Economics

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Euro Weekly

The Franco-German Competitiveness Pact

- Despite its name, the "competitiveness pact" actually involves more fiscal austerity than growth-enhancing measures. Structural reforms to improve competitiveness would be necessary in core countries too, but most of the efforts are required from the peripheral countries.

- Euro area economic governance and coordination of economic policies is the price core countries are asking for extending the liquidity facilities for the debt-burdened euro periphery. Yet, with the bargaining power of core countries never so high before, some structural changes will likely result from the European negotiating process searching for solutions to the euro debt crisis (Giada Giani, see page 2).

Michael Saunders
+44-20-7986-3299
michael.saunders@citi.com

Jürgen Michels
+44-20-7986-3294
juergen.michels@citi.com

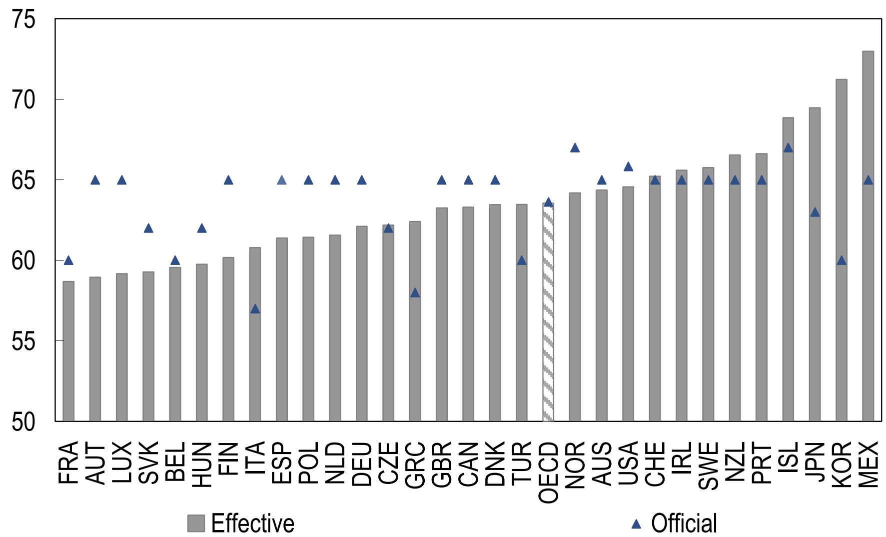
Giada Giani
+44-20-7986-3281
giada.giani@citi.com

Figure 1. Citi Market Forecast

	$/€	Euro Repo	10-yr Bunds	£/€	U.K. Bank Rate	10-yr Gilt-Bund	SKr/€	SEK Policy Rate	NOK/€	NOK Policy Rate	SFr/€	CHF Policy Rate	CHF Spread vs Bunds
End 2Q 11	1.31	1.00	3.20	0.81	0.75	64	8.80	1.75	7.80	2.25	1.30	0.25	-150
End 4Q 11	1.39	1.25	3.50	0.80	1.00	74	8.80	2.50	7.80	2.50	1.34	0.75	-160

Source: Citi Investment Research and Analysis

Figure 2. OECD Countries – Effective and Legal Retirement Age (Average 2002-07)



Sources: OECD and Citi Investment Research and Analysis

For all distribution enquiries regarding Citi Economics research, including access via Citi websites and via third party distribution channels, please contact michael.saunders@citi.com or jan.maguire@citi.com

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The Franco-German Competitiveness Pact

Closer economic integration now on the agenda of European policymakers

With the Franco-German proposal for a "competitiveness pact" launched last week, the level of the debate among European policymakers has clearly shifted from *"how to solve the debt problems of euro peripheral countries"* to *"how to improve economic governance"* within the overall EMU. The Eurogroup and ECOFIN meetings next week are set to have the proposal on their agenda in addition to the measures to expand the lending capacity and the scope of the current rescue facilities. However, the two objectives are still closely interlinked, as Germany now wants to make the latter a precondition to move forward on the former. Despite its name, we think the main focus of the "competitiveness pact" is to reinforce German-style fiscal discipline among euro members rather than boost potential growth. And it seems that Germany and France themselves have not fully agreed on the details of the proposal. Yet, by requiring a common special resolution regime for banks it may involve a step in the right direction in the resolution of the euro debt crisis. More importantly, the initiative might be overall more powerful than the Commission-led Lisbon Agenda or the new Commission initiative to boost economic performance by 2020. The bargaining power of the core countries is strong and some form of compromise on deeper economic coordination and additional structural reforms is likely to result as part of the attempts to solve the euro sovereign debt crisis.

Six policy areas aimed at boosting competitiveness

The details of the Franco-German proposal have not been yet fully disclosed, but various newspapers report that it consists of six key policy areas on which national governments are asked to act over the next 12 months, with the EU Commission as the supervisory body to assess their effective implementation. These areas are: 1. Abolition of wage/salary indexation systems; 2. Mutual recognition of education diplomas and qualifications for the promotion of mobility of workers in Europe; 3. Creation of a common assessment basis for corporate income tax; 4. Adjustment of the pension system to demographic developments (i.e., higher age of retirement); 5. Obligation for all member states to inscribe a "debt brake" mechanism in their constitution; 6. Establishment of a national crisis-management regime for banks. Let us review some of them and assess their political feasibility and economic relevance for specific euro area countries.

Figure 3. Euro Area – Adjustment of Base Wages to Inflation (Pct.)

