9 May 2014 │ 16 pages

Developed Markets
Western Europe

Euro Economics Weekly

How Might QE Affect Financial Conditions?

- We try to assess the channels via which QE (our base case by end-2014) may affect financial conditions and the euro area economy. At present, the Citi Financial Condition Index (FCI) still suggests that euro area financial conditions are not particularly supportive of economic activity, mainly due to still-high bank lending rates and the strong currency.
- As our base case, we estimate that €1tn QE could improve the Citi FCI by 0.4-0.5 SD and boost real GDP by 0.7% in total over the next three years, while inflation could be raised by 0.1-0.2% per year. But we stress the uncertainties over these channels, especially over the extent to which QE actually would improve financial conditions. If QE does not produce a significant gain in asset prices, lower lending rates and/or a weaker currency it probably would not give much boost to the economy. Conversely, if QE were to cause financial conditions to improve really sharply (eg via a large depreciation in the euro) then the resultant boost to growth and prices could be much larger than our base case.

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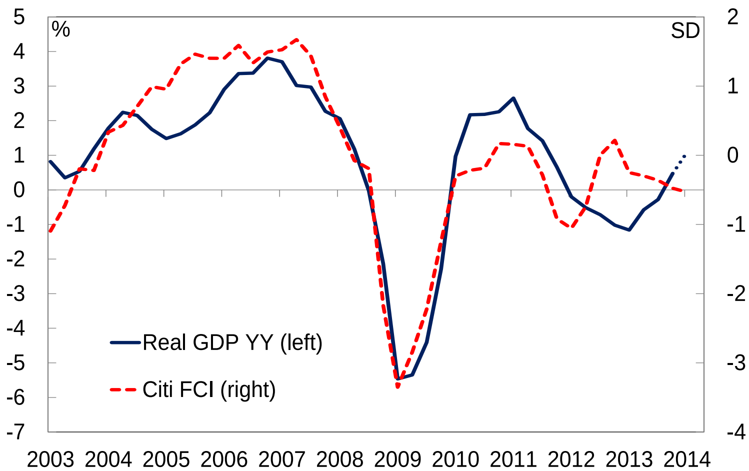
Figure 1. Citi Forecasts

	$/€	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
4Q 14	1.35	0.10	1.60	0.79	0.75	173	9.19	0.50	8.03	1.50	1.25	0.00	-65
2Q 15	1.37	0.10	1.70	0.80	1.50	188	9.13	0.75	7.90	1.75	1.26	0.00	-68

Source: Citi Research

Figure 2. Euro Area – Real GDP Growth (YY) and Citi Financial Condition Index, 2003-Mar 14



Sources: ECB, Haver Analytics and Citi Research

How Might QE Affect Financial Conditions?

Financial conditions are still not very supportive of economic activity

The ECB left its key policy rates unchanged this week, and did not initiate any unconventional monetary and credit policy measures, but indicated its intentions to deliver additional monetary policy accommodation in coming months. Our Citi Financial Condition Index (FCI) for the euro area suggests that financial conditions are not particularly supportive of economic activity, despite historically low policy and Euribor interest rates and more favourable market-based financing conditions. In the absence of further stimulus or a boost to export demand, we argue that further easing in financial conditions is probably necessary for GDP growth to pick up more vigorously and to increase the likelihood of inflation moving back to target over the medium-term. We analyse the 12 components of the Citi euro area FCI to gauge the channels via which additional monetary policy accommodation in the form of QE (our base case by the end of 2014[1]) would affect the euro area economy.[2] We estimate that asset purchases in the order of €1,000bn (or 10% of euro area GDP) may ease financial conditions by around 0.4-0.5 SD. This should translate into higher real GDP by ¾% in total over the 2015-2017 period and higher HICP inflation by 0.1-0.2% per year in the same period.[3]

Financial conditions not really supportive of growth in the euro area

Financial conditions have slightly tightened in the past 12 months…

It has been almost a year since we last wrote about our Citi euro area FCI. According to this indicator, financial conditions have actually deteriorated slightly in the past 12 months, after a significant improvement recorded from mid-2012 (see Figure 2 on the front page).[4] The level of the FCI in March 2014 stood at 0.54 standard deviations above its long-run average (a higher level indicates tighter financial conditions), against 0.3 SD above average in Q2 13. This is clearly less restrictive than the peaks reached in Q1 12 (+1.3 SD) and in 2009 (+3.6 SD), but still much less accommodative than in the 2003-2008 period (see Box 1 for details on how the FCI is constructed).

…as lower short-term rates have not been feeding through into lower lending rates at the euro area aggregate level

Figure 3 gives a snapshot of the 12 components which feed into the FCI. It is immediately clear what factors are still contributing to a restrictive stance. Bank lending rates on business loans, and to a smaller extent on consumer loans (both measured as spread against bank deposit rates), remain significantly higher than their historical average (see Figure 4). High lending rates are mainly a feature of the periphery countries and may reflect a variety of factors, including still-high perception of borrower risks, high mark-ups in an attempt to raise capital and/or greater monopoly power after the restructuring of banking sectors. While lending rates have remained broadly stable since mid-2012 at the euro area aggregate level, a simultaneous decline in deposit rates (by 50bp for businesses' deposits) has caused the lending-to-deposit spread to widen over the past year or so, contributing to a tightening in overall financial conditions. One may argue that falling deposit rates are a positive sign that reflects the normalization in bank funding costs, and it should not really translate into a tightening in financial conditions. On the other hand, falling deposit rates have reflected lower short-term rates, which have failed to be transmitted to a decline in lending rates. When adjusted for HICP inflation, real euro area lending rates have also increased significantly over the past 18 months due to lower inflation rates.

