

Euro Economics Weekly

The Euro Area Now and Japan Then: Separated by One Large Shock

- The euro area is not currently in deflation. But, with very low inflation, ample slack and sluggish growth, we believe the euro area is — like mid-90s Japan — potentially just one major adverse shock away from deflation. To be sure, there are some differences between the euro area now and mid-90s Japan. But, in our view, the commonalities outweigh the differences. In Japan's case, the slide into deflation was triggered by the late 1990s EM crisis. It is not inevitable that the euro area will be hit by a similar shock but, if it is, then — like Japan — the region could well be tipped into deflation.
- Sustained deflation is mostly a policy failure, in our view. But fighting off deflation may require very large macro stimulus. The ECB is technically and legally capable of providing such stimulus, and the ECB is likely to start purchasing some assets outright in the case of further modest inflation undershoots. But we think that the (self-imposed) hurdles for the ECB to take decisive action (asset purchases of, say, 10% of GDP pa) are still large.

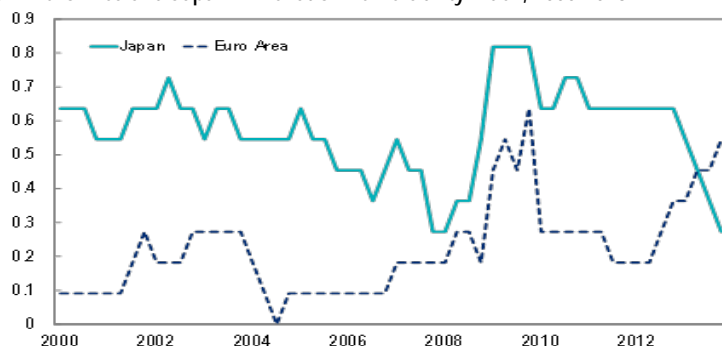
Figure 1. Citi Market Forecasts –

		Euro Repo	10-yr Bunds	£/€	UK Bank Rate	10-yr Gilt- Bund	SEK Policy Rate	NOK Policy Rate	CHF Policy Rate	CHF Spread vsBunds			
	\$/€					\$/€							
2Q 14	1.39	0.00	1.70	0.80	0.50	158	8.71	0.75	8.12	1.50	1.24	0.00	-73
4Q 14	1.40	0.00	1.80	0.80	0.75	183	8.79	0.75	7.95	1.50	1.26	0.00	-77

Source: Citi Research

Sources: Citi Research

Figure 2. Euro Area and Japan — Deflation Vulnerability Index, 2000-2013



Note: The index combines price, activity, credit and asset price data, as in Decressin, J. and D. Laxton (2009), "Gauging risks for deflation", IMF Staff Position Note, 28 January 2009. Index values are not strictly probabilities, but values above 0.5 indicate 'high' deflation risk, 0.3 to 0.5 'moderate' risks, 0.2-0.3 'low' and below 0.2 'minimal' risks. Source: Citi Research

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Euro Area and Japan: Separated By One Large Shock

The Eurozone is in the deflation danger zone

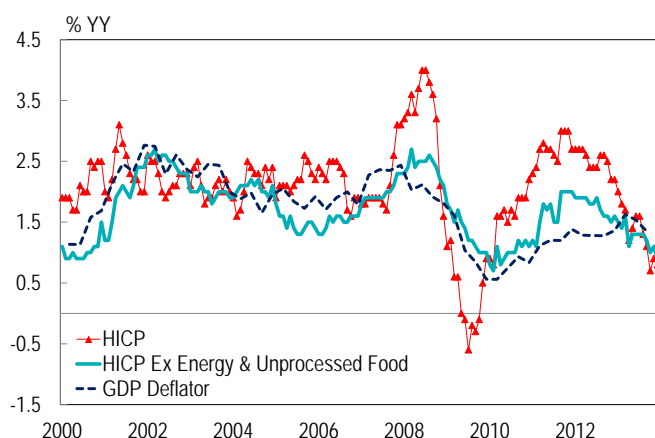
Deflationary pressure may have been even greater in Japan, but the main difference is that Japan was hit by a large shock when it was already in the danger zone

Very decisive (and ideally combined monetary-fiscal) policy action may be needed to fight off deflation — and we have doubts whether such action would be forthcoming quickly in the EA when deflation threatens more acutely

Euro area inflation has fallen to very low levels, with core CPI inflation close to all-time lows (at 0.8%YY in January), headline inflation in January at 0.7%YY (see Figure 3), and the share of CPI items whose prices are falling in YY terms rising fast (see Figure 4). Given the large output gap amid marked demand weakness and deleveraging pressures in the euro area, a weak banking sector, reactive monetary policy, and strong exchange rate, very low inflation should not be too much of a surprise. These factors also call to mind the Japanese experience in recent decades. There, inflation declined quickly after the stock market and real estate bubble burst in 1989-90. After a brief dip into deflation in '95, deflation entrenched itself in 1997/8 (the GDP deflator fell persistently in '95-'97 already, see Figure 5), after it was hit by a triple shock: the Asian crisis, a banking crisis and fiscal tightening. It is only now emerging from deflation.

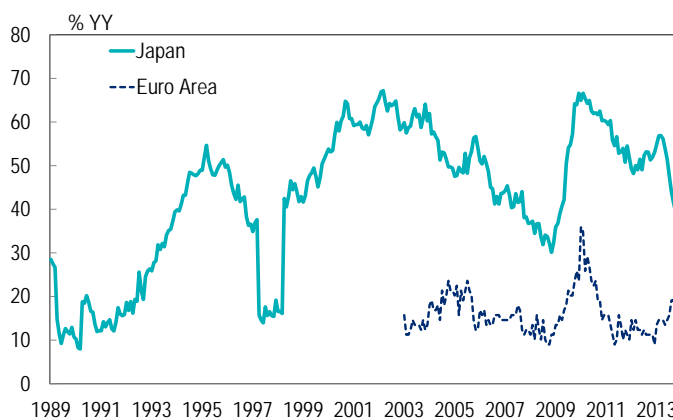
ECB President Draghi recently presented five reasons why the euro area is in a different situation than Japan. Here, we evaluate this claim and find that deflationary forces were perhaps moderately stronger in Japan in the mid-90s than they are for the euro area average currently. But the parallels outweigh the differences, in our view. Notably, in both economies policymakers allowed the economies to enter the deflation 'danger zone' in the aftermath of a financial crisis, while the examples of the UK and the US show that such sustained deflation risks are not inevitable. The biggest difference so far between the EA and the Japanese experience is, in our view, that Japan was hit by a large shock in 1998 when it was already in the deflation danger zone. In Japan, policymakers then aggravated their situation by not being sufficiently aggressive in trying to get Japan out of deflation. In the euro area, it remains to be seen how aggressive policymakers would be in such a scenario, but we worry that the policy response could also be insufficient, at least initially.