	Past	Expected
BE	98.2	0
ES	38.3	16.2
SI	20.3	2.7
GR	14.8	5.2
AT	8.6	1.3
LT	7.3	3.7
HU	7.2	4.2
CZ	5.8	2.6
FR	4.9	1
PL	4.7	2.5
PT	2.7	6.5
EE	2.6	1.3
IE	2.4	2.8
IT	1.2	0.5
NL	0	0
EURO AREA	13.8	3.5

Sources: ECB and Citi Investment Research and Analysis

Figure 4. Euro Area, Spain, Belgium – Wage Growth (YY), 2001-10

Sources: Eurostat and Citi Investment Research and Analysis

Wage indexation is really relevant only in Belgium and Spain

Wage indexation mechanisms make pay rise in wage agreements (to varying extents) automatically linked to past or expected inflation. These systems are a prominent feature in only few euro area countries, primarily Belgium and Spain. Data based on an ad-hoc ECB survey, shown in Figure 3, provide a snapshot of the extent of wage indexation in euro area countries[1]. In Belgium wage indexation is set by law and it covers almost the entire universe of wage contracts (98%). In Spain, wage indexation is not set by law, but it is a widely and long-diffused practice; it is applied in around half of the signed contracts. In other countries (like Greece) automatic wage indexation is present but it is a much more limited phenomenon.

Indexing wages to inflation makes monetary policy less effective and possibly increases structural unemployment…

The main economic implication of indexing wages to past inflation is that it creates downward rigidities in real wage adjustments, as its very purpose is indeed to preserve the real purchasing power of labour income. This, among other things, implies that inflation shocks tend to be more persistent in the system. This eventually weakens the transmission mechanism of monetary policy. There is also empirical evidence that wage rigidities have a negative effect on employment, as firms tend to cut more jobs if wages are not allowed to adjust to a deteriorating condition in the labour market. Moreover, wage indexation clauses — which are normally implemented at a centralized or semi-centralised level — do not allow to take different productivity performances into account, weighing negatively on unit labour costs and hence on overall competitiveness.

…but significant impact on overall euro area competitiveness uncertain…

While automatic wage indexation mechanisms are definitely not a desirable feature, especially when they occur only in some members of a monetary union, it is less obvious whether their removal could have a significant impact on overall competitiveness of the aggregate euro area. The recent history of indexation systems does not suggest a straightforward answer. Despite having an almost 100% degree of indexation, Belgian wages have moved broadly in line with the euro area average over the past decade (rising at around 3% per annum between 2000 and 2009) and they have been even more volatile (so less persistent) than euro area wages. In contrast, Spanish wages have been increasing persistently more (around 4% per annum) than the euro area average (see Figure 4).

…although it may lead to long-term benefits in Spain

Nonetheless, studies (including a recent one from the IMF[2]) do show that changes to the collective bargaining system including, among other things, the removal of wage indexation clauses may help reduce the structurally high unemployment rate in Spain. Lower structural unemployment would, first, improve trend growth in domestic demand and, second, diminish the pressure imposed on the public budget by unemployment benefits.

Wage indexation next hurdle in Spanish politics

Despite calls from European institutions and the Bank of Spain to abolish wage indexation clauses, nothing in this respect was included in the labour market reform implemented last summer by the Spanish government, probably reflecting trade unions' opposition. However, the government has recently announced that the issue is now on the agenda for further labour market reforms. At this particular juncture for the Spanish economy, with rising headline inflation and wage growth deceleration, the abolition of wage indexation clauses may indeed help to speed up the necessary rebalancing process away from domestic demand and towards more export-oriented sectors. Yet, the opposition from the trade unions may still be an obstacle to agreement on such

[1] See *"How Are Firms' Wages and Prices linked – Survey Evidence in Europe"*, ECB WP No 1084

[2] See *"The Spanish Labour Market in a Cross-Country Perspective"*, IMF WP/11/11.

changes. Opposition from Belgium – which still has no regular government — may also be substantial given that the use of these systems is so entrenched in the economy and given that it is less clear that the Belgian economy needs to go through a similar disinflationary process as Spain.

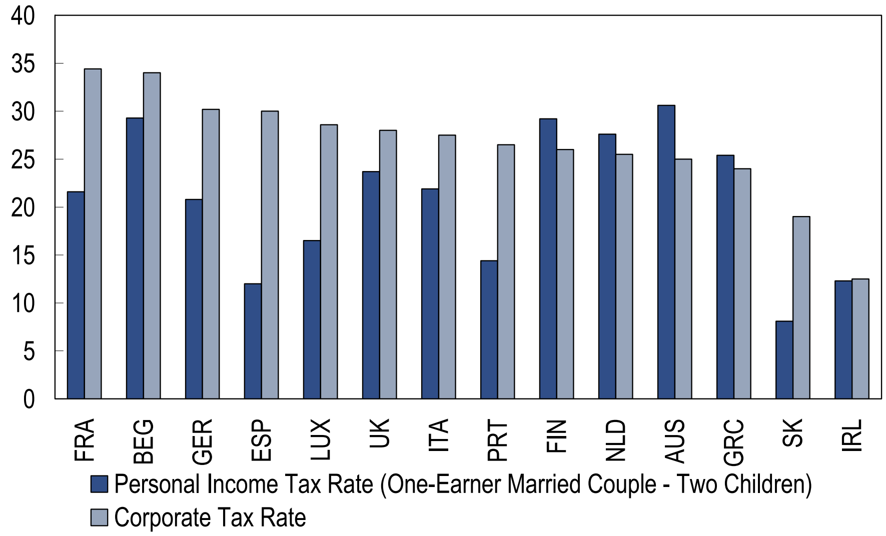
Consolidated tax base less far-reaching than harmonized corporate tax rate

Corporate tax harmonization seems to revert back to the idea of a **Common Consolidated Corporate Tax Base (CCCTB)** — something that has been circulating for more than a decade at the European level, seen as an important element for the completion of the single internal market. The idea is that large European cross-border corporations may opt for a harmonized corporate tax rate, rather than paying several national rates, by consolidating their tax base across their European operations. The underlying rationale would be to avoid double taxation, reduce compliance costs and generate efficiency gains by simpler accounting rules. Clearly, this proposal is far from advocating harmonization of the national corporate tax rates across the member states — something that has been circulating in some press reports in the last few days.

