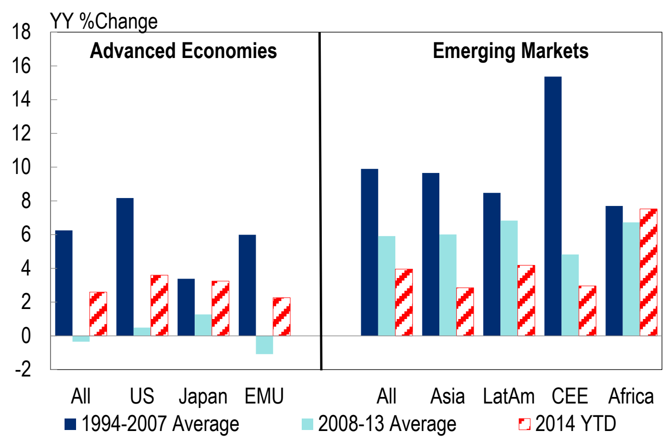
Joseph Seydl

Globalisation, i.e. the increased integration of trade, financial services, information and people around the world, is changing. Along significant dimensions — most notably for trade and financial flows — it is stalling. Even the World Wide Web is threatened with balkanisation through the imposition of national firewalls. Along other dimensions, e.g. migration, globalisation continues (even though its pace has also slowed). This essay discusses the drivers of recent changes in globalisation.[4]

## Growth of Global Trade, Finance and Migration Has Fallen

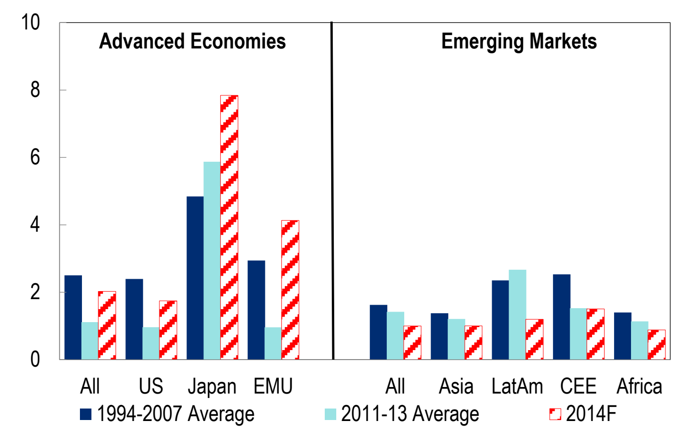
Global growth of goods imports in volume terms was 3.3% YY in the Jan-Sep average in 2014, according to CPB data. Even though that is higher than the 2.7% YY growth in 2013, it is less than half of the average growth rate of 7.5% YY in 1994-2007 (see Figure 10).[5] World trade growth is running only slightly above global growth in GDP or industrial production (IP), which were running at around 2.5-3% YY in Q3. By contrast, in 1994-2007 growth in world trade ran at about twice GDP or IP growth (see Figure 11). The slower pace of trade growth has meant that, relative to GDP, world trade (the sum of global imports and exports) has remained stuck at around 60% of GDP since 2008, after rising relatively steadily from around 40% of GDP in 1990.

**Figure 10. Global — Goods Import Growth In Volume Terms (%), 1994-2014**




Note: 2014 YTD is average YY% growth in January-September
Source: CPB and Citi Research

**Figure 11. World — Ratio Between Import Growth and GDP growth, 1994-2014**




Note: Import growth is real growth of imports of goods and services. 2014 is IMF forecast. Sources: IMF and Citi Research

Financial flows have also remained sharply below pre-crisis levels. In H1 2014, annualised global gross capital inflows amounted to 6% of GDP, after they were 9%

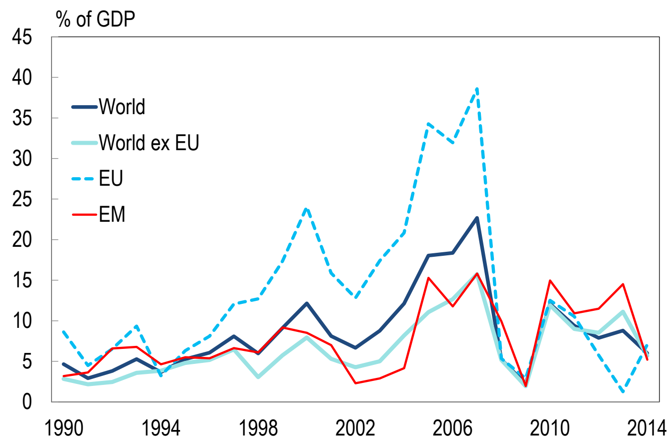
[4] See also "Why Is World Trade So Sluggish?", Michael Saunders in Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2014 and Beyond . We note that globalisation is in retreat on a number of other dimensions, which are beyond the scope of this note to address: for example, the cost of legitimate cross-border trade and mobility is raised by the emergence of dysfunctional forms of globalization, such as international terrorism and pandemics (Ebola). Meanwhile, the correlation of inflation rates across countries has risen in recent years. See "Will *Advanced* Economy *Low-flation Persist?*", Michael Saunders in this publication.

[5] According to the IMF, import growth of goods and services in volume terms was somewhat higher in 2013, at 2.8%, and the IMF expects a pickup to 4.0% growth in 2014, but this is still far below pre-crisis growth of 7% on average in 1995-2007.

of GDP in 2013 (see Figure 12).[6] The pre-crisis period had seen a large and fairly steady rise in global gross capital inflows of 2-5% of GDP pa in the first half of the 1990s reaching more than 20% of GDP in 2007. The fall in capital inflows has meant that the rise in gross international investment positions has slowed sharply. Global gross international liabilities in 2013 amounted to 174% of global GDP, down from the 185% of GDP in 2007, with a fall in bank loans and other debt made up by a rise in FDI (see Figure 13). In fact, the sum of global FDI inflows and outflows has remained close to the 1995-2007 average in the post-crisis period at around 4% of GDP, according to data from the UN. By contrast in 1995-2007, gross international liabilities grew by 9pp of GDP pa on average.

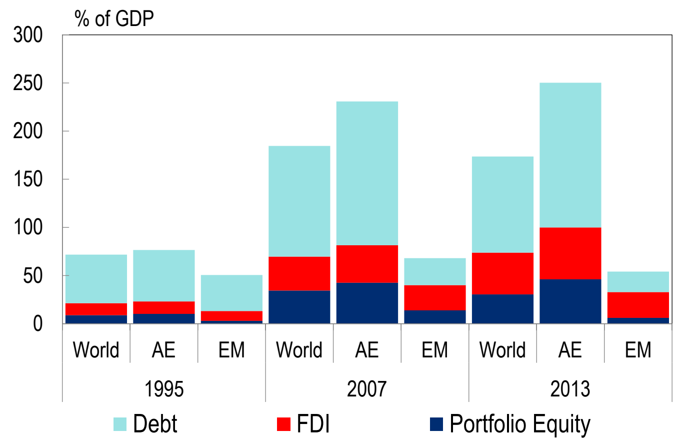
The rate of global migration has also fallen somewhat. According to the UN, the total international stock of migrants (i.e. the foreign or foreign-born population) rose by 1.6% pa in 2010-2013 on average, after growing by 2.3% pa in 2000-2010. However, global migration rates remain relatively high in the historical context (in 1990-2000, the migrant stock grew by 1.2% pa on average, see Figure 14) and migrant populations continue to rise faster than the global population as a whole (global population growth in 2010-13 has been 1.2% pa). Even though migration flows have slowed, the globalization of labour markets therefore continues.

**Figure 12. World — Capital Inflows (% of GDP), 1990- 2014**




Note: 2014 is H1 only, annualised.
Sources: IMF, National Sources and Citi Research

**Figure 13. World — International Investment Position by Asset Class (% of GDP)**




Sources: Lane, P. and G. Millesi-Ferreti (2012), IMF and Citi Research

For most of the post-crisis period, the advanced economies (AEs) have accounted for much of the slowdown in globalisation. AE imports of goods were roughly flat between 2008 and 2013, having grown by roughly 6% pa on average in 1994-2007. The impact of slower AE import growth on world trade is magnified by the fact that AEs still account for the bulk of world trade (62% of world imports in 2013). EM import growth also slowed, but contributed much less, statistically, to the fall in global trade growth since the Great Financial Crisis (GFC) of 2007-09.

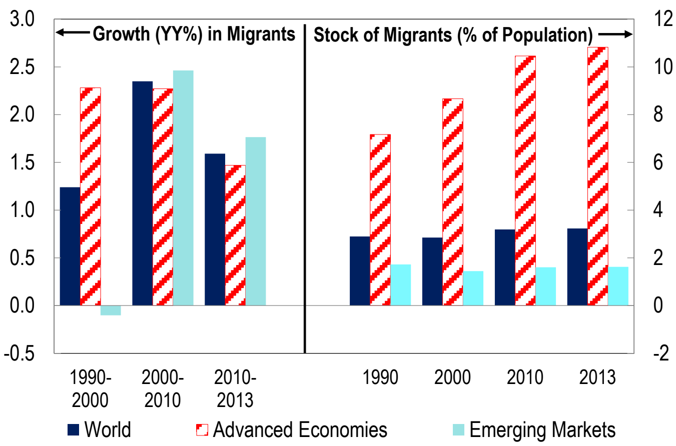
The fall in capital inflows was sharpest in the AEs, where gross inflows dropped from 25% of GDP in 2007 to 7.5% on average in 2010-13 and 5% in 2013. The drop in AE capital flows in turn was concentrated in the EU, where gross capital inflows (including inflows from the rest of the world as well as between EU member states)

[6] Capital flows for H1 2014 are based on a smaller sample of countries, as IMF data on global capital flows for Q2 2014 are not available for all countries yet (the countries included in the 2014 estimate account for roughly 88% of global GDP and global capital inflows).

dropped even more sharply, from 35% of GDP on average in 2005-07 to around 7.5% in 2010-13. The drop in EU capital inflows has accounted for a notable share of the drop in post-crisis capital flows (as well as the pre-crisis rise), as EU capital inflows accounted for 53% of global capital inflows in 2005-07 (but only 19% in 2010-2013). EM gross capital inflows actually remained quite resilient post-crisis, at 13% of GDP on average in 2010-13, compared to 16% of GDP at the peak in 2007.[7] Migration into AEs has also fallen more than into EMs and migration to EMs is now slightly faster than to developed countries (the increase in the stock of migrants in AEs was 1.5% pa on average in 2010-13 vs 1.8% in EMs, whereas in 1990-2010, the increase was 2.3% pa in AEs vs 1.2% in EMs. The stock of migrants relative to the population remains sharply higher in AEs, (see Figure 14).

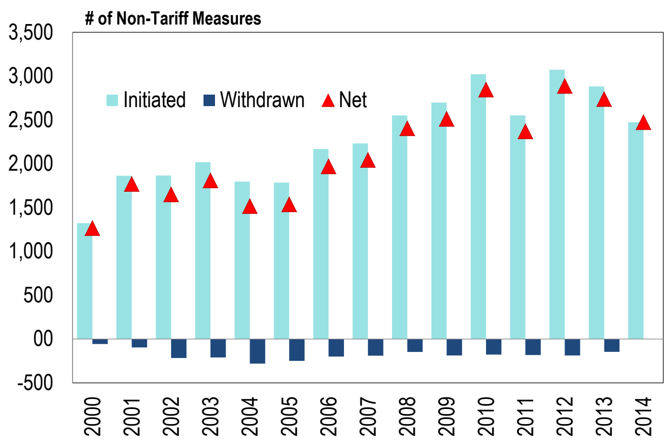
However, the relative resilience of EM trade and financial flows may be ending. In 2014, AE goods import growth picked up noticeably in absolute terms (to 2.4% YY YTD in 2014 vs -0.4% pa in 2010-13) and relative to AE GDP growth (to 2 from 1.1 in 2010-13). Meanwhile, EM import growth has slowed (to 3.3% from 5.8% in 2013 as well as relative to GDP growth), and limited the pickup in global trade growth. EM capital inflows dropped sharply in 2014 (they were already temporarily low around the 'taper tantrum' in Q2 2013 but remained high in 2013 overall).

**Figure 14. World — Growth in the Stock of Migrants, 1990-2014**




Note: Migrants are foreign and foreign-born residents.
Sources: UN and Citi Research

**Figure 15. World — Number of Newly Introduced and Withdrawn Non-Tariff Barriers To Trade, 2000-2014**




Note: Net measures are newly introduced measures minus the measures withdrawn.
Sources: WTO and Citi Research

## Why have some dimensions of globalisation stalled?

In our view, there are a number of reasons why global growth in trade, financial and migration flows has fallen in recent years. We highlight:

**Policies that are less favourable to globalisation.** Multilateral trade negotiations are going nowhere. The WTO's Doha Development Agenda negotiations, which had been ongoing since 2001, broke down in 2008. The attempts to revive the Doha Round since then may just about have birthed the Bali Accord, dealing with bureaucratic barriers to commerce – better than nothing but a small step indeed for mankind. Regional and bilateral trade negotiations, with their inevitably ambiguous effects on global trade liberalization, now rule the roost.

[7] However, gross international liabilities in AEs actually grew faster between 2007 and 2013 than in EMs relative to GDP despite higher gross inflows into EM (relative to GDP). The reason is twofold: first, EM GDP grew much faster than AE GDP and, second, asset prices increased more in AEs than in EMs, raising the value of AE gross international liabilities.

In addition, a number of recent reports have highlighted a rise in protectionist measures since 2008.[8] The WTO's I-TIP database suggests that the number of new 'net' (i.e. minus those withdrawn) non-tariff barriers imposed globally amounted to more than 2,500 in 2012 and 2013 and looks to exceed that level again in 2014, significantly above pre-crisis trends (see Figure 15).[9] The 2014 Global Trade Alert (GTA) report argues that the WTO still significantly undercounts the number of protectionist measures. And the European Commission's recent Report on the Monitoring of Potentially Trade-restrictive Measures noted that more new protectionist measures were introduced between June 2013 and June 2014 than in the previous 13 months and that fewer protectionist measures were withdrawn.[10]

Financial protectionism and migration restrictions have also increased since 2008, according to the GTA database. But it is worth noting that many policies which impede globalisation are not principally motivated by their foreign effects. For example, many recent initiatives to boost financial stability have made cross-border banking flows more difficult or expensive. These include increased emphasis of bank supervisors on national minimum levels of liquidity or capital (including for domestic subsidiaries of foreign banks). Such emphasis on 'ringfencing' may have been explicit through new rules (such as in the case of Foreign Bank Organisations rules in the US) or the stricter interpretation of existing rules or simply through 'soft pressure' by supervisors, as in some EU countries.[11] The post-crisis period has also seen instances of new or tightened formal capital controls. In contrast to the past, the majority of these have involved controls on capital *inflows*, motivated usually by a desire of mostly EM countries to limit currency appreciation or hot-money inflows linked to extraordinary monetary easing measures of AE central banks.[12]

There are some exceptions to the rise in protectionism. The WTO's regional trade agreement (RTA) database notes 7 more RTAs that went into force in 2014, after 11 RTAs in 2013. On the financial side, both China and India have somewhat reduced restrictions on capital inflows (including FDI) in recent years and the Banking Union initiatives in the Eurozone may over time reduce the still-remaining national focus of some Eurozone financial supervisors.

Some 'globalization-unfriendly' measures are reciprocal, taken in response to what are perceived to be negative effects of foreign policies and other external developments on the domestic economy. These negative spillovers from the rest of

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[8] Keeping track of protectionism is not straightforward. A wide variety of legal, fiscal and administrative measures can potentially have trade-impeding effects, including some which may not principally be concerned with trade (such as environmental, health or labour standards). And even if one identifies a particular non-tariff and non-quota measure as protectionist, it is usually difficult to quantify, by calculating its 'tariff equivalent', say, and to compare its trade-impeding effects with other protectionist measures. Even the calculation of the impact of tariffs on trade is complex and inexact. For non-tariff barriers to trade (such as quotas, licensing requirements or the above-mentioned standards), which are becoming increasingly common relative to tariff barriers to trade, determining the impact on trade and economic activity is even harder.

[9] The non-tariff measures tracked in the WTO's I-TIP database include: Anti-Dumping Measures, Countervailing Measures, Quantitative Restriction, Safeguard Measures, Sanitary and Phytosanitary Measures, Special Safeguard Measures and Technical Barriers to Trade. These categories comprise a much broader array of measures compared to those in the WTO's Trade Monitoring Database (and in the GTA's database), including policies that are not driven by protectionist intent, but also has the advantage of a longer available time series.

[10] See Evenett, Simon J (2014), The Global Trade Disorder: The 14th GTA Report. CEPR. September.

[11] See e.g. US FBO – More Time Afforded - First Take on US FBO Rules and Goldberg, L and A Gupta "Ring-Fencing and "Financial Protectionism" in International Banking", Liberty Street Economics, Federal Reserve Bank of New York, 9 January 2013.

[12] See Asia Macro and Strategy Outlook - Asia's Policy Trilemma — Priorities & Tradeoffs and Asia Macro and Strategy Outlook - Currency Wars? More Like Currency Skirmishes.

the world may be the result of identifiably protectionist foreign actions or they may be policies and practices with a domestic focus which can have negative external spillovers, such as the aggressive monetary easing policies of many advanced economies in the post-crisis period (which confronted many EM countries with currency appreciation pressures and financial stability challenges) or the wide-spread retreat from foreign lending in EMs by many AE banks. There have also been a number of idiosyncratic, including geopolitical, events that have produced barriers to trade, notably the sanctions and import bans imposed as a result of tensions in Ukraine in 2014 and the capital controls imposed as part of the Cypriot bailout programme in 2013.

But a lack of policies to support or enhance globalization is also a consequence of the falling popular and political support for globalization more broadly. Part of that is related to the post-crisis environment: economic crises and weak economic growth often strengthen the voices of the losers and potential future losers from international trade, often along with a desire to achieve a competitive advantage for the 'home country' and shift costs onto the rest of the world. A rise in protectionism and less globalization-friendly policies can be (and were) therefore expected in the aftermath of the GFC given the persistent weak growth and high unemployment in many parts of the world. But, in our view, the fall in political support for globalization probably also reflects disillusionment with the post-cold war consensus, at least in advanced economies, that trade and financial liberalization would bring widely shared prosperity, and that beyond that free trade and global financial integration would also help spread the idea of liberal democracy and thereby ultimately increase political stability and global security. Recent years have seen a loss of support for both elements of this consensus (the belief that a liberal domestic and international economic order would boost prosperity and democracy). The western view of the World Wide Web as the handmaiden of the Open Society — a network boosting the free and unfettered sharing of information, ideas and opinions – was never shared by the political leadership of more authoritarian EMs. The growing number of increasingly effective attempts to control content through national firewalls is the natural outcome of this rejection of the original WWW model.

The fact that the bulk of the increase in protectionism has occurred in EMs is, in our view, partly due to the fact that many EMs only partly bought into this consensus in the first place, and partly because institutional constraints (including WTO rules) and the greater integration of advanced economies into the global economy made it more difficult for the AEs to reverse globalization comprehensively.

The fall in support for globalisation is also a result of a lack of global leadership, and in turn makes it harder to achieve global leadership or even agreements. Protectionism remains mostly a 'large country' issue (Russia, India and China were the three countries which imposed the largest number of trade-impeding measures in 2013/4 according to the EC), as smaller countries have smaller hopes for self-sufficiency and may be more exposed to the risk of foreign retaliation. And despite the repeated assurances of the G20 that they would avoid resorting to protectionism, there is no longer a consensus among the large countries that trade, financial and migration liberalisation is in their common interest.[13] It is therefore

[13] See "We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome." Declaration, Summit on Financial Markets and the World Economy, November 15, 2008. https://www.g20.org/sites/default/files/g20_resources/library/Washington_Declaration_0.pdf

perhaps unsurprising that the G20 countries have failed to uphold their repeatedly stated ambition not to engage in trade-restricting policies, even though it is arguable, as the WTO has recently claimed, that the observed rise in protectionism has in fact been somewhat smaller than had been feared after the GFC.

**A less trade-intensive mix of global demand.** During 1995-2007, AEs accounted for 59% of global growth according to the IMF (at market exchange rates). By contrast, during 2010-13 EMs accounted for 70% of global growth. The shift from AE- to EM-driven growth matters for trade growth as AE growth tends to be more trade-intensive, with the ratio of import growth to GDP growth at 2.5 on average for AEs in 1995-2007 compared to 1.6 for EMs. In addition, AE growth itself is less trade-intensive than it used to be, in part due to a shift from investment spending towards less trade-intensive consumption in the post-crisis period (the ratio of import growth to trade growth fell to 1.1, on average, in 2011-13, lower than the 1.4 in EMs), and, as we noted above, AEs still account for the bulk of global trade. Weaker domestic demand in AEs and the shift away from investment may in part be because of lower credit availability after the GFC and rising external vulnerabilities and at least, qualitatively, the drivers of the very recent fall in import growth in EMs may be similar.

**Fewer trade-supportive supply-side developments.** Developments in transport and information technology provided major boosts to international trade in previous decades, with the growth in container traffic probably particularly important. The internationalisation of supply chains boosted trade both directly, but also indirectly (through a drop in the relative price of tradables). There are some signs that the internationalization of supply chains and technological boosts to trade may have levelled off recently.

Commodity-related supply-side developments may also weigh on trade growth prospects. Commodities account for a material share of global trade flows, as commodity supply is unevenly distributed across countries and often needs to be shipped to the point of consumption or processing. A fall in the natural resource intensity of production would therefore be expected to reduce trade growth, other things equal. In addition, the shale oil and gas boom in North America, for instance, reduces the import needs of what was previously the largest net importing region for oil and gas in the world. Beyond the impact on oil and gas trade, the fall in North American energy prices may also lower manufacturing trade due to some onshoring of energy-intensive and other carbon-intensive manufacturing in North America as a result of lower oil and gas costs.[14] Falling relative cost competitiveness of some EM exporter countries (such as China) may also reduce the scope for some of the AE-EM trade links that have developed over the last two or three decades, even though the overall impact of the rising prosperity in EMs that it was associated with may end up boosting the prospects for trade growth. The growth of international terrorism and the greater awareness of the threat of pandemics have acted as a form of ‘technical regress’, raising the cost of doing cross-border business generally. However, it is worth noting that supply-side and technological arguments cannot explain the stalling of all dimensions of globalization. For instance, population ageing in advanced economies as well as improvements in information technology could in principle boost the prospects for migration.

**Financial regulation and restructuring.** The growth of finance was a major driver of global financial flows but probably also of trade flows (both by boosting trade-supportive demand and through easy availability of trade finance) in the run-up to

[14] However, the net effect on manufacturing trade of the rise in energy supplies could still be positive, as new export possibilities may be created.

the GFC. The post-GFC retrenchment of the financial sector and in particular of banks has hit cross-border financial flows particularly hard, for two reasons: cross-border positions were often viewed as 'non-core' and therefore an easy target for restructuring and cutbacks, and cross-border flows were often among the most underregulated areas of finance. A shortage of access to foreign (notably dollar) funding and the rise of local players (mainly in EM) further affirmed the retreat from cross-border banking in particular. The change in business models and in the financial and regulatory environment shifted the type of financial flows away from bank lending and towards FDI, particularly in EMs. Along with the fall in cross-border capital flows, trade growth is also held back by lower credit availability in general, and specifically for trade finance, compared to the pre-crisis years.

## The Outlook for Globalisation

In our view, the outlook for the globalization of trade and financial flows remains subdued, as we expect the above-mentioned factors which stand in the way of further rapid globalisation to persist. But it is worth highlighting that the pre-crisis period was probably unusually benign for globalisation, with rapid (and partly trade-related) technological progress, significant trade and financial liberalisation and easy availability of finance. We expect global imports to rise by 3.9% in 2015 and 4.5% in 2016, after 3.1% growth in 2014, implying a moderate pickup from current growth rates but still clearly behind pre-crisis norms and also below the forecasts of the IMF (which expects world imports to grow by 5.0% in 2015 and 5.5% in 2016).

The outlook for financial flows is probably mixed. EM capital inflows are falling and deteriorating growth prospects, rising external vulnerabilities and the prospect of (even a delayed) monetary tightening in the US suggest that a durable recovery in EM capital inflows may be some way away[15]. But additional large monetary easing the BoJ and the ECB is likely to provide a boost to global capital flows over the next two years. And over the medium-term, the further gradual liberalization of the capital accounts of India and China may dominate the restrictive impact on cross-border financial flows of much of the recent financial regulation. Continuing progress on banking union in the EU should boost intra-EU member state gross financial flows and may also boost financial flows between the EU and the rest of the world.

The outlook for legal migration is poor, as populist political entrepreneurs in the AEs exploit the fear of job losses to immigrant competitors, the fear of benefit tourism, nationalism, xenophobia and racial tensions. Illegal immigration will be much harder to restrict in countries with extensive land-borders and/or easy access by sea.

Other things equal, the falling support for globalization is probably bad news for global growth. This is because international trade, finance and migration have historically been important conduits to diffuse technological progress and to exploit international economies of scale and scope. In addition, global trade and financial flows also allowed fast-growing countries to pull along weaker economies. Falling support for globalization is also a symptom of a more polarized and conflict-prone global policy environment. This raises the prospect of political tensions lessening the likelihood of policy cooperation and coordination across countries, which could also harm global growth prospects.[16]

[15] See "Will Advanced Economy Low-flation Persist?", Michael Saunders and "EM Prospects 2015", David Lubin in this publication

[16] See also "Is This the Start of the Breakdown?", Tina Fordham in this publication

# Is This the Start of the Breakdown?

Tina Fordham

## Proliferating Geopolitical Risks, Popular Discontent, and the New World Disorder

Geopolitical risks have increased to levels not seen since the fall of the Berlin Wall in 1989. This is not only apparent from the headlines, it can be tracked in indicators ranging from a rise in the number of conflicts and coups globally; the rate of terrorist attacks, from ISIS in the Middle East, to Al-Shahab in the Horn of Africa to Nigeria's Boko Haram; and the number of NATO-Russia "incidents", recently returned to Cold War levels. At the same time, the rate of *Vox Populi* risk events (mass protests, rising support for non-mainstream parties and government collapses) also remains high, as evidenced by events such as the Scottish independence referendum and the so-called "umbrella protest" movement in Hong Kong. From the grass roots to the geopolitical, the global system is under immense pressure. In some places, it is cracking.

The outlook for 2015 will almost certainly be dominated by the aftershocks of the two key geopolitical events that marked 2014: Russia's annexation of Crimea and the emergence of ISIS from Syria to Iraq, which was followed by an almost immediate declaration of the end to the Middle East's 1912 Sykes-Picot borders, which divided many regional tribes and ethnic groups. These two developments are very different in their scope and antecedents, but we regard them as a significant change in trend. History, it is said, does not repeat itself. But it rhymes. It certainly hasn't ended, as optimists posited in 1989, when the collapse of communism fuelled a rise in optimism over a more pro-Western, pro-globalization order.

Taken together, the regional disputes in the former Soviet Union and Middle East have raised the specter of a return to conflict over borders and territory, a risk compounded by fears that collective defense agreements such as NATO — the cornerstone of Western security in the post-Cold War era — no longer retain their relevance. From jihadism to populism to revanchism, politically-generated challenges to globalization are transforming the landscape. Yet policymakers have few levers with which to address these developments, and populations have little patience for bearing the costs of prevention, deterrence, or conflict—beyond limited, piecemeal measures — in times of continued fiscal and budgetary concerns. Yet remarkably, despite the significance for the global political and security environment, these developments have had limited impact upon financial markets, in stark contrast to previous crises such as the 1973 oil price shock. We do not foresee this disconnect lasting indefinitely; indeed the increase in geopolitical risk is likely contributing to the drag in the global economic recovery and weighing upon investor sentiment.

### The Sense of an Ending

Until recently, investors have localized political risks, treating them as one-off, idiosyncratic developments; tempests in teapots, spots of local bother. This stance has been generously supported by continued central bank liquidity and shale gas supplies, combining to minimize the impact — but also providing what may prove a false sense of security. While easy money and cheap and abundant shale supplies may have insulated markets and prevented regional disturbances from generating catastrophic impacts on the global economy and financial system, we see the uptick in geopolitical risk as likely to be persistent; a source of frequent future disruptions in 2015 and beyond. Moreover, in our view, investor ambivalence about geopolitics may actually be making matters worse, contributing to a sort of moral hazard risk for foreign policy. By failing to perform their historic function of registering risks,

markets may unwittingly be creating the conditions for further deterioration — risks which may be mitigated by a “pinprick” military response or incremental sanctions.

2015 will likely see more Congressional grappling over the funding and planning of the fight against ISIS, with foreign policy one of the few areas where our expectation of a gridlocked, unproductive Congress can come to agreement — but potentially in direct conflict with the White House. Where President Obama failed to gain either Congressional or public support in defense of so-called US “red lines” in Syria over the alleged use of chemical weapons in the summer of 2013, he has now become the fourth successive US president to order air strikes in Iraq, an especially paradoxical development considering that his rise to the presidency in 2007 was largely fuelled by his opposition to the US intervention under George W. Bush.

In a time when public opinion and economic considerations are the key drivers for government decision-making — following the combination of conflict fatigue post-Iraq and Afghanistan and greater inward focus post-Global Financial Crisis—the bar for military intervention is higher. US public opposition to military intervention in the Middle East prevailed until ISIS began executing foreign hostages; public support for intervention increased 20% after US hostage James Foley was killed.[17] This move consolidated the notion that ISIS poses not only a regional risk, but had become a threat to US domestic security, rapidly altering the political calculus. This move provides a valuable clue about what circumstances can motivate otherwise slow-to- react governments to act quickly.

Yet neither the authorization of air strikes, nor the deployment of non-combatant military advisors, is likely to defeat ISIS, the richest terrorist organization in history according to independent estimates, and one that has called for “volcanoes of jihad” all over the world. With that in mind, US political battles over funding for “regional solutions”, such as funding and equipping local militia groups, and measures such as no-fly zones will feature prominently in the year ahead, as will potential Congressional action on new sanctions against Russia and/or Iran, moves which would have significant impact abroad, but bear limited political or economic costs at home.

This is particularly salient when contrasted against European public opinion, which has been more focused upon Russia-Ukraine tensions, and more recently, fears of a return to tensions between Russia and the West. Security concerns emanating from the EU’s Baltic member states and Poland prompted NATO to authorize a “rapid-reaction force” at its annual summit that could be deployed quickly to eastern member states. But European gas dependence upon Russia, and its much-larger trade relationship with Russia compared to the US, has been at the center of the EU’s “incremental” approach on sanctions. Thus, fears of a cold European winter and return to recession are balanced against concerns that Europe’s security may be at risk from a frozen conflict in Ukraine that could generate wider instability on the European Continent.

Divisions in public opinion within the 28-member EU have impacted the sanctions process considerably. Any acceleration of tensions could shift the balance toward further sanctions — which would worsen Europe’s economic outlook. Even so, unless there is a significant de-escalation, a seemingly remote prospect given reports of troops and arms being transported from Russia into Ukraine’s breakaway southeastern provinces, we do not envision the potential for a “Russia Reset” as followed the Russia-Georgia war of 2008, and expect sanctions to remain, at least at their current level, until mid-2015, if not longer.

[17] Source: Washington Post – ABC News Poll, reported on 9 Sep 2014.

## Previous Convictions

Geopolitical risks, as well as burgeoning geo-economic risks such as the Ebola outbreak and ever-larger cyber-attacks, have exposed the fragility of the international system, marking the end of the post-Cold War order, defined by the highest levels of prosperity and relative stability in human history. Many investors have little, if any, memory of the bi-polar world that preceded it, a system which featured its own rules and stability of a kind; fewer still have the experience to operate in an environment that looks more like the 19th century, with its regional hegemons and asymmetric risks. The shape of things to come has not yet been defined — though one compelling theory by a prominent foreign policy scholar suggests that a “Great Unravelling” is unfolding. Building upon this conceptualization, our framework for the world order is one defined by weak states, small wars, regular uprisings and greater opportunity for rogue actors—the start of the breakdown of the Post-Cold War Order. While apocalyptic predictions rarely materialize, market complacency that a pre-Crimea annexation, pre-ISIS “business as usual” will return seems increasingly unfounded. We also observe the disproportionate impact, relative to the statistical likelihood, of risks such as Ebola and terrorism on both popular and investor perception.

This shift away from a macro global political and economic operating environment that prompted unprecedented levels of integration, and by extension, globalization, and the rise of new middle classes is taking place at the same time as — at the grass roots level — popular discontent with elites continues to simmer, and occasionally rises to the surface. From the close shave of September’s popular Scottish referendum on independence, to Hong Kong’s orderly but persistent pro-democracy movement, which rattled Beijing and sparked fears of repression, the potential for civic movements to challenge the established political order continues to be much in evidence. History suggests that such movements, once mobilized, frequently recur, and at unpredictable junctures. With this in mind, for the second year in a row, we see Fragmentation Risk, whether of the polity or of physical borders, as a major source of political risk for 2015.

## *“Ya me canse”.* Vox Populi Risk Continues — Even Where Growth Has Returned

The continuation of the Vox Populi phenomenon that we first identified in 2012 — shifting and more volatile public opinion posing a new type of risk to the business and investment environment — presents significant challenges to political and business elites. In a more divided and uncertain world, marked by lower, slower growth and where leaders are more sensitive to public opinion than ever before, policy options are limited.

We identify two sets of countries most vulnerable to Vox Populi Risk: 1) Petro-states, especially those with weak government institutions, will be particularly vulnerable to protest amid falling oil prices and declining revenues 2) the spate of European Union countries heading to the polls, some for the first time since 2011, before the euro crisis had reached its peak: the United Kingdom, Spain, Portugal, Greece, Finland and Poland. Of these, the two most systemically significant are UK and Spanish elections, neither of which is expected to deliver a majority government. In each contest, we expect anti-establishment parties to have a significant impact, though fall short of attaining a majority.

**Figure 16. Selected 2015 Political Signposts**

| Country | Date |
|---|---|
| Nigeria | February 14 |
| Finland | April (TBD) |
| United Kingdom | May 7 |
| Turkey (legislative) | June 13 |
| Mexico (legislative) | July 5 |
| Iran (Expiration of Iran Nuclear Deal) | July 15 |
| Denmark | September (TBD) |
| Argentina | October (TBD) |
| Canada | October (TBD) |
| Poland | October (TBD) |
| Portugal | October (TBD) |
| Spain | December (TBD) |

Source: Citi Research

In Mexico, impressive reform momentum under President Pena Nieto has been undermined not only by falling oil prices, but outcry against police excess, crystallized following the suspected deaths of 43 university students. Mexican public anger toward perceived corrupt politicians has sparked protests, galvanized by the expression “Ya me canse” (I’ve had enough) which reverberated on social media following its attribution to a public official answering an investigation about the case. “Ya me canse”, in one form or another, is a slogan likely to continue to resonate in the year ahead.

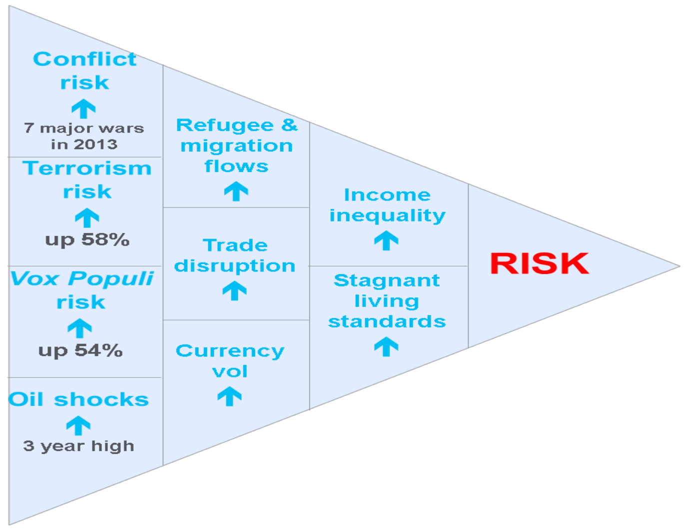
A key catalyst for Vox Populi Risk events identified in our empirical study is corruption concerns and evidence of elite misbehavior. For those petroleum-dominated economies with weaker government institutions and high levels of perceived corruption, the combination of falling prices and persistent corruption perceptions could prompt an increase in protest activity if such conditions continue. Venezuela, Nigeria, Brazil and Russia may be particularly tested by this risk.

Among the most closely-watched political signposts for investors in 2015 will be the UK general elections, the outcome of which will also determine the likelihood of a so-called in/out referendum on British membership in the European Union, or “Brexit”. The performance of non-mainstream political parties in Europe in 2014 was striking, most notably the 25% support for the UK Independence Party (UKIP) in the European Parliamentary elections despite a robust economic recovery and comparatively low unemployment levels. The UKIP result is significant not only in that it highlights the extent to which the linkage between aggregate growth and support for mainstream political parties has blurred, but also the potential for the party to pose a meaningful threat to a stable political outcome in the 2015 general election, a fact which is having considerable impact on the British political debate. Significant proportions of citizens of industrialized and emerging market democracies do not trust their leaders to represent interests other than their own in the midst of a process of globalization that is perceived to be delivering dramatically uneven benefits.

Future developed country elections will likely continue to see the popularity of new — and not so new — anti-establishment parties, from France’s National Front to Greece’s Syriza to Spain’s up-and-coming far-left Podemos, increasing the risk of fragile multi-party coalitions and reducing the already limited political capital of leaders. In our view, the appetite for political alternatives will endure for many years to come, and their public support could increase in the event of a triple-dip European recession, a non-negligible risk, particularly if future Russian sanctions spark retaliation that hits the fragile eurozone recovery. Conversely, growth in real wages, moves that regain the confidence of younger and disenfranchised cohorts of

the population and reduced perceptions of elite abuses could stem support for alternatives.

