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GEMS

Emerging Markets Macro and Strategy Outlook

Will DM's Recovery Be EM-friendly?

- Of the EM central banks that have held policy meetings since last week's FOMC, the two largest – India's and South Africa's – have expressed almost identical sentiment about the aftermath of the Fed's decision. Both the RBI governor and the SARB governor emphasized the *temporary* nature of the relief that emerging economies will enjoy from the Fed's decision. In the words of the RBI's Raghuram Rajan, *'Let us remember that the postponement of tapering is only that, a postponement'.*

- If that's the case, and if capital flows to EM continue to become scarcer, the market will rely more and more on signs that EM can export its way out of its problems. EM export growth has been very poor in the past year, owing partly to the fact that Developed Market (DM) import volume growth has been negative since August 2012. What the market is hoping for, in other words, is that EM may gain on the *current* account what Fed tapering might cause it to lose on the *capital* account.

- There is some good news: strengthening export growth from China and Korea in August was part of the story behind the EM rally that we've seen since early September. But we have some reasons to question whether the EM export recovery we'll see will be really robust. After all, EM export growth used to benefit from a number of factors – very cheap EM real exchange rates, plentiful credit availability in DM, strong Chinese growth – which aren't so supportive these days.

- And there are some other factors that raise some questions about the future of EM export growth. Japan's recovery, for example, is partly built on a cheap yen, which is likely to make room for import substitution. In the Eurozone, what used to be a purely German current account surplus has now spread to many other countries, and the import-compression that has produced these surpluses may take time to unwind. And in the US, there may be evidence that the growth of EM's share of US imports might have peaked. Finally, EM exports to China – particularly for the most China-dependent economies like Brazil, Korea and Taiwan – don't seem to exhibit a huge amount of strength these days.

- All this makes us cautious about the economic environment EM is about to enter. While export data seem likely to continue to recover, we think the recovery might be a shallow one, and thus not a reason to discount the growth risks that have plagued EM in the past couple of years.

EM Economics and Strategy

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Contents

Will DM's recovery be EM-friendly?

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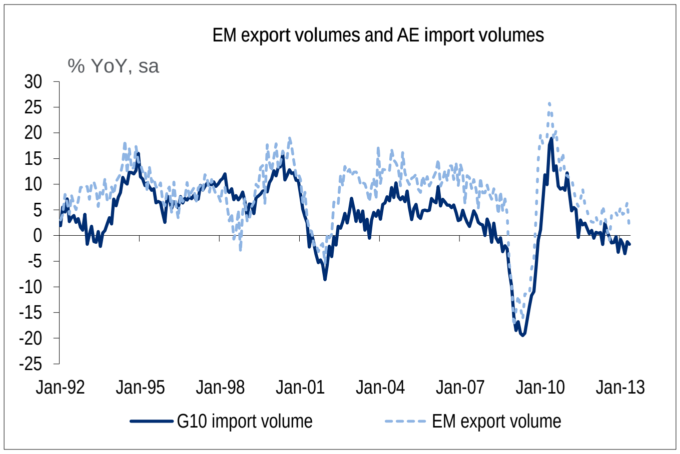
Aside from the apparent respite for EM that results from last week's FOMC, we still think that the underlying questions facing emerging economies haven't changed much. Of the EM central banks that have held policy meetings since last week's FOMC, the two largest – India's and South Africa's – have expressed almost identical sentiment about the aftermath of the Fed's decision. Both the RBI governor and the SARB governor emphasized the *temporary* nature of the relief that emerging economies will enjoy from the Fed's decision. In the words of the RBI's Raghuram Rajan, *'Let us remember that the postponement of tapering is only that, a postponement'.*

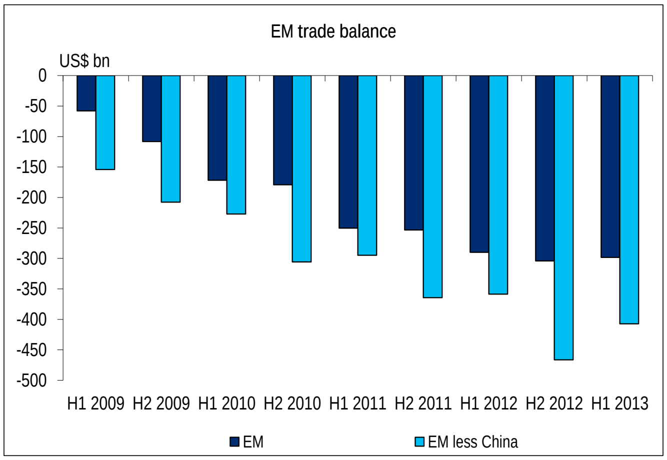
With that in mind, we turn to an important question: if the 'genie' of US monetary tightening really is out of the bottle for good, how will EM be affected? We know two things so far. The first is that the prospect of US monetary tightening is, as always, a factor that pulls capital away from EM, and that the countries that suffer most from this process are those that have the greatest dependence on capital inflows: ie those with the largest external financing needs. The second thing we know is that EM policymakers in 2013 face very hard choices in combating those capital outflows. It wouldn't be so tough if the deficits in EM were the result of domestic overheating and very rapid import growth. If that were the case, then EM central banks would happily tighten monetary policy, and governments would happily tighten fiscal policy (see Citi GPS Opinion: Emerging Markets: Lousy Policy Options Help Deepen the Crisis). Those responses would help ease the sell-off by convincing foreign investors that these countries' external financing gaps would shrink in due course. But EM deficits these days are not the result of over-rapid import growth, but come instead from a collapse in export growth. This is more or less illustrated in Figure 1, which shows that import volume growth in the Advanced Economies has been negative since August 2012. It is this 'trade shock' confronting EM that provides the background not just for the weak growth performance of EM in recent quarters, but also for deterioration in the EM trade balance.