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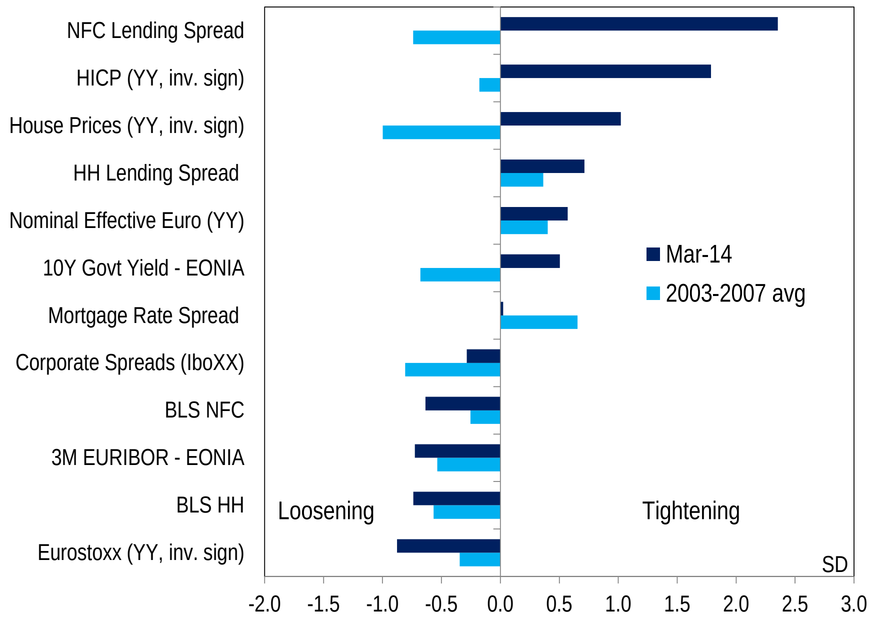
[1] See "Euro Area - The ECB and QE: "Whatever it Takes", Redux", Citi Research, 22 April 2014.

[2] We define quantitative easing as non-sterilised larger-scale asset purchases of both private securities and sovereign debt.

[3] See "Global Economic Outlook and Strategy", Citi Research, 30 April 2014

[4] See "Euro Economics Weekly – Financial Conditions Neutral, At Best, on Growth", Citi Research, 7 June 2013.

Figure 3. Euro Area – 12 Components of the FCI (SD vs. LT average), 2003- Mar-14



Note: Non-financial corporation (NFC), Household (HH), Bank Lending Standards (BLS)
Sources: ECB, Haver Analytics, and Citi Research

Falling house prices and falling inflation have also contributed to keep FCI tight

House price inflation and historically-low HICP inflation are the other obvious contributors to still not accommodative FCI. Both house and consumer prices inflation rates have a negative coefficient in the FCI, implying that lower inflation rates are associated with a tighter FCI. Negative (or low) house price inflation causes negative wealth effects and hence is associated with tighter financial conditions. The link between FCI and HICP inflation may not be straightforward to interpret: while a lower consumer price *level* raises the purchasing power of a given nominal income, a lower *inflation rate*, holding constant nominal interest rates, raises real interest rates. Our empirical findings indicate that low inflation is normally associated with tight financial conditions.

Appreciating currency and still-high average term premium also help to explain the restrictive stance…

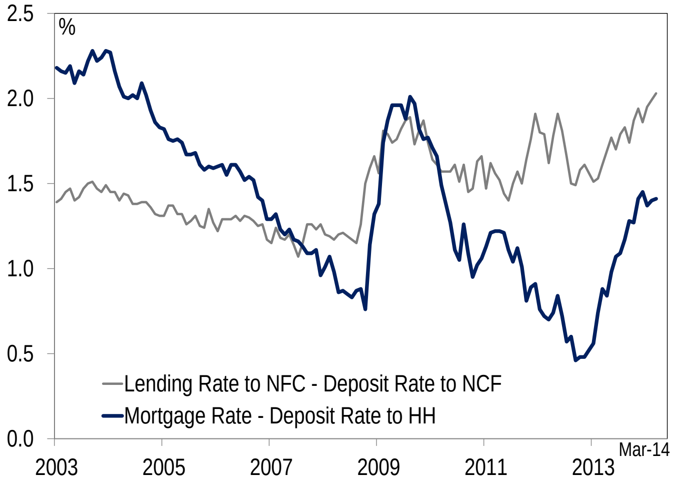
The recent strengthening of the euro is also contributing to keep FCI below historical levels. Note that we use the YY growth rate in the exchange rate as the input into the FCI, rather than the level of the currency. The effective nominal euro exchange rate against a basket of 20 currencies has appreciated by 4.6% YY on average in the past 12 months, a trend well above its historical pattern. Finally, despite the sizable periphery-core spread compression, the euro area weighted average 10-Y government bond yields stood at some 270bp above overnight rates in March (before falling to 235bp in April) – well above the 135bp average prevailing in the 2003-2007 period (see Figure 5).