**Figure 17. Conflict, Terrorism & Political Risks All On the Rise**




Sources: United States Institute for Peace, Rand Institute and Citi Research

## Fear and Loathing

We also observe the disproportionate impact, relative to the statistical likelihood, of risks such as Ebola and terrorism on both popular and investor perception. Perhaps fuelled by social media, the "fear factor" seems to be one of the few sources of urgency for otherwise hamstrung policymakers, as evidenced by rapid, albeit highly erratic efforts to control Ebola in the US and to attack ISIS in Iraq. According to a 44-country survey by the Pew foundation, in developing Asia and Latam, pollution and environment concerns came out on top; in parts of Africa, Aids and Pandemics; in numerous EMEA countries (Turkey, Ukraine and Nigeria) as well as Pakistan and Japan, nuclear weapons were most feared.

**Figure 18. Global – Countries Where Population Has The Greatest Level of Concern Over Key "Dangers in the World", 2014**

| Religious & Ethnic Hatred | Inequality | Aids & Other Diseases | Nuclear Weapons | Pollution & Environment |
|---|---|---|---|---|
| Lebanon | Spain | Uganda | Japan | Colombia |
| Palest. Ter | Greece | Tanzania | Ukraine | Thailand |
| Tunisia | Germany | South Africa | Turkey | Peru |
| UK | Argentina | Kenya | Nigeria | Philippines |
| Nigeria | France | Senegal | Chile | China |
| Egypt | Italy | Nicaragua | Pakistan | Vietnam |
| France | Poland | Venezuela | Russia | Nicaragua |

Note: For each issue, we show the seven countries where concern over this issue is greatest. Sources: Pew Research Global Attitudes Project and Citi Research

Other fears are less existential; in much of Europe, fears of inequality came out on top; with the exception of the UK, which shared a top fear of ethnic and religious hatred with Lebanon, Tunisia and Nigeria. These almost existential fears underscore additional challenges for policymakers working with limited political capital and increasingly focused on short-term considerations.

On the legislative agenda, there are reasonable grounds for optimism about the potential for trade deals, such as the long-awaited Trans-Pacific Partnership Agreement, which could be approved by Congress in 2015 and forms the cornerstone of the so-called US Asia Pivot. After a failure to reach comprehensive agreement, the temporary extension on Iran's nuclear program has now been agreed by the P5+1 (until July 2015). The failure to come to a more durable agreement with Iran has undoubtedly become entangled in the other regional concerns in which Russia and the US share interests, most notably the fight against ISIS. That said, the window for reaching broader agreement is closing; tolerance for continued negotiations without sanctions relief is rapidly declining in Tehran, while the US Congress is likely to move to pass new sanctions in the new term, a development which could potentially spell the end of the diplomatic process and prompt a return to talk of air strikes on Iran's nuclear facilities.

### Key Risks and Silver Linings

Thus far, the Russia-Ukraine dispute and the advance of ISIS and civil war in Syria have remained regionalized thanks to liquidity provided by central banks and shale gas. The continuation of this masking effect is highly tenuous. Key risks include a worsening in Libya's fragile security situation, given its status as a major energy producer; any developments which jeopardized Iraq's output, and developments which sparked deeper, so-called Level 3 sanctions against Russia, measures which would be more likely in the event of a "land grab" of Ukrainian territory or significant challenge to a European Union country. In light of developments this year, there is a non-negligible, even moderate probability, of any or all of these risks to materialize.

Historic geopolitical hotspots such as North Korea have been relatively calm by comparison in recent months, but the disappearance of Kim Jong-Un for a period of weeks highlighted the opaqueness of the DPRK regime, serving as a reminder of its potential to generate instability.

Although the global political outlook is undeniably fraught, full of new and old challenges and riven by social and political divides, it could be worse. Crucially, as long as the US-China relationship remains constructive, as it is today, a landscape scarred by the growing list of small wars, weak states and unpopular governments has less potential to destabilize than it would otherwise. Greater tensions within the US-China G2 — a characterization Beijing rejects, yet one which bears useful explanatory value — would significantly alter the current fragile geopolitical outlook.

This fact is one of many that make us skeptical about suggestions of a return to a Cold War: quite simply, the US-Russia relationship is less significant in economic, geopolitical and trade terms than the US-China relationship is now (although clearly further sanctions or conflict with Russia could be deeply destabilizing, it remains, after all, a nuclear weapons state). And while perhaps not symbiotic, neither are relations between Washington and Beijing openly confrontational either. The recent agreement at the APEC conference between the US and China on cutting greenhouse gas emissions was described as historic, and followed months of talks. Nevertheless, commentators at the gathering still resorted to Kremlinology-style observations about handshakes and other cues in the hopes of de-coding relations between world leaders, suggesting that even the rise of "Big Data" cannot necessarily predict outcomes in a highly-charged global environment. Old geopolitical habits, it seems, die hard.

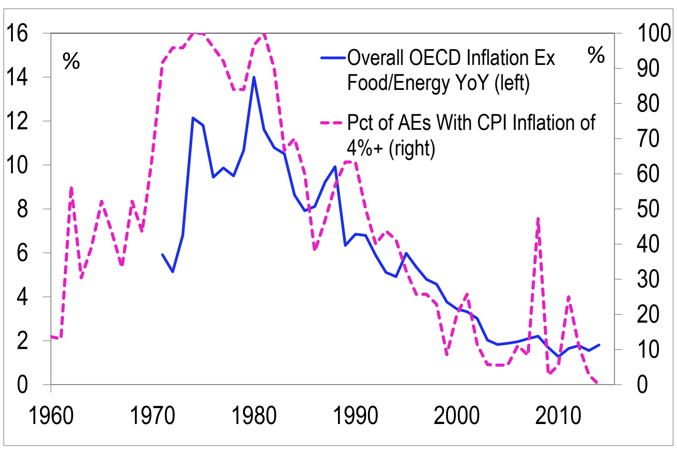
# Will Advanced Economy Low-flation Persist?

Michael Saunders

Across the OECD as a whole, CPI inflation (excluding the relatively volatile food and energy items) has now been at or below 2% YoY each month since the start of 2009[18] — the longest period of sustained low inflation since data began 43 years ago. And low inflation is becoming more widespread. For the first time in at least 55 years, not a single advanced economy[19] had CPI inflation of 4%-plus in 2014. To be sure, the number of AEs with inflation of 4%+ has been quite low over the last 10 years, but (until 2014) was never zero. Indeed, as recently as 2011, a quarter of advanced economies had inflation of 4% YoY or higher.

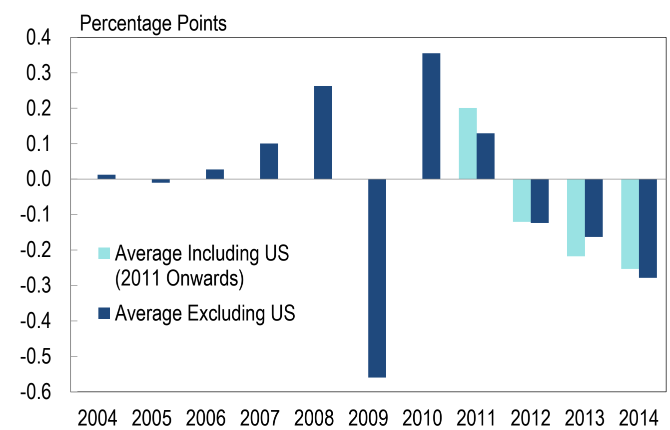
Moreover, recent AE inflation outturns have generally been lower than expected. For example, in 2010-11, inflation outturns across advanced economies generally overshot central bank forecasts from the end of the prior year, with an average overshoot of 0.5 percent in 2010 and 0.2 percent in 2011[20]. By contrast, inflation generally undershot in 2012, 2013 and 2014, with notable undershoots in 2014 (at last 0.5 percent) for the euro area, UK and Sweden. Similarly, overall AE inflation overshot the IMF's forecasts (made towards the end of the prior year) in 2010-12, but undershot by 0.2-0.3 percent in 2013 and 2014. In turn, consensus forecasts for AE inflation have been trending down since late 2012, the longest run of consensus downgrades since the late 1990s.

**Figure 19. Advanced Economies — Average Inflation and Breadth of Low Inflation, 1960-2014**




Source: Citi Research

**Figure 20. Advanced Economies — Inflation Outturns Compared to Central Bank Forecasts At End of Prior Year, 2004-14**




Note: We show the average for inflation outturns compared to central bank forecasts made at the end of the prior year for the US, EMU, Japan, UK, Canada, Australia, Sweden and Switzerland. Figures for Australia only from 2008 onwards. Sources: DataStream, central banks and Citi Research

So what is going on? — and will it continue? This note aims to explain why AE inflation is undershooting, whether it will continue and the implications.

There have been some country-specific or temporary factors at work. For example, the embargo on various food exports to Russia may have contributed to downward pressure on good prices in Western Europe, while UK and euro area inflation

[18] This includes one month, Dec-11, in which inflation was exactly 2.0000% YoY.

[19] We use here the IMF definition of advanced economies.

[20] We use headline CPI inflation for the Euro Area, Switzerland and the UK (RPIX for 2004), core PCE inflation for the US, CPI ex fresh foods for Japan, core CPI inflation for Canada, underlying inflation for Australia and CPIF inflation for Sweden (UND1X for 2008 and earlier).

additionally has been depressed by the end of regulatory and tax-driven price hikes. But, in our view, the persistent weakness of AE inflation mainly reflects a mix of cyclical and structural factors, both national and global.

Domestically, we suspect that the consensus (and central banks) have probably overstated growth prospects and understated the disinflationary effects from large output gaps plus high unemployment. Across the advanced economies as a whole, the level of real GDP per head of the population this year is only about 2% above the 2007 level, the weakest multi-year stretch of the last 30 years. In turn, the IMF judge that there is still a relatively large output gap for the AEs as a whole (2.5% of potential GDP) — the sixth consecutive year with a sizeable output gap. The overall OECD jobless rate has fallen by 0.6 percentage points (from 7.9% to 7.3%) over the last year but has now been above 7% for six consecutive years — the longest stretch for at least 35 years. Indeed, the OECD jobless rate still roughly matches the *peak* of the 1997-07 period. With ample labour market slack, overall OECD pay growth has slowed from an average of 3.0% YoY in 1996-07 to an average of just 2% YoY since the start of 2010 (and just 1.8% YoY so far in 2014), with unit labour cost growth down from 1.4% YoY in 1996-07 to just 0.7% YoY since the start of 2010 (and roughly 1% YoY in H1-2014).

Moreover, there are signs in some countries that there may be even more labour market slack than implied by jobless rates alone. For example, in the US, the jobless rate (5.8%) is fairly close to the precrisis average (1998-07 average was 4.9%, a period for which the IMF judge the output gap on average was close to zero), but wider measures of unemployment and under-employment remain well above pre-crisis norms. For example, the U6 measure[21] is at 11.5% in Oct-14 versus the 8.5% average for 1998-07, reflecting high numbers of people working part-time but available and looking for full-time work, as well as people who have recently looked for work but not in the latest month. We have calculated a similar U6-type jobless measure for the euro area[22]. This broader measure was at 23.5% in Q2 among people aged 15-64 years, up from 17.4% in Q2-07 and more than twice the standard jobless rate (10.5%). As with the US, the gap between this wider jobless measure and the standard jobless rate has widened markedly over the last 10 years — reflecting in particular a sharp rise in the numbers of involuntary part-timers who would like to work full-time.

In addition, inflows of foreign workers via migration and internal company transfers add an extra aspect to labour supply across a wide range of areas. For example, since 2005, the numbers of foreign nationals in work has risen by 30% in the euro area and by 84% in the UK: whereas the numbers of domestic citizens in work has fallen by 0.6% in the euro area and risen by just 0.4% in the UK. And in the UK, a series of tax and benefit reforms also have expanded internal labour supply – with the participation rate close to record highs — and added to downward pressure on real wages.

There is tentative evidence that, across the OECD countries as a whole, the relation between unemployment and pay growth appears to have shifted downwards since 2008 (ie pay growth is lower for a given jobless rate). We stress that this evidence is still only tentative at this stage. This is partly because this relationship is quite imprecise. But, in addition, the case for a structural break in this relation will only

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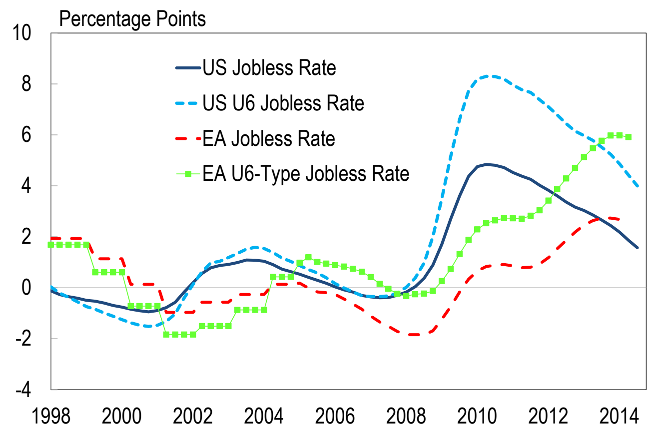
[21] U6 counts the unemployed, plus discouraged workers, people who have looked for work recently but not within the last few weeks, and people working part-time but who would like full-time work.

[22] This covers the numbers of people who are unemployed, or those who would like to work but are classed as inactive because they have not looked for work in the latest month, or working part-time that would like to work full-time, as a share of the active population.

become more certain if and when jobless rates return to the pre-crisis norms. Moreover, this apparent shift in part reflects the limitations of the standard jobless rate as a guide to labour market slack at a time of structural changes: the evidence for a shift in the link between unemployment and nominal wage growth probably would be much weaker if we use a wider U6-type jobless measure. But, at the very least, there is no evidence that hysteresis-type effects are preventing high unemployment from bearing down on wage growth.

**Figure 21. US and Euro Area — Unemployment Rates Compared to 1998-2007 Average, 4-Quarter Averages, 1998-2014**




Note: The EA data are not seasonally adjusted, and this is why we show 4-quarter averages. Sources: BLS, Eurostat and Citi Research

**Figure 22. OECD — Estimated Relation Between Unemployment and Pay Growth, Quarterly Data 1996Q4 to 2014Q2**


Sources: OECD and Citi Research.

In addition, we suspect that central banks and investors probably have understated the spillovers to inflation in individual AE countries from swings in global growth and capacity pressures, transmitted in particular via swings in commodity prices and prices of traded goods and services. For example, in 2010-11, AE economies in general had disinflationary conditions of large output gaps, high unemployment and sluggish wage growth. However, global growth (using IMF data at constant prices) was above average, fuelled in particular by emerging markets, with the result that AE inflation generally overshot consensus and central bank expectations. Conversely, in 2013-14, global growth slowed below trend, and resultant weakness in commodity prices has reinforced the weakness in AE inflation.

For example, whereas the correlation between the change in overall AE inflation and the change in the overall AE output gap has been fairly stable in recent years, the correlation between the change in AE inflation and EM GDP growth (a proxy for the change in the EM output gap) has risen sharply, to 80-90% over the last five years. Moreover, revisions to consensus inflation forecasts have tended to follow (with a lag) swings in global commodity prices (in SDR terms): the fact that the adjustment to consensus inflation forecasts does not appear to be immediate suggests that the consensus sometimes may be slow to recognise the importance of external factors in driving each country's inflation.

We expect that AE inflation in general will remain subdued, at about 1¼% YoY, in 2015-17, close to the 2014 pace and reflecting much the same factors as recently: there is still some spare capacity in labour markets while recent declines in food and energy prices will continue to feed through. Within that, we see even lower inflation in the EA, slightly higher in the US, but do not expect any advanced economy to have inflation of more than 3% YoY in any year during 2015-19. Moreover if EM growth continues to disappoint, then renewed weakness in commodity prices may

well add further downside to AE inflation compared to our forecast and current levels.

### What's wrong with low-flation?

There is a widespread consensus among policy makers that both very high inflation and deflation are costly and should be avoided[23]. High inflation disrupts economic activity because of the adverse interplay with tax systems, difficulties in disentangling relative price changes from the general inflationary trend, and the inefficiencies as businesses, households and investors focus heavily on trying to avoid being on the wrong side of unexpected and large price hikes. Conversely, deflation magnifies debt burdens, especially given difficulties in setting interest rates significantly below zero.

But a long period of very low inflation (ie low-flation) can be costly as well. To be sure, it may be marginally easier for businesses and consumers to perceive relative price changes if inflation is 1% rather than 2%. But, with many central banks unwilling to push nominal policy rates significantly below zero, and nominal wage rigidity, very low inflation (and repeatedly lower-than-expected inflation) can make it harder for achieve declines in real interest rates and real wages, even if such declines are warranted by economic developments. In addition if (as we believe is the case) persistent low AE inflation is a symptom of persistent high unemployment and sizeable output gap across AEs, then very low inflation comes with a large economic and social cost of wasted resources. And, within the euro area, low aggregate inflation in coming years would probably imply that several under-performing economies will be in or near actual deflation, hence making it even harder to stabilize public debt burdens. Until recently, the BoJ for a long period tolerated conditions of economic stagnation and roughly zero (or negative) inflation. But, this attitude probably in part reflected the lack of mass unemployment. We doubt that other AE central banks (or governments) would be willing to tolerate Japan-style persistent low inflation or deflation if (as is likely) this comes with persistently high unemployment.

Indeed, in our view, there is a good case in principle for central banks to aim for inflation of slightly higher than 2%, perhaps 3% or (as suggested by a recent IMF paper) 4%[24], in order to limit the frequency with which monetary policy or scope for real wage declines are constrained by the zero bound. Such an approach could be especially useful for the EA, given the reluctance of some policymakers to countenance QE or other unconventional policies when inflation is below target, coupled with the risk that low aggregate EA inflation with limited fiscal burden sharing is likely to produce deflation and fiscal strains in individual countries.

However, we do not expect any central banks will actually change their inflation targets in coming years. Nevertheless, we do expect that risks of continued low-flation will ensure that AE central banks continue to run a loose (and in some cases loosening) monetary stance in 2015. The BoJ's QE program is likely to continue throughout the coming year, while the ECB also is likely to start a major QE program in the next few months. The central banks of Sweden and Denmark are also likely to loosen further, while the SNB will probably maintain the zero rates and currency cap introduced in late-2011. We do expect that the Fed and BoE will start to hike rates in late-2015. But, with low inflation, we expect that both central banks will have an asymmetric policy bias, leaning more in the direction of low for longer rather than an early withdrawal of stimulus.

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23 See, for example, "Price stability: Why is it important for you?", ECB, 2011.

24 See "The Case for a Long-Run Inflation Target of Four Percent", Laurence Ball, June 2014, IMF.

# EM Prospects 2015

**David Lubin**

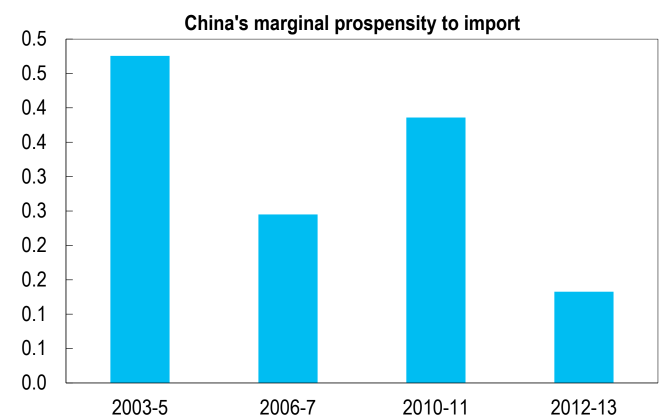
**EM's prospects in 2015 will be governed by familiar themes: i) China's slowdown and its consequences; ii) the impact of falling commodity prices; and iii) the risks associated with US monetary tightening**. Perhaps the most reliable observation one can make about all three of these forces is that they will continue to pressure emerging economies to find a 'new model' for GDP growth. The biggest rewards will be for countries making effort to introduce structural reforms. That helps explain why Mexico and India — the two most promising reform stories in EM these days — are likely to see some of the biggest gains in GDP growth over the next two years.

**Economic developments in China are becoming increasingly less EM-friendly**. One puzzle in 2014 was this: why did Chinese policymakers fail to implement a bigger stimulus when it was clear that GDP growth would undershoot the 7.5% target which, earlier in the year, had seemed so important to them? There are two likely answers to the puzzle, neither of which is very promising for EM. The first is that Chinese policymakers are making a more serious effort to defuse the risk of a recession by managing down the rate of credit growth in an orderly way. Since the stock of credit rose from 128% of GDP in 2007 to 200% in 2013, an effort to manage this risk should be no surprise. And certainly it seems that the growth of credit extension — particularly from the shadow banking system — is visibly under downward pressure. The flow of Total Social Financing in the first 10 months of 2014, for example, was 26% of GDP, down from 31% in the same period of 2013. And the composition of Chinese financing is coming out of the 'shadows': in recent months, plain vanilla yuan loans have made up over 3/4ths of total financing, while that ratio was less than ½ in late 2012 and early 2013. And another possible answer to the China puzzle this year is that employment growth was very strong, possibly thanks to the strong performance of the under-recorded services sector (services growth has been faster than industrial growth since 2012). If Chinese policymakers can achieve their employment targets with slower GDP growth, then a slowdown may be more tolerable to them.

**Figure 23. Not only is weaker Chinese import growth contributing to lower commodity prices…**


Source: Citi Research

**Figure 24. …but the entire relationship between Chinese income growth and Chinese imports is becoming less EM-friendly**




Source: Citi Research

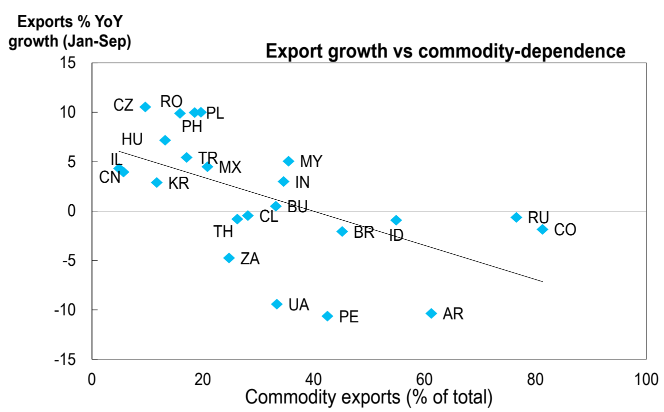
**The consequence of diminished Chinese credit stimulus and a stronger services sector weakens the links between China and EM**. As credit stimulus diminishes, so does import growth, and Figure 23 highlights the link between declining Chinese import growth and the fall in global commodity price inflation. In addition to this, we think the rise of China's services sector may be leading to a

change in the entire relationship between Chinese income growth and import growth: the marginal propensity to import is falling (see Figure 24). One further implication of the rise in China's services sector is that it provides some evidence of a 'domestic rebalancing' of the Chinese economy, by which the economy becomes less investment-driven over time, while the ratio of consumer spending to GDP rises. Indeed, the data up to 2012 — the latest for which we have a breakdown — suggests that imports of consumer goods has been growing more rapidly than imports of capital goods. And since the biggest suppliers of consumer goods to China are to be found in DM rather than EM, it makes sense to expect China to be a less-friendly factor for EM in the next few years.

**Falling commodity prices is a very important consequence of all this**. The fall in commodity prices generally — and oil prices specifically — was a defining feature of EM in 2014, and we suspect that this will continue to shape EM in 2015 and beyond. The significance of weaker commodity prices in EM in the last few quarters has had a notable effect on macroeconomic performance across the group of EM commodity exporters. As a rule, EM's commodity exporters are suffering weaker economic activity, lower export growth, worse current account balances, greater currency pressure, higher inflation, lower investment efficiency and bigger risk premia than EM's manufacturing economies.

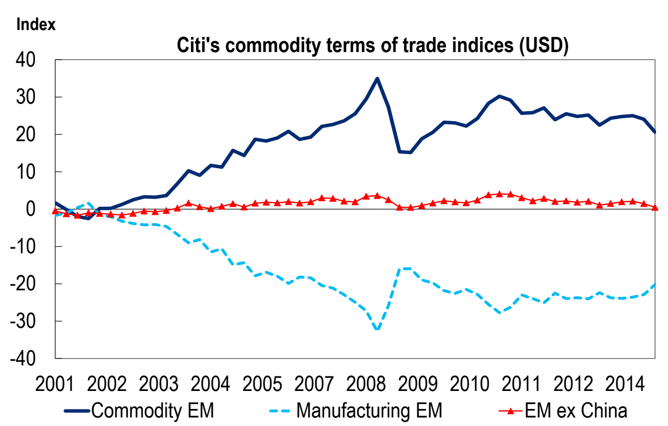
**It has become clear this year that the more commodity-dependent an economy is, the worse its export performance is likely to have been** (see Figure 25 this partly explains why, among the 'Fragile 5' for example, it is only the manufacturing exporters — India and Turkey — that have been able to reduce their current account deficits since the 'taper shock' of May 2013). Further weakness in commodity prices is likely to keep these trends intact, not least because, as Figure 26 shows, the terms of trade for EM's commodity exporting countries is still quite elevated in historical terms. This reflects the fact that, for example, the real price of metals is still over 50% higher than its 20-year average; while the real price of energy is over 70% higher. In other words, the deflation of a long-established commodities boom is likely to play out over an extended period, and the full effects on EM have still to play out. In this environment, it is likely to be commodity-importing EM — those with deficits and with surpluses — that benefit.

**Figure 25. The more commodity-dependent you were in 2014, the worse your export growth is likely to have been…**




Source: Citi Research

**Figure 26. …and the decline in the terms of trade for commodity exporting EMs may still be in its early stages**




Note: 'Commodity EM' is a GDP-weighted average of Brazil, Chile, Colombia, Peru, Argentina, Indonesia, South Africa, Russia; 'Manufacturing EM' is a GDP-weighted average of Czech, Hungary, Poland, Turkey, Israel, India, Philippines, Korea, Thailand, Malaysia, Mexico. A change of +5 in the in the index between any two dates means that export prices have outperformed import prices by 5% in this period.
Sources: Kristjan Kasikov and CitiFX.

**Commodity-exporting emerging economies with current account deficits are likely to remain in the spotlight**. In 2013 the most relevant distinction within emerging markets was that between countries with current account deficits and those with current account surpluses. Because capital flows to EM were threatened by the 'taper shock' of May last year, the countries most exposed were those with the largest external financing needs (a proxy for which is the current account deficit). What's happened in 2014 is that another distinction has become relevant: that between commodity-exporting EMs and manufactured-exporting EMs. We think this distinction will remain relevant in 2015, and it makes room for a conceptualization of EM along the lines presented in Figure 27. It seems intuitive that the countries least likely to suffer capital outflows or macroeconomic disruption are those in the upper-right-hand quadrant: manufacturing economies with current account surpluses. Equally, it seems intuitive that the most vulnerable countries in EM will remain those in the lower-left-hand quadrant, commodity exporters with current account deficits. A trickier question is: how to evaluate the relative vulnerability of the intermediate quadrants? In general we think that commodity-exporting economies — regardless of whether they are running current account surpluses or deficits — will have to go through a potentially painful adjustment process. But the true vulnerability of EMs with external financing needs in 2015 will depend on the outlook for capital flows, and here the question is: what impact will a rising US policy rate have on capital flows to EM?

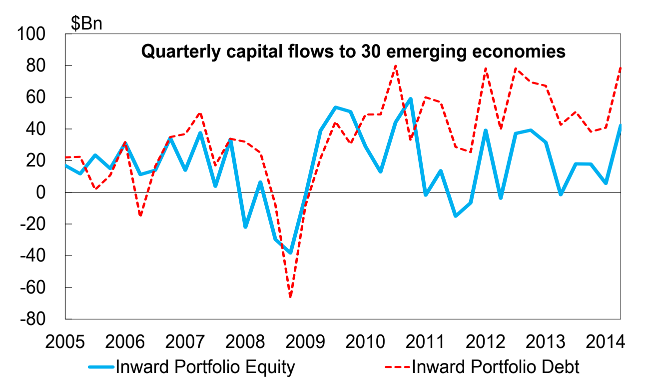
**US monetary tightening in 2015 would cloud the outlook for capital flows to EM, but is unlikely to be a catastrophe**. The experience of the past 40 years suggests that capital flows to EM can go into reverse during periods of US monetary tightening, but there are three factors which should limit this fear in 2015. The *first* is that there has been an important change in the composition of capital flows in the last couple of decades: commercial banks are no longer the dominant supplier of cross-border flows to EM; institutional investors are. This is important because commercial banks are the creditors most likely to have the highest degree of sensitivity to an increase in the front-end of the US curve. The *second* is the evidence that 'home bias' among institutional investors has declined rather sharply. On a scale of 1 to 0, where 1 represents complete 'home bias' and 0 its complete absence, the advanced economy members of the G20 have seen their home bias fall sharply in recent years: from 0.76 in 1995 to 0.58 in 2011. This is likely to be a structural change. *Finally*, the expected US monetary tightening in 2015 will take place against a background of 'monetary policy divergence' in the advanced economies: the fact that rates in Japan and the Eurozone should stay very low will help to mitigate the impact of rising US rates.

**Figure 27. Commodity exporters with current account deficits seem likely to remain among the most vulnerable countries within EM…**

| | Commodity Exporting | Manufactures Exporting |
|---|---|---|
| **Current Account Surplus** | Russia<br>Nigeria<br>Venezuela | Korea<br>Hungary<br>Poland<br>Israel |
| **Current Account Deficit** | South Africa<br>Brazil<br>Indonesia<br>Peru | India<br>Turkey |

Source: Citi Research

**Figure 28. …but there are reasons to be optimistic about capital flows to EM, possibly due to a sustained decline in global 'home bias'**



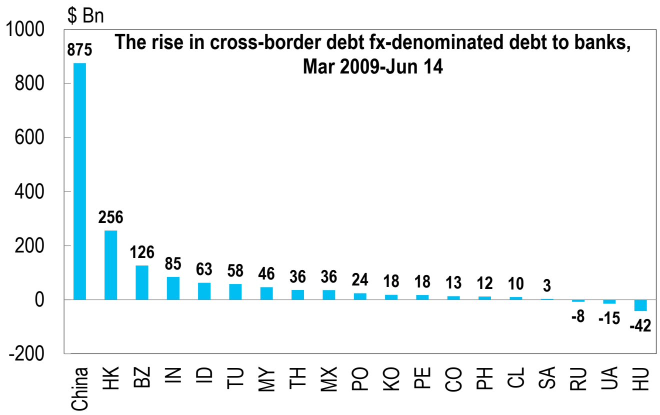

Sources: Institute of International Finance and Citi Research

**But there is one country in which cross-border commercial bank lending has been very aggressive, and where capital outflows seem likely: China**. Data from the BIS on cross-border bank lending to EM show that international lending to China has risen very dramatically in the past few years (see Figure 29). Since the first round of QE, China's international debt to banks has risen by almost $900bn, creating a stock of external bank debt of over $1 trillion (more than half of this rise took place in the past 2 years), some 10% GDP. Of this stock, 80% has original maturities of less than one year. It is sensible to argue that the vast bulk of this largely short-term debt has been accumulated in the context of speculative capital inflows: China's currency has been a 'one-way-bet' since 2010, and dollar funding costs have been exceptionally low. Now these two factors are in transition: the Chinese currency has been exhibiting more two-way risk in recent months and, as US rates rise, there is a much greater chance that China suffers speculative outflows rather than speculative inflows — as has been the case in the past few months - particularly as Chinese rates fall next year. Of course, a large speculative outflow from China can easily be financed by the central bank. But a large capital outflow could, we think, increase some of the downside risks to Chinese growth, and could also set the stage for a more depreciated renminbi (which is in Citi's forecasts). Another factor to consider in thinking about the renminbi next year is the risk of deflation: if prices fall, currency depreciation could become an attractive policy tool, as it seems to be for many other economies these days.

**Is there deflation risk in EM?** One of the consequences of falling commodity prices — and in particular, falling energy prices — is that it can increase the chance of a falling price level. A temporary fall in the price level induced by falling oil prices may not be of much concern, but to capture the extent of the deflationary risk in China specifically — and in EM generally — we have adapted an approach developed by the IMF[25] which attempts to rank countries' vulnerability to deflation. The model scores countries across 13 variables, including the output gap; developments in consumer, core, and producer inflation; the evolution of the real exchange rate; credit and money growth; and asset prices. The results of the exercise are presented in Figure 30, which assigns high deflation risk to countries already in deflation (Poland, Czech, Hungary, Israel) and others in Asia. China's deflation risk is 'moderate' according to this analysis, but on the very edge of 'high' risk, thanks to slowdown, producer price deflation, real exchange rate appreciation, and previous episodes of very low inflation. The risk is that this, alongside the risk of capital outflows, might lead Chinese policymakers to prefer currency depreciation. That would probably create some risk aversion towards EM in general, adding to the pressure that already results from China's slowdown, and its contribution to weaker commodity prices and lower growth across some parts of the emerging world.

[25] See 'Gauging Risks for Deflation', IMF Staff Position Note SPN/09/01, January 2009. https://www.imf.org/external/pubs/ft/spn/2009/spn0901.pdf

**Figure 29. China's rise in short-term debt to banks may presage the risk of capital outflows…**




Sources: Bank for International Settlements and Citi Research

**Figure 30. …while the risk of deflation – in China and elsewhere – might incline more countries to seek weaker currencies**

| Index of Deflation Risk | | | |
|---|---|---|---|
| **Minimal <0.2** | **Low 0.2 to 0.3** | **Moderate 0.3 to 0.5** | **High >0.5** |
| India<br>Indonesia<br>Mexico | Argentina<br>Brazil<br>Philippines<br>Russia<br>S Africa<br>Turkey | Chile<br>China<br>Korea<br>Malaysia<br>Peru<br>Thailand | Czech<br>HK<br>Hungary<br>Israel<br>Poland<br>Singapore<br>Taiwan |

Source: Citi Research

All these risks will raise the importance of structural reforms in EM. Structural reform is evident in some countries — Mexico, India, for example — but across the board there is no broad consensus about the pressing need for reform, nor what kind of reforms should be implemented. And that, in turn, reflects uncertainty about what the future will be for EM's 'growth model'. It seems reasonable to suppose that 'net exports' will not be contributing strongly to EM growth in the way that it did before the Lehman crisis. In the summer of 2014, the growth rate of world import volume fell below the growth rate of world industrial production. If that trend continues, the scope for strong export-led growth will be eroded further. But the capacity of EM to rely enthusiastically on domestic drivers of growth is not self-evident. The history of credit booms in a number of countries means that the scope for strong rates of domestic credit creation is relatively limited. That could limit the scope of private domestic spending growth. Equally, while EM sovereign balance sheets are historically quite strong, the scope for looser fiscal policy is constrained. Brazil's recent experience is an illustration: fiscal policy has been notably loosened in recent years, without doing much for GDP growth, but securing a sovereign rating downgrade from S&P as well as the need for exceptionally high real interest rates. Even if more public spending were to be concentrated on investment spending — in infrastructure, say — it is not clear that growth will accelerate easily. Overall we agree with the IMF's recent assessment: "…the past strong growth momentum is unlikely to be sustained going forward"[26].

[26] 'Slowdown in Emerging Markets: Sign of a Bumpy Road Ahead?', IMF Working Paper WP/14/205, November 2014. http://www.imf.org/external/pubs/ft/wp/2014/wp14205.pdf

# Long-Term Nominal GDP Projections to 2025

Michael Saunders

In this section we update projections for the size of different economies in terms of nominal GDP expressed in USD, based on our forecasts and assumptions for economic growth, inflation and exchange rates. We stress that these projections are inevitably sensitive to various assumptions, and have sizeable margins of error.

Compared to last year's projections, there are two major changes. First, we have again scaled back the extent of prospective EM outperformance, and second within the advanced economies, we have downgraded medium-term prospects for the euro area and Japan compared to the US (reflecting both lower nominal GDP growth and currency trends). The result is to extend the US's status as the world's largest economy in USD terms. For example, two years ago, we forecast that China's nominal GDP would be about 9% above the US level in 2025 in USD terms, last year we judged that the two economies would be of roughly equal size, and now we expect that in 2025 US nominal GDP will still be about 10% above the level in China. Note, however, that in PPP terms, the IMF estimates that China's nominal GDP already overtook the US this year, in 2014, and on this basis China's lead is likely to expand in coming years.

Nevertheless, we still expect that EM countries in general will show higher real and nominal growth than advanced economies: aggregated across a wide range of countries, we expect nominal GDP (in USD terms) to rise by about 8% YoY over the rest of this decade, versus roughly 3% YoY for advanced economies. As a result, we expect that roughly 70% of the growth in global nominal GDP (in USD terms) over the rest of this decade will take place in emerging markets. Moreover, some notable individual crossovers are likely in coming years, with India's nominal GDP likely to exceed Italy's in 2015, to exceed France in 2016 and to surpass Germany and Japan around 2020.

The rankings of the various different economies looks quite different viewed in terms of nominal consumer spending or nominal investment spending (both in USD terms). The level of investment spending in China this year is about 40% above the US level, and by far the biggest of any country. By contrast, the level of consumer spending in the US in 2015 in USD terms will be roughly three times as great as in China. Similarly, we if we take the five biggest (in nominal USD terms) EM economies (Brazil, Russia, India, China, Korea), their combined nominal consumer spending is about 60% below the combined level of consumer spending in the five biggest AEs (US, Japan, Germany, UK, France). However, in terms of investment spending in USD terms, the EM-5 will probably overtake the AE-5 in 2015, and we expect aggregate investment spending in the EM-5 in 2025 to be about 50% greater than in the AE-5.