Figure 1. The 'external shock' to EM produced by negative import volume growth in Advanced Economies has not ended yet…



Source: Haver Analytics, Citi Research. Note that EM export growth in early 2013 was inflated by misinvoicing of Chinese data

Figure 2. …with the effect that the deterioration of EM's trade balance remains visible

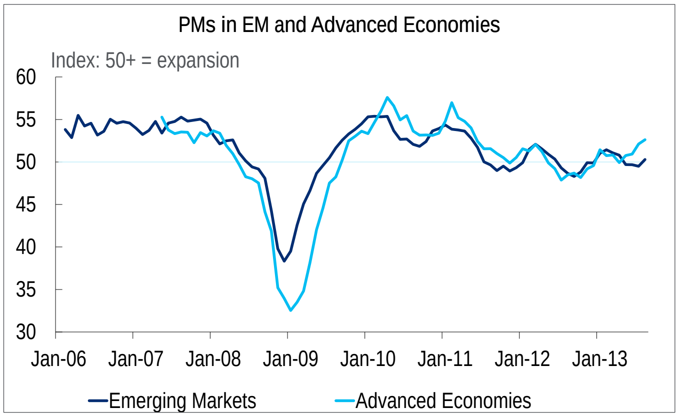


Source: Haver Analytics, Citi Research

The nature of the shock facing EM means that the only reliable route out of EM's problem is an export-led recovery. Indeed, one of the factors that helped to stabilize EM asset prices, even before last week's FOMC, was the evidence, particularly from Asia, that some export recovery has become evident. August export growth from China, Korea and Taiwan all seemed to give some reasons for

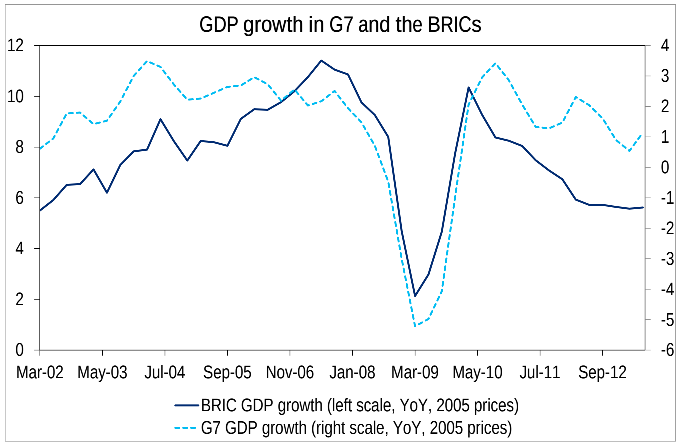
optimism. Most recently, for example, the HSBC PMI for China showed the new export order sub-index at a 10-month high of 50.8. In other words, what EM may lose on the *capital* account of the balance of payments may be offset by an improvement in the *current* account. But the question is worth asking: will EM enjoy the kind of export growth that fully cancels out the capital account shock that will result from tapering over the next year? While we acknowledge that this is an extremely difficult issue to quantify, we think there are some reasons to doubt the strength of EM export rebound.

Figure 3. PMIs in the G4 have picked up much more noticeably than in EM…



Source: Bloomberg, Haver Analytics, Citi Research.

Figure 4. ...and Q2 GDP growth in the G7 picked up without any visible follow-through to EM

