

Euro Economics Weekly

Weak Pay Trends Imply Further Inflation Undershoot

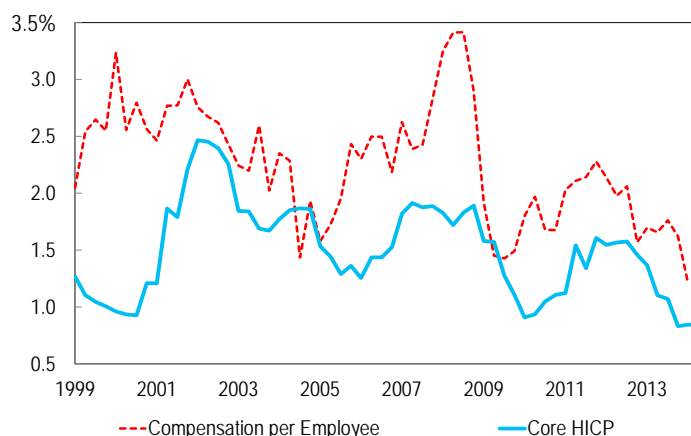
- Wage growth in the euro area has reached new record-low levels in Q1 14, running at 1.2% YY, despite the fact that negotiated pay rises in Germany have started to pick up and wage deflation in some periphery countries has eased. We expect pay growth to decelerate further in coming quarters and to start rising only modestly in 2015, as we think further wage moderation is to be expected in France and Italy, amid increased government efforts to implement business-friendly reforms.
- Pay growth is important to assess overall domestic price pressures and tends to lead core inflation moves in the eurozone. The expected weakness in wage dynamics suggests further declines in core inflation from current low levels. This is in contrast to the latest ECB forecasts which foresee an imminent turnaround in core inflation. This further supports our view that euro area inflation will continue to undershoot and that additional monetary policy easing will become necessary.

Figure 1. Citi Forecasts

| | | Euro Repo | 10-yr Bunds | £/€ | UK Bank Rate | 10-Yr Gilt- Bund | SEK Policy Rate | NOK Policy Rate | CHF Policy Rate | CHF Spread vsBunds | | | |
|-------|------|--------------|----------------|------|--------------------|------------------------|-----------------------|-----------------------|-----------------------|--------------------------|------|------|-----|
| | \$/€ | | | | | SKr/€ | | NOK/€ | SFr/€ | | | | |
| 4Q 14 | 1.36 | 0.15 | 1.50 | 0.77 | 0.75 | 157 | 9.09 | 0.50 | 8.20 | 1.50 | 1.24 | 0.00 | -55 |
| 2Q 15 | 1.36 | 0.15 | 1.55 | 0.77 | 1.25 | 162 | 9.08 | 0.50 | 8.02 | 1.50 | 1.26 | 0.00 | -53 |

Source: Citi Research

Figure 2. Euro Area — Wage Growth (YY) and Core Inflation (YY), 1999-Q 14



Sources: Eurostat, Haver Analytics and Citi Research

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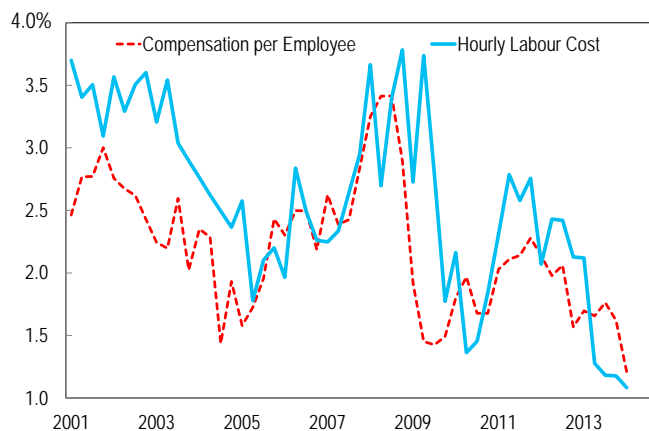
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Weak Pay Trends Imply Further Inflation Undershoot

Euro area wage growth fell close to 1% YY in Q1 14, a new record-low level...

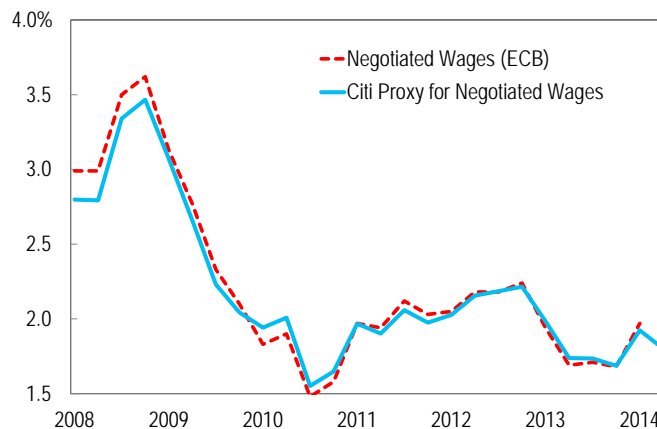
Monitoring wage growth is important as it provides a gauge of underlying domestic inflationary pressures in the economy. The latest data on euro area wages showed that pay growth has reached new record-low levels in Q1 14. Growth in compensation per employee — the national account definition of wages per head — has fallen to 1.2% YY in Q1, from 1.6% YY in Q4 13. This is now below the previous cyclical trough of 1.4% reached in Q3 09 and in Q3 04 (see Figure 3). When measured on an hourly basis, labour cost inflation has been running at an even slower pace than compensation per employee over the past year, falling to 1.1% YY in Q1 14. This is mirroring the progressive pick-up in hours worked per head as economic activity improves. Finally, unit labour costs (which measure wage dynamics relative to productivity growth) have weakened to 0.4% YY in Q1 — the slowest pace of growth since Q1 11, but still far from record lows — as productivity growth has picked up (from -0.2% YY in Q4 12 to 0.8% YY in Q1 14), but remain quite feeble relative to previous recoveries. ULC inflation was negative at -0.6% YY on average in 2010 and even during the expansionary years of 2004 -2006, ULC inflation only averaged 0.9% YY.