Tax systems in Europe still present largely different features

The composition of tax rates is still highly heterogeneous across European countries, and so are the corporate tax rates, ranging from 30-35% in some core countries like Germany and France to as little as 12% in Ireland (see Figure 5). However, as there are often large differences in tax allowances and exemptions the headline corporate tax rates may also be misleading. Harmonization of corporate tax rates to a single reference value would be a huge task to accomplish as it would involve an overhaul of almost all national tax systems.

Figure 5. Euro Area – Corporate (2010) and Personal (2009) Tax Rates (Pct.)



Sources: OECD Tax Database and Citi Investment Research and Analysis

Consolidated tax base a softer tool to remove some Irish tax advantages

Still, even if far less ambitious, a common corporate tax base has been strongly opposed, since its first proposal almost ten years ago, by Ireland and the UK. Ireland in particular fears that these changes in the EU corporate tax system would reduce the significant advantage for European multinational companies to relocate their headquarters to Ireland — an important source of economic growth for Ireland in the past decade. While the introduction of a CCCTB is a less far-reaching proposal than an outright increase in the national corporate tax rate of 12% - as Germany and France have been requesting since last

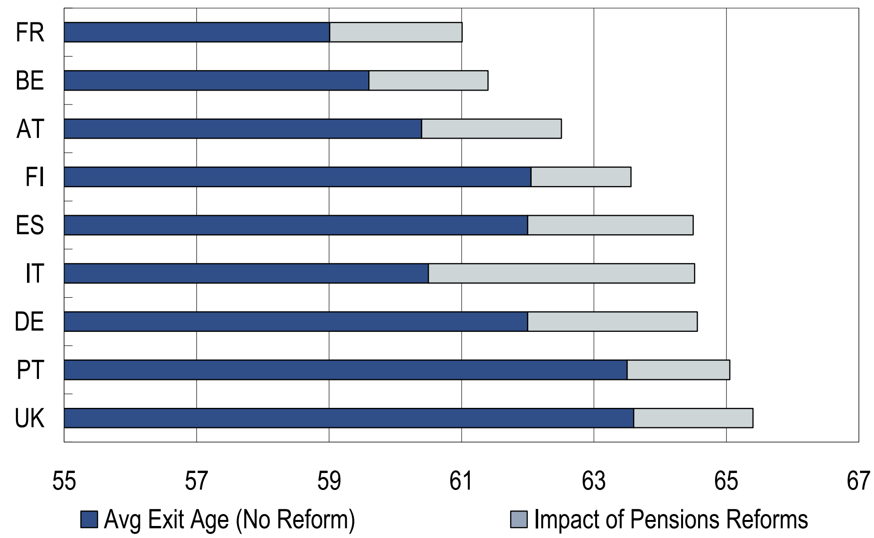
year's Irish bail-out package — it is probably just a softer tool to reach the same aim, i.e., reducing the Irish tax advantage relative to the rest of euro area. Hence, we see significant opposition arising from Ireland to this proposal.

Effective retirement age already set to increase as a result of past reforms

Closer economic integration now on the agenda of European policymakers

Retirement age. The Franco-German pact for competitiveness would also envisage an increase in legal retirement age towards a common level – 67 years, according to some press reports – and the introduction of some kind of indexation of the legal retirement age to life expectancy, in order to guarantee future sustainability of the public pension systems. At present, legal and, especially, effective retirement ages are well below this threshold in most European countries (see Figure 2 on the front page). However, several pension reforms over the past few years have already incorporated in the systems a progressive increase in legal/effective pension age over the next decades, which will help bringing the effective age of retirement significantly higher than today by 2060 (see Figure 6). But, given the deterioration in public finances in the current crisis, even these existing plans are probably not ambitious enough.

Figure 6. Men Average Retirement Age (2007) and Impact of Pension Reforms in 2060



Sources: EU Commission Ageing Report 2009 and Citi Investment Research and Analysis

Peripheral countries have recently agreed more or less sizable pension reforms…

The most recent example is the pension reform tabled by the Spanish government just two weeks ago, aimed at increasing the legal retirement age from 65 to 67 by 2027[3]. Greece has also put in place a comprehensive pension reform last summer, as part of its economic adjustment program. The Greek reform will raise the effective retirement age towards 65 and, according to the government's preliminary estimate, it will reduce the "hump" in the pension expenditure-to-GDP ratio by a sizable 10pp of GDP by 2060. Portugal has also implemented a significant pension reform in 2007, which should contribute to raise significantly the average retirement age by 2060. Italy also has adjusted the mechanisms of its pension system a few times in the past 20 years, with a significant effect on retirement age in the next decades (projected close to 65 for men by 2060).

[3] See "*Spain: A Praiseworthy, but Somewhat Half-Hearted, Pension Reform*", Giada Giani, Citi, 28 January 2011.

…while some core countries like France are still lagging behind on projected retirement age

It seems to us that the biggest burden from retirement age harmonization would fall on some core countries rather on the periphery. France stands out in international comparisons by its current very low age of retirement (average and legal). This would probably be still true even after last year's pension reform. While the reform will lead to an increase in the age to get full retirement benefits to 67 in 2027, the more important legal retirement age will increase only from 60 to 62. On the other hand, pension spending as a percentage of GDP in France – which has less worrisome demographics than most other European countries — is not projected to increase sizably from current levels, in contrast with additional fiscal burdens projected for many other European countries. Other core euro countries, like Belgium and Austria, would also have to implement significant changes to their pension systems to comply with the new retirement age requirement.

