Citi Research

Economics

6 June 2014 | 16 pages

Developed Markets
Western Europe

Euro Economics Weekly

ECB TLTRO: Ambitious But Probably Not Enough, QE Lies Ahead

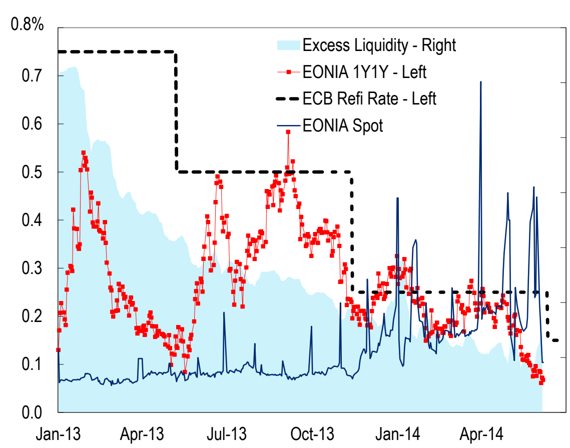
- **Rate cuts and liquidity aimed at loosening financial conditions** — The ECB unveiled an ambitious package of measures at the June meeting, cutting all its key interest rates, resulting in a negative deposit rate, extended the fixed-rate full allotment procedure, suspended the weekly sterilisation of the SMP and introduced a 4-year targeted LTRO (TLTRO), with a potential initial entitlement of €400bn.
- **Stronger forward guidance and ABS programme in sight** — Equally importantly, the ECB confirmed that it was actively involved in preparatory work related to outright purchases in the asset-backed securities (ABS) market. With stronger forward guidance, we believe that this puts the ECB in a position to do more soon.
- **QE programme around year-end remains our baseline** — Given the likely delay in the pass-through from the TLTRO to firms, we suspect that inflation dynamics will be important in determining the timing of a large-scale asset purchase programme. Persistently low inflation and the strong euro should prompt the ECB to ease again.

Figure 1. Citi Forecasts

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

Source: Citi Research

Figure 2. Euro Area — ECB Refi Rate and EONIA (%), Excess Liquidity (€bn), Jan-13 to Jun-14



Sources: European Central Bank, Bloomberg and Citi Research

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ECB Unveils Ambitious Package

A comprehensive ECB package

On Thursday, 5 June, the ECB Governing Council (GC) presented "*a package of measures to provide additional monetary policy accommodation and to provide lending to the real economy*". The ECB cut interest rates, extended the fixed-rate full allotment procedure, suspended the weekly sterilisation of the Securities Market Programme (SMP) and introduced a new instrument called the targeted long-term refinancing operation (TLTRO) aimed at improving bank lending to the euro area private sector, excluding household mortgages, over a window of two years. Mr. Draghi indicated that the GC had been unanimous in approving the package.

ABS securities an option and strengthened forward guidance

Equally importantly, the ECB confirmed that it was actively involved in preparatory work related to outright purchases in the asset-backed securities (ABS) market. Although the ECB modified its forward guidance statement, indicating that "*key ECB interest rates will remain at present levels for an extended period of time*", removing the reference to lower rates, it reiterated that "*if required, we will act swiftly with further monetary policy easing*", adding that the GC "*is unanimous in its commitment to using also unconventional instruments within its mandate should it become necessary to further address risks of too prolonged a period of low inflation*". We believe that this is significant from a signaling standpoint, leaving the door open to do more and implying a shift from marginal rate cut to broader measures.

A significant amount of additional stimulus unlikely to be enough to bring inflation to target, in our view

Overall, these announcements amount to significant additional stimulus. But we doubt it will be enough to prevent a continued inflation undershoot. Given our baseline of headline inflation easing further in the summer (averaging 0.3% in 3Q-14) and that disinflationary headwinds from poor credit availability and the strong euro persist, we expect the ECB to do more by relying on non-standard measures. We still expect the ECB to launch a fully-fledged QE, possibly in Dec-14.

What has the ECB done?

- **Main policy rates**: 10bp rate cut in the main refinancing rate to 15bp and a 10bp rate cut in the deposit rate to -10bp. By cutting the interest rate on the marginal lending facility by 35bp to 40bp, the GC narrowed the interest rate corridor to 50bp, its tightest ever range. The ECB noted that the negative deposit rate would apply to all banks' average reserve holdings in excess of the minimum reserve requirements, and other deposits held in the Eurosystem, including balances on Target 2 accounts – a guideline will be published by 7 June.

- **Liquidity**: as expected, the GC lengthened the window for fixed-rate full allotment for its one-week main refinancing operations (MRO) at least until Dec-16, instead of Jul-15. The extension also applies to the 3-month LTROs. The GC discontinued the special-term one-month refinancing operation, following a final allotment on 10 June 2014. Finally, the GC suspended the weekly fine-tuning operation sterilizing the €164.5bn liquidity injected under the Securities Market Programme (SMP). Mr. Draghi remarked during the Q&A that the much lower inflation environment meant that the decision to sterilise taken in 2011 was no longer appropriate.

- **Two-year programme of eight TLTROs:** these 4-year fixed-rate (refi +10bp spread) liquidity facilities will have strings attached, but it is not clear to us whether funds obtained through the TLTRO will allow banks to buy sovereign debt. The ECB's introductory statement indicated that "*a number of provisions will aim to ensure that the funds support the real economy*". President Draghi noted in the Q&A that the ECB was "*determined that the [TLTRO] money is not spent on sovereigns*". As a result, counterparties that have "*not fulfilled certain*

conditions regarding the net volume of their net lending to the real economy will be required to pay back borrowings in Sep-16".

