Global Economic Outlook and Strategy

Prospects for Economies and Financial Markets in 2013 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 2013 and beyond, along with Overview essays on private sector deleveraging; the EMU crisis; the transition of emerging markets to a new growth model; political risks; monetary policies; and longrun projections for the size of major economies.*

- We expect that 2013 will be another year of modest global growth, with sizeable divergences between regions and countries. Our base case is for global growth of 2.6% in 2013 and 3.1% in 2014 (at current exchange rates), a little below consensus and IMF forecasts, after 2.5% in 2012. Nevertheless, we expect faster expansion subsequently, with global growth of 3½%-4% YoY in 2015-17. Major central banks probably will keep policy loose near term, with tightening not until 2015 in the US and rather later in Europe and Japan.

- China's economy is transitioning to a slower growth path of about 7% per year, with more emphasis on consumer spending. Even so, China will remain a global powerhouse, directly accounting for about a third of global growth in 2013-17e. In 2013, investment spending in China will probably exceed investment in the US and euro area combined. But, in coming years, the global expansion will become more broad-based across countries and economic sectors, with rapid growth in consumer spending and investment across many other emerging markets as well. Moreover, provided fiscal tightening is not abrupt, US growth is likely to rise to 3%+ from late 2013 as constraints from weak balance sheets and poor credit availability ease. The euro area and UK economies will remain weak in 2013e and beyond.

- We still expect Grexit over the next 12-18 months. We also now include in our base case sovereign debt restructuring (most likely via a mix of coupon reductions and maturity extension) during 2013-17 for at least five EA countries (Greece, Ireland, Italy, Portugal, and Spain). These countries' sovereign ratings probably will all be rated as sub-investment grade — and in selective default status (or equivalent) by the rating agencies for a period in the event of restructuring — during the next few years.

Figure 1. Currency and Interest Rate Forecasts, as of 26 November 2012

	26 Nov 2012	1Q 13F	2Q 13F	3Q 13F	4Q 13F	1Q 14F	2Q 14F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.67	1.75	1.95	2.20	2.50	2.65	2.90
Euro Area: US$/€	1.28	1.23	1.22	1.21	1.20	1.20	1.20
Euro Repo Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
10-Yr. Bunds (Period Ave.)	1.42	1.50	1.75	1.75	1.50	1.25	1.50
Japan: Yen/US$	81	84	85	85	84	84	83
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.74	0.85	1.00	0.90	1.10	1.10	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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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 2. Forecast Highlights and Changes from Last Month

■ Global	Our global growth forecasts are little changed from last month, at 2.6% for 2013 and 3.1% for 2014, with Asia outperforming, the US picking up after near-term weakness, and Europe staying weak through 2013-14.
■ United States	Modest growth is expected to continue amid a continuing focus on fiscal drag and an emerging housing rebound. We expect a short-term agreement to avoid most of the fiscal cliff while the Fed is likely to extend QE through at least the better part of 2013 and possibly beyond.
■ Euro Area	We expect the euro area to remain in recession in 2013 (-0.7%) and 2014 (-0.4%). While the ECB's OMT programme is likely to reduce risks of a broad-based EMU break up, we expect Greece to leave the euro area, probably in early 2014, and sovereign debt restructuring in several periphery countries. The ECB is likely to cut the refi rate to +0.25% and the deposit rate to -0.25% in the course of 2013.
■ China	We revise up 2013 growth forecast slightly from 7.6% to 7.8%. The current growth rebound may last into 1H next year, due to lagged effect of policy easing and supported by the investment impulse of the local governments. As the policy stance returns to neutral and more aggressive reforms are introduced in late 2013, growth may decelerate again in 2H, and YoY growth may briefly fall below 7% in early 2014.
■ Japan	Following a prospective change in the government in the upcoming general elections on December 16th, the Bank of Japan leadership will also change next spring. How the basic thrust of economic policies — both monetary and fiscal — will change will probably be an important key for financial markets in 2013.
■ United Kingdom	The UK economy may well fall back into slightly negative growth in Q4 as the boost from the Olympics unwinds, and the underlying momentum of the economy is likely to remain weak in 2013.
■ Canada	Externally-focused downside risks and lingering uncertainties will keep the BoC on the sidelines at least through mid-2013. Policy normalization will be modest and protracted thereafter. Guidance is likely to remain slightly hawkish.
■ Australia	The challenge of rebalancing the economy against a backdrop of deleveraging and global uncertainty likely will require some further easing of monetary policy, probably early in the new year.
■ Emerging Asia (ex China)	Growth should rebound on the back of lagged impact of policy accommodation supporting domestic demand. While a few countries (Korea, India, Thailand, Vietnam) may ease monetary policy early next year, a number of countries will signal normalization of policy rates (Indonesia hiking earlier). Asian FX of current account surplus countries should outperform on the back of China's steady tolerance to a market-led currency appreciation.
■ CEEMEA	CEEMEA is likely to remain the 'sick man' of EM next year. First, further bank deleveraging will stay as a serious threat to Central and Eastern Europe, contributing to weak domestic credit growth and capital outflows. Second, CEEMEA will continue to be home to the biggest external financing gaps in EM: Turkey, Poland, Romania, Hungary and South Africa all exhibit external vulnerability to a greater or lesser extent. Third, downside risks to energy prices could make the macro environment in Russia more complex.
■ Lat Am	GDP recovered in 2012 after a harsh slowdown in Brazil and Argentina, but the pace of recovery remains timid despite strong monetary and fiscal stimuli. By contrast, in the Andeans, where GDP has been resilient despite declining commodity prices, we expect growth to remain robust while, in Mexico, gains in export market share at the expense of China will continue to account for strong performance despite sluggish US growth. Inflation will continue to test the upper limits of the target bands as central banks constrain exchange rate flexibility to avoid excessive real appreciation. Risks include loss of competitiveness in manufacturing due to accumulated real appreciation in all countries except Mexico.

Source: Citi Research

Figure 3. Selected Countries — Industrial Production Forecasts (Pct.), 2012-14F

	2012F	2013F	2014F
World	1.8%	2.1%	3.7%
United States	3.8	2.4	4.2
Japan	-1.4	-2.6	2.4
Euro Area	-2.1	-1.5	0.1
United Kingdom	-1.5	1.3	0.8
Canada	0.6	0.1	1.8
China	10.0	10.0	9.2
India	3.2	4.4	5.6
Korea	2.1	3.2	7.0
Brazil	-2.5	3.1	4.0

Source: Citi Research

Prospects for 2013 and Beyond: Recovery and Recession in a Divergent Outlook

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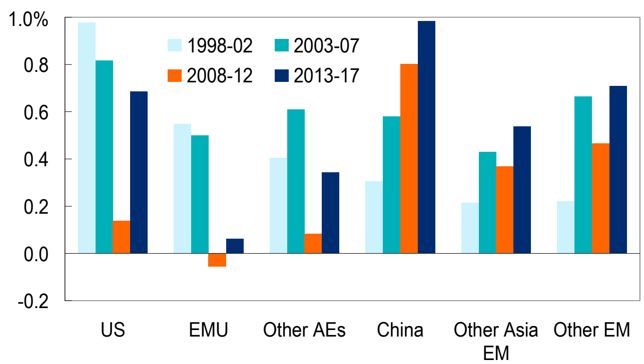
Global growth probably will remain subdued in 2013, gradually giving way to faster expansion subsequently

We expect that 2013 will be another year of modest global growth, a little below its longrun average, with sizeable divergences between regions and individual countries. Our base case is for global growth of 2.6% in 2013 and 3.1% in 2014 (at current exchange rates), after 2.5% in 2012. Our forecasts are a little below the consensus and IMF (the IMF expects global growth of 2.9% in 2013 and 3.5% in 2014 at current exchange rates). But, we do expect modest near-term growth to give way to faster expansion subsequently, with real global GDP growth of 3½%-4% YoY in 2015-17 (although our forecasts for later years also are a bit below the IMF's). Against this backdrop, major central banks probably will continue to keep policy loose near term, and generally loosen further in 2013, with tightening not until 2015 in the US and rather later in Europe and Japan.

Growth will remain uneven, but more broad-based than recently

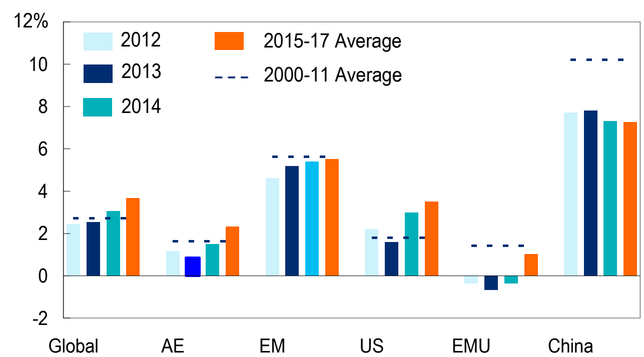
Over the last five years, global growth has been heavily China-dependent and China's growth has been heavily investment-dependent. In all, China's GDP has accounted for 45% of global growth in 2008-12 and an even bigger share including the spillovers from China's expansion to other countries. China's economy is now transitioning to a slower growth path of about 7% per year, with a marked pick up in consumer spending. China will remain a global powerhouse, with real GDP doubling every ten years or so and directly accounting for about a third of global growth in 2013-17e. Nevertheless, this impetus will be supplemented by a gradual but powerful renewed acceleration in US growth. In addition, we expect consumption and investment will grow rapidly across many emerging markets in coming years, especially in Asia and the Middle East, reflecting policy loosening plus background drivers of rapid growth of middle-income consumers, urbanization, and major infrastructure projects by cash-rich governments and state-linked bodies.

Figure 4. Global — Contributions to Global GDP Growth, Annual Averages, 1998-2017F



AE advanced economies. F Forecast. Note: Contributions measured at current exchange rates. Sources: IMF and Citi Research forecasts

Figure 5. Global — YoY Real GDP Growth By Region, 2000-17F



F Forecast. Source: Citi Research

The US is set for the greatest sustained outperformance versus the euro area for decades…

Although the global financial crisis hit both the US and Europe in 2007-09, we expect very different recovery paths, reflecting differing policy choices in managing the deleveraging process, plus underlying differences in terms of the supply-side and energy availability. In 2012, US real GDP growth outperformed the euro area by about 2¾%, the widest gap since 1993. We expect similar sustained US outperformance in coming years. With improving private sector balance sheets and falling energy costs, we believe that — provided near-term fiscal tightening is gradual — US growth will gradually transition to 3%+ from late-2013 and into subsequent years. US real GDP per head probably will regain the 2007 level in

2013 or 2014, and rise about 9-10% above the 2007 level by 2017 — clearly outperforming Japan's "lost decade" (real GDP per head rose by 5% from 1992-02).

…whereas the euro area and UK are likely to underperform Japan's "lost decade" in terms of real GDP per head

By contrast, in the euro area, we expect continued recession in 2013 and 2014 and prolonged weakness thereafter — with ongoing financial strains and, over the next few years, Grexit plus a series of sovereign debt restructurings. In the euro area and UK, real GDP per head will probably remain 3-4% below the 2007 level even in 2017, with a greater shortfall in many periphery countries — markedly underperforming versus Japan's "lost decade". The European economies still have underlying potential to grow: but we expect that private sector deleveraging, weak banking system, early fiscal austerity and financial strains resulting from flawed EMU structures will continue to cap demand for an extended period.

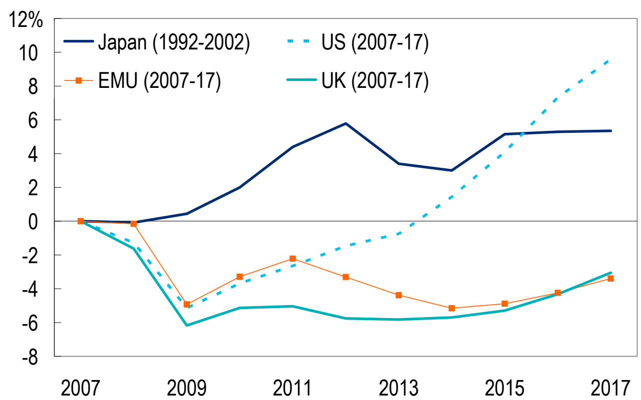
Key uncertainties concern the interplay between private deleveraging and fiscal tightening, plus the eventual resolution of the ongoing EMU crisis

The main uncertainties in the outlook concern the interplay between high private sector debts, and the high fiscal deficits across many advanced economies. Our base case assumes that US will manage a "goldilocks" policy transition, with gradual fiscal tightening kicking in as private deleveraging eases. If fiscal consolidation is excessively deferred, then bond yields could back up sharply, especially as private savings fall. Conversely, as Europe's experience shows, aggressive early fiscal tightening could tip the US economy back into stagnation or worse. In Europe, we assume that in the near term, as recently, creditor nations will continue to do just enough — through official support — to prevent EMU disintegrating, but not enough to return the periphery countries to sustainable fiscal paths. Eventually, we expect Grexit and a series of sovereign debt restructurings, alongside moves towards tighter integration among EMU countries.

Global CA imbalances are likely to shrink, but may be a source of potential tension in some cases

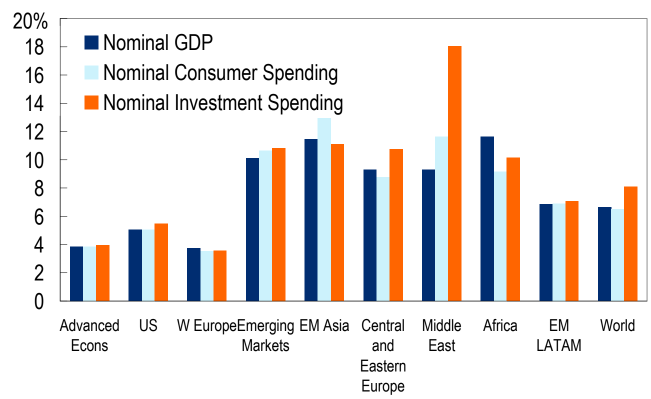
The aggregate current account surplus of EM countries is likely to vanish in coming years as the growth of domestic demand and imports continues to outpace advanced economies. However, sizeable imbalances probably will remain and some new ones will develop. We still expect that China will continue to run CA surpluses in coming years, while in aggregate other EM countries will run modest deficits. At the same time, the US will probably remain in CA deficit, while in the euro area, like Japan, sluggish domestic demand probably will produce persistent CA surpluses and capital outflows. By and large, we do not expect CA imbalances to be a major destabilising factor in the global outlook, but there may be strains in some individual EM countries.

Figure 6. US, Euro Area, Japan and UK — Cumulative Change in Real GDP Per Head After Banking Crises, 1992-2017F



Sources: World Bank, Datastream and Citi Research forecasts

Figure 7. Global — Expected Average YoY Growth of Nominal Economic Activity in USD Terms, 2012-20



Note: We aggregate nominal GDP at forecast exchange rates to 2017, extrapolations thereafter. Sources: IMF and Citi Research forecasts

Private and Public Deleveraging: Are We Nearly There Yet?

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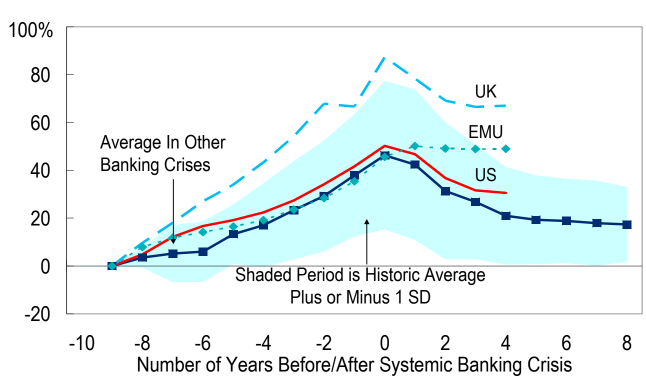
How far will private deleveraging continue to cap demand?

Increases in debt can serve a valuable role in allowing firms and individuals to expand spending and investment in anticipation of future income gains, and to smooth spending in the face of temporary falls in incomes. But, in the boom, private debt levels rose far above historic norms in the US and many European countries and, since the 2007-09 crisis, spending has been capped by a desire among borrowers and lenders to deleverage. Private deleveraging — in the aftermath of the major boom-bust credit cycle — will probably continue to be a major drag on global growth in 2013 and beyond, but with substantial divergences between the US and Europe. This note assesses how far deleveraging has proceeded so far, how much remains, contrasts the varied experiences of different countries, and assesses vulnerability — who may be next?

The classic pattern of boom/bust cycles is an extended period of deleveraging, with deep recessions and sluggish recoveries

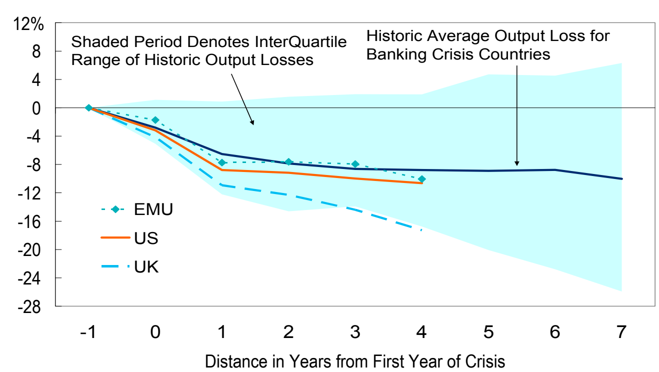
There is considerable variation in private debt/GDP ratios and levels of household assets across countries, depending on, for example, home ownership rates. However, changes in debt/GDP ratios in boom-bust cycles have tended to follow a broadly similar pattern of leverage, crisis, and extended deleveraging. Figure 8 shows the change in the private debt/GDP ratio averaged across 12 major boom-bust credit cycles in recent decades[1]. On average for these countries, the private debt/GDP ratio rose by 46 points in the nine years leading up to the peak followed — amidst a mix of weaker income expectations, falling asset values and weakened banks — by an extended period of deleveraging which reversed about two-thirds (ie 30 points) of that rise over the next 8 years. In turn, the bias to deleveraging was mirrored in a sharp rise in private savings and ultra-low interest rates, with short-term interest rates falling 4-5 percent below their pre-crisis level for the next 10 years or so. But, even with low central bank rates, countries with boom/bust credit cycles typically have deep recessions and sluggish recoveries, with GDP remaining 9-10% below the pre-crisis trend in the next 5-10 years[2].

Figure 8. US, EMU and UK — Change in Private Debt/GDP Ratios Compared to Trends in Prior Boom/Bust Credit Cycles, 1999-2012



Note: We show changes in private debt/ GDP ratios from nine years before each country's crisis, with the recent crises dated at 2008. Private debt for US, EMU and UK is the sum for household and non-financial corporate sectors. Latest data are Q2-2012. Sources: World Bank, BIS, Eurostat, Datastream and Citi Research

Figure 9. US, EMU and UK — Shortfalls of Real GDP Per Head Versus Pre-Crisis Trend, 2006-2012



Note: Using the IMF approach, the trend for real GDP per head is measured over the seven years up to T-2, where T denotes the year of financial crisis. Latest figure is Citi estimate for 2012.
Sources: IMF, World Bank, Eurostat, US Federal Reserve, ONS and Citi Research

[1] The countries are Chile (1981), Finland, Norway, Sweden (all 1991), Indonesia, Japan, Malaysia , the Philippines, Thailand (all 1997), Ivory Coast (1998), Nicaragua (2000), and Uruguay (2002). See "*Systemic Banking Crises Database: An Update*", Laeven and Valencia, IMF 2012.

[2] See "*IMF World Economic Outlook*", September 2009, and also "*Debt of Nations*", Willem Buiter and Ebrahim Rahbari, 20 November 2012, Citi.

In comparing recent trends in private sector leveraging and deleveraging in the US and Europe against this template, several points stand out.

The aggregate rises in private debt/GDP ratios in the US and Europe were similar to prior major boom/bust cycles…

- The rises in the private debt/GDP ratios in the US and euro area in the boom (45-50 points) were substantially greater than their own prior experience (where data are available) but broadly similar to the average for prior cases of boom-bust credit cycles. Within those totals, the rise in US private debt mainly reflected household debt, while in the euro area it was mainly corporate debt, but the aggregate rises in debt were broadly similar.

…and the economic path for the US and Europe also is fairly typical of the experience after boom/bust cycles…

- Since the 07-09 crisis, private savings have risen sharply in many countries and, with weak demand, real GDP per head in both the US and euro area has slipped about 10% below the pre-recession trend. This is similar to the norm for prior countries with boom/bust credit cycles. The UK had a much bigger buildup of debt (private debt/GDP ratio rose by 87 points from 1999 to 2008) and, exacerbated by fiscal drag, real GDP per head now is about 17% below the pre-crisis trend.

…but overall, the pace of deleveraging has been faster in the US than in Europe

- The rise in private savings has been reflected in a general bias to deleveraging across advanced economies, but the decline in debt/GDP ratios has been much faster in the US than the euro area in terms of both aggregate private debt and household debt. In the US, the private debt/GDP ratio is down by 21 points from the peak and, at 159% in Q2-2012, is back to the 2006 level. Within that, household debt has fallen by 6.3% since Q1-08 in absolute terms, while the household debt/GDP ratio is down by 14 points and is the lowest since Q4-03. By contrast, in the euro area there has been little or no aggregate deleveraging. The private debt/GDP ratio peaked at 168% in Q2-09 and has merely edged down to 165% in Q2-2012 — slightly above the US level. For the euro area, household and corporate debts have continued to rise in nominal terms. The household debt/GDP ratio is down by just one point from its peak, and the corporate debt/GDP ratio down by 2-3 points indeed.

The rises in debt in some individual countries has been exceptionally large…

- The rises in debt among individual European countries vary greatly and some cases have been far bigger than in the US. Four groups of countries stand out: EMU periphery countries (eg Ireland, Cyprus, Spain, Portugal, Greece), for which the average private debt/GDP ratio rose by 93 percentage points during 2000-09; the Baltics (Estonia, Latvia, Lithuania), with the average private debt/GDP ratio up by 96 points during 2000-09; several other recent EU entrants (Romania, Slovenia, Bulgaria, Hungary), with the private debt/GDP ratio up by 99 points on average from 2000 to 2009; the Scandis (Finland, Sweden Norway, and, Denmark), with their average debt/GDP ratio up by 74% from 2000 to 2009. In Spain, for example, the private debt/GDP ratio surged from 97% in 1999 and 122% in 2000 to 227% in 2009, roughly twice the rise in the US. The rise in private debt/GDP ratios in the boom in France and Italy was slightly less than in the US (with much less rise in household debt), but there has been little or no subsequent deleveraging. Germany's private debt/GDP ratio has fallen since 2001.

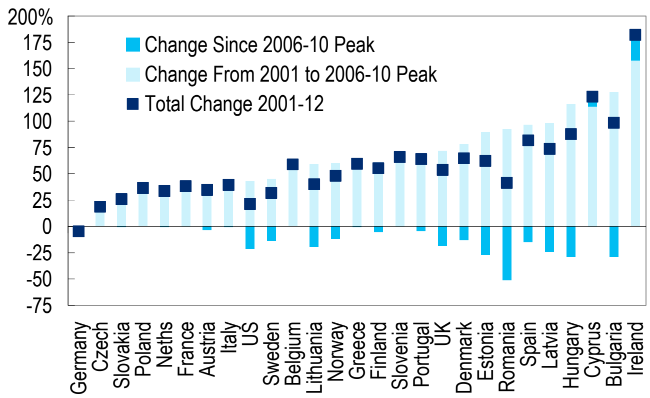
…with wide variation in the pace of deleveraging

- Among these high-debt EU countries, the pace of deleveraging has varied considerably — but in general has been faster outside EMU than inside it. For example, there has been little or no deleveraging in Greece, while the private debt/GDP ratio has continued to rise in Ireland and Cyprus (because incomes and debts are shrinking at about the same pace). There has been only limited deleveraging in Spain and Portugal, with the private debt/GDP ratio in Q1-2012 down by just 4 points and 13 points respectively from the peak. By contrast, the private debt/GDP ratio has fallen by 18 points in the UK, 26 points in Latvia, 29 points in Bulgaria, 27 points in Estonia and 51 points in Romania.

A range of factors accounts for the US-Europe divergence in deleveraging

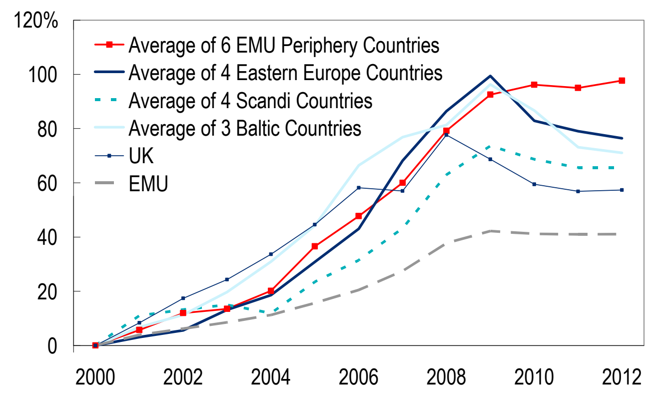
The US-EMU divergence partly reflects higher growth of nominal GDP and incomes in the US and the bigger rise in private savings — and hence debt repayment — in the US[3]. In addition, there has been a much higher contribution to deleveraging from insolvencies and debt write-offs in the US than in Europe. This partly reflects the more aggressive regulatory approach in the US, driven in part by the ability of banks to recoup losses through relatively high interest margins. In addition, many EU countries have relatively complex and difficult insolvency laws, which limit the extent to which insolvencies can contribute to deleveraging. Indeed, it is striking that Ireland and Spain — which had exceptionally large rises in household debt/income ratios — have exceptionally low personal insolvency rates[4], because of the complexity of their insolvency law and lack of non-recourse mortgages.

Figure 10. Selected Countries — Change in Private Debt/GDP Ratios from 2001 Level, 2001-2012



Note: Private debt measured by sum of debt of household and non-financial corporate sectors. Latest data are Q1-2012 (2011 for Bulgaria, Cyprus, Netherlands and Romania), earlier data are annual. Countries ranked in terms of rise in private debt/GDP ratio from 2001 to peak.
Sources: Eurostat, Federal Reserve and Citi Research

Figure 11. Selected Countries — Change in Private Debt/GDP Ratios from 2001 Level, 2000-2012



Note: The six periphery EMU countries are Italy, Spain, Ireland, Greece, Portugal and Cyprus. The three Baltic countries are Estonia, Latvia, Lithuania. The four E Europe countries are Bulgaria, Hungary, Romania, Slovenia. The three Scandi countries are Sweden, Denmark and Finland.
Sources: Eurostat and Citi Research

Private sector deleveraging has been faster in countries with more aggressive monetary loosening, less fiscal tightening and more responsive insolvency frameworks

These comparisons highlight two key points. First, the recent experience of deep recessions and modest recoveries of the US, Euro area and UK fits reasonably well into the template of other countries which have experienced major credit cycles, with a subsequent shift to high private savings, persistent weakness in domestic demand, and ultra-low interest rates. Second, the countries that have made fastest progress in deleveraging are where: (1) there is some offsetting support for economic growth from either: currency depreciation (eg US, UK, Romania), or a high export/GDP ratio (eg Baltics), or aggressive monetary loosening (eg US, UK) (2) private deleveraging is not accompanied by heavy early fiscal austerity (eg Scandis, and the US, where fiscal policy loosened significantly in 2007-10 and has tightened only modestly since then); and (3) the regulatory framework encourages prompt recognition of insolvencies (personal and corporate) and write-offs[5], as well as the necessary bank recapitalization (eg US, Baltics[6], but not Ireland and Spain —

[3] In the euro area, the private sector financial balance has risen from 0.6% of GDP in 2008 to 4.2% of GDP in the four quarters ending mid-2012, whereas in the US the private sector has moved from a deficit of 3.8% of GDP in 2006 to a surplus of 6.1% of GDP on average in the last four quarters.

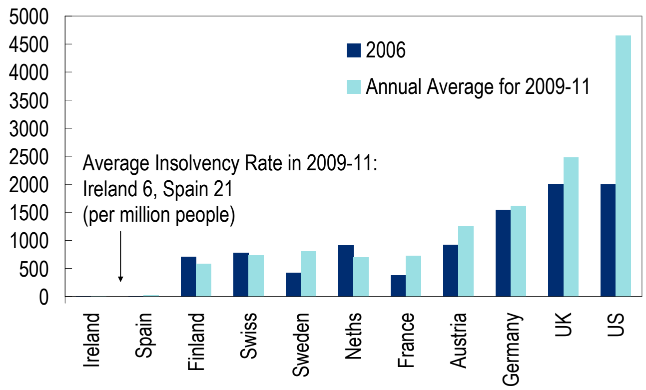
[4] See "Insolvencies in Europe", CreditReform, February 2012.

[5] See "*Dealing with Household Debt*", IMF World Economic Outlook, April 2012.

[6] See "*Corporate and Household Debt Distress in Latvia: Strengthening the Incentives for a Market-Based Approach to Debt Resolution*", IMF working Paper 11/85, 2011, "*Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008-09*", IMF working paper 10/213, 2010.

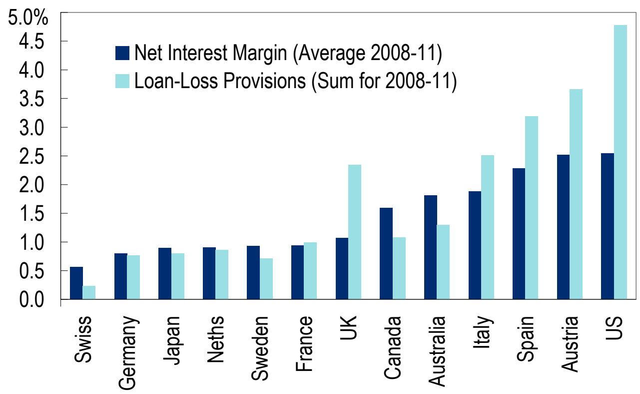
for which the personal insolvency regime is complex[7]). By contrast, the approach in many euro area countries — layering early fiscal austerity on top of private retrenchment, and with less aggressive loosening of monetary conditions and a more restrictive insolvency regime — has produced marked economic weakness without actually achieving much private deleveraging so far.