…offsetting the accommodation provided by market-based financing means

Unsurprisingly, the market-based financing channels are all supportive of accommodative financial conditions, with equity price growth in the order of 20% YY over the past year, corporate bond spreads moderately accommodative, albeit less so than in 2003-2007, and the bank lending survey (BLS) signaling looser-than-average credit supply conditions (see Figure 5).[5]

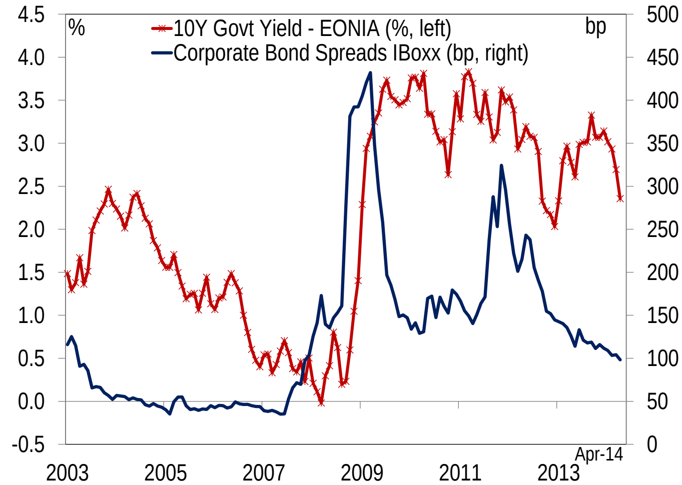
[5] However, the BLS captures the changes in lending standards vs. the previous quarter, rather than the absolute level, which may still be restrictive by historical terms given the significant tightening recorded during recent years.

Figure 4. Euro Area – Bank Lending Rates Minus Deposit Rates (%), 2003-Mar-14



Source: ECB and Citi Research

Figure 5. Euro Area – Sovereign 10Y Yield Minus EONIA (%) and Corporate Bond Spreads (Iboxx, bp), 2003-Apr-14



Source: ECB, Haver Analytics, and Citi Research

OECD FCI shows a more accommodative stance

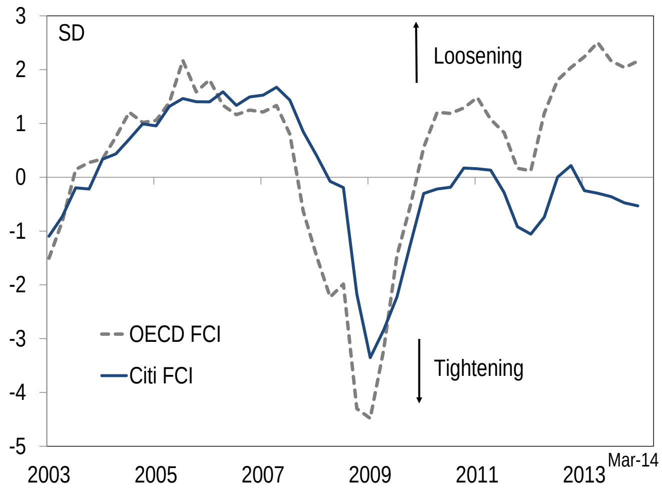
Of course, the Citi euro area FCI is only one of the several possible ways to measure financial conditions, and admittedly quite a simplistic one since it does not rely on structural relationships between key macroeconomic and financial variables. For example, the OECD financial condition index, published this week in the May 2014 Economic Outlook, shows quite a different picture, with financial conditions in the euro area close to their most accommodative level since 2003, although retrenching slightly over the past three quarters (see Figure 6).[6]

For any one SD move in the FCI, GDP growth tends to move by 1¾%

However, the correlation between the Citi FCI and GDP dynamics has been fairly good in the past 10 years. We have run a simple regression of the quarterly average values of the Citi FCI against the QQ or YY GDP growth rates, to which we have added the changes in the structural fiscal balance in order to capture the evolution in the fiscal stance. The equation gives fairly high R^2 (of 0.58 and 0.83, respectively for the QQ and YY real GDP growth rates) (see Figure 7). The results suggest that one SD increase/decline in the FCI is associated with 1¾% lower/higher YY GDP growth. If the same regression is run on nominal GDP, it gives a slightly higher coefficient of around 2%, suggesting that most of the elasticity to financial conditions is to be found in real GDP rather than inflation. Note that the relationship between FCI and GDP growth is strongest with no lags in the equation (but a 4-quarter lag for the fiscal stance), suggesting that there are probably common factors which simultaneously explain changes in GDP growth and movements in financial conditions.

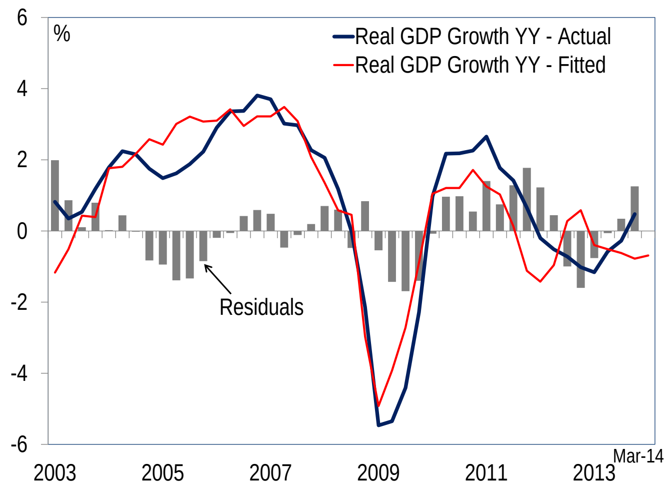
[6] The OECD FCI is based on model-estimated GDP elasticities to six financial variables, namely short and long-term interest rates, bank lending survey's credit conditions, corporate bond spreads, real exchange rate and households' wealth. Therefore, the main difference between the Citi FCI and OECD FCI is the inclusion of bank lending rates as an input. See "Quantifying the Effect of Financial Conditions in the Euro Area, Japan, United Kingdom and United States", OECD Working Paper No 677, March 2009.

