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Quarterly

Global Economic Outlook

2014 - Four Seasons of Leverage

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1# Bumpy growth relay from emerging to advanced: For the first time post-crisis, we expect advanced economies in 2014 to see an increased contribution to global growth as emerging economies deleverage. **Commodity markets will sit at the heart of this dynamic – our strategists look for range-bound markets in 2014.**

2# From QE to forward guidance … 2014 isn't 1994: Tapering is no longer a question of if, but when. The Fed has already clearly indicated its willingness to keep rates low for longer. **For 2014, expect US yield curves to steepen further and pressure to mount on the more vulnerable emerging economies.**

3# Cross-Atlantic uncertainty gap: Policy uncertainty is a key driver of investment and hiring and explains much of **the gap between sustainable recovery in the US and lacklustre growth in the euro area.**

4# Euro area's lost decade: For the period 2007 to 2018, we expect GDP per capita to be essentially flat, marking a lost decade of growth for the region. We blame much of this on slow policy. The ECB toolbox is not empty, but we see no bazookas unless deflation fears intensify. **The risk is that the euro will stay stronger for longer.**

#5 Reform of Asia giants to deliver slowly: Each has its own specific challenges, but Asia's three giants (China, India and Japan) are at a crossroads where structural reform holds the key. **Monetary policy will play a unique role in each case; we see further tightening from RBI, further easing from the BoJ and PBOC FX intervention.**

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Special! 2014 Indicator Watch

A frequent question from our clients is which economic indicators to watch. Our job entails analysis of literally hundreds of indicators across the world's major economies and to us all are important in building a picture of the whole economy. As a special supplement to our 2014 GEO, we have nonetheless set the difficult task of selecting just two indicators for each economy, that we consider the most critical to our outlook.

Country notes with detailed forecasts for the major global economies are available on the SG Research website.

Document completed on 25 November 2013

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Editorial

2014 – Four Seasons of Leverage

Like the four seasons, leverage follows well-known patterns. However, just as seasonal change can be tricky, so too can the leverage cycle. For policymakers and investors alike, understanding where economies are in the leverage cycle will hold the key to success in 2014. In the US, spring is just around the corner as fiscal tightening eases and housing recovery gains traction. For the Fed, this will be a particularly challenging time, managing the transition from QE to forward guidance. Our expectation is to see yield curves steepen to new historic highs. Moreover, as the cycle matures we believe the Fed will be willing to accept higher inflation. The mechanics of our UK outlook hold many similarities to the US, albeit with a less dynamic recovery. For the BoE too, 2014 will see the first test of the forward guidance policy. In Japan, the ultimate success of Abenomics will be judged on its ability to generate private sector investment and, with that, credit expansion. Of the major central banks, we believe the BoJ will be the most aggressive when it comes to easing and, if there is a G4 currency battle to be fought, Japan will win. The euro area continues to battle the headwinds of deflationary pressures and financial fragmentation. 2014 will be a critical year for European Banking Union; our view remains the repair will come only slowly. In the euro area, it's still winter. Turning to the major emerging economies of China, Brazil and India, autumn is creeping in as these economies embark on a process of deleveraging. The right structural reform mix, however, could significantly alleviate the process. In aggregate, however, the emerging market growth engine is clearly losing steam.

Chart 1: SG forecasts – Below consensus for Euro Area

Growth Forecasts	SG				Consensus		EU Commission		IMF	
	2013	P	2014	P	2013	2014	2013	2014	2013	2014
G5										
Euro area	-0.4	*-0.3*	0.6	*0.6*	-0.4	0.9	-0.4	1.1	-0.4	1.0
Germany	0.5	*0.4*	1.4	*1.4*	0.5	1.7	0.5	1.7	0.5	1.4
France	0.2	*0.1*	0.5	*0.5*	0.1	0.8	0.2	0.9	0.2	1.0
Italy	-1.9	*-1.5*	0.3	*0.0*	-1.8	0.5	-1.8	0.7	-1.8	0.7
Spain	-1.3	*-1.2*	0.0	*-0.5*	-1.3	0.5	-1.3	0.5	-1.3	0.2
United States	1.7	*1.8*	2.9	*3.1*	1.7	2.6	1.6	2.6	1.6	2.6
China	7.7	*7.6*	6.9	*6.9*	7.6	7.5	7.5	7.4	7.6	7.3
Japan	1.9	*2.2*	1.7	*1.9*	1.9	1.6	2.1	2.0	2.0	1.2
United Kingdom	1.5	*1.4*	2.7	*2.2*	1.4	2.3	1.3	2.2	1.4	1.9
Other advanced										
Switzerland	1.8	*1.7*	1.7	*1.7*	1.8	1.9	1.7	1.8	1.7	1.8
Australia	2.4	*2.5*	2.4	*2.8*	2.5	2.7	2.6	2.8	2.5	2.8
S. Korea	2.7	*2.6*	3.5	*3.3*	2.7	3.5	2.8	3.7	2.8	3.7
Taiwan	1.9	*2.3*	3.0	*3.4*	2.1	3.4	-	-	2.2	3.8
Emerging economies										
Brazil	2.8	*3.1*	2.1	*2.9*	2.4	2.4	2.2	2.5	2.5	2.5
Russia	1.3	*1.7*	2.4	*3.3*	1.6	2.5	1.9	3.0	1.5	3.0
India	4.0	-	5.2	-	4.6	5.6	2.9	4.0	3.8	5.1
Poland	1.3	*1.2*	2.7	*2.3*	1.2	2.7	1.3	2.5	1.3	2.4
Czech Republic	-1.4	*-0.8*	1.4	*1.8*	-1.1	1.8	-1.0	1.8	-0.4	1.5
Slovakia	1.0	*0.8*	2.1	*2.2*	0.9	2.2	0.9	2.1	0.8	2.3
Mexico	1.6	*2.9*	4.1	*3.6*	1.2	3.2	1.3	3.1	1.2	3.0
Chile	4.6	*4.4*	3.5	*4.0*	4.2	4.1	-	-	4.4	4.5

Source: IMF, EU Commission, Consensus Economics, SG Cross Asset Research/Economics, Consensus = November 2013, IMF = October 2013, EUC= November 2013

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Anchor Themes (Summary)

1. **Bumpy growth relay from emerging to advanced:** For the first time post-crisis, we expect advanced economies in 2014 to see a marked increase in their contribution to global growth. Emerging economies have over the past few years offered a welcome support to global growth, but this relied in part on a build-up of credit that now needs to be paid down. The hope is for advanced economies to take over the baton from the emerging economies as the main driver of global growth. The US is now poised for sustainable recovery and in Japan hopes remain that Abenomics will work. The euro area, however, continues to lag. As such, the growth relay from emerging to advanced is likely to prove a bumpy process. **Commodity markets will sit at the heart of this dynamic – our strategists look for range-bound markets in 2014.**

2. **From QE to forward guidance … 2014 isn't 1994:** Spring 2013 saw US 10-year bond yields gain over 100bp as expectations of a turning point in US monetary policy gained traction in line with the recovery of the real economy. Given our growth forecast of 2.9% for 2014, tapering is no longer a question of if, but when. Our forecast is for tapering to start in March 2014 and be completed in July 2014. The Fed has, however, already clearly indicated its willingness to keep rates well below levels implied by traditional policy rules for much longer. We expect the first rate hike only in mid-2016. Ultimately, inflationary pressures will build and we forecast the Fed to act more aggressively and tighten too much too late in the cycle. This is a question for 2018/2019. **For 2014, expect US yield curves to steepen further and pressure to mount on the more vulnerable emerging economies. Adjustable exchange rates and overall stronger economic balances, should prevent a broad-based emerging market crisis.**

3. **Cross-Atlantic uncertainty gap:** All eyes will be back on Washington early 2014. While a new shutdown and/or debt-ceiling stand-off are risks, we believe the odds to favour a more benign scenario. This, in turn, should allow policy uncertainty in the US to resume the downward trend established in the course of 2013. In the euro area, policy uncertainty, on the other hand, is set to ease only very slowly, reflecting a still-challenging political process. **Policy uncertainty is a key driver of investment and hiring decisions and is an important explanatory factor in explaining the gap between our US and euro area growth forecasts.**

4. **Euro area's lost decade:** Summer optimism on euro area recovery has faded to grey winter skies. Looking ahead we see continue weak growth in the region with only a very gradual recovery. For the 2007 to 2018, we expect GDP per capita to be flat, marking a lost decade of growth for the region. We blame much of this weak performance on a slow policy response in tackling both the sovereign and banking crisis, and the still too slow pace of structural reform. The fear is now that the euro area is on the verge of deflation. The ECB toolbox is not empty, but in our central scenario of low inflation (and not outright deflation) we see an additional LTRO and extension of unlimited liquidity. **The risk is that the euro will stay stronger for longer, adding to deflationary pressures.**

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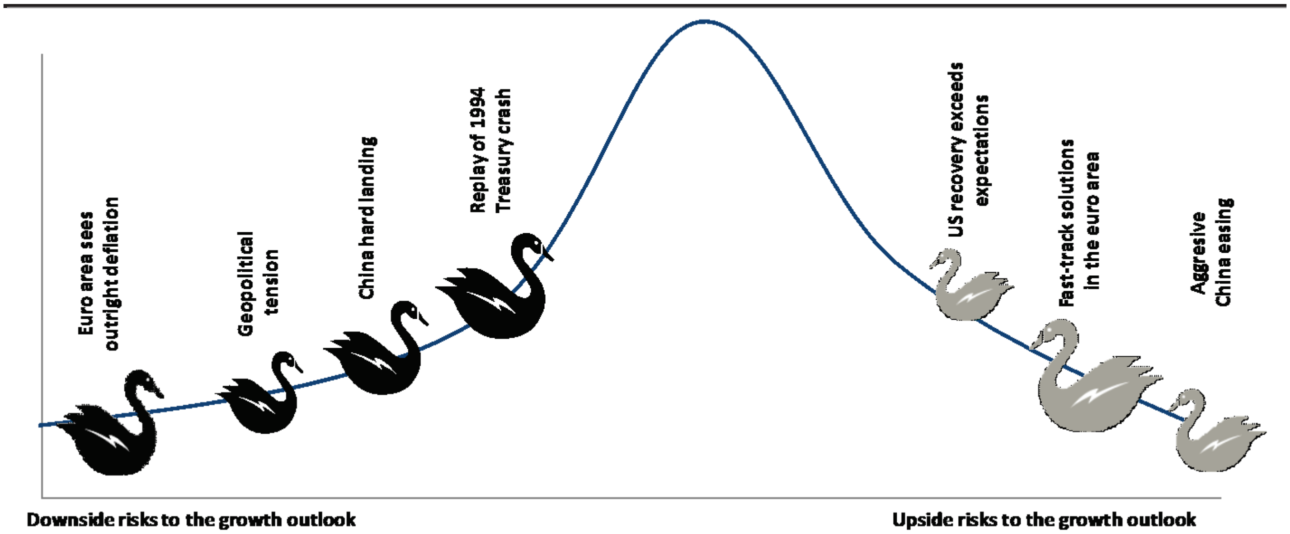
5. **Reform of Asia giants to deliver slowly:** Each has its own specific challenges, but Asia's three giants (China, India and Japan) are at a crossroads where structural reform holds the key to the future economic outlook. In China, reform in a nutshell is about removing the 100% implicit state guarantee and reining in excess supply capacity. In Japan, we believe Womanomics holds much of the key to sustainable growth long-term. In India, the challenge for the new government due to be elected in May is to embrace supply-side reforms. **Monetary policy will play a unique role in each case; we see further tightening from RBI to tame inflation and support the INR, further easing from the BoJ to keep the yen weak and PBOC intervention to prevent too strong appreciation of the CNY.**

Risks to our central scenario remain tilted to the downside. Turning points in US monetary policy are delicate operations to manage and the fear is set to be a replay of 1994. The aim of forward guidance is clearly to manage such risks. A disorderly market move holds the greatest risk for the most vulnerable emerging economies. Further risks in the US centre on the fiscal decisions to be taken in Washington in early 2014. In the euro area, risks appear more balanced relative to our below-consensus central scenario. Fast-track political solutions – including full delivery of banking union – hold the greatest upside potential. China's reform transformation will create short-term uncertainty; the danger is a hard-landing – the temptation the being to adopt further credit stimulus.

Chart 1: SG Swan Chart: The 2014 marks a 1994 replay is the key risk



	1994 replay / China hard landing Probability 20%	Four seasons of leverage Probability 70%	Fast-track recovery Probability 10%
Growth Inflation Policy-mix	Fears that 2014 will see a replay of 1994 are already generating lively debate. Should the Fed fail to convince markets of its resolve to keep rates lower for longer, US Treasuries could see a sharp collapse. In emerging markets, the reversal of flows could prove disorderly. In the euro area, the periphery would be the most vulnerable. A China hard landing remains a risk as the reform agenda is rolled out.	As emerging economies embrace deleveraging, advanced economies will act as a growth relay. Monetary policy will remain globally accommodative, even as the Fed starts to taper. We see further easing from both the BoJ and ECB. We also look for rate cuts in Russia and Chile.	The greatest upside potential is in the euro area, where fast track progress on both institutional and structural reform has the potential to unblock significant growth. The more likely upside, however, comes from a stronger than expected US recovery.

SG Risk Map: The x-axis gives an indication of how probable we consider a risk factor to be. The size of the swans gives an indication of how important the impact of that event materialising would be in terms of its upside or downside shock to the outlook.

Source: SG Cross Asset Research/Economics

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SG Anchor Themes

Anchor theme		Growth	Economic balances	Monetary policy	Market issues
Global **Bumpy growth relay from emerging to advanced**	For the first time post-crisis, we expect advanced economies in 2014 to see a marked increase in their contribution to global growth.	Emerging economies need to deleverage; advanced economies, and notably the US, will act as recovery relays. These early-stage recoveries remain vulnerable.	Deleveraging remains a headwind for the global economy. In advanced economies, private sector deleveraging has advanced but public sector debt is too high.	Emerging central banks will have to manage a delicate balance between inflation, credit and growth. Overall, we expect little new stimulus.	Commodity markets sit at the heart of the bumpy hand-off from emerging to advanced economies. We see range-bound commodity markets for 2014.
Global / US **QE to forward guidance … 2014 isn't 1994**	Tapering is no longer a question of if, but when. We expect taper to start in March, but the Fed will use forward guidance in a bid to keep rates low.	The US is on track for sustainable recovery with credit channels back in working order, the excess on household balance sheets unwound and the fiscal drag abating.	Washington will revisit the issues of continuing resolutions and the debt ceiling early 2014. We expect a solution to be found, but medium-term, public debt remains an issue.	Taper to start in March and be completed in July. We expect forward guidance for unemployment to be cut to 6% and thus see the first rate hike in mid-2016.	The US yield curve is set to steepen to new highs. The transition from QE to forward guidance is set to see renewed market uncertainty.
US / Euro area **Cross-Atlantic uncertainty gap**	We assume no new US shutdown and/or debt-ceiling stand-off, allowing a decline of policy uncertainty. In the euro area, high policy uncertainty is set to linger for longer.	The US and euro area economies are set to see a continued large growth differential.	Weak domestic demand in the euro area keeps the current account in surplus. Germany's current account surplus is forecast to decline.	As the Fed prepares to taper, we expect the ECB to take additional action to ease with a new variable rate LTRO and a further extension of unlimited liquidity.	We target 1.30 on EUR/USD mid-2014 and 1.25 end-2014. The risk is a stronger euro for longer. This would force the ECB to more aggressive action as deflation risks mount.
Euro area **One lost decade … but not two**	Lost decades are not just about weak growth, but slow reform. Progress on reform will remain slow, but should suffice to avoid a second lost decade.	Fast-track structural reform - both at the institutional level of the euro area and at the national level - holds significant upside potential. We see slow progress only.	Deleveraging past excesses is a slow process. Focus should be on Banking Union and the capital account, less on the trade balance and unit labour costs.	The ECB toolbox is not empty, but it will take outright deflation to bring out the big bazookas.	Blue skies of summer optimism have faded to grey. Comprehensive assessment will be key; this will be credible. But politics on resolution remain challenging.
Asia **Reform will deliver … slowly**	Medium-term China reform will deliver stability; short-term, there are risks. India needs supply side reform. Abenomics will see a critical test with the consumption tax hike.	Near-term, we see softer growth as China abandons the implicit 100% state guarantee and Japan hikes the consumption tax hike. In Indian reforms will deliver growth.	China needs corporate deleveraging and a reduction of excess capacity. Japan needs to see a boost to investment. India need a single market.	BoJ will continue to provide ample stimulus. PBoC will seek to stem CNY appreciation. RBI is set to hike further near-term.	We see a fairly stable USD/CNY, but look for yen depreciation. China hard landing risks are likely to reappear in the market debate.

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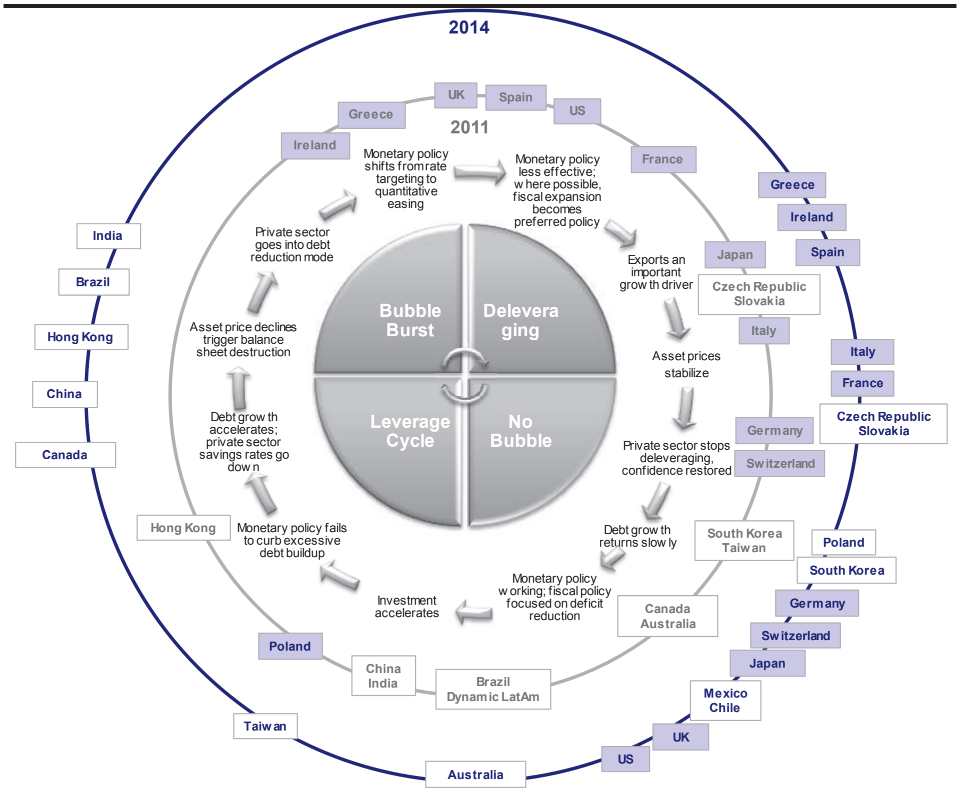
ANCHOR THEME #1

BUMPY GROWTH RELAY FROM EMERGING TO ADVANCED

For the first time post-crisis, we expect advanced economies in 2014 to see a marked increase in their contribution to global growth. Emerging economies have over the past few years offered a welcome support to global growth, but this relied in part on a build-up of credit that now needs to be paid down. The hope is for advanced economies to take over the baton from the emerging economies as the main driver of global growth. The US is now poised for sustainable recovery and in Japan hopes remain that Abenomics will work. The euro area, however, continues to lag. As such the growth relay from emerging to advanced is likely to prove a bumpy process. **Commodity markets will sit at the heart of this dynamic – our strategists look for range-bound markets in 2014.**

Chart 1.1: A new rotation of the global leverage cycle



Source: SG Cross Asset Research/Economics

This new rotation of the global leverage cycle is an integral part of our monetary policy outlook, which we discuss in greater detail in the following sections. Several features are worth noting:

- **Time for emerging economies to deleverage:** Post crisis, emerging economies adopted accommodative economic policies to offset the collapse in demand for their output. Providing a further boost, accommodative monetary policies in advanced economies drove significant financial flows into the region. Combined, these fuelled credit expansion. With the turn in the US interest rate cycle back in the spring, external financing conditions tightened. Moreover, in a number of emerging economies, policymakers have become increasingly concerned by a build-up in leverage; this is not just a story of level, but also one of speed. As seen from our

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leverage cycle, we believe the emerging economies have now moved to a phase of deleveraging. Our emerging market theme, however, is not just one of a cyclical downturn. As we have highlighted on several occasions, we believe potential growth is structurally slowing and no more so than in China.

Chart 1.2: The US yields cycle has turned

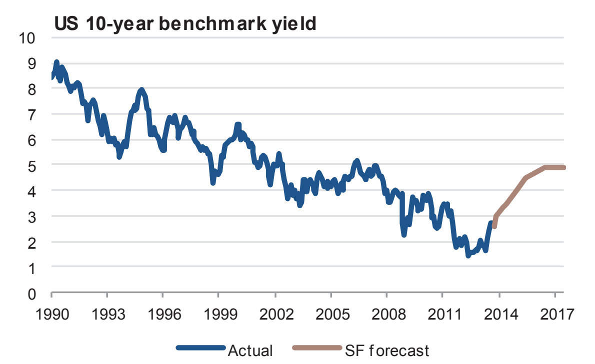
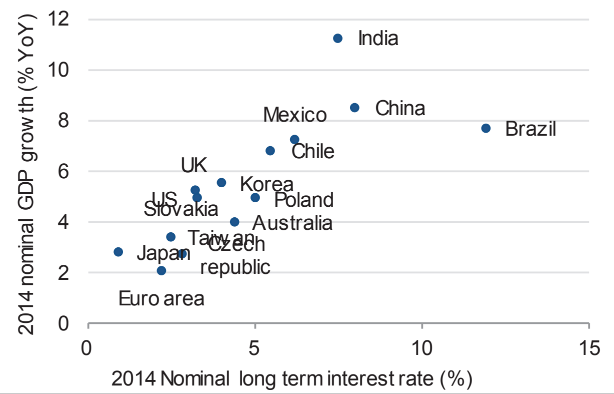


Chart 1.3: Yields and nominal GDP growth

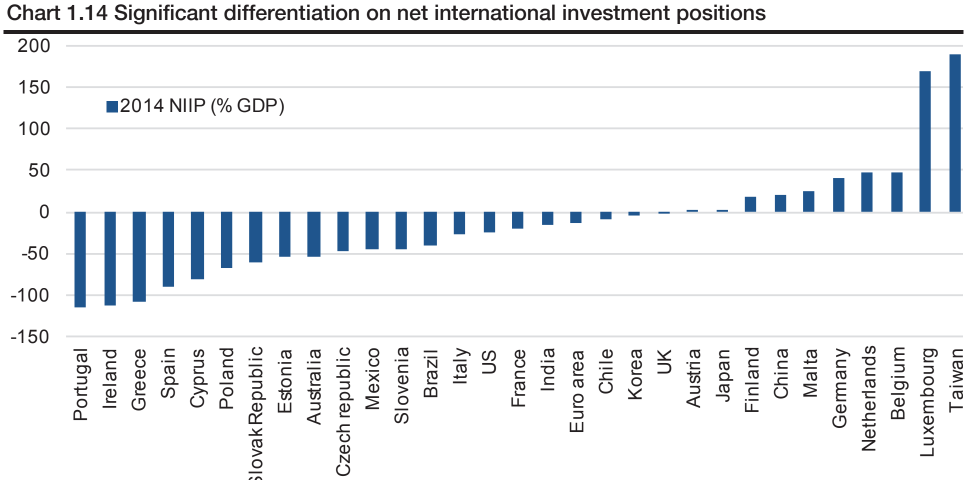


Sources: Federal Reserve Board, IMF, SG Cross Asset Research/Economics

▪ The deleveraging challenges for individual emerging economies differ substantially. The following three boxes highlight different challenges: **Box 1 on Brazil's need for smaller government**, **Box 2 on Korea's private sector debt burden** and **Box 3 on CEE challenges**.

A popular metric used to gauge vulnerabilities is to take a snapshot of the net international investment positions (NIIP). We urge caution, however, in focusing on external imbalances alone. As we discuss in our Country Notes, evaluating the stance of the individual economies requires a closer look at several other important metrics.

Chart 1.14 Significant differentiation on net international investment positions



Source: National sources, SG Cross Asset Research/Economics

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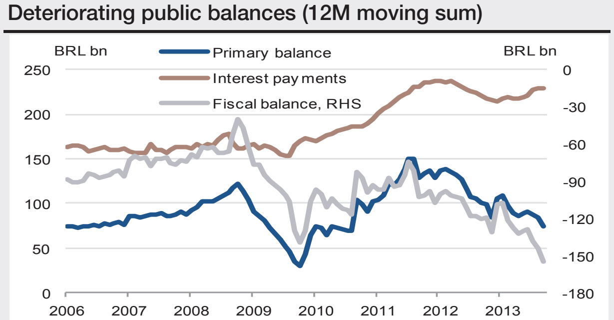
Box 1 Brazil

Brazil needs smaller government

Brazil's fiscal woes suddenly deepened in September when the Federal government's primary balance deteriorated considerably, raising the prospect of a rating downgrade. What Brazil needs is smaller government that will not only raise productivity and growth prospects, but also help attain fiscal goals. However, political realities do not signal any significant improvement in policy direction, implying that there is quite a significant risk that the country's rating could be downgraded.

The September fiscal release shook the Brazilian market and investor sentiment after government data showed the primary balance falling by BRL9 bn, dragging down the overall fiscal deficit to BRL22.9 bn. The decline in the balance was predominantly due to an increase in the Federal primary deficit that rose to (BRL10.7 bn), its highest level since December 2008 when the sharp fall in revenue did not deter the government from going ahead with counter-cyclical spending. Unlike 2008-09, however, the deteriorating public balance appears more chronic in nature given the immediate growth outlook and structural deficiencies of Brazilian public spending. For example, Brazilian social security spending rose from 36% of total spending to over 39% between 2010 and 2013. While this spending is still not too high compared to the pre-2008-09 level (when this spending ratio was declining), it has certainly jumped in an environment of high growth (unlike before). Note also that the size of Brazilian government spending at 40% of GDP is too overwhelming in comparison with other countries in the region and it has been expanded by the last two governments of President Lula and President Rousseff (both with ideological leanings in favour of larger government).

Deteriorating public balances (12M moving sum)

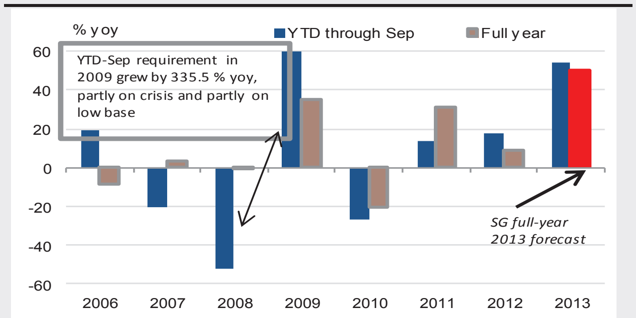


Source: Datastream, BCB, SG Cross Asset Research/Economics

Apart from spending, the pace of revenue growth declined in 2012 (to 7.3% from 12.5% in 2011 and 26.2% in 2010) on low growth and has not improved significantly this year (7.7% through September). Over the past few months, we can also see the rise in interest payment requirements since monetary tightening began with inflationary pressure earlier this year. Interest payments or non-primary fiscal balance could rise further in Q4 and in 2014 (but not quite as sharply as in 2010-11).

A combination of revenue, spending and interest payment requirements have raised borrowing requirements in the first three quarters spectacularly (next only to the 2009 jump). While there are instances of improvements in the public balances in Q4 (due to the seasonal nature of government accounts), we are sceptical of the result this time, partly because of the narrowing revenue base (a slowdown in growth is anticipated) and partly due to the rising interest burden with higher interest rates.

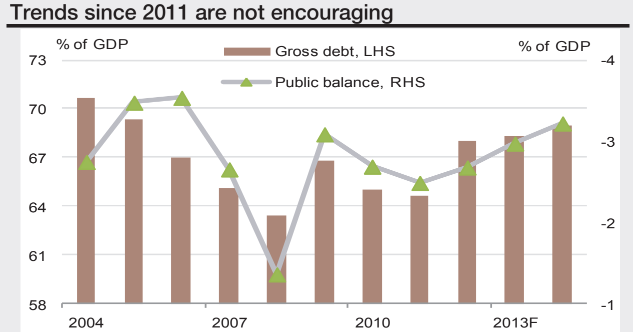
Sharp rise in borrowing requirements



Source: Datastream, BCB, SG Cross Asset Research/Economics

The primary and fiscal balance deterioration in September came just a few months after S&P warned about the possibility of a rating downgrade on deteriorating fiscal prospects largely due to the growth outlook and the resulting possibility of fiscal slippage going forward, particularly as the presidential election approaches (President Rousseff's recent request to put the fiscally stretching projects on hold notwithstanding).