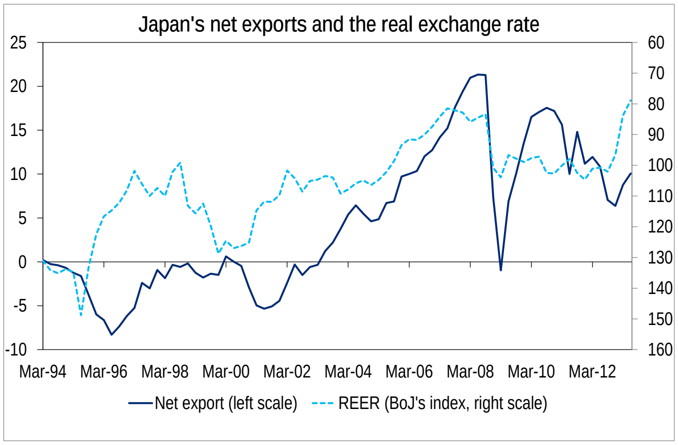


Source: Citi Research

There might be reasons to doubt that EM exports are enjoying as strong a sensitivity to G10 growth as used to be the case. In the first place, there might already be some reasons to think that the pick-up in Advanced Economies hasn't yet – at least – properly fed through into optimism about EM. This is the suggestion that emerges from Figure 3, which points to greater PMI upside in recent months for the Advanced Economies than for EM. Q2 GDP shows the same picture: G7 GDP growth rose above 1% in Q2, while BRIC growth as a whole stayed flat at 5.6%. Of course, it is absolutely possible that there is a lag between a G10 pick-up and an EM export response. And the export data that we've seen from China, Korea and Taiwan may provide early indications that this is the right thing to expect. But the persistence of the G10 'import recession' during Q2 this year – when volume import growth rates remained negative – raises a doubt. And there are a few arguments that may suggest that the recovery in G10 that we're seeing could prove to be less EM-friendly than G10 growth has been in the past. While we can't really say anything conclusive about these arguments, they are worth exploring.

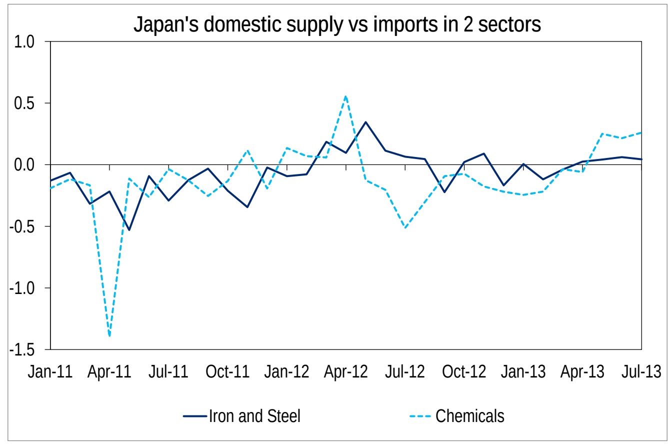
First, Japanese growth is based on a weak exchange rate, which might lead to some import-substitution. Intuitively, it makes sense to suppose that recoveries that hinge on a cheap currency are likely to make room for more import substitution than recoveries that are built on credit-fuelled domestic spending and a more appreciated exchange rate. In the case of Japan, it's relatively clear that the contribution of net exports to GDP does indeed decline when the real exchange rate is more depreciated (Figure 5), and it's also clear that the real yen has indeed weakened considerably in recent months. And the data in Figure 6 at least suggest that the ratio of domestic supply to imported supply in Chemicals and in Iron and Steel has been rising recently, which might provide some further evidence of import-substituting behaviour among Japanese firms.

Figure 5. Japan's net exports seem to rise when the real effective exchange rate depreciates...



Source: Haver Analytics, Citi Research.

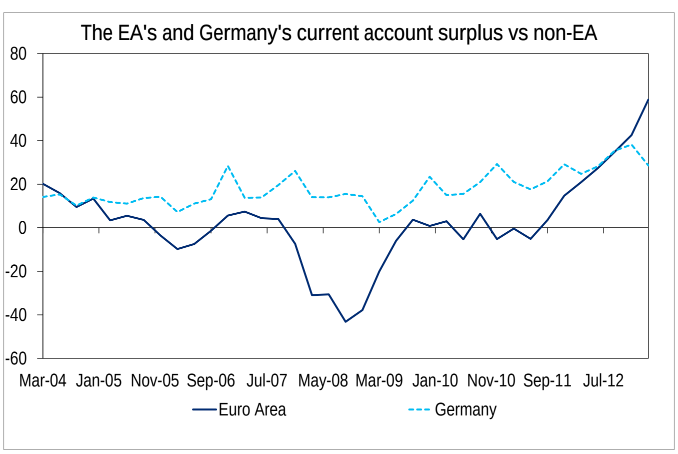
Figure 6. ... and there is some evidence that the growth of domestic supply is outstripping that of imports in Iron & Steel and Chemicals