Figure 3. Euro Area — Measures of Inflation (%YY), 2000-2013



Sources: Eurostat and Citi Research

Figure 4. Euro Area and Japan— Share of Prices that are Falling YoY (% of Total), 1989-2013



Sources: Eurostat, Ministry of Internal Affairs and Communications and Citi Research

Draghi's five differences between the euro area and Japan

ECB President Draghi: five reasons why the Eurozone is different from Japan

At the December meeting (and repeated at the January meeting), ECB President Draghi gave five reasons why the situation of the euro area is different from the one in Japan: ¹

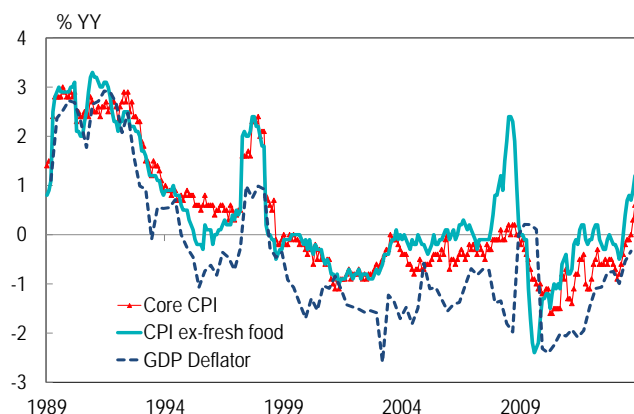
¹ Mario Draghi, "Introductory statement to the press conference (with Q&A)", Frankfurt am Main, 5 December 2013, <http://www.ecb.europa.eu/press/pressconf/2013/html/is131205.en.html>. ECB President Draghi repeated these reasons at the January meeting.

1. “Monetary policy reacted more decisively in the euro area”

Monetary policy may have been somewhat slower in reacting to deflationary pressure in Japan

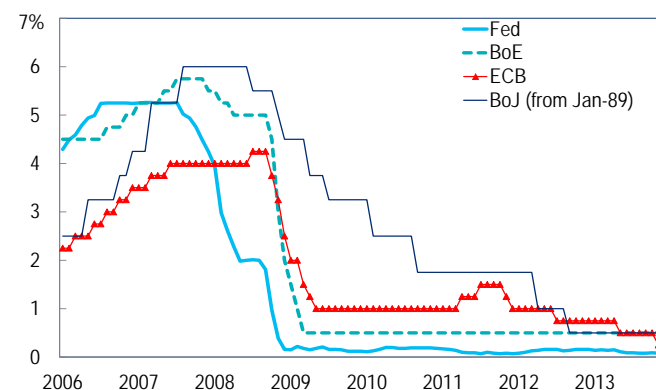
The assessment of how slow the BoJ was in reacting depends on when one times the crisis in Japan. As noted, the stock market and land prices peaked in late '89 and '90, respectively. But the Japanese economy still grew in the early and mid-1990s and the first time growth was negative for two consecutive quarters was only in 1997-8 when sustained deflation also began. The BoJ first cut rates in July '91 (GDP had fallen in Q2 '89 and Q1 '90) and continued cutting rates thereafter, but did so relatively slowly (see Figure 6). Thus, the policy rate was still above 2% in Japan when inflation had already fallen below 1% in 1994, and was only lowered to 0.5% in mid-95 when the GDP deflator was already in negative territory. The BoJ also did not engage in any meaningful non-conventional measures for many years after the Japanese asset bubble burst (see Figure 7).²

Figure 5. Japan — Measures of Inflation (%YY), 1989-2013



Sources: Ministry of Internal Affairs and Communications and Citi Research

Figure 6. Selected Countries — Central Bank Policy Rates (%), Post-Crisis, 2006-2013



Note: Data start in January 1989 for BoJ.
Sources: BoE, BoJ, Fed, ECB and Citi Research

Once the ECB had started cutting rates in 2008, it initially did so quite quickly, and its balance sheet expanded by almost 20% of GDP in the following four years. We would therefore tend to agree that the ECB reacted somewhat more quickly than the BoJ did. But the ECB has been far from decisive in our view in staving off deflation pressures. It was slower in cutting rates than the Fed or the BoE initially, hiked rates in 2011, it took the ECB as long as the BoJ (more than four years) to lower rates to 0.5%, it has done little to address the recent fall in inflation beyond a further 25bp rate cut in November and it has allowed its balance sheet expansion to reverse dramatically over the past year (see Figure 7).

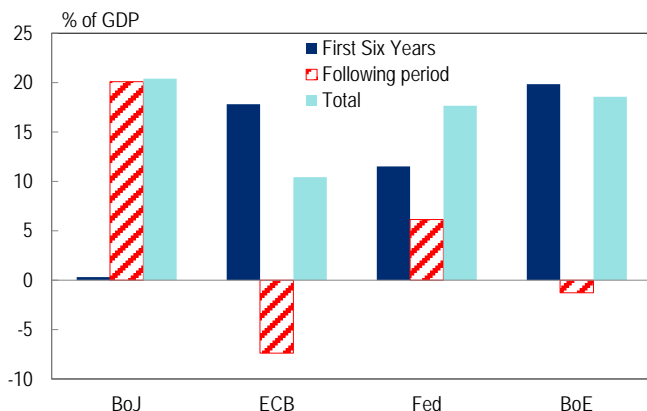
2. “Private sector balance sheets were under more pressure in Japan”

Private sector balance sheets were under greater pressure in Japan

Private sector balance sheets were indeed under greater stress in Japan than in the Eurozone. The peak 5-year increase in private (household and non-financial corporate (NFC)) gross debt was 47% of GDP in Japan (between 1985-90) vs 30% in the euro area ('04-'09) and gross debt levels peaked at 221% of GDP in Japan (in '93) vs 168% in the euro area (in '10). NFCs rather than households accounted for most of the difference between Japan and the euro area (see Figure 8).