Trends since 2011 are not encouraging



Source: IMF WEO Oct 2013, SG Cross Asset Research/Economics

The resulting rise in public debt will only push interest rates higher, fuelling the growth slowdown and increasing the fiscal burden (possibly encouraging public authorities to monetize debt issuance). During a high growth period or even at other times, what Brazil really needs is a smaller government but this appears highly unlikely given the current political situation in the country. A sharp deterioration in growth certainly raises the probability of a rating downgrade under this scenario.

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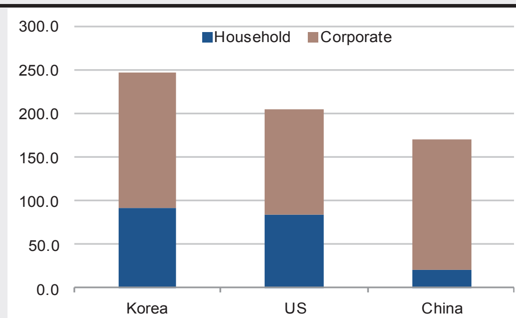
Box 2 South Korea

The burden of private sector leverage

High private sector (household and corporate) leverage has been the key risk for the Korean economy in recent years, and has weighed on domestic demand. Usually the focus falls only on the burden of household deb; at 91.1% of GDP in 2012, it stands above the 82..8% of the US. But the burden of corporate debt is equally serious. Corporate debt to GDP in Korea was 155.5% in 2012, way beyond the 122.0% of the US and even higher than the 150% of China where excessive corporate leverage is a concern.

Ratio of private leverage to GDP

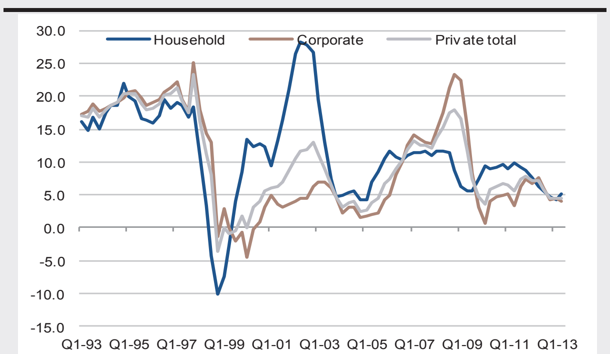


Source: Central banks, SG Cross Asset Research/Economics

Three boom-bust cycles…

Korea has experienced three boom-bust cycles in credit in the last 20 years. The first boom was in 1993-97, and was mainly driven by the corporate sector. This was triggered by the government's financial market liberalisation measures that led banks to take on large quantities of external debt, and drove strong investment and a sizable current account deficit. This ended in tears: Korea was hit by the Asian currency crisis which led to an IMF bailout, followed by a massive recession and painful deleveraging. 1998-99 saw an absolute contraction in private sector credit.

Growth of household and corporate leverage (%yoy)



Source: The Bank of Korea, SG Cross Asset Research/Economics

The second boom came in 2000-02, driven by the household sector. Strictly speaking, it was not a real credit boom as peak growth in private credit (12.9% yoy in Q4 2002) was about the same as peak growth in nominal GDP (12.7%).

However, the increase in household debt was astonishing, and was initiated by financial institutions looking to expand their assets through mortgage loans and credit cards amid the restructuring of the corporate sector. The government encouraged the trend as it helped the Korean economy to recover from the Asian crisis. Consumption growth accelerated due to a steep decline in the household savings rate, and an impressive housing market boom ensued. This boom also ended in a 'mini-crisis' characterised by a surge in credit card defaults and the contraction of consumption.

The third boom in 2005-08 was again driven by the corporate sector. This time, FX hedging by exporters on future receivables and domestic investors on overseas assets led to an increase in external debt: the government was at least responsible for the increase in domestic investors' overseas investment activity. Household debt was relatively stable, but the country witnessed another housing boom which led to new regulations on mortgage loans. Although the Korean economy didn't experience the typical signs of a credit boom, such as overheating domestic demand, a higher current account deficit or high inflation, the increase in external debt represented a severe burden which ultimately hit Korea in the middle of the global financial crisis in 2008 when the country had to face another credit bust caused by the sudden deleveraging of the corporate sector.

… and a consolidation process

In the wake of the global financial crisis we have seen a period of consolidation in private sector debt. Private credit growth accelerated a bit in 2010-11, led by household debt, but has since slowed again. The government still has concerns about high household debt and is basically maintaining regulation on mortgage loans. Meanwhile its initiatives to encourage loans to SME appear ineffective. The housing market is still in the doldrums and the occasional credit events are negative for corporate credit growth.

Economic growth naturally slowed along with the slowdown in credit in 2012. While GDP growth has started to rebound in 2013, we haven't yet seen any clear signs of a rebound in credit (debt) growth on either the household or corporate sides. One of the reasons we are seeing a 'recovery without credit' could be the contribution made by the government in the form of investment or government credit.

We now expect a modest recovery in private credit growth, from the current pace of around 5%, along with a sustained recovery in economic growth. However, we suspect the chances of another credit boom are pretty small, given the continued concerns regarding private sector leverage. The government is unlikely to ease current regulations on mortgage loans, and both households and corporates will remain cautious on additional borrowing. We assume private credit growth will not exceed 8% (i.e. previous peak of Q4 2011), which should limit the recovery in domestic demand. The absence of a credit boom also represents a key assumption underlying our BoK forecast of no rate hikes throughout 2014.

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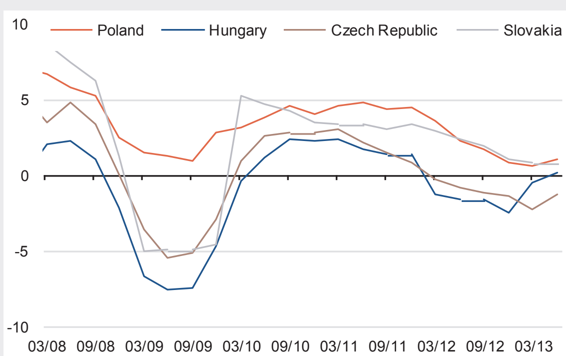
Box 3 CEE Challenges

One-off measures will not solve the problems

In a broad sense, the common challenge for CEE countries is to achieve stable growth and stable public finances medium term. Several examples of the planned or implemented measures by the government should be treated as one-off factors. The positive impacts on public finances in one year will not guarantee a stable situation for public finances in the future. Fundamental reforms are necessary, not only to improve the fiscal outlook, but to increase the growth potential of CEE economies too.

Economic activity in all CEE countries is weak and below potential (see chart). Adequate government measures, which positively impact economic activity on the one hand and do not hurt domestic public finances on the other, are quite challenging for the CEE region.

GDP yoy growth in the CEE region



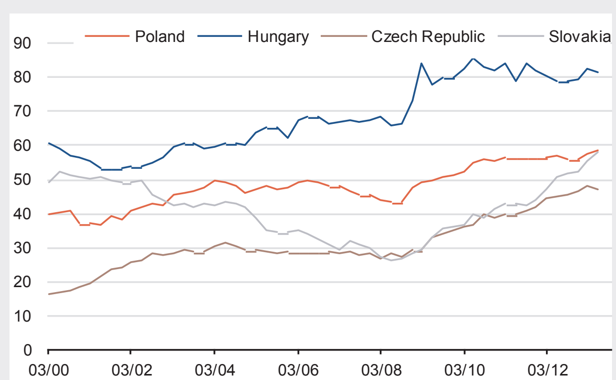
Source: Eurostat, Bluenomics

Since 2009, Poland has been under the Excessive Deficit Procedure. Because of that, the most obvious medicine of better growth–lower taxes, was scrapped from the potential economic "rescue" package. The growing debt to GDP ratio was the key reason for the government to introduce changes in the pension system (see: *Poland Country Note*). According to preliminary estimates, the new regulations may lower public debt by around 9.2pp of GDP in 2014. There are some doubts regarding the possibility of maintaining a lower debt to GDP ratio in the coming years without long-term measures. Even the European Commission expects that, after the surplus in general government in 2014, a deficit above 3% of GDP in 2015 is very likely. That is why Poland needs long-term measures which will stabilize public finances and ensure GDP growth remains above potential. The steady acceleration in private consumption in Poland is very likely due to positive effects of the country's low interest rate policy and weak inflation which will impact disposable income and private consumption. It is also possible that we will see Poland benefit from fund inflows under the new EU financial framework for 2014-2020. Several investment infrastructure projects scheduled for 2014-15 may also impact economic activity.

One-off measures were also introduced in Hungary. Tax-increasing measures and expenditure cuts are not enough to tightening the budget deficit long term. Weak economic activity in Hungary is not helpful either, even though the first quarters of 2013 were marked by a moderate rebound in economic activity. The pace of future real GDP growth is likely to remain relatively slow. According to the European Commission's estimates, the Hungarian economy is expected to grow in real terms by 0.7% this year, 1.8% in 2014 and 2.1% in 2015. Notably, the following years are unlikely to bring an improvement in balancing revenues and expenditure either. Furthermore, the situation on the Hungarian labour market should be seen as a challenge. The unemployment rate is likely to remain in double digits for the next two years.

After several years of very strict fiscal consolidation, the Czech Republic is expected to exit the Excessive Deficit Procedure in 2014. Yet, the price the Czech Republic had to pay was high, i.e. since Q411 the economy has been in recession. The situation should improve in the coming years, firstly because the new government which will emerge from the latest elections is very likely to shift away from austerity. Second, the CNB intervened on the FX market and weakened the CZK by about 5% against the euro. This easing of monetary conditions should help growth, but only from 2015 on. However, to ensure decent long-term growth and sustainable fiscal finances, competitiveness needs to be improved (see *Competitiveness: the hidden menace for some CEE countries*). This also holds true for Slovakia, which lost out in terms of competitiveness as well, even though the country is doing better in terms of growth. Yet, on the other hand, the Slovak government is likely to miss its fiscal target and the public debt to GDP ratio is expected to continue to rise this year, to approach the 60% threshold.

Debt to GDP ratio in the CEE region



Source: Eurostat, Bluenomics

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■ **China must tame excess capacity:** With NFC debt at over 150% of GDP and significant excess capacity, China is ripe for deleveraging. Already in 2013, a notable feature of our forecast has been that the Chinese authorities would resist market pressure to ease monetary policy and further fuel the credit bubble. Nonetheless, shadow bank credit has continued to expand and, with that, problems of excess capacity. China's challenge now is to deleverage and reform. The two in many ways go hand in hand and we discuss these issues in Boxes 5 and 14. It is worth nothing here that reform in China is tantamount to removing the 100% implicit state guarantee. And looking ahead, even state-backed companies could be allowed to fail. Herein resides also a potential trigger for the risk scenario of a hard landing, should such a company failure be poorly managed and spin out of control.

■ **Japan's corporate sector to cut savings to invest:** Investment and savings are two sides of the same coin and to secure sustainable recovery in Japan, corporations need to reduce savings and invest. The BoJ's monetary policy is already working through the currency channel and our expectation is to see a pick-up in corporate investment next. This is not just a function of monetary policy, but also the two remaining arrows of Abenomics, namely fiscal stimulus and structural reform. We see significant opportunities medium-term from reform as discussed in Box 13. Short-term, the BoJ is poised to deliver further stimulus and we look for additional asset purchases to be announced early in the new fiscal year (commencing April 1).

Chart 1.7: Japanese corporates to cut savings ... and invest

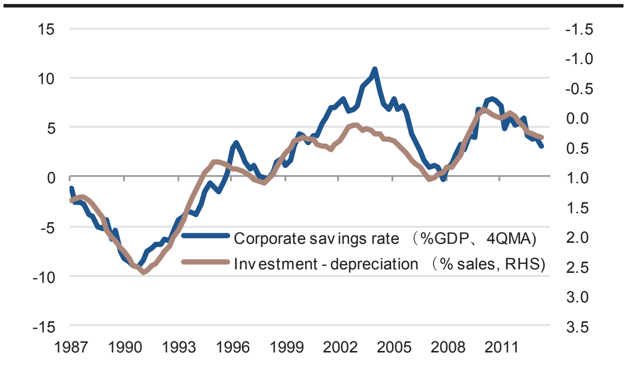
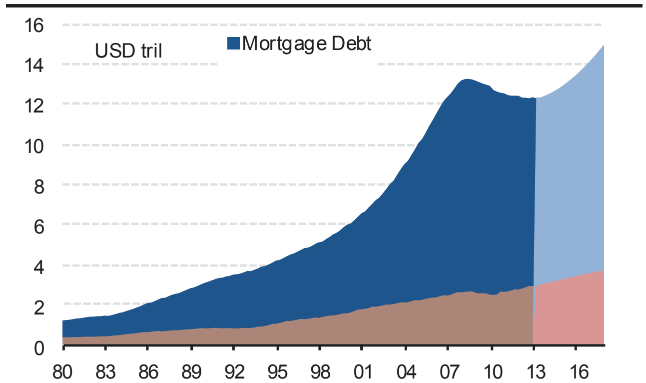


Chart 1.8: US household credit cycle now turning



Sources: Japanese Ministry of Finance, Federal Reserve Board, SG Cross Asset Research/Economics

■ **US credit cycle is turning:** Credit channels have been repaired, household balance sheets deleveraged and excess housing stock unwound. Combined, these lay the foundations for sustainable recovery. In 2013, fiscal tightening exerted a headwind to growth, but this is now easing allowing GDP growth to accelerate to 2.9% in 2014. For the Fed, setting the right monetary policy during this transition will be challenging; this is the focus of anchor theme 2. A glance at our leverage cycle suggests that the challenge as recovery gains traction over time is to avoid a build-up of excess leverage. This is not an immediate concern to our minds. Although we forecast household credit expansion, our forecast for household income growth is higher, entailing some further reduction of the household debt-to-income ratio.

■ **UK housing credit has been boosted by government measures:** Supported by policy initiatives, UK housing is staging a recovery. This is highly dependent on mortgage loan conditions and the BoE will be keen to keep rates low. We expect the Bank to lower the unemployment rate threshold on its forward guidance from 7.0% to 6.5% (and reduce the NAIRU from 6.5% to 6.0%). The hope medium-term, is that this housing-driven recovery will

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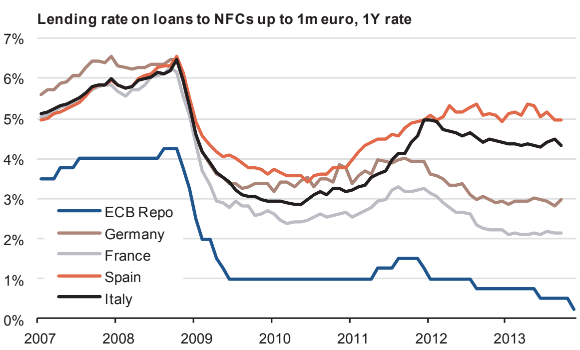
eventually become broader based with stronger confidence, consumption, exports, corporate investment and lower unemployment. Much will depend, however, on euro area recovery as of 2015. Longer-term, a possible UK referendum on EU membership remains a point of uncertainty.

Chart 1.9: Pick-up in UK housing credit

Chart 1.10: Continued euro area fragmentation

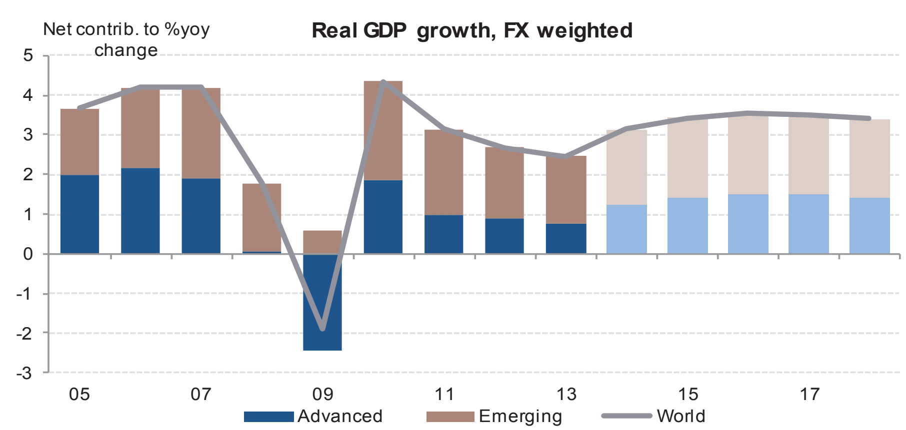


Sources: ONS, European Central Bank, SG Cross Asset Research/Economics

- **Euro area still facing headwinds:** As illustrated, individual euro area economies are in very different stages on the leverage cycle. Germany is the most advanced, followed by France, Italy and Spain. For several euro area economies, financial fragmentation and fiscal austerity remain serious headwinds. 2014 will see the arrival of a Single Supervisory Mechanism. As we discuss in Box 10, progress on a Single Supervisory Mechanism continues to disappoint and our base line remains for only a gradual repair of credit channels. Moreover, structural reforms are also not progressing at the desired pace, albeit with significant variation from country to country. The danger for the euro area is to become trapped in a lost decade of very low growth and low inflation. The ECB still has options as we discuss in Box 12. The real game changer opportunities, however, reside with governments to deliver quantum leaps on reform – at both the euro area and national levels. For now, progress remains disappointingly slow.

Summing up our view, 2014 will thus be the first year post crisis when advanced economies make an increased contribution to global GDP growth.

Chart 1.11 Advanced economies to make increased contribution to global growth



Sources: IMF, SG Cross Asset Research/Economics

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ANCHOR THEME #2

QE TO FORWARD GUIDANCE … 2014 ISN'T 1994

2013 saw US 10 year bond yields rise almost 100bp as expectations of a turning point in US monetary policy gained traction in line with the recovery of the real economy. Given our growth forecast of 2.9% for 2014, tapering is no longer a question of if, but when. Our forecast is for tapering to start in March 2014 and be completed in July 2013. The Fed has, however, already clearly indicated its willingness to keep rates well below levels implied by traditional policy rules for much longer. We expect the first rate hike only in mid-2016. Ultimately, inflationary pressures will build and we forecast the Fed to act more aggressively and tighten too much too late in the cycle. This is a question for 2018/2019. For 2014, we expect US yield curves to steepen further and pressure to mount on the more vulnerable emerging economies. Adjustable exchange rates and overall stronger economic balances, should prevent a broad-based emerging market crisis.

Chart 2.1: Past Fed tightening …

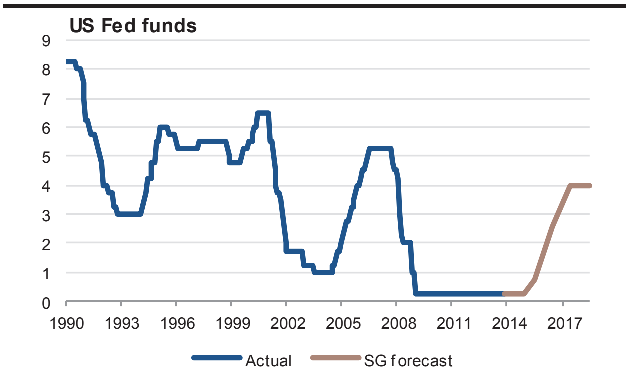
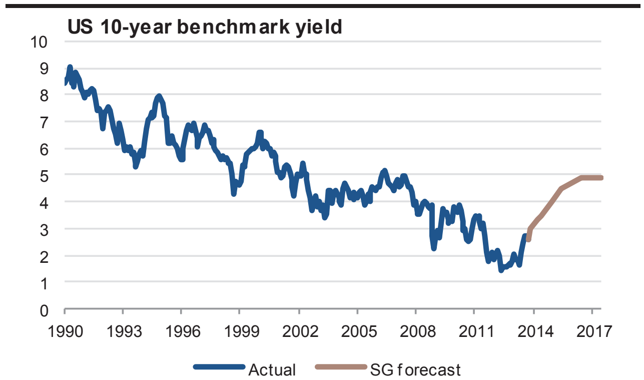


Chart 2.2: ... and US Treasury yields



Sources: Federal Reserve Board, SG Cross Asset Research/Economics

With the US economy now in recovery, there is clearly concern at the Fed that the benefits of QE are now being outweighed by the potential costs. The risk of tightening too slowly in recovery is the generation of bubbles that will ultimately burst in a painful way. The danger of tightening too quickly is to send the economy back into recession just as recovery is gaining traction. When the Fed first discussed tapering back in the spring, the market response was immediate and financial conditions deteriorated substantially as a result. As seen from chart 2.3, recent market developments have eased financial conditions back to the levels that prevailed when the Fed opted not to taper in September. And this despite the fact that the 10-year benchmark Treasury yield is broadly unchanged.

Against the backdrop of continued economic recovery, we expect the Fed to commence tapering in March 2014. In a bid to avoid a replay of the 1994 bond market crash, the Fed will seek to anchor expectations for rate hikes through its forward guidance policy. At present, the Fed's forward guidance states that it deems the target range of 0-0.25% appropriate as long as (1) the unemployment rate remains above 6.5%, (2) inflation between one and two years ahead is projected to be no more than 0.5pp above the long-term goal of 2%, and (3) long-term inflation expectations continue to be well-anchored. On our forecast, this sets the first rate hike in mid-2015, but we expect the Fed to lower its forward guidance on the unemployment rate to 6%, thus placing the first rate hike in mid-2016. We discuss this in more detail in **Box 4, How much slack in the US labour market?.**

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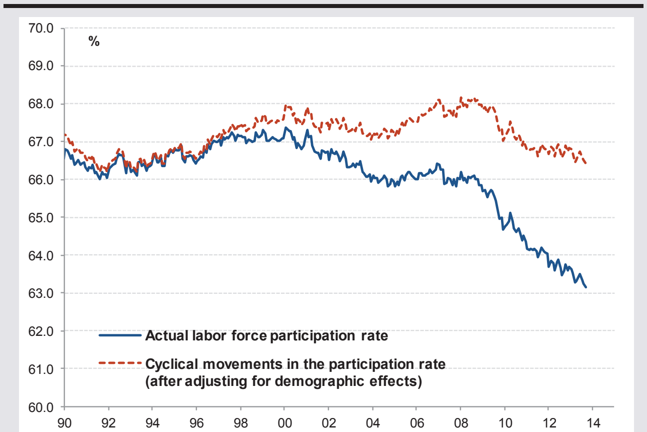
Box 4 — United States

How much slack in the US labour market?

We believe that the Fed will soon lower the unemployment rate threshold for rate hikes from 6.5% to 6.0%. What would this mean for the timing of the rate lift-off? The answer depends not only on job growth, but also on the future trajectory of the participation rate. Our central scenario assumes that labour force participation remains constant going forward and we explain why below. With trend growth in the labour force now running at just 80,000-90,000, payroll growth of 200,000 per month will translate to a fairly rapid decline in the unemployment rate. We expect to reach the current 6.5% threshold in late 2014 and the new 6.0% threshold in late 2015. This would imply an initial rate hike in 1H 2016.

In most cycles, changes in the unemployment rate are driven primarily by employment growth. In this cycle, much of the decline since the cyclical peak of 10% is attributable to declining participation rate. This is not to say that employment growth has been absent. Since 2011, payroll growth has averaged a respectable 180,000 per month. However, this is merely in line with the trend growth in the working-age population, defined as those 16 years and older. Hence, the employment-to-population ratio has remained broadly constant since registering post-recession lows, and the entire drop in the unemployment rate has been driven by the declining participation rate.

Chart 1: Participation rate – stripping out the demographic impact

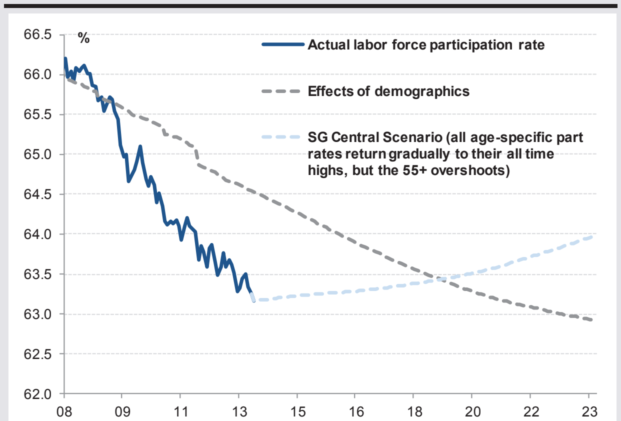


Source: Haver Analytics, SG Cross Asset Research/Economics

One of the important questions for monetary policy going forward – aside from predicting job growth – is what will happen to the participation rate? And, the answer to that question depends critically on an assessment of what has driven the decline over the past five years: namely, what portion of the decline in labour force participation is due to cyclical vs. structural factors. Fed officials have begun to make this distinction, with Bernanke often referring to the "cyclical movements in the participation rate". We therefore begin by breaking down recent movements into these two components. Our analysis suggests that aging accounts for about half of the decline in the participation rate since 2007 (see chart 1). If the other half is indeed cyclical, then surely this will have to reverse, putting upward pressure on the unemployment rate over the next few years? Not exactly. While the cyclical portion will most likely rise at some point, the effects of demographics will continue to induce downward pressure on the participation rate over the coming decade.

What accounts for this prolonged demographic effect? The oldest age cohort, i.e. those 55 years and over, has an average participation rate of about 40%. This compares to the 20-55 year old population whose participation rates average between 70%-80%. The downward drag on the trend participation rate comes from the fact that a growing portion of the population is moving into the 55 years+ age bucket. In 2007, it accounted for 29.5% of working population, today it accounts for 33.7% and a decade from now, it is projected to account for 38% of working population. Even if the participation rate in this age group were to increase from the current 40%, i.e. people retire later than they have in the past, it would still be very difficult – if not impossible – to fully offset the projected demographic shifts.

Chart 2: Participation rate – convergence to trend



Source: Haver Analytics, SG Cross Asset Research/Economics

Accounting for the projected demographic shifts, the trend participation rate stands at around 64.5% today, about 1.25% above the actual rate. Yet, over the next ten years, the trend is expected to decline to 63%, which is even lower than today's

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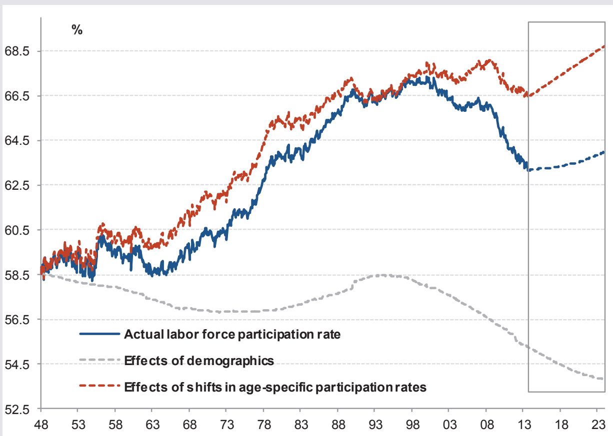
levels (see chart 2). Therefore, the overall participation rate could converge to that trend by simply remaining at current levels. In this scenario, the cyclical portion would gradually return to previous cyclical highs, but this would be almost entirely offset by a continued demographic drag.

Chart 3: Participation rate – our assumptions going forward



Source: Haver Analytics, SG Cross Asset Research/Economics

In our central scenario, we have made the assumption that over the next decade all age-specific participation rates return to their 2007 levels, while the oldest age group's participation exceeds those levels by 3 percentage points. In this scenario, the cyclical portion would overshoot its previous cyclical peak, but most of this would be offset by the demographic drag. The net effect would be only a very modest increase in the overall participation rate (see chart 3).

With the participation rate projected to be broadly range-bound over the next 5 years, our forecast for the unemployment rate is driven primarily by changes in non-farm payrolls. Our GDP projections suggest that payroll growth should remain near the 175,000-200,000 monthly pace which is enough to put significant downward pressure on unemployment. One thing to note is that the break-even pace of job growth, i.e. the pace required to keep the unemployment rate stable, has declined considerably over the past decade. During the 2000s, the breakeven was seen around 130,000-150,000, but today it is estimated at just 80,000-90,000. The shift is driven by the same demographic effects described above. Though the working population (i.e. those able to work) continues to grow at roughly 1.0%-1.1% annually, about the same pace as it did a decade ago, the trend growth in the labour force (i.e. those able <u>and</u> willing to work) has slowed from 1.3% in 2000 to 09% in 2010 and is projected to slow to 0.7% by 2015. Since the labour force is the denominator in the unemployment rate calculations, this slowdown implies a decreasing hurdle for job growth.