Source: Datastream, Citi Research

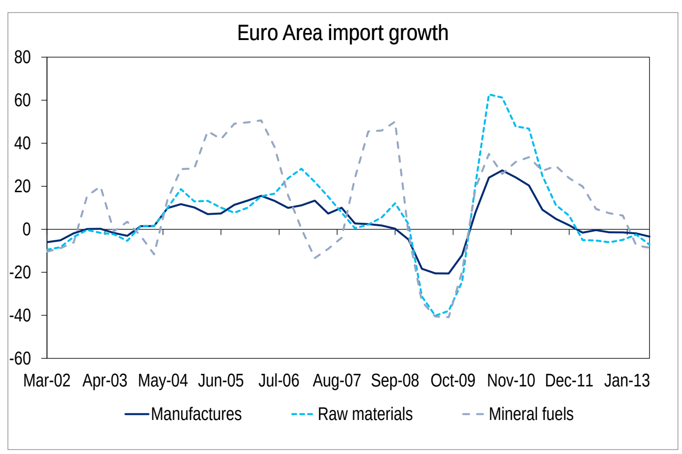
It is also possible that the Eurozone's recovery could be less EM-friendly than in the past. What used to be a German-only current account surplus with the rest of the world (outside the Euro Area) has now spread in the context of the EA's peripheral crisis, as Figure 7 demonstrates. This, of course, is the inevitable consequence of the crisis in the Euro Area, and the important implication for EM is that the current account adjustment that's taken place there has been, as is often the case, the result of import compression (Figure 8). One important caveat, though, is that this import compression doesn't seem to have prevented a recovery in central Europe, where recent PMI data have pointed to a rather strong recovery. Yet as we've highlighted in recent research (see Central Europe Macro View - CEE vulnerability: Now on safer ground?), this recovery itself is based partly on the fact that, unlike several other EMs, real exchange rates in CEE remain considerably weaker than in 2008, given the pounding that these economies took during the past five years from bank deleveraging and the external shock produced by the depth of the Eurozone crisis. In other words, just as these economies bore the brunt of the Eurozone crisis, they benefit disproportionately from its stabilization. What's happened to Central Europe may not be representative of broader EM.

Figure 7. What used to be a German current account surplus vis a vis the non-Euro Area has spread across other EA members...



Source: Haver Analytics, Citi Research.

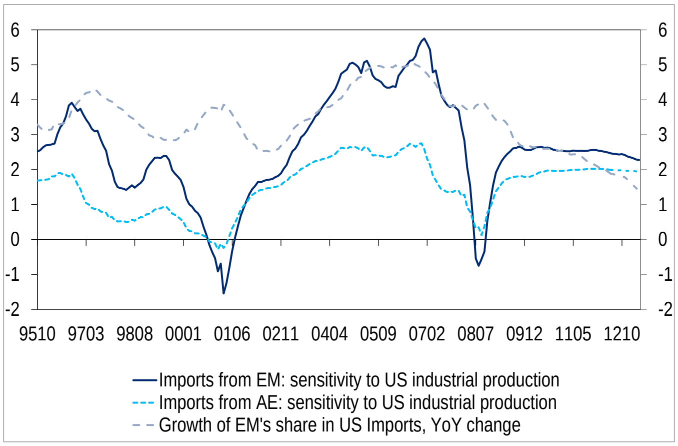
Figure 8. ... and, as with most crisis-induced current account adjustments, most of the work has been done by import compression



Source: Haver Analytics, Citi Research

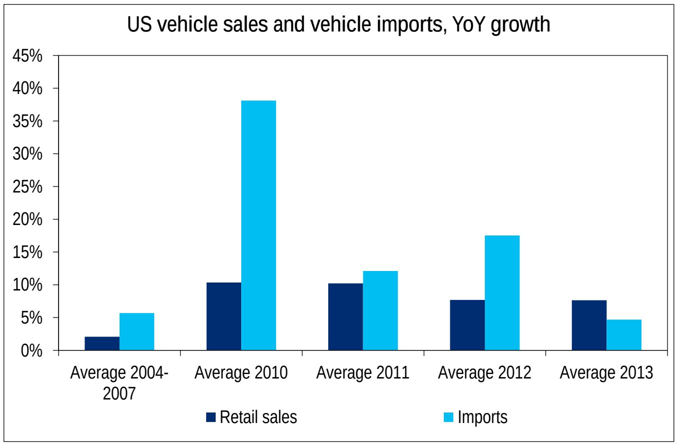
Whether or not the US recovery might be less EM-friendly than it used to be is tough to nail down. We've drawn a blank in our attempts to find any change in the elasticity of US imports to GDP growth. However, there is some tentative evidence that economic developments in the US may be becoming marginally less EM-friendly. The right scale of Figure 9 shows how the growth of EM's share of US imports has staged a notable decline during the few years. Of course it's difficult to say definitively that this loss in the growth of market share will not be reversed, but the trend isn't encouraging. And the left scale shows that the sensitivity of imports from EM to changes in US industrial production is nowhere near as strong as it was during the 2000s. And in recent months, it appears that the sensitivity of imports from EM to US industrial production changes is converging towards the same (low) degree of sensitivity that imports from Advanced Economies have to changes in US output. And Figure 10 suggests that, at least for US car sales, domestic sales are growing much faster than imports for the first time in recent memory.