Figure 12. Selected Countries — Personal Insolvency Rates (Insolvencies Per Million People), 2006-11



Sources: CreditReform, Datastream and Citi Research

Figure 13. Selected Countries — Banking Sector Loan-Loss Provisions and Net Interest Margins, 2008-11



Note: Loan-loss provisions and margins are measured as a share of bank assets.
Sources: BIS and Citi Research

The most aggressive phase of private deleveraging probably is past in the US…

Going forward, we suspect that the most aggressive phase of private deleveraging (falling debt levels) is probably at or near its end in the US, although the household debt/GDP ratio may continue to edge down. US household debt rose 0.3% QoQ (non annualized) in Q2, the first significant rise since Q1-08 and surveys show a sharp rise in the share of households who believe it is a good time to buy a house. By contrast, we suspect that an extended further period of private deleveraging remains ahead in Europe, reflecting both the greater rise in debt in some individual countries, weaker income growth and — with weaker banks — the general bias to tighter bank lending standards evident in recent ECB surveys[8].

…contributing to persistently wide US-Europe growth differentials

Our base case includes fiscal tightening of about 1% of GDP in both the US and euro area in 2013, with rather more in the UK (about 1½% of GDP) and most EMU periphery countries. We assume the US will not fall off the "fiscal cliff" and that the US in coming years continues to proceed cautiously with fiscal consolidation while private sector deleveraging is underway. In the US, this fiscal drag is likely to be offset by a modest decline in private savings to keep economic growth around 2% in 2013 as a whole, with a step-up to about 3% QoQ SAAR from late 2013. By contrast, in the euro area, continued fiscal drag — severe in many periphery countries — is likely to be accompanied by a continued bias to private deleveraging. As a result (and with the US's other advantages in terms of economic flexibility and energy supply), we expect the US will continue to markedly outperform the euro area in economic terms in coming years. The UK is likely to continue be capped by the combination of ongoing private deleveraging and heavy fiscal drag, while — with no need to tighten fiscal policy early — the Scandis probably will continue to outperform in Europe.

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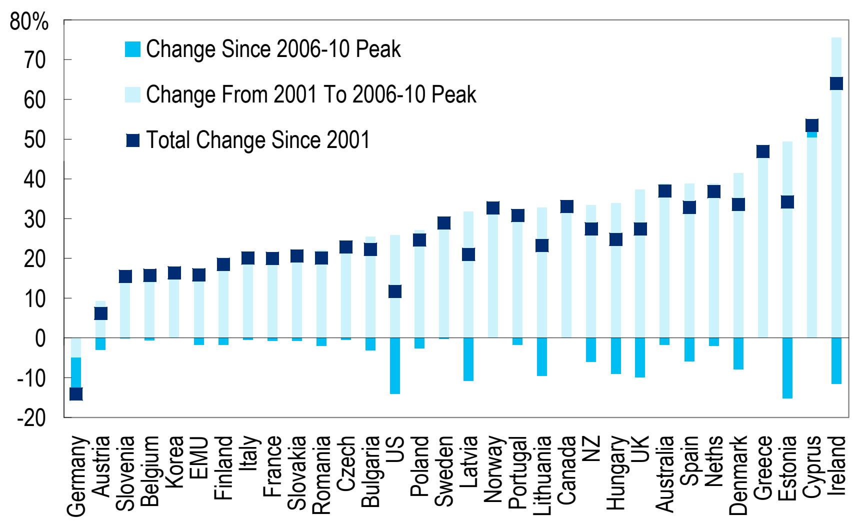
[7] Reforms underway in Ireland are now likely to trigger a sharp rise in personal insolvencies.

[8] See Euro Economics Weekly - Credit Drought backs ECB rate cuts, but not in November, Guillaume Menuet and Jürgen Michels, 2 November 2012, Citi.

Canada, Norway, Sweden, Finland, Australia, the Netherlands and Korea feature in our list of countries for which a greater future bias to household deleveraging is a notable risk

Of course, there is no cast-iron rule which dictates that booms must be followed by busts, or that deleveraging cycles must last 8 years or so. Indeed, a few countries with major housing and credit booms in recent years have (so far) managed to avoid falling into deleveraging cycles with an accompanying surge in private savings. Notable examples are Canada, Norway, Sweden, Finland, Australia, the Netherlands and Korea. Common features are that all are relatively small open economies, and most are well-placed in relatively buoyant sectors (eg natural resources in Australia, Norway and Canada, capital goods in Sweden, Finland and Korea). The resultant optimism over further income gains (and low interest rates in some cases) have, so far, helped avert the abrupt retrenchment seen elsewhere and even encourage the continued buildup of debt. To be sure, most of these countries also have reasonably well capitalised banking systems, although experience in other countries shows that published capital levels can erode quickly if a cycle of deleveraging and falling asset prices takes hold. Our base case for all these countries is that the current credit cycles will deflate smoothly without crisis. But, risks of private retrenchment seem sizeable in some of these countries — perhaps especially the Netherlands and Denmark (which both have exceptionally high levels of the household debt/GDP ratio).

Figure 14. Selected Countries — Change in Household Debt/GDP Ratios Since 2001, 2001-12



Note: Latest data are 2011 for Bulgaria, Cyprus and Romania, Q2-2012 for the UK, US, Australia, NZ, Canada and Norway, Q1-2012 for the rest.
Sources: Eurostat and Citi Research

EMU Crisis: Sovereign Debt Restructuring, Banking Union and Grexit Ahead

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At the end of 2012, the euro area (EA) periphery (Greece, Ireland, Portugal, Spain, Italy, Cyprus and Slovenia) is facing fiscal unsustainability (despite austerity), tight financial conditions, low growth or recession, intense private deleveraging pressures, poor (though generally improving) competitiveness, and growing austerity fatigue. In our view, these challenges are likely to be met over time by a mixture of policies and institutional innovation. This includes continuing structural reform and fiscal austerity, continuing very low interest rates and liquidity support for sovereigns and banks by the ECB, limited sovereign and bank debt mutualisation, extensive sovereign and bank debt restructuring and Grexit. At the same time, more fundamental reform of the EA governance and political accountability framework is under way, to introduce more far-reaching financial integration ('banking union'), and limited fiscal integration aimed both at more effective prevention of fiscal unsustainability and at more rapid and effective remedies for excessive sovereign debt and deficits.

We expect the EA's challenges to be met by fiscal austerity, structural reform, sovereign and bank debt restructuring and limited fiscal integration

We consider sovereign debt restructuring likely in at least five EA countries: Greece, Ireland, Italy, Portugal, and Spain

We expect banking union and limited fiscal integration to be insufficient to eliminate financial and fiscal imbalances in the EA. For now, political leaders in the EA maintain that Greece is special and that sovereign debt restructuring is neither necessary nor desirable in other EA periphery countries. We expect that a desire to limit official exposure to EA periphery sovereigns and/or demands for debt relief from those same periphery countries will change this assessment over time and expect some form of debt restructuring for at least five EA sovereigns (Greece, Ireland, Italy, Portugal, and Spain; and in Cyprus and Slovenia unless substantial bank debt restructuring takes place) by 2017. In 2013, we expect that the unsustainability of Portugal's sovereign debt will become increasingly clear (even though action on it may be delayed). We expect Italy and Spain to enter sovereign bail-out programmes in 2013, and that debt restructuring will only be considered and implemented there and in Ireland in later years. In Greece, debt restructuring is unavoidable whether Greece exits the euro area (our base case, with a 60% probability in the next 12-18 months) or not.[9] Banking sector deleveraging throughout the EA — both core and periphery — will occur through consolidation and recapitalisation, but also through resolution, debt restructuring and liquidation.

The EA will likely remain in recession until 2014

Incremental fiscal tightening, structural reforms, tight financial conditions and a continued 'uncertainty overhang' will continue to weigh strongly on domestic demand and keep the EA in recession until 2014e, although with improving competitiveness, external demand may provide some relief. Sovereign yield spreads vs Bunds and bank funding stress indicators are likely to remain high in many EA countries in coming years and are only expected to come down gradually. We do not, however, expect the euro area to break up in 2013 or the following years (other than Grexit), nor do we expect the disorderly default of an EA sovereign (except possibly in the case of Greece). The risk that either or both of these adverse scenarios materialise remains, however, non-negligible.

Banking union and limited fiscal integration

The OMT has not solved the EA crisis

The announcement of the ECB's Outright Monetary Transactions (OMT) facility and the birth of the European Stability Mechanism (ESM) in September 2012 have reduced the near-term risk of default and EA exit for any EA periphery state,

[9] See Euro Economics Weekly - Grexit — Delayed But Not Cancelled, 12 October, 2012, Citi.

including Italy and Spain. EA sovereign credit spreads have consequently narrowed substantially from their peaks and estimates of break-up probabilities have fallen.

'Banking union' is likely to come, and is a major development — but will likely fail to eliminate financial fragmentation in the EA

The ESM and the OMT are likely to be followed by a number of further changes to the EA's institutional set-up. Among the most significant is 'banking union'. We expect the ECB to be given the power in 2013/14 to choose to supervise directly any bank, and to overrule the national supervisor/regulator in case of conflict. For operational and political reasons, the ECB will likely directly supervise only systemically important cross-border banks and banks in countries under programmes, while the day-to-day responsibility for other EA banks will remain with national supervisors. A common EA bank recapitalization facility (through the ESM) and a single bank resolution regime and fund are likely to follow soon after, probably in 2014. However, banking union is likely to fall short of its most ambitious configuration. Thus, we do not expect substantial pooling of resources, let alone sovereign backing or redenomination-proofness, for centralized EA deposit insurance, even though a gradual build-up of a limited, privately funded common deposit insurance fund remains plausible in the medium term. Legacy liabilities on bank balance sheets are likely to be dealt with through a mixture of more extensive bail-ins of private creditors, national fiscal resources and limited bank debt mutualisation. The fragmentation of financial conditions in the EA should fall, but still remain substantial, in coming years, as economic divergences between EA countries and excessive exposure of some banks to domestic sovereigns persist.

Limited fiscal integration is also likely, but, again, not on a scale to address fiscal imbalances

We expect only a limited degree of further fiscal integration, e.g. through a dedicated EA fiscal capacity with aggregate spending powers in the order of 1% of EA GDP per year (in addition to the current EU budget), to be used for cyclical stabilization (e.g. to support unemployment benefits, as the French government and the EC advocate) and/or to provide incentives for structural reform (as the German government suggests). This central fiscal facility is likely to have a strictly capped borrowing capacity, and would otherwise be funded through transfers from member states or some dedicated revenue streams. More comprehensive fiscal integration, including substantial joint and several bond issuance other than for specific projects (Eurobonds), remains unlikely, in our view, due to a combination of political concerns in the EA 'core' and legal concerns about assuming other EA countries' liabilities.

Additional central oversight over national budget processes beyond the 'six-pack' and 'two-pack' are also likely, but we doubt that we will soon see a European fiscal commissioner with the option to veto national parliaments. In our view, there is much that can still be done by stretching the existing EU Treaties to allow banking union and further fiscal integration to proceed. However, as the scope and powers of European institutions increase, their democratic deficit will become increasingly obvious. We expect this to be addressed by an increasing role of national parliaments in EA decision making, by raising the profile of the European Parliament and likely also eventually by some form of more substantial Treaty change.

We expect sovereign debt restructuring in Spain and Italy

Both Spain and Italy's growth and fiscal prospects are weak

We expect both countries to enter an ESM programme with sovereign support in 2013

Across the EA periphery, growth and fiscal prospects remain weak, including in Spain and Italy. Private deleveraging, tight financing conditions and fiscal tightening are likely to keep Spain in recession in 2013-14 (we forecast GDP to fall by 2.4% in 2013 and 1.9% in 2014). We expect the deficit to continue to exceed official forecasts in 2013 (Citi forecast of 6.4% of GDP vs an official target of 4.5%) and 2014 (5.8% vs 2.8%), despite additional austerity, and gross general government (GG) debt to reach 110% of GDP by 2014 (rising by more than 70ppts of GDP since 2007). Fiscal risks remain high, as additional tax-payer bail-outs of the banking sector and subnational entities are likely and austerity fatigue as well as tensions between the central government and the autonomous regions will cap further deepening of austerity. In Italy, the fiscal deficit, banking sector concerns and private deleveraging pressures are smaller (yet still significant), but the stock of public debt is substantially higher and political concerns are more intense. We expect that even if a mainstream coalition, possibly but not necessarily led by current PM Monti, comes into power following the general election that is due by April 2013, the appetite for additional fiscal austerity and structural reform will be limited. Growth undershoots and deficit overshoots relative to official targets remain likely in the years ahead and we expect gross GG debt to reach 134% of GDP in 2014.

The mere existence of the ESM and OMT is unlikely to sufficiently and durably allay investor concerns about the poor fiscal and growth prospects of Spain and Italy. We therefore expect both countries to enter an ESM programme with ECB OMT support in the spring of 2013, with Spain likely to go first.

But we also expect that such a programme would fail to return Spain and Italy to fiscal sustainability

But in our view even an ESM/OMT programme that would initially last for up to two years would not restore fiscal sustainability in Spain and Italy. Direct benefits from reductions in funding costs associated with a bail-out programme will be useful, but too small to move the fiscal dial. More importantly, fiscal outcomes over time are likely to continue to underperform official projections due to weaker-than-expected growth (partly as fiscal multipliers turn out to be larger than expected), a lack of substantial incremental austerity (due to growing austerity fatigue), or both. As regards the ability of troika programmes to return these countries to fiscal sustainability, the situation is thus similar to the cases of Ireland and Portugal.

We also expect sovereign debt restructuring in Ireland and Portugal in 2014/5

We have long argued that we consider the fiscal trajectories in Ireland and Portugal to be unsustainable, despite the fact that both countries have generally complied with the conditions of their existing troika programmes. In both cases, we expect extensions to their currently existing bail-out programmes on their expiry in late 2013 and 2014, respectively. Both countries grapple with the strongly contractionary effects of deleveraging by a highly indebted private (household and business) sector and of fiscal tightening. Of the two countries, Ireland is in a stronger position, as its economy is more competitive (with a current account surplus and the economy is not in recession), it has met fiscal targets and austerity fatigue is moderate. But despite years of austerity, Ireland's fiscal deficit remains the highest in the EA (above 8% of GDP in headline terms and 7-8% of GDP in structural terms), growth is highly dependent on external demand, and contingent liabilities to the banking sector remain high. In the light of Ireland's commendable performance in meeting programme targets so far, we expect that it will be allowed a restructuring of part of the €64bn of debt incurred through bank bail-outs (e.g. through maturity lengthening and coupon reductions on its outstanding promissory notes) in 2013 and that its full troika programme will be followed by a 'conditionality-lite'-type (ECCL) programme, similar to the case of Spain and Italy (including potential ECB OMT support). But unless and until Ireland restructures its bank recapitalisation costs or sovereign debt more broadly, the country's chances of regaining fiscal sustainability are low.

A desire to limit ESM/ECB exposure or demands by debtor countries for debt relief make some form of debt restructuring likely

The fiscal and growth outlook in Portugal remains even more challenging. We expect GDP to fall by 4.6% and 2.4% in 2013 and 2014, and austerity fatigue is growing quickly. Government debt, without restructuring, would likely rise above 140% of GDP in 2014. In the absence of a return to fiscal sustainability or sufficiently effective financial repression of private investors, the alternatives narrow to ever-increasing exposure of the official creditors to the IIPS country (Ireland, Italy, Portugal and Spain) sovereigns, or some form of debt restructuring. The choice between these two options will depend on the relative balance of several objectives of EA creditor and periphery countries, and the ECB. EA official creditors and the ECB will want to limit their exposure to EA periphery sovereigns. The periphery countries will look for debt and liquidity relief. And all countries have an interest in avoiding EA break-up, and in limiting the political fallout and the risks to financial stability, including the need for (more) extensive bank recapitalization following a series of sovereign debt restructurings. In the light of these multiple, and partially conflicting, objectives, some form of debt restructuring featuring mostly maturity lengthening and coupon reductions appears the most plausible outcome.

The ESM will likely have relatively little money left at the end of 2014

The amount of ESM bond purchases under potential Italian, Spanish (and maybe future Irish and Portuguese) programmes is uncertain, but could easily eat up a big portion of its €500bn capacity. Spain and Italy's combined funding requirements (excluding bills) are likely to be €350-400bn per year (around 4% of 2012 EA GDP) in 2013/14. Ireland and Portugal could add another €30-40bn/year. The ESM may have to earmark 50% of total primary (non-bills) issuance under precautionary programmes for these — which would exhaust the bulk of its commitment capacity in two years without spending a cent on bank recapitalizations or other future sovereign bail-outs — even though in practice the ESM may purchase much less.

IIPS funding needs are likely to fall over time, as the share of debt to official creditors (which has longer maturities) rises and deficits fall, but would still be substantial in 2014. If we assume refinancing requirements of 11% of national GDP, total funding needs (including budget deficits) for the IIPS countries from 2015-17 would still be €1trn. We think that EA creditor countries would be willing to further increase the size of the ESM (among other measures, including some limited fiscal integration) to avoid break-up, but that potential increases in the size of the ESM would be combined with measures to reduce periphery funding needs.

Maturity extensions and coupon reductions can materially reduce funding needs for the EA periphery countries

Universally extending maturities would reduce 2015-17 IIPS funding needs (which would be equal to budget deficits) to €280bn. Coupon reductions could further reduce the funding requirements. For example, a coupon reduction by 1.5ppts for all countries in addition to maturity lengthening would reduce the funding needs to €110bn. Such a coupon reduction would be similar in effect to that of reducing the interest rate sufficiently to bring Italy's budget into balance by 2016 or to reduce the average interest rate in these countries to close to 3%, which may be close to the rate the ESM would charge.

We expect the ECB to participate in the debt restructuring

And the ESM to fund the remaining deficits thereafter

Debt restructuring would reduce the overall funding needs of IIPS sovereigns, but the ESM would probably have to be ready to fill their entire remaining financing need for a number of years (presumably under a full rather than precautionary programme). The reason is that, in our view, the ECB would participate in the restructuring, as long as it can be seen to have its hands tied, e.g. through a — potentially creative — use of CACs, as the terms of the OMT imply that the ECB would accept pari passu status with private investors in any restructuring. But following a restructuring, the ECB may be unwilling to continue its (OMT) support for these EA sovereigns, due to its convention, so far upheld, not to fund or purchase securities of defaulted sovereigns or banks, and private investors would be unlikely to fill the gap. The decision to limit the support would not be based on funding constraints - for the Eurosystem an increase equivalent to 50% of the financing requirements for 2013-14 would add just above 10% to its current balance sheet size of €3trn and is clearly within its financial capacity (which is infinite in nominal terms and likely above €3trn in non-inflationary loss absorption capacity).[10] The actual increase in the Eurosystem balance sheet size over time is likely to be much larger, as the private sector may attempt to offload some holdings of Spanish and Italian sovereign debt to the ECB and ECB funding for banks is likely to further increase, too. But even a longer commitment by the ECB to support EA sovereigns is unlikely to test its financial capacity anytime soon. Where financial capacity may

[10] See Global Economics View - Looking into the Deep Pockets of the ECB, 28 February 2012, Citi

not tip the balance in favour of sovereign debt restructuring, concerns about financial exposure, including popular concerns, by EA creditor countries and demands for debt relief by the debtor nations may.

Debt restructuring in IIPS countries is likely to involve maturity lengthening, coupon reductions, and moderate debt relief in NPV terms

We would expect moderate debt relief (in NPV terms) for the IIPS countries to result from debt restructuring. More decisive debt restructuring would likely be impeded, as debt may then fall below the debt levels of the next-most highly-indebted EA sovereigns (in 2015, we expect GG gross debt/GDP to be 114% of GDP in Belgium and 97% in France) and reflecting the aversion of official sector creditors to accept face value haircuts. Assuming that the ESM & OMT will jointly fill 50% of these 2013-14 funding requirements implies a combined exposure of EA creditors and the Eurosystem to IIPS sovereigns of €420-715bn, including existing Securities Markets Programme (SMP) purchases and the Spanish bank bail-out.[11] Maturity lengthening, if done at below-market interest rates (e.g. if combined with coupon reductions), could still generate substantial debt relief in NPV terms in addition to liquidity relief, even if it leaves the stock of debt unchanged at face value — in Uruguay's 'reprofiling' in 2003, the NPV debt reduction was 19%. As debt/GDP ratios would remain elevated in all IIPS countries even post-restructuring, the risk of re-defaults in the following years would likely remain.

Debt restructuring would likely involve a menu to be offered to creditors, including various combinations of face value haircuts, maturity lengthening and coupon reductions. An option that involves maturity lengthening (probably with coupon reductions) but no face value haircuts would be virtually certain to be included on this menu to appeal to the official creditors, but potentially also to other creditors, as long as regulators would allow them to avoid realizing losses on these holdings (which could trigger a need for recapitalizations). As we expect the unsustainability of sovereign debt in Portugal to become more evident than in the other EA countries, the scope and terms of debt restructuring in Portugal — which we expect in 2014 — could establish a precedent, even though we also cannot rule out that sovereign debt restructuring in the larger countries will be handled differently.

Grexit remains our base case with 60% probability, but debt restructuring in Greece is near-inevitable whether it remains in the EA or not

We continue to expect that Greece will leave the EA over the next year or two. The probability of Grexit in the very near term has come down, mostly reflecting a change in attitudes among EA creditor nations, especially Germany, which appear to have decided that the likely economic and electoral costs of near-term Grexit exceed the likely costs of just enough additional financing for Greece to remain in the EA for now. But there is no sign that the EA creditor countries are willing to restructure Greek debt enough or moderate the required fiscal tightening (which would require additional funding) enough to allow the Greek economy some breathing room to recover. Greek general government gross debt/GDP probably will reach about 193% of GDP in 2013 amid a continuing collapse in GDP, despite the debt exchange in the spring of 2012 and despite intense fiscal austerity. Programme targets remain out of reach for the foreseeable future, while social unrest and austerity fatigue continue to rise. In the absence of recovery, Greece is likely to walk out of the EA even if it is not pushed by its creditors. Eventual sovereign debt restructuring remains near-inevitable whether Greece remains in the EA or not.

[11] The lower bound assumes funding needs of €380bn/year, €40bn for the Spanish bank bail-out and that all of the SMP purchases will have matured. The upper bound assumes €440bn of funding needs, €100bn for the bank bail-out and that none of the estimated €175bn in SMP purchases have matured.

Emerging Markets: To a New Growth Model

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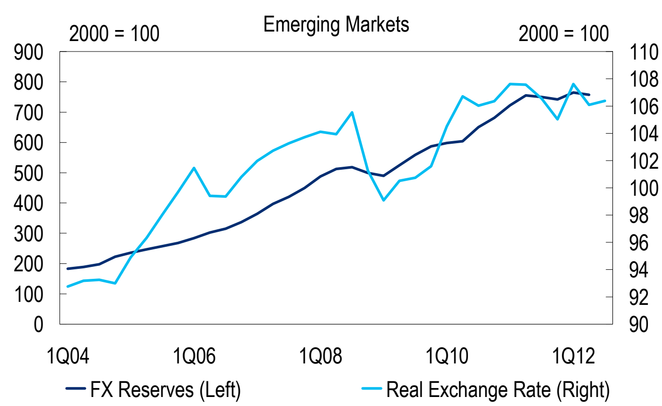
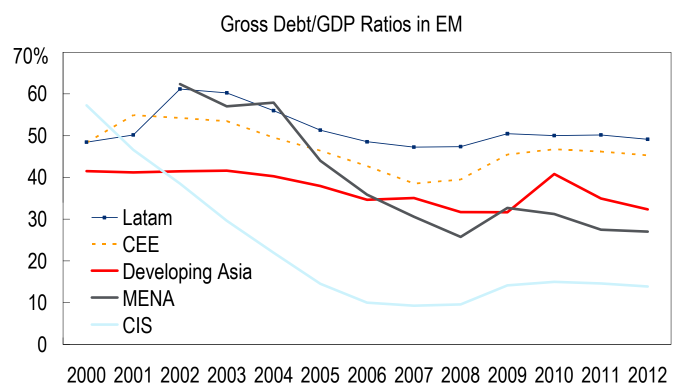
During much of the 2000s, rapid export-led EM growth pleased rating agencies and attracted investors. In the 10 years between 2002 and 2011, emerging economies enjoyed rapid growth, large trade surpluses, appreciating real exchange rates and stronger balance sheets as public debt burdens fell and fx reserves assets increased. These virtues have all been interconnected. Many EM currencies were undervalued 10 years ago thanks to the legacy of previous crises, and this helped support export-led GDP growth, which in turn helped to keep the EM balance of payments strong. Balance of payments strength comfortably made room for real exchange rate appreciation in many countries, and also helped to finance a build-up of fx reserves. And reserves accumulation, in turn, helped to strengthen public sector balance sheets as well as external balance sheets. And all of this was reinforced by a culture of careful balance sheet management among EM policymakers heavily influenced by their own legacy of crises in the 1980s and 90s, and wary of the need both to 'self-insure' and to preserve competitiveness. These trends are illustrated in Figures 15 and 16, which show trends in fx reserves, the real exchange rate and in public debt burdens across EM.

Figure 15. The 2000s saw strong trade surpluses which made room for reserves accumulation and real exchange rate appreciation



Source: Citi Research

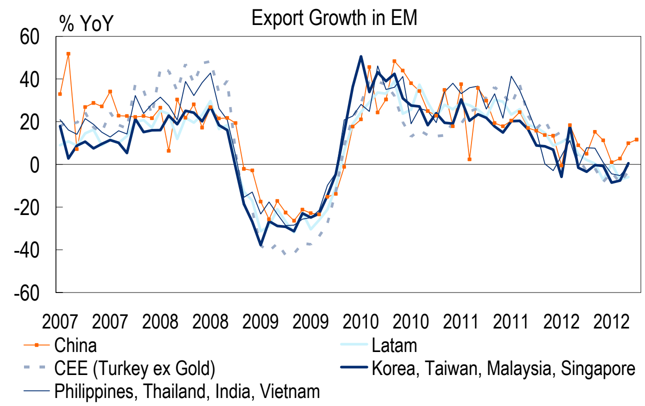
Figure 16. Public sector balance sheets improved during the 2000s thanks to strong growth and careful balance sheet management



Source: Citi Research

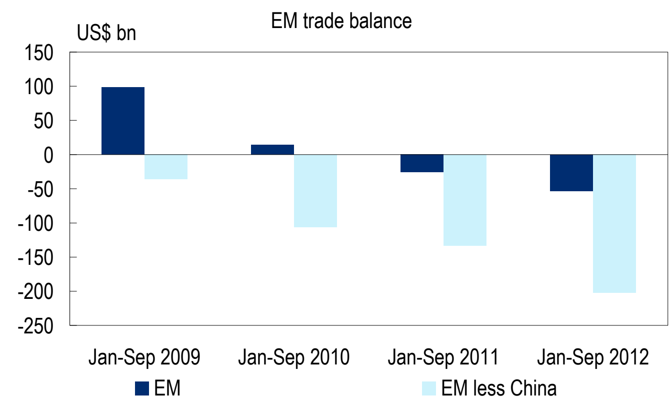
One thing investors need to consider in the next couple of years is whether the EM growth model might undergo some changes. EM growth has fallen in the past couple of years, and while we expect a recovery in 2013 — to 5.1% growth, vs 4.6% in 2012 - we are unlikely to see a return to the average growth rates that EM enjoyed during the 2000s: annual EM GDP growth averaged 6.5% between 2002 and 2011. The immediate problem that EM faces is an export-led slowdown, thanks to weak-ish demand in the developed world, and decelerating growth of domestic demand in China. That in turn has helped to deliver an important change in the EM trade balance: EM has gone from trade surplus to trade deficit during the past two years, and it's not obvious that we will ever see a return to the kind of export-led, trade-surplus-generating growth that was evident in the 2000s. This decline in the EM trade balance has helped to decelerate the rate of reserves accumulation in EM.

Figure 17. The immediate problem facing EM is a sharp slowdown in export growth this year...



Source: Citi Research

Figure 18. ...and this has helped push the EM trade balance further into deficit

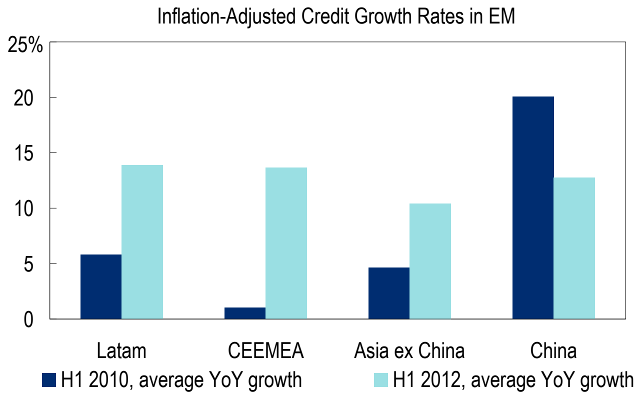


Source: Citi Research

The conditions for a revival in export-led growth don't seem too encouraging. In the first place, EM currencies aren't as cheap as they were: most official assessments of the RMB, for example, no longer consider it as an undervalued currency, and the same can be said for many emerging markets exchange rates (with some exceptions of course, probably including the Mexican peso, the Polish zloty, and the Korean won). The more expensive currencies get, the more this is likely to bias the sources of growth in EM towards domestic demand rather than net exports, and this trend is heavily reinforced by the weakness of global demand growth, which will remain a theme next year in light of our forecast of modest global growth: we expect GDP growth in the advanced economies to be just 0.8% next year, compared to the 'boom' years of 2002-2007 when their growth was 2.3% on average. We're not trying to argue that export growth will disappear forever — indeed, Figure 17 suggests that there has recently been some pick-up in exports, particularly in Asia — but simply that new, domestic drivers of GDP growth are likely to become more apparent.