Figure 6. Euro Area – Financial Condition Indices, 2003 Q1 14



Sources: OECD, ECB and Citi Research

Figure 7. Euro Area – Real GDP Growth, Actual and Fitted, 2003 Q1 14



Note: Fitted values are obtained by regressing real GDP growth (YY) on Citi FCI and change in the structural fiscal balance as estimated by the EU Commission.
Sources: ECB, EU Commission, Haver Analytics, and Citi Research

How QE might affect the euro area economy

Using the 12 components of the FCI provides, in our view, a good framework to assess the channels via which non-sterilised large-scale asset purchases may affect financial conditions in the euro area. We reckon that the expansion of bank reserves as a direct effect of QE (reserve channel) may not have a meaningful impact in itself on the economy, in an environment of already-ample liquidity and low money market rates. Conversely, taking as a guideline the analyses by the BoE and the Fed on QE effects in the UK and US, we conclude that the most relevant impact of QE will most likely be on asset prices – both of those assets directly bought by the central bank and, indirectly through the portfolio rebalancing effect, of those assets that the sellers to the central bank will buy or sell as they attempt to rebalance their portfolios – their substitutes or complements.

We assume that QE could compress the average 10-y government bond yield by 50bp and corporate bond yields by 40bp

Studies for the UK suggest that the non-sterilised QE (amounting to 14% of UK GDP) compressed gilt yields around the QE announcements by a total of 100bp (average change in the 5 to 25-year rates, measured by the total reaction to each of the QE news events). Estimates for the Fed's QE 1 (asset purchases throughout 2009 and early 2010, amounting to about 12% of 2009 US GDP) suggest a smaller impact of 50bp.[7] Taking an average of the two cases, and scaling it for the smaller size of asset purchases we expect the ECB to do initially (€1tr, or about 10% of GDP), we assume a 50bp drop in the average 10-year government bond yield and a 40bp drop in corporate bond yields. The impact on equity prices may be more difficult to gauge, as guidelines from the UK and US could be less representative for the euro area – QE in the UK and US occurred at the trough of the equity cycle while it would happen after sizable gains in equity prices in the euro area. We nevertheless assume that equity prices will increase by 20% YY following QE, broadly maintaining the pace of growth of the last 12 months and hence their recent positive contribution to financial conditions.

[7] For the UK we take as a reference study *"The United Kingdom's quantitative easing policy: design, operation and impact"*, BoE Quarterly Bulletin, September 2011. For the US, see "Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?", Chung et al, Federal Reserve Bank of San Francisco, 2011.

Effects of QE on bank lending rates have not been so obvious in UK and US experiences of QE

On the other hand, the impact of QE on bank lending rates – the most restrictive factor at the moment in euro area financial conditions, according to Citi FCI – may be less straightforward to assess. The BoE study finds little evidence that bank lending rates on new loans for businesses and households fell significantly following QE purchases. On the other hand, the Fed study indicates that the spread of US residential mortgage rates over Treasury yields fell by 50bp in the few months following the Fed's QE announcements, in part because the programme (which involved a large chunk of MBS purchases) assured a steady demand for these securities at a time of strained market conditions.[8]

Bank lending rates may fall because banks are helped by better valuations of non-performing loans

We believe the ECB's QE would also involve purchases of private assets, mostly sitting on banks' balance sheets. This could help banks work out their large stocks of non-performing loans (NPLs) by indirectly improving the functioning of the market for distressed credit. Moreover, the improvement in the general economic climate resulting from QE could reduce banks' risk perceptions vis-à-vis private sector borrowers – which could be one of the main factors currently keeping lending rates high in the periphery.[9] However, this expected improvement may take some time to occur and it is unlikely to drive lending rates much lower if the stock of NPLs is not first reduced.

Even a small decline in lending rates may still imply a decent change in FCI

Overall, we assume a small, but permanent, decline in bank lending rate spreads relative to deposit rates by some 10bp for both businesses and households. While this may sound a small change, it represents a move of more than 0.4 SD for business lending rates (0.3SD and 0.2SD for consumer and mortgage rates, respectively). Moreover, given the high coefficient by which business lending rates affect the Citi FCI, even a small shift of just 10bp could, if sustained, have an important impact in financial conditions. On the other hand, we have assumed bank lending standards will not be meaningfully affected as a result of QE, since these measures are already close to their historical lows.

Rising inflation will help to compress real interest rates further

Some indirect effects on financial conditions could stem from marginally higher inflation on consumer and house prices. Better economic activity generated by higher asset prices and lower lending rates will likely lift consumer price inflation which in turn will, other things being equal, reduce real interest rates. Equally, house prices may be boosted by rising households' financial wealth and improving nominal income growth, although we expect this effect to be quite delayed and limited.

We assume the euro effective exchange rate will stabilise rather than weaken significantly

Probably the most problematic effect of QE to gauge is the one on the euro. Evidence from the UK and US experiences of QE suggests that the currency has not really moved much around QE announcements (the USD has slightly depreciated and GBP has slightly appreciated over the period from 50 days before the announcements to 100 days after). On the other hand, it can be argued that a large-scale asset purchases by the ECB (following a rate cut in the refi and deposit rates) at the same time when other major central banks are probably getting closer to zero-exit, would weaken the euro. All in all, we assumed that QE will stop the recent appreciation in the euro, but will not weaken it significantly over time.[10] Yet, since the exchange rate enters into the FCI calculation in YY growth terms, a stable currency (even at high levels) would still imply less tight financial conditions compared with the recent appreciating trend.