Figure 9. The sensitivity of US imports from EM to US IP changes has fallen sharply, and so has the growth of EM's share in US imports



Source: Citi Research. With many thanks to Benjamin Mandel at Citi for his research into this question

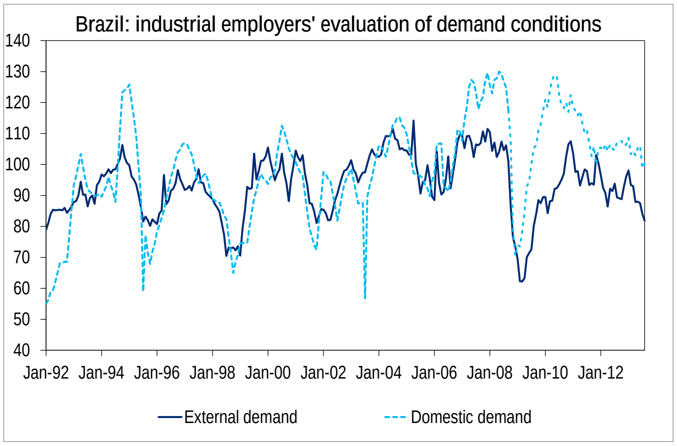
Figure 10. US vehicle sales are growing faster than vehicle imports this year, for the first time in recent memory



Source: Citi Research

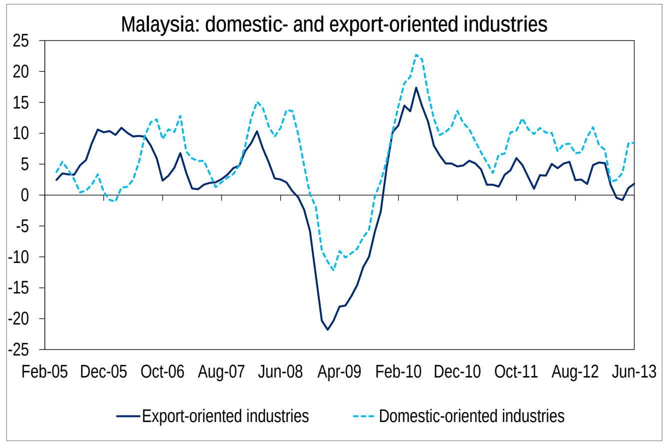
Adding to our suspicion that G10 growth may not be so EM-friendly, is the evidence in some EM countries at least that domestic factors are becoming more important to output growth. As examples of this, consider the data in Figures 11 and 12, which show, for Brazil and Malaysia, how domestic spending (at least in these two countries) has progressively broken away from external demand as a source of industrial activity. The FGV's survey of industrial employers – where the data extend to August 2013 – asks them how they evaluate domestic and external demand conditions. And in Malaysia (where the data extend only to June), the breakdown of industrial production data into export-oriented and domestic-oriented industries equally points to the more favourable conditions at home.

Figure 11. Brazilian producers continue to report that external demand is a much weaker stimulus to output than domestic conditions...



Source: Haver Analytics, Citi Research.

Figure 12. ...and the breakdown of Malaysian industrial production shows more life in domestic-oriented industries

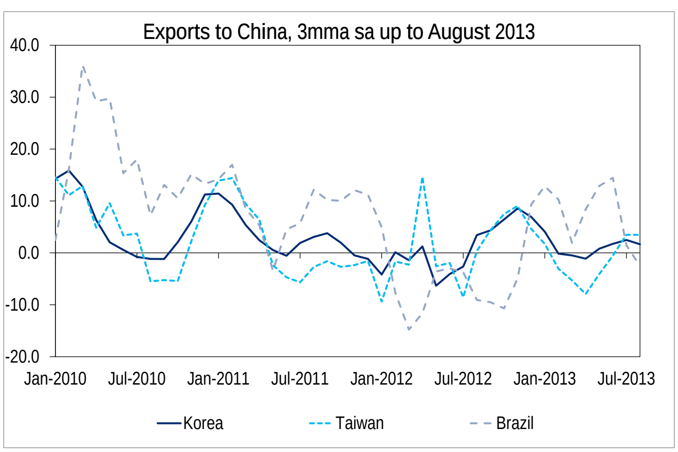


Source: CEIC, Citi Research

Finally, it is worth pointing out that the possible threat to solid EM export growth doesn't just come from the G10, but from China. We've repeatedly emphasized how 'China-dependent' EM is as an asset class and as a group of economies. Three of the most China-linked economies – Korea, Taiwan and Brazil – have produced trade data for August, and an indicator of export 'momentum' – the 3-month moving average of seasonally adjusted annualized month-on-month changes – doesn't necessarily deliver much cause for optimism (Figure 13). And overall export momentum for a group of countries that have reported August trade data (Figure 14) equally doesn't generate any signs that things are changing much.