Figure 3. Euro Area — Wage Inflation Measures (YY), 2001-Q1 2014



Sources: Eurostat, Haver Analytics and Citi Research

Figure 4. Euro Area – Negotiated Wages (YY), 2008-Q2 2014F



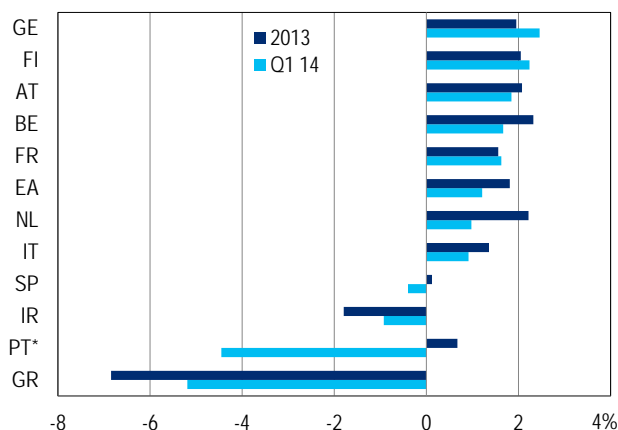
Sources: ECB, Haver Analytics and Citi Research

Note Q2 2014 data is our estimate based on the April data from the six countries that report negotiated wages on a monthly frequency.

...despite recent signs of accelerating pay growth in Germany

On the other hand, a somewhat contrasting signal has come from the ECB indicator for euro area negotiated wages, which increased 1.97% YY in Q1 14 (highest since Q4 12), from 1.68% YY in Q4 13, closing in on its long-run average of 2.3% YY. This may be read as a signal of overall pay growth being at a turning point. We tend to disagree. The uptick in the aggregate indicator for negotiated wages was entirely driven by one-off effects in Germany in January that have already reduced to some extent in the latest data for April. Net of these effects, the increase in the annual rate at the euro area level would have been more modest (probably by only 0.1pp). Our proxy for euro area contractual wages, which uses monthly and quarterly data from eight countries (and tracks quite well the ECB indicator), points to a likely payback for Q2 to around 1.8% YY (see Figure 4).

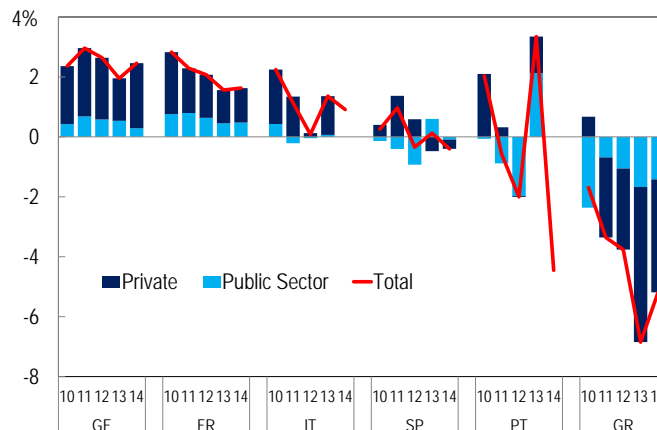
Figure 5. Euro Area — Compensation per Employee (YY), 2013-Q1 14



*For Portugal we consider the average over 2012 and 2013, not just 2013, to smooth out large swings in public sector wages over these two years.

Sources: Eurostat, Haver Analytics and Citi Research

Figure 6. Euro Area — Compensation per Employee (YY), Private and Public Sector Contributions, 2010-Q1 14



Sources: Eurostat, Haver Analytics and Citi Research

The largest contribution to low wage growth in the euro area still comes from the periphery...

Lower wage inflation is perfectly consistent with the still large amount of slack in the euro area labour market, despite the recent declines in the unemployment rate.¹ Unsurprisingly, country data show that the largest disinflationary pressures on euro area wages come from the periphery, where the labour market slack is the largest. In particular, compensation per employee in Greece, Portugal, Ireland and to a small degree in Spain currently is (and it has been for a while) recording outright declines (see Figure 5). It is interesting to note also that while public sector wage cuts in 2011 and 2012 were the main drivers for wage disinflation in the periphery, pushed by severe fiscal consolidation efforts (in 2009-2010 in Ireland), over the past couple of years private sector wage growth has been leading the overall muted wage dynamics (see Figure 6). For instance, Spanish private sector wage inflation (in YY terms) has been negative since Q4 12 and we reckon this has been one of the main ingredients explaining the earlier and faster-than-expected recovery in employment growth.

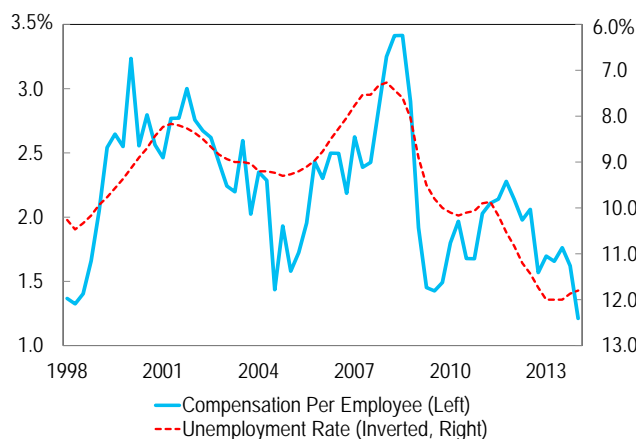
...although the recent slowdown has been driven by “soft core” countries

However, wage moderation is not just a periphery phenomenon. In the countries where wage inflation is still positive, with the exception of Germany and Finland, wage growth in Q1 14 was equal to, or lower than, the 2013 average (see Figure 5). Wage inflation seems to be slowing in “soft core” countries like France, Belgium and the Netherlands, where the unemployment rate is lower than the euro area average (albeit higher than historical average to different degrees), possibly showing a lagged response to the accumulation of labour market slack over the last few years. Wage moderation is happening in Italy as well, although in our view to a lesser degree than the ample labour market slack would call for.² On the other hand, sharp wage declines seem to be moderating in some periphery countries (namely Greece and Ireland) that had experienced the largest drops in recent years.

¹ See “Euro Economics Weekly – Labour Market Slack”, Citi Research, 13 June 2014.

² Unemployment rate in Italy is currently at 12.6% but broader unemployment measures indicate a higher degree of slack than headline unemployment rate suggests.

