2 December 2013 │ 80 pages

Global

Global Economic Outlook and Strategy

Prospects for Economies and Financial Markets in 2014 and Beyond

- In this "*Prospects*" edition, Citi's research team presents updated forecasts for economies, policy, commodity prices and sovereign ratings around the world for 2014 and beyond, along with Overview essays on EMU banking union, world trade growth, global imbalances, challenges facing emerging markets, political risks and long-run projections for the size of major economies.
- We expect a modest reacceleration in global real GDP growth (at market exchange rates) from 2.4% in 2013 to about 3.1% in 2014, the best since 2010, with growth in advanced economies (AEs) up from 1.1% in 2013 to about 2.0% in 2014. Growth is likely to be around 3% in the US and UK in 2014-15. Japan's growth is likely to slow significantly during 2014 as the consumption tax hike bites. We expect that EM growth will continue to outpace AE growth in 2014, as in every year since 1999. However, the EM-AE growth gap in 2014 is likely to be the smallest since 2002 and we continue to revise EM growth forecasts lower on balance.
- Monetary policy is likely to remain loose across advanced economies, and indeed we expect further loosening in 2014 from the BoJ and ECB — with the ECB probably setting a slightly negative deposit rate alongside a lower refi rate, extra liquidity and enhanced forward guidance. The Fed is likely to end asset purchases in late 2014, but its balance sheet at end-2014 will most likely be larger than it is now. A range of advanced economies (probably including the US, UK, Canada, Australia) will begin to withdraw stimulus in 2015, but are unlikely to tighten enough to trigger significant slowdowns. The ECB and BoJ will probably not begin to tighten policy until 2017-18 at the earliest. By contrast, we expect a range of EM countries to tighten monetary policy in 2014, even amidst disappointing growth, reflecting a mix of worries over inflation, current account/fiscal imbalances and rapid private credit growth.
- Public debt/GDP ratios are likely to rise further in most euro area periphery countries in coming years. More OSI/PSI (official and/or private sector involvement) may still be needed, notably in Greece, Cyprus and Portugal. We no longer have PSI in our medium-term outlook for Italy and Spain, but debt restructuring for those countries remains a material risk, especially if nominal GDP growth disappoints.

Figure 1. Currency and Interest Rate Forecasts, as of 2 December 2013

	2 Dec 2013	1Q 14F	2Q 14F	3Q 14F	4Q 14F	1Q 15F	2Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	2.75	2.80	2.95	3.15	3.25	3.40	3.50
Euro Area: US$/€	1.34	1.37	1.39	1.40	1.40	1.40	1.40
Euro Repo Rate	0.25	0.25	0.00	0.00	0.00	0.00	0.00
10-Yr. Bunds (Period Ave.)	1.70	1.70	1.70	1.70	1.80	1.90	1.90
Japan: Yen/US$	101	103	104	105	105	105	105
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.60	0.55	0.50	0.60	0.70	0.90	1.00

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

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With thanks to Jan Maguire

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Figure 2. Forecast Highlights and Changes

■ Global	We expect a modest increase in global growth, with the impetus coming more from advanced economies rather than emerging markets.
■ United States	We continue to expect a modest firming in growth as fiscal drag declines sharply and already stronger cyclical forces take charge with the aid of highly supportive financial conditions. The emphasis in Fed accommodation has begun to shift toward anchoring forwards and should allow for an end to asset purchases later in 2014.
■ Euro Area	The euro area is recovering, albeit at a crawling pace, with GDP growth seen at 0.9% in 2014 and 1.0% in 2015. With the balance of risks around the outlook for inflation skewed to the downside, we expect the ECB to cut its key interest rates in H1-14 and introduce additional non-standard measures. However, we doubt that downside surprises to its inflation mandate will be sufficiently large to overcome reluctance to engage in large scale sovereign bond purchases/QE.
■ China	Steady growth and a stable job market allow the government to focus on structural reforms. The recently-approved reform package, if adequately implemented, would facilitate better allocation of resources, although growth may suffer in the short run. We expect a further growth slowdown in the next two years, but the government appears determined to defend 7% growth. We keep our growth forecast of 7.6% for 2013 and slightly raise our 2014 growth forecast to 7.3%.
■ Japan	We expect a bumpy ride in the economy in 2014. The 3%-point consumption tax hike in April 2014 likely will have a strong negative impact on economic activity. The Bank of Japan is likely to implement additional easing in the form of purchases of JGBs and risk assets, most likely in June or July 2014 — after the consumption tax hike.
■ United Kingdom	We are further lifting our UK growth forecasts, and expect a mix of above-consensus real GDP growth and below-consensus inflation in 2014-15, with the jobless rate falling to the MPC's 7% threshold around end-2014 and a modest tightening cycle in 2015-16.
■ Canada	Given the BoC's more dovish tack, a slightly softer profile for growth and a more protracted convergence of CPI inflation to target, we have delayed our expectation of the next rate hike by two quarters to 3Q 2015. Rate cuts are unlikely, in our view.
■ Australia	We are slightly lowering our 2014 real GDP forecast and pushing back the timing of the first tightening by the RBA to early 2015.
■ Emerging Asia (ex China)	EM Asia ex China growth in 2014 is expected to be slightly stronger than 2013, led by a mild rebound in Korea, Taiwan but others will see domestic demand growth weighed from household debt (Singapore, Malaysia and Thailand) and the need to curb the current account deficits amid an election year (Indonesia and India).
■ CEEMEA	We highlight three main issues to consider next year in CEEMEA. First, the consequences of Turkey and South Africa's failure so far to see much adjustment in their current account deficits. External vulnerability for these two countries remains a critical issue. Second, the impact of softening energy prices on Russia, whose growth dynamics have become grim in the past few quarters. And third, the continuing outperformance of Poland and Hungary, whose growth fundamentals seem increasingly robust.
■ Lat Am	We continue to expect sluggish growth in Brazil, and look for real GDP growth of only about 2.0% in 2014. Conversely, we expect GDP growth to rise to about 3.8% in Mexico. Despite slow growth, the Selic rate should reach 10.75% in Brazil, while in Mexico we expect Banxico to remain on hold in 2014. In Argentina and Venezuela, macroeconomic imbalances continue to grow, leading to low growth and high inflation, and eroding international reserves.

Source: Citi Research

Figure 3. Selected Countries — Industrial Production Forecasts (Pct.), 2013-15F

	2013F	2014F	2015F
World	**2.1%**	**3.3%**	**4.3%**
United States	2.4	3.0	3.9
Japan	-0.4	4.3	1.3
Euro Area	-0.6	1.7	2.1
United Kingdom	-0.4	1.1	0.8
Canada	0.4	1.4	1.8
China	9.6	9.2	8.6
India	1.5	4.4	5.8
Korea	0.1	3.3	4.2
Brazil	1.6	2.3	2.5

Source: Citi Research

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Overview — Marginal Revolution

As 2013 draws to a close, the global economy looks to be exiting the slowdown of the past three years and entering a new phase of modest recovery and growth. Global real GDP growth measured at market exchange rates looks poised to strengthen, from about 2½% this year to roughly 3¼% next year, with further modest increases in 2015 and 2016. But even if this relatively good news materializes, substantial spare capacity (particularly in the advanced economies) is likely to persist.

Yet what is revolutionary about 2014 is that the likelihood of severe downside tail events, which could paralyze the global economy, seems to have diminished significantly (though not disappeared). Granted, the euro-area is still work in progress, China presents meaningful question marks, Congressional gridlock in the US could still throw sand in the federal fiscal wheels and geopolitics can always surprise. But, enough progress has been made that all of these issues seem less threatening today than 12 months ago.

We expect 2014 to be marked by progress in three major areas of economic policy. Although it is difficult to find perfect synchronicity across the world, we think that monetary and fiscal policies, plus structural reforms, will deliver some moderate adjustments, and that these changes will be broadly supportive of global growth and stability. More specifically, although monetary policy in some countries may turn less accommodative, the pace of tightening of fiscal policy among the world's advanced economies is expected to slow. Structural reforms are also likely to continue in several corners of the world (including the euro area periphery, China, and Mexico), although these reforms are likely to remain, in most cases, incremental.

Is monetary policy on its way to normalization?

US monetary policy is likely to continue being highly accommodative. Even after the Fed begins to taper its securities purchases, most likely early in 2014, Federal Reserve policy will remain expansionary. And even if tapering commences as anticipated, the size of the Fed's balance sheet (the key variable determining the resulting stimulus) will likely expand through most of next year. And it has become clear from the confirmation hearings of the likely next Fed Chair, Janet Yellen, that policymakers don't see rate hikes as a serious possibility until well into 2015.

Japan continues to pursue the cyclical targets of ending deflation, moving to 2% inflation, and closing the output gap. To date, the major instruments used have been a temporary fiscal stimulus and, more notably, an unprecedented expansion of the Bank of Japan's balance sheet and the monetary base (which is slated to double from its end-2012 level by the end of 2014). While this aggressive policy mix can make headway in defeating the deflationary demons that have long plagued Japan, even more stimulus may be required. In particular, the 3 percentage point sales tax increase scheduled for April 2014 and the further 2 percentage point increase expected for October 2015 could kill the budding recovery. Our assessment is that the Bank of Japan is prepared do more, likely next summer, but we worry that the necessary support from fiscal policy may not be forthcoming.

In the euro area, besides structural and fiscal headwinds, the recovery has received less support from monetary policy than has been the case in many other advanced economies. The recent drop in inflation to around ¾%, well below the ECB's below-but-close-to 2% objective, prompted a modest rate cut at the central bank's November meeting. But the ECB has failed to use all its policy tools to aggressively counter the disinflationary — even deflationary — risks that appear to be taking hold. Even if outright deflation is avoided, the ECB's stance seems too restrictive.

Unemployment is running high, at 12.2%, and there is excess capacity in most individual member states. (Germany, of course, is a notable exception.) Yet the ECB has allowed its balance sheet to shrink significantly since the end of 2012, and was unwilling until last month to cut the refi rate. Perhaps more worrying, policymakers seem hamstrung regarding the use of additional policy tools, with little consensus regarding another LTRO (with an eye toward boosting bank liquidity and lending) a cut in the deposit rate into negative territory (which might help weaken the external value of the euro) or credit easing measures aimed directly at lowering the cost and increasing the availability of credit for SMEs, especially in the periphery.

Monetary policy in EMs was disproportionately affected by external conditions during 2013. We expect a similar situation for 2014. Despite the mild hysteria in financial markets, the Fed's "taper talk" through the late spring and summer does not appear to have done significant damage even to the worst-affected EMs. Indeed, as financial shocks imported from the US go, this one was rather mild — which reflected two factors: First, the US financial shock was rather small. Unlike previous shocks, which typically have brought a triple whammy of bad news (higher official US policy rate, higher US long rates, and lower US growth), the news in this case was more mixed (higher long rates but also higher US growth). Second, despite some fragilities, EMs were in a better position to respond to it and live with it than in the past. No doubt when tapering is actually implemented (and when US rates are ultimately hiked), there will again be some financial arrhythmia and another rush out of EM securities and currencies. But the effects of this on the real economies will likely be minor, partly muffled by the use of monetary policy. The countries to watch remain those with: (1) a prior domestic credit boom/bubble; (2) an open capital account; and (3) external vulnerability through a large current account deficit and a large stock of foreign currency liabilities. The so-called 'fragile five' — India, Indonesia, Brazil, Turkey and South Africa tick all three boxes. Some progress has been made in a few of these countries to strengthen their economies (mainly in India), but electoral cycles unfortunately make prompt action unlikely.

On the road to fiscal sustainability?

The US economy has had a rather disappointing 2013, with growth likely to come in at around 1.6% — well below the 2.8% achieved in 2012. This is due in large measure to front-loaded fiscal tightening the US inflicted on itself, through the 'fiscal cliff' at the beginning of the year and the March sequestration. This premature burst of fiscal austerity also suffered from poor composition and may have cost roughly 1.5% of GDP. But this tightening is unlikely to be repeated, assuming that between now and March 2014, Congress and the White House can engineer a continuing resolution to fund the government and reach an agreement to raise the debt ceiling. Our central view is that this fiscal minefield will be navigated more successfully than in 2013, with US growth next year rising to 2.6%.

On the other hand, in Japan, the (permanent) sales tax increases scheduled for April 2014 and October 2015 are likely to be met with some temporary fiscal stimulus and, if necessary, some further monetary stimulus. Apart from the tax package, there are no signs of a long-term strategy for dealing with Japan's unsustainable public debt and deficit. Thus far, the markets are happy to hold 10-year JGBs at nominal yields near 60 bps, but we see risks that even sleepy bond-market vigilantes may eventually wake up. It is therefore time for Japan to design a medium- to long-term strategy for closing the deficit and reducing the debt-to-GDP ratio. Clearly, restoring fiscal sustainability would be much easier if the growth rate of potential output could be raised significantly.

The European economy is once again showing that it has a pulse — indeed quite a vigorous one in countries like the UK. The euro area (EA) economy is performing better, but is still sluggish. Growth is expected to close 2013 mildly negative, and we

anticipate 0.9% growth for 2014. The reduction in the severity of fiscal austerity that has taken place has been one of the contributors to this modest recovery.

However, the vigor of the EA recovery remains challenged by persistent question marks regarding fiscal sustainability and sovereign solvency in the periphery. Bail-ins of official creditors (official sector involvement or OSI) remains a frequent occurrence. The sovereign debt of Greece, Ireland and Portugal held by the EU or EA member state governments, through the Greek Loan Facility, the EFSF and the ESM, has been the subject of repeated maturity extensions, coupon reductions, and deferrals of interest payments. This debt is quickly becoming indistinguishable from a zero coupon perpetuity — a promise to pay nothing forever, with full face value and zero net present value. Writing down the face value of the officially held obligations of the Greek, Irish and Portuguese sovereigns would be cleaner than the current version of "extend and pretend" now offered to program countries.

In addition, it is still possible that more OSI/PSI (official/private sector involvement) may be needed in the EA. Greece and Portugal remain vulnerable. And Italy, Spain, and Ireland could be threatened if sustained GDP growth remains elusive.

Meanwhile, fiscal policy in EM continues to loosen. The response to the global financial crisis brought a generalized expansionary change in fiscal stance which has not been reversed since. As growth in EM has slowed — partly due to cyclical factors but also partly in response to structural challenges — governments throughout EM have maintained a bias towards expansionary fiscal policies. As we move into 2014, the fiscal anchor is expected to drift further. The electoral cycle, slow growth and continued availability of funding are driving governments from Chile to Mexico, India to Turkey to open their purse, increasing the risk of a sudden stop in external funding.

Incremental progress on structural challenges

Structural reforms, while acutely needed in both AEs and EMs to speed-up growth, remain gradual and incremental in nature. Properly sequenced and executed structural reforms that are needed to resolve supply side difficulties, even in regions with wide output gaps, could boost domestic demand and assist the recovery. Nevertheless, from China's reform agenda to Europe's bank reforms, progress is likely to be slow.

We believe that sustained recovery in the EA (i.e., growth that closes the output gap) will require (1) much stronger actions than those to date to clean up and recapitalize the banking system, and (2) dealing with the sometimes excessive indebtedness of other sectors — including sovereigns in the periphery and households in a range of countries (for example, Ireland, Spain, Portugal and the Netherlands). Fortunately, European policymakers have recognized the importance of restoring the banking sector to health and of breaking the perverse feedback loops between weak sovereigns and weak banks. We expect that the proposals currently under discussion — for a bank recovery and resolution directive at the level of the EU and for a single resolution mechanism at the EA level — will be implemented in time to allow the ECB to don the mantle of the EA banking supervisor in November 2014 and to permit capital shortages identified by the stress tests to be filled during 2015.[1] Structural reforms aimed at producing a higher growth rate of potential output are likely to continue to be uneven across countries and on balance disappointing.

In Japan, the third arrow of Abenomics, supply-side reform aimed at increasing the growth rate of potential output, has yet to deliver an agenda that raises much hope of success. Boosting the effective supply of labor through immigration policies,

[1] For more details, see the accompanying essay by Buiter and Rahbari.

encouraging the labor force participation of women, and ending lifetime employment in large corporations may look like low-hanging fruit economically. But, the politics of their implementation places them close to the top of the tree. The same holds for trade liberalization in agricultural products and tradable services, deregulation of Japan's low productivity service sectors, and opening up the non-traded service sectors to FDI. Without such reforms, the Japanese economy will, after a couple of years of cyclical recovery, be consigned to resume its anemic growth.

China's path to reform stemming from its plenary session also emphasizes gradualism. Yet, the country faces a triple challenge. It has to bring its credit and housing bubbles under control without causing a financial crunch and a significant cyclical slowdown in economic growth. It also needs to redesign its countercyclical fiscal stabilization policy in such a way that neither its composition nor its funding are in direct conflict with its medium- and long-term rebalancing objectives. Finally, it has to achieve a change in its growth model (a rebalancing), from an investment-led model concentrated on high-visibility infrastructure and on SOEs, to growth that is driven by private and public consumption and investment in the service sectors (including health and utilities) and private corporates.

The outcome of the Third Plenum of the Communist Party provides a broad roadmap toward these objectives, but the available specificity does not provide clarity as to whether the long-term rebalancing challenges will be met. In particular, although the medium- and long-term reform agenda appears ambitious, its gradualism and focus suggest that, in some cases, it could fall short of the needed changes to achieve rebalancing. As regards avoiding a cyclical downturn, the Chinese authorities have legacy central planning instruments and institutions that may give them more control over the exit process from the financial excesses of the past five years, but there remains a material risk of a sharp correction.

Conclusion

It is almost never quite true that one year resembles the previous one. Still, we expect 2014 to resemble in many dimensions a slightly improved version of 2013. Global growth is likely to be somewhat higher with a better grounded recovery. We do not expect monetary policy to turn dramatically in advanced economies, nor is fiscal policy set to tighten to the point of threatening growth. Structural reforms are not likely to be earth shattering in 2014. Thus, we see the next year bringing a gradual return to normalcy.

Of course, normal also implies surprises and some risks. Geopolitics can always surprise, though 2014 seems leaner as regards threats than has typically been the case in recent years. National politics, with presidential elections in several EM nations and a midterm contest in the US, could also throw a curve ball, but such shocks rarely are large enough to materially affect global economic performance over the course of a year. Sovereign accidents in Europe, a fiscal mishap in the US, or a bursting bubble in China are also possibilities, but seem either less likely than this year or, should they happen, of less global systemic significance. The initiation of tapering by the Fed and some macroeconomic vulnerabilities in a few systemically important EMs could create a bit of a jolt. But, once again, it is unlikely that 2014 will bring an EM crisis like those of yesteryear.

Moderate risks, moderate recovery. The trademark of 2014 appears to be that of incremental improvements. Yet, consistent, marginal improvement is, for this day and age, revolutionary.

Will Banking Union Save EMU?

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Many euro area policymakers and independent experts have argued in recent months that banking union in the euro area (EA) is of the utmost importance.[2] We think that narrow banking union — a single supervisor and a common resolution mechanism — is necessary for the euro area to survive, and are modestly optimistic that the key elements will be in place by the time they are needed. Broad banking union — narrow banking union plus a single rulebook (a single legal and regulatory framework for all banks in the EA (or even the EU)) — is probably necessary in for the EA/EU to prosper, and for the Single Market to deliver on its promises.

Banking union and why the euro area needs it

A broad definition of banking union includes:

- A single legal and regulatory framework for all banks
- A single bank supervisor
- A single bank recovery, recapitalisation and resolution mechanism (authority and fund), including provisions to bail in creditors efficiently when needed
- A single deposit guarantee system

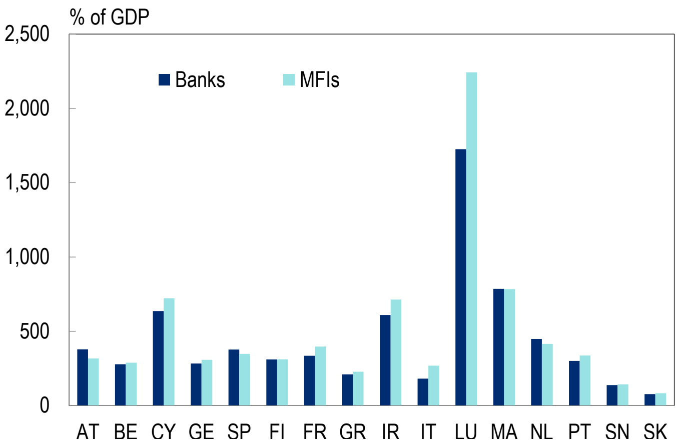
The rationales for banking union in a monetary union are financial stability, efficiency of financial intermediation and the effective and uniform transmission of monetary policy throughout all member states. Banking union demands that the creditworthiness of a national sovereign be decoupled from the creditworthiness of the banks in its jurisdiction. Only then can there be a level playing field for banks in the monetary union. Only then can the perverse feedback loops between weak banks and weak sovereigns be avoided.

But there is another reason why banking union makes a lot of sense for the euro area: national financial regulation, supervision and intervention simply have not worked well. This is partly due to national regulators and supervisors appearing to be asleep at the wheel for much of the time since EMU creation. Regulatory capture of the national regulators and supervisors by the domestic banking sector and by national governments has been the norm. Capture of a supranational supervisor/regulator by both banks and national governments will be harder (although not impossible) and will take time. Also, in a number of smaller EA countries, banks are probably too large to be effectively regulated and supervised or resolved at the national level (see Figure 4). Finally, EA businesses and households rely disproportionately on banks for funding compared to, say, the UK or the US, so an optimal functioning of the banking sector is essential for effective financial intermediation. According to a recent ECB report, loans on bank balance sheets account for 85% of household debt and 47% of non-financial corporate debt in the euro area, but only 28% and 21% respectively in the US.[3]

There is also an acute rationale for banking union *now*: financial conditions remain fragmented across EA countries (see Figure 5), and banking systems remain fragile amid high reliance on central bank liquidity, high levels of non-performing loans, unknown but potentially significant unrecognized losses on legacy investments and excessive exposure to risky own-government debt in most EA periphery countries.

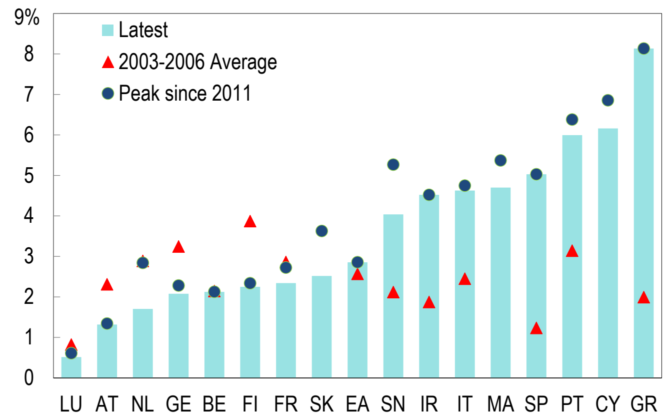
[2] See e.g. Asmussen, J, "*Banking Union – essential for the ins, desirable for the outs!*", speech at the Danske Bank Financial Forum 2013, 5 November 2013.
[3] ECB, "*Banking Structures Report*", November 2013.

Figure 4. Selected Countries — Aggregate Banking Sector Balance Sheet Size (% of GDP), 2012



Note: MFIs are monetary-financial institutions. Balance sheet size corresponds to total financial assets.
Sources: ECB and Citi Research

Figure 5. Selected Countries — Average Real Rates on Loans <€1m to Non-Financial Corporations (%), 2003-13



Note: Loans with maturity between 1 to 5 years for all countries except for Luxembourg, Ireland, Malta, Portugal and Cyprus, for which it correspond to loans with all maturities. Latest refers to Sep-13 except for Greece (Jun-13).
Sources: ECB and Citi Research

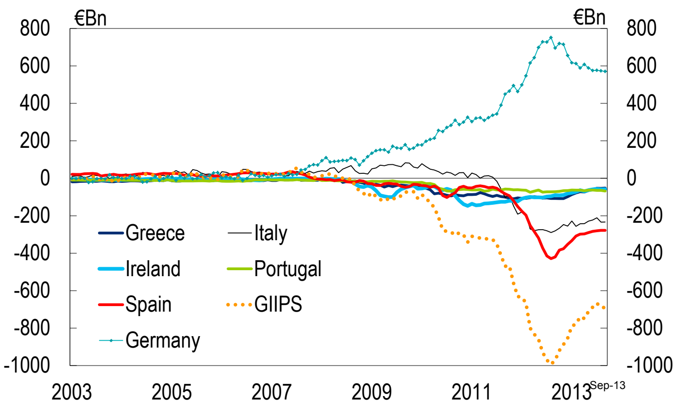
A necessary condition for a currency union to survive is a lender of last resort (LLR) for illiquid sovereigns and national banking systems. In the EA, this is provided through access to the Eurosystem funding facilities and the Target2 system which allows individual national central banks (NCBs) to borrow from it (and through it from other NCBs in the Eurosystem) when they face liquidity outflows.

In the event, the Eurosystem balance sheet and Target2 imbalances were allowed to rise substantially (see Figure 6 and Figure 7). In the periphery, the re-liquified banks bailed out their sovereigns through purchases of domestic sovereign debt on terms and in quantities that reflected financial repression. But in our view, continued open-ended liquidity insurance is unsustainable as long as the solvency of a significant part of the EA banking system is in question. The necessary dimensions of banking union thus are those required to sustain the liquidity insurance function without turning the Eurosystem into a back-door, open-ended and uncapped source of quasi-fiscal transfers. In our view, these key dimensions are i) a common supervisor, ii) a common resolution and recapitalization authority and fund.

A common supervisor is required to ensure that supervisors do their job and are not readily 'captured' by local banks and national governments. The common resolution and recapitalization facility is necessary to correct potential weaknesses that the supervisor may find.

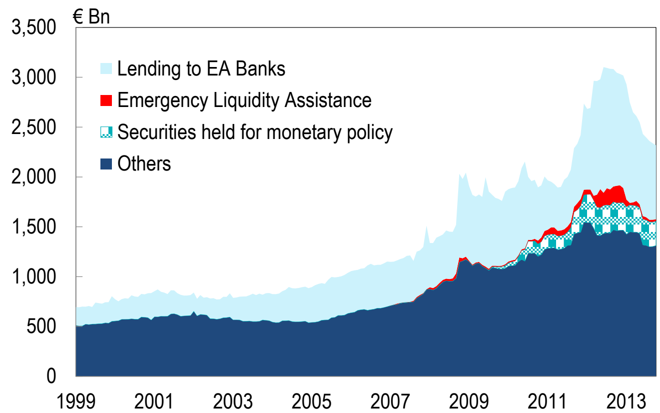
Common deposit insurance and a 'single rule book' are not necessary for the EA to survive in our view, although they are highly desirable. In particular, deposit insurance is not necessary for financial stability in the presence of a working LLR that can compensate for liquidity outflows during bank runs. Credible deposit insurance can be useful in limiting bank runs and as a tool for social protection for small depositors, but would not make a contribution to financial stability that cannot be provided by other means. In any case, common deposit insurance requires a deeper fiscal union than the minimal common backstops required to make monetary union work, and is therefore unlikely in the foreseeable future for political reasons.

Figure 6. Selected Countries — Target2 Net Amount Outstanding (€Bn), 2003-2013



Sources: National Central Banks and Citi Research

Figure 7. Euro Area — Eurosystem Financial Assets (€Bn), 1999-2013



Note: Securities held for monetary policy correspond to SMP and covered bond holdings outstanding. Sources: ECB and Citi Research

In the presence of potential government insolvency, a common supervisor and resolution authority and fund would be a necessary but probably not a sufficient condition for the EA to survive. In some periphery countries, sovereign (near-) insolvency impedes banking sector recovery and resolution. Orderly joint restructuring of sovereign and bank debt may be required in some cases. A sovereign debt restructuring mechanism (SDRM) for the EA, with statutory powers to support market-based or contractual arrangements, may be necessary to handle legacy sovereign debt restructurings as well as future and as yet unforeseen sovereign insolvencies. But given the large exposure of EA banks to domestic governments, orderly sovereign debt restructuring may be impossible without common resolution and recovery capacities for banks.

What is being done and will it be enough?

There has been some progress on the road to banking union, and current plans indicate that the key elements of narrow banking union are likely to be in place when they are needed to ensure the survival of the euro area.

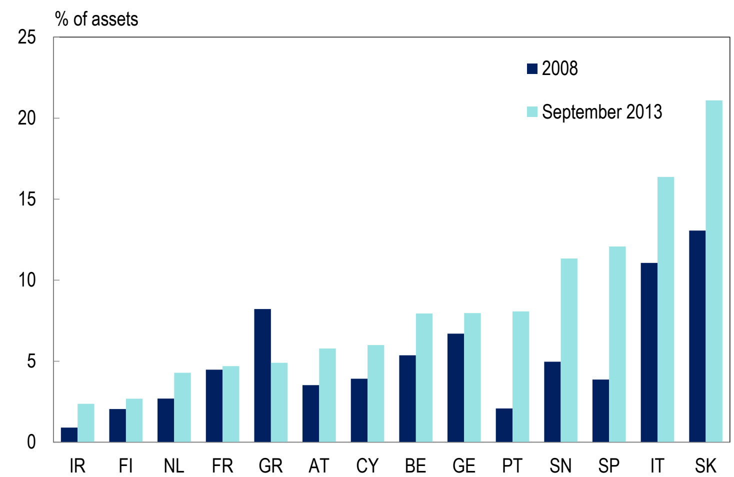
The single supervisory mechanism (SSM), according to which the ECB will directly supervise the 120-130 most significant EA banks (accounting for roughly 85% of EA banking assets) is targeted to be operational on November 4, 2014, after the conclusion of a 'comprehensive assessment' (CA) of these EA banks.[4] The planned setup is not ideal, many details remain to be worked out and it will be a herculean task to build up a single supervisor from scratch by the target date, but there is a fair chance that the SSM will be operative on the target date or soon thereafter.

That leaves the second central pillar of banking union: an effective single resolution capacity. Even un-captured regulators and supervisors will get it wrong sometimes. Key is the ability of national resolution regimes to restructure liabilities at the speed of crises (overnight or at most over a weekend) to restore (near-) insolvent systemically important banks to solvency while keeping their essential functions intact. The ability to create a bridge bank, to separate assets (including to a good bank or a bad bank) and to impose losses on investors through bail-ins (writedowns of equity and/or debt, debt-to-equity conversions) are crucial elements of an effective resolution regime. An efficient and effective bail-in regime should minimize

[4] The relevant legislation took effect on November 4, 2013 and the SSM is targeted to be effective one year after that date, unless the ECB delays its activation if it considers itself not to be ready.

the need for additional funds for recapitalization from the domestic fiscal authority or from a common fiscal back-up facility. But as a safety net, an effective backstop in the form of a resolution and recovery fund (which could be funded ex-ante or ex-post by banks) should also be part of the resolution regime, with a domestic or mutualized fiscal backstop in place if maximum bank creditor bail-in is insufficient to restore a systemically important bank to solvency.

Figure 8. Selected Countries — Monetary Financial Institutions Holdings of Domestic General Government Gross Debt (% Assets), 2008-2013



Note: Holdings of general government gross debt includes loans and securities.
Sources: ECB and Citi Research

The EA resolution cake has three layers. A number of EA countries (e.g. Ireland, Germany, and Spain) — but by no means all — have introduced national bank resolution arrangements in recent years. Even among those that did establish bank resolution regimes, some did not include provisions to bail in e.g. senior unsecured debt outside of liquidation. Numerous differences exist between national schemes.

The EU bank recovery and resolution directive (BRRD) is meant to i) create harmonised resolution arrangements across the EU (not just the EA), and ii) introduce provisions to allow the restructuring of banks at low cost to the taxpayer. The BRRD includes provisions to allow the bail-in of all liabilities, including senior unsecured debt, except those explicitly excluded (mostly insured and other 'small' deposits, secured liabilities, salaries and trade credit) in case of a capital shortfall, and a common seniority ranking for bail-inable instruments. It also requires bailing in a minimum of 8% of liabilities before any public funds can be used.[5]

The BRRD is likely to be a major step forward and is in the final stages of the European approval processes (it is set for a final vote in the European parliament in March 2014) and targeted to be transposed into national law by end-2014.

However, the BRRD still contains shortcomings. First, some important provisions are only to be phased in the too-distant future. In particular, as the draft BRRD is worded today, its bail-in provisions are only meant to take effect in 2018 and the national resolution funds are only meant to be funded at their target level by 2022. Second, the BRRD's bail-in provisions contain a vague and broad list of reasons that potentially allow national resolution authorities to avoid bailing in creditors. Third, the BRRD does not create an EA/EU level resolution authority or fund.

[5] Unsecured junior debt is no more that 1.5 percent of the balance sheet of the EA banking sector.

The weaknesses in the BRRD are not irremediable. As regards the delayed introduction of bail-in, the EC's revised State Aid rules that took effect on August 1 2013 mandate the bail-in of shareholders and junior creditors before public funds can be used for bank support (with some exceptions). The final version of the BRRD is likely to bring forward the introduction of the bail-in tools, possibly to the start of 2015. In the meantime, national resolution authorities may of course choose to bail in creditors, including senior unsecured ones, if their national resolution regimes permit it. The degree of national discretion may also yet be narrowed down in the final legislation.

That leaves the issues of a common resolution authority and a potential fiscal backstop(s). Both are meant to be addressed through the Single Resolution Mechanism (SRM) for the euro area. EA policymakers have repeatedly affirmed that the target is for the SRM to be agreed in principle by end-2013 and for it to take effect in January 2015. However, at this point, many disagreements remain. The most important relates to the 'singleness' of the resolution authority, i.e. the ability of the national governments to block or influence decisions about their 'national banks'. The EC has proposed for itself to have the ultimate resolution authority, but Germany has countered with a proposal that would attach the resolution authority to the Council. The German government also resists both a common — even privately (bank) funded — resolution fund and allowing the ESM to be the backstop should the national resolution funds not suffice (and even after unsecured bank creditors have been bailed in). The target dates for senior unsecured debt to be bailed in before the tax payers (domestic or mutualized) also remain contentious.

The disagreements on these issues are material but they are not fatal. In our view, a workable compromise will mostly likely be found that will allow common resources to be used when needed even though they will also include substantial safeguards, through deep creditor bail-ins and prior national contributions, to ensure that a common backstop will probably not be used frequently or on a substantial scale.

In our view, the logic for narrow banking union is rather apparent in its 'steady state'. The tricky part is how to get there, as most of the costs and risks attach to the transition to this steady state. This is where the ECB's CA of major EA banks and the arrangements to deal with its results are so crucial. The CA consists of three steps (a supervisory risk assessment, an asset quality review, AQR, and a stress test — the latter carried out by the EBA) and needs to be concluded before the ECB takes over its supervisory role, i.e. probably by November 2014. It has the key objective of providing a clear assessment of the balance sheets of the major EA banks. If done rigorously, it would demarcate the responsibility and accountability of the national supervisors from that of the ECB. The assessment would also provide the basic information required to clean up bank balance sheets. A rigorous assessment would also signal a clear break from the past of underwhelming EA stress tests conducted by the EBA and the national supervisory authorities. Comprehensive loss recognition, recapitalization of systemically important banks and liquidation of systemically unimportant insolvent banks would eliminate zombie banks as a major obstacle to a meaningful recovery in the EA.