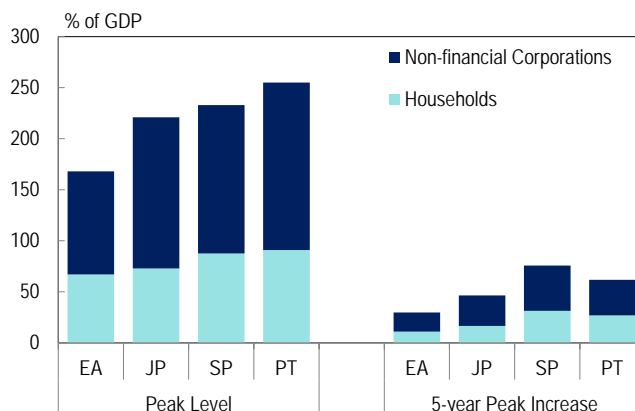
² The BoJ announced is zero interest rate policy (ZIRP) in 1999 and its policy of quantitative easing in 2001. See for instance Takatoshi Ito, Frederic S. Mishkin, "Two Decades of Japanese Monetary Policy and the Deflation Problem," in Takatoshi Ito and Andrew K. Rose, editors, "Monetary Policy under Very Low Inflation in the Pacific Rim, NBER-EASE, Volume 15" University of Chicago Press (2006).

Figure 7. Selected Countries — Central Bank Balance Sheet Increase (% of GDP), Post-Crisis



Note: First six years are 1991-97 for BoJ, 2008-2013 for the rest. Following period is 1997-2005 for BoJ, 2013 for the rest. Sources: BoE, BoJ, Fed, ECB and Citi Research

Figure 8. Selected Countries — Pre-Crisis Peak Level and Increase in Private Sector Debt (% of GDP)

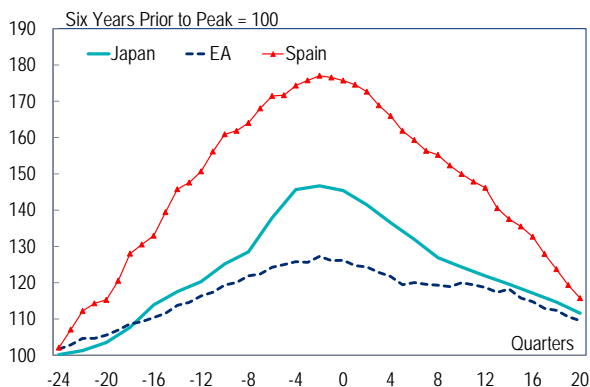


Note: Peaks are 2010 in the euro area, Portugal and Spain and 1995 in Japan. Sources: BIS and Citi Research

Since the asset bubble and bust in Japan (see Figure 9) were also greater, the damage to private net worth was larger than in the EA. Businesses in particular stopped spending and started saving. NFC net borrowing — which reached 9% of GDP in '90 in Japan — fell to zero by '96 and averaged -5% of GDP (i.e. NFCs were net lenders) in 98-05. Household financial surpluses in Japan fell during that time, but private sector saving overall increased much more than in the EA recently.

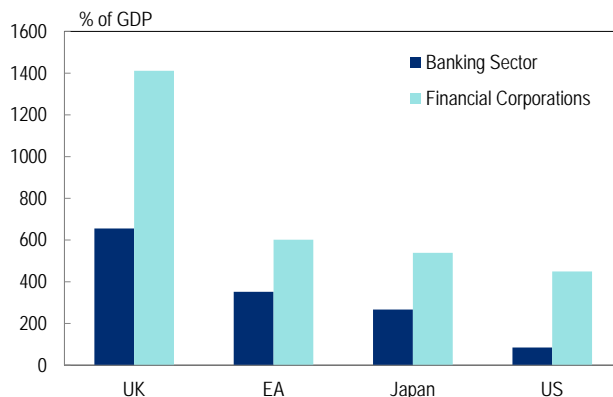
3. “The euro area is cleaning up its banks better and faster than Japan did”

Figure 9. Selected Countries — Real Estate Price Rises Before and After Peak in Real Terms (Six Years Prior to Peak=100)



Note: Urban land prices in Japan. Property prices (all dwellings) for euro area and Spain. 0 corresponds to time of peak in real (CPI-deflated) prices. Peaks are in 1990 for Japan and 2008 in the euro area and Spain. Sources: BIS and Citi Research

Figure 10. Selected Countries — Peak Banking and Financial Sector Size (% of GDP)



Note: Banking sector size is total assets of commercial banks in the US, and of banks in the UK, EA and Japan. Financial corporation size is total assets of financial corporations (which include the central bank) on a non-consolidated basis. For Japan, the peak is the peak in the 1980-2000 period. Sources: BoE, BoJ, ECB, Fed and Citi Research

Japan was very slow in cleaning up its banking sector — but that mostly applies to the Eurozone, too

Comparing the situation in the respective banking sector presents a mixed picture. On the one hand, the Eurozone's banking system and financial sector are bigger than Japan's were in the mid-90s (see Figure 10) and increased more in the pre-crisis period. On the other hand, Japan recapitalised its banks very late (a first major round of recapitalisations only occurred after three major banks failed in 98-99 and non-performing loans were only finally dealt with in 2005) and lending growth only returned in 2005. But just as in Japan, in the euro area regulatory forbearance, a lack of loss recognition, and undercapitalisation of banks also

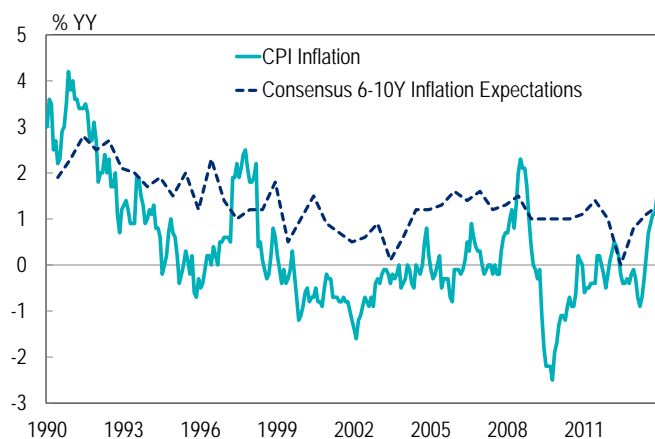
continued for years.³ In the euro area, some notable progress in raising provisions and capital has been achieved recently, but much still depends on how rigorous the upcoming AQR and stress test will be and how well-capitalised banks will be in its aftermath. We are modestly optimistic that the EA will do a better job in restructuring its banks than Japan, but only against that desperately low benchmark.