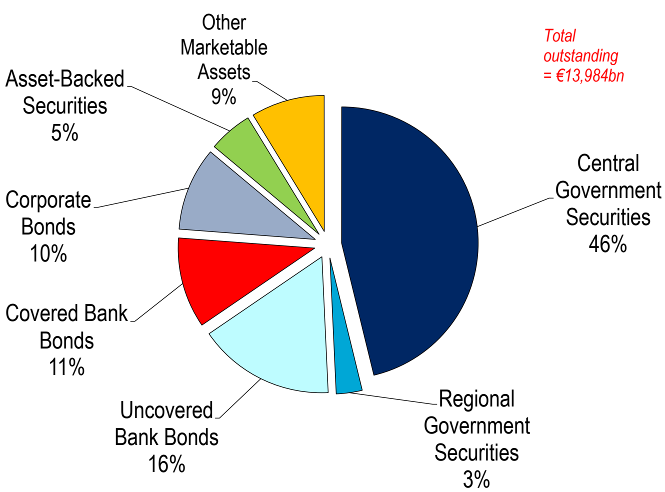
The ECB unveils a two-year plan enabling investors to lock in liquidity over 4 years at 25bp

Why two years? We suspect that this corresponds to the period when the central bank has a reasonable degree of confidence that economic activity will stay muted, the private sector will continue to deleverage and inflation will undershoot its medium-term price stability objective by a wide margin. This two-year period also corresponds to the extended liquidity window provided by the GC now that both the main one-week refinancing operation (MRO) and the three-month LTROs will be conducted as fixed rate tender procedures with full allotment until the reserve maintenance period ending in December 2016.

Extended eligibility of additional assets as collateral until Sep-18

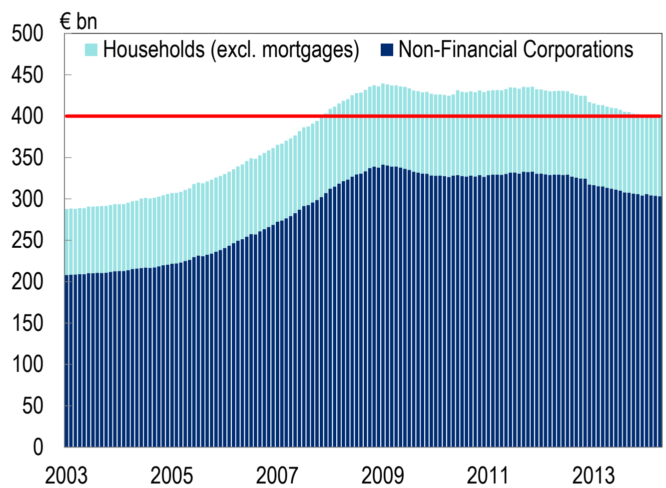
Another measure adopted by the Governing Council and linked to the TLTROs was the extension of the existing eligibility of additional assets as collateral, notably under the additional credit claims (ACC) framework, at least until September 2018. This is an important announcement, in our view. While we had suspected that some form of collateral loosening could be announced in the third quarter, this decision to give counterparties visibility about the second collateral list for a period of four years is a meaningful step in our view. This will allow the financial system to utilise credit claims (€1,217bn as of Q1-2014 or 8.7% of eligible Eurosystem market assets, see Figure 3) to increase collateral available to counterparties[1].

Figure 3. Eurosystem – Eligible Market Assets, € Billions, 1Q-2014



Sources: European Central Bank and Citi Research

Figure 4. Euro Area – Breakdown of Initial TLTRO Allowance (7% of Household and NFC Loans Outstanding), 2003 to 2014



Sources: European Central Bank and Citi Research

Our take on the main announcements

The package should generate some loosening in financial conditions…

We argue that these policy measures will probably lead to modest reductions in interbank rates, government bond yields and credit spreads, and will likely contribute to stopping a further appreciation of the euro. An important question is whether banks will feel that the cheap funding will be too good an opportunity to miss. Obtaining 4-year funds at a guaranteed fixed rate of 0.25% (the rate is the one prevailing at the time of the take up plus 10bp) will likely be attractive for most institutions, especially for those who still have some of the 3-year LTROs

[1] On 8 December 2011, as a temporary measure the Eurosystem implemented the additional credit claims (ACC) framework aiming to temporarily expand the use of credit claims as collateral so as to increase collateral availability to counterparties.
http://www.ecb.europa.eu/press/pr/date/2012/html/pr120209_2.en.html

outstanding (shorter and more expensive) and generally compared to senior unsecured funding. This would likely encourage a sizeable bid in the first two TLTROs, although maybe not as much as the €400bn maximum (see Figure 4).

… but will banks bid aggressively at the TLTROs?

On the grounds that the rate is more attractive than that of the FLS (BoE's Funding for Lending Scheme under which banks bid for around 2/3 of the funds on offer), banks could be tempted to bid more aggressively than for the FLS, perhaps as much as 85% or €340bn. Assuming some novelty effect and some encouragement by the national central banks, we could see a 70/30 split between the first and second TLTROs, implying bids of around €240bn and €100bn, respectively.

Subsequent TLTROs will likely see much smaller amounts, based on 3x the net lending above the reference benchmark

In the subsequent six TLTROs, to be conducted quarterly from Mar-15 to Jun-16, banks will be able to borrow additional amounts within a limit of 3x each counterparties' net lending (new private sector loans excluding household mortgages minus redemptions) in excess of the benchmark recorded in the 12-month period up to 30 April 2014. The ECB press release[2] notes that TLTRO counterparties whose net lending in the 2-year period from 1 May 2014 to 30 April 2016 is below the benchmark will be required to pay back borrowings in September 2016.