What does this all mean for Fed policy? There is no doubt that there is a significant excess slack in the labor market today. In addition to an unemployment rate that is far away from NAIRU (non-accelerating inflation rate of unemployment), there is additional slack reflected in the cyclical portion of the participation rate and in the high incidence of part-time workers. However, as we move through time, this slack will be gradually eroded by structural shifts related to demographics. Looking at chart 2 above, even if the participation rate remains at current levels by 2018, the Fed will no longer be able to claim that this is a source of labour market slack as the entire post-2007 decline will have been explained by population aging.

The bottom line is that we expect the employment gap to be eroded gradually and steadily over the coming years. This will be supported not just by faster employment growth, but also by the slowing growth in the labour force. If the Fed does extend the guidance for zero rates until the unemployment rate declines below 6%, we have no doubt that they will keep the promise. This would imply no rate hike until 1H 2016 given our estimates. Yet, our concern lies in what will happen after the initial lift-off. By early 2017, we project that unemployment will be in line with NAIRU and the cyclical portion of the participation rate will be at or above cyclical highs. In this context, wage pressures could materialize faster than the Fed currently anticipates.

Until now, we have been sanguine about the Fed's unconventional policies and have not viewed them as particularly risky for the inflation outlook. However, a further extension of zero-rate guidance, which has been signalled by Fed officials, would increase the chances that inflation will overshoot in the medium-term. In this scenario, the eventual tightening cycle could prove to be far more aggressive than that currently anticipated by the Fed or the markets.

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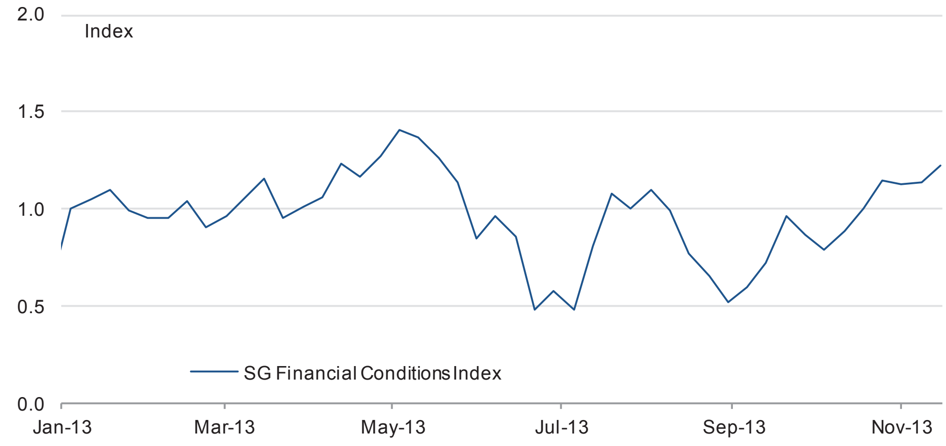
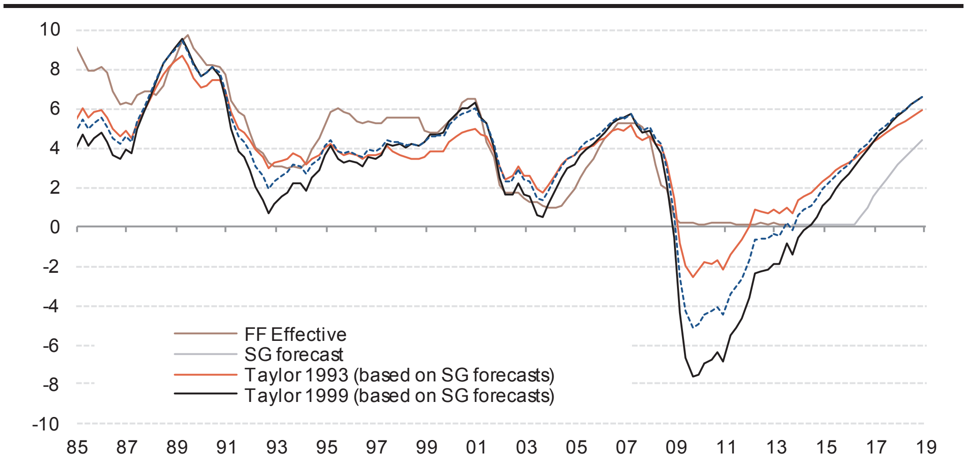
Chart 2.3: US financial conditions back to pre-taper talk levels (higher = better)



Sources: Haver Analytics, SG Cross Asset Research/Economics

The concern is that in keeping rates well below levels suggested by traditional monetary policy rules, the Fed will generate inflation. Medium-term, our forecast does indeed foresee higher inflation, but the Fed has clearly indicated that this is a risk it is willing to take. In the near-term, we see the greater risks from the Fed's monetary policy as residing outside the US.

Chart 2.4: Lower fed funds … for so much longer



Sources: Federal Reserve Board, SG Cross Asset Research/Economics

While QE in the US – and ultra-accommodative monetary policies in other advanced economies - failed to trigger credit creation in the respective national economies, it can be argued that it did generate significant capital inflows to emerging economies, boosting credit in these economies. In China, this liquidity, combined with a further boost from domestic government policies, found its way to fixed asset investments. This led initially to a welcome demand boost for commodities and a wide variety of capex goods. Today, however, the result is that China suffers significant excess capacity and poor capital returns, not to mention a shaky shadow banking system. As we detail in **Box 5, Unwinding China's excess capacity**, we now expect China to exert deflationary pressure on the global economy.

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Box 5 China

Unwinding China's excess capacity

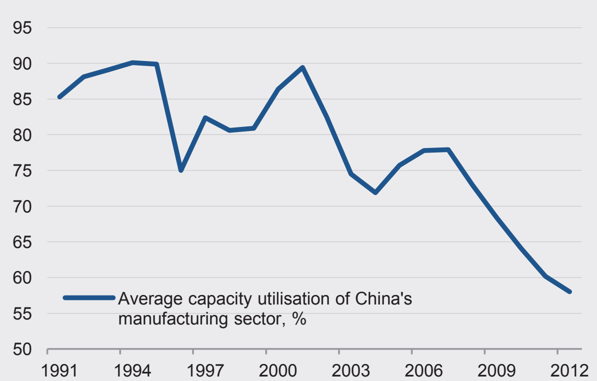
Can we ever have too much of a good thing? Sometimes. This is exactly the case with China's manufacturing capacity.

Structural excess

The IMF estimated the average capacity utilisation of five key industries (cement, pig iron, steel, iron alloy and motor vehicles) at only 60% in 2011. It was not always this bad. China's utilisation rate of this measure was moving closer to 80% in 2007, before collapsing to 70% as soon as the Lehman crisis hit. However, the really problematic development was what happened afterwards. China's economic growth recovered quickly to 9.2% in 2009 and 10.4% in 2010, and growth in 2011 was also a solid 9.3%. However, capacity utilisation contracted by another 10ppt at that time. During those three years, manufacturing fixed asset investment surged by 112%, exceeding the breakneck paces of infrastructure (92%) and property investment (98%)!

Comprehensive and timely data on capacity are scarce in China, but producer price inflation (PPI) is a good proxy of the relative speed of a demand recovery and capacity expansion. Judging from the extended long period of producer price deflation, we reckon that the woes of low capacity utilisation are fairly widespread and have hardly lessened in the past two years.

Persistent low capacity utilisation



Source: IMF, SG Cross Asset Research/Economics

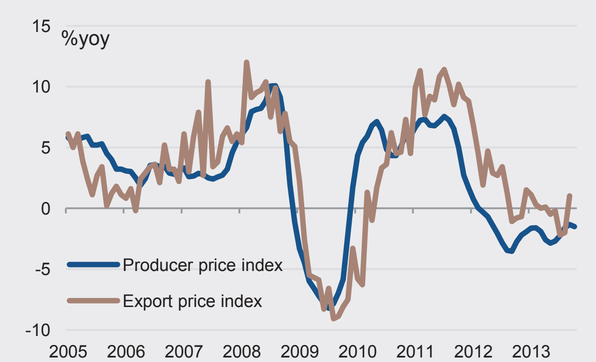
China's excess capacity problem now looks more structural than cyclical. First, the glut is unusually large. As a comparison, the long-term average capacity utilisation rate of the US manufacturing sector has been around 75% since the 1970s. Second, expansion is often pushed by the government, rather than market demand. In China, capacity expansion has been the most effective way to achieve growth targets for local governments and a handy countercyclical policy tool –facilitated by easy credit from state banks – for the central government. Hence, expansion persists throughout cycles and usually accelerates during downturns. The so-called four-trillion stimulus package implemented in 2009/10 was a prime example of this.

Third, due to government involvement in the first place, consolidation is politically difficult. As local governments focus on local GDP, tax revenue and employment, many inefficient local firms – both state-run and private alike – have been kept alive by bank credit and fiscal subsidies. The central government has been issuing warnings and capacity-reduction targets since 2001, with little success until today. Hence, unsurprisingly, problems have merely accumulated.

Deflationary

The lack of auto-correction in China's capacity cycle therefore results in an unprecedented divergence between the supply side of the economy and the demand side. This means that the conventional supply model is not particularly relevant to analysing China's potential GDP and output gap. If we consider excess capacity as part of the effective capital stock, China's output gap could be 5-6% of the (bloated) potential GDP. This is obviously deflationary, which is clearly evident in China's PPI data. As we go to press, producer prices have been stuck in yoy contraction territory for 20 good months now – the longest streak ever. Also, deflation is more pronounced in those sectors that are suffering more from excess capacity, such as nonferrous metal, ferrous metal, chemical fibres and coal mining.

China is exporting deflation



Source: NBS, CEIC, SG Cross Asset Research/Economics

As China's own demand cannot absorb all the excess capacity, Chinese manufacturers have naturally looked to external demand. There has been a close correlation between producer prices and export prices, with the former leading the latter by one to two months. Export price inflation followed PPI lower during 2012 and has remained fairly muted so far this year, despite the yuan appreciation and rapid wage inflation. An unpleasant consequence of China's attempt to dump excess capacity abroad has been the rising trade tension with its major trading partners.

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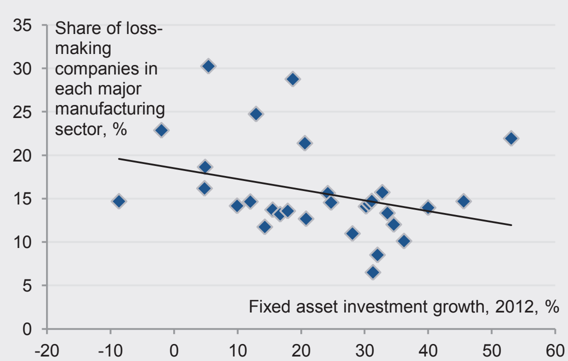
Furthermore, China has become a major importer of nearly all the key commodities. Industries that are suffering from excess capacity have seen outright capacity destruction but new investment growth has slowed in response to profit compression. For instance, over one-fifth of Chinese steel manufacturers have been steadily loss-making since early 2012 and the FAI growth in this sector was the slowest among all major sectors. As a result, China's commodity import growth decelerated in late 2012 and early 2013, which put immense downward pressure on global prices. It is true that there is always a chicken-and-egg relationship between China and global prices, but we observe that, in this cycle, China's domestic prices fell beyond the degree that this relationship would suggest.

It is worth pointing out that this round of deflationary pressure from China is different from the previous round in the early 2000s when China emerged in the global market as a source of cheap labour, and exerted immense downward pressure on consumer goods prices.

Less new investment, but eventually consolidation needed



Source: NBS, CEIC, SG Cross Asset Research/Economics

Solutions

Looking ahead, a recovery in demand is unlikely to be the solution to China's excess capacity as it is more concentrated in heavy industry. Demand mainly came from external sources before the Great Recession as well as from China's own infrastructure needs and also the property sector afterwards. As Europe is just at the beginning of its deleveraging process, China cannot count on external demand to close the supply glut anytime soon. Chinese policymakers could use infrastructure to alleviate the problem, but the scope for this is limited in our view. Although we would agree that China still needs more infrastructure in general, the growth of the past is hardly repeatable. Furthermore, China has yet to find a sustainable financing model for infrastructure projects. The outlook for China's property sector is mixed, to say the least. After a decade of rapid expansion, lower tier cities, which account for more than half of total housing construction, are now suffering from oversupply.

Capacity consolidation and destruction will have to form a key part of the solution. The longer this process is postponed, the longer deflation and profit margin compression will persist for Chinese as well as global manufacturers. Accelerating this process will also undoubtedly inflict a great deal of pain. Capacity elimination means corporate failures and debt defaults. China's financial system will come under pressure.

The new leadership seems to be more determined to fix this problem. During its first year in office, the new government has issued four documents on this topic. Although a large part of the proposal still looks the same as before, the overall reform on liberalising factor prices – from energy, utility, water, environment, land and interest rates – may turn out to be much more effective in forcing out excess capacity. More importantly, the financial liberalisation that Beijing is now heading towards means moving away from the widely-held belief that the central government has the resources, control and willingness to guarantee (almost) all of the debt in the system, which means that even state-backed companies can fail (cf. "Asian Themes – Deflating China's credit bubble", September 2013). Only when such creative destruction takes place will we see the end of excess capacity.

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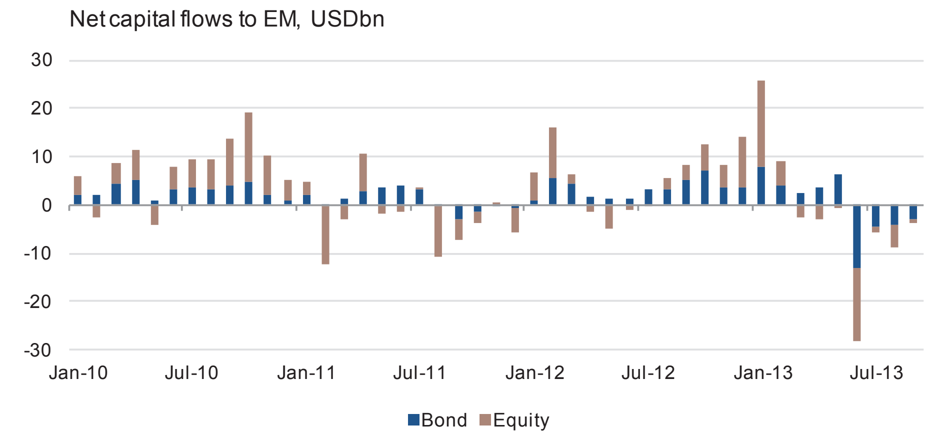
While in China, the impact of QE was seen mainly on the supply side, other economies such as Brazil and India saw the effect concentrated on the demand side, via consumer credit. Initially, local currency appreciation masked this inflationary aspect of QE. With Fed taper talk, however, a new dilemma appeared for central banks in these economies as local currency depreciation added to domestic inflationary pressures at a time of slowing growth momentum. Contrary to China's deflationary impact on the global economy, we do not expect these inflationary forces to be exported. As households struggle to deleverage balance sheets, the end result, however, could prove deflationary. The concern is that, as the Fed starts to taper, these emerging economies will again come under pressure.

Chart 2.5: Net capital flows to emerging markets



Sources: Datastream, SG Cross Asset Research/Economics

In considering the parallels to 1994 and the risk of renewed crisis, we note stronger balances for the emerging economies in aggregate, stronger economic structures on the back of reforms and in many instances the escape value of a flexible exchange rate. As is clear from our discussion, structural reform holds the key.

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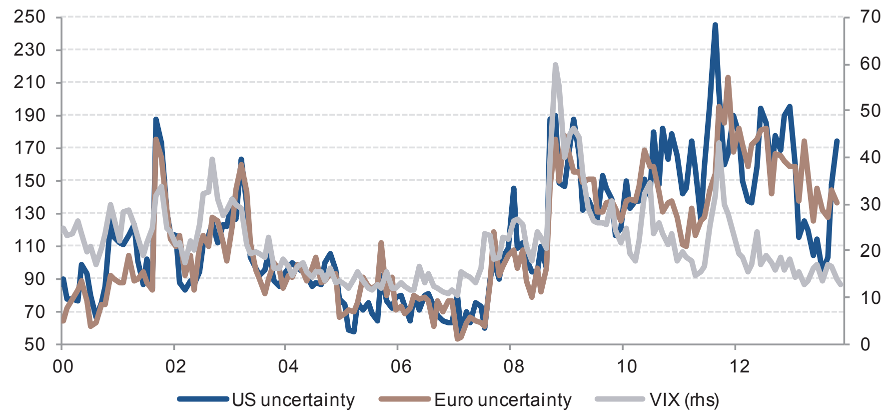
ANCHOR THEME #3

CROSS-ATLANTIC POLICY GAP

All eyes will be back on Washington in early 2014. While a new shutdown and/or debt-ceiling stand-off are risks, we believe the odds to favour a more benign scenario. This, in turn, should allow policy uncertainty in the US to resume the downward trend established in the course of 2013. In the euro area, policy uncertainty, on the other hand, is set to ease only very slowly, reflecting a still-challenging political process. Policy uncertainty is a key driver of investment and hiring decisions and is an important explanatory factor in explaining the gap between our US and euro area growth forecasts.

Chart 3.1 Policy uncertainty is not the same as market uncertainty



Source: www.policyuncertainty.com, SG Cross Asset Research/Economics

While central banks have successfully reduced uncertainty in financial markets, policy uncertainty remains above pre-crisis levels in many of the advanced economies. As we detail in **Box 6, Life on the other side of uncertainty**, we find a significant impact of policy uncertainty on growth and employment. A rapid return to pre-crisis levels of policy uncertainty would according to our estimates have the potential to boost US GDP by 0.8% cumulated over 2014 and 2015, and euro area GDP by 1.2% over the same timeframe.

In the US, policy uncertainty spiked in the autumn due to the government shutdown and debt ceiling stand-off. The solutions agreed were only temporary and a new debate in Washington is due in early 2014. While a new shutdown and/or debt ceiling stand-off is a risk, we believe the odds favour a more benign scenario as we discuss in **Box 7, Why Washington cannot hurt us any "more"**. Our US outlook assumes that policy uncertainty will return to the lows observed in August in early 2014. **Relative to our central scenario, the risk in the US is thus biased to the downside, should policy uncertainty persist for longer than expected.** A new government shutdown would add a further drag to the economy; we estimate that for every two weeks the US government is shut, quarterly annualised GDP growth for that quarter sees a loss of 0.2pp. In our opinion, the risk of a technical default of the US is low, but could have a material impact on global markets should it materialise.

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Box 6

US-Europe

Life on the other side of uncertainty

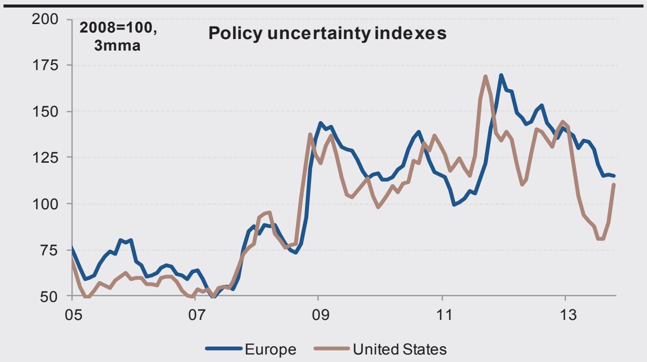
The US and the euro area are in different stages of the leverage cycle (cf. Anchor Theme 1). A common factor to both, however, is that reducing uncertainty could deliver a real boost to growth.

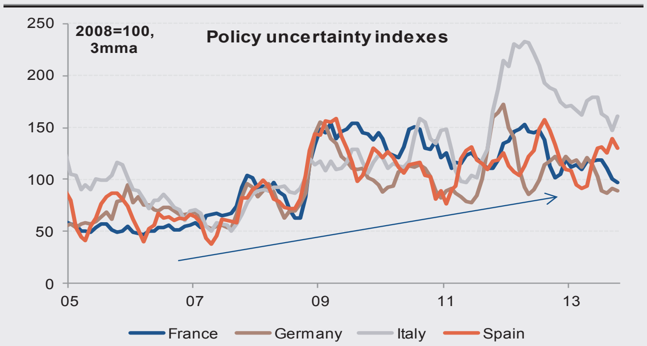
We estimate that returning to pre-crisis levels in terms of uncertainty would provide a 1.2-ppt boost to euro area real GDP growth over the 2014-2015 time span. The American economy would also benefit from a reduction in uncertainty, and indeed grow by an additional 0.8ppt of GDP over the same period.

The more you know, the faster you grow

Businesses make investment decisions based on assumptions about future revenues and income, and those outcomes are directly affected by economic policy and regulatory changes. Therefore a lack of visibility on how these issues will evolve over time would increase uncertainty about the viability of potential projects, and could put some of them in jeopardy. Recently, researchers at Stanford University have created an index of policy-related economic uncertainty for the world's major economies. Each gauge was constructed using a news flow-based indicator (a count of news articles with a given word, say "uncertainty") as well as the dispersion of economists' forecasts regarding consumer prices and government budget balances.

The crisis delivered a durable uncertainty shock





Sources: www.policyuncertainty.com, SG Cross Asset Research/Economics

Not surprisingly, Spain and Italy are the countries that would

The fact is that policy uncertainty has remained high since the beginning of the 2008 financial crisis – driven by political shortcomings experienced in Greece, Spain, Italy, and more recently by the government shutdown and the debt ceiling standoff in the US.

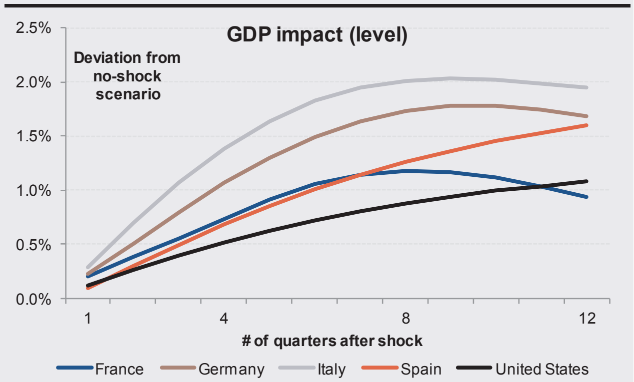
To get back to pre-crisis levels would undoubtedly provide a powerful boost to growth and employment. We discuss the prospects for easing policy uncertainty in Europe and the US in separate boxes. Here, we focus on quantifying the potential upside for growth.

In the US, our central scenario assumes a quick return during the first quarter of 2014 to the level of August 2013 (the lowest since the crisis – see accompanying chart, left). On the contrary, we see little scope for improvement in the euro area in 2014, and therefore a durable reduction in uncertainty would prompt us to revise our growth projections.

Quantifying the growth upside

Using a VAR impulse response function (for details on our methodology, click here), we estimate that if policy uncertainty were reduced permanently to pre-crisis levels, this would provide and between 1.5 and 2ppts within three years. The American economy would also benefit from a reduction in uncertainty, and indeed grow by an additional 1.3ppt of GDP in the long run (see accompanying chart, below).

The cost of uncertainty in terms of growth



Source: SG Cross Asset Research/Economics

Interestingly, the French economy does not seem to be as sensitive to spikes in the policy uncertainty gauge as other economies. And despite the importance of the negative uncertainty shock that we applied, the French economy would only benefit by an additional 0.9% in GDP growth over a three-year period.

When clarity comes, what sectors will benefit the most?

We believe that consumer spending could see some upside but, above all, business investment could rebound from the

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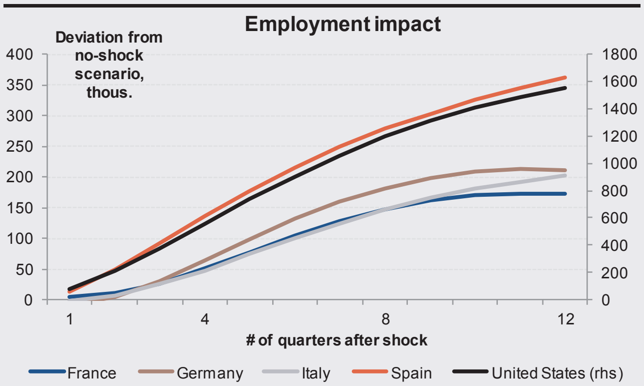
benefit the most in terms of growth from a permanent shift to pre-crisis levels (1.6 and 1.9ppts of GDP growth after three years, respectively). Besides, we estimate that in Spain it could take up to ten years for the shock to be fully digested by the economy, with GDP standing a healthy 2.5% above the level that would prevail in its absence.

Quantifying the upside for jobs

The story in terms of jobs is broadly the same. And here again each country could enjoy sizeable gains from lifting the veil of policy uncertainty. We estimate that total employment in the US would jump by an impressive 1.2m jobs two years after the shock, and by more than 1.6m in the long run (see accompanying chart, below). Aside from being a measure of what a country would gain by reducing policy uncertainty, the estimates that we provide can also be interpreted as a proxy of what was lost during the crisis due to the lack of clarity on future policy developments.

We estimate that the uncertainty factor in itself has led to the loss of around 950,000 jobs in France, Germany, Italy and Spain combined. If we could reproduce the same methodology with the area's remaining countries, the total job gain would probably exceed one million.

The impact of uncertainty on employment



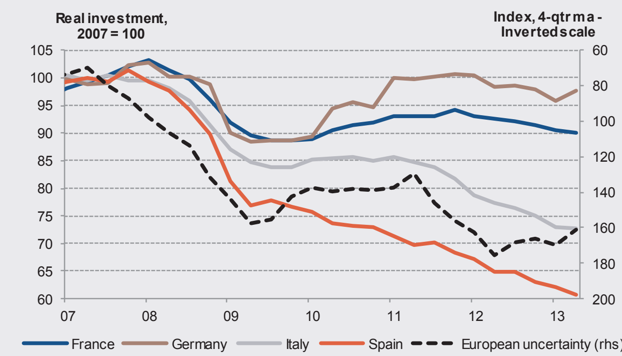
Source: SG Cross Asset Research/Economics

The Spanish simulations were the most difficult to run. In fact, the first results that we obtained pointed to very important potential job gains. The construction sector, alone, has lost around 1.7m jobs since 2008 (almost 10% of total employment in 2008). Though the job losses experienced by this sector were concomitant with the surge in policy uncertainty, everything indicates that they were more of a structural phenomenon and that a reduction in policy uncertainty would not lead to a lot of job creation in that field. That is why we ran our estimates without taking the level of employment in the construction sector into account.

Excluding construction, employment in Spain has tumbled by 13% (2.1m jobs) since the cyclical peak (Q2 2008). It is a lot larger than the drop witnessed in France (1%), Italy (4.1%) and the increase in German employment. In that regard, the estimate that we have for Spain (around 350,000 jobs in a three-year time period) does not seem unreasonable. After all it represents less than 25% of the total amount of job losses.

historically-low levels we have seen in recent quarters. The high level of policy uncertainty has likely prompted companies to postpone investment decisions (see accompanying chart, below). This should provide a compelling argument for euro area governments to swiftly clarify issues such as the Banking Union, as well as financial sector regulation.

Uncertainty has prevented businesses from hiring



Sources: Eurostat, SG Cross Asset Research/Economics

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UK policy uncertainty has recently seen a notable decline; a factor that underpins our confidence in the UK recovery scenario. Medium-term, however, the Conservatives promise if

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re-elected in the 2015 election to hold a referendum on the UK's European Union membership. This could create considerable uncertainty. Both Labour and the Liberal Democrats oppose the referendum and, as such, this proposal is unlikely to find a majority in the current Parliament. Should the referendum ultimately go ahead and the UK electorate vote to leave the EU, we believe this would have a highly detrimental effect on the economy.

Turning to the euro area, we forecast only a very gradual reduction in policy uncertainty for several reasons:

1. **Ongoing challenges for fiscal austerity and structural reform:** The 22 November Eurogroup statement brought a clear reminder that fiscal consolidation and structural reform is still very much the prescribed policy for euro area member states. In Italy, the political situation remains challenging and progress on reform has been insufficient. Although policy uncertainty there has eased from its peak, it remains noticeably above the other major euro area member states. For Italian business leaders, the lack of visibility on future reform is in our opinion holding back investment and hiring decisions. In France and Spain, policymakers also face significant challenges in advancing quickly on the reform agendas.

