EC Recommends More Fiscal Tightening in France and Italy

Summary | Today's News in Detail | Latest Issues of Sovereign Debt Update | Macroeconomic Forecasts | Recent Research

3 June 2014

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Industrialised G7 Countries

Summary

ECB's Nowotny: the effect of negative interest is *"a question that entails a long discussion"*. More important is to identify whether deflation is a one-off or a trend.

Former ECB Chief Economist Jürgen Stark sees interest rate cuts as *"cosmetic"*, as no investment decisions would depend on such a small rate change.

German Chancellor suggests vote in European Council on EU Commission Presidency. A successful candidate would require a qualified majority.

EC recommends closing Excessive Deficit Procedure for six countries (Austria, Belgium, Czech Republic, Denmark, the Netherlands and Slovakia). For **France**, the EC says more budgetary adjustments and structural reforms are needed to end the EDP in 2015, while for **Italy**, it recommends additional fiscal tightening in 2014 as debt rule has not been met, but does not initiate any disciplinary action. In its opinion on the country's national reform programme and stability programme, it recommends that **Germany** preserve its sound fiscal position but still boost demand. For **Spain**, it suggests further reforms and reinforcement of the budgetary strategy, fully specifying the underlying measures for 2015 and beyond, to ensure the excessive deficit correction by 2016.

The German flash CPI for May was very weak at 0.9% YY for the national definition and at 0.6% YY for the HICP, the lowest levels since June and February 2010, respectively, and 0.2pp and 0.4pp below expectations. Final May German Manufacturing PMI revised down to 52.3 from 52.9 in the flash, leaving it at a seven-month low.

Moody's on EU election result: credit positive for Italy, Moody's says, while it was a credit negative for France and Greece because of the Eurosceptic tone of the election outcome.

Spain's King Juan Carlos to abdicate, after nearly 40 years on the throne. His son, Crown Prince Felipe, is expected to take over by the end of June.

Spanish data – registered unemployment fell by 111.9k in May, broadly in line with expectations (-112.5k). **Car sales** rose by 16.9% YY in May, after a 28.7% YY increase in April and a 3.3% rise over 2013.

Portugal – deadline for last bailout tranche to be postponed, *Diario Economico* reports, after the Constitutional Court rejected three budgetary measures of the 2014 Budget and left a fiscal gap estimated at 0.35% of GDP.

Greece – government reshuffle may see replacement of FinMin Stournaras, *Ekathimerini* reports, after the poor showing of the main ruling party New Democracy in the recent EU elections.

Recent Research

Euro Economics Weekly — Negative Deposit Rate: Limiting Risks, Limited Upside

30- May 2014

We expect the ECB to lower the Refi rate and to set a negative Deposit rate for the first time at the June meeting. In our view, these actions will lead to modest reductions in interbank rates, government bond yields, and credit spreads and will also modestly weaken the euro, even though many of these effects may be priced in by now.

Ebrahim Rahbari

UK Economics Weekly — Inflation Downtrend Probably Over

30 May 2014

We suspect the recent sharp downtrend in CPI inflation and consensus inflation forecasts is now basically over. Underlying inflation has not weakened recently and the BoE agents' survey (like other surveys) shows a steady

Today's News in Detail

ECB's Nowotny on negative interest rates: during a round table panel when discussing hypothetical steps a central bank could take to counter deflationary trends Mr Nowotny remarked about negative interest rates that *"if that has any effect is a question that entails a long discussion"*. Mr. Nowotny was quoted by Reuters stressing that the biggest danger for central banks is allowing expectations of deflation to lead to economic stagnation, as once seen in Japan. Mr. Nowotny added that the Governing Council's main task was to identify whether deflation is a one-off or a trend, with the key determinant likely to be expectations. Comment: we do not believe that these remarks amount to much ahead of Thursday's Governing Council meeting. Rather they indicate that a possible cut in the deposit rate into negative territory is unlikely to be the panacea for all members. On inflation, it is clear in our view that the recent downward shift in the distribution of private sector inflation forecasts for 2015 and 2018 warrants some form of monetary policy response from the ECB. Action on Thursday will be important to cement the ECB's forward guidance, highlighting its willingness to act to defend its inflation target – see Euro Economics Weekly - Negative Deposit Rate: Limiting Risks, Limited Upside.