Provisions and reporting requirements unlikely to stop banks using these funds to purchase sovereign debt

Our colleagues from credit research presume that the "*number of provisions*" the ECB refers to will include some form of constraint on loan or borrowing size. It is difficult to envisage exactly what the conditions will be at this stage, in the absence of technical details to be released by the ECB in due course. What we can gather from the Q&A[3] is that there will be "*additional reporting requirements*", "*with checks on the use of the initial allocation and the quarterly allocations*". Although President Draghi noted during the press conference that the GC is "*determined that this money is not spent on sovereigns*", we suspect that banks will be free to buy sovereign debt over the first two years of the facility, using this cheap funding as a hedge against the possibility of higher policy rates over the next four years. One of the issues will continue to lie with the risk-weighting of SME loans in terms of cost of capital, compared to the zero-risk weighting for sovereign debt. A solution would be to reduce/suspend the former, or at least reduce the gap between the two in order to make it more attractive for banks to take on more credit risk.

The likely delay in the effect of the measures on the real economy could lead certain GC members to argue for more time before moving to QE

That the GC is focusing its attention on the banking system makes sense given the high reliance on intermediation as a source of funding for euro area corporates[4]. If the take-up is successful, it could at the margin delay the timing of our Dec-14 QE programme, as many GC members will likely argue that more time is needed to assess whether the policy is working. How long will it take for the full effect of these measures to develop? While it should be immediate for the money market, there will probably be delayed real economy effects, possibly over three or four quarters. We suspect that inflation dynamics will be more important therefore in determining the timing of a large-scale asset purchase programme. The ECB is likely to face a significant inflation undershoot, unless the euro weakens sharply or credit availability improves markedly. More evidence of a persistently low inflation outlook will likely come from the Sep and Dec-14 Staff macroeconomic projections. The commitment to delivering on its mandate of price stability will probably lead the GC

[2] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html

[3] http://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html

[4] The Bank of Japan in its statement on monetary policy dated 18 February 2014 decided to double the scale of (i) the Fund-Provisioning Measure to Stimulate Bank Lending and (ii) the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, and to extend the application period for these facilities by one year.

to act along the lines of "*whatever it takes*"[5], as suggested once more in the key second paragraph of the introductory statement.

Staff Projections

Lower GDP growth in 2014, but upward revisions to 2015 and 2016

The introductory statement did not significantly change the GC's broad economic assessment as staff macroeconomic GDP projections for the euro area were revised down for 2014 but up for 2015-16. The ECB also maintained the view that the risks surrounding the economic outlook for the euro area continue to be on the downside. The main changes to the euro area GDP forecast were a sizeable downward revision to the outlook for investment (now forecast to grow by 1.7% in 2014, 3.1% in 2015 and 3.5% in 2016, instead of 2.1%, 2.7% and 3.7%, respectively, see Figure 5). The projected unemployment rate trajectory was revised down across the board, with falls of 0.2ppt, 0.3ppt and 0.4ppt in 2014-15-16, respectively, following revisions to labour force estimates in several countries.

Lower inflation over the entire forecast horizon, with the mandate under greater threat

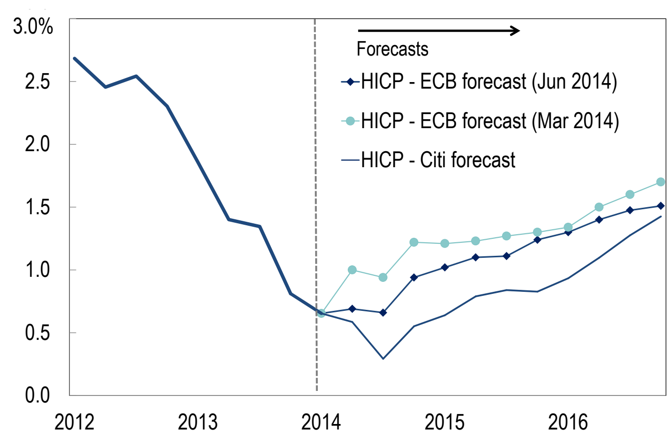
The staff forecasts acknowledged the recent lower levels for inflation, cutting the headline euro area average HICP forecast by 0.3ppt, 0.2ppt and 0.1ppt for 2014-15-16 to 0.7%, 1.1% and 1.4%, respectively[6] mainly due to the lower starting point. The GC continued to see both "*upside and downside risks to the outlook for price developments as limited and broadly balanced*". Importantly, the 4Q-16 euro area HICP estimate was revised down by 0.2ppt to 1.5% (see Figure 6), a situation that the GC described as "*underpinning the case of today's decision*". While the GC reiterated that "*inflation expectations for the euro area over the medium to long term continue to be firmly anchored*", the final sentence in the inflation paragraph stipulated that "*looking ahead, the GC is strongly determined to safeguard this anchoring*", suggesting its mandate is under increasing threat.

Figure 5. Euro Area – Selected Staff Macroeconomic Projections Forecasts, 2014 to 2016

		June 2014			March 2014		
	2013	2014	2015	2016	2014	2015	2016
Real GDP	-0.4	1.0	1.7	1.8	1.2	1.5	1.8
Private Consumption	-0.6	0.7	1.5	1.6	0.7	1.2	1.4
Govt. Consumption	0.2	0.4	0.4	0.4	0.4	0.4	0.7
Gross Fixed Capt. Formation	-2.7	1.7	3.1	3.5	2.1	2.7	3.7
Exports	1.7	3.6	4.8	5.3	3.6	4.7	5.1
Imports	0.5	3.6	4.8	5.5	3.5	4.7	5.2
Employment	-0.8	0.3	0.5	0.7	0.2	0.5	0.7
Unemployment Rate	12.0	11.8	11.5	11.0	11.9	11.7	11.4
HICP	1.4	0.7	1.1	1.4	1.0	1.3	1.5

Sources: European Central Bank and Citi Research

Figure 6. Euro Area – June 2014 Macroeconomic Staff Projections, 2Q-14 to 4Q-16



Sources: European Central Bank and Citi Research

[5] See "The ECB And QE: "Whatever it Takes", Redux", Euro Area Special Comment, Guillaume Menuet, 22 April 2014, Citi

[6] Note that every component of the 2015-16 inflation forecast was revised down in June, with the staff macroeconomic projections anticipating lower core inflation, lower growth in unit labour costs, lower wage growth offsetting lower labour productivity.