Figure 7. Euro Area — Wage Growth (YY) and Unemployment Rate, 1998-Q1 14



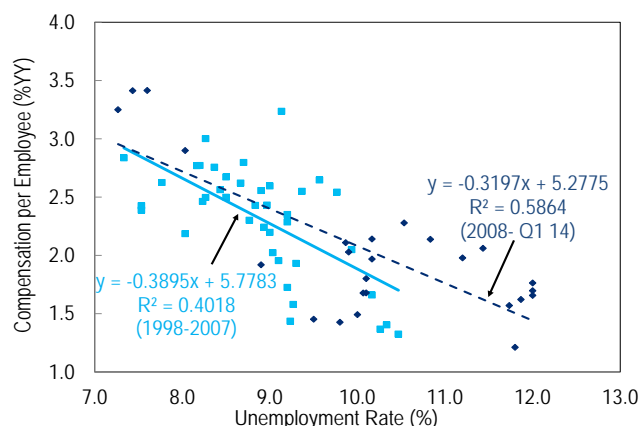
Sources: Eurostat, Haver Analytics and Citi Research

Phillips curve analysis does not show meaningful differences relative to pre-crisis years at the euro area level ...

...but labour market reforms seem to have made wages more responsive to unemployment in the periphery

Euro area wage dynamics expected to remain very low even by the end of 2015

Figure 8. Euro Area — Estimated Phillips Curve, Q1 98-Q1 14



Sources: Eurostat, Haver Analytics and Citi Research

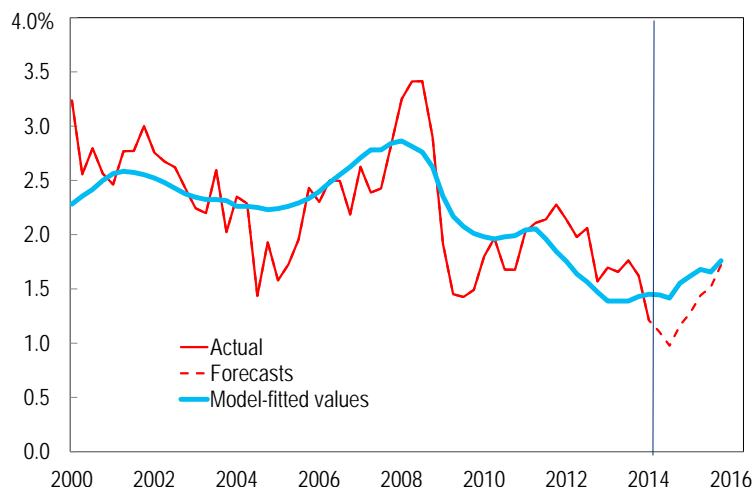
In general, euro area wage growth over the past five years has responded to labour market conditions broadly as it used to do in pre-recession years (see Figure 7). A simple regression analysis of the Phillips curve (which relates changes in wages to the unemployment rate) suggests that the estimated beta of wages over the estimation period 2008-2014 has been fairly similar to the beta estimated over the previous ten years (1998-2007) (see Figure 8). However, when the same analysis is run using a panel of data for ten euro area countries, we find that the Phillips curve coefficient has turned slightly more negative since 2008 (pointing to increased wage responsiveness of wages to the unemployment rate) compared with the pre-recession years.

This empirical evidence indicates that the euro area unemployment rate (peaking at 12.0% in mid-2013) may have not reached the thresholds above which wage responsiveness could start to increase (i.e., non-linear Phillips curve). This makes it easier to use the estimated relationship to project wage growth over the coming quarters, by using our expectations for the unemployment trajectory. However, the analysis also suggests that a higher responsiveness of wages to unemployment may have occurred in some high-unemployment countries in the periphery, where wage adjustments seem to have been more severe even than conditions in the labour market would have predicted. This could reflect non-linearities in the Phillips curve or more likely, in our view, extensive public sector wage cuts and structural reforms which have allowed more wage negotiation flexibility and/or less wage indexation and/or abolished minimum wages (all features of labour market reforms in Spain and Greece).

Using the estimated Phillips curve for the euro area and our expectation of a gradual decline in the unemployment rate (to 10.8% by the end of 2015, from 11.8% in Q1 14), we estimate wage growth to bottom out towards the end of 2014 at around 1% and to start rising very modestly during 2015. We would expect wage growth to still be as low as 1.7% YY at the end of 2015. In making this projection we allow for the usual undershoot of wage growth relative to the model predictions around turning points (see Figure 9). As a reference, this is well below the latest ECB staff projections, which see compensation per employee rising by 1.7% on average in 2014 and by 2.0% in 2015, clearly implying a sharp acceleration relative to the Q1 14 1.2% YY print.³

³ Moreover, the ECB forecasts are based on projections for the unemployment rate which are *higher* than Citi's, both for 2014 (11.9% vs. 11.7%) and 2015 (11.7% vs. 11.1%).

Figure 9. Euro Area – Compensation per Employee (YY): Actual and Projected, 2000-2015F



Sources: Eurostat, Haver Analytics and Citi Research

German wage inflation may start picking up, while deep wage cuts in the periphery may ease

Some may argue that wage growth is bound to start rising sooner and faster than our predictions, on the back of a tight labour market in the largest euro area economy. Germany should see wage pressures rising in coming months also because of the introduction of a minimum wage in 2015. We have recently estimated that the introduction of a minimum wage at €8.50/hour in Germany may have an impact of around 0.6pp on headline German CPI inflation over the next three years, with the bulk of it taking place in 2015.⁴ Recent wage agreements, with pay rises on average at a six-year high around 3% YY, may support this view. It may also be argued that wage declines in the smaller periphery countries might end soon, since Greece, Ireland and Portugal have already undergone deep wage adjustments, hence reducing their negative effect on the euro area.⁵

But structural reforms in France and Italy are likely to compress pay growth in these countries

While we may share some of these concerns, we reckon that wage moderation has further to go in the second and third largest euro area countries, Italy and France. In both countries, the pressure to implement more business-friendly structural reforms continue to rise, and we think this may well result in more wage flexibility and reduced labour costs in the next couple of years in both countries. For example, the latest labour market reform introduced by Italian PM Renzi in May envisages more flexibility in using temporary contracts and this should help push overall wage dynamics lower, even if negotiated wage growth for standard contracts may not be affected much. In France, the government is focusing its strategy of reducing labour costs (see [Euro Economics Weekly: France: Will Valls Succeed Where Others Have Failed?](#)). Overall, we believe there is enough room for further wage disinflation in Italy and France (and ongoing close-to-zero wage growth in Spain likely to continue) to offset some pickup in pay rise in Germany.