There remain material doubts (1) as to whether the assessment will indeed be sufficiently rigorous and (2) whether appropriate mechanisms will exist to deal with the capital shortfalls that may be identified by the assessment. Unlike the national supervisors that were operationally in charge of previous stress tests, the ECB has a strong incentive to reveal the full extent of the capital shortage in the EA banks. From November 2014 the ECB, as head of the SSM, will likely be blamed and potentially held accountable for any legacy bank losses subsequently discovered but not revealed by the AQR and stress test. Its reputation as a supervisor would be

damaged by a failure to identify or reveal asset quality problems. There would also be the risk of damage, through reputational cross-contamination, to the ECB's reputation as a monetary authority.

But the incentive for the ECB to be rigorous is not absolute. In particular, the ECB's incentive for truthful revelation would be diminished if there were to be uncertainty as to whether the resources would be available to fill the capital holes that the assessment could uncover. Where these resources would come from remains unclear at this point. Fiscal space is scarce in most EA countries. A significant joint fiscal backstop remains politically unrealistic. That makes it even more important for bail-in tools to be ready to be used if needed.

How urgently effective backstops (bail-in or fiscal) would be needed depends on the magnitude of the potential capital shortfalls. The size of unrecognized losses — legacy losses carried since the start of the financial crisis and new losses incurred due to recessions and weak growth in most EA member states — is anybody's guess. ECB data show that total assets of the consolidated EA banking sector amount to €25trn, with loans amounting to €18trn. In previous banking crises, e.g. in Japan, Norway or Sweden, as well as during the ongoing episode in Ireland), credit losses (excluding losses on non-loan assets) often exceeded 10% of loans. So far, EA banks have raised more than €800bn in provisions and more than €200bn in equity since 2008, and have started to deleverage in the last two years. Existing reserves, excess capital, future operating profits and divestments can absorb some losses and the stronger banks will be able to raise equity, too. Disguised 'state aid', like the €5-7 bn revaluation of the equity stakes in the Banca d'Italia held by the Italian banks, or the miraculous transformation of €25-30 bn of deferred tax assets held by Spanish banks (which don't count as tier 1 capital) into tax credits (which do) will also help. But it is certainly possible that residual shortfalls could still be substantial, particularly as the distribution of losses across banks may be quite different from the distribution of capital, provisions and profits. Capital needs would also be significantly higher, especially in the periphery, if the riskiness of 'own' sovereign debt were reflected in appropriate risk-weightings similar to those assigned to commercial debt.[6] [7]

What about the risks of bailing in creditors, including senior unsecured creditors? Could it cause financial panics, contagion from unsound to sound banks and a dramatic increase in bank funding costs, or even a sudden stop on bank funding? After all, ECB President Draghi himself warned the EC and Eurogroup President Dijsselbloem over the summer against mechanically bailing in even junior debt (when banks are undercapitalized rather than insolvent) before public funds could be used to recapitalize the bank.[8]

In our view, such concerns seem overdone. When there is a credible LLR for banks, no solvent bank can be illiquid and unable to access the capital markets. If and when contagion becomes a material threat, the Eurosystem can handle it. Interestingly, the ECB itself does seem to have warmed to the idea of bail-in of even senior unsecured debt more recently in its opinion on the Single Resolution Mechanism which supports applying the bail-in provisions of the BRRD/SRM from January 2015. It said. *"Bail-in is considered to already be priced-in to a large extent,*

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[6] Standard & Poor's recently estimated the capital shortfall of the EA banks at around €95Bn, presumably prior to divestments and capital raisings. See Reuters, November 8, 2013, "S&P sees euro zone banks' capital shortfall of about 95Bn euros". http://www.reuters.com/article/2013/11/08/eurozone-banks-idUSL5N0IT1L120131108

[7] See ECB, "Monthly Bulletin", September 2013.

[8] Reuters, Saturday October 19, 2013, "Draghi asked EU to keep state aid rules for banks flexible", http://www.reuters.com/article/2013/10/19/us-banks-bondholders-draghi-idUSBRE99I03B20131019

so the impact on funding is expected to be marginal. Furthermore, having the bail-in tool in place would contribute towards legal certainty, consistency and predictability, thus avoiding ad hoc solutions."[9] Even though we don't agree that bail-in risk is priced properly in the euro area (for bank creditors or for periphery sovereign creditors), we agree that, once the solvency-restoring actions, including bail-ins have taken place and the banking sector has been restored to balance sheet health, the impact on the cost and availability of bank funding will be limited. The risks in our view attach more to bail-in regimes not being ready or to be applied inconsistently or insufficiently to restore bank solvency.

The transition towards banking union will be costly even if the CA is carried out rigorously, and capital shortfalls found are filled in an orderly manner thereafter. The CA is only to be completed by late 2014, with some additional time to be allowed for the recapitalisation process. Between now and then, access to funding for banks (and lending by banks) will be adversely affected for as long as the parameters of the AQR and stress test and the likely capital holes remain uncertain and until those capital holes are filled. The morale of the story is to proceed with these steps as quickly as possible, while making sure to demonstrate that the euro area is serious about (narrow) banking union regime and about decoupling the sovereigns from 'their' banks. Key steps to watch in the next few months will thus be whether there will be an agreement on an SRM, a clarification of bail-in rules and procedures and the disclosure of the methodology and assumptions for the AQR and stress test.

So what?

Progress towards banking union and an SDRM has been impeded by a lack of market pressure in recent months, and by the political paralysis created by Germany's parliamentary elections, the delays in forming a new German government and now the wait for the European Parliament elections in May 2014. But our outlook for banking union is modestly optimistic: the necessary ingredients will likely be ready when they are needed and should allow the EA banking sector to eventually and slowly start lending again.

Yet much remains to be done to escape the halfway house of a single supervisor and eighteen national legal and regulatory regimes for banks. The state of the banking sector is also by no means the only source of economic weakness in the euro area. In fact, it is not even the only source of weakness restricting credit. External funding flows to the non-financial private sector are not just restricted by the inability or unwillingness of banks to lend. Private non-financial sector debt remains high in a number of sectors and countries and continues to weigh on both willingness to lend and on credit demand. Sovereign debt burdens continue to rise in most EA member states. Excessive levels of non-financial private and public debt will prevent financial conditions from converging fully even when narrow banking union is complete. But banking union is a prerequisite for dealing decisively with the non-financial private and public debt overhangs.

The importance of banking union for the euro area is thus hard to overstate. By contrast, beyond the limited mutualized fiscal backstops necessary for banking union and the SDRM, deep fiscal union (mutualisation of past sovereign debt through a redemption fund and/or of future sovereign deficits; a transfer union, a non-trivial EA budget with supranational tax and borrowing powers, or large-scale back-door debt mutualisation through the ECB) is neither necessary nor likely in the foreseeable future.

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[9] http://www.ecb.europa.eu/ecb/legal/1353/1330/html/index.en.html?skey=CON/2013/76

Why Is World Trade So Sluggish?

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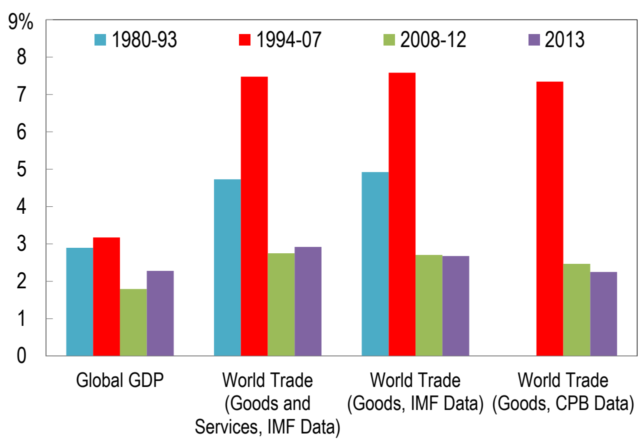
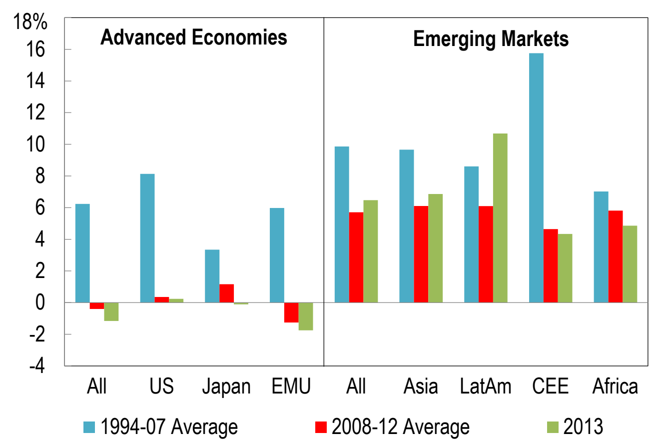
World trade growth remains unusually weak, far below pre-crisis norms. The IMF estimates that in 2013, world trade (goods and services, volume terms) grew by 2.9%, similar to the sluggish average of 2008-12 (2.8% YoY) and close to global GDP growth (2.3% YoY). If anything, 2013 trade growth may undershoot the IMF's estimate, given that the CPB report world trade growth (goods only) in January-September of just 2.4% YoY. By contrast, over 1980-2007, world trade growth (goods and services) averaged 6.1% YoY, rising to 7.5% YoY for 1994-07, roughly twice the pace of global GDP growth (3.0% YoY for 1980-07)[10]. Trade growth is also weak compared to industrial production: for Jan-Sep 2013, world trade in goods grew by 2.3% YoY, whereas global IP rose by 2.0%: by contrast, over 1994-07, trade growth in goods (averaging 7.3% YoY) grew 2.3 times as fast as global IP growth (averaging 3.2% YoY). Trade in services has slowed to a broadly similar extent as trade in goods. This essay considers why world trade growth is so sluggish, whether it will continue, and sketches out some implications.

Figure 9. Global — YoY Growth of World Trade and GDP, Volume Terms, 1980-2013



Note: the CPB figure for world trade growth in 2013 is the outturn for January-September. Sources: IMF, CPB and Citi Research

Figure 10. Global — YoY Growth of Import Volumes, Goods Only, 1994-2013



Note: the CPB figure for world trade growth in 2013 is the outturn for January-September. Sources: CPB and Citi Research

The slowdown in export growth is quite widespread across AEs and EMs. But, viewed in terms of import growth, weakness is far more concentrated, with sharp slowdowns among advanced economies (AEs), especially the US and Europe, as well as Central and Eastern Europe. Using CPB data, the growth of AE import volumes (goods only) averaged 6.2% YoY in 1994-07, directly generating 53% of total world trade growth over that period. That contribution has collapsed since then. AE import volumes fell by an average of 0.4% YoY in 2008-12 (with marked weakness in the US and Europe) and fell by a further 1.2% YoY in Jan-Sep 2013. Japan's import growth has slowed in recent years, but accounts for only a modest share of world trade growth. During 1994-07, US import growth directly generated 15% of global import growth, whereas Japan's imports generated just 2%.

Aggregate import growth among EMs has also slowed — down from 9.8% YoY on average in 1994-07 to about 6% YoY since then — but less sharply than AE import growth. Indeed, imports by EM countries in aggregate accounted for *all* of the growth in world trade since 2007. Among EMs, import growth has slowed modestly

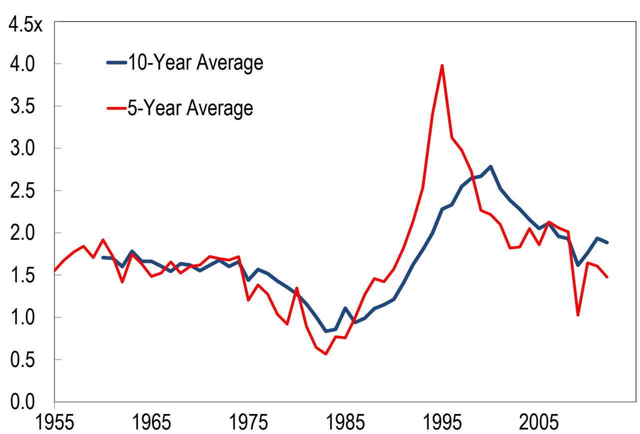
[10] GDP measured here at market exchange rates. There are various data sources for trade and GDP, with slightly different methodologies and results. We focus here on data from the IMF, WTO and CPB.

in Asia and Africa, and there has been a renewed acceleration in LatAm import growth in 2013. Intra-EM trade has grown rapidly, but is not large enough to offset the weakness in AE imports. In nominal terms, exports of goods by EM to EM countries rose by 69% from H1-08 to H1-13 (average gain of 11% YoY). However, EM-EM trade only accounts for 17% of total world trade, whereas EM exports to AEs accounts for 24% and 38% is accounted for by AE exports to AEs.

In seeking to explain sluggish world trade growth, one set of views emphasises the persistent weakness of AE GDP growth in recent years. On this view, economic recovery in AEs should bring about a revival of world trade growth to something like the precrisis trend (ie world trade expands roughly twice as fast as global GDP). However, so far, the recovery in AE GDP growth is not providing much boost to imports: in Q2 and Q3 of 2013, AE GDP growth averaged 0.5% QoQ, close to the 1996-07 average (0.6% QoQ).[11] AE IP growth (0.6% QoQ) was slightly above its 96-07 average (0.5% QoQ). However, AE import volumes growth (goods only) remains relatively sluggish, rising 0.7% QoQ on average in Q2 and Q3 versus an average of 1.4% QoQ in 1996-07. World trade growth in Q2-Q3 averaged about 0.7% QoQ versus 1.8% QoQ over 1994-07. In other words, the AE recovery so far is not returning world trade growth to anything like the pre-crisis norm.

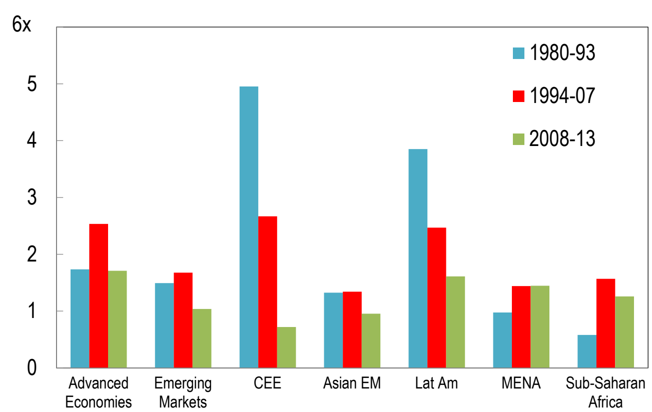
Viewed over a longer period, the precrisis years stand out as a rare period of rapid global integration and trade growth rather than the norm. There is no iron law that world trade growth is always roughly twice world GDP growth: it varies according to the circumstances of the time. Note also that the ratio of import growth (goods only) to GDP growth is not uniformly close to 2 across countries: this ratio has generally been lower in EM countries, and over an extended period has been 1-1.5 times in Asian EM countries. Nor has the relation between global GDP growth and trade growth been stable over time. World trade grew rapidly from around 1850 to 1914, was very weak in the 1920s and 1930s, with a strong acceleration in both world trade and GDP over a couple of decades after 1950. Using WTO data[12], the ratio of world trade growth to world GDP growth (volume terms) was 1.6 during 1950-73 (8.2% trade growth, 5.1% GDP growth), but this ratio then slipped below 1 in 1974-86 (2.9% trade growth, 3.3% GDP growth) before the surge above 2.0 in the pre-crisis period.

Figure 11. Global — Ratio of World Trade Growth (Goods) to GDP Growth, 1955-2012



Sources: WTO and Citi Research

Figure 12. Global — Ratio of Import Growth (Goods) to GDP Growth By Region, 1980-2013



Sources: IMF and Citi Research

[11] We proxy AE GDP growth by the weighted average of growth for the US, Euro Area, Japan and UK.

[12] The WTO trade and GDP data differ slightly from the IMF data but extend over a longer period.

We suspect the precrisis surge in world trade largely reflected the unusual conditions of that period.

- **Globalisation of production to lower-cost and more efficient structures**, reflecting among other things improving global transport, reduced global political risks following the end of the Cold War, China's entry to the WTO (2001), plus the rapid growth in container traffic. For example, the stock of FDI expanded from 6% of global GDP in 1980 to 10% in 1991, 24% in 2001 and 32% of GDP in 2007. The initial wave was concentrated in developed countries, with a gradual shift to developing countries, especially from the mid- and late-1990s. The stock of FDI in developing countries soared from $610bn (14% of GDP in developing countries) in 1992 to $4612bn (31% of GDP) in 2007 and $7745 bn (30% of GDP) in 2010. The internationalisation of supply chains boosted trade flows directly, but the indirect effect of this process probably was more powerful, with a sharp drop in the relative price of traded manufactured goods that helped spur demand for traded goods. From 1991 to 2004, the price (ie unit value) of exports and imports of manufactured goods was roughly stable (indeed, it fell by 0.8%), whereas the overall CPI for advanced economies rose by 33%, hence producing a sharp decline in relative prices for traded goods.

- **Widespread move to lower tariffs**, reflecting hopes among policymakers that global trade integration was a "win-win" means to advance global prosperity, that would improve the growth/inflation performance of AE economies, provide a route to faster EM growth, while also helping to draw EM countries into a general US/EU centered system of political cooperation and openness. From 1990 to 2000, the weighted average tariffs applied to imports of manufactured goods for the US fell from 4.1% to 1.9%, with the average for imports to the EU27 countries down from 6.1% to 1.8%, and the average for imports to Japan down from 2.3% to 1.2%[13]. This partly reflected the expansion of major trading blocs with low or zero internal tariffs — eg EU enlargement, plus the creation of Mercosur (1991) and NAFTA (1994) — but also reduced tariffs on trade between blocs.

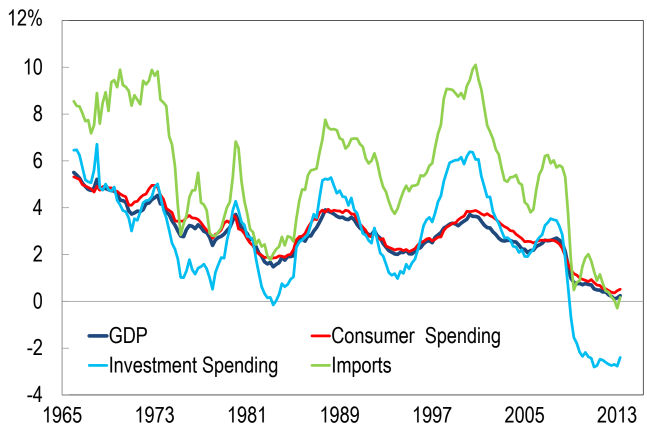
- **Unusual mix of AE growth**. The combination of relative price shifts, generally easy credit availability and greater confidence over long-run growth prospects prompted rapid capital accumulation among AE households and businesses, with buoyant demand for capital goods, consumer durables and semi-durables — items with a high import content. Rapid AE import growth was mirrored in sectoral imbalances and ballooning private debt/GDP ratios. The import elasticity of demand may have been further magnified by capacity shortages within AEs: the IMF judges that in 2007, for the only time in the last 30 years, every single advanced economy had a positive output gap (ie real GDP was above potential). The pre-crisis surge in aggregate imports for the US plus EU15[14] is not that unusual given the strong growth in consumer spending and, especially, investment spending of that period. We have constructed a simple model to explain trends (5-year averages) in aggregate import growth for the US plus EU15, using only aggregate investment and consumer spending, and this model tracks the swings of recent years tolerably well[15]. Seen in this light, the pre-crisis surge in imports and post-crisis stagnation among AEs is largely a mirror image of the unsustainable precrisis boom, and recent stagnation, in AE capex and consumer spending.

[13] Source: UNCTAD.

[14] OECD data for the US and EU15 are summed at fixed exchange rates and in 2005 prices.

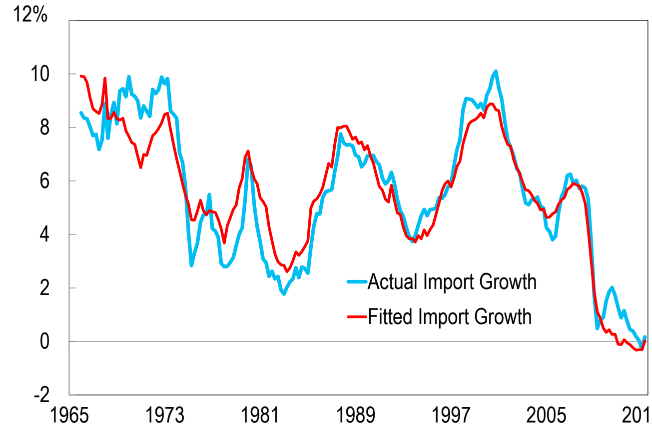
[15] The dependent variable is the average growth over 20 quarters of goods and services import volumes for the US and EU15, explanatory variables are the 20-quarter average growth of consumer spending and investment, adjusted R-squared is 86%, using quarterly data for Q1-1966 to Q2-2013.

Figure 13. EU15 Plus US — GDP, Consumer Spending, Investment and Imports, Annualised Growth Over 20 Quarters, 1965-2013



Sources: OECD and Citi Research

Figure 14. EU15 Plus US — Actual and Fitted Import Volume Growth, 1965-2013



Sources: OECD and Citi Research

We doubt these conditions will recur in coming years even with some recovery in AE GDP growth. Through policy choices and post-crisis hangovers, AE growth is unlikely to be as import-intensive as the pre-crisis period. AE domestic demand and import growth is likely to remain capped by fiscal drag (especially in Japan in 2014-15, to a lesser extent also in Europe and the US) plus greater caution over high debt levels among lenders, borrowers and regulators (especially in the CEE and periphery EMU countries). With currency shifts and cost cutting, the real exchange rates (deflated by unit labour costs) of the US, Japan and UK are 14%, 21% and 5% respectively below the 94-07 averages, improving export cost-competiveness and import substitution. Indeed, in the last two quarters, the QoQ gain in AE export volumes has outpaced EM export growth.

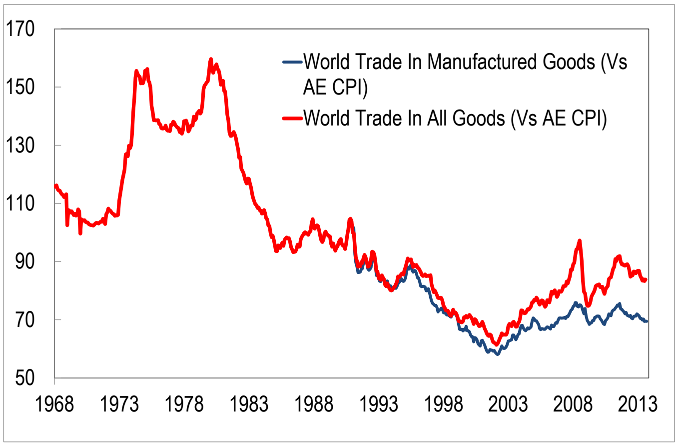
Moreover, credit for trade is harder to obtain and trade liberalization has stalled. Political support among AEs to pursue general free trade has weakened, with greater focus on trying to protect jobs and avoid damage to sensitive domestic sectors at home. Globalization of trade and capital flows has gone alongside rising income inequality in AEs and, in recent years, persistent economic weakness. The political case for free trade to help anchor countries in a US-EU political orbit has become less important as the Cold War has receded, while China's development challenges the notion that rising prosperity inevitably means a trend to Western-style political openness and democracy. Average global tariffs have been little changed in recent years. Indeed the WTO reports a general uptrend in the use of new non-tariff measures to restrict trade in goods[16], for example through anti-dumping legislation, safety checks or sanitary and health legislation. Discussions on global trade liberalization have drifted for years, with a greater focus on more selective trade integration (eg US-EU TTIP talks).

In addition, the downward effect on traded goods prices from globalization seems to be diminishing. FDI inflows to developing countries remain high, and accounted for more than 50% of aggregate FDI flows in 2012. Even so, overall cost disparities between EM and AEs are shrinking, with unusual real wage flexibility in many AEs, in part because of high unemployment and in part in response to competition from low-cost producers overseas and inflows of migrant workers. As a result, the relative price of manufactured goods has stopped falling in recent years — indeed, unit values for manufactured imports have slightly outpaced AE consumer prices since

[16] See the WTO's "I-TIP" portal.

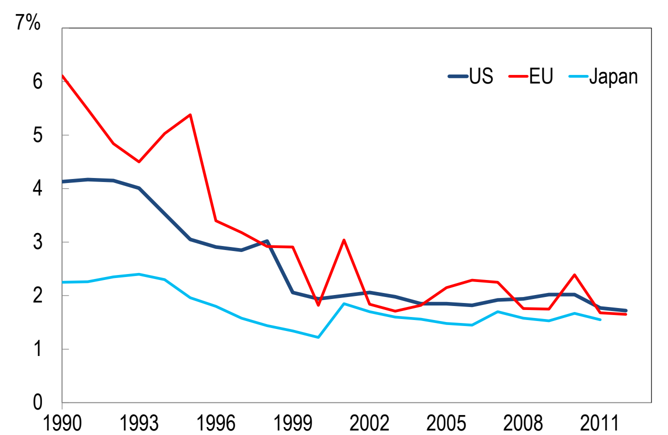
2004. The internationalization of supply chains has leveled off: the WTO report that the share of parts and components in total imports of manufactured goods rose from 22.1% in 1980 to 29.0% in 2000 but has drifted down to 26.2% in 2011[17]. Another factor is the growing shift to high-tech products from hardware to software, from physical content (eg discs) to digital content, from bulky PCs with a lengthy supply chain to smaller mobile devices with fewer built-in components (and greater use of cloud technology). This may contribute to a less trade-intensive form of growth, especially for many Asian economies[18].

Figure 15. Global — Real Price of Imports of Goods and Manufactured Goods, Indexed to Jan 1991 = 100, 1968-2013



Note: We show the ratio of the world unit value for trade in manufactured goods, and for world trade in all goods, divided by the average CPI for advanced economies.
Sources: IMF, CPB and Citi Research

Figure 16. US, EU, Japan — Weighted Average Tariff Applied on Imports of Manufactured Goods, Percentage, 1990-2012



Sources: UNCTAD and Citi Research

Intra-EM trade probably will continue to grow rapidly, reflecting ongoing trade integration and relatively high domestic demand growth. However, EM-EM trade as yet is not large enough by itself to produce rapid world trade growth. Moreover, GDP growth — and especially Asian EM growth — generally has not been as import-intensive as AE GDP growth. In addition, with the prospect that global liquidity conditions will become tougher — given that Fed tapering is on the horizon and an eventual turn in US policy rates seems likely over the next 2-3 years — markets and policymakers are likely to believe that any country with buoyant import growth and worsening current account needs to tighten policy promptly. As a result, it is unlikely that other EM or AE countries will replace the US and Europe as importers on a sufficient scale to recreate the pre-crisis world trade boom.

We expect that world trade growth in coming years will pick up from the recent pace, but probably will stay well below pre-crisis norms. Our country-by-country forecasts imply global import growth in 2014-15 of about 4¾% YoY (versus 7.5% YoY over 1994-07) even with GDP growth of about 3¼% (a little above the 1994-07 average), an average elasticity of 1.5 times. The IMF expects world trade growth (goods and services) of about 5.5% YoY over 2014-18. For 2014-20 as a whole, we expect global exports (goods and services) will grow by about 6½% YoY on average in nominal USD terms, only slightly ahead of global nominal GDP growth (about 6¼% YoY). Such a path is likely to pose severe challenges to EM countries seeking to use AE recovery as a springboard to return to export-led growth.

[17] Source: "*WTO World Trade Report 2013*", October 2013.

[18] See "*Asia Macro Flash - Disruptive Technology and Asia's Changing Export "Beta"*", Johanna Chua, 18 November 2013, Citi.

Global Imbalances: How Much Progress?

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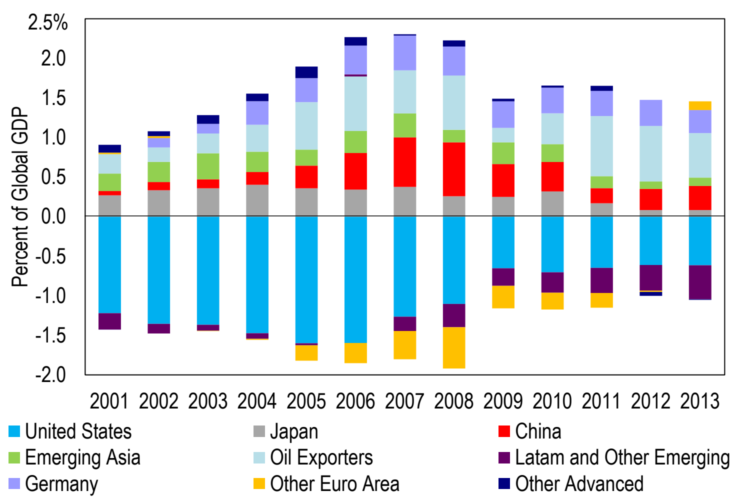
By our reckoning, "global imbalances" (defined as the pattern of current account surpluses and deficits across countries) have adjusted meaningfully in the years since the financial crisis erupted. Most conspicuously, the U.S. current account deficit has shrunk to about half its peak size, and the surpluses of China and Japan have declined as well.

In this brief essay, we offer some thoughts on this important but, admittedly, controversial subject. We first document the adjustment that has taken place, and then consider whether the progress to date has defused the attendant risks to the global economy. How worried do we still need to be? Is the observed adjustment likely to be sustained in the years ahead? In examining these questions, we first document the recent evolution of current account balances across regions and countries. Second, we look carefully at the euro area and the major emerging-market economies, two groups of countries that we see playing a pivotal role in determining the prospects for imbalances going forward. Third, we examine the current account projections embedded in our Citi global forecast.

Figure 17. Global Current Account Balances, Pct of Global GDP, 2001-13



Sources: IMF and Citi Research.

Figure 17 highlights the broad sweep of global imbalances since the early 2000s. A number of observations stand out. In the years before the global financial crisis, the U.S. deficit increased to a gaping 1½ percent of global GDP. This deficit reflected a decade of rapid U.S. GDP growth and an appreciation of the dollar from the mid-1990s through early-2002. In addition, a steep rise in U.S. asset prices (first equities and then housing) pushed down the household saving rate. This period also saw sharply increasing surpluses in China (especially following its accession to the WTO in late 2001), the oil-exporting countries (as oil prices trended upward), and Germany (which reaped competitiveness gains from a decade of wage restraint).[19]

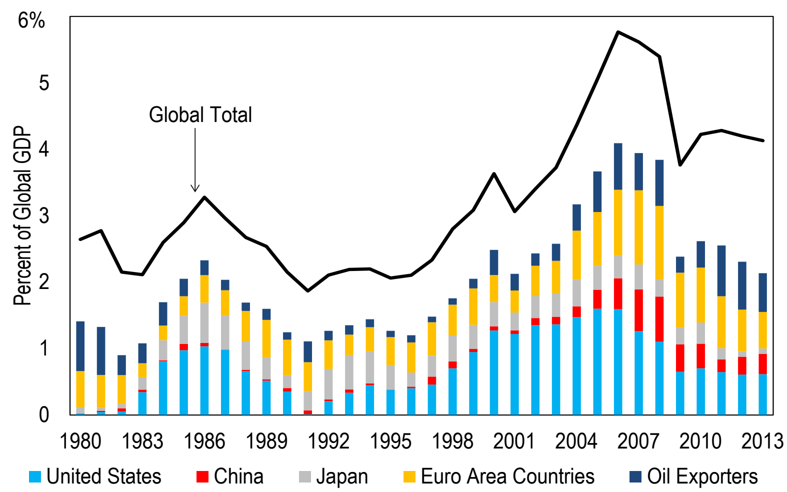
In the years since the financial crisis erupted, the magnitude of imbalances has generally narrowed, but this has not occurred uniformly across countries and regions. A headline development is that the U.S. deficit has now shrunk to a little

[19] In addition, during this period, the global discrepancy swung from positive (more deficits than surpluses) to negative (more surpluses than deficits). For more details, see Helbling and Torres, "From Deficit to Surplus: Recent Shifts in Global Current Accounts," IMF World Economic Outlook, October 2009.

over ½ percent of global GDP. Notably, the aggregate deficit of the emerging markets outside of Asia has widened and currently rivals the U.S. imbalance in magnitude. (We look at deficits in these economies in more detail below.) On the surplus side of the ledger, China and Japan have both seen their balances narrow since 2007. In contrast, the surpluses of the oil exporters and Germany have remained large, while other euro-area countries in aggregate have recently had their current account balances move into surplus as well.

Figure 18 assesses global imbalances through a complementary lens: the sum of the absolute magnitude of current account positions across countries. For example, if there were two countries in the world and one had a surplus of 1 percent of global GDP and the other had a deficit of 1 percent of global GDP, this measure would be equal to 2 percent of global GDP.

Figure 18. Sum of Absolute Current Account Balances, Pct of Global GDP, 1980-13



Sources: IMF and Citi Research.

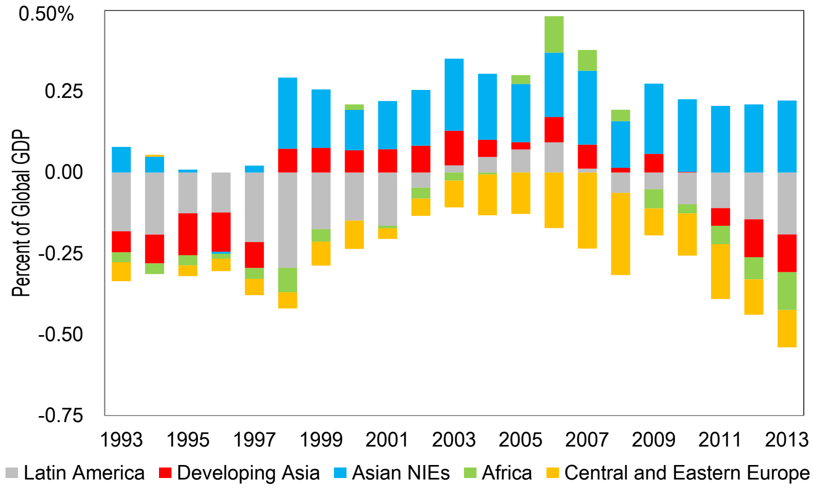
From 1980 through the late 1990s, the absolute current account positions of the countries for which the IMF reports data (more than 180) hovered between 2 and 3 percent of global GDP. However, this measure surged to nearly 6 percent of global GDP in the years before the financial crisis. Since then, the sum of absolute balances has declined to 4 percent of global GDP, still above its levels in the 1980s and 1990s but well off pre-crisis peaks. This decline is largely accounted for by narrowing imbalances in the United States, China, and Japan. But, in addition, the overall magnitude of imbalances in the euro area has also narrowed in recent years, as large deficits in the peripheral countries have swung into small surpluses.