Sensitivity analysis takes a look at 'lower foreign demand'

In the section related to sensitivity analysis (pages 8-10), the staff macroeconomic projections replaced the scenario of a 'lower exchange rate' in March with one of 'lower foreign demand' in June[7]. This could reflect the fact that the ECB staff is less confident about a lower euro effective exchange rate path and more concerned about the external environment, as illustrated by the presentation of a special box reviewing "*the euro area's exposure to the crisis in Ukraine*". The sensitivity analysis estimates that reduction of 0.3ppt in the growth of euro area foreign demand in 2014 and 1.4ppt in both 2015 and 2016 would lower real GDP growth by 0.2ppt in 2015-16 and would lower HICP inflation in 2016 by 0.1ppt.

What's next?

All possible responses to Contingency 1 have been enacted

President Draghi's "reaction function" speech[8] had listed possible policy responses to three contingencies: i) unwarranted tightening of the policy stance, ii) further impairment in the transmission of the monetary policy stance and iii) reduction of the medium-term outlook for inflation. Of the possible policy responses related to the first scenario, Thursday's announcement has ticked all the boxes: further lowering of the interest rate corridor, further extension of the fixed-rate full allotment procedure, new liquidity injections including longer-term fixed rate operations.

More than 50% of the possible responses to Contingency 2 have also been announced

To address the impairment in the transmission of the policy stance, the package has also ticked off the long-term refinancing operation introduced to encouraging bank lending. The announcement of the intensification of preparatory work related to outright purchases in the ABS market suggests that a second possible policy response (ABS purchase programme) could be activated in coming months, provided that more work with "*other actors*" aiming to "*eliminate undue discrimination against ABS*" when they are "*simple, real and transparent*". Although some hurdles remain to activating an ABS programme, reassuring investors about the possibility of using additional non-conventional measures was necessary, in our view. The market reaction, however, has been muted following some initial sell-off in EUR/USD. At the time of writing the pair is trading at 1.365, a level similar to that just before the rate announcement, but below its recent highs of 1.393 in early May.

Contingency 3 aka QE remains some time away, in our view

This leaves the third contingency, ie the lower medium-term outlook for inflation, still unaddressed. President Draghi suggested this could stem from possible causes such as a broad-based weakening of aggregate demand derailing the baseline scenario of a moderate recovery and/or a substantial positive supply shock loosening the anchoring of medium-term inflation expectations. These events appear unlikely given the June 2014 Eurosystem staff macroeconomic projections for the euro area. However, we think that evidence of a sub-par recovery coinciding with a persistently large output gap, anaemic private sector credit growth and the disinflationary impact from a strong currency would go some way to increasing its probability. With respect to the risks of some loosening in the anchoring of medium-term inflation expectations, we have argued previously that some evidence is becoming more compelling[9], either from the Survey of Professional Forecasters (SPF) or the inflation swaps market. Given our baseline of headline inflation easing further in the summer (averaging 0.3% in 3Q-14) and that disinflationary headwinds from poor credit availability and the strong euro persist, we still expect the ECB to launch a fully-fledged QE in the next few quarters, possibly in Dec-14.

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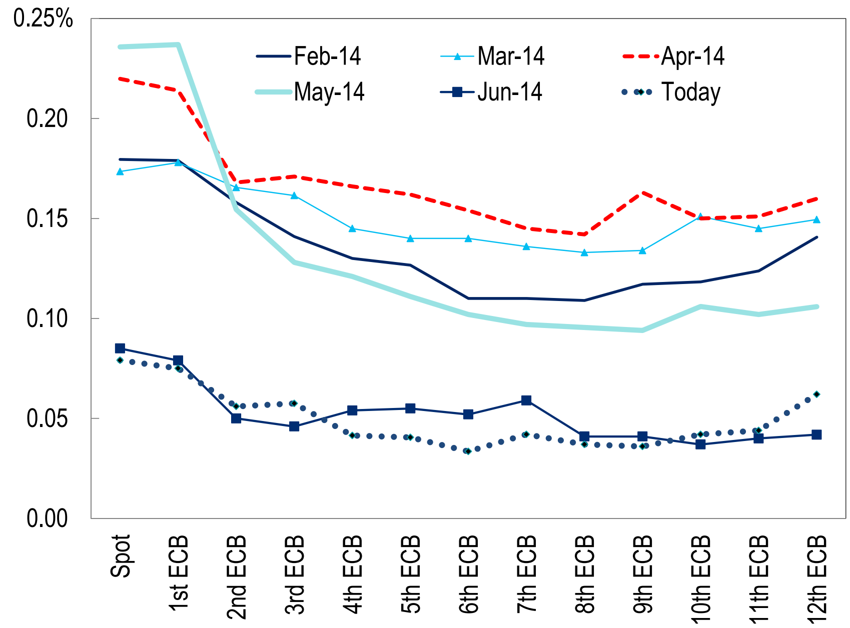
7 http://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201406en.pdf?