**Figure 31. Selected Countries — Approximate Size of 10 Biggest Economies, Indexed to US = 100, 1980-2025F**

| | 1980 | | 2000 | | 2010 | | 2015F | | 2020F | | 2025F | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Rank | US=100 | Rank | US=100 | Rank | US=100 | Rank | US=100 | Rank | US=100 | Rank | US=100 |
| 1 | US | 100 | US | 100 | US | 100 | US | 100 | US | 100 | US | 100 |
| 2 | Japan | 38 | Japan | 46 | China | 40 | China | 61 | China | 77 | China | 91 |
| 3 | Germany | 29 | Germany | 18 | Japan | 37 | Japan | 23 | India | 20 | India | 28 |
| 4 | France | 25 | UK | 15 | Germany | 22 | Germany | 18 | Japan | 19 | Japan | 17 |
| 5 | UK | 19 | France | 13 | France | 18 | UK | 16 | Germany | 17 | Germany | 16 |
| 6 | Italy | 16 | China | 12 | UK | 15 | France | 14 | UK | 16 | UK | 16 |
| 7 | China | 11 | Italy | 11 | Brazil | 14 | India | 13 | France | 13 | Russia | 14 |
| 8 | Canada | 10 | Canada | 7 | Italy | 14 | Brazil | 11 | Russia | 12 | France | 13 |
| 9 | Argentina | 9 | Mexico | 7 | India | 11 | Italy | 10 | Brazil | 11 | Brazil | 11 |
| 10 | Mexico | 8 | Brazil | 6 | Canada | 11 | Russia | 10 | Canada | 10 | Mexico | 11 |
| Euro Area | | 95 | | 61 | | 81 | | 65 | | 60 | | 57 |

F Forecast: Sources: IMF and Citi Research estimates

**Figure 32. Selected Countries — Economic Forecast Overview (Percent), 2014-2019F**

| | GDP Growth | | | | | |
|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F |
| **Global** | **2.7** | **3.1** | **3.4** | **3.4** | **3.5** | **3.4** |
| *Based on PPP weights* | *3.2* | *3.6* | *4.0* | *4.1* | *4.1* | *4.1* |
| **Industrial Countries** | **1.7** | **2.1** | **2.3** | **2.1** | **2.1** | **2.1** |
| **United States** | **2.3** | **3.0** | **2.8** | **2.5** | **2.5** | **2.5** |
| **Japan** | **0.3** | **0.9** | **1.8** | **0.5** | **1.2** | **1.2** |
| **Euro Area** | 0.8 | 1.1 | 1.6 | 1.7 | 1.7 | 1.7 |
| Canada | 2.4 | 2.4 | 2.3 | 2.3 | 2.2 | 2.1 |
| Australia | 3.3 | 3.1 | 3.2 | 3.5 | 3.1 | 2.8 |
| New Zealand | 3.5 | 2.9 | 2.4 | 2.6 | 2.7 | 2.3 |
| Germany | 1.5 | 1.1 | 1.6 | 1.7 | 1.7 | 1.7 |
| France | 0.3 | 0.7 | 1.6 | 1.8 | 1.9 | 2.0 |
| Italy | -0.4 | 0.3 | 1.0 | 1.1 | 0.9 | 0.8 |
| Spain | 1.3 | 2.0 | 2.1 | 2.0 | 1.8 | 1.8 |
| Greece | 0.8 | 1.5 | 1.7 | 1.7 | 1.9 | 1.9 |
| Ireland | 5.5 | 4.4 | 5.2 | 4.9 | 4.3 | 4.1 |
| Portugal | 0.8 | 1.5 | 2.0 | 2.0 | 1.9 | 1.9 |
| Netherlands | 0.7 | 1.3 | 1.7 | 1.9 | 2.0 | 2.0 |
| Belgium | 0.9 | 1.0 | 1.6 | 1.8 | 2.1 | 2.1 |
| Denmark | 0.7 | 1.1 | 1.7 | 1.8 | 2.0 | 1.9 |
| Norway | 2.6 | 1.9 | 2.2 | 2.6 | 2.7 | 2.5 |
| Sweden | 2.0 | 2.2 | 2.5 | 2.6 | 2.4 | 2.3 |
| Switzerland | 1.3 | 2.0 | 2.4 | 2.1 | 2.1 | 2.1 |
| United Kingdom | 3.0 | 3.0 | 3.0 | 2.8 | 2.7 | 2.4 |
| **Emerging Markets** | **4.2** | **4.4** | **4.9** | **5.2** | **5.1** | **5.0** |
| **China** | **7.3** | **6.9** | **6.7** | **7.1** | **6.8** | **6.5** |
| Taiwan | 3.6 | 3.6 | 3.8 | 4.0 | 4.0 | 4.0 |
| India | 5.6 | 6.5 | 7.0 | 7.1 | 7.1 | 7.4 |
| Indonesia | 5.1 | 5.1 | 5.3 | 5.6 | 5.9 | 5.8 |
| Korea | 3.4 | 3.5 | 3.7 | 3.8 | 3.4 | 3.2 |
| Czech | 2.3 | 2.3 | 3.0 | 3.2 | 3.1 | 2.6 |
| Hungary | 3.3 | 2.5 | 1.8 | 2.0 | 2.6 | 2.2 |
| Poland | 3.3 | 3.4 | 3.6 | 3.5 | 3.2 | 3.0 |
| Romania | 2.8 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Russia | 0.5 | -1.0 | 1.7 | 2.1 | 2.2 | 2.2 |
| Turkey | 3.1 | 3.3 | 3.4 | 3.4 | 3.5 | 3.5 |
| Nigeria | 6.2 | 4.8 | 6.3 | 6.5 | 6.7 | 6.0 |
| South Africa | 1.4 | 2.2 | 2.8 | 3.3 | 4.1 | 4.0 |
| Argentina | 0.0 | -1.0 | 1.0 | 2.5 | 3.0 | 3.0 |
| Brazil | 0.1 | 0.5 | 1.8 | 2.5 | 2.5 | 2.5 |
| Mexico | 2.4 | 3.9 | 4.4 | 4.5 | 4.6 | 5.0 |
| Venezuela | -4.0 | -2.2 | 1.9 | 1.8 | 1.7 | 1.6 |

| | CPI Inflation | | | | | |
|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F |
| **Global** | **2.7** | **2.5** | **2.8** | **2.9** | **3.0** | **3.0** |
| *Based on PPP weights* | *3.5* | *3.4* | *3.5* | *3.6* | *3.8* | *3.8* |
| **Industrial Countries** | **1.4** | **1.3** | **1.7** | **1.7** | **1.8** | **1.9** |
| **United States** | **1.4** | **1.4** | **1.8** | **1.9** | **2.2** | **2.2** |
| **Japan** | **2.9** | **1.4** | **1.1** | **1.0** | **1.2** | **1.3** |
| **Euro Area** | 0.5 | 0.8 | 1.5 | 1.3 | 1.4 | 1.5 |
| Canada | 2.0 | 1.8 | 2.0 | 2.0 | 2.0 | 2.0 |
| Australia | 2.5 | 2.6 | 2.3 | 2.4 | 2.4 | 2.4 |
| New Zealand | 2.1 | 2.2 | 2.2 | 2.2 | 2.4 | 2.0 |
| Germany | 0.9 | 1.1 | 1.8 | 1.8 | 1.7 | 1.8 |
| France | 0.6 | 0.9 | 1.7 | 1.4 | 1.5 | 1.6 |
| Italy | 0.2 | 0.5 | 1.1 | 0.9 | 0.9 | 0.9 |
| Spain | -0.1 | 0.2 | 0.7 | 0.6 | 0.8 | 0.9 |
| Greece | -1.3 | -1.3 | 0.1 | 0.3 | 0.4 | 0.7 |
| Ireland | 0.4 | 1.0 | 1.1 | 1.6 | 1.7 | 1.7 |
| Portugal | -0.1 | 0.2 | 0.7 | 0.7 | 0.9 | 1.0 |
| Netherlands | 0.4 | 0.9 | 1.5 | 1.4 | 1.5 | 1.7 |
| Belgium | 0.6 | 1.1 | 1.7 | 1.6 | 1.7 | 1.8 |
| Denmark | 0.6 | 1.1 | 1.5 | 1.8 | 1.9 | 1.9 |
| Norway | 2.0 | 2.1 | 2.1 | 2.2 | 2.4 | 2.5 |
| Sweden | -0.2 | 0.5 | 1.7 | 2.2 | 2.5 | 2.2 |
| Switzerland | 0.0 | -0.4 | 0.1 | -0.2 | 0.1 | 0.1 |
| United Kingdom | 1.5 | 1.3 | 2.0 | 2.0 | 2.3 | 2.2 |
| **Emerging Markets** | **4.4** | **4.3** | **4.3** | **4.5** | **4.6** | **4.6** |
| **China** | **2.0** | **1.9** | **2.2** | **2.8** | **3.0** | **3.0** |
| Taiwan | 1.4 | 1.7 | 2.0 | 1.8 | 1.8 | 1.8 |
| India | 7.2 | 6.2 | 6.0 | 6.0 | 6.0 | 6.0 |
| Indonesia | 6.3 | 7.2 | 4.6 | 4.3 | 4.3 | 4.0 |
| Korea | 1.3 | 1.6 | 2.6 | 2.8 | 2.7 | 2.6 |
| Czech | 0.4 | 1.2 | 2.1 | 1.6 | 1.8 | 1.8 |
| Hungary | 0.0 | 1.7 | 2.8 | 3.1 | 3.0 | 3.3 |
| Poland | 0.0 | 0.8 | 2.4 | 2.5 | 2.5 | 2.5 |
| Romania | 1.2 | 2.2 | 2.6 | 2.5 | 2.5 | 2.5 |
| Russia | 7.5 | 7.6 | 5.8 | 5.2 | 4.8 | 4.3 |
| Turkey | 8.9 | 6.7 | 7.0 | 6.5 | 6.4 | 6.1 |
| Nigeria | 8.1 | 9.9 | 9.3 | 9.9 | 9.2 | 8.7 |
| South Africa | 6.1 | 5.6 | 5.2 | 5.7 | 5.6 | 5.5 |
| Argentina | NA | 22.6 | 34.8 | 32.5 | 24.0 | 12.0 |
| Brazil | 6.3 | 6.5 | 6.1 | 5.5 | 5.5 | 5.5 |
| Mexico | 4.0 | 3.5 | 3.6 | 3.6 | 3.6 | 3.6 |
| Venezuela | 61.3 | 70.3 | 80.0 | 85.0 | 90.0 | 95.0 |

| | Central Bank Policy Rates | | | | | |
|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F |
| **Global** | **2.40** | **2.32** | **2.58** | **2.85** | **3.16** | **3.47** |
| *Based on PPP weights* | *3.38* | *3.36* | *3.54* | *3.71* | *3.91* | *4.08* |
| **Industrial Countries** | **0.36** | **0.34** | **0.64** | **1.13** | **1.70** | **2.33** |
| **United States** | **0.25** | **0.29** | **0.75** | **1.63** | **2.38** | **3.02** |
| **Japan** | **0.13** | **0.10** | **0.10** | **0.10** | **0.30** | **0.50** |
| **Euro Area** | 0.16 | 0.05 | 0.05 | 0.07 | 0.50 | 1.46 |
| Canada | 1.00 | 1.00 | 1.63 | 2.38 | 2.75 | 3.00 |
| Australia | 2.50 | 2.56 | 3.25 | 3.75 | 4.19 | 4.50 |
| New Zealand | 3.25 | 3.56 | 4.00 | 4.25 | 4.50 | 5.00 |
| Germany | | | | | | |
| France | | | | | | |
| Italy | | | | | | |
| Spain | | | | | | |
| Greece | | | | | | |
| Ireland | | | | | | |
| Portugal | | | | | | |
| Netherlands | | | | | | |
| Belgium | | | | | | |
| Denmark | 0.20 | 0.10 | 0.20 | 0.22 | 0.60 | 1.56 |
| Norway | 1.50 | 1.50 | 1.51 | 1.83 | 2.42 | 2.98 |
| Sweden | 0.47 | -0.22 | -0.14 | 0.22 | 1.05 | 1.71 |
| Switzerland | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.38 |
| United Kingdom | 0.50 | 0.54 | 1.46 | 2.54 | 3.40 | 3.50 |
| **Emerging Markets** | **5.34** | **5.18** | **5.29** | **5.23** | **5.14** | **4.97** |
| **China** | **2.97** | **2.38** | **2.25** | **2.38** | **2.63** | **2.75** |
| Taiwan | 1.88 | 1.88 | 2.19 | 2.63 | 3.13 | 3.63 |
| India | 8.00 | 7.50 | 7.00 | 7.00 | 7.00 | 7.00 |
| Indonesia | 5.75 | 5.75 | 5.75 | 5.75 | 5.38 | 5.10 |
| Korea | 2.31 | 1.75 | 2.00 | 2.50 | 2.75 | 2.63 |
| Czech | 0.05 | 0.05 | 0.05 | 0.61 | 1.54 | 2.73 |
| Hungary | 2.33 | 2.10 | 3.04 | 3.62 | 4.02 | 4.50 |
| Poland | 2.38 | 2.00 | 2.25 | 3.38 | 3.50 | 3.50 |
| Romania | 3.19 | 2.75 | 3.81 | 5.00 | 5.00 | 5.00 |
| Russia | 7.63 | 9.00 | 7.83 | 6.54 | 5.54 | 5.00 |
| Turkey | 9.03 | 8.25 | 9.88 | 9.50 | 9.00 | 8.50 |
| Nigeria | 13.00 | 13.50 | 12.00 | 9.00 | 9.00 | 9.00 |
| South Africa | 5.63 | 5.75 | 6.17 | 6.75 | 7.00 | 7.00 |
| Argentina | 23.13 | 30.79 | 42.74 | 38.00 | 29.00 | 17.00 |
| Brazil | 11.02 | 12.35 | 11.50 | 11.00 | 11.00 | 11.00 |
| Mexico | 3.21 | 3.08 | 3.94 | 5.00 | 5.75 | 6.25 |
| Venezuela | 14.50 | 14.50 | 18.00 | 18.00 | 18.00 | 18.00 |

Note: For inflation, we use the PCE deflator in the US, GDP deflator in Ireland. For Indonesia we refer to the FasBI rate to reflect actual money market rates
Source: Citi Research

**Figure 33. Selected Countries — Economic Forecast Overview (Percent), 2014-2019F**

| | Current Balance (Pct of GDP) | | | | | | Fiscal Balance (Pct of GDP) | | | | | | Government Debt (Pct of GDP) | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F |
| **Global** | **0.8** | **0.8** | **0.8** | **0.6** | **0.6** | **0.5** | **-3.2** | **-3.1** | **-3.0** | **-2.7** | **-2.5** | **-2.5** | **86** | **86** | **86** | **85** | **84** | **83** |
| Based on PPP weights | *0.9* | *0.8* | *0.8* | *0.6* | *0.5* | *0.5* | *-3.3* | *-3.4* | *-3.2* | *-2.9* | *-2.8* | *-2.7* | *76* | *76* | *76* | *75* | *75* | *74* |
| **Industrial Countries** | **-0.2** | **0.2** | **0.3** | **0.3** | **0.3** | **0.3** | **-3.8** | **-3.3** | **-3.2** | **-2.8** | **-2.6** | **-2.6** | **112** | **112** | **112** | **111** | **111** | **110** |
| **United States** | **-2.2** | **-1.2** | **-0.8** | **-0.8** | **-0.8** | **-0.7** | **-4.4** | **-4.1** | **-4.5** | **-4.3** | **-4.4** | **-4.6** | **106** | **106** | **106** | **106** | **106** | **106** |
| **Japan** | **0.1** | **0.7** | **0.4** | **1.0** | **0.7** | **0.7** | **-8.0** | **-6.5** | **-6.4** | **-5.4** | **-5.0** | **-4.6** | **243** | **247** | **249** | **252** | **255** | **256** |
| **Euro Area** | 2.7 | 3.0 | 2.8 | 2.7 | 2.5 | 2.5 | -2.5 | -2.3 | -1.9 | -1.6 | -1.3 | -1.0 | 95 | 96 | 96 | 95 | 94 | 92 |
| Canada | -2.1 | -2.0 | -1.8 | -1.6 | -1.4 | -1.4 | -0.1 | 0.1 | 0.2 | 0.2 | 0.3 | 0.5 | 88 | 87 | 85 | 84 | 82 | 82 |
| Australia | -3.3 | -4.2 | -4.6 | -4.5 | -3.6 | -3.6 | -3.1 | -1.8 | -1.0 | -0.6 | -0.2 | -0.2 | 32 | 34 | 33 | 33 | 34 | 35 |
| New Zealand | -4.2 | -5.4 | -5.0 | -5.4 | -6.6 | -5.3 | -1.6 | -0.4 | 0.5 | 1.2 | 2.2 | 1.5 | 39 | 36 | 37 | 37 | 34 | 31 |
| Germany | 7.4 | 7.7 | 6.7 | 6.4 | 6.0 | 5.9 | 0.3 | 0.2 | 0.0 | -0.1 | -0.2 | -0.1 | 76 | 74 | 70 | 68 | 67 | 66 |
| France | -0.6 | 0.0 | 0.5 | 0.2 | -0.1 | -0.3 | -4.3 | -4.2 | -3.7 | -3.1 | -2.5 | -2.1 | 98 | 101 | 102 | 102 | 101 | 100 |
| Italy | 1.6 | 1.6 | 1.7 | 1.7 | 1.7 | 1.7 | -3.0 | -3.0 | -2.2 | -1.6 | -1.1 | -0.8 | 131 | 133 | 133 | 132 | 132 | 130 |
| Spain | -0.1 | 0.5 | 0.5 | 0.7 | 0.7 | 0.8 | -5.6 | -4.7 | -3.7 | -3.0 | -2.5 | -2.1 | 100 | 102 | 103 | 103 | 102 | 101 |
| Greece | 1.4 | 1.1 | 1.1 | 1.1 | 1.2 | 1.4 | -1.9 | -2.1 | -1.8 | -1.8 | -1.7 | -2.0 | 178 | 179 | 178 | 175 | 172 | 169 |
| Ireland | 4.0 | 3.8 | 4.2 | 4.3 | 4.2 | 4.1 | -3.6 | -2.4 | -1.3 | 0.2 | 1.6 | 2.6 | 110 | 107 | 101 | 95 | 88 | 81 |
| Portugal | 0.5 | 0.7 | 0.9 | 1.3 | 1.5 | 1.6 | -4.3 | -3.4 | -2.7 | -2.2 | -1.7 | -1.2 | 139 | 138 | 136 | 134 | 132 | 131 |
| Netherlands | 10.8 | 9.6 | 9.1 | 8.7 | 8.2 | 7.8 | -2.0 | -1.8 | -1.7 | -1.4 | -1.2 | -1.0 | 74 | 73 | 73 | 72 | 71 | 69 |
| Belgium | -0.6 | -0.1 | 0.3 | 0.3 | 0.1 | 0.1 | -3.0 | -2.8 | -2.7 | -2.2 | -1.5 | -0.7 | 110 | 110 | 109 | 108 | 106 | 102 |
| Denmark | 6.1 | 5.6 | 5.4 | 5.6 | 5.5 | 5.2 | -0.8 | -2.5 | -2.3 | -1.5 | -1.1 | -0.9 | 45 | 47 | 48 | 47 | 47 | 46 |
| Norway | 10.8 | 11.5 | 12.0 | 12.3 | 12.2 | 12.2 | 10.1 | 9.7 | 9.5 | 9.2 | 9.0 | 9.0 | NA | NA | NA | NA | NA | NA |
| Sweden | 5.9 | 5.8 | 5.4 | 5.7 | 5.6 | 5.5 | -2.1 | -1.2 | -0.3 | 0.2 | 0.7 | 0.9 | 42 | 42 | 41 | 39 | 36 | 34 |
| Switzerland | 13.2 | 12.5 | 12.4 | 11.8 | 11.2 | 10.8 | 0.5 | 0.9 | 1.3 | 1.3 | 1.4 | 1.5 | 47 | 46 | 44 | 41 | 39 | 37 |
| United Kingdom | -4.7 | -4.2 | -4.3 | -4.0 | -3.8 | -3.6 | -5.6 | -4.8 | -3.2 | -1.8 | -0.7 | -0.9 | 91 | 92 | 92 | 90 | 87 | 84 |
| **Emerging Markets** | **2.1** | **1.4** | **1.3** | **0.9** | **0.8** | **0.6** | **-2.4** | **-2.9** | **-2.7** | **-2.5** | **-2.4** | **-2.4** | **47** | **48** | **48** | **48** | **48** | **48** |
| **China** | **2.5** | **2.7** | **2.5** | **2.0** | **1.8** | **1.5** | **-2.1** | **-2.5** | **-2.5** | **-2.5** | **-2.5** | **-2.5** | **55** | **56** | **56** | **57** | **57** | **57** |
| Taiwan | 12.0 | 11.0 | 8.0 | 8.0 | 8.0 | 8.0 | -1.4 | -1.6 | -1.3 | -1.0 | -1.0 | -1.0 | 39 | 38 | 38 | 38 | 38 | 37 |
| India | -1.6 | -1.3 | -1.2 | -1.2 | -1.2 | -1.2 | -6.7 | -6.4 | -6.1 | -5.8 | -5.5 | -5.2 | 68 | 66 | 65 | 63 | 61 | 61 |
| Indonesia | -3.1 | -2.7 | -2.7 | -2.6 | -2.5 | -2.4 | -2.4 | -2.0 | -1.8 | -1.8 | -1.7 | -1.6 | 26 | 27 | 27 | 27 | 27 | 26 |
| Korea | 6.2 | 5.9 | 5.3 | 3.3 | 2.6 | 2.3 | 0.9 | 0.3 | 0.3 | 0.9 | 1.1 | 1.4 | 35 | 37 | 38 | 38 | 38 | 38 |
| Czech | 0.2 | -0.6 | -1.1 | -2.1 | -1.1 | -1.1 | -1.9 | -2.3 | -2.0 | -1.7 | -1.4 | -1.0 | 44 | 42 | 42 | 41 | 40 | 39 |
| Hungary | 4.3 | 3.8 | 3.3 | 2.6 | -1.7 | -2.2 | -2.8 | -2.4 | -2.1 | -2.2 | -2.4 | -2.1 | 77 | 77 | 76 | 75 | 73 | 72 |
| Poland | -1.8 | -3.2 | -3.9 | -4.0 | -3.7 | -3.5 | -2.9 | -2.4 | -2.2 | -2.2 | -2.2 | -2.2 | 47 | 47 | 47 | 46 | 46 | 46 |
| Romania | -1.2 | -2.0 | -2.2 | -2.5 | -3.5 | -3.5 | -1.7 | -2.0 | -2.5 | -2.5 | -2.5 | -2.5 | 42 | 42 | 43 | 43 | 43 | 43 |
| Russia | 3.3 | 3.5 | 2.7 | 1.9 | 0.9 | 0.0 | 0.0 | -1.0 | -0.6 | -1.0 | -1.0 | -1.0 | 12 | 13 | 14 | 14 | 14 | 15 |
| Turkey | -5.5 | -5.1 | -5.5 | -5.4 | -5.3 | -5.3 | -2.0 | -2.9 | -3.0 | -3.3 | -3.3 | -3.3 | 36 | 36 | 35 | 35 | 33 | 33 |
| Nigeria | 2.4 | -0.9 | 0.6 | 0.3 | 0.2 | 0.3 | -2.0 | -2.4 | -2.0 | -1.9 | -1.5 | -1.5 | NA | NA | NA | NA | NA | NA |
| South Africa | -5.3 | -4.7 | -4.1 | -3.2 | -2.7 | -1.8 | -4.1 | -4.1 | -3.5 | -2.9 | -1.8 | -1.2 | 50 | 51 | 51 | 50 | 47 | 45 |
| Argentina | -1.0 | -1.4 | -1.2 | 1.0 | 1.0 | 1.0 | -3.7 | -4.7 | -3.7 | -0.5 | -1.0 | -1.0 | 38 | 46 | 54 | 52 | 51 | 51 |
| Brazil | -4.0 | -4.1 | -3.9 | -3.8 | -3.6 | -3.5 | -5.5 | -4.7 | -4.4 | -3.9 | -4.0 | -4.0 | 60 | 60 | 61 | 61 | 61 | 61 |
| Mexico | -2.2 | -2.0 | -2.4 | -2.5 | -2.4 | -2.4 | -3.6 | -3.5 | -3.5 | -3.0 | -2.5 | -2.5 | 42 | 43 | 43 | 43 | 42 | 42 |
| Venezuela | 4.4 | 2.4 | 4.1 | 2.0 | 2.0 | 2.0 | -12.3 | -12.6 | -12.7 | -12.9 | -12.5 | -12.6 | 44 | 49 | 50 | 50 | 51 | 52 |

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. For Spain, fiscal deficits include the effect of financial support for banks. For Greece, we assume further reductions in the cost of official loans. Source: Citi Research

**Figure 34. Selected Countries — Changes in Economic Forecasts (Percentage Points), 2014-2016F**

| | GDP Growth | | | CPI Inflation | | | Current Balance (Pct of GDP) | | | Fiscal Balance (Pct of GDP) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| **Global** | | **-0.1** | **-0.2** | | **-0.1** | **-0.2** | | | **0.2** | **0.1** | **-0.3** | **-0.2** |
| *Based on PPP weights* | *-0.1* | *-0.2* | *-0.2* | | *-0.1* | *-0.2* | *0.1* | | *0.3* | | *-0.4* | *-0.3* |
| **Industrial Countries** | | **-0.1** | **-0.2** | | **-0.1** | **-0.2** | **-0.1** | | **0.1** | **0.4** | | |
| **United States** | **0.1** | **-0.2** | **-0.4** | | | **-0.4** | **-0.2** | | **0.2** | **1.1** | **0.3** | **0.2** |
| **Japan** | **-0.5** | | **0.6** | **0.1** | **-0.2** | **-0.5** | | **0.2** | **-0.6** | | **-0.3** | **-0.6** |
| **Euro Area** | | | **-0.1** | | **-0.1** | **0.1** | | **0.1** | **-0.1** | **0.1** | **0.2** | **0.1** |
| Canada | 0.1 | -0.1 | -0.2 | 0.1 | 0.2 | | 0.1 | -0.2 | -0.3 | | -0.2 | -0.2 |
| Australia | 0.1 | 0.1 | | | | | 0.1 | -0.7 | -0.9 | | | |
| New Zealand | | | | | | | | | | | | |
| Germany | 0.1 | -0.1 | -0.1 | | -0.3 | -0.2 | 0.1 | 0.2 | -0.2 | 0.2 | 0.2 | |
| France | | | | | | 0.3 | | | | 0.2 | 0.3 | 0.3 |
| Italy | | -0.1 | 0.1 | | 0.4 | 0.5 | | -0.1 | | | | |
| Spain | | | -0.1 | | -0.2 | | -0.3 | | -0.1 | | | -0.1 |
| Greece | 0.7 | | | -0.1 | -0.3 | 0.1 | | | | 0.5 | 0.2 | -0.2 |
| Ireland | | 0.1 | 0.4 | | | | 0.1 | -0.1 | -0.3 | -1.6 | -3.2 | -3.5 |
| Portugal | -0.1 | -0.2 | -0.1 | | -0.1 | | | | | -0.1 | -0.1 | -0.1 |
| Netherlands | | 0.1 | | | -0.4 | -0.2 | -0.3 | | | 0.5 | 0.1 | -0.3 |
| Belgium | | | | | 0.1 | | 0.2 | 0.6 | 0.9 | | -0.5 | -1.2 |
| Denmark | | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 | -0.6 | -0.1 | | | 0.1 | -0.4 |
| Norway | 0.2 | -0.2 | -0.4 | | | | -0.2 | -0.2 | -0.1 | -0.8 | -1.3 | -0.5 |
| Sweden | -0.2 | -0.4 | -0.2 | | -0.2 | -0.2 | -0.3 | -0.3 | -0.4 | | | |
| Switzerland | 0.2 | 0.7 | 0.7 | -0.2 | -1.6 | -1.0 | 0.1 | 0.6 | 1.1 | 1.1 | 1.3 | 1.5 |
| United Kingdom | | -0.2 | -0.3 | | -0.2 | 0.1 | 0.2 | 0.9 | 1.3 | -1.5 | -1.4 | -1.1 |
| **Emerging Markets** | | **-0.2** | **-0.2** | **0.0** | **-0.1** | **-0.1** | **0.0** | **-0.1** | **0.4** | **-0.2** | **-0.7** | **-0.5** |
| **China** | | | | **-0.1** | **-0.3** | **-0.4** | **0.2** | **0.4** | **0.5** | | **-0.5** | **-0.5** |
| Taiwan | -0.1 | -0.4 | -0.4 | -0.1 | -0.3 | 0.2 | 1.0 | 0.8 | | | -0.8 | -0.7 |
| India | | | | -0.6 | | | 0.2 | 0.6 | 0.6 | | 0.1 | 0.1 |
| Indonesia | | | -0.2 | 0.1 | 0.5 | -1.4 | 0.1 | 0.2 | 0.1 | | -0.1 | -0.1 |
| Korea | -0.2 | -0.3 | -0.3 | -0.1 | -0.6 | -0.3 | 0.9 | 1.9 | 2.5 | | -0.1 | -0.4 |
| Czech | -0.1 | -0.1 | -0.2 | | -0.1 | 0.2 | 0.2 | 0.2 | -0.4 | | | 0.2 |
| Hungary | 0.2 | 0.3 | 0.3 | -0.2 | -0.4 | -0.1 | -0.2 | 0.2 | 0.1 | 0.1 | 0.6 | 0.8 |
| Poland | 0.3 | | 0.1 | -0.1 | -0.4 | -0.3 | 0.3 | 0.2 | 0.3 | 0.1 | -0.1 | |
| Romania | 0.8 | -0.4 | -0.6 | -0.1 | -0.5 | | | | 0.3 | 0.6 | 0.3 | -0.2 |
| Russia | -0.2 | -2.0 | -0.7 | 0.1 | 0.6 | -0.1 | 0.1 | 0.5 | 0.4 | | | |
| Turkey | | -0.2 | -0.2 | -0.1 | -0.2 | | -0.2 | 0.2 | 0.1 | 0.8 | 0.3 | 0.3 |
| Nigeria | -0.2 | -1.6 | -0.5 | -0.1 | 0.4 | 0.4 | 0.3 | -2.4 | -0.6 | | -0.3 | 0.3 |
| South Africa | | -0.4 | -0.6 | -0.1 | -0.1 | -0.1 | | | | | | |
| Argentina | | | | | -6.4 | -2.2 | 0.2 | -0.3 | | | | |
| Brazil | | -0.5 | -1.0 | | -0.1 | | -0.1 | -0.1 | 0.2 | -0.4 | -1.0 | -0.8 |
| Mexico | | | | | | | | | -0.4 | | | -0.5 |
| Venezuela | | | | | | 20.0 | 0.0 | -3.8 | 1.1 | | | |

Note: For Ireland we use the GDP deflator rather than the CPI. Source: Citi Research

**Figure 35. Selected Countries — Economic Forecast Overview (Percent), 2014-2019F**

| | 10-Year Yields | | | | | | Exchange Rates Versus U.S Dollar | | | | | | Exchange Rate Versus Euro | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F |
| **Industrial Countries** | | | | | | | | | | | | | | | | | | |
| **United States** | **2.55** | **2.85** | **3.08** | **3.18** | **3.25** | **3.30** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **1.30** | **1.11** | **1.02** | **1.04** | **1.11** | **1.18** |
| **Japan** | **0.56** | **0.50** | **0.60** | **0.75** | **1.25** | **1.50** | **108** | **125** | **132** | **129** | **121** | **112** | **141** | **138** | **135** | **134** | **134** | **133** |
| **Euro Area** | **1.26** | **0.91** | **1.25** | **1.44** | **1.65** | **1.92** | **1.30** | **1.11** | **1.02** | **1.04** | **1.11** | **1.18** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** |
| Canada | 2.24 | 2.40 | 2.85 | 2.95 | 2.90 | 2.90 | 1.11 | 1.17 | 1.19 | 1.18 | 1.14 | 1.11 | 1.44 | 1.30 | 1.22 | 1.22 | 1.27 | 1.31 |
| Australia | 3.78 | 4.21 | 4.95 | 5.50 | 5.75 | 6.30 | 0.90 | 0.81 | 0.76 | 0.76 | 0.78 | 0.80 | 1.45 | 1.38 | 1.34 | 1.37 | 1.43 | 1.48 |
| New Zealand | 4.44 | 5.08 | 5.65 | 5.80 | 6.00 | 6.50 | 0.82 | 0.72 | 0.65 | 0.63 | 0.64 | 0.65 | 1.59 | 1.54 | 1.56 | 1.64 | 1.73 | 1.82 |
| Germany | 1.26 | 0.91 | 1.25 | 1.44 | 1.65 | 1.92 | | | | | | | | | | | | |
| France | 1.69 | 1.11 | 1.45 | 1.64 | 1.85 | 2.12 | | | | | | | | | | | | |
| Italy | 2.90 | 2.01 | 2.35 | 2.44 | 2.55 | 2.72 | | | | | | | | | | | | |
| Spain | 2.69 | 1.86 | 2.15 | 2.29 | 2.45 | 2.67 | | | | | | | | | | | | |
| Greece | 6.66 | 5.79 | 4.88 | 4.81 | 4.53 | 4.29 | | | | | | | | | | | | |
| Ireland | 2.31 | 1.46 | 1.80 | 1.99 | 2.20 | 2.48 | | | | | | | | | | | | |
| Portugal | 3.70 | 2.66 | 3.00 | 2.94 | 2.90 | 2.92 | | | | | | | | | | | | |
| Netherlands | 1.47 | 0.96 | 1.30 | 1.49 | 1.70 | 1.97 | | | | | | | | | | | | |
| Belgium | 1.73 | 1.11 | 1.45 | 1.64 | 1.85 | 2.12 | | | | | | | | | | | | |
| Denmark | 1.43 | 1.07 | 1.40 | 1.69 | 1.90 | 2.17 | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA |
| Norway | 2.52 | 1.91 | 2.20 | 2.29 | 2.50 | 2.77 | 6.36 | 7.37 | 7.71 | 7.27 | 6.58 | 6.00 | 8.29 | 8.20 | 7.85 | 7.57 | 7.32 | 7.07 |
| Sweden | 1.76 | 1.29 | 1.85 | 1.94 | 2.15 | 2.42 | 7.00 | 8.41 | 8.93 | 8.53 | 7.85 | 7.25 | 9.13 | 9.34 | 9.09 | 8.89 | 8.72 | 8.55 |
| Switzerland | 0.70 | 0.46 | 0.66 | 0.77 | 0.88 | 1.02 | 0.93 | 1.10 | 1.22 | 1.22 | 1.16 | 1.10 | 1.22 | 1.22 | 1.24 | 1.27 | 1.29 | 1.30 |
| United Kingdom | 2.57 | 2.46 | 2.95 | 3.25 | 3.50 | 3.75 | 1.63 | 1.42 | 1.32 | 1.34 | 1.42 | 1.49 | 0.80 | 0.78 | 0.77 | 0.78 | 0.79 | 0.79 |
| **Emerging Markets** | | | | | | | | | | | | | | | | | | |
| **China** | **3.76** | **3.46** | **3.94** | **4.11** | **4.36** | **4.49** | **6.18** | **6.21** | **6.06** | **6.01** | **6.03** | **6.05** | **8.05** | **6.90** | **6.17** | **6.26** | **6.71** | **7.14** |
| Taiwan | 1.63 | 1.74 | 1.90 | 2.16 | 2.46 | 2.76 | 30.41 | 31.22 | 30.34 | 29.56 | 28.96 | 28.38 | 39.64 | 34.71 | 30.88 | 30.78 | 32.18 | 33.47 |
| India | 8.50 | 8.00 | 7.50 | 7.50 | 7.50 | 7.50 | 60.96 | 62.45 | 62.80 | 60.75 | 57.69 | 54.71 | 79.47 | 69.42 | 63.92 | 63.26 | 64.11 | 64.52 |
| Indonesia | 8.10 | 8.25 | 8.50 | 8.60 | 8.25 | 8.00 | 11885 | 12420 | 12495 | 12378 | 12211 | 12049 | 15494 | 13808 | 12718 | 12889 | 13570 | 14210 |
| Korea | 3.01 | 2.68 | 2.90 | 3.05 | 3.05 | 2.90 | 1057 | 1118 | 1116 | 1083 | 1040 | 998 | 1378 | 1243 | 1136 | 1128 | 1156 | 1177 |
| Czech | 1.57 | 1.10 | 1.78 | 2.21 | 2.57 | 2.91 | 21.1 | 25.1 | 26.8 | 25.3 | 22.9 | 20.8 | 27.5 | 27.9 | 27.2 | 26.3 | 25.4 | 24.6 |
| Hungary | 4.75 | 3.87 | 4.59 | 4.77 | 5.15 | 5.30 | 237 | 283 | 313 | 310 | 293 | 279 | 310 | 314 | 319 | 322 | 326 | 329 |
| Poland | 3.52 | 2.88 | 3.84 | 4.15 | 4.05 | 3.86 | 3.21 | 3.78 | 4.05 | 3.89 | 3.59 | 3.32 | 4.19 | 4.20 | 4.12 | 4.05 | 3.98 | 3.92 |
| Romania | NA | NA | NA | NA | NA | NA | 3.41 | 3.84 | 3.94 | 3.71 | 3.44 | 3.19 | 4.44 | 4.27 | 4.01 | 3.87 | 3.83 | 3.76 |
| Russia | 9.24 | 9.29 | 7.88 | 6.70 | 6.52 | 6.52 | 39.3 | 50.4 | 51.8 | 49.3 | 45.4 | 41.5 | 51.3 | 56.0 | 52.7 | 51.4 | 50.4 | 49.0 |
| Turkey | NA | NA | NA | NA | NA | NA | 2.20 | 2.46 | 2.58 | 2.61 | 2.63 | 2.65 | 2.87 | 2.73 | 2.62 | 2.72 | 2.92 | 3.12 |
| Nigeria | NA | NA | NA | NA | NA | NA | 164 | 182 | 193 | 207 | 225 | 235 | 214 | 203 | 197 | 216 | 250 | 277 |
| South Africa | 8.13 | 8.04 | 8.14 | 8.38 | 8.77 | 9.00 | 10.89 | 11.35 | 11.47 | 11.26 | 10.92 | 10.60 | 14.20 | 12.62 | 11.67 | 11.72 | 12.14 | 12.50 |
| Argentina | NA | NA | NA | NA | NA | NA | 8.25 | 11.13 | 15.61 | 19.74 | 23.25 | 25.06 | 10.76 | 12.37 | 15.88 | 20.56 | 25.84 | 29.56 |
| Brazil | 12.14 | 12.52 | 13.02 | 12.51 | 11.75 | 11.75 | 2.40 | 2.74 | 2.87 | 2.92 | 2.96 | 2.99 | 3.12 | 3.05 | 2.92 | 3.05 | 3.29 | 3.53 |
| Mexico | 6.02 | 6.20 | 6.25 | 6.28 | 6.37 | 6.87 | 13.3 | 13.4 | 13.1 | 12.8 | 12.6 | 12.4 | 17.3 | 14.9 | 13.3 | 13.4 | 14.0 | 14.6 |
| Venezuela | 15.83 | 19.00 | 19.00 | 19.00 | 19.00 | 19.00 | 6.30 | 12.00 | 21.36 | 39.09 | 73.49 | 141.83 | 8.21 | 13.34 | 21.74 | 40.70 | 81.66 | 167.26 |