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[8] However, these studies could be misleading as they measure the time series impact of QE on lending rates and not the impact relative to the counterfactual – bank lending rates could have increased in the absence of QE.

[9] See OECD Economic Outlook, May 2014.

[10] See Foreign Exchange Forecasts: April 2014.

Overall, QE may produce an easing in financial conditions by 0.4-0.5 SD, lifting GDP by ¾% over the next three years

Combining all the effects, we compute that QE may improve overall FCI by 0.4-0.5 SD. Based on our simple regression which relates FCI and GDP growth, this should correspond to a higher real GDP of 0.7%, which we assume to be spread over the next three years (that is 0.2-0.3% per year). The impact on inflation is likely to be more subdued (0.1-0.2% per year), at least over the next three years, given the still ample spare capacity which needs to be re-absorbed first before exerting upward pressure on prices.

Estimated effects of QE for the UK and the US have been larger

These estimates are somewhat more conservatives than those cited by the Fed and BoE studies on the effects of BoE's and Fed's QE. Even by scaling down the UK and US estimates for a smaller size of expected QE from the ECB (around 10% of GDP), those studies would suggest a boost to the euro area real GDP *level* of 1.3%-1.8% and of 0.6-0.8% to CPI inflation. A recent newspaper article from the German Frankfurter Allgemeine cited internal ECB studies suggesting that €1tn of asset purchases would lift HICP inflation by 0.2-0.8pp.

For QE to work it probably needs to produce a combination of higher asset prices, lower lending rates and/or a weaker currency

However, we have to acknowledge that these estimates are uncertain because (a) the reaction of asset prices to QE is unclear, and (b) because the reaction of economic variables to asset price changes is also somewhat variable. A key point to stress here, in our view, is that if QE does not generate some combination of higher asset prices, lower bank lending spreads and/or a weaker currency, it is unlikely to boost GDP growth significantly. If the effect of QE would be only to reduce government bond yields, with a limited impact on lending rates and/or the currency, its effects on growth and inflation are probably going to be rather limited. The ECB's QE would occur at a very different stage in the economic cycle compared to the UK or US, possibly implying that the Fed and BoE estimates of QE effects on GDP and inflation may have captured other positive drivers of economic activity not directly connected with QE. Or the UK and US QE may have occurred in conditions which make QE much more effective, such as less liquid markets and bottom-low equity prices. This could suggest a smaller impact of QE in the euro area.

Box 1. The Citi Euro Area Financial Condition Index (FCI)

The Citi euro area Financial Condition Index (FCI) is derived by running a principal component analysis on 12 financial indicators (standardized against their long-run average) which should capture the main channels through which financial conditions affect economic activity. The 12 indicators can be grouped into four categories:

(1) **bank lending rates** – non-financial corporations (NFC) bank lending rate on new loans minus bank deposit rate on new NFC deposits, bank mortgage rates on new loans minus household deposit rate, consumer loans rates minus household deposit rate.

(2) **supply of credit** – change in bank credit standard for business loans over the past 3 months, change in bank credit standard for household loans (average of housing and consumer loans) over the past 3 months.

(3) **measures of market-based financing costs** – spread between 3-month Euribor vs. overnight rate (EONIA), spread of euro area average 10-year government bond yields vs. 3-month Euribor, IBoXX EUR corporate bond spreads.

(4) **price changes** – Eurostoxx YY growth, HICP YY growth, nominal effective euro (against 20 currencies) YY growth, euro area house prices YY growth.

The FCI is constructed by aggregating the weighted average of the first three principal components (weighted by their share of explained variance). Together they explain more than 82% of the total variance. By construction, the FCI is a linear combination of the 12 components, which allows the contribution of each component to the overall index to be

estimated. The estimated coefficients are reported in the table below.

Indicator	Coefficient
NFC Bank Lending Rate Spreads over NFC Deposit Rates	0.22
Mortgage Rate Spreads over HH Deposit Rates	0.09
Consumer Loans Rate Spreads over HH Deposit Rates	0.12
Bank Lending Conditions to NFC (Bank Lending Survey)	0.22
Bank Lending Conditions to HH (Bank Lending Survey)	0.25
3M EURIBOR minus EONIA	0.07
10Y government bond yield (EA AVG) minus EONIA	0.16
Corporate Bond Spreads (IboXX)	0.22
Eurostoxx Prices Changes (YY)	-0.21
HICP Inflation YY	-0.16
Nominal Effective Euro (YY)	0.06
House Prices (YY)	-0.18

Key Economic Indicators (12 May – 16 May 2014)