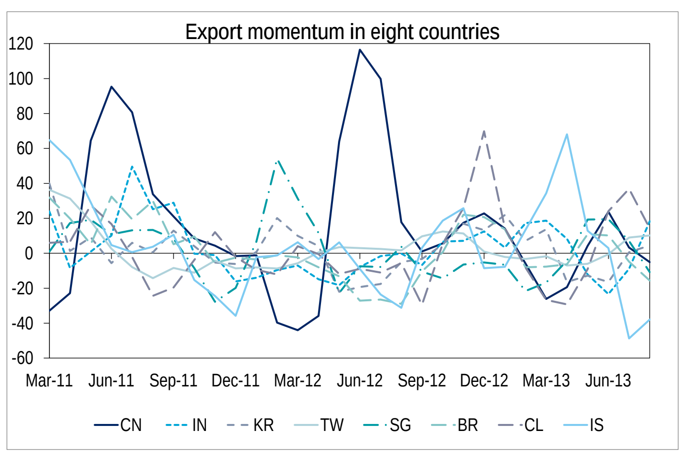
All in all, while it is quite possible that EM exports show some recovery in the coming months, we think there might be reason to doubt the strength of that recovery. Rapid export growth from EM in the years before the Lehman Crisis benefited from three factors in particular: heavily depreciated real exchange rates; a pattern of G10 growth that was marked by high levels of credit availability and strong domestic absorption; and the emergence of China. Those factors are, slowly, being replaced by more appreciated EM exchange rates; and a China that doesn't seem to be the same kind of support for the rest of EM that it once was.

Figure 13. The momentum of exports to China from Brazil, Korea, Taiwan doesn't appear to have staged any notable recovery...



Source: Haver Analytics, Citi Research.

Figure 14. ...and overall export momentum for eight counties that have produced August trade data doesn't hold out huge signs of hope



Source: Haver Analytics, Citi Research

Thoughts on EM credit strategy

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EM spreads have bounced back significantly since the announcement of the Fed's decision to delay tapering. Owing largely to that decision, EM spreads have outperformed other credit markets in September after lagging dramatically for most of the year. Overall, while we think EM spreads valuations are still somewhat attractive versus other markets, the room for further outperformance looks more limited after the recent outperformance, and we could see another round of sell-offs if the data in the coming months turn back to disappointment.

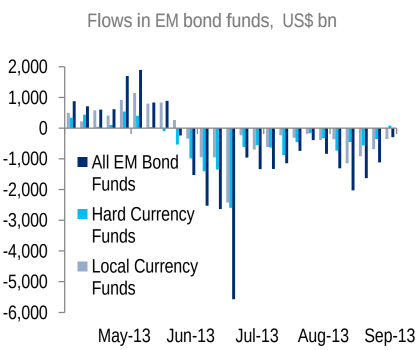
After the recent outperformance, EM spreads are still wide compared with other credit markets but do not seem as relatively attractive as they did a just a couple of weeks ago. In a recent piece (For investment grade sovereigns, ratings give little guidance), we discussed the amount of rating downgrades that are implied by EM sovereign spreads. A year ago, EM sovereign CDS spreads traded in line with similarly rated US and European corporates. That relationship has moved dramatically this year owing to the negative EM sentiment. We calculate the amount of implied weakness as how many downgrades would be necessary for a given country's spread to be in line with the average for similarly rated US and EU corporates (e.g. from BBB+ to BBB- would be two notches). When we ran the exercise a couple of weeks ago, the average amount of downgrades required was 2.1. It has now fallen to 1.7 notches. There is still room for some further spread outperformance in order to move the relationship back in line but the potential extent is more limited now.

With this in mind, we maintain our underweight recommendations on all three major high-beta sovereigns – Venezuela, Ukraine and Argentina. Of the three, Ukraine has seen the most weakness in recent days on the back of Moody's downgrade of the sovereign. Near-term financing is a growing issue especially as reserves approach the $20 billion level with $1.6 billion to the IMF in the next two months. The government has thus far been publicly adamant in being unwilling to submit to the IMF's terms, making an agreement unlikely barring a surprise reversal of course from the government. And, while it seems likely that the government will sign an Association Agreement with the EU in November, that doesn't necessarily make an IMF deal more likely. We think an IMF deal will be increasingly unavoidable for the Ukraine government, given the likely further drain on fx reserves in the next few months, but market pressure is likely to materialize before news of an IMF deal does.

In Venezuela, the biggest item to watch in the near term is the potential re-opening of the parallel FX market. The market was shut down in 2010 due to government allegations that market speculation was driving the FX rate beyond levels that were reasonable. At the time, the parallel rate was just over 8 bolivars per dollar. Currently, with the official exchange rate now at 6.3, the unofficial rate is over 40 bolivars per dollar. The government acknowledges that something must be done to address the shortage of USD in the economy. The government has been unable to meet demand and the SICAD auction system has been a failure. The only way to encourage private supply of USD is to open a true parallel market. Unfortunately the government is unlikely to go far enough. We do not yet know the details of the parallel market that will eventually begin, but reports thus far indicate it is likely to be a managed rate. If so, the primary supply of dollars into the system will continue to come from public entities. If so, the net supply of USD will not increase, and shortages will continue. The economic situation is unlikely to improve. With reserves continuing to shrink and cash flows increasing on external debt next year, 2014 could be problematic.