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Former ECB Chief Economist sees interest rate cuts as *"cosmetic"*. Former ECB Chief Economist Jürgen Stark said in *Frankfurter Allgemeine Zeitung* that no investment decision would depend on a rate cut of 10-15bp, therefore making such a step *"rather cosmetic in nature".* Stark added that the exchange rate was not a reason to ease monetary policy, as it was only relevant insofar as it had a significant impact on price developments and that euro strength was a *"temporary phenomenon"* that would reverse with changes in US monetary policy. Stark said that he did not see a danger of deflation in the Eurozone and saw an inflation rate of 0.7% as a sign of price stability, as disinflation was mainly due to falls in oil and commodity prices. Finally, Stark suggested that monetary policy should focus on the medium term and see through the current trough in inflation.

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German Chancellor suggests vote on EU Commission Presidency. Bloomberg reports that German Chancellor Angela Merkel left the door open to a vote in the European Council on the European Commission Presidency, noting that the UK Prime Minister did not have a veto as the vote would be according to a qualified majority. Merkel added that she was *"working for the greatest degree of consensus"* and renewed her support for former Luxembourg PM Jean-Claude Juncker but Steffen Seibert, Merkel's chief spokesman, also said yesterday that Germany's goal was to keep the UK in the EU.

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EC recommends closing EDP for six countries. The European Commission yesterday recommended that the EU Council close the Excessive Deficit Procedure (EDP) for six EU countries: Austria, Belgium, Czech Republic, Denmark, the Netherlands and Slovakia, after they reduced their deficits below 3% of GDP in 2014.

France: the European Commission says more budgetary adjustments and structural reforms are needed to end Excessive Deficit Procedure in 2015. The European Commission recommended that France takes action over the 2014-15 period, with a particular focus on reinforcing its budgetary strategy, namely by specifying the underlying measures for 2014 and beyond to ensure correction of the excessive deficit in a sustainable manner by 2015. The Commission highlighted the need for a *"credible implementation of ambitious*

uptrend in domestic cost and capacity pressures. We also expect the RPI-CPI wedge to widen sharply over the next year or two, with RPI inflation likely to average close to 4% YoY in 2015-16.

Michael Saunders

Sweden — Setback for 1Q GDP

30 May 2014

In line with expectations, GDP corrected lower at the outset of the year following the strong 4Q-13 reading. The quarterly 0.1% decline was driven by weak inventories and net exports, while private consumption and fixed investments acted as offsets. Underlying demand, meanwhile, was somewhat mixed with exports and investment markedly outpacing our forecasts, while private consumption came in on the weak side. On balance, we see a slight downside risk to our full-year 2014 2.6% Y/Y forecast.

Tina Mortensen

UK — Help To Buy Statistics

29 May 2014

The government today released new data on the number of Help To Buy mortgages, covering the Help to Buy equity loans scheme (HTB-E, which began in April 2013) to end-April this year and the Help to Buy mortgage guarantee scheme (HTB-M, which began last October) to end-March. These data suggest that if, as some suggest, the HTB cap is cut from £600k to £300k or £400k, the effects on overall housing activity probably would be small.

Michael Saunders

Scandi Economics Update — Riksbank Jansson: Inflation Must Rise "Relatively Quickly"

3 June 2014

Sweden — Riksbank Jansson: Inflation must rise "relatively quickly" for the Riksbank to fulfill its mandate — Riksbank dismisses Svensson claim that the Bank lacks democratic controls — Sentiment indicators continue to signal a shaky recovery for the manufacturing sector.

Norway — Registered unemployment to edge lower in May (out at 9.00 UK time).

Tina Mortensen

structural reforms" and reminded the government that it needs to pursue *"a structural adjustment towards the medium-term objective of at least 0.5% of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met to put the high general government debt ratio on a sustained downward path".* Comment: the Commission's assessment is that France will need to do more to bring its budget deficit to the 3%-of-GDP target in 2015, given the downside risks to the government's targets, expressing some doubts about the ambitious planned amount of savings. The 10-page document gives a long list of recommendations that will be discussed by EU leaders and ministers in June before their final adoption on July 8.