⁴ See ["Euro Economics Weekly: German Inflation: Lower For a Little Longer"](#), Citi Research, 21 February 2014.

⁵ However, we believe that even if wage moderation in the periphery were to ease soon, the consumer price adjustment may take much longer to complete, having started later and being at a less advanced stage (see ["Euro Economics Weekly: Internal Devaluation in the Periphery"](#), Citi Research, 7 March 2013)

Implications for future HICP inflation

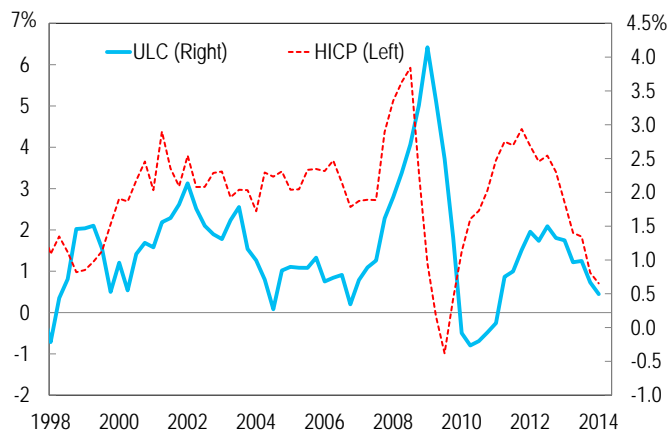
Unit labour cost inflation does not display meaningful correlation with HICP inflation

Economic theory suggests that the most appropriate wage measure to forecast consumer price inflation would be unit labour costs (ULC). This is because theoretically the cost of producing one unit of output should be the key variable in setting its price (alongside non-labour costs and unit profit margins). In practice, however, unit labour costs in the euro area have displayed little correlation with headline inflation. If anything, ULC growth have tended to lag rather than lead core inflation moves, probably due to the lagged response of labour productivity in the business cycle and decisions by businesses to adjust their profit margins (see Figure 10). In the current juncture, we expect further decline in ULC growth, even if wage growth were to stabilise at current levels, as labour productivity should pick up from the recent muted pace, as it is typically the case in the early stages of recovery.

Compensation per employee tends to lead core inflation dynamics by three quarters

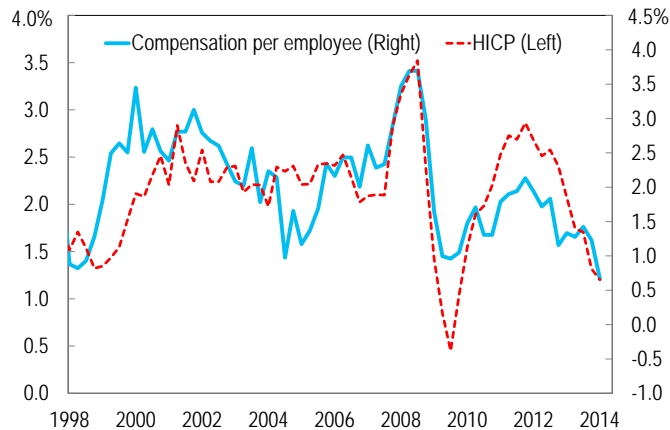
Instead, we believe that nominal wage growth is a better indicator to gauge overall price pressures in the economy. Correlation with HICP inflation is 65% for growth in compensation per employee, while it is close to zero for ULC growth (see Figure 11). Moreover, compensation per employee has some leading properties over core HICP inflation (excluding food, energy and tobacco), with the correlation between the two measures peaking with a three-quarter lag at 62% (see Figure 2 on the front page). Finally, compensation per employee appears to be the best indicator for future core inflation moves, as it tends to be more reactive to cyclical conditions than negotiated wages. The wage drift (ie the gap between negotiated wages and take-home pay) can probably be adjusted quicker to evolving market conditions than the usually-delayed rounds of wage agreements. Compensation per employee is also a much smoother indicator than hourly labour cost.

Figure 10. Euro Area — Inflation (YY) and ULC (YY), 1998-Q1 2014



Sources: Eurostat, Haver Analytics and Citi Research

Figure 11. Euro Area — Inflation (YY) and Wages (YY), 1998-Q1 2014



Sources: Eurostat, Haver Analytics and Citi Research

Weak pay growth suggests core inflation could drop further and hence continue to undershoot the ECB projections

The simple relationship between core inflation and compensation per employee suggests that HICP inflation ex-food, energy and tobacco still has further room to decelerate from current levels (of 0.8% YY) over the next three to four quarters, before starting to rise mildly in H2 15. This is a message consistent with the indications from our core inflation model which foresees the core rate falling further as a result of a large output gap, past appreciation of the currency and pass-through of previous commodity price changes.⁶ Compared with the ECB forecasts for core

⁶ Note that our core inflation model does not include any wage measure as explanatory variable as we find once the other explanatory variables are included in the model, wage dynamics becomes insignificant.

inflation this is a much more subdued inflation outlook: the June staff projections envisage core HICP inflation (ex. energy and food) to start rising pretty soon, averaging 1.0% in 2014, 1.2% in 2015 and 1.5% in 2016. Once again, we argue the ECB inflation forecasts are likely to prove too high and will probably have to be revised lower, most likely by December, leading the Governing Council to deliver additional monetary policy stimulus that we believe will likely take the form of an unsterilised large scale asset purchase programme.