In Argentina, the two main issues continue to be the ongoing legal battle and the diminishing FX reserves. It now seems that the legal battle will continue to drag on well into next year. As discussed in our September 17 Argentina and Venezuela Update, the Supreme Court is likely to reject Argentina's first petition for a writ of certiorari when it holds its Long Conference on September 30. However, Argentina would likely get a second chance if, as we suspect, its latest petition for a rehearing at the 2nd Circuit Court of Appeals is denied. That denial could take several months, pushing back the time that Argentina needs to submit its next appeal. While this makes a default in the near term unlikely, we do expect Argentina to eventually run out of options, although possibly not until late 2014 or early 2015. Even ignoring the legal issues, Argentina's fundamental picture continues to look more problematic. Reserves have been shrinking rapidly since the beginning of the year, and there is a growing possibility that paying the maturity on the local law Boden 15s in two years could be troublesome. If net reserves fall below $25 billion, which is possible, the government may choose to attempt to restructure those bonds rather than further strain their reserves.

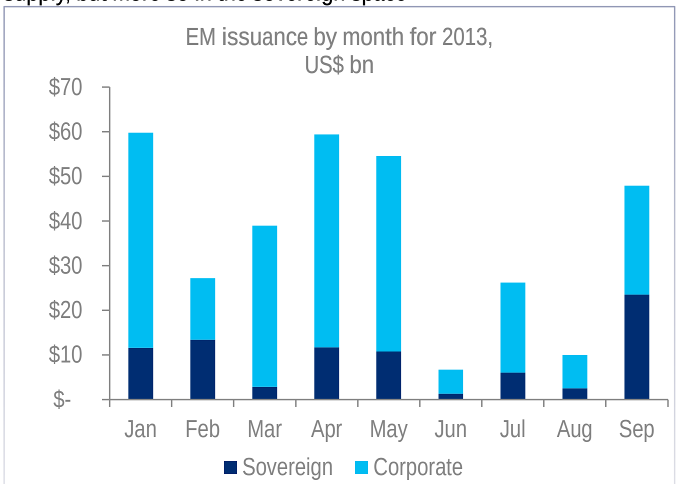
Figure 15. Flows into hard currency funds have become much more benign



Source: Citi Research

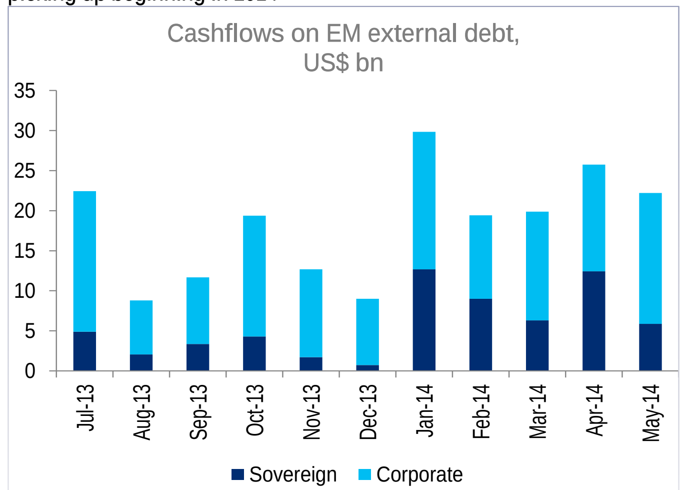
In the coming months technicals seem fairly balanced. On one hand we are unlikely to experience anywhere near the outflows that we saw in June-August. Part of the reason we had such a significant sell-off in June-August was that the market, especially non-traditional EM investors, had been investing heavily in emerging markets. That situation saw a large reversal during the sell-off, so the technical long position that led up to June is not nearly as significant. Outflows in EM bonds reported by EPFR have dropped significantly in recent weeks, and during the latest week funds investing solely in EM hard currency debt experienced net inflows for the first time since mid-May. Based upon daily data, flows for the week ending September 25 may approach a net inflow of $1 billion for all EM funds.

Figure 16. EM issuance has rebounded, easing some of the pent-up supply, but more so in the sovereign space



Source: Bloomberg, Citi Research

Figure 17. Cash flows become less supportive at the end of the year, picking up beginning in 2014



Source: Bloomberg, Citi Research

On the other hand the cash flow/supply dynamic could be troublesome. The sell-off caused many issuers to hold off on bringing new deals to the market during the summer, leading to a large amount of pent-up supply. We have started to see that ease in September as overall issuance this month is approaching what we saw at the beginning of the year, but it seems likely that much more is yet to come. From January through May, corporates represented 79% of all EM issuance. So far in September, they have only represented about 51% (Figure 16). As is typical following periods of severe volatility, the market has opened first for sovereigns, with more corporate issuance likely on the way. Historically, the end of the year is a relatively slow period for EM issuance. Because of that, cash flows coming due on EM bonds tend to be seasonally low in the final months (Figure 17). With supply likely to be higher than normal, the cash flows from existing bonds will not be as supportive.