		Forecast	Last
Monday 12 May		Forecast	Last
07:30	France: Bank of France Business Sentiment, Apr		
08:15	Switzerland: Retail Sales, Mar		
Tuesday 13 May		Forecast	Last
07:45	France: Balance of Payments, Mar		
08:30	Sweden: Consumer Prices, Apr	0.3% MM, -0.1% YY	0.0% MM, -0.6% YY
	CPIF, Apr	0.3% MM, 0.4% YY	0.1% MM, 0.0% YY
09:00	Italy: HICP, Apr Final		
10:00	Germany: ZEW Current Situation, May	57.5	59.5
	ZEW Economic Sentiment, May	45.2	43.2
Wednesday 14 May		Forecast	Last
07:00	Germany: Consumer Prices, Apr Final		
07:00	Sweden: Prospera Inflation Expectations Survey		
07:45	France: HICP, Apr	0.1% MM, 0.6% YY	0.4% MM, 0.6% YY
	Consumer Prices, Apr	-0.1% MM, 0.8% YY	0.5% MM, 0.7% YY
	CPI Ex Tobacco Index, Apr	126.12	126.29
08:00	Spain: HICP, Apr Final	0.3% YY	-0.2% YY
08:30	Netherlands: Retail Sales, Mar		
09:30	UK: LFS Unemployment, 3-Month Average, Jan-Mar	-140K QQ, 6.8% Rate	-77K QQ, 6.9% Rate
	LFS Unemployment, Single Month, Mar	6.8% Rate	6.6% Rate
	Claimant Count Unemployment, Apr	-30.0K MM, 3.3% Rate	-30.4K MM, 3.4% Rate
	Average Earnings Ex Bonuses, Mar	1.6% YY	1.3% YY
09:30	Italy: General Government Debt, Mar		
10:00	Euro Area: Industrial Production, Mar	-0.2% MM	0.2% MM
10:30	UK: Bank of England *Inflation Report*		
	Norway: Supplementary 2014 Budget		
Thursday 15 May		Forecast	Last
06:30	France: GDP, 1Q Flash	0.2% QQ, 1.1% YY	0.3% QQ, 0.8% YY
07:00	Germany: GDP, 1Q Flash	0.8% QQ, 2.2% YY	0.4% QQ, 1.4% YY
08:15	Switzerland: Producer and Import Prices, Apr		
08:30	Netherlands: GDP, 1Q Flash	0.1% QQ, 1.4% YY	0.9% QQ, 0.9% YY
08:30	Netherlands: Trade Balance, Mar		
08:30	Netherlands: Unemployment, Apr		
09:00	Euro Area: ECB Monthly Bulletin		
09:00	Italy: GDP, 1Q Flash	0.2% QQ, -0.2% YY	0.1% QQ, -0.9% YY
09:00	Norway: Trade Balance, Apr		
09:30	Portugal: GDP, 1Q Flash		
10:00	Greece: GDP NSA YY, 1Q Flash		
10:00	Cyprus: GDP, 1Q Flash		
10:00	Euro Area: GDP, 1Q Flash	0.4% QQ, 1.1% YY	0.2% QQ, 0.5% YY
10:00	Euro Area: HICP, Apr Final	0.7% YY	0.5% YY
Friday 16 May		Forecast	Last
07:00	EU-27: New Car Registrations, Apr		
07:45	France: Nonfarm Payrolls, 1Q Flash	0.1% QQ, -0.1% YY	0.1% QQ, -0.4% YY
09:00	Italy: Trade Balance, Mar		
10:00	Euro Area: Trade Balance, Mar		