*Per USD except Euro Area, Australia, New Zealand, United Kingdom. For China we use 5Y bond yields. Source: Citi Research

**Figure 36. Short Rate Forecasts (End of Period), as of 1 December 2014 (Percent)**

| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | 2Q 16F |
|---|---|---|---|---|---|---|---|
| **United States** | **0.25** | **0.25** | **0.25** | **0.25** | **0.50** | **0.50** | **0.75** |
| **Japan** | **0.10** | **0.10** | **0.10** | **0.10** | **0.10** | **0.10** | **0.10** |
| **Euro Area** | **0.05** | **0.05** | **0.05** | **0.05** | **0.05** | **0.05** | **0.05** |
| Canada | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 | 1.50 |
| Australia | 2.50 | 2.50 | 2.50 | 2.50 | 2.75 | 3.00 | 3.25 |
| New Zealand | 3.50 | 3.50 | 3.50 | 3.50 | 3.75 | 4.00 | 4.00 |
| Denmark | 0.20 | 0.10 | 0.10 | 0.10 | 0.10 | 0.20 | 0.20 |
| Norway | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Sweden | 0.00 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |
| Switzerland | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| United Kingdom | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 1.00 | 1.50 |
| **China** | **2.75** | **2.50** | **2.25** | **2.25** | **2.25** | **2.25** | **2.25** |

Source: Citi Research

**Figure 37. 10-Year Yield Forecasts (Period Average), as of 1 December 2014 (Percent)**

| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | 2Q 16F |
|---|---|---|---|---|---|---|---|
| **United States** | **2.21** | **2.70** | **2.85** | **2.90** | **2.95** | **3.00** | **3.05** |
| **Japan** | **0.44** | **0.45** | **0.45** | **0.55** | **0.55** | **0.60** | **0.60** |
| **Euro Area (Bunds)** | **0.70** | **0.65** | **0.85** | **1.00** | **1.15** | **1.25** | **1.25** |
| Canada | 1.89 | 2.25 | 2.40 | 2.45 | 2.50 | 2.70 | 2.75 |
| Australia | 3.15 | 3.25 | 3.50 | 3.70 | 3.90 | 4.10 | 4.20 |
| New Zealand | 3.91 | 4.50 | 4.50 | 4.70 | 4.90 | 5.20 | 5.40 |
| Denmark | 0.93 | 0.85 | 1.00 | 1.15 | 1.30 | 1.40 | 1.40 |
| Norway | 1.83 | 1.75 | 1.85 | 1.95 | 2.10 | 2.25 | 2.20 |
| Sweden | 1.01 | 0.95 | 1.15 | 1.40 | 1.65 | 1.85 | 1.85 |
| Switzerland | 0.32 | 0.34 | 0.43 | 0.50 | 0.57 | 0.62 | 0.62 |
| United Kingdom | 1.91 | 2.25 | 2.45 | 2.55 | 2.60 | 2.80 | 2.90 |

Source: Citi Research

**Figure 38. 10-Year Yield Spread Forecasts (Period Average), as of 1 December 2014 (Percent)**

| | Spread vs. US$ | | | | | | Spread vs. Germany | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F |
| **United States** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **152** | **207** | **202** | **192** | **182** | **177** |
| **Japan** | **-178** | **-227** | **-242** | **-237** | **-242** | **-242** | **-26** | **-20** | **-40** | **-45** | **-60** | **-65** |
| **Euro Area (Germany)** | **-152** | **-207** | **-202** | **-192** | **-182** | **-177** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** |
| Canada | -32 | -46 | -46 | -46 | -46 | -30 | 120 | 161 | 156 | 147 | 137 | 147 |
| Australia | 95 | 56 | 66 | 81 | 97 | 112 | 247 | 263 | 268 | 273 | 279 | 289 |
| New Zealand | 173 | 183 | 168 | 183 | 199 | 225 | 325 | 390 | 370 | 376 | 381 | 402 |
| France | -122 | -182 | -177 | -167 | -157 | -152 | 28 | 20 | 20 | 20 | 20 | 20 |
| Italy | -16 | -97 | -92 | -82 | -72 | -67 | 134 | 110 | 110 | 110 | 110 | 110 |
| Spain | -33 | -117 | -112 | -92 | -82 | -87 | 118 | 90 | 90 | 100 | 100 | 90 |
| Netherlands | -139 | -202 | -197 | -187 | -177 | -172 | 12 | 5 | 5 | 5 | 5 | 5 |
| Belgium | -128 | -182 | -177 | -167 | -157 | -152 | 23 | 20 | 20 | 20 | 20 | 20 |
| Austria | -136 | -197 | -192 | -182 | -172 | -167 | 14 | 10 | 10 | 10 | 10 | 10 |
| Finland | -143 | -192 | -187 | -177 | -167 | -162 | 7 | 5 | 5 | 5 | 5 | 5 |
| Ireland | -84 | -152 | -147 | -137 | -127 | -122 | 66 | 55 | 55 | 55 | 55 | 55 |
| Portugal | 59 | -32 | -27 | -17 | -7 | -2 | 209 | 175 | 175 | 175 | 175 | 175 |
| Greece | 608 | 343 | 348 | 258 | 218 | 198 | 758 | 550 | 550 | 450 | 400 | 375 |
| Denmark | -128 | -187 | -187 | -177 | -167 | -162 | 23 | 20 | 15 | 15 | 15 | 15 |
| Norway | -38 | -97 | -102 | -97 | -87 | -77 | 113 | 110 | 100 | 95 | 95 | 100 |
| Sweden | -120 | -177 | -172 | -152 | -132 | -117 | 31 | 30 | 30 | 40 | 50 | 60 |
| Switzerland | -189 | -238 | -244 | -242 | -240 | -240 | -38 | -31 | -42 | -50 | -58 | -63 |
| United Kingdom | -30 | -46 | -41 | -35 | -35 | -20 | 121 | 161 | 162 | 157 | 147 | 157 |

Source: Citi Research

**Figure 39. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 1 December 2014**

| | Current Rate | Mar 15F | Jun 15F | Sep 15F | Dec 15F | Mar 16F | Total Cumulative Rate Moves Expected |
|---|---|---|---|---|---|---|---|
| Turkey | 8.27 | -30 | -50 | 100 | 50 | 50 | 120 |
| Brazil | 11.25 | 125 | 0 | 0 | -50 | 0 | 75 |
| Mexico | 3.00 | 0 | 0 | 0 | 50 | 25 | 75 |
| Philippines | 4.00 | 0 | 0 | 0 | 0 | 50 | 50 |
| Malaysia | 3.25 | 0 | 0 | 25 | 0 | 0 | 25 |
| Chile | 3.00 | 0 | 0 | 0 | 0 | 25 | 25 |
| South Africa | 5.75 | 0 | 0 | 0 | 0 | 25 | 25 |
| Hungary | 2.10 | 0 | 0 | 0 | 0 | 25 | 25 |
| Indonesia | 5.75 | 0 | 0 | 0 | 0 | 0 | 0 |
| Poland | 2.00 | 0 | 0 | 0 | 0 | 0 | 0 |
| Korea | 2.00 | -25 | 0 | 0 | 0 | 25 | 0 |
| Israel | 0.25 | -25 | 0 | 0 | 25 | 0 | 0 |
| China | 2.75 | -25 | -25 | 0 | 0 | 0 | -50 |
| Thailand | 2.00 | -50 | 0 | 0 | 0 | 0 | -50 |
| India | 8.00 | -25 | -25 | 0 | -25 | -25 | -100 |
| Russia | 9.50 | 0 | 0 | -100 | 0 | 0 | -100 |

Source: Citi Research

**Figure 40. Foreign Exchange Forecasts (End of Period), as of 1 December 2014**

| | vs. USD | | | | | | | vs. EUR | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Current | Mar 15F | Jun 15F | Sep 15F | Dec 15F | Mar 16F | Jun 16F | Current | Mar 15F | Jun 15F | Sep 15F | Dec 15F | Mar 16F | Jun 16F |
| **United States** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **1.24** | **1.16** | **1.12** | **1.09** | **1.07** | **1.05** | **1.02** |
| **Japan** | **118** | **121** | **124** | **126** | **128** | **130** | **132** | **146** | **141** | **139** | **137** | **137** | **136** | **135** |
| **Euro Area** | **1.24** | **1.16** | **1.12** | **1.09** | **1.07** | **1.05** | **1.02** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** |
| Canada | 1.12 | 1.15 | 1.17 | 1.18 | 1.19 | 1.19 | 1.19 | 1.39 | 1.34 | 1.31 | 1.29 | 1.27 | 1.24 | 1.22 |
| Australia | 0.87 | 0.84 | 0.81 | 0.80 | 0.79 | 0.78 | 0.77 | 1.43 | 1.39 | 1.38 | 1.37 | 1.36 | 1.35 | 1.34 |
| New Zealand | 0.79 | 0.75 | 0.73 | 0.71 | 0.69 | 0.68 | 0.66 | 1.57 | 1.55 | 1.54 | 1.53 | 1.54 | 1.55 | 1.56 |
| Norway | 6.77 | 7.14 | 7.34 | 7.48 | 7.55 | 7.63 | 7.70 | 8.41 | 8.32 | 8.24 | 8.16 | 8.07 | 7.98 | 7.89 |
| Sweden | 7.45 | 8.02 | 8.35 | 8.59 | 8.69 | 8.80 | 8.91 | 9.26 | 9.34 | 9.38 | 9.37 | 9.28 | 9.21 | 9.13 |
| Switzerland | 0.97 | 1.04 | 1.08 | 1.11 | 1.15 | 1.18 | 1.21 | 1.20 | 1.21 | 1.21 | 1.21 | 1.22 | 1.23 | 1.24 |
| United Kingdom | 1.57 | 1.48 | 1.44 | 1.40 | 1.37 | 1.35 | 1.32 | 0.79 | 0.79 | 0.78 | 0.78 | 0.78 | 0.78 | 0.77 |
| China | 6.12 | 6.19 | 6.23 | 6.23 | 6.18 | 6.13 | 6.08 | 7.6 | 7.2 | 7.0 | 6.8 | 6.6 | 6.4 | 6.2 |
| India | 61.8 | 62.2 | 62.4 | 62.5 | 62.6 | 62.7 | 62.8 | 76.7 | 72.5 | 70.1 | 68.2 | 66.9 | 65.7 | 64.4 |
| Korea | 1114 | 1107 | 1119 | 1124 | 1122 | 1120 | 1118 | 1384 | 1290 | 1257 | 1226 | 1199 | 1172 | 1146 |
| Poland | 3.38 | 3.63 | 3.75 | 3.84 | 3.90 | 3.97 | 4.03 | 4.20 | 4.22 | 4.21 | 4.19 | 4.17 | 4.15 | 4.13 |
| Russia | 45.7 | 49.4 | 50.2 | 50.9 | 51.2 | 51.5 | 51.8 | 56.8 | 57.5 | 56.4 | 55.4 | 54.6 | 53.8 | 53.0 |
| South Africa | 10.93 | 11.22 | 11.34 | 11.41 | 11.43 | 11.45 | 11.47 | 13.58 | 13.07 | 12.74 | 12.44 | 12.21 | 11.98 | 11.75 |
| Turkey | 2.22 | 2.35 | 2.45 | 2.51 | 2.53 | 2.55 | 2.57 | 2.76 | 2.74 | 2.75 | 2.74 | 2.70 | 2.67 | 2.63 |
| Brazil | 2.53 | 2.69 | 2.73 | 2.76 | 2.79 | 2.82 | 2.85 | 3.15 | 3.13 | 3.07 | 3.01 | 2.98 | 2.95 | 2.92 |
| Mexico | 13.6 | 13.5 | 13.4 | 13.4 | 13.3 | 13.2 | 13.1 | 16.9 | 15.7 | 15.1 | 14.6 | 14.2 | 13.8 | 13.4 |

Source: Citi Research

**Figure 41. Foreign Exchange Forecasts (End of Period), as of 1 December 2014**

| | vs. JPY | | | | | | |
|---|---|---|---|---|---|---|---|
| | Current | Mar 15F | Jun 15F | Sep 15F | Dec 15F | Mar 16F | Jun 16F |
| **United States** | **118** | **121** | **124** | **126** | **128** | **130** | **132** |
| **Japan** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** | **NA** |
| **Euro Area** | **146** | **141** | **139** | **137** | **137** | **136** | **135** |
| Canada | 105 | 105 | 106 | 107 | 108 | 109 | 110 |
| Australia | 102 | 101 | 100 | 100 | 100 | 101 | 101 |
| New Zealand | 93.1 | 90.6 | 90.2 | 89.6 | 88.8 | 87.8 | 86.8 |
| Norway | 17.4 | 16.9 | 16.8 | 16.8 | 16.9 | 17.0 | 17.1 |
| Sweden | 15.8 | 15.1 | 14.8 | 14.7 | 14.7 | 14.8 | 14.8 |
| Switzerland | 122 | 116 | 115 | 113 | 112 | 110 | 109 |
| United Kingdom | 184 | 179 | 177 | 176 | 176 | 175 | 175 |
| China | 19 | 20 | 20 | 20 | 21 | 21 | 22 |
| India | 1.91 | 1.94 | 1.98 | 2.01 | 2.04 | 2.07 | 2.10 |
| Korea | 9.46 | 9.16 | 9.06 | 8.93 | 8.77 | 8.63 | 8.48 |
| Poland | 34.8 | 33.3 | 33.0 | 32.7 | 32.8 | 32.7 | 32.7 |
| Russia | 2.6 | 2.4 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| South Africa | 10.8 | 10.8 | 10.9 | 11.0 | 11.2 | 11.3 | 11.5 |
| Turkey | 53.1 | 51.4 | 50.5 | 50.2 | 50.6 | 51.0 | 51.3 |
| Brazil | 46.5 | 44.9 | 45.3 | 45.6 | 45.8 | 46.0 | 46.2 |
| Mexico | 8.7 | 8.9 | 9.2 | 9.4 | 9.6 | 9.8 | 10.0 |

Source: Citi Research

# Country Commentary

## United States

William Lee

Peter D'Antonio

Strengthening fundamentals and lower oil prices should help to bolster above-trend US growth in the near term. However, we have downgraded the underlying growth path to reflect incipient downside risks. In particular, as the US traded sector has doubled (to 30 percent of GDP) compared with its size in the 1980s, the US economy has become more vulnerable to weakness in global growth. Moreover, important economic relationships that have traditionally propelled consumption growth (e.g., the wealth effect) appear to have weakened after the 2008 Global Recession. Despite healthy gains in household net worth, consumption growth remains tepid. As noted by Chair Yellen, the economy has been unable to shake the headwinds that have hampered growth since the financial crisis. Residual uncertainty about the sustainability and potential robustness of the US expansion continues to dampen domestic spending compared with previous recoveries.

Nevertheless, we continue to project modest above-trend growth for the next two years, and a further decline in the unemployment rate toward the natural rate by end-2016. Combined with the drop in oil prices and an appreciating dollar, this implies modest and below-Fed-target inflation through most of 2017. Consequently, we have revised our forecast for the timing of the first policy rate increase to December 2015, and have moderated our projected pace of rate increases thereafter.

Economic fundamentals in the labor market and household balance sheets continue to support growth. Labor income has increased this year along with the pickup in payroll employment. Consumer deleveraging is largely complete, and remaining delinquent loans have become de minimis. With net worth growing rapidly as equity markets soar to new highs, we continue to hope for more support for consumption growth to materialize. Approximately two-thirds of the $15 trillion rise in household net worth since 2012 reflects rising equity prices, but the gains are unevenly distributed in favor of high-income households who have lower propensities to consume these gains. Such distributional factors along with higher post-2008 uncertainty-induced increases to precautionary saving seem likely to limit consumers from spending their wealth gains. In the very near term, we project a powerful boost to consumption from lower gasoline prices. We estimate a nearly $900 per household windfall gain that translates to temporarily stronger consumption mainly in the first quarter of 2015. Assuming half the windfall is spent, we estimate it would raise consumer spending growth to about 3½ percent in the first quarter.

The Federal budget deficit has declined dramatically in the past two years, but mainly because of cyclical influences. We project that fiscal policy will be neutral for US growth in the next year. We are concerned that there is little prospect for limiting mandatory entitlement spending, which would cause the deficit to resume growing as a share of GDP after 2015. A "trifecta" of looming fiscal issues will have to be addressed soon: (1) high and rising structural deficits; (2) high debt as a share of GDP; and (3) a dysfunctional political process unable to forge effective coalitions. State and local governments are no longer a drag to growth. Job openings and actual hires are rising as their fiscal and financial positions improve. Even California is now posting fiscal surpluses.

Beleaguered sectors earlier in the recovery no longer pose a drag on growth. Weakness in the housing sector is not from lack of demand, but because of supply constraints. Rapidly rising labor and material costs are limiting the supply of lower-cost housing. Also, tighter credit standards for borrowers, due to the Dodd-Frank legislation, limit mortgage credit availability, especially to first-time homebuyers.

Nevertheless, the housing market has been expanding in terms of construction, sales and prices. The multifamily market has been especially strong, as new demand drives up rents.

Business fixed investment (capex) has been mildly disappointing during this recovery, especially in light of historically high profit margins. Demand has been relatively soft and our downgrade of growth short-circuits the GDP accelerator driver for investment spending. Ultimately we project little material pickup for investment in the coming year.

We project moderate and below-Fed-target inflation for the next two years. Estimates of expected inflation are mixed: surveys show smaller declines in long-term expected inflation than market-based breakeven rates. We continue to believe inflation expectations remain well-anchored. There is general agreement that the slope of the Phillips curve is estimated to be very shallow. So even if economic slack were to be absorbed rapidly, wage pressures are likely to remain muted. Also, corporate profit margins are historically high and help buffer wage pressures from being passed through to prices.

Our Fed call has changed in the wake of the growing imbalance of downside risks to our economic outlook. We have decided to push back our forecast for the timing of the first policy rate increase to the December 2015 FOMC meeting. With inflation prospects expected to remain tepid through 2017, we now project a more moderate pace of rate increases that slows even further beyond 2016. We do not expect policy rate normalization until after 2018. FOMC members have emphasized that decisions about the pace of rate increases will depend on progress toward their objectives of full employment and 2 percent inflation. So the timing and pace of rate hikes is fluid and remains data dependent, in accordance with the Committee's carefully crafted symmetric policy reaction function.

**Figure 42. United States — Economic Forecasts, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3QF | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| GDP | SAAR | | | | 3.9 | 2.5 | 3.2 | 2.8 | 2.7 | 2.7 | 2.8 | 2.9 |
| | YoY | 2.3 | 3.0 | 2.8 | 2.4 | 2.2 | 3.5 | 3.1 | 2.8 | 2.8 | 2.7 | 2.8 |
| Domestic Demand | SAAR | | | | 3.2 | 2.1 | 3.1 | 3.0 | 2.8 | 2.9 | 2.9 | 2.8 |
| | YoY | 2.3 | 2.9 | 2.9 | 2.5 | 2.3 | 2.9 | 2.8 | 2.7 | 3.0 | 2.9 | 2.9 |
| Consumption | SAAR | | | | 2.2 | 2.5 | 3.4 | 3.1 | 2.8 | 2.7 | 2.8 | 2.6 |
| | YoY | 2.3 | 2.8 | 2.7 | 2.4 | 2.1 | 2.7 | 2.8 | 2.9 | 3.0 | 2.8 | 2.7 |
| Business Investment | SAAR | | | | 7.1 | 5.1 | 6.2 | 6.4 | 6.0 | 5.9 | 5.2 | 5.4 |
| | YoY | 6.1 | 6.3 | 5.6 | 7.2 | 5.8 | 7.0 | 6.2 | 5.9 | 6.1 | 5.9 | 5.6 |
| Housing Investment | SAAR | | | | 2.7 | 5.2 | 2.3 | 3.8 | 6.3 | 10.0 | 10.0 | 8.7 |
| | YoY | 1.6 | 4.5 | 8.4 | -0.8 | 2.7 | 4.7 | 3.5 | 4.4 | 5.6 | 7.5 | 8.7 |
| Government | SAAR | | | | 4.2 | -2.2 | 0.3 | 0.0 | 0.2 | 0.4 | 0.3 | 0.6 |
| | YoY | -0.2 | 0.3 | 0.4 | 0.3 | 0.7 | 1.0 | 0.5 | -0.4 | 0.2 | 0.2 | 0.4 |
| Exports | SAAR | | | | 4.9 | 3.7 | 4.2 | 4.0 | 4.3 | 4.2 | 3.8 | 4.4 |
| | YoY | 3.2 | 4.5 | 4.1 | 3.8 | 2.3 | 5.9 | 4.2 | 4.0 | 4.1 | 4.0 | 4.2 |
| Imports | SAAR | | | | -0.7 | 0.9 | 2.8 | 4.1 | 4.0 | 4.6 | 4.1 | 3.4 |
| | YoY | 3.4 | 3.0 | 3.8 | 3.4 | 3.3 | 3.5 | 1.7 | 2.9 | 3.9 | 4.2 | 4.0 |
| PCE Deflator | YoY | 1.4 | 1.4 | 1.8 | 1.5 | 1.3 | 1.4 | 1.2 | 1.4 | 1.7 | 1.8 | 1.8 |
| Core PCE Deflator | YoY | 1.4 | 1.7 | 1.8 | 1.5 | 1.5 | 1.6 | 1.6 | 1.7 | 1.8 | 1.8 | 1.8 |
| Unemployment Rate | % | 6.2 | 5.5 | 5.3 | 6.1 | 5.7 | 5.6 | 5.5 | 5.4 | 5.4 | 5.4 | 5.3 |
| Federal Gov't Balance (Fiscal Year) | $Bn | -483 | -450 | -550 | | | | | | | | |
| | % of GDP | -2.8 | -2.5 | -2.9 | | | | | | | | |
| General Gov't Balance (Cal Year) | % of GDP | -4.4 | -4.1 | -4.5 | | | | | | | | |
| Federal Debt | % of GDP | 73 | 73 | 73 | | | | | | | | |
| General Gov't Debt | % of GDP | 106 | 106 | 106 | | | | | | | | |
| Current Account | US$bn | -388 | -217 | -153 | -439 | -311 | -249 | -222 | -200 | -196 | -179 | -160 |
| | % of GDP | -2.2 | -1.2 | -0.8 | -2.5 | -1.7 | -1.4 | -1.2 | -1.1 | -1.1 | -0.9 | -0.8 |
| S&P 500 Profits (US$ Per Share) | YoY | 8.0 | 6.9 | NA | 8.1 | 8.7 | 6.8 | 5.6 | 6.0 | 9.2 | NA | NA |

Notes: F Citi forecast. E Citi Estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. Domestic demand excludes inventories and net exports.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, I/B/E/S, Treasury Department, *Wall Street Journal* and Citi Research forecasts

## Japan

Kiichi Murashima

Naoki Iizuka

We are revising Japan's economic outlook in a meaningful manner at this forecast round, mostly reflecting PM Abe's decision to delay the additional consumption tax hike (originally scheduled for October 2015) until April 2017. The economy is likely to achieve above-trend growth in the years to come, in part thanks to postponement of sharp fiscal tightening. Meanwhile, the recent declines in oil prices, if sustained, will have a significant negative impact on the CPI in coming quarters. We expect core inflation (excluding just fresh food) will undershoot the Bank of Japan's (BoJ) bullish forecasts with a wide margin in 2015, barring a sharp rebound in oil prices and expect this will prompt policymakers to implement additional easing measures. Given the scale of the BoJ's balance sheet expansion, the eventual exit from the unprecedented QE might be quite tricky and may pose a significant risk to financial markets over the medium- to long-term, in our view.

On November 18, PM Abe officially decided to delay the second consumption tax hike until April 2017 and to hold a snap election (i.e., lower house elections) on December 14th. The negative impact from the tax hike in April 2014 was much larger and more protracted than the government had expected, as is clearly shown by the negative GDP growth data for Q2 and Q3. PM Abe is concerned that another tax hike just 18 months after the first hike might make his eventual goal of eradicating deflation clearly unattainable.

Reflecting this announcement, we are upgrading our GDP growth profile for late 2015 and beyond. Previously, we expected that the payback to frontloaded demand ahead of the tax hike, plus a more permanent impact from the decline in real income, would weigh on household spending materially in Q4-2015 and beyond. However, we now anticipate a much smoother growth path of roughly +1.5-2% QoQ SAAR. Moreover, a prospect of more stable and higher growth may have some positive impact on business investment, especially at small firms and non-manufacturers.

The better growth also should be fundamentally positive for an inflation outlook. However, the near-term inflation outlook will likely be dominated by the recent sharp declines in oil prices. Under the assumption that oil prices continue to hover at around $80 per barrel and USDJPY goes up Y120 early next year, we estimate that contributions of energy (i.e., petroleum product, electricity and gas) to year-on-year changes in the core CPI will turn negative next spring versus +0.2 percentage points in the September data. Hence, unless core inflation excluding energy unexpectedly picks up sharply, overall core inflation will likely decline in coming quarters. We expect core inflation of just +0.8% YoY (adjusted for the impact from the tax hike) in 2015. Lower oil prices will likely support consumer spending by increasing the real purchasing power of household nominal income.

Meanwhile, the next round of the spring wage negotiation will be the important key for the inflation outlook. While large companies are likely to increase base salaries at a faster pace than this spring in part thanks to strong profit growth, growth in nationwide wages will probably continue to be subdued. First, under Japan's life-time employment system where each employee can enjoy a pay rise as the seniority goes up, employees have less incentive to leave the firm and as a result, companies have less incentive to hike base salaries apart from the seniority-based hike. Second, small firms, who are suffering from the negative impact from yen depreciation and the tax hike, will probably continue to hesitate to lift base salaries.

The BoJ unexpectedly eased monetary policy on 31 October. According to the BoJ, policymakers dealt with the rising risk that the oil-driven drop in inflation will push

inflation expectations lower again. However, given that the BoJ's core inflation forecast of +1.7% YoY for fiscal 2015 is predicated on higher oil prices, the BoJ will probably need to ease further in 2015 if as we anticipate, oil prices remain flattish into 2015. We currently expect additional BoJ easing in July 2015 in the form of increased purchases of risk assets and possibly JGBs. Assuming that the BoJ maintains the current pace of asset purchases in years to come, the BoJ's holding of JGBs will reach Y280 trillion at end-2015 (57% of GDP) and Y360 trillion at end-2016 (71%), which is unprecedented territory. We are sceptical that the 2% inflation target will be met in the foreseeable future on a sustained basis. And, at some point, the difficulties in making further large-scale JGB purchases from Japanese banks (who may need a certain amount of JGBs as collateral for transactions) plus a sense of fatalism about the extent to which QE can help achieve the 2% inflation target, might prompt the BoJ to taper bond purchases. But that time is probably distant at present, and in any case the BoJ would still have options to buy other assets (eg ETFs).

The outlook for structural reforms remains unclear even after two years after the inauguration of the Abe administration. For example, the fundamental question remains unanswered whether the government can really achieve its goal of maintaining the total population at 100 million in 2060 without an easier immigration policy. The LDP appears likely to win the upcoming elections on December 14th, but we remain sceptical that the LDP's victory will prompt bolder structural reforms including labour market reform over the near-term. Meanwhile, the Abe administration will have to show a more compelling fiscal reform plan in the not-too-distant future. On balance, the BoJ's unprecedented monetary accommodation, along with a relatively favourable growth outlook, is likely to push up Japan's asset prices (including equities) in 2015, in our view. Meanwhile, JGB yields will probably remain super-low thanks to the BoJ's huge JGB purchase operation, despite the weak fiscal outlook.

**Figure 43. Japan — Economic Forecasts, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3Q | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| Real GDP | YoY | 0.3 | 0.9 | 1.8 | -1.1 | -0.2 | -1.3 | 1.0 | 2.0 | 1.9 | 1.9 | 1.8 |
| | SAAR | | | | -1.6 | 1.9 | 2.0 | 1.9 | 2.3 | 1.4 | 1.9 | 1.7 |
| Domestic Demand | YoY | 0.3 | 0.5 | 1.7 | -1.4 | -1.1 | -2.4 | 1.0 | 1.9 | 1.8 | 1.7 | 1.7 |
| | SAAR | | | | -1.6 | 1.7 | 2.1 | 1.8 | 2.0 | 1.1 | 1.8 | 1.9 |
| Private Consumption | YoY | -1.0 | 0.5 | 1.5 | -2.6 | -2.1 | -3.6 | 2.0 | 2.1 | 1.9 | 1.6 | 1.5 |
| | SAAR | | | | 1.5 | 1.9 | 2.6 | 2.1 | 1.7 | 1.3 | 1.4 | 1.7 |
| Business Investment | YoY | 5.3 | 1.9 | 3.9 | 2.9 | 3.4 | -3.1 | 2.8 | 4.2 | 3.9 | 4.3 | 4.1 |
| | SAAR | | | | -0.9 | 5.0 | 3.3 | 4.0 | 4.5 | 3.9 | 4.7 | 3.4 |
| Housing Investment | YoY | -4.8 | -4.0 | 4.1 | -12.1 | -15.7 | -16.9 | -5.7 | 3.2 | 6.2 | 5.7 | 4.4 |
| Public Investment | YoY | 4.4 | -4.3 | -3.5 | 2.1 | -1.0 | -1.0 | -3.5 | -5.5 | -7.0 | -6.0 | -5.0 |
| Exports | YoY | 7.7 | 3.8 | 3.7 | 7.5 | 8.7 | 3.0 | 4.3 | 4.0 | 4.0 | 4.2 | 4.0 |
| | SAAR | | | | 5.3 | 5.4 | 3.4 | 3.0 | 4.3 | 5.4 | 4.3 | 2.1 |
| Imports | YoY | 7.0 | 2.0 | 3.4 | 5.0 | 2.5 | -2.5 | 3.8 | 3.7 | 3.3 | 3.3 | 3.6 |
| | SAAR | | | | 3.1 | 5.1 | 4.2 | 2.7 | 2.9 | 3.6 | 3.9 | 3.9 |
| CPI | YoY | 2.9 | 1.4 | 1.1 | 3.3 | 3.0 | 3.1 | 0.9 | 0.8 | 0.9 | 0.9 | 1.0 |
| Core CPI | YoY | 2.7 | 1.3 | 1.1 | 3.2 | 2.9 | 2.9 | 0.7 | 0.8 | 0.9 | 0.9 | 1.0 |
| Nominal GDP | YoY | 2.1 | 1.5 | 2.3 | -0.8 | 0.6 | 0.7 | 0.9 | 0.5 | 0.6 | 0.7 | 0.5 |
| Current Account | ¥ tn | 0.7 | 3.5 | 2.1 | 1.4 | 4.3 | 3.8 | 3.5 | 3.4 | 3.4 | 3.0 | 2.2 |
| | % of GDP | 0.1 | 0.7 | 0.4 | 0.3 | 0.9 | 0.8 | 0.7 | 0.7 | 0.7 | 0.6 | 0.4 |
| Unemployment Rate | % | 3.6 | 3.5 | 3.3 | 3.6 | 3.6 | 3.6 | 3.5 | 3.5 | 3.4 | 3.4 | 3.3 |
| Industrial Production | YoY | 1.6 | 0.2 | 2.7 | -1.0 | -3.0 | -4.9 | -0.2 | 2.6 | 3.5 | 3.3 | 2.8 |
| Corporate Profits (Fiscal Year) | YoY | 12.5 | 12.5 | 20.0 | | | | | | | | |
| General Govt. Balance (Fiscal Year) | % of GDP | -8.0 | -6.5 | -6.4 | | | | | | | | |
| General Govt Debt | % of GDP | 243 | 247 | 249 | | | | | | | | |

F Citigroup forecast. SAAR Seasonally adjusted annual rate. YoY Year-to-year percent change. Corporate profits are TSE-I nonfinancials consolidated recurring profits. Source: Citi Research

## Euro Area

Guillaume Menuet

Ebrahim Rahbari

Antonio Montilla

Euro area GDP rose by 0.2% QQ in 3Q after a 0.1% QQ gain in Q2, allaying fears of renewed recession. But the overall picture remains fragile: business sentiment surveys suggest that economic activity is likely to remain subdued and uneven, while the continued focus on budgetary consolidation in member states whose deficit exceeds the medium-term objective means that fiscal support will be negligible. Stronger domestic demand dynamics in countries where structural reforms have been the most ambitious should support GDP growth in coming years. Yet, very few jobs are being created across the euro area and uncertainties pertaining to the strength of external demand will likely translate into a very slow recovery in business investment. We forecast that GDP growth will accelerate slightly from 0.8% in 2014 to 1.1% in 2015 and 1.6% in 2016. This forecast is based on the assumption that the ECB will ease further and that the euro will weaken significantly, hence lifting exports despite sluggish import growth in key trading partners. We expect the Governing Council (GC) to embark on a QE programme in Q1-15 but possibly as early as in Dec-14 if there were to be enough evidence of a noticeable fall in medium-term inflation expectations.

One of the key uncertainties going into 2015 is how the euro area economy and ultimately the ECB will react to the fall in oil prices. Falling oil prices should boost employment and private consumption, as well as non-financial corporate profits for the Eurozone, which is a net oil importer. But the fall in the price of oil also lowers inflation and raises the risk that inflation expectations may become dis-anchored. Hence, the significant downward impact of lower oil prices (and energy prices) on the euro area HICP rate will likely exacerbate concerns for many GC members who have been highlighting the dangers of persistent 'low-flation'.

We estimate that euro area inflation will remain below 1% until Q4 2015, and is unlikely to move much above 1.5% until Q1 2016. This rebound is likely to be transitory, reflecting a much lower EUR/USD trajectory – which we expect to reach parity 2-3 years ahead. One important aspect of this persistently subdued inflation trajectory is the likelihood of muted underlying inflationary pressures, given the persistence of a wide output gap, and the lagged effect of the appreciation of the euro between July-2012 and the spring of 2014. As a result, we estimate that core inflation (excluding unprocessed food and energy) will likely stay very low, increasing from 0.8% in 2015 to 0.9% in 2016 and 1.1% in 2017. We believe that risks are probably skewed to the downside and that this assessment is also beginning to be shared more widely by the GC. In the November bulletin, the ECB devoted a box to recent revisions to projections of euro area HICP inflation, noting that "*uncertainties associated with the measurement and impact of economic slack, may also have played a role. In this context, structural reforms and increased competition may have exerted downward pressure on prices through a greater responsiveness to economic slack*".

The ECB GC sent a clear dovish signal to investors at the November press conference about the importance of balance sheet targeting. President Mario Draghi highlighted two contingencies for action: i) a weak macroeconomic profile and ii) failure of previous measures (to reach the balance sheet target). The GC also highlighted a greater degree of urgency about the need to monitor the monetary policy stance, asking the Staff to prepare additional policy measures in a timely manner. We believe that both the inflation and balance sheet contingencies will likely be triggered soon, and estimate that a majority of GC members would favour additional policy action. Indeed, we believe that the doves and the neutrals already currently outnumber the hawks, whose numbers will likely diminish as 'low-flation' persists.

A key obstacle to QE is likely to be Germany. The euro area's largest economy's influence over ECB decisions probably exceeds its share of GC votes. And the Bundesbank is not alone in expressing concerns about large-scale purchases of government bonds, considering those to be unnecessary, ineffective and potentially harmful. We nevertheless believe that this opposition is not unconditional and will probably be lessened over time by continued inflation undershoots and the preference by some of the budgetary hawks for monetary stimulus over fiscal easing. We argue that the Bundesbank and the German government would likely avoid a public confrontation with the ECB, partly for fears of stoking euroscepticism. Note that legal concerns will not be a major impediment to a decision to start buying government bonds, in our view. This is because the concerns the German Constitutional Court has raised about the Outright Monetary Transactions (OMT) – and which the ECJ may or may not share – apply to aspects of the OMT which are not essential for a 'plain vanilla' QE program. It is also possible that the upcoming ruling of the European Court of Justice (ECJ) around mid-January could even reduce the legal uncertainty over potential QE purchases.