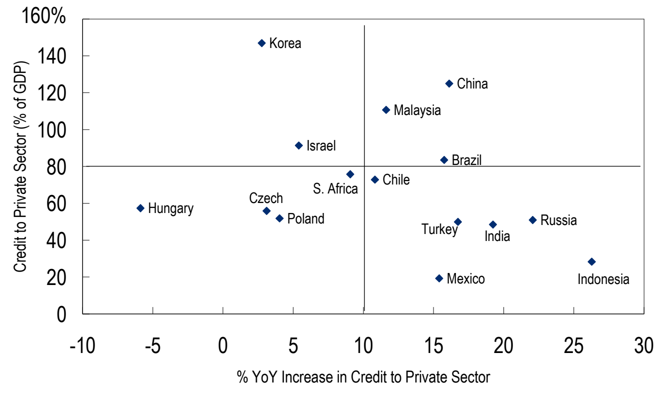
Less competitive exchange rates and weak global demand growth might bias EM policymakers towards policies which lean more heavily on domestic sources of growth. The two obvious mechanisms policymakers can rely on to help stimulate domestically-driven GDP growth are i) the domestic credit market, and ii) fiscal policy. In some ways it is already evident that domestic credit markets have helped to soften the blow of an externally-driven EM slowdown. This can be seen in Figure 19, which shows how real private credit growth has accelerated compared to the situation a couple of years ago. And it is probably true to say that EM credit markets have room to evolve further: Figure 20 shows the combination of credit growth rates and credit stocks. While there is a relatively large group of countries with private sector credit growth rates in double digits, most of these countries have relatively small stocks of credit, and that might help justify continued credit growth. Of course the exception to this pattern is China, which sits in the upper right hand quadrant of Figure 20. That's significant because it puts a limit on the extent to which China itself can pursue more credit-fuelled growth, as it has done since the Lehman crisis. This in turn helps to argue for a gradual deceleration in Chinese growth rates. Weaker Chinese growth is another factor that encourages us to think that domestic spending will need to assume a more important role in the rest of EM.

Figure 19. Real credit growth in EM has accelerated compared to a couple of years ago, with the notable exception of China...



Source: Citi Research

Figure 20. ...partly because China has an unwelcome combination of rapid credit growth and a large stock of credit

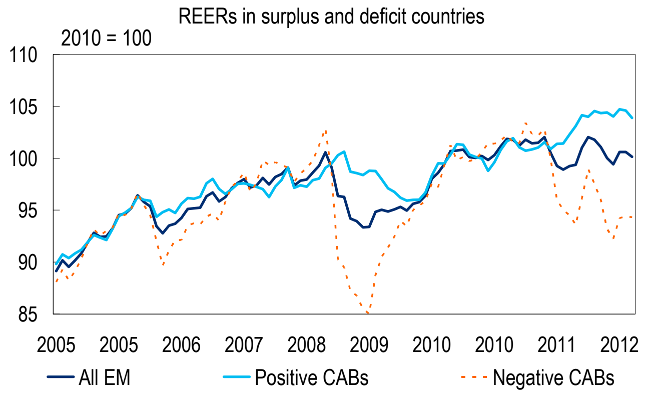


Source: Citi Research

Fiscal policy is another area where EM policymakers might feel tempted to loosen. To some extent this is old news: Figure 16 demonstrates that debt/GDP ratios in EM have already been allowed to bear some of the strain of the post-Lehman environment, and so the idea of further fiscal relaxation in EM shouldn't come as any surprise. And indeed, fiscal stances in a number of EM economies have loosened in recent months, as policymakers seek to soften the blow created by the export shock they've suffered. In some cases, these two broad ideas — higher levels of credit extension and more active fiscal policy — are combined. A good example of this is Brazil, where credit markets have been instrumental in delivering GDP growth and helping to smooth external shock: the stock of credit to the private sector has risen from 60% of GDP in 2004 to 62% now (the ratio has fallen in the rest of EM). But at the same time there is evidence of a quasi-fiscal element to this credit expansion: the market share of publicly owned banks is growing at the expense of privately owned banks. And Brazilian fiscal activism has been quite evident in 2012 as the government has sought to support growth through a range of measures include tax cuts and cheaper public credit.

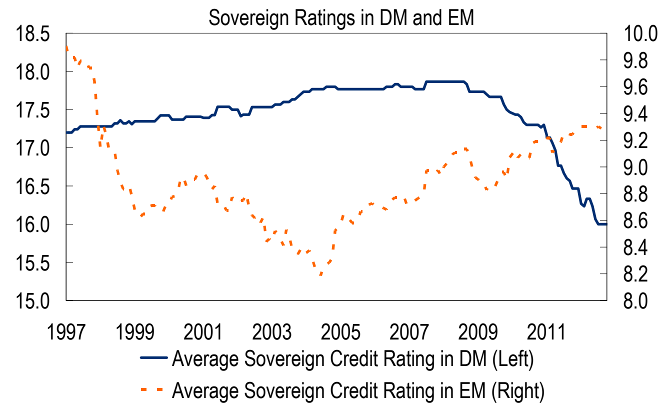
We don't think that looser domestic policies will create risks of financial instability. In theory at least, the combination of weaker EM export growth and a heavier bias towards domestic sources of aggregate demand could be good news for 'global rebalancing', allowing heavily indebted advanced economies to export their way out of their debt burdens. While we agree with the idea that we're not going to see a return to the trade-surplus-generating growth of the 2000s, it is probably far-fetched to assume that this ideal kind of global rebalancing will materialize any time soon. The reason for this is that there is still a high degree of sensitivity among EM policymakers about the risks associated with current account deficits. One reason for this is that there is more evidence that countries with current account deficits — or at least, rapidly growing current account deficits that are not properly financed with FDI flows — see their currencies punished. This can be seen in Figure 21, which shows how the real exchange rates of countries with current account deficits have diverged from those of the surplus countries in recent quarters. This is partly due to efforts that policymakers have made in deficit countries to weaken their exchange rates in an effort to minimize the deterioration of their external balances; but it is also due to the fact that the market has a tendency to vote with its feet when external imbalances grow rapidly. What all this means is that EM policymakers will tread carefully in seeking new domestic sources of growth in a world where export potential stays relatively weak.

Figure 21. There's been a divergence between the real exchange rates of countries with current account surpluses and those with deficits



Source: Citi Research

Figure 22. Trends in sovereign creditworthiness argue in favour of capital continuing to move to EM at the margin



Sources: Fitch Ratings, Citi Research. Fitch's sovereign ratings are converted to numerical value: eg AAA is 19, BBB- is 10.

EM policymakers are likely to prefer not to see their currencies appreciate too much. In a world where large trade surpluses are common, EM policymakers might be relaxed about seeing their currencies appreciate, especially if they have domestic inflationary pressures to worry about. But looking into 2013, inflation is unlikely to be the big concern that it was in 2010/11, and so EM policymakers will be reluctant to see their currencies strengthen. In fact there is already some evidence of this reluctance in 2012, as a number of countries have made greater use of various controls on capital inflows, or have cut interest rates with the more-or-less explicit goal of reducing inflows (in addition to direct interventions in the fx market). For example: Peru has raised reserve requirements on fx inflows; Korea has tightened restrictions on the forward fx position of banks; Turkey uses a 'reserve option coefficient' that allows banks to satisfy their TRY reserve requirements in fx, which facilitates reserves accumulation by the central bank; the Philippines has introduced measures to limit arbitrage between offshore and onshore yields.

Bigger efforts to put a stop to unwelcome capital flows might be needed. There are still strong push factors that are likely to drive capital flows towards EM. Not only will real interest rates remain negative in the large advanced economies for the foreseeable future, but the continuing deterioration of creditworthiness in advanced economies looks unattractive compared to the relatively stable level of creditworthiness in EM (see Figure 22). So it is worth being optimistic about capital flows to EM. From emerging economies' point of view, capital flows will more likely be needed if they move more permanently into trade deficit. But since EMs will also want to limit exchange rate appreciation while this happens, plentiful capital flows will lead to greater efforts on the part of EM policymakers to limit these flows. Capital controls are likely to remain a hot topic of debate.

Global Political Outlook: Vox Populi Risk to Continue as World Leaders Remain Under Pressure

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With thanks to Matt Dabrowski

Following a Very Political Year, What's Next?

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2012 has been an exceptionally political year, with elections and leadership transitions in some of the world's most economically and geopolitically significant countries: France, Russia, the United States and China, among others. Far from resolving political uncertainty, these political transitions have often served merely as signposts of public opinion or organised power transfers, bringing in leaders who face the challenge of presiding during a period of high public discontent amid weak economic prospects.

Whether newly elected or once popular, elected leaders are finding their approval ratings steadily declining, as evidenced both in the case of newly elected French president Francois Hollande, who saw his ratings fall 20 points in six months, and re-elected Russian president Vladimir Putin, who faced urban protests unprecedented in Russia since *perestroika*. Even in the US, where President Obama won a second term despite high unemployment and comparatively low approval ratings, there will be no political honeymoon, as the challenges of addressing the 'fiscal cliff' immediately take centre-stage.

In China, the scheduled leadership transition was interrupted by accusations of scandal and impropriety in the ranks of the senior-most leadership, an unwelcome distraction given the ruling party's emphasis on stability. According to data from the Pew Global Attitudes Project, a full 50% of Chinese now state that corrupt officials are a "very big problem," an increase from 39% in 2008. This increase is despite the fact that 70% of Chinese rate their living standards as higher than they were five years ago, underscoring the fact that rising living standards and a growing middle class may actually help increase public expectations of leaders. Outgoing Chinese president Hu Jintao explicitly addressed these challenges in his final address, noting, "Combating corruption and promoting political integrity...is a clear-cut and long-term political commitment of the party. If we fail to handle this issue well, it could prove fatal to the party, and even cause...the collapse of the state."

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Regardless of the type of political system, global political elites currently face a combination of challenges almost unprecedented in the modern era during peacetime, and a greater level of public scrutiny, thanks to wider access to information, than at any time in history. From the Arab Street to Main Street, concerns about income inequality and elite corruption have risen to the top of the political agenda, threatening to topple leaders when they least expect it. Whether they choose to consolidate their hold on power in the face of heightened "People Power," or take the risks inherent in reform will determine the shape of things to come for decades.

On a positive note, we are comparatively more optimistic about the prospects for diplomacy in response to global challenges, and see war — at least in the traditional sense of state-to-state conflict — as an unattractive policy choice given global economic fragility and its growing unpopularity with conflict-fatigued citizens and greater fiscal constraints. While prospects for global trade agreements remain remote, we think that the possibility of ratification of further regional or bi-partisan Free Trade Agreements could increase in the face of continuing high unemployment.

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Beware the Vox Populi

In our view, heightened *Vox Populi* Risk —the concept that shifting and more volatile public opinion poses a newly powerful risk to the investment environment—will carry on for the foreseeable future, with political risk a long-term feature of the investment environment. Vox Populi risk can take the form of either orderly political transitions, through elections or other formal mechanisms, or protests and demonstrations, as evidenced over the course of 2012 in numerous eurozone countries over austerity measures. The potential for Vox Populi risk to bring about change in policy or leadership has been accelerated by media and technology and the continuing weak economic outlook, substantially compressing the timeframe for galvanising political or protest movements.

Given these constraints, we expect a limited appetite for reforms beyond those mandated by market pressure, and a continued preference for what we have previously called "sticking plaster policy measures," short-term, just-in-time piecemeal solutions.[12] The US fiscal cliff is the latest example of a policy challenge that elected officials on both sides of the aisle agree must urgently be addressed, yet disagree on the path for doing so. With this in mind, even following a decisive result in the November elections, the best outcome in a highly polarised political environment is a short-term compromise that prevents the worst, but continues the uncertainty into the new year.

Even where incumbent leaders are re-elected, as in the US and as current polls suggest is likely for Angela Merkel in Germany in 2013, we believe that global political elites will struggle to govern in the months and years ahead, constrained by weaker mandates, shrinking political capital and rising public expectations in the face of lower growth prospects and the need to undertake unpopular measures.

Populism, Separatism, Political Fragmentation

The risks of populism and rising social tensions are also likely to increase in these conditions, further increasing the trend toward political fragmentation that we have been tracking for the past several years in the form of more multi-party coalitions in parliamentary democracies and the rise of *NEAPs* — new, extreme and/or alternative parties.

NEAPs have yet to take power in any country; only in crisis-wracked Greece, where living standards have reversed to the level of a decade ago, has challenger Syriza made significant headway into displacing mainstream political parties. We stress that, while they have occasionally gained strength as vehicles for anti-elite sentiment, such as Italy's Five Star Movement, or the Tea Party movement in the US — initially conceived as a low-tax, small-government focused faction — ongoing frustration with political and business elites could see their support increase over time, particularly if challenging economic conditions increase and middle classes experience dislocation.

[12] See Tina Fordham section in "*Prospects for Economies and Financial Markets In 2012 and Beyond*", Willem Buiter et al, 28 November 2011, Citi

But these new, extreme and/or alternative parties' lack of experience, inferior political organisational strength compared to mainstream parties and typically limited policy platform may ultimately constrain their ability to gain power — for now

In the near term, NEAPs will serve to influence the political debate, as in the Netherlands, where the far-Left Socialists saw an initial spike in support on the strength of their anti-bailout message, eventually co-opted by the re-elected mainstream Liberal party, returning them to power. But these parties' lack of experience, inferior political organisational strength compared to mainstream parties and typically limited policy platform may ultimately constrain their ability to gain power — for now.

At this early stage we might expect the same trajectory from billionaire Frank Stronach's new Team Stronach party in Austria, which has already received a few defectors in parliament from the mainstream parties. A rise in support for Team Stronach and its dump-the-euro views could complicate the political outlook for Austria, a key eurozone creditor country, which will hold elections no later than September 2013.

Adding to this uncertain political outlook is rising separatism in Europe, with Spain's Catalonia and Basque Country, the UK's Scotland and Belgium's Flanders all seeing increases in support for greater autonomy, or outright separation. While we see the growth in public support for parties and movements embracing the potent combination of regional identity and economic considerations as potentially destabilising to national politics, particularly when it comes to budget issues, we note that support for independence and autonomy can be strong without ultimately resulting in separation; the Quebec example being a key case in point. Thus rising separatist sentiment matters in its influence on the national political debate and budget priorities, but in our view is unlikely to transpire for some years, if ever.

Poll Position: 2013 Elections Include Italy and Germany in the Eurozone, and Israel and Iran, Bearing Wider Geopolitical Implications

Although 2013 will feature fewer elections with global market implications than 2012, several countries important for markets will go to the polls

Although 2013 will feature fewer elections with global market implications than 2012, several countries important for markets will go to the polls. In Israel, which holds elections on January 22, incumbent Prime Minister Benjamin Netanyahu is expected to return to power. At this writing, 9 weeks before the contest, Israel is embroiled in the worst uptick of hostilities with Hamas in years, with fears that the conflict could widen given ongoing regional volatility.

Iran's presidential elections on June 14 are expected to be tightly controlled, but one key actor will inevitably change, as President Mahmoud Ahmedinejad is unable to run again due to term limits, providing Iran's leadership with an opportunity to send a signal to the international community at a time when tough sanctions appear to be having a more pronounced effect than in the past.

Italy's elections are expected in March, and mark an important political milestone following the departure in 2011 of Silvio Berlusconi and his replacement with an un-elected technocrat, Mario Monti. In the short term, reforms are likely to be on hold as parties position themselves for the race. Will Italians turn up at the ballot box, given the widespread mood of public apathy and "anti-politics," amid unpopular austerity measures and sliding growth? Will they vote for existing parties, or new parties — with at least two parties being formed in the past year? In the main, the polls suggest Italy's election will be the next of a series of European anti-incumbent elections next year, but the political system is in such flux that making confident predictions is difficult. But will 'anti-politics' mean anti-Europe?

The latest polls show the right-wing coalition, formerly Berlusconi's, losing as many as 200 seats or more in the Chamber of Deputies. Though Berlusconi and his people are no longer in the government, they still sit in those seats in Parliament, and we've written that much of Berlusconi's 'will he or won't he' flirtations over the past few months can be understood in the context of a party facing down what looks like a very rough defeat at the polls.

The center-left coalition will be the beneficiary of the right's misfortunes, and today they maintain a double-digit lead in the polls. With a return to government imminent and the political system in disarray, it's no surprise that the coalition-head Democratic Party is having a vigorous internal primary to decide the leadership. Recent developments suggest that centrist political forces may attempt to forge a new political party, partly, speculation suggests, as a platform for Monti to run as a candidate in the elections. A chief organizer is industrialist Luca di Montezemolo. Monti for his part has stayed conspicuously low profile about his future political intentions[13].

Even with the recent slowdown, Germany remains a top economic performer among eurozone economies. Chancellor Angela Merkel and her CDU/CSU have maintained a lead in the polls for two years. As Merkel looks forward to elections no later than October 2013 but almost certainly sooner, she seeks to avoid any eurozone disorder that could send the German economy into recession. Since her coalition partner the Free Democrats (FDP) have seen their vote share drop by at least half recently (below the threshold to enter parliament), many observers expect a CDU/CSU and SPD coalition after next year’s election.

United States: Fiscal Cliff & Tax Reform in Focus in 2013 as Obama Starts His Second Term

The continuation of the US political status quo underlines our assumption about how the fiscal cliff negotiations will be resolved. A temporary, minimalist compromise is our base-case scenario

In a rare recent instance of an incumbent candidate winning a second term, Barack Obama was re-elected US president, and will go on to a second four-year term. From the looming fiscal cliff, to the challenge of reforming the tax code, to a likely resumption of Israel-Iran tensions, ongoing conflict in Syria and the need to work with a new Chinese leadership, Obama in his second term faces significant challenges at home and abroad. Nevertheless, domestic pressures will be centre-stage, with the fiscal cliff immediately commanding attention for the remaining weeks of the 'lame duck' session of Congress and testing the limits of bipartisan deal-making in a highly polarised environment.

The continuation of the US political status quo underlines our assumption about how the fiscal cliff negotiations will be resolved. A temporary, minimalist compromise is our base-case scenario, with the timing – before December 31st, or sometime into the new session in January – still in question. Watch for statements from party leaders in both houses of Congress, as well as the Ways & Means and Finance Committees, as their signals matter most.

In the US system, the next election is never more than two years away; with this in mind, both parties will already be thinking of how to position themselves for 2014, and may be moderately more willing to compromise than in the run-up to elections. Will they go far enough? Politics is the art of the possible; what is politically possible in the current US political configuration seems likely to disappoint markets hoping for a "grand bargain".

[13] See Tina Fordham "Italy: In the Lions’ Den," Mauro Baragiola et al, 25 September 2012 Citi.

The Outlook for Monetary Policy: Another Year of Stimulus

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The ongoing challenges facing the major economies, coupled with our subdued projections for inflation, suggest that central banks will remain broadly expansionary through 2013 and probably well beyond. With policy rates in the advanced economies already near zero, their central banks will focus mainly on providing support through various flavors of balance sheet policies and — at least for the Federal Reserve — through innovative communication. The emerging market economies, in contrast, still have scope for further conventional rate cuts. But even so, these central banks will generally keep policy on hold over the next year, at fairly stimulative rates, as they await evidence of a stronger global recovery.

The Federal Reserve continues to view balance sheet expansion as an effective, but admittedly imperfect, substitute for conventional rate cuts. Accordingly, given the Fed's concerns about the weak labor market, we see it continuing to purchase $40 billion a month of MBS into the second half of next year and possibly for some time thereafter. In addition, at its upcoming December meeting, the Fed is likely to announce purchases of long-term Treasuries, of around $45 billion a month, to replace its expiring Twist operation; these purchases will also continue into at least the second half of next year. All told, QE3 is likely to total roughly $700 billion to $1 trillion of purchases and to lift the size of the balance sheet to around $3½ to $4 trillion, or 25 percent of GDP (see Figure 23). The attention of Fed policymakers will also increasingly focus on finding ways to enhance credit availability for less creditworthy households and small businesses.

In marked contrast to the Federal Reserve, the Bank of England seems to be experiencing a crisis of faith regarding the capacity of asset purchases to provide stimulus. On the one hand, we expect that the heavy weight of private deleveraging, poor credit availability, and fiscal contraction — coupled with the medium-term risk of an inflationary undershoot — will be sufficient for the BoE to continue with ultra-low policy rates and the maintenance of a sizable balance sheet. On the other hand, given recent soundings from key MPC members, we now expect only modest further increases in QE. The BoE seems to be putting great hopes in its Funding for Lending Scheme, but the effects on the economy have been limited to date.

The Bank of Japan under Governor Shirakawa has long voiced similar skepticism about the ability of balance sheet policies to stimulate the economy. As such, our base case calls for the BoJ to continue its incremental approach to policy, with further stimulus coming in reaction to yen appreciation and political pressures, through the end of Shirakawa's term in early April. However, with the LDP poised to take power following the mid-December parliamentary elections, the pressures on the BoJ to become more aggressive will increase and, in any event, Shirakawa's successor is likely to be more comfortable with unconventional policies, both shifting the tone of the BoJ's rhetoric and implementing the asset purchase program more aggressively.

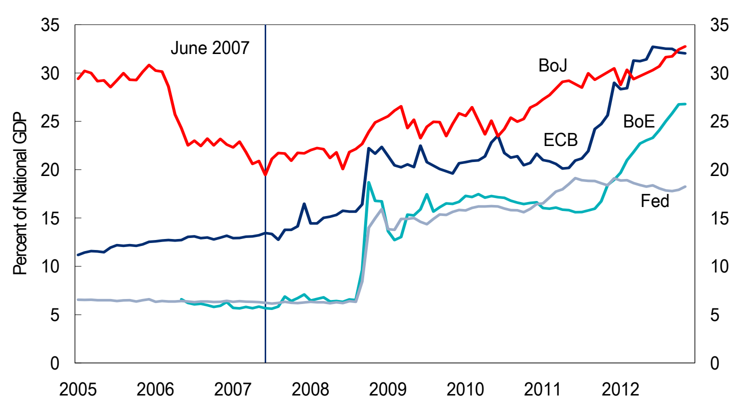
Unlike these other central banks, the ECB has typically deployed its balance sheet with an eye toward financial stability objectives, rather than to stimulate the economy *per se*. Consistent with this approach, we expect that both Spain and Italy will be receiving support from the ECB's OMT facility by the end of next year, and Portugal and Ireland may be receiving support by then as well. Even so, we think total securities purchases will be relatively limited, somewhere in a range of €100 to €200 billion, as investors will not test the ECB's determination. And with repayment of some funds borrowed under the 3-year LTROs, the size of the ECB's balance sheet is likely to be little changed. The coming year should also see another 50 basis points of cuts in the ECB's benchmark refi rate, taking this rate down to 25 basis points, as the recession persists. We expect that the ECB will reduce its deposit rate into slightly negative territory by mid-year to support bank lending and temper upward pressures on the currency.

After easing some over the past year, Chinese monetary policy is poised to move into a holding pattern in 2013, as the country's new leadership fleshes out priorities for economic policy and as growth stabilizes near its current 7½ percent pace. With Chinese growth projected to level out, and the advanced economies continuing to grapple with severe policy challenges, monetary policy in many other emerging market economies will likewise be in a wait-and-see mode over the next year. Central banks in these economies will mainly focus on fine-tuning their policies in response to the ebb and flow of economic data and market developments. There are some notable exceptions to this general statement, however. For example, Poland, Hungary, and Chile are likely to ease by 50 basis points (or more) over the next year to offset continued downside risks facing their economies; and looser policy will also be evident in Turkey, where the central bank now seems determined to avoid currency appreciation. But the consequences of looser policy — weaker exchange rates and higher inflation — will need to be dealt with eventually. Brazil will provide an example of this in the coming year, with 100 basis points of rate hikes likely necessary to reverse stimulus delivered in 2012.

Of course, the outlook for monetary policy in the emerging markets is bracketed by important risks. A stronger global recovery than we anticipate would bring more "risk on" positioning in financial markets and consequent challenges in managing capital inflows. Conversely, a continued softening of activity in China or further disruptions in the advanced economies would likely require renewed monetary easing.

Finally, we note that the next year will see the departure of several major central bank governors. In addition to Governor Shirakawa, who will leave the BoJ in early April, Governor King's term at the BoE expires in June, and indications are that Governor Zhou will soon leave his post at China's central bank. Also, Chairman Bernanke's term at the Fed expires in January 2014, so his successor will likely be nominated next fall. A new Governor of the BoJ, appointed by the LDP, is likely to bring a new energy to Japanese monetary policy. But in these other instances, the passing of the baton is unlikely to result in any sharp discontinuities in policy. Even so, this is an issue that we will be watching closely in the year ahead.

Figure 23. US, EMU, Japan and UK – Central Bank Assets, Pct of GDP, 2005-12



Sources: National Central Banks and Statistical Agencies, Haver Analytics and Citi Research.

Nominal GDP Projections to 2025

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This year, 4 of the world's biggest 10 economies are emerging markets

In this section we update our projections for the size of different economies, based on our forecasts for economic growth, inflation and exchange rates. Recent years already have seen marked changes: China displaced Japan as the world's second biggest economy (in terms of nominal GDP expressed in USD) in 2010, while Brazil has leapt from the world's 13th biggest economy in 2004 to the 7th biggest in 2012, and India and Russia have now also entered the top 10 in the last two years.

We still expect China to overtake the US as the world's biggest economy by 2025

These projections are inevitably sensitive to assumptions on exchange rates, inflation and real economic growth. Versus last year's forecasts, we have reduced our medium-term expectations for nominal GDP growth in many Asian EM and EU countries[14]. Hence, we now expect that in 2025, China's nominal GDP will be about 9% bigger than the US, whereas last year we forecast that it would be about 22% above the US level. Nevertheless, in PPP terms (using IMF PPP estimates), China's nominal GDP already overtook the euro area in 2011, and India probably has overtaken Japan as the third-biggest national economy in 2012. Indeed, on a PPP basis, China's nominal GDP is likely to overtake the US around 2017.

We expect global nominal GDP growth of 6½%-7% during 2012-20, with faster growth in EM

At market exchange rates, Brazil's nominal GDP will probably overtake France and the UK in 2013, with India likely to also overtake France and the UK around 2015. We continue to expect that, by 2020, India's nominal GDP will exceed Germany's. Nominal GDP for the euro area is 78% of the US level in 2012, but will slip to about 70% (current EA members ex Greece) of the US level in 2020 and 66% in 2025. China's nominal GDP will probably surpass the euro area in 2017 or 2018. We continue to expect that by 2025, three of the world's biggest four economies will be emerging markets, with Brazil and Indonesia also in the top 10, and Korea, Mexico and Turkey all in the top 15. In all, we expect that the EM share of global GDP will rise from around 39% in 2012 to above 50% in 2020 and about 58% in 2025. Our forecasts imply average global nominal GDP growth of 6½%-7% YoY between 2012 and 2020 in USD terms, split between 10% YoY in emerging markets (11½% in Asia EM) and 4% in advanced economies (5% in the US and 3¾% in the euro area).

Figure 24. Selected Countries — Approximate Size of 10 Biggest Economies, Indexed to US = 100, 1980-2025F

	1980		2000		2012F		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	China	109
2	Japan	39	Japan	48	China	53	China	64	China	85	US	100
3	Germany	30	Germany	19	Japan	38	Japan	34	Japan	26	India	33
4	France	25	UK	15	Germany	22	Germany	19	India	23	Russia	23
5	UK	19	France	13	France	17	Brazil	16	Germany	19	Japan	21
6	Italy	17	China	12	UK	16	India	16	Russia	19	Brazil	21
7	Canada	10	Italy	11	Brazil	15	UK	15	Brazil	18	Germany	18
8	Mexico	8	Canada	7	Italy	13	France	15	France	15	Indonesia	15
9	Spain	8	Mexico	7	Russia	12	Russia	15	UK	14	France	14
10	Argentina	7	Brazil	6	India	12	Canada	12	Canada	12	UK	14
Euro Area		97		63		78		68		70		66

F Forecast. Sources: IMF and Citi Research estimates

In 2012, more than 50% of global investment spending was in emerging markets

The degree of EM outperformance — and especially Asia — varies across different components of GDP. The level of investment spending in China (in USD terms) already overtook the US in 2009, overtook the euro area in 2010 and we expect that

[14] See Prospects For Economies And Financial Markets In 2012 And Beyond, Willem Buiter et al, 28 November 2011, Citi.

in 2013 investment spending in China will exceed the US and euro area combined. In 2012, there was more investment in India than in Germany, and in 2014 investment in India will probably exceed investment in the UK plus France combined. Emerging markets already account for about 55% of global investment spending and we expect this ratio will rise to about 67% in 2020 and 75% in 2025. By contrast, nominal consumer spending in Japan in 2012 was still about 22% above the level in China, even though China's GDP is more than 20% above that in Japan. Consumer spending in the US in 2012 is about 75% greater than consumer spending in all Asian emerging markets combined.