Key Economic Indicators (30 June – 4 July 2014)

| During the Week | | Forecast | Last |
|-------------------------|--|-------------------------|--------------------------|
| 08:00 | UK: Halifax House Prices, Jun | | |
| Monday 30 June | | Forecast | Last |
| 07:00 | Germany: Retail Sales (ex Cars), May SWDA | 1.6% MM, 1.4% YY | -1.5% MM, 0.3% YY |
| 08:30 | Sweden: Household Lending, May | 5.2% YY | 5.2% YY |
| 09:00 | Norway: Retail Sales (excluding Petrol Stations), May | -0.2% MM | 0.5% MM |
| 09:00 | Norway: Credit Indicator C2, May | 5.6% YY | 5.6% YY |
| 09:00 | Norway: Norges Bank Daily FX Purchases, Jul | NOK 0 Million/Day | NOK 0 Million/Day |
| 09:00 | Italy: Producer Prices, May | | |
| 09:00 | Euro Area: M3, May | 0.7% YY | 0.8% YY |
| 09:30 | UK: Personal Borrowing, May | | |
| 10:00 | Italy: HICP, Jun Flash | 0.4% YY | 0.4% YY |
| 10:00 | Euro Area: HICP, Jun Flash | 0.6% YY | 0.5% YY |
| 10:00 | Greece: Retail Sales, Apr | | |
| | Spain: Current Account, Apr | | |
| | EU: Greek Presidency ends | | |
| Tuesday 1 July | | Forecast | Last |
| | EU: Italy assumes Presidency until end-Dec | | |
| 07:30 | Sweden: Manufacturing PMI, Jun | 54.3 | 54.1 |
| 08:00 | Norway: Manufacturing PMI, Jun | 49.8 | 49.8 |
| 08:55 | Germany: Unemployment, Jun | -15K MM SA, -83K MM NSA | +24K MM SA, -186K MM NSA |
| 09:00 | Italy: Unemployment Rate, May | 12.6% | 12.6% |
| 09:00 | Euro Area: Manufacturing PMI, Jun Final | 51.9 | 52.2 |
| 09:30 | UK: Manufacturing PMI, Jun | 57.0 | 57.0 |
| 10:00 | Euro Area: Unemployment Rate, May | 11.7% | 11.7% |
| | Italy: Budget Balance, Jun | | |
| Wednesday 2 July | | Forecast | Last |
| 07:00 | UK: Nationwide House Prices, Jun | | |
| 08:00 | Spain: Registered Unemployment, Jun | -140K MM | -112K MM |
| 09:30 | UK: Construction PMI, Jun | | |
| 10:00 | Euro Area: GDP, 1Q Final | | |
| 10:00 | Euro Area: Industrial Product Prices, May | | |
| 11:00 | Ireland: Unemployment Rate, Jun | | |
| Thursday 3 July | | Forecast | Last |
| 07:30 | Sweden: Services PMI, Jun | 58.0 | 58.5 |
| 08:30 | Sweden: Riksbank Interest Rate Decision | 25bp Cut to 0.50% | 0.75% |
| 08:30 | Sweden: Average House Prices, Jun | | |
| 09:00 | Euro Area: Services PMI, Jun Final | 52.8 | 53.2 |
| | Composite PMI, Jun Final | 52.8 | 53.5 |
| 09:30 | UK: Services PMI, Jun | 58.5 | 58.6 |
| 10:00 | Euro Area: Retail Sales, May | 0.2% MM, 0.9% YY | 0.4% MM, 1.9% YY |
| 11:00 | Ireland: GDP, 1Q | | |
| 11:00 | Ireland: Balance of Payments, 1Q | | |
| 12:45 | Euro Area: ECB Meeting Outcome – Press Conference at 13:30 | | |
| Friday 4 July | | Forecast | Last |
| 07:00 | Germany: Incoming Orders, May | -1.0% MM, 6.3% YY | 3.1% MM, 6.4% YY |
| 08:30 | Sweden: Services Production, May | 0.2% MM | 0.7% MM |
| 08:30 | Sweden: Industrial Production, May | -0.1% MM | 3.0% MM |
| 09:00 | Italy: Deficit to GDP, 1Q | | |
| | US: Independence Day Holiday | | |

Sources: National statistical offices, central banks and Citi Research

Economic Indicators

Euro Area

| | | | |
|-----------------|--|-----------------------------------|--------------------------------|
| Jun 30 09:00 | M3, May | Forecast: 0.7% YY | Prior: 0.8% YY |
| London Time | M3 growth likely weakened further in May to a 3½ year-low of 0.7% YY, reflecting ongoing bank deleveraging. The contraction in the stock of credit to the private sector has reached a new record-low of -2.5% YY in Mar-Apr, and it may have eased only marginally in May. Credit flows to the household sector have started to expand again since Feb, while flows to non-financial corporations have likely probably remained negative in May, but less so than in recent months (€-7bn on average in the past six months). | | |
| Jun 30 10:00 | HICP, Jun P | Forecast: 0.6% YY | Prior: 0.5% YY |
| London Time | Headline inflation likely edged up to 0.6% in June, on a large rebound in German HICP inflation. Core inflation (ex-food, energy and tobacco) probably edged higher to 0.9% YY from 0.8% YY in May on different timing of early-June school holidays relative to last year. Food price disinflation probably continued, offsetting the rise in core inflation. We expect headline HICP inflation to ease further during the summer to around 0.4% YY. | | |
| Jul 1 09:00 | Manufacturing PMI, Jun F | Forecast: 51.9 | Prior: 52.2 |
| London Time | The final manufacturing PMI reading should confirm the small decline at the aggregate level, with recent cross-country trends also confirmed: weak French numbers, Germany moving sideways and still some improvement in the periphery, i.e. Spain and Italy. | | |
| Jul 1 10:00 | Unemployment Rate, May | Forecast: 11.7% | Prior: 11.7% |
| London Time | The unemployment rate may have stabilised in May at the same level as Apr, after falling by 0.3pp from the record-high level of 12.0% observed in mid-2013. | | |
| Jul 3 09:00 | Services PMI, Jun F | Forecast: 52.8 | Prior: 53.2 |
| London Time | Composite PMI, Jun F | Forecast: 52.8 | Prior: 53.5 |
| | Composite PMI showed a second consecutive drop in June, which the final report is likely to confirm. This would bring the index back in line with its long-term average, from being 0.3 SD above it in April. Weakness in France and Germany may have been partly offset by further improvements in the periphery. | | |
| Jul 3 10:00 | Retail Sales, May | Forecast: 0.2% MM, 0.9% YY | Prior: 0.4% MM, 1.9% YY |
| London Time | We forecast another small gain in retail spending in May, after a large increase in Apr. Retail sector sentiment indicators have been pointing to further expansion in retail activity for 2Q 14, after a 0.7% QQ rise in 1Q. | | |