Following President Draghi's Frankfurt speech on Nov 21, we remain convinced that ECB QE is only a matter of time. We still think that the GC is more likely to make a formal announcement at the Jan 22 meeting (note the new 2015 meeting schedule) although weak inflation data and expectations could still trigger a Dec 4 decision. Alternatively, a successful implementation of the private sector asset purchase programme, perhaps supplemented by non-financial corporate bonds, could enable the GC to wait until March 5. A key uncertainty remains whether the GC will be successful with its first QE attempt whereas it took a number of iterations for many central banks to deliver the appropriate stimulus their economies required. Our QE baseline contains €600bn of government bond purchases over 12 months, supplementing €400bn of private sector asset purchases to reach the €1tn target, alongside a generous €500bn of TLTROs. Despite these assumptions, our central projection does not envisage headline inflation reaching the ECB's target over the forecast horizon. As a result, we argue that further rounds of QE could very well be on the ECB's mind at some stage during the second half of 2016.

**Figure 44. Euro Area — Economic Forecasts, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3QF | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| Real GDP | YoY | 0.8 | 1.1 | 1.6 | 0.8 | 0.6 | 0.7 | 0.9 | 1.2 | 1.5 | 1.5 | 1.6 |
| | SAAR | | | | 0.6 | 0.5 | 1.3 | 1.3 | 1.6 | 1.8 | 1.5 | 1.7 |
| Final Domestic Demand | YoY | 0.7 | 1.0 | 1.3 | 0.6 | 0.6 | 0.6 | 1.0 | 1.1 | 1.3 | 1.4 | 1.3 |
| Private Consumption | YoY | 0.7 | 1.2 | 1.3 | 0.8 | 1.0 | 1.1 | 1.2 | 1.1 | 1.2 | 1.2 | 1.3 |
| Government Consumption | YoY | 0.8 | 0.7 | 0.5 | 0.9 | 0.9 | 0.4 | 0.7 | 0.7 | 1.1 | 1.0 | 0.6 |
| Fixed Investment | YoY | 0.3 | 0.9 | 2.4 | -0.3 | -0.7 | -0.6 | 0.8 | 1.5 | 1.9 | 2.2 | 2.3 |
| Business Equipment | YoY | 1.1 | 1.0 | 2.4 | 0.7 | -0.2 | 0.1 | 0.7 | 1.5 | 1.8 | 2.1 | 2.3 |
| Construction | YoY | -0.7 | 0.7 | 2.4 | -1.5 | -1.5 | -1.6 | 1.0 | 1.6 | 2.0 | 2.3 | 2.4 |
| Stocks (Contrib. to Y/Y GDP Growth) | | 0.1 | 0.1 | 0.0 | -0.1 | 0.1 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 |
| Exports | YoY | 3.4 | 3.2 | 3.9 | 3.6 | 3.0 | 3.5 | 3.0 | 3.1 | 3.4 | 3.4 | 3.7 |
| Imports | YoY | 3.6 | 3.5 | 3.4 | 3.3 | 3.5 | 3.8 | 3.4 | 3.3 | 3.5 | 3.3 | 3.2 |
| CPI | YoY | 0.5 | 0.8 | 1.5 | 0.4 | 0.3 | 0.3 | 0.6 | 0.8 | 1.3 | 1.5 | 1.5 |
| CPI Ex Unprocessed Food & Energy | YoY | 0.9 | 0.8 | 0.9 | 0.9 | 0.7 | 0.7 | 0.7 | 0.7 | 0.9 | 0.9 | 1.0 |
| Unemployment Rate | YoY | 11.5 | 11.2 | 10.5 | 11.2 | 11.4 | 11.9 | 11.1 | 10.9 | 11.0 | 11.3 | 10.5 |
| Current Account Balance | €bn | 272.0 | 301.4 | 294.9 | | | | | | | | |
| | % of GDP | 2.7 | 3.0 | 2.8 | | | | | | | | |
| General Government Balance | €bn | -254.2 | -239.5 | -201.4 | | | | | | | | |
| | % of GDP | -2.5 | -2.3 | -1.9 | | | | | | | | |
| Primary Balance | % of GDP | 0.3 | 0.6 | 1.0 | | | | | | | | |
| General Government Debt | €bn | 9,593.4 | 9,812.4 | 10,013.9 | | | | | | | | |
| | % of GDP | 95.4 | 96.1 | 95.7 | | | | | | | | |
| Gross Operating Surplus | YoY | 1.5 | 1.4 | 2.2 | | | | | | | | |

We publish further details of our European forecasts monthly in European Economic Forecast Highlights. Sources: Eurostat and Citi Research

## Germany

Ebrahim Rahbari

We expect growth of about 1.1% for 2015 and 1.6% for 2016 after roughly 1.5% growth in 2014, and have again revised down our forecasts for coming years. Domestically-driven growth remains well supported by very low unemployment, rising real wages, strong financial conditions and the robust housing sector, although private consumption has been weaker than we had expected. Meanwhile, we expect external headwinds to persist, also hitting business investment. German inflation has been only about 0.9% in 2014, and is likely to remain very subdued in 2015, at about 1.1% with a gradual pickup (reflecting expected currency weakness) to about 1.8% in 2016.

## France

Guillaume Menuet

The French economy is growing very slowly, but has outpaced Germany on average in the last couple of quarters. However, part of the upside surprise stemmed from a noticeable increase in government expenditure and inventories that will probably not be repeated in Q4. Together with a probable further slowdown in corporate investment to reflect the recent falls in business confidence, we expect Q4 GDP growth to be close to zero. Prospects for 2015 do not look great, although GDP growth might improve slightly provided that the government delivers on its structural reform agenda and gives clear guarantees that the tax burden will not rise further. The low inflation environment will make it hard for the government to hit its budget deficit targets, likely resulting in another overshoot.

## Italy

Guillaume Menuet

Antonio Montilla

The Q3 real GDP data confirmed that the Italian economy fell back into yet another recession, and we expect GDP in Q4 to keep falling. Economic weakness continues to be driven by falling private investment, on the back of tight financial conditions, poor confidence levels, and relatively weak external competitiveness. Nevertheless, we expect export growth to benefit from a weaker euro in 2015-16, which together with some normalisation in financial conditions (stemming from ECB QE) and a more supportive fiscal policy should generate a modest rise in domestic demand. We expect the government to overshoot its recently-revised fiscal deficit target in 2015, and we see the public debt-to-GDP ratio peaking only in 2015-16.

**Figure 45. Germany, France and Italy — Economic Forecasts, 2014-16F**

| | | Germany | | | France | | | Italy | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 1.5 | 1.1 | 1.6 | 0.3 | 0.7 | 1.6 | -0.4 | 0.3 | 1.0 |
| Final Domestic Demand | YoY | 1.5 | 1.4 | 1.7 | 0.3 | 0.6 | 1.3 | -0.4 | 0.3 | 0.6 |
| Private Consumption | YoY | 1.1 | 1.5 | 1.6 | 0.3 | 0.8 | 1.4 | 0.2 | 0.6 | 0.5 |
| Government Consumption | YoY | 1.2 | 1.5 | 1.5 | 1.9 | 1.3 | 0.1 | -0.3 | -0.3 | -0.2 |
| Fixed Investment | YoY | 2.9 | 0.9 | 2.4 | -1.7 | -0.7 | 2.3 | -2.6 | 0.0 | 1.8 |
| Exports | YoY | 3.7 | 2.8 | 2.4 | 2.0 | 2.4 | 3.8 | 1.7 | 2.6 | 3.7 |
| Imports | YoY | 3.6 | 4.0 | 3.2 | 2.9 | 2.1 | 2.3 | 1.1 | 2.6 | 2.4 |
| CPI | YoY | 0.9 | 1.1 | 1.8 | 0.6 | 0.9 | 1.7 | 0.2 | 0.5 | 1.1 |
| Unemployment Rate | % | 5.0 | 5.0 | 5.0 | 9.8 | 10.0 | 9.7 | 12.5 | 12.4 | 12.0 |
| Current Account | €bn | 210.5 | 222.8 | 203.4 | -13.3 | -0.1 | 10.7 | 25.6 | 26.8 | 27.6 |
| | % of GDP | 7.4 | 7.7 | 6.7 | -0.6 | 0.0 | 0.5 | 1.6 | 1.6 | 1.7 |
| General Govt. Balance | €bn | 8.3 | 5.2 | -0.3 | -89.8 | -88.9 | -80.3 | -48.9 | -48.4 | -35.7 |
| | % of GDP | 0.3 | 0.2 | 0.0 | -4.3 | -4.2 | -3.7 | -3.0 | -3.0 | -2.2 |
| Primary Balance | % of GDP | 2.2 | 2.0 | 1.6 | -2.0 | -2.0 | -1.5 | 1.7 | 1.4 | 2.0 |
| General Govt. Debt | % of GDP | 76.0 | 73.8 | 70.3 | 98.5 | 101.2 | 101.7 | 131.4 | 133.1 | 132.8 |
| Gross Trading Profits | YoY | 1.1 | 0.5 | 2.5 | 1.9 | 3.6 | 4.5 | NA | NA | NA |

F Citi forecast. YoY Year-to-year growth rate. Note: The German annual figures are derived from quarterly Bundesbank data and adjusted for working days. Forecasts for GDP and its components are calendar adjusted. Sources: Deutsche Bundesbank, Statistisches Bundesamt, INSEE, ISTAT and Citi Research

## Spain

Antonio Montilla

We expect the Spanish economic recovery to strengthen in 2015-17, given the more supportive fiscal policy backdrop, high confidence levels, improving jobs market, and less-tight financial conditions. Export growth should benefit from further competitiveness gains and a weaker euro. Yet, political uncertainties are likely to rise in the run-up to parliamentary elections due in autumn 2015, with an increasing probability of a fragmented political environment (i.e. no government majority) and therefore a scenario of political inaction. We expect the government to overshoot its fiscal deficit targets in coming years.

## Greece

Ebrahim Rahbari

Recent revisions imply that Greek growth (YY%) was positive in Q2 for the first time since Q2 2008 and Q3 growth was almost 3% SAAR, boosted by a strong tourism season. We expect tourism to be a major driver of the growth of 1.5% in 2015 and 1.7% in 2016 (after 0.8% growth in 2014). The major risk in the outlook come from upcoming political events, including uncertainty about a follow-up arrangement to Greece's ending bailout programme, a potential early election in the spring of 2014 and the risk of a Syriza-led government.

## Ireland

Michael Saunders

The "Celtic Tiger" is back. Ireland's economy roared back in 2014, with GDP growth of about 5% YoY, driven by the sharp rise in industrial production in hi-tech and export-related sectors. We do not expect growth to be quite so strong in 2015, but do expect that the combination of the sharp decline in unit labour costs, and solid growth in key export markets in the US and UK, will produce continued rapid growth and set the public debt/GDP ratio on a clear downward trend.

## Portugal

Antonio Montilla

We expect real GDP growth to pick up to about 1.5% in 2015 and 2% in 2016, driven by rising domestic demand and some acceleration in export growth. The pace of reduction in the budget deficit is likely to be smaller than the government's official targets but, with the debt-to-GDP ratio probably peaking in 2014, this will probably not create too many concerns among Portugal's creditors. Politics are likely to remain a key focus in the run-up to the national elections in Oct-15, with polls suggesting a change at the government through a shift to the left.

**Figure 46. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2014-16F**

| | | Spain | | | Greece | | | Ireland | | | Portugal | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 1.3 | 2.0 | 2.1 | 0.8 | 1.5 | 1.7 | 5.5 | 4.4 | 5.2 | 0.8 | 1.5 | 2.0 |
| Final Domestic Demand | YoY | 1.6 | 2.0 | 1.9 | -0.4 | 0.9 | 1.3 | 2.5 | 2.2 | 3.2 | 1.2 | 1.4 | 1.6 |
| Private Consumption | YoY | 2.2 | 2.1 | 2.0 | 0.3 | 0.8 | 0.9 | 1.1 | 1.6 | 2.1 | 1.6 | 1.7 | 1.8 |
| Government Consumption | YoY | 0.5 | 0.5 | 0.5 | -0.7 | 0.2 | 0.3 | 1.3 | -2.5 | 0.3 | 0.0 | -0.4 | 0.2 |
| Fixed Investment | YoY | 0.9 | 3.2 | 3.2 | -4.3 | 3.5 | 5.4 | 8.2 | 8.2 | 8.7 | 0.9 | 2.4 | 2.4 |
| Exports | YoY | 3.7 | 5.7 | 5.4 | 10.2 | 5.6 | 4.4 | 10.0 | 5.4 | 7.2 | 2.4 | 4.2 | 6.1 |
| Imports | YoY | 5.3 | 6.3 | 4.8 | 7.4 | 2.9 | 3.1 | 8.1 | 3.9 | 6.1 | 5.3 | 3.1 | 5.0 |
| CPI | YoY | -0.1 | 0.2 | 0.7 | -1.3 | -1.3 | 0.1 | 0.4 | 1.0 | 1.1 | -0.1 | 0.2 | 0.7 |
| Unemployment Rate | % | 24.5 | 22.9 | 21.5 | 26.7 | 25.6 | 24.7 | 11.4 | 10.2 | 9.3 | 13.8 | 12.4 | 11.7 |
| Current Account | €bn | -0.7 | 5.0 | 5.7 | 2.5 | 1.9 | 1.9 | 7.3 | 7.5 | 8.7 | 0.9 | 1.2 | 1.6 |
| | % of GDP | -0.1 | 0.5 | 0.5 | 1.4 | 1.1 | 1.1 | 4.0 | 3.8 | 4.2 | 0.5 | 0.7 | 0.9 |
| General Govt. Balance | €bn | -57.7 | -49.7 | -39.8 | -3.4 | -3.7 | -3.3 | -6.6 | -4.8 | -2.7 | -7.1 | -5.7 | -4.7 |
| | % of GDP | -5.6 | -4.7 | -3.7 | -1.9 | -2.1 | -1.8 | -3.6 | -2.4 | -1.3 | -4.3 | -3.4 | -2.7 |
| Primary Balance | % of GDP | -2.3 | -1.6 | -0.7 | 2.1 | 1.9 | 2.2 | 0.5 | 1.3 | 2.4 | 0.9 | 2.0 | 2.5 |
| General Govt. Debt | % of GDP | 99.6 | 102.0 | 102.7 | 178.4 | 179.2 | 177.6 | 109.7 | 107.2 | 101.1 | 139.3 | 137.9 | 135.8 |

Note: Spain forecast is not updated for the ESS-2010 data released on 27 November 2014. Source: Citi Research

## Netherlands

**Guillaume Menuet**

If, as we expect, EUR/USD depreciates to around parity by the end of 2016, then the Netherlands — as a small but open economy — is likely to benefit. As a result, we expect some acceleration in economic growth in 2015-16. However, some noticeable headwinds will persist, and ongoing private sector deleveraging plus fiscal consolidation are likely to limit the recovery in private consumption.

## Belgium

**Guillaume Menuet**

We look for a very gradual upturn in Belgian GDP growth in 2015. In light of significant street protests against the government's focus on delivering reforms, we believe that consumer spending will not grow much in the next few quarters, despite some windfall gains from lower oil prices. While the PM's plans to increase the legal retirement age, skipping automatic wage indexation and impose spending cuts focused on public administration and health care should benefit Belgium over the medium term, in the short term these measures may hurt growth.

## Slovakia

**Jaromir Sindel**

We are lifting our 2014 GDP outlook by 0.1 percentage point to 2.4% due to stronger GDP in 3Q14, but cutting our 2015 forecast by 0.1pp to 2.5%. Overall, we continue to expect domestic demand to support GDP growth in 2015 due to the improving labour market and larger fiscal buffer for 2015. However, risks to our outlook are skewed to the downside for 2015, focused in particular on external demand and the large errors in the balance of payments data. While we do not expect major political changes, the left-wing SMER-SD party is unlikely to be able to form another one-party majority government after the elections in March 2016.

## Slovenia

**Jaromir Sindel**

We expect little change in growth in 2015. The outlook for export demand is weaker than before, but remains underpinned by Slovenia's better export competitiveness. This should support further, though probably modest, improvements in the labour market. Gains in jobs, low inflation and reduced fiscal drag are likely to also support domestic demand. However, we forecast construction to be less supportive and banking sector resolution will remain a headwind for recovery. We expect privatizations to continue slowly and the current government to stay in power.

**Figure 47. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2014-16F**

| | | Netherlands | | | Belgium | | | Slovakia | | | Slovenia | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 0.7 | 1.3 | 1.7 | 0.9 | 1.0 | 1.6 | 2.4 | 2.5 | 3.1 | 2.5 | 1.6 | 2.3 |
| Final Domestic Demand | YoY | 0.4 | 0.7 | 0.9 | 1.1 | 0.9 | 1.3 | 4.0 | 2.5 | 2.8 | 1.1 | 1.1 | 1.5 |
| Private Consumption | YoY | -0.1 | 0.6 | 0.8 | 0.6 | 0.6 | 1.0 | 2.8 | 2.0 | 2.4 | 0.5 | 1.1 | 1.3 |
| Government Consumption | YoY | 0.1 | 0.0 | 0.3 | 0.3 | 0.5 | 0.9 | 3.8 | 2.5 | 1.9 | -1.2 | -0.3 | -0.8 |
| Investment (Ex Stocks) | YoY | 1.6 | 1.7 | 2.1 | 2.9 | 2.0 | 2.6 | 7.1 | 3.8 | 4.6 | 4.8 | 1.6 | 3.7 |
| Exports | YoY | 4.0 | 3.1 | 3.4 | 2.9 | 3.7 | 4.1 | 5.5 | 4.9 | 7.3 | 5.0 | 7.5 | 7.6 |
| Imports | YoY | 4.0 | 2.8 | 2.8 | 2.0 | 3.8 | 3.8 | 7.2 | 5.8 | 7.6 | 4.3 | 6.9 | 7.2 |
| CPI (Average) | YoY | 0.4 | 0.9 | 1.5 | 0.6 | 1.1 | 1.7 | -0.1 | 1.1 | 2.3 | 0.1 | 0.2 | 2.5 |
| Unemployment Rate | % | 8.3 | 7.9 | 7.4 | 8.5 | 8.5 | 8.2 | 12.8 | 12.1 | 11.4 | 9.6 | 9.2 | 8.8 |
| Current Account | % of GDP | 10.8 | 9.6 | 9.1 | -0.6 | -0.1 | 0.3 | 1.5 | 0.5 | 0.5 | 3.4 | 4.3 | 4.5 |
| General Govt Balance | % of GDP | -2.0 | -1.8 | -1.7 | -3.0 | -2.8 | -2.7 | -2.9 | -2.8 | -2.1 | -4.2 | -2.9 | -2.5 |
| Primary Balance | % of GDP | -0.3 | -0.2 | -0.2 | 0.3 | 0.4 | 0.4 | -2.1 | -1.8 | -1.2 | -1.3 | -0.1 | 0.5 |
| General Govt Debt | % of GDP | 73.8 | 73.5 | 72.9 | 109.6 | 110.2 | 109.4 | 54.5 | 54.3 | 52.1 | 82.2 | 81.0 | 78.9 |

F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Research forecasts

## United Kingdom

Michael Saunders

The UK outlook is a mix of strong growth, low inflation, large twin deficits and rising political risks. Our base case is for real GDP growth of about 3% YoY in 2015 and CPI inflation of about 1.3%, and, compared to the last GEOS, we are cutting 0.2 percent off our 2015 forecasts for both growth and inflation. This leaves us with a growth forecast above consensus (2.6%) and an inflation forecast below consensus (1.6%). Private sector balance sheets have improved significantly, monetary policy is very loose, fiscal policy is not exerting a significant drag and supply-side conditions remain favourable. The ONS report that corporate profitability (ie the net return on capital for the nonoil sector) is the highest since 1998. Moreover, weakness in commodity prices is creating powerful disinflationary forces for the UK (and other advanced economies) that will help lift real incomes. Household real wage and salary income growth has picked up sharply, and we expect real disposable income growth of roughly 3% YoY in 2015, the highest since 2001.

The main uncertainties in the outlook are downside external growth risks, coupled with the UK's twin deficits and political risks. The fiscal deficit is overshooting official forecasts sharply, with revenues undershooting due to weakness in average earnings and the reduction in the tax burden at the low end of the income scale. We doubt the government will seek to correct this shortfall, implying a longer period with relatively high deficits in coming years. The UK general election (May 2015) seems likely to produce a "doubly hung" parliament, that is one in which no single party or even a two-party coalition could achieve a majority. Such an outcome may lead to a relatively-fragile multi-party coalition, or a period with a weak minority government — probably making it harder to implement fiscal consolidation. Further ahead, uncertainties over a possible Brexit referendum may start to weigh on business confidence in 2016-17.

**Figure 48. United Kingdom — Economic Forecasts, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3Q | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| Real GDP | YoY | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 | 3.2 | 2.8 | 3.0 | 3.1 | 2.9 | 3.0 |
| | SAAR | | | | 2.7 | 2.7 | 3.4 | 2.5 | 3.4 | 3.1 | 2.5 | 3.2 |
| Domestic Demand | YoY | 3.1 | 3.5 | 3.2 | 2.5 | 2.8 | 3.7 | 3.6 | 3.3 | 3.7 | 3.3 | 3.2 |
| (Incl. Inventories) | SAAR | | | | 4.9 | 1.9 | 4.0 | 3.4 | 3.7 | 3.4 | 2.6 | 3.2 |
| Private Consumption | YoY | 2.3 | 3.4 | 3.3 | 2.4 | 3.0 | 3.2 | 3.5 | 3.5 | 3.4 | 3.4 | 3.3 |
| | SAAR | | | | 3.3 | 3.5 | 3.7 | 3.5 | 3.4 | 3.1 | 3.6 | 3.3 |
| Government Consumption | YoY | 1.6 | 0.6 | -1.0 | 1.7 | 1.9 | 2.2 | 1.1 | -0.2 | -0.5 | -0.8 | -0.9 |
| | SAAR | | | | 4.5 | 0.4 | -0.1 | -0.5 | -0.5 | -1.0 | -1.0 | -1.0 |
| Investment | YoY | 8.0 | 8.9 | 9.0 | 7.1 | 7.6 | 7.7 | 8.5 | 9.9 | 9.5 | 9.5 | 9.4 |
| | SAAR | | | | 4.0 | 11.7 | 10.4 | 8.0 | 9.6 | 9.9 | 10.7 | 7.6 |
| Exports | YoY | -1.2 | 3.2 | 4.6 | -1.0 | 0.9 | 2.1 | 2.9 | 4.5 | 3.3 | 3.6 | 4.6 |
| | SAAR | | | | -1.6 | 8.6 | 3.5 | 1.3 | 4.6 | 3.9 | 4.7 | 5.4 |
| Imports | YoY | -0.7 | 5.1 | 5.3 | -2.4 | 0.4 | 4.0 | 5.4 | 5.5 | 5.4 | 5.2 | 5.4 |
| | SAAR | | | | 5.5 | 5.7 | 6.0 | 4.6 | 5.8 | 5.3 | 5.0 | 5.5 |
| Unemployment Rate | % | 6.2 | 5.4 | 4.6 | 6.0 | 5.7 | 5.6 | 5.5 | 5.3 | 5.1 | 4.9 | 4.7 |
| CPI Inflation | YoY | 1.5 | 1.3 | 2.0 | 1.5 | 1.1 | 1.0 | 1.1 | 1.3 | 1.8 | 2.0 | 2.0 |
| Merch. Trade | £bn | -110.6 | -113.1 | -117.1 | | | | | | | | |
| | % of GDP | -6.1 | -6.0 | -5.9 | | | | | | | | |
| Current Account | £bn | -84.5 | -79.5 | -85.5 | | | | | | | | |
| | % of GDP | -4.7 | -4.2 | -4.3 | | | | | | | | |
| PSNB | £bn FY | -99.6 | -88.7 | -61.6 | | | | | | | | |
| | % of GDP | -5.4 | -4.6 | -3.0 | | | | | | | | |
| General Govt. Balance | % of GDP | -5.6 | -4.8 | -3.2 | | | | | | | | |
| Government Primary Balance | | -2.6 | -1.5 | 0.3 | | | | | | | | |
| Public Debt | % of GDP | 90.7 | 92.3 | 91.9 | | | | | | | | |
| Gross Nonoil Trading Profits | YoY | 6.1 | 5.8 | 5.6 | | | | | | | | |

Source: Citi Research

## Switzerland

Michael Saunders

In some ways, the Swiss outlook remains extraordinarily benign, with a roughly zero fiscal deficit, large current account surplus and continued economic growth. However, the economy has slowed recently and, with inflation close to zero since early 2009, the SNB is likely to remain highly alert for risks that the economy will get tipped into deflation. We expect the SNB will continue to strongly defend the CHF1.20/€ cap and keep the policy rate at zero for many years.

## Sweden

Tina Mortensen

After its latest rate cut, the Riksbank believes it has done enough to revive growth, close the output gap and return inflation to target. However, if growth disappoints and/or inflation stays low for longer (and we think it will), then the case for further easing is likely to come together, in our view. We expect the Riksbank will loosen further in coming months, with another rate cut (into negative territory) plus forward guidance to signal a long period of low rates. Beyond that, QE is a possibility if low-flation persists. The new government's budget bill included a fully-financed SEK 25.4bn spending package, suggesting fiscal policy will be neutral next year. The 1% of GDP budget surplus target is unlikely to be achieved until 2020 at the earliest.

## Denmark

Tina Mortensen

With rising geopolitical unrest and weaker momentum for Denmark's key trading partners, the near-term outlook looks meagre. Further out, we continue to expect the Danish economy to gain further, albeit only modest, momentum, with private spending lifted by rising employment and positive real wage growth. Mirroring ECB actions, the DNB cut the CD-rate to a negative 0.05% in July. To keep pace with the further ECB easing that we expect, the DNB is likely to be forced to cut the CD-rate deeper into negative territory ahead.

## Norway

Tina Mortensen

A sharp payback from electricity output weighed on growth in the mainland economy in 3Q; activity slowed from a strong 1.2% Q/Q in 2Q to 0.4% Q/Q. Weaker investment growth in the petroleum sector next year and ongoing erosion in competitiveness will keep mainland GDP growth below-trend rate pace ahead, and the economy could weaken further if oil prices continue to slide. In line with Norges Bank, we expect initial tightening to commence in late-16.

**Figure 49. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2014-2016F**

| | | Switzerland | | | Sweden | | | Denmark | | | Norway | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 1.3 | 2.0 | 2.4 | 2.0 | 2.2 | 2.5 | 0.7 | 1.1 | 1.7 | 2.6 | 1.9 | 2.2 |
| Final Domestic Demand | YoY | 1.6 | 2.8 | 2.6 | 2.7 | 2.7 | 2.2 | 0.9 | 1.5 | 1.7 | 2.2 | 2.1 | 2.6 |
| Private Consumption | YoY | 1.4 | 2.4 | 1.7 | 2.9 | 2.7 | 2.4 | 0.7 | 1.7 | 1.9 | 1.8 | 2.2 | 2.6 |
| Government Consumption | YoY | 0.0 | 0.6 | 0.7 | 1.1 | 1.6 | 0.9 | 0.9 | 0.8 | 0.6 | 3.0 | 2.2 | 2.3 |
| Investment (Ex Stocks) | YoY | 2.8 | 5.1 | 5.7 | 3.9 | 4.0 | 3.3 | 1.3 | 2.1 | 2.6 | 2.0 | 1.7 | 2.8 |
| Exports | YoY | 4.7 | 4.4 | 5.0 | 2.1 | 3.0 | 4.8 | 1.0 | 2.1 | 3.3 | 2.6 | 3.1 | 3.1 |
| Imports | YoY | 3.4 | 5.4 | 6.2 | 4.1 | 4.0 | 4.4 | 2.3 | 2.9 | 3.4 | 1.7 | 2.2 | 2.8 |
| CPI (Average) | YoY | 0.0 | -0.4 | 0.1 | -0.2 | 0.5 | 1.7 | 0.6 | 1.1 | 1.5 | 2.0 | 2.1 | 2.1 |
| Unemployment Rate | % | 3.3 | 3.0 | 2.5 | 8.0 | 7.6 | 7.3 | 6.6 | 6.5 | 6.2 | 3.4 | 3.7 | 3.6 |
| Current Account | % of GDP | 13.2 | 12.5 | 12.4 | 5.9 | 5.8 | 5.4 | 6.1 | 5.6 | 5.4 | 10.8 | 11.5 | 12.0 |
| General Govt Balance | % of GDP | 0.5 | 0.9 | 1.3 | -2.1 | -1.2 | -0.3 | -0.8 | -2.5 | -2.3 | 10.1 | 9.7 | 9.5 |
| General Govt Debt | % of GDP | 47.1 | 46.2 | 43.8 | 41.9 | 42.1 | 40.7 | 45.2 | 46.7 | 47.6 | NA | NA | NA |

Source: Citi Research

## Canada

**Dana M. Peterson**

The outlook for the Canadian economy is slightly dimmed by weaker global growth, the steep decline in commodity prices, and expectations of somewhat less demand momentum in the US. Nonetheless, the Canadian expansion is still expected to continue at a moderate pace. Exports will probably grow, albeit at a slower pace, supported by global oil trade and goods trade with the United States. Business investment in physical and human capital will likely broaden as domestic firms seek to enhance their competitiveness. Canada's improved fiscal position suggests the end of drag from federal government consolidation. Further currency depreciation (on USD strength) should benefit exporters, manufacturers and retailers.

Reflecting the decline in energy prices, overall CPI inflation will probably fall below the Bank of Canada's 2% target in 2015 and not return until early 2016. Core CPI inflation will likely also slow from recent highs over the course of the next year. The rate should stabilize at 2% by mid-2016. Risks to the inflation outlook remain roughly balanced, in our view. Upside risks include (1) US outperformance; while downside risks relate to (1) weaker global growth; (2) insufficient exports and capex growth; (3) lower commodity prices; and (4) domestic household imbalances.

We now expect resumption of monetary policy normalization in 1Q 2016. The mix of moderate growth, sub-target inflation, and a mild domestic housing market correction, plus uncertainty over global growth and the effects of US Fed tightening on Canadian bond yields next year, suggest no central bank actions until then. BoC officials have also indicated that the current overnight rate target of 1.00% is high relative to other central banks, providing room for the bank to bide its time. The timing may be shifted out further if global growth and inflation prospects worsen.

**Figure 50. Canada — Economic Forecast, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3Q | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| Real GDP | YoY | 2.4 | 2.4 | 2.3 | 2.6 | 2.4 | 2.8 | 2.5 | 2.3 | 2.3 | 2.2 | 2.2 |
| | SAAR | | | | 2.8 | 2.0 | 2.5 | 2.4 | 2.1 | 2.1 | 2.3 | 2.5 |
| Final Domestic Demand | YoY | 1.6 | 2.1 | 2.0 | 1.8 | 2.0 | 2.5 | 2.1 | 1.9 | 1.9 | 1.9 | 2.0 |
| | SAAR | | | | 2.8 | 1.7 | 2.1 | 1.9 | 1.7 | 1.7 | 2.1 | 2.3 |
| Private Consumption | YoY | 2.8 | 2.5 | 2.0 | 2.8 | 2.7 | 3.0 | 2.5 | 2.3 | 2.2 | 2.1 | 2.0 |
| | SAAR | | | | 2.8 | 2.4 | 2.4 | 2.3 | 2.0 | 2.0 | 2.0 | 2.0 |
| Government Spending | YoY | -0.1 | 0.4 | 0.8 | 0.0 | 0.2 | 0.5 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | SAAR | | | | 0.3 | 0.0 | 0.5 | 0.5 | 0.5 | 0.5 | 1.0 | 1.0 |
| Private Fixed Investment | YoY | 0.7 | 2.9 | 3.6 | 1.1 | 1.9 | 3.4 | 3.3 | 2.4 | 2.6 | 2.8 | 3.4 |
| | SAAR | | | | 5.9 | 1.7 | 2.9 | 2.6 | 2.5 | 2.4 | 3.9 | 4.6 |
| Exports | YoY | 5.6 | 5.3 | 4.1 | 7.4 | 7.3 | 8.2 | 4.7 | 4.0 | 4.3 | 4.1 | 4.0 |
| | SAAR | | | | 6.9 | 3.2 | 4.6 | 4.3 | 4.1 | 4.2 | 4.0 | 3.9 |
| Imports | YoY | 1.7 | 3.6 | 3.3 | 2.5 | 2.8 | 4.9 | 3.3 | 3.0 | 3.1 | 3.2 | 3.2 |
| | SAAR | | | | 4.0 | 3.0 | 3.0 | 3.1 | 3.0 | 3.3 | 3.3 | 3.3 |
| CPI | YoY | 2.0 | 1.8 | 2.0 | 2.1 | 2.1 | 1.7 | 1.6 | 1.8 | 1.9 | 2.0 | 2.0 |
| Core CPI | YoY | 1.8 | 2.0 | 1.9 | 2.0 | 2.3 | 2.2 | 2.0 | 2.0 | 1.7 | 1.8 | 1.9 |
| Unemployment Rate | % | 6.9 | 6.8 | 6.6 | 6.9 | 6.7 | 6.9 | 6.9 | 6.7 | 6.6 | 6.8 | 6.7 |
| Current Account Balance | C$bn | -42.0 | -40.6 | -39.5 | -33.6 | -43.8 | -43.7 | -42.9 | -39.4 | -36.5 | -40.3 | -40.8 |
| | % of GDP | -2.1 | -2.0 | -1.8 | -1.7 | -2.2 | -2.2 | -2.1 | -1.9 | -1.7 | -1.9 | -1.9 |
| Net Exports (Pct. Contrib.) | | 1.1 | 0.5 | 0.2 | 0.9 | 0.0 | 0.5 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 |
| Inventories (Pct. Contrib.) | | -0.4 | -0.2 | 0.0 | -1.0 | -0.1 | 0.0 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 |
| Budget Balance (Fiscal Year) | % of GDP | -0.1 | 0.1 | 0.2 | | | | | | | | |
| Federal Budget Debt | % of GDP | 30.8 | 29.5 | 28.1 | | | | | | | | |
| General Govt. Debt | % of GDP | 87.8 | 86.7 | 85.4 | | | | | | | | |

F Citi forecast. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. Sources: Statistics Canada and Citi Research forecasts

## Australia

**Paul Brennan**

**Joshua Williamson**

The key drivers of the economic outlook this year are likely to remain in play again in 2015. The shift in the mining and energy boom from the investment phase to the production and export phase will gather pace, and low interest rates will continue to support housing and consumer spending. A key issue for 2015 will be whether the headwinds that have been holding back consumer spending — most notably low levels of confidence, the decline in the terms of trade and a muted wealth effect — begin to moderate. A strengthening in consumer spending would probably also encourage a pickup in non-mining business investment and lead to a return to trend economic growth. In this regard, if the sharp drop in the oil price is sustained (as our analysts expect) then this could be the catalyst for stronger consumer spending and business investment. Even so, we doubt that economic growth next year will be materially different to this year's growth of around 3%. With underlying inflation expected to be in the bottom half of the 2%-3% target, the RBA is probably on a similar tightening timetable to the Fed with the first increase in the cash rate around the end of next year.

## New Zealand

**Paul Brennan**

**Joshua Williamson**

Activity is likely to remain solid in 2015. But we see this occurring against a backdrop of moderate inflation. Ongoing solid migration gains should continue to add to the supply side of the economy. This will help keep wage inflation moderate. Elsewhere, low global inflation and softer commodity prices will blunt some of the impact of easing in the exchange rate, keeping imported inflation from becoming an issue. We believe the RBNZ will need to re-start the process of normalising interest rates, but they are ahead of the curve and still have the luxury of keeping high LVR macroprudential tools as a weapon against any resurgent house price strength. On our forecasts, the RBNZ will not lift the OCR until very late in 2015. The risk is that the supply side of the economy does not continue to provide support for the idea that potential growth is higher than at similar stages in previous recoveries. We also will be keeping an eye on whether businesses start pushing up prices in a bid to recover margins.