8 Presented in a speech on 24 April 2014, See "ECB: Reaction Function Points to Looser Stance Ahead", *Euro Economics Weekly*, Guillaume Menuet, 2 May 2014, Citi

9 See "Soft Growth, Low HICP And Weak SPF Point To ECB Cut In June", *Euro Economics Weekly*, Guillaume Menuet, 23 May 2014, Citi

Figure 7. Euro Area – 1mth EONIA Forwards Based on ECB Meeting Dates (bp), Feb to Jun-14



Sources: Bloomberg and Citi Research

Key Economic Indicators (9 June – 13 June 2014)

Monday 9 June		**Forecast**	**Last**
08:30	Sweden: Household Consumption, Apr		
09:30	Euro Area: Sentix Investor Confidence, Jun		
11:00	Portugal: GDP, 1Q		
Tuesday 10 June		**Forecast**	**Last**
06:45	Switzerland: Unemployment, Apr		
07:00	Germany: Insolvencies, Mar		
07:30	France: Bank of France Business Sentiment, May	98	98
07:45	France: Industrial Production, Apr	1.5% MM, -1.0% YY	-0.7% MM, -0.8% YY
	Manufacturing Production, Apr	1.0% MM, 0.2% YY	-0.7% MM, 1.5% YY
08:15	Switzerland: Retail Sales, Apr		
08:30	Netherlands: Consumer Prices, May		
09:00	Norway: Consumer Prices, May	0.2% MM, 1.9% YY	0.4% MM, 1.8% YY
	CPI-ATE, May	0.1% MM, 2.3% YY	0.6% MM, 2.5% YY
09:00	Italy: Industrial Production, Apr	0.5% MM	-0.5% MM
09:30	UK: Industrial Production, Apr	0.4% MM, 2.8% YY	-0.1% MM, 2.3% YY
	Manufacturing Output, Apr	0.2% MM, 3.8% YY	0.5% MM, 3.3% YY
10:00	Italy: GDP Details, 1Q	-0.1% QQ, -0.5% YY	0.1% QQ, -0.9% YY
10:00	Greece: Industrial Production, Apr		
10:00	Greece: Consumer Prices, May		
Wednesday 11 June		**Forecast**	**Last**
09:30	UK: LFS Unemployment, 3-Month Average, Feb-Apr	-166K QQ, 6.6% Rate	-133K QQ, 6.8% Rate
	LFS Unemployment Rate, Single Month, Mar	6.5% Rate	6.8% Rate
	Claimant Count Unemployment, May	-25K MM, 3.3% Rate	-25.1K MM, 3.3% Rate
	Average Earnings, Feb-Apr	1.2% YY	1.3% YY
Thursday 12 June		**Forecast**	**Last**
00:01	UK: RICS House Price Survey, May		
07:45	France: CPI – EU Harmonised, May	0.0% MM, 0.8% YY	0.0% MM, 0.8% YY
	Consumer Price Index, May	0.0% MM, 0.7% YY	0.0% MM, 0.7% YY
	CPI Ex Tobacco, May	126.22	126.24
07:45	France: Balance of Payments, Apr		
08:30	Sweden: Consumer Prices, May	-0.1% MM, -0.3% YY	0.4% MM, 0.0% YY
	CPIF, May	-0.1% MM, 0.3% YY	0.4% MM, 0.5% YY
08:30	Sweden: Average House Prices, May		
08:30	Netherlands: Trade Balance, Apr		
09:00	Euro Area: ECB Monthly Bulletin		
10:00	Euro Area: Industrial Production, Apr	0.8% MM	-0.2% MM
10:00	Greece: Unemployment Rate, 1Q		
11:00	Ireland: Consumer Prices, May		
Friday 13 June		**Forecast**	**Last**
06:30	France: Nonfarm Payrolls, 1Q	-0.2% QQ, -0.4% YY	0.1% QQ, -0.4% YY
07:00	Germany: HICP, May Final	-0.3% MM, 0.6% YY	-0.3% MM, 1.1% YY
	National CPI, May Final	-0.1% MM, 0.9% YY	-0.2% MM, 1.3% YY
08:00	Spain: Consumer Prices, May Final	0.2% YY	0.3% YY
08:30	Sweden: LFS Unemployment Rate, May	8.4% NSA, 8.1% SA	8.7% NSA, 8.2% SA
08:30	Netherlands: Retail Sales, Apr		
09:00	Italy: Consumer Prices, May Final		
09:30	Italy: General Government Debt, Apr		
09:30	UK: Construction Output, Apr		
10:00	Euro Area: Trade Balance, Apr		
10:00	Euro Area: Employment, 1Q		
	Spain: Trade Balance, Apr		

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area

Jun 12 10:00 London Time	***Industrial Production, Apr***	**Forecast: 0.2% MM**	**Prior: -0.2% MM**

Industrial output likely rebounded in April quite strongly, after losing some momentum in 1Q, partly because of poor energy production (probably related to a mild winter) but possibly also to the slowdown in international trade. The April rise, suggested by fairly strong readings from some country data, should leave the index 0.7% above the 1Q average, suggesting activity may be accelerating in 2Q relative to the meagre 0.2% QQ gain in 1Q.

Germany

Jun 13 07:00 London Time	***HICP, May Final***	**Forecast: -0.3% MM, 0.6% YY**	**Prior: -0.3% MM, 1.1% YY**
	National CPI, May Final	**Forecast: -0.1% MM, 0.9% YY**	**Prior: -0.2% MM, 1.3% YY**

We expect the final readings for German inflation in May to confirm the flash readings for both the national definition and the HCIP at their much lower than expected levels. Very low package holidays affected by the timing of Easter, low food and energy prices and base effects from a lottery price increase in May 2013 were driving the very low inflation reading. Some of these are one-off effects, but have driven inflation now back to its early/mid-2010 lows in Germany

France

Jun 10 07:30 London Time	***Bank of France Business Sentiment, May***	**Forecast: 98**	**Prior: 98**

The Bank of France sentiment survey in the industrial sector has been showing a slightly lower level of confidence than the manufacturing PMI or INSEE industry survey for the last three months. Although measures of capacity utilisation are increasing a little and order books are judged to be a little above (0.3sd) their long-term average, industrialists appear to be concerned about the strong euro, a lacklustre domestic recovery and clear uncertainty about the government's economic policy strategy. We think confidence will improve gradually over the summer, but doubt that the recent electoral results will increase their confidence in the government's ability to deliver more business-friendly reforms.