4. “Inflation expectations are anchored in the EA, and were not in Japan”

Long-term inflation expectations in Japan were more volatile than they are in the Eurozone currently, but lagged actual inflation and never turned negative.

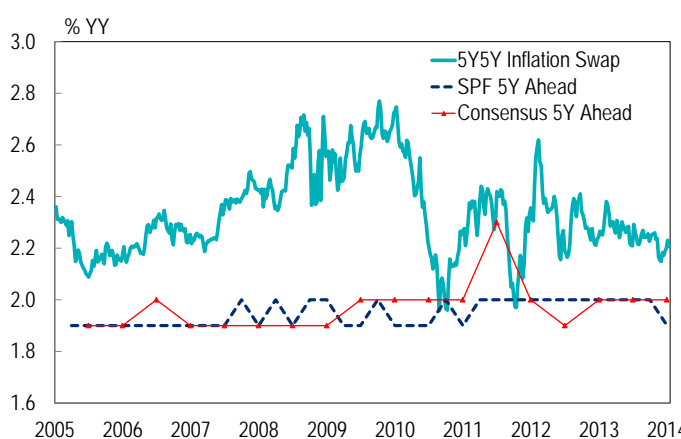
The ECB has noted at various times that it is mainly focused on medium- to longer-term inflation expectations.⁴ In the euro area, longer-term expectations, such as the market-based measures (based e.g. on 5y5y forward inflation swaps or inflation-linked bonds), the 5-year ahead forecast of the survey of professional forecasters (SPF) or long-term consensus forecasts have indeed moved very little recently (see Figure 12). This may be because inflation expectations are firmly anchored or because forecasters expect the ECB to take sufficient action to meet its mandate — which would not remove the need for such action. For instance, the SPF's 5 year-ahead forecasts have been in a narrow band between 1.8-2.0% since the data series started in 2000, and the same mostly applies for the consensus forecasts.

Figure 11. Japan — Inflation Expectations (%YY), 1990-2013



Sources: Consensus Economics, Bloomberg and Citi Research

Figure 12. Euro Area — Inflation Expectations (%YY), 2005-13



Sources: Bloomberg, Consensus Economics, ECB and Citi Research

The evidence that inflation expectations were unanchored in Japan is rather thin. The only data for long-term expectations in the '90s that we are aware of are consensus forecasts (6-10 years ahead, available bi-annually). These were more volatile than in the euro area, falling from almost 3% in 1991 to 0% in 2003, before quickly recovering to 1-2%. They have yet to go negative, even after more than a decade and a half of sustained deflation. Shorter-term (1-year ahead) consensus inflation expectations were negative from 2002, but even those lagged actual inflation by *five years*.⁵ Market-based longer-term inflation rates are only available from 2004 and those also only turned negative in 2008, 10 years after deflation manifested itself in Japan. Maybe inflation expectations are more anchored in the euro area than in Japan, but we doubt that these measures would provide much warning of deflation risk until it is (much) too late.

³ See e.g. Hoshi, Takeo & Kashyap, Anil K (2010) "Will the U.S. bank recapitalization succeed? Eight lessons from Japan," *Journal of Financial Economics*, Elsevier, vol. 97(3), pages 398-417.

⁴ See e.g. ECB (2011), "Inflation expectations in the euro area: a review of recent developments", *ECB Monthly Bulletin* February 2011.

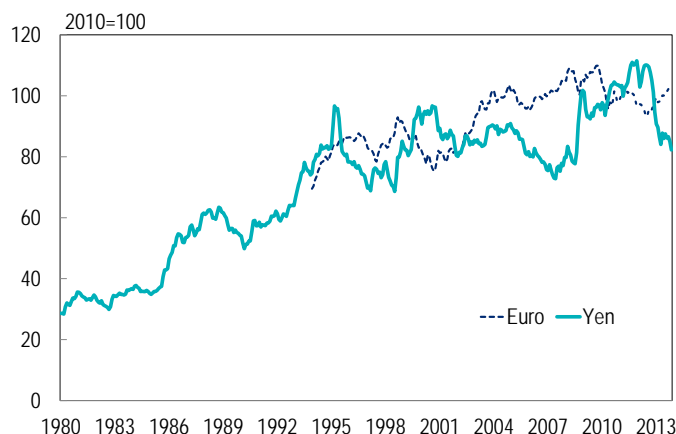
⁵ Survey measures for short-term (12M ahead) price expectations are also available for this period in Japan, but the ECB has variously noted that it does not consider such (short-term) surveys very informative.

5. "The euro area has carried out more substantial structural reforms."

The Eurozone has carried out more structural reforms, but that may raise rather than lower deflationary pressure in the near-term

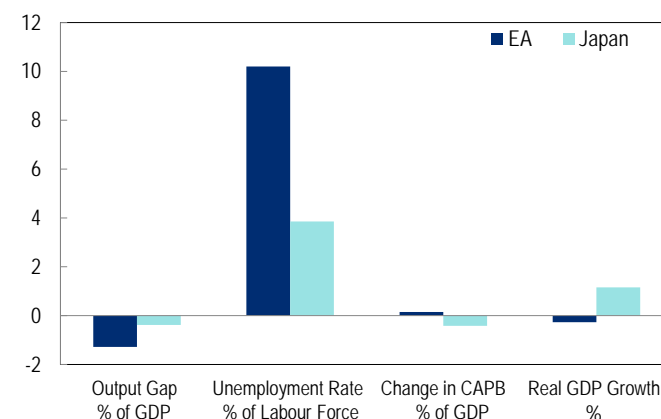
We agree with the ECB President that the Eurozone has probably carried out more structural reforms than Japan had in the two decades following the bust of its stock market bubble. Notably, there have been labour market reforms in Portugal and Spain, pension reforms in many EA countries and some product market reforms in Greece, Portugal and Spain. The only meaningful attempt at structural reform we remember was by then-PM Koizumi from 2001, which did not lead to major achievements. However, it is not obvious to us that structural reforms can help much to ward off deflation. By contrast, structural reforms that increase downward flexibility of wages, increase competition (putting downward pressure on prices) or have contractionary effects may in fact increase deflationary tendencies in the short-run.⁶