Germany

| | | | |
|-----------------|---|--|--|
| Jun 30 07:00 | Retail Sales (ex Cars), May SWDA | Forecast: 1.6% MM, 1.4% YY | Prior: -1.5% MM, 0.3% YY |
| London Time | After a rather large fall (including a further downward revision) of -1.5% MM for April, German retail sales (excluding cars) are almost flat in year-on-year terms, even after 1Q grew at the fastest quarterly pace since 1991. Even though the 1Q data clearly overstated the momentum in private consumption (as they were partly a payback to weak growth in previous quarters and buoyed by very mild winter weather), the weakness in April was exaggerated too. In May, we therefore expect a robust increase of 1.6% MM, bringing the YY growth rate more clearly into positive territory again but still leaving the Apr-May average slightly below the 1Q average. | | |
| Jul 1 08:55 | Unemployment, Jun | Forecast: -15K MM SA, -83K MM NSA | Prior: +24K MM SA, -186K MM NSA |
| London Time | German unemployment rose unexpectedly in May, but we generally see no reversal in the previous trends of small declines in unemployment amid robust gains in jobs and moderate increases in the labour force. In June, we expect unemployment to fall slightly again, still leaving the unemployment rate at 6.7% (a low since 1991). | | |
| Jul 4 07:00 | Incoming Orders, May | Forecast: -1.0% MM, 6.3% YY | Prior: 3.1% MM, 6.4% YY |
| London Time | After a larger-than-expected increase in industrial orders in April, we expect orders to decline in May, partly as a payback to the strong April reading, but also as sentiment indicators have been on the weak side recently. Even the roughly 1% MM fall we project would imply that orders in April-May would still be almost 1% above the 1Q average and more than 6% YY higher. | | |

Italy

| | | | |
|-----------------|--|--------------------------|-----------------------|
| Jun 30 10:00 | HICP, Jun P | Forecast: 0.4% YY | Prior: 0.4% YY |
| London Time | Inflation likely remained unchanged at 0.4% YY in June. We expect a further drop in food price inflation (from -0.3% to -0.6% YY), which probably offset the rebound in service price inflation after the very weak May reading. Base effects are likely to drive the headline inflation rate lower in coming months. | | |
| Jul 1 09:00 | Unemployment Rate, May | Forecast: 12.6% | Prior: 12.6% |
| London Time | The unemployment rate likely remained unchanged at 12.6% in May, in line with the past two months and only a tad lower than the peak of 12.7% reached in 1Q 14. Job shedding should start reducing, given the improvements (albeit mild) in economic activity, but the still large pool of unutilised working hours implies the unemployment rate will decline only marginally in coming months. | | |

Spain

| | | | |
|----------------|--|---------------------------|------------------------|
| Jul 2 08:00 | Registered Unemployment, June ('000) | Forecast: -140K MM | Prior: -112K MM |
| London Time | We expect the number of jobless claimants to fall by 140K in June, after MM declines of 112K in both May and April, boosted by the start of the labour-intensive summer season. The seasonally-adjusted series should still show ongoing improvement in registered unemployment (we estimate falling by -0.3% MM in June in SA terms), as observed since August 2013. Registered unemployment, however, in recent quarters has been less representative of the developments in the labour market than the labour force survey (due to changes in the criteria to access jobless benefits and rising long term unemployment). Total unemployment (as measured by the labour force survey) stood at 5.9m in 1Q 14, against 4.7m jobless claimants. | | |

Economic Indicators

| | | | |
|-----------------|--|-----------------------------|----------------|
| Sweden | | | |
| Jun 30 08:30 | Household Lending, May | Forecast: 5.2% YY | Prior: 5.2% YY |
| London Time | Annual lending growth is showing signs of acceleration, although the upturn has been somewhat weaker than expected. Given ongoing gains on the housing market, we see a clear risk that household lending could pick up further ahead. Although this is well in line with the Riksbank's expectations, we reckon the board would be more comfortable with a slowdown in lending growth. | | |
| Jul 1 07:30 | Manufacturing PMI, June | Forecast: 54.3 | Prior: 54.1 |
| London Time | Manufacturing PMI slipped 1.4 point to 54.1 in May, extending the 1.1 point decline in the previous month, and falling below the long-term average of 54.4. NIER manufacturing sentiment recovered in June, but with a reading of 99.8 still signals a shaky recovery for the manufacturing sector. Hard data have only just started to improve from very low levels. We note that international PMI levels have been somewhat weaker than expected with the euro area PMI falling 0.3 points to 51.9 and German PMI basically unchanged in June (52.4 vs. 52.3 in May). Swedish hard data have only just partly started to recover. | | |
| Jul 3 07:30 | Services PMI, June | Forecast: 58.0 | Prior: 58.5 |
| London Time | Services sector PMI gained 0.6 points to 58.5 in May, the highest level since April 2011. The series, though, is very volatile and one gets a more precise picture by looking at three-month moving averages. On this basis, the services PMI ticked slightly higher, to 56.7 in the three-month period Mar-May. Service sector sentiment, according to NIER, has been mixed, with sentiment in private services gradually ticking lower since the Jan-14 peak (of 108.3), while retail trade confidence remains well above the historical average (109.6 in June). Production data paint a picture of a strong domestic economy. | | |
| Jul 3 08:30 | Riksbank Interest Rate Decision | Forecast: 25bp Cut to 0.50% | Prior: 0.75% |
| London Time | Given persistent low inflation, we expect the Riksbank to cut the key policy rate, most likely by 25bp to 0.50%, at the July monetary policy meeting. The conditional interest rate path will be revised lower, and probably continue to show a near-term easing bias. Besides lowering its inflation forecast, the Bank will most likely also have to cut its domestic and international GDP growth forecasts. Expansive measures from the ECB support our dovish expectations for the Riksbank. | | |
| Jul 3 08:30 | Average House Prices, June | | |
| London Time | Real estate prices for one- or two-dwelling buildings increased by 2% during the three-month period Mar-May 2014, compared to the previous period Dec13-Feb14. In annual terms, home prices gained 5% during the last three-month period Mar-May 2014, compared to the same period a year earlier. House prices have increased gradually since 2013, and the uptrend looks set to continue this year; short-term indicators point to ongoing upward near-term pressures. Ahead, we expect house prices gradually to level out next year as the Riksbank starts hiking rates combined with macroprudential measures restraining lending. With focus back on inflation, we do not expect a continued moderate increase in housing (and lending) will have immediate implications for monetary policy. | | |
| Jul 4 08:30 | Service Production, May | Forecast: 0.2% MM | Prior: 0.7% MM |
| London Time | Momentum in the service sector is accelerating, hence offsetting weakness in the manufacturing sector. This is well in line with indications from the services PMI, which has now been above 50 for eleven consecutive months, and with a 58.5 reading points to strong growth in the sector. NIER service sector sentiment has improved steadily since late-2012, and despite some setback in recent months, still stands above its historical average. Actual service production data paint a picture of a strong domestic economy, and we expect the uptrend to continue ahead. | | |
| Jul 4 08:30 | Industrial Production, May | Forecast: -0.1% MM | Prior: 3.0% MM |
| London Time | Sweden's industrial production (seasonally adjusted) rebounded by a full 3.0% MM in April, but this was still not sufficient to offset the massive 3.6% MM plunge in the previous month. In quarterly terms, production was 1.1% above the 1Q average in April, but compares with a 1.2% QQ decline in 3Q-14 and a 0.1% QQ drop in 4Q-13. On a year-ago basis, industrial production was up 0.6%, but this follows a 4.4% plunge in the previous month. In other words, the trend in manufacturing production remains relatively weak and we lack signs of recovery. In addition, we note that the order intake remains at a low level, and even declined somewhat in April (by 1.3% MM). | | |
| Norway | | | |
| Jun 30 09:00 | Retail Sales excluding Petrol Stations, May | Forecast: -0.2% MM | Prior: 0.5% MM |
| London Time | Monthly consumption metrics point to a turnaround; households' domestic spending on goods accelerated to 0.7% QQ in 1Q and the April outcome was 1.0% above the 1Q average. Goods consumption accounts for a little less than 50% of overall private consumption. While improving conditions on the housing market should support private consumption, slightly higher unemployment will likely weigh in the opposite direction. Following a much stronger-than-expected gain in March, we see risk of payback in April. Following six consecutive gains, we expect a minor setback for retail sales in May. | | |
| Jun 30 09:00 | Credit Indicator Growth, May | Forecast: 5.6% YY | Prior: 5.6% YY |
| London Time | The latest lending survey showed that household credit demand was slightly up in 1Q, likely reflecting the recovery in the housing market. Meanwhile, this has not been reflected in the monthly credit growth indicator for households, which slipped 0.3pp to 6.8% YY in 1Q (stable in Apr). With positive house price growth for the past three months (up by 0.3% YY on average in the three-month period Mar-May 2014), a large downward correction on the housing market has become more remote, suggesting that household credit demands could pick up in the near term. The latest lending survey also showed a pick-up in credit demand from non-financial enterprises. The monthly development in corporate credit growth, meanwhile, moderated further in 1Q from 3.9% YY in 4Q-14 to 3.5% YY (and to 3.2% in Apr). In May, we expect credit to households and non-financial enterprises to remain in the area of 6.8% YY and 3.2% YY, respectively. Meanwhile, credit to municipalities will probably pick up slightly (7.5% YY in Apr). | | |