2. **Elections and new governments:** In May 2014, voters will elect a new European Parliament (EP). There is concern that anti-European Union parties could enjoy significant gains. In the last election in 2009, the participation rate stood at a dismal 43%. In the event of anti-European Union parties winning significant ground, this could become disruptive to advancing further on European institutions. Most areas today fall under the "ordinary legislative procedure" which requires the approval of both the Parliament and the Council for a text to become law. As we head to press, the hope is that Germany will soon reach agreement on a Grand Coalition. The first hurdle will come when the SPD's 470,000 members vote on the Grand Coalition agreement. Our baseline assumes a Yes-vote, but this is not a foregone conclusion. In the risk scenario of a No-vote, new elections seem the likely outcome. A possibility would be to explore a possible coalition between the CDU/CSU and the Greens. Even in the scenario of a Yes to the Grand Coalition deal, there is a real risk that the coalition will falter before its electoral term expires. 2015, moreover, will see a general election in Spain (due before 20 December).

3. **Still many unresolved issues on the euro area agenda:** As we discuss in **Box 8, Heavy agenda for Brussels**, the euro area agenda is packed with issues that still need to be resolved. Legislation for a Single Resolution Mechanism in the European Banking Union is still work in progress and the hope is now that this will be adopted before the European Parliamentary elections in May. The risk is, however, for further delay. The German Constitutional Court, moreover, has still to rule on the OMT. A solution to the Greek funding situation is also on the agenda and our expectations remain that Portugal will need help to return to the markets. Add to this the still many unknowns of the ECB's comprehensive assessment ahead of taking over as the single supervisory mechanism within the EBU.

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Box 7 United States

Why Washington can't "hurt" us any more

We expect the US economy to break away from trend growth next year and begin to make more rapid progress toward full capacity. This projected acceleration has a lot to do with the outlook for fiscal policy. To be clear, we don't expect Washington to become constructive to growth in the near term. But, in a nutshell, we expect them to "hurt" less. And that, at the margin, is a big plus.

We can state with near-absolute certainty that the drag from fiscal policy – both in direct and indirect terms – will ease significantly next year. In direct terms, the fiscal contraction is set to shrink from 1.7% in 2013 to 0.9%. So, while still a drag on growth, this drag will be almost cut in half. All else being equal, this will give a mechanical lift to GDP growth of about 0.8% (or, slightly smaller if we adjust for fiscal multipliers). These numbers are already baked in, unless Congress embarks on new spending cuts and/or tax increases. We view the risk of new austerity as extremely small.

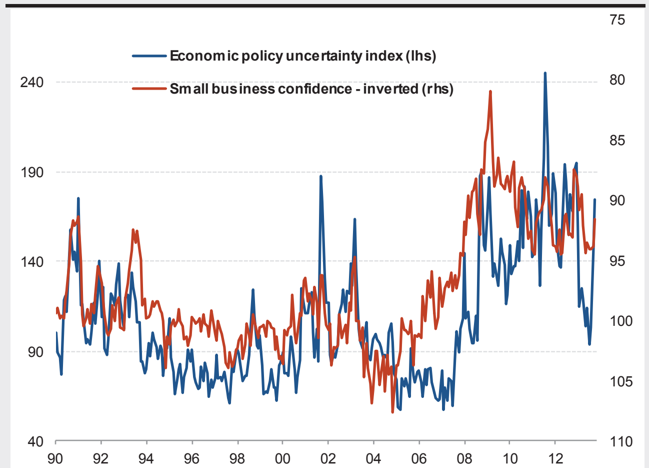
The indirect effects of fiscal policies on growth are more difficult to estimate. We classify them under the umbrella of policy uncertainty. As outlined in Box 6, a complete reversal of the uncertainty shock that began in 2008 would add 1.3% to US GDP growth and 1.6 million jobs over four years. But, what exactly constitutes policy uncertainty? And, what are the prospects that this headwind will ease going forward?

We would divide sources of economic policy uncertainty into three general categories: (1) the risk of future austerity (tax hikes, spending cuts); (2) regulatory uncertainty; and (3) the risk of government-related business disruptions. We expect overall uncertainty to ease meaningfully next year, driven largely by point #1.

No new austerity

When we consider the amount of uncertainty that existed a year ago, there is no doubt that visibility has improved significantly. Personal tax rates have been stabilized on a permanent basis. The sequester – like it or not – is a done deal and can only be eased from here. As a result of these measures, the debt/GDP ratio is now projected to remain in current ranges, i.e. slightly above 70%, for the remainder of the decade. This means that the risk of new austerity, i.e. on top of what has already been legislated, is extremely thin. The longer-term fiscal picture still needs contentious stand-offs: the debt ceiling crisis in summer 2011, the fiscal cliff work, most likely in the form of entitlement and tax reform, but these long-term solutions are unlikely to pose a challenge to growth in the near term. On the contrary, if any of these structural challenges were to be addressed in the coming months as part of the upcoming debt ceiling negotiations, this would constitute an upside risk to our economic scenario.

Chart 1: A new uncertainty shock. Will it last?



Source: Haver Analytics, SG Cross Asset Research/Economics

Reflecting the improved visibility on tax and spending policies, the policy uncertainty index was showing steady improvement from January through August (see chart 1). Unfortunately, the government shutdown and the debt-ceiling stand-off singlehandedly erased most of that improvement. Where do we go from here?

Can Washington do it again?

The agreement to reopen the government on October 17 produced two new deadlines: the current Continuing Resolution (i.e. government funding) will expire on January 15, and the debt ceiling suspension will be lifted on February 7. After accounting for "extraordinary measures", the Treasury will probably run out of borrowing authority by early April. We cannot say with absolute certainty that another government shutdown and/or debt ceiling stand-off cannot happen. However, we do believe that the odds are stacked against it.

First, it must be noted that continuing resolutions and frequent debt ceiling deadlines have been a fact of US life since 2009. Only three of those episodes have resulted in

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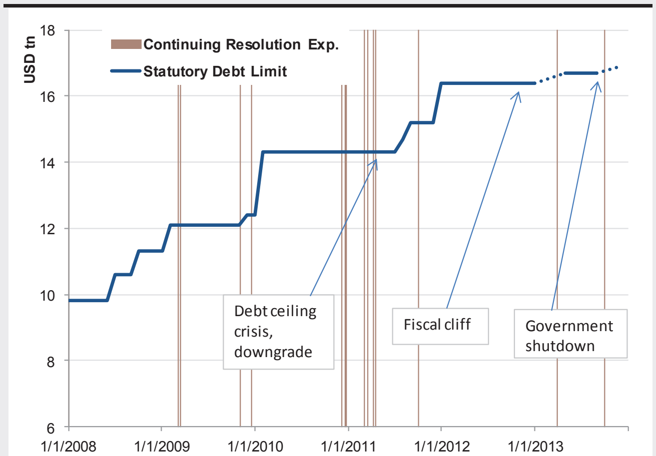
conflict which culminated at the end of 2012, and the government shutdown of October 2013 (see chart 2). It is noteworthy that these events have been spaced out in time by at least nine, and as many as sixteen months. Why? Because someone always loses – in some cases both sides – and there is little appetite immediately after the loss to do it all over again. Indeed, we draw comfort from the events of early 2013. After mishandling the fiscal cliff negotiations, House Speaker John Boehner had to pass the fiscal cliff deal in the 11th hour with Democratic votes, having failed to build consensus on any agreement within his own party. This was considered a significant defeat for the Speaker and for the Republican party, and not surprisingly, they decided not to contest the next debt ceiling deadline (February) or the next continuing resolution (March).

Chart 2: Not all debt ceiling/CR deadlines are created equal



Source: SG Cross Asset Research/Economics

The proximity of the upcoming fiscal deadlines to the mid-term election (November 4, 2014) also argues against another stand-off in our view. If anything, the lesson from the October government shutdown was that in order to affect change, you have to win elections. And, risking another shutdown or flirting with the debt ceiling will not bring the Republican party any closer to that goal. On the contrary, it could cost them seats in the House. Lastly, the recent problems deploying “Obamacare” have weakened the hand of Democrats and perhaps will make them more open to negotiations as well.

In all, we would place the probability of another government shutdown/debt ceiling standoff in early 2014 at around 15%. Not insignificant, but not very likely.

Regulatory risks remain

It is difficult to define policy uncertainty as it undoubtedly means different things to different people. In addition to the factors discussed above, business leaders often speak of regulatory uncertainty impeding their appetite for new investments. The regulatory burden is hitting different industries and different regions with varying force, but, on the whole, we don’t expect much change here. Therefore, this source of uncertainty is likely to persist, at least until the 2016 election cycle.

Lastly, the Affordable Care Act is another major source of uncertainty which we would put under the broad umbrella of regulatory risk. In addition to the individual mandate and the employer penalty, set to go into effect on Jan 1, 2013 and Jan 1, 2014 respectively, perhaps the greatest source of concern is the uncertain impact on health insurance premiums. It may be premature to draw conclusions from early enrolment data, but, so far, the average age of subscribers on the new healthcare exchanges has exceeded the official projections. Unless younger participants start signing up in greater numbers, health insurance companies could see their costs rise significantly, which in turn would trigger an across-the-board increase in the premiums they charge. Healthcare costs have already been a growing burden on both individuals and employers, and a new hike would constitute a further and potentially significant cost pressure.

Summing it all up – Washington won’t help, but the pain will ease

The uncertainty about future economic policy has been a significant headwind to growth generally, and to business investment in particular. Capex growth has been surprisingly sluggish in the past two years, despite good fundamentals. What are the prospects now?

Visibility on some fiscal issues will remain murky for some time. A tighter regulatory environment is a new fact of life. The implications for the Affordable Care Act on business costs remain uncertain for now. Polarization in Washington is unlikely to vanish any time soon, though the mid-term elections may ease the gridlock. However, with the debt trajectory stabilised for now, the risk of new tax hikes or spending cuts is extremely low in our view. And, that is a huge improvement relative to the situation just one year ago.

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Box 8

Euro policy uncertainty

Heavy agenda for Brussels

The euro area is exiting from recession, but the recovery is "*weak, uneven and fragile*", as highlighted by ECB President Draghi. The pace of fiscal consolidation is easing but financial fragmentation remains a headwind. Structural reforms have stalled this year in most euro area countries. On average, policy uncertainty remains very high. As outlined in Box 6, a complete reversal of the uncertainty shock that began in 2009 could boost euro area GDP by 2pp within three years. A full banking union could lift euro area GDP by around 1% by 2017. And, a well-designed package of structural reforms could boost GDP per capita by 10pp after ten years. Sustainable political solutions are needed to unlock the euro area's full potential. The list below identifies the heavy agenda and key challenges that Brussels and national policymakers are going to face in 2014. Greece needs a third bailout and it is not sure if Portugal will be able to regain full access to market funding next year. Italy and Germany still need stable governments.

1. Will Slovenia seek an EU/IMF programme?

Results of Slovenian banks' stress tests will be published before year end. The Slovenian government has earmarked €1.2bn for recapitalisation needs and will issue €4bn in 2014. If the actual cost proves to be significantly higher, it could be hard for the Slovenian government to raise the financing needs without an EU/IMF programme. The amounts at stake are not big compared to ESM capabilities, but after the Cyprus bail-in this year, Slovenia could become another template for dealing with weak banks in the euro area.

2. Greece needs to strike a deal with the Troika. Substantial debt forgiveness unlikely

Talks began in September between the Troika and the Greek government for the completion of the Fifth Review of the EU/IMF programme. Despite the strong improvement in the primary budget balance (expected to rise to 1.5% of GDP next year), these talks have yet failed to yield any result. The Troika argues that Greece needs to close the 2014-2015 fiscal gap, and make further progress on structural reforms and on privatisation, while the Greek government mentions austerity fatigue. Press reports suggest that the financing gap to meet 2014 public finance targets has been reduced to €1-1.5bn next year. There is little doubt that the Greek government will eventually strike a deal with the Troika. However, the key question is whether Greece will be offered much relief on its general government debt load of close to 175% of GDP. Eurogroup leaders have suggested that this question will be examined next spring, after the release of 2013 public finance figures. Substantial debt forgiveness seems unlikely in our opinion, even if it would be beneficial for the country in the long run and would improve market sentiment. Any relief would probably come with new conditionality (only at the margin in the form of lower interest rates and maturity extension) and potentially with some additional support from structural funds.

3. Can Portugal opt for a clean exit? Probably not

In contrast with Ireland, we believe that Portugal will likely be granted a precautionary credit line – an Enhanced Conditions Credit Line from the ESM (ECCL) – after the end of its EU/IMF programme in June 2014. Under the current programme, Portugal is due to raise a modest €4.4bn of medium- to long-term market–based funding. Those market-based financing needs are expected to rise to around €14-16bn in 2014, €22bn in 2015 and €25bn in 2016. Market conditions need to improve substantially to make this a viable plan. Moreover, the constitutional court has overturned major budget measures and reforms (such as the labour bill to allow public sector dismissals). This contributes to political tensions within the ruling coalition and weakens the government's bargaining position with the Troika. It is not sure either that Portugal will be eligible for a precautionary medium-term credit line. Indeed, an ECCL from the ESM would be available for one year and be limited in size to 10pp of GDP (€16-17bn). This means that a second, full bailout package could be contemplated in late 2014 or 2015. We expect general government debt to peak at 133% of GDP in 2016. Should Portugal need to rely on the official sector for all its funding out to 2016, then the official sector's holding of Portuguese government debt would increase from 40% to 60%. The black-swan tail risk is that policymakers, in light of issues on Portuguese debt sustainability and the template of the Greek second bailout, opt for debt restructuring (Private Sector Involvement). We consider this as a very low probability event.

4. Is Ireland out of the woods? Not yet

Ireland will exit its bailout programme in January 2014 without requesting a precautionary credit line. Indeed, the Irish programme has been successful, combining realistic macroeconomic targets, a well-designed package of measures, efficient implementation, and backed by a strong consensus among the country's largest political parties. However, the Irish situation remains challenging. For public debt to become sustainable, 10y bond yields would need to decline further (from 3.5% at end-November) or the nominal growth outlook would need to improve materially. The Irish economy is probably the most indebted economy of all the OECD countries, and the simultaneous deleveraging of all economic agents will weigh on growth rates in the medium to long term. Ireland striking a deal with the ESM to retroactively recapitalise its banks would come as welcome news, all the more as the upcoming AQR/stress tests could reveal the need for further bank recapitalisation. It is probably too early to be very optimistic.

5. Will the euro area change its austerity strategy? No

At the euro level, structural reform stalled in 2013 and public deficit targets were put off for two years. With the new EU governance processes, we expect euro area policymakers to request more compliance with

commitments. In November, the new governance procedures

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of the Fiscal Compact were tested, since it became effective at end-May 2013. In particular, the "Two-Pack" strengthens the budgetary monitoring. Euro area countries send their draft budgets mid-October, which are then assessed by the EU Commission and discussed between "peers" at the Eurogroup, before the final vote by national Parliaments. EU Commissioner Rehn said that the fiscal stance was 1.5pp of GDP in 2012, 0.75pp in 2013 and, assuming no further measures, 0.25pp in 2014. The pace of consolidation is easing, and this has allowed the exit from recession. However, more austerity is required than is currently provided for in several of the draft budgets. This is one of our key assumptions for our below-consensus forecasts next year. In particular, Italy and Spain are at "risk of non-compliance" with their 2014 deficit targets. Their finance ministers assured that *"extra measures are in the pipeline"*. For France, the Netherlands and Slovenia, the budgets are said to be compliant but without any margin for possible slippage; as a result, the Eurogroup urged rigorous implementation. In our opinion, another postponement of fiscal targets is possible, but it would come at the price of lower European integration, and would probably not be a welcome idea.

6. Will the German constitutional court say no to OMT? Not likely

The German constitutional court will rule on the OMT programme in early 2014. The court has already placed some conditions on Germany's involvement in European mechanisms. In particular, it imposed a cap on Germany's contribution to the ESM, which cannot be raised without the approval of the German parliament. The OMT programme can have a potential impact on Germany's liabilities, via the ECB's balance sheet. A decision from the German constitutional court to cap the OMT size would undermine the credibility of the OMT. As it would come into conflict with the ECB's independence, we believe that the risk of a negative ruling is limited.

7. Anti-European parties at the European parliament

European elections will be held in May 2014, ruling parties are likely to pay a heavy price for having implemented policies combining austerity measures and structural reform. Polls suggest that anti-European parties will make strong gains in each country and could even be able to form a new bloc at the European parliament. The risk is that the new European Parliament limits progress on the integration process.

8. Will the German government favour the European integration process?

German Grand Coalition talks are entering their final stages. See box 9. The agreement is set to include the minimum wage, new infrastructure spending and new taxes. It seems that the CDU/CSU and the SPD have agreed: 1) that no funds from the ESM should be made directly available for the recapitalisation of the banks; 2) to reject the proposal of the European Commission on the Full Banking Union (i.e., to take a decision on a purely inter-governmental basis); and 3) to reject euro bonds. This does not bode well for the European Integration process. Progress is still possible but will be made under strict conditionality.

9. Italy at risk of a longish period of political uncertainty

Council President Letta managed to avoid the fall of his government in early October. The centre-right party split into Forza Italia, headed by Mr Berlusconi and now in opposition, and the New Centre Right, a party in government. This could act to stabilise the present government and it is far from sure that the Letta government will fall in 2014. However, the difficult bargaining on the 2014 budget bill is a reminder that the parliament remains highly fragmented. Needless to say, the government's inability to make decisive economic choices raises the probability of a rating downgrade. Without a change in the electoral law, we believe that Italy is doomed to political instability, and that no fragmented government will have the ability to implement the structural reforms the country deeply needs.

10. ECB's comprehensive assessment of banks' balance sheet needs a capital backstop

At first sight, the ECB appears as rigorous and transparent as expected. ECB President Draghi made it clear that a few banks will have to fail the tests for the exercise to be credible. Capital, liquidity and funding will all be part of the Comprehensive Assessment exercise, to be published on October 2014. At this stage, there is no direct recapitalisation available at the euro level yet. Any identified corrective measures, including required capital increases, will come from private sources first (bail-in) and if insufficient "*Member States taking part in the SSM will make all appropriate arrangements*". A capital backstop at the euro level will probably be made available next year, once the SRM is decided, but there are still significant objections to direct recapitalisation via ESM, especially from the German side.

11. Progress on the banking union and fiscal union is required

The comprehensive assessment of bank balance sheets is a potential game changer, but in the broader context of building a European Banking Union, including the Single Recovery Mechanism (SRM), a single resolution fund or even a single deposit guarantee scheme. A vote on the European Commission's proposal is expected before the term of the current European Parliament comes to an end (May 2014), but this deadline appears very tight. We believe full banking union will at best become effective on 1 January 2015; more likely, however, on 1 January 2018. Hence, we do not anticipate major progress on resolving financial fragmentation any time soon.

In December, the Eurogroup will discuss a proposal of the European Commission that could lay the foundation for building a fiscal union: '*Contractual arrangements*', consisting of providing grant and loan support for countries implementing economic reforms. There is probably a long way to go before full fiscal union, but any progress could help diminish uncertainty about the integration project.

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Box 9 New German Government

Crunch time for negotiations

Talks enter final stage

In Germany, after nearly five weeks of negotiations, Angela Merkel's CDU/CSU and Sigmar Gabriel's SPD are approaching crunch time for results, with expectations of a shared programme for government to be presented on 27 November, just after we go to press. Throughout this period, there have been media reports of steady and gradual progress in the talks, mainly on topics of less controversial nature.

While the SPD will likely not budge on its demand for a statutory minimum wage of €8.5 per hour (which the CDU/CSU may accept) the CDU/CSU are unlikely to give in to higher taxes, (it is unclear if the SPD will accept this). Apart from that, the issue of allowing dual citizenship for people born in Germany who also hold a passport from a non-EU country remains contested while all proposals involving spending will need to be assessed together, in order to determine financing (without raising taxes or debt).

Topics on which agreement seems to have been found include energy, quotas for women on company boards (>30%), a planned financial transaction tax, rent controls and rejection of euro bonds (and ESM direct recapitalisation of banks) while issues still discussed include pensions and infrastructure spending. There has been some speculation that spending could amount to as much as €50bn (or 1.8% of GDP) if all the various proposals go ahead, but senior CDU members have clarified that all proposals need to be scaled back (to about €10 bn) and financed. This would be in line with our expected scope for reforms of up to 0.5% of GDP in the short term, which would have only a small impact on short-term growth in Germany and the rest of Europe.

But main challenge still lies ahead

Even if we do not exclude some delay in a final agreement, the real challenge may still lie ahead. That challenge comes in the form of the promised ballot among the 470,000 SPD members. Media has reported that the results of that vote will be announced on 14 December.

We would expect SPD members to endorse the leadership's proposals, but a 'NO' vote cannot be excluded. As seen recently at the SPD party conference in Leipzig, sentiment towards a Grand Coalition among grass-root members is lukewarm at best and unless they see real progress for SPD policies, they may prefer not to support an already strong Chancellor. The SPD also made an important tactical change, namely to end the ban on a possible coalition including the Left party (die Linke, far-left party originating from former communists). This would indeed provide the SPD with a whole new option, given that the SPD, the Greens and the Left party together hold a majority in Parliament. Given the still major divergences in policies (the Left party for instance wants to exit NATO), this may be a more realistic option for future elections, beyond 2017. At the state level, such cooperation has started in earnest in one state (Brandenburg).

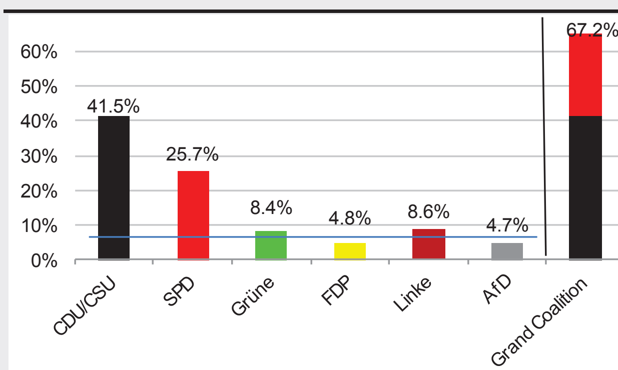
What happens if no deal is reached?

So, as we approach the final days of negotiations, we expect some core controversies to emerge, including elements of ideological differences. While the pragmatic Angela Merkel may be able to handle these controversies in the short term, we still expect to see a less stable political environment in Germany than what we have grown used to.

In the event of a breakdown in the final stages of negotiations or if there is a 'NO' vote from SPD members, we believe the CDU/CSU could initially have another go with the Greens. Exploratory talks had been held already but with the Greens walking out due to lack of interest from the CDU/CSU to discuss higher taxes to be able to finance more expansionary economic policies. While the Greens are unlikely to have changed their views on these matters, internal discussions may also have progressed, given its change in leadership and need for re-profiling.

Instead, the most likely outcome stemming from no deal with the SPD would be new elections. German voters have already shown strong support for Angela Merkel and it is possible that a new election would give Ms Merkel an absolute majority on her own (she would only need another 5 seats). Faced with such a possible outcome, the SPD may also tone down their demands in the final round of talks, and accept to become part of a Grand Coalition while pushing harder for SPD policies while in office. Failing that, they could still work on a platform, supported by the Left party, for the 2017 elections. By then, Angela Merkel may have worked out an exit strategy, further adding to the expectation of reduced political stability in Germany in the years ahead.

Final results in the 2013 federal election



Source: Datastream, SG Cross Asset Research/Economics

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ANCHOR THEME #4

ONE LOST DECADE … BUT NOT TWO FOR THE EURO AREA

Summer optimism on euro area recovery has faded to grey winter skies. Looking ahead we see continue weak growth in the region with a very gradual recovery only. For the 2007 to 2018, we expect GDP per capita to be essentially flat, marking a lost decade of growth for the region. We blame much of this weak performance on a slow policy response in tackling both the sovereign and banking crisis, and the still too slow pace of structural reform. The fear is now that the euro area is on the verge of deflation. The ECB toolbox is not empty, but in our central scenario of low inflation (and not outright deflation) we see an additional LTRO and extension of unlimited liquidity. The risk is that the euro will stay stronger for longer adding, to deflationary pressures.

Chart 4.1: Lost decades

GDP Per capita, 2007 = 100

	United States	Euro area	Germany	France	Italy	Spain	Greece	Portugal	Ireland	United Kingdom	Switzerland	Czech Republic	Slovakia	Russia	Brazil	Mexico	Japan	South Korea	Australia	China
1999	87.7	87.4	87.8	89.7	91.8	84.7		92.7	75.2	81.0	80.7	69.2	65.2	56.1	98.0	89.7	89.7	82.6	84.9	47.3
2000	90.3	90.6	90.6	92.5	95.3	88.1	76.9	95.9	82.2	84.3	83.4	72.4	65.9	61.9	99.3	92.9	91.5	85.8	86.6	50.9
2001	90.3	91.9	91.9	93.6	96.9	90.3	80.0	97.1	85.3	85.8	83.6	74.7	68.2	65.1	97.9	90.9	91.6	85.4	87.6	54.7
2002	91.0	92.3	91.8	93.8	97.3	91.5	82.4	97.1	88.5	87.4	83.2	76.7	71.3	68.7	97.4	90.0	91.7	89.5	90.2	59.3
2003	92.6	92.4	91.4	94.0	96.8	92.7	87.0	95.6	90.5	90.5	82.7	79.6	74.6	73.6	95.3	90.3	93.1	90.1	91.9	64.9
2004	95.3	93.7	92.1	95.5	97.3	94.2	90.6	96.5	93.0	92.9	84.2	83.2	78.7	79.3	97.6	93.0	95.2	92.3	94.6	71.0
2005	97.6	94.9	92.9	96.5	97.4	96.0	92.3	96.8	96.3	95.3	85.7	88.8	83.8	84.6	97.5	95.1	96.4	94.1	96.3	78.6
2006	99.2	97.6	96.6	98.4	99.1	98.4	97.0	97.9	99.2	97.3	87.9	94.9	90.6	91.9	98.7	98.6	98.0	97.0	97.4	88.0
2007	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2008	98.8	99.8	101.0	99.3	98.0	99.3	99.4	99.9	95.4	98.6	101.1	102.0	105.8	105.2	102.6	99.5	98.9	100.4	100.5	109.1
2009	95.2	95.1	96.1	95.7	92.0	94.8	95.9	96.9	88.4	93.0	98.0	96.7	100.3	97.1	100.7	93.5	93.4	98.8	100.1	118.6
2010	96.8	96.6	100.0	96.8	93.0	94.3	90.8	98.7	87.0	93.8	99.8	98.6	104.6	101.3	106.6	95.2	97.8	103.2	101.3	130.3
2011	97.9	97.9	103.4	98.3	93.2	94.3	84.3	97.3	88.5	94.1	100.4	100.6	108.3	106.0	107.9	97.8	97.4	105.0	102.2	141.7
2012	99.9	97.1	104.1	97.8	90.5	92.6	79.1	94.6	88.5	93.5	100.2	99.5	110.0	110.1	107.0	100.2	99.5	105.3	104.1	151.8
2013	100.9	96.5	104.9	97.5	88.5	91.6	76.0	92.9	87.4	94.1	100.7	97.9	111.0	111.9	108.1	100.8	101.6	106.3	105.2	162.7
2014	102.9	96.9	106.6	97.6	88.5	91.8	76.7	93.0	87.8	95.8	101.2	99.0	113.2	115.0	108.4	103.9	103.5	106.4	106.4	173.1
2015	105.4	97.8	108.2	98.3	89.2	93.0	77.4	93.5	89.2	97.2	101.9	101.6	115.6	118.9	109.8	106.8	105.4	108.3	108.3	183.8
2016	108.0	99.0	109.9	99.3	90.2	94.6	79.2	94.4	90.5	98.9	102.5	104.0	118.4	123.1	111.6	109.6	107.1	110.4	110.1	195.1
2017	110.6	100.3	111.6	100.5	91.2	96.2	80.9	95.9	91.9	100.7	102.9	106.3	121.0	127.6	113.0	112.3	109.1	112.5	112.1	205.8
2018	113.0	101.7	113.4	101.8	92.4	97.5	82.7	97.9	93.6	102.8	103.3	108.5	123.3	132.2	115.0	114.5	110.8	112.8	114.2	216.1

Source: IMF, SG Cross Asset Research/Economics

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Several headwinds remain for the euro area:

1. **Private-sector deleveraging:** Although progressing, private sector deleveraging remains a headwind for several member states, including Spain. Furthermore, as discussed in **Box 10, Banking Union needs fast track politics**, financial fragmentation has come with a high price tag for the periphery.

2. **Softer, but still in austerity mode:** The drag from fiscal policy has eased allowing exit from recession, but a long road of fiscal consolidation still lies ahead. The 22 November Eurogroup was clear: deficit/debt reduction and structural reform remain the prescribed policies. Italy and Spain, moreover, were noted by the Eurogroup as at *"risk of non-compliance"* on their 2014 deficit targets and have already promised that extra measures are in the pipeline. That these measures are in fact delivered is one of the key assumptions behind our below-consensus 2014 forecasts.

3. **Still-high policy uncertainty**: As discussed in Anchor Theme 3, policy uncertainty remains fairly high for the euro area and our baseline assumption is that this will be the case in much of 2014, easing only very gradually medium-term.