Special resolution regimes for banks a key step towards fixing the euro debt crisis

We have extensively discussed the necessity of setting up **special resolution regimes (SRR)** for banks — preferably on EU-wide common standards — in our Global Economics View "Debt of Nations" research piece[4]. We think SRRs are one of the key ingredients to solve the sovereign debt crisis, as they would force private creditors of the banks to be wiped out before any public money is injected, reducing the contingent liabilities of the public sector. SRRs would allow banks to continue their financial intermediation functions while at the same their balance sheets are restructured. Germany and Ireland have already taken legal steps to set up these mechanisms at the end of last year (although with quite different features). Spain would be the most obvious next candidate where the establishment of special resolution regimes for banks would help to reduce the uncertainty on contingent liabilities of the government. We think that the introduction of an EU-wide special resolution regime for banks would be a key step forward in the attempts to resolve the euro debt crisis.

The "competitiveness pact" involves more fiscal discipline than growth-enhancing measures

Overall, it seems to us that the set of measures included in the so-called "competitiveness pact" are devoted more to improve fiscal discipline, rather than to boost competitiveness and enhance medium-term growth potential. The requirement to introduce a "debt brake" (probably meaning some kind of rule for a balanced budget over the cycle) into national laws — or even into national constitutions — is clearly signaling the German imprint in this respect. This exactly reflects a policy decision already taken by Germany in 2009, which will become fully effective in 2016. The removal of wage indexation mechanisms may have some positive impact, albeit small, on medium-term growth prospects in Spain, but it may well have a negative impact on short-term domestic demand as real wages will be allowed to continue to adjust lower as they have done recent quarters.

Tackling euro area competitiveness should involve more product and labour market deregulation…

Surely, institutional changes like more harmonization in corporate tax rates or the mutual recognition of education qualifications are a positive development, but nothing that, in our view, would meaningfully change the growth outlook for the euro area aggregate and over-indebted peripheral countries. No mention in the competitiveness pact, for example, is made of the necessity of further deregulation in product and labour markets — steps which would probably have a much larger impact on potential growth rates for the overall area than the other proposed measures.

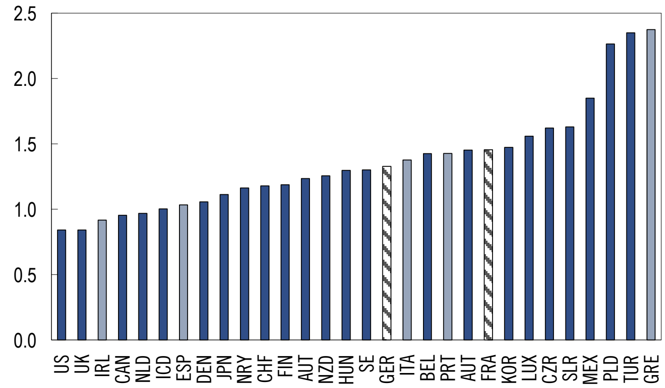
…not just in peripheral but also in core countries

As the EU Commission frequently stressed, the rebalancing of euro area macro-economic imbalances should involve policy actions both from current account deficit and current account surplus countries. Policymakers in the

[4] See, "The Debt of Nations", *Global Economics View* , Williem Buiter et al, Citi, 7 January 2011.

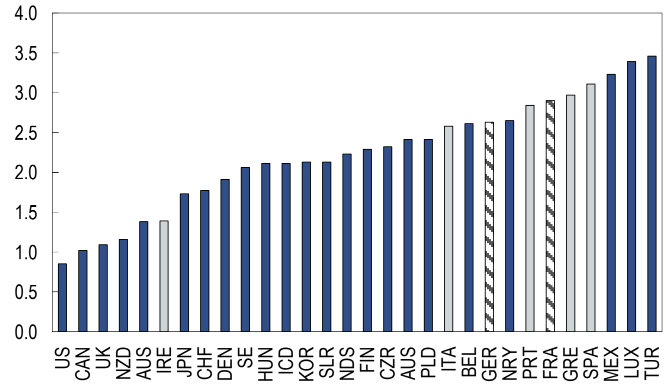
former should facilitate the transition away from domestic demand-driven growth towards exports by removing price and wage rigidities, but the latter should facilitate stronger domestic demand growth, for example by further de-regulation. Targeting freer product and labour markets in current account surplus countries would be a step in this direction (Figure 7and Figure 8). And it would make the burden of implementing structural efforts more equally balanced among the euro members. Some peripheral countries – like Ireland and Spain — already score significantly better than core countries on some of these important structural features.

Figure 7. OECD – Product Market Regulation Indicator, 2008



Sources: OECD and Citi Investment Research and Analysis

Figure 8. OECD – Employment Protection Legislation, 2008



Sources: OECD and Citi Investment Research and Analysis

Political hurdles potentially still ahead on the form and the contents of the proposal…

We reckon the cold reaction from the other European leaders to the Franco-German proposal at last week's EU Council meeting reflected this clear imbalance in the focus of the competitiveness adjustment. And also it surely reflected the uneasiness of other countries with respect to the change in the level of negotiations, from an EU-led to an inter-governmental level led by Germany and France. This shift may risk Germany and France losing support on the contents that many core but small countries are surely willing to provide. Therefore, this formal issue will probably be resolved in the negotiating process with Germany (and France) letting the Commission to (at least formally) take again the lead in managing the adjustment process.