Figure 13. Euro and Yen — Broad Effective Exchange Rates (2010=100), 1980-2013



Note: Rising values indicate appreciations.
Sources: BIS and Citi Research

Figure 14. Euro Area and Japan — Average Output Gap, Unemployment Rate, Change in CAPB and Real GDP Growth Post-Crisis



Note: For Japan, averages are for 1991-2005, for the euro area for 2008-2013. CAPB is cyclically-adjusted primary balance.
Sources: IMF, OECD and Citi Research

Overall, deflationary pressures in Japan were probably moderately larger than in the Eurozone

But the parallels outweigh the differences and the Eurozone is also in the deflation 'danger zone'

The main difference is that Japan was hit by a major (triple) shock in 1998 once it was already in the danger zone

Overall, the above factors suggest to us that Japan in the mid-90s (before the triple shock) did face moderately greater deflationary pressure than the Eurozone does currently. However, many EA periphery countries are experiencing pressures of similar size to Japan (Figure 8 and Figure 9) and we expect these to be in or close to deflation in coming years. Even for the Eurozone average, the commonalities with Japan, including reactive monetary policy, weak private demand and weak banking sectors are more telling than these differences. In fact, there are even more parallels. These include a relatively strong exchange rate (see Figure 13) and subdued imported price pressures⁷, sizable increases in current account surpluses and adverse demographics. It should also be noted that during its two lost decades, Japan did enjoy intermittent periods of positive growth (including in 95-96) and rising asset prices, which did not end deflation persistently. One difference in Japan's favour is that fiscal policy was structurally tighter in the Euro area than it was in Japan throughout most of the two lost decades (there were 'only' two years of notable fiscal tightening in Japan during this period, in 97/98 and 2001/02). The Eurozone's unemployment rate and output gap post-crisis have also been larger in recent years than they were in Japan (Figure 14).

⁶ See e.g. Krugman, K. and P. Eggertsson (2012), "Debt, Deleveraging and the Liquidity Trap: A Fisher-Minsky-Koo Approach", The Quarterly Journal of Economics 127 (3): 1469-1513

⁷ However, in both the EA and Japan, GDP deflator inflation was/is not above CPI inflation, suggesting that imported disinflation was not a decisive contributor to the disinflationary/deflationary momentum.

All of these factors confirm our assessment that the Eurozone is also in the deflation 'danger zone' (see [Euro Economics Weekly - One Shock Away from Deflation](#) and Figure 2 on the Front Page). The biggest difference between Japan and the euro area in our view is therefore one that was not mentioned by Draghi: that Japan was hit by a very large shock when it was already in the danger zone: in 1997/98, when it was confronted with the Asia crisis (which led the yen to soar and Japanese export growth to collapse), a banking crisis and planned fiscal tightening. While such a crisis is not our base case, it is certainly conceivable that the current EM troubles could escalate and hit the Eurozone's external growth prospects and lift the trade-weighted euro.

Sufficiently large macro stimulus can probably avert or eliminate deflation — sustained deflation is thus mostly a sign of policy failure

For monetary policy to be successful to fight off deflation, its actions may need to be very large.

In our view, sufficiently large macro stimulus can prevent deflation or jolt the economy out of it, once deflation has set in. Combined monetary-fiscal stimulus stands the best chance of fighting off deflation. For monetary policy alone to do the job, it may need to be very large. In any case, sustained deflation is a sign of policy failure, in our view. In Japan, the failure was twofold. First, policymakers did not do enough to build up a 'buffer' against deflation ahead of the '98 triple shock. Second, policy failed to act aggressively enough once deflation began.

Just as in Japan, euro area policymakers (both the ECB and national governments) are also to be blamed for not being proactive enough and allowing the euro area to get into the deflation danger zone. A key question is whether we should expect policymakers in the euro area to react more forcefully (and successfully) to get out of deflation if it manifests itself.

How would the ECB react to deflation?

The ECB could engage in very large asset purchases, including of government bonds

The hurdles for the ECB to take large action (say, purchase assets amounting to 10% of GDP pa) are large

The constraints to such action are mostly self-imposed

In our view, the ECB is likely to adopt a range of policies (only) once it is confronted with an immediate and sustained deflation risk. These would likely include further rate cuts and liquidity measures, but also asset purchases of various kinds (of public and/or private securities), as noted by various ECB officials recently.⁸ We suspect that as long as headline and core inflation remain positive and long-term inflation expectations are close to 2%, these purchases would be modest in size. But the example of the BoJ (which expanded its balance sheet by roughly 2.5% of GDP per annum in 98-05 through asset purchases without successfully ending deflation) suggest that large purchases would probably be needed to fight off deflation. Technically and legally, the ECB can buy many assets, including equity and government bonds (on secondary markets), in any size. Rather, the main constraint to large and timely action could be the consensus-driven and politically-charged decision-making process at the ECB.⁹

For the ECB to take significant action (purchasing assets amounting to say, 10% of GDP pa), actual inflation may need to be negative, long-term inflation expectations significantly below 2% and the ECB's inflation projections two years out close to zero.

Even very large monetary stimulus may not be sufficient to end deflation, particularly if it is entrenched. Fiscal support may be needed and the prospect of effective monetary-fiscal coordination in the Eurozone are probably little better than they were in Japan in the last two decades. But the difficulty of escaping deflation only strengthens the case for taking preemptive policy action to avoid getting into deflation in the first place.

⁸ See e.g. "ECB's Praet: All Options on Table", Wall Street Journal, 13 November 2014

⁹ See also "ECB poised for battle to ward off deflation", Financial Times, 26 January 2014.

Key Economic Indicators (3 February – 7 February 2014)