4. **Slow progress on reform:** Key to the medium-term outlook is continued progress on structural reform – at both the national and euro area levels. We assume that progress will continue, but only at a slow pace.

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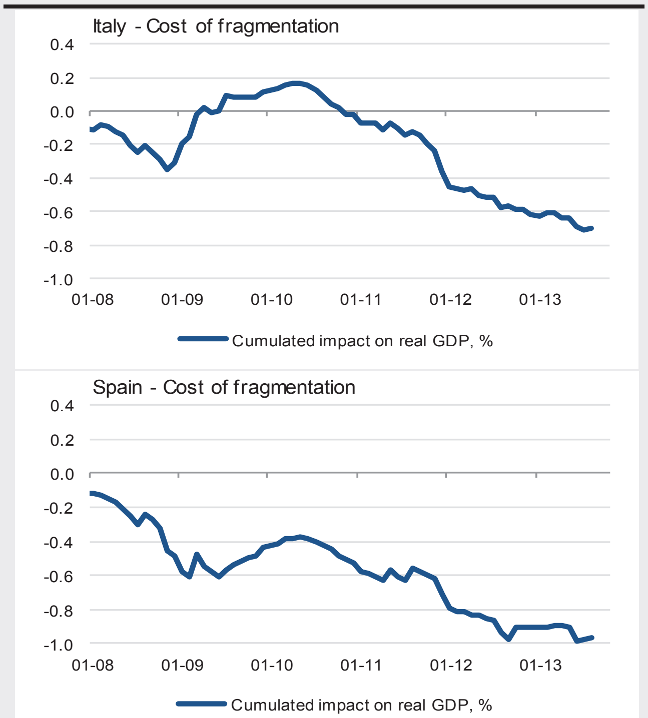
Box 10 Europe

Banking Union Needs Fast-Track Politics

Well drafted and executed, European Banking Union (EBU) could fix broken credit channels and boost euro area real GDP by 1% by 2017, offering a fundamental support to risky assets in the region. While a Single Supervisory Mechanism will be in place by the end of 2014, the Single Resolution Mechanism is suffering a slow political progress. In our recent thematic report Focus Banking Union – Green Shoots for Credit, we considered the potential hereof. We highlight the key economic conclusions below.

Drawing on pre-crisis patterns between bank lending rates in individual euro area countries, the ECB's repo rate and the long bond yield (German Bund), we build an estimate for where bank lending rates would have been absent fragmentation. We then subtract this theoretical bank lending rate from the observed rate to derive a "fragmentation premium" (shown in the chart below). Next, we adjust this premium for the share of bank lending in the member states in question. The result is then multiplied by the elasticities derived by the OECD with respect to a change in bank lending rates (cf. thematic report for detail).

High cost of financial fragmentation



Source: ECB, Datastream, SG Cross Asset Research/Economics

Potential wins from removing financial fragmentation are thus significant. To this we can add further wins from the reduced funding costs that we expect a full European Banking Union would yield. By 2017, we believe EBU could boost euro area GDP by as much as 1%.

Next step comprehensive assessment

On 23 October, the ECB provided details of the comprehensive assessment, comprising three building blocks (1) supervisory risk assessment (SRA), (2) asset quality review (AQR) and (3) stress tests. Box 12 summarises the key points of the ECB's communication. This exercise will pave the way for the Single Supervisory Mechanism (SSM) to become operational in November 2014. Experience from past financial crises suggests that bank asset quality issues require full recognition and resolution in order for broader economic growth to recover via new lending to sound borrowers. The hope now is that this too will materialise for the euro area.

In our opinion, the process will be credible. The ECB should provide a new liquidity backstop in the form of a new LTRO. Capital backstops, however, are likely to be national as opposed to euro area. Results from the comprehensive assessment are due in October 2014 and the ECB can then assume the role of Single Supervisor in November 2014.

Single Resolution Mechanism needed

To fully reap the benefits, banking union requires a Single Resolution Mechanism (SRM). The process has already suffered delay, and recent developments hint at very slow future progress with a less ambitious outcome. Our concern is that rather than a true SRM, it will be a co-ordination of national authorities. The danger in such an outcome is that it will prove less effective in breaking the doom-loop between banks and sovereigns. As such, repair of financial fragmentation would remain a very slow exercise. Our baseline scenario thus assumes only half of the potential gains from EBU is realised over the forecast horizon.

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Against this backdrop, the debate has once again turned to what action the ECB could take. Our view is that everything is possible, but not probable. We draw three key messages from recent ECB speak:

1. **The ECB toolbox is not empty.** Options include a further rate cut, a negative deposit rate, further LTROs - possibly with a fixed rate and asset purchases. Less debated in the media, but also an option in our opinion, is foreign exchange intervention. Most likely such action would come only if backed by the G20.

2. **ECB's policy action will be a function of the fundamentals … and notably price stability.** In our opinion, it will take a significant intensification of deflation risks for the ECB to take action much beyond an additional variable rate LTRO (to act as liquidity backstop to weaker banks ahead still struggling to secure market funding at reasonable pricing) and possibly a 12.5bp repo rate cut with a further extension of liquidity provision.

3. **Governments need to deliver sustainable public finances and structural reform.** The ECB alone cannot deliver sustainable recovery for the euro area.

The inflation outlook holds the key to our ECB call. The December 5 meeting will deliver new economic forecasts and the focus will be on inflation. In September, the ECB forecast 2014 inflation at 1.3% (with a range of 0.7-1.9%). Our baseline scenario assumes a modest downward revision only to the inflation outlook. In **Box 11, Euro area disinflation with a lag,** we take a closer look at the euro area inflation dynamics; our baseline scenario is low inflation and not deflation.

In 2013, the euro surprised by its strength and this even before the Fed pushed back taper expectations. We are often asked what a stronger euro would entail. Drawing on the elasticities from the OECD's new global growth model, the charts below illustrate the assumed impact on the euro area economy from exchange rates on both growth and inflation in our central scenario (depreciating to 1.25 end-2014 and then to 1.15 by 2018) if the EUR/USD remains unchanged at 1.35. As seen, a stronger euro would have notable implications for both the growth and inflation outlooks.

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Box 11 Euro area - Inflation

Euro area disinflation with a lag

Disinflation is now taking more shape. In fact, consumer prices are set to grow at a slow pace over the medium term; we expect the euro area HICP to average 1.0% yoy in 2014 and 1.4% yoy 2015. All in all, we see downside risks to our scenario, but no deflation. In fact, long-term price expectations remain well anchored.

In the peripheral economies, disinflation is materialising strongly as most of the indirect tax effects have dropped out of the annual comparison. Risks to our outlook would be slightly tilted to the downside. On one hand, we see downside risks via lower energy and commodity prices. The role of the euro will be key and should be closely monitored. In addition, we believe that further adjustments in unit labour costs are now more likely to pass through domestic prices. On the other hand, upside risks could arise from additional indirect tax hikes (VAT, green taxes etc.).

Lower commodity prices and a strong currency, if sustained, are a major threat to our outlook.

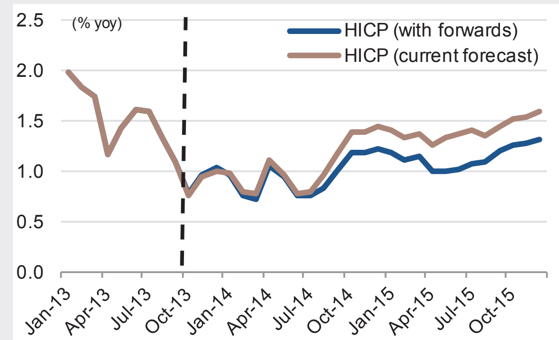
In October, on the back of changes in the inflation outlook, the ECB cut its refinancing rate by 25bp. In fact, since the beginning of the year, HICP inflation has been decelerating broadly across countries. In the euro area, HICP inflation fell from 2.0% yoy in January to 0.7% yoy in October, while core inflation remained somehow resilient up until October when it fell to 0.8% yoy (from 1.3% yoy in January). So most of the deceleration in consumer prices since the beginning of the year can be explained by fluctuations in energy and food prices.

Looking at energy developments, Brent prices fell by 8% from their peak in August to early November. While the EUR/USD rose by nearly 3% during the same period.

However, it is worth noting that the pass-through to consumer prices is not immediate and only partial. On energy prices, we view lags of one month and seven months as significant. Also, according to our models, a 10% appreciation of the EUR/USD lowers the euro HICP by 20bp.

When looking at our assumptions, one risk stands out: while we expect a broadly flat behaviour of Brent prices, we expect the EUR/USD to depreciate by broadly 13% by the end of 2015. At the time of writing, the forward curve remains around the 1.34 level up until 2015. Chart 1 shows the potential impact that the currency at current levels could have on our inflation outlook over the medium term. Actually, if the EUR/USD parity was to be sustained at current levels, it would lower our projections by c.25bp at the end of next year. This clearly represents a major downside risk to our scenario.

Chart 1 - Euro area HICP inflation outlook (SG assumptions VS forwards)



Source: Eurostat, Datastream, SG Cross Asset Research/Economics

Therefore, the euro currency is one to watch closely, as its behaviour passes through domestic prices via energy prices.

When looking at food developments, we have observed some fall in the UN measure of food prices (FAO), which dropped by 5% from its peak in April to October. Yet, on this component, the pass-through is much more difficult to estimate. In fact, the Common Agricultural Policy (CAP) is preventing and/or delaying most of the food price adjustments. Studies show that international food inflation shocks take from one to six quarters to pass through to domestic headline inflation. The elasticity is close to 0.2 in advanced countries, therefore, global food prices are only one factor that influences domestic food prices. We can also add to this the ULC as the share of wages in the retail sector cost structure is significant.

The link between unit labour costs and domestic prices has strengthened.

Since 2009, unit labour costs have decelerated a lot but surprisingly this fall did not pass through to domestic prices. This is surprising because both the economic theory and our econometric models suggest a strong pass-through of ULC to core prices over the long run (the elasticity in our models ranges between 0.5 and 1 over the long run when considering the core components).

Yet, there are many reasons for this muted effect. Two reasons could be profits and indirect taxation, which acted as buffers between ULC behaviour and final domestic prices, thus preventing sharp price adjustments (please see Euro area: linking prices, ULC and profits for more details). Another reason is the stickiness of prices relative to downward adjustments. In Spain for instance, ULC has dropped by 10% since Q2 2009, while core prices have actually grown by 3.2% in the same period. But since 2008, Spain has raised its standard VAT rate by 5ppt.

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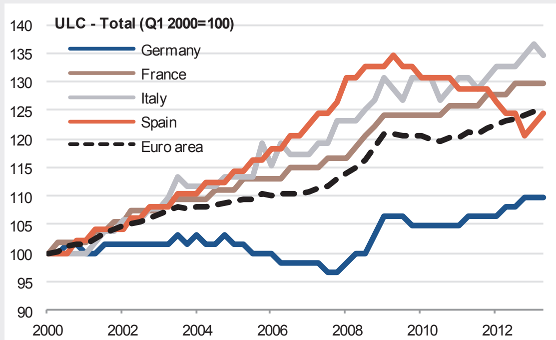
Chart 2 - Euro area unit labour costs



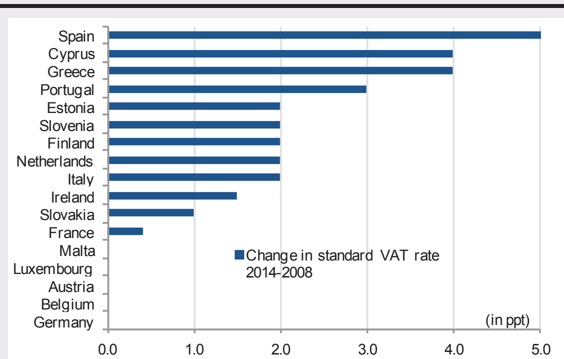
Source: ECB, Datastream, SG Cross Asset Research/Economics

However, the relationship between profits and prices is set to strengthen. In fact, the still depressed economies can hardly keep on containing their margins unless their core prices drop lower over the medium term, thus reflecting a structural adjustment in both profits and prices. Following the October HICP core inflation reading, we believe that ULC developments and consumer prices are now broadly in line again. Therefore, if unit labour costs were to fall further in the peripheral economies, we would see some mechanical adjustments in core prices, in line with the economic theory.

Additional indirect tax hikes could be contemplated.

One upside risk lies in indirect tax hikes. In fact, indirect taxation has played an increasing role in the past few years. On average since 2011, the tax effect has contributed 35bp to the euro area headline HICP. There is room for further tax hikes and reductions in tax exemptions. This is the line of recommendations set by the Commission toward France and Spain for instance.

Chart 3 - Indirect tax hikes have proved handy in times of fiscal austerity



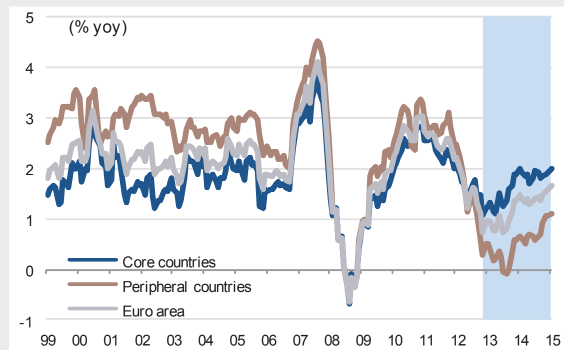
Source: EU Commission, Datastream, SG Cross Asset Research/Economics

In fact, France and Cyprus have a planned VAT hike in January 2014. In addition, governments can also be tempted to implement green taxes. In France, for instance, the government was contemplating an eco-tax which has now been postponed. We have detailed in French inflation: When France contemplates indirect taxes the impact of such measures on consumer prices: +0.4% after one year.

Disinflation in a fragmented area...

Now let's do the math! We expect peripheral economies to experience HICP inflation rates close to 0 or moderately negative. In the case of Spain, for instance, we expect the 2014 average to print at -0.2% yoy. We also expect core countries to print HICP rates well below 2% over the medium term. Therefore, the euro average is set to remain at low levels over the medium term. We expect it to average 1.0% yoy in 2014 and 1.4% yoy the following year.

Chart 4 - Euro area diverging inflation



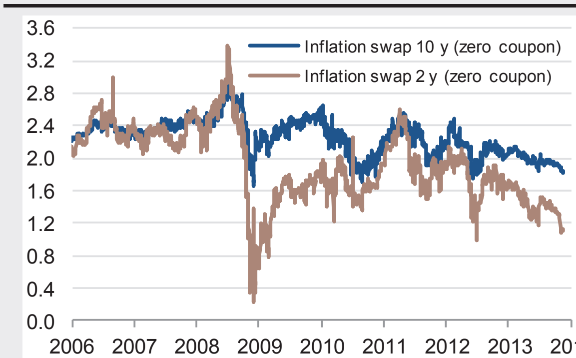
Source: Eurostat, Datastream, SG Cross Asset Research/Economics

...But NO deflationary spiral!

One should be cautious that negative rates of inflation do not mechanically imply a deflationary spiral. The latter being a "self-fulfilling fall in prices across a very large category of goods", using Mr Draghi's words. In this scenario, the agents would anticipate further falls in prices and delay their consumption, damaging the economy. Yet negative rates of inflation could also benefit the economy if not prolonged and moderately negative. In such a case, because of the stickiness of wages relative to downward adjustments, a moderately negative inflation rate can lead to an increase in purchasing power and therefore boost domestic demand.

Besides, inflation expectations (Chart 5) remain well anchored, and this reduces the risk of a deflationary spiral.

Chart 5 - Inflation expectations firmly anchored



Source: Bloomberg, SG Cross Asset Research/Economics

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Box 12 ECB toolbox can fight deflation

Plenty of options left – but few with real effects

The ECB toolbox is not empty and the ECB's policy action will be a function of the fundamentals and notably price stability. In our opinion, the risks of deflation would have to intensify significantly for the ECB to take action much beyond further LTROs (possibly with conditions and/or an adjustable capped rate), a further extension of liquidity provisions and possibly a 10-15bp repo rate cut. However, we view most of these actions as largely ineffective, with a symbolic impact beyond buying time. As long as the inflation and growth outlooks do not deteriorate materially, this may be sufficient. A particularly important point would be when the Fed starts tapering as we expect this to lead to an easing pressure on the euro and indirectly on inflation. In the event the euro continued to rise, which could increase the risks of deflation, we would put a high probability of a small negative deposit rate and of direct purchases of foreign currency. An unwarranted rise in market rates (e.g. due to US tapering) could lead the ECB to re-examine its forward guidance statement and/or to contemplate purchases of covered bonds/ABS. In a real deflationary scenario (or in a break-up scenario), the ECB would be tempted by an area-wide QE programme.

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Baseline scenario: Low inflation, tension in interbank markets and continued fragmentation

	Main advantages	Disadvantages	Probability
Publication of Minutes	Already on the agenda. This would show a genuine willingness to increase transparency.	Publishing minutes could reveal each ECB member's point of view, which could in turn politicize the debate.	Baseline
Extension of refinancing operations at full allotment	The main refinancing operations are made at fixed-rate, full allotment until mid-2015. Another time extension helps avoid any "liquidity accident".	The ECB will probably be obliged to come back to the usual liquidity operations when it decides to hike rates. Hence, any extension tells us about the time horizon of the forward guidance.	Baseline
Classic LTRO (12 to 36 months)	Avoid liquidity accidents and support a weaker euro. The need for liquidity may have declined as the full-allotment of MRO has been extended to July 2015 and many banks prefer not to hold excess liquidity ahead of the AQR. While market access has improved, we expect a number of banks to still need long-term funding next year, and the ECB may prefer to provide funding to avoid market disturbances (but could still fail them in the AQR), thereby providing a liquidity back-stop ahead of the AQR. An indirect effect may also be increased pressures on peripheral bond yields as peripheral banks scale back high levels of government securities. Moreover, more liquidity could help counter the effects (on the currency and inflation) from policy easing in the rest of the world.	Uncertain effect on corporate lending. The take-up of another LTRO could be low as healthy banks diminish their reliance on ECB funding ahead of the AQR. We expect more LTRO in H1 2014 for around 18 months, but with significant modifications such as an adjustable capped rate, which would add weight to forward guidance, and possible targets for increased lending.	Baseline
LTRO conditionned on lending to the private sector	Conditionality on the liquidity provision could result in better allocation of liquidity for the real economy, and discourage financing of sovereigns (as with LTROs). It would limit the stigma of accepting LTRO loans.	No effect on weak banks that carry on deleveraging. In the UK, the Funding for Lending Scheme has been a success in terms of providing consumer lending but not corporate lending.	40%
LTRO with adjustable and capped interest rate	Would add weight to forward guidance and provide incentive for greater take-up by banks.	Uncertain effect on corporate lending could leak into sovereign carry trades. Could be seen as a subsidy to banks.	40%
Cutting the key rate by a smaller step (by 10-15bp).	Buys time in case of a weakening inflation (and growth) outlook. Potential to impact the yield curve and push back rate hike expectations, while making LTRO costs cheaper and reducing money market volatilty.	Overall impact is likely to be limited, due to already low market rates.	40%
Reduction of collateral haircuts and changes in collateral rules	Increases the pool of available collateral, thereby easing funding conditions. The impact on credit growth is unclear.	Collateral rules have already been expanded considerably, and there is criticism of too soft collateral rules.	20%

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Risk trigger: Continued rise in euro (+10%) and risks of deflation (inflation outlook close to 0%)			
	Main advantages	**Disadvantages**	**Probability**
Negative deposit rate (up to -0.25%)	Main effect likely to be a weaker currency as foreign investors reduce excess euro reserves. In theory, this increases the cost of holding cash and thus should, ceteris paribus, increase the risk appetite of interbank and regular lending.	It could reduce banks' profitability (due to higher costs), liquidity of money markets and credit growth. Major risks of disruption on money market funds.	25%
FX purchases	Given the constraints of buying sovereign bonds, buying a broad set of currencies could be contemplated (without targeting any levels), which, without sterilisation, would have the same effect of expanding the balance sheet as a QE programme (e.g. FX floor in Switzerland). Most likely such action would take the form of currrency swaps.	Political - this could be seen as a hostile act in the global "currency war" and may end up in the G20. Amount of purchases may need to be significant for any lasting effect and the ECB would take currency risk, which may be high.	15%
Stopping sterilisation of the SMP programme	Liquidity addition - could add some €184bn.	The SMP programme was highly controversial and stopping sterilisation could be considered as further proof of monetary financing.	10%
Lowering the reserve requirement from 1.0% to 0.5%	This could add some €50bn in excess liquidity. The ratio was cut from 2% to 1% in early 2012.	No disadvantage - but limited positive impact	10%
Risk trigger : Unwarranted rise in market rates (e.g. due to US tapering)			
Specify forward guidance	An unspecified formulation (*"...key rates to remain at present or lower levels for an extended period of time")* was introduced in July 2013. A time threshold could be established to anchor expectations of the first rate hike (e.g. not until 2016). In theory, this would lower the money market rate and weigh on the exchange rate. It could also be combined with an adjustable capped rate LTRO (see above).	It is unclear if markets would consider the rule as time consistent, which could blur transparency over reaction function and weigh on credibility. Other targets (such as unemployment) could blur primary objective of price stability.	25%
Covered bonds	The covered bond programmes (€57bn in November) could be renewed. Current market size is €1930bn. Annual gross issuances are close to €100bn. A key question is whether the ECB would want to target the flows (which would help decreasing bond yields) or the outstanding, in order to remove risks from bank's balance sheet.	Implies taking credit risk on balance sheet and the ECB has proved reluctant to take high risk.	20%
ABS	Current market size is €1500bn, but half of which is retained as collateral by banks. Placed issuances (not retained as collateral) are below €90bn.	Same remarks as for covered bonds, considering that ABS assets are riskier than covered bonds. Moreover, the ABS market is not liquid.	10%
Risk trigger: Deflation threat (self-fulfilling and broad-based decline in prices) or break-up risks			
GDP weighted QE programme	Reduce long-term interest rates and create incentives for investing in real economy.	Legal constraints very important. An area-wide application of the QE programme could be motivated on the grounds of pursuing the primary objective of price stability.	<5%

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ANCHOR THEME #5

REFORMING ASIA'S GIANTS

Reform of Asia giants to deliver slowly: Each has its own specific challenges, but Asia's three giants (China, India and Japan) are at a crossroads where structural reform holds the key to the future economic outlook. In China, reform in a nutshell is about removing the 100% implicit state guarantee and reining in excess supply capacity. In Japan, we believe Womanomics holds much of the key to sustainable growth long-term. In India, the challenge for the new government due to be elected in May is to embrace supply side reforms. **Monetary policy will play a unique role in each case: we see further tightening from RBI to tame inflation and support the INR, further easing from the BoJ to keep the yen weak and PBOC intervention to prevent too strong appreciation of the CNY.**

Japan – an advanced economy looking for growth: In Japan, the issue is one of raising potential growth in an advanced economy with poor demographics. Boosting growth is about finding an opportunity and providing the labour, capital and institutions required to leverage it. While Japanese exports can help, we do not see Japan increasing its already high market share sufficiently to boost growth over the coming decades. The opportunity we see is on the domestic front reforming the service sector, leveraging the potential of the female population in the labour force and ensuring that Japanese savings are put to productive use domestically. This is what Prime Minister Abe's third arrow is all about. Delivering it will be key for the medium-term growth prospects. Short-term, the BoJ will continue to fire monetary stimulus arrows and the planned consumption tax hike from 5% to 8% will be partly offset by the second arrow of fiscal stimulus.

China – an emerging economy with excess supply capacity: In China, past success came from the growth opportunity of cheap labour supply, winning global export market share and building up domestic infrastructure and productive capacity. This model has run its course and has even been over-extended as witnessed by the capacity glut and high level of corporate leverage. China needs to unwind excess supply and excess leverage. The challenge now is to manage a growth transition as we detail in Box 14, China's reform boat sets sail … in rough seas. Medium-term, China will need to see exchange rate appreciation. Near-term, the PBoC will continue to intervene to stem yuan appreciation.

India – an emerging economy with a weak supply side: In India, the supply side has continuously lagged the demand side due to a weak program and implementation of structural reforms. It is not only a question of infra-structure, but establishing a functioning single domestic market, opening up protected sectors and managing social issues to be able to secure a future sufficient supply of well educated labour. India's supply side constraints are visible through the external and internal imbalances of the economy and excessive inflation. The RBI faces a very difficult balancing act of managing growth, inflation and preventing a collapse of the INR. We expect further rate hikes. 2014 will see the election of a new government and failure to adopt structural reform quickly will add to the pressure on the RBI, in a manner that we believe ultimately unsustainable.

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Box 13 The third arrow of Abenomics

Womanomics

Japan's recovery is so far on the right track, boosted by the fiscal and monetary policies of *Abenomics* – also known as arrows one and two. However, for the current cyclical economic recovery to turn into sustainable higher growth, the government's long-term growth policies – known as the third arrow of *Abenomics* – must succeed. There is a multitude of policy areas that merit attention, but in our view promoting a more active role for women in the economy is of key importance. It would address the growing labour shortage in Japan, and it could also raise productivity given the high level of education attained by many Japanese women, which is currently not utilised. PM Abe has fully grasped this, as illustrated in a speech in April 2013 where he said "women are Japan's most underutilised resource". He also elaborated on the theme in an editorial in the *Wall Street Journal* (25 September 2013). The PM outlined some measures aimed at closing the gender gap in the Japanese workforce, and stressed that *womanomics** is one of the most important elements in his long-term growth strategy.

Data produced by the OECD suggest that the overall female participation rate in Japan is actually higher than the OECD average (see table below). But the OECD figures are influenced by some member states with very low rates (Turkey, Mexico, Chile etc). However, compared to other (Western) advanced economies, the rate is indeed low.

What is striking about Japan is that the labour force participation rates of women with tertiary education are particularly low compared with other nations: compared to the OECD average, it is an astonishing 13.8pp lower (again, see table below) This means that there are many highly educated Japanese women who are not working – either due to a lack of childcare facilities or other reasons such as a lack of flexible working conditions. If these obstacles were removed, Japanese women could substantially increase the labour force and hence potential economic growth. This is not to say that there are not women who both want and are happy to be full-time mothers – there clearly are.

Female participation rates

Region	Prime age (25-54) participation rates, %, 2012	Participation rates of women with tertiary education, %, 2011
Germany	82.2	86.3
France	83.4	85.3
Canada	82.3	83.0
UK	79.0	79.6
US	74.5	79.6
Italy	66.4	79.3
Japan	72.3	69.3
OECD	71.7	83.1

Source: OECD, SG Cross Asset Research/Economics

Abe's growth strategy focuses on this point (*womanomics*) as a measure to boost economic growth in the long term. It is important to accurately address what the obstacles are for parenting-age women to continue working, and how these obstacles can be removed. The problem needs to be solved from two points of view. One is to increase the number of childcare places, which means increasing the number of nurseries and nursery staff – this is a job primarily for the public sector. The other is to change the working environment so as to make it easier to balance work with childcare – primarily a responsibility of the private sector. And, more importantly, to narrow the equality gap in pay, which is particularly large in Japan (30.2% vs 20.1% in the US), according to the PM.

So far, Abe has promised to increase the number of childcare places as a matter of urgency, so that the total number of children accepted into childcare institutions will increase by 200k by FY14 and by another 200k by FY17. By comparison, the total number of places rose by a mere130k in the five years from 2007 to end-2011.

Creating a better working environment for working mothers is also a necessity. According to studies by the Ministry of Health, Labour and Welfare, about 26.1% of female workers who had to leave a job during pregnancy or after childbirth cited the difficulty of balancing work and childcare (for reasons such as inflexible working hours incompatible with childcare, workplaces not willing to support mothers, etc). Another 9% cited dismissal or suggestion to leave work by the employer, and about 2.6% cited change in job duties and responsibilities after childbirth.

Abe has already set out some goals to be achieved by 2020: to increase women's labour force participation rate (for women between 25-44 years old) to 73% from 68% in 2012, support women to continue to work after the birth of their first child so that 55% of such women can continue to work from only 38% in 2010, increase the share of men who take parental leave to 13% from a negligible 2.6% in 2011, and also to push up the percentage of women in executive positions to at least 30%. The Equal Employment, Children and Families Bureau is in charge of creating a framework, and to encourage employers to address the issue and help employers create an appropriate working environment which allows for a variety of working practices.

Back in 1999, Kathy Matsui estimated that by tapping further into the female work pool, Japan could raise its GDP by 15%. While such estimates are of course subject to uncertainty and debate, one thing is clear: the growth dividend of *womanomics* for Japan could be very large indeed.