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Italy – EU Commission recommends additional fiscal tightening in 2014, but no disciplinary actions. The EU Commission assessment of the Stability Programme presented in April indicated *"non-compliance with the debt reduction benchmark in 2014 as the projected structural adjustment (only 0.1pp of GDP) falls short of the required structural adjustment of 0.7pp GDP".* It recommended the Italian government to *"reinforce the budgetary measures for 2014"* and *"significantly strengthen the budgetary strategy"* in 2015 to ensure compliance with the debt reduction requirement. The Commission however did not go as far as opening formal disciplinary actions against Italy due to the limited structural adjustment, probably because the nominal deficit is still seen falling within the 3%-of-GDP threshold (at 2.6%). The Commission also reiterated its recommendation for Italy in deepening the structural reform efforts on several aspects, including a new labour market reform, intensifying the fight against corruption and upgrading the education system. Also, the Commission told the Italian government to *"further shift the tax burden from productive factors to consumption, property and the environment, in compliance with the budgetary targets"*. Comment: Italy is clearly in breach of the debt rule which requires, from 2016 onwards, for Italy to be able to reduce the debt-to-GDP ratio by more than 3pp of GDP per year (i.e., 1/20th of the part in excess of the 60%). In order to achieve this target, in the 2013-2015 transition years Italy would have to achieve a significant structural adjustment in the primary balance, which is clearly not envisaged in the government's plans as presented in the stability programme. We reckon some leeway will be granted to Italy on the EU fiscal rules, given the improved credibility of the Renzi government on its structural reform efforts and the acknowledgement that kick-starting some economic recovery is the key ingredient to achieve public debt sustainability.

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EC recommends Germany to preserve sound fiscal position but still boost demand. In its opinion on Germany's national reform programme and stability programme, the European Commission highlighted that Germany was in a very benign macroeconomic position. In its recommendations, the ECB recommended that Germany maintain its sound fiscal position. At the same time, it called on Germany to i) reduce high taxes and social security contributions, particularly for low-wage earners, ii) to keep the costs of energy reform low, and iii) to stimulate competition in its services sector.

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Spain – Further reforms and reinforcement of the budgetary strategy, EU Commission recommends. In its latest recommendations, the EU Commission (EC) noted that the Spanish government needs to reinforce its budgetary strategy by fully specifying the underlying measures for 2015 and beyond in order to ensure the correction of the excessive deficit by 2016. The EC said also that a durable correction of the fiscal imbalances requires a credible implementation of the ambitious structural reforms approved so far, including the activation of the new independent fiscal authority as well as the Budgetary Stability Organic Law. In addition, the EC urged the Spanish government to

adopt by the end of 2014 a comprehensive tax reform and in particular to shift revenues towards less distortive taxes (e.g. consumption, environmental and recurrent property taxes), remove inefficient personal and corporate income tax expenditures, and consider lowering employers' social security contribution. Additional recommendations included to complete the reform of the saving banks sector, further reforms to the labour market to reduce segmentation, implement the Youth Entrepreneurship and Employment Strategy, implementation of the Law on market unity, and finally to ensure the effective elimination of deficit in the electricity system as of 2014. Comment: the government has announced that it is preparing an overhaul of the tax system, which is expected to include cuts in both corporate and personal income taxes as well as a reduction in employers' social contribution. In terms of personal income tax, the government announced that it intends to raise the tax-free threshold to €12k, while income tax rates would be reduced for middle and low incomes (the tax relief would affect 12m people). In terms of corporate taxes, we expect the reform to include a reduction in the nominal tax rate (currently at 30%), but also an elimination of tax deductions, possibly implying an overall increase in the effective tax rate. Details of the reform are expected to be disclosed this month.

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German flash CPI for May very weak. The German flash CPI for May was very weak at 0.9% YY according to the national definition (Citi and Consensus: 1.1%) and at 0.6% YY according to the HICP (Citi and Consensus: 1.0%). The press releases for the states noted that the timing of Easter (through its effect on the price of package holidays) and base effects (from a rise in lottery prices in May 2012) contributed to the decrease in inflation, and that food prices (along with energy prices) were now falling in YY% terms which also exerted downward pressure on inflation. Comment: the German HICP is now at the lowest level since February 2010 (June 2010 for the national definition) and this low level makes it likely that tomorrow's HICP reading will be 0.5% YY rather than 0.6% YY as we expected previously. Even though the German and Eurozone inflation data for May will not be included in the update for the ECB's staff projections, it will strengthen the case for easing on Thursday at the ECB June meeting.