During The Week		Forecast	Last
08:00	UK: Halifax House Prices, Jan		
Monday 3 February		Forecast	Last
07:30	Sweden: Manufacturing PMI, Jan	53.5	52.2
08:00	Norway: Manufacturing PMI, Jan	51.2	51.6
09:00	Euro Area: Manufacturing PMI, Jan Final	53.9	52.7
09:30	UK: Manufacturing PMI, Jan	57.5	57.3
	Italy: Budget Balance, Jan		
Tuesday 4 February		Forecast	Last
08:00	Spain: Registered Unemployment, Jan	104K MM	-108K MM
10:00	Italy: HICP, Jan Flash	0.6% MM	0.7% YY
10:00	Euro Area: Industrial Producer Prices, Dec		
16:30	Ireland: Exchequer Return, Jan		
Wednesday 5 February		Forecast	Last
07:30	Sweden: Services PMI, Jan	57.8	57.7
09:00	Euro Area: Services PMI, Jan Final	51.9	51.0
	Composite PMI, Jan Final	53.2	52.1
09:30	UK: Services PMI, Jan	59.0	58.8
10:00	Euro Area: Retail Sales, Dec	-0.3% MM, 1.7% YY	1.4% MM, 1.5% YY
11:00	Ireland: Unemployment Rate, Jan		
Thursday 6 February		Forecast	Last
06:45	Switzerland: SECO Consumer Confidence, Jan		
07:00	Switzerland: Trade Balance, Dec		
07:45	France: Survey on Industrial Investment, Jan		
08:30	Sweden: Average House Prices, Jan		
11:00	Germany: Incoming Orders, Dec	-0.5% MM, 5.2% YY	2.1% MM, 6.8% YY
12:00	UK: MPC Meeting Outcome		
12:45	Euro Area: ECB Meeting Outcome – Press Conference at 13:30		
Friday 7 February		Forecast	Last
07:00	Germany: Trade Balance, Dec		
07:00	Germany: Insolvencies, Nov		
07:45	France: Trade Balance, Dec		
07:45	France: Budget Balance, Dec YTD		
08:00	Spain: Industrial Production, Dec	2.7% YY	2.7% YY
08:15	Switzerland: Retail Sales, Dec		
08:30	Netherlands: Industrial Production, Dec		
08:30	Sweden: Services Production, Dec	0.4% MM	0.5% MM
08:30	Sweden: Industrial Production, Dec	-0.7% MM	5.7% MM
09:00	Norway: Manufacturing Production, Dec	0.2% MM	-0.2% MM
09:30	UK: Trade Balance – Goods & Services, Dec	£-3.0 Billion	£-3.2 Billion
09:30	UK: Industrial Production, Dec	0.3% MM, 1.9% YY	0.0% MM, 2.5% YY
	Manufacturing Output, Dec	0.4% MM, 2.1% YY	0.0% MM, 2.8% YY
11:00	Germany: Industrial Production, Dec	0.2% MM, 3.3% YY	1.9% MM, 3.1% YY
11:00	Ireland: Industrial Production, Dec		

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area

Feb 3	Manufacturing PMI, Jan F	Forecast: 53.9	Prior: 52.7
London Time	After a temporary slowdown in the autumn, the manufacturing PMI posted two consecutive hefty gains in December and January (by 1.1 and 1.2 points, respectively). We expect the January reading to be confirmed in the final reading, at 53.9 (or 0.5 standard deviations above average). The increase in the euro area aggregate index (taken together with the large gain recorded by Germany and France) suggests that Spain and Italy are also likely to report a gain in January, but probably smaller than Germany and France.		
Feb 5	Services PMI, Nov F	Forecast: 51.9	Prior: 51.0
09:00	Composite PMI, Nov F	Forecast: 53.2	Prior: 52.1

The euro area composite PMI should be confirmed at 53.2 in January – highest reading since June 2011 and largest MM gain since last August (+1.1 points). At these levels, historically the composite PMI has been consistent with quarterly GDP growth of around 0.35%-0.4% QQ over the same quarter.

Feb 5	Retail Sales, Dec	Forecast: -0.3% MM, 1.7% YY	Prior: 1.4% MM, 1.5% YY
10:00			
London Time	After a large increase in November, retail sales may have slowed down slightly in December, although they should maintain the underlying rising trend of the previous six months. The annual rate of increase for retail spending would be the highest since 2007.		

Germany

Feb 6	Incoming Orders, Dec	Forecast: -0.5% MM, 5.2% YY	Prior: 2.1% MM, 6.8% YY
11:00			
London Time	We expect industrial orders in Germany to register a modest decline in December as a partial payback for the strong increase in November, as the November increase included a large amount of capital goods orders, particularly from abroad. With the expected decline in December, incoming orders in 4Q would still be 1.1% above the 3Q average, after a 1.7% increase in 2Q.		
Feb 7	Industrial Production (incl Constr.), Dec SWDA	Forecast: 0.2% MM, 3.3% YY	Prior: 1.9% MM, 3.1% YY
11:00			
London Time	After a large increase in November, we expect German IP to be roughly stable in December. Orders in recent months have grown solidly and business confidence and expectations continue to be strong. In November, construction output was surprisingly weak, while industrial output excluding construction grew very strongly, and we expect a partial reversal of that in December. With the expected stable IP reading, IP in 4Q average would be up by 0.9% on 3Q.		

Italy

Feb 4	HICP, Jan P	Forecast: 0.6% YY	Prior: 0.7% YY
10:00			
London Time	We expect HICP inflation to have continued to subside at the beginning of 2014, amid falling fuel prices and an expected reversal of the December increase in fresh food prices. Core inflation pressures remain very subdued, and winter seasonal sales may well have been bigger than last year (as has been happening in the past few years), causing a further decline (albeit temporary) in the core inflation rate (HICP core inflation stood at 0.9% YY in December).		

Spain

Feb 4	Registered Unemployment, Jan ('000)	Forecast: 104K MM	Prior: -108K MM
08:00			
London Time	We expect the number of registered jobless claimants to rise by 104K in Jan, mainly driven by strong seasonal factors (historically January has tended to show the highest MM increase in registered unemployment over the year). The underlying trend should continue to show a marginal reduction in registered unemployment, as observed since Aug 2013. Registered unemployment, however, has recently been less representative of the developments in the labour market than the labour force survey (due to changes in the criteria to access jobless benefits): total unemployment (as measured by the labour force survey) stood at 5.9mln in 4Q 13, against 4.7mln jobless claimants.		
Feb 7	Industrial Production, Dec	Forecast: 2.7% YY	Prior: 2.7% YY
08:00			
London Time	Improvements in survey data (manufacturing PMI bounced back to 50.8 in Dec, 0.2 sd above its long-term average) suggest industrial production probably continued to increase in December (we project 0.6% MM after an expansion of 1.1% in Nov), amid data pointing to a pickup in external demand after weak readings in the previous couple of months. We expect this will translate into a stable YY figure (WDA) in Dec at 2.7% – highest since August 2011. Overall, we expect output to post positive growth in 4Q of around 0.1%QQ, just below our forecast for real GDP growth for the period (of 0.3% QQ).		