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- *The term was first coined in 1999 by Kathy Matsui, Goldman Sachs' Japan-based equity strategist*

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Box 14

China's reform boat sets sail…in rough seas

The Third Plenum of the 18th Central Committee of China's Communist Party has concluded. The Reform Decision released has reassured many that there will indeed be changes. Although we also find the reform proposal encouraging and as a result have become more optimistic about China's long-term prospects, we think the journey in-between will still be bumpy.

The plan

The reform decision from the Plenum set the year of 2020 as the date when major breakthroughs in all major reform areas will be achieved. Reform is to change the system –how resources, benefits and costs are allocated in the economy. Let us fast forward seven years to end-2020 and picture how the Chinese economic system will work then, if reform pans out according to the plan.

- Corporate sector The private sector – domestic and foreign companies alike – will compete freely on a level playing field with state-owned enterprises (SOEs) in nearly all the sectors. SOEs, which will probably be much smaller in aggregate size and numbers, will be left free to run like profit-driven corporates most of the time, with the government, represented by state asset management companies, limiting its role to being the biggest shareholder – collecting dividends (30% of the profit) and voting on critical decisions.

- Financial markets Interest rates will be fully liberalised and (largely) determined by a market that has experiences with defaults. A non-negligible number of financial institutions will be private and foreign players. The yuan will have a market-based floating exchange rate, with a wide band (±5-10%) around a central reference rate that is set monthly or quarterly. Foreign financial investors will be able to access (most) domestic financial assets with few strings attached and, likewise, Chinese households will have much greater freedom to make overseas direct or portfolio investment.

- Land and other resources Farmers will be able to sell their non-agriculture land directly to the market, without it being grabbed first by local governments and converted into state land. Prices of oil, gas, water, electricity and telecommunication services will be subject to the market force of supply and demand, and so subsidies – implicit and explicit – will be removed. The cost of pollution will be internalised by tax (to some extent).

- Fiscal system Local governments will care less about growth targets, responding to a more comprehensive evaluation system that puts equal (or more) emphasis on social targets and risk management. All channels of government financing and all forms of spending will be subject to greater scrutiny by the public. The central government will both run and fund the lion's share of the pension, healthcare, education and other social security systems. Land sales revenue will become a smaller part of the local government revenue, and local taxes (e.g. property tax, consumption tax, carbon tax, etc.) a bigger part. Spending and revenue will be broadly matched at various levels of the government, fulfilling the critical condition for complete abolishment of the Hukou system. Direct bond issuance by local governments will be permitted and the proceeds will be used mainly for a more selective list of infrastructure projects.

A brighter future… for some

If the economic system does run like the plan envisions, it is not difficult to get an idea who will see a brighter future and who will not. Basically, any industry or company that has to continue relying on the old institutions for survival will suffer and struggle, while those who have not been able to realise their potential due to current restrictions that are subsequently lifted, will get a good chance to grow and thrive.

- Sectors and industries: The performance of various manufacturing industries will be negatively correlated to the amount of existing excess capacity in their industries, but positively correlated to the share of their business that comes from the demand of Chinese households and a greener economy. The long-term trend for the real estate sector is already emerging – a great divergence between higher-tier cities and lower-tier cities due to the different demand and supply situations. Infrastructure will probably be less expansive as well, as the funding becomes more selective. Within the financial sector, banks, which have been exceptionally profitable, will pay back in the form of tighter interest rate margin and rising non-performing assets. Other financials, including brokerages and insurers, may do well, as a deeper financial market offers more opportunities. Those service industries that are currently monopolised by SOEs will do well, since more competition will be introduced to improve efficiency and productivity there.

- State vs private The state sector as a whole will inevitably lose market share to the private sector (domestic and foreign) in all competitive industries. Besides rising competition, SOEs will also have to cope with the potential downsizing of all kinds of subsidies, the (implicit) credit risk-free assumption. However, not all SOEs will do badly. In industries that need capacity consolidation, the leading firms – mostly SOEs – will see margin improvement.

Over time, healthy industries and companies will account for bigger shares in the equity and bond markets. However, at the moment, the potential winners represent less than half of the domestic stock market (A-share) and an even smaller proportion of the H share index. Nearly all the corporate bonds in China are issued by either SOEs or local government financing vehicles.

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A-share market capitalisation by sector

% of total	SOEs	Non-SOEs	Total
Banks	15.5	6.5	21.9
Nonbank Financials	4.9	5.5	10.4
Consumer	11.1	11.3	22.4
Diversified	0.5	0.2	0.7
Industrial	9.3	8.0	17.3
Technology	0.8	2.3	3.1
Utilities	2.4	0.3	2.7
Communications	1.6	1.4	3.1
Basic Materials	4.7	2.7	7.4
Energy	10.5	0.6	11.1
Total	61.2	38.8	100.0

* The red bold sectors are the potential beneficiaries of reform in our view.
Source: Wind, Bloomberg, SG Cross Asset Research/Economics

Systemic risk on the way…

Reform should help China achieve a better and more stable long-term growth outlook, which is unambiguously good news for everyone. However, we are concerned that reform could also quicken the unwinding of China's debt problem.

The path for financial liberalisation has the greatest clarity and best progress among all major reform. True financial liberalisation aims to improve the efficiency of capital market allocation. In China's case, credit allocation is often not determined by the profitability of businesses but rather by government connections, or in other words, implicit state guarantees. At the end of the day, whether private firms are able to enjoy equal access to credit probably depends more on how lenders perceive their credit riskiness compared with government-related borrowers than on the restraints set by Beijing on lending/deposit rates. Hence, if the government is serious about reform, it will have to withdraw the 100% state guarantee as well. This means that China's financial market will finally see defaults.

We see that the new leadership is well aware of the danger of the high and rising leverage and is moving to correct the problem. The central government has always (quite rightly) perceived a deposit insurance scheme and a bankruptcy law for financial institutions as prerequisites for deposit rate liberalisation, which looks like one of the most imminent reform actions. The scheme and the law, by default, imply that not every interest-bearing financial product will be backed by the central government and even banks can go under within the legal structure. Since mid-year, the People's Bank of China has kept putting pressure on the interbank market, forcing banks – formal and shadow alike – to delever. Liquidity conditions are no longer easy and credit growth has decelerated, which increases the chance of credit events in the near future.

Overall, liberalisation means letting go of control, but letting go of control means that the chance of things going wrong will rise.

Bullish but realistic

There are several bitter pills that the Chinese economy will have to swallow in the short term for long-term health. This is one of the reasons, besides vested interests, why reform was slow in the past. The Plenum shows that the new leaders have the willingness to make difficult changes.

Mostly because of the magnitude of the debt problem, the path will inevitably be bumpy, in our view. Although China pulled off a crisis-free bad debt clean-up once in the early 2000s, we think that the same smooth growth path is unlikely to repeat. The new leadership is rightly looking at a more market-based approach of bad-debt clean-up and potentially even bank recapitalisation (cf. "Asian Themes – Deflating China's credit bubble", September 2013). More importantly, China's amazing growth achieved in the 2000s was mostly because of the bold structural reforms pushed through before and during the bad-debt clean-up, rather than the state-funded clean-up itself. This time China needs to reform and do debt clean-up at the same time, which is clearly more difficult.

We think that the policy trajectory going forward will consist of many repetitions of this year's pattern: policymakers force deleveraging and quicken reform; as a result, growth decelerates and financial risk rises; when the situation becomes too precarious, they pause deleveraging and stabilise the economy (with some investment); then as soon as the economy steadies, they go again. To avoid a sharp growth correction, the sequence of reform will also matter a great deal. Of all the reforms, pro-business policy – especially corporate sector liberalisation – can generate positive gains more quickly than others, thus helping to offset the deleveraging drag and mitigate financial risk.

The certainty that we have now is that reform will happen, and probably more quickly than before. However, there are still many unknown factors – the timetable and the execution details of each reform as well as the relative pace of the various reforms. Even if all reforms go as planned, how the government manages market expectations when going through reform pains could make a huge difference to China's growth trajectory.

Investors can be bullish, but have to be realistic and pragmatic at the same time.

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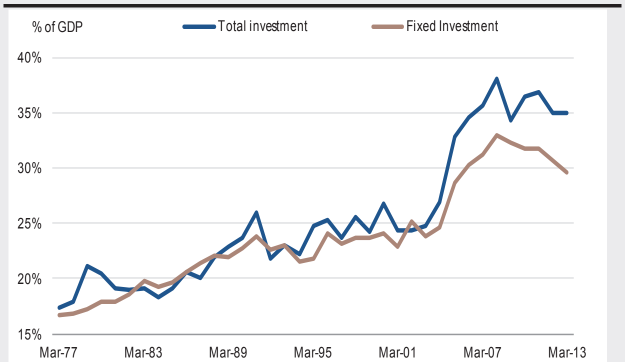
Box 15 India's supply side woes

Policy mis-steps engender supply side constraints

That the Indian economy is in a near stagflation situation is no longer in doubt. Statistically, GDP growth may have bottomed out and inflation may have peaked, but the stress is visible. The economy will continue to muddle through for the rest of the year even as an elevated level of inflation remains a concern. India's monetary policy continues to remain hawkish as RBI Governor Raghuram Rajan fights a lone battle to get the economy back on track while the government fails to walk the talk. A classic case of Nero fiddling while Rome is burning.

Sub-optimal policy choices of the past dictated by political reality, corruption in the process of distribution of rights to natural resources and clear evidence of policy paralysis – all are conspiring to hold back the economy as increasing supply side constraints reduce growth potential and lower efficiency. Thus, while investment has been falling in India (especially fixed capital investment)…

Falling investment



Source: RBI, SG Cross Asset Research/Economics

…the twin deficit reached alarming levels last year. While the current account balance is likely to be relatively better contained this year, the fiscal balance will continue to be at alarming levels.

The economic reforms that were ushered in during 1991 have outlived their utility as catalysts for growth. The country now needs to embark on the next round of reform measures to remove the structural constraints that impact growth.

India's supply side constraints that require immediate attention are:

Boosting power supply and rationalising power tariffs: India suffers frequent blackouts due to the continued failure to generate adequate supply to meet surging demand. The issues that plague power supply are multiple, including not commissioning enough new plants, lack of investment in distribution and challenges in securing a sufficient supply of coal. The spillover effect from the poor power supply situation is only too visible when it comes to corporate investment. Moreover, as power production falters, heavy users of power are forced to generate their own power, which means increased demand for diesel – further weighing on the current account deficit.

Optimising use of natural resources: Despite accounting for virtually 10% of global coal reserves, India's coal productivity remains abysmal. Land acquisition and environmental issues are additional problems crippling the sector. The recently passed Land Acquisition Bill has unfortunately resulted in the process of acquisition becoming more cumbersome (bringing in more layers of approval), difficult (requiring consent of 80% of land owners) and costly (multiple times of the existing market values).

Streamlining administrative procedures: Tying in closely to the points above are delays in project approvals. Power and mining are far from the only areas affected hereby. The setting up of large projects in India requires multiple approvals from myriad government departments with no certainty as to the time required for the entire process. Unfortunately, there is no law in India dealing explicitly with punishment for wrongs done due to administrative delays. The problem is further exacerbated by the inordinate delays caused by India's slow moving judiciary system – adding to costs and that are, in many ways, tantamount to denying justice. While cross-country data on the delay in delivering justice is not available, the overall inefficiency of India's judicial system is very clear when one compares data under 'Enforcing Contracts' in the World Bank's Doing Business report.

Fiscal consolidation: Inordinately high fiscal deficit not only restricts the fiscal space for the government to carry out necessary capital expenditure, it also leads to a crowding out of private investment. As the government continues to commit itself to a plethora of politically relevant populist spending, the country's fiscal condition is being impaired as revenue streams fail to match expenditure requirements. We believe that the public sector has aggravated the supply constraints by boosting demand in an inefficient and unsustainable manner.

Reduce policy uncertainty to boost investment: As highlighted in our previous Global Economic Outlook, policy uncertainty has been an important factor shaping the economic outlook for several of the advanced economies. In our work, we have drawn on the research of Scott R. Baker, Nick Bloom and Steven J. Davis. The index developed for India, in contrast to that of the US and Europe, remains fairly elevated reflecting the high level of policy uncertainty in the country. This incorporates many of the points already highlighted in the points above on taxation policy, land rights, environmental issues, etc.

We believe that this has acted as an additional deterrent to investment spending, from both domestic and foreign sources.

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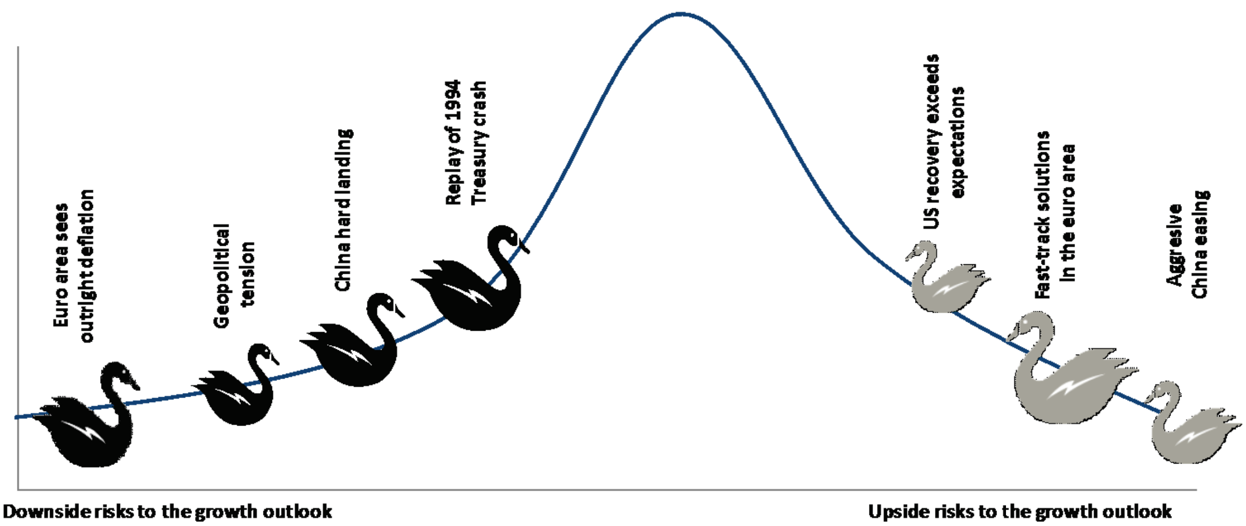
Market focus will be on the risk of a 1994 replay

Risks to our central scenario remain titled to the downside. Turning points in US monetary policy are delicate operations to manage and the fear is set to be a replay of 1994. The aim of forward guidance is clearly to manage such risks. A disorderly market move holds the greatest risk for the most vulnerable emerging economies. Further risks in the US centre on the fiscal decisions to be taken in Washington in early 2014. In the euro area, risks appear more balanced relative to our below-consensus central scenario. Fast-track political solutions – including full delivery of banking union – hold the greatest upside potential. China's reform transformation will yield short-term uncertainty; the danger is a hard-landing – the temptation to adopt further credit stimulus.

Chart 35: SG Swan Chart: Ongoing risk shift to the emerging economies



	1994 replay / China hard landing Probability 20%	Four seasons of leverage Probability 70%	Fast-track recovery Probability 10%
Growth Inflation Policy-mix	Fears that 2014 will see a replay of 1994 are already generating lively debate. Should the Fed fail to convince markets of its resolve to keep rates lower for longer, US Treasuries could see a sharp collapse. In emerging markets, the reversal of flows could prove disorderly. In the euro area, the periphery would be the most vulnerable. A China hard landing remains a risk as the reform agenda is rolled out.	As emerging economies embrace deleveraging, advanced economies will act as a growth relay. Monetary policy will remain globally accommodative, even as the Fed starts to taper. We see further easing from both the BoJ and ECB. We also look for rate cuts in Russia and Chile.	The greatest upside potential is in the euro area, where fast track progress on both institutional and structural reform has the potential to unblock significant growth. The more likely upside, however, comes from a stronger than expected US recovery.

SG Risk Map: The x-axis gives an indication of how probable we consider a risk factor to be. The size of the swans gives an indication of how important the impact of that event materialising would be in terms of its upside or downside shock to the outlook.

Source: SG Cross Asset Research/Economics

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SG Growth Outlook

Real GDP

P= previous forecast*	2011	2012	P*	2013f	P*	2014f	P*	2015f	P*	2016f	P*	2017f	P*	2018f	P*
World (Mkt FX weights)	**3.1**	**2.7**	2.6	**2.5**	2.5	**3.1**	3.2	**3.4**	3.4	**3.6**	3.6	**3.5**	3.6	**3.4**	
World (PPP weights)	**3.9**	**3.2**	3.1	**2.9**	2.9	**3.6**	3.6	**3.9**	3.9	**4.0**	4.0	**3.9**	4.0	**3.8**	
Developed countries (PPP)	**1.7**	**1.4**	1.5	**1.2**	1.2	**2.1**	2.1	**2.4**	2.4	**2.6**	2.6	**2.6**	2.7	**2.5**	
Emerging countries (PPP)	**6.3**	**5.0**	4.9	**4.5**	4.5	**4.9**	5.0	**5.2**	5.2	**5.3**	5.3	**5.1**	5.1	**5.0**	
G5															
Euro area	**1.6**	**-0.6**	-0.6	**-0.4**	-0.4	**0.6**	0.5	**1.2**	1.0	**1.5**	1.3	**1.5**	1.4	**1.6**	
Germany	**3.4**	**0.9**	0.7	**0.5**	0.4	**1.4**	1.4	**1.3**	1.4	**1.4**	1.4	**1.4**	1.4	**1.4**	
France	**2.0**	**0.0**	0.0	**0.2**	0.1	**0.5**	0.5	**1.2**	1.3	**1.5**	1.5	**1.6**	1.7	**1.7**	
Italy	**0.6**	**-2.6**	-2.6	**-1.9**	-2.0	**0.3**	0.0	**1.0**	1.0	**1.3**	1.5	**1.3**	1.4	**1.4**	
Spain	**0.1**	**-1.6**	-1.6	**-1.3**	-1.2	**0.0**	-0.5	**1.2**	0.2	**1.4**	0.8	**1.4**	1.1	**1.1**	
United States	**1.8**	**2.8**	2.8	**1.7**	1.7	**2.9**	3.0	**3.3**	3.5	**3.4**	3.6	**3.3**	3.7	**3.1**	
China	**9.3**	**7.7**	7.8	**7.7**	7.6	**6.9**	6.9	**6.7**	6.7	**6.7**	6.7	**6.0**	6.0	**5.5**	
Japan	**-0.6**	**1.9**	2.0	**1.9**	2.2	**1.7**	1.9	**1.5**	1.3	**1.4**	1.4	**1.5**	1.6	**1.1**	
United Kingdom	**1.1**	**0.1**	0.2	**1.5**	1.4	**2.7**	2.2	**2.3**	2.3	**2.5**	2.5	**2.6**	2.5	**2.9**	
Other advanced															
Switzerland	**1.8**	**1.0**	1.0	**1.8**	1.7	**1.7**	1.5	**1.8**	1.6	**1.8**	1.8	**1.7**	1.8	**1.7**	
Australia	**2.4**	**3.7**	3.7	**2.4**	2.5	**2.4**	2.8	**3.0**	3.1	**3.0**	3.0	**3.1**	3.1	**3.1**	
South Korea	**3.7**	**2.0**	2.0	**2.7**	2.6	**3.5**	3.3	**3.5**	3.5	**3.6**	3.6	**3.6**	3.6	**3.4**	
Taiwan	**4.1**	**1.3**	1.3	**1.9**	2.3	**3.0**	3.4	**3.4**	3.6	**3.6**	3.9	**3.3**	3.7	**3.2**	
Emerging economies															
Brazil	**2.7**	**0.9**	0.9	**2.8**	3.1	**2.1**	2.9	**2.9**	3.2	**3.4**	3.5	**3.2**	3.5	**3.4**	
Russia	**4.3**	**3.4**	3.4	**1.3**	1.7	**2.4**	3.3	**3.1**	3.5	**3.2**	3.5	**3.3**	3.5	**3.2**	
Poland	**4.5**	**1.9**	1.9	**1.3**	1.2	**2.7**	2.3	**3.5**	3.3	**4.0**	4.0	**3.5**	3.5	**4.0**	
Czech Republic	**1.8**	**-0.9**	-1.2	**-1.4**	-0.8	**1.4**	1.8	**2.7**	2.1	**2.6**	2.4	**2.3**	2.4	**2.2**	
Slovakia	**3.0**	**1.8**	2.0	**1.0**	0.8	**2.1**	2.2	**2.2**	2.6	**2.5**	2.7	**2.3**	2.6	**2.0**	
Mexico	**4.0**	**3.7**	3.6	**1.6**	1.4	**4.1**	3.4	**3.8**	3.5	**3.6**	3.7	**3.5**	4.0	**3.0**	
Chile	**5.9**	**5.6**	5.6	**4.6**	4.4	**3.5**	4.0	**4.1**	4.4	**4.1**	4.7	**3.7**	4.5	**3.9**	
India	**7.5**	**4.1**		**3.4**		**5.1**		**6.1**		**6.6**		**6.8**		**7.1**	

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SG Inflation Outlook

CPI

	2011	2012	P*	2013f	P*	2014f	P*	2015f	P*	2016f	P*	2017f	P*	2018f	P*
World (Mkt FX weights)	**4.2**	**3.4**	3.3	**3.2**	3.1	**3.1**	3.1	**3.1**	3.1	**3.3**	3.2	**3.1**	3.0	**3.1**	
World (PPP weights)	**4.9**	**4.1**	4.0	**3.8**	3.8	**3.7**	3.7	**3.7**	3.7	**3.8**	3.7	**3.6**	3.4	**3.5**	
Developed countries (PPP)	**2.7**	**2.0**	2.0	**1.4**	1.4	**1.7**	1.6	**1.9**	1.9	**2.3**	2.2	**2.2**	2.1	**2.3**	
Emerging countries (PPP)	**7.2**	**6.2**	6.2	**6.3**	6.3	**5.7**	5.7	**5.2**	5.4	**5.1**	5.2	**4.8**	4.7	**4.6**	
G5															
Euro area	**2.7**	**2.5**	2.5	**1.4**	1.4	**1.0**	1.0	**1.4**	1.4	**1.5**	1.6	**1.5**	1.5	**1.6**	
Germany	**2.5**	**2.1**	2.1	**1.6**	1.6	**1.6**	1.8	**1.8**	1.9	**2.1**	2.0	**2.0**	2.0	**2.1**	
France	**2.3**	**2.2**	2.2	**1.0**	1.1	**1.2**	1.7	**1.5**	1.7	**1.7**	1.7	**1.7**	1.9	**1.7**	
Italy	**2.9**	**3.3**	3.3	**1.3**	1.5	**0.9**	1.2	**1.1**	1.1	**1.3**	1.2	**1.2**	1.2	**1.3**	
Spain	**3.1**	**2.4**	2.3	**1.5**	1.6	**-0.2**	0.2	**0.5**	0.2	**0.9**	0.6	**0.8**	0.6	**1.0**	
United States	**3.1**	**2.1**	2.1	**1.5**	1.5	**1.6**	1.4	**2.0**	2.0	**2.6**	2.3	**2.5**	2.4	**2.9**	
China	**5.4**	**2.7**	2.7	**2.7**	2.5	**3.0**	2.7	**3.0**	3.0	**3.5**	3.5	**3.0**	2.5	**2.6**	
Japan	**-0.3**	**0.0**	0.0	**0.3**	0.3	**2.7**	2.6	**2.0**	1.7	**2.5**	2.2	**2.1**	1.3	**2.1**	
United Kingdom	**4.5**	**2.8**	2.8	**2.6**	2.6	**2.8**	2.9	**3.2**	3.4	**3.2**	3.2	**2.7**	2.7	**2.3**	
Other advanced															
Switzerland	**0.2**	**-0.7**	-0.7	**-0.2**	-0.3	**0.6**	0.6	**1.3**	1.3	**1.5**	1.5	**1.7**	1.7	**1.6**	
Australia	**3.3**	**1.8**	1.8	**2.4**	2.1	**2.9**	2.7	**2.5**	2.5	**2.5**	2.6	**2.7**	2.8	**2.8**	
South Korea	**4.0**	**2.2**	2.2	**1.2**	1.3	**2.0**	2.1	**2.5**	2.5	**2.5**	2.5	**2.5**	2.5	**2.4**	
Taiwan	**1.4**	**1.9**	1.9	**1.0**	0.9	**1.3**	1.3	**1.6**	1.6	**2.0**	2.0	**1.8**	1.8	**1.6**	
Emerging economies															
Brazil	**6.6**	**5.4**	5.4	**6.2**	6.5	**5.7**	5.7	**5.3**	6.0	**5.0**	5.0	**5.0**	5.0	**4.8**	
Russia	**8.0**	**5.3**	5.1	**6.5**	6.5	**4.9**	4.7	**3.9**	4.6	**3.8**	4.5	**3.6**	4.2	**3.3**	
Poland	**4.3**	**3.7**	3.7	**1.1**	1.1	**2.3**	2.6	**3.0**	3.0	**2.5**	2.5	**2.5**	2.5	**2.5**	
Czech Republic	**1.9**	**3.3**	3.3	**1.4**	1.5	**0.8**	1.3	**1.5**	1.3	**1.0**	1.4	**2.0**	2.0	**2.1**	
Slovakia	**4.1**	**3.7**	3.7	**1.5**	1.7	**1.2**	1.5	**1.8**	1.8	**1.9**	1.7	**2.0**	2.1	**2.2**	
Mexico	**3.4**	**4.1**	4.1	**3.7**	3.7	**3.3**	3.4	**3.4**	3.6	**3.4**	3.6	**3.4**	3.4	**3.4**	
Chile	**3.3**	**3.0**	3.0	**1.8**	1.7	**2.8**	2.7	**2.8**	2.8	**3.2**	3.2	**3.6**	3.6	**3.6**	
India	**9.5**	**7.5**		**6.1**		**5.8**		**4.8**		**5.8**		**5.3**		**4.6**	

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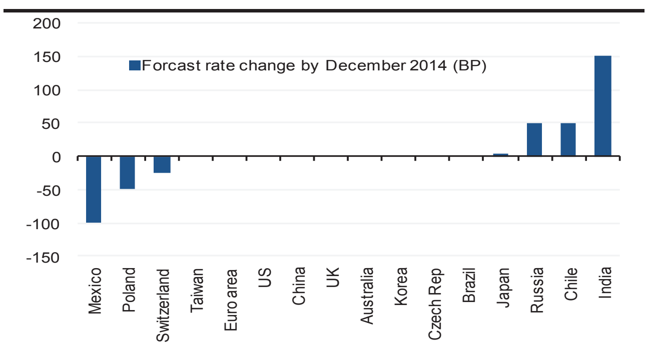
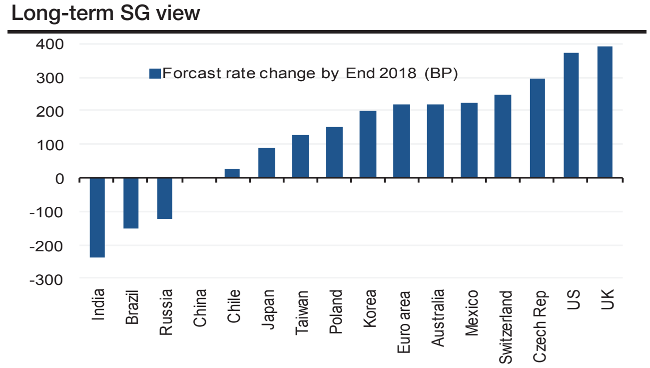
SG Monetary Policy Rate Outlook – Key Rates

	Nov 25	Mar 2014	Jun 2014	Sep 2014	Dec 2014	2013	2014	2015	2016	2017	2018
G5											
Euro area	**0.25**	0.25	0.25	0.25	0.25	0.50	0.25	0.25	0.50	1.38	2.44
US	**0.25**	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.75	2.57	3.98
China	**3.00**	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.25	3.00
Japan	**0.10**	0.07	0.07	0.07	0.07	0.09	0.07	0.07	0.07	0.39	1.00
UK	**0.50**	0.50	0.50	0.50	0.50	0.50	0.50	0.88	2.44	3.88	4.44
Other advanced											
Switzerland	**0.00**	0.00	0.00	0.10	0.25	0.00	0.09	0.69	1.38	2.31	2.50
Australia	**2.50**	2.50	2.50	2.50	2.50	2.69	2.50	2.50	3.04	3.98	4.69
Korea	**2.50**	2.50	2.50	2.50	2.50	2.56	2.50	3.00	4.00	4.50	4.50
Taiwan	**1.88**	1.88	1.88	1.88	1.88	1.88	1.88	2.13	2.56	3.00	3.13
Emerging economies											
Brazil	**9.50**	10.00	10.00	9.50	9.50	8.56	9.75	9.13	8.13	8.00	8.00
Russia	**5.50**	5.25	5.00	5.00	5.00	5.50	5.06	4.75	4.50	4.25	4.25
Poland	**2.50**	2.50	2.50	2.75	3.00	2.75	2.69	4.00	4.50	4.50	4.00
Czech Rep.	**0.05**	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.60	1.97	3.00
India	**8.75**	8.00	7.75	7.75	7.25	8.56	7.69	7.00	6.63	6.50	6.38
Mexico	**3.50**	3.50	3.50	4.00	4.50	3.81	3.88	5.75	6.50	5.94	5.75
Chile	**4.50**	4.25	4.00	4.00	4.00	4.88	4.06	4.00	4.13	4.75	4.75