We now turn to two groups of countries that, in our view, are likely to figure prominently in the evolution of global imbalances in the years ahead — the euro area and the emerging-market economies. Figure 19 provides more detail on the performance of the emerging markets, excluding China and the oil exporters (whose balances were shown in Figure 17). Notably, the emerging-market regions were generally in surplus in the years before the global financial crisis, with Central and Eastern Europe the one exception. Since the crisis, however, the situation has shifted. By 2013, all major emerging-market regions (except the Asian NIEs) had swung into sizable deficit.[20] Indeed, the overall magnitude of these deficits was broadly comparable to those registered in the late 1990s in the prelude to the Asia

[20] For example, between 2007 and 2013, current account positions deteriorated by 5 percent of GDP or more in Malaysia, Chile, Peru, Thailand and Indonesia.

crisis. While we judge the level of emerging-market vulnerability to be much lower than 15 years ago (for example, these countries have stronger financial systems, generally flexible exchange rate regimes, and significantly larger reserve coverage), this recent deterioration in current account performance does offer a cautionary tale.

Figure 19. Emerging Market Current Account Balance, Pct of Global GDP, 1993-2013



Sources: IMF and Citi Research.

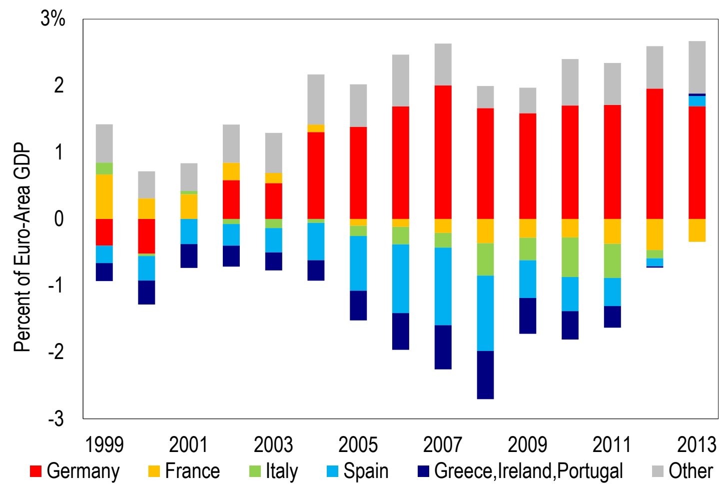
Figure 20 shows the external performance of key euro-area countries over the past decade. Quite remarkably, in the years immediately following the introduction of the euro, Germany recorded a small current account *deficit*. As the decade progressed, however, the country's current account saw growing surpluses, with the balance hovering between 1½ and 2 percent of euro-area GDP. Given that moves in the foreign exchange value of the euro were generally sufficient to keep the euro area's aggregate current account near balance, the counterpart to Germany's sizable surplus was mainly deficits in other euro-area countries, particularly the peripherals.

Since the financial crisis erupted, four major developments have occurred. First, the euro area as a whole has swung into external surplus. Second, France's deficit has widened further. At the time of the introduction of the euro, France was a surplus country and remained so through the middle of the last decade. But in recent years, France has recorded a growing deficit, as measures of its competitiveness have slipped. Third, and probably most striking, deficits in the peripheral countries have moved into surplus, as these countries have made progress improving their external competitiveness. Finally, we note that Germany's surplus has remained large.

The next figure focuses explicitly on the last two of these observations—the relationship between Germany's sustained current account surplus, on the one hand, and the improved external performance of the peripherals, on the other. Notably, as shown in the upper panel, the annual exports of the peripherals have risen by about €85 billion since late 2007 (just under 3 percent of their collective GDP).[21] Of this rise, the lion's share, roughly 90 percent, has come from larger sales to countries outside of the euro area. The peripherals' exports to Germany have risen a bit, while exports to other euro-area countries have been about flat.

[21] The data in Figure 21 come from the IMF Direction of Trade Statistics, which are not seasonally adjusted. We have also done this exercise with four-quarter moving averages and with data we seasonally adjusted ourselves -- and obtain results broadly consistent with those discussed here.

Figure 20. Euro Area Imbalances, Pct of Euro Area GDP, 1999-2013



Sources: IMF and Citi Research.

The lower panel highlights that the improvement in the peripherals' current account balances has also reflected import compression, as domestic spending in these countries has plunged. In total, peripheral imports are down more than €125 billion at an annual rate (4 percent of their GDP). In this case, the euro-area countries have shouldered a much larger share of the adjustment than with exports; the peripherals' imports from Germany have declined €38 billion since 2007, and their imports from the rest of the euro area are down nearly €47 billion.

Figure 21. Trade of Euro-Area Peripherals (Billions of Euros, Annual Rate), 2007-2013

	Change in Exports (2007:Q4 to 2013:Q2)				
	Germany	Rest of EA	Rest of World	Total	Share of GDP
Greece	-0.3	0.5	6.5	6.7	3.7
Ireland	-0.4	-3.0	-1.3	-4.8	-2.9
Italy	2.1	-13.5	28.2	16.8	1.1
Portugal	1.0	2.3	6.4	9.8	6.0
Spain	5.2	12.6	38.5	56.3	5.5
Sum	*7.6*	*-1.0*	*78.3*	*85.0*	*2.8*

	Change in Imports (2007:Q4 to 2013:Q2)				
	Germany	Rest of EA	Rest of World	Total	Share of GDP
Greece	-3.8	-9.6	-4.7	-18.1	-9.9
Ireland	-2.4	-2.0	-14.1	-18.6	-11.4
Italy	-12.8	-6.4	-21.9	-41.1	-2.6
Portugal	-2.2	-6.0	0.7	-7.4	-4.5
Spain	-16.6	-23.0	-0.7	-40.3	-3.9
Sum	*-37.8*	*-47.0*	*-40.7*	*-125.5*	*-4.1*

Sources: IMF and Citi Research.

This discussion suggests two broad conclusions. First, while the story in each country differs somewhat, roughly 40 percent of the peripherals' aggregate trade adjustment to date has come through increased exports, while 60 percent has come through import compression. Our sense is that the step-up in the peripherals' exports corresponds to a release of real resources from their domestic economies into the international economy and is likely to be sustained. In contrast, we

anticipate that at least a portion of the import decline will be reversed as domestic spending in these economies eventually recovers.[22] This suggests to us that external adjustment in the peripherals remains work in progress and, specifically, is likely to require further export gains in the years ahead.

Second, Germany and other euro-area countries have made hefty contributions to peripheral adjustment, but this has mainly reflected the plunge in the peripherals' imports. In addition to our concerns about the sustainability of this adjustment, we deem this a "lose-lose" approach to euro-area rebalancing — with shrinking demand in the peripherals leading to reduced production elsewhere in the currency zone. The more powerful approach to rebalancing would be for the less afflicted euro-area countries, particularly Germany (which is best positioned), to take more determined measures to stoke their domestic spending. This would lift import demand in these stronger countries and, thus, fuel production in the peripherals. The available data, however, provide little evidence that much of this "win-win" adjustment has yet occurred.

This discussion brings us to the question of how global imbalances are likely to behave in the years ahead. Is the recent reduction in these imbalances only a temporary phenomenon related to the financial crisis or something more durable? Figure 22 provides our views on these issues.

As a general statement, the outlook for global imbalances embedded in our baseline forecast is quite sanguine. We expect these imbalances to remain well contained and, in some important instances, to narrow further. More specifically, as shown in the upper-left panel, the U.S. current account deficit is seen to continue to close over the next five years, as eventual recoveries in the U.S. and global economies have competing effects on imports and exports. Our forecast envisions some dollar appreciation in the years ahead, but the impact on the current account is likely to be more than offset by reduced oil imports as U.S. energy production remains on a rising trajectory.

China's surplus (the upper-right panel) is expected to narrow slightly further over the next few years, as additional renminbi appreciation constrains the size of the balance and the authorities' emphasis on domestic demand-led growth supports imports. In addition, with China already accounting for around 12 percent of global exports, the scope for further penetration of world export markets strikes us as much reduced relative to a decade ago. Similarly, Japan's balance is projected to remain in positive territory, supported by recent (and expected future) yen depreciation. The bottom line is that external imbalances in the United States, China, and Japan — which were the essence of global imbalances before the financial crisis — should remain on a lower trajectory.

As shown in the lower-left panel, we anticipate that the current account surplus that has emerged in the euro area will persist in the years ahead, at just over 2 percent of GDP. The composition of this balance across countries is expected to shift, however. Specifically, the adjustment in the peripherals is seen to continue, with their exports gaining enough traction to keep their external surpluses on a gently rising trajectory even in the face of an eventual recovery in domestic demand and imports. Consistent with this picture, Germany's relatively rapid growth should manifest itself in a declining current account surplus. As such, our baseline forecast incorporates a benign resolution of external imbalances in the euro area. Suffice it to say, this outlook is bracketed by significant risks.

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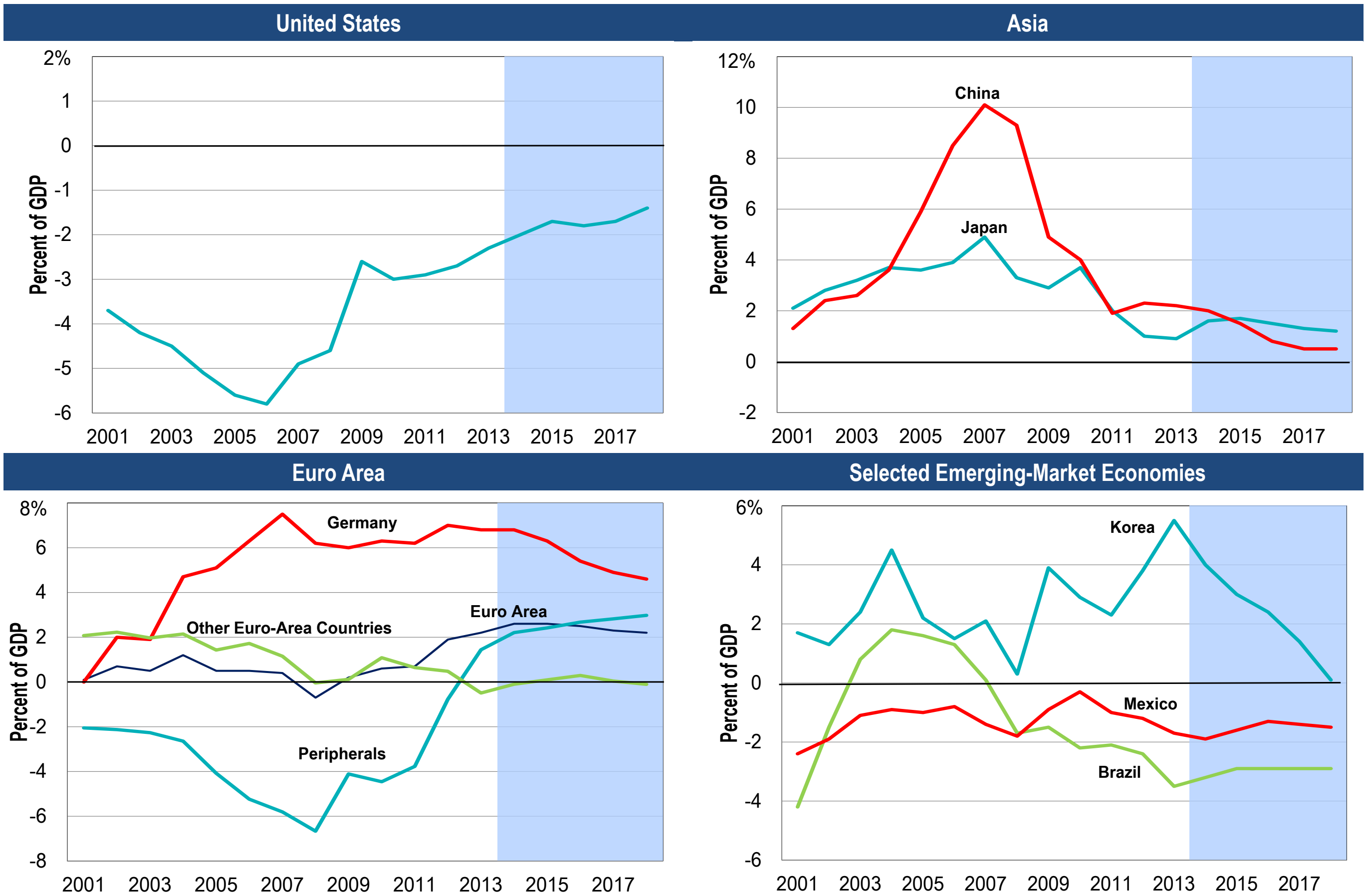
[22] This argument is broadly consistent with our reading of the experience of the emerging Asian countries in the aftermath of their financial crisis in the late 1990s.

Figure 22. Current Account Projections, Pct of GDP, 2001-18F



F Citi Forecast. Source: Citi Research

The final panel highlights that in the years ahead current account deficits in Brazil and Mexico are likely to hover at 3 percent of GDP and at about 1½ percent of GDP, respectively. Although deficits of this size should be sustainable, any softening in the quality of economic policies or further widening of current account deficits could leave these countries vulnerable to a weakening of investor sentiment.[23] Finally, we see Korea's current account surplus gradually closing, on the back of 3¾ to 4 percent projected real GDP growth and a strengthening currency.

Some concluding thoughts. Taken together, the evidence presented in this essay points to a significant decline in global imbalances since the financial crisis. But in addition, the composition of these imbalances has shifted meaningfully. In our view, Germany's external surpluses now loom particularly large — in terms of both their absolute size and their potential role in contributing to a sustained rebalancing of demand within the euro area. We also see warning signs associated with rising deficits in the emerging-market economies. This situation merits careful scrutiny, but our judgment (at least for now) is that overall vulnerabilities in the emerging markets remain much reduced relative to crisis periods in the past. Finally, imbalances in the United States and China have narrowed, but maintaining this progress will require continued commitment to sound policies. For the United States this entails ongoing efforts to boost and sustain national saving. For China, this means following through on measures to strengthen consumption and allow greater exchange rate flexibility.

[23] These observations underscore the concerns we raised in our discussion of Figure 19.

Three Questions about EM

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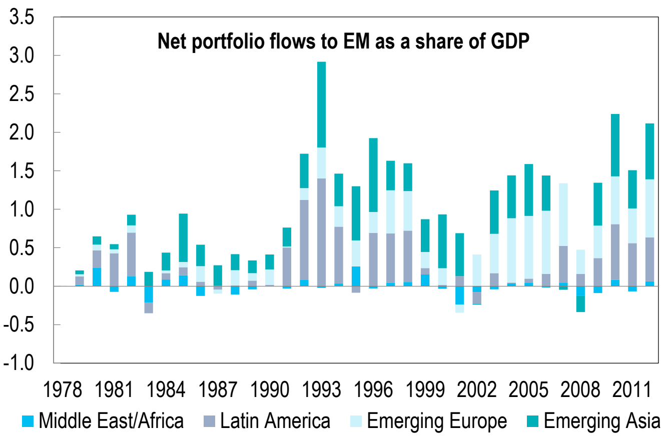
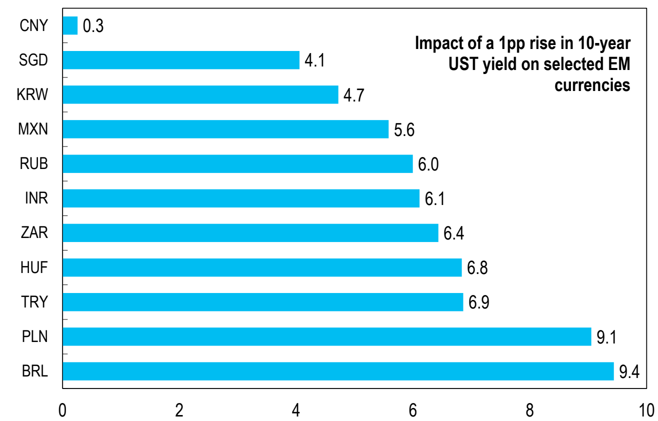
Three questions are likely to dominate investors' thinking about EM in 2014. The *first* is about the future of capital flows to EM: will Fed 'tapering' and the prospect of US monetary tightening cause sustained outflows from EM? The *second* is about EM's export recovery: will EM's recent export slump ever reverse? And the *third* is about China: will 'China risk' re-emerge as a threat to EM growth? These three questions were very broadly discussed among investors during the course of 2013, and so in a sense 'nothing's new' as we go into the New Year. Overall we find it difficult to come up with optimistic answers to any of these questions, and so we think it makes sense to be quite cautious about the environment facing emerging markets. That said, there are few market participants these days that are truly optimistic about EM: the risks facing this group of economies are increasingly well-understood. Since the perception of those risks is, to some degree, reflected in asset prices now, there probably isn't a strong case to argue that EM faces a 'crisis'. Indeed, a better way to think about EM is that it faces a '*chronis*' — no abrupt chaos necessarily, but rather a series of smaller adjustments in asset prices as investors get used to a world where EM is no longer characterized by rapid, export-led growth and large accumulations of fx reserves; but is driven instead by slower growth, slightly weaker sovereign balance sheets, and more reliance on domestic spending.

Figure 23. Portfolio flows to EM in 2010 and 2012 reached levels, as a share of GDP, almost as high as in 1993, just before the Tequila crisis…



Sources: IIF and Citi Research

Figure 24. …and EM currencies exhibited a high degree of sensitivity this year to rising US Treasury yields



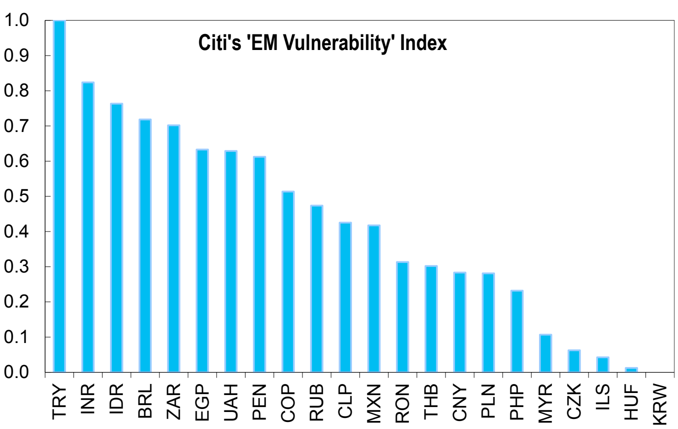
Sources: Bloomberg and Citi Research

We think it is worth being cautious about the outlook for capital flows to EM. Net portfolio flows have been exceptionally strong in recent years (see Figure 23), stronger than we've seen them since 1993 — the year that preceded the 'Tequila' crisis. And in some respects at least, the rationale behind the recent surge in capital inflows is similar to what it was then: a period of extremely loose US monetary policy. Of course, there are substantial differences between EM now and EM 20 years ago: the accumulation of fx reserves in recent years has created big pools of 'self-insurance'; pegged exchange rate regimes have, for the most part, given way to floating exchange rates; and the *composition* of capital flows has improved in the sense that currency risk is better-shared these days between debtors and creditors, whereas in the past it resided mostly with debtors in EM. But still, expected changes in US monetary policy create uncertainty about the outlook for capital flows to EM. Indeed, EM's sensitivity to rising US Treasury yields was a dominant theme of 2013, and it would probably be prudent to assume that further increases in US Treasury yields will remain a source of stress for EM currencies and bond markets. That stress will be magnified, we think, at whatever stage the *front-end* of the US

Treasury curve starts to shift upwards. For some countries — India, Chile, Turkey, Colombia, Indonesia, Malaysia, Brazil — cross-border borrowing from *international banks* has also been an important feature of their capital inflows, and these flows could be threatened when short-term US rates rise. The reason for this is that banks tend to fund themselves at the shorter end of the US curve, and so their willingness to continue extending cross-border credit to EM might be constrained as we get closer to rising short-term US rates.

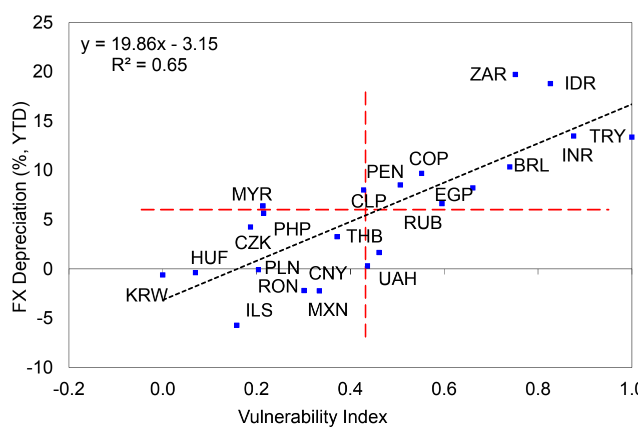
Vulnerability to capital outflows needs to be understood with a broad set of tools. Brazil presented an interesting puzzle in 2013. As Figure 24 suggests, the Real was heavily affected by the rise in US Treasury yields. But why? Brazil's real *ex ante* policy rate is very high by global standards and, uniquely in EM, actually went up during 2013. Moreover, Brazil's current account deficit, just over 3% of GDP, is largely financed by FDI, and its level of fx reserves adequacy is among the strongest in EM. On the face of it, there's no obvious reason why Brazil proved so vulnerable. Its inclusion in the group of countries so badly affected by rising US yields suggests that a broad set of vulnerability indicators — including credit growth and inflation, as well as more intuitive indicators like the current account deficit — need to be included in order to provide a more solid picture of vulnerability. The results of our attempt to do that are included in Figure 25.

Figure 25. Our index of EM vulnerability relies on credit growth, C/A gap (% of GDP), reserves (% of GDP) and inflation…



Source: Citi Research

Figure 26. …and goes some way to explain FX vulnerability during the course of 2013

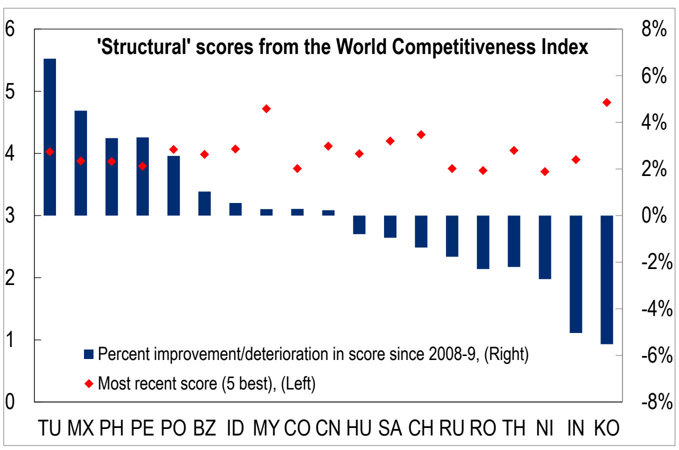


Sources: Bloomberg and Citi Research

EM doesn't face a 'sudden stop', but if capital inflows prove to be scarcer, it will be difficult for EM to manage the impact of this with a sharp increase in export growth. In the past, episodes of capital outflow from EM have often been described as 'sudden stops', as though flows are governed by a kind of 'on-off' switch. Bond issuance data for 2013 suggests that EM is far from suffering a 'sudden stop' in this way: monthly issuance in September 2013, following four months of fear about US 'tapering', was $58 bn, only $2 bn short of the $60 bn issued in January this year. One reason for this is that, after all, EM fundamentals are considerably better than they were during previous episodes of capital outflow. Another is based on the idea that what EM loses on the capital account (through capital outflows) it might recover on the current account (through export growth). In principle, there are three main paths towards optimism about EM export growth. One is that 'structural reform' in EM can impressively increase the supply capacity of EM exporters. Another is that a recovery in DM demand conditions will help to fuel a recovery in EM export growth. And if neither of these work, a third path towards export recovery is real exchange rate depreciation: EM re-prices its goods and services to levels that allow exports to grow.

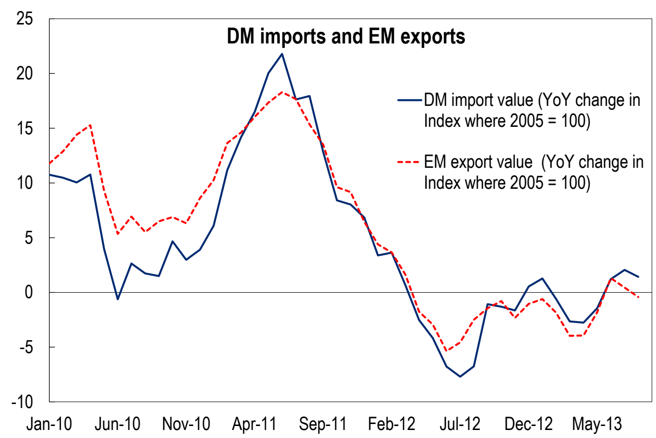
'Structural reform' is unlikely to deliver a quick boost to EM export growth. To be sure, there are some EMs — China, Mexico, India — where structural reform has been a topic of heated debate for years. But in general, structural reform has been on the back burner in recent years. One reason for this can be traced back to the EM crises of the 1990s and early 2000s. During that period, the principal diagnosis of EM vulnerability was that it largely resulted from *weak sovereign balance sheets*: excessively high public debt/GDP ratios and inadequate levels of fx reserves. During the past 10 years, EM policymakers made strenuous effort to address those balance sheet weaknesses, and doing so — in the context of big gains in EM's terms of trade — helped to push into the background any concerns about structural weaknesses. And now it's coming to the foreground, but not consistently: Figure 27 shows the improvement/deterioration since 2008 in 'structural' aspects of the World Competitiveness Indices of the World Economic Forum. The picture is mixed across EM, and in any case it will take time for structural reform to deliver a reliable boost to export growth in EM.

Figure 27. Progress on structural reform since 2008 has been mixed: Turkey and Mexico seem to have done well, India and Korea not so well



Sources: WEF and Citi Research

Figure 28. EM export growth seems constrained by weak DM demand, and a slight recovery in DM import values this year didn't help much



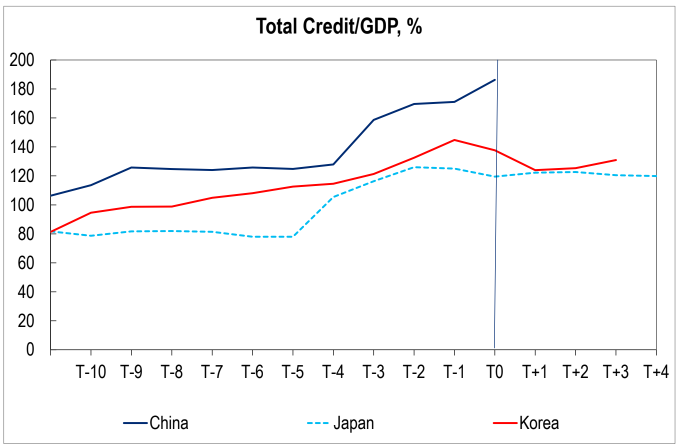
Sources: CPB Netherlands and Citi Research

DM growth might continue to be relatively EM-unfriendly. And meanwhile, it is worth being cautious about the prospects for a DM recovery to provide a substantial demand boost to EM exporters. That was apparently true in 2013: acceleration in DM GDP growth, particularly in Q2, apparently did little to deliver a boost to EM export growth: import demand in the G10 economies apparently recovered a bit (see Figure 28) but not with any substantial benefit to EM. It remains to be seen whether strong EM export growth can re-emerge but there are at least reasons to be cautious given some of the features of G10 economies now: a Japanese recovery based in part on a cheap yen; a Eurozone that will feature a large current account surplus for the foreseeable future; and a US which seems to have a lower marginal propensity to import.

'China risk' is unlikely to have disappeared for good. Market perceptions of 'China risk' have eased considerably in recent months: the 5 year CDS spread has fallen from 140 bp in June to 65 bp in late November, supported by i) three consecutive months of double-digit industrial production growth between August and October this year, and ii) an enthusiastic response to the reforms outlined in November's Third Plenary. Yet we think the risks surrounding an abrupt Chinese slowdown will not have disappeared permanently. Chinese officials themselves often talk about Japan's slowdown in the mid-1970s and Korea's slowdown in the late 1990s as a way of explaining the inevitability of China's transition to a weaker level of GDP growth. But Japan's experience in the 70s, and Korea's in the 90s, are

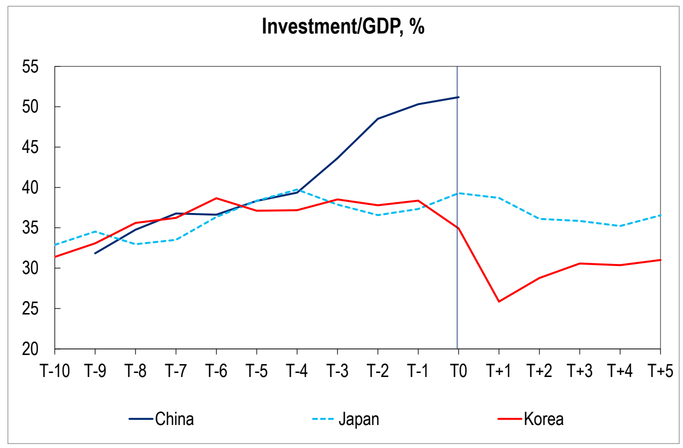
not obviously auspicious precedents for China: both these countries suffered a very abrupt slowdown after a period of strong, credit-fuelled, investment-led growth which boosted their investment/GDP ratios to historically high levels[24]. Japan's experience during these years was also associated with rapid appreciation of the real exchange rate, which has also been a feature of China's economic development in the past few years. Of course, the abrupt slowdown that 70s Japan and 90s Korea faced didn't put a stop to their development: per capita income levels continued to rise in PPP terms after a one-year shock (1974 for Japan, 1998 for Korea). But the decline in average GDP growth was notable in both cases. In Japan, GDP growth averaged 8.6% in the five years up to 1973, but only 3.1% in the five years from 1974; while in Korea, GDP growth averaged 7.4% in the five years up to 1997, but only 5% in the five years from 1998. Each country suffered a year of recession: 1974 in Japan, 1998 in Korea.

Figure 29. Substantial accumulation of credit stocks was evident in Japan in the early 1970s and Korea in the 1990s…



T0 was 1973 for Japan, 1997 for Korea
Source: Citi Research.

Figure 30. …and those credit stocks helped to keep investment ratios high until an external shock triggered slowdown and rebalancing.



T0 was 1973 for Japan, 1997 for Korea
Source: Citi Research.

Vulnerability to a slowdown is not, by itself, enough to bring on a slowdown. The overwhelming lesson of Japan's and Korea's experiences in the 1970s and 1990s is that their sharp slowdowns were, in each case, triggered by an external shock: the oil crisis in Japan's case, and the Asian Financial Crisis in Korea's case. And this probably provides the single most important lesson for China. Whatever vulnerabilities are created by China's credit-fuelled, investment-led growth, or by the associated decline in the return on capital in China, it seems right to suppose that it will take some trigger to turn that into a sharp slowdown. It seems that some informal equation — *crisis = vulnerability + trigger* — holds true. By definition, of course, no one is able to predict or identify a trigger. But it does seem true that market participants will remain highly alert to whatever might trigger a possible abrupt Chinese slowdown, given the sharp slowdowns that have occurred in countries with similar development paths in the past. And since EM remains highly China-dependent, both as an asset-class and as a group of economies, nervousness about China's vulnerability to a trigger is likely to preoccupy investors at various stages in 2014.

[24] See, for example, *'China's Rebalancing: Lessons from East Asian Economic History'*, John L. Thornton China Center Working Paper Series, October 2013, by David Dollar; and '*Rebalancing China's Economic Growth: Some Insights from Japan's Experience*', by Tomoyuki Fukumoto and Ichiro Muto, Bank of Japan Working Paper Series No. 11-E-5, July 2011; *'An Economy in search of stable growth: Japan since the oil crisis'*, by Nakamura Takafusa, The Journal of Japanese Studies, Winter 1980.

2014 Global Political Outlook: Between Polarization and Populism

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Political developments dominated the headlines in 2013: the election stalemate in Italy; a spike in tensions in North Korea; the death of Hugo Chavez in Venezuela; the largest-ever popular protests in Brazil, India and Turkey; a military takeover in Egypt; the first government shutdown in seventeen years in the United States; elections in Germany; and the threat of US military intervention in Syria. Yet thanks largely to accommodative policy from the Federal Reserve and European Central Bank, coupled with signs of economic recovery, these developments generated minimal market jitters rather than significant destabilization.

Given that neither liquidity nor modest economic growth will reverse the underlying causes of political risk, in our view *Vox Populi* risk — the notion that shifting and more volatile public opinion represents a new and powerful risk to the business & investment environment — remains a significant force. The combination of polarized electorates more prone to either protest or turning to non-mainstream political alternatives; weak political leadership, and limited international consensus on addressing global challenges remains potent. At the forefront for 2014 will be US midterm elections, a spate of elections in EM middle-income democracies — many of which saw major protests this year — European Parliamentary elections, and ongoing geopolitical challenges in the Middle East and Asia.

Even so, the probability that political risk will generate systemically-significant disruptions remains comparatively moderate in the year ahead, given the small number of elections or planned changes in government in systemically significant markets and the shift toward diplomacy over military conflict. But longstanding political risks will continue to surface periodically until the next major election cycle, hampering economic governance and business confidence in the process.

In our view, given persistently high unemployment, the modest growth pickup in DM will not reverse the trend toward fractured polities and anti-reform pressures. In EM, new middle classes are likely to continue to demand more from their leaders, even where they have been delivering growth and improving living standards. At the same time, the international system will struggle to address geopolitical challenges, as the focus on narrow domestic considerations collides with less room for maneuver for leaders constrained by low approval ratings and weak mandates.

Taken together, the global political outlook suggests an ongoing fragile equilibrium, with last-minute, piecemeal policymaking that may prevent the worst-case outcomes yet nonetheless continues the pattern of periodic heart attacks. In an era marked by a high degree of distrust of elites and dissatisfaction with politics, we find limited prospect for the improved economic governance that markets and corporates expect, keeping the pressure high on already “super-empowered” central banks. With Citi Research’s global growth forecast at 3.1% next year and 0.9% in the eurozone, slow growth and high unemployment will mean that political risks continue to occupy center stage in the years to come.

Figure 31. Political Signposts for 2013-2014

December 13, 2013	Deadline for "Son of Supercommittee" budget panel (United States)
January 15, 2014	United States budget deadline, approximate sequestration date
February 7	United States debt ceiling deadline
March 23	French municipal elections (second round on March 30)
March 30	Turkish local elections
April	Algerian presidential election
April 5	Afghanistan presidential election
April 9	Indonesian legislative election
May	Last date for Hungarian parliamentary election
May 22-25	European Parliament elections
May 25	Belgian federal election
May 25	Colombian presidential election
May 31	Last date for Indian federal election
July	Last date for South African general election
July	Last date for Thailand general election
July 9	Indonesian presidential election
September 14	Swedish general elections
September 18	Scottish independence referendum
October 5	Brazilian general elections (runoff on October 26)
November	Lebanese parliamentary election (tentative)
November 4	United States midterm election
December	Last date for Romanian presidential election

Source: Citi Research

Key Themes for 2014

Key EM elections. Next year will see elections in key emerging market economies: Turkey, Indonesia, India, South Africa and Brazil. Over the past year, all of them have seen among the largest mass protests or labor unrest in their recent history. All five have longstanding incumbent governing parties, ranging from ten years (India and Indonesia) up to 20 years (South Africa) in office. History suggests that long-tenured leaders often face significant challenges in the run-up to elections, especially in weakening economic and fiscal conditions. A key indicator for protest activity is a recent history of protests, suggesting that further mass protests in the run-up to the polls in these countries is highly likely.