Norway

Feb 3	Manufacturing PMI, Jan	Forecast: 51.2	Prior: 51.6
08:00			
London Time	We expect the Norwegian PMI to correct slightly lower in December. This would be better in line with indications from other business surveys, which on average signal slightly around trend-pace growth ahead (RNR points to below-trend growth while the BTS signals slightly above-trend growth). We note that PMI is not closely watched by Norges Bank as there often are problems with the seasonal adjustment procedure. Also, the PMI covers a very small sample compared to e.g. Norges Bank's own Regional Network Report and the quarterly manufacturing survey from Statistics Norway.		
Feb 7	Manufacturing Production, Dec	Forecast: 0.2% MM	Prior: -0.2% MM
09:00			
London Time	Short-term momentum in manufacturing has slowed in recent quarters, with the quarterly growth pace easing from 2.1% QQ in 2Q to 0.5% QQ in 3Q, and in October and November combined, manufacturing production slipped 1.2% vs. the 3Q average. Given the large decline in the orders index in the December PMI survey (51.4 vs. 59.4 in Nov), this indicates further moderation ahead. We note, though, that the PMI survey is very volatile and should be read with caution.		

Economic Indicators

Sweden			
Feb 3 07:30 London Time	Manufacturing PMI, Jan	Forecast: 53.5	Prior: 52.2
	The PMI slipped 3.8 points in December to 52.2, below the long-term average (54.4). Ahead, we expect the manufacturing sector to gradually recover, supporting economic recovery. Hard data (production and exports) have only just started to recover.		
Feb 5 07:30 London Time	PMI Services, Jan	Forecast: 57.8	Prior: 57.7
	The services sector PMI gained 0.7pp to 57.7 in December, but this follows a 3.3 points jump in November. The series, however, is very volatile and one gets a more precise picture by looking at three-month moving averages. On this basis, the services PMI moved up to 56.2 in 4Q – the highest level since mid-2011. Service sector sentiment according to NIER has increased steadily since late 2012, with sentiment both in private services and retail trade above the historic average. Meanwhile, production data have only just started to catch up with sentiment data; actual service production was up 0.4% QQ Oct-Nov combined vs. 3Q (+0.5% MM in 3Q and -0.5% MM in 2Q). We expect the service sector to recover further ahead.		
Feb 6 08:30 London Time	Average House Prices, Jan		
	House prices in 4Q were up by 1% QQ and nearly 4% YY. Hence, house prices have increased gradually during 2013, and short-term indicators point to ongoing upward pressures in the near term. Ahead, we expect house prices gradually to level out next year as the Riksbank starts hiking rates combined with macroprudential measures restraining lending. Given the Riksbank's strong focus on financial stability (although the Swedish FSA has been assigned the main responsibility for macro-prudential policy), a stronger momentum in the housing market clearly is a headache for the Bank. However, key to watch are developments in household lending; in November, growth in loans to households held steady at 4.9% YY. Meanwhile, with ongoing gains in housing starts, this suggests that the re-acceleration in lending growth during 2013 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 fuel an immediate rate hike.		
Feb 7 08:30 London Time	Service Production, Dec	Forecast: 0.4% MM	Prior: 0.5% MM
	The trend in services production has been weak during the past year, and although we are seeing signs of improvement, we have not yet seen the strong pick-up suggested by sentiment data. In Oct-Nov combined, service production printed a 0.4% MM gain vs. the 3Q average (+0.5% MM in 3Q and -0.5% MM in 2Q). We expect the service sector to recover further ahead.		
Feb 7 08:30 London Time	Industrial Production, Dec	Forecast: -0.7% MM	Prior: 5.7% MM
	The November industrial and service sector production data support the picture painted by sentiment indicators of a recovery starting to take shape in Sweden; service sector production was up by a steady 0.5% M/M, industrial production jumped a stronger-than-expected 5.7% M/M, and the order intake picked up (+2.9% M/M), supporting a recovery in manufacturing also in coming months. Admittedly there are some temporary factors at play when it comes to the strong rebound in industrial production; 1) the gain should partly be seen as a bounce back following the temporary shutdown of a refinery in Southern Sweden (Lysekil), which lowered industrial production substantially in September and October, and 2) production in industry for computers and electronics was up an overwhelming 57.4% over the month, suggesting that a reversal may be on the cards in coming months. Although the production data is very volatile, we still see this as a sign of a brewing recovery in the manufacturing and service sector.		
United Kingdom			
Feb 3 09:30 London Time	Manufacturing PMI, Jan	Forecast: 57.5	Prior: 57.3
	Both PMIs weakened a little last month but, with reasonably solid trends in the CBI manufacturing survey and euro area PMI for January, we look for this index to be roughly stable and remaining well above average.		
Feb 5 09:30 London Time	Services PMI, Jan	Forecast: 59.0	Prior: 58.8
	The services PMI in recent months has been far above its longrun average of around 55, and hence signals strong output growth. We look for another solid reading and are relatively unconcerned by minor ups and downs around such a high level.		
Feb 7 09:30 London Time	Trade Balance – Goods & Services, Dec	Forecast: £-3.0 billion	Prior: £-3.2 billion
	The trade deficit has edged down slightly in the first 11 months of 2013, reaching £28.4bn versus £31.3bn in the same period of 2012. We expect little change in the deficit for December and such a figure would put the full year deficit at about £31.3bn versus £33.6bn in 2012. We expect little further change in the deficit in 2014.		
Feb 7 09:30 London Time	Industrial Production, Dec	Forecast: 0.3% MM, 1.9% YY	Prior: 0.0% MM, 2.5% YY
	Manufacturing Output, Dec	Forecast: 0.4% MM, 2.1% YY	Prior: 0.0% MM, 2.8% YY
	Surveys suggest that manufacturing output is expanding fairly strongly, and hence we expect that the flat November figure will be followed by renewed growth in December. A figure in line with our forecast would put 4Q manufacturing output up by 0.8% QQ, although still more than 10% below the precrisis peak.		