Short-term SG view



Long-term SG view



- The "neutral rate" for key rates and the "trend fair value" for bond yields give our estimate of "fair value" assuming an output gap of zero and inflation at trend. The trend fair value for currencies reflects a PPP based valuation. Average = average over the year figures.
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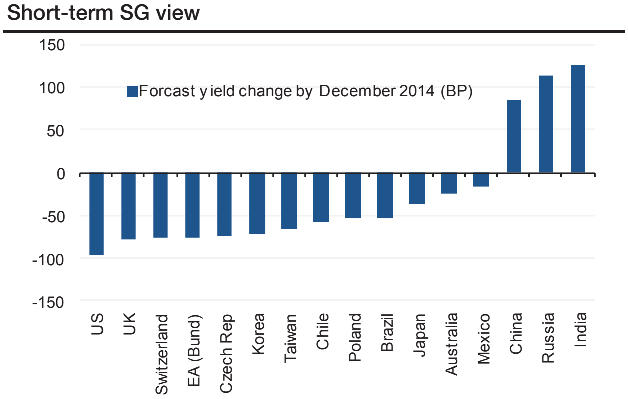
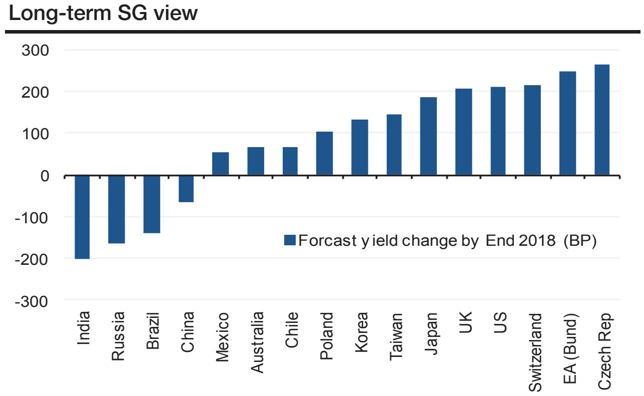
SG Long Gvt. Bond Yield Outlook (10Y)

	Nov 25	Mar 2014	Jun 2014	Sep 2014	Dec 2014	2013	2014	2015	2016	2017	2018	Trend Fair Value
G5												
Euro area	**1.74**	1.95	2.20	2.30	2.50	1.65	2.24	2.60	3.30	4.00	4.20	**4.50**
US	**2.78**	3.00	3.35	3.50	3.75	2.41	3.40	4.00	4.50	4.90	4.90	**4.75**
China	**4.65**	4.00	4.20	4.00	3.80	3.77	4.00	4.00	4.25	4.25	4.00	**4.50**
Japan	**0.63**	0.80	0.90	0.95	1.00	0.70	0.91	1.61	1.95	2.33	2.50	**2.50**
UK	**2.82**	2.85	3.15	3.30	3.60	2.41	3.23	3.30	3.95	4.70	4.90	**5.00**
Other advanced												
Switzerland	**0.94**	1.15	1.40	1.50	1.70	0.97	1.44	1.70	2.30	2.90	3.10	**2.75**
Australia	**4.34**	4.20	4.30	4.35	4.60	3.80	4.36	4.75	5.00	5.25	5.00	**5.00**
Korea	**3.68**	3.75	3.90	4.00	4.40	3.31	4.01	4.50	4.75	5.00	5.00	**5.00**
Taiwan	**1.70**	1.95	2.10	2.40	2.50	1.53	2.05	2.50	3.00	3.20	3.20	**1.53**
Emerging economies												
Brazil	**11.67**	11.40	11.85	12.20	12.20	10.37	11.91	12.50	11.75	11.00	10.25	**11.00**
Russia	**7.64**	6.60	6.50	6.50	6.50	7.23	6.53	6.35	6.30	6.05	6.00	**6.50**
Poland	**4.46**	4.45	4.70	4.80	5.00	4.24	4.74	5.00	5.50	6.00	5.50	**5.00**
Czech Rep.	**2.37**	2.65	2.75	2.95	3.10	2.22	2.86	3.30	3.80	4.50	5.00	**5.00**
India	**8.75**	8.25	8.25	7.75	7.50	8.10	7.94	7.50	7.25	7.00	6.75	**7.00**
Mexico	**6.24**	6.10	6.15	6.25	6.40	5.68	6.23	6.20	6.40	6.60	6.80	**6.50**
Chile	**4.93**	5.45	5.50	5.50	5.50	5.36	5.49	5.30	5.60	5.60	5.60	**5.70**

Short-term SG view



Long-term SG view



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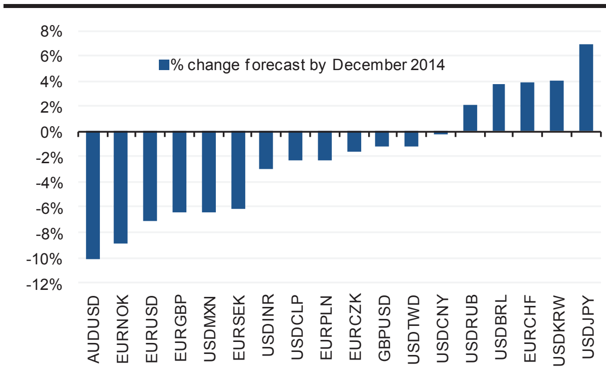
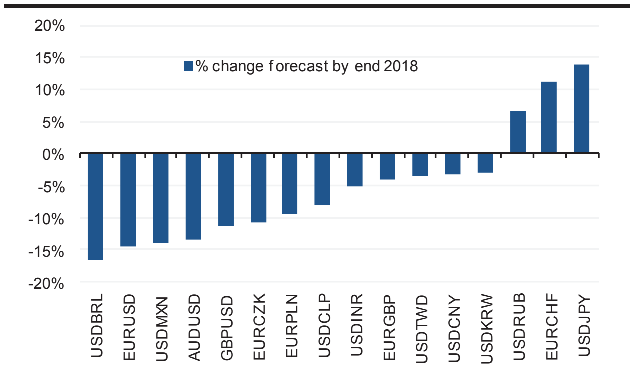
SG FX Outlook

	Nov 25	Mar 2014	Jun 2014	Sep 2014	Dec 2014	2013	2014	2015	2016	2017	2018	Trend Fair Value
EURGBP	**0.83**	0.83	0.81	0.80	0.78	0.84	0.81	0.81	0.81	0.82	0.80	**0.75**
EURUSD	**1.35**	1.33	1.30	1.27	1.25	1.32	1.29	1.25	1.20	1.15	1.15	**1.20**
USDCNY	**6.09**	6.10	6.12	6.09	6.08	6.14	6.10	6.10	6.00	5.95	5.90	**6.00**
USDJPY	**101**	100	102	105	108	97	103	110	112	115	115	**105**
GBPUSD	**1.62**	1.60	1.60	1.59	1.60	1.57	1.60	1.54	1.48	1.40	1.44	**1.60**
EURCHF	**1.23**	1.24	1.25	1.27	1.28	1.22	1.26	1.31	1.33	1.35	1.37	**1.40**
AUDUSD	**0.92**	0.95	0.91	0.87	0.83	0.96	0.91	0.85	0.82	0.80	0.80	**0.85**
USDKRW	**1063**	1060	1075	1090	1105	1097	1078	1110	1080	1050	1030	**1000**
USDTWD	**29.6**	29.8	29.3	29.2	29.2	29.71	29.38	29.80	29.50	29.00	28.50	**28.00**
USDBRL	**2.31**	2.45	2.40	2.40	2.40	2.19	2.41	2.33	2.24	2.11	1.93	**2.10**
USDRUB	**33.01**	33.09	33.26	33.66	33.71	32.04	33.43	33.94	34.66	34.93	35.20	**33.00**
EURPLN	**4.20**	4.28	4.15	4.10	4.10	4.22	4.16	4.00	3.90	3.80	3.80	**4.00**
EURCZK	**27.2**	27.0	27.0	27.0	26.8	26.1	27.0	25.9	25.1	24.7	24.3	**25.1**
USDINR	**62.9**	66.0	63.0	62.0	61.0	61.1	63.0	61.0	60.8	60.3	59.8	**60.0**
USDMXN	**13.09**	13.00	12.75	12.50	12.25	12.81	12.63	12.10	11.75	11.50	11.25	**12.00**
USDCLP	**522**	525	515	510	510	499	515	485	480	480	480	**485**

Short-term SG view



Long-term SG view



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KEY EVENTS 2014

Global	
12-Apr	IMF and World Bank Spring meeting
4-Jun	G-8 Summit (Russia)
11-Oct	IMF and World Bank Fall meeting
15-Nov	G-20 Summit (Australia)
TBC	BRICS Summit (Brazil)
Europe ex-UK	
TBC	Constitutional Court decision on legality of OMT
Mid Feb	European Commission publishes Winter Economic Forecast
Mar	Presidential Elections (Slovakia)
Mar	European Commission publishes in-depth reviews of countries with potential economic risks
9-16 Mar	Municipal Elections (France)
14-Mar	EU heads of State meeting
31-Mar	Merkel Attends G-20 Summit in London
Apr	Member State submit Stability/Convergence programmes
Apr	Eurostat publishes preliminary deficit and debt estimates
May	European Commission publishes Spring Economic Forecast
May	European Commission publishes country-specific recommandations for budgetary, economic and social policies
22 - 25 May	Elections to the European parliament
25-May	Parliamentary Elections (Belgium)
14-Jun	End of Troika's assistance program to Portugal
1-Sep	Governing Council meeting of the ECB in Frankfurt

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18-Sep	General Council meeting of the ECB
Oct	Banks' Comprehensive assessment by the ECB
Mid Oct	Government publish their budget draft
Nov	European Commission publishes Autumn Economic Forecast
Nov	European Commission publishes Annual Growth Survey and Alert Mechanism Report
Nov	European Commission publishes opinion on draft budget plans
Dec	Agreement on the Bank Recovery and Resolution Directive and Single Recapitalisation Mechanisms
Dec	Publication of stress test results on Slovenian banks
European Council meetings	February 14, March 21, May 16, June 27
ECB Meetings	January 9, February 6, March 6, April 3, May 8, June 5, July 3, August 7, September 4, October 2, November 6, December 5
UK	
Mar-Apr	Budget
22-25 May	European Parliament elections
18 Sep	Scottish Independence referendum
Inflation Report MPC	February 12, May 14, August 13, November 12
North America	
15-Jan	US current continuing resolution expires
7-Feb	US debt ceiling suspension lifted
4-Nov	US Mid-term election
FOMC Dates	January 29, March 19, April 30, June 18, July 30, September 17

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Asia	
Mar	National People's Congress (China)
Mar-May	General Assembly (India)
1-Apr	Consumption tax hike from 5 to 8% (Japan)
4-Jun	Local government elections (South Korea)

Other Emerging	
4-Feb	Changes in pension system (Poland)
12-Jun	FIFA World Cup Football (Brazil)
30-Jul	End of decision for OFE participants (Poland)
5-Oct	General Elections (Poland)
Jan-Mar	Forming of the New Government (Czech Republic)
7-Feb	Winter Olymic Games (Russia)

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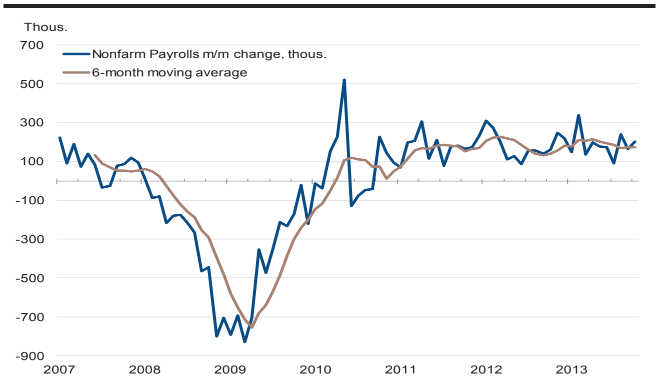
Special supplement! 2014 Indicator watch

US: Nonfarm Payroll Change and Total Housing Demand

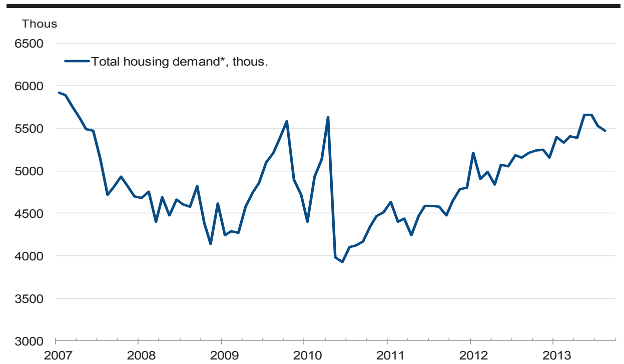
Aneta Markowska

- **Nonfarm Payroll Change:** One of the conditions for tapering is continued progress on employment. We take this to mean non-farm payroll growth has to remain at least in the 175k-200k range before the Fed feels comfortable reducing the pace of asset purchases. Maintaining this pace of job growth will also put steady downward pressure on the unemployment rate, with "breakeven" job growth now estimated at around 80k-90k per month. Job growth significantly above 200k would signal faster declines in unemployment, bringing forward the timing of the expected rate increases. Conversely, falling short of the 175k for a number of months in a row would extend the timeframe for tapering and for eventual tightening.
  - **Critical Level:** 175k-200k is consistent with a Q1 taper and with 2016 rate hikes.
- **Total Housing Demand:** Housing is another important litmus test for the Fed executing its exit strategy. Before allowing bond yields to rise further (first via tapering, eventually via tightening), the Fed needs solid evidence that the housing recovery remains on track. Recent housing data have been choppy, and the sector is still adjusting to the 100 basis point increase in mortgage rates. We define total housing demand as the sum of new and pending home sales (rebased), both of which are reported as of contract signing.
  - **Critical Level:** Any decline in this indicator below the January 2013 level of about 5300 (down 2.5% from current pace) could potentially put tapering on hold.

Nonfarm Payroll Change



Total Housing Demand



* Total housing demand is defined as the sum of new and pending home sales

Source: SG Cross Asset Research/Economics.

Euro area: Inflation forecast and Inflation expectations

Michel Martinez

- **Inflation forecast:** In November, the trigger for the ECB rate cut was the inflation outlook. Actual inflation figures are very low for broad-based reasons (0.7% yoy in October), but a key factor is the strength of the euro. ECB staff forecasts in December will settle the central scenario for an unchanged policy. The bank's most recent 2014 inflation forecast in September was 1.3%. It is likely that this will be revised down to 1.0% yoy. We see headline inflation hovering between 0.5% yoy and 1.0% yoy until next summer.
  - **Critical Level:** 0.5% for monthly annual rate, 1.0% for the 2014 average.
- **Inflation expectation:** Measures of inflation expectations five years out starting in five years remain anchored. The 5Yx5Y HICP swaps rate stands at 2.2%, not far from the average of the past three years. This is a key argument for downplaying the threat of deflation (deflation is a "*self-fulfilling*" fall in prices). The ECB seems to suggest that the ECB would meet its mandate so long as it can ensure long-term inflation expectations are in line with 2%.
  - **Critical Level:** 2%

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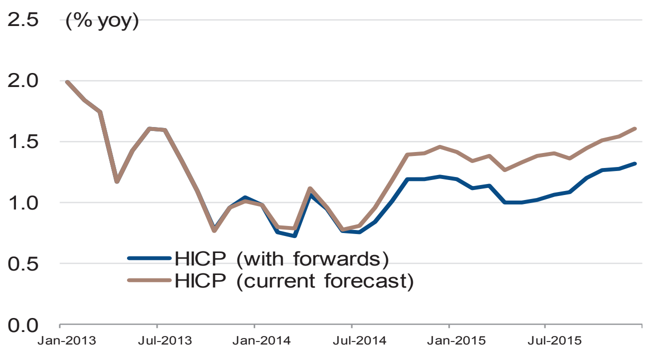
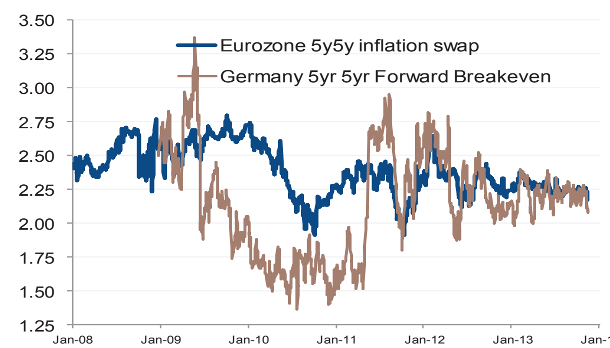
Inflation forecast



Inflation expectations



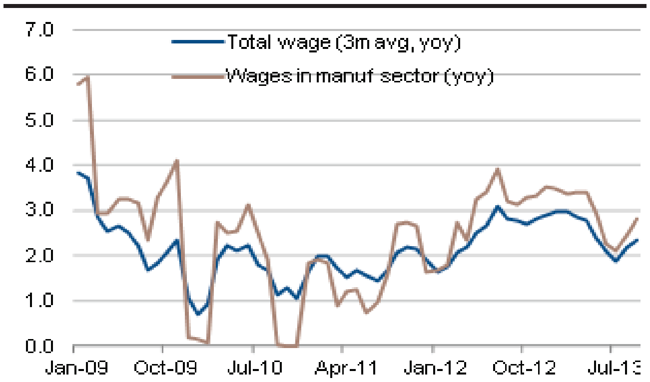
Source:Datastream, SG Cross Asset Research/Economics

Germany: Wages and unemployment

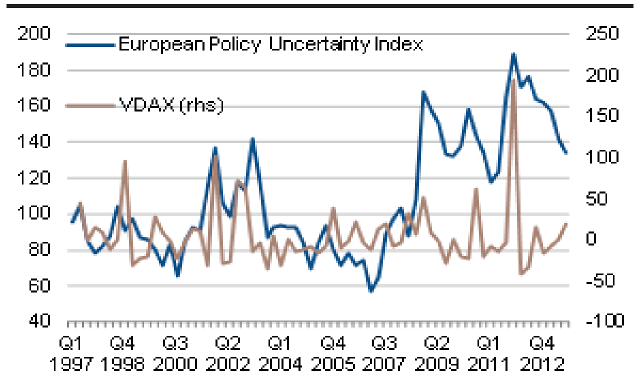
Anatoli Annenkov

- **Wages:** Our key scenario is based on solid support from household income. Given the labour market situation, with growing signs of labour shortages, we would expect wage growth to remain robust, at around 3%. Over the year, however, there has been a weakening trend in wages due to considerable uncertainty on the growth outlook. We expect this uncertainty to ease gradually and this should allow for a return of wage growth around or above 3%.
  - **Critical Level:** 2.5%
- **Unemployment:** German machinery and equipment investment appears to have been heavily affected by European policy uncertainty in recent years. We expect a return to pre-crisis levels over the course of 2014.
  - **Critical Level:** Continued improvement expected, gradually approaching pre-crisis levels.

Wages



Unemployment



Source: SG Cross Asset Research/Economics

France: Non-financial business investment and Wholesale trade of capital goods

Michel Martinez

- **Non-financial business investment:** France is exiting recession and the key question is: how firm will the recovery be? One of the assumptions behind our below-consensus growth forecast for 2014 (median 0.9%, SG 0.5%) is related to corporate investment behaviour. After a rebound in Q2, capex fell again in Q3.
  - **Critical Level:** 3% yoy.

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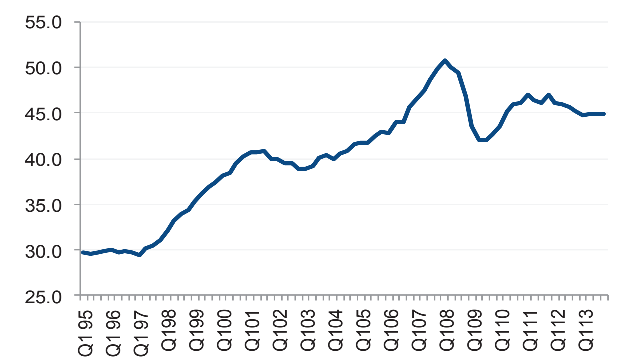
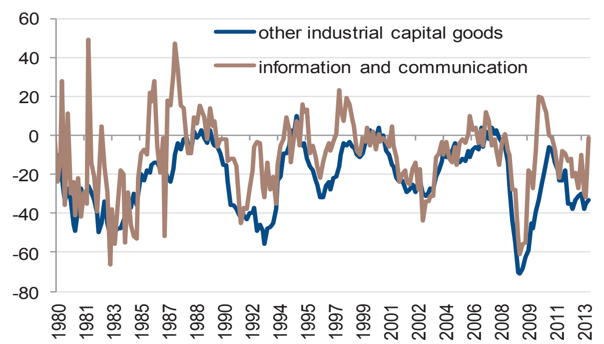
- **Wholesale trade of capital goods - Opinion on ordering intentions:** Surveys of wholesale trade of capital goods generally provide good signal of a recovery in capex. Opinions on ordering intentions in the capital goods sector remain in the doldrums, at -40. Levels close to -20 suggest a cyclical recovery in capex.
  - **Critical Level:** -20

Non financial business investment (EUR2005bn)



Wholesale trade of capital goods - Opinion on ordering intentions



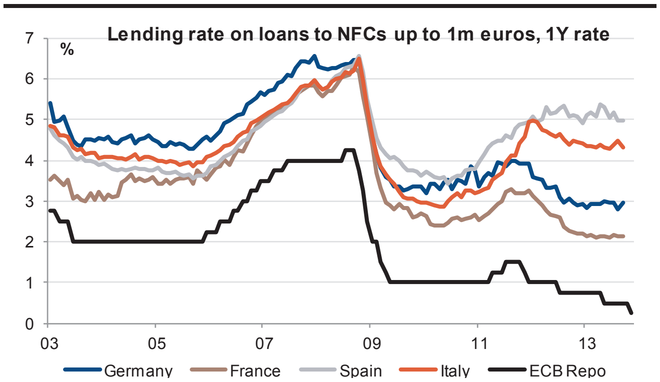
Source: SG Cross Asset Research/Economics

Italy: Lending Rate and Uncertainty

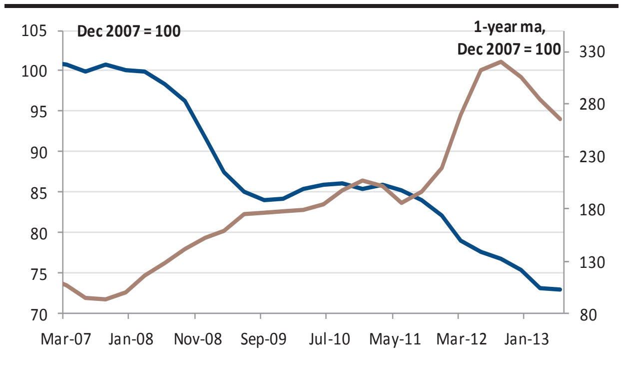
Yacine Rouimi

- **Lending Rate:** It remains difficult for Italian non-financial corporates to borrow money at an affordable rate. Having made some progress on fragmentation in terms of bank funding, lending remains subdued, also due to heightened risk aversion and uncertainty. This is a key objective that is to be addressed by the upcoming Asset Quality Review (AQR) and President Draghi was emphatic in emphasizing that, for the AQR to be effective, it will have to be credible, and that in turn will require a transparent and rigorous approach.
  - **Critical Level:** 3%
- **Uncertainty:** A lasting reduction in uncertainty would prompt us to revise our growth projections, as there would be the likelihood of a reversal of the negative implications it had on both growth and employment. We believe that consumer spending could see some upside but, above all, business investment could make a recovery from the historically low levels seen in recent quarters. We estimate that, if policy uncertainty were reduced permanently to pre-crisis levels, this would provide a 2-ppt boost to Italian real GDP growth after three years, and create more than 200,00 new jobs.
  - **Critical Level:** 185

Lending Rate



Uncertainty



Source: SG Cross Asset Research/Economics

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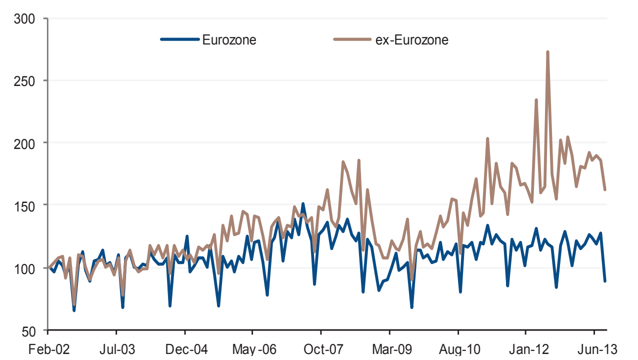
Spain: Exports and Industrial Orders and Credit Growth

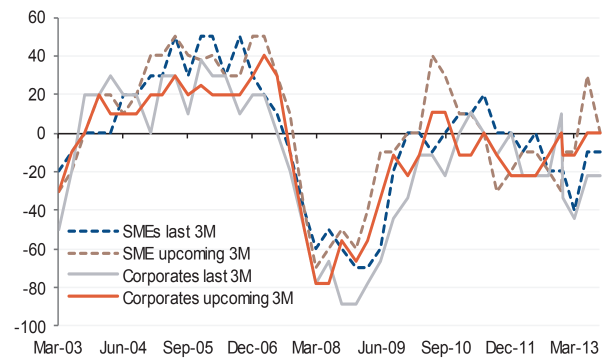
Souheir Asba

- **Exports and Industrial Orders:** Industrial orders received will be a leading indicator for export trends. Europe remains the main destination for Spanish exports as its recent recovery is absorbing the effects of slowing demand from Emerging Markets.
  - **Critical Level:** 250 for the aggregate.
- **Credit Growth:** SMEs and large corporates' restricted access to credit is undermining growth. There has been no significant improvement in credit growth over the past year. The scars from the housing and construction bubble – which was responsible for high credit growth prior to 2008 – are still evident.
  - **Critical Level:** above 0 levels would be indicators of a recovery in credit demand.

New Industrial Orders Received, mom change index (2002 = 100)



Net changes in demand for loans or credit lines %*



Source: SG Cross Asset Research/Economics. *(Adjusted to seasonal fluctuations)

UK: Unemployment and GDP Growth

Brian Hilliard

- **Unemployment:** This lies at the heart of the Bank of England's forward guidance framework. The threshold for a reconsideration of interest rate policy is a 7% unemployment rate. The Bank now predicts that, on unchanged rates, this level could be reached in Q4 2014. We expect them to lower the threshold as that number looms into view because the Bank will be in no rush to raise rates, as long as inflation remains reasonably well behaved.
  - **Critical Level:** 7.2%.
- **GDP growth:** Currently the economy is at a sweet spot with growth suddenly accelerating far above potential. The Bank of England has very aggressive GDP forecasts, well above market. The longer the economy maintains the current pace of growth, the more likely are market rate expectations to continue moving nearer.
  - **Critical Level:** 3.0% yoy for several years.

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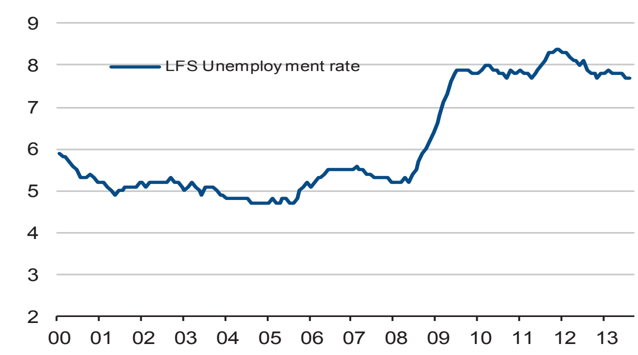
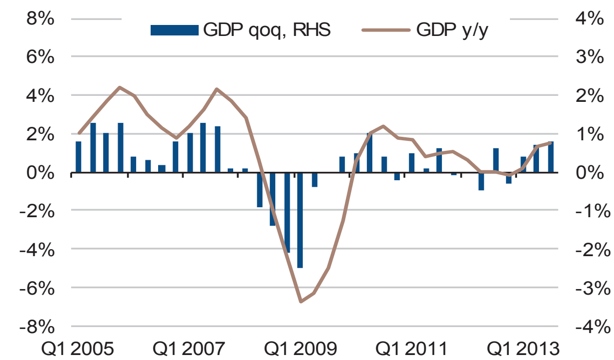
Unemployment



GDP Growth



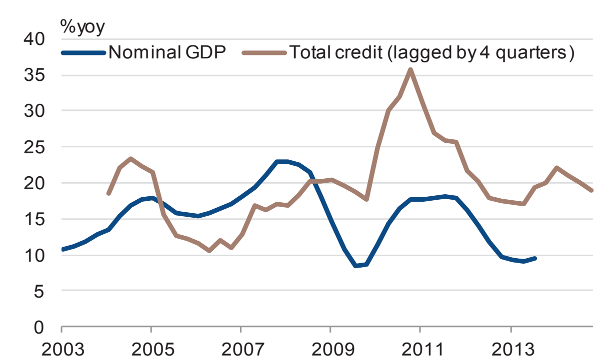
Source: ONS, Datastream, SG Cross Asset Research/Economics.