Mass demonstrations have long been a major feature of country risk, but the scale of the 2013 protests in EM middle-income democracies suggested a new variation, fuelled by new middle classes and enabled by access to technology. Nevertheless, major demonstrations do not necessarily mean a change of government, especially where the opposition is weak. Only Indonesia and India are likely to produce opposition victories based on current polling trends. But the new manifestation of "flash mob" democracy could mean episodic disruptions to local markets, even after elections have taken place, and greater tendency for fiscal loosening and populism in an attempt to placate a restive public.

Figure 32. *Vox Populi* Risk in 2014: Key EM Elections

	Likely Date	Citi GDP2014F	Political Snapshot
Turkey	March	3.5%	Local elections provide first test for Recep Tayyip Erdogan's AKP government after the Gezi Park protests.
Indonesia	April, July	5.3%	Susilo Bambang Yudhoyono leaves office in the wake of fuel price protests, falling equity markets and a currency crisis. Newcomer Jakarta governor Joko Widowo leads in the presidential polls.
India	May	5.6%	Pro-business Narendra Modi leads the BJP opposition against Congress's 11-year government as the economy sputters.
South Africa	April-July	2.8%	Jacob Zuma's ANC will win re-election, but faces labor unrest, high unemployment, and growing challenges on both the left and right.
Brazil	October	2.0%	Dilma Rousseff remains favored for re-election after the Salad Revolution, but environmentalist Marina Silva cuts into her base.

Source: Citi Research

Slow growth Europe faces European Parliament elections, fragmentation risk.

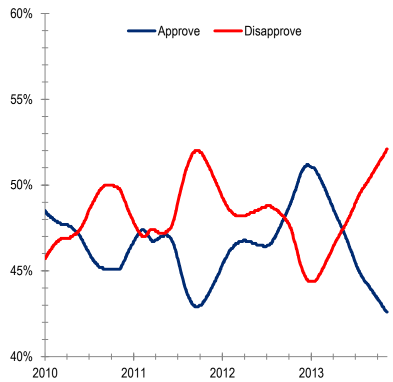
Weak coalition governments in Greece and Italy still face the threat of snap elections, making these a key eurozone political risk for 2014, as coalition partners are faced with tough choices. European Parliamentary elections are in May, providing an opportunity to test the support of populist NEAP's — the new, extreme or alternative parties that have seen a significant increase in support over the past two years. Amid persistently high unemployment, austerity fatigue and rising euroskepticism, particularly in the creditor countries, NEAPs could win big at the European Parliamentary level. In the hopes of blunting support for non-mainstream parties, Brussels will continue to apply less pressure on budget targets. European Parliamentary elections will be closely watched ahead of the national election cycle in the eurozone that will resume in 2015 as a lead indicator of public sentiment. Typically ignored by markets, these elections will likely get greater focus in the wake of recent attempts to pass the financial transactions tax and limit portfolio managers' pay.

Risks to European Union cohesion and rising separatism will also feature in 2014, with September's Scottish independence referendum as well as the continued tensions between Madrid and Spain's autonomous regions. As the European crisis evolves, secessionism, euroskepticism, and willingness to experiment with non-mainstream parties have grown (although notably most contemporary secession movements are ardently pro-EU). In both the Scottish and Spanish cases, support for secession falls short of a majority in the polling data, but is sufficient to suggest continued pressure on central governments and cloud the policymaking outlook, increasing the risks of populism.

Arab Spring realignments and geopolitical risk in Asia. Despite the military intervention in Egypt and raging civil war in Syria, diplomatic efforts on Syria's chemical weapons and the interim agreement between Tehran and the P5+1 Iran nuclear negotiations have significantly reduced the risk of Western military intervention, thereby lowering the geopolitical risk temperature. The Iran diplomatic breakthrough, which will see Iran's nuclear program "frozen" in exchange for limited sanctions relief, reduces the likelihood of military action in Iran, a longstanding geopolitical risk that has worried markets. Yet the potential for improved US-Iran relations has strained the Saudi-US relationship as well as US-Israel ties. Further, worries of an eventual Iranian nuclear weapons capability could spark a regional WMD arms race over the longer-term. More significant for global energy supplies are the persistent security problems in Libya and Iraq, which show little prospect of subsiding.

In Asia, China-Japan tensions over the disputed islands continue, most recently illustrated in China's effort to create a new air zone over the disputed islands. Though neither side wants a military conflict to disrupt regional stability or commercial relations, friction is likely to continue sporadically, increasing the risk of an accidental conflict. US-China relations remain in a holding pattern, with the Obama administration maintaining a commitment to the Asia pivot even as attention is drawn back to the Middle East — and domestic concerns in Washington.

Figure 33. President Obama's Approval Rating Ties for the Lowest of His Presidency



Sources: Huffington Post/Pollster.com and Citi Research

Outlook for US midterm elections. Partisan polarization and demographic shifts have created conditions where many US politicians have more to fear from opponents from within their own party in primary contest than from the opposition party in a general election, a phenomenon which heightens polarization by hollowing out the political center and further reduces the political space for moderates. Where moderates remain in office, regardless of their party affiliation, pressure to avoid compromise is high. Consequently, short-term agreements have become the rule. The cyclical nature of these battles, which we call *Lather, Rinse, Repeat*, are likely to be replayed at regular intervals. Indeed we expect 2-3 more budget showdowns before midterm elections in November 2014. The US budget expires on January 15 and both sides are positioning themselves for next fight: sequestration. This highly partisan, disruptive cycle will continue until one party takes control of both houses of Congress, a scenario which is unlikely for some years according to current polling trends.

US political drama takes place against a background of strikingly dismissive public opinion in the United States. As of this writing, Congress's approval rating is in the single digits, and President Barack Obama's approval rating ties for the lowest of his presidency. Setbacks in implementing the health care law, regarded as the signature achievement of his presidency, will weigh further on the president's support and worry Democrats heading into the midterm elections.

In November 2014, the entire House and one-third of the Senate will be up for election. In the House, Democrats need seventeen (17) seats to take control. However, leading US election prognosticators only see only 44-52 competitive seats in the entire country, with 24-26 already held by Democrats.[25] This means Democrats would have to win more than two-thirds of all competitive Republican seats, the type of sweep only seen in wave elections. In the Senate, Republicans need six (6) seats to take control. According to the current polling data, taking at least three seats are possible (potentially Montana, South Dakota and West Virginia, and perhaps Arkansas as well). But the next three seats look far more difficult, with well-established Democratic incumbents in Alaska, Louisiana, and North Carolina.

Conclusion

As more and more governments face intense pressure to be responsive to popular discontent and to produce sustainable economic benefits for the whole society, the Vox Populi will remain a force to be reckoned with and an important risk factor for the foreseeable future.

Some suggest that democracy is in decline in the aftermath of the global financial crisis, with various indicators of democratic freedoms going into reverse. Yet demand for political alternatives and accountability of leaders, the spike in protest activity and the flexibility, if lack of muscularity, found in the world's democracies over the course of the post-crisis period refute this argument. Demand for democracy, civil rights and liberties shows no signs of slowing, nor do the pressures and opportunities of globalization. It will be the ability of leaders to respond to public concerns while anticipating the shifts in the global system that will largely determine the shape of things to come.

[25] *The Cook Political Report*, Larry Sabato's Crystal Ball, *The Rothenburg Political Report*. Accessed November 14, 2013.

Long-term Nominal GDP Projections to 2025

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

The relative rankings of major economies have changed markedly in recent decades: China was the world's 10th biggest economy in 1990 but replaced Japan as the world's second biggest in 2010. Brazil has leapt from the world's 13th biggest economy in 2004 to the 7th biggest in 2013, and India and Russia joined the top 10 since 2010. We still expect that EM countries in general will show higher real and nominal growth than developed countries: aggregated across a wide range of EM countries, we expect nominal GDP (in USD terms) to rise by 9-10% YoY over the rest of this decade, versus roughly 4% YoY for advanced economies. Nevertheless, we have markedly scaled back our estimates for EM outperformance. For example, last year, we judged that in 2025, the biggest five EM countries (China, India, Russia, Brazil, Indonesia) would have a combined nominal GDP that is 20% bigger than the biggest five advanced economies (US, Japan, Germany, France, UK). Now, we expect the combined nominal GDP of the EM-5 in 2025 will be only marginally (2-3%) bigger than that of the AE-5.

We now expect that China's nominal GDP (in USD terms) will roughly match the US level in 2025, whereas a year ago we forecast that China's nominal GDP would be about 9% above the US level in 2025. In PPP terms, the US-China crossover will probably come earlier, perhaps around 2017 using the IMF's PPP adjustments. Unlike last year's forecast, we now expect that the nominal GDP of Brazil and India will stay a little below the UK and France even in 2015. Based on countries covered in this report (which jointly account for about 94% of global GDP), we estimate that EM countries in total account for about 34% of global consumer spending, but about 53% of global investment spending. Indeed, investment (in USD terms) in China this year will probably be about 55% greater than investment in the US. Investment in India in 2013 probably is the fifth highest for any country and is likely to replace Germany in fourth place around 2015.

Figure 34. Selected Countries — Approximate Size of 10 Biggest Economies, Indexed to US = 100, 1980-2025F

	1980		2000		2010		2015F		2020F		2025F	
	Rank	US = 100	Rank	US = 100	Rank	US = 100	Rank	US = 100	Rank	US = 100	Rank	US = 100
1	US	100	US	100	US	100	US	100	US	100	US	100
2	Japan	38	Japan	46	China	40	China	61	China	81	China	100
3	Germany	29	Germany	18	Japan	37	Japan	26	Japan	22	India	27
4	France	24	UK	15	Germany	22	Germany	22	Germany	20	Russia	20
5	UK	19	France	13	France	17	UK	17	India	20	Germany	20
6	Italy	16	China	12	UK	15	France	16	Russia	17	Japan	19
7	China	11	Italy	11	Brazil	14	Russia	14	France	15	Brazil	15
8	Canada	10	Canada	7	Italy	14	India	13	UK	15	UK	15
9	Mexico	8	Mexico	7	Russia	11	Brazil	13	Brazil	14	France	14
10	Spain	8	Brazil	6	India	11	Italy	12	Italy	10	Indonesia	11
Euro Area		97		61		81		76		69		66

F Forecast: Sources: IMF and Citi Research estimates

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Source: Citi Research.

Figure 36. Selected Countries — Economic Forecast Overview (Percent), 2013-2018F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F
Global	**2.4**	**3.1**	**3.3**	**3.5**	**3.5**	**3.4**	**2.6**	**3.0**	**3.0**	**3.4**	**3.5**	**3.5**	**2.20**	**2.28**	**2.52**	**3.02**	**3.52**	**3.82**
Based on PPP weights	*2.9*	*3.6*	*3.8*	*4.0*	*4.1*	*3.9*	*3.1*	*3.4*	*3.5*	*3.9*	*4.0*	*4.0*	*2.77*	*2.89*	*3.20*	*3.68*	*4.13*	*4.47*
Industrial Countries	**1.1**	**2.0**	**2.1**	**2.3**	**2.1**	**1.9**	**1.3**	**1.7**	**1.6**	**1.5**	**1.6**	**1.7**	**0.42**	**0.34**	**0.45**	**1.04**	**1.73**	**2.45**
United States	**1.7**	**2.7**	**3.1**	**3.2**	**2.7**	**2.2**	**1.1**	**1.8**	**2.0**	**2.2**	**2.3**	**2.2**	**0.25**	**0.25**	**0.41**	**1.50**	**2.70**	**3.80**
Japan	**1.8**	**1.6**	**0.9**	**1.2**	**1.2**	**1.0**	**0.3**	**2.3**	**1.4**	**1.6**	**0.7**	**1.0**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.50**
Euro Area	**-0.4**	**0.9**	**1.0**	**1.3**	**1.4**	**1.5**	**1.3**	**0.9**	**0.7**	**1.1**	**1.6**	**1.7**	0.50	0.06	0.00	0.06	0.50	1.00
Canada	1.7	2.4	2.7	2.7	2.6	2.4	1.0	1.5	1.9	2.0	2.0	2.0	1.00	1.00	1.19	2.13	2.50	2.75
Australia	2.5	2.9	3.0	3.2	3.1	3.2	2.5	3.1	2.4	2.4	2.4	2.4	2.69	2.50	3.44	4.44	4.50	4.75
New Zealand	2.4	3.0	2.7	2.5	1.7	1.9	1.2	2.1	2.2	2.3	2.3	2.2	2.50	3.19	4.56	4.75	4.75	5.00
Germany	0.5	1.9	1.7	1.7	1.7	1.6	1.5	1.5	1.6	1.8	2.0	1.9						
France	0.2	0.8	0.9	1.4	1.7	1.8	1.0	1.2	1.3	1.5	1.3	1.6						
Italy	-1.8	0.2	0.3	0.4	0.5	0.6	1.3	0.2	-0.3	0.4	1.2	1.5						
Spain	-1.3	0.2	0.8	1.2	1.3	1.4	1.5	-0.4	-0.2	0.1	0.5	0.9						
Greece	-3.3	-1.9	-0.5	1.1	1.4	1.3	-0.8	-2.9	-2.4	-1.4	-0.4	0.8						
Ireland	-0.5	1.4	1.6	2.7	3.0	3.3	-0.3	0.5	1.0	1.5	1.5	1.5						
Portugal	-1.6	-0.5	0.4	0.7	0.9	1.1	0.4	-0.4	-1.2	-0.2	0.6	1.0						
Netherlands	-1.1	0.4	0.9	1.2	1.6	1.9	2.6	1.3	1.3	1.4	1.5	1.8						
Belgium	0.1	0.6	1.0	1.4	1.9	2.1	1.2	1.3	1.1	1.1	1.7	2.0						
Denmark	0.4	1.2	1.5	1.6	1.7	1.9	0.8	1.5	1.7	1.8	1.9	2.0	0.20	0.13	0.25	0.47	0.78	1.00
Norway	1.8	2.1	2.4	2.6	2.9	2.7	2.1	2.0	2.2	2.0	2.3	2.5	1.50	1.50	1.71	2.08	2.74	3.33
Sweden	0.9	2.1	2.5	2.6	2.9	3.0	0.0	1.1	1.9	2.4	2.3	2.0	0.99	0.75	0.98	1.42	2.18	2.80
Switzerland	2.0	2.0	2.0	2.2	2.0	2.0	-0.2	-0.1	0.9	1.1	1.2	1.2	0.00	0.00	0.00	0.00	0.25	1.00
United Kingdom	1.5	3.2	3.2	2.7	2.0	2.1	2.6	2.0	1.9	2.1	2.0	2.0	0.50	0.50	0.81	1.75	2.21	2.71
Emerging Markets	**4.6**	**4.9**	**5.0**	**5.3**	**5.4**	**5.3**	**4.7**	**5.0**	**5.2**	**5.1**	**5.1**	**5.0**	**4.99**	**5.19**	**5.60**	**5.91**	**6.08**	**6.03**
China	**7.6**	**7.3**	**7.0**	**7.5**	**7.3**	**7.0**	**2.7**	**3.3**	**3.7**	**3.8**	**4.0**	**3.8**	**3.00**	**3.03**	**3.63**	**3.88**	**4.25**	**4.50**
Taiwan	2.0	3.2	3.8	4.2	4.5	4.5	1.1	1.7	2.3	1.8	1.8	1.8	1.88	1.97	2.44	2.88	3.38	3.88
India	4.8	5.6	6.7	7.3	7.4	7.5	6.0	5.0	5.0	5.0	5.0	5.0	7.75	8.00	8.00	8.00	8.00	8.00
Indonesia	5.7	5.3	5.5	5.7	5.9	5.7	7.1	6.6	5.7	5.4	5.3	5.5	4.88	6.00	6.44	6.25	6.00	6.00
Korea	2.9	3.7	3.9	4.0	3.7	3.8	1.2	2.3	3.1	3.1	3.0	2.9	2.56	2.50	3.13	3.75	4.13	4.25
Czech Republic	-1.3	1.9	2.4	2.4	2.7	3.1	1.4	1.2	1.9	1.0	2.0	2.0	0.05	0.05	0.05	0.55	1.54	2.54
Hungary	1.0	1.9	1.5	1.4	1.6	2.0	1.7	1.5	3.3	3.2	3.1	2.6	4.19	3.02	4.00	4.00	4.00	4.00
Poland	1.4	3.1	3.6	3.6	3.5	3.2	1.0	1.9	2.8	2.7	2.5	2.5	2.92	2.63	3.75	4.21	4.35	4.00
Romania	2.5	2.8	3.3	3.5	3.5	3.5	4.1	1.9	2.7	2.5	2.5	2.5	4.69	3.75	4.69	5.00	5.00	5.00
Russia	1.4	2.6	2.7	2.9	3.0	3.0	6.7	5.3	4.9	4.7	4.5	4.2	8.25	7.90	7.31	7.10	6.83	6.83
Turkey	3.5	3.5	3.6	3.8	4.0	4.0	7.5	7.3	6.9	6.5	6.1	5.8	6.08	7.80	9.13	9.06	8.63	8.25
Nigeria	6.5	6.5	6.3	6.6	7.0	6.2	8.5	8.8	10.6	10.8	9.9	9.2	11.75	11.75	12.50	11.25	9.00	9.00
South Africa	1.9	2.8	3.5	3.9	3.7	3.5	5.8	5.6	5.5	5.8	6.0	5.3	5.00	5.00	5.75	6.50	6.50	6.50
Argentina	5.1	3.0	2.0	-2.0	3.5	3.0	10.5	12.4	13.8	50.0	30.0	20.0	16.90	21.51	25.16	28.00	28.00	20.00
Brazil	2.6	2.0	2.0	2.5	3.0	3.0	6.2	6.0	5.7	5.5	5.5	5.5	8.44	10.73	11.90	11.50	11.00	11.00
Mexico	1.2	3.8	4.0	4.4	4.5	4.6	3.8	4.0	3.7	3.6	3.6	3.6	3.94	3.50	3.94	5.40	6.42	6.75
Venezuela	2.0	0.0	2.0	2.0	2.0	2.0	38.8	59.0	63.8	60.0	60.0	60.0	14.50	14.50	14.50	14.80	14.80	14.80

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

Figure 37. Selected Countries — Economic Forecast Overview (Percent), 2013-2018F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F
Global	**0.7**	**0.7**	**0.6**	**0.3**	**0.1**	**0.1**	**-3.7**	**-3.2**	**-2.7**	**-2.5**	**-2.4**	**-2.3**	**88**	**86**	**86**	**85**	**84**	**83**
Based on PPP weights	*0.4*	*0.4*	*0.3*	*0.1*	*-0.1*	*-0.1*	*-3.7*	*-3.2*	*-2.8*	*-2.6*	*-2.6*	*-2.5*	*79*	*79*	*79*	*78*	*77*	*76*
Industrial Countries	**-0.2**	**0.1**	**0.2**	**0.1**	**0.0**	**0.2**	**-4.8**	**-3.8**	**-3.1**	**-2.9**	**-2.6**	**-2.4**	**116**	**114**	**115**	**115**	**114**	**114**
United States	**-2.3**	**-2.0**	**-1.7**	**-1.8**	**-1.7**	**-1.4**	**-5.8**	**-4.6**	**-3.9**	**-3.9**	**-3.8**	**-3.8**	**106**	**107**	**107**	**106**	**106**	**106**
Japan	**0.9**	**1.6**	**1.7**	**1.5**	**1.3**	**1.2**	**-9.8**	**-8.0**	**-6.2**	**-5.8**	**-5.4**	**-5.0**	**244**	**246**	**251**	**255**	**258**	**260**
Euro Area	**2.2**	**2.6**	**2.6**	**2.5**	**2.3**	**2.2**	**-3.0**	**-2.6**	**-2.2**	**-2.1**	**-2.0**	**-1.7**	**96**	**98**	**99**	**99**	**99**	**98**
Canada	-3.2	-4.2	-4.2	-3.8	-3.8	-3.4	-1.0	-0.3	0.2	0.2	0.3	0.4	87	85	85	83	82	81
Australia	-2.5	-3.6	-4.3	-4.5	-4.7	-4.7	-1.2	-2.6	-1.9	-1.0	-0.1	0.3	25	25	25	25	25	25
New Zealand	-3.7	-4.7	-4.9	-3.8	-3.6	-3.3	-2.7	-1.8	-0.7	-0.9	-0.2	1.1	37	40	36	37	38	38
Germany	6.8	6.8	6.2	5.3	4.7	4.4	0.0	0.0	-0.1	-0.3	-0.3	-0.3	79	76	74	71	70	68
France	-1.5	-0.8	-0.1	0.4	0.1	-0.2	-4.1	-3.6	-3.2	-2.9	-2.4	-2.0	94	96	97	98	97	96
Italy	1.1	1.4	1.5	1.6	1.7	1.7	-3.1	-2.8	-2.7	-2.5	-2.6	-2.3	133	137	139	141	142	142
Spain	1.1	2.1	2.6	3.0	3.2	3.4	-6.9	-6.2	-5.4	-4.8	-4.3	-3.9	94	101	105	109	111	112
Greece	0.4	1.6	2.3	3.5	3.9	3.8	-2.9	-2.3	-1.8	-1.3	-0.6	-0.5	175	190	199	202	201	198
Ireland	8.6	10.1	10.4	11.2	12.0	12.7	-7.1	-5.6	-4.0	-3.4	-3.5	-3.1	127	126	127	127	125	122
Portugal	0.7	2.5	2.8	2.9	3.0	3.0	-6.0	-5.0	-4.4	-3.8	-3.4	-3.5	130	141	146	149	151	152
Netherlands	10.2	10.0	8.6	8.1	7.6	7.2	-3.6	-2.9	-2.2	-1.5	-0.6	0.7	75	76	76	76	74	71
Belgium	-3.9	-4.1	-3.9	-3.3	-2.6	-1.7	-2.9	-2.3	-1.5	-1.0	-0.6	0.0	102	103	102	100	97	93
Denmark	6.1	5.8	4.7	4.8	5.1	5.0	-1.6	-1.8	-1.5	-1.0	-1.0	-0.9	47	47	47	47	46	45
Norway	12.8	13.1	13.4	13.7	14.0	14.2	11.3	11.8	11.0	10.0	10.0	9.0	NA	NA	NA	NA	NA	NA
Sweden	6.2	5.9	5.6	5.6	5.4	5.3	-1.4	-1.6	-0.7	0.7	1.4	1.5	40	40	39	36	33	30
Switzerland	12.2	13.0	12.8	13.8	14.0	14.0	0.2	0.6	0.8	1.2	1.2	0.9	48	46	45	45	44	44
United Kingdom	-3.7	-3.0	-3.1	-3.2	-3.1	-2.8	-6.8	-4.9	-3.7	-1.9	-1.0	0.0	93	95	95	94	92	89
Emerging Markets	**1.9**	**1.6**	**1.1**	**0.5**	**0.1**	**-0.1**	**-2.0**	**-2.2**	**-2.1**	**-1.9**	**-2.1**	**-2.1**	**42**	**42**	**42**	**41**	**40**	**40**
China	**2.2**	**2.0**	**1.5**	**0.8**	**0.5**	**0.5**	**-2.0**	**-2.0**	**-1.5**	**-1.5**	**-1.5**	**-1.5**	**45**	**45**	**44**	**43**	**41**	**40**
Taiwan	10.9	9.8	9.5	8.0	8.0	8.0	-1.5	-1.4	-1.2	-1.0	-0.7	-0.5	42	41	42	43	44	44
India	-2.7	-2.4	-2.4	-2.2	-2.1	-1.9	-6.7	-6.4	-6.2	-5.9	-5.6	-5.6	67	66	64	62	61	59
Indonesia	-3.5	-2.8	-2.3	-2.1	-2.0	-2.0	-2.1	-1.8	-1.7	-1.9	-2.0	-2.0	25	26	25	25	25	25
Korea	5.6	4.1	3.2	2.5	1.6	0.6	0.9	2.3	2.3	2.6	2.1	1.8	35	33	31	29	28	27
Czech Republic	0.0	1.3	0.7	1.2	0.0	-1.4	-2.4	-2.9	-2.9	-2.8	-2.5	-2.0	48	49	50	51	51	51
Hungary	1.5	0.9	0.8	0.6	0.4	0.4	-2.9	-3.0	-2.9	-2.9	-3.0	-3.0	79	79	78	77	76	75
Poland	-1.5	-2.4	-3.4	-4.4	-4.5	-4.2	-4.6	5.2	-2.6	-2.5	-2.5	-2.5	55	47	47	46	46	45
Romania	-1.2	-3.1	-4.2	-4.5	-4.5	-4.5	-2.5	-2.3	-2.3	-2.3	-2.3	-2.3	41	40	40	39	39	39
Russia	1.6	1.1	0.8	-0.4	-1.2	-2.1	-2.0	-4.3	-4.9	-1.3	-1.3	-1.3	8	10	14	14	13	13
Turkey	-7.0	-6.3	-5.8	-5.4	-5.0	-4.7	-1.2	-2.8	-3.2	-3.3	-3.3	-3.3	37	37	37	36	35	33
Nigeria	4.3	2.0	2.2	2.1	2.0	1.2	-2.1	-2.9	-2.9	-2.7	-2.5	-2.4	NA	NA	NA	NA	NA	NA
South Africa	-7.1	-5.7	-5.3	-4.7	-4.6	-4.7	-4.4	-4.3	-4.4	-4.2	-4.0	-3.8	46	47	49	50	49	50
Argentina	-0.5	-0.4	-0.4	3.0	1.0	1.0	-2.3	-3.1	-2.3	0.0	-0.5	-1.0	40	44	50	48	47	46
Brazil	-3.5	-3.4	-3.1	-3.1	-3.1	-3.1	-3.6	-3.9	-2.7	-3.2	-3.2	-3.2	59	60	60	60	60	60
Mexico	-1.7	-1.9	-1.7	-1.3	-1.4	-1.5	-2.4	-3.5	-2.5	-2.0	-2.0	-2.0	38	38	38	37	37	37
Venezuela	3.6	3.8	3.3	3.0	3.0	3.0	-11.7	-11.8	-11.9	-12.4	-12.6	-12.1	41	43	42	43	44	45

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

Figure 38. Selected Countries — Changes in Economic Forecasts (Percentage Points), 2013-2015F

	GDP Growth			CPI Inflation			Current Balance (Pct of GDP)			Fiscal Balance (Pct of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Global	**-0.1**	**-0.1**	**-0.1**		**0.1**	**-0.3**			**0.2**	**-0.2**	**-0.2**	**-0.1**
Based on PPP weights			*-0.1*		*0.1*	*-0.3*			*0.2*	*-0.3*	*-0.1*	*-0.1*
Industrial Countries			**-0.1**		**-0.1**		**-0.1**	**0.1**	**0.3**	**-0.4**	**-0.2**	**-0.2**
United States	**0.1**	**0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.2**	**0.6**	**1.0**	**-1.0**	**-0.3**	**-0.1**
Japan	**-0.1**	**-0.2**	**-0.1**	**0.2**	**0.2**	**-0.1**	**-0.6**	**-0.8**	**-0.1**			
Euro Area	**-0.1**	**0.1**		**-0.1**	**-0.4**	**-0.6**	**-0.4**	**0.1**	**0.1**	**-0.2**	**-0.3**	**-0.4**
Canada	0.1		-0.2					-0.9	-1.0			0.2
Australia		-0.1		0.1	0.1	-0.1	-0.1	-0.3	-1.0		-0.1	-0.4
New Zealand	-0.2		0.7	0.3	0.2	-0.2	2.4	5.6	4.7	-0.1	-0.1	-0.2
Germany	-0.1				-0.1	-0.2	-0.1	0.9	1.0		-0.2	-0.3
France				-0.1	-0.5	-0.1	0.1		0.1	-0.1	-0.1	-0.1
Italy	-0.1	0.1	0.3	-0.1	-0.7	-0.9			0.1			0.1
Spain		0.1	0.1	-0.2	-1.3	-1.0		0.3	0.3	-0.1	-0.3	-0.5
Greece	0.5	1.0	0.9	-0.2	-1.7	-1.9	0.8	0.8	0.9	1.8	1.7	1.0
Ireland												
Portugal	0.1	0.1	0.4	-0.1	-0.3	-0.9	-0.6	-0.8	-0.9			0.1
Netherlands	0.1	0.1		-0.1	-0.1	-0.2	0.8	1.1	-0.9	0.3	0.5	0.6
Belgium	0.1	0.1			-0.4	-0.7	-0.3	-0.9	-1.4	0.1	0.3	0.3
Denmark	0.1		0.1				0.7	0.7	0.5	0.4	-0.3	-0.5
Norway		-0.1	-0.1		0.4	0.2				-0.8		-1.8
Sweden	0.3	-0.1	-0.1		-0.1		0.3	0.3	0.3			
Switzerland	0.3	0.5	0.3		-0.4	-0.3	-0.7		-0.1	-0.5	-0.3	
United Kingdom	0.1	0.2			-0.2	-0.3	0.1	-0.1	-0.2	0.1	0.7	0.8
Emerging Markets	**-0.1**	**-0.1**	**-0.2**		**0.3**	**0.3**			**0.1**		-0.1	-0.1
China		**0.1**			**0.3**							
Taiwan	-0.6	-0.6	-0.2	-0.1		0.3	0.7	0.8	1.5	-0.3	-0.1	-0.2
India							1.0	0.2	0.3			
Indonesia							-0.2	-0.1	-0.3			
Korea				-0.1	-0.1	-0.1	0.5	0.9	1.2			
Czech Republic	-0.3	0.2	0.1		0.3	0.5	0.6	2.0	1.8	0.4		
Hungary	0.4	0.1	0.4	-0.2	-0.4	-0.2	0.2	-0.3	-0.9		0.3	0.1
Poland	0.1		0.3		-0.2	0.3	0.6	0.6	0.1	-0.3	0.4	0.3
Romania	0.9		-0.2	-0.1	-0.5	-0.4	0.3	0.9	0.5	-0.3	0.2	
Russia		-0.2	-0.5		-0.1	-0.1		0.2	2.5		-0.1	-0.3
Turkey		-0.5	-0.6	0.2			-0.1	0.3	0.5		-0.1	-0.5
Nigeria							2.7	1.6	1.5	0.5	0.5	0.5
South Africa	-0.2	-0.1	0.1	-0.1	0.1	-0.1	-1.1	-0.1	-0.2	0.6	0.5	
Argentina	-0.2			0.1	-0.2			0.2	0.1	-0.2	-0.3	-0.3
Brazil					0.1			-0.2	-0.1	0.2	-0.2	-0.1
Mexico					0.5		0.1	0.1	0.1			
Venezuela	-0.3	-2.8	-0.1	1.2	15.6	28.8	0.1	-5.2	-2.9	-7.7	-7.8	-7.1

Source: Citi Research

Figure 39. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2013-2018F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F	2013F	2014F	2015F	2016F	2017F	2018F
Industrial Countries																		
United States	**2.30**	**3.04**	**3.55**	**3.85**	**4.15**	**4.35**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.32**	**1.39**	**1.40**	**1.40**	**1.40**	**1.40**
Japan	**0.71**	**0.59**	**1.00**	**1.25**	**1.50**	**1.50**	**98**	**104**	**105**	**105**	**105**	**105**	**130**	**145**	**147**	**147**	**147**	**147**
Euro Area	**1.60**	**1.80**	**2.00**	**2.25**	**2.50**	**2.75**	**1.32**	**1.39**	**1.40**	**1.40**	**1.40**	**1.40**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	2.25	2.91	3.45	3.70	3.95	4.00	1.04	1.08	1.08	1.08	1.08	1.08	1.37	1.50	1.51	1.51	1.51	1.51
Australia	3.65	4.30	4.75	5.50	5.50	5.80	0.95	0.89	0.90	0.91	0.92	0.92	1.39	1.57	1.56	1.54	1.53	1.51
New Zealand	4.00	5.25	6.15	6.40	6.40	6.70	0.82	0.82	0.81	0.80	0.78	0.76	1.62	1.69	1.72	1.76	1.81	1.85
Germany	1.60	1.80	2.00	2.25	2.50	2.75												
France	2.15	2.26	2.45	2.70	2.95	3.20												
Italy	4.25	3.80	3.75	4.00	4.25	4.50												
Spain	4.55	3.75	3.50	3.75	4.00	4.25												
Netherlands	1.95	2.15	2.35	2.60	2.85	3.10												
Belgium	2.40	2.60	2.65	2.90	3.15	3.40												
Denmark	1.75	2.10	2.10	2.40	2.75	3.00	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	2.55	2.95	2.85	3.00	3.25	3.50	6.01	5.76	5.44	5.27	5.15	5.03	7.94	8.00	7.61	7.38	7.21	7.05
Sweden	2.10	2.55	2.75	2.85	3.00	3.25	6.59	6.52	6.30	6.14	5.98	5.84	8.72	9.07	8.83	8.59	8.38	8.18
Switzerland	0.80	1.00	1.20	1.45	1.70	1.90	0.93	0.90	0.91	0.92	0.92	0.92	1.23	1.25	1.28	1.29	1.29	1.29
United Kingdom	2.35	3.10	3.60	3.80	4.00	4.20	1.58	1.73	1.75	1.75	1.75	1.75	0.84	0.80	0.80	0.80	0.80	0.80
Emerging Markets																		
China	**3.90**	**4.02**	**4.40**	**4.77**	**5.15**	**5.40**	**6.14**	**6.05**	**6.01**	**6.01**	**6.03**	**6.05**	**8.11**	**8.41**	**8.42**	**8.42**	**8.45**	**8.47**
Taiwan	1.52	1.82	2.32	1.70	2.00	2.50	29.73	29.24	29.04	28.80	28.54	28.29	39.31	40.64	40.66	40.33	39.95	39.60
India	8.25	8.50	8.50	8.50	8.50	8.50	59.95	62.98	59.26	56.97	55.57	54.3	79.25	87.54	82.96	79.76	77.80	76.0
Indonesia	7.37	8.39	8.75	8.75	8.75	8.75	10737	11795	11199	10633	10133	9665	14195	16395	15678	14886	14187	13531
Korea	3.03	3.59	4.03	4.30	4.55	4.75	1096	1032	1003	993	991	989	1448	1434	1404	1391	1387	1384
Czech Republic	2.10	2.27	2.39	2.61	2.97	3.20	19.8	19.4	18.7	18.0	17.2	16.5	26.2	26.9	26.2	25.2	24.1	23.1
Hungary	5.98	6.29	6.68	6.50	6.50	6.50	227	222	221	223	226	228	300	309	310	312	316	319
Poland	4.05	4.69	4.97	5.15	4.99	0.48	3.20	3.00	2.89	2.84	2.82	2.79	4.23	4.17	4.04	3.98	3.94	3.91
Romania	NA	NA	NA	NA	NA	NA	3.34	3.22	3.19	3.13	3.06	3.00	4.42	4.48	4.47	4.38	4.29	4.20
Russia	NA	NA	NA	NA	NA	NA	32.3	32.7	33.1	33.3	33.3	33.3	42.7	45.5	46.4	46.6	46.6	46.6
Turkey	NA	NA	NA	NA	NA	NA	1.96	2.09	2.08	2.05	2.03	2.01	2.59	2.91	2.91	2.87	2.84	2.81
Nigeria	NA	NA	NA	NA	NA	NA	159	164	168	171	175	180	211	227	235	239	245	252
South Africa	7.20	7.73	8.04	8.14	8.38	8.77	9.85	10.36	10.29	10.31	10.39	10.47	13.03	14.39	14.40	14.44	14.55	14.66
Argentina	NA	NA	NA	NA	NA	NA	5.52	7.44	10.04	15.72	22.00	25.35	7.30	10.34	14.06	22.01	30.81	35.49
Brazil	9.73	12.75	14.25	13.13	11.75	11.75	2.19	2.42	2.49	2.43	2.34	2.25	2.90	3.37	3.48	3.40	3.27	3.15
Mexico	5.60	6.56	7.12	7.46	7.95	8.00	12.8	12.6	12.4	12.3	12.3	12.3	16.9	17.5	17.3	17.2	17.2	17.2
Venezuela	10.91	10.67	10.56	15.50	15.50	15.50	6.13	10.00	16.50	26.07	41.19	65.08	8.11	13.90	23.10	36.50	57.67	91.11