Jun 10 07:45 London Time	***Industrial Production, Apr***	**Forecast: 1.5% MM, -1.0% YY**	**Prior: -0.7% MM, -0.8% YY**
	Manufacturing Production, Apr	**Forecast: 1.0% MM, 0.2% YY**	**Prior: -0.7% MM, 1.5% YY**

Although we expect industrial production to increase in April, the strong gains recorded in April 2014 in both the broad index (+1.7%) and manufacturing (+2.3%) mean that the YY rates will probably fall compared to those seen in March. A positive factor in the last few months has been the significant increase in capacity utilisation and better signals from the manufacturing PMI (breaking above 50 in March for the first time since July-11). Our forecast would imply a 2Q IP entry point some 1.1% above its 1Q-14 average.

Jun 12 07:45 London Time	***CPI – EU Harmonised, May***	**Forecast: 0.0% MM, 0.8% YY**	**Prior: 0.0% MM, 0.8% YY**
	Consumer Price Index, May	**Forecast: 0.0% MM, 0.7% YY**	**Prior: 0.0% MM, 0.7% YY**
	CPI Ex Tobacco Index, May	**Forecast: 126.22**	**Prior: 126.24**

Consumer prices are expected to have been flat for the second successive month in May. Food prices likely recorded a modest decline due to favourable weather developments while energy prices also likely eased for the second successive month. For services and manufactured product prices, we see some room for a marginal upside, particularly in the former reflecting seasonal patterns. Core inflation is expected to slow to a four-month low of 0.8% YY in May from 1.0% in April. We look for the CPI headline rate to be stable at 0.7% YY, but see some slight downside risks to this forecast coming from the volatile components. For the HICP headline rate, we also expect an unchanged reading of 0.8%. Our near-term inflation trajectory for France envisages lower headline rates, with the 3Q expected to average 0.4% YY.

Jun 13 06:30 London Time	***Non-Farm Payrolls, 1Q F***	**Forecast: -0.2% QQ, -0.4% YY**	**Prior: 0.1% QQ, -0.4% YY**

Non-farm private payrolls recorded a surprise drop of 23.6k in 1Q-14 after the fourth quarter had seen some jobs being created for the first time since 1Q-12. While both the construction and industrial sectors contributed equally to the drop in employment, the weakness in services was unexpected and related primarily to unexpectedly poor readings for temporary employment. We expect this trend to reverse in the second quarter, but surveys of private sector employment have been showing signs of treading water in April, highlighting the fragility of business confidence.

Italy

Jun 10 09:00 London Time	***Industrial Production, Apr***	**Forecast: 0.5% MM**	**Prior: -0.5% MM**

Industrial output likely rebounded in April, after two consecutive monthly declines. This is consistent with a level for the manufacturing PMI – the best survey-based indicator of industrial activity – which is still some 0.6sd above its long-term average (despite declining in May from 54.0 to 53.2).

Jun 10 10:00 London Time	***GDP, 1QF***	**Forecast: -0.1%QQ; -0.5% YY**	**Prior: 0.1% QQ; -0.9%YY**

1Q GDP dynamic – as reported in the first estimate – disappointed, posting a decline of 0.1% QQ. The details will likely show that a decline in private consumption (partly reflecting low spending on heating due to the mild winter) contributed to the negative GDP reading, together with a payback in business investment (after a 2.5% QQ gain in 4Q 13). Exports growth also likely slowed significantly, but a larger decline in imports probably left a positive contribution from net exports (+0.2pp).

Spain

Jun 13 08:00 London Time	***HICP, May F***	**Forecast: 0.2%**	**Prior: 0.3%**

According to the flash estimate, inflation slowed to 0.2% YY in May, in line with expectations, falling from 0.3% YY in Apr. Weak food prices and some further easing in core inflation (excluding fresh food and energy) are likely to compensate for an acceleration in the inflation rate in the energy component (to 3% YY from 1.6% in April), driven by adverse base effects and some pick-up in fuel prices in May. Price pressures remain very subdued in Spain: data released last week showed the GDP deflator falling by 0.6% YY in 1Q, lowest YY decrease since the start of the series in 1995.

Economic Indicators

Sweden

Jun 12	***Consumer Prices, May***	**Forecast: -0.1% MM, -0.3% YY**	**Prior: 0.4% MM, 0.0% YY**
08:30	***CPIF, May***	**Forecast: -0.1% MM, 0.3% YY**	**Prior: 0.4% MM, 0.5% YY**
London Time			

The inflation bounce in April was slightly stronger than expected, but core inflation once again surprised to the low side versus the Riksbank's forecast, although the undershoot narrowed to "just" 0.1pp. However, parts of the upside inflation surprise in April reflected higher prices on international air fares, which should be reversed already this month, and slightly lower petrol prices should also weigh on inflation in May. On balance, we expect the inflation gap versus the Riksbank forecast to widen a tad again in May (Riksbank: CPI: 0.0% YY, CPIF: 0.6% YY).