Figure 25. Selected Countries — Approximate Level of 10 Biggest Consumer and Investment Markets, Indexed to US = 100, 2012-2020F

	Consumer Spending						Investment Spending					
	2012		2015F		2020F		2012		2015F		2020F	
	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	China	235	China	269	China	334
2	Japan	32	China	34	China	52	US	100	US	100	US	100
3	China	26	Japan	28	Japan	23	Japan	78	Japan	72	India	74
4	Germany	18	Germany	16	India	18	India	39	India	52	Japan	63
5	Brazil	14	Brazil	16	Brazil	17	Germany	38	Germany	34	Russia	47
6	UK	14	UK	13	Germany	16	France	33	Brazil	34	Brazil	38
7	France	14	India	12	UK	13	Brazil	31	Russia	30	Indonesia	35
8	Italy	11	France	12	France	12	Australia	27	France	29	Germany	32
9	India	10	Italy	9	Russia	12	Russia	26	Indonesia	24	France	29
10	Canada	9	Russia	9	Italy	8	Italy	23	Canada	23	Korea	27
Euro Area		61		54		54		139		116		119

F Forecast. Sources: IMF and Citi Research estimates

Consumer spending in Asia is likely to grow rapidly in coming years

With the rapid growth of EM middle income classes — especially in Asia — we expect these consumer disparities to narrow, but not vanish, in coming years. Our forecasts imply that global nominal consumer spending will grow by about 6½% YoY between 2012 and 2020 in USD terms, split between 3¾% YoY for advanced economies and 10½% YoY for emerging markets — with 13% YoY in Asian emerging markets. We expect that the US will still be the world's biggest national consumer market even in 2020 and 2025. Nevertheless, we expect that nominal consumer spending in Asian EM as a whole will double over the next six years, and roughly treble over the next 10 years — overtaking consumer spending in the euro area in 2013 and overtaking the US around 2020. Between now and 2020, we expect that emerging markets will account for about 68% of growth in global nominal GDP, 64% of the global growth in nominal consumer spending and 81% of the growth in global investment spending.

World trade trends are likely to continue to shift towards emerging markets

These trends are being reflected in a marked ongoing shift in global trade flows. Comparing H1-2012 with H1-2008, the value of exports by advanced economies to advanced economies has fallen by 8%, while exports from EM to EM are up 40%. The share of world trade in goods that involves EM countries (either as exporter or importer) edged up from 33% in 1990 to 38% in 1999, but has since surged to 51% in 2006 and 61% in H1-2012. Our economic forecasts imply that this shift in trade flows is likely to continue in coming years, with the share of global trade flows that involve EM countries (as exporter or importer) likely to hit 70-75% by 2020.

Figure 26. Selected Countries — Economic Forecast Overview (Percent), 2012-2017F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F
Global	2.5	2.6	3.1	3.6	3.8	3.7	2.9	2.8	3.0	2.9	2.8	2.9	2.35	2.23	2.47	2.82	3.24	3.35
Based on PPP weights	3.0	3.2	3.7	4.0	4.3	4.2	3.3	3.2	3.3	3.3	3.2	3.2	2.94	2.81	3.05	3.37	3.74	3.80
Industrial Countries	1.2	0.9	1.5	2.2	2.5	2.2	1.9	1.7	1.8	1.7	1.6	1.6	0.63	0.45	0.50	0.88	1.42	1.96
United States	2.2	1.6	3.0	3.5	4.0	3.0	1.8	1.9	2.0	2.0	2.0	2.0	0.25	0.25	0.25	1.10	2.10	2.90
Japan	1.6	0.7	0.7	1.5	1.2	1.2	0.0	-0.3	1.6	0.5	0.2	0.5	0.07	0.07	0.13	0.10	0.27	0.50
Euro Area	-0.4	-0.7	-0.4	0.7	1.1	1.3	2.6	2.0	1.5	1.5	1.3	1.2	0.88	0.31	0.25	0.25	0.31	0.75
Canada	2.1	2.1	2.8	3.0	3.2	2.8	1.6	1.4	2.0	2.0	2.0	2.0	1.00	1.19	2.13	2.50	3.00	3.00
Australia	3.7	3.1	3.1	3.5	3.6	3.2	1.9	2.9	2.7	2.8	2.5	2.3	3.69	3.00	3.50	4.00	4.75	4.75
New Zealand	1.8	2.2	2.3	3.2	3.4	3.1	1.2	1.8	2.1	2.9	2.8	2.5	2.50	2.69	4.00	4.75	5.00	5.00
Germany	0.9	0.5	0.3	0.9	1.1	1.4	2.0	1.9	2.5	2.2	2.0	1.9						
France	0.1	-0.2	0.2	1.0	1.5	1.9	2.3	1.5	1.8	1.6	1.9	1.7						
Italy	-2.1	-1.2	-1.5	0.3	0.2	0.2	3.3	1.8	1.2	0.5	0.2	0.2						
Spain	-1.5	-2.4	-1.9	0.4	1.2	1.0	2.4	1.9	0.4	0.5	0.6	0.5						
Greece	-7.2	-7.4	-11.8	-3.7	1.6	2.8	1.0	0.3	16.7	13.2	7.8	6.6						
Ireland	-0.1	0.4	1.0	1.6	2.4	2.3	1.7	1.2	1.4	1.6	1.6	1.7						
Portugal	-3.3	-4.6	-2.4	0.0	1.0	0.9	2.8	1.7	0.9	0.6	0.6	0.4						
Netherlands	-1.1	-0.9	0.2	0.9	1.2	1.3	2.6	2.8	1.7	2.0	1.7	1.4						
Belgium	-0.2	-0.3	0.3	1.2	1.5	1.7	2.9	1.9	1.9	2.2	2.2	1.9						
Denmark	0.1	1.0	1.7	1.7	1.8	2.0	2.5	2.0	2.1	2.2	2.0	2.0	0.43	0.10	0.25	0.75	1.00	1.00
Norway	3.4	3.1	2.7	2.7	2.9	2.9	0.8	1.7	2.0	2.3	2.5	2.5	1.55	1.73	2.21	2.75	3.25	3.50
Sweden	1.0	1.6	2.3	2.4	2.5	2.5	0.9	0.6	1.7	1.9	2.2	2.3	1.45	0.78	1.34	2.10	2.50	2.79
Switzerland	1.1	0.9	0.6	0.7	0.7	1.0	-0.7	-1.4	-0.9	0.5	0.9	1.0	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	-0.1	0.8	1.0	1.2	1.8	2.0	2.8	2.5	2.1	1.8	1.5	1.3	0.50	0.50	0.50	0.50	1.04	2.04
Emerging Markets	4.7	5.3	5.5	5.5	5.6	5.7	4.4	4.6	4.7	4.6	4.5	4.5	5.21	5.02	5.37	5.60	5.73	5.16
China	7.7	7.8	7.3	7.0	7.5	7.3	2.7	2.8	3.6	3.8	3.8	4.0	3.25	3.13	3.50	3.75	3.88	4.00
Taiwan	1.0	3.0	3.8	4.0	4.5	4.5	2.0	2.0	1.1	1.8	1.8	1.8	1.88	1.88	1.97	1.17	1.40	1.40
India	5.4	6.2	6.9	7.3	7.4	7.5	7.5	7.0	6.0	6.0	6.0	6.0	7.80	7.50	7.50	7.50	7.50	7.50
Indonesia	6.2	6.1	6.3	6.5	6.5	6.7	4.4	4.7	4.7	5.7	5.4	5.3	3.88	4.19	4.50	4.63	5.13	5.30
Korea	2.3	3.4	4.0	4.1	4.2	3.8	2.3	2.7	3.1	3.0	3.2	3.1	3.06	2.56	3.31	3.75	4.13	4.38
Czech Republic	-1.2	0.0	0.9	2.0	2.3	2.7	3.3	2.4	1.0	2.1	1.8	2.0	0.49	0.05	0.08	0.79	1.63	2.54
Hungary	-1.3	0.3	1.3	1.0	1.4	1.6	5.8	4.8	3.9	3.9	3.5	3.3	6.69	5.50	5.50	5.44	5.00	5.10
Poland	2.1	1.3	2.8	3.3	3.3	3.2	3.7	2.2	2.4	2.5	2.5	2.5	4.60	3.50	3.79	4.58	4.75	4.75
Romania	0.8	1.7	2.8	3.3	3.3	3.2	3.4	4.8	3.5	3.0	2.5	2.5	5.25	5.69	5.50	5.50	5.00	5.00
Russia	3.6	3.2	3.8	3.7	3.7	3.8	5.1	6.8	5.8	5.0	5.1	4.7	8.08	8.38	7.50	7.00	7.00	0.00
Turkey	2.8	4.0	4.3	4.6	4.5	4.5	9.2	7.3	6.3	5.9	5.4	5.2	5.75	5.13	6.88	8.00	8.00	7.50
Nigeria	7.4	6.5	7.2	6.9	7.2	7.0	12.2	10.9	9.9	9.5	9.0	9.9	12.00	11.50	11.00	10.00	9.50	9.00
South Africa	2.2	2.5	3.4	4.0	4.2	4.4	5.7	5.6	5.3	5.4	5.5	5.5	5.25	5.00	5.08	6.17	6.50	6.50
Argentina	2.3	3.0	3.0	2.0	-2.0	3.5	9.9	11.9	14.5	15.0	50.0	30.0	14.13	17.87	20.83	22.00	22.00	22.00
Brazil	1.4	3.9	4.0	3.5	3.5	3.7	5.4	5.3	5.4	5.2	4.8	4.5	8.46	7.46	8.75	9.50	9.88	9.00
Mexico	3.9	3.6	3.8	4.0	3.8	3.7	4.2	4.1	3.6	3.6	3.6	3.6	4.50	4.50	4.65	5.46	6.42	6.42
Venezuela	5.0	3.0	3.0	2.1	2.5	2.5	21.2	22.3	25.2	27.3	25.2	25.2	14.40	14.40	14.40	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 FasB1 rate to reflect actual money market rates. Source: Citi Research

Figure 27. Selected Countries — Economic Forecast Overview (Percent), 2012-2017F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F
Global	0.2	0.1	-0.1	-0.3	-0.3	-0.4	-4.5	-3.8	-3.2	-2.7	-2.4	-2.3	89	90	89	88	87	85
Based on PPP weights	*0.1*	*0.0*	*-0.2*	*-0.4*	*-0.5*	*-0.5*	*-4.3*	*-3.8*	*-3.3*	*-2.9*	*-2.6*	*-2.4*						
Industrial Countries	-0.8	-0.7	-0.7	-0.7	-0.5	-0.5	-5.9	-4.8	-3.8	-3.0	-2.7	-2.5	117	121	122	123	123	122
United States	-3.0	-3.0	-3.1	-3.2	-3.2	-3.0	-8.3	-7.0	-5.0	-4.0	-4.0	-4.0	106	110	112	112	112	112
Japan	1.0	1.1	1.6	1.5	1.5	1.3	-10.7	-8.1	-6.6	-6.2	-5.8	-5.4	237	243	244	248	252	255
Euro Area	0.9	1.2	1.3	1.3	1.3	1.4	-3.3	-2.9	-2.4	-1.5	-0.9	-0.4	94	98	96	95	93	91
Canada	-4.1	-4.2	-3.7	-3.2	-2.8	-2.4	-1.4	-0.9	-0.4	-0.1	0.1	0.1	86	86	85	83	82	81
Australia	-3.8	-4.7	-5.5	-3.5	-3.2	-3.0	-3.0	0.1	0.1	0.2	0.4	0.5	29	29	27	26	23	23
New Zealand	-6.2	-8.7	-9.2	-7.9	-6.5	-5.8	-5.3	-3.2	-1.1	0.1	0.9	0.9	39	38	42	42	41	40
Germany	6.1	5.0	4.1	3.7	3.6	3.7	0.0	-0.3	-0.5	-0.3	-0.1	0.1	84	83	82	81	79	77
France	-1.8	-1.0	-0.2	0.4	0.9	0.6	-4.3	-3.7	-3.0	-2.5	-1.4	-0.1	91	95	97	97	95	91
Italy	-1.3	-0.9	-0.7	-0.3	0.0	0.2	-3.0	-2.6	-2.6	-0.2	0.1	0.1	126	130	134	132	131	130
Spain	-1.5	1.3	3.0	2.8	2.5	1.8	-8.2	-6.4	-5.8	-3.7	-2.9	-2.0	88	97	110	112	113	113
Greece	-4.5	-3.5	2.0	4.2	5.1	3.7	-8.0	-6.7	-1.5	-0.6	2.6	2.3	178	193	453	452	417	145
Ireland	5.0	6.6	7.0	7.4	7.6	7.8	-8.3	-7.9	-5.5	-2.4	-1.7	-1.6	118	121	122	119	116	113
Portugal	-3.7	-1.4	-1.0	-0.9	-0.6	-0.7	-5.0	-5.0	-4.3	-3.0	-2.4	-1.8	121	132	105	109	110	109
Netherlands	10.1	9.6	8.7	9.2	9.2	9.4	-3.8	-3.4	-3.7	-2.5	-2.6	-1.8	70	72	75	75	75	75
Belgium	-0.7	0.3	0.9	1.8	2.2	1.8	-2.8	-2.7	-2.1	-1.7	-0.7	0.0	110	116	116	114	111	106
Denmark	5.4	5.4	4.4	3.5	3.7	3.8	-3.8	-2.0	-1.2	-1.0	0.5	1.0	49	50	49	48	46	43
Norway	14.3	14.9	15.2	15.2	15.8	14.5	13.2	14.0	13.7	14.5	16.0	15.0	NA	NA	NA	NA	NA	NA
Sweden	6.6	6.6	6.3	6.0	6.0	5.9	-0.3	-0.9	-0.3	0.7	1.3	1.5	37	37	36	33	31	28
Switzerland	12.7	13.1	13.0	13.6	14.5	14.0	0.6	0.4	0.3	-0.2	-0.6	-0.6	47	45	44	44	45	47
United Kingdom	-3.9	-2.5	-2.2	-1.6	-1.0	-0.7	-5.9	-5.0	-5.9	-5.1	-4.0	-3.7	88	92	96	100	101	103
Emerging Markets	1.8	1.2	0.6	0.1	-0.1	-0.2	-2.0	-2.1	-2.3	-2.4	-2.2	-2.1	42	41	40	40	39	38
China	2.5	2.0	1.5	1.0	0.7	0.5	-2.4	-2.0	-2.0	-2.0	-1.5	-1.5	44	43	41	39	37	35
Taiwan	8.7	8.4	8.0	8.0	8.0	8.0	-1.6	-1.6	-1.3	-1.0	-0.7	-0.5	39	40	42	43	44	44
India	-3.7	-2.8	-2.5	-2.5	-2.5	-2.5	-8.5	-8.0	-7.5	-7.0	-6.5	-6.0	69	68	67	66	65	64
Indonesia	-2.3	-1.7	-1.5	-1.2	-0.9	-0.8	-2.1	-1.5	-1.4	-1.0	-0.5	-0.4	24	22	21	21	20	20
Korea	2.9	1.5	1.0	0.1	-0.7	-0.5	0.8	1.3	1.6	1.5	2.2	1.9	34	33	31	29	27	25
Czech Republic	-1.5	-1.9	-1.2	-3.3	-2.3	-0.8	-3.2	-3.2	-2.7	-2.2	-1.5	-0.5	45	47	49	49	48	46
Hungary	1.3	1.7	2.1	2.4	2.5	2.6	-2.8	-2.9	-3.2	-3.0	-2.8	-3.0	78	78	78	78	77	77
Poland	-3.6	-3.9	-4.7	-4.7	-4.2	-4.2	-3.5	-3.5	-2.8	-2.5	-2.4	-2.5	53	52	51	50	49	49
Romania	-3.8	-4.2	-4.5	-4.7	-5.0	-5.0	-2.4	-2.2	-2.5	-2.3	-2.0	-2.0	40	40	39	38	37	37
Russia	4.9	3.3	0.9	-0.6	-1.8	-2.6	-0.1	-1.2	-2.4	-2.7	-3.0	-3.0	9	10	11	12	14	15
Turkey	-7.0	-7.1	-7.1	-6.8	-6.2	-5.4	-2.5	-2.7	-2.7	-2.7	-3.0	-3.0	38	37	36	36	36	36
Nigeria	2.3	3.4	3.0	1.9	1.3	0.5	-2.9	-2.1	-2.6	-3.0	-2.6	-2.7	NA	NA	NA	NA	NA	NA
South Africa	-5.9	-5.6	-5.3	-4.5	-3.3	-3.0	-4.7	-5.0	-4.6	-4.2	-3.7	-3.5	40	42	42	42	41	41
Argentina	0.8	0.4	0.2	0.2	3.0	1.0	-2.4	-2.7	-2.9	-3.0	0.0	-0.5	38	39	41	42	40	38
Brazil	-2.2	-2.5	-2.6	-2.8	-2.9	-3.1	-2.6	-2.4	-2.1	-1.8	-2.0	-1.8	54	55	55	56	56	57
Mexico	-0.4	-0.9	-1.2	-2.5	-2.7	-2.7	-2.2	-2.1	-2.0	-2.0	-2.0	-2.0	40	38	38	38	37	37
Venezuela	5.4	5.1	6.1	6.5	5.8	5.9	-5.0	-4.0	-4.0	-4.8	-4.6	-4.5	40	46	40	41	42	42

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. We assume sovereign debt restructuring in Portugal in 2014 and Greece, Italy, Spain and Ireland in 2015. For Spain, fiscal deficits include the effect of financial support for banks in 2011 (€5.4bn) and 2012 (€11.6bn). Source: Citi Research

Figure 28. Selected Countries — Changes in Economic Forecast from the Previous Month (Percentage Points), 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (Pct of GDP)			Fiscal Balance (Pct of GDP)		
	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Global		-0.1		0.1	-0.1	-0.1		0.1			-0.1	-0.2
Based on PPP weights	*-0.1*		*0.2*	*0.1*	*-0.1*		*0.1*		*-0.1*	*-0.2*	*-0.3*	*-0.4*
Industrial Countries					-0.1	-0.1			-0.1	0.1	0.1	
United States	0.1	-0.2				-0.1	0.2	0.1				
Japan	-0.4	-0.2	0.5	-0.1	-0.2	-0.6	-0.3	-0.5	0.1			
Euro Area			-0.3		-0.3		-0.1	-0.2	-0.2		-0.2	
Canada	-0.1	0.1			-0.1		-0.5	-0.2		-0.2	-0.4	-0.3
Australia		-0.1	-0.3	0.1	-0.1	-0.2			0.1			-0.1
New Zealand	-0.5	-0.6	-0.7	-0.4	-0.4	-0.5	-1.2	-1.7	-2.8	-1.2	0.4	-0.2
Germany	-0.2	-0.1	-0.5		-0.3				-0.7	0.2		-0.1
France	0.1		-0.3	0.3	0.1	0.4					-0.1	0.1
Italy	0.2	0.2	0.3	-0.1	-0.3	0.1	0.4	0.4	0.4	-0.1		0.0
Spain			-0.1		-0.2	-0.1	-0.1	-0.2	-0.5			-0.1
Greece		-0.1	-1.0	0.1	-1.8	-0.2	1.8	1.9	2.1	1.1	1.0	2.2
Ireland	-0.5	-0.3	-1.8				1.8	1.1	-0.9	-0.2	-0.2	-0.6
Portugal			-0.1	-0.1	-0.6	-0.1	1.2	1.4	0.9			0.9
Netherlands	-0.5		-0.6	0.1	0.1	0.1	0.1		0.1	0.5	0.4	-0.2
Belgium	-0.1	-0.1	-0.2		0.1			0.1		-0.1	-0.8	-0.3
Denmark		-0.1	0.1									
Norway	-0.1	-0.1										-1.3
Sweden	-0.1	-0.1			-0.4	-0.4	-0.1	-0.3	-1.0		-0.1	
Switzerland										0.2	0.4	0.4
United Kingdom	0.2	0.1	0.2	0.1	0.4	0.2	0.1	0.4	0.4	1.0	3.0	1.7
Emerging Markets			-0.1		-0.1	-0.1	0.2	0.1			-0.2	-0.5
China		0.2			-0.4	-0.3	0.5	0.5	0.5		-0.5	-1.0
Taiwan	-0.7	-0.6	-0.7			-0.7						
India				-0.5			-0.5	-0.5	-0.8			
Indonesia									-0.4			
Korea	-0.3		0.3	-0.1	-0.1		0.7	0.1	0.2			
Czech Republic		-0.4	-0.2			-0.5	-0.7	-0.2	1.6		-0.2	-0.4
Hungary	-0.1	-0.1	-0.2	-0.1	-0.4	0.1		-0.6	-0.4			-0.1
Poland	-0.3	-0.9		-0.1	-0.4	-0.1			0.5	-0.1	-0.5	-0.3
Romania	-0.5	-0.8	-0.2	-0.1	-0.4	-0.2	0.2	0.5				
Russia	0.1	-0.8	-0.3		-0.1	-0.2	-0.5	-0.6	-0.6	-0.4	-1.3	-2.3
Turkey	0.3						0.5		-0.5		-0.2	-0.2
Nigeria						-0.4						
South Africa	-0.3	-0.1	-0.8	0.2	0.5	-0.4	-0.2			0.1	-0.8	-1.0
Argentina			1.0			-0.5	-0.2	-0.2	1.2	0.4	0.3	0.1
Brazil						0.1			0.1			
Mexico		-0.2	0.3		0.1	-0.3	0.6	0.5	1.3		-0.1	-0.1
Venezuela			-1.0	0.2	-0.2	-2.7	0.5	0.6	0.3			1.2

Source: Citi Research

Figure 29. Selected Countries — Economic Forecast Overview and Exchange Rate Forecasts (Percent), 2012-2017F

	10-Year Yields						Exchange Rates Versus U.S. Dollar*						Exchange Rate Versus Euro					
	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F	2012F	2013F	2014F	2015F	2016F	2017F
Industrial Countries																		
United States	1.80	2.10	2.80	3.25	3.50	3.75	NA	NA	NA	NA	NA	NA	1.28	1.21	1.20	1.24	1.31	1.38
Japan	0.85	0.96	1.13	1.50	1.75	1.75	81	85	83	82	82	82	104	103	99	102	108	113
Euro Area	1.59	1.63	1.44	1.50	2.00	2.50	1.28	1.21	1.20	1.24	1.31	1.38	NA	NA	NA	NA	NA	NA
Canada	1.88	2.33	3.25	3.35	3.50	3.75	1.00	0.98	0.97	0.97	0.96	0.95	1.28	1.20	1.16	1.20	1.26	1.31
Australia	3.28	3.23	3.90	4.20	5.00	5.15	1.03	0.98	0.94	0.93	0.92	0.92	1.24	1.24	1.27	1.34	1.42	1.50
New Zealand	3.61	3.83	4.20	4.60	5.30	5.40	0.82	0.79	0.71	0.68	0.67	0.66	1.57	1.55	1.68	1.82	1.95	2.08
Germany	1.59	1.63	1.44	1.50	2.00	2.50												
France	2.57	2.60	2.64	3.00	2.80	3.00												
Italy	5.44	5.19	4.94	5.50	5.00	5.00												
Spain	5.96	5.50	5.19	5.50	5.00	5.00												
Netherlands	1.98	2.03	1.69	1.70	2.20	2.70												
Belgium	3.11	2.78	2.74	3.10	3.00	3.20												
Denmark	1.52	1.59	1.49	1.65	2.25	2.75	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Norway	2.14	2.28	2.09	2.20	2.75	3.25	5.81	5.95	6.05	5.85	5.55	5.29	7.45	7.22	7.24	7.26	7.27	7.28
Sweden	1.59	1.66	1.54	1.65	2.25	2.75	6.73	6.84	6.96	6.75	6.42	6.14	8.63	8.31	8.33	8.38	8.41	8.44
Switzerland	0.45	0.60	0.57	0.61	0.96	1.30	0.94	0.99	1.00	0.99	0.97	0.94	1.20	1.20	1.20	1.23	1.26	1.30
United Kingdom	1.90	1.90	1.75	1.75	2.50	3.00	1.59	1.54	1.51	1.57	1.66	1.74	0.81	0.79	0.79	0.79	0.79	0.79
Emerging Markets																		
China	3.24	3.49	3.74	3.99	4.12	4.24	6.29	6.15	6.07	6.05	6.06	6.06	8.06	7.47	7.27	7.51	7.93	8.34
Taiwan	1.20	1.20	1.32	1.50	1.70	2.00	29.30	28.47	28.27	28.20	28.20	28.20	37.58	34.59	33.83	34.98	36.92	38.80
India	8.25	8.25	8.25	8.25	8.25	8.25	52.99	53.66	53.58	52.64	51.47	50.34	67.96	65.19	64.12	65.31	67.40	69.27
Indonesia	5.81	5.73	6.10	6.30	6.60	6.50	9469	9802	9703	9621	9567	9516	12145	11909	11610	11935	12527	13093
Korea	3.22	2.89	3.76	4.48	5.00	5.15	1117	1065	1012	993	991	989	1433	1294	1211	1232	1298	1360
Czech Republic	2.82	2.88	3.42	3.82	4.00	4.00	19.7	21.3	21.1	19.6	17.8	16.3	25.3	25.9	25.2	24.3	23.3	22.4
Hungary	7.81	7.05	6.63	6.29	6.00	6.05	225	245	244	232	217	204	289	297	292	288	284	281
Poland	5.03	4.66	5.19	5.40	5.34	0.65	3.26	3.50	3.34	3.14	2.98	2.83	4.19	4.25	3.99	3.90	3.90	3.90
Romania	NA	NA	NA	NA	NA	NA	3.48	3.69	3.66	3.48	3.24	3.06	4.46	4.49	4.38	4.32	4.24	4.21
Russia	NA	NA	NA	NA	NA	NA	31.1	33.4	34.3	33.5	32.0	30.5	39.9	40.6	41.1	41.5	41.9	42.0
Turkey	NA	NA	NA	NA	NA	NA	1.80	1.86	1.90	1.91	1.91	1.91	2.31	2.26	2.27	2.37	2.50	2.63
Nigeria	NA	NA	NA	NA	NA	NA	158	161	164	168	171	175	203	196	196	208	224	241
South Africa	7.19	7.19	8.15	9.15	9.20	9.25	8.29	9.15	9.42	9.61	9.76	9.91	10.63	11.12	11.28	11.92	12.78	13.63
Argentina	NA	NA	NA	NA	NA	NA	4.58	5.46	6.74	9.75	16.58	20.72	5.87	6.63	8.06	12.10	21.70	28.51
Brazil	9.85	9.21	9.79	9.35	8.25	8.00	1.99	1.99	2.02	1.99	1.91	1.82	2.55	2.42	2.42	2.47	2.49	2.51
Mexico	5.73	6.44	6.84	6.99	7.29	7.95	13.0	12.7	12.6	12.6	12.8	13.0	16.6	15.4	15.0	15.7	16.7	17.8
Venezuela	11.40	11.55	11.85	15.50	15.50	15.50	4.30	6.50	6.50	9.75	10.50	12.71	5.52	7.90	7.78	12.10	13.75	17.48

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

Figure 30. Short Rates (End of Period), as of 26 November 2012 (Percent)

	Current	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14	2Q 14
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	0.75	0.50	0.25	0.25	0.25	0.25	0.25
Canada	1.00	1.00	1.00	1.25	1.50	1.75	2.00
Australia	3.25	3.00	3.00	3.00	3.00	3.00	3.00
New Zealand	2.50	2.50	2.50	2.75	3.00	3.50	3.50
Denmark	0.20	0.05	0.05	0.15	0.15	0.25	0.25
Norway	1.50	1.50	1.75	1.75	2.00	2.25	2.25
Sweden	1.25	0.75	0.75	0.75	0.75	1.00	1.25
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	0.50
China	3.00	3.00	3.00	3.00	3.25	3.50	3.50

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 31. 10-Year Yield Forecasts (Period Average), as of 26 November 2012 (Percent)

	Current	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14	2Q 14
United States	1.67	1.75	1.95	2.20	2.50	2.65	2.90
Japan	0.74	0.85	1.00	0.90	1.10	1.10	1.00
Euro area (Germany)	1.42	1.50	1.75	1.75	1.50	1.25	1.50
Canada	1.75	1.85	2.05	2.55	2.85	3.05	3.30
Australia	3.26	3.00	3.10	3.30	3.50	3.75	3.90
New Zealand	3.54	3.70	3.75	3.85	4.00	4.20	4.25
Denmark	1.38	1.40	1.70	1.75	1.50	1.30	1.46
Norway	2.18	2.10	2.40	2.40	2.20	2.00	2.15
Sweden	1.53	1.50	1.75	1.80	1.55	1.35	1.53
Switzerland	0.50	0.65	0.56	0.65	0.56	0.46	0.56
United Kingdom	1.83	1.85	1.95	2.00	1.80	1.65	1.80

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 32. 10-Year Yield Spreads (Period Average), as of 26 November 2012

	Spread vs. US$						Spread vs. Germany					
	Current	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14	Current	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14
United States	NA	NA	NA	NA	NA	NA	26	26	21	46	102	142
Japan	-94	-91	-96	-131	-142	-157	-68	-65	-75	-85	-40	-15
Euro Area	-26	-26	-21	-46	-102	-142	NA	NA	NA	NA	NA	NA
Canada	8	10	10	35	35	41	34	36	31	82	137	182
Australia	161	126	116	112	102	112	187	152	137	158	203	254
New Zealand	189	198	183	167	152	158	215	223	204	214	254	299
France	50	54	69	54	18	-22	75	80	90	100	120	120
Italy	313	324	329	279	298	258	338	350	350	325	400	400
Spain	402	424	329	279	323	283	427	450	350	325	425	425
Netherlands	1	4	9	-6	-42	-82	26	30	30	40	60	60
Belgium	63	79	84	69	33	-12	88	105	105	115	135	130
Austria	19	24	24	-1	-52	-87	44	50	45	45	50	55
Finland	2	4	4	-21	-72	-112	27	30	25	25	30	30
Ireland	286	294	299	249	268	228	311	320	320	295	370	370
Denmark	-29	-36	-26	-46	-102	-137	0	-10	-5	0	0	5
Norway	51	34	44	19	-32	-67	55	60	65	65	70	75
Sweden	-14	-26	-21	-41	-97	-132	0	0	0	5	5	10
Switzerland	-117	-111	-140	-156	-196	-221	-92	-85	-119	-110	-94	-79
United Kingdom	16	10	0	-20	-71	-101	41	36	21	26	31	41