**Figure 51. Australia and New Zealand — Economic Forecast, 2014-2016F**

| | Australia | | | New Zealand | | |
|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP[a] | 3.3 | 3.1 | 3.2 | 3.5 | 2.9 | 2.4 |
| Real GDP (4Q versus 4Q) | 2.6 | 3.1 | 3.3 | 3.0 | 2.9 | 2.8 |
| Real Final Domestic Demand | 1.4 | 1.8 | 2.1 | 5.3 | 4.0 | 2.4 |
| Private Consumption | 2.5 | 3.2 | 3.3 | 3.3 | 3.0 | 2.3 |
| Govt. Current & Capital Spending[b] | 1.5 | 2.0 | 2.0 | 3.0 | 3.0 | 2.9 |
| Housing Investment | 8.6 | 8.1 | 2.7 | 16.0 | 14.4 | -9.0 |
| Business Investment[c] | -5.3 | -5.7 | -3.1 | 13.0 | 7.0 | 5.3 |
| Exports of Goods & Services | 8.1 | 9.7 | 6.8 | 1.5 | 2.5 | 3.4 |
| Imports of Goods & Services | 0.7 | 3.7 | 3.4 | 7.6 | 4.7 | 2.6 |
| CPI | 2.5 | 2.6 | 2.3 | 2.1 | 2.2 | 2.2 |
| CPI (4Q versus 4Q) | 1.9 | 2.7 | 2.4 | 2.1 | 2.3 | 2.3 |
| Unemployment | 6.3 | 6.1 | 5.7 | 5.3 | 5.0 | 5.4 |
| Merch. Trade, BOP (Local Currency, bn) | 0.6 | -20.6 | -22.8 | -0.1 | -2.5 | -1.8 |
| Current Account, (Local Currency, bn) | -52.7 | -71.5 | -81.3 | -9.6 | -13.0 | -12.7 |
| Percent of GDP | -3.3 | -4.2 | -4.6 | -4.2 | -5.4 | -5.0 |
| Budget Balance[d] (Local Currency, bn) | -50.1 | -30.3 | -17.8 | -3.8 | -0.9 | 1.3 |
| Percent of GDP | -3.1 | -1.8 | -1.0 | -1.6 | -0.4 | 0.5 |
| General Govt. Debt (% of GDP)[e] | 32.1 | 33.5 | 33.3 | 39.0 | 36.3 | 36.7 |
| Gross Operating Surplus | 4.9 | 4.0 | 7.6 | NA | NA | NA |

BOP Balance of payments basis. CPI Consumer Price Index. F Citi forecast. NA Not available. [a]Averaged-based GDP in Australia and New Zealand. [b] In New Zealand excludes capital spending. [c] In New Zealand includes government capital spending. [d] Fiscal year ending June. Australia's underlying cash balance. [e] Australia and New Zealand Budget definition and forecasts. Sources: ABS, StatsNZ, NZIER and Citi Research forecasts

## China

Minggao Shen

Shuang Ding

China's period of very strong investment-led growth has probably ended in 2014. This is the first year since 2003 seeing fixed asset investment (FAI) growth significantly below 20%, 15.9% YoY in the first 10 months this year vs. 26.5% annualized growth between 2003-2013. This downward trend will most likely continue next year, in our view. Part of the slowdown was intended. Tightening regulation in the shadow banking sector and slow-paced monetary policy easing have weighed on growth. Disinflation (i.e., headline CPI at 1.6% YoY in September and October) is indicative of a negative output gap in the economy, but the government has been hesitant to stimulate the economy until recently. Chinese leaders might have realized that they have to tolerate slower growth and accommodate more structural changes. Changing dynamics in the labor market this year have also reduced the government's obsession with high-speed growth. In line with President Xi Jingping's statement that economic growth will level off from the "high speed growth" to a new phase of "medium-to-high speed growth", we believe a new cycle of medium-speed growth is unfolding.

The government will probably lower the growth target to 7% for 2015, but we do think it is possible that this target could be breached again and the reported growth will be 6.9%. The recent growth downturn has been driven by weaker investment growth. The rising cost of capital and falling inflation are both rooted in China's over-levered and over-supplied "old normal" economic model. Since the global financial crisis, the economy has been leveraging up quickly, and its total debt to GDP surged from 179% in 2007 to 233% in 2013, led by local governments and SOEs. Non-financial corporate debts were 124% of GDP in 2013, exceeding levels in most major economies in the world, and according to our estimation, 44.6% of them accumulated in the SOE sector. Those less-productive sectors have crowded out credit availability for the non-SOE and consumer sectors, suppressed productivity growth, and pushed up the cost of funding. An over-leveraged economy is also over-supplied — these are two sides of the same coin. The sharp slowdown of the Chinese economy in the past 7 years has intensified the over-capacity problem, with PPI deflation in the past 32 months and clear CPI disinflation recently. The high cost of capital and disinflation could be mutually reinforcing and exacerbated by FX weakness — in effect exported deflation — from Japan and euro area.

Recent policy developments suggest that the Chinese leaders are keen to tackle the core problems of the "old normal" economic model. On one hand, despite a slow start, China is launching fiscal reforms and SOE reforms to tackle the debt problems. On the other hand, it is pursuing an aggressive strategy to export excess capacity, for example via the Asian Infrastructure Investment Bank, FTAAP, and the new Silk Road Plan. Four new trends are emerging.

- First, debt regionalization and nationalization will lead to local government deleveraging and centralised re-leveraging. Banks, PPP and the bond market may share the funding needs of about Rmb7 tn amid local government de-leveraging in 2015, reducing the risk of local defaults. Both PPP boom and bond market expansion are natural consequences of the fiscal reform while local government financing vehicles will cease functioning by the end of 2015.

- Second, SOEs will start to implement the "asset light" strategy to comply with rising cost of capital in the longer term. This could result in the liquidation or securitization of trillions of SOE assets (which total Rmb104.1tn): with plausible assumptions, the size could go as high as Rmb20 tn, and this is likely to be positive for ROEs. According to our estimates, SOEs have contributed Rmb31.5 tn to the debts of non-financial corporates.

- Third, the adoption of new GDP measurement methods will probably reveal that the Chinese economy is less distorted than current statistics suggest, and the data may suggest that the quality of growth is improving, albeit slowly. The level of China's nominal GDP may be scaled up by 2.5-5% after the change in GDP calculation method next year, lifting the household consumption share in GDP by 1-3 ppts above levels shown in the current data.

- Fourth, the "go overseas" approach will probably export excess capacity to countries that are supplementary in growth stages and running trade surplus with China. This will likely be gradual alongside the rise of Chinese multinational companies and RMB internationalization.

China's GDP growth rate is already half of the rate seen seven years ago in 2007. We believe that, after the sharp slowdown of the past seven years, it is more likely that economic growth will stabilize within the range of 6-7% in the coming new cycle. In particular, Chinese leaders vowed to double 2010 GDP in real terms by 2020 which requires 6.8% annualized growth from now to 2020. We believe that China's economy can still grow by more than 7% YY for a few years without causing inflationary pressures, if capacity can be used more fully. We estimate China's potential growth at around 7.4% YY for 2015 and about 6.4% for 2020. However, the uncertain global outlook and the property market correction may weaken both external and domestic demand in 2015. We estimate the self-sustained rate of growth (ie under a neutral macro policy stance) at 6.0-6.5% in coming years by 2020 due to weak demand, a result of over-investment creating excess capacity. The economy is may run below potential during 2014-16, capping CPI inflation at around 2% YY.

Chinese policymakers are fighting two battles simultaneously, defending the near-term growth bottom-line with accommodative monetary and fiscal policies, and structural reform to tackle longer-term concerns. In order to cement stable growth, we expect two more rate cuts by mid-2015 and believe that RRR cuts are conditional on the pace of capital outflows. We expect fiscal policy to be expansionary next year with fiscal deficits up to 2.5% of GDP. In an environment of slow growth, lower inflation and rates, and stronger US dollar, the RMB may reverse its recent course of appreciation against the dollar and weaken to 6.25 in next 6-12 months. It is likely to remain a two-way bet within the range of 6-6.3.

**Figure 52. China — Economic Forecasts, 2014-2016F**

| | | | | | 2014 | | 2015 | | | | 2016 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 3Q | 4QF | 1QF | 2QF | 3QF | 4QF | 1QF | 2QF |
| Real GDP | YoY | 7.3 | 6.9 | 6.7 | 7.3 | 7.1 | 6.7 | 6.8 | 7.0 | 7.1 | 7.0 | 6.8 |
| Real Final Domestic Demand | YoY | 6.8 | 6.6 | 6.8 | | | | | | | | |
| Consumption | YoY | 7.1 | 7.1 | 7.1 | | | | | | | | |
| Fixed Capital Formation | YoY | 6.5 | 6.1 | 6.4 | | | | | | | | |
| Industrial Production | YoY | 8.3 | 7.4 | 7.1 | 8.0 | 7.7 | 7.0 | 7.2 | 7.6 | 7.8 | 7.6 | 7.2 |
| Exports | YoY | 6.2 | 6.7 | 5.2 | 13.1 | 9.0 | 8.0 | 7.0 | 6.0 | 6.0 | 6.0 | 5.0 |
| Imports | YoY | 1.9 | 4.0 | 4.0 | 1.2 | 3.5 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Merchandise Trade Balance | $bn | 357 | 434 | 482 | 128 | 126 | 37 | 107 | 146 | 144 | 49 | 117 |
| FX Reserves | $bn | 4,011 | 4,303 | 4,531 | 3,888 | 4,011 | 4,008 | 4,080 | 4,191 | 4,303 | 4,302 | 4,375 |
| Current Account | % of GDP | 2.5 | 2.7 | 2.5 | | | | | | | | |
| Fiscal Balance | % of GDP | -2.1 | -2.5 | -2.5 | | | | | | | | |
| General Govt. Debt* | % of GDP | 55.2 | 56.1 | 56.5 | | | | | | | | |
| Urban Unemployment Rate | % | 4.1 | 4.1 | 4.3 | 4.1 | 4.1 | 4.2 | 4.2 | 4.2 | 4.2 | 4.3 | 4.3 |
| CPI | YoY | 2.0 | 1.9 | 2.2 | 2.0 | 1.7 | 1.8 | 1.8 | 1.7 | 2.3 | 2.2 | 2.2 |
| Exchange Rate (end period) | CNY/$ | 6.15 | 6.18 | 6.00 | 6.14 | 6.15 | 6.19 | 6.23 | 6.23 | 6.18 | 6.13 | 6.08 |
| 1-Yr Deposit Rate (end period) | % | 2.75 | 2.25 | 2.25 | 3.00 | 2.75 | 2.50 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 |

Note: F Citi forecast. E Citi estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate. * General Govt. Debt includes the debt of central, local government and Ministry of Railway. Sources: Haver Analytics and Citi Research forecasts

## India

Rohini Malkani

Anurag Jha

2014 has been a transformative year for India. The most significant change has been in the political environment, with the business-friendly Modi government winning the largest mandate in 30 years. Another key development is the RBI's adoption of a new monetary policy framework and its push for financial sector reforms. Last but not the least, the sharp drop in commodity prices has benefited India, given its high energy dependency.

Going forward, as mentioned in our latest Macroscope, we expect the process of normalization to continue. A quick recap: in 2013, it was the CAD that came down from 4.7% of GDP to 1.7%; in 2014, it was inflation which fell from a peak of 11% to 5.5% currently, and in 2015 we believe normalization will show up in interest rates and growth. That said, the reform momentum has gathered pace. In addition to recently-announced energy sector reforms, more industry-friendly measures in the area of taxation, labor and land acquisition are likely to follow. The Government's flagship initiatives such as "Make in India", the Jan-dhan financial inclusion scheme, and project facilitation by PMG could further revive economic activity. Overall, we expect GDP growth to pick up to 5.6% in FY15 and gradually improve towards 7% by FY17

On inflation, normalization has been faster than expected, with CPI inflation down to 5.5% YoY from double digits last year. We expect CPI inflation to glide towards the RBI's 6% target by Jan-16, reflecting continued supply-side efforts by the government and softer commodity prices. Thus, we expect conditions to turn conducive for easing in coming months, resulting into a cumulative 100bps cut in repo rates by FY16. Such a path, with the repo rate easing to 7% from 8% currently, would leave the real rate at least 100bps above the RBI's inflation target. In line with our rate view, we expect bond yields to soften towards 7.75% by end-2015.

On the external front, we expect stable trends to continue in FY16 with the CAD at about 1.3% GDP or US$30bn. The risk on the CAD is balanced, with a lower import bill due to softer commodity prices largely being offset by the weaker export outlook to Europe and China. Thanks to the stable CAD and slowing inflation, the fundamentals for INR remain supportive, and we expect the unit to remain around its fair value of 60-63. Lastly, the ongoing trends in fiscal consolidation has led S&P to revise India's sovereign rating outlook to 'Stable' from 'Negative'. Going forward, implementation of GST, direct cash transfer for subsidies and expenditure rationalization could improve fiscal balances even further, increasing the likelihood of a ratings upgrade.

**Figure 53. India — Economic Forecasts, FY 2014/15-2016/17F**

| | | FY 14/15F | FY 15/16F | FY 16/17F |
|---|---|---|---|---|
| Real GDP | YoY | 5.6 | 6.5 | 7.0 |
| Final Domestic Demand | YoY | 4.6 | 6.7 | 7.3 |
| Private Consumption | YoY | 5.5 | 7.0 | 7.0 |
| Fixed Investment | YoY | 2.5 | 6.5 | 8.5 |
| Exports | YoY | 11.0 | 9.3 | 9.0 |
| Imports | YoY | 9.5 | 9.0 | 9.3 |
| Wholesale Price Index | YoY | 4.0 | 4.0 | 4.0 |
| Consumer Price Index | YoY | 7.2 | 6.2 | 6.0 |
| Current Account | US$ bn | -33.2 | -30.0 | -34.4 |
| | % of GDP | -1.6 | -1.3 | -1.2 |
| Consolidated Fiscal Balance | % of GDP | -6.7 | -6.4 | -6.1 |
| Centre Fiscal Balance | % of GDP | -4.1 | -4.0 | -4.0 |
| US Dollar Exchange Rate | Average | 62.0 | 62.6 | 62.7 |

Sources: Haver Analytics and Citi Research forecasts

## Korea

Jaechul Chang

The readings on industrial production and exports during August-October this year suggest that the growth path has been lower than we previously expected. Moreover, the recovery in coming months also seems to be weaker than we previously expected as weak economic sentiment will probably continue to weigh on consumption and facilities investment. Furthermore, the delay of government spending to next year (to avoid a fiscal cliff in 4Q14 due to lack of tax revenue) is likely to lower the growth contribution from government spending in the quarter. The National Assembly Budget Office (NABO) recently estimated that the shortfall of tax revenue will reach KRW12.5trn in 2014 and KRW4.4trn in 2015. That has led us to take into account a drag on economic growth from this fiscal constraint. Therefore, we are cutting our 2014 and 2015 growth forecasts by 0.2 percentage points and 0.3pp respectively, to 3.4% and 3.5%. In particular, we believe real GDP growth will fall further to 2.8% YoY in 1Q15, leading policy makers to consider another round of accommodative policy. Given the fiscal constraints noted above and very low inflation, the BoK is likely to cut the policy rate by 25bps in early 2015, most likely in January, and consider an expansion of lending facilities.

## Indonesia

Helmi Arman

Despite a sub-optimal political landscape, we think the government will be able to deliver quick wins on reform, such as better implementation on infrastructure projects and bureaucracy reform. However growth momentum will probably remain limited because of the adverse effect on household purchasing power from the reduction in energy subsidies in November. Growth will probably be weakest in H1-15, when households have just been hit and government spending is likely to remain weak, and will probably be roughly flat for the full year. Meanwhile the trade numbers may improve soon on weak domestic demand, but this must be weighed against the possibility of a rise in imports of investment goods later in the year. Overall GDP growth in 2015 should remain relatively flat from 2014 at around 5.1%. At the same time, inflation is likely to hover at 7-7.5% YoY in 1H15, before dropping to around 5.1% at end-15 as the fuel hike impact drops out. On monetary policy, we expect the policy rate be maintained at current levels. This is amid a backdrop of a still-high current account deficit and inflation on one hand, but weakness in credit growth and household consumption on the other. Given the need to rebalance consumption over investment, we think macroprudential policies will remain central in BI's policy mix.

**Figure 54. Korea and Indonesia — Economic Forecasts, 2014-2016F**

| | | Korea | | | Indonesia | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 3.4 | 3.5 | 3.7 | 5.1 | 5.1 | 5.3 |
| Final Domestic Demand | YoY | 2.7 | 3.6 | 3.9 | 5.0 | 4.7 | 4.9 |
| Private Consumption | YoY | 1.9 | 2.9 | 3.3 | 5.3 | 4.1 | 4.4 |
| Fixed Investment | YoY | 4.0 | 4.9 | 5.5 | 4.9 | 6.1 | 6.3 |
| Exports | YoY | 3.3 | 4.9 | 5.6 | -1.3 | 4.2 | 4.1 |
| Imports | YoY | 2.6 | 6.0 | 6.1 | -4.0 | 2.5 | 2.6 |
| Consumer Price Index | YoY | 1.3 | 1.6 | 2.6 | 6.3 | 7.2 | 4.6 |
| Unemployment Rate | % | 3.5 | 3.5 | 3.3 | 5.9 | 6.1 | 6.0 |
| Current Account | US$ bn | 88.0 | 82.5 | 78.2 | -26.7 | -25.4 | -27.9 |
| | % of GDP | 6.2 | 5.9 | 5.3 | -3.1 | -2.7 | -2.7 |
| Fiscal Balance | % of GDP | 0.9 | 0.3 | 0.3 | -2.4 | -2.0 | -1.8 |
| US Dollar Exchange Rate | Average | 1057 | 1118 | 1116 | 11885 | 12420 | 12495 |

Source: Haver Analytics and Citi Research forecasts

## Hong Kong

**Adrienne Lui**

We expect another bumpy year in 2015 with a moderate overall recovery in growth. HK will likely continue to see a slowdown in consumption and export of services (tourism), but the US recovery is likely to sustain a trade recovery. The Fed's prospective normalization of interest rates and China's economic slowdown are headwinds for HK. The Shanghai-HK Stock Connect launch opens a new paradigm for HK to function as an offshore RMB center. Further enhancement to the Connect is likely in 2015 and cooperation with Qinghai is being discussed. Weakness in house prices will likely remain limited by supply constraints, while we expect that commercial rentals (except street level shops) will be flat in 2015. The HKD peg is likely to continue to prevail, with EFN rates largely following US Treasury yields. Politics are likely to stay noisy as HK seeks universal suffrage in 2017. The 2015/16 Policy Address likely again will focus on housing and welfare.

## Singapore

**Kit Wei Zheng**

Exports may remain lacklustre given Singapore's increasing dependence on a US capex recovery, even as competitiveness is eroded by the strong real exchange rate. On the domestic front, the weakening housing market is likely to hit construction. Private consumption is expected to soften on household deleveraging, home equity erosion and lower population growth. Disinflation may expand beyond headline to core measures as weaker consumption crimps the ability of businesses to pass costs onto consumers. Despite domestic and external headwinds, the tight labour market remains the key constraint to MAS easing, and we would watch for cracks here as a signpost for policy easing. If early elections are held in 2H15 and the PAP obtains a favourable result, population and housing policies could be relaxed — though an outright policy reversal remains unlikely.

## Taiwan

**Adrienne Lui**

Steady growth and benign inflation are likely to continue in 2015. We expect that a further recovery in tech exports will be modest as tech products evolve. Political campaigns for the 2016 presidential and legislative elections will start in mid-2015. We expect higher fiscal spending in what will be a pre-election year. With ECFA discussion stalled by politics, investors hope that banks-related cross-strait liberalization can be implemented separately. Without quick actions on TPP/RECP, adverse impacts from Korea-China FTA on Taiwan's exports and investment might become more visible in 2016. We expect TWD to depreciate along with regional FX in 6-12M to preserve export competeiveness. We expect policy rates to stay on hold until 1Q16, while long-term bond yields again may creep up with Fed normalization.

**Figure 55. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2014-2016F**

| | | Hong Kong | | | Singapore | | | Taiwan | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 2.3 | 2.6 | 3.0 | 2.9 | 3.0 | 3.0 | 3.6 | 3.6 | 3.8 |
| Final Domestic Demand | YoY | 1.2 | 1.7 | 1.7 | 0.3 | 0.9 | -0.2 | 2.1 | 2.6 | 2.6 |
| Private Consumption | YoY | 1.9 | 1.7 | 1.5 | 1.5 | 0.5 | -0.1 | 2.4 | 3.2 | 3.1 |
| Fixed Investment | YoY | -1.4 | 2.2 | 2.7 | -1.2 | -0.4 | -2.3 | 1.9 | 2.2 | 2.7 |
| Exports | YoY | 2.3 | 4.4 | 5.0 | 3.3 | 3.6 | 3.7 | 4.6 | 5.2 | 5.4 |
| Imports | YoY | 2.1 | 3.9 | 4.5 | 2.0 | 2.4 | 2.7 | 4.0 | 4.0 | 4.3 |
| CPI | YoY | 4.4 | 4.2 | 3.8 | 1.1 | 0.6 | 1.4 | 1.4 | 1.7 | 2.0 |
| Unemployment Rate | % | 3.3 | 3.6 | 3.5 | 2.0 | 2.2 | 2.3 | 4.0 | 3.9 | 3.9 |
| Current Account | US$ bn | 7.3 | 12.1 | 17.1 | 54.3 | 52.9 | 51.4 | 60.1 | 58.5 | 45.4 |
| | % of GDP | 2.6 | 4.1 | 5.5 | 18.0 | 18.0 | 17.0 | 12.0 | 11.0 | 8.0 |
| Fiscal Balance | % of GDP | 1.3 | 0.7 | 1.0 | -0.3 | 0.2 | 1.5 | -1.4 | -1.6 | -1.3 |
| US Dollar Exchange Rate | Average | 7.76 | 7.79 | 7.76 | 1.27 | 1.32 | 1.34 | 30.41 | 31.22 | 30.34 |

Source: Citi Research

## Russia

Ivan Tchakarov

Ekaterina Vlasova

The Russian economy probably is near recession, with little prospect for significant near-term improvement. The impact of sanctions on the Russian economy will become clearer over time. But, many other factors help explain Russia's slowdown, and the slowdown was evident even before the Ukraine crisis. Even though the economy will probably eke out positive growth in 2014 (0.5%), we expect heightened geopolitical uncertainty, still-rising inflation, weak currency and declining oil prices will continue to weigh on consumer and business confidence, creating the perfect storm for the economy's performance to deteriorate more meaningfully in 2015. As a result, we are cutting our 2015 GDP growth forecast from +1.0% to -1.0%, as sanctions continue to bite and uncertainty lingers. This will be the 6th consecutive year of a worsening GDP performance. Consumer and investment spending will suffer, with net exports the only component of GDP remaining robust as the weaker RUB is likely to boost exports while crimping imports. Tighter monetary policy will also weigh on economic performance. The Central Bank of Russia's transition to a free float in late 2014 will allow the RUB to respond more nimbly to market forces in 2015, thus facilitating the economic adjustment to shocks, but at the cost of heightened currency volatility.

## Turkey

Ilker Domac

Gultekin Isiklar

In our view, growth will get harder, for at least two reasons. First, the country's ability to tap external sources will be adversely affected by the monetary policy normalization process in the US. Given Turkey's excess reliance on foreign savings to finance growth, it will be difficult for Turkey to repeat its past performance. Second, with corporate and household balance sheets more stretched, it will be harder for Turkey to rely on domestic demand to deliver decent growth rates. It is true that policymakers display a greater recognition of structural impediments to growth — such as labor market rigidity and low domestic saving. The reform package announced so far, however, lacks specificity and prioritization, leading us to be skeptical about its effectiveness. Looking ahead, we believe that lower oil prices and the likely temporary decline in inflation in 1H next year can create cyclical opportunities, particularly in the bond market. However, the country's large external financing needs and poor inflation record will continue to cloud macroeconomic stability, leaving Turkish assets at the mercy of global financial markets.

**Figure 56. Russia and Turkey — Economic Forecast, 2014-2016F**

| | | Russia | | | Turkey | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 0.5 | -1.0 | 1.7 | 3.1 | 3.3 | 3.4 |
| Final Domestic Demand | YoY | -0.5 | -1.2 | 1.1 | 1.1 | 3.1 | 3.3 |
| Private Consumption | YoY | 0.5 | -0.7 | 1.0 | 1.3 | 3.2 | 3.5 |
| Fixed Investment | YoY | -3.5 | -3.3 | 2.5 | -1.3 | 2.0 | 2.4 |
| Exports | YoY | 0.0 | 1.0 | 1.0 | 5.2 | 4.4 | 4.5 |
| Imports | YoY | -3.0 | -1.0 | 4.4 | -2.0 | 3.5 | 4.0 |
| CPI | YoY | 7.5 | 7.6 | 5.8 | 8.9 | 6.7 | 7.0 |
| Unemployment Rate | % | 5.7 | 6.0 | 5.8 | 9.9 | 10.2 | 10.4 |
| Current Account | US$ bn | 60.3 | 53.3 | 43.5 | -44.0 | -40.1 | -45.6 |
| | % of GDP | 3.3 | 3.5 | 2.7 | -5.5 | -5.1 | -5.5 |
| Fiscal Balance | % of GDP | 0.0 | -1.0 | -0.6 | -2.0 | -2.9 | -3.0 |
| US Dollar Exchange Rate | Average | 39.3 | 50.4 | 51.8 | 2.20 | 2.46 | 2.58 |

Sources: Haver Analytics and Citi Research forecasts

## Hungary

**Eszter Gargyan**

Economic growth is likely to slow but remain around 2.5% in 2015 as the positive stimulus provided by accelerated EU fund absorption and by car capacity extensions fade. Domestic demand is likely to underpin growth, as the household debt burden should fall by 25% in average as a result of the FX mortgage aid scheme. Given the ongoing recovery in consumption, inflation is likely to pick up close to the 3% target by early 2016 as the impacts of utility price cuts and food price deflation drop out from the annual index. Therefore, we believe the NBH is unlikely to resume rate cuts unless core inflation decelerates further. In our view, the MPC will focus on keeping the base rate low for an extended period instead of implementing more cuts. Following the conversion of FX mortgages in 2015, households will be exposed to HUF interest rate sensitivity, which may allow the NBH to keep monetary conditions loose and tolerate more exchange rate volatility. Therefore we believe rates are likely to remain on hold until at least early 2016 and rise only gradually thereafter as headline inflation picks up. We expect a gradually weaker HUF, as USD strength is likely to weigh on EMFX and the MPC will probably remain behind the curve. The risks of a sharp FX depreciation seem low given the sustained current account surplus and the sensitivity of the public debt ratio to FX weakness.

## Poland

**Piotr Kalisz**

**Cezary Chrapek**

Despite weaker growth in the Eurozone and Russia, the Polish economy is holding up well, mostly thanks to robust domestic demand and the healthy labour market. We expect growth path to be relatively flat in coming quarters, with GDP growth fluctuating close to 3% YoY in early 2015 and significantly accelerating thereafter. The biggest threat to this scenario is a possibility of sharper slowdown in Germany, as this would put disproportionate pressure on domestic demand. Despite relatively strong growth, inflation remains negative and may remain so in early 2015. We expect inflation to rise gradually from 2Q as the impact of low food and fuel prices falls out from the annual index. However, overall demand-side pressures seem very weak and the monetary authorities may be still considering some additional rate adjustment. Having said this, the room for rate cuts is limited (in our view not more than 25bps) unless the growth and inflation outlook deteriorates substantially. Since 2015 will be a year of presidential and parliamentary elections, political factors may become more important for markets than in past years. However, consistent with recent opinion polls, our base case scenario assumes economic policy continuity.

**Figure 57. Hungary and Poland — Economic Forecasts, 2014-2016F**

| | | Hungary | | | Poland | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 3.3 | 2.5 | 1.8 | 3.3 | 3.4 | 3.6 |
| Final Domestic Demand | YoY | 3.5 | 2.2 | 1.0 | 3.4 | 2.7 | 3.8 |
| Private Consumption | YoY | 2.0 | 2.5 | 2.2 | 2.3 | 2.6 | 3.2 |
| Fixed Investment | YoY | 11.0 | 3.5 | -1.0 | 7.7 | 3.5 | 6.0 |
| Exports | YoY | 6.8 | 6.0 | 6.2 | 3.4 | 3.9 | 6.0 |
| Imports | YoY | 7.1 | 6.1 | 6.0 | 4.4 | 3.8 | 7.0 |
| CPI | YoY | 0.0 | 1.7 | 2.8 | 0.0 | 0.8 | 2.4 |
| Unemployment Rate | % | 7.5 | 6.8 | 6.5 | 11.7 | 11.3 | 10.9 |
| Current Account | US$ bn | 5.6 | 4.4 | 3.7 | -9.5 | -14.9 | -18.3 |
| | % of GDP | 4.3 | 3.8 | 3.3 | -1.8 | -3.2 | -3.9 |
| Fiscal Balance | % of GDP | -2.8 | -2.4 | -2.1 | -2.9 | -2.4 | -2.2 |
| Euro Exchange Rate | Average | 310 | 314 | 319 | 4.19 | 4.20 | 4.12 |

Source: Citi Research

## Czech Republic

Jaromir Sindel

We cut both our 2014 and 2015 GDP forecasts by 0.1 percentage point (to 2.3% in both years) on the back of weaker foreign demand, but still expect Czech GDP growth to accelerate to around 3% in 2016. Recent business surveys counter some of the downside risks from the external environment. First, November confidence improved to the highest since early-2011, which suggests that Q4 growth could be around 3%YoY (well above our 2.0% YoY forecast). Second, the readings for manufacturing capacity use and export orders both increased. However, the foreign demand outlook and Ukraine/Russian crisis remain key risks. The CNB´s Inflation Report suggests that there would be a negative impact on Czech GDP growth of 0.4%pt in 2015 if there is one-year 20% drop in Russian imports. However, the Czech economy should be supported by the better labour market in 2014 and fiscal easing in 2015-16. Weaker GDP growth and a long period of low ECB rates will probably delay the CNB´s exit from the EURCZK floor to end of 2016. However, our forecast does not point to a rise in the CNB's floor for EURCZK, partly as we expect a weaker koruna. However, in the recent Minutes, the CNB Board welcomed the fact that the currency was weaker than the 27.4 level assumed in CNB's forecast. We expect that minor tensions within the center-left government will intensify around spring 2016, before the Autumn election for 1/3 of the Upper House (and general elections are scheduled for autumn 2017).

## Romania

Ilker Domac

Gultekin Isiklar

The stronger-than-expected 3Q GDP reading and the revision of the past data lead us to lift our 2014 growth forecast to 2.8% from 2.0%. Nevertheless, we believe that it would be premature to argue that the economy is now on a sustained recovery path. We saw some signs of a pick-up in private consumption this year, but the failure of investment spending to gain momentum remains an important drag on the recovery. Looking ahead, we believe that private consumption is likely to remain resilient, thanks to the combination of low inflation and an accommodative monetary policy stance. This, coupled with recent developments such as a tax exemption for reinvested profits and a cut in social security contributions, should finally boost investment, in our view. Against this backdrop, we look for a moderate pick-up in economic activity next year with GDP growth reaching 3% YoY. At the same time, we expect inflation to reach 2.8% YoY at end- 2015 from about 1.8% in 2014. This, coupled with other factors, leads us to believe that the NBR is likely to keep rates on hold throughout 2015, although we do expect the Bank will relax its policy stance through lowering RRRs.

**Figure 58. Czech Republic and Romania — Economic Forecasts, 2014-2016F**

| | | Czech Republic | | | Romania | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 2.3 | 2.3 | 3.0 | 2.8 | 3.0 | 3.0 |
| Final Domestic Demand | YoY | 2.2 | 2.7 | 3.8 | 1.8 | 3.4 | 3.0 |
| Private Consumption | YoY | 1.7 | 2.1 | 2.3 | 5.0 | 3.5 | 3.5 |
| Fixed Investment | YoY | 4.2 | 5.1 | 7.6 | -8.0 | 4.0 | 1.7 |
| Exports | YoY | 8.4 | 5.0 | 8.6 | 10.0 | 4.0 | 4.6 |
| Imports | YoY | 8.6 | 5.6 | 10.1 | 8.0 | 4.1 | 4.0 |
| CPI | YoY | 0.4 | 1.2 | 2.1 | 1.2 | 2.2 | 2.6 |
| Unemployment Rate | % | 6.1 | 5.7 | 5.5 | 5.5 | 5.5 | 5.5 |
| Current Account | US$ bn | 0.4 | -1.3 | -2.1 | -2.3 | -3.5 | -4.0 |
| | % of GDP | 0.2 | -0.6 | -1.1 | -1.2 | -2.0 | -2.2 |
| Fiscal Balance | % of GDP | -1.9 | -2.3 | -2.0 | -1.7 | -2.0 | -2.5 |
| EURCZK, USDRON | Average | 27.5 | 27.9 | 27.2 | 3.4 | 3.9 | 4.0 |

Sources: Haver Analytics and Citi Research forecasts

## Brazil

Marcelo Kfoury

Dilma Rousseff's second term has effectively already started and next year promises to be a very difficult year for Brazil. Besides the challenging domestic and international environment, plus the open wounds of the election process, Rousseff will have to face the political consequences of the corruption scandal in Petrobras. Brazil has been warned by ratings agencies that a downgrade is possible and that it is necessary to produce a gradual fiscal consolidation. We forecast a primary surplus of 1% of GDP in 2015, which probably is not enough to stabilize the debt GDP ratio. Scope for an improvement in the fiscal number will be even more difficult given the worsening growth outlook — we are cutting our GDP growth forecast from 1.0% to 0.5% for 2015 and from 2.8% to 1.8% for 2016. Our 2015 year-end inflation forecast (6.8% YoY) is above the upper bound of the inflation target (6.5%), despite anemic growth and monetary policy tightening (we expect the policy rate to be at 12% at end-2015). External conditions (commodity prices and dollar strength) have turned against the BRL, but the current account numbers have yet to improve.

## Mexico

Sergio Luna Martinez

Economic activity rebounded in 2014, but less than we were expecting at the beginning of the year. GDP will likely grow by 2.4% this year versus 1.4% in 2013, reflecting greater dynamism in external demand. Meanwhile, local demand is recovering, although still at a moderate rate. For 2015, we forecast that this general trend will prevail, supported by a solid recovery in the U.S. economy, in particular the manufacturing sector. Meanwhile, local demand growth is likely to accelerate, driven mainly by spill-overs from the export sector, the uptrend in the local labor market and greater productive investment related to the structural reforms. We therefore expect short- and medium-term economic expectations to improve, with real GDP growth averaging about 4.5% YoY in 2016-2019. For inflation, low external growth should lead to lower price levels for basic goods. Also, the boost to inflation from higher taxes in early 2014 will be diluted, reducing inflationary pressures. Thus, we expect inflation to end 2015 at about 3.3% YoY versus around 3.9% in 2014. However, Banxico will probably begin its reference rate hiking cycle in the second half of 2015, and we expect the first (25 basis-point) hike to be made in October, most likely before the Fed starts its normalization process. We forecast Mexico's reference rate to close next year at 3.50%, versus 3.0% at year-end 2014.

**Figure 59. Brazil and Mexico — Economic Forecasts, 2014-2016F**

| | | Brazil | | | Mexico | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 0.1 | 0.5 | 1.8 | 2.4 | 3.9 | 4.4 |
| Final Domestic Demand | YoY | 0.0 | 0.5 | 1.9 | 2.3 | 4.2 | 4.9 |
| Private Consumption | YoY | 1.2 | 0.9 | 2.1 | 2.2 | 3.8 | 4.3 |
| Fixed Investment | YoY | -6.9 | 1.0 | 3.6 | 2.8 | 6.8 | 8.1 |
| Exports | YoY | 2.3 | 2.4 | 2.4 | 6.4 | 7.3 | 10.1 |
| Imports | YoY | 0.2 | 2.1 | 3.5 | 4.8 | 8.2 | 9.9 |
| CPI | YoY | 6.3 | 6.5 | 6.1 | 4.0 | 3.5 | 3.6 |
| Unemployment Rate | % | 4.9 | 5.3 | 5.8 | 4.9 | 4.6 | 4.4 |
| Current Account | US$ bn | -86.4 | -85.3 | -84.3 | -28.3 | -28.3 | -36.8 |
| | % of GDP | -4.0 | -4.1 | -3.9 | -2.2 | -2.0 | -2.4 |
| Fiscal Balance | % of GDP | -5.5 | -4.7 | -4.4 | -3.6 | -3.5 | -3.5 |
| US Dollar Exchange Rate | Average | 2.40 | 2.74 | 2.87 | 13.26 | 13.40 | 13.09 |

Source: Citi Research

## Argentina

Guillermo Mondino

The outlook remains very uncertain in Argentina. Key amongst those sources of uncertainty is whether the government will settle with the holdouts. The mix of widening fiscal deficit in a country in default, a deep recession, accelerating inflation and presidential elections in October 2015 are likely to result in significant volatility. While the market expects an early resolution to the debt default, our baseline scenario assumes that no settlement will be reached in 2015. As a result, we forecast (non-official) activity to shrink by 2.5% in 2015, on top of the 2.3% contraction this year. The fiscal deficit is expected to widen, boosting money printing, given the fiscal dominance of monetary policy. As a result, we expect (non-official) inflation to rise to 45% in 2015 and anticipate that new pressures on the USDARS will emerge. Given the extensive financial repression, it is likely that economic agents will anticipate a devaluation after the elections, putting pressure on the parallel FX market. The one tool the authorities have to manage expectations is to increase the likelihood of a settlement with the holdouts. We believe that such an action may improve economic conditions, but would be unlikely to suffice to fully stabilize the economy.

## Venezuela

Munir Jalil

Weakness in activity and mounting inflationary pressures will probably continue in 2015, due to overall scarcity of goods and US dollars. We currently expect activity to contract by about 2.2% in 2015, and for inflation to end 2015 at about 75% YoY. Low prices for the Venezuelan basket of oil, if maintained, and their impact in the availability of foreign currency, will probably force the government to announce economic measures such as a devaluation of the official USDVEF 6.3 exchange rate to levels closer to the SICAD I rate of 12. In addition, we expect the government to reduce imports by a further USD4 billion in 2015 — an amount lower than the reductions observed over the previous two years. We believe that if imports fall below USD40bn, the political costs would be intolerably large for the government given that Congress elections are expected to take place in 2015. At the same time, we assume that the government will be forced to renegotiate the Petrocaribe arrangement in a similar way to what they did with the Chinese loans. All in all, the country's high dependence on oil revenues and the sharp decline in them stemming from recent reductions in oil prices, make Venezuela the most vulnerable country in LatAm — and the one that faces the most difficult adverse scenario.