…but the negotiating power of core countries is strong and it will produce some structural changes

Whichever form the process may take, we reckon the negotiating power of core countries will still be very high. As we discussed last week, the extension of the size and scope of the European rescue facilities is unlikely to definitively solve the debt sustainability issues in peripheral countries, as they most likely just provide further liquidity support. Yet, this is something peripheral countries still cannot afford to give up at this stage. The "carrot and stick" mechanism entrenched in the negotiations is something that resembles the pre-euro convergence process — probably the last time when a large number of structural reforms were implemented in a great number of euro area countries. As the recent developments in Spain show, the sovereign debt crisis has already provided a strong impetus for the structural reform zeal in the weaker peripheral countries. Although not as comprehensive as it may have ideally been, we believe some further structural steps will be taken in many euro member countries as a result of the ongoing negotiating process around the new economic governance in the euro area.

Key Economic Indicators (14 February – 18 February 2011)

Monday 14 February		Forecast	Last
10:00	Portugal: GDP, 4Q Flash Estimate		
10:00	Euro Area: Industrial Production, Dec	-0.3% MM, 7.9% YY	1.4% MM, 7.6% YY
Tuesday 15 February		**Forecast**	**Last**
06:30	France: GDP, 4Q Flash Estimate	0.3% QQ	0.4% QQ
07:00	Germany: GDP, 4Q Flash Estimate	0.3% QQ	0.7% QQ
08:00	Spain: HICP, Jan Final	3.0% YY	2.9% YY
08:30	Sweden: Riksbank Monetary Policy Outcome	25bp Hike to 1.50%	1.25%
08:30	Netherlands: GDP, 4Q Flash Estimate		
08:30	Netherlands: Trade Balance, Dec		
08:30	Netherlands: Retail Sales, Dec		
09:00	Norway: Trade Balance, Jan		
09:00	Sweden: AMS Unemployment Rate, Jan	4.6%	4.5%
09:00	Italy: GDP, 4Q Flash Estimate	0.2% QQ, 1.3% YY	0.3% QQ, 1.1% YY
09:30	UK: Consumer Prices, Jan	0.4% MM, 4.3% YY	1.0% MM, 3.7% YY
	CPI Ex Food, Drink, Tobacco, Energy, Jan	-0.1% MM, 3.3% YY	0.7 %MM, 2.9% YY
	Retail Prices, Jan	0.5% MM, 5.3% YY	0.7% MM, 4.8% YY
	RPIX – Excludes Mortgages, Jan	0.5% MM, 5.3% YY	0.7% MM, 4.7% YY
10:00	Italy: Trade Balance, Dec		
10:00	Germany: ZEW Economic Expectations, Feb	20	15.4
10:00	Euro Area: GDP, 4Q Flash Estimate	0.3% QQ	0.3% QQ
10:00	Euro Area: Trade Balance, Dec	€-1.6 Billion	€-1.8 Billion
	Greece: GDP, 4Q Flash Estimate		
Wednesday 16 February		**Forecast**	**Last**
07:30	EU-25: New Car Registrations, Jan		
08:00	Spain: GDP, 4Q Details	0.2% QQ, 0.6% YY	0.0% QQ, 0.2% YY
09:30	UK: Claimant Count Unemployment, Jan	-2,000 MM, 4.5% Rate	-4,100 MM, 4.5% Rate
	LFS Unemployment, Oct-Dec	+52K QQ, 7.9% Rate	+49K QQ, 7.9% Rate
10:00	Italy: Current Account, Dec		
10:30	UK: Bank of England's Quarterly *Inflation Report*		
Thursday 17 February		**Forecast**	**Last**
08:30	Sweden: Consumer Prices, Jan	-0.3% MM, 2.6% YY	0.7% MM, 2.3% YY
	CPIF, Jan	-0.2% MM, 2.2% YY	0.6% MM, 2.3% YY
08:30	Netherlands: Unemployment, Jan		
09:00	Norway: Mainland GDP (SA), 4Q	0.2% QQ	0.9% QQ
09:00	Euro Area: Balance of Payments, Dec		
10:00	Euro Area: Construction Output, Dec		
11:00	UK: CBI Industrial Trends Survey – Output Expectations, Feb	+20%	+17%
	CBU Order Books, Feb	-10%	-16%
	CBI Selling Prices, Feb	+25%	+31%
15:00	Euro Area: Consumer Confidence, Feb Flash		
Friday 18 February		**Forecast**	**Last**
07:00	Germany: Producer Prices, Jan	0.9% MM, 5.4% YY	0.7% MM, 5.3% YY
07:45	France: Industrial Confidence, Feb	107	108
08:30	Netherlands: Consumer Confidence, Feb		
09:00	Italy: Industrial Orders, Dec	5.8% MM	-4.3% MM
09:30	UK: Retail Sales Volumes, Jan	0.0% MM, 3.9% YY	-0.8% MM, 0.0% YY
	Greece: Current Account, Dec		
Sunday 20 February		**Forecast**	**Last**
	Germany: State Elections in Hamburg		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