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area			
May 14 10:00 London Time	*Industrial Production, Mar*	Forecast: -0.2% MM	Prior: 0.2% MM
	Industrial activity in March probably slowed relative to the previous two months, as suggested by the country data released so far. Yet, even with a negative monthly reading, IP would be up by 0.4% QQ in 1Q, only marginally slower than in 4Q (+0.5% QQ) and showing signs that the recovery is consolidating.		
May 15 10:00 London Time	*GDP, 1Q Flash*	Forecast: 0.4%QQ; 1.1% YY	Prior: 0.2% QQ; 0.5%YY
	GDP growth probably picked up in 1Q, to 0.4% QQ – fastest pace since 1Q11 – on signs that the recovery is broadening out to private consumption (expected to gain 0.3% QQ in 1Q). The net export contribution to GDP growth has probably continued to slow to a marginally negative QQ contribution in 1Q, as imports are picking up.		
May 15 10:00 London Time	*HICP, Apr Final*	Forecast: 0.7%	Prior: 0.5%
	HICP inflation should be confirmed at 0.7% YY in April, with a smaller increase than generally expected before the preliminary data were released. Full breakdown details should show that most of the increase in the headline and core rates (HICP ex-food, energy and tobacco was up to 1.0% YY from 0.7% YY in Mar) was explained by the later timing of Easter, with a payback to be expected in May (especially in core).		
Germany			
May 13 10:00 London Time	*ZEW Current Situation, May* *ZEW Economic Sentiment, May*	Forecast: 57.5 Forecast: 45.2	Prior: 59.5 Prior: 43.2
	We expect the ZEW index of financial market analysts to stabilise in March. For the current conditions component, we expect a small decline after four consecutive monthly increases that left the index at its highest level since mid 2011. For the expectations component, we expect a small increase after two large falls, which were likely at least in part to have been related to tensions in Russia and Ukraine. Both components remain comfortably (more than 1 std) above their longterm averages. Currently, the current conditions index is almost 1.5 standard deviations above its LT average, while the expectations index is only 0.5 sd above its LT average after the declines in recent months.		
May 15 07:00 London Time	*Real GDP, 1Q Flash*	Forecast: 0.8% QQ, 2.2% YY	Prior: 0.4% QQ, 1.4% YY
	We are slightly raising our forecast to 0.8% QQ (from 0.7% QQ): The German economy grew strongly in 1Q, boosted by unusually mild weather in addition to the building cyclical momentum. Strong retail sales (partly a payback to a very weak 4Q) and robust industrial production suggest that growth could be even stronger than our slightly above-consensus forecast, but a payback from the large positive contribution to growth of net trade in 4Q is likely to be at least partially unwound, with some downside risk to GDP if the negative contribution of net trade is even larger than we expect.		
France			
May 14 07:45 London Time	*CPI – EU Harmonised, Apr* *Consumer Price Index, Apr* *CPI Ex Tobacco Index, Apr*	Forecast: -0.1% MM, 0.6% YY Forecast: -0.1% MM, 0.8% YY Forecast: 126.12	Prior: 0.4% MM, 0.6% YY Prior: 0.5% MM, 0.7% YY Prior: 126.29
	Consumer prices are expected to have fallen a little in April. Manufactured goods prices likely stabilised after two months of sizeable gains, while services prices likely dropped marginally, leaving core CPI to print a small drop of 0.1% MM. For the volatile components, modest gains in food prices are likely to have been offset by falls in energy prices. Overall, the French inflation picture remains subdued, with headline domestic inflation set to average 0.7% YY again in 2Q-14. We expect 2014 to mark the low point in the inflation trajectory, but do not anticipate much acceleration over the forecast horizon as the new focus on competitiveness continues to foster wage moderation.		
May 15 06:30 London Time	*Gross Domestic Product, 1Q P*	Forecast: 0.2% QQ, 1.1% YY	Prior: 0.3% QQ, 0.8% YY
	The flash estimate is forecast to show a 0.2% gain, indicating a modest slowdown in the rate of expansion, even if base effects should push the headline YY rate up to 1.1%, highest level since Q4-11. Domestic demand is forecast to have been flat in 1Q, with a gain in fixed investment offset by a drop in public sector spending and a weak performance in private consumption in the aftermath of the Jan-14 VAT rate hike. Latest IP and household spending data suggest that there are slight downside risks. With sentiment surveys gaping lower in April, the recovery appears to be treading water, despite the government's best efforts to provide better visibility about its programme of expenditure cuts and reforms.		
May 16 07:45 London Time	*Non-Farm Payrolls, 1Q P*	Forecast: 0.1% QQ, -0.1% YY	Prior: 0.1% QQ, -0.4% YY
	We look for a small 0.1% gain in non-farm payrolls in 1Q, with favourable base effects enough to push the headline YY rate very close to positive territory. Note that recent dynamics in employment expectations surveys conducted by both INSEE and BdF suggest that the gradual uptrend is continuing. Enough in our view for employment growth to turn positive in 2014 (+0.4%) for the first time in three years. Wage moderation and government policies to lower labour costs should help job creation over time, helping stem the destruction of manufacturing sector jobs.		
Italy			
May 15 09:00 London Time	*GDP, 1Q Flash*	Forecast: 0.2%QQ; -0.2% YY	Prior: 0.1% QQ; -0.9%YY
	We estimate GDP dynamics to have picked up in 1Q14, although to a quite meagre pace of 0.2% QQ and still underperforming the rest of the euro area. We reckon improving export growth and the boost to corporate liquidity provided by the repayment of government arrears (1.3% of GDP in 2H13) will probably help lift economic activity in 1H14.		
Spain			
May 14 08:00 London Time	*HICP, Apr Final*	Forecast: 0.3% YY	Prior: -0.2% YY
	According to the flash estimate, inflation bounced back to 0.3% YY in Apr, slightly above our forecast (0.2%) but in line with market expectations, up from -0.2% YY in Mar. We expect the composition to show some pick-up in energy inflation, driven by adverse base effects (energy prices probably flat MM in Apr-14 against a 2.7% MM drop in Apr-13), as well as in core inflation due to the later timing of Easter. On the other hand, we expect some further easing in food price inflation. In our view, inflation should decline again in coming months and in general remain close to zero this year.		