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 33. Emerging Market Countries — Short Rates Actual and Forecast of Additional Rate Moves (End of Period), as of 26 November 2012

Country	Current Rate (%)	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Total Cumulative Rate Moves Expected
Brazil	7.25	0	0	0	0	100	100
Indonesia	4.00	0	0	0	25	25	50
China	3.00	0	0	0	0	25	25
Korea	2.75	0	-25	0	0	25	0
Israel	2.00	0	-25	0	0	25	0
Mexico	4.50	0	0	0	0	0	0
Philippines	3.50	0	0	0	0	0	0
Czech	0.05	0	0	0	0	0	0
South Africa	5.00	0	0	0	0	0	0
Thailand	2.75	-25	0	0	0	0	-25
Russia	8.25	0	25	0	0	-50	-25
Ukraine	7.50	25	0	-25	-25	0	-25
Chile	5.00	0	0	-50	0	0	-50
India	8.00	-25	-25	-25	0	0	-75
Turkey	5.75	0	-25	-50	0	0	-75
Hungary	6.25	-50	-25	0	0	0	-75
Poland	4.50	-25	-50	-25	-25	0	-125

Source: Citi Research

Figure 34. Foreign Exchange Forecasts (End of Period), as of 26 November 2012

	vs. USD						vs. EUR					
	Current	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Current	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
United States	NA	NA	NA	NA	NA	NA	1.28	1.23	1.22	1.21	1.20	1.20
Japan	81	84	85	85	84	84	104	104	103	102	101	100
Euro Area	1.28	1.23	1.22	1.21	1.20	1.20	NA	NA	NA	NA	NA	NA
Canada	1.00	1.00	0.99	0.98	0.98	0.98	1.28	1.23	1.20	1.18	1.18	1.17
Australia	1.04	1.01	0.98	0.97	0.96	0.95	1.23	1.22	1.24	1.25	1.26	1.26
New Zealand	0.81	0.80	0.80	0.78	0.76	0.74	1.57	1.53	1.53	1.55	1.58	1.62
Norway	5.78	5.90	5.93	5.96	5.99	6.02	7.37	7.26	7.22	7.20	7.21	7.22
Sweden	6.78	6.82	6.82	6.84	6.88	6.91	8.65	8.40	8.30	8.26	8.28	8.30
Switzerland	0.94	0.98	0.99	0.99	1.00	1.00	1.21	1.20	1.20	1.20	1.20	1.20
United Kingdom	1.59	1.55	1.54	1.53	1.52	1.52	0.80	0.79	0.79	0.79	0.79	0.79
China	6.23	6.18	6.16	6.14	6.12	6.10	8.0	7.6	7.5	7.4	7.4	7.3
India	55.0	53.1	53.7	54.0	53.9	53.8	70.2	65.4	65.4	65.2	64.8	64.5
Korea	1087	1076	1072	1063	1048	1033	1388	1324	1305	1284	1262	1240
Poland	3.25	3.47	3.52	3.53	3.47	3.42	4.15	4.27	4.29	4.26	4.18	4.10
Russia	31.7	32.4	33.3	33.9	34.0	34.2	40.4	39.8	40.5	40.9	41.0	41.0
South Africa	8.85	9.06	9.12	9.18	9.25	9.32	11.30	11.15	11.10	11.09	11.14	11.19
Turkey	1.80	1.83	1.86	1.87	1.88	1.89	2.30	2.25	2.26	2.26	2.27	2.27
Brazil	2.09	2.04	1.98	1.96	1.98	2.00	2.66	2.51	2.41	2.37	2.38	2.40
Mexico	13.1	12.8	12.7	12.7	12.6	12.6	16.7	15.7	15.5	15.3	15.2	15.1

Source: Citi Research

Figure 35. Foreign Exchange Forecasts (End of Period), as of 26 November 2012

	vs. JPY					
	Current	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
United States	81	84	85	85	84	84
Japan	NA	NA	NA	NA	NA	NA
Euro Area	104	104	103	102	101	100
Canada	81	85	86	87	86	86
Australia	84	85	83	82	81	79
New Zealand	66.2	67.9	67.4	66.2	64.0	61.9
Norway	14.1	14.3	14.3	14.2	14.0	13.9
Sweden	12.0	12.4	12.4	12.4	12.2	12.1
Switzerland	86	87	86	85	84	84
United Kingdom	129	131	130	130	128	127
China	13	14	14	14	14	14
India	1.48	1.59	1.58	1.57	1.56	1.55
Korea	13.37	12.74	12.64	12.55	12.46	12.37
Poland	25.0	24.3	24.1	24.0	24.2	24.4
Russia	2.6	2.6	2.5	2.5	2.5	2.4
South Africa	9.2	9.3	9.3	9.2	9.1	9.0
Turkey	45.1	46.1	45.7	45.2	44.7	44.2
Brazil	39.0	41.4	42.8	43.2	42.5	41.8
Mexico	6.2	6.6	6.7	6.7	6.7	6.6

Source: Citi Research

Country Commentary

United States

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The pace of economic growth is expected to remain modest in 2013 as a new round of fiscal belt tightening blunts the effects of a maturing cyclical expansion. Slow and erratic growth has been a hallmark of the recovery thus far as businesses have been wary of a variety of downside threats, while lingering imbalances in key sectors have limited recovery's breadth. Among the latter, however, housing is transitioning for the better and consumer finances are somewhat improved alongside a healthy corporate sector. These factors suggest growth could accelerate over the longer two-year forecast horizon, if some key policy uncertainties are safely resolved and business confidence revives.

The looming fiscal cliff remains the central uncertainty in the forecast. If unaddressed, large-scale income tax hikes and spending restraint set to be implemented over the turn of the year threaten to drive GDP down by our estimates at a 2½% rate in the first half of next year. Moreover, lawmakers also must pass an increase in Treasury borrowing authority over the next couple of months and face a larger challenge to put in place comprehensive budget reforms that would stabilize the path of public debt beyond the next several years. Despite its size and scope, the fiscal cliff fails to address the key driver of structural deficits in rising middle class entitlement commitments.

For this forecast round we have made mostly compositional changes to a long-standing fiscal policy base case that most of the pending restraint would be hurdled by a late-year compromise. The deal would leave roughly 1¼% of drag on 2013, dominated by the expiration of the payroll tax holiday and emergency jobless benefits, which together slash nearly $150 billion from household disposable income. The election may have tilted the balance of power slightly in the Administration's favor, so we have assumed taxes will increase for high-end earners with the revenues coming from scaling back deductions as well as higher health-care related taxes on investment income rather than higher marginal rates. We assume that the sequester of about $80 billion will be halved and that other routine features of current policy like the AMT patch and the Doc Fix will continue.

The expected agreement likely will only resolve the short-term fiscal cliff issue. Although we have incorporated additional spending restraint for 2014, we have not assumed any grand bargain that encompasses major entitlement reform. Moreover, as of this writing, it is very unclear whether this compromise will include raising the debt ceiling. As a result, clearing the immediate hurdle is unlikely to provide a meaningful or lasting boost to business confidence or financial conditions.

The cloud over fiscal policy tends to dampen an otherwise improving cyclical backdrop. In the financial sector, bank credit is rising faster than GDP as lending terms and standards have been loosened for many loan categories. Financial stress indicators have subsided and credit performance continues to improve. Nonetheless, sustaining an accommodative financial setting has eluded policymakers and some key headwinds remain in the form of tight mortgage credit and the lowest levels of nonfarm, nonresidential small business lending in nearly a decade.

Consumers remain selective in their use of credit but overall household balance sheets do not appear to be hampering recovery. We continue to see a range-bound saving rate as household wealth has recovered and moderate job gains, easily topping two million in 2013, should support trend-like growth in consumer spending beyond the initial drag from higher payroll taxes at the start of the year (see Figure 36).

The job market recovery is expected to gain an additional lift from reviving housing-related employment where conditions have stabilized in the past year. With housing supply/demand substantially more in balance, home prices have stopped falling and several housing leads have posted steady increases. We expect gains in residential investment in a 15% to 20% range with housing starts likely to top one million next year, but still far below sustainable levels.

We expect inflation to remain safely within range of 2% over the forecast horizon. Although monetary policy has been highly accommodative, the effects of that have shown through mostly by closing off the threat of declining inflation expectations, whereas financial sector deleveraging has capped the expansion of money and credit. Business pricing intentions have firmed slightly but within normal ranges. Although unemployment remains high, labor costs have stopped slowing and some measures of compensation have edged up. Core nonfuel import prices have been flat in the past year and producer price measures have been soft, especially prices of crude materials.

Well anchored inflation trends have provided a key element of flexibility for Fed policy to pursue greater accommodation with a goal of stronger labor markets. Although these efforts have been an uneven success with diminishing returns, officials appear highly intent on continuing large-scale asset purchases of MBS and Treasuries next year. Based on the expectation of slow declines in unemployment, we think the recent pace of $85 billion of longer-duration securities will persist through at least most of next year and possibly into 2014.

Figure 36. United States — Economic Forecasts, 2012-2014F

					2012		2013				2014	
		2012F	2013F	2014F	3QE	4QF	1QF	2QF	3QF	4QF	1QF	2QF
GDP	SAAR				3.0%	0.6%	1.1%	1.3%	2.4%	3.0%	3.0%	3.4%
	YoY	2.2%	1.6%	3.0%	2.6	1.7	1.5	1.5	1.3	2.0	2.4	2.9
Domestic Demand	SAAR				2.2	0.8	0.4	1.6	2.3	3.1	3.2	3.2
	YoY	2.0	1.4	2.9	2.0	1.7	1.2	1.2	1.3	1.8	2.5	2.9
Consumption	SAAR				1.9	1.8	0.7	1.6	2.3	3.2	3.4	3.4
	YoY	1.9	1.6	3.1	1.9	1.9	1.5	1.5	1.6	1.9	2.6	3.1
Business Investment	SAAR				-0.2	-1.7	1.4	3.4	4.5	5.7	6.1	6.2
	YoY	7.2	1.8	5.7	5.0	2.2	0.8	0.7	1.9	3.7	4.9	5.6
Housing Investment	SAAR				14.4	13.6	17.1	18.8	18.5	21.2	16.7	14.3
	YoY	11.9	16.4	17.3	13.8	14.2	13.4	16.0	17.0	18.9	18.8	17.6
Government	SAAR				3.3	-2.9	-3.0	-1.8	-1.2	-1.2	-1.1	-1.0
	YoY	-1.5	-1.5	-1.1	-0.7	-0.9	-0.9	-1.1	-2.2	-1.8	-1.3	-1.1
Exports	SAAR				1.7	2.1	2.8	3.5	4.4	4.8	5.5	6.1
	YoY	3.7	3.1	5.3	3.2	3.4	3.0	2.5	3.2	3.9	4.5	5.2
Imports	SAAR				0.2	2.1	2.2	2.7	2.5	3.3	5.1	5.5
	YoY	3.0	2.2	4.1	2.7	2.0	1.8	1.8	2.4	2.7	3.4	4.1
PCE Deflator	YoY	1.8	1.9	2.0	1.5	1.9	1.7	2.0	2.1	1.9	1.9	2.0
Core PCE Deflator	YoY	1.8	1.6	1.9	1.6	1.7	1.6	1.5	1.6	1.7	1.7	1.8
Unemployment Rate	%	8.1	7.8	7.1	8.1	7.9	7.8	7.9	7.8	7.6	7.4	7.2
Federal Gov't Balance (Fiscal Year)	$Bn	-1089	-830	-640								
	% of GDP	-7.0	-5.0	-3.7								
General Gov't Balance (Cal Year)	% of GDP	-8.3	-7.0	-5.0								
Federal Debt	% of GDP	72	75	76								
General Gov't Debt	% of GDP	106	110	112								
Current Account	US$bn	-472	-475	-517	-417	-466	-457	-481	-469	-494	-499	-529
	% of GDP	-3.0	-3.0	-3.1	-2.6	-2.9	-2.9	-3.0	-2.9	-3.0	-3.0	-3.2
S&P 500 Profits (US$ Per Share)	YoY	5.3	4.9	4.6	1.0	4.5	2.7	4.7	4.6	7.4	5.7	4.6

Notes: F Citi forecast. E Citi Estimate. YoY Year-to-year percent change. SAAR Seasonally adjusted annual rate
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 the Japanese economy to pick up in 2013 after two consecutive negative GDP readings in H2-2012, mostly thanks to a renewed increase in exports, driven by a moderate pick-up in economic activity in the key trading partners, and frontloaded demand ahead of the consumption tax hike in April 2014. Meanwhile, following a prospective change in the government in the upcoming general elections on December 16, the Bank of Japan (BoJ) leadership will also change next spring. How the basic thrust of economic policies — both monetary and fiscal — will change will probably be an important key for financial markets in 2013.

GDP growth is likely to return to positive territory in the first quarter of 2013 after negative growth in Q3 and Q4. We expect exports to start picking up in the quarter reflecting some improvement in economic activity in the major trading partners. In particular, the Chinese economy currently shows increasing signs of picking up. In this context, if (as we anticipate) an adverse impact from the China-Japan confrontation over the disputed island weakens gradually, export to China likely will increase again. Moreover, a strong negative impact from expiration of the government's subsidy for eco-car purchases in late September on consumer spending will probably run its course by the end of this year. Meanwhile, as year 2013 unfolds, frontloaded demand for housing and consumption ahead of the planned 3%-point consumption tax rate hike in April 2014 likely will materialize in a meaningful manner. As a result, we expect GDP growth in the four quarters before the tax hike to average near 3% annualized.

In fiscal 2014 (starting April 2014), however, economic activity likely will fall sharply as the consumption tax hike is implemented. There will most likely be reactionary declines in household spending after frontloading in demand in the previous year. Moreover, higher inflation driven by the consumption tax rate hike will erode the real purchasing power of household nominal income. As a result, we expect a sharp, if temporary, contraction in activity in the second quarter of 2014. This might make the second consumption tax hike scheduled in October 2015 difficult to implement.

Core inflation (excluding just fresh food but including energy) likely will stay exceptionally low in coming years, apart from a temporary rise driven by the 3%-point consumption tax hike. We expect declining but persistent economic slack, along with continued declines in unit labor costs, to continue to exert downward pressures on prices. We figure that the BoJ's core inflation forecast of +0.8% (adjusted for the consumption tax hike) for fiscal 2014 is too high and will probably be revised down sooner rather than later. Meanwhile, the current account balance is likely to manage to stay in surplus, if meager, in years to come. We are skeptical that Japan's current account balance will fall into deficit on a sustainable basis.

Lower House elections will be held on December 16th. It seems highly likely that the Liberal Democratic Party (LDP), the main opposition party, will take control of the Lower House from the Democratic Party of Japan (DPJ) and that Shinzo Abe, the LDP leader, will become the next Prime Minister. In that case, the focus of economic policies likely will shift to reviving and revitalizing the corporate sector, for example by driving the yen's depreciation, reducing the corporate tax rate and lowering energy costs through gradual resumption of the nuclear power stations. Over the near term, an Abe administration would likely introduce fiscal pump priming measures in a supplementary budget early next year. In addition, the LDP proposes that the BoJ should introduce an inflation target of 2% and ease monetary policy much more aggressively. Meanwhile, Mr.Abe has personally been more cautious about hiking the consumption tax rate if deflation has not been eradicated.

We expect the BoJ to continue its incremental policy approach, mostly driven by the yen's appreciation and the political pressure under the current leadership that will end its term next spring, although near-term uncertainty over policy rose reflecting the ongoing political transition. While one more easing action seems likely in December or January with BoJ's near-term economic outlook likely to be revised down again and with the political pressure expected to increase under the new administration, a concrete measure would likely be another moderate expansion of the asset purchase program centered on JGBs. However, if the political pressure intensifies under the new administration, the possibility of a reduction in the rate of interest on excess reserves (currently 0.10%) cannot be ruled out.

Governor Shirakawa's term will come to an end on April 8th, while two deputy governors will also leave office on March 19. In our view, it is highly likely that the next administration will nominate candidates more dovish than the current leadership to these positions. Given that three policy board members out of nine have a dovish view on monetary policy, the sweeping change in the leadership would shift the overall balance on the policy board to the dovish side. As for the next governor, as of this writing, Toshiro Muto, an ex-MoF official who also served as a BoJ Deputy Governor until 2008, appears to be the most likely candidate.

The BoJ's words and deeds likely will change under new leadership. We expect the next governor to highlight that monetary policy remains effective in supporting the economy and that there is more that the BoJ can do to end deflation. Judging from recent statements, however, Mr. Muto appears cautious about implementing out-of-the-box policy options such as the BoJ purchases of foreign bonds. It is probably more likely that Mr. Muto would implement the current asset purchase program more aggressively, for example by extending the maximum maturity of JGBs that the BoJ purchases and/or purchasing more risky assets. While these measures are unlikely to have an immediate strong impact on the economy and prices, the meaningful shift by the BoJ may gradually change the general external perceptions about the BoJ.

Figure 37. Japan — Economic Forecasts, 2012-14F

					2012		2013				2014	
		2012F	2013F	2014F	3Q	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	1.6%	0.7%	0.7%	0.2%	0.1%	-0.7%	-0.2%	1.4%	2.3%	2.8%	0.4%
	SAAR				-3.5	-1.4	1.8	2.4	3.1	2.0	3.5	-6.8
Domestic Demand	YoY	2.3	1.0	0.4	1.6	0.8	0.0	0.4	1.4	2.2	2.7	-0.1
	SAAR				-0.8	-0.8	0.9	2.2	3.2	2.7	2.6	-8.2
Private Consumption	YoY	2.1	0.6	0.7	1.1	0.3	-0.6	0.0	1.0	2.0	3.0	-0.1
	SAAR				-1.8	-1.2	1.0	2.1	2.1	3.0	4.8	-9.7
Business Investment	YoY	1.1	0.1	2.6	0.7	-4.5	-2.9	-3.1	2.3	4.2	5.0	3.7
	SAAR				-12.1	-1.6	-0.9	2.9	9.0	5.9	2.4	-2.3
Housing Investment	YoY	1.9	9.3	-7.3	1.2	2.0	6.6	8.4	10.8	11.3	4.7	-6.4
Public Investment	YoY	9.0	-0.4	-8.6	10.6	13.0	6.5	1.5	-3.2	-5.8	-6.5	-10.0
Exports	YoY	0.4	-1.3	3.5	-4.9	-3.1	-4.8	-5.0	1.0	4.1	3.7	3.5
	SAAR				-18.7	-9.7	6.3	4.5	3.8	1.9	4.6	3.7
Imports	YoY	5.5	0.7	1.2	4.7	2.0	-0.2	-1.1	0.5	3.8	3.2	0.9
	SAAR				-1.4	-6.5	0.4	3.2	5.1	6.4	-1.7	-5.6
CPI	YoY	0.0	-0.3	1.6	-0.3	-0.2	-0.7	-0.4	-0.1	0.0	0.0	2.1
Core CPI	YoY	-0.1	-0.1	1.7	-0.2	-0.1	-0.2	-0.2	-0.1	0.0	0.0	2.1
Nominal GDP	YoY	0.7	0.2	1.5	-0.6	-0.5	-1.4	-0.8	0.9	1.9	2.5	1.4
Current Account	¥ tn	4.7	5.0	7.9	3.7	3.2	4.4	5.1	5.3	5.0	6.5	8.2
	% of GDP	1.0	1.1	1.6	0.8	0.7	0.9	1.1	1.1	1.1	1.4	1.7
Unemployment Rate	%	4.4	4.3	4.3	4.2	4.3	4.4	4.3	4.2	4.2	4.2	4.3
Industrial Production	YoY	-1.4	-2.6	2.4	-4.6	-8.6	-8.1	-5.7	-0.8	5.0	4.6	2.3
Corporate Profits (Fiscal Year)	YoY	3.0	15.0	-9.0								
General Govt. Balance (Fiscal Year)	% of GDP	-10.7	-8.1	-6.6								
General Govt Debt	% of GDP	237	243	244								

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

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Euro Area

We expect the euro area to remain in recession in 2013 (-0.7%) and 2014 (-0.4%). The contraction will be deeper in the periphery countries than the core/ soft-core countries, but even the members of the latter group will at least flirt with recession. While there are differences in the weighting of the sources of economic weakness, in most cases it is a combination of private sector deleveraging, austerity measures and tight financing conditions producing an undershooting of the already-low growth potential. In addition, the ongoing risk of a euro area break-up — which has been substantially reduced by the ECB's OMT programme announcement — will undermine economic activity in the periphery countries. As we expect that Greece will leave the euro with a probability of 60% within the next 12 to 18 months, probably in early 2014, our economic forecast for the euro area from 2014 onwards excludes Greece. While we expect Grexit to happen (maybe followed by an exit by Cyprus) we do not foresee a broad break-up of the Euro area, because we expect governments and the ECB to put in place measures to contain its contagion (see EMU Crisis Outlook, page 11).

Area-wide debt reduction only through Grexit and debt restructurings

In early 2013 weaker economic data than currently projected by governments are likely to raise doubts on government fiscal targets and we expect that most countries will fail to meet the requirements currently set by the Excessive Deficit Procedure (EDP). With a stronger focus on structural rather than headline deficits, the EDP targets probably will be amended and therefore we do not expect additional large rounds of austerity for 2013, maybe with the exception of Spain where even reaching the structural deficit target is questionable. However, with the exception of Germany, there seems to be little room for fiscal easing in 2013 and we do not expect that already planned fiscal tightening will be withdrawn. In our view, a crucial factor is that policy makers are unlikely to change their assessment that more fiscal tightening is necessary. Therefore additional gradual austerity measures are in the pipeline for 2014 and beyond. In this environment, we expect a reduction of the area wide deficit-to-GDP ratio from 3.3% in 2012 to 2.9% in 2013 and 2.4% in 2014. This would be substantially smaller than the pace of deficit reduction in the previous two years, when the deficit-to-GDP ratio fell by 2.9 points. We forecast a further increase of the area wide debt-to-GDP from 94.5% in 2012 to 97.5% 2013. If Greece stayed in the euro area in 2014 and without sovereign debt restructurings in Portugal, the debt-to GDP ratio would reach 100% in 2014. From 2015 onwards some debt restructuring in Spain, Italy and Ireland (mainly in form of maturity extension and a reduction of coupons by around 150 basis points) will probably help to lead to a reduction in the euro area 2015 deficit-to-GDP ratio to 1.5% and a decline in the debt ratio from 95.7% of GDP in 2014 to 95.0% in 2015 down to 91.4% in 2017.

Limited use of the OMT in 2013

With future sovereign debt restructurings, in most cases probably coming together with bank restructuring (Slovenia and Cyprus might see only the latter) spreads of public and private sector funding costs will remain large between periphery and core countries. While the ECB's OMT programme will likely keep sovereign bond spreads in a range of up to 300bp relative to Bunds, we doubt that the ECB will use it to force a narrowing of spreads below 100bp. In our view, there is no chance that the ECB will use the OMT programme for a country that is not under an ESM/EFSF programme. Therefore, we expect that, after facing increasing market pressure, first Spain, and then Italy, will ask for ESM programmes in the form of an Enhanced Conditions Credit Line (ECCL). As market participants will probably not be keen to *"fight the ECB"* at the beginning of the programme, the OMT purchases should be relatively small in 2013. With only Spain and Italy qualifying for the OMT in 2013, maybe joined by Ireland at the end of the year, we expect total OMT purchases in a range between €100bn and €200bn, maybe even lower. This suggests that with a likely use of the repayment option of the 3Y LTROs — which we expect to be around €200bn — the ECB's balance sheet of currently €3.03trn (32% of GDP) is likely to move sideways in 2013.

The initial positive effects on government bond markets from the activation of the OMT in early 2013 are likely to prevent an escalation of the liquidity squeeze among banks at least in 1H 2013, despite some disappointment of market participants in respect of the speed of the implementation of the single supervision mechanism (SSM) and the strength of the banking union. While the ECB will remain ready to step in with an easing of collateral rules and additional multi-year (probably for 3 years) LTROs to prevent liquidity shortages in the banking sector, it probably will take until early 2014 (when Grexit is likely to happen) for the ECB to engage in further rounds of LTROs.

Further ECB rate cuts to come

We expect the ECB to cut interest rates further, as it is likely to become more obvious to the General Council that inflation will undershoot the inflation target of "*close, but below to 2%"* in the medium term. We expect a 25bp cut of the refi rate in 1Q 2013, followed by a second refi rate cut, which will be probably come in combination with a cut of the deposit rate by 25bp (to -0.25%) in mid 2013. With more possibilities for the banks to reduce excess liquidity (option to repay 3Y LTRO funding) the ECB probably will use the negative deposit rate to increase the pressure on banks to "use" the available liquidity. In addition, following the successful example of Denmark, the ECB might use a negative deposit rate to reduce upside pressure on the currency. The alternative to limiting upside pressure on the currency would be a Fed-like verbal intervention, by committing to keep interest rates low for a prolonged period of time. Such a policy does not look very likely for the ECB, in our view, because it would take away its ability to react quickly to a surprising increase of inflation risks. However, in a likely backdrop of low growth and low inflation, we see no interest rate hikes until 2016/17.

We publish further details of our European forecasts monthly in European Economic Forecast Highlights

Figure 38. Euro Area — Economic Forecasts, 2012-14F

					2012F		2013F				2014F	
		2012F	2013F	2014F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-0.4%	-0.7%	-0.4%	-0.6%	-0.7%	-0.9%	-0.7%	-0.6%	-0.2%	-0.3%	-0.4%
	SAAR				-0.3	-1.7	-0.7	0.0	0.1	-0.2	-1.2	-0.4
Final Domestic Demand	YoY	-1.4	-1.1	-0.5	-1.6	-1.6	-1.5	-1.2	-1.0	-0.7	-0.8	-0.7
Private Consumption	YoY	-1.1	-0.9	-0.2	-1.3	-1.1	-1.1	-0.9	-0.8	-0.6	-0.5	-0.4
Government Consumption	YoY	-0.2	-0.9	-0.5	-0.1	-0.6	-0.9	-1.1	-0.9	-0.6	-0.6	-0.5
Fixed Investment	YoY	-3.6	-2.1	-1.4	-4.1	-4.2	-3.4	-2.2	-1.6	-1.2	-1.6	-1.6
— Business Equipment	YoY	-3.1	-2.1	-2.4	-3.6	-3.7	-2.8	-2.0	-2.1	-1.4	-2.4	-2.7
— Construction	YoY	-3.9	-1.9	-0.5	-3.8	-4.1	-3.1	-1.7	-1.4	-1.3	-1.1	-0.8
Stocks (Contrib. to Y/Y GDP Growth)		-0.4	-0.1	-0.1	-0.5	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
Exports	YoY	2.7	1.5	0.7	2.4	2.3	1.9	1.1	1.2	1.7	1.1	0.6
Imports	YoY	-0.5	0.2	0.2	-1.0	0.2	0.3	-0.1	0.1	0.3	0.0	-0.2
CPI	YoY	2.6	2.0	1.5	2.5	2.5	2.0	2.1	2.0	1.7	1.6	1.5
Core CPI	YoY	1.6	1.3	1.1	1.6	1.7	1.3	1.4	1.4	1.1	1.1	1.1
CPI Ex Energy and Food	YoY	1.8	1.4	1.2	1.7	1.8	1.4	1.6	1.5	1.2	1.8	-0.3
Unemployment Rate	YoY	11.3	11.9	12.2	11.5	11.7	11.7	11.8	11.9	12.0	12.1	12.2
Current Account Balance	EUR bn	89.1	118.9	122.5								
	% of GDP	0.9	1.2	1.3								
General Government Balance	EUR bn	-314.3	-276.3	-237.4								
	% of GDP	-3.3	-2.9	-2.4								
Primary Balance	% of GDP	0.0	0.5	0.8								
General Government Debt	EUR bn	8,977.9	9,342.9	9,277.9								
	% of GDP	94.5	97.5	95.7								
Gross Operating Surplus	YoY	-0.4	-0.5	0.1								

Sources: Eurostat and Citi Research forecasts

Germany

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With manufacturing suffering from weak external demand, the German economy is likely to enter a period of weak growth, with a risk of slipping into recession around the turn of 2012/13. However, resilient domestic demand, supported by historically low funding costs and low private debts, is likely to prevent a sharp economic downturn. We expect that fiscal easing of between ¼% and ½% of GDP will also help stabilize growth. Political stalemate is likely before the general election, which is due in autumn (probably September) 2013. In our view, it looks unlikely that the current CDU/CSU and FDP coalition will be re-elected, but Angela Merkel probably will stay as Chancellor, most likely of a grand-coalition of CDU/CSU and SPD.

France

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Investors have been worried for some time about the French economy, wondering whether greater reliance on tax increases than expenditure cuts to close the budget gap would threaten the already-fragile GDP baseline. The evidence to date suggests that France has narrowly avoided falling back into recession, with a 0.2% QQ gain in 3Q GDP. Nevertheless, we continue to see downside risks to economic activity in 2013, and forecast a mild recession of 0.2% as the government's fiscal tightening strategy will have negative consequences on GDP. However, the government is taking clear steps to tackle some of its structural issues, having announced a National Pact for Growth, Competitiveness and Employment. We view this as a positive development, confirming that France is finally undertaking some of the necessary reforms that should over time help to lift potential growth.