**Figure 60. Argentina and Venezuela — Economic Forecasts, 2014-2016F**

| | | Argentina | | | Venezuela | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 0.0 | -1.0 | 1.0 | -4.0 | -2.2 | 1.9 |
| Final Domestic Demand | YoY | -1.0 | -1.2 | 0.9 | -4.7 | -2.0 | 0.6 |
| Private Consumption | YoY | -1.1 | -0.7 | 1.4 | -5.0 | -4.0 | 0.2 |
| Fixed Investment | YoY | -3.1 | -5.7 | -1.2 | -6.0 | 1.0 | 0.4 |
| Exports | YoY | -5.7 | -2.5 | -0.2 | -1.0 | -1.0 | 4.6 |
| Imports | YoY | -6.2 | -3.4 | -0.6 | -5.0 | -1.0 | -1.0 |
| CPI | YoY | NA | 22.6 | 34.8 | 61.3 | 70.3 | 80.0 |
| Unemployment Rate | % | 8.6 | 8.9 | 9.5 | 7.0 | 8.0 | 8.5 |
| Current Account | US$ bn | -5.1 | -6.6 | -5.9 | 14.9 | 6.9 | 12.4 |
| | % of GDP | -1.0 | -1.4 | -1.2 | 4.4 | 2.4 | 4.1 |
| Fiscal Balance | % of GDP | -3.7 | -4.7 | -3.7 | -12.3 | -12.6 | -12.7 |
| US Dollar Exchange Rate | Average | 8.25 | 11.13 | 15.61 | 6.30 | 12.00 | 21.36 |

Sources: Haver Analytics and Citi Research forecasts

## Saudi Arabia

Farouk Soussa

We expect some economic headwinds in 2015 for Saudi Arabia, as lower oil prices put downward pressure on government revenues, potentially tipping the budget into a deficit if prices do not recover from current levels. Saudi Arabia has confounded our expectations that it would cut production in order to support the market, and we expect that production will remain close to current levels for the foreseeable future. We believe that Saudi's reluctance to cut makes good economic sense: in the absence of a coordinated move in that direction with other global suppliers, it is not clear that Saudi would achieve much with a cut other than reduced revenues and market share. Lower oil prices are also supportive of global demand and will restrict future uncompetitive supply, helping balance the market outlook. It remains to be seen whether the pressure of budget revenues will translate into a more cautious approach on the expenditure side, or whether the Saudi authorities will prefer to push ahead with planned expenditure and fund any deficits through a drawdown of the Kingdom's substantial assets or by raising debt, or a combination of both. Indeed, we have no concerns that falling oil prices will tip Saudi into anything resembling a fiscal squeeze: by our calculations, Saudi can finance the current level of expenditures (in real terms) with $80 oil from its reserves for the next eight years, without needing to raise any debt at all. But while Saudi has ample fiscal reserves to fund such deficits, as well as plenty of capacity to raise debt, we do expect that the Saudi authorities will seek to put public finances on a sustained footing over the medium term. This implies an accelerated timetable for fiscal consolidation and economic reform, and early signs of this may appear in 2015.

## United Arab Emirates

Farouk Soussa

The UAE economy is also vulnerable to the drop in oil prices. Abu Dhabi's fiscal breakeven oil price is just below US$80 per barrel, meaning the room for expenditure growth is limited, and expenditure rationalization may be required should the oil price fall further. While Abu Dhabi, like Saudi, has ample fiscal space to fund deficits in the medium term, we believe that the Abu Dhabi authorities are less likely to do so and will prefer to curtail expenditure. We believe this is in keeping with Abu Dhabi's past track record, and reflects the emirate's conservative approach and lower expenditure pressures. Dubai, although not an oil economy itself, is also vulnerable to oil price falls through such channels as liquidity, sentiment, foreign investment, and reduced regional opportunities. That said, there is considerable potential upside to Dubai should a deal with the P5+1 lead to the opening of Iranian markets in the medium term.

**Figure 61. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2014-2016F**

| | | Saudi Arabia | | | United Arab Emirates | | |
|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 4.8 | 4.2 | 4.7 | 4.0 | 4.0 | 4.4 |
| Final Domestic Demand | YoY | 8.0 | 8.1 | 8.1 | 4.7 | 4.7 | 4.8 |
| Private Consumption | YoY | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Fixed Investment | YoY | 10.0 | 10.0 | 10.0 | 5.0 | 5.0 | 5.0 |
| Exports | YoY | -3.9 | -18.1 | 7.5 | 13.0 | 14.0 | 14.0 |
| Imports | YoY | 10.0 | 10.0 | 10.0 | 15.0 | 15.0 | 15.0 |
| CPI | YoY | 2.9 | 3.0 | 3.4 | 2.0 | 2.4 | 2.9 |
| Current Account | US$ bn | 100.5 | 16.6 | 19.2 | 94.9 | 63.0 | 58.6 |
| | % of GDP | 13.4 | 2.3 | 2.5 | 22.0 | 13.6 | 11.8 |
| Fiscal Balance | % of GDP | 4.7 | -3.4 | -2.6 | NA | NA | NA |
| US Dollar Exchange Rate | Average | 3.75 | 3.75 | 3.75 | 3.67 | 3.67 | 3.67 |

Source: Citi Research

## Nigeria

**David Cowan**

A weakening oil price, the ongoing battle with Boko Haram and the rapidly approaching February 2015 elections have all focused attention on Nigeria in recent months. And while all are challenges in the short term, of more interest to investors is whether economic policy will alter after the polls and whether the economy can continue to grow at rates of around 6% in 2015-16. The key issue could well prove to be the extent to which the new government moves ahead with long-stalled structural reforms after the polls, notably of the power sector and proposed changes to the oil industry. The other major issue will be the extent to which oil prices remain low and how the Central Bank of Nigeria (CBN) responds to this. While the CBN will try to maintain naira stability up to the elections, the ongoing low oil price is likely to force it into making a devaluation in 1H 2015, especially if foreign exchange reserves continue to fall. Devaluation would have a short-term economic impact in terms of pushing up inflation and possibly slowing growth in early 2015. But, in the long term it is part of the necessary adjustment which would help to slow import growth, boost the agricultural sector and government revenue, and allow growth to pick up again into 2016 and beyond.

## South Africa

**David Cowan**

The South African economy is currently flirting with stagflation, and we expect real GDP growth of only 1.4% YoY in 2014 with inflation stuck around the top end of the SARB's target band of 3-6%. Moreover, the potential rebalancing of the economy away from consumer-led growth seems to have stalled despite rand weakening. And a consumer-driven recovery seems unlikely to gain ground until into 2016, meaning the recovery will remain fragile in 2015. With a large current account deficit, which is still funded by significant portfolio inflows, this continues to leave the ZAR vulnerable, especially if the US Federal Reserve does move into a more aggressive hiking mode in 2H 2015. How the SARB would respond to this is unclear. In the immediate future, if inflation continues to trend down as we expect, and given low growth, the SARB will probably not react unless the ZAR was to weaken significantly. But at some point in 2015 this equation may start to change, with the SARB restarting the process of policy rate normalization in Q2 2015. Although the recent Medium-Term Budget Statement did not change the proposed path of fiscal consolidation and put off any tax announcements until the February budget, we think the government will have little choice but to raise the current 14% VAT rate over the next 18 months even if this negatively impacts on the slow recovery.

**Figure 62. Egypt, Nigeria and South Africa — Economic Forecast, 2014-2016F**

| | | Egypt | | | Nigeria | | | South Africa | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Real GDP | YoY | 2.4 | 3.2 | 5.2 | 6.2 | 4.8 | 6.3 | 1.4 | 2.2 | 2.8 |
| Final Domestic Demand | YoY | 3.8 | 3.5 | 5.5 | NA | NA | NA | 2.4 | 2.6 | 3.1 |
| Private Consumption | YoY | 3.0 | 2.6 | 3.2 | NA | NA | NA | 2.2 | 2.4 | 4.2 |
| Fixed Investment | YoY | 1.6 | 9.9 | 19.4 | NA | NA | NA | 3.4 | 3.6 | 5.4 |
| Exports | YoY | -2.8 | 5.6 | 6.0 | NA | NA | NA | 3.7 | 4.6 | 5.9 |
| Imports | YoY | 4.8 | 7.2 | 6.7 | NA | NA | NA | 1.7 | 6.3 | 7.1 |
| CPI | YoY | 10.7 | 12.4 | 10.5 | 8.1 | 9.9 | 9.3 | 6.1 | 5.6 | 5.2 |
| Unemployment Rate | % | 14.2 | 14.5 | 13.5 | NA | NA | NA | 25.0 | 24.6 | 24.2 |
| Current Account | US$ bn | -6.0 | -7.2 | -9.8 | 13.6 | -5.4 | 4.0 | -17.7 | -16.6 | -16.1 |
| | % of GDP | -2.1 | -2.3 | -2.8 | 2.4 | -0.9 | 0.6 | -5.3 | -4.7 | -4.1 |
| Fiscal Balance | % of GDP | -11.7 | -9.4 | -7.8 | -2.0 | -2.4 | -2.0 | -4.1 | -4.1 | -3.5 |
| US Dollar Exchange Rate | Average | 7.08 | 7.28 | 7.46 | 164 | 182 | 193 | 10.89 | 11.35 | 11.47 |

Source: Citi Research

**Figure 63. Selected Emerging Market Countries — Economic Forecast Overview, 2014-2016F**

| | GDP Growth | | | CPI Inflation | | | Current Balance (% of GDP) | | | Fiscal Balance (% of GDP) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| **Asia** | **6.1** | **6.1** | **6.1** | **3.0** | **2.8** | **2.9** | **2.6** | **2.6** | **2.3** | **-2.4** | **-2.6** | **-2.5** |
| China | 7.3 | 6.9 | 6.7 | 2.0 | 1.9 | 2.2 | 2.5 | 2.7 | 2.5 | -2.1 | -2.5 | -2.5 |
| Hong Kong | 2.3 | 2.6 | 3.0 | 4.4 | 4.2 | 3.8 | 2.6 | 4.1 | 5.5 | 1.3 | 0.7 | 1.0 |
| India | 5.6 | 6.5 | 7.0 | 7.2 | 6.2 | 6.0 | -1.6 | -1.3 | -1.3 | -6.7 | -6.4 | -6.1 |
| Indonesia | 5.1 | 5.1 | 5.3 | 6.3 | 7.2 | 4.6 | -3.1 | -2.7 | -2.7 | -2.4 | -2.0 | -1.8 |
| Korea | 3.4 | 3.5 | 3.7 | 1.3 | 1.6 | 2.6 | 6.2 | 5.9 | 5.3 | 0.9 | 0.3 | 0.3 |
| Malaysia | 6.0 | 5.3 | 5.1 | 3.2 | 3.9 | 3.3 | 5.7 | 4.5 | 5.0 | -3.5 | -3.0 | -2.5 |
| Mongolia | 6.5 | 9.0 | 8.0 | 13.0 | 12.6 | 10.4 | -9.7 | -8.6 | -12.5 | -7.9 | -6.9 | -6.5 |
| Pakistan | 5.4 | 4.5 | 4.3 | 8.6 | 7.5 | 7.5 | -1.2 | -0.9 | -2.0 | -5.5 | -6.2 | -6.1 |
| Philippines | 6.3 | 6.5 | 7.3 | 4.3 | 3.5 | 3.6 | 4.3 | 4.3 | 4.2 | -1.1 | -1.3 | -1.2 |
| Singapore | 2.9 | 3.0 | 3.0 | 1.1 | 0.6 | 1.4 | 18.0 | 18.0 | 17.0 | -0.3 | 0.2 | 1.5 |
| Sri Lanka | 7.7 | 7.8 | 7.6 | 3.4 | 4.6 | 6.0 | -2.7 | -2.6 | -2.1 | -5.4 | -5.2 | -4.5 |
| Taiwan | 3.6 | 3.6 | 3.8 | 1.4 | 1.7 | 2.0 | 12.0 | 11.0 | 8.0 | -1.4 | -1.6 | -1.3 |
| Thailand | 0.5 | 3.0 | 3.8 | 1.9 | 1.3 | 2.0 | 2.6 | 2.2 | 2.0 | -2.7 | -2.2 | -1.8 |
| Vietnam | 5.7 | 5.9 | 6.2 | 4.3 | 5.0 | 5.7 | 4.9 | 3.9 | 3.2 | -6.4 | -6.0 | -5.7 |
| **Latin America** | **0.9** | **1.6** | **2.8** | **7.6** | **7.6** | **8.0** | **-2.8** | **-3.0** | **-2.9** | **-4.4** | **-4.2** | **-3.9** |
| Argentina | 0.0 | -1.0 | 1.0 | NA | 22.6 | 34.8 | -1.0 | -1.4 | -1.2 | -3.7 | -4.7 | -3.7 |
| Brazil | 0.1 | 0.5 | 1.8 | 6.3 | 6.5 | 6.1 | -4.0 | -4.1 | -3.9 | -5.5 | -4.7 | -4.4 |
| Chile | 1.5 | 2.5 | 4.0 | 4.4 | 3.5 | 3.1 | -1.9 | -2.8 | -3.0 | -2.0 | -1.6 | -0.7 |
| Colombia | 4.8 | 4.5 | 4.5 | 2.8 | 3.0 | 3.1 | -4.5 | -4.5 | -4.5 | -1.6 | -1.5 | -0.3 |
| Costa Rica | 3.0 | 2.5 | 3.5 | 4.5 | 4.8 | 4.6 | -5.5 | -5.3 | -5.0 | -6.7 | -7.3 | -8.0 |
| Dominican Republic | 6.8 | 5.0 | 4.5 | 3.1 | 2.4 | 3.3 | -3.7 | -3.4 | -3.3 | -4.0 | -3.6 | -4.5 |
| El Salvador | 2.0 | 2.2 | 2.5 | 1.3 | 1.6 | 1.9 | -6.0 | -5.8 | -6.0 | -3.4 | -3.6 | -3.5 |
| Mexico | 2.4 | 3.9 | 4.4 | 4.0 | 3.5 | 3.6 | -2.2 | -2.0 | -2.4 | -3.6 | -3.5 | -3.5 |
| Panama | 6.2 | 5.5 | 6.5 | 2.8 | 1.5 | 2.2 | -9.0 | -8.6 | -7.0 | -4.5 | -3.5 | -3.0 |
| Peru | 2.5 | 3.8 | 4.6 | 3.3 | 2.6 | 2.6 | -5.6 | -4.8 | -5.9 | 0.5 | -2.7 | -1.7 |
| Venezuela | -4.0 | -2.2 | 1.9 | 61.3 | 70.3 | 80.0 | 4.4 | 2.4 | 4.1 | -12.3 | -12.6 | -12.7 |
| **Europe** | **1.4** | **1.1** | **2.6** | **6.0** | **5.9** | **5.2** | **0.2** | **-0.1** | **-0.6** | **-1.6** | **-2.0** | **-1.7** |
| Bulgaria | 1.5 | 2.0 | 2.5 | -1.2 | 1.4 | 1.3 | 0.5 | -0.5 | -1.5 | -3.7 | -3.8 | -2.0 |
| Croatia | -0.7 | 0.3 | 1.3 | -0.1 | 1.5 | 1.6 | 1.0 | 0.8 | -0.5 | -5.5 | -5.6 | -5.4 |
| Czech Republic | 2.3 | 2.3 | 3.0 | 0.4 | 1.2 | 2.1 | 0.2 | -0.6 | -1.1 | -1.9 | -2.3 | -2.0 |
| Hungary | 3.3 | 2.5 | 1.8 | 0.0 | 1.7 | 2.8 | 4.3 | 3.8 | 3.3 | -2.8 | -2.4 | -2.1 |
| Kazakhstan | 4.0 | 4.3 | 5.0 | 6.6 | 6.4 | 5.7 | 2.3 | 1.8 | 2.1 | -2.4 | -2.2 | -1.9 |
| Poland | 3.3 | 3.4 | 3.6 | 0.0 | 0.8 | 2.4 | -1.8 | -3.2 | -3.9 | -2.9 | -2.4 | -2.2 |
| Romania | 2.8 | 3.0 | 3.0 | 1.2 | 2.2 | 2.6 | -1.2 | -2.0 | -2.2 | -1.7 | -2.0 | -2.5 |
| Russia | 0.5 | -1.0 | 1.7 | 7.5 | 7.6 | 5.8 | 3.3 | 3.5 | 2.7 | 0.0 | -1.0 | -0.6 |
| Serbia | -2.0 | -0.5 | 1.5 | 2.2 | 3.5 | 4.3 | -5.3 | -4.8 | -4.5 | -7.8 | -6.0 | -4.5 |
| Slovakia | 2.4 | 2.5 | 3.1 | -0.1 | 1.1 | 2.3 | 1.5 | 0.5 | 0.5 | -2.9 | -2.8 | -2.1 |
| Turkey | 3.1 | 3.3 | 3.4 | 8.9 | 6.7 | 7.0 | -5.5 | -5.1 | -5.5 | -2.0 | -2.9 | -3.0 |
| Ukraine | -6.4 | -2.4 | 1.6 | 12.1 | 16.2 | 8.4 | -3.2 | -2.7 | -2.1 | -10.0 | -6.0 | -4.0 |
| **Africa/Mideast** | **3.9** | **4.3** | **5.0** | **4.5** | **5.1** | **5.1** | **8.8** | **3.5** | **3.9** | **0.1** | **-3.4** | **-2.8** |
| Bahrain | 4.8 | 4.4 | 4.4 | 2.5 | 2.1 | 2.2 | 5.2 | -5.0 | -4.1 | -4.1 | -5.9 | -4.5 |
| Egypt | 2.4 | 3.2 | 5.2 | 10.7 | 12.4 | 10.5 | -2.1 | -2.3 | -2.8 | -11.7 | -9.4 | -7.8 |
| Ghana | 4.6 | 4.0 | 6.0 | 15.2 | 13.2 | 8.0 | -8.9 | -7.8 | -8.3 | -9.8 | -7.6 | -6.5 |
| Iraq | 0.1 | 8.9 | 10.4 | 2.5 | 5.0 | 5.0 | 9.3 | 2.5 | 5.2 | -4.2 | -4.8 | -0.9 |
| Israel | 2.3 | 2.2 | 2.5 | 0.5 | 0.3 | 1.0 | 2.0 | 1.8 | 3.3 | -3.0 | -3.3 | -2.5 |
| Jordan | 3.6 | 3.8 | 4.3 | 3.0 | 4.0 | 4.2 | -9.2 | -2.7 | -2.0 | -6.4 | -6.8 | -6.8 |
| Kenya | 5.4 | 6.0 | 6.2 | 7.3 | 7.3 | 6.6 | -7.6 | -7.5 | -8.0 | -6.0 | -5.8 | -5.6 |
| Kuwait | 3.8 | 3.9 | 2.7 | 3.0 | 3.5 | 3.5 | 36.9 | 27.4 | 27.5 | 25.2 | 3.5 | 2.6 |
| Lebanon | 3.6 | 9.8 | 5.8 | 1.6 | 2.3 | 2.5 | -14.9 | -9.6 | -8.4 | -9.5 | -8.9 | -8.6 |
| Nigeria | 6.2 | 4.8 | 6.3 | 8.1 | 9.9 | 9.3 | 2.4 | -0.9 | 0.6 | -2.0 | -2.4 | -2.0 |
| Oman | 4.1 | 2.7 | 2.3 | 1.0 | 0.9 | 1.2 | 6.5 | -1.8 | -0.4 | -2.7 | -5.4 | -4.6 |
| Qatar | 5.4 | 5.5 | 5.4 | 3.0 | 3.5 | 4.5 | 29.4 | 23.3 | 23.6 | 9.6 | 3.6 | 1.0 |
| Saudi Arabia | 4.8 | 4.2 | 4.7 | 2.9 | 3.0 | 3.4 | 13.4 | 2.3 | 2.5 | 4.7 | -3.4 | -2.6 |
| South Africa | 1.4 | 2.2 | 2.8 | 6.1 | 5.6 | 5.2 | -5.3 | -4.7 | -4.1 | -4.1 | -4.1 | -3.5 |
| Tanzania | 7.1 | 7.2 | 6.4 | 6.4 | 6.2 | 6.8 | -13.9 | -12.9 | -12.1 | -6.2 | -6.5 | -5.5 |
| UAE | 4.0 | 4.0 | 4.4 | 2.0 | 2.4 | 2.9 | 22.0 | 13.6 | 11.8 | NA | NA | NA |
| Uganda | 6.1 | 6.5 | 6.9 | 4.6 | 4.9 | 4.7 | -9.7 | -10.1 | -11.0 | -5.3 | -5.6 | -5.3 |
| Zambia | 6.5 | 6.3 | 6.1 | 7.8 | 7.5 | 6.8 | 1.5 | 1.8 | 1.0 | -5.3 | -4.4 | -5.2 |
| **Total** | **4.2** | **4.4** | **4.9** | **4.4** | **4.3** | **4.3** | **2.1** | **1.4** | **1.3** | **-2.4** | **-2.9** | **-2.7** |

Source: Citi Research

# Sovereign Ratings

Michael Saunders

Peter Goves

The *Sovereign Ratings Outlook* is a joint product between the Citi economics and rate strategy teams, with input from various other research teams. We aim to forecast the direction and scale of sovereign debt ratings (local currency), as well as any changes in the ratings outlook, for a range of countries. These are our judgments over the ratings outlook, rather than model-determined recommendations. All economic and fiscal forecasts are consistent with those published in Citi's monthly "*Global Economic Outlook and Strategy*" or other research. We do not aim to make a judgment on the financial market implications of ratings changes, except in so far as we expect any such market implications to affect other sovereign ratings.

Given economic updates in this publication and based on rating agency criteria, we highlight our economists' and strategists' main expectations for sovereign ratings over the near (2-3 quarters) and longer (2-4 years) term.

**Figure 64. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts**

| | S&P Ratings | | | | Moody's Ratings | | | |
|---|---|---|---|---|---|---|---|---|
| Country | Current Rating | Current Outlook | Citi Near Term (Up to 9 Mths) Forecast Rating | Citi Long Term (Next 2-4 Years) Forecast Rating & Outlook | Current Rating | Current Outlook | Citi Near Term (Up to 9 Mths) Forecast Rating | Citi Long Term (Next 2-4 Years) Forecast Rating & Outlook |
| US | AA+ | Stable | AA+ (Stable) | AA+ | Aaa | Stable | Aaa (Stable | Aaa |
| Canada | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| Japan | AA- | Neg | AA- (Neg) | A+ ↓ | A1 | Stable | A1 (Stable) | A1 |
| Germany | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| France | AA | Neg | AA (Neg) | AA | Aa1 | Neg | Aa1 (Neg) | Aa1 |
| Italy | BBB | Neg | BBB (Neg) | BBB | Baa2 | Stable | Baa2 (Stable) | Baa2 |
| Spain | BBB | Stable | BBB (Stable) | BBB | Baa2 | Pos | Baa1 (Stable) ↑ | Baa1 ↑ |
| Austria | AA+ | Stable | AA+ (Stable) | AA+ | Aaa | Stable | Aaa (Stable | Aaa |
| Belgium | AA | Stable | AA (Stable) | AA | Aa3 | Stable | Aa3 (Stable) | Aa3 |
| Greece | B | Stable | B- (Stable) | B | Caa1 | Stable | Caa1 (Stable) | Caa1 |
| Ireland | A- | Pos | A (Stable) ↑ | A+ ↑↑ | Baa1 | Stable | Baa1 (Pos) | A2 ↑↑ |
| Netherlands | AA+ | Stable | AA+ (Stable) | AA+ | Aaa | Stable | Aaa (Stable) | Aaa |
| Portugal | BB | Stable | BB (Pos) | BB+ ↑ | Ba1 | Stable | Ba1 (Stable) | Baa3 ↑ |
| UK | AAA | Stable | AAA (Stable) | AAA | Aa1 | Stable | Aa1 (Stable) | Aa1 |
| Switzerland | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| Sweden | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| Denmark | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| Norway | AAA | Stable | AAA (Stable) | AAA | Aaa | Stable | Aaa (Stable) | Aaa |
| EU | AA+ | Stable | AA+ (Stable) | AA+ | Aaa | Stable | Aaa (Stable | Aaa |
| ESM | Not rated | | | | Aa1 | Stable | Aa1 (Stable) | Aa1 |

Note: Arrows denote expected ratings changes from the current rating. (Neg) denotes negative outlook. (Neg W) denotes negative watch. SD means Selective Default. (P) means Provisional. The number of arrows denotes the expected change in ratings notches from the current level. We show a maximum of five arrows even for countries where we expect more than five notches of ratings change. NA Not available. Sources: Moody's, S&P and Citi Research

# Expected Ratings Issues

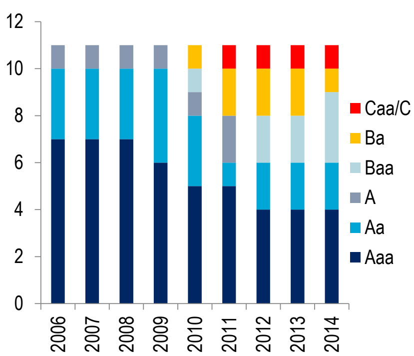
Michael Saunders

Peter Goves

## EMU sovereign credit quality has stabilised — literally

**Fewer rating transitions with a slight upgrade bias:** One key theme pertinent to the 2015 outlook for sovereign credit quality is the ongoing stabilization of EMU ratings. This was already apparent in 2013, as there were no rating upgrades/downgrades by Moody's of 2012 ratings (see Figure 65). Indeed in 2014, there have been several upgrades, not least the restoration of investment grade status for Ireland (which is now rated Baa1/A-). In addition, we also expect fewer rating transitions. Quite simply, and unlike 2013 and before, 2014 has seen the vast majority of ratings outlooks being restored from "negative" to "stable" as shown (using Moody's ratings) in Figure 66. Out of all 18 EMU sovereigns, 16 have stable outlooks, 1 has a negative outlook (France) and 1 has a positive outlook (Spain).

Figure 65. Moody's EMU-11 rating distribution over time (count of ratings as of Dec per yr)




Sources: Citi Research, Moody's and Bloomberg

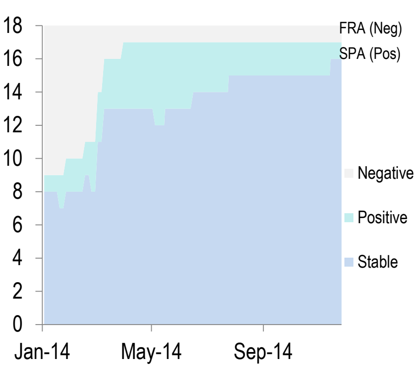
## We expect Spain to be rated higher than Italy

One of our key strategic themes remains Spain's economic and market outperformance relative to other periphery sovereigns (*Why Spain Is Likely to Decouple Further From the Periphery*). Due to higher growth prospects (2.0% in 2015, Italy 0.3% in 2015), successful reform implementation, falling unit labour costs and debt ratio stabilization we expect Spain to be higher rated than Italy in 2015. This can happen in a number of ways. Note that Spain and Italy are equally rated at Baa2/BBB by Moody's and S&P. However, Moody's rates Spain with a positive outlook, S&P rates Italy with a negative outlook. We believe Renzi's focus on reform is likely to be enough to keep Italy at BBB over the medium term, and instead have the upgrade of Spain by Moody's to Baa1 as our base case.

## We expect France to remain AA/Aa1 despite the negative outlook(s)

The prospect of another downgrade of France will continue to linger in 2015 – note France is rated with a negative outlook by both Moody's (since November 2012) and S&P (since October 2014, *S&P revises France's AA outlook to negative*). Implementation risks of the reform agenda clearly remain and the decision to delay the 3% deficit target (again) to 2017 is credit negative in our view. However, provided the commitment to engage with structural reform and boost potential GDP remains strong and ongoing, we believe this is likely to be looked on favourably by the rating agencies. Our base case is for France to remain AA/Aa1 over the medium term but for both Moody's and S&P to leave France on negative outlook.

Figure 66. Moody's change in EMU rating "outlooks" over 2014 - stabilisation




Sources: Citi Research, Moody's and Bloomberg

## We no longer expect an upgrade of the UK

We had previously penciled in a restoration of the UK's Aaa status by Moody's given the strong growth rebound and prospect for the debt/GDP ratio to stabilize. However, fiscal performance has been disappointing, due to undershoots in tax receipts despite falling unemployment. Combined with prospects of rising political uncertainty and the escalating Brexit debate, we no longer expect an upgrade in 2015 – and indeed, such factors may contribute to downgrade pressures rising. Note that the head of sovereign ratings at S&P, Moritz Kraemer, recently reiterated that the UK's membership of the EU is "integral" to its credit rating, citing the various benefits such membership has provided[27].

## Further upgrades of Ireland also likely

Finally, we expect further upgrades of Ireland by both Moody's and S&P, reflecting strong growth prospects and consequent improvement to debt metrics. Indeed, S&P currently has Ireland on a positive outlook, signifying upgrade potential.

[27] Bloomberg, 21 November 2014

# Yield and Spread Forecast Commentary

Amitabh Arora

**US**: We now expect only a 25 bp rise in funds rate end-2015, versus 75 bp earlier, and have pushed out the date of first hike from Sep-15 to Dec-15. With this change, we are lowering our end 2015 2-year and 10-year yield forecasts by 47 bp and 12bp. respectively and projecting a much steeper curve than previously. We note that it may take the market a while to reprice to our view; specifically, we will need to see a change in FOMC rhetoric, acknowledging that the 35 bp decline in 1y1y inflation expectations since the end of June is a matter of concern.

Alessandro Tentori

**Core Europe**: The environment for core EGBs remains constructive into 2015. Increasingly-dovish ECB talk reflects the deterioration of growth and inflation expectations for the Eurozone, in the context of a global slowdown. Additional policy stimulus via sovereign QE remains our baseline scenario and will continue to affect pricing. One important question is related to Bunds' reaction post QE. In theory, a higher inflation risk premium should also lift nominal yields (e.g. QE2 in the US), but uncertainty surrounding this view — especially with regards to the ECB's ability to control inflation expectations at all — is increasing. Therefore, we expect only a mild and gradual increase in German 10y yields towards the end of 2015. Our Bund yield projection reflects a positive sensitivity to our US Treasury forecast. Core and semi-core spreads are expected to tighten as a result of ECB buying, thus contributing to a lower average real yield for the euro area as a whole.

Peter Goves

**EMU Periphery**: ECB QE is our central driver of periphery markets in 2015 and we expect strong spread tightening of the periphery in Q1. There are various drivers that are likely to affect individual cross-market spreads in 2015. Particularly, the Spanish general election (in December) could cause some softness in H2. Specifically, we maintain that relative fundamentals are likely to keep Spain trading at a tighter 10yr spread to Germany than Italy (targeting 90bp in Bono-Bunds and 110bp in BTP-Bunds in Q1), but for the BTP-Bono spread itself to narrow as the election draws closer. There are also prospects for ongoing political uncertainty in Greece with the Presidential election in February which may weigh on sentiment.

Jamie Searle

**UK**: Inflation looks set to remain well below the MPC's 2% target for at least H1-15. In this context, and given the asymmetric bias to policy near the lower zero bound, the MPC appears to be in no rush to raise rates. We have pushed back the timing of the first rate hike to November 2015 from May 2015. Consequently, we have lowered our gilt yield forecast for 2015, especially in the front-end, and our Q4 forecast for the 10yr rate is now just 2.6% (vs the current level of 2.0%). We continue to look for a flatter 2s10s curve, but the bulk of this is now deferred to later in the year. LDI demand is likely to continue to support the long-end, allowing 10s30s to flatten by around 35bp.

Takeki Fukushima

**Japan**: We are cutting our forecasts for JGB yields on the back of the BoJ's additional easing on October 31. The BoJ raised the annual pace of JGB purchase from net 50trn to net 80trn, and extended the average maturity from 6-8yr to 7-10yr. On the other hand, the GPIF cut the allocation target for domestic bonds from 60% to 35%. Unlike the verbal interventions called "PKO" in the past two decades, this is a major change, in our view. We expect the super-long sector to remain volatile until 1Q 2015, due to GPIF selling and BoJ purchases, amidst tight balance sheets among dealers. As the 2nd consumption tax hike was postponed by PM Abe, we eliminate our forecast for a dip in yields in 3Q-15, which reflected anticipation of the adverse effects on growth of the hike. Even so, we revise down our 10y forecast because of weak CPI forecast due to low oil prices and the favourable supply/demand balance in the market. Given that the BoJ is likely to ease further around mid-2015, 10y yields are likely remain below 60bp until 2016.

**Figure 67. Interest Rate and Bond Market Forecasts as of 1 December 2014**

| | | Quarterly Average (Unless Specified) | | | | | |
|---|---|---|---|---|---|---|---|
| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | 2Q 16F |
| **US** | | | | | | | |
| Policy Rate (Fed Funds) End Quarter | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.75 |
| 3-Month Libor | 0.23 | 0.25 | 0.25 | 0.30 | 0.40 | 0.55 | 0.80 |
| 2 Year Treasury Yield | 0.50 | 0.80 | 1.05 | 1.20 | 1.40 | 1.60 | 1.80 |
| 5 Year Treasury Yield | 1.53 | 2.05 | 2.25 | 2.35 | 2.45 | 2.50 | 2.60 |
| 10 Year Treasury Yield | 2.21 | 2.70 | 2.85 | 2.90 | 2.95 | 3.00 | 3.05 |
| 30 Year Treasury Yield | 2.92 | 3.20 | 3.30 | 3.30 | 3.35 | 3.35 | 3.35 |
| 2-10 Year Treasury Curve, bp | 170 | 190 | 180 | 170 | 155 | 140 | 125 |
| 2 Year Swap Spread (Swap Less Govt), bp | 20 | 23 | 26 | 29 | 30 | 30 | 30 |
| 10 Year Swap Spread (Swap Less Govt), bp | 13 | 14 | 16 | 19 | 20 | 20 | 20 |
| 30 Year Swap Spread (Swap Less Govt), bp | -2 | -2 | -2 | -2 | -2 | -2 | -2 |
| 30 Year Mortgage Yield | 3.97 | 4.30 | 4.45 | 4.55 | 4.65 | 4.70 | 4.75 |
| 10 Year Breakeven Inflation, bp | 181 | 200 | 210 | 218 | 220 | 223 | 225 |
| **Euro Area** | | | | | | | |
| Policy Rate End Quarter | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| Overnight Rate (EONIA) | 0.03 | 0.00 | -0.05 | -0.10 | -0.10 | -0.10 | -0.10 |
| 3-Month (EURIBOR) | 0.06 | 0.10 | 0.05 | 0.00 | 0.00 | 0.00 | 0.00 |
| 2 Year Schatz Yield | -0.04 | 0.00 | -0.05 | -0.08 | -0.10 | -0.10 | -0.10 |
| 5 Year Bobl Yield | 0.11 | 0.05 | 0.00 | 0.05 | 0.10 | 0.10 | 0.10 |
| 10 Year Bund Yield | 0.70 | 0.65 | 0.85 | 1.00 | 1.15 | 1.25 | 1.25 |
| 30 Year Bund Yield | 1.59 | 1.55 | 1.70 | 1.80 | 1.95 | 2.00 | 2.00 |
| 2-10 Year Bund Curve, bp | 74 | 65 | 90 | 108 | 125 | 135 | 135 |
| 10 Year BTP-Bund Spread, bp | 135 | 110 | 110 | 110 | 110 | 110 | 110 |
| 10 Year Bono-Bund Spread, bp | 121 | 90 | 90 | 100 | 100 | 90 | 90 |
| 2 Year BTP-Schatz Spread, bp | 53 | 20 | 20 | 20 | 20 | 20 | 20 |
| 2 Year Bono Schatz Spread, bp | 44 | 20 | 20 | 20 | 20 | 20 | 20 |
| 10 Year OAT-Bund Spread, bp | 28 | 20 | 20 | 20 | 20 | 20 | 20 |
| 10 Year Swap Spread (Swap Less Govt.), bp | 22 | 20 | 20 | 20 | 20 | 20 | 20 |
| 10 Year Breakeven Inflation, bp | 95 | 100 | 125 | 130 | 130 | 130 | 130 |
| 5y5y Implied Vol, bp | 62 | 64 | 62 | 60 | 60 | 60 | 60 |
| **Japan** | | | | | | | |
| Policy Rate End Quarter | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 3-Month Libor | 0.11 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 2 Year Treasury Yield | 0.01 | 0.05 | 0.05 | 0.10 | 0.10 | 0.10 | 0.10 |
| 5 Year Treasury Yield | 0.11 | 0.15 | 0.15 | 0.25 | 0.25 | 0.25 | 0.25 |
| 10 Year Treasury Yield | 0.44 | 0.45 | 0.45 | 0.55 | 0.55 | 0.60 | 0.60 |
| 30 Year Treasury Yield | 1.43 | 1.60 | 1.60 | 1.65 | 1.65 | 1.70 | 1.70 |
| 2-10 Year Treasury Curve, bp | 43 | 40 | 40 | 45 | 45 | 50 | 50 |
| 2 Year Swap Spread (Swap Less Govt.), bp | 14 | 15 | 15 | 13 | 13 | 12 | 12 |
| 10 Year Swap Spread (Swap Less Govt.), bp | 15 | 13 | 12 | 15 | 15 | 17 | 17 |
| 10 Year Breakeven Inflation, bp | 114 | 100 | 100 | 95 | 95 | 90 | 90 |
| **UK** | | | | | | | |
| Policy Rate End Quarter | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 1.00 | 1.50 |
| 3-Month Libor | 0.55 | 0.55 | 0.55 | 0.55 | 1.00 | 1.25 | 1.80 |
| 2 Year Treasury Yield | 0.50 | 0.75 | 1.00 | 1.25 | 1.55 | 1.85 | 2.20 |
| 5 Year Treasury Yield | 1.26 | 1.55 | 1.75 | 1.90 | 2.10 | 2.40 | 2.65 |
| 10 Year Treasury Yield | 1.91 | 2.25 | 2.45 | 2.55 | 2.60 | 2.80 | 2.90 |
| 30 Year Treasury Yield | 2.65 | 2.90 | 2.95 | 3.00 | 3.05 | 3.10 | 3.15 |
| 2-10 Year Treasury Curve, bp | 140 | 150 | 145 | 130 | 105 | 95 | 70 |
| 10 Year Swap Spread (Swap Less Govt.), bp | 6 | 8 | 10 | 15 | 20 | 20 | 25 |
| 10 Year Breakeven Inflation, bp | 276 | 295 | 305 | 315 | 320 | 325 | 325 |
| **Australia** | | | | | | | |
| Policy Rate End Quarter | 2.50 | 2.50 | 2.50 | 2.50 | 2.75 | 3.00 | 3.25 |
| 3-Month Libor | 2.76 | 2.80 | 2.80 | 2.90 | 3.00 | 3.25 | 3.50 |
| 2 Year Treasury Yield | 2.47 | 2.40 | 2.50 | 2.55 | 2.80 | 3.10 | 3.40 |
| 5 Year Treasury Yield | 2.67 | 2.60 | 2.85 | 3.15 | 3.55 | 3.85 | 4.05 |
| 10 Year Treasury Yield | 3.15 | 3.25 | 3.50 | 3.70 | 3.90 | 4.10 | 4.20 |
| 2-10 Year Treasury Curve, bp | 68 | 85 | 100 | 115 | 110 | 100 | 80 |
| 10 Year Swap Spread (Swap Less Govt.), bp | 42 | 40 | 40 | 45 | 50 | 60 | 60 |

Source: Citi Research

# Cross-Market Outlook

Jeremy Hale

The commentary surrounding Citi's economic forecasts sounds gloomy in this Prospects with secular stagnation, stalling globalisation and low-flation all concerning our team. But the forecasts still show global real GDP growth accelerating slowly from 2.7% this year to 3.1% in 2015 and 3.4% in 2016. Meanwhile, global inflation is broadly stable and likely falling a bit in 2015. For us, this background remains supportive of risk assets. Previous episodes of accelerating real growth and stable inflation have generated roughly twice the long-run average volatility-adjusted returns to US equities (see Figure 68).