Final German Manufacturing PMI revised down. The final German manufacturing PMI for May was revised down to 52.3 from 52.9 in the flash reading, compared to 54.1 in April and leaving it at a seven-month low. The lower reading mainly reflected slower growth rates of output and new orders, even though production growth still remained above the long-term average and some companies noted that the mild weather had previously boosted demand. Input costs fell further in May, while output charges rose marginally.

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Italy – EU election result is credit positive for Italy, Moody's says. Reuters reported a Moody's report yesterday saying that the *"solid showing for Italy's centre-left Partito Democratico headed by Renzi had helped dispel concerns about his government".* However, according to the Reuters report, the rating agency said that, in contrast to Italy, the outcome of the EU election was credit negative for France and Greece because of their Eurosceptic tone. Italy is rated Baa2 by Moody's with a stable outlook and a review of the Italian rating is scheduled on 13 June.

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Spain – King Juan Carlos to Abdicate. Spain's King Juan Carlos announced yesterday in a nationally televised address his intention to abdicate after nearly 40 years on the throne as *"a new generation must be at the forefront".* His son, Crown Prince Felipe, is expected to take over the throne likely by the end of June. PM Mariano Rajoy said that the Spanish Parliament must approve a law to complete the abdication and handover in coming weeks.

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Spain – Registered unemployment fell by 111.9k in May, broadly in line with expectations (-112.5k), showing the largest MM decline in May since the start of the series (in 1977). When adjusted for seasonal factors, we compute that registered unemployment fell by 0.6% MM in May, after declining by 1.1% MM and 0.4% MM in April and March, respectively. In addition, registered employment (SA) rose by 0.3% MM in May, after a 0.4% MM gain in April. Comment: the underlying trend continues to show a reduction in jobless claims since Aug 2013 and suggests the improvement in the Spanish labour market continues. We expect that positive employment growth, together with much reduced fiscal drag, should allow an expansion in 2014 household nominal disposable income for the first time since 2009 and boost private consumption.

Spain – Car sales rose by 16.9% YY in May, after a 28.7% YY increase in April and a 3.3% rise over 2013, data from the Association of Car Manufacturers (Anfac) showed yesterday. Year-to-date car registrations are now 16.9% above Jan-May 13. The increase in car registrations continued to be strongly affected by the government's car subsidy scheme PIVE, with car sales to private persons rising by 27.7% YY in Jan-May 14, Anfac noted.

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Portugal – deadline for last bailout tranche to be postponed, *Diario Economico* reports, after the ruling of the Constitutional Court rejected three budgetary measures of the 2014 Budget and left a fiscal gap estimated at 0.35% of GDP. The newspaper reports that the government has to present to the troika new alternative measures for 2014 and 2015 in order to reach the budget deficit targets agreed with international creditors of 4.0% of GDP and 2.5% of GDP, respectively. FinMin Albuquerque reportedly said that the government will need time to prepare the alternative measures due to the significant impact on public finances. Comment: while the government may take some time before announcing the alternative measures, which most likely will include some tax increases, we reckon that the fiscal target at least for 2014 is within reach thanks to the improving macroeconomic environment.

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Greece – government reshuffle may see replacement of FinMin Stournaras, *Ekathimerini* reports. The newspaper says that the timing of the government reshuffle, after the defeat of the main ruling party New Democracy in the recent EU elections, remains unclear but it should reportedly be announced later on this week. The post of finance minister is also possibly at stake, with Stournaras likely leaving to go to the Bank of Greece. The post may be taken by a more *"political"* figure, *Ekathimerini* reports, ahead of the start of the negotiations for debt relief with the international creditors (likely to start before year-end). Separately, Finance Minister Stournaras yesterday replied to his German counterpart Mr Schäuble's statement that Greece will need a small third bailout program. The Greek FinMin said that Greece is fully funded until the summer of 2015 and that its financing needs from mid-2015 to 2016 would *"depend to a great degree"* on the results of stress tests on banks due later on this year. Comment: the level of confrontation between Greece and its European creditors is bound to rise in coming months as discussions of debt relief will begin. The victory of opposition party SYRIZA at the EU elections will force the government to raise requests for debt relief.