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

Figure 40. Short Rates (End of Period), as of 2 December 2013 (Percent)

	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
United States	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**	**0.25**
Japan	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**	**0.10**
Euro Area	**0.25**	**0.25**	**0.00**	**0.00**	**0.00**	**0.00**	**0.00**
Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Australia	2.50	2.50	2.50	2.50	2.50	2.75	3.25
New Zealand	2.50	2.75	3.00	3.25	3.75	4.25	4.50
Denmark	0.20	0.20	0.10	0.10	0.10	0.20	0.20
Norway	1.50	1.50	1.50	1.50	1.50	1.50	1.75
Sweden	1.00	0.75	0.75	0.75	0.75	0.75	1.00
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50	0.75
China	**3.00**	**3.00**	**3.00**	**3.00**	**3.25**	**3.50**	**3.75**

Note: The rates shown are overnight rates, except for Denmark, where it is the central bank's lending rate; Switzerland, where it is the SNB's three-month Libor target; and China, where it is the one-year deposit rate. Source: Citi Research

Figure 41. 10-Year Yield Forecasts (Period Average), as of 2 December 2013 (Percent)

	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
United States	**2.75**	**2.80**	**2.95**	**3.15**	**3.25**	**3.40**	**3.50**
Japan	**0.60**	**0.55**	**0.50**	**0.60**	**0.70**	**0.90**	**1.00**
Euro Area (Germany)	**1.70**	**1.70**	**1.70**	**1.70**	**1.80**	**1.90**	**1.90**
Canada	2.55	2.60	2.85	3.05	3.15	3.30	3.40
Australia	4.32	4.30	4.40	4.50	4.60	4.75	4.95
New Zealand	4.73	4.90	5.10	5.40	5.60	6.00	6.20
Denmark	1.74	1.80	1.80	1.80	1.90	2.00	2.00
Norway	2.74	2.85	2.85	2.80	2.90	2.80	2.75
Sweden	2.26	2.40	2.40	2.45	2.55	2.65	2.65
Switzerland	0.87	1.02	1.02	1.02	1.07	1.11	1.11
United Kingdom	2.78	2.85	3.05	3.20	3.30	3.40	3.50

Note: Bond yields measured on local market basis (semi-annual for the United States, United Kingdom, Canada, Australia, and New Zealand; annual for the rest). The 10-year yield for the euro area is the Bund yield. Source: Citi Research

Figure 42. 10-Year Yield Spreads (Period Average), as of 2 December 2013

	Spread vs. US$						Spread vs. Germany					
	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**107**	**112**	**127**	**147**	**148**	**153**
Japan	**-222**	**-232**	**-237**	**-247**	**-238**	**-243**	**-115**	**-120**	**-110**	**-100**	**-90**	**-90**
Euro Area	**-107**	**-112**	**-127**	**-147**	**-148**	**-153**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	-20	-20	-10	-10	-10	-10	87	92	117	137	137	143
Australia	160	153	148	138	138	138	267	265	275	285	285	291
New Zealand	202	214	219	230	240	266	309	326	347	377	388	419
France	-59	-62	-82	-102	-103	-108	46	50	45	45	45	45
Italy	130	108	83	53	27	22	235	220	210	200	175	175
Spain	137	118	93	33	2	-3	242	230	220	180	150	150
Netherlands	-72	-77	-92	-112	-113	-118	33	35	35	35	35	35
Belgium	-41	-32	-42	-72	-78	-88	64	80	85	75	70	65
Austria	-71	-72	-92	-112	-113	-118	34	40	35	35	35	35
Finland	-85	-87	-102	-122	-123	-128	20	25	25	25	25	25
Ireland	74	63	38	8	-13	-18	179	175	165	155	135	135
Denmark	-101	-102	-117	-137	-138	-143	4	10	10	10	10	10
Norway	-1	3	-17	-37	-58	-68	104	115	115	110	110	90
Sweden	-49	-42	-52	-72	-73	-78	56	70	70	75	75	75
Switzerland	-188	-180	-195	-215	-221	-232	-83	-68	-68	-68	-73	-79
United Kingdom	3	5	10	5	5	0	108	117	137	153	153	153

NA Not applicable. Note: Spreads calculated on annual basis (except those of the United Kingdom, Canada, Australia and New Zealand over the United States).
Source: Citi Research

Figure 43. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 2 December 2013

Country	Current Rate (%)	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Total Cumulative Rate Moves Expected
Turkey	6.34	86	30	50	50	25	241
Brazil	10.00	75	0	0	0	100	175
Poland	2.50	0	0	25	25	50	100
Hungary	3.20	-40	0	25	75	20	80
Philippines	3.50	0	0	25	25	25	75
China	3.00	0	0	0	25	25	50
Indonesia	5.75	25	0	0	0	25	50
Israel	1.00	0	0	0	50	0	50
South Africa	5.00	0	0	0	0	50	50
India	7.75	25	0	0	0	0	25
Korea	2.50	0	0	0	0	25	25
Mexico	3.50	0	0	0	0	0	0
Thailand	2.25	-25	0	0	0	25	0
Peru	4.00	-50	0	0	0	0	-50
Chile	4.50	-50	0	0	0	0	-50
Russia	8.25	-25	-25	0	0	-25	-75

Note: *For Turkey we use the average funding rate of the CBT instead of the 1-week repo rate. Source: Citi Research

Figure 44. Foreign Exchange Forecasts (End of Period), as of 2 December 2013

	vs. USD						vs. EUR					
	Current	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Current	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15
United States	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**	**1.34**	**1.37**	**1.39**	**1.40**	**1.40**	**1.40**
Japan	**101**	**103**	**104**	**105**	**105**	**105**	**135**	**141**	**145**	**147**	**147**	**147**
Euro Area	**1.34**	**1.37**	**1.39**	**1.40**	**1.40**	**1.40**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Canada	1.05	1.07	1.08	1.08	1.08	1.08	1.41	1.46	1.49	1.51	1.51	1.51
Australia	0.93	0.90	0.89	0.88	0.89	0.89	1.45	1.53	1.57	1.59	1.58	1.57
New Zealand	0.82	0.83	0.82	0.82	0.82	0.82	1.64	1.66	1.69	1.71	1.71	1.72
Norway	6.12	5.94	5.80	5.68	5.61	5.54	8.22	8.15	8.05	7.96	7.86	7.76
Sweden	6.64	6.64	6.55	6.48	6.43	6.38	8.92	9.10	9.10	9.07	9.00	8.93
Switzerland	0.92	0.90	0.90	0.90	0.90	0.91	1.23	1.24	1.25	1.25	1.26	1.27
United Kingdom	1.61	1.69	1.73	1.75	1.75	1.75	0.83	0.81	0.80	0.80	0.80	0.80
China	**6.09**	**6.07**	**6.06**	**6.05**	**6.04**	**6.03**	**8.2**	**8.3**	**8.4**	**8.5**	**8.4**	**8.4**
India	62.9	63.5	63.5	63.0	61.9	60.8	84.6	87.0	88.2	88.2	86.7	85.2
Korea	1063	1045	1035	1027	1020	1013	1428	1432	1438	1438	1428	1418
Poland	3.12	3.06	3.01	2.97	2.95	2.92	4.19	4.19	4.18	4.16	4.13	4.09
Russia	33.0	32.7	32.7	32.7	32.8	33.0	44.3	44.9	45.4	45.8	46.0	46.1
South Africa	10.16	10.31	10.37	10.39	10.36	10.33	13.65	14.13	14.40	14.54	14.50	14.46
Turkey	2.02	2.08	2.09	2.10	2.09	2.09	2.72	2.85	2.91	2.94	2.93	2.92
Brazil	2.30	2.36	2.42	2.45	2.46	2.47	3.09	3.24	3.36	3.44	3.45	3.46
Mexico	13.1	12.6	12.6	12.6	12.5	12.5	17.7	17.3	17.5	17.6	17.5	17.4

Source: Citi Research

Figure 45. Foreign Exchange Forecasts (End of Period), as of 2 December 2013

	vs. JPY					
	Current	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15
United States	**101**	**103**	**104**	**105**	**105**	**105**
Japan	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
Euro Area	**135**	**141**	**145**	**147**	**147**	**147**
Canada	96	97	97	97	97	97
Australia	93	93	93	93	93	93
New Zealand	82.8	85.3	85.8	86.0	85.8	85.6
Norway	16.5	17.4	18.0	18.5	18.7	19.0
Sweden	15.2	15.5	15.9	16.2	16.3	16.5
Switzerland	110	114	116	117	117	116
United Kingdom	163	174	180	184	184	184
China	**17**	**17**	**17**	**17**	**17**	**17**
India	1.60	1.63	1.64	1.67	1.70	1.73
Korea	10.54	10.12	9.92	9.78	9.71	9.65
Poland	32.3	33.8	34.6	35.3	35.6	35.9
Russia	3.1	3.2	3.2	3.2	3.2	3.2
South Africa	9.9	10.0	10.1	10.1	10.1	10.2
Turkey	49.9	49.6	49.8	50.1	50.2	50.3
Brazil	43.8	43.7	43.2	42.8	42.6	42.4
Mexico	7.7	8.2	8.3	8.4	8.4	8.4

Source: Citi Research

Country Commentary

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With diminishing headwinds and ongoing support from Fed accommodation, the US economic expansion is expected to continue over the next couple of years. Over the two-year horizon, we expect above-trend growth averaging roughly 2¾% (full-year basis) with unemployment declining to less than 6% by late 2015. Although the recovery is now in its fifth year, it still has the upside of significant cyclical headroom in substantial labor and resource slack. Moreover, it does not show evidence of the sectoral imbalances that often doom mature cycles. A key hurdle is that policy uncertainties at times have undermined business and consumer confidence: Fed communications fumbles have compounded the effects of a dysfunctional fiscal policy process. Nonetheless, financial conditions now are extremely accommodating and the short-term fiscal outlook is shifting from considerable drag to an almost neutral stance in 2014.

The transition to a new Fed Chair and the fate of budget sequestration are two pressing issues in the immediate outlook. Janet Yellen's nomination to succeed Ben Bernanke appears on track and with Fed policy missing on both ends of its dual mandate, the main challenge next year will likely focus on phasing out asset purchases while relying more on anchoring short-term rate expectations as a way to sustain accommodation.

On fiscal policy, chances of major tax and budget reforms appear remote at best, and both sides are seeking minimal ways to undo some of the constraints on discretionary spending. We don't think another shutdown or debt limit crisis is likely but it may be too much to expect that reliance on continuing resolutions will be overcome next year. We expect fiscal drag of less than a half point and would not rule out something closer to zero if the remaining $20 billion of sequester-related drag in calendar 2014 is offset.

Ever since the Fed hesitated to taper QE in September, market participants have been unsure about the key policy drivers. The FOMC cited higher rates, downside risks from fiscal policy and reduced confidence in sustained labor market improvement, but on all three counts events so far hint that officials' concerns may be overdone. In particular, financial conditions are looser despite higher rates and solid job growth has been reaffirmed in typical revisions to soft summer data. Policymakers seem quite willing to err on the side of ease and may be waiting for especially compelling signs of a virtuous cycle of self-sustaining demand, employment and growth that can withstand modestly higher bond yields.

Our base case is that tapering will be announced in March and that the balance sheet expansion will peak next September, followed by initial rate hikes possibly in 3Q 2015 as unemployment nears 6%. In the lead-up to this forecast round, rate markets appear to be more accepting of the Fed's assertions that tapering is not tightening and that unwinding QE does not imply an earlier normalization of short rates. Rates out to five years have held more or less in check in the period following more favorable payroll gains, in part on signs that inflation has remained well below the Fed's 2% target and closer to 1%. We think forward guidance could embrace more formally the view that rates are unlikely to rise until unemployment is considerably below 6½% or as long as inflation is expected to remain below target for some time.

Unlike previous years in the current upturn, Fed policy in 2013 can claim notable successes in promoting highly accommodative financial conditions. The Citi FCI has averaged plus one sigma or better for a year running, the most favorable backdrop

since the late 1990s. Bank credit terms and standards have traced a similar pattern with all major loan categories looser, including a modest net improvement in mortgage credit availability in the two most recent quarterly surveys. The sudden back up in mortgage rates combined with sharply higher home prices have stalled the housing rebound and the sector's revival seems impeded in part by limited inventory that may be slow to normalize. We still expect solid growth in residential investment, especially as employment and income continue to gain, but we have trimmed back how much this sector is likely to contribute to overall expansion.

Although unemployment is still relatively high, job growth is very broad-based (six-month diffusion at 65%) and more than adequate to bring down the jobless rate now that housing-related and state and local employment are rebounding. The combination of improved hiring surveys, slowing productivity and better than average profit margins suggests payroll gains should remain close to or better than the recent 185,000 pace. Along with slightly faster wage gains, the job recovery is expected to bolster household income and spending, in turn lifting business investment at a faster rate.

We expect inflation to remain below the Fed's 2% medium-term target near term with some modest firming as the expansion matures and global growth picks up. The recent slowing in inflation has been dominated by a relative price shock in commodities as rents, medical care, transportation and other core services are rising at a 2½% pace. Nominal income and demand are well supported, unit labor costs are accelerating modestly and household surveys as well as business pricing intentions all suggest that risks of an undesirable disinflation or worse are very low.

Figure 46. United States — Economic Forecasts, 2013-2015F

					2013		2014				2015	
		2013F	2014F	2015F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
GDP	SAAR				3.3%	1.0%	3.3%	2.8%	3.0%	3.2%	3.2%	3.0%
	YoY	1.7%	2.7%	3.1%	1.8	2.0	2.5	2.6	2.5	3.1	3.1	3.1
Domestic Demand	SAAR				1.7	2.0	3.2	3.0	3.3	3.2	3.2	3.0
	YoY	1.5	2.7	3.1	1.4	1.6	2.2	2.5	2.9	3.2	3.2	3.2
Consumption	SAAR				1.5	2.7	2.9	3.0	3.2	3.2	3.2	3.0
	YoY	1.9	2.7	3.1	1.8	2.1	2.2	2.5	2.9	3.1	3.2	3.1
Business Investment	SAAR				1.6	4.0	4.7	5.0	5.2	5.2	4.9	4.4
	YoY	2.2	4.3	4.8	2.7	1.4	3.7	3.8	4.7	5.0	5.1	4.9
Housing Investment	SAAR				14.6	8.7	13.4	16.2	17.6	13.5	13.0	11.4
	YoY	13.9	13.8	12.6	15.3	12.5	12.7	13.2	13.9	15.2	15.1	13.8
Government	SAAR				0.2	-3.0	1.4	-0.5	-0.3	-0.2	0.3	0.2
	YoY	-2.1	-0.4	0.0	-2.8	-1.9	-0.5	-0.5	-0.6	0.1	-0.2	0.0
Exports	SAAR				3.1	4.2	4.2	4.5	3.9	4.2	4.5	4.4
	YoY	2.3	4.3	4.4	2.7	3.4	4.8	4.0	4.2	4.2	4.3	4.2
Imports	SAAR				2.0	2.6	3.8	5.1	4.6	4.6	4.7	4.4
	YoY	1.4	3.9	4.5	1.5	3.0	3.8	3.3	4.0	4.5	4.7	4.5
PCE Deflator	YoY	1.1	1.8	2.0	1.1	1.0	1.3	1.9	1.9	2.1	2.1	2.0
Core PCE Deflator	YoY	1.3	1.8	2.0	1.2	1.2	1.4	1.8	2.0	2.1	2.1	2.0
Unemployment Rate	%	7.5	6.8	6.1	7.3	7.3	7.1	6.9	6.6	6.4	6.3	6.2
Federal Gov't Balance (Fiscal Year)	$Bn	-680	-550	-435								
	% of GDP	-4.1	-3.2	-2.4								
General Gov't Balance (Cal Year)	% of GDP	-5.8	-4.6	-3.9								
Federal Debt	% of GDP	72	73	73								
General Gov't Debt	% of GDP	106	107	107								
Current Account	US$bn	-392	-348	-314	-403	-349	-346	-352	-350	-343	-336	-322
	% of GDP	-2.3	-2.0	-1.7	-2.4	-2.1	-2.0	-2.0	-2.0	-1.9	-1.9	-1.8
S&P 500 Profits (US$ Per Share)	YoY	5.5	6.2	NA	4.2	7.6	6.2	5.6	7.0	5.9	NA	NA

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

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We expect a bumpy ride in the economy in 2014. The consumption tax hike from 5% currently to 8% in April 2014 likely will provide strong distortions to economic activity. Most notably, the 3%-point hike in the tax rate in the context of only modest growth in wages is expected to erode real purchasing power of household income and weigh on household spending materially. Meanwhile, "policy offsets" to mitigate the negative impact from the tax hike are probably not sufficient, in our view. In this environment, the Bank of Japan (BoJ) is likely to implement an additional easing measure in the form of increased purchases of JGBs and risk assets in 2014, although a timing of the action will probably be June or July 2014, so after the consumption tax hike in April.

We expect solid GDP growth of annualized 3.4% in the current quarter and 5.0% in the next quarter but a sharp contraction of -4.8% in the second quarter of 2014 (see Figure 47). Frontloaded demand ahead of the consumption tax hike likely will push up activity artificially over the near term, but payback to frontloaded demand, along with erosion in real purchasing power of household nominal income, will probably cause a sharp fall in household spending right after the tax hike. While we believe that negative growth is confined to the second quarter, it will probably take 4-5 quarters for real GDP to regain the pre-tax hike levels in the first quarter of 2014.

Meanwhile, policy offsets to mitigate the negative impact from the tax hike (to be finalized this month) are unlikely to be sufficient. First, whether additional public works spending in the upcoming economic package is implemented smoothly, in a way that can offset the negative impact from the tax hike is quite uncertain as Japan's construction sector is facing supply constraints such as labor shortages. Second, a planned reduction in the effective corporate tax rate from 38% currently to 35.6% in FY2014 is a token action and probably will not change corporate behavior meaningfully. Lastly, new and broadened tax incentives for private capex will probably have only a modest impact on investment, mostly because the proportion of Japanese companies facing liquidity constraints is very low with the corporate sector having large excess saving.

Significant attention is currently being paid to whether or not wages are raised in the wage negotiations in spring 2014. The Abe Administration decided to broaden tax incentives for companies to increase compensation and also is repeatedly suggesting that companies should reflect improving profits to compensation. Indeed, some representative companies indicated intentions to hike base salaries next spring. However, salaries paid by large firms are only a quarter of total salaries while small- and medium-sized firms account for three quarters. If as we anticipate, smaller firms, which are heavily dependent on household demand, are concerned about the negative impact from the consumption tax hike in the new fiscal year, we think they are unlikely to increase base salaries meaningfully.

We expect core inflation (excluding fresh food but including energy) to start falling again next spring with positive impacts from energy prices expected to taper off. In our view, service prices are unlikely to rise clearly if wage growth next year is modest and private consumption (including spending on services) slows because of the consumption tax hike. We expect core inflation (adjusted for a direct 2%-point impact from the tax hike) to fall from 1.0% YoY in the first quarter to 0.6% YoY in the third quarter. We continue to believe that it is quite difficult for the BoJ to meet its 2% inflation target in two years.

With this economic backdrop, the BoJ likely will implement additional easing measures in 2014. We expect that policymakers will decide on additional action in the wake of likely disappointing wages data for April 2014 (to be published in late

May) and the negative impact from the consumption tax hike. In our view, a concrete timing of the next action will likely be June or July (in July, policymakers make an interim review of their semiannual economic outlook). However, we cannot dismiss the possibility that the BoJ acts in a more forward-looking manner, especially if medium- to long-term inflation expectations do not pick up. Moreover, the BoJ is already committed to extending the current policy framework into 2015, if policymakers judge that they will not be able to achieve a 2% inflation target on a sustained basis by around the end of 2014.

We expect the BoJ's next action will be increased purchases of risk assets, in particular ETFs, and JGBs. More specifically, we assume that the BoJ will increase monthly JGB purchases by ¥1 trillion (annualized ¥12 trillion yen) and annual ETF purchases by ¥2-4 trillion, so from ¥1 trillion currently to ¥3-5 trillion, resulting in an around ¥15 trillion increase (roughly 3% of GDP) in the asset purchase program. These actions likely will eventually lead to further yen depreciation and higher equity markets, in our view.

Finally, the Abe Administration is still struggling to craft a compelling "growth strategy" (a third arrow of *Abenomics*). The Administration so far announced deregulation regarding healthcare, agriculture, real property markets and so forth, introduction of the Special Strategic Districts (where tax cuts and deregulation are implemented ahead of other regions), a decision to participate in the TPP (Transpacific Partnership Agreement) negotiation, new and broadened tax incentives for companies to increase investment and compensation, and a prospective modest reduction in the effective corporate tax rate. However, whether and to what extent these measures will improve the medium- to long-term growth potential of the economy is quite questionable. In our view, the Administration likely will have to redefine its growth strategy in the coming year.

Figure 47. Japan — Economic Forecasts, 2013-2015F

					2013		2014				2015	
		2013	2014F	2015F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	1.8%	1.6%	0.9%	2.6%	3.3%	3.5%	1.3%	1.0%	0.5%	-0.4%	1.2%
	SAAR				1.9	3.4	5.0	-4.8	0.9	1.2	1.5	1.1
Domestic Demand	YoY	1.9	0.9	0.5	2.6	3.2	3.3	0.8	0.1	-0.5	-0.9	1.2
	SAAR				3.5	3.6	3.0	-6.6	0.6	1.3	1.4	1.3
Private Consumption	YoY	1.7	0.4	0.5	1.9	2.4	3.1	-0.4	-0.3	-0.8	-1.9	1.5
	SAAR				0.4	3.8	6.0	-10.7	0.6	1.7	1.4	2.3
Business Investment	YoY	-1.3	4.2	3.9	0.1	3.0	4.5	3.8	4.6	4.0	3.5	4.0
	SAAR				0.7	6.9	6.2	1.6	3.8	4.3	4.1	3.9
Housing Investment	YoY	8.4	-5.9	0.4	8.8	8.0	3.6	-5.8	-9.9	-10.9	-6.4	4.2
Public Investment	YoY	15.0	0.8	-8.7	18.2	15.6	9.5	5.3	-2.8	-7.4	-6.5	-9.6
Exports	YoY	1.7	5.1	4.5	3.2	8.0	5.5	4.0	5.8	5.3	5.0	4.5
	SAAR				-2.4	6.5	6.3	5.9	4.3	4.5	5.3	3.9
Imports	YoY	2.9	1.1	2.9	3.2	7.2	4.4	1.1	-0.2	-0.9	2.1	5.2
	SAAR				9.2	8.7	-6.5	-5.8	3.4	6.0	5.1	6.2
CPI	YoY	0.3	2.3	1.4	0.9	1.1	1.2	3.1	2.6	2.4	2.4	0.5
Core CPI	YoY	0.3	2.2	1.4	0.7	1.0	1.0	2.8	2.6	2.4	2.4	0.5
Nominal GDP	YoY	1.4	2.7	1.0	0.4	1.1	1.3	0.1	-0.1	0.5	0.5	0.2
Current Account	¥ tn	4	8	8	1	1	2	2	2	2	2	2
	% of GDP	0.9	1.6	1.7	0.1	0.2	0.3	0.4	0.4	0.4	0.4	0.4
Unemployment Rate	%	4.0	3.8	3.9	4.0	3.9	3.8	3.7	3.9	3.9	3.9	3.8
Industrial Production	YoY	-0.4	4.3	1.3	2.3	6.5	7.6	5.0	3.4	1.4	0.3	1.7
Corporate Profits (Fiscal Year)	YoY	5.0	40.0	5.0								
General Govt. Balance (Fiscal Year)	% of GDP	-9.8	-8.0	-6.2								
General Govt Debt	% of GDP	244	246	251								

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

Euro Area

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The euro area is recovering, albeit at a crawling pace. The process started in 2Q-13 and continued in Q3 when GDP rose by 0.1% QQ (0.36% annualised), leaving annual GDP growth in negative territory (-0.4% YY). The rebound in economic activity during 2014 (0.9%) and 2015 (1.0%) is expected to be slow and uneven, given persistent headwinds from private sector deleveraging, a strong euro and high unemployment. With governments having made significant progress in terms of fiscal consolidation, and with austerity fatigue now pervasive, fiscal policy should turn broadly neutral in 2014 removing of the major drags of previous years. Despite some improvement, domestic demand is underperforming compared to previous recoveries. The resulting large output gap has been a key factor in the rapid disinflationary phase of the last 22 months. With the balance of risks around the outlook for inflation skewed to the downside, we expect the ECB to cut its key interest rates in H1-14 and introduce additional non-standard measures. However, we doubt that downside surprises to its inflation mandate will be sufficiently large to overcome reluctance to engage in large scale sovereign bond purchases/QE.

Banking Union

Banking union will be one of the important developments. The ECB is meant to take over as supervisor of the major euro area banks in November 2014 and will carry out a 'comprehensive assessment' of these banks, including an asset quality review, before then. While some key issues remain, we are modestly optimistic that this assessment will be much more rigorous than prior pan-European stress tests. Euro area banks have deleveraged and built up capital in recent years to an extent, but residual losses and capital needs are uncertain and could still be large. As sizeable bail-outs of banks are unlikely in most countries, bail-ins of bank creditors could then play a major role. Even with a relatively credible assessment and stress test, convergence in financial conditions across euro area countries looks unlikely, although aggregate credit growth should turn positive in 2014.

Bailout programme countries

Three bailout programmes will expire over the next seven months. Ireland and Spain have announced they will exit theirs in Dec-13 with no additional support required. The case for Portugal (programme to end in Jun-14) is more complicated, as the country is at a less advanced stage in its economic rebalancing and 10-Y yields are still about 250bp above Ireland. Weak nominal GDP growth and additional transfers of private sector liabilities onto the government balance sheet will likely keep the public debt/GDP ratio rising over the next few years. While a precautionary credit line is marginally more likely after Jun-14, risks of a full second bailout are high. We do not expect PSI on Portuguese sovereign debt in 2014, but some restructuring of non-marketable government liabilities is likely. Additional OSI for Greece also is likely in 2014, but it will probably not be sizable enough to restore debt sustainability. Finally, Slovenia may be the sixth euro area country to request external financial assistance in 2014.

Inflation and ECB rate outlook

Two consecutive weak and below-consensus inflation prints in September and October, together with the strengthening euro, reignited concerns about deflationary risks in the euro area and prompted the ECB to cut its refi rate by 25bp to 0.25% in November. Our inflation model predicts euro area core inflation continuing to fall in 2014 and in 2015, getting close to 0% YY by end-2015. As a result, our inflation forecast has headline inflation averaging 0.9% in 2014 and 0.7% in 2015. All eyes will be on the ECB's new inflation projection to be published at the 5 December Governing Council (GC) meeting to get a sense of the likelihood of additional policy action. We believe that the 2015 mid-point inflation forecast will be just above 1%, a little lower than the forecast for 2014. The key question is for how long, and what the ECB will do if inflation were to drift lower in the next 12 months?

While we think that the ECB will be keen to keep its policy options open and talk about various tools, we see four main options. We believe that the **first** option would involve some enhancement to forward guidance. This would be, in our view, the path of least resistance for most GC members, with rates already very close to the zero lower bound. We doubt that guidance will be based on targets, but more likely rely on qualitative measures, such as publishing a longer-dated inflation forecast and/or linking the length of monetary policy support to credit dynamics — making some loose reference to the pace of credit growth. The **second** option would likely involve additional provision of liquidity (including suspending reserve requirements) to give more visibility about the length of the accommodative policy stance, possibly complemented by some modest relaxation in collateral rules and/or credit easing. We expect a fixed rate LTRO will be launched in 2014, but not likely before 2Q-14, and for a one-year period instead of two, now that MROs will be conducted as fixed rate tender procedures with full allotment to at least 7 July 2015.

Because we think these non-standard measures will be insufficient on their own in the face of rising disinflationary risks, a **third** option would likely require another cut in the main policy rates. Depending on how the euro trades around the Fed tapering announcement in Mar-14, and following a likely ratcheting down of its 2015 inflation mid-point, we expect the ECB to cut the refi rate to zero around Jun-14 and lower the deposit rate into negative territory to -0.1%, narrowing the rate corridor further. Any downside risk to the euro area recovery baseline in the intervening period could be a trigger for early action, perhaps through a small 15bp cut in the refi rate.

The **fourth** policy option could involve direct asset purchases — may be replicating the Fed's first large-scale asset purchases programme — on the secondary market. The problem is that the euro area does not have a "*single signature*", leaving the ECB in the uncomfortable position of potentially having to buy assets (probably government bonds) on a pro-rata basis. We think that it will take strong evidence of euro area deflation risks for the ECB to launch a QE programme of sovereign debt purchases. But, with the GC having demonstrated it has a symmetric inflation target, the ECB would likely react to further downward inflation surprises, probably via purchases of other assets, for example, covered bonds and securitized SME loans. We expect the refi rate to stay at record lows until at least late 2016.

Figure 48. Euro Area — Economic Forecasts, 2013-2015F

					2013		2014				2015	
		2013F	2014F	2015F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-0.4%	0.9%	1.0%	-0.4%	0.4%	0.8%	0.8%	0.9%	0.9%	0.8%	1.0%
	SAAR				0.4	1.0	1.0	0.8	0.9	0.8	0.9	1.3
Final Domestic Demand	YoY	-1.0	0.6	0.9	-0.8	-0.2	0.5	0.5	0.6	0.7	0.7	0.8
Private Consumption	YoY	-0.5	0.6	1.1	-0.3	0.2	0.6	0.6	0.6	0.7	0.9	1.0
Government Consumption	YoY	0.2	0.0	0.0	0.5	0.4	0.4	-0.1	-0.1	-0.1	-0.1	0.0
Fixed Investment	YoY	-3.8	1.0	1.4	-3.6	-2.1	0.7	0.7	1.3	1.3	1.2	1.4
Stocks (Contrib. to Y/Y GDP Growth)		-3.3	1.2	2.7	-2.7	-0.9	1.2	1.1	1.2	1.1	2.1	2.6
Business Equipment		-4.3	-1.2	1.2	-4.0	-3.4	-2.1	-1.5	-0.9	-0.1	1.3	1.0
- Construction		0.0	0.0	-0.1	0.1	0.3	0.0	0.1	0.1	0.0	-0.1	-0.1
- Exports	YoY	0.7	2.7	3.0	0.3	1.6	3.2	2.2	2.8	2.6	2.7	2.9
Imports	YoY	-0.4	2.4	2.8	-0.4	1.2	2.8	2.0	2.4	2.3	2.5	2.7
CPI	YoY	1.3	0.9	0.7	1.3	0.8	0.7	0.9	0.7	1.1	0.9	0.8
CPI Ex Unprocessed Food & Energy	YoY	1.2	0.7	0.4	1.3	1.0	0.8	0.8	0.6	0.6	0.6	0.5
Unemployment Rate	YoY	12.1	12.3	12.1	12.2	12.3	12.3	12.3	12.2	12.3	12.2	12.2
Current Account Balance	EUR bn	206.5	252.2	255.2								
	% of GDP	2.2	2.6	2.6								
General Government Balance	EUR bn	-286.9	-255.7	-220.2								
	% of GDP	-3.0	-2.6	-2.2								
Primary Balance	% of GDP	0.0	0.4	0.8								
General Government Debt	EUR bn	9,220.2	9,563.5	9,803.5								
	% of GDP	96.2	98.2	98.9								
Gross Operating Surplus	YoY	1.7	2.2	2.4								

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

Germany

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We expect German economic growth to pick up to an above-trend 1.9% in 2014 and 1.7% in 2015, from 0.5% in 2013. Domestic demand should account for all of the increase, as robust employment and wage growth and probably a modest fiscal stimulus boost domestic consumption, and investment recovers amid an improved external outlook and low financing constraints. Politically, 2014 will also be an important year in Germany. The new (most likely Grand Coalition) government's decisions on energy reform, minimum wages and tax increases will probably have modestly negative effects on German competitiveness. As the European Parliament elections and major decisions on bailout programmes and banking union are approaching, we expect German eurozone support to remain cautious and reactive.

France

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French 3Q GDP showed a surprise drop of 0.1% QQ, with flat domestic demand, underscoring the economy's very weak path. Fiscal pressure has continued to increase in 2013, and will do so again in 2014, including a 1 January 2014 VAT rate hike, putting pressure on household spending. The government suffers from record low levels of popularity (23% of positive opinion for President Hollande and 22% for PM Ayrault), and is likely to do badly in upcoming municipal elections (23 & 30 March) and EU parliamentary elections. Nevertheless, given EU pressure, we doubt that the government can deviate from President Hollande's budget consolidation plans, which are based solely on spending restraint from 2015.

Italy

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GDP has lagged the timid recovery in the rest of the euro area, still falling by 0.1% QQ in Q3. We expect growth to be marginally positive in Q4, but not to pick up further in 2014. Tight credit conditions ahead of the ECB's AQR and EBA stress tests, and poor competitiveness are behind the weak growth outlook. Inflation has been weakening significantly in 2013 and we now expect this downtrend to continue in 2014 and 2015 on the back of a wide output gap and euro strength. This may lift real incomes and consumer spending a bit, hence the small upward revision in our real GDP forecasts. Political instability will likely remain elevated, with early elections in 2014 still a possibility. The scope for meaningful structural reforms to benefit medium-term growth remains limited. Poor nominal GDP growth is likely to prevent the debt-to-GDP ratio from stabilizing in coming years.