Also supportive of equity markets will be another year of highly accommodative monetary policy in developed economies. In recent weeks, Citi economists have pushed back the predicted time for first/ further rate hikes in the US and many other developed economies. Meanwhile, the BoJ has announced accelerated money base growth and the ECB is targeting a balance sheet expansion back to early 2012 levels. A consolidated G4 Central Bank balance sheet in USD terms has risen 9.3% annualised since early 2009 and will rise a further 9% in 2015 assuming BoJ and ECB plans are achieved (see Figure 69). LSAPs do not correlate well month by month with changes in asset prices due to markets anticipating and reacting to announcements rather than actual buying. But, over time, the QE support does seem to underpin stocks.

Financial engineering also continues to support equity market outperformance of fixed income, at least in the US. US corporates are issuing debt at a rate of around 5-7.5% of corporate GVA according to recent quarterly Fed flow of funds accounts. Yet overall, the corporate sector borrowing requirement (more or less investment less earnings) is only just positive due mainly to a continued sub-par capex cycle. Corporate CEOs see yields on debt well below earnings yields on stocks and do the arbitrage, issuing debt and returning capital to shareholders (see Figure 70). With 10y USTs currently below 2.3% and S&P500 earnings yields around 5.5% (see Figure 71), modestly higher bond yields as predicted by Citi strategists seem unlikely to prevent further buybacks, M&A, dividend growth and private equity activity from supporting share prices.

As a result, we expect equity returns to beat fixed income returns. But, in Global Macro Strategy anyway, we are not that bearish on fixed income returns per se. Credit spreads in the US look to us close to fair value versus underlying leverage, profits, financing gap and default fundamentals. And bond yields have noticeably failed this year to rise in line with consensus expectations. Looking ahead, we see the Fed on hold for nearly another year, low-flation persisting, USD strength helping to redistribute low inflation from Europe and Japan to the US and capital flows to USTs likely to be significant from Japan, non-Japan Asia and, especially the Euro Area. As a result, a risk to the Citi view of higher yields is that markets somewhat repeat a muted version of the 2004-2006 episode where the Fed tightened 425bp but the 10y UST yield broadly traded sideways (see Figure 72).

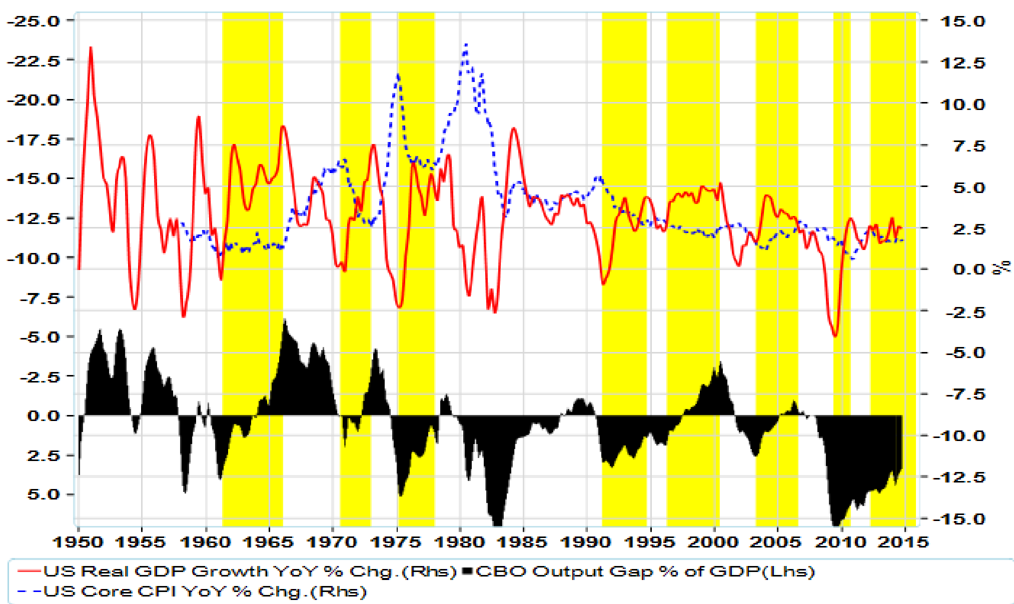
The recycling of a likely growing EA current account surplus looks especially interesting. The ECB needs a lower EUR to achieve its immediate objective to get inflation/inflation expectations up and real yields down. We think the EUR/USD is headed much lower and will approach and maybe breach parity over the next couple of years. But if initial ECB efforts do little to boost domestic demand, a much lower EUR likely means an even bigger current account surplus. Already in September the surplus jumped to 3.7% of GDP and net debt capital outflows to EUR50bn. The ECB could, theoretically achieve many objectives by simply buying USTs (balance sheet expansion, liquidity, credit quality, fairness within the EA, lower

EUR/USD) but this will likely not go down well in the international community. Instead, we expect ECB LSAPs to displace EA investors from some asset markets who will instead seek yield in other debt markets including the US. It is quite possible that these flows will give rise to a new bond market puzzle, a Yellen conundrum, as yields fail to rise even when Fed tightening approaches.

In essence, we think there is a risk that growth divergence between the US on one side and the EA and Japan on the other may translate much more into significant currency movements in response to capital flows and that underlying inflation and yield divergence may be dampened down with the US curve likely flattening more than forwards if the Fed does eventually begin a tightening cycle.

Finally, on commodities, while Ed Morse and team present a neutral to bearish outlook elsewhere in this Prospects, the recent drop in both commodity spot prices and correlations to other risk assets such as equities does present an opportunity to investors to diversify into the asset class at some point. Adding commodities to equity/ bond portfolios lowers portfolio volatility in most years historically and improves Sharpe Ratios. The risk that is being hedged is essentially one of a supply shock driven spike in energy prices which has mainly been a negative for equities historically and sometimes for bonds too. One should obviously look to enter such diversification programmes only when commodity prices are both off their highs and uncorrelated which makes current conditions interesting for renewed long term investor interest in the asset class.

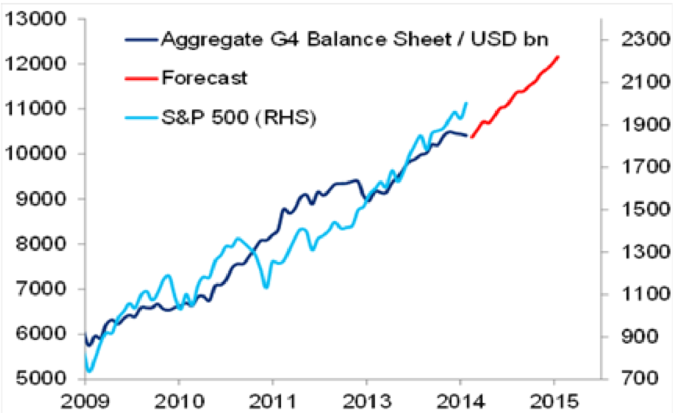
**Figure 68. Growth Up, Inflation Stable – Good For Equities**




| | Annualised % Return | | | | | | |
|---|---|---|---|---|---|---|---|
| | SPX Index | MSCI EM | CRB CMDT Index | SPGSCI Index | Dollar Index | US Gov | US IG Credit |
| Average Return during Periods* | 15.2% | 52.6% | 2.9% | 9.0% | 1.1% | 4.2% | 5.3% |
| Standard Deviation of Returns in Periods | 10.6% | 69.6% | 8.6% | 18.8% | 5.0% | 4.0% | 2.5% |
| Standard Deviation of Annualised Returns in Periods | 13.2% | 14.6% | 7.0% | 17.6% | 6.7% | 8.7% | 9.4% |
| Average Return during Period / Risk | **1.15** | **3.60** | **0.41** | **0.51** | **0.16** | **0.48** | **0.56** |
| Average Return (Entire History) | 9.2% | 17.7% | 1.5% | 4.8% | -1.0% | 11.7% | 13.3% |
| Standard Deviation of Annualised Daily Returns (Entire History) | 16.2% | 16.1% | 6.6% | 19.2% | 8.3% | 7.7% | 9.4% |
| Average Return over Entire History / Risk | **0.57** | **1.10** | **0.22** | **0.25** | **-0.12** | **1.51** | **1.42** |

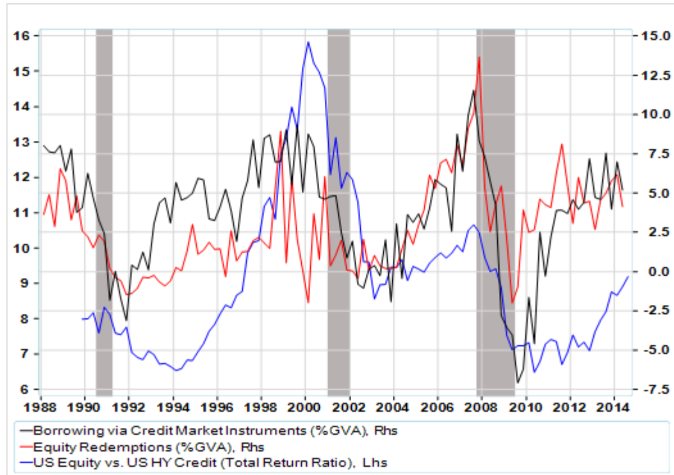
Sources: Citi Research and Macrobond

**Figure 69. S&P500 Index vs. G4 Central Bank Balance Sheet ($Bn)**




Sources: Citi Research and Bloomberg

**Figure 70. Corporate Financial Engineering**

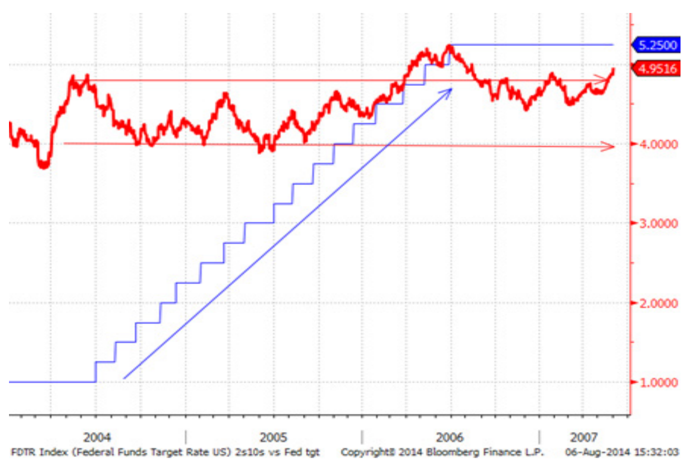



Sources: Citi Research, Macrobond and Federal Reserve

**Figure 71. Spread Between Equity Earnings Yield and Bond Yield - US**


Sources: Citi Research and Bloomberg

**Figure 72. Fed Funds Rate (Blue) vs. 10y UST Yield (Red) 2004-2007**




Sources: Citi Research and Bloomberg

# Commodities Market Outlook

Edward L Morse

Aakash Doshi

**Flaccid commodity demand growth through 2015 parallels the continued expected weakness in the global economy. The result is a neutral-to-bearish cast across this consumable asset class for 2015, with perhaps wishful thinking among producers that lower prices, especially for petroleum, will be a prompt for higher activity by year-end. But commodities are cyclical and given the price drop in certain markets ex-energy, and tightening fundamentals in certain metals and bulks markets, opportunities could be reemerging**. Overall it is not just the sluggish or negative growth in most advanced and some of the largest EM economies that is weighing on sentiment. Perhaps most important is the near-certain prospect that Chinese commodity demand will weaken further at least through the first half of 2015, even when compared to the challenges confronted in 2014 by the largest driver of commodity demand growth in the world.

**Figure 73. Citi Research 2015 Commodities Market Sentiment***

| | Bullish | Neutral | Bearish |
|---|---|---|---|
| **Energy** | | Brent Crude | WTI Crude, HH Natural Gas |
| **Base Metals** | Nickel, Copper, Lead | Aluminum, Zinc | |
| **Precious Metals** | Platinum, Palladium | Gold, Silver | |
| **Bulks** | Thermal Coal | Met Coal | Iron Ore |
| **Agriculture** | Coffee | Corn, Wheat, Cocoa | Cotton, Soybeans |

Source: Citi Research, *as of curves on 20 November 2014

**Of all the commodities, petroleum with its much lower prices is likely to be especially consequential, given the multiple ramifications of oil prices on both the world economy and on other commodities**. The sharp drop in oil prices in Q3 and Q4 this year point to the lowest oil prices the world has seen since the 2008 Great Recession. Citi's base case of $80 for Brent in 2015 looks precarious enough. If OPEC doesn't move to credibly balance the markets in 2015, oil prices can fall even lower, with a small probability that the producer group will get its act together and to hold it for a full year, in which case prices could return to $90 or even higher for a while. The collapse in oil prices touches virtually every corner of the global economy and could add to global growth by year-end. The pain for producers is asymmetrically larger than the gains for consumers, yet for sure lower fuel and food prices can keep inflation tamed in most economies. And the impact of lower prices on different sectors of the economy, on different commodities (most of which are energy intensive themselves) and different countries, suggests differentiated opportunities and challenges in each sector and region.

**Financial flows have reflected this turn in sentiment as the BCOM commodity index has been hovering at ten-year seasonal lows since September, taking benchmark prices back to pre-commodity super cycle levels**. Indeed, passive index and commodity ETF inflows which totaled c$7.5Bn in 1H'14 have since given back c$18Bn in net investment during 2H'14 with fund positioning across a variety of markets — crude oil, gold and wheat to name a few —near all-time lows. While such soft positioning increases the possibility of short-covering rallies, it has been weak fundamentals that underpinned the selling. The question then arises, under a more tepid macro backdrop, will investors reengage with the asset class and pursue opportunities from a long/short, curve spread or relative value mindset.

## Energy

**The slide in oil prices that started in early 3Q'14 has run into 4Q'14 with Brent flat price down 17% QTD to c$80 per barrel as of late November**. The root cause is clear; an overhang of light sweet crude in the Atlantic Basin against a background of much weaker oil demand growth, and although financial flows, a strong US dollar and seasonality played a role in the oil price slide, the oversupply in the market needs to be abated in order to lift prices. Addressing this problem would require a supply-side pullback as demand should be slow to adjust in the near-term, particularly amidst a weak macro backdrop and the impact of lower crude prices for consumers muted by a combination of steep taxes (in Europe for example) and regulated prices in many emerging markets.

US shale oil production costs have been cited as a potential "floor" but in the near-term this seems unlikely given half-cycle costs of production are in the $30-45 per barrel range (see also Citi's report "The Abyss Stares Back"). This leaves OPEC action required to balance markets, but the producer group is stuck between a rock and a hard place. A cut in production of over one million barrels per day can clear out some spec shorts, relieve the oversupply and lift prices to perhaps ~$90 per barrel but it will likely require reduced output across all members (especially the African light sweet crude oil producers). The ability of OPEC to do this remains a big question mark, but if it can it will just give further impetus to the US shale revolution. If the producer group does not cut production, prices can fall further and the marginal costs of shale will be tested. Yet given that WTI prices will likely need to fall to $65/bbl or lower for any meaningful reaction, it looks like OPEC will have to weather some serious pain as government revenues are crushed, which is particularly worrisome for the likes of Venezuela, Iran and Iraq. Either path will prove difficult for OPEC, but any inaction will likely be punished by the market.

**With shale oil production growth remaining robust even in a lower oil price environment, the US should remain well supplied, meaning that ongoing adjustments to imports and exports need to be made**. This means WTI should be pressured to move to wider discounts below Brent through 2015. This supply is not only coming from shale plays in North Dakota and Texas (as well as the Rockies region, Oklahoma and elsewhere), but also from deep water Gulf of Mexico production that is beginning to grow again after a multi-year hiatus, and new pipeline capacity bringing heavy sour crude oil from western Canada all the way to the US Gulf Coast. This means that going forward, production growth is not just in the light sweet crude quality category, but also heavier, sourer crudes that directly compete with Saudi, Mexican and Venezuelan barrels.

Imports can continue to be pushed out (or those producers would face lower price realizations if they want to retain US market share) while US crude exports can continue to rise to as high as a million barrels per day by mid-2015, made up of exports to eastern Canada, exchanges with Mexico, exports of minimally processed condensates, exports from Alaska, and re-exports of Canadian crude. But even with robust growth of US crude exports, Gulf Coast crude inventories still look like they can fill up over 2015, pressuring US crude prices. Meanwhile, US crude export policy could see some major incremental changes in 2015, including the potential to open up routes to other FTA countries, particularly Chile, Israel, Singapore, and South Korea. Part of this process could be complicated by how Sen. Mary Landrieu (D-LA) fares in the December run-offs; if she loses, as expected, Sen. Maria Cantwell (D-WA) is next in line as ranking member in the Senate Energy and Natural Resources Committee, and would likely be less cooperative with Sen. Murkowski (R-AK) on pro-export and pro-production issues. Murkowski is set to

become the Chair of the Committee; Landrieu has generally been pro-exports, bolstering support for these issues from both sides of the aisle.

**Falling oil prices are also affecting gas markets globally but to varying degrees.** In global LNG, lower oil prices drag down oil-linked LNG prices, where the near month spot price (JKM) has fallen to ~$10.40/MMBtu at the time of writing, with January prices in a similar range. This is nearly a 50% drop from the $20/MMBtu observed in the same month in last two years, when oil prices averaged in the $100/bbl range. Even though oil prices have only fallen to the high-$70/bbl level, over-supply in the global LNG market is also contributing to the price reduction. Asian utilities have purchased LNG cargoes earlier than normal, reducing the need to buy from the spot market this winter; over-supply in Europe also makes more LNG available; the pending restart of nuclear units in Japan, about a year after reactors were commonly expected to restart, also damped sentiment.

Meanwhile, sufficient supply in Europe, in addition to the recent de-escalation in Ukraine's gas supply (not necessarily the actual geopolitical situation), along with low oil prices putting pressure on oil-linked supply, also lowered the forward curve of gas in Europe. NBP forwards through Q3'15 are all below $9/MMBtu. Gas inventories remain high. We expect both the JKM and NBP to remain subdued in the current range of $10 to $11 for Asia, and ~$8.50 for NBP in Europe

**In North America, although gas prices are supposed to be traded according to gas' own supply-demand fundamentals, lower oil prices could affect tight oil production at marginal wells, which tend to have higher shares of associated gas production, and the economics of liquids drilling.** When oil prices were around $100/bbl, the NGL basket price was around $40/bbl. But with the same NGL-to-oil price ratio, the NGL basket price at an oil price of $75/bbl (WTI) would fall to $30/bbl, or a 25% decline in the NGL basket price. Associated gas production growth could fall by ~0.3-Bcf/d if oil production growth were to fall by ~0.1-mb/d. Spreading this throughout the year is equivalent to cutting 100-Bcf in storage, turning the market from being rather bearish to somewhat more neutral. But the most significant driver is a very cold November and the potential for another very cold N. American winter. Weather was the primary driver that propelled prices from $3.6 to almost $4.5/MMBtu. If weather continues to stay cold, prices would continue to be supported, lifting 2015's prices higher from the $4.0 level. But if weather turns normal or milder in the rest of winter, strong supply should weigh on prices, lowering 2015 prices closer to the mid to high-$3 range.

## Shipping

**Shipping tanker rates have firmed going into 4Q 14 as cheaper oil prices supported buying activity. Overall, the outlook for tanker rates in 2015 calls for tempered optimism, as net additions to the fleet look to be minimal, creating supportive conditions for pricing if oil trade volumes are firm or growing. In particular, the US production and export outlook is set to be one of the biggest factors impacting oil trade flows in 2015. As the US continues to back out imports, at first glance this seems to be reducing trade volumes and therefore demand**. Yet if barrels from West Africa that traditionally came to the US shift to longer routes to Asia, this could actually be supportive of total tonne-mile demand and prices. Hence factors looming large for tanker markets in 2015 will likely be the pace of US oil production growth and export growth, as well as China's crude import appetite, which Citi expects to moderate in 2015. Finally, shipping fuel costs are set to undergo significant and opposing shifts in 2015. These include new low sulfur (.1%) fuel rules in North American and European Emissions Control Areas (ECAs), which could meaningfully raise fuel costs in compliance areas, but also

around 25% lower prices since August for conventional bunker fuels (3.5%) on the back of oil price declines, which will decrease costs in non-compliance areas.

## Base Metals

**Base metals have remained relatively range bound over the last month, with downside moves limited by a general lack of physical availability (most notably with copper) and upside trajectory limited by continuing US dollar strength on the one hand, and concerns over softening macro-economic data from the world's biggest metals consumer, China.** Concerns over Europe and to a lesser extent Japan have only acted as a side show to the main US-Chinese macro drivers. However, the fact that macro-sensitive copper prices have remained resilient in the face of compelling macro-arguments for price deterioration, suggests a top-down analysis of metals markets is warranted.

**We believe that 'Dr Copper's' macro forecasting properties have been severely diminished this year, with price activity appearing to be more linked to micro-economic metals-focussed data points rather than macro-indicators, and in particular Chinese macro-indicators**. For example, in the year-to-October, Chinese copper product fabrication volumes have jumped by 19.5%, a level of growth that belies China's slowing IP and PMI data. A key reason for this divergent trend is, we believe, the growth in consumer market-focussed metals demand, which we expect to be a continuing trend in 2015. While infrastructure spending, particularly related to energy, will be an important demand driver in 2015, we believe that the consumer product sector will be a strong area of demand for metals. 2014 has seen a significant acceleration in many types of consumer product manufacturing. In the year-to-October, TV production has surged by 16% to 126.7 million units, micro-wave oven production is up by 8% to 62.3 million units, and computer production has jumped 16% to 277 million units, while total auto production for the year-to-date has reached 19.3 million vehicles. With consumer confidence on an upward trend since Q1 of this year, we expect the domestic consumer market to grow strongly in 2015. An added boost for copper in particular has been the introduction of energy efficiency subsidies on many white goods, particularly those that require heat exchangers such as fridges, freezers, air-conditioning units etc, favouring the purchase of more energy efficient higher copper content products.

A number of metals markets, but chiefly copper, have also found support by the metal buying activities of the Chinese State Reserves Bureau (SRB), which we believe has purchased between 230,000 t - 500,000 t of refined copper amongst other metals this year. This activity has pushed the global market into an effective deficit of between 70,000 — 340,000 t, given the tightly held nature of SRB copper stocks. We understand that the SRB could be targeting the purchasing up to an additional 500,000 t of copper over the next year pointing to further postponements of effective surpluses, in turn suggesting that prices will remain well supported in 2015. On a longer term basis, we are forecasting copper prices to average $7,200/t in Q4 next year.

## Precious Metals

**Gold prices found some support in November as some of the currency and macro headwinds became more fully priced-in by October. On the fundamental side, there have at last been signs that the Chinese gold and silver markets have begun to react positively to the recent low price environment, with Yuan based retail spending on gold and silver jewellery picking up by 17.8% Y/Y in October after a somewhat disappointing Q3**. In

addition, market concerns over the prospect of a positive (yes) vote in the upcoming referendum on Swiss National Bank (SNB) gold policy, under which the central bank would be forced to increase gold holdings to the equivalent of 20% of total reserves and refrain from being a gold seller going forward, added to upward momentum. The plan, if supported, would require around 1,500 t of gold to be purchased over a five year period. Irrespective of the final vote count, we see little prospect of significant and sustained upside gold price movement over the next 3-6 months, with ongoing USD strength and tepid inflation expectations weighing on prices. However, the recent strength of both the Indian and Chinese markets suggests gold staying supported over the next quarter. We project gold prices to average around $1,200/oz. over the three months, as market fundamentals provide support, while dollar strength and producer hedging on the rallies limit upside.

## Bulk Commodities

**Due to incoming return of supply growth, iron ore prices are expected to fall slightly in the first three quarters of 2015, slowly rebound in 4Q, and increase in 2016 and 2017**. Production growth is expected to return in 1H15, because supply is more resilient than the market appreciates. Producers do not cut production easily and are even more reluctant to close assets completely. Prices need to be clearly below cash costs for a prolonged period to induce significant production cuts. FX movements have also helped iron ore producers, with currencies of virtually every significant exporter having depreciated versus the USD since the start of the year. Chinese mines responded modestly to price declines in 2014. However, we believe the scope of such curtailments are likely to be insufficient to accommodate the roughly 150 Mt of new production expected to hit the market in 2015.

**Spot coking coal prices have remained relatively stable after a big fall, and will grow slowly amid weak China demand.** Supply growth is slowing, as price-induced curtailments have totaled around 15 Mt/y of exports since April and we forecast only modest supply growth in 2015. On the demand side, we expect weak demand in Asia, especially China and Japan, to keep prices depressed in H1, but for somewhat better demand in H2 to move prices higher. The Chinese market is generally balanced and inventories remain stable. Met coal demand has suffered due to weak year-to-date steel production growth, and only a seasonal pick up is expected post-Q1. Steel mills and coke plants maintain stable inventories but port stocks declined to record low levels.

**Thermal coal prices have consistently made new lows in 2014 falling past the lowest levels since 2009.** The precipitous fall has been driven by a significant increase in Australian exports since the beginning of 2014 and ongoing recovery of supply from Colombia. We expect supply growth to slow down in 2015 but remain elevated. The biggest medium term catalyst for prices will be prospects for Chinese imports. However, we remain bearish thermal coal demand due to rising environmental pressures in China and developed markets, as well as the declining cost competitiveness of coal compared to renewable energy sources. India and ASEAN should see stronger growth though and supply growth should slow from 2016, allowing prices to rebound to long-run levels.

## Agriculture

**Grains are short-cycle markets because supply is less predictable and extremely weather sensitive versus energy and metals commodities. But with the devastating 2012 drought for now a distant memory — and given that global importers already had the chance to rebuild stocks during 2013/14 —**

**we argue that markets are still in the midst of an era with sufficient inventory overhangs and availabilities which should keep a lid on prices for the next few years (assuming normal weather)**. The oilseed complex has boosted US grain prices c15% this quarter despite expectations for record output and physical markets entering what typically coincides with the normalized seasonal nadir for corn, soybean and wheat prices (the month of November representing the annual low in spot markets during the past twenty years). Harvest delays, railcar/transport congestion and robust US export developments are a few key factors that have lifted grain contracts in recent weeks even though 2014/15 and 2015/16 US and international supply/demand balances for these markets have appeared exceedingly bearish in USDA and Citi Research publications throughout most of 2014. *Bottom line:* fundamentals do not indicate material tightness in our view.

**Underlying US field crop prices should remain compressed and we are biased to an overall weak pricing environment for the staple cereals to persist (certainly versus the 2010 – 1H 13 period).** USDA data imply a very well-supplied domestic and global grains market and absent a weather shock next year, the outlook for 2015/16 oilseed prices in particular appears quite weak as the deferred new-crop US soybean carryout is forecast by Citi to exceed 500-mn bu. With more favorable sowing conditions in Brazil materializing in recent weeks, the Latin American oilseed loadings program should continue to loom large in 2Q'15, even if slightly delayed and modestly downgraded by CONAB in November. The recent rebound in maize and wheat prices could also buttress 2015/16 farmer planting intentions to the upside. This is a grains environment that would favor consumers.

**World food price inflation has already started easing dramatically pursuant to our forecasts.** The FAO Food Price Index has collapsed 21.5 points since 1Q 14 to 192.3 posting its lowest levels since August 2010 and affirming sustained relief for importers following violent price spikes throughout 2010-1H 13 and 1Q'14 for grains, dairy and related products. Aggregate food prices could ease further in 2015 if the weather were especially ideal, else stay compressed, and favor Northern Hemisphere buyers with so many leading exporters (i.e. US, Brazil, Ukraine) posting strong seasonal harvest outlooks; milk, butter and cheese prices having come off so sharply from their 2014 peaks on improving supplies and as vegetable oil prices have weakened as output ramps-up on abundant/cheaper feedstock.

**Official agency data show that while world grain costs have declined c30% since early 2013, global meat prices have increased c12%.** The US West Coast drought and high grain costs during 2010-1H 13 prompted the lowest US cattle-head count in forty years and disease diminished annual hog slaughter this year. Although the availability of poultry products including turkeys have been better, the ill-supplied livestock situation is likely to keep supporting meat prices for the next few quarters. Protein-intensive animal units often take time to build. However, lower feed grain prices should help in the supply recovery as feeder margins are favorable again and to be certain, they have likely helped quell the rapid rise in pork and beef prices to some degree. While weather remains the perennial wild card, it seems that net staple food supply should beat demand growth at least over the next few years.

## Figure 74. Citi Commodities Price Forecast*

| | | Point Prices | | | | | | | | | | | | | | | | | | Annuals | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 0-3M | 6-12M | | Q4 2014E | Q1 2015E | Q2 2015E | Q3 2015E | Q4 2015E | Q1 2016E | Q2 2016E | Q3 2016E | Q4 2016E | 2012 | 2013 | 2014E | 2015E | 2016E | 2017E | 2018E |
| **Energy** | | | | **5Y Cyclical** | | | | | | | | | | | | | | | | |
| NYMEX WTI | USD/bbl | 73.0 | 75.0 | 81.0 | 73.0 | 72.0 | 67.0 | 74.0 | 75.0 | 76.0 | 69.0 | 76.0 | 79.0 | 94.1 | 98.0 | 93.0 | 72.0 | 75.0 | 79.0 | 82.0 |
| ICE Brent | USD/bbl | 80.0 | 82.0 | 85.0 | 80.0 | 80.0 | 75.0 | 80.0 | 85.0 | 85.0 | 80.0 | 85.0 | 90.0 | 111.7 | 108.7 | 101.0 | 80.0 | 85.0 | 85.0 | 85.0 |
| Henry Hub Natural Gas | USD/MMBtu | 4.20 | 3.50 | 5.50 | 3.90 | 4.20 | 3.50 | 3.50 | 3.60 | 4.0 | 4.1 | 4.2 | 4.3 | 2.75 | 3.73 | 4.40 | 3.70 | 4.20 | 4.70 | 4.70 |
| **Base Metals** | | | | **LT Price** | | | | | | | | | | | | | | | | |
| LME Aluminum | USD/MT | 1,960 | 2,000 | 2,200 | 1,985 | 1,970 | 1,980 | 2,000 | 2,050 | 2,070 | 2,090 | 2,110 | 2,130 | 2,049 | 1,888 | 1,895 | 2,000 | 2,100 | 2,200 | 2,300 |
| LME Copper | USD/MT | 6,820 | 7,200 | 6,200 | 6,780 | 6,840 | 7,000 | 7,100 | 7,200 | 7,350 | 7,600 | 7,850 | 8,000 | 7,945 | 7,352 | 6,880 | 7,035 | 7,700 | 8,200 | 8,400 |
| LME Lead | USD/MT | 2,150 | 2,250 | 2,200 | 2,060 | 2,150 | 2,100 | 2,200 | 2,250 | 2,400 | 2,300 | 2,390 | 2,500 | 2,072 | 2,158 | 2,125 | 2,175 | 2,400 | 2,450 | 2,360 |
| LME Nickel | USD/MT | 20,000 | 23,000 | 21,000 | 16,050 | 20,000 | 21,500 | 22,000 | 23,000 | 24,500 | 25,000 | 25,000 | 26,500 | 17,592 | 15,105 | 16,980 | 21,625 | 25,250 | 26,000 | 24,500 |
| LME Tin | USD/MT | 20,600 | 23,000 | 20,000 | 19,900 | 20,600 | 22,000 | 22,900 | 23,100 | 22,600 | 23,000 | 23,000 | 23,500 | 21,108 | 22,340 | 21,900 | 22,150 | 23,025 | 24,000 | 23,000 |
| LME Zinc | USD/MT | 2,300 | 2,350 | 2,100 | 2,265 | 2,300 | 2,280 | 2,320 | 2,350 | 2,380 | 2,395 | 2,350 | 2,400 | 1,963 | 1,940 | 2,170 | 2,315 | 2,380 | 2,350 | 2,320 |
| **Precious Metals** | | | | **LT Price** | | | | | | | | | | | | | | | | |
| COMEX Gold | USD/T. oz | 1,200 | 1,240 | 1,050 | 1,205 | 1,210 | 1,215 | 1,220 | 1,225 | 1240.0 | 1250.0 | 1260.0 | 1280.0 | 1,669 | 1,416 | 1,265 | 1,220 | 1,260 | 1,340 | 1,400 |
| Silver | USD/T. oz | 18.3 | 18.7 | 16.5 | 16.4 | 16.3 | 16.5 | 16.6 | 16.7 | 16.8 | 16.9 | 17.2 | 17.6 | 31.2 | 24.0 | 19.1 | 16.5 | 17.2 | 18.6 | 20.0 |
| Platinum | USD/T. oz | 1,400 | 1,500 | 1,763 | 1,250 | 1,290 | 1,325 | 1,375 | 1,410 | 1450.0 | 1500.0 | 1580.0 | 1630.0 | 1,552 | 1,490 | 1,390 | 1,350 | 1,540 | 1,763 | 1,880 |
| Palladium | USD/T. oz | 890 | 920 | 780 | 780 | 830 | 865 | 885 | 900 | 900.0 | 905.0 | 915.0 | 920.0 | 645 | 728 | 800 | 870 | 910 | 950 | 980 |
| **Bulk Commodities** | | | | **5Y Cyclical** | | | | | | | | | | | | | | | | |
| Hard Coking Coal (Spot) | USD/MT | 112 | 125 | 170 | 112 | 112 | 117 | 125 | 135 | 140 | 140 | 140 | 140 | 191 | 148 | 115 | 122 | 140 | 150 | 145 |
| Thermal Coal Asia (NEWC) | USD/MT | 70 | 65 | 90 | 67 | 70 | 68 | 65 | 65 | 70 | 75 | 75 | 80 | 94 | 84 | 72 | 67 | 75 | 85 | 100 |
| Iron Ore Spot (TSI) | USD/MT | 75 | 62 | 81 | 78 | 72 | 65 | 60 | 62 | 65 | 65 | 65 | 65 | 128 | 135 | 98 | 65 | 65 | 73 | 80 |
| **Agriculture** | | | | | | | | | | | | | | | | | | | | |
| CBOT Corn | USd/bu | 360 | 388 | N/A | 355 | 360 | 375 | 400 | 400 | 420 | 440 | 435 | 400 | 695 | 578 | 410 | 385 | 425 | 450 | N/A |
| CBOT Soybeans | USd/bu | 1,000 | 980 | N/A | 975 | 1,000 | 1,010 | 950 | 950 | 950 | 960 | 950 | 940 | 1,465 | 1,406 | 1,245 | 975 | 950 | 1,040 | N/A |
| CBOT Wheat | USd/bu | 515 | 540 | N/A | 520 | 515 | 530 | 550 | 540 | 560 | 560 | 570 | 530 | 750 | 684 | 580 | 535 | 555 | 570 | N/A |
| NYB-ICE Cotton | USd/lb | 55.0 | 60.0 | N/A | 60.0 | 55.0 | 60.0 | 59.0 | 59.0 | 60 | 60 | 60 | 60 | 80.0 | 84.0 | 76.0 | 58.0 | 60.0 | N/A | N/A |
| ICE Coffee | USd/lb | 215 | 225 | N/A | 195 | 215 | 225 | 225 | 240 | 225 | 225 | 225 | 225 | 175 | 125 | 175 | 225 | 225 | N/A | N/A |
| ICE Cocoa | USD/MT | 2,900 | 2,800 | N/A | 2,925 | 2,900 | 2,800 | 2,800 | 2,600 | 2600 | 2600 | 2600 | 2600 | 2,348 | 2,400 | 3,000 | 2,775 | 2,600 | N/A | N/A |

Source: Citi Research, *subject to revision

**Figure 75. Citi Global Economics Team** *(For Informational Purposes Only)*

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# Appendix A-1

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