Italy

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The recession is likely to continue in the next couple of years, reflecting fiscal tightening (albeit smaller than in 2012), tight credit conditions and high uncertainty. Political uncertainty will probably rise ahead of the general election in spring 2013, with fears that the new government will be less committed to austerity and reforms than the current Monti-led administration. Italy's primary surplus probably will be close to 3% of GDP by end-2013, but the debt-to-GDP ratio is likely to go on rising due to the "snowball effect". Grexit and further sovereign debt restructurings in the eurozone periphery will intensify headwinds to growth in 2014. We expect Italy will enter into an OMT/ESM financial support programme in 2013 which will cap financing costs. However, debt restructuring — probably through maturity extensions and coupon reductions — will probably be inevitable in 2015, once it becomes clear that austerity alone cannot restore fiscal sustainability.

Figure 39. Germany, France and Italy — Economic Forecasts, 2012-14F

		Germany			France			Italy		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	0.9%	0.5%	0.3%	0.1%	-0.2%	0.2%	-2.1%	-1.2%	-1.5%
Final Domestic Demand	YoY	0.7	1.2	1.2	0.4	-0.1	0.2	-3.9	-2.7	-2.3
Private Consumption	YoY	0.9	1.2	0.7	0.0	-0.1	0.1	-3.7	-2.8	-1.4
Fixed Investment	YoY	-0.3	1.9	2.8	0.4	-0.6	0.4	-8.0	-4.9	-7.5
Exports	YoY	4.1	0.7	1.3	2.5	1.4	0.6	1.4	1.4	-1.9
Imports	YoY	2.8	1.7	2.6	0.1	0.6	0.6	-7.9	-3.9	-5.2
CPI	YoY	2.0	1.9	2.5	2.3	1.5	1.8	3.3	1.8	1.2
Unemployment Rate	%	5.5	5.8	6.0	9.8	10.3	10.0	10.7	11.9	12.4
Current Account	€bn	162.2	133.3	112.1	-37.1	-20.5	-4.9	-19.7	-14.1	-10.2
	% of GDP	6.1	5.0	4.1	-1.8	-1.0	-0.2	-1.3	-0.9	-0.7
General Govt. Balance	€bn	-1.0	-9.4	-13.7	-87.1	-77.4	-63.9	-47.7	-41.2	-40.4
	% of GDP	0.0	-0.3	-0.5	-4.3	-3.7	-3.0	-3.0	-2.6	-2.6
Primary Balance	% of GDP	2.0	1.1	0.6	-2.1	-1.4	-0.6	2.2	2.7	2.9
General Govt. Debt	% of GDP	84.0	82.7	82.2	91.0	95.2	96.7	126.5	129.7	133.5
Gross Trading Profits	YoY	1.0	-2.4	-2.9	1.0	2.0	4.0	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, Haver and Citi Research forecasts

Spain

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With thanks to Deimante Kupciuniene

We keep our GDP growth forecasts for 2012-14 virtually unchanged at -1.5% (2012), -2.4% (2013) and -1.9% (2014). Popular pressures to provide homeowners with mortgage relief and fading willingness of EA creditor countries to mutualise legacy bank liabilities lead us to assume an additional €60bn (6% of GDP) in bank bail-outs by the sovereign in 2014. We continue to expect Spain to enter a precautionary ESM programme (with OMT support) soon, but do not expect it to succeed in returning Spain to fiscal sustainability and expect some form of debt restructuring in 2015, via coupon reductions and maturity lengthening.

Greece

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With ongoing recession, the 2012 fiscal deficit target (6.6% of GDP) is likely to be missed, despite savings from PSI. The disbursement of the latest bailout tranche remains uncertain, leaving some risks of Grexit near term. Even if the tranche is paid and creditors provide Greece with liquidity for a few more quarters, Greece will remain insolvent, in our view, unless there is major restructuring on official debt (unlikely, we believe). We see a 60% probability that Greece decides (or is "gently" forced) to leave EMU in the next 12-18 months. We expect that the immediate aftermath of Grexit will see further economic weakness and surging inflation.

Ireland

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Ireland's economic and fiscal prospects remain weak, in our view. Domestic demand and employment have fallen for five consecutive years, while — even after relentless austerity — the European Commission judges that the structural fiscal deficit is still 7-8% of GDP. We expect that — on current policies — the debt/GDP ratio will peak above 120% and still exceed 110% even in 2020 (a debt/GNP ratio of 130-140%). With a high debt ratio and acute vulnerability to external shocks, we expect that Ireland will need external support for many years. We assume that the coupon payments on the promissory notes will be halved in 2013, no transfer of bank recapitalisation costs to the ESM, and eventual sovereign debt restructuring (coupon reductions and maturity extensions) in 2015 to cut the fiscal deficit further.

Portugal

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With heavy fiscal tightening — worth 3.2% of GDP in 2013, including more tax hikes — plus high private debts, 2013 probably will be another year of deep recession. This will likely lead to a further deficit overshoot. We expect Portugal will probably need additional external support by the end of 2013/early 2014, when the current programme nears its end. Like Greece, this will likely prompt requests for a haircut on the sovereign debt in order to limit the exposure of official creditors. The re-balancing of the economy has only just started, we reckon, and it will take a few more years to complete.

Figure 40. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2012-14F

		Spain			Greece			Ireland			Portugal		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.5%	-2.4%	-1.9%	-7.2%	-7.4%	-11.8%	-0.1%	0.4%	1.0%	-3.3%	-4.6%	-2.4%
Final Domestic Demand	YoY	-3.9	-4.6	-3.4	-9.2	-8.6	-13.1	-3.6	-3.7	-1.6	-7.3	-6.0	-3.1
Private Consumption	YoY	-1.8	-2.7	-1.6	-8.2	-7.4	-14.5	-2.5	-2.3	-1.5	-6.2	-5.5	-1.0
Fixed Investment	YoY	-8.9	-7.7	-7.3	-17.8	-15.4	-22.3	-7.1	-9.9	1.5	-15.2	-10.7	-10.7
Exports	YoY	3.7	6.2	0.3	-1.5	0.0	-9.3	2.7	3.1	3.1	4.5	1.2	-0.9
Imports	YoY	-3.9	-0.5	-4.3	-7.5	-5.9	-14.1	-0.6	0.8	1.2	-6.3	-2.9	-3.2
CPI	YoY	2.4	1.9	0.4	1.0	0.3	16.7	1.7	1.2	1.4	2.8	1.7	0.9
Unemployment Rate	%	25.0	26.6	27.4	24.6	29.7	35.9	15.1	16.2	16.9	15.5	18.0	19.9
Current Account	€bn	-16.1	13.6	30.3	-8.7	-6.2	3.8	8.0	10.8	11.8	-6.2	-2.3	-1.7
	% of GDP	-1.5	1.3	3.0	-4.5	-3.5	2.0	5.0	6.6	7.0	-3.7	-1.4	-1.0
General Govt. Balance	€bn	-85.8	-66.5	-59.8	-15.4	-12.9	-1.1	-13.5	-12.9	-9.2	-8.3	-8.1	-6.9
	% of GDP	-8.2	-6.4	-5.8	-8.0	-6.7	-1.5	-8.3	-7.9	-5.5	-5.0	-5.0	-4.3
Primary Balance	% of GDP	-4.1	-2.6	-1.6	-2.3	-1.5	-1.5	-4.3	-2.6	-0.4	-0.5	-0.2	0.0
General Govt. Debt	% of GDP	87.9	97.5	110.0	178.0	192.8	453.2	117.8	120.9	122.1	121.1	132.2	105.1

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: ISTAT, INE, Haver Analytics, Eurostat and Citi Research forecasts

Netherlands

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The coalition of PM Mark Rutte's centre-right VVD and the centre-left PdL agreed on extra fiscal tightening worth about 2½% of GDP for the period 2013-17. Trying to reduce income inequality, the tightening is biased to high-income households. Tax deductibility of mortgage interest payments will be reduced from 2014 onwards. We expect that household deleveraging — which has barely started — will be a headwind for GDP growth in 2013 and beyond. With a likely contraction in GDP in 2013, we doubt that the government will be able to reduce the deficit to a ratio below 3% of GDP as required under the EDP.

Belgium

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Prospects for the Belgian economy will remain challenging in 2013. Because of its high openness, the economy is sensitive to external demand (particularly from other EMU countries) for its intermediate goods exports. With less fiscal tightening than, for example, France or the Netherlands during 2013, we anticipate that domestic demand will recover marginally, helping limit the contraction in GDP to 0.3% in 2013. The main risk to the already elevated debt numbers continues to be related to the size of the contingent liabilities extended to the banking sector.

Slovakia

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GDP increased by 0.6%QoQ in 3Q12 as we expected, still driven by car production, while there was a downward revision in previous quarters. We expect a larger deceleration to 2.1%YoY in 4Q12 (0.4%QoQ) owing to weaker export and industrial activity. As a result we cut our GDP growth estimates in 2012-2014. Although the government has both solid financing and budget reserves, the deficit is likely to slightly exceed 3% of GDP in 2013. We expect more cuts in the social and health care systems in the future to keep the consolidation on track.

Slovenia

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Market optimism after the MinFin tapped for USD2.25bn was impaired by referendum woes. While the 35-day period to collect 40k signatures to evoke a referendum on the Bad Bank started on 19 November, the government will ask the Constitutional Court for its review. If the Bad Bank law is not put in place, Slovenia is likely to be closer to ask for help from the ESM. The National Assembly approved the government proposal of tax, pension and labour market reforms in the first reading; however, the legislative process in the National Assembly is not yet finished. Previous PM Borut Pahor and current President Danilo Turk proceeded to the second round of the Presidential election, which will take place on 2 December.

Figure 41. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2012-2014F

		Netherlands			Belgium			Slovakia			Slovenia		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.1%	-0.9%	0.2%	-0.2%	-0.3%	0.3%	2.5%	1.3%	1.7%	-2.0%	-1.6%	-0.5%
Final Domestic Demand	YoY	-1.6	-1.2	0.0	-0.3	0.2	0.6	-0.2	0.6	1.2	-3.5	-3.4	-0.6
Public Consumption	YoY	0.5	0.1	0.0	0.2	0.0	0.3	-0.5	-0.8	0.2	-2.9	-5.3	-1.0
Private Consumption	YoY	-1.6	-1.5	0.1	-0.5	0.1	0.5	-0.2	0.2	0.5	-1.9	-2.7	-0.8
Investment (Ex Stocks)	YoY	-5.0	-2.5	-0.2	-0.1	0.5	1.4	-0.3	2.3	3.3	-8.2	-3.6	0.0
Exports	YoY	2.5	0.5	0.8	-0.6	0.8	1.1	7.9	2.1	2.8	1.4	-0.2	0.1
Imports	YoY	2.2	-0.2	0.5	-0.8	0.9	1.4	4.5	1.6	2.3	-2.9	-3.3	1.0
CPI (Average)	YoY	2.6	2.8	1.7	2.9	1.9	1.9	3.7	3.0	2.5	2.7	3.0	2.5
Unemployment Rate	%	6.2	6.9	7.0	7.4	7.8	7.4	13.4	13.8	14.0	8.5	9.3	10.3
Current Account	% of GDP	10.1	9.6	8.7	-0.7	0.3	0.9	2.5	1.9	1.8	1.7	1.9	2.3
General Govt Balance	% of GDP	-3.8	-3.4	-3.7	-2.8	-2.7	-2.1	-4.9	-3.1	-2.9	-4.2	-3.3	-2.8
Primary Balance	% of GDP	-2.2	-2.1	-2.1	-0.3	0.3	1.0	-3.4	-1.6	-1.4	-2.1	-1.1	-0.5
General Govt Debt	% of GDP	69.6	72.2	74.6	109.9	116.0	115.8	52.1	54.5	55.4	52.9	57.1	60.5

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

UK

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The economy continues to underperform versus consensus, official forecasts and recent cycles. The technical rebound in GDP in Q3 appears to have given way to zero or negative growth in Q4. For 2012 as a whole, growth was around zero, well below the start of year consensus (0.5%), making the fourth year in the last five with sub-consensus growth. We expect another undershoot in 2013, with growth of about 0.8% versus the 1.2% consensus. The economy faces powerful headwinds from private deleveraging, poor credit availability, heavy fiscal drag, the EMU crisis and the bias among companies to allocate new investment overseas. We expect that real GDP will not regain the prerecession peak (Q1-2008) until 2016. Real GDP per head probably will remain below its peak (Q4-2007) even at the end of this decade (ie Q4-2019). Inflation will remain sticky near term, reflecting increases in external costs and university tuition fees. However, we believe that medium-term risks are firmly tilted to an inflation undershoot, given the sluggish economy. As a result, we continue to expect some modest further increase in QE over time.

In the Autumn Statement (Dec 5), the Chancellor is likely to confirm that the weakness of nominal GDP growth has caused tax revenues to undershoot the OBR forecasts by 1-2% this year, with a further undershoot likely in 2013 and beyond. The Chancellor is likely to go ahead with the existing fiscal plans, which imply heavy drag — of about 1½% of GDP — in both 2013 and 2014. However, contrary to our fears last month, we no longer expect the Chancellor will have to scrap the debt target. Indeed, he may well extend the debt target, announcing a new target of lower debt beyond 2015. The key point is that the OBR will probably project that the UK remains on course to hit the debt target, despite weak revenues, because of downward revisions to debt service payments (reflecting lower gilt yields and a lower path for future RPI inflation) and the transfer of the APF's net interest income to the Treasury's accounts.

Figure 42. United Kingdom — Economic Forecasts, 2012-2014F

					2012F		2013F				2014F	
		2012F	2013F	2014F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-0.1%	0.8%	1.0%	-0.1%	0.2%	0.8%	1.3%	0.5%	0.8%	0.9%	0.9%
	SAAR				4.0	-0.4	1.1	0.7	0.5	0.9	1.7	0.5
Domestic Demand	YoY	0.4	0.1	0.8	0.2	0.5	0.5	0.0	-0.3	0.4	0.6	0.8
(Incl. Inventories)	SAAR				1.6	-1.6	0.3	-0.2	0.4	1.2	1.1	0.4
Consumption	YoY	0.7	0.9	1.3	1.3	1.3	1.1	1.4	0.6	0.5	0.8	1.1
	SAAR				4.1	0.7	0.5	0.5	0.5	0.6	1.6	1.7
Investment	YoY	0.3	-3.1	-1.6	-1.7	-0.4	-1.8	-4.0	-3.0	-3.6	-3.9	-0.6
	SAAR				-5.5	2.6	7.1	-18.4	-1.2	-0.1	6.0	-6.7
Exports	YoY	0.6	4.1	4.7	2.2	0.7	3.4	5.4	4.3	3.5	4.3	4.2
	SAAR				7.9	6.0	4.1	3.6	3.5	2.8	7.2	3.5
Imports	YoY	2.4	1.9	4.0	3.1	1.8	2.3	1.1	1.7	2.2	3.1	3.8
	SAAR				0.7	1.7	1.5	0.7	3.0	3.7	5.1	3.2
Unemployment Rate	%	8.0	7.8	7.6	7.8	8.0	8.0	7.8	7.8	7.7	7.6	7.6
CPI Inflation	YoY	2.8	2.5	2.1	2.4	2.6	2.5	2.6	2.6	2.3	2.2	2.1
Merch. Trade	£bn	-99.8	-86.9	-84.8								
	% of GDP	-6.4	-5.4	-5.1								
Current Account	£bn	-60.4	-40.4	-35.7								
	% of GDP	-3.9	-2.5	-2.2								
PSNB	£bn FY	-86.1	-73.5	-90.8								
	% of GDP	-5.5	-4.5	-5.5								
General Govt. Balance	% of GDP	-5.9	-5.0	-5.9								
Government Primary Balance		-3.3	-4.0	-3.1								
Public Debt	% of GDP	88.0	92.0	96.4								
Gross Nonoil Trading Profits	YoY	6.4	8.8	3.5								

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

Switzerland

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The Swiss economy has slowed in 2012, but continues to outperform the euro area — as it has done every year since 2004. Exports slowed during 2012, hit by EMU weakness, but this has been largely offset by a pick up in consumer spending — supported by solid gains in employment and house prices. We expect the Swiss economy will continue to outperform in coming years. Household debt remains quite low, offering continued traction from low interest rates, while exports are underpinned by high exposure to emerging markets. External uncertainties probably will sustain inflows to Swiss assets at a high pace, keeping inflation negative or low and hence allowing the SNB to keep interest rates ultra-low for many years.

Sweden

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Earlier signs of Swedish resilience have now been reversed, but supportive economic policies suggest that a recession in Sweden should be avoided; fiscal policy will add stimulus of 0.6% of GDP next year and we expect expansion of an equivalent size in 2014. The Riksbank's policy rate stands near historically low levels and is likely to fall further heading into 2013. Being a small open economy, a major risk clearly relates to external demand prospects, especially from Western Europe.

Denmark

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The Danish economy is expected gradually to return to the growth track next year, supported by households' large pent-up potential (which gradually should boost consumer spending), a delayed positive contribution from public sector consumption and investment and improved competitiveness. Risks, however, are substantial and tilted to the downside, and the Danish economy is unlikely to get back to pre-crisis output levels during the forecast period.

Norway

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Norway will likely suffer a bit from the slowdown across advanced economies, but the cushion of high oil receipts should ensure that the economy continues to outpace most other European economies, and mainland GDP is seen above its long-term average in coming years. Underlying inflation remains low and, with the currency still strong, Norges Bank can afford to keep interest rates stable and see how the EMU crisis unfolds. Global slowdown or lower international policy rates will put a limit on how rapidly the Bank can tighten monetary policy ahead, but is unlikely to change the Bank's tightening bias.

Figure 43. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2012-2014F

		Switzerland			Sweden			Denmark			Norway		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	1.1%	0.9%	0.6%	1.0%	1.6%	2.3%	0.1%	1.0%	1.7%	3.4%	3.1%	2.7%
Final Domestic Demand	YoY	2.2	0.7	0.8	1.7	1.6	2.0	0.8	1.3	1.6	2.8	3.6	3.1
Public Consumption	YoY	2.1	1.5	1.4	0.9	1.1	0.8	0.2	0.8	0.6	1.9	2.5	2.3
Private Consumption	YoY	2.3	0.5	1.9	1.5	1.7	2.2	0.7	1.2	1.7	3.2	3.5	3.1
Investment (Ex Stocks)	YoY	1.9	0.9	-2.5	3.5	1.8	3.4	2.2	2.4	2.9	3.1	5.7	4.2
Exports	YoY	0.7	2.5	0.9	0.5	2.7	3.6	2.3	2.6	3.1	2.9	2.7	2.9
Imports	YoY	1.9	1.4	1.3	0.0	2.3	3.2	2.7	2.9	3.1	5.0	3.0	2.5
CPI (Average)	YoY	-0.7	-1.4	-0.9	0.9	0.6	1.7	2.5	2.0	2.1	0.8	1.7	2.0
Unemployment Rate	%	3.2	3.5	4.2	7.6	7.8	7.9	7.8	7.8	7.6	3.0	3.1	3.1
Current Account	% of GDP	12.7	13.1	13.0	6.6	6.6	6.3	5.4	5.4	4.4	14.3	14.9	15.2
General Govt Balance	% of GDP	0.6	0.4	0.3	-0.3	-0.9	-0.3	-3.8	-2.0	-1.2	13.2	14.0	13.7
General Govt Debt	% of GDP	46.6	45.5	44.1	36.6	36.7	35.6	49.1	49.7	49.0	NA	NA	NA

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

Canada

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Canada remains embroiled in a tug-of-war between domestic strength and external weakness. Financial conditions are robust and the economy continues to be fueled by consumer spending, business investment and inventories. But outsized housing activity is moderating in the wake of additional curbs on mortgage lending, BoC moral suasion, and discouragement of potential homebuyers in expensive markets. Fiscal consolidation is still underway and net exports are weighing on growth.

Global forces are expected to continue to limit expansion, and output will remain modest over the medium term as a consequence. The economy is poised to expand by about 2% this year and next, and pick-up to 2¾% in 2014. Total and core consumer inflation should return to the Bank of Canada's 2% target in 2H 2013.

Risks to the inflation outlook are two-sided, but remain roughly in balance. Upside risks include faster global inflation, stronger Canadian exports amid reduced competitiveness constraints or stronger US demand, and unrelenting domestic housing exuberance. Downside risks are associated with the ongoing EA crisis, looming US Fiscal Cliff, moderating EM expansions, and Canadian consumer retrenchment caused by elevated debt levels and/or a rapid decline in home prices.

Externally focused downside risks and lingering uncertainties should keep the BoC on the sidelines at least through mid-2013. But, domestic strength and concern about household debt should prompt the central bank to retain its slightly hawkish policy tack. We anticipate 50 basis points of tightening of the overnight rate in the second half of 2013, lifting it from 1.00% presently to 1.50%. The pace of monetary policy normalization likely will be modest and protracted thereafter.

The government now anticipates return to a balanced budget one year later citing global forces, including lower commodity prices. Nonetheless, surplus, and a retreat of debt-to-GDP to a pre-crisis level in five years, remain its base-case scenario.

Figure 44. Canada — Economic Forecast, 2012-2014F

					2012F		2013F				2014F	
		2012F	2013F	2014F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	2.1%	2.1%	2.8%	1.7%	1.7%	1.8%	1.8%	2.3%	2.4%	2.6%	2.8%
	SAAR				1.0	2.2	1.9	2.2	2.7	2.9	2.7	3.0
Final Domestic Demand	YoY	1.8	2.2	2.6	1.9	1.9	2.0	2.2	2.2	2.4	2.5	2.6
	SAAR				2.4	1.8	2.2	2.3	2.6	2.7	2.5	2.5
Private Consumption	YoY	1.8	2.3	2.5	1.8	1.8	2.0	2.4	2.4	2.4	2.4	2.5
	SAAR				2.7	2.4	2.3	2.4	2.4	2.5	2.5	2.5
Government Spending	YoY	-0.9	1.2	1.4	-0.8	0.2	0.9	1.2	1.3	1.4	1.4	1.4
	SAAR				1.0	1.0	1.4	1.4	1.4	1.4	1.4	1.4
Private Fixed Investment	YoY	5.8	3.2	4.2	6.2	4.4	3.3	2.8	3.0	3.9	4.2	4.3
	SAAR				3.9	1.2	2.6	3.4	4.6	5.0	3.9	3.9
Exports	YoY	1.9	1.7	5.9	-1.0	-1.8	0.0	-0.2	3.0	4.2	5.1	6.0
	SAAR				-7.5	1.2	2.6	3.2	5.0	6.3	6.1	6.8
Imports	YoY	2.4	3.1	4.7	2.5	1.9	2.2	2.7	3.3	4.0	4.4	4.5
	SAAR				1.7	1.2	3.5	4.5	4.0	4.2	5.0	5.0
CPI	YoY	1.6	1.4	2.0	1.2	1.3	1.1	0.9	1.6	2.0	2.2	2.4
Core CPI	YoY	1.8	1.9	2.0	1.5	1.6	1.7	1.8	2.2	2.0	2.1	2.1
Unemployment Rate	%	7.3	7.1	6.7	7.3	7.4	7.2	7.1	7.1	7.0	6.9	6.6
Current Account Balance	C$bn	-73.7	-78.9	-71.7	-80.9	-82.5	-84.4	-77.1	-77.2	-76.8	-72.9	-69.5
	% of GDP	-4.1	-4.2	-3.7	-4.5	-4.5	-4.6	-4.2	-4.1	-4.0	-3.8	-3.6
Net Exports (Pct. Contrib.)		-0.2	-0.5	0.2	-3.0	0.0	-0.4	-0.5	0.2	0.5	0.2	0.4
Inventories (Pct. Contrib.)		0.5	0.3	-0.1	1.5	0.4	0.1	0.3	-0.1	-0.3	0.0	0.0
Budget Balance (Fiscal Year)	% of GDP	-1.4	-0.9	-0.4								
Federal Budget Debt	% of GDP	33.4	33.2	32.2								
General Govt. Debt	% of GDP	86.2	85.9	84.9								

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

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Australia

The economy faces a challenging year ahead. The once in a century boost to national income from the record terms of trade is past and household debt remains relatively high. The contribution to economic growth from mining and energy investment is likely to be about one-third of this year's contribution and the boost to non-mining sectors from the easing of monetary policy will take time to build momentum. Consumers are likely to maintain high levels of saving given the soft outlook for asset prices and wealth and the recovery in housing investment is likely to be constrained by the limited appetite for debt. Consequently, we expect economic growth to slow to around 3% in 2013 and for the unemployment rate to rise moderately. Despite the slowing in economic growth and low government debt, the government is committed to returning the budget to surplus. This may require further fiscal measures. The challenge of rebalancing the economy against a backdrop of deleveraging and global uncertainty likely will require some further easing of monetary policy, probably early in the new year.

New Zealand

Economic growth is likely to be domestically generated in 2013. The high exchange rate will limit the contribution from exports, while imports will be boosted by the necessary plant, materials and equipment to assist with the Canterbury rebuild. The reconstruction effort will help to keep housing investment growth strong and will promote some durables based consumption. That said, we expect the economy to grow below a trend rate. Other drivers of economic growth remain subdued. Households continue the deleveraging process and employment growth is likely to remain subdued, only lowering the unemployment rate by a small amount. The Government continues the process of returning the budget to a balanced state, meaning little positive fiscal stimulus to demand. In all of this, the RBNZ will maintain interest rates at a low setting, only seeking to begin lifting the OCR slowly in the second half of the year.

Figure 45. Australia and New Zealand — Economic Forecast, 2012-2014F

	Australia			New Zealand		
	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP[a]	3.7%	3.1%	3.1%	1.8%	2.2%	2.3%
Real GDP (4Q versus 4Q)	3.6	3.0	3.1	1.4	2.3	3.1
Real Final Domestic Demand	5.0	3.4	2.9	2.4	3.3	3.1
Consumption	4.0	2.9	3.2	1.8	2.6	2.1
Govt. Current & Capital Spending[b]	2.3	1.8	2.5	0.6	1.7	1.8
Housing Investment	-4.9	2.8	6.4	16.6	16.3	6.0
Business Investment[c]	15.7	6.9	1.1	4.0	4.6	6.7
Exports of Goods & Services	6.3	7.8	8.7	0.2	-1.5	1.0
Imports of Goods & Services	7.8	6.7	5.4	2.9	3.7	3.6
CPI	1.9	2.9	2.7	1.2	1.8	2.1
CPI (4Q versus 4Q)	2.8	2.5	2.8	1.6	2.1	2.1
Unemployment	5.3	5.6	5.8	7.0	6.6	6.0
Merch. Trade, BOP (Local Currency, bn)	-14.4	-28.5	-42.4	0.3	-2.2	-4.1
Current Account, (Local Currency, bn)	-56.1	-72.6	-91.1	-12.7	-18.6	-20.4
Percent of GDP	-3.8	-4.7	-5.5	-6.2	-8.7	-9.2
Budget Balance[d] (Local Currency, bn)	-44.4	1.1	2.2	-10.9	-6.9	-2.4
Percent of GDP	-3.0	0.1	0.1	-5.3	-3.2	-1.1
General Govt. Debt (% of GDP)[e]	29.0	28.9	27.4	38.9	38.4	41.8
Gross Trading Profits[f]	-3.7	4.3	5.2	NA	NA	NA

BOP Balance of payments basis. CPI Consumer Price Index. F Citigroup 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. [f]Company gross operating surplus. Sources: ABS, StatsNZ, NZIER and Citi Research forecasts

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Recent leadership reshuffle will likely reshape China's economy in the next 10 years. China just underwent the second orderly leadership transition in the history of the Communist Party of China, confirming that the decennial transfer of power is increasingly institutionalized. The number of members in the Standing Committee was reduced from nine to seven. In addition, Mr. XI Jinping is becoming the top leader of the party, the government and the military all at once, which should improve policy delivery. While five of the seven Standing Committee members will retire in five years, the top two members (Mr. XI Jinping and Mr. LI Keqiang) are expected to serve through 2022, joined by five new faces in 2017.

Longer-term challenges

The new leaders have set a new growth target, focused on improving household welfare going forward. The report approved by the recent national party congress aims at doubling 2010 GDP and per capital income of urban/rural households by 2020. The new leaders may accept lower potential growth, but may not pursue big bang reforms that promise to unleash long-term potential but can sacrifice growth significantly in the short run. In particular, the government may see 7% annual growth as a minimum acceptable growth rate, and required to double 2010 GDP by 2020.

In our base case scenario, the government will probably just achieve the growth target. By following sufficient reforms without introducing aggressive stimulus measures, we estimate that average GDP growth will reach roughly 7.1% during 2013-20, and 2020 GDP in real terms would be twice that of 2010. In case of external shocks which would threaten the achievement of the targets, the government may rely on stimulus measures to contain the downside risks. Achieving the household income target would require either faster GDP growth or significant income redistribution measures. We estimate that in 2020, China's nominal GDP may reach about US$20tn, or roughly US$15,000 per capita.

Substantial structural reforms will be needed to strengthen the growth potential. The new leaders are likely more pro-stability with only incremental reforms to sustain growth. In order to fulfill the growth targets, in our view, a reform agenda will have to be launched in the fall of 2013 to address the following issues: (1) making investment more efficient by normalizing the cost of capital through interest rate and exchange rate reforms, development of multi-tier capital markets and equal access to resources and markets by private capital; (2) promoting new growth drivers to balance between investment and consumption and service industries through urbanization and fiscal policy reforms; (3) encouraging innovations by introducing a more effective incentive system, including protection of intellectual property rights; (4) facilitating job creation by deregulating the service sector to absorb possible layoffs from the manufacturing sector that suffers from overcapacity.

A near-term mild rebound

The Central Economic Work Conference in mid-Dec will be hosted by the new leaders and shall voice their policy for 2013. It probably will keep the current macro policy mix, i.e., proactive fiscal policy and prudent monetary policy, to support a growth rebound. Although September and October data pointed to positive growth momentum, it is recognized that the foundation of growth still needs to be consolidated, and growth stabilization is likely the government’s short-term priority. Meanwhile, we do not expect fresh stimulus from the new leadership, especially when the growth target is within reach and the job market remains stable.