Economic Indicators

Euro Area			
Feb 14 10:00 London Time	***Industrial Production, Dec***	**Forecast: -0.3% MM, 7.9% YY**	**Prior: 1.4% MM, 7.6% YY**
	We expect a decline in industrial production in December, partly correcting a decent gain in November and partly due to temporary distortions by the heavy snow in large parts of the region in December. If our forecast is correct, IP increased by 1.6% QQ in 4Q after expanding by 1.1% QQ in 3Q.		
Feb 15 London Time	***GDP, 4Q 2010 Flash***	**Forecast: 0.3% QQ**	**Prior: 0.3% QQ**
	In 4Q GDP growth is likely to remain roughly the same as in 3Q. We expect that the adverse weather conditions in large parts of the area had a dampening impact on overall activity. Furthermore, we reckon that the periphery countries performed weakly as fiscal tightening measures take their toll.		
Feb 15 10:00 London Time	***Trade Balance, Dec***	**Forecast: €-1.6 Billion**	**Prior: €-1.8 Billion**
	We expect a fifth consecutive increase in exports (by 0.4% MM) and a second consecutive gain in imports, but after the surge in November the increase in imports will probably be modest (0.2%). This would lead to a reduction in the trade deficit in December. For the year 2010 in aggregate this would lead to a modest deficit of €1.7bn after a surplus of €17.1bn in 2009.		
Germany			
Feb 15 07:00 London Time	***GDP, 4Q 2010 Flash***	**Forecast: 0.3% QQ**	**Prior: 0.7% QQ**
	Available survey and hard economic data suggest a slowdown in economic activity in 4Q. The slowdown is probably temporary and mainly due to the snow-related drop in construction activity and consumer expenditures in December. While the statistical office will not provide details, they probably will mention that increasing investment in machinery and equipment and increasing exports contributed to growth. However, net-exports were probably roughly unchanged in 4Q. We expect a rebound in GDP growth in 1Q 2011.		
Feb 15 10:00 London Time	***ZEW Economic Expectations, Feb***	**Forecast: 20**	**Prior: 15.4**
	We expect a fourth consecutive increase in ZEW business expectations bringing the index to the highest reading since July 2010. The outlook for ongoing solid foreign demand and encouraging signs of an acceleration in domestic demand probably will propel business expectations. We also expect a further increase in the assessment of the current business situation, by 1.2 points MM to 84. The combined index of expectations and the current business situation is likely to increase from 49.1 in January to 52.0 in February, the highest reading since June 2007.		
Feb 18 07:00 London Time	***Producer Prices, Jan***	**Forecast: 0.9% MM, 5.4% YY**	**Prior: 0.7% MM, 5.3% YY**
	As in previous months, higher import prices – mainly caused by a surge in commodity prices – probably led to a further increase in producer prices. The YY rate is likely to show the highest reading since October 2008.		
France			
Feb 15 06:30 London Time	***GDP, 4Q 2010 Flash***	**Forecast: 0.3% QQ**	**Prior: 0.4% QQ**
	We expect a modest slowdown in GDP growth from 0.4% QQ in 3Q to 0.3% QQ in 4Q. The slowdown is partly due to the temporary negative impact of the strikes against the pension reform in October and unusually heavy snow in parts of the country in December. Recent survey data suggest a growth acceleration at the beginning of 2011.		
Feb 18 07:45 London Time	***Industrial Confidence, Jan***	**Forecast: 107**	**Prior: 108**
	After the four point surge in January, leading to the highest reading of the series since March 2008, we expect a small downward correction in the INSEE sentiment indicator in February. However, the index is likely to stay around 0.4 standard deviations above its long-term average		
Italy			
Feb 15 09:00 London Time	***GDP Preliminary, 4Q***	**Forecast: 0.2% QQ, 1.3% YY**	**Prior: 0.3% QQ, 1.1% YY**
	GDP growth may have decelerated somewhat in 4Q relative to the previous quarters, reflecting the slowdown in industrial activity. The end of the inventory re-building cycle may explain this slowdown, while exports have continued to expand at a quite fast pace. Domestic demand probable remained very feeble, especially due to a deceleration in investment spending after the end of tax breaks on profits last summer.		
Feb 18 09:00 London Time	***Industrial Orders, Dec***	**Forecast: 5.8% MM**	**Prior: -4.3% MM**
	We expect industrial orders to bounce back in Dec, after a surprisingly weak monthly reading in Nov. Survey-based indicators suggest the underlying trend is still a moderately positive one for the manufacturing sector, mainly supported by rising exports.		
Spain			
Feb 15 08:00 London Time	***HICP, Jan***	**Forecast: 3.0% YY**	**Prior: 2.9% YY**
	HICP-measured inflation edged higher in Jan to 3.0% according to the flash estimate. However the increase in the national CPI was larger than that, up to 3.3% from 3.0% YY in Dec. The discrepancy stemmed from a new statistical treatment of some seasonal items in the HICP basket, which is likely to generate some short-term volatility in its YY rate in the coming months. Aside from these effects on the HICP, CPI inflation will probably be confirmed at 3.3%, boosted by higher energy and food prices. Core CPI inflation should be stable at 1.5% YY.		
Feb 16 08:00 London Time	***GDP Preliminary, 4Q***	**Forecast: 0.2% QQ, 0.6% YY**	**Prior: 0.0% QQ, 0.2% YY**
	According to the preliminary estimate, GDP returned to positive growth in 4Q, expanding by 0.2% QQ – somewhat above our original forecast of a zero growth rate. Domestic demand, however, probably declined again in 4Q, although probably not as sharply as in 3Q (-1.3% QQ). Net-exports works as an offsetting factor, as imports fluctuate in tandem with domestic demand. In trend terms, we think output growth remains close to zero. We do not expect any improvement to occur this year, as we expect fiscal consolidation to bite more severely than in 2010 on the economy.		

Economic Indicators

Sweden

Feb 15 08:30 London Time

Feb 15 08:30 London Time	***Riksbank Interest Rate Decision***	**Forecast: 1.50%**	**Prior: 1.25%**

We feel confident that the Riksbank will hike the key policy rate by 25bp, to 1.50%, at today's policy meeting. This is in line with the Central Bank's own rate path, consensus and current market pricing. Since the last meeting in December domestic data have proven to be even stronger than expected, with an overshoot of headline and core inflation, and undershoot in unemployment. The global economy is also doing better than the Riksbank anticipated last year. Moreover, we expect that the Riksbank will lift its conditional forecast for the policy rate in response to the output gap closing and future upside inflation risks. The Riksbank's previous path implied that rates would rise to 2.25% at end-2011 and 3.0% in late 2012. We expect rates to rise to 2.5% by the end of this year and 3.5% by end-2012, and even higher thereafter. Such rate hikes should not choke off growth, but reflect a withdrawal of the recent exceptional policy stimulus.