Figure 49. Germany, France and Italy — Economic Forecasts, 2013-15F

		Germany			France			Italy		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	0.5%	1.9%	1.7%	0.2%	0.8%	0.9%	-1.8%	0.2%	0.3%
Final Domestic Demand	YoY	0.6	2.1	2.0	0.2	0.4	0.6	-2.4	0.2	0.2
Private Consumption	YoY	1.1	1.9	2.1	0.4	0.6	0.7	-2.5	-0.3	0.3
Government Consumption	YoY	0.5	1.1	1.2	1.6	0.5	0.1	-0.1	-0.3	-0.6
Fixed Investment	YoY	-0.7	3.8	2.9	-2.4	-0.4	1.1	-4.6	2.4	1.2
Exports	YoY	0.3	2.9	3.5	0.3	1.6	2.6	0.0	3.3	3.0
Imports	YoY	0.9	3.5	4.4	1.0	1.7	1.5	-2.6	3.6	3.2
CPI	YoY	1.5	1.5	1.6	1.0	1.2	1.3	1.3	0.2	-0.3
Unemployment Rate	%	5.3	5.2	5.1	10.6	10.7	10.4	12.2	12.4	12.2
Current Account	€bn	189.6	191.2	179.6	-31.8	-16.2	-3.0	17.6	21.9	23.4
	% of GDP	6.8	6.8	6.2	-1.5	-0.8	-0.1	1.1	1.4	1.5
General Govt. Balance	€bn	1.3	0.6	-2.9	-83.6	-75.0	-69.1	-48.0	-44.0	-42.3
	% of GDP	0.0	0.0	-0.1	-4.1	-3.6	-3.2	-3.1	-2.8	-2.7
Primary Balance	% of GDP	2.4	2.3	2.0	-1.5	-1.0	-0.6	2.4	2.5	2.8
General Govt. Debt	% of GDP	78.5	76.5	73.8	93.9	96.0	97.3	132.8	136.6	139.2
Gross Trading Profits	YoY	3.0	5.6	3.5	0.0	2.5	3.0	NA	NA	NA

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

Spain

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We lift our 2014 and 2015 real GDP forecasts by 0.1ppts (to 0.2% and 0.8%, respectively) but we now see inflation remaining in slightly negative territory in the next couple of years due to still ample spare capacity. This, together with less fiscal drag, will help private consumption and Spain's competitiveness. Exports will continue to perform strongly, but reducing the fiscal deficit will continue to prove difficult and require sizable fiscal efforts, limiting the pick-up in domestic demand.

Greece

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The contraction in GDP has recently eased (-3.0% YY in Q3), thanks to a reduced fiscal drag relative to 2011-12 and falling inflation. We revise down our inflation forecasts considerably to account for the persistently large output gap in coming years. Further (planned) tax hikes and spending cuts, together with still not very competitive exports, will likely prevent GDP from expanding in 2014 or 2015. Negotiations on additional debt relief from official lenders may trigger further political instability and increase risks of early elections. Only a haircut on official loans could restore fiscal sustainability in our view, but this is unlikely to be agreed any time soon.

Ireland

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The economy seems to have been roughly flat in Q3, with strong retail sales growth (4.0% QoQ) balanced by a 1.6% QoQ drop in industrial production and a 7.0% QoQ plunge in industrial new orders. We do expect positive real economic growth in 2014, but with inflation very low, nominal GDP growth is likely to undershoot official forecasts in 2014 and later years, hence keeping the public debt/GDP ratio above official forecasts (and most likely still above 120% even in 2018). With exports at more than 100% of GDP, and no credit line back up, Ireland's fiscal path is highly vulnerable to external shocks.

Portugal

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GDP growth has returned into positive territory in mid-2013, but it is likely to decelerate again if the 2014 Budget (including 2.3pp of GDP of fiscal tightening) is fully implemented. The recent fall in inflation is likely to continue, partly offsetting the negatives of the fiscal drag on real incomes. We now expect inflation to enter and remain in mild negative territory over the next couple of years. Therefore, nominal GDP growth will remain subdued, hence preventing the public debt-to-GDP ratio to stabilize. A precautionary credit line is likely to be agreed in Jun-14, but a full second bailout remains a clear risk.

Figure 50. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2013-15F

		Spain			Greece			Ireland			Portugal		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	-1.3%	0.2%	0.8%	-3.3%	-1.9%	-0.5%	-0.5%	1.4%	1.6%	-1.6%	-0.5%	0.4%
Final Domestic Demand	YoY	-3.2	-0.6	0.1	-6.3	-3.1	-1.9	-2.5	-0.5	-1.0	-3.3	-1.4	-0.2
Private Consumption	YoY	-2.5	0.5	1.0	-5.6	-2.1	-1.3	-1.3	0.7	-0.2	-2.3	-0.7	0.3
Government Consumption	YoY	-1.6	-1.2	-1.5	-5.2	-4.6	-3.8	-1.3	-2.8	-2.5	-2.4	-3.3	-1.1
Fixed Investment	YoY	-7.0	-3.2	-0.8	-11.5	-6.1	-2.0	-9.9	-3.0	-3.2	-8.3	-1.9	-1.1
Exports	YoY	5.2	5.0	4.0	1.7	2.6	2.5	0.8	5.2	4.2	6.2	3.5	3.0
Imports	YoY	-0.6	2.7	2.4	-8.2	-3.4	-2.5	0.9	3.5	2.7	2.4	1.5	1.5
CPI	YoY	1.5	-0.4	-0.2	-0.8	-2.9	-2.4	-0.3	0.5	1.0	0.4	-0.4	-1.2
Unemployment Rate	%	26.6	27.0	26.6	27.8	28.7	28.9	13.6	13.2	13.0	16.2	15.4	15.4
Current Account	€bn	11.7	22.0	26.7	0.8	2.8	3.8	14.0	16.7	17.7	1.2	4.1	4.5
	% of GDP	1.1	2.1	2.6	0.4	1.6	2.3	8.6	10.1	10.4	0.7	2.5	2.8
General Govt. Balance	€bn	-70.7	-63.8	-56.3	-5.3	-4.0	-3.0	-11.5	-9.2	-6.8	-9.9	-8.1	-7.1
	% of GDP	-6.9	-6.2	-5.4	-2.9	-2.3	-1.8	-7.1	-5.6	-4.0	-6.0	-5.0	-4.4
Primary Balance	% of GDP	-3.4	-2.5	-1.5	1.2	1.7	1.6	-2.7	-1.1	0.5	-1.6	-0.2	0.4
General Govt. Debt	% of GDP	93.9	100.7	105.4	175.2	189.6	199.2	126.9	126.2	127.2	130.2	141.1	146.1

F Citi forecast. YoY Year-to-year growth rate. For Ireland we show the GDP deflator rather than the CPI, for Spain fiscal deficits include the effect of financial support for banks in 2011 (€5.4bn) and 2012 (€11.6bn). Sources: INE, Haver Analytics, Eurostat and Citi Research forecasts

Netherlands

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The Netherlands exited recession in 3Q 2013. Nevertheless, the level of Dutch GDP is 4.1% below its 1Q-08 peak. We anticipate a slow rebound in economic activity during 2014 (+0.4%) and 2015 (+0.9%), with domestic demand still contributing negatively to GDP in 2014, leaving growth dependent on net trade. Downward pressure on the residential housing market as a result of changes in the tax treatment of mortgage interest will likely constrain household investment in coming years. Furthermore, the challenging labour situation and continued focus on budgetary consolidation does not point to near-term disposable income gains.

Belgium

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Belgian Q3 GDP growth accelerated to 0.3% QQ after a 0.2% QQ gain in Q2, showing the strongest pace of economic activity since Q1 2011. With business and household sentiments surveys recovering gradually, we look for GDP growth of 0.6% in 2014 and 1.0% in 2015. The country goes to the polls in May 2014, and the few polls released so far suggest that support for the Flemish separatists is eroding, with the N-VA in Flanders only receiving 30% of voting intentions. We expect the government formation process to be quicker and smoother than in 2010.

Slovakia

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Exports and investment are likely to continue to be supportive for growth, while consumption is likely to follow later due to the weaker recovery in the labour market and limits for fiscal policy. The Government is desperately looking for cash to avoid an enforced balanced budget, which is under risk if government debt exceeds 57% of GDP. The presidential election may influence economic policy in the long-term, especially if PM Fico does not win the election. Large inconsistencies in the BoP data (>5% of GDP) imply possible risks of downward revisions to GDP.

Slovenia

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We are cutting our 2014 GDP growth forecast by 0.4%pts to -0.9% owing to recent weaker economic data and the postponement of banking sector resolution. The downside risk may be more significant if there is another delay in resolution beyond the end of 2013. The MinFin issued €1.5bn of 3y bond in a private placement, implying central government deposits will be depleted only by 1Q15 and leaving room for these to be used to cover, at least partly, bank recap costs in 2014. These should be known in mid-December. The political outlook will probably remain uncertain, particularly in the event of large bank recapitalisation costs.

Figure 51. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2013-15F

		Netherlands			Belgium			Slovakia			Slovenia		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	-1.1%	0.4%	0.9%	0.1%	0.6%	1.0%	0.8%	1.8%	2.4%	-2.3%	-0.9%	0.9%
Final Domestic Demand	YoY	-2.6	-0.1	0.3	-0.3	0.4	0.9	-1.1	1.4	2.3	-2.7	-1.0	1.5
Private Consumption	YoY	-2.0	-0.4	0.4	0.3	0.4	0.7	0.2	0.9	1.7	-2.9	-1.7	-0.1
Government Consumption	YoY	-1.1	-0.6	0.0	0.7	0.3	0.7	-0.1	0.1	1.6	-2.4	-1.4	0.4
Investment (Ex Stocks)	YoY	-6.6	1.3	0.4	-3.0	0.4	1.9	-5.1	3.9	4.4	-2.5	0.0	1.6
Exports	YoY	1.6	1.4	2.4	-0.2	2.4	3.5	4.5	5.8	6.2	1.9	3.5	5.5
Imports	YoY	-0.3	1.3	2.0	-0.8	2.4	3.8	2.4	6.1	6.3	-1.3	0.8	4.8
CPI (Average)	YoY	2.6	1.3	1.3	1.2	1.3	1.1	1.4	1.1	1.8	1.9	1.9	1.5
Unemployment Rate	%	8.4	9.2	9.0	8.7	9.2	9.0	14.3	14.4	13.7	10.5	11.6	12.5
Current Account	% of GDP	10.2	10.0	8.6	-3.9	-4.1	-3.9	4.3	4.0	3.4	3.9	4.9	4.9
General Govt Balance	% of GDP	-3.6	-2.9	-2.2	-2.9	-2.3	-1.5	-3.4	-3.2	-2.6	-6.7	-6.8	-4.6
Primary Balance	% of GDP	-1.6	-0.9	-0.2	0.6	1.2	2.0	-2.0	-1.7	-1.1	-4.0	-3.9	-1.8
General Govt Debt	% of GDP	74.8	76.0	76.0	101.8	102.5	101.9	55.5	57.0	56.4	61.6	68.1	71.0

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

UK

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The UK is set for high economic growth, falling unemployment, and low inflation in 2014-15. We are lifting our 2014 growth forecast by a further 0.2pp, to 3.2%, while leaving our 2015 forecast at 3.2%. Our forecasts are well above consensus, which is for growth of just 2.3% in 2014. Our forecast implies that the level of real GDP will finally regain its pre-crisis peak during 2014, although real GDP per head will only regain the pre-crisis peak (Q3-07) in late 2016. The economy already has grown at an annualised pace of about 3% over the last two quarters, and business surveys point to continued strength. Recovery reflects a mix of (1) aggressive monetary and credit stimulus; (2) reduced headwinds from household deleveraging, fiscal policy and the euro crisis; (3) pent-up demand for cars, housing and investment. Recovery initially is likely to be relatively unbalanced, led by consumption and housebuilding, with modest recoveries in business investment and exports. Rapid economic growth will ensure that the fiscal deficit falls quite rapidly, but the current account deficit is likely to remain quite high, at around 3% of GDP in 2014-15.

The jobless rate is likely to hit the MPC's 7% threshold in late 2014, hence terminating the current forward guidance framework. Given uncertainties about the UK's sustainable jobless rate, we do not expect the MPC to re-issue guidance with a lower jobless threshold: rather, we expect the MPC will subsequently revert to their pre-guidance framework of setting policy to anchor their inflation forecast close to the 2% target, accepting tradeoffs from time to time between the inflation target and the desire to reduce or limit imbalances. We expect the MPC probably will look to return real rates to around zero quite promptly in 2015-16, implying a less expansionary (but not neutral) stance, with a further gradual rise to rates of about 2½%-3% (we put neutral at perhaps 3-4%) in 2018 or so.

Figure 52. United Kingdom — Economic Forecasts, 2013-2015F

					2013		2014				2015	
		2013F	2014F	2015F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	1.5%	3.2%	3.2%	1.6%	2.7%	3.0%	3.0%	3.2%	3.4%	3.4%	3.4%
	SAAR				3.2	3.3	2.7	3.0	3.8	4.1	2.6	3.0
Domestic Demand	YoY	1.6	3.4	3.3	2.2	3.1	3.7	3.8	2.9	3.1	3.2	3.4
(Incl. Inventories)	SAAR				6.9	3.4	2.1	2.8	3.3	4.2	2.5	3.6
Private Consumption	YoY	2.0	2.8	3.2	2.4	2.3	2.3	3.0	2.9	3.0	3.1	3.0
	SAAR				3.1	2.5	2.6	3.6	2.7	3.1	2.9	3.4
Government Consumption	YoY	1.1	1.9	-0.4	1.1	3.5	3.6	2.8	2.0	-0.9	-0.7	-0.4
	SAAR				1.9	11.3	-0.4	-1.3	-0.9	-0.9	0.1	0.1
Investment	YoY	-2.5	11.2	11.6	-1.6	4.3	7.1	9.8	12.6	15.0	14.0	12.8
	SAAR				5.8	7.8	12.0	13.9	16.8	17.6	8.1	9.2
Exports	YoY	1.6	5.4	5.3	-1.1	4.2	5.4	3.3	7.6	5.5	5.6	5.6
	SAAR				-9.1	14.9	4.8	4.1	7.0	6.0	5.2	4.1
Imports	YoY	2.5	6.1	5.5	1.5	6.2	7.8	5.7	6.6	4.6	5.0	5.5
	SAAR				1.7	15.1	2.9	3.5	5.4	6.4	4.5	5.7
Unemployment Rate	%	7.7	7.3	6.4	7.6	7.6	7.6	7.5	7.3	7.0	6.7	6.5
CPI Inflation	YoY	2.6	2.0	1.9	2.7	2.2	2.0	2.0	1.9	1.9	1.9	1.8
Merch. Trade	£bn	-106.7	-100.7	-102.9								
	% of GDP	-6.6	-5.9	-5.7								
Current Account	£bn	-60.1	-51.3	-56.2								
	% of GDP	-3.7	-3.0	-3.1								
PSNB	£bn FY	-107.2	-79.6	-59.6								
	% of GDP	-6.5	-4.6	-3.3								
General Govt. Balance	% of GDP	-6.8	-4.9	-3.7								
Government Primary Balance		-3.5	-1.6	-0.1								
Public Debt	% of GDP	93.1	95.1	95.4								
Gross Nonoil Trading Profits	YoY	4.8	9.1	6.2								

Note: Fiscal deficit shown excluding financial interventions, RM and APF transfers. F Citi forecast. YoY Year-to-year growth rate. Sources: ONS and Citi Research forecasts

Switzerland

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Switzerland is set for fairly solid growth with price stability in the next 2-3 years. We are lifting our 2014 growth forecast to 2.0% from 1.5% last month, given the support from ultra-low interest rates, and fairly buoyant trends in the KOF and PMI surveys. The currency-induced decline in the CPI seems to be easing, with CPI ex food, drink and tobacco rising at an annualised pace of 0.7% in the last six months. Further ahead, we are now pencilling in an eventual modest hike in interest rates from 2017 onwards as deflation risks recede further.

Sweden

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Economic activity is slowly picking up. A protracted global recovery means that domestic demand will be more important than usual for Swedish growth. With strong real income growth (fuelled by low inflation and tax cuts), together with rising house prices, high household savings and improved balance sheets, this should support private spending ahead. Inflation should remain subdued and combined with low capacity use and ongoing expansionary policies from international central banks, the key policy rate should stay low for a prolonged period. Financial stability considerations remains an upside risk, although the new macro prudential framework means that it has become less likely that this will trigger a rate hike.

Denmark

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Stagnation has characterized the Danish economy since mid-2010, and our forecast assumes only moderately accelerating growth ahead, driven by rising domestic demand, but also supported by growing exports now the euro area has exited recessionary territory. Several years of crisis and nil growth implies that there currently is plenty of spare capacity in the economy. Economic activity is around 4% lower than in a normal economic situation, which largely reflects a lower-than-normal employment level. The weak growth outlook for coming years will only just help turn the labour market around and slowly start closing the sizeable output gap.

Norway

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Weaker growth, deteriorating labour market and cooler housing market suggest that Norway is heading towards a more moderate expansion, with below-trend growth in coming years. Oil investment is set to slow and the business sector (which has become increasingly dependent on the oil industry) will, hence, be unable to lean as much on impulses from the oil (and housing) sector. Also, the ongoing erosion in competitiveness suggests that Norway will be unable to benefit fully from global recovery. Meanwhile, the expansionary fiscal policy stance and ongoing low policy rates should ensure a soft landing rather than an abrupt halt to economic activity.

Figure 53. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2013-2015F

		Switzerland			Sweden			Denmark			Norway		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	2.0%	2.0%	2.0%	0.9%	2.1%	2.5%	0.4%	1.2%	1.5%	1.8%	2.1%	2.4%
Final Domestic Demand	YoY	1.9	1.3	2.1	1.0	2.0	2.3	0.7	1.4	1.5	2.3	2.3	2.8
Private Consumption	YoY	2.1	1.2	1.7	1.8	2.1	2.5	0.5	1.2	1.6	2.2	2.4	2.9
Government Consumption	YoY	2.2	1.2	0.7	1.1	1.2	0.8	0.2	0.5	0.7	2.1	2.6	3.0
Investment (Ex Stocks)	YoY	1.1	1.7	4.2	-1.1	2.8	4.1	2.1	3.1	2.2	2.8	1.6	2.0
Exports	YoY	2.2	3.4	4.0	-1.5	1.8	3.7	0.6	2.5	2.1	0.1	1.1	2.1
Imports	YoY	0.4	2.3	5.0	-2.2	1.4	3.5	2.3	3.1	2.1	2.3	2.5	2.3
CPI (Average)	YoY	-0.2	-0.1	0.9	0.0	1.1	1.9	0.8	1.5	1.7	2.1	2.0	2.2
Unemployment Rate	%	3.1	2.7	2.3	8.0	7.9	7.6	7.0	6.9	6.7	3.6	3.8	3.9
Current Account	% of GDP	12.2	13.0	12.8	6.2	5.9	5.6	6.1	5.8	4.7	12.8	13.1	13.4
General Govt Balance	% of GDP	0.2	0.6	0.8	-1.4	-1.6	-0.7	-1.6	-1.8	-1.5	11.3	11.8	11.0
General Govt Debt	% of GDP	48.2	46.3	45.1	39.5	39.9	38.9	46.9	47.4	47.5	NA	NA	NA

[a] For Norway, mainland GDP. F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Research forecasts

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Canada

The Canadian economy likely will expand at a moderately faster pace in 2014 relative to 2013, supported by reduced fiscal drag in the US, a cheaper Canadian dollar, and infrastructure expansion of the North American energy complex. However, growth may be limited by the rotation of Canadian demand away from consumers and government, and towards business capex and exports. Political uncertainty and softening Emerging Market growth will remain external headwinds.

Consumer inflation gauges continue to linger near the lower bound of the BoC's 1-3% control zone, and a material degree of slack persists. Total CPI is unlikely to revert to the bank's 2% target until late 2015 when aggregate supply and demand return to balance. Risks to the inflation outlook are two-sided, but roughly balanced.

Upside risks include stronger-than-anticipated Advanced Economy growth; greater momentum in domestic demand amid improving business confidence; and sustained domestic housing market strength that reinforces existing imbalances. Downside risks include setbacks in the EA recovery; weaker-than-expected global demand that restrains Canadian exports; and domestic consumer retrenchment linked to household debt and/or disorderly unwind of housing market activity.

The BoC unexpectedly removed its slight tightening bias in October amid growing concern about disinflation. The bank acknowledged that excising the bias posed a risk of exacerbating domestic consumer debt accumulation and housing excesses. We contend that these imbalances continue to threaten financial stability. But given the central bank's more dovish tack, we have delayed our expectation for the next rate hike by two quarters to 3Q 2015. Rate cuts are unlikely, in our view. The Federal Government has pledged a return to fiscal surplus by FY2015/16 and to restore debt as a share of GDP to pre-crisis norms within the next five years.

Figure 54. Canada — Economic Forecast, 2013-2015F

					2013F		2014F				2015F	
		2013F	2014F	2015F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	1.7%	2.4%	2.7%	1.9%	2.1%	2.3%	2.5%	2.4%	2.6%	2.6%	2.6%
	SAAR				2.7	1.8	2.8	2.5	2.4	2.5	2.9	2.8
Final Domestic Demand	YoY	1.8	2.3	2.2	1.7	2.1	2.6	2.5	2.2	2.1	2.1	2.2
	SAAR				1.8	2.4	2.4	1.9	2.0	2.0	2.5	2.2
Private Consumption	YoY	2.3	2.4	2.4	2.3	2.4	2.7	2.3	2.3	2.3	2.3	2.4
	SAAR				2.2	2.2	2.4	2.0	2.4	2.2	2.5	2.5
Government Spending	YoY	1.1	0.7	0.4	0.7	1.0	1.1	0.9	0.5	0.4	0.3	0.4
	SAAR				0.8	1.1	0.7	0.3	0.0	0.5	0.5	0.5
Private Fixed Investment	YoY	1.3	4.2	3.7	1.1	2.6	4.0	5.1	3.9	3.7	3.8	3.7
	SAAR				2.4	4.5	4.3	3.8	3.2	3.4	4.9	3.3
Exports	YoY	0.7	2.7	4.7	1.7	1.0	0.8	1.7	3.6	4.5	4.5	4.7
	SAAR				-2.0	1.0	4.6	4.4	4.7	4.4	4.6	5.1
Imports	YoY	1.2	2.5	3.2	-0.1	1.8	2.0	2.2	2.7	3.0	3.0	3.2
	SAAR				-1.4	2.0	3.0	2.5	3.3	3.0	3.3	3.3
CPI	YoY	1.0	1.5	1.9	1.1	1.2	1.2	1.6	1.6	1.8	1.9	1.8
Core CPI	YoY	1.3	1.5	1.9	1.3	1.3	1.2	1.3	1.5	1.9	1.9	2.0
Unemployment Rate	%	7.0	6.6	6.2	7.1	6.9	6.7	6.7	6.6	6.5	6.2	6.3
Current Account Balance	C$bn	-60.3	-81.0	-82.8	-64.0	-73.7	-74.4	-86.5	-76.1	-87.1	-78.6	-88.0
	% of GDP	-3.2	-4.2	-4.2	-3.4	-3.9	-3.9	-4.5	-4.0	-4.5	-4.0	-4.5
Net Exports (Pct. Contrib.)		-0.2	0.0	0.3	-0.2	-0.4	0.4	0.5	0.3	0.3	0.3	0.4
Inventories (Pct. Contrib.)		0.0	0.0	0.1	1.2	-0.3	0.0	0.0	0.0	0.1	0.1	0.1
Budget Balance (Fiscal Year)	% of GDP	-1.0	-0.3	0.2								
Federal Budget Debt	% of GDP	32.9	32.3	31.0								
General Govt. Debt	% of GDP	86.9	85.3	84.5								

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

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Australia

The year 2014 should see further signs of rebalancing in the economy, but only in a gradual fashion. Mining capex should be held up by the high level of work yet to be done on committed projects and the continued strong commodity demand in China, while the low level of interest rates should support some improvement in household demand. However, on our forecasts the AUD will remain a headwind to business investment and hiring in non-mining sectors. And fiscal policy will probably be moderately contractionary. As a result, we forecast only slightly stronger GDP growth next year. This economic backdrop points to no broad-based upward pressure on inflation, allowing the RBA to ease monetary policy further if needed. But our base case is that with global growth closer to trend next year, the Fed finally tapering and domestic monetary policy already stimulatory, the RBA will be on hold in 2014. We have pushed back the start of the tightening cycle until early in 2015 in what could be a very gradual tightening cycle given the protracted drag from declining mining capex.

New Zealand

Early evidence suggests mortgage LVR restrictions are beginning to influence behavior in the housing market. The RBNZ reported a drop in buyer traffic and transaction volumes, while auction clearance rates and first home buyer interest was also reported as being lower. These early results are encouraging, but it will take a few more months to ascertain whether the restrictions are likely to sustainably reduce the risk to the financial system and economy from the housing market. In the interim, the RBNZ will likely continue trying to jawbone the currency lower and remind investors that interest rate rises are more likely to be a 2014 position. Citi hasn't changed its view, keeping the forecast start of the hiking cycle in March next year. Strong migration flows, a pick-up in employment, more reconstruction activity and higher forecast dairy prices for farmers argue the case for the RBNZ to be the first developed central bank to being the process of interest rate normalization.

Figure 55. Australia and New Zealand — Economic Forecast, 2013-2015F

	Australia			New Zealand		
	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP[a]	2.5%	2.9%	3.0%	2.4%	3.0%	2.7%
Real GDP (4Q versus 4Q)	2.4	3.0	3.1	1.9	3.1	2.1
Real Final Domestic Demand	1.3	2.7	2.3	4.2	4.4	3.3
Private Consumption	2.2	2.9	3.0	3.7	2.8	1.9
Govt. Current & Capital Spending[b]	1.3	2.1	2.4	0.4	2.6	2.5
Housing Investment	2.4	4.9	5.8	19.3	14.0	11.5
Business Investment[c]	2.8	0.5	-1.3	6.5	9.2	6.3
Exports of Goods & Services	6.7	8.4	10.9	-0.6	-2.1	0.5
Imports of Goods & Services	-1.0	6.8	6.3	4.1	5.3	3.3
CPI	2.5	3.1	2.4	1.2	2.1	2.2
CPI (4Q versus 4Q)	2.8	2.6	2.4	1.9	2.0	2.3
Unemployment	6.0	5.9	6.0	6.1	5.6	5.4
Merch. Trade, BOP (Local Currency, bn)	10.3	-2.5	-13.1	0.8	-0.8	-1.6
Current Account, (Local Currency, bn)	-39.0	-57.4	-72.1	-8.0	-10.9	-11.7
Percent of GDP	-2.5	-3.6	-4.3	-3.7	-4.7	-4.9
Budget Balance[d] (Local Currency, bn)	-18.5	-41.5	-31.8	-5.9	-4.2	-1.7
Percent of GDP	-1.2	-2.6	-1.9	-2.7	-1.8	-0.7
General Govt. Debt (% of GDP)[e]	25.5	25.5	25.5	36.8	39.7	36.2
Gross Operating Surplus	1.8	5.2	5.1	NA	NA	NA

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

China

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Steady growth and a stable job market allow the government to focus on reform. Macro indicators suggest that the economy continues to expand at a solid pace following the growth rebound in 3Q, but inflation is trending up. The growth target of 7.5% for 2013 is within reach (we forecast 7.6%). Meanwhile, the job market has been stable, with 10.7 million new jobs created in urban areas in the first nine months, better than the same period of last year. The economy is running within the reasonable range defined by the Premier, allowing the government to focus on addressing the deep-rooted structural problems through reforms.

The Decision approved by the third Plenary Session of the 18th CCCPC lays out a comprehensive reform plan, emphasizing that the market should play a decisive role (a “basic” role in the previous official documents) in allocating resources. The Party leaders promise to make major achievements in key areas by 2020, suggesting reforms will be incremental and growth below 7% is not acceptable in the near term.

The reform package is long on breadth with some shortfalls on depth. Land reform and investment deregulation exceeds expectations; price, financial and population policy reforms broadly match expectations; fiscal reform is a bit below expectations, and SOE reform is a major disappointment. While the package seems suboptimal, the establishment of a leading group overseeing the design, coordination and implementation of reforms raises hopes of better policy delivery. We have become more positive on the reform setting, although implementation is key.

The reforms, if adequately implemented, may incur output loss in the near term. In particular, price reform, land reform and interest rate reform may increase the cost of investment, and land reform could reduce revenues of the local governments and their capability to invest in infrastructure. Stricter environmental standards might well put constraints on the old growth model, which is resource-intensive and pollution-prone. However, over time, the reform measures will facilitate better allocation of resources, promote private investment to substitute government-driven investment, and increase disposable income (and hopefully consumption) of the households.

The government may set a growth target of 7% next year. Even as the growth slows to below 8%, job market data suggest overall labor shortages. In addition, inflation starts to pick up. These are signs that China’s potential growth is already below 8%, and any effort to boost growth above the current level may be inflationary. In recognition of changing demographic dynamics and to leave more room for structural reforms, we expect the government to lower its growth target to 7.0% next year, and maintain its target for annual average inflation at 3.5% with allowance for the impact of price reforms.

The macro policies have become tighter in 2H. Monetary and credit conditions were loose early this year, with broad money (M2) growth reaching 15-16% and total social financing (TSF) in 1H 30% higher than the same period of last year. The Premier and PBOC have made it clear that the government will neither loosen nor tighten monetary policy, but with M2 growth staying above the annual target of 13%, we already see policy fine-tuning with a tightening bias. New RMB credit and TSF were significantly lower than expected in Oct, and overall credit conditions would be tighter in 2H this year than 1H. Less accommodative policies will likely slow growth tangibly by the end of the year.

We expect the government to maintain a proactive fiscal policy and prudent monetary policy next year, but overall policy will become less accommodative. The government has emphasized on several occasions that the budget deficit will not be increased. The Budget deficit will probably stay at 2% of GDP next year, implying that fiscal policy will not provide an additional boost to growth. For monetary policy, the policy stance may continue to shift to a neutral position and remain neutral next year, relative to an easing bias this year. More specifically, the M2 growth target probably will be kept at 13%, but the PBOC is likely to treat the target as a ceiling in 2014 instead of (as this year) a floor. We expect the PBOC will raise its benchmark interest rate by 25bps late next year, with inflation likely to exceed the one-year deposit rate, and market interest rate levels may rise gradually regardless of the benchmark rate as a result of tighter liquidity.

A recovering global economy would help reduce downside risks. We expect global growth to accelerate next year, with US growth rebounding by more than 1ppt to 2.7% and Eurozone stepping out of recession. The improving external demand is already reflected in China's new export orders and recent export data, although YoY export growth numbers may look lackluster in the next few months due to a high base created by inflated export data in late-2012 and early-2013. As a result, China may continue to run a trade surplus, and net exports may make a small positive contribution to GDP growth, compared with a small negative contribution in the first three quarters this year. However, US tapering, which is expected to begin in Mar and end in Sep next year, may lead to sizable capital outflows and sporadic depreciation of the currency. In the next 12 months, we forecast limited appreciation of RMB with two way volatility.

We expect growth to slow down further to 7.3% in 2014 and 7.0% in 2015. The risk of a more dramatic slowdown is low as the government sees 7% growth as the bottom-line, and has the willingness and capacity to introduce small-scale stimulus in case of a sharp deceleration, even at the expense of slowing reforms. In 2014, growth may start high and end low, given the time it takes for the impact of difficult reforms and less-accommodative policies to be felt by the real economy.

Figure 56. China — Economic Forecasts, 2013-2015F

					2013F		2014F				2015F	
		2013	2014F	2015F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	7.6%	7.3%	7.0%	7.8%	7.5%	7.6%	7.4%	7.0%	7.2%	7.3%	7.1%
Real Final Domestic Demand	YoY	7.8	7.3	7.2								
Consumption	YoY	7.2	7.1	7.6								
Fixed Capital Formation	YoY	8.5	7.5	6.7								
Industrial Production	YoY	9.6	9.2	8.6	10.1	9.6	9.8	9.4	8.6	9.0	9.2	8.8
Exports	YoY	6.7	4.4	6.4	3.9	3.0	-3.0	5.0	7.0	8.0	8.0	7.0
Imports	YoY	7.1	6.5	7.5	8.4	6.3	4.0	6.0	8.0	8.0	8.0	8.0
Merchandise Trade Balance	$bn	239	208	200	62	69	8	64	61	75	9	64
FX Reserves	$bn	3,769	3,917	4,067	3,660	3,769	3,757	3,806	3,852	3,917	3,906	3,955
Current Account	% of GDP	2.2	2.0	1.5								
Fiscal Balance	% of GDP	-2.0	-2.0	-1.5								
General Govt. Debt*	% of GDP	45.1	45.2	44.1								
Urban Unemployment Rate	%	4.1	4.2	4.3	4.1	4.1	4.2	4.2	4.2	4.3	4.3	4.3
CPI	YoY	2.7	3.3	3.7	2.8	3.1	3.0	3.3	3.1	3.9	3.7	3.6
Exchange Rate (end period)	CNY/$	6.08	6.04	6.00	6.12	6.08	6.07	6.06	6.05	6.04	6.03	6.02
1-Yr Deposit Rate (end period)	%	3.00	3.25	3.75	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.75

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

India

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The year 2013 has been eventful for India. Initially benefiting from lower commodity prices and incremental policy steps, the taper fears in the summer led to mayhem in financial markets. Since September, India has bought itself some time, partly because of (1) postponement of taper, (2) hard work on the domestic policy front and (3) compression in the current-account deficit (CAD) ahead of expectations. But, tapering will come and could 'taper off' improved expectations. This coupled with the upcoming general elections will be an important event for India in 2014. As discussed in India Macroscope - No Room for Complacency, India's fortunes go well beyond the taper. It lies in (1) the direction of the fiscal deficit, (2) sustained compression in the CAD, (3) monetary policy — and its ability to contain inflation and (4) the economy's response to these and other policy measures.

While current data trends are disappointing with 1QFY14GDP at 4.4%, we expect growth to pick up to average 4.8% in FY14. Key drivers of the marginal pick-up include the outcome of good monsoons, a mild export recovery and initiatives being taken to 'unlock' investments. Effective implementation of measures such as auctioning of coal blocks, revision in gas prices, SEB debt recast, fast tracking through Project Monitoring Group etc. is key for growth to pick up to 5.6% in FY15. On the external front, the policy measures initiated earlier have begun to bear fruit. In contrast to other EMs where the current account deficit (CAD) widened due to slowing G-10 imports, India's CAD was largely a result of oil, gold and coal imports. We expect the CAD in FY14 to narrow to 2.7% of GDP from 4.8% last year, with the possibility of an even smaller deficit if mining/coal issues are sorted out soon. On the fiscal front, assuming a partial rollover of subsidies, expenditure is likely to be contained within budget targets. However, trends in revenues appear challenging and could result in a marginal slippage in the fiscal deficit in 13/14 to 5% of GDP versus budget estimates of 4.8%.