The government may set the 2013 growth target at 7%. While views are still divided, the majority of the policy makers appear to agree that China's potential GDP growth rate will fall into the 7-9% range in next five years, and faster growth supported by another stimulus or further loosening monetary policy would only be costly for future reforms. The official growth target for 2013 may be set at 7% (the minimum the government can accept) during the National People's Congress in March, with macro policies supportive of somewhat higher growth than the target.

The policy stance will probably gradually return to neutral amid strong investment growth. Even without stimulus from the central government, local governments would be obsessed with initiating new projects and exploring ways to finance them. The policy may be normalized by shifting from an easing bias to a neutral position amid possible inflation rebound. We expect the government to reduce the budget deficit (according to our definition) to 2.0% of GDP in 2013. The PBOC may set broad money growth target at 13%, and keep RMB new lending at 8.5-9.0tn. Based on our assessment of the BOP and assumption on open market operations, we think 3-5 RRR cuts would be necessary in 2013 to ensure an adequate liquidity condition. RMB may continue to appreciate gradually against the USD and reach 6.15 at end-2013. Benchmark interest rates will likely be raised by 25bps in late 2013 due to rising inflation, but the PBOC may instead increase the floating range.

Reform measures that have started and planned this year are expected to be implemented. In the next 12 months, resource price reform may be expanded from electricity to coal, gas and water. Deposit insurance is likely to be introduced. Interest rate and exchange rate flexibility may be further increased. Barriers to long-term capital flows will likely be further reduced. We may see more tax cuts for small business, introduction of VAT for service industries in more regions, and an expansion of the pilot reform of the property tax.

We expect that growth will reach about 7.8% in 2013. The current growth rebound probably will last into 1H next year, due to lagged effects of policy easing of 2012 and supported by the investment impulse of local governments. As the policy stance returns to neutral and external demand is expected to remain sluggish, growth may decelerate again in 2H, flirting with 7% in early 2014.

Figure 46. China — Economic Forecasts, 2012-2014F

					2012F		2013F				2014F	
		2012F	2013F	2014F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	7.7%	7.8%	7.3%	7.4%	7.8%	8.0%	8.2%	7.7%	7.5%	6.9%	7.1%
Real Final Domestic Demand	YoY	8.4	8.4	7.8								
Consumption	YoY	8.6	8.7	8.4								
Fixed Capital Formation	YoY	8.3	8.1	7.3								
Industrial Production	YoY	10.0	10.1	9.3	9.1	10.0	10.3	10.5	9.8	9.6	8.8	9.2
Exports	YoY	7.5	6.8	11.2	4.5	7.8	6.0	9.0	7.0	5.0	8.0	10.0
Imports	YoY	5.5	9.2	13.1	1.4	7.4	9.0	12.0	9.0	7.0	10.0	12.0
Merchandise Trade Balance	$bn	202	171	152	79	54	-13	61	76	47	-23	57
FX Reserves	$bn	3,341	3,517	3,603	3,290	3,341	3,328	3,389	3,465	3,517	3,475	3,517
Current Account	% of GDP	2.5	2.0	1.5								
Fiscal Balance	% of GDP	-2.4	-2.0	-2.0								
General Govt. Debt*	% of GDP	43.6	42.5	40.8								
Urban Unemployment Rate	%	4.1	4.1	4.2	4.1	4.1	4.1	4.1	4.1	4.1	4.2	4.2
CPI	YoY	2.7	2.8	3.6	1.9	2.1	2.3	2.5	2.9	3.5	3.5	3.5
Exchange Rate (end period)	CNY/$	6.21	6.12	6.05	6.28	6.21	6.18	6.16	6.14	6.12	6.10	6.08
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	3.50

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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2012 was a year of two halves, with the despair seen in 1H reversed to optimism, following a slew of government measures post September. However, while the current reforms led to a revival in investor sentiment and "bought" time to avoid a rating downgrade, implementation of measures is important. Key steps to help speed up growth would be setting up the National Investment Board, and addressing execution-related obstacles in power, coal, gas, land and environment. Until there is further action on the above, we are maintaining our 5.4% GDP estimate for FY13 and 6.2% in FY14.

2013 is thus a crucial year for the economy (1) Economically - will the economy respond to recent measures and (2) Politically — will the govt be able to pass legislation given its minority status; will a pre-election year take its toll on the fiscal position? On the fiscal outlook, accounting for expenditure and revenue slippages, we maintain our view of the FY13 deficit coming in at 5.9% of GDP vs. the govt's target of 5.1%. Recent initiatives towards fiscal consolidation include (1) Setting up a platform for cash transfers and (2) Focusing on implementing GST by March 13. Going forward, taking into account that FY14 will be a pre-election year, implementation of the above is one of the key factors that could help India avert a sovereign rating downgrade and help the government peg a lower deficit of 5.5% in FY14.

A combination of cyclical and structural factors has resulted in inflation remaining well above the RBI's comfort zone of 4%-5% over the last three years, with the latest reading of the WPI and CPI at 7.5% and 9.7%, respectively. Going forward, given the downtrend in commodity prices and a stable rupee, we expect inflation to moderate to ~7% levels. Thus, despite growth coming off sharply from ~8% levels to 5.4% in FY13E, sticky inflation leaves little room for much monetary easing. We thus maintain our view of the RBI likely easing by 50bps, taking repo rate to 7.5%.

On the external account, the global slowdown is taking its toll on exports (both merchandise and software). As regards imports, despite lower crude prices, India's inelastic demand for oil and gold is likely to keep the current account deficit elevated at 3.7% of GDP in FY13 and 2.8% in FY14. While the reforms are likely to aid capital flows, the relatively high CAD is likely to limit any reserve build-up. This, coupled with the declining fx import cover and vigilant rating agencies, is likely to result in the INR trading in the Rs52.50-Rs54 range over the next 12 months.

Figure 47. India — Economic Forecasts, FY2012/13-2014/15F

		FY 12/13F	FY 13/14F	FY 14/15F
Real GDP	YoY	5.4%	6.2%	6.9%
Final Domestic Demand	YoY	4.8	5.8	7.3
Private Consumption	YoY	5.0	5.5	6.7
Fixed Investment	YoY	4.5	6.0	9.0
Exports	YoY	8.0	15.0	11.0
Imports	YoY	6.0	10.8	9.5
Wholesale Price Index*	YoY	7.5	7.0	6.0
Consumer Price Index	YoY	7.0	6.5	6.0
Current Account	US$ bn	-70	-62	-62
	% of GDP	-3.7	-2.8	-2.5
Consolidated Fiscal Balance	% of GDP	-8.5	-8.0	-7.5
Centre Fiscal Balance	% of GDP	-5.9	-5.5	-5.0
US Dollar Exchange Rate	Average	52.6	53.9	53.4

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

Korea

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Weak external demand and sluggish domestic demand will continue to weigh on economic growth in 1H of 2013 at 2.6%YoY. Yet we expect a visible recovery of the economy in 2H, growing 4.1% YoY, driven by a rebound in exports and facilities investment along with a gradual improvement in the global economic environment and better prospects for the next year. Annual growth will likely post 3.4%, staying below our estimated potential GDP growth of 3.8% for the third consecutive year. We expect CPI inflation at 2.7%, but the narrowing negative output gap in 2H and rising inflationary pressures from service sectors will likely push up inflation to above 3% in 2H. Based on economic growth and the inflation path, we expect the BoK to cut the policy rate by 25bps in early 1H and to prepare to shift to a normalization stance in late 2H by raising the rate at end 4Q13. The new government is highly likely to implement stimulus measures in 1H to a prevent delay in economic recovery. The measures will be focused on stabilizing the housing market to increase construction investment and boosting facilities investment. The KRW is likely to strengthen further but gradually, due to the authorities' intervention and increased regulatory oversight.

Indonesia

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The pace of the economic slowdown, which has mainly been driven by export-related sectors, has been in line with our expectation and we continue to see GDP growth slowing to a still-respectable rate of 6.1% in 2013, from an expected 6.2% in 2012. Domestic demand may slow somewhat as investment in machinery for export-oriented industries (eg mining) weakens. Meanwhile consumption growth may also moderate in 2013 if exports of plantation commodities, production of which is more labor-intensive vs. coal, also weakens further. However an environment of benign inflation should help maintain domestic purchasing power in urban areas. Fuel price hikes remain a low-probability high impact event worth monitoring. The authority over prices will revert to the government; but we think any fuel price hike will likely be accompanied by a social safety net program which will still be preceded by discussions with parliament. Meanwhile the CA deficit has shown signs of moderating but is still likely to remain sizable in the quarters to come; the IDR still risks further depreciation despite the improved outlook on portfolio inflows. As for the FasBI rate, we still expect 2 x 25bps hikes by YE13 from currently 4.00%. Yet we have shifted back our timing call to 2H13. Macroprudential measures which may further affect consumption credit growth may be introduced in the near term and we think BI may want to wait to see further data points before acting on rates.

Figure 48. Korea and Indonesia — Economic Forecasts, 2012-2014F

		Korea			Indonesia		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	2.3%	3.4%	4.0%	6.2%	6.1%	6.3%
Final Domestic Demand	YoY	1.5	2.6	3.5	6.0	6.5	7.0
Private Consumption	YoY	1.7	2.1	3.5	5.1	4.4	5.0
Fixed Investment	YoY	-0.3	2.8	4.2	10.5	10.5	9.5
Exports	YoY	4.0	5.1	9.2	1.3	5.5	10.2
Imports	YoY	2.5	4.0	8.4	4.3	7.7	11.9
Consumer Price Index	YoY	2.3	2.7	3.1	4.4	4.7	4.7
Unemployment Rate	%	3.2	3.3	3.3	6.1	5.9	5.8
Current Account	US$ bn	33.8	19.3	15.2	-20.4	-17.0	-16.4
	% of GDP	2.9	1.5	1.0	-2.3	-1.7	-1.5
Fiscal Balance	% of GDP	0.8	1.3	1.6	-2.1	-1.5	-1.4
US Dollar Exchange Rate	Average	1117	1065	1012	9469	9802	9703

Sources: Haver Analytics and Citi Research forecasts

Hong Kong

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We expect the economy to embark on a slow recovery in 2013, with inflation sticky around 3.5% YoY. Trade uncertainties and moderating consumption are likely to continue to weigh on 1H performance. Ongoing property construction and infrastructure works are good cushions to growth, while fiscal stimulus is also likely to help jobs and low-income households. Despite difficulties in getting new policies through the legislature, more policy reforms are likely, geared towards removing obstacles to closer integration with mainland China. Ongoing policy actions targeting the property market will likely stabilize prices and cap turnover. Interest rates will probably remain low. Recent inflows likely have eased funding tightness, but credit growth is likely capped by weak loan demand and banks' preparation for Basel III. We envisage more HKMA interventions to defend the peg during times of fund inflows.

Singapore

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The growth inflation trade-off will remain adverse in 2013, amidst sub-par external demand, supply constraints, and the erosion of cost competitiveness from REER appreciation. We expect continued sub-potential growth in 2013, at about 2%, only slightly better than 2012 (about 1.4% YoY). Risks of technical recession are likely to persist at least through 1H13. Even so, supply constraints, including from tighter foreign worker policy, probably will keep inflation elevated at about 3.8% YoY in 2013 — almost twice the historical average (1.7%). With the output gap still positive, monetary and fiscal policies will stay on a tightening bias in 2013. REER appreciation could hurt manufacturing and tradables services and firms may well react via industry consolidation and relocation/expansion overseas.

Taiwan

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We expect a very gradual GDP recovery throughout 2013. Exports remain vulnerable to external deleveraging, with consumption constrained by falling wages. Additional revenue from Mainland tourists will probably only make a small contribution. The Government's new plan to lift growth via private/Mainland investments will take time to gain traction but, if implemented smoothly, may help growth in 2H-13. Inflation is likely to be stable around 2% YoY in 2013, allowing the CBC to keep the policy rate on hold in 2013. Recent progress in cross-straits relationships are encouraging, in particular the new RMB banking business will stay in the limelight. ECFA progress and potential FTA signings could also expand export markets over time. Recent policy reforms are hurting the ruling party's popularity ratings, which need to be worked on before 2014's local elections.

Figure 49. Hong Kong, Singapore and Taiwan — Economic Forecasts, 2012-2014F

		Hong Kong			Singapore			Taiwan		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	1.4%	2.8%	3.5%	1.4%	2.0%	4.0%	1.0%	3.0%	3.8%
Final Domestic Demand	YoY	4.8	2.2	2.0	2.9	2.4	3.3	0.1	1.5	3.2
Private Consumption	YoY	3.8	1.9	2.1	2.0	2.9	3.2	0.9	1.9	2.7
Fixed Investment	YoY	8.1	2.8	2.1	6.2	1.6	3.5	-2.5	1.3	7.2
Exports	YoY	1.0	1.8	4.3	0.2	2.1	2.8	-0.5	3.9	4.4
Imports	YoY	1.9	1.7	3.7	1.4	3.0	2.7	-2.3	2.4	3.6
CPI	YoY	4.0	3.5	3.7	4.6	3.8	3.4	2.0	2.0	1.1
Unemployment Rate	%	3.4	3.7	3.5	2.2	1.9	1.8	4.3	4.2	4.0
Current Account	US$ bn	13.2	15.7	18.5	45.2	42.5	44.0	42.9	45.4	45.6
	% of GDP	5.0	5.6	6.2	16.2	13.9	13.3	8.7	8.4	8.0
Fiscal Balance	% of GDP	0.8	1.1	1.1	1.3	1.0	1.0	-1.6	-1.6	-1.3
US Dollar Exchange Rate	Average	7.76	7.76	7.75	1.24	1.20	1.19	29.30	28.47	28.27

Sources: Haver Analytics and Citi Research forecasts

Russia

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GDP growth decelerated to 2.9%YoY in 3Q12 from 4.5%YoY in 1H12. Retail sales rose 4.4%YoY in October, but are likely to decelerate to about 3.5% YoY near term given the deterioration of consumer confidence. The October CPI of 6.5%YoY made the CBR pause with the tightening, and, as we argued last month, the regulator is unlikely to hike key rates this year. Still, we expect inflation to remain above 6-6.5%YoY in 1H13, forcing the CBR into a situation where its credibility in capping inflation at 5-6% YoY might again be tested. In our view, the next step is a hike of the deposit rate, but it might be postponed until next year. The high interest rate environment is weighing on investment, and some offsetting fiscal stimulus for capital spending might come next year. At the same time, the private sector is borrowing from abroad, and loans at US$26bn in 3Q helped lower the net capital outflow. In December, the high (US$22bn) external debt repayments and budget deficit are likely to weaken the ruble. However, in our base case, we expect the ability to use Euroclear for Russian bonds to start in 1Q13, and, coupled with the seasonally-strong current account, this should drive the ruble to 34.8/BASK.

Turkey

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Turkey has made good progress on re-balancing the economy and received the eagerly-awaited investment grade (IG) status from Fitch in 2012. The combination of lower capital inflows and the CBT's aggressive tightening has led to a marked softening in domestic demand, with growth decelerating to an estimated 2.8% this year from 8.5% in 2011. This, coupled with the unexpected increase in net gold exports, played an important role in narrowing the current account deficit to about 7.0% of GDP this year from 10% of GDP in 2011. Looking ahead, we think the tug of war between liquidity and fundamentals will continue in 2013. Specifically, we believe there has not been a meaningful change in the country's growth strategy, which relies excessively on foreign savings. This feature of the Turkish economy, which is underpinned by low savings and a sizeable competitiveness gap, plus the country's poor inflation track record, will continue to overshadow macroeconomic stability. From this prism, we argue that further appreciation of Turkish assets in 2013 should not be taken for granted since valuation concerns are likely to emerge eventually — particularly if the favorable trend in the current account balance is reversed. The excessive discretion in the conduct of monetary policy, which continues to juggle mutually incompatible goals, and the possibility of a relaxation in fiscal policy ahead of the heavy election calendar (local and presidential in 2014), further complicate the outlook for Turkish assets.

Figure 50. Russia and Turkey — Economic Forecast, 2012-14F

		Russia			Turkey		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	3.6%	3.2%	3.8%	2.8%	4.0%	4.3%
Final Domestic Demand	YoY	4.6	4.2	4.8	-0.1	3.4	4.8
Private Consumption	YoY	5.9	5.0	5.0	0.0	3.2	4.3
Fixed Investment	YoY	6.9	4.6	6.9	-2.0	4.2	6.7
Exports	YoY	1.3	1.3	1.9	16.0	4.5	4.2
Imports	YoY	4.3	4.4	4.8	-2.8	2.5	6.1
CPI	YoY	5.2	6.8	5.8	9.2	7.3	6.3
Unemployment Rate	%	5.5	6.5	7.0	9.2	9.5	9.5
Current Account	US$ bn	95.9	67.5	20.3	-57.0	-61.4	-67.3
	% of GDP	4.9	3.3	0.9	-7.0	-7.0	-7.1
Fiscal Balance	% of GDP	-0.1	-1.2	-2.4	-2.5	-2.7	-2.7
US Dollar Exchange Rate	Average	31.1	33.4	34.3	1.80	1.86	1.90

Sources: Haver Analytics and Citi Research forecasts

Hungary

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The ongoing deleveraging process is likely to weigh on growth prospects, hitting lending and investment in particular. While the government is likely to keep the fiscal balance tight to maintain access to EU Cohesion Funds, projected fiscal adjustment needs may keep inflation above target despite the contraction in domestic demand. Based on weak prospects for a recovery in domestic demand, we expect Hungary's external balance to remain in surplus, helping to stabilize the currency in addition to an ongoing reduction in Hungary's external debt level. The upcoming change in the NBH governance in March 2012 and the April 2014 general elections will be important milestones to the medium-term outlook. The replacement of the executive MPC members is one of the key risks to watch, pointing towards a looser monetary policy stance. We no longer expect the government to take up an IMF/EU loan program prior to the April 2014 general elections, leaving Hungary vulnerable to global liquidity conditions. A new political alliance launched by former PM Bajnai has balanced chances to replace the current Fidesz government in 2014, in our view, which may impact Hungary's risk assessment positively.

Poland

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We expect economic growth to be subdued in the coming quarters. Taking into account disappointing 2Q GDP data and a series of weak labour market indicators in recent months, we are now more pessimistic about private consumption growth in 2013. Consumer spending is likely to grow by only 1% next year and given downside risks to investment activity this would imply GDP growth of around 1.3-1.5%, down from a previously expected 2.2%. Sub-potential growth will most likely keep wage and price pressures under control and we expect headline inflation to return to the central bank's target of 2.5% already in early 2013. A mix of low inflation and disappointing growth performance will pave the way to deeper rate cuts, in our view. On balance, however, we believe the MPC remains more hawkish than market participants seem to believe and will be unwilling to deliver quick policy easing. With our weak growth scenario we expect the central bank's reference rate to fall towards 3.25% in 2013 but the easing cycle will be probably spread over a longer period of time. On the fiscal side, the government remains committed to cautious fiscal policy, but weak growth creates headwinds and we expect the 2013 fiscal deficit to remain close to 3.5% of GDP.

Figure 51. Hungary and Poland — Economic Forecasts, 2012-2014F

		Hungary			Poland		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.3%	0.3%	1.3%	2.1%	1.3%	2.8%
Final Domestic Demand	YoY	-2.0	-1.4	-0.7	0.8	0.1	2.9
Private Consumption	YoY	-1.2	-0.7	-0.2	1.2	1.1	3.1
Fixed Investment	YoY	-5.6	-4.0	-2.5	0.3	-3.1	2.7
Exports	YoY	1.8	4.3	6.2	1.5	2.2	8.5
Imports	YoY	0.5	3.1	5.1	-2.0	-0.1	9.0
CPI	YoY	5.8	4.8	3.9	3.7	2.2	2.4
Unemployment Rate	%	11.0	10.8	10.2	13.3	14.2	13.4
Current Account	US$ bn	1.6	2.1	2.8	-17.9	-18.7	-25.1
	% of GDP	1.3	1.7	2.1	-3.6	-3.9	-4.7
Fiscal Balance	% of GDP	-2.8	-2.9	-3.2	-3.5	-3.5	-2.8
Euro Exchange Rate	Average	289	297	292	4.19	4.25	3.99

Sources: Haver Analytics and Citi Research forecasts

Czech Republic

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While we maintain our 2012 GDP forecast at -1.2%YoY, we are cutting our 2013 forecast to zero from 0.4% previously and cutting the 2014 forecast to 0.9% from 1.1%. GDP fell 1.5%YoY in 3Q12 (with a downward revision to growth in 1H12), a much sharper drop than the CNB expected (-0.8% YoY), partly reflecting weakness in consumption in 1H12. The CZSO will publish the details on 7 December. The weaker koruna is likely to support exports. But, we expect GDP to fall again (by 0.2% QoQ) in 4Q12 and we cut our 2013 forecast on weakness in foreign demand, German exports, private consumption and investment, plus the continued euro area tensions. We expect the CNB to sound more dovish on 19 December, which will likely push its forecast of a comfortable EURCZK level to 25.6-25.8 in 1Q13 from 25.1 currently. On the fiscal front, we expect a central government budget shortfall of around CZK10bn both in 2012 and 2013. While the risk of an early general election has eased after the Lower House approved tax austerity measures, it has not disappeared, as we still believe the government's majority of 101 MPs in the Lower House is fragile.

Romania

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The economy has made a large adjustment following the severe downturn during the 2008-09 crisis. Driven largely by spending cuts, sustained fiscal consolidation has led to a marked reduction in the budget deficit. Moreover, labour market reforms have contributed to a better-functioning labour market and a moderate employment recovery, while structural reforms in energy and transportation have progressed, albeit slowly. The improved macroeconomic backdrop has, in turn, eased financing pressures, paving the way for a renewed access to the Eurobond market. Nonetheless, the post-crisis recovery has turned out to be disappointing, as growth momentum lags behind most other European emerging economies. This, along with persistent domestic political tensions, runs the risk of overshadowing the sustainability of the reform program through increasing the risk of reform fatigue and undermining investor confidence. In our view, the deteriorating inflation outlook, which limits the NBR's ability to ease, further complicates the macro picture. We believe the NBR will be forced to hike by 50bp in 1H 2013 as keeping the policy rate constant will be even harder to justify in the context of the 2.5% 2013 inflation target. All in all, we believe political stability following the election on 9 December, progress on the implementation of the EU-IMF supported program, which is expected to be renewed in 2013, and improving EU funds absorption will play a significant role in shaping the performance of Romanian assets next year.

Figure 52. Czech Republic and Romania — Economic Forecasts, 2012-2014F

		Czech Republic			Romania		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.2%	0.0%	0.9%	0.8%	1.7%	2.8%
Final Domestic Demand	YoY	-2.2	-0.4	1.3	1.7	1.7	2.6
Private Consumption	YoY	-3.3	0.0	1.0	0.6	1.4	2.4
Fixed Investment	YoY	-1.4	0.3	2.4	6.5	3.0	3.5
Exports	YoY	3.2	-0.3	0.3	-1.7	3.0	4.0
Imports	YoY	0.0	-3.0	0.0	-0.2	2.4	3.0
CPI	YoY	3.3	2.4	1.0	3.4	4.8	3.5
Unemployment Rate	%	8.6	9.1	9.3	5.0	5.2	5.5
Current Account	US$ bn	-2.9	-3.4	-2.2	-6.5	-7.3	-8.4
	% of GDP	-1.5	-1.9	-1.2	-3.8	-4.2	-4.5
Fiscal Balance	% of GDP	-3.2	-3.2	-2.7	-2.4	-2.2	-2.5
EURCZK, USDRON	Average	25.3	25.9	25.2	3.5	3.7	3.7

Sources: Haver Analytics and Citi Research forecasts

Brazil

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Given the increasing signs of growth acceleration, we continue to expect 2013 GDP to expand by 3.9%, better than the 1.4% figure expected for 2012, but only slightly above our potential GDP growth estimate. The significant monetary stimulus continues to boost domestic demand, especially private consumption. However, the unfavorable global outlook and the softer use of other policy instruments (especially fiscal and credit) continue to suggest that the current recovery will likely prove more gradual compared with the 2009 monetary easing cycle. On the inflation front, we keep our view that 2013 CPI inflation will reach 5.3%, lower than the 5.4% figure expected for this year, reflecting the likely drop in energy prices. Therefore, even though CPI inflation remains above the mid-point target of 4.5%, it will remain inside the target band. Regarding monetary policy, after the central bank's clear indication that the Selic rate will remain stable at 7.25% for an extended period, we expect the tightening cycle to initiate only in October 2013 due to the risks of 2014 CPI inflation moving further away from the target path. Moreover, fiscal policy will likely be consolidated at a looser stance, with the primary surplus stabilizing at 2.5% of GDP. Finally, although fundamentals continue calling for BRL appreciation (against the USD), we think the government will keep on intervening in the FX market (as well as through capital inflow taxes), keeping USD/BRL in a range between 2.0 to 2.10.

Mexico

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After expanding strongly at the beginning of 2012, real GDP growth slowed in the second half. This, together with the persistence of a weak external outlook, and in particular slower US manufacturing growth, has led us to revise down our GDP growth forecast to 3.6% for 2013 from the previous 3.8%, also below our 3.9% forecast for 2012. We are sticking to an above-potential growth expectation as we expect progress on structural reform — an example is the recently approved labor reform — which will have a positive impact on expectations and investment in the short term, and a broader effect from 2014. Therefore, we are revising up our GDP growth forecast for 2014 to 3.8% from 3.5% before. On inflation, external conditions should push the prices of basic items down to lower levels, thus alleviating inflationary pressures. We expect year-end inflation rates of 3.8% and 3.6% in 2013 and 2014, respectively, once again within the central bank's variability range (2-4%). This is the main reason why we think Banxico will hold its reference rate at 4.5% in the long term. We expect the first interest rate increase (25 basis points) in 3Q14.

Figure 53. Brazil and Mexico — Economic Forecasts, 2012-2014F

		Brazil			Mexico		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	1.4%	3.9%	4.0%	3.9%	3.6%	3.8%
Final Domestic Demand	YoY	2.4	4.8	4.3	3.8	4.0	4.2
Private Consumption	YoY	3.1	4.7	4.3	3.4	3.7	3.7
Fixed Investment	YoY	-1.0	8.5	8.4	6.4	6.5	7.0
Exports	YoY	1.5	21.3	21.5	3.7	4.4	8.5
Imports	YoY	5.3	20.7	21.0	2.0	0.7	9.6
CPI	YoY	5.4	5.3	5.4	4.2	4.1	3.6
Unemployment Rate	%	5.5	5.5	5.4	4.9	4.4	4.5
Current Account	US$ bn	-46.5	-56.5	-63.7	-5.0	-12.2	-17.5
	% of GDP	-2.2	-2.5	-2.6	-0.4	-0.9	-1.2
Fiscal Balance	% of GDP	-2.6	-2.4	-2.1	-2.2	-2.1	-2.0
US Dollar Exchange Rate	Average	1.99	1.99	2.02	12.96	12.70	12.55

Sources: Haver Analytics and Citi Research forecasts

Argentina

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We forecast official GDP growth at 2.3% in 2012 and 3% in 2013 and “true” (non-official) growth at 0% and 3%, respectively. We expect the federal primary and overall fiscal deficits to be 0.2% and 2.4% of GDP, respectively, in 2012. For 2013, an expansionary fiscal policy due to the mid-term elections should cause the primary deficit to widen to 1.4% of GDP and the overall deficit, to 2.7%. Provincial finances, on the other hand, have evolved worse than expected; hence we are now expecting to see their primary and overall deficits rise to 1.2% and 1.4% of GDP in 2012, respectively, with little chance of improvements going forward. As regards the balance of payments, we forecast the 2013 trade balance surplus to be more or less the same as in 2012 in US dollar terms. Since exports should be able to rise by 6.5% next year, the government will have some room to ease controls on imports other than energy in 2013. We expect capital controls to remain tight and “true” (non-official) CPI inflation to reach 25% in 2012 and 30% in 2013. Last but not least, we forecast the official market’s end-of-year USDARS to be 4.9 in 2012 and 6 in 2013.

Venezuela

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Over a 2-year horizon we do not expect a radicalization of President Chávez's policies beyond what we have already seen during his 14-year tenure. For 2013 and 2014, debt sustainability will depend on oil price dynamics and the related fiscal revenues. Next year, we expect to see some increases in oil production as a result of the ongoing Orinoco Basin projects, but the biggest impact will be felt in 2014. While we think the government should have enough cash flow to honor its debt obligations, economic performance next year will likely be characterized by lower fiscal spending, lower GDP growth and an increase in inflation. Also, we expect a devaluation of the VEF by late 2012 or early 2013, and a reopening of the parallel exchange rate market as a way to release pressure on the current two-tier FX regime. In that context, it is important to note that the external accounts of Venezuela could stay in check if the average Venezuelan oil basket manages to be above USD82 per barrel on average next year. On the political front, the December regional elections should be useful to assess the state of the opposition. The spotlight will be on to the Miranda state elections, where former presidential candidate Henrique Capriles is running against President Chávez’s protégée Elias Jaua.