Economic Indicators

Norway continued

| | | | |
|-----------------|---|------------------------------------|---------------------------------|
| Jun 30 09:00 | Norges Bank Daily FX Purchases, Jul | Forecast: NOK 0 Million/Day | Prior: NOK 0 Million/Day |
| London Time | The revised budget (out 15 May) supports our expectations that Norges Bank will have no need to buy FX (sell NOK) this year on behalf of the Government for the Pension Fund Global. This was confirmed in the press statement on Norges Bank's foreign exchange purchases in June, saying that <i>"This means that Norges Bank will not purchase foreign exchange for the GPFG in the coming months"</i> . Meanwhile, we might end up in a situation where the Bank might well have to buy NOK, possibly next year: <i>"Somewhat further ahead, the government's foreign currency revenues from the SDFI may exceed the transfers to the GPFG. In that case, the surplus foreign exchange will have to be sold in the market"</i> . Hence, <i>"Norges Bank will be tasked with selling the foreign exchange in the same way as it has been tasked to date with purchasing foreign exchange, on behalf of the government, for the GPFG"</i> . | | |
| Jul 1 09:00 | Manufacturing PMI, June | Forecast: 49.8 | Prior: 49.8 |
| London Time | We expect Norwegian PMI to remain broadly unchanged in June, in line with indications from the latest Regional Network Report by Norges Bank (points to stable below-trend growth ahead), and also from the basically unchanged PMI in Germany (up 0.1 point to 52.4). We note that the PMI is not closely watched by Norges Bank as there often are problems with the seasonal adjustment procedure. Also, PMI covers a very small sample compared to e.g. Norges Bank's own Regional Network Report and the quarterly manufacturing survey from Statistics Norway. | | |

United Kingdom

| | | | |
|----------------|---|-----------------------|--------------------|
| Jul 1 09:30 | Manufacturing PMI, Jun | Forecast: 57.0 | Prior: 57.0 |
| London Time | The PMI has been around the 57 level since August last year, and we see little change either way this month. These survey readings have been validated by rapid growth in manufacturing output, and a figure in line with our forecast would point to continued rapid output growth in coming months. | | |
| Jul 3 09:30 | Services PMI, Jun | Forecast: 58.5 | Prior: 58.6 |
| London Time | The service sector PMI remains well above average and we expect another strong reading this month. The ONS services output data have been pretty strong recently and this probably will continue in coming months. | | |

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

Key Economic Indicators (7 July – 11 July 2014)