China: Credit growth and PPI

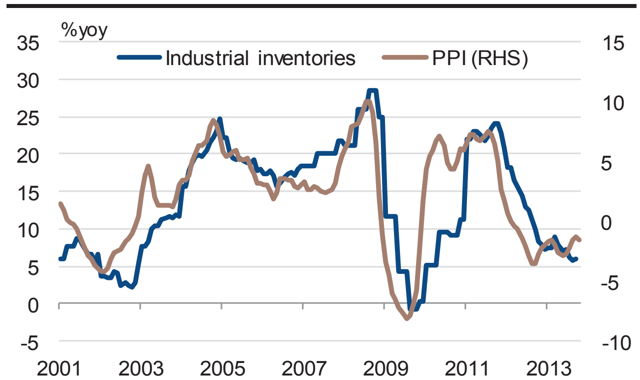
Wei Yao

- **Credit growth:** Total credit is calculated by taking the sum of bank loans, trust loans, entrust loans, bankers' acceptance bills and non-financial corporate bonds. Growth of total credit usually leads economic growth by three to four quarters and also closely correlates with liquidity conditions in the domestic financial system. Hence, it is not only a good leading indicator for growth but a timely barometer of financial tensions.
  - **Critical level:** Total credit growth has significantly outpaced nominal GDP growth since 2009, resulting in a big increase in the overall leverage of the Chinese economy. The new leadership has recognised that deleveraging is the right path to take to ensure long-term sustainability and has set about working on it. We expect total credit to trend lower and converge with the rate of economic growth in five years.
- **PPI:** This indicator captures the relative speed of demand recovery against capacity consolidation in China. A higher yoy rate suggests that demand is increasing faster than capacity, thus improving profit margins for manufacturers. This series also correlates well with inventory cycles.
  - **Critical level:** 0 (% yoy)

Credit growth



PPI



Source: SG Cross Asset Research/Economics

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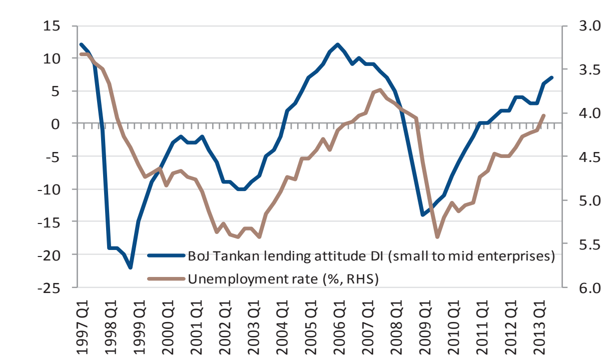
Japan: Tankan lending attitude to SMEs and Tankan manuf. employment conditions

Takuji Aida

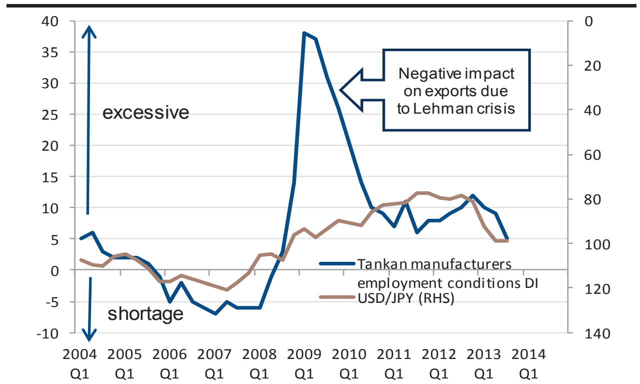
- **Tankan lending attitude to SMEs:** To see a sustainable recovery in domestic demand and an easing deflationary environment, we need to see a strong expansion in aggregate wages. To achieve this, the unemployment rate needs to reach 3.5% (versus 4% at present). Most companies in the service sectors are small to mid-size, and these companies will be the main drivers for employment growth. The point is that these companies need to feel that the lending attitudes of financial institutions are easing before business expansion can occur.
  - **Critical level:** +12 (previous cycle peak)
- **Tankan manufacturing employment conditions:** Among the non-manufacturers employment conditions are expanding strongly. However, manufacturers have a lingering perception of excess employment, and remain focused on restructuring and cost-cutting rather than investing and hiring. This represents an obstacle to further improvement in the unemployment rate and the expansion of aggregate wages. As the US economy recovers, we expect exports to recover and the yen to depreciate further. Finally, the perception of excess employment should recede, allowing employment and wages to improve.
  - **Critical level:** 0 (perception of excess employment disappears at 0).

Tankan lending attitude to SMEs



Source: BoJ, Statistics Bureau, SG Cross Asset Research/Economics

Tankan manufacturing employment conditions



BoJ, SG Cross Asset Research/Economics

Poland: Investment and Debt to GDP ratio

Janecki Jaroslaw

- **Investment:** During the first wave of the crisis, investment decreased by –10.3% yoy, in Q1 2010. In the period of stable growth, investment is one of the most important components of GDP. The contribution to GDP was in the range of 1.7-2.8pp in H2 11. It will be difficult to close the output gap without investment growth. Delays in some investment projects may negatively impact our GDP projection. We estimate 2014 investment at 2.0% yoy. The negative or close-to-zero growth in investment in subsequent years will constitute a risk for our economic growth scenario.
  - **Critical Level:** 0% growth yoy.
- **Debt to GDP ratio:** The full impact of the new regulations regarding the changes in the pension system is not yet known. It could lower public debt by around 9.2pp of GDP in 2014. There are still some doubts it will be possible to maintain a lower debt-to-GDP ratio in the coming years without long-term measures. A debt-to-GDP ratio growth close to 55% will be a risky scenario for Poland's public finances. We forecast debt-to-GDP growth ratio close to 56% without the changes in pension system.
  - **Critical Level:** 55 percent of GDP (in polish methodology), 60 percent of GDP (ESA'95 methodology).

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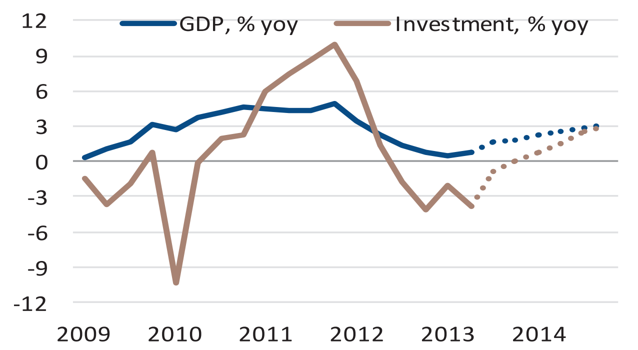
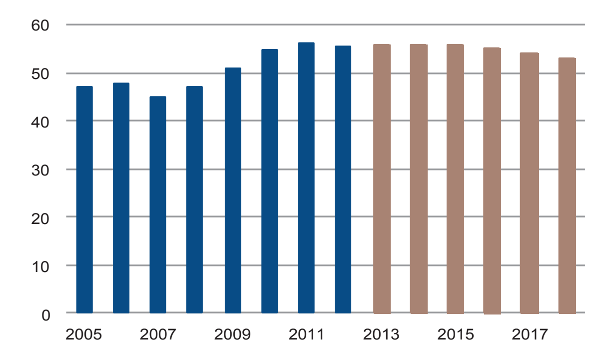
Investment



Debt to GDP ratio without changes in pension fund



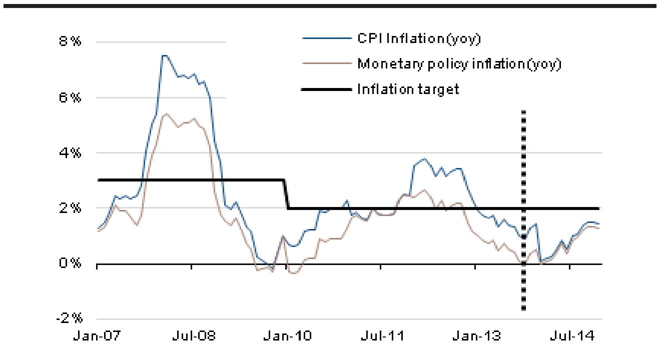
Source: SG Cross Asset Research/Economics.

Czech Republic: CPI and Household consumption

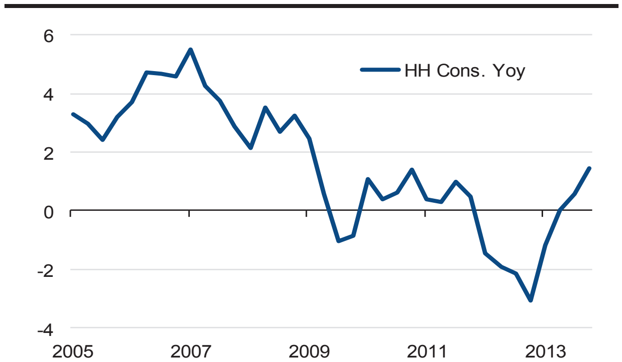
Jiri Skop

- **CPI:** Inflation is crucial for the timing of exit from the FX intervention regime. The CNB targets inflation at 2% yoy, and this level should be reached at the end of 2014, in our view.
  - **Critical Level:** 2% yoy.
- **Household consumption:** If domestic demand recovers strongly than anticipated, demand-pulled inflationary pressures might speed up inflation toward the target. On the other hand, household consumption should be negatively affected by higher import prices at the beginning of 2014.
  - **Critical Level:** 2% yoy.

Inflation outlook



Household consumption



Source: SG Cross Asset Research/Economics.

Slovakia: Public finance deficit and Disinflationary trends

Miroslav Frayer

- **Public finance deficit below 3% of GDP in 2013:** The government plans a public finance deficit of 2.98% of GDP this year, followed by 2.83% in 2014, 2.57% in 2015 and 1.50% in 2016. Previously, the government had warned this year's deficit could reach 3.04% of GDP. But, we are still very sceptical regarding this year as we do not expect fulfilment of the Maastricht criterion.
  - **Critical Level:** -3% of GDP.

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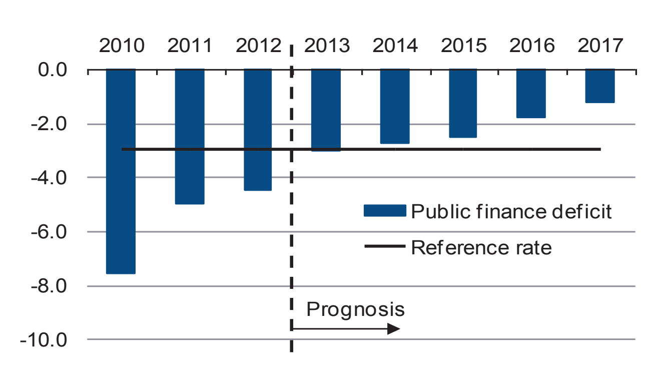
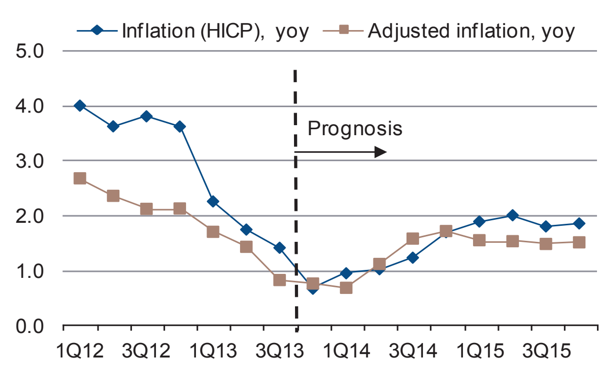
- **Disinflationary trends in the economy:** Inflation has declined since October 2012, and in May 2013 it was below the ECB's inflationary target for the first time since December 2010. In October, inflation amounted to 0.6%. In Q3 13, the main surprise was adjusted inflation again, which slowed significantly to 0.8%. For now, we do not expect a further significant deceleration in the inflation rate, but the risk of a negative inflation rate is increasing. A decline into negative territory for a longer period would change our outlook for the future economic recovery.
  - **Critical Level:** 0.0% yoy.

Public finance deficit below 3% of GDP in 2013



Disinflationary trends in the economy



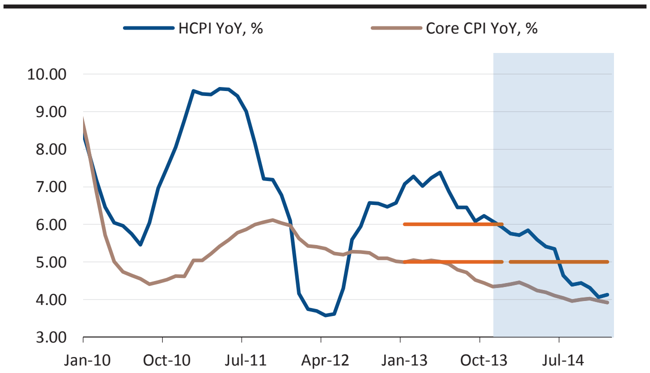
Source: SG Cross Asset Research/Economics.

Russia: Headline CPI and Fixed assets investments

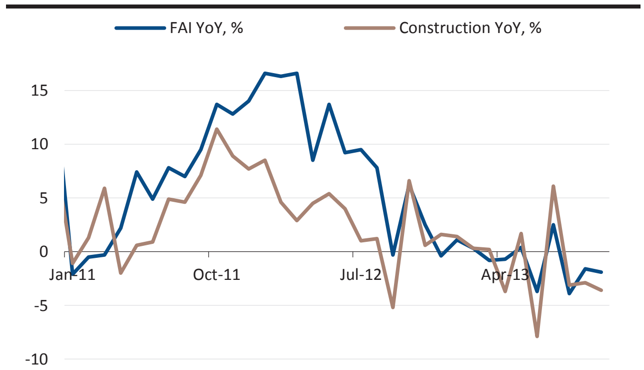
Evgeny Koshelev

- **Headline CPI: The** CBR intends to finalise its transition to inflation targeting by 2015 and is to set a target for the HCPI at 5.0% yoy (+/-1.5%) level. Although the core component is moving lower, the most volatile components are of particular concern for the CBR and stand in the way of an outright cut to the policy rate.
  - **Critical Level:** 5.70-5.80% in Q1 14, or two-three consecutive months of disinflation to trigger the key rate cut.
- **Fixed assets investments (FAI):** Investment demand remains one of the weakest components of domestic demand and this too is standing in the way of a rebound in GDP. The government tends to apply stimulation to the economy via 'backdoor' infrastructural spending and curbing tariff indexation.
  - **Critical Level:** Expect an acceleration in mandatory investments to counter the sentiment-driven slowdown.

Headline CPI vs Core CPI



FAI and Construction



Source: SG Cross Asset Research/Economics.

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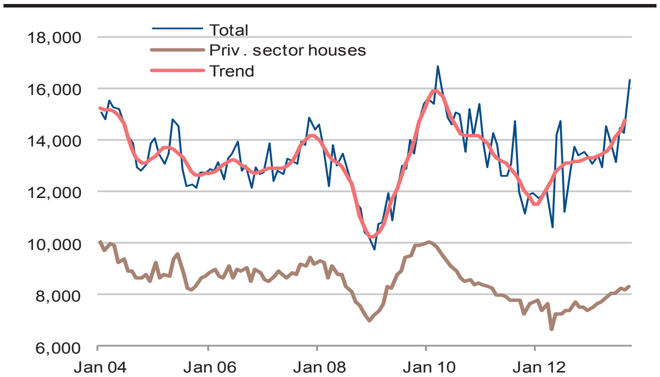
Australia: Building approvals and exchange rate

Klaus Baader

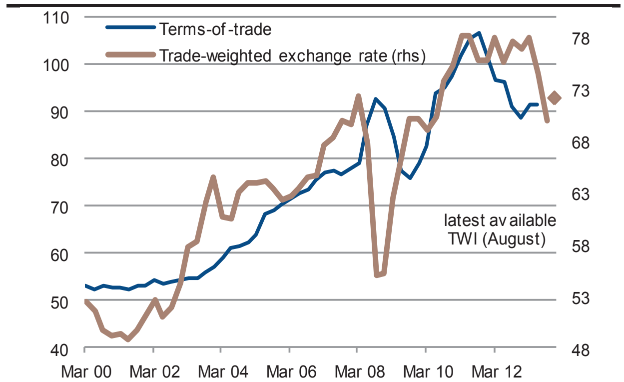
- **Building approvals:** The biggest break on growth in Australia is the decline in mining investment. In order to avoid a severe slowdown in the economy in general, it is imperative that other sources of demand fill the void. In the first instance, that is likely to be residential housing activity – including house prices driving consumption demand through the wealth effect. But more important is housing investment, and building approvals are a good leading indicator for this.
  - **Critical level:** There is no critical level as such as this is a highly volatile series – what is important is that the trend remains at or above current levels, which are in themselves already quite high.
- **Exchange rate:** A second factor of key importance to successfully manage the transitions away from resource investment to other sources of demand is the exchange rate. It remains highly valued, and is thus putting downward pressure on manufacturing as well as key services exports (tourism, education).

  It is clear that policy makers would like a lower exchange rate, but if this is in line with fundamentals is an open question. Historically there has been a fairly close relationship with the terms of trade. Right now these are broadly in line with the TWI, but are expected to decline.
  - **Critical level:** This depends on the terms of trade – what is important is that a moderate downtrend is maintained.

Building approvals



Exchange rate



Source: SG Cross Asset Research/Economics

South Korea: Growth of private sector leverage and inflation

Suktae Oh

- **Growth of private sector leverage:** The burden of private sector (household and corporate) leverage has been the key risk for the Korean economy, given that leverage as a percentage of GDP is as high as some highly leveraged developed economies. We have recently observed the slowdown in private sector leverage, though the ratio of leverage to GDP is not declining considering that GDP growth is also slowing.
  - **Critical Level:** 8%, a previous high was seen in Q4 11. Our base scenario of no credit boom assumes that private credit growth will not exceed this level. If we observe higher growth in leverage, both growth and inflation will be strengthened, and the chances of a BoK rate hike will increase.
- **Headline CPI inflation:** Headline inflation has been undershooting the BoK's target range since H2 12, raising concerns regarding disinflation or even deflation. The inflation outlook will depend on the output gap, currency markets, credit growth and monetary policy. It appears that the BoK does not care about the lower limit of the inflation target range.
  - **Critical Level:** 2%, a psychologically important level for 'normal' inflation in most developed economies. Our base scenario assumes that headline inflation will rise above this level in H1 14. If headline inflation stays below this level into H2 14, concerns on low inflation (or even deflation) will rise further and exert pressure on the BoK to cut rates.

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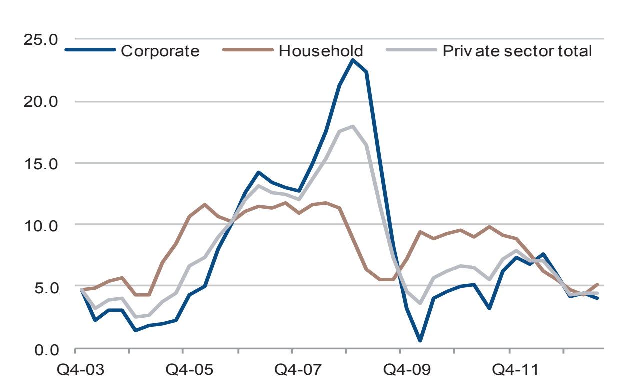
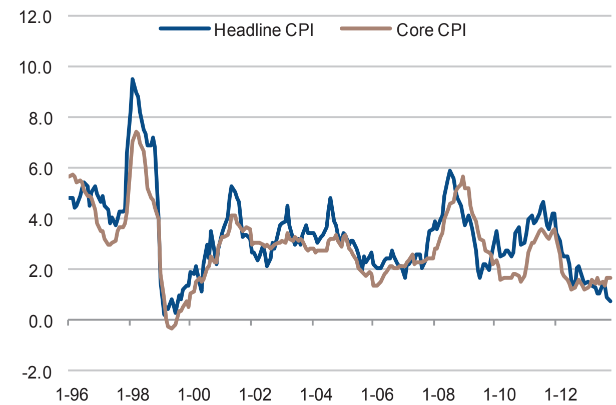
Growth of private sector leverage



Headline CPI inflation



Source: SG Cross Asset Research/Economics

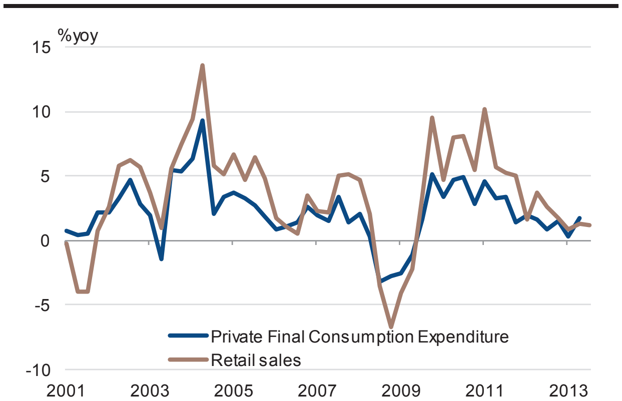
Taiwan: Export orders and retail sales

Wei Yao

- **Export orders:** Exports are the most important part of Taiwanese economy, accounting for nearly three-quarters of the economy. Export orders often lead exports by one or two months, thus providing some idea of the short-term outlook for the economy.
  - **Critical Level:** The higher the better.
- **Retail sales:** Retail sales are one of the timeliest indicators of household consumption in Taiwan.
  - **Critical Level:** The higher the better.

Export orders

Retail sales



Source: SG Cross Asset Research/Economics

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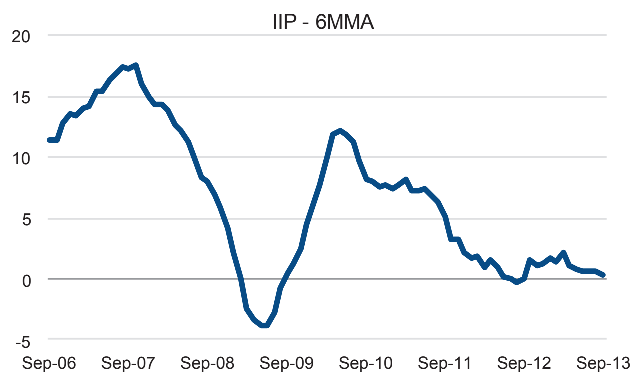
India: Industrial production and inflation

Kunal Kundu

- **Industrial production:** India's industrial production data (as given by the Index of Industrial Production or IIP) continues to remain weak, given the amount of demand destruction that the economy has been experiencing. While the monthly data is highly volatile, the six month moving average data continues to trend down and is closer to zero expansion level now. We do not expect much reversal in here, given the extent of inventory accumulation that has taken place.
  - **Critical level:** 4.5% yoy.
- **Inflation:** With the government not doing its bit and leaving the RBI to fight a lone battle, monetary conditions are tight as inflation rages on and inflationary expectations remain stubbornly high.
  - **Critical level:** Headline WPI inflation averaging more than 6.5% yoy during FY14 would raise a red flag.

Industrial production



Inflation

Source: SG Cross Asset Research/Economics

Mexico: Exports and Manufacturing production

Dev Ashish

- **Exports:** Being an open economy with high share of trade in GDP and strong co-movement of domestic demand and sentiment regarding external demand, exports become a key indicator. Importantly, Mexican exports rely heavily on US demand growth. Since 2005, Mexican exports on average have grown by almost 10% annually. Substantially stronger export performance would add to the upside risk to growth.
  - **Critical Level:** 12.0%.
- **Manufacturing production:** The bulk of Mexico's exports is manufacturing goods and a revival in manufacturing production (and overall industrial production) will also signal improvement in the external demand outlook. Looking at past data, 5-6% annual manufacturing growth is consistent with slightly above trend growth which is what we are looking for the Mexican economy from 2014 onwards.
  - **Critical Level:** 5.5%.

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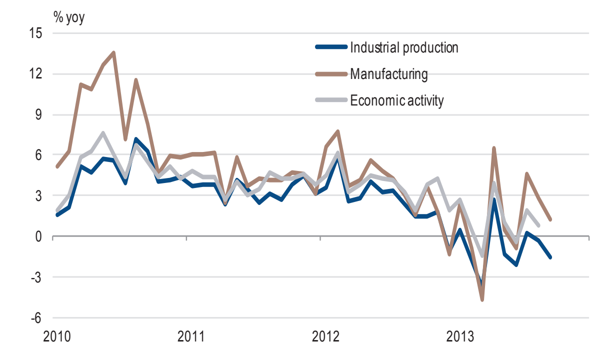
Exports

Manufacturing production



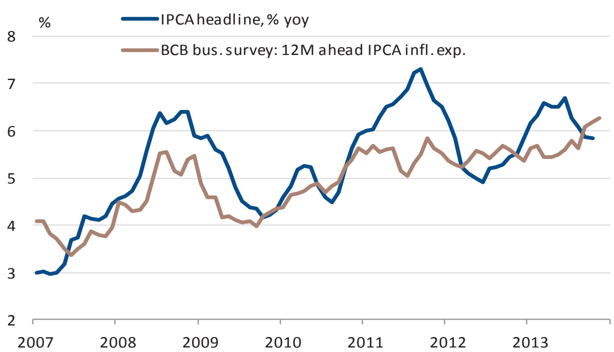
Source: SG Cross Asset Research/Economics.

Brazil: IPCA inflation and Industrial production

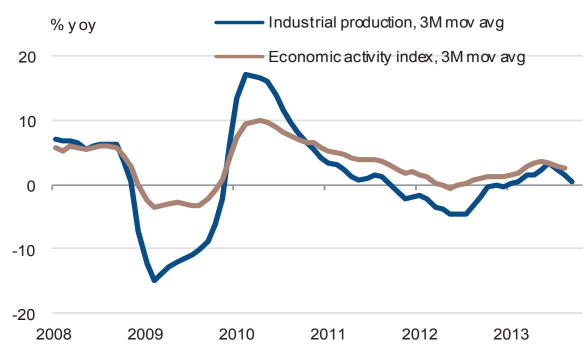
Dev Ashish

- **IPCA inflation:** IPCA is the broadest measure of inflation and the single most important indicator affecting monetary policy rate. The BCB targets inflation at 4.5% with a 2% tolerance range either sides. We estimate 2013 inflation at 6.2% and expect it to fall to 5.7% in 2014 (with the actual decline materialising in H2). A range of 5.3% to 6.0% annual inflation in 2014 will be most conducive for our forecasts.
  - **Critical Level:** 5.5%
- **Industrial production:** IP is the largest component in the monthly economic activity index that tracks supply side GDP. A growth range of 3% to 5% in IP will roughly signal economy growing near trend. Above trend IP growth will also signal strengthening competitiveness of manufacturing exports.
  - **Critical Level:** 4.0%.

IPCA inflation



Industrial production



Source: SG Cross Asset Research/Economics.

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Chile: Retail sales and Exports

Dev Ashish

- **Retail sales:** Over the past several months, the strength of retail sales and overall consumption demand has been surprising given much weaker production side data. The strength of consumption demand presents a challenge to our sub-trend outlook for Chile. It's possible that domestic consumption eventually lead manufacturing out of trouble for the time being. 5% annual growth in retail sales is consistent with our slightly sub-trend growth outlook.
  - **Critical Level:** 5.5%
- **Exports:** Chile is a small open economy with a high share of exports in GDP. The biggest component of Chilean export is metal (primarily copper). Improvements in export growth will also mean stronger investment demand in the domestic economy, improving the overall outlook. Since 2004, Chile recorded strong export growth of an average 17% annually on the back of strong commodity prices and metal demand. Weaker than average export growth will drag the economy's actual and potential growth lower.
  - **Critical Level:** 12.0%.

Retail sales

Exports

Source: SG Cross Asset Research/Economics.

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