Economic Indicators

Netherlands			
May 15	*GDP, 1Q Flash*	Forecast: 0.1%QQ; 1.4% YY	Prior: 0.9% QQ; 0.9%YY
08:30			
London Time	We look for a payback in GDP growth in 1Q, forecasting a 0.1% QQ increase after what was an abnormally strong 4Q (+0.9% QQ) distorted by a very large increase (9.9% QQ) in gross fixed investment. We raised our 2014 GDP forecast by 0.1pt to 1.3% in our last *Global Economic Outlook and Strategy* and expect the recovery to continue, benefiting from better external demand conditions, and our more constructive take on the euro area. With private sector deleveraging and some residential housing market adjustment ongoing, private consumption growth will likely stay soft for a few more years.		
Sweden			
May 13	*Consumer Prices, Apr*	Forecast: 0.3% MM; -0.1% YY	Prior: 0.0% MM, -0.6% YY
08:30	*CPIF, Apr*	Forecast: 0.3% MM; 0.4% YY	Prior: 0.1% MM, 0.0% YY
London Time			
	We believe that core (and headline) inflation likely bottomed in March, and expect prices to gradually pick up from here. The deviation in the seasonal pattern for international travel in March amid the late timing of Easter last year will likely lift inflation in April; international transport prices declined 11.2% YY in March, deducting nearly 0.3pp from the annual change in CPIF. Even if travel prices likely will continue to decline in the near-term, we still believe that the size of the March decline exaggerates the underlying trend. Moreover, we believe that energy prices likely bottomed in March. Meanwhile, lower-than-expected clothing prices in March are probably a reaction to weaker-than-expected winter sales of clothes at the beginning of the year, indicating that prices likely will stay low going forward. In addition, food prices will most likely also stay lower in the near term. On balance, this suggests that the probability that inflation will be below the Riksbank's forecast also in April and May is very high, supporting our call for a 25bp rate cut at the next meeting in July. For April, the Riksbank forecasts CPI at 0.0% YY and CPIF at 0.6% YY.		
Norway			
May 14	*Supplementary 2014 Budget*		
09:00			
London Time	Fiscal policy looks set to become somewhat more expansionary in the years ahead with a non-socialist government in office (and a slowing Norwegian economy). The supplementary 2014 budget from the new non-socialist government (out 8 Nov) turned out slightly more expansionary than the budget bill presented by the previous government (Stoltenberg II), but given the limited amount of time to implement changes (election was held on 9 Sep), the non-socialist government did not manage to make its impact felt in earnest. Total fiscal easing is estimated at 0.5% of mainland trend-GDP, which is 0.2pp above indications in the National Budget. This is still a very modest loosening, suggesting that the new government is aiming at showing fiscal prudence. The extra spending will be used on lowering taxes and boosting infrastructure and education. The non-oil budget deficit is projected to amount to an unchanged 2.9% of the Government Pension Fund Global (GPFG) next year. Although fiscal policy likely will get looser, we see no risk of a breach of the 4% fiscal spending rule as the conservatives (dominant partner in the new government) has made it clear that the fiscal policy rule will remain in place.		
United Kingdom			
May 14	*LFS Unemployment, 3-Month Average, Jan-Mar*	Forecast: -140,000 QQ, 6.8% Rate	Prior: -77,000 QQ, 6.9% Rate
09:30	*LFS Unemployment, Single Month, Mar*	Forecast: 6.8% Rate	Prior: 6.6% Rate
London Time	*Claimant Count Unemployment, Apr*	Forecast: -30,000 MM, 3.3% Rate	Prior: -30,400 MM, 3.4% Rate
	Average Earnings Ex Bonuses, Mar	Forecast: 1.6% YY	Prior: 1.3% YY
	The three-month average of the LFS jobless rate dropped below the 7% threshold last month and we expect a further drop this month. The single month figures have been 6.9% for January and 6.6% for February and the relatively high December figure (7.2%) will drop out of the three-month average this time. Our forecast puts the three-month average at 6.75% (rounded up to 6.8%), and hence there is a chance that the rate could even drop to 6.7% this month.		

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

Key Economic Indicators (19 May – 23 May 2014)

Monday 19 May		Forecast	Last
08:30	Sweden: Unemployment, Apr		
10:00	Euro Area: Construction Output, Mar		
	Spain: Trade Balance, Mar		
Tuesday 20 May		**Forecast**	**Last**
07:00	Germany: Producer Prices, Apr		
09:00	Norway: AKU Unemployment, Mar		
09:00	Norway: GDP, 1Q		
09:00	Italy: Industrial Orders, Mar		
09:30	UK: Producer Input Prices, Apr	-0.3% MM, -5.0% YY	-0.6% MM, -6.5% YY
09:30	UK: Producer Output Prices, Apr	0.1% MM, 0.6% YY	0.2% MM, 0.5% YY
	Excluding Food, Drink, Tobacco, Energy, Apr	0.1% MM, 1.0% YY	0.1% MM, 1.0% YY
09:30	UK: Consumer Prices, Apr	0.3% MM, 1.7% YY	0.2% MM, 1.6% YY
	CPI Ex Food, Drink, Tobacco, Energy, Apr	0.3% MM, 1.8% YY	0.4% MM, 1.6% YY
	Retail Prices, Apr	0.5% MM, 2.6% YY	0.2% MM. 2.5% YY
	RPIX – Ex Mortgages, Apr	0.5% MM, 2.7% YY	0.3% MM, 2.5% YY
10:00	Italy: Current Account, Mar		
14:00	Belgium: Consumer Confidence, May		
Wednesday 21 May		**Forecast**	**Last**
08:30	Netherlands: Consumer Confidence, May		
08:30	Netherlands: Consumer Spending, Mar		
09:00	Euro Area: Monthly Balance of Payments, Mar		
09:30	UK: Retail Sales Volumes, Apr		
09:30	UK: MPC Minutes		
09:30	UK: Bank of England Agents' Summary of Business Conditions, May		
15:00	Euro Area: Consumer Confidence, May Flash		
Thursday 22 May		**Forecast**	**Last**
07:45	France: Manufacturing Confidence, May	102	100
	Own-Company Production Outlook, May	13	9
09:00	Norway: Unemployment, Mar		
09:00	Euro Area: Flash PMIs, May		
09:30	UK: Public Sector Net Borrowing, Ex RM, APF & Fin. Interventions, Apr		
09:30	UK: GDP, 1Q (2nd Release)	Provisional: 0.8% QQ, 3.1% YY	0.7% QQ. 2.8% YY
09:30	UK: Service Sector Output, Mar		
09:30	UK: Migration Statistics, Jan-Mar		
11:00	UK: CBI Output Expectations, May	+28%	+32%
	CBI Order Books, May	+4%	-1%
	CBI Selling Prices, May	+10%	+9%
	Greece: Current Account, Mar		
Friday 23 May		**Forecast**	**Last**
07:00	Germany: GDP Details, 1Q		
08:00	Sweden: Business and Consumer Confidence, May		
09:00	Germany: ifo Business Climate, May		
09:00	Italy: Retail Sales, Mar		
10:00	Italy: Contractual Wages, Apr		
14:00	Belgium: Business Confidence, May		

Sources: National statistical offices, central banks and Citi Research

Appendix A-1

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