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

Key Economic Indicators (10 February – 14 February 2014)

Monday 10 February		Forecast	Last
06:45	Switzerland: Unemployment, Jan		
07:30	France: Bank of France Business Sentiment, Jan		
07:45	France: Industrial Production, Dec		
09:00	Italy: Industrial Production, Dec		
09:00	Norway: Consumer Prices, Jan		
10:00	Greece: Industrial Production, Dec		
Tuesday 11 February		Forecast	Last
07:00	Sweden: PES Unemployment Rate, Jan		
Wednesday 12 February		Forecast	Last
07:45	France: Balance of Payments, Dec		
08:15	Switzerland: Consumer Prices, Jan		
09:00	Norway: GDP, 4Q		
10:00	Euro Area: Industrial Production, Dec		
10:30	UK: BoE <i>Inflation Report</i>		
Thursday 13 February		Forecast	Last
00:01	UK: RICS House Price Survey, Jan		
07:00	Germany: Consumer Prices, Jan Final		
08:15	Switzerland: Producer & Import Prices, Jan		
08:30	Netherlands: Consumer Prices, Jan		
08:30	Netherlands: Retail Sales, Dec		
08:30	Sweden: Unemployment, Jan		
08:30	Sweden: Riksbank Monetary Policy Outcome		
09:00	Euro Area: ECB Monthly Bulletin		
10:00	Greece: Unemployment Rate, Nov		
Friday 14 February		Forecast	Last
06:30	France: GDP, 4Q Flash		
07:00	Germany: GDP, 4Q Flash		
07:45	France: Nonfarm Payrolls, 4Q		
08:00	Spain: Consumer Prices, Jan Final		
08:30	Netherlands: GDP, 4Q Flash		
08:30	Netherlands: Trade Balance, Dec		
09:00	Italy: GDP, 4Q Flash		
09:30	UK: Construction Output, Dec		
09:30	Italy: General Government Debt, Dec		
09:30	Portugal: GDP, 4Q Flash		
10:00	Greece: GDP Flash, 4Q NSA YY		
10:00	Euro Area: GDP, 4Q Flash		
10:00	Euro Area: Trade Balance, Dec		

Sources: National statistical offices, central banks and Citi Research

Title	Author	Date
Euro Area – Sovereign Debt Update		
ECB's Coeuré on Declining Fragmentation	European Economics Team	Jan 31, 2014
ECB's Noyer Warns About A Strong Euro	European Economics Team	Jan 30, 2014
German High Court: "Contentious Discussions" on OMT	European Economics Team	Jan 29, 2014
ECB's Noyer Not Particularly Worried about EM	European Economics Team	Jan 28, 2014
ECB's Draghi on Potential ECB Purchases	European Economics Team	Jan 27, 2014
Euro Area		
Euro Area - Bank Lending Survey Confirms Supply-Side Improvement	Guillaume Menuet	Jan 30, 2014
Euro Area - Weak Money Supply But Stabilisation In Credit Dynamics	Guillaume Menuet	Jan 29, 2014
European Economic Forecast Highlights - January 2014	Ann O'Kelly	Jan 23, 2014
Euro Area - Composite Flash PMIs – Strong Start To 2014	Guillaume Menuet	Jan 23, 2014
ECB - Door Firmly Open to Easing to Address Two Contingencies	Guillaume Menuet	Jan 9, 2014
ECB January 9 Meeting Preview - Many issues to attend to, but no decisions expected yet	Guillaume Menuet	Jan 3, 2014
ECB - Ready to Act, But Likely Conditional on Lower Inflation Path	Guillaume Menuet	Dec 5, 2013
ECB - Seen on Hold in December, but More Easing Likely in 2014	Guillaume Menuet	Nov 28, 2013
Germany - What if Grand Coalition negotiations fail?	Ebrahim Rahbari	Nov 25, 2013
ECB - Aiming for Low Real Rates	Guillaume Menuet	Nov 7, 2013
ECB Preview - Expect Dovish Tone, Leaving Door Open to a Cut in December	Guillaume Menuet	Nov 5, 2013
Euro Economics Weekly		
Spain Is Becoming More German	Giada Giani	Jan 24, 2014
Belgium: Politics the Likely Main Wild Card in 2014	Guillaume Menuet	Jan 17, 2014
Germany 2014 Outlook: Recovery And Rebalancing	Ebrahim Rahbari	Jan 10, 2014
2014 Outlook: GDP Risks, Credit Dynamics and Inflation Update	European Economics Team	Jan 6, 2014
Spain: 2014 Outperformer?	Giada Giani	Dec 13, 2013
Why Is France Underperforming? And How To Fix It	Guillaume Menuet	Dec 6, 2013
Is Deflation Good or Bad for the Eurozone Periphery?	Ebrahim Rahbari	Nov 29, 2013
Is This the End of Austerity?	Giada Giani	Nov 22, 2013
Recovery Watch: SME Lending is Key	Guillaume Menuet	Nov 15, 2013
One Shock Away from Deflation	Giada Giani	Nov 8, 2013
Why the ECB Should Worry About the Strong Euro	Ebrahim Rahbari	Nov 1, 2013
Italy and Spain Look Well Positioned For Job Growth	Guillaume Menuet	Oct 25, 2013
Portugal – What After June 2014?	Giada Giani	Oct 18, 2013
Will the ECB's Comprehensive Assessment of Banks be the Euro Area's TARP Moment?	Ebrahim Rahbari	Oct 11, 2013
Italy – Political and Banking Fragility	Giada Giani	Oct 4, 2013
New ECB LTRO? Not Like Waiting for Godot	Guillaume Menuet	Sep 27, 2013
Housing Not Yet Turning Around	Ebrahim Rahbari	Sep 20, 2013
Chief Economist Publications		
Global Economic Outlook and Strategy - January 2014	Willem Buiter	Jan 22, 2014
Scandi		
Scandi Economics Update	Tina Mortensen	Jan 31, 2014
Norway - Weak Momentum In Private Spending	Tina Mortensen	Jan 31, 2014
Sweden - The Riksbank's Continued Dilemma	Tina Mortensen	Jan 29, 2014
UK		
UK - Highlights of the BoE Data and EC Survey	Michael Saunders	Jan 30, 2014
UK - GDP Data Show Solid Growth	Michael Saunders	Jan 28, 2014
UK - YouGov Reports Lower Inflation Expectations	Michael Saunders	Jan 27, 2014
UK - Carney Speech	Michael Saunders	Jan 24, 2014
UK - Change of UK Rate View	Michael Saunders	Jan 22, 2014
UK Economics Weekly		
Is Growth Credit-Led?	Michael Saunders	Jan 31, 2014
After Forward Guidance... "Fuzzy Guidance"	Michael Saunders	Jan 24, 2014
What Will the MPC Say When Unemployment Hits 7%?	Michael Saunders	Jan 17, 2014
Inflation Convergence and Divergence	Michael Saunders	Jan 10, 2014
2014 Outlook — Recovery and the New Normal	Michael Saunders	Jan 8, 2014
Source: Citi Research		

Appendix A-1

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