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Latest Issues of Sovereign Debt Update

ECB Reportedly to Cut Rates and Announce LTRO

2 June 2014

ECB to cut rates and announce LTRO says FT, LTRO to target SMEs say Spiegel and FAZ. ECB's Constancio and Visco: "we are ready to act". BoE and ECB support revival of EU securitisation market. Choice of EU president remains contentious. Germany may revise up 2014 net borrowing. BoE & BuBa call for new loss-absorbing capital standard for banks. Spain's Rajoy announces €6.3bn stimulus. Portugal's Constitutional Court rejects budget measures. Slovenia's president sets 13 July date for election.

Giada Giani

ECB and BoE to Publish Joint Paper on Securitization

30 May 2014

ECB and BoE to publish follow-up paper on securitisation today. German retail sales weak in April after very strong 1Q increase. Spain's fiscal reform to be discussed at Cabinet on June 13. Spain's HICP inflation slows to 0.2% YY in May. Portugal's government still waiting for Constitutional Court ruling.

Ebrahim Rahbari

ECB Sees No Risk of Stress in Bank Funding Conditions

29 May 2014

ECB no longer sees risk of stressed bank funding conditions. Merkel says eastern European countries need not choose between EU and Russia. No quick choice for EC presidency - consultations needed about range of positions. Euro Area: Economic sentiment back to 2011 levels, weak M3 but fall in private sector loans eases. Spain's 1Q GDP confirmed at 0.4% QQ. Bank of Spain says economy continues to improve in 2Q. Spanish house prices continue falling. Italy's business confidence falls.

Ebrahim Rahbari

Race Wide Open for European Commission Presidency

28 May 2014

Race for EU Commission Presidency wide open - Merkel favours "broad tableau" of candidates, although EPP's Juncker remained her choice. EU leaders put off further sanctions on Russia after Ukraine election. German import prices fall. France: consumer spending falls, consumer confidence unchanged. Italy: consumer confidence improves again. Spain has turned corner but more efforts needed, says IMF. Spain's central govt deficit narrows, retail sales rebound. Danish GDP rebounds in 1Q.

Ebrahim Rahbari

ECB’s Draghi Lays Out Case for Credit Easing

27 May 2014

ECB's Draghi comments on "anatomy and physiology of disinflation", makes case for credit easing. EU Parliament results: NEAPs (new, extreme or alternative parties) do well as expected, taking first place in UK, Greece and France. No clarity on front runner for next EU Commission President. Belgium's general election: Flemish separatists N-VA ahead. EU Commission considers sovereign risk weights, details Russia sanctions, plans flat rate contribution to resolution funds.

Ebrahim Rahbari

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Macroeconomic Forecasts

European Economic Forecast Highlights — May 2014

22 May 2014

This companion to Global Economic Outlook and Strategy - May 2014 gives more detailed forecasts for the main European countries to end 2015. Figures 20-21 give annual forecasts to 2018 for growth, inflation, current balance, fiscal balance, primary balance and government debt.

Ann O'Kelly

Global Economic Outlook and Strategy — May 2014

21 May 2014

This publication contains updated forecasts for a wide range of economies, interest rates and currencies by the Citi economists and strategy teams. We expect the ECB to loosen policy at the June meeting, with a lower refi rate, negative deposit rate and a probable extension of the full allocation fixed rate MRO window until 2016. We look for further easing subsequently, with QE in 4Q. The BoJ remains likely to loosen further but is unlikely to act before the autumn — and maybe even later.

Willem Buiter

Emerging Markets Macro and Strategy Outlook — Is the rally safe?

23 May 2014

Late last year, we identified three forces that would shape the outlook for EM economies and asset prices in 2014. The first was the outlook for capital flows to EM; the second was the outlook for China; and the third was the outlook for EM exports. As things stand, none of these three forces are generating much in the way of bad news for EM. Yet we think there are reasons to doubt that this benign environment for EM can be sustained. This isn’t the same as saying the rally is about to end. But we think the factors governing the EM rally are not well-entrenched.

Guillermo Mondino

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Appendix A-1

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