Inflation continues to be a bug-bear for the economy. While there are dis-inflationary factors at play — negative output gap, moderating rural wages and lower MSP increases, there are also offsetting factors. These include the INR depreciation, sticky food prices and relatively high wage inflation, which is likely to result in the WPI and CPI averaging 6% and 9%, respectively. With RBI's focus shifting more towards containing inflationary expectations and CPI, we expect that — following the two consecutive rate hikes of 25bps each — another 25bps repo rate hike is likely taking repo to 8% in FY14. We expect rates to stay elevated in FY15 as well.

Figure 57. India — Economic Forecasts, FY2013/14-2015/16F

		FY 13/14F	FY 14/15F	FY 15/16F
Real GDP	YoY	4.8%	5.6%	6.7%
Final Domestic Demand	YoY	4.1	6.1	7.8
Private Consumption	YoY	4.5	6.5	8.0
Fixed Investment	YoY	2.5	5.5	8.0
Exports	YoY	5.2	11.0	9.0
Imports	YoY	5.0	9.5	9.3
Wholesale Price Index*	YoY	6.0	5.0	5.0
Consumer Price Index	YoY	9.2	7.5	7.5
Current Account	US$ bn	-50	-55	-66
	% of GDP	-2.7	-2.4	-2.4
Consolidated Fiscal Balance	% of GDP	-6.7	-6.4	-6.2
Centre Fiscal Balance	% of GDP	-5.0	-4.6	-4.5
US Dollar Exchange Rate	Average	63.5	61.9	57.8

Note: * In India, policymakers look at the wholesale price index. Sources: Haver Analytics and Citi Research forecasts

Korea

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We expect the economy to grow by 3.7% in 2014, faster than 2.9% in 2013, on the back of a further recovery of exports and domestic demand. Exports will remain as the main driver of economic growth, expanding around 6% YoY, mostly due to continued upswing of ITC products and autos as well as recovery of the global economy. Consumption growth is likely to be supported by better asset market conditions, some upside potentials in housing price and Kospi, and resilient job growth. Facilities investment, which contracted for two consecutive years, is likely to rebound sharply alongside improved domestic and overseas economic conditions. However, construction is likely to slow with reduced SOC spending and apartment pre-sales. Inflation will likely stay at around 1% YoY in 1H-2014, but rise above 2% in 2H due to the reduced output gap and base effects. The current account surplus will probably narrow to 4.1% of GDP in 2014 from about 5.6% in 2013 as the recovery of domestic demand increases imports. We expect some fiscal drag, especially in 2H-2014, given the government's frugal spending plan of a 2.5% increase from the 2013 budget. This, in our view, would lead the BoK to keep policy rate at current 2.5% to end-2014.

Indonesia

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We believe Indonesia's GDP growth may continue to decelerate in 2014 to 5.3%, from an expected 5.7% in 2013, following a slew of stabilization and tightening policies aimed to bring down imports. Inflation may revert back towards 5% as the effects of this year's fuel price adjustment and exchange rate depreciation fully subsides. However, the direction of interest rates will be driven more by the current account as opposed to inflation dynamics. We expect a further 25bps rate hike in early 2014. Lending rates will also be higher and credit growth may slow towards 16%. Elections will take place in April (parliamentary) and July (presidential). Post-2014, we don't see risks of drastic changes in the broad direction of economic policy under any new presidency, and are even hopeful that new leadership could add momentum on reforms. However, the political environment during the election year may hamper room for much-needed reforms, meaning that the monetary authorities may bear most of the burden in capping the current account deficit. Apart from higher interest rates, we think a weaker currency will also remain a relevant trend for 2014. On a positive note, we highlight that the current growth slowdown is not a crisis, as government, corporate and financial balance sheets have been well-managed.

Figure 58. Korea and Indonesia — Economic Forecasts, 2013-2015F

		Korea			Indonesia		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	2.9%	3.7%	3.9%	5.7%	5.3%	5.5%
Final Domestic Demand	YoY	2.5	3.2	3.3	5.1	4.7	5.1
Private Consumption	YoY	1.9	3.0	3.3	5.0	4.6	4.3
Fixed Investment	YoY	3.4	4.3	4.0	5.4	4.8	6.0
Exports	YoY	4.7	6.0	6.9	3.5	5.5	10.0
Imports	YoY	3.8	5.4	6.6	0.8	4.0	9.0
Consumer Price Index	YoY	1.2	2.3	3.1	7.1	6.6	5.7
Unemployment Rate	%	3.1	3.1	3.1	6.3	6.5	6.3
Current Account	US$ bn	67.9	56.3	48.1	-30.7	-24.4	-23.1
	% of GDP	5.6	4.1	3.2	-3.5	-2.8	-2.3
Fiscal Balance	% of GDP	0.9	2.3	2.3	-2.1	-1.8	-1.7
US Dollar Exchange Rate	Average	1096	1032	1003	10737	11795	11199

Sources: Haver Analytics and Citi Research forecasts

Hong Kong

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We expect recovery will again be bumpy in 2014 as HK needs to trot through potential liquidity outflows with Fed tapering, housing price adjustments, and headwinds from slower Chinese growth. Meanwhile, public/ private construction will drive growth in coming years; and tourism will continue to support consumption. Some fiscal support is likely to be announced in the Policy Address and Budget Speech in January/February 2014, with public spending on social housing, welfare and poverty reduction. We also expect a modest global trade recovery, which is likely to benefit HK's logistic sector. Policy-makers will remain vigilant on the overheated housing market, rising household debt and banks' exposure to China. The HKD peg is likely to continue to prevail, with EFN rates largely following US Treasury yields.

Singapore

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The economy is likely to continue a patchy expansion in 2014 amidst uncertainties in external demand and supply-side constraints. Export sensitivity to G3 domestic demand has fallen, while a likely slowdown in China and Indonesia could cap merchandise exports and services. Domestically, persistent labour supply constraints may not be offset by faster productivity gains, and pass-through of cost pressures could lift core inflation in 2014. Medium-term deflationary risks stem from 1) cost competitiveness strains from REER appreciation; 2) downturn in property prices; and 3) over-leverage among some households, which could worsen the downturn in property prices and reduce consumption when interest rates rise.

Taiwan

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The economy is likely to pick up pace, with benign inflation, in 2014. Trade, manufacturing and investment are likely to improve with faster global trade, while Taiwan should reap gains from ECFA (with China) and FTAs (with Singapore and New Zealand). A consumption recovery story could take hold in 2H, if stock market performance and real wage improvements continue. Fiscal policy remains constrained by frequent political hurdles and public debt is approaching the debt ceiling. RMB banking reached an initial year of success, but a swap line with PBOC (expected by mid-2014) would be needed to foster more yuan financial product development. The TWD is likely to appreciate mildly on the current account surplus and macro recovery. We expect policy rates to remain on hold till 3Q14, while long-term bond yields again creep up with Fed tapering talks.

Figure 59. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2013-2015F

		Hong Kong			Singapore			Taiwan		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	3.0%	3.4%	3.8%	4.0%	3.5%	4.0%	2.0%	3.2%	3.8%
Final Domestic Demand	YoY	3.3	2.1	2.4	2.8	2.9	1.7	1.5	1.9	2.5
Private Consumption	YoY	4.1	2.0	2.4	2.6	2.4	1.3	1.3	1.7	2.8
Fixed Investment	YoY	1.8	2.6	2.8	0.5	2.8	1.3	3.0	3.6	3.2
Exports	YoY	7.0	5.2	6.2	3.3	3.6	2.9	3.4	4.6	6.2
Imports	YoY	7.2	4.8	5.7	3.3	2.9	2.9	3.1	3.6	5.2
CPI	YoY	4.3	3.6	4.0	2.4	2.1	2.2	1.1	1.7	2.3
Unemployment Rate	%	3.3	3.2	3.1	1.9	1.8	1.8	4.2	4.0	3.9
Current Account	US$ bn	7.7	9.2	12.0	40.7	42.7	44.8	53.0	51.3	52.8
	% of GDP	2.8	3.1	3.9	14.0	13.5	13.0	10.9	9.8	9.5
Fiscal Balance	% of GDP	2.2	1.6	0.7	0.7	0.5	0.5	-1.5	-1.4	-1.2
US Dollar Exchange Rate	Average	7.76	7.76	7.75	1.25	1.24	1.20	29.73	29.24	29.04

Sources: Haver Analytics and Citi Research forecasts

Russia

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The economy continues to underperform, with 3Q GDP posting another disappointing 1.2%YoY, bringing year-to-date growth to a meager 1.3% YoY. Hopes that 2H GDP will be lifted by a bumper harvest were dashed in September, which turned out to be the rainiest on record. While PMI data does suggest some pick-up in activity in 4Q, we think that 2013 GDP will come in at only 1.4%. 2014 GDP growth will likely edge up to 2.5% chiefly on account of a favorable base and a recovery in Europe. Monetary policy should also lend a helping hand in 2014 as expectations for moderating inflation, deriving from the decision to freeze utility and railway tariffs, provides room for cutting interest rates. Medium-term growth prospects remain only slightly better due to adverse demographics and lack of incentives for enhancing capital accumulation and productivity growth. In a refreshing, if belated, recognition of these structural impediments, in early November the Ministry of Economy downgraded significantly its GDP forecasts for 2013-2030 to an average of 2.8% from 4.3% previously.

Turkey

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In light of the likelihood of a more hostile external environment going forward, we believe Turkey needs to formulate a new narrative underpinned by a tighter policy framework with a supply-side focus. We think this is not very likely to materialize owing to an election heavy calendar. Consequently, we believe the low level of domestic savings, a sizeable competitiveness gap, and the country's poor inflation track record will continue to overshadow macroeconomic stability, leaving Turkish assets at the mercy of global risk appetite. With the current account deficit projected to remain too wide for comfort next year (about 6.5% of GDP) even in the presence of a subpar growth forecast of 3.5%, we remain concerned with the emerging macroeconomic picture. In particular, the possibility of a prolonged period of slow growth, which cannot be ruled out, would be uncharted territory for Turkey. As a result, it would be difficult for us to predict the implications of such a scenario for the economy and political stability. With this caveat in mind, while our base case scenario envisions Turkey will muddle-through, the possibility of another sudden stop episode that could push the economy into recession sometime in the next 12 months cannot be ruled out. From this prism, we believe Turkish assets are heading for another volatile year, as the excessive discretion in the conduct of monetary policy and the possibility of a more accommodative fiscal stance ahead of the elections further complicate the outlook.

Figure 60. Russia and Turkey — Economic Forecast, 2013-2015F

		Russia			Turkey		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	1.4%	2.6%	2.7%	3.5%	3.5%	3.6%
Final Domestic Demand	YoY	2.6	3.5	3.7	3.6	2.7	4.2
Private Consumption	YoY	4.4	4.2	4.1	3.7	3.0	4.3
Fixed Investment	YoY	0.1	3.8	4.5	2.0	0.9	4.2
Exports	YoY	1.5	2.0	2.1	4.0	4.3	5.0
Imports	YoY	5.5	4.5	7.2	7.0	1.6	7.0
CPI	YoY	6.7	5.3	4.9	7.5	7.3	6.9
Unemployment Rate	%	5.6	5.7	5.8	9.5	9.5	9.5
Current Account	US$ bn	34.0	24.0	18.6	-56.6	-52.4	-54.5
	% of GDP	1.6	1.1	0.8	-7.0	-6.3	-5.8
Fiscal Balance	% of GDP	-2.0	-4.3	-4.9	-1.2	-2.8	-3.2
US Dollar Exchange Rate	Average	32.3	32.7	33.1	1.96	2.09	2.08

Sources: Haver Analytics and Citi Research forecasts

Hungary

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Growth may surprise positively in the coming quarters, helped by the central bank's monetary stimulus — which is likely to produce a positive contribution to growth from domestic demand. Over the medium term, Hungary's key challenge remains its weak growth potential until the economy deleverages, as fiscal policy and the structure of tax revenues are unlikely to change much in 2014-2018 (the next electoral cycle) assuming the current government remains in power. We expect consumption and fixed investment stimulus may narrow the current account surplus as domestic demand recovery outpaces external demand. While headline inflation has fallen sharply below the 3% target, we expect a sharp rebound in December 2014 as the impact of utility price cuts will be fully eliminated from the annual price index. We project headline inflation will come in the range of 3-3.5% after 2014 without assuming any external price shocks, which in our view is not consistent with interest rates of below 4%. Rising global core yields and the prospect of higher inflation will likely force the NBH to partly reverse the recent rate cuts in late 2014/early 2015. This may help to reduce the steepness of the yield curve and help to stabilize the currency.

Poland

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The economy is likely to enter the New Year with growth exceeding 2.5%YoY and will probably expand by more than 3% in 2014. A gradual increase in employment, relatively strong wage growth, and signs of some pickup in consumer lending reinforce our forecast of stronger private consumption. Low rates and improving German growth prospects should lead to higher investment by Polish firms and this is likely to be followed by an increase in public investment in late 2014. In contrast to 2010-2012, fiscal policy will not now be a serious drag on growth anymore, as planned changes in the pension system will create some fiscal space by reducing the public debt below 50% of GDP. However, if the pension system overhaul were to be vetoed by President or stopped by the Constitutional Court (probability of around 20%), this would imply a need to tighten policy by around 2% of GDP. Such an outcome would force us to downgrade our growth forecasts. As far as monetary policy is concerned, the MPC signaled interest rates would remain on hold at least until end of June 2014, which makes the bar very high for any front-loaded rate changes. We expect that stronger growth and a gradual rise in inflation will eventually lead to rate hikes, but the tightening cycle will probably only begin around September 2014 and any rate hikes will be very slow.

Figure 61. Hungary and Poland — Economic Forecasts, 2013-2015F

		Hungary			Poland		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	1.0%	1.9%	1.5%	1.4%	3.1%	3.6%
Final Domestic Demand	YoY	0.1	1.3	0.5	0.3	2.5	3.6
Private Consumption	YoY	0.4	1.2	1.0	0.9	2.3	3.2
Fixed Investment	YoY	-0.3	3.1	0.0	-2.0	3.6	6.0
Exports	YoY	2.6	3.5	3.6	3.8	6.1	6.5
Imports	YoY	2.1	3.1	3.0	0.7	6.9	7.5
CPI	YoY	1.7	1.5	3.3	1.0	1.9	2.8
Unemployment Rate	%	9.7	9.5	10.1	14.2	13.4	12.4
Current Account	US$ bn	1.9	1.2	1.1	-7.7	-13.7	-21.3
	% of GDP	1.5	0.9	0.8	-1.5	-2.4	-3.4
Fiscal Balance	% of GDP	-2.9	-3.0	-2.9	-4.6	5.2	-2.6
Euro Exchange Rate	Average	300	309	310	4.23	4.17	4.04

Sources: Haver Analytics and Citi Research forecasts

Czech Republic

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After contracting 0.5% QoQ in 3Q13, we expect working-day adjusted GDP in 4Q to show growth of 1.3% QoQ (versus our 0.5% forecast previously). This should imply 0% YoY growth in 4Q and -1.3% for 2013 as a whole (versus our previous forecast of a 1% decline in 2013). Going into 2014, the export-driven recovery should lift growth to about 1.9%YoY (from 1.7% previously). Central bank intervention to weaken the koruna has pushed up our CPI forecast to 1.2% YoY in 2014 from 0.9% previously. While the CNB's FX target "EURCZK close to 27" will be re-evaluated with every new forecast, the CNB has indicated that changes to the desired level of EURCZK are likely to be rare. We expect the CNB's preference, if new disinflationary risks emerge, would be for a longer period of EURCZK weakness, rather than an even weaker near-term koruna, unless we see a larger deterioration in exports. With another ECB easing likely in 2014, the CNB's FX interventions are likely to intensify and a slightly negative CNB policy rate cannot be ruled out. Even if a centre-left coalition were formed, it is unlikely any positive impact on fiscal and economic policy would materialize any time soon.

Romania

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Romania's growth momentum continues to lag behind its regional peers. Growth is overly dependent on net exports, as deleveraging continues to be a significant drag on private consumption and investment. Looking ahead, the new IMF-EU supported program bodes well for bolstering policy predictability. However, we believe there are two important caveats. First, the upcoming 2014 presidential election may have implications for the stability of the ruling coalition. Second, the risk of reform fatigue, particularly if growth disappoints, may undermine the implementation of policy measures included in the new IMF-EU supported program. Where do we go from here? We expect growth drivers to switch from net exports to domestic demand — especially private investment, owing to faster absorption of EU funds. As a result, we see a moderate increase in growth next year to 2.8% from about 2.5% in 2013. Concurrently, we expect inflation to hit 3% in 2014 from about 2% in 2013. In our view, recent development, the ECB's unexpected rate cut, the new *Inflation Report* and Governor Isarescu's recent remarks, have raised the likelihood of a 25bp easing in 1Q 2014. This, coupled with the NBR's inclination to leave excess liquidity in the market, paints a more challenging outlook for the leu in 2014.

Figure 62. Czech Republic and Romania — Economic Forecasts, 2013-2015F

		Czech Republic			Romania		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	-1.3%	1.9%	2.4%	2.5%	2.8%	3.3%
Final Domestic Demand	YoY	-0.8	1.6	2.5	-0.4	2.3	3.3
Private Consumption	YoY	-0.3	1.2	1.2	0.3	2.1	3.5
Fixed Investment	YoY	-4.1	3.5	6.4	-3.0	3.2	3.5
Exports	YoY	1.1	6.4	7.1	9.0	4.5	4.5
Imports	YoY	0.7	6.4	7.4	0.5	3.0	4.0
CPI	YoY	1.4	1.2	1.9	4.1	1.9	2.7
Unemployment Rate	%	7.1	6.6	5.7	5.2	5.5	5.5
Current Account	US$ bn	0.1	2.7	1.4	-2.3	-6.3	-9.2
	% of GDP	0.0	1.3	0.7	-1.2	-3.1	-4.2
Fiscal Balance	% of GDP	-2.4	-2.9	-2.9	-2.5	-2.3	-2.3
EURCZK, USDRON	Average	26.2	26.9	26.2	3.3	3.2	3.2

Sources: Haver Analytics and Citi Research forecasts

Brazil

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We continue to believe that economic growth will not show a significant improvement after the disappointing 3Q13 GDP figure, supporting our 2013 and 2014 annual GDP growth estimates of 2.6% and 2.0%, respectively. BRL depreciation and resultant inflationary risks will likely lead the Central Bank to hike the Selic rate further to 10.75% in February 2014. We expect the Central Bank to resume the tightening cycle in 2015 and to increase the Selic rate by 125bps, to 12%, in 1H15. Tighter monetary policy should roughly offset the impact of the weaker BRL, and thus we keep our 2014 and 2015 year-end CPI inflation estimates at 5.9% and 5.5%, respectively. In terms of fiscal policy, we continue to see the primary surplus at around 1.5% of GDP in 2014, an insufficient level to ensure a declining trend for the net public debt/GDP ratio. The weaker BRL and a steady improvement in global growth should cause the current account deficit to narrow in coming years. Finally, President Rousseff's popularity continues at a level which suggests that her reelection is the most likely outcome in the October 2014 presidential election.

Mexico

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Economic activity has started to recover gradually. 3Q13 data show evidence of a rebound in exports, supported by the recovery in U.S. activity. For 2014 and 2015, we expect GDP to grow 3.8% and 4.0%, respectively. Our forecasts are based on better prospects for external demand, which should eventually spill over into the local economy. Inflation continues to trend towards Banxico's permanent target of 3%, with core inflation acting as an important anchor for headline inflation. For 2014, we expect inflation to remain in check on the back of weak domestic demand and low international food commodity prices. We estimate the recently-approved Fiscal Reform will have an impact of 67bps on inflation, driving it up to about 4.2% in 2014. In this context, Banxico cut the overnight rate by 25bps in October for the second time in a row, but confirmed the end of the mini easing cycle, stating that '*no further reductions in the reference rate would be advisable for the foreseeable future*'. We expect the central bank to keep the policy rate at its current level (3.5%) until 2015. The structural reform agenda continues to move forward. We expect Congress to approve the widely-anticipated energy reform before yearend, while the corresponding secondary laws could be ready in 1Q14.

Figure 63. Brazil and Mexico — Economic Forecasts, 2013-2015F

		Brazil			Mexico		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	2.6%	2.0%	2.0%	1.2%	3.8%	4.0%
Final Domestic Demand	YoY	3.1	1.8	1.9	2.0	4.1	4.3
Private Consumption	YoY	1.9	1.9	1.9	2.5	4.0	3.9
Fixed Investment	YoY	7.6	0.3	1.1	1.7	5.8	6.9
Exports	YoY	1.9	6.3	6.8	2.6	8.0	7.6
Imports	YoY	8.0	3.9	4.4	3.0	8.5	8.4
CPI	YoY	6.2	6.0	5.7	3.8	4.0	3.7
Unemployment Rate	%	5.5	5.8	6.0	5.0	4.8	4.8
Current Account	US$ bn	-77.5	-71.6	-70.6	-21.2	-26.4	-25.1
	% of GDP	-3.5	-3.4	-3.1	-1.7	-1.9	-1.7
Fiscal Balance	% of GDP	-3.6	-3.9	-2.7	-2.4	-3.5	-2.5
US Dollar Exchange Rate	Average	2.19	2.42	2.49	12.76	12.57	12.37

Sources: Haver Analytics and Citi Research forecasts

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Plummeting international reserves, stagnant activity, a widening fiscal deficit and consistently high inflation combine to create a challenging mix for 2014. Clearly, the most pressing issue for the authorities is the drain in BCRA reserves. We expect international reserves to stand near USD31bn by end-13, down from USD43.3bn a year earlier. With USD7bn payments of public debt in 2014 (assuming a December GDP warrants payment), BCRA gross reserves could stand close to USD20bn by end-2014 in the absence of new FX measures. The likely government response is a tightening in FX controls. If successful, the resulting rise in FX purchases by the BCRA, together with increased fiscal needs in pesos, should lead to an acceleration in money growth from 27% this year to around 35% in 2014. Inflationary pressures are a likely consequence and the parallel exchange rate premium could widen. Higher inflation, together with weaker currencies in key trading partners, may push the BCRA to increase the rate of crawl of the official USDARS, which is expected to increase from 6.25 at end-2013 to 8.45 by end-2014. Lastly, we expect our in-house GDP estimator to increase only 0.5% in 2014, after expanding 2.7% in 2013.

Venezuela

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The political and economic outlook continues to worsen. President Maduro's recent announcements of further price- and FX-controls have heightened uncertainty over future economic policies. We now expect a significant economic slowdown, from 5.6% GDP growth in 2012, to 2.0% in 2013, and about 0% in 2014. In our view, the economic slowdown will not translate into lower inflation, since inflationary dynamics continue to be driven by ample liquidity, scarcity and bottlenecks in local production — issues that the government is not tackling. In addition, we forecast a devaluation of the CADVI rate from VEF6.3 to VEF10, and we expect SICAD's or another government's alternative rate to stand around VEF17. The main risk will continue to be the evolution of oil revenues, which in turn will depend on the dynamics of oil prices. In that sense, we computed three levels for the average price of the Venezuelan oil basket for 2014 which could affect the country's current account (CA) surplus in different magnitudes. According to our calculations, a price of USD91.4 per barrel for the Venezuelan basket could take the CA surplus to 3% of GDP. Additionally, an average oil price of USD86.8 per barrel could take the CA surplus to 1.8% of GDP. The CA surplus could evaporate if the average price of the Venezuelan oil basket reaches USD80 per barrel.

Figure 64. Argentina and Venezuela — Economic Forecasts, 2013-2015F

		Argentina			Venezuela		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	5.1%	3.0%	2.0%	2.0%	0.0%	2.0%
Final Domestic Demand	YoY	6.2	2.8	2.1	1.4	-0.7	0.7
Private Consumption	YoY	6.3	3.3	2.3	3.8	0.3	0.3
Fixed Investment	YoY	5.6	1.2	0.1	-0.5	-2.4	0.9
Exports	YoY	-0.4	-1.6	-1.5	0.0	1.3	4.2
Imports	YoY	8.3	-1.9	0.0	-0.3	-1.5	-1.0
CPI	YoY	10.5	12.4	13.8	38.8	59.0	63.8
Unemployment Rate	%	7.5	7.8	7.8	5.9	6.5	6.7
Current Account	US$ bn	-2.5	-1.9	-1.6	13.7	13.5	11.4
	% of GDP	-0.5	-0.4	-0.4	3.6	3.8	3.3
Fiscal Balance	% of GDP	-2.3	-3.1	-2.3	-11.7	-11.8	-11.9
US Dollar Exchange Rate	Average	5.52	7.44	10.04	6.13	10.00	16.50

Sources: Haver Analytics and Citi Research forecasts

Saudi Arabia

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We believe the Saudi non-oil economy is set to continue growing strongly, but that oil production is likely to shrink slightly, and we are forecasting an average for 2013 of 9.2mbpd, down from an expected average of around 9.5mbpd this year. The drop in production will reflect the slight softening in oil prices that we are forecasting going forward, along with increased production elsewhere in the region, most notably Iraq. The ongoing talks between the P5+1 and Iran may, in our opinion, result in an easing of some sanctions on oil exports. If this were to happen, it would represent a downside risk to Saudi production and our economic forecasts. Public finances and external balances are expected to remain robust in the near term: the current account surplus will remain in double digits in 2014, while the fiscal surplus will narrow from around 10% this year to a still-healthy 5% in 2014. That said, we think rising expenditures and an expected leveling off in oil revenues present a challenge in the medium- to long-term. The fiscal breakeven oil price will rise to $90 per barrel in 2014 and will continue to rise, resulting in forecast deficits as early as 2016. Although Saudi has ample resources to finance expected deficits from current cash reserves, the outlook does underscore the need for structural reform to set public finances on a long-term sustainable footing.

United Arab Emirates

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Dubai has just learned that its bid to host the 2020 World Expo has been successful. We believe that this successful bid will provide a moderate stimulus to Dubai's economy, and do not believe the government's commitment to financing the required US$7bn in capital outlays to host the event will present significant additional financing risks to the Dubai sovereign. However, we do have concerns the impact on sentiment will lead to further exuberance in the real estate market. Cluttons' data show that the average selling price of mid-range villas in August has risen 34% since the start of the year, and 50% compared with the same period a year earlier. The announcement of new real estate projects capitalizing on the resurgence of the property market continues unabated. For now, construction activity remains contained to new developments in prime locations, such as on the Palm or in the Downtown area. Should we see a surge in construction activity in less prime areas, accompanied by aggressive off-plan sales strategies, we believe the potential for further property-led volatility in the Dubai economy will become increasingly likely. Dubai Expo could, in our view, be a trigger for such activity.

Figure 65. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2013-2015F

		Saudi Arabia			United Arab Emirates		
		2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	6.1%	5.8%	6.2%	3.7%	4.0%	4.0%
Final Domestic Demand	YoY	8.0	8.1	8.1	4.7	4.7	4.7
Private Consumption	YoY	5.0	5.0	5.0	5.0	5.0	5.0
Fixed Investment	YoY	10.0	10.0	10.0	5.0	5.0	5.0
Exports	YoY	-1.2	1.0	1.3	14.0	13.0	14.0
Imports	YoY	15.0	15.0	15.0	15.0	15.0	15.0
CPI	YoY	3.5	3.4	4.1	1.1	1.3	1.5
Current Account	US$ bn	134.5	106.4	75.8	114.8	102.5	90.1
	% of GDP	18.1	13.5	9.0	28.0	23.3	19.1
Fiscal Balance	% of GDP	10.3	5.1	0.4	NA	NA	NA
US Dollar Exchange Rate	Average	3.75	3.75	3.75	3.67	3.67	3.67

Sources: Haver Analytics and Citi Research forecasts

Egypt

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The military's political roadmap to a new political dispensation should clearly unfold in 2014. We expect a new constitution to be approved by a referendum early in the year, paving the way for parliamentary and presidential elections in the rest of the year. This is likely to have the support of foreign governments, and although the course of the transition may not be smooth, it is likely to remain on track. Meanwhile, considerable inflows of Gulf support have helped stabilize the exchange rate and eased, but not eliminated, foreign exchange shortages. Moreover, the government plans to use Gulf support to fund a major push in capital spending in 2014 to kick-start the economy. The hope is that, with greater political stability, investment and tourism will start to recover in 2H 2014 and into 2015. But while this scenario would help drive a recovery, it is not a long-term solution to the problems facing the economy or stabilizing the EGP, notably the pressing need for a medium- to long-term strategy to reduce the fiscal deficit.

South Africa

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We now see more downside risk to both 2013 and 2014 GDP in South Africa. Prolonged strike action in the motor sector may well pull this year's GDP growth below 2.0% and is a reminder that labour unrest is a significant risk to our forecast for 2.8% GDP growth in 2014. Consumption may rise slightly in the very near-term owing to sticky wages, some disinflation, temporary employment (ahead of the April 2014 National Elections) and the credit amnesty. However, stretched balance sheets remain a significant 'cap' to household consumption growth. The limited take-up of EM exports by DMs, ZAR volatility and the ongoing labour saga means business confidence will remain low, keeping private sector capex sluggish and limiting the responsiveness of exports to a weaker ZAR. The persistently wide current account and budget deficits bring structural weakness to the fore, keeping the ZAR on the back foot and prompting a hawkish undertone to SARB commentary. That said, rate hikes are still highly unlikely while CPI is back within the 3-6% target band (even if mostly due to base effects). Put together, we believe all these factors create the perfect storm for another sovereign ratings downgrade which only clear policy direction and diminished labour strife can avoid. Unfortunately, the risk of service delivery and/or labour strikes is elevated ahead of the Q2 14 National Elections while politics will still take some time to 'settle' after the event, limiting policy progression.

Figure 66. Egypt, Nigeria and South Africa — Economic Forecast, 2013-2015F

		Egypt			Nigeria			South Africa		
		2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Real GDP	YoY	2.0%	2.9%	3.4%	6.5%	6.5%	6.3%	1.9%	2.8%	3.5%
Final Domestic Demand	YoY	3.1	4.2	6.1	NA	NA	NA	2.8	3.5	4.3
Private Consumption	YoY	2.7	3.5	5.1	NA	NA	NA	2.5	3.5	4.1
Fixed Investment	YoY	3.0	8.9	10.3	NA	NA	NA	3.6	3.8	5.0
Exports	YoY	2.9	2.0	6.0	NA	NA	NA	5.4	4.4	5.4
Imports	YoY	2.3	4.7	13.4	NA	NA	NA	6.4	6.6	7.5
CPI	YoY	9.2	8.1	6.8	8.5	8.8	10.6	5.8	5.6	5.5
Unemployment Rate	%	13.5	14.2	14.5	NA	NA	NA	25.5	25.0	24.6
Current Account	US$ bn	-6.8	-7.5	-9.0	14.0	7.2	9.1	-24.7	-20.5	-20.8
	% of GDP	-2.7	-2.8	-3.2	4.3	2.0	2.2	-7.1	-5.7	-5.3
Fiscal Balance	% of GDP	-12.8	-12.1	-10.0	-2.1	-2.9	-2.9	-4.4	-4.3	-4.4
US Dollar Exchange Rate	Average	6.89	7.16	7.54	159.4	163.54	168.00	9.85	10.36	10.29

Sources: Haver Analytics and Citi Research forecasts

Figure 67. Selected Emerging Market Countries — Economic Forecast Overview, 2013-2015F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Asia	**6.2%**	**6.2%**	**6.3%**	**3.7%**	**3.9%**	**4.1%**	**2.0%**	**1.8%**	**1.3%**	**-2.3%**	**-2.1%**	**-1.7%**
China	7.6	7.3	7.0	2.7	3.3	3.7	2.2	2.0	1.5	-2.0	-2.0	-1.5
Hong Kong	3.0	3.4	3.8	4.3	3.6	4.0	2.8	3.1	3.9	2.2	1.6	0.7
India*	4.8	5.6	6.7	6.0	5.0	5.0	-2.7	-2.4	-2.4	-6.7	-6.4	-6.2
Indonesia	5.7	5.3	5.5	7.1	6.6	5.7	-3.5	-2.8	-2.3	-2.1	-1.8	-1.7
Korea	2.9	3.7	3.9	1.2	2.3	3.1	5.6	4.1	3.2	0.9	2.3	2.3
Malaysia	4.5	5.0	4.9	2.1	3.4	4.3	3.7	4.4	4.0	-4.2	-3.5	-3.0
Mongolia	12.0	11.0	8.0	10.3	12.0	9.0	-27.4	-21.4	-17.6	-8.0	-6.4	-3.0
Philippines	6.7	7.3	6.8	2.8	3.5	3.9	3.5	3.1	2.9	-1.7	-1.8	-1.2
Singapore	4.0	3.5	4.0	2.4	2.1	2.2	14.0	13.5	13.0	0.7	0.5	0.5
Sri Lanka	6.8	7.0	7.0	7.0	6.5	6.5	-4.6	-3.1	-3.6	-6.0	-5.7	-5.5
Taiwan	2.0	3.2	3.8	1.1	1.7	2.3	10.9	9.8	9.5	-1.5	-1.4	-1.2
Thailand	2.8	3.1	4.3	2.1	2.2	3.1	-0.9	-0.7	-1.0	-1.8	-2.0	-2.4
Vietnam	5.2	5.5	5.8	6.7	7.1	7.2	5.0	3.8	2.5	-5.3	-4.5	-4.0
Latin America	**2.6**	**2.7**	**3.0**	**7.4**	**8.6**	**8.9**	**-2.4**	**-2.4**	**-2.2**	**-3.4**	**-3.8**	**-2.8**
Argentina	5.1	3.0	2.0	10.5	12.4	13.8	-0.5	-0.4	-0.4	-2.3	-3.1	-2.3
Brazil	2.6	2.0	2.0	6.2	6.0	5.7	-3.5	-3.4	-3.1	-3.6	-3.9	-2.7
Chile	4.0	4.0	4.5	1.7	2.6	2.9	-3.5	-3.8	-4.0	-0.4	-0.5	-0.6
Colombia	3.9	4.6	5.0	2.0	2.4	3.3	-3.1	-3.2	-3.5	-1.1	-0.7	-0.7
Mexico	1.2	3.8	4.0	3.8	4.0	3.7	-1.7	-1.9	-1.7	-2.4	-3.5	-2.5
Panama	7.2	6.5	5.5	4.0	2.7	2.8	-14.3	-13.6	-9.2	-3.5	-3.0	-3.0
Peru	5.1	5.3	6.0	2.8	2.5	2.5	-4.6	-4.8	-4.0	-0.6	-2.0	0.5
Venezuela	2.0	0.0	2.0	38.8	59.0	63.8	3.6	3.8	3.3	-11.7	-11.8	-11.9
Europe	**1.8**	**2.8**	**3.0**	**5.3**	**4.8**	**4.7**	**-1.0**	**-1.2**	**-1.4**	**-2.3**	**-2.5**	**-3.6**
Bulgaria	0.5	1.5	2.5	1.2	2.8	2.5	0.0	-0.8	-1.5	-2.0	-2.0	-1.2
Croatia	-1.0	1.2	2.0	2.3	2.3	2.8	-0.1	-0.5	-1.0	-5.5	-5.7	-5.0
Czech Republic	-1.3	1.9	2.4	1.4	1.2	1.9	0.0	1.3	0.7	-2.4	-2.9	-2.9
Hungary	1.0	1.9	1.5	1.7	1.5	3.3	1.5	0.9	0.8	-2.9	-3.0	-2.9
Kazakhstan	5.1	4.0	4.4	5.8	5.5	5.3	0.2	1.6	2.1	2.7	1.8	1.7
Poland	1.4	3.1	3.6	1.0	1.9	2.8	-1.5	-2.4	-3.4	-4.6	5.2	-2.6
Romania	2.5	2.8	3.3	4.1	1.9	2.7	-1.2	-3.1	-4.2	-2.5	-2.3	-2.3
Russia	1.4	2.6	2.7	6.7	5.3	4.9	1.6	1.1	0.8	-2.0	-4.3	-4.9
Serbia	2.5	2.0	2.2	8.3	6.6	5.9	-5.5	-6.0	-6.5	-5.0	-5.0	-4.7
Slovakia	0.8	1.8	2.4	1.4	1.1	1.8	4.3	4.0	3.4	-3.4	-3.2	-2.6
Turkey	3.5	3.5	3.6	7.5	7.3	6.9	-7.0	-6.3	-5.8	-1.2	-2.8	-3.2
Ukraine	-0.7	1.6	3.3	-0.3	3.9	4.8	-6.8	-5.4	-5.0	-6.7	-4.2	-4.0
Africa/Mideast	**4.4**	**5.0**	**5.3**	**4.2**	**4.5**	**5.0**	**12.5**	**10.3**	**8.1**	**2.8**	**1.1**	**-0.3**
Bahrain	4.3	4.0	4.1	3.3	2.2	2.0	5.3	2.4	-1.5	-2.2	-3.3	-5.5
Egypt	2.0	2.9	3.4	9.2	8.1	6.8	-2.7	-2.8	-3.2	-12.8	-12.1	-10.0
Ghana	7.4	6.8	6.5	11.4	11.2	8.8	-12.0	-11.2	-10.2	-9.2	-7.7	-6.5
Iraq	3.1	10.4	11.6	2.2	5.8	6.0	13.5	13.8	12.8	1.6	3.5	4.3
Israel	3.2	3.4	3.5	1.6	2.3	3.0	2.6	2.0	0.7	-3.6	-3.0	-2.5
Jordan	3.0	4.0	4.5	5.7	4.8	5.0	-15.2	-14.2	-11.9	-8.2	-9.5	-9.3
Kenya	5.5	6.1	6.5	5.6	6.6	7.3	-10.1	-9.5	-9.0	-7.0	-5.5	-4.5
Kuwait	4.2	3.8	3.9	2.6	3.3	5.0	51.0	49.5	47.8	36.8	32.1	29.5
Lebanon	1.4	-0.9	-3.1	2.1	3.7	5.0	-4.5	-5.4	-6.5	-10.0	-9.6	-8.3
Nigeria	6.5	6.5	6.3	8.5	8.8	10.6	4.3	2.0	2.2	-2.1	-2.9	-2.9
Oman	6.7	6.7	6.7	1.3	2.0	3.0	10.3	8.1	6.2	-0.2	-3.4	-5.4
Qatar	5.6	5.9	6.1	3.1	3.0	3.5	29.7	25.5	20.7	8.1	4.2	1.2
Saudi Arabia	6.1	5.8	6.2	3.5	3.4	4.1	18.1	13.5	9.0	10.3	5.1	0.4
South Africa	1.9	2.8	3.5	5.8	5.6	5.5	-7.1	-5.7	-5.3	-4.4	-4.3	-4.4
Tanzania	6.8	7.0	8.1	8.0	6.5	6.7	-10.2	-14.1	-12.4	-5.0	-5.2	-5.9
UAE	3.7	4.0	4.0	1.1	1.3	1.5	28.0	23.3	19.1	NA	NA	NA
Uganda	5.0	5.6	6.5	5.9	8.7	6.0	-12.0	-13.9	-14.9	-3.4	-3.3	-3.5
Zambia	6.0	6.4	6.3	7.1	6.8	7.4	-3.2	-2.8	-3.0	-8.5	-6.4	-5.5
Total	**4.6**	**4.9**	**5.0**	**4.7**	**5.0**	**5.2**	**1.9**	**1.5**	**1.1**	**-2.0**	**-2.2**	**-2.1**