Jun 12	***Average House Prices, May***		
08:30			
London Time			

House prices have increased gradually during the last year, and the uptrend looks likely to continue this year; short-term indicators point to ongoing upward near-term pressures. Ahead, we expect house prices gradually to level out next year as the Riksbank starts hiking rates combined with macroprudential measures restraining lending. Key to watch, though, are developments in household lending; in April, growth in loans to households accelerated slightly to 5.2% YY. With ongoing gains in housing starts (up by 28% YY in 2013), this suggests that the moderate re-acceleration in lending growth last year could become more pronounced this year. However, with focus back on inflation, we do not expect a continued moderate increase in housing and lending will have immediate implications for monetary policy.

Jun 13	***LFS Unemployment Rate, May***	**Forecast: 8.4%**	**Prior: 8.7%**
08:30	***LFS Unemployment Rate, May (SA)***	**Forecast: 8.1%**	**Prior: 8.2%**
London Time			

Unemployment remains sticky, driven by a combination of strong population growth and an upward trend in labour force participation. The development in unemployment has been somewhat weaker than expected by the Riksbank back in April; in the first quarter, the LFS jobless rate overshot the Central Bank's forecast by 0.1pp and the April reading was 0.2pp above the Bank's 2Q average forecast. The upturn in LFS unemployment contrasts with recent developments in registered unemployment, which has declined for the last six months. Employment growth was flat on the month in April, but this follows a 0.3% MM gain in both February and March. Short-term indicators point to ongoing solid growth in employment, and in turn unemployment will likely start to decline soon.

Norway

Jun 10	***Consumer Prices, May***	**Forecast: 0.2% MM, 1.9% YY**	**Prior: 0.4% MM, 1.8% YY**
09:00	***CPI-ATE, May***	**Forecast: 0.1% MM, 2.3% YY**	**Prior: 0.6% MM, 2.5% YY**
London Time			

Core CPI posted another upside surprise in April, doubling the overshoot versus Norges Bank's forecast (to 0.2pp). However, the upside surprise was sparked by a temporary Easter effect, which should reverse somewhat this month. Meanwhile, a weaker NOK is expected to exert further upward pressure on inflation in coming months (should wane by late-summer). For comparison, the Norges Bank forecasts CPI at 2.0% YY and CPI-Ate at 2.1% Y/Y in May.

United Kingdom

Jun 10	***Industrial Production, Apr***	**Forecast: 0.4% MM, 2.8% YY**	**Prior: -0.1% MM, 2.3% YY**
09:30	***Manufacturing Output, Apr***	**Forecast: 0.2% MM, 3.8% YY**	**Prior: 0.5% MM, 3.3% YY**
London Time			

Surveys suggest that manufacturing output continues to expand rapidly, and a reading in line with our forecast would put output in the last three months up by 1.8% from the previous three months, an annualised pace of more than 6%. Industrial production may additionally benefit from a rebound in utilities output after relatively depressed readings in the last couple of months.

Jun 11	***LFS Unemployment, 3-Mo Avge, Feb-Apr***	**Forecast: -166,000 QQ, 6.6% Rate**	**Prior: -133,000 QQ, 6.8% Rate**
09:30	***LFS Unemployment, Single Month, Apr***	**Forecast: 6.5% Rate**	**Prior: 6.8% Rate**
London Time	***Claimant Count Unemployment, May***	**Forecast: -25,000 MM, 3.3% Rate**	**Prior: -25,100 MM, 3.3% Rate**
	Average Earnings Ex Bonuses, Feb-Apr	**Forecast: 1.2% YY**	**Prior: 1.3% YY**

These figures probably will show a continued rapid drop in unemployment, and we are torn between 6.6% and 6.7% for our forecast for the three-month average, coming down marginally in favour of 6.6%. Average earnings growth may be dampened a bit this month by base effects from the relatively strong (and tax-distorted) figure a year ago.

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

Key Economic Indicators (16 June – 20 June 2014)

Monday 16 June		**Forecast**	**Last**
09:00	Norway: Trade Balance, May		
10:00	Euro Area: HICP, Final, May		
Tuesday 17 June		**Forecast**	**Last**
06:545	Switzerland: SECO Economic Forecasts, Jun		
07:00	Sweden: PES Unemployment Rate, May		
07:00	EU-27: New Car Registrations, May		
08:00	Spain: Labour Costs, 1Q		
08:15	Switzerland: Producer and Import Prices, May		
09:00	Italy: Trade Balance, Apr		
09:30	UK: Consumer Prices, May		
09:30	UK: Producer Prices, May		
10:00	Germany: ZEW Economic Expectations, Jun		
10:00	Euro Area: Labour Cost Index, 1Q		
10:00	Euro Area: Job Vacancies, 1Q		
Wednesday 18 June		**Forecast**	**Last**
08:00	Sweden: Business and Consumer Confidence, Jun		
09:00	UK: Bank of England Minutes of Jun 5 Meeting		
10:00	Euro Area: Construction Output, Apr		
Thursday 19 June		**Forecast**	**Last**
08:30	Switzerland: SNB Monetary Policy Assessment & Press Conference		
09:00	Norway: Norges Bank Monetary Policy Outcome		
08:30	Netherlands: Unemployment, May		
09:30	UK: Retail Sales Volumes, May		
10:00	Italy: Current Account Balance, Apr		
11:00	UK: CBI Industrial Trends, Jun		
14:00	Belgium: Consumer Confidence, Jun		
Friday 20 June		**Forecast**	**Last**
07:00	Germany: Producer Prices, May		
08:30	Netherlands: Consumer Confidence, Jun		
08:30	Netherlands: Consumer Spending, Apr		
09:00	Euro Area: Monthly Balance of Payments (ECB), Apr		
09:00	Italy: Industrial Orders, Apr		
09:30	UK: Public Sector Net Borrowing (Ex RM, APF& Fin. Intervent'ns), May		
15:00	Euro Area: Flash Consumer Confidence, Jun		