Feb 15 09:00 London Time	***AMS Unemployment Rate, Jan***	**Forecast: 4.6%**	**Prior: 4.5%**

According to preliminary statistics released weekly by the Swedish employment agency, the numbers of unemployed people increased by about 13,500 in January, while new hires displayed an increase of only 2,670 persons. At the same time, the number of workers enrolled in government-sponsored programs decreased by 3,200 persons – the first decrease in labour market programmes since August 2010. All in all, we expect the registered unemployment rate to go against the overall decreasing trend of last year and increase by 0.1pp to 4.6% in November.

Feb 17	***Consumer Prices, Jan***	**Forecast: -0.3% MM, 2.6% YY**	**Prior: 0.7% MM, 2.3% YY**
08:30	***CPIF, Jan***	**Forecast: -0.2% MM, 2.2% YY**	**Prior: 0.6% MM, 2.3% YY**
London Time			

We expect the CPI to fall 0.5% MM in January, although this will still leave the YY rate (expected to be 2.6%) above the Riksbank's forecast of 2.4% for the third consecutive month. The Riksbank's own inflation measure CPIF, which adjusts for costs of mortgages, is expected to show a lower YY increase of 2.2% in January – however, still above the Riksbank's forecast (2.0%).

Norway

Feb 17 09:00 London Time	***Mainland GDP (SA), 4Q***	**Forecast: 0.2% QQ**	**Prior: 0.9% QQ**

The recovery, so far, has been soft, with very subdued growth in Mainland GDP in the first half of 2010, but a somewhat stronger number in 3Q. We see growth in Mainland GDP at 0.2% QQ in 4Q 2010, producing in total 1.8% yearly growth rate, which is just above the Norges Bank's forecast of 1.65% growth (from the latest monetary Policy Report in October). We expect the main driver behind last quarter's growth to come from increasing private consumption and investment, confirming a gradual domestic recovery, while weighing on the downside of today's number is decreasing government spending. For this year we expect Mainland GDP to start showing some real pickup, forecasting a 2.8% increase in mainland GDP over 2011.

United Kingdom

Feb 15	***Consumer Prices, Jan***	**Forecast: 0.4% MM, 4.3% YY**	**Prior: 1.0% MM, 3.7% YY**
09:30	***CPI Ex Food, Drink, Tobacco, Energy, Jan***	**Forecast: -0.1% MM, 3.3% YY**	**Prior: 0.7% MM, 2.9% YY**
London Time	***Retail Prices, Jan***	**Forecast: 0.5% MM, 5.3% YY**	**Prior: 0.7% MM, 4.8% YY**
	RPIX – Excludes Mortgages, Jan	**Forecast: 0.5% MM, 5.3% YY**	**Prior: 0.7% MM, 4.7% YY**

We expect that CPI inflation will take another step up this month, rising above 4.0% YY for the first time since late 2008. Our forecast includes the sharp rise in petrol prices observed during January, but also assumes that slightly more than half of the January VAT hike is passed through this month, with some further pass-through in subsequent months. There is therefore an upside risk to our forecast if it turns out that the VAT hike is passed through quickly, especially if the VAT hike is used as an excuse to pass through other cost pressures..

Feb 16	***Claimant Count Unemployment, Jan***	**Forecast: -2,000 MM, 4.5% Rate**	**Prior: -4,100 MM, 4.5% Rate**
09:30	***LFS Unemployment, Oct-Dec***	**Forecast: +52K QQ, 7.9% Rate**	**Prior:+49K QQ, 7.9% Rate**
London Time			

These indicators have given slightly mixed messages recently, with a slight rise in the LFS unemployment measure but a slight drop in the claimant count series. The claimant count has the smaller margin of error and hence probably is a more reliable guide to the short-run trend. Either way, we expect no clear trend in the jobless data during this year, with public sector job losses roughly balanced by private sector hiring.

Feb 17	***CBI Industrial Trends Survey, Feb***		
09:30	***Output Expectations Net Balance, Feb***	**Forecast: +20%**	**Prior: +17%**
London Time	***Order Books Net Balance, Feb***	**Forecast: -10%**	**Prior: -16%**
	Selling Prices Net Balance, Feb	**Forecast: +25%**	**Prior: +31%**

The CBI manufacturing survey has been quite strong recently, with both output expectations and order books above average. Give the stimulus from the low pound plus strong global growth, we expect another strong reading this month. The reading for manufacturers' price expectations is likely to remain far above average, signalling future upside inflation risks.

Feb 18 09:30 London Time	***Retail Sales Volumes, Jan***	**Forecast: 0.0% MM, 3.9% YY**	**Prior: -0.8% MM, 0.0% YY**

There is a lot of uncertainty over our forecast for January retail sales. First, the January retail sales figures tend to be volatile: in 12 of the past 15 years, the January data have shown either a large rise (more than 1%) or a decline, a higher frequency of outliers than almost all other months. Second, the December figures were hit by heavy snow, and the reversal of that should boost January sales. Third, sales in January may have been hit by the VAT hike. On balance we go for volumes to be flat MM, in which case base effects will sharply lift the YY rate, but we attach a wide margin of error to our forecast.