* Note: In India, policymakers look at the wholesale price index. Sources: National sources and Citi Research forecasts

Sovereign Ratings Outlook

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

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

Figure 68. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

	S&P Ratings				Moody's Ratings			
Country	Current Rating	Current Outlook	Citi Near-term (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-4 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Near-term (Up to 9 Months) Forecast Rating	Citi Longterm (Next 2-4 Years) Forecast Rating & Outlook
US	AA+	Stable	AA+ (Stable)	AA+	Aaa	Stable	Aaa (Stable)	Aaa
Canada	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3 (Stable)	A1 ↓
Germany	AAA	Stable	AAA (Stable)	AAA	Aaa	Neg	Aaa (Neg)	Aaa
France	AA	Stable	AA (Stable)	AA	Aa1	Neg	Aa2 (Stable) ↓	Aa2 ↓
Italy	BBB	Neg	BBB- (Neg) ↓	BBB- ↓	Baa2	Neg	Baa2 (Neg)	Baa3 ↓
Spain	BBB-	Stable	BBB- (Stable)	BBB-	Baa3	Neg	Baa3 (Stable)	Baa3
Austria	AA+	Stable	AA+ (Stable)	AA+	Aaa	Neg	Aaa (Neg)	Aaa
Belgium	AA	Neg	AA (Neg)	AA	Aa3	Neg	Aa3 (Neg)	Aa3
Finland	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa
Greece	B-	Stable	B- (Stable)	B-	Caa3	Stable	Caa3 (Stable)	Caa3
Ireland	BBB+	Positive	A- (Stable) ↑	A- ↑	Ba1	Stable	Baa3 (Pos) ↑	Baa2 ↑↑
Netherlands	AA+	Stable	AA+ (Stable)	AA+	Aaa	Neg	Aa1 (Stable) ↓	Aa1 ↓
Portugal	BB	Neg W	BB- (Neg) ↓	BB- ↓	Ba3	Stable	Ba3 (Stable)	Ba3
UK	AAA	Neg	AAA (Stable)	AAA	Aa1	Stable	Aa1 (Stable)	Aa1
Switzerland	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa
Sweden	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa
Denmark	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa
Norway	AAA	Stable	AAA (Stable)	AAA	Aaa	Stable	Aaa (Stable)	Aaa

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

* Based Citi economists' longer term (2015-2018) view, Citi expects Greece and Portugal to remain sub-investment grade in coming years.

Expected Ratings Issues in 2014 and Beyond

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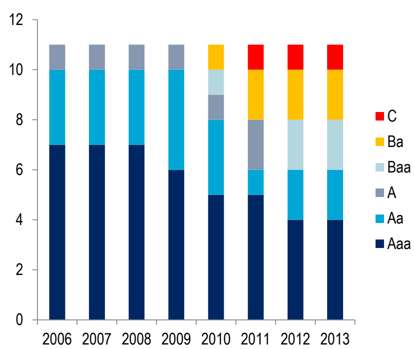
Overview: As Moody's explicitly stated in its recent 2014 Outlook (25 November), "*After several tumultuous years, global sovereign credit worthiness is likely to be comparatively stable in 2014*"[26]. In 2014, we expect the pace of rating changes to slow. There is already evidence of this from 2013 and note that more sovereigns have been placed back onto "stable" outlook by various rating agencies (*European Rates Weekly*). Furthermore, the rating distribution by Moody's of EMU-11 countries is the same in 2013 as it was in 2012 — following several downgrades in 2010-2012 (see Figure 69). In fact, this year so far only saw 3 downgrades (Figure 70), all by S&P (Italy from BBB+ to BBB, France from AA+ to AA, and the Netherlands from AAA to AA+). We detail our country-specific forecasts below.

Figure 69. EMU-11* Rating Transitions (Count of sovereigns as rated by Moody's at the end of each year)



Sources: Citi Research, Moody's, Bloomberg
*Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Ireland, Portugal, Greece

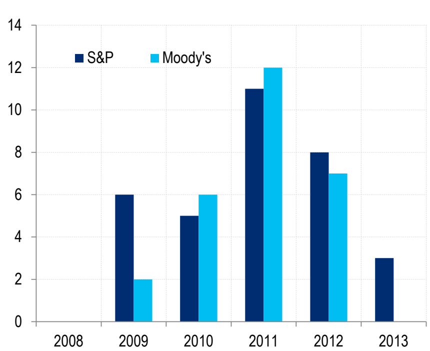
France: We expect Moody's to cut France's sovereign rating by one notch to Aa2 in coming months, matching S&P's move (AA, stable outlook) as very slow progress on the structural reform path and low nominal GDP growth continue to suggest that the debt-to-GDP ratio will only peak in 2016, close to 98%.

Netherlands: Soft GDP growth and the housing market are areas of concerns, against a backdrop of banking system weakness. Together with the difficulties encountered by the government in passing the budget, we think Moody's will downgrade by one-notch to Aa1 (in line with the recent move by S&P).

Belgium: The sovereign rating is likely to remain unchanged over the forecast horizon at AA and Aa3, for S&P and Moody's, respectively. The political situation is a credit risk, but stabilisation in the public debt/GDP ratio and gradual reduction in worries over the banks will likely help both agencies assign a neutral outlook.

Ireland: Ireland is the only sovereign whose rating is on "positive" outlook (S&P). The last time S&P upgraded a sovereign (excluding Greece from "SD" to B-) was back in December 2004 (upgrading Spain to AAA). Moody's also changed its outlook on Ireland's Ba1 rating from "negative" to stable. We continue to expect Ireland to be upgraded by one notch by both rating agencies in 2014.

Figure 70. Count of downgrades of EMU-11 sovereigns*



Sources: Citi Research, Moody's, S&P, Bloomberg
*This is simply a count of whether a downgrade occurred or not – it does not count the number of notches per downgrade

Italy: Another downgrade by S&P (to BBB-) in coming months is likely in our view, due to the government shift towards a looser fiscal policy, lack of progress on growth-enhancing measures and of meaningful spending cuts. Medium-term, we revised our call for a debt restructuring occurring within the next 4 years and hence lifted the rating outlook; but we think the rising debt/GDP ratio will keep Italy's rating at the low end of the investment grade spectrum.

Spain: With ongoing modest improvement in economic activity and progress in the rebalancing the economy (also via marginally negative inflation), we think the rating outlook may be revised to stable also by Moody's in 2014. However the still-large fiscal deficit and limited reform efforts, together with sluggish GDP growth, will likely keep the rating at the low end of the investment grade scale in coming years.

UK: Given the strong recovery, we believe S&P in 2014 will remove its negative outlook on the UK's AAA rating. It is possible that Moody's (which rates the UK Aa1 with a stable outlook) will put the UK on a positive outlook over the next few years.

US: The US is rated AA+ Stable by S&P and Aaa Stable by Moody's and as such, we do not anticipate any change in the US rating over the long term, although the rating agencies are likely to follow closely a return of the debt ceiling debate in Q1.

[26] Moody's Investor Service "*2014 Outlook – Global Sovereigns*" 25 November 2013.

Yield and Spread Forecast Commentary

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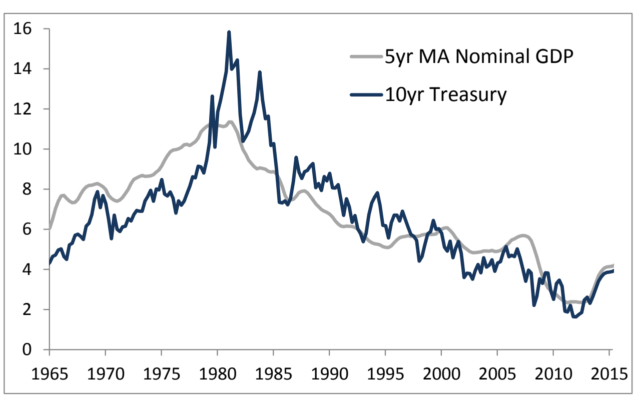
US Rates Strategy: 2014 is likely to be a year when we need to further analyze what 'normalization' means. Entering 2013, Treasury yields were driven by tail risks, namely European risk factors. Now they are driven primarily by US economic fundamentals and the associated expectations surrounding the Federal Reserve. Entering 2013, 10yr TIPS real yields and estimated term premium of 10yr nominal Treasuries were significantly negative. Now real yields are meaningfully positive and the term premium is slightly positive. With relatively optimistic economic expectations for 2014, we would expect further normalization in Treasury yields in 2014. The question to ask is: what does normalization mean following a 30-year drop in 10yr Treasury yields from above 15% in 1981 to below 1.5% in 2012? To get a sense for an appropriate 'terminal' level on 10yr Treasury yields we can look at a very long-term relationship between nominal GDP and 10yr Treasury yields (see Figure 71). Over the past 50 years 10yr Treasury yields have averaged about 25bp less than nominal GDP. Based on our longer-term economic expectations this would suggest a top of cycle 10yr Treasury yield of just above 4%. We do not expect 2014 to be the top of the cycle (Fed Funds are likely to remain on hold the entire year), so 4% as a mid-range point on 10yr yields is probably still a few years away. However, we do expect 10yr yields to move safely above 3% in 2014 and end the year at 3.3%.

The 5yr – 10yr Treasury curve will likely bear flatten in 2014 as the initial Fed Funds date draws near. However, further steepening is likely early in 2014.

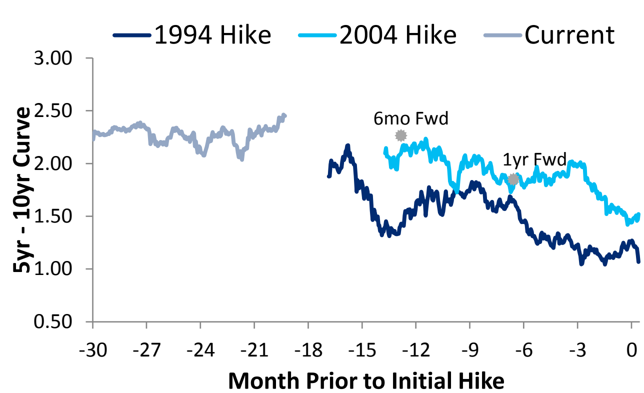
Perhaps even more interesting in 2014 will be the evolution of the Treasury curve. We expect the Federal Reserve will end QE 3 by September of 2014, with the initial tapering of purchases coming in March. With purchases focused on longer maturity securities and one of the main impacts of QE thought to be on term premiums, this should have the most impact on longer maturity yields. However, the true impact of QE has appeared far more complicated and changes in QE expectations have often equally impacted shorter-maturity yields. This is something the Federal Reserve expressed frustration in during 2Q-2013, when 'taper talk' had the most impact on the 5yr and 7yr part of the curve. Since then, the Fed has been diligent in trying to disentangle QE expectations and Fed Funds expectations - with some degree of success late in 2013. While the curve has steepened into 2013 year-end, we think that room remains for additional steepening based on the likely amount of time to the first hike of Fed Funds. Figure 72 shows that current market levels of the 5yr – 10yr curve are in line with the 2004 Fed tightening cycle, when adjusted for months prior to initial hike. Given the potential for a flatter path of hikes in this cycle, perhaps this curve should be even steeper early in 2014. However, by late 2014 this curve risks flattening dramatically as the date of the initial hike draws nearer.

Figure 71. 10yr Treasury Yields Tend Towards 4% at Cycle Top



Sources: Bloomberg and Citi Research

Figure 72. Curve Steepness is Appropriate Given Time to Fed Hike



Sources: Bloomberg and Citi Research

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Core Europe: Bullish domestic factors will blend with a bearish US yield environment in 2014. We do not expect a substantial deviation of Bund yields from current levels in the coming three quarters (1.7-1.8%). However, the front-end of the EUR curve will de-couple further from the US given our forecast of another 25bp refi rate cut and 10bp deposit rate cut by the ECB. Together with somewhat enhanced forward guidance, this should anchor the 0-5y sector to flat monetary policy expectations, thus fuelling carry trades and further lowering Bobl's sensitivity to UST. Going into 2015, we see a slight improvement in the beta between Treasuries and Bunds and forecast yields to test 2%. The uncertainty around our baseline comes mainly from further potential downward adjustment in HICP and the efficacy of ECB's response. The yield curve will reflect all these factors and we expect a steepening, especially in the 5-10y segment. The Eurozone's Three Pillar strategy will continue to provide ample support for core and non-core EGBs alike. Spreads to Bunds should remain at current tight levels with Austria and Belgium expected to outperform France and the Netherlands in 2014.

EMU Periphery: Steady demand from resident investors together with an increased risk appetite from foreign investors have been the main drivers of peripheral spreads in 2013. Apart from sporadic and short-lived bursts of risk aversion, macroeconomic, fiscal and political arguments have played a minor role. In this benign environment, we expect the ECB's measures to continue supporting the performance of peripheral EGBs also in 2014, albeit not at the pace seen this year. We expect 10y Bonos to outperform BTPs again, mainly due to Italy's persistent underachievement in terms of implementing a credible reform agenda. Special mention to Ireland, which will be outside of the official support programme in 2014 and is expected to validate the high level of expectations that have driven its performance in 2013.

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Japan: We expect JGB yields to hover at low levels in the first half of 2014. Investors will likely plan their portfolio management with an eye on reinvestment risks due to the cumulative market impact of the BoJ's bond purchase program and the redemption of high coupon JGBs. A transient slowdown of domestic growth is envisaged around the time of 3% consumption tax hike in April next year, which we believe will curb the top side of JGB yields. Meanwhile, the BOJ is expected to implement further easing around Jun/Jul 2014. PM Abe in his policy management will likely stay focused on economic growth and JGB yields will then shift higher on a moderate pace from summer onwards along with gradual rises in growth and inflation expectations. That said, however, many players in the bond market are skeptical that the BoJ will be able to achieve a 2% price stability target and so a rise of JGB yield will be modest, in our view.

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UK: The forecasts for gilt yields in 2014 suggest a gradual shift towards higher yield levels. For the yield outlook, the speed of policy normalisation is more important than the timing of the first rate hike. Our base case is that policy rates begin to move higher in Q2 2015 and reach around 2% relatively quickly before a fresh assessment is made. The economic uncertainties remain great, but the recovery appears to be gathering pace and the risks to our forecasts are probably skewed towards higher yields. The core themes reflected in the forecasts are further underperformance of gilts vs Bunds and a relatively tight spread vs Treasuries. The 2s10s curve is likely to begin to bear flatten from mid-2014 as the first rate hike comes into view.

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Australia: With RBA policy most likely unchanged next year, we expect Aussie fixed income markets to be highly correlated to offshore event risks. The yield curve will remain directional, implying a risk of further steepening as Fed tapering pushes US yields higher. In the latter months of 2014 we see a greater risk of domestic curve flattening and cross market underperformace for AUD markets as the risk of a reversal in the policy cycle draws closer.

Figure 73. Interest Rate and Bond Market Forecasts as of 2 December 2013

	Quarterly Average						
	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.24	0.24	0.24	0.24	0.24	0.32	0.45
2 Year Treasury Yield	0.28	0.31	0.45	0.63	0.80	0.98	1.13
5 Year Treasury Yield	1.35	1.40	1.58	1.80	2.05	2.30	2.50
10 Year Treasury Yield	2.75	2.80	2.95	3.13	3.25	3.38	3.50
30 Year Treasury Yield	3.84	3.92	4.13	4.30	4.40	4.53	4.65
2-10 Year Treasury Curve	247	249	250	250	245	240	238
2 Year Swap Spread (Swap Less Govt), bp	10	15	20	20	20	20	20
10 Year Swap Spread (Swap Less Govt), bp	7	8	13	15	15	15	15
30 Year Swap Spread (Swap Less Govt), bp	-9	-7	-5	-5	-5	-5	-5
30 Year Mortgage Yield	4.35	4.43	4.60	4.78	4.95	5.15	5.33
10 Year Breakeven Inflation	220	230	240	238	235	238	238
Euro Area							
Policy Rate	0.25	0.25	0.00	0.00	0.00	0.00	0.00
Overnight Rate (EONIA)	0.13	0.10	0.00	0.00	0.00	0.00	0.00
3-Month (EURIBOR)	0.19	0.20	0.10	0.15	0.15	0.15	0.15
2 Year Schatz Yield	0.12	0.15	0.00	0.05	0.10	0.10	0.10
5 Year Bobl Yield	0.65	0.60	0.50	0.50	0.50	0.60	0.60
10 Year Bund Yield	1.70	1.70	1.70	1.70	1.80	1.90	1.90
30 Year Bund Yield	2.63	2.60	2.60	2.60	2.60	2.60	2.60
2-10 Year Bund Curve	158	155	170	165	170	180	180
10 Year BTP-Bund Spread	218	220	210	200	175	175	175
10 Year Bono-Bund Spread	246	230	220	180	150	150	150
2 Year BTP-Schatz Spread	100	100	75	75	50	50	50
2 Year Bono Schatz Spread	118	110	75	75	50	50	50
10 Year OAT-Bund Spread	47	50	45	45	45	45	45
10 Year Swap Spread (Swap Less Govt.), bp	27	35	25	25	25	25	25
10 Year Breakeven Inflation	144	140	145	145	150	150	150
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.14	0.15	0.15	0.15	0.15	0.15	0.15
2 Year Treasury Yield	0.09	0.10	0.10	0.10	0.10	0.15	0.15
5 Year Treasury Yield	0.20	0.20	0.15	0.20	0.25	0.35	0.40
10 Year Treasury Yield	0.60	0.55	0.50	0.60	0.70	0.90	1.00
30 Year Treasury Yield	1.65	1.65	1.60	1.65	1.70	1.85	1.95
2-10 Year Treasury Curve	51	45	40	50	60	75	85
2 Year Swap Spread (Swap Less Govt.), bp	12	12	10	12	14	17	19
10 Year Swap Spread (Swap Less Govt.), bp	17	15	11	14	16	19	20
10 Year Breakeven Inflation	96	95	90	85	85	95	100
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75
3-Month Libor	0.52	0.52	0.55	0.60	0.65	0.70	0.90
2 Year Treasury Yield	0.44	0.50	0.70	0.85	1.00	1.25	1.50
5 Year Treasury Yield	1.54	1.60	1.85	2.00	2.15	2.40	2.60
10 Year Treasury Yield	2.78	2.85	3.05	3.20	3.30	3.40	3.50
30 Year Treasury Yield	3.58	3.65	3.75	3.85	3.90	3.95	4.00
2-10 Year Treasury Curve	234	235	235	235	230	215	200
10 Year Swap Spread (Swap Less Govt.), bp	-5	0	0	5	5	10	15
10 Year Breakeven Inflation	286	280	285	290	295	300	300
Australia							
Policy Rate	2.50	2.50	2.50	2.50	2.50	2.75	3.25
3-Month Libor	2.58	2.60	2.60	2.60	2.65	2.95	3.45
2 Year Treasury Yield	2.69	2.80	2.90	2.90	3.20	3.50	3.80
5 Year Treasury Yield	3.47	3.50	3.60	3.75	3.90	4.20	4.45
10 Year Treasury Yield	4.32	4.30	4.40	4.50	4.60	4.75	4.95
2-10 Year Treasury Curve	164	150	150	160	140	125	115
10 Year Swap Spread (Swap Less Govt.), bp	27	30	30	35	40	45	45

Source: Citi Research

Commodities Market Outlook

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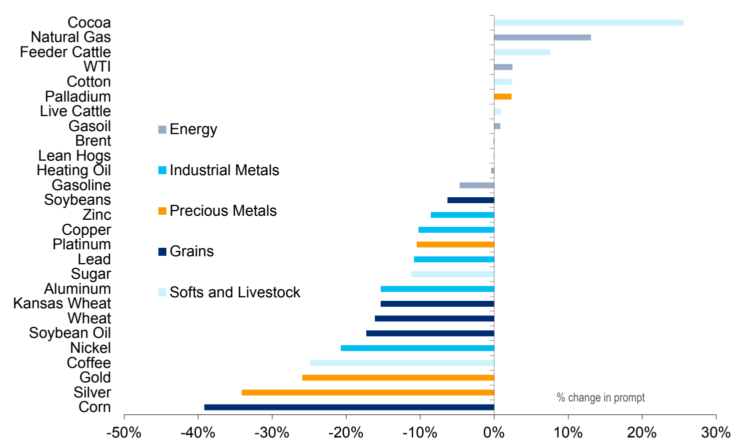
The outlook for commodities is neutral to bearish for 2014 and into 2015, as the sector goes through the final death throes of the super cycle of the last decade. Unless weather or geopolitical tail risk events unfold, 2014 is highly unlikely to show an improvement over 2013 (let alone a V-shaped price recovery) for most commodities, with the pace of declines accelerating in oil and decelerating in most other commodities.

Grains and softs could hold pole positions yet again in aggregate performance, with the bias towards ongoing agricultural underperformance as crop supplies in the US and other producers rebound from the 2012 drought and heat, allowing a cushion of inventories to build despite some tightness for thinly traded cocoa. Precious metals should continue to underperform, with a divergence between a tighter palladium market outperforming gold and silver. Waterborne crude oil streams like Brent, Urals and Oman/Dubai should remain range-bound in a $5-10 lower trading range, with US and Canadian crudes on the whole trading stronger relative to Brent as North America re-connects to global markets.

Figure 74. Commodity Price Changes YTD



Sources: Bloomberg and Citi Research

Some of the weakness in commodities can be attributed to languishing global growth, particularly in the largest emerging market economies. But most of the weakness stems from the growing supply response across virtually all commodities resulting from a record amount of capital expenditures, which mushroomed globally starting in 2002-03 and accelerated through the last decade, with the exception of 2008-09. On top of exploding capital deployment, after a period of severe cost inflation, commodities investments have become increasingly efficient, triggering more supply against stable or even declining capital investment in recent years. This serves as a reminder that commodities markets have always been cyclical, with periods of over-investment leading to more supply and lower prices triggering periods of under-investment, rising demand and higher prices.

The coming year should see US natural gas prices start a march toward higher levels, which Citi forecasts should rise by 70% over the next five years, before stabilizing around $5.50. Copper and most other industrial metals should see recent price slides moderating over the next year and then start another period of rising prices, with an acceleration of new project cancelations resulting from current and expected lower price signals.

Petroleum prices should continue to slide in the years ahead, with new supply from unconventional plays in deep water, oil sands, and tight/shale formations, continuing to increase as the shale revolution deepens in North America and spreads to other areas and as costs continue to decline. But the decline in petroleum should at some point stabilize, perhaps with Brent crude at $90 a new mean reversion level or even a new ceiling price in the period 3- to 5 years ahead. While supply disruptions should continue to haunt the oil markets, as they have since early 2011, the political momentum could well see more supply from Libya, Iraq and even Iran, exacerbating markets that are already oversupplied. To stem a sharp price decline, OPEC might have to take action to rein in prices, which could prove to be challenging in 2014.

Meanwhile, gold has taken a pause, with the major sources of demand falling below expectations. First, private investors continue to disinvest from holdings in both physical gold and in gold-ETFs. Second, jewelry buying, especially in what was once the largest of markets, India, has fallen due to high prices and government import controls. But third, central banks in emerging markets, whose balance sheets were rapidly expanding, are buying less gold than had been expected and this trend looks likely to continue in 2014. But with prices trending toward break-even cost levels for marginal producers, prices look likely to be buffered from another significantly decline. What's more, with an expected recovery in the global economy, emerging market central banks are expected to want to increase their purchases in the years ahead and will likely want to increase their holdings just to make sure they have diversified their reserve base adequately. Meanwhile, with the potential for dollar appreciation and equity market outperformance, there is a less compelling reason to hold gold when appreciating or interest earning assets are available as alternatives.

Two changes in the Chinese economy — lower growth in the 7-8% range (versus last decade's 10-12%) and significantly lower growth of fixed asset investment along with slower and "smarter" urbanization should continue to reduce the commodity intensity of the Chinese economy. On top of this, China has developed a growing amount of indigenous supply of copper and other commodities and this, along with the declining intensity of the economy, should reduce the pull of the China market on global supplies.

While the agricultural sector remains vulnerable to tail risk weather events, there is a big difference in the markets entering 2014 in comparison to this past year. As 2013 started, global inventories were low, as a result of the poor row crop yields in the United States as well as other supplier countries. With a record amount of acreage cultivated in 2013 and with favorable weather conditions around the world, global inventories have been largely restored, thus establishing a decent cushion to buffer bad weather ahead, should drought and high temperatures again prevail in 2014.

Citi believes the conditions for a return to super-cycle conditions are unlikely to re-appear any time soon. Commodities are extraordinarily cyclical when it comes to supply. Capital and acreage can be marshaled fairly quickly when agricultural sector conditions change and markets can be re-balanced within a couple of years. The metals markets are more reflective of age-old Biblical conditions of seven years of feast followed by seven years of famine, for that's just about — if somewhat short of — what it takes to expand mines. And the petroleum sector, especially when it is chasing new sources of supply at high cost frontiers, take more like 20 years to pull in new supply. It is Citi's view that the supply revolutions unfolding in shale, deepwater and oil sands, are ushering in an extended period of ample supply and moderate prices. And, the energy intensity of most commodities should make a new super cycle unlikely any time soon. Even if metals and bulk commodities should see

market tightness ahead, given their energy intensity, price increases should be muted in comparison to what occurred over the last decade. Prices could also be less volatile.

Investors in commodities still have ample opportunities for decent reward versus risk profitability. Seasonality in agriculture and energy, relative value trades between commodities or within commodity groups (e.g. palladium versus gold and silver), and investments based on changing forward curve structures all provide opportunities for investors. And it remains the case that nothing brings returns to investors as large as those in commodities confronting supply-side tail risk events.

Figure 75. Commodities Price Outlook*

		Point Prices																			
		0-3M	6-12M		Q3 2013	Q4 2013E	Q1 2014E	Q2 2014E	Q3 2014E	Q4 2014E	Q1 2015E	Q2 2015E	Q3 2015E	Q4 2015E	2012	2013E	2014E	2015E	2016E	2017E	2018E
Energy				**5Y Cyclical**																	
NYMEX WTI	USD/bbl	97.0	92.5	81.0	108.0	99.0	97.0	89.0	97.0	88.0	91.0	83.0	90.0	81.0	94.1	98.9	92.8	86.3	83.0	78.0	80.0
ICE Brent	USD/bbl	100.0	97.5	85.0	112.0	105.0	100.0	95.0	100.0	95.0	95.0	90.0	95.0	90.0	111.7	108.2	97.5	92.5	90.0	85.0	85.0
Henry Hub Natural Gas	USD/MMBtu	3.70	3.80	N/A	3.55	3.60	3.70	3.60	3.70	3.90	4.20	4.50	4.50	4.80	2.75	3.70	3.70	4.50	4.90	4.90	5.50
Base Metals				**LT Price**																	
LME Aluminum	USD/MT	1,730	1,900	2,200	1,827	1,810	1,780	1,820	1,850	1,880	1,925	1,940	1,960	1,975	2,049	1,885	1,835	1,950	2,000	2,100	2,200
LME Copper	USD/MT	6,700	6,400	6,200	7,096	7,100	6,800	6,700	6,600	6,500	6,500	6,600	7,000	7,200	7,945	7,335	6,650	6,825	7,500	7,800	8,000
LME Lead	USD/MT	2,250	2,300	2,200	2,116	2,160	2,250	2,000	2,150	2,300	2,350	2,100	2,200	2,370	2,072	2,165	2,175	2,255	2,350	2,400	2,360
LME Nickel	USD/MT	17,500	18,000	20,000	13,996	14,400	17,000	16,500	17,000	17,500	18,000	18,500	19,000	20,500	17,592	15,210	17,000	19,000	23,000	24,000	24,000
LME Tin	USD/MT	22,500	23,500	20,000	21,284	22,200	22,000	21,500	22,000	24,000	25,000	24,000	23,000	24,000	21,108	22,140	22,375	24,000	25,000	24,000	23,000
LME Zinc	USD/MT	1,800	1,950	2,100	1,896	1,890	1,840	1,850	1,850	1,900	2,000	2,050	2,000	2,150	1,963	1,930	1,860	2,050	2,250	2,300	2,320
Precious Metals				**LT Price**																	
COMEX Gold	USD/T. oz	1,220	1,280	1,050	1,330	1,280	1,250	1,230	1,260	1,280	1,300	1,340	1,360	1,400	1,669	1,417	1,255	1,350	1,370	1,400	1,420
Silver	USD/T. oz	20.0	20.7	16.5	21.5	21.1	20.2	20.0	20.4	20.7	21.2	21.9	22.4	23.2	31.2	24.1	20.3	22.2	22.5	23.0	23.1
Platinum	USD/T. oz	1,500	1,525	1,531	1,453	1,500	1,500	1,475	1,500	1,525	1,575	1,625	1,625	1,675	1,552	1,515	1,500	1,625	1,700	1,750	1,825
Palladium	USD/T. oz	800	860	680	724	750	750	800	800	850	900	900	950	950	645	732	800	925	925	950	950
Bulk Commodities				**5Y Cyclical**																	
Hard Coking Coal (benchmark Asia)	USD/MT	150	160	200	145	155	155	160	160	165	170	170	170	170	211	159	160	170	180	190	200
Thermal Coal Asia (NEWC)	USD/MT	85	80	105	77	73	82	77	75	80	88	84	82	85	94	82	79	85	85	90	100
Iron Ore Spot (TSI)	USD/MT	135	115	81	133	121	130	120	115	115	115	100	95	90	128	132	120	100	90	90	90
Agriculture																					
CBOT Corn	USd/bu	420	390	N/A	512	435	440	450	430	380	420	450	505	505	695	595	425	470	515	N/A	N/A
CBOT Wheat	USd/bu	670	700	N/A	650	685	700	705	685	670	650	640	635	635	750	690	690	640	615	N/A	N/A
CBOT Soybeans	USd/bu	1,265	1,000	N/A	1,405	1,265	1,260	1,250	1,135	1,075	1,050	1,050	1,000	1,100	1,465	1,390	1,180	1,050	1,075	N/A	N/A
CBOT Rice	USD/cwt	15.5	15.3	N/A	15.6	15.5	15.4	15.3	15.4	15.0	14.4	14.2	14.1	14.1	14.9	15.5	15.3	14.2	N/A	N/A	N/A
NYB-ICE Cotton	USd/lb	79.0	77.8	N/A	85.6	80.0	79.0	78.0	80.5	75.0	75.0	75.0	75.0	75.0	80.0	84.0	78.0	75.0	N/A	N/A	N/A
Sugar#11	USd/lb	18.0	18.0	N/A	16.7	18.3	18.0	18.0	18.0	18.0	18.5	18.5	18.5	18.5	21.6	17.5	18.0	18.5	N/A	N/A	N/A
ICE Coffee	USd/lb	105	115	N/A	118	108	100	105	115	115	120	120	120	120	175	125	105	120	N/A	N/A	N/A
ICE Cocoa	USD/MT	2,600	2,700	N/A	2,420	2,700	2,550	2,550	2,700	2,600	2,600	2,600	2,600	2,600	2,348	2,400	2,600	2,600	N/A	N/A	N/A

Source: Citi Research, *subject to revision

Notes

Appendix A-1

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