Sources: National statistical offices, central banks and Citi Research

Publication Title	Author	Date
Euro Area — Sovereign Debt Update		
ECB Cuts Rates, Announces Several Liquidity Measures	European Economics Team	Jun 6, 2014
All Eyes on ECB: Rates at 12:45, the Rest at 13:30	European Economics Team	Jun 5, 2014
ECB Sources: Next ECB Rate Cut May Not Be The Last	European Economics Team	Jun 4, 2014
EC Recommends More Fiscal Tightening in France and Italy	European Economics Team	Jun 3, 2014
ECB Reportedly to Cut Rates and Announce LTRO	European Economics Team	Jun 2, 2014
Euro Area		
ECB - Door firmly open to additional stimulus and QE in late 2014	Guillaume Menuet	Jun 5, 2014
Euro Area - Inflation Surprises Once Again to the Downside	Giada Giani	Jun 3, 2014
Euro Area - Economic Sentiment Strengthens, But France Stays Weak	Ebrahim Rahbari/Antonio Montilla	May 28, 2014
Euro Area - Weak M3 but fall in private sector loans eases in April	Ebrahim Rahbari/Antonio Montilla	May 28, 2014
Italy - Q1 GDP Downward Surprise and Political Uncertainty	Giada Giani	May 23, 2014
European Economic Forecast Highlights - May 2014	Ann O'Kelly	May 22, 2014
Euro Area - Q1 GDP Disappoints Probably Due To Exceptionally Mild Winter	Giada Giani	May 15, 2014
Euro Area - No Pickup in NFC Net Borrowing in Q1	Antonio Montilla/Ebrahim Rahbari	May 15, 2014
ECB - Comfortable with a June rate cut (and a negative depo rate)	Guillaume Menuet	May 8, 2014
Euro Area - Strong PMIs Argue Against ECB Rate Cut on Thursday	Guillaume Menuet	May 6, 2014
Spain - A Wider Output Gap Reduces the Need for Fiscal Austerity	Giada Giani	May 6, 2014
Spain - Economic Recovery Strengthens in Q1	Antonio Montilla/ Giada Giani	May 1, 2014
Euro Area - The ECB And QE: “Whatever it Takes”, Redux	Guillaume Menuet	Apr 22, 2014
Euro Area - ECB Bulletin Highlights: Slack, Recovery And Fiscal Multipliers	Guillaume Menuet	Apr 10, 2014
Spain - What’s Next For Catalonia Following Congress Rejection?	Giada Giani	Apr 8, 2014
Euro Economics Weekly		
Negative Deposit Rate: Limiting Risks, Limited Upside	Ebrahim Rahbari	May 30, 2014
Soft Growth, Low HICP And Weak SPF Point To ECB Cut In June	Guillaume Menuet	May 23, 2014
Long Live (s) The Rise of the Current Account Surplus	Ebrahim Rahbari	May 16, 2014
Euro Economics Weekly - How Might QE Affect Financial Conditions?	Giada Giani	May 9, 2014
ECB: Reaction Function Points to Looser Stance Ahead	Guillaume Menuet	May 2, 2014
Private Deleveraging: Picking Up, but Hurting Less	Ebrahim Rahbari	Apr 25, 2014
Portugal: “Clean Exit” or Precautionary Credit Line?	Giada Giani	Apr 17, 2014
France: Will Valls Succeed Where Others Have Failed?	Guillaume Menuet	Apr 11, 2014
The Rise of The Output Gap	Ebrahim Rahbari	Apr 4, 2014
Italy — Some Short-Term Optimism	Giada Giani	Mar 28, 2014
Euro Area: Upside Risks To Q2 GDP	Guillaume Menuet	Mar 21, 2014
The Eurozone Investment Recovery	Ebrahim Rahbari	Mar 14, 2014
Internal Devaluation in the Periphery	Giada Giani	Feb 7, 2014
ECB to Cut: Beware the (Early) Ides of March	Guillaume Menuet	Feb 28, 2014
German Inflation: Lower For a Little Longer	Ebrahim Rahbari	Feb 21, 2014
Could Eurozone Politics Return to the Fore?	Giada Giani	Feb 14, 2014
ERS: An Alternative Solution to OMT?	Guillaume Menuet	Feb 7, 2014
Chief Economist Publications		
Global Economic Outlook and Strategy - May 2014	Willem Buiter	May 21, 2014
Scandi and Switzerland		
Scandi Economics Update	Tina Mortensen	Jun 6, 2014
Denmark - Unchanged Rates from DNB	Tina Mortensen	Jun 6, 2014
Sweden - Mfg. Prod. Rebounds in April, But Weak Order Intake a Concern	Tina Mortensen	Jun 4, 2014
Norway - Upside Surprise in Unemployment	Tina Mortensen	Jun 3, 2014
Switzerland - Solid Gain In Q1 GDP, SNB Unlikely To Match ECB Easing	Michael Saunders	May 28, 2014
UK		
UK - REC Survey Suggests Labour Market Still Tightening	Michael Saunders	Jun 6, 2014
UK - YouGov Report Uptick in Inflation Expectations	Michael Saunders	May 30, 2014
UK - Help To Buy Statistics	Michael Saunders	May 29, 2014
UK - Confidence Among People In Full-Time Work At New Record High	Michael Saunders	May 28, 2014
UK - GDP Data and CBI Survey	Michael Saunders	May 22, 2014
UK Economics Weekly		
Inflation Downtrend Probably Over	Michael Saunders	May 30, 2014
Will Macro-Pru Allow “Low for Longer”?	Michael Saunders	May 23, 2014
UK Economics Weekly - Where Next for the MPC?	Michael Saunders	May 16, 2014
MPC Likely to Retreat from “Low for Longer”	Michael Saunders	May 9, 2014

Source: Citi Research

Appendix A-1

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