Sources: National Statistical Offices, National Central Banks, Bloomberg, CIRA forecasts

Key Economic Indicators (21 February – 25 February 2011)

Sunday 20 February		**Forecast**	**Last**
	Germany: State Elections in Hamburg		
Monday 21 February		**Forecast**	**Last**
08:30	Netherlands: Producer Confidence, Feb		
09:00	Germany: ifo Business Climate, Feb		
09:00	Euro Area: PMI, Feb Flash		
Tuesday 22 February		**Forecast**	**Last**
09:30	UK: Public Sector Net Borrowing – Ex Costs of Fin. Intervention, Jan	£0.7 Billion Surplus	Year Ago: £1.0 Billion Deficit
	Fiscal Year To Date, Apr-Jan	£117.7 Billion Deficit	Year Ago: £127.8 Billion Deficit
Wednesday 23 February		**Forecast**	**Last**
06:30	France: Consumer Prices, Jan		
08:15	Switzerland: Producer and Import Prices, Jan		
08:30	Netherlands: Household Consumption, Dec		
09:00	Norway: AKU Unemployment Rate, Dec		
09:00	Italy: HICP, Jan Final		
09:30	UK: BBA No. of Mortgage Approvals for House Purchase, Jan	30,000 MM, -15.8% YY	28,276 MM, -37.8% YY
09:30	UK: Minutes of Feb 10 MPC Meeting		
09;30	UK: BoE Agents' Summary of Business Conditions, Feb		
10:00	Euro Area: Industrial New Orders, Dec		
Thursday 24 February		**Forecast**	**Last**
07:00	Germany: GfK Consumer Confidence, Mar		
07:00	Germany: GDP, 4Q Details		
07:45	France: Consumer Confidence, Jan		
08:15	Switzerland: Employment, 4Q		
08:15	Sweden: Business & Consumer Confidence, Feb		
09:00	Italy: Retail Sales, Dec		
10:00	Euro Area: Business & Consumer Surveys, Feb		
11:00	UK: CBI Retail Survey, Feb		
18:00	France: Job Seekers, Net Change, Jan		
Friday 25 February		**Forecast**	**Last**
00:01	UK: GfK Consumer Confidence, Feb		
	Germany: HICP, Feb Preliminary		
07:45	France: Manufactured Goods Consumption, Jan		
08:00	Spain: Producer Prices, Jan		
09:00	Norway: Unemployment Rate, Feb		
09:00	Euro Area: M3, Jan		
09:30	UK: GDP, 4Q (2nd Release)		
09:30	UK: Service Sector Output, Dec		
10:30	Switzerland: KOF Economic Barometer, Feb		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

Recent Research Publications	Author	Date of Publication
Euro Area		
Euro Area — Sovereign Debt Crisis Update	Jürgen Michels	February 11, 2011
ECB — Uncertainty About Axel Weber's Future	Jürgen Michels	February 09, 2011
Spain — Wage Moderation Already at a Turning Point?	Giada Giani	February 08, 2011
ECB — No Further Language Escalation	Jürgen Michels	February 03, 2011
Spain — A Praiseworthy, but Somewhat Half–Hearted, Pension Reform	Giada Giani	January 28, 2011
European Economic Forecast Highlights	Ann O'Kelly	January 21, 2011
Euro Area — Probably Still Too Early for Voluntary Greek Debt Restructuring	Jürgen Michels	January 19, 2011
ECB: Starting to Bark; We Now Expect First Bite in 2H 2011	Jürgen Michels	January 13, 2011
Euro Weekly		
A European "Grand Deal" Still Leaves Room For Disappointment	Jürgen Michels	February 04, 2011
ECB — Strong Words, But No Deeds	Jürgen Michels	January 28, 2011
ELA: An Emperor Without Clothes?	Jürgen Michels	January 21, 2011
Sovereign Crisis — Still Many Hurdles Ahead	Jürgen Michels	January 14, 2011
Nordics		
Sweden — 25bp Rate Hike and Higher Rate Path	Michael Saunders	February 11, 2011
Norway — Manufacturing Production Slips In December	Michael Saunders	February 07, 2011
Sweden — Retail Sales Slip, But Trend Still Solid	Michael Saunders	January 28, 2011
Sweden — PPI Shows Highest Monthly Rise in 15 Years, and Confidence Readings Rise Further	Michael Saunders	January 27, 2011
Norway — Key Policy Rate on Hold, but "Should Not Be Kept Low For Too Long".	Michael Saunders	January 26, 2011
Norway — Unchanged Rate At The New Governor's First Policy Meeting	Michael Saunders	January 24, 2011
Sweden — The OECD Praises Sweden's "Strong " Economy	Michael Saunders	January 21, 2011
Global		
Global Economics View: ELA: An Emperor without Clothes?	Willem Buiter	January 21, 2011
Global Economic Outlook and Strategy: January 2011	Willem Buiter	January 20,2011
Global Economics View — The Debt of Nations	Willem Buiter	January 7, 2011
UK		
UK — Producer Price Inflation Soars Further	Michael Saunders	February 11, 2011
UK — MPC On Hold	Michael Saunders	February 10, 2011
UK — Manufacturing Leads In Rebalancing	Michael Saunders	February 10, 2011
UK — Import Prices Continue to Climb	Michael Saunders	February 09, 2011
UK — Services PMI Rounds	Michael Saunders	February 03, 2011
UK — Corporate Liquidity Improves Further	Michael Saunders	February 01, 2011
UK — YouGov Survey Shows Inflation Expectation Still Elevated	Michael Saunders	January 28, 2011
UK — MPC Minutes and BoE Agents	Michael Saunders	January 26, 2011
Sterling Weekly		
MPC Will Hike Soon, But Perhaps Not Yet	Michael Saunders	February 04, 2011
Mixed Signals	Michael Saunders	January 28, 2011
Further Inflation Increases to Come	Michael Saunders	January 21, 2011
Inflation Scare Worsens	Michael Saunders	January 14, 2011

Source: Citi Investment Research And Analysis

Notes

Appendix A-1

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