| Monday 7 July | | Forecast | Last |
|-------------------------|--|------------------|------------------|
| 07:00 | Germany: Industrial Production, May | | |
| 08:00 | Spain: Industrial Production, May | | |
| 08:15 | Switzerland: Unemployment, Jun | | |
| 09:00 | Norway: Industrial Production, May | | |
| 09:30 | Euro Area: Sentix Investor Confidence, Jul | | |
| Tuesday 8 July | | Forecast | Last |
| 00:01 | UK: BCC Quarterly Economic Survey, 1Q | | |
| 07:00 | Germany: Trade Balance, May | | |
| 07:30 | France: Bank of France Business Sentiment, Jun | | |
| 07:45 | France: Trade Balance, May | | |
| 07:45 | France: Budget Balance, May | | |
| 08:15 | Switzerland: Consumer Prices, Jun | | |
| 09:30 | UK: Industrial Production, May | 0.2% MM, 3.1% YY | 0.4% MM, 3.0% YY |
| | Manufacturing Output, May | 0.4% MM, 5.6% YY | 0.4% MM, 4.4% YY |
| Wednesday 9 July | | Forecast | Last |
| 07:00 | Sweden: PES Unemployment Rate, Jun | | |
| 09:30 | UK: Profitability of UK Companies, 1Q | | |
| Thursday 10 July | | Forecast | Last |
| 00:01 | UK: RICS House Price Survey, Jun | | |
| 07:45 | France: Consumer Prices, Jun | | |
| 07:45 | France: Industrial Production, May | | |
| 08:30 | Netherlands: Consumer Prices, Jun | | |
| 08:30 | Netherlands: Industrial Production, May | | |
| 08:30 | Sweden: Consumer Prices, Jun | | |
| 09:00 | Norway: Consumer Prices, Jun | | |
| 09:00 | Italy: Industrial Production, May | | |
| 09:00 | Euro Area: ECB Monthly Bulletin | | |
| 09:30 | UK: Trade Balance – Goods & Services, May | £-2.0 Billion | £-1.8 Billion |
| 10:00 | Greece: Industrial Production, May | | |
| 10:00 | Greece: Unemployment Rate, Apr | | |
| 12:00 | UK: MPC Outcome | | |
| Friday 11 July | | Forecast | Last |
| 07:00 | Germany: Consumer Prices, Jun Final | | |
| 07:45 | France: Balance of Payments, May | | |
| 08:00 | Spain: Consumer Prices, Jun Final | | |
| 09:30 | UK: Construction Output, May | | |

Sources: National statistical offices, central banks and Citi Research

| Publication Title | Author | Date |
|---|----------------------------------|--------------|
| Euro Area — Sovereign Debt Update | | |
| EU Summit: More Flexibility in Budget Rules, But No Wholesale Changes | European Economics Team | Jun 27, 2014 |
| French GDP Growth Revised Lower | European Economics Team | Jun 26, 2014 |
| French President Calls for €240bn Investment Initiative | European Economics Team | Jun 25, 2014 |
| ECB's Nowotny: Multiple Euro-Area Bond Markets Problematic for QE | European Economics Team | Jun 24, 2014 |
| Juncker Set To Become Next EU Commission President | European Economics Team | Jun 23, 2014 |
| Euro Area | | |
| ECB Preview - Rendez-vous in September? | Guillaume Menuet | Jun 26, 2014 |
| European Economic Forecast Highlights - June 2014 | Ann O'Kelly | Jun 26, 2014 |
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| Euro Area - Inflation Surprises Once Again to the Downside | Giada Giani | Jun 3, 2014 |
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| Euro Area - Weak M3 but fall in private sector loans eases in April | Ebrahim Rahbari/Antonio Montilla | May 28, 2014 |
| Italy - Q1 GDP Downward Surprise and Political Uncertainty | Giada Giani | May 23, 2014 |
| European Economic Forecast Highlights - May 2014 | Ann O'Kelly | May 22, 2014 |
| Euro Area - Q1 GDP Disappoints Probably Due To Exceptionally Mild Winter | Giada Giani | May 15, 2014 |
| Euro Area - No Pickup in NFC Net Borrowing in Q1 | Antonio Montilla/Ebrahim Rahbari | May 15, 2014 |
| Euro Economics Weekly | | |
| A Great Rotation towards Eurozone Portfolio Assets? | Ebrahim Rahbari | Jun 20, 2014 |
| Labour Market Slack | Giada Giani | Jun 13, 2014 |
| ECB TLTRO: Ambitious But Probably Not Enough, QE Lies Ahead | Guillaume Menuet | Jun 6, 2014 |
| Negative Deposit Rate: Limiting Risks, Limited Upside | Ebrahim Rahbari | May 30, 2014 |
| Soft Growth, Low HICP And Weak SPF Point To ECB Cut In June | Guillaume Menuet | May 23, 2014 |
| Long Live (s) The Rise of the Current Account Surplus | Ebrahim Rahbari | May 16, 2014 |
| Euro Economics Weekly - How Might QE Affect Financial Conditions? | Giada Giani | May 9, 2014 |
| ECB: Reaction Function Points to Looser Stance Ahead | Guillaume Menuet | May 2, 2014 |
| Private Deleveraging: Picking Up, but Hurting Less | Ebrahim Rahbari | Apr 25, 2014 |
| Portugal: "Clean Exit" or Precautionary Credit Line? | Giada Giani | Apr 17, 2014 |
| France: Will Valls Succeed Where Others Have Failed? | Guillaume Menuet | Apr 11, 2014 |
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| Italy — Some Short-Term Optimism | Giada Giani | Mar 28, 2014 |
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| The Eurozone Investment Recovery | Ebrahim Rahbari | Mar 14, 2014 |
| Internal Devaluation in the Periphery | Giada Giani | Feb 7, 2014 |
| Chief Economist Publications | | |
| Global Economic Outlook and Strategy - June 2014 | Willem Buiter | Jun 25, 2014 |
| Global Economics View - The Long-Run Decline in Advanced-Economy Investment | Willem Buiter | Jun 12, 2014 |
| Scandi and Switzerland | | |
| Scandi Economics Update | Tina Mortensen | Jun 27, 2014 |
| Sweden - RB Forecast: Rate Cut and Lower Conditional Interest Rate Path | Tina Mortensen | Jun 25, 2014 |
| Norway - NB Delays Rate Hike, Raises Prospects of Near-Term Rate Cut | Tina Mortensen | Jun 19, 2014 |
| UK | | |
| UK GDP And BOP Data, European Commission Survey | Michael Saunders | Jun 27, 2014 |
| UK - FPC Report, Announcement and Press Conference | Michael Saunders | Jun 26, 2014 |
| UK - Retail Sales and CBI Data | Michael Saunders | Jun 19, 2014 |
| UK - MPC Minutes and BoE Agents Survey | Michael Saunders | Jun 18, 2014 |
| UK - CPI Inflation Falls Further | Michael Saunders | Jun 17, 2014 |
| UK Economics Weekly | | |
| How Resilient Will The Economy Be To Rising Rates? | Michael Saunders | Jun 20, 2014 |
| The "Jobs Miracle" Continues | Michael Saunders | Jun 13, 2014 |
| Implications for the UK of ECB Easing; | Michael Saunders | Jun 6, 2014 |
| Inflation Downtrend Probably Over | Michael Saunders | May 30, 2014 |
| Source: Citi Research | | |

Appendix A-1

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