Figure 54. Argentina and Venezuela — Economic Forecasts, 2012-2014F

		Argentina			Venezuela		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	2.3%	3.0%	3.0%	5.0%	3.0%	3.0%
Final Domestic Demand	YoY	2.3	3.3	2.8	8.4	1.4	1.7
Private Consumption	YoY	4.9	3.5	3.2	6.2	0.3	1.1
Fixed Investment	YoY	-6.6	1.6	1.9	7.5	2.2	2.2
Exports	YoY	-4.4	2.2	-1.9	1.8	4.9	5.9
Imports	YoY	-6.6	4.4	-2.3	14.3	-0.9	0.1
CPI	YoY	9.9	11.9	14.5	21.2	22.3	25.2
Unemployment Rate	%	7.3	7.5	7.6	6.0	6.5	6.9
Current Account	US$ bn	3.9	2.0	1.0	20.1	16.5	25.0
	% of GDP	0.8	0.4	0.2	5.4	5.1	6.1
Fiscal Balance	% of GDP	-2.4	-2.7	-2.9	-5.0	-4.0	-4.0
US Dollar Exchange Rate	Average	4.58	5.46	6.74	4.30	6.50	6.50

Sources: Haver Analytics and Citi Research forecasts

Saudi Arabia

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Sustained high oil prices have meant that Saudi production continues at a record high of close to 10 million barrels per day in October. Saudi officials continue to reassure markets that they are willing and capable of providing further output, despite what they see as a balanced physical market in terms of supply and demand. State oil producer Aramco has also said it plans to invest US$35bn over the next 5 years in order to maintain current excess capacity levels, although Minister of Oil Naimi recently stated that it is unclear whether Saudi will need to increase its overall production capacity, given uncertainty in global supply and demand in the long term. Meanwhile, domestic oil consumption (mainly for electricity generation) continues to rise strongly, threatening to erode Saudi's export capacity in the long term. As a result, authorities have responded with a redoubling of efforts to increase gas production and reduce reliance on crude oil. In recent months, sizeable discoveries have been made, production at the Karan and Wasit gas fields is expected to add 40% to total gas production (Reuters, October 16), and there are expectations of sizeable commercially exploitable shale gas reserves in the north and west of the Kingdom, which Baker Hughes Inc (the oil and gas services company) estimates could be the world's fifth largest. Meantime, we continue to expect robust growth in the non-oil economy (7.5% in 2012) on the back of continued high government expenditure and increased domestic demand. At the beginning of July, the Saudi Council of Ministers finally approved the long-awaited mortgage law and we believe it will transform the stagnant mortgage market, though some caution is merited given the likely challenges a surge in housing demand could introduce.

United Arab Emirates

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We have upgraded our growth projections for Dubai, mainly on the back of a reassessment of the growth prospects in the construction and real estate sectors. Dubai has seen a steady recovery in the property market through the year, with villa prices rising by over 20%YoY in the first half of 2012, according to research by Jones Lang Lasalle, the property services company. While the recovery is mainly in the prime market, there is strong anecdotal evidence of an increase in general construction activity in the Emirate, with stalled projects being completed and new projects being announced. While we had previously expected a continued contraction of the construction and real estate sectors in 2012, we now expect modest growth of 2%-3% in real terms, with the net effect of lifting overall real GDP growth to 5.1% in 2012 (previously 1.9%).

Figure 55. Saudi Arabia and United Arab Emirates — Economic Forecasts, 2012-2014F

		Saudi Arabia			United Arab Emirates		
		2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	7.0%	5.2%	7.8%	2.1%	4.6%	4.9%
Final Domestic Demand	YoY	7.8	7.9	8.0	3.4	3.4	3.8
Private Consumption	YoY	5.0	5.0	5.0	2.0	2.0	3.0
Fixed Investment	YoY	10.0	10.0	10.0	5.0	5.0	5.0
Exports	YoY	6.4	-6.5	1.8	13.0	13.0	13.0
Imports	YoY	15.0	15.0	15.0	15.0	15.0	15.0
CPI	YoY	4.8	6.0	8.0	1.1	1.3	1.5
Current Account	US$ bn	161.0	106.6	80.7	12.0	20.7	31.1
	% of GDP	25.2	16.7	11.9	3.7	5.9	8.1
Fiscal Balance	% of GDP	14.2	4.7	-1.4	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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In many ways, 2012 has been a lost year for Egypt in terms of growth and economic reform. However, on the plus side, changes to the leadership of the Supreme Council of the Armed Forces (SCAF) in August 2012 have swung power back to the new president, Mohamed Mursi, and the Muslim Brotherhood (MB). But the government still needs to push on with re-writing the new constitution (an incomplete draft was made public in October) and decide when to hold new parliamentary elections as it seeks to consolidate civilian power. The other positive late-2012 change has been the new political leadership's realization that it needs to sign a deal with the IMF to attract wider donor and financial support. This is likely in early 2013. FX reserves were only US$15.5bn at end-October, giving the government little room for manoeuvre and a strong incentive to keep talking. But while the signing of an IMF deal should help stabilize the economy in the near term, the real question is whether it will drive a return to higher long-term growth rates and whether the current government really has a long-term vision of the Egyptian economy's development. But in the short run there is a strong acceptance that without getting the economy up and running, the long-term outlook will look bleaker.

South Africa

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While H1 12 GDP was dragged lower mostly by global issues, domestic factors are now at play. Mining strikes in Q3 resulted in a 12.0%QoQ SAAR contraction in production and as a result, we forecast GDP to decelerate to just over 2.0%QoQ SAAR in Q3 (following 3.2% in Q2). With continuing strikes, Q4 GDP will also be hampered. Poor export performance in H1 has raised the current account deficit to 6.4% of GDP in Q2. Ongoing global distress and local production issues leave us expecting it to hit around 6.0% of GDP in 2012 as a whole, after 3.3% in 2011, and to remain high in 2013. Consumption has been the long-standing underpin of growth, but also is running out of steam. The recent pick up in wages affects only a small sub-sector, while job growth is weak and rising inflation will curb spending power. The SARB may have stepped in with a 50bp rate cut in July in order to 'insure' the economy against global headwinds but the deteriorating inflation outlook no longer provides room for a further reduction. SARB commentary reveals it is mindful of currency weakness, political instability and the rise in food inflation. The SARB has stressed that monetary policy is also limited when dealing with politically derived growth obstacles. We continue to expect a rise in political uncertainty ahead of the ANC's Elective Conference in December and think another sovereign rating downgrade in early-2013 is very likely. This would be rand-negative in our view.

Figure 56. Egypt, Nigeria and South Africa — Economic Forecast, 2012-2014F

		Egypt			Nigeria			South Africa		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	2.0%	2.9%	4.2%	7.4%	6.5%	7.2%	2.2%	2.5%	3.4%
Final Domestic Demand	YoY	2.7	2.8	4.5	NA	NA	NA	3.7	3.4	4.2
Private Consumption	YoY	0.9	0.8	3.0	NA	NA	NA	3.1	3.3	4.0
Fixed Investment	YoY	3.7	7.1	7.7	NA	NA	NA	5.1	3.3	5.6
Exports	YoY	-3.8	6.3	5.9	NA	NA	NA	-2.6	2.3	7.4
Imports	YoY	-2.3	5.5	6.9	NA	NA	NA	5.5	6.3	7.4
CPI	YoY	7.2	10.5	11.9	12.2	10.9	9.9	5.7	5.6	5.3
Unemployment Rate	%	13.0	14.5	15.0	NA	NA	NA	25.7	26.5	27.0
Current Account	US$ bn	-7.1	-7.2	-9.7	6.9	11.9	12.3	-22.5	-21.3	-21.7
	% of GDP	-2.9	-2.7	-3.3	2.3	3.4	3.0	-5.9	-5.6	-5.3
Fiscal Balance	% of GDP	-9.4	-7.7	-7.1	-2.9	-2.1	-2.6	-4.7	-5.0	-4.6
US Dollar Exchange Rate	Average	6.07	6.31	6.64	158.0	161.08	164.00	8.29	9.15	9.42

Sources: Haver Analytics and Citi Research forecasts

Figure 57. Selected Emerging Market Countries — Economic Forecast Overview, 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Asia	6.1	6.6	6.6	3.5	3.5	3.9	1.9	1.5	1.2	-2.9	-2.5	-2.4
China	7.7	7.8	7.3	2.7	2.8	3.6	2.5	2.0	1.5	-2.4	-2.0	-2.0
Hong Kong	1.4	2.8	3.5	4.0	3.5	3.7	5.0	5.6	6.2	0.8	1.1	1.1
India*	5.4	6.2	6.9	7.5	7.0	6.0	-3.7	-2.8	-2.5	-8.5	-8.0	-7.5
Indonesia	6.2	6.1	6.3	4.4	4.7	4.7	-2.3	-1.7	-1.5	-2.1	-1.5	-1.4
Korea	2.3	3.4	4.0	2.3	2.7	3.1	2.9	1.5	1.0	0.8	1.3	1.6
Malaysia	5.2	5.2	6.0	1.8	2.1	2.6	5.0	4.0	3.3	-4.5	-4.0	-3.5
Mongolia	12.0	13.8	11.0	14.2	12.0	10.0	-25.5	-10.8	3.0	-4.0	-2.0	-2.0
Philippines	5.0	5.3	5.8	3.1	3.5	3.8	2.8	2.3	1.1	-2.4	-2.2	-1.8
Singapore	1.4	2.0	4.0	4.6	3.8	3.4	16.2	13.9	13.3	1.3	1.0	1.0
Sri Lanka	6.7	7.3	7.5	7.4	6.7	6.5	-5.4	-4.3	-3.6	-6.7	-6.2	-5.5
Taiwan	1.0	3.0	3.8	2.0	2.0	1.1	8.7	8.4	8.0	-1.6	-1.6	-1.3
Thailand	4.0	4.5	4.8	3.0	3.3	4.3	0.1	0.4	0.9	-2.1	-2.2	-2.1
Vietnam	5.0	5.4	6.0	9.4	8.2	7.5	0.3	-0.5	-0.9	-4.4	-4.2	-4.0
Latin America	2.7	3.9	4.0	5.8	5.8	5.9	-1.1	-1.5	-1.5	-2.3	-2.2	-2.1
Argentina	2.3	3.0	3.0	9.9	11.9	14.5	0.8	0.4	0.2	-2.4	-2.7	-2.9
Brazil	1.4	3.9	4.0	5.4	5.3	5.4	-2.2	-2.5	-2.6	-2.6	-2.4	-2.1
Chile	5.6	4.5	5.3	3.1	3.1	3.0	-3.7	-2.4	-2.5	0.4	-0.3	-0.4
Colombia	4.4	4.5	5.5	3.2	2.9	3.4	-2.9	-3.1	-2.9	-1.4	-1.2	-0.7
Mexico	3.9	3.6	3.8	4.2	4.1	3.6	-0.4	-0.9	-1.2	-2.2	-2.1	-2.0
Panama	10.5	9.0	8.0	5.7	4.4	4.4	-8.5	-8.1	-7.8	-2.8	-3.0	-3.0
Peru	6.1	5.8	6.0	3.7	3.0	2.7	-3.3	-2.6	-2.7	0.5	-0.6	-2.0
Venezuela	5.0	3.0	3.0	21.2	22.3	25.2	5.4	5.1	6.1	-5.0	-4.0	-4.0
Europe	2.7	2.8	3.5	5.4	6.1	5.1	0.3	-0.7	-1.9	-1.4	-1.9	-2.4
Czech Republic	-1.2	0.0	0.9	3.3	2.4	1.0	-1.5	-1.9	-1.2	-3.2	-3.2	-2.7
Hungary	-1.3	0.3	1.3	5.8	4.8	3.9	1.3	1.7	2.1	-2.8	-2.9	-3.2
Kazakhstan	5.5	4.8	4.1	5.1	6.8	6.4	7.0	4.2	2.7	1.7	3.0	2.2
Poland	2.1	1.3	2.8	3.7	2.2	2.4	-3.6	-3.9	-4.7	-3.5	-3.5	-2.8
Romania	0.8	1.7	2.8	3.4	4.8	3.5	-3.8	-4.2	-4.5	-2.4	-2.2	-2.5
Russia	3.6	3.2	3.8	5.1	6.8	5.8	4.9	3.3	0.9	-0.1	-1.2	-2.4
Slovakia	2.5	1.3	1.7	3.7	3.0	2.5	2.5	2.0	1.8	-4.9	-3.1	-2.9
Turkey	2.8	4.0	4.3	9.2	7.3	6.3	-7.0	-7.0	-7.1	-2.5	-2.7	-2.7
Ukraine	0.6	1.7	3.7	1.2	8.1	4.2	-8.3	-9.3	-7.4	-3.3	-4.0	-3.5
Africa/Mideast	4.4	4.9	5.6	5.2	5.6	6.1	8.8	6.5	4.8	2.4	-0.4	-2.5
Bahrain	2.8	3.6	4.4	1.5	3.0	2.5	11.4	3.3	-0.5	0.4	-0.3	-0.5
Egypt	2.0	2.9	4.2	7.2	10.5	11.9	-2.9	-2.7	-3.3	-9.4	-7.7	-7.1
Ghana	7.4	7.0	6.8	10.2	8.4	7.4	-7.3	-4.9	-6.3	-6.8	-5.5	-4.1
Iraq	9.0	12.1	9.9	5.0	6.0	6.0	23.0	19.9	15.9	5.7	1.9	0.4
Israel	3.1	3.5	2.8	1.8	2.3	2.6	-1.5	-2.3	-2.5	-3.9	-1.8	-2.5
Jordan	2.5	3.0	4.0	5.0	5.0	5.0	-19.8	-14.3	-12.0	-11.0	-10.9	-10.9
Kenya	5.0	5.8	6.0	9.7	5.8	7.6	-10.5	-9.5	-7.2	-4.7	-4.2	-4.5
Kuwait	0.9	2.8	2.9	5.0	5.0	5.0	42.2	41.0	40.4	10.7	4.3	2.7
Lebanon	3.5	4.3	4.5	6.0	5.0	5.0	-24.2	-25.1	-25.3	-6.9	-8.1	-9.1
Nigeria	7.4	6.5	7.2	12.2	10.9	9.9	2.3	3.4	3.0	-2.9	-2.1	-2.6
Oman	3.0	4.4	4.4	3.0	3.0	3.0	2.7	8.3	7.0	6.0	3.7	2.0
Qatar	6.0	8.3	7.2	3.0	3.0	3.0	20.9	12.9	5.5	9.8	5.0	0.5
Saudi Arabia	7.0	5.2	7.8	4.8	6.0	8.0	25.2	16.7	11.9	14.2	4.7	-1.4
South Africa	2.2	2.5	3.4	5.7	5.6	5.3	-5.9	-5.6	-5.3	-4.7	-5.0	-4.6
Tanzania	6.4	6.8	7.0	15.4	7.7	5.8	-11.9	-10.2	-10.2	-6.2	-5.8	-6.0
UAE	2.1	4.6	4.9	1.1	1.3	1.5	3.7	5.9	8.1	NA	NA	NA
Uganda	4.5	5.5	6.2	14.7	5.7	5.4	-12.5	-10.7	-12.1	-5.5	-5.2	-4.5
Zambia	6.5	6.9	7.5	6.7	7.1	7.4	-3.4	0.5	3.0	-3.5	-2.5	-2.7
Total	4.7	5.3	5.5	4.4	4.6	4.7	1.8	1.2	0.6	-2.0	-2.1	-2.3

* 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 58. 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+	Neg	AA+ (Neg)	AA	Aaa	Neg	Aa1 (Neg W)	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA	AA+ ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
France	AA+	Neg	AA+ (Neg)	AA ↓	Aa1	Neg	Aa1 (Neg)	Aa2 ↓
Italy	BBB+	Neg	BBB+ (Neg)	SD* ↓↓↓↓↓	Baa2	Neg	Baa2 (Neg)	Ca* ↓↓↓↓↓
Spain	BBB-	Neg	BBB- (Neg)	SD* ↓↓↓↓↓	Baa3	Neg	Baa3 (Neg)	Ca* ↓↓↓↓↓
Austria	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Belgium	AA	Neg	AA (Neg)	AA- ↓	Aa3	Neg	Aa3 (Neg)	A1 ↓
Finland	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Greece	CCC	Stable	CCC	SD* ↓↓↓↓↓	C		C	Ca* ↓↓↓↓↓
Ireland	BBB+	Neg	BBB+ (Neg)	SD* ↓↓↓↓↓	Ba1	Neg	Ba1 (Neg)	Ca* ↓↓↓↓↓
Netherlands	AAA	Neg	AAA (Neg W)	AA+ ↓	Aaa	Neg	Aaa (Neg W)	Aa1 ↓
Portugal	BB	Neg	BB- ↓	SD* ↓↓↓↓↓	Ba3	Neg	B1 ↓	Ca* ↓↓↓↓↓
UK	AAA	Stable	AAA (Neg)	AA+ ↓	Aaa	Neg	Aaa (Neg W)	Aa1 ↓
Switzerland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	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 on our economists longer term (2015-2017) view, Citi expects Greece and Portugal to remain sub-investment grade in coming years, and for Italy, Spain and Ireland to fall to sub-investment grade ratings (Ireland currently is sub-investment grade with Moody's but not S&P), and this may well include a period of "selective default" (or equivalent) as determined by the rating agencies around the time of debt restructuring. Following the restructuring, we expect such sovereigns to attain a mid sub-IG rating.

Expected Ratings Issues in 2013 and Beyond

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Citi forecasts EMU debt restructuring over the longer-term

We are keeping our view that over the next 2-3 quarters in 2013, ratings on most euro area sovereigns are likely to be unchanged by Moody's and S&P. This is largely predicated on two core reasons. Firstly the ECB's OMT programme has reduced the risks that EMU sovereigns lose market access in the near term. Secondly, Citi no longer believes Greece will leave EMU in the immediate quarters ahead. However, given ongoing economic weakness (in terms of the fiscal and growth outlook), we are keeping the view that Portugal may be downgraded by one-notch by the rating agencies some time over the next 2-3 quarters.

Over the longer term (2015-2017), our economists expect some form of debt restructuring for at least five euro area sovereigns including: Greece, Ireland, Italy, Portugal and Spain (see page 11). This would follow many years of tight financial conditions, low growth or recession, intense private sector deleveraging pressures, poor competitiveness and growing austerity fatigue across the euro area. ESM/OMT programmes (which we expect in 2013 for Spain and Italy) would last up to two years, but will ultimately not restore fiscal sustainability in Citi's view. Based on our economists' view, Citi expects Greece and Portugal to remain sub-investment grade in coming years, and for Italy, Spain and Ireland to fall to sub-investment grade ratings (Ireland currently is sub-investment grade with Moody's but not S&P), and this may well include a period of "selective default" (as determined by the rating agencies) around the time of debt restructuring (which we expect will involve a combination of maturity extensions or coupon payment reduction).

Moody's likely to assess the UK rating in early 2013

Moody's recently indicated (Credit Opinion of 14 November) that it will assess the Aaa rating and Negative Outlook in early 2013. This will follow the Autumn Statement which will give more clarity about the pace of fiscal consolidation, the growth outlook and prospects that the debt trajectory will stabilize and ultimately start to decline. The transfer of APF coupon income to the Treasury will improve the headline debt numbers for the UK. However, overall credit fundamentals do not significantly change, in part, due to the Treasury's indemnification of the Bank of England against any losses. In line with our economists' weak outlook (page 43), we believe Moody's will place the UK on Negative Watch (indeed, this may already be implicit in their statement that they will "assess the rating") and S&P will likely put the UK on Negative Outlook in 2013. We continue to expect a one notch downgrade of the UK's rating by both agencies over the longer term (next 2-4 years).

US rating and the fiscal cliff

We expect that Moody's will put the US on Negative Watch (or put the rating "under review" or "under assessment") in 2013 – reflecting the rising debt/GDP ratio and continued uncertainties over medium-term fiscal trends – but will not change the rating at that stage. We continue to expect that Moody's will move the US rating to Aa1 sometime in the next 2-4 years. In a recent report (11 September), Moody's said "*the direction of the US rating and its outlook will most likely be determined by the outcome of budgetary negotiations during the course of 2013*". Our economists argue (page 34) that most of the pending US fiscal restraint is likely to be hurdled by a late-year compromise, but that the expected agreement likely will only resolve the short-term fiscal cliff issue. Note that S&P downgraded the US to AA+ on 5th August 2011 due to its outlook on the sovereign's debt dynamics and because of broad considerations about the "*effectiveness, stability and predictability of American policymaking and political institutions*".

Commodities 2013 — The New Abnormal

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2012 has been a mixed bag for commodities, marked by heightened differentiation across complexes but also within, coupled with periods of severe volatility. The confluence of tail risks — be they weather, geopolitical or policy induced — led to significant price swings for individual underliers despite almost no change in benchmark commodity index levels in the year-to-date. This is likely part of the 'new abnormal' for commodities as it is now clear that the commodity super-cycle is over; no longer will underlying prices see the nominal returns expected during 2002-2008. Nor will conditions approximating those of the last decade return any time soon.

There are both supply and demand aspects to the unfolding commodities paradigm. On the supply side, what first occurred in US natural gas — a marshalling of capital and a new supply surplus — is being replicated across most commodities, including critical industrial and bulk commodities and in other longer-lead time products such as oil, despite supply disruption risks. On the demand side, the main drivers will come from emerging markets. There will be considerable variations within markets. In oil and grains, seasonality has been on the rise over the past few years, impacting fuel and food and through them inflation rates across the world. This increase reflects changing precipitation and temperature as well as changing inventory patterns.

Figure 59. Commodities Price Forecasts*

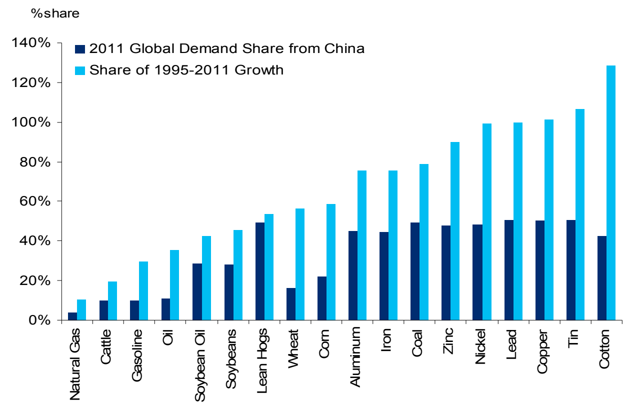
		Point Prices													
		0-3M	6-12M	5Y Cyclical	Q1 2012	Q2 2012	Q3 2012	Q4 2012E	2012E	Q1 2013E	Q2 2013E	Q3 2013E	Q4 2013E	2013E	2014E
Energy															
NYMEX WTI	USD/bbl	85.0	85.0	81.0	103.0	93.3	92.2	80.0	92.0	85.0	85.0	85.0	85.0	85.0	83.0
ICE Brent	USD/bbl	105.0	97.0	85.0	118.4	108.8	109.4	105.0	110.0	105.0	95.0	100.0	95.0	99.0	93.0
Henry Hub Natural Gas	USD/MMBtu	3.50	3.70	N/A	2.47	2.27	2.87	3.40	2.75	3.50	3.50	3.60	3.70	3.55	4.10
Base Metals															
LME Aluminum	USD/MT	2,050	2,075	2,200	2,216	2,019	1,944	2,050	2,057	2,100	2,050	2,100	2,150	2,100	2,175
LME Copper	USD/MT	8,000	7,900	6,200	8,314	7,833	7,711	8,020	7,970	8,160	8,000	7,800	7,900	7,965	7,775
LME Lead	USD/MT	2,150	2,025	2,200	2,118	1,987	1,984	2,150	2,060	2,150	2,050	2,000	2,150	2,090	2,200
LME Nickel	USD/MT	20,000	21,740	20,000	19,721	17,228	16,383	18,000	17,833	21,050	22,475	21,000	22,550	21,770	24,400
LME Tin	USD/MT	22,000	23,250	18,600	22,986	20,619	19,281	21,000	20,972	22,500	23,000	23,500	22,000	22,750	22,875
LME Zinc	USD/MT	1,950	2,040	2,100	2,040	1,933	1,902	1,950	1,956	1,975	2,000	2,080	2,100	2,040	2,125
Precious Metals															
COMEX Gold	USD/T. oz	1,770	1,770	1,050	1,691	1,613	1,654	1,760	1679	1790	1750	1735	1720	1749	1655
Silver	USD/T. oz	33	32	16.5	32.6	29.6	29.9	33.0	31.3	32.5	31.5	30.0	30.0	31.0	26.5
Platinum	USD/T. oz	1,614	1,675	1,500	1,604	1,505	1,500	1,614	1556	1650	1650	1700	1700	1675	1775
Palladium	USD/T. oz	627	744	600	683	630	613	627	638	700	725	750	800	744	925
Bulk Commodities															
Hard Coking Coal (benchmark Asia)	USD/MT	170	205	200	235	215	225	170	211	190	200	210	210	203	213
Thermal Coal Asia (NEWC)	USD/MT	98	105	105	113	88	94	98	98	105	105	105	105	105	111
Iron Ore Spot (TSI)	USD/MT	105	122	81	142	139	112	105	125	115	122	122	120	120	122
Agriculture															
CBOT Corn	USd/bu	800	675	N/A	641	618	783	770	700	770	750	655	620	700	625
CBOT Wheat	USd/bu	925	850	N/A	643	641	870	885	760	900	900	825	825	860	775
CBOT Soybeans	USd/bu	1,700	1,460	N/A	1,272	1,426	1,675	1,575	1,490	1,625	1,550	1,430	1,400	1,500	1335
CBOT Rice	USD/cwt	15.2	15.3	N/A	14.3	14.8	15.3	15.1	14.9	15.2	15.2	15.3	15.5	15.3	N/A
NYB-ICE Cotton	USd/lb	67	68	N/A	93	81	73	67	78	65	65	70	70	68	N/A
Sugar#11	USd/lb	20.0	21.0	N/A	24.5	21.2	21.0	20.5	21.8	21.0	21.0	21.0	21.0	21.0	N/A
ICE Coffee	USd/lb	160	167	N/A	205	171	172	160	177	160	165	165	170	165	N/A
ICE Cocoa	USD/MT	2,600	2,510	N/A	2,308	2,221	2,440	2,500	2,370	2,540	2,500	2,500	2,520	2,515	N/A

*Subject to revision[15]
Source: Citi Research

[15] See: "The New Abnormal: 2013 Commodities Outlook.", Ed Morse, 19 November 2012, Citi

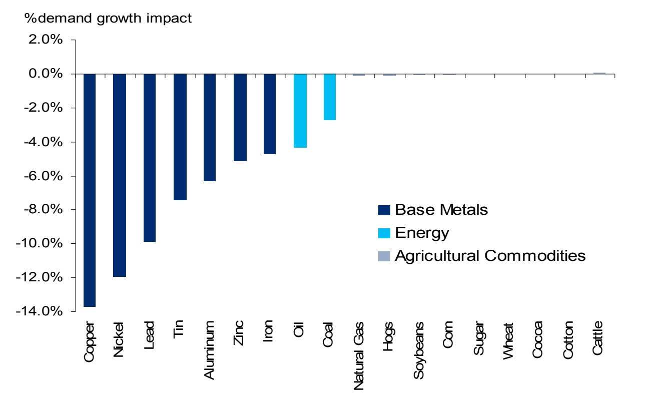
But two structural shifts in China are also forcing a re-evaluation of commodity demand. First is the shift from robust 10%+ annual GDP growth to a significantly lower 6-7% annual rate in the medium term and to 5.5% by the end of this decade (at some point in the near term China will likely have to confront an even more significant short-term rebalancing). Additionally, Chinese growth is likely to be much less energy and commodity-intensive than it has been with gallivanting increases in fixed asset investment and industrial production. The elimination of subsidies is occurring, slowing electricity and major primary energy sources as well as base metals and bulk commodities. The combination of these two factors has repercussions across commodities, particularly those linked to industrial output.

Figure 60. Chinese share of world commodity demand, historical growth



Sources: BP, China Customs, WBMS, WGC and Citi Research

Figure 61. Commodity demand growth impact in China in new 'abnormal'



Source: Citi Research

Nonetheless, in the short-term, we expect a global rebound in commodities demand from today's weak levels, perhaps by the end of 2013 given all of the policy stimuli packages that are being implemented (albeit inflation expectations across developed and emerging markets are tempered for next year). To be sure, some markets will tighten more quickly than others, but as demand rebounds along with global growth, commodity prices are unlikely to move sharply higher. As a result of these new supply and demand conditions, commodity performance is likely to become increasingly differentiated, with winners and losers depending on the fundamentals for individual commodities.

We expect industrial metals to see mostly steady prices from 2012 into 2013, but with copper and lead weakening and nickel, tin and zinc showing modest strength. Crude oil looks to be under pressure with the weight of incremental supply balanced less by demand than by punctuated supply disruptions. Precious metals look to remain firm, particularly gold, platinum and palladium, with major bulk commodities mildly weakening. Grains markets will be adjusting to tight inventory conditions ahead but should weaken as more normalized weather patterns re-emerge. Most soft commodities will likely remain subdued, with cocoa possibly seeing modest strength in the period ahead on stronger confectionary demand and a deficit market.

Radically changing market conditions are also at work. In oil there has been a marked increase in the normal scale of supply disruptions; more than doubling from 400-500-thousand barrels a day before the Libyan revolution. Indeed, add to that imposed boycotts on Iranian crude oil as 2013 approaches, over two million barrels a day of oil that could be available are off-line. In addition, significantly higher oil and gas production is a possibility if not a probability in a wide variety of places (Angola, Australia, Brazil, Canada, China, Colombia, Cyprus, Iran, Iraq, Israel, Kurdistan, Mexico, Russia, Sudan, much of East Africa), but “above ground” issues keep preventing the oil from either being produced or evacuated efficiently to markets. As a result the residual inventory for the world — Saudi spare production capacity — has been limited, buoying prices.

Enhanced seasonality, commodity differentiation and macro conditions will continue to create new long-short strategic contexts and investment opportunities for speculators, governments and upstream/downstream entities to consider in the years ahead. Combining commodities with foreign exchange as well as other asset markets including equities, is also likely to have a bigger impact on prices as hard asset markets become more ‘financialized’ globally.

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Notes

Notes

Appendix A-1

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