Annual Indicators

Figure 18. Emerging Markets – Economic Forecasts, 2012-2014F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
Asia	6.2	6.2	6.2	3.9	3.6	3.7	1.8	1.7	1.5	-2.3	-2.3	-2.2
China	7.7	7.6	7.2	2.6	2.7	3.0	2.3	2.2	2.0	-2.0	-2.0	-2.0
Hong Kong	1.5	3.0	3.4	4.1	4.3	3.6	1.1	2.2	3.7	3.3	1.8	1.0
India*	5.0	4.8	5.6	7.3	5.5	5.0	-4.8	-3.7	-2.6	-7.0	-6.7	-6.4
Indonesia	6.2	5.7	5.3	4.3	7.2	6.6	-2.8	-3.5	-2.7	-1.9	-2.1	-1.8
Korea	2.0	2.9	3.7	2.2	1.5	2.5	3.8	4.3	2.4	1.5	0.9	2.3
Malaysia	5.6	4.8	5.0	1.6	2.0	3.7	6.1	2.3	2.0	-4.5	-4.0	-3.5
Mongolia	12.4	13.8	11.0	14.3	9.9	10.0	-31.2	-24.5	-13.6	-8.3	-7.8	-5.8
Philippines	6.8	7.3	6.9	3.2	2.7	3.2	2.8	3.6	3.3	-2.3	-2.3	-2.0
Singapore	1.3	3.2	4.0	4.6	2.4	2.3	18.6	14.0	13.5	1.1	0.7	0.5
Sri Lanka	6.4	6.5	6.8	7.5	7.3	7.0	-6.6	-5.3	-3.4	-6.4	-6.2	-5.7
Taiwan	1.3	2.6	3.8	1.9	1.2	1.7	10.5	10.1	9.0	-1.6	-1.2	-1.3
Thailand	6.5	4.0	4.4	3.0	2.4	2.3	0.0	-0.8	-1.0	-2.1	-2.6	-2.3
Vietnam	5.3	5.1	5.4	9.3	6.6	7.1	6.3	4.2	3.0	-5.2	-4.8	-4.0
Latin America	2.5	2.6	2.9	5.7	7.1	6.8	-1.8	-2.5	-2.1	-2.3	-2.8	-2.8
Argentina	1.9	5.3	3.0	10.0	10.4	12.6	0.0	-0.5	-0.6	-2.6	-2.1	-2.8
Brazil	0.9	2.6	2.0	5.4	6.2	6.1	-2.4	-3.6	-3.3	-2.5	-3.8	-3.7
Chile	5.6	4.0	4.5	3.0	1.7	3.1	-3.5	-4.0	-4.2	0.6	-0.3	-0.4
Colombia	4.2	3.8	4.5	3.2	2.1	2.9	-3.2	-3.2	-3.2	0.3	-1.1	-0.7
Mexico	3.8	1.2	3.8	4.1	3.7	3.4	-0.9	-1.5	-1.4	-2.6	-2.1	-2.0
Panama	10.7	8.0	7.0	5.7	4.6	4.4	-9.0	-14.2	-13.1	-2.1	-3.0	-3.0
Peru	6.3	5.1	5.3	3.7	3.0	3.0	-3.6	-4.6	-4.8	1.9	-0.6	-2.0
Venezuela	5.6	2.3	2.8	21.1	35.9	35.6	3.1	3.7	8.3	-5.0	-4.0	-4.0
Europe	2.2	1.7	2.9	5.3	5.3	4.9	-0.3	-0.4	-1.5	-1.8	-2.3	-2.5
Bulgaria	0.8	0.5	2.0	3.0	1.6	3.9	-1.5	-1.2	-2.1	-0.5	-1.5	-0.7
Croatia	-2.0	-1.0	1.2	3.4	2.5	3.0	0.1	-0.1	-0.5	-2.4	-4.5	-4.0
Czech Republic	-1.2	-1.1	1.6	3.3	1.5	1.3	-2.4	-1.0	-1.6	-4.4	-2.8	-2.9
Hungary	-1.7	0.6	1.8	5.7	1.9	2.0	1.6	1.8	1.8	-1.9	-2.9	-3.3
Poland	1.9	1.3	2.8	3.7	1.1	2.2	-3.5	-2.1	-3.2	-3.9	-4.3	4.7
Romania	0.4	1.6	2.8	3.3	4.4	2.8	-3.9	-1.5	-4.0	-2.2	-2.2	-2.5
Russia	3.4	1.4	2.8	5.1	6.6	5.4	3.5	2.8	0.9	-0.7	-2.0	-4.2
Serbia	-1.7	2.3	2.0	7.8	8.8	7.2	-10.6	-6.5	-8.0	-5.7	-5.0	-5.0
Slovakia	2.0	0.8	1.8	3.6	1.7	1.9	2.2	4.0	3.5	-4.3	-3.5	-3.2
Turkey	2.2	3.5	4.0	8.9	7.3	7.3	-5.8	-6.9	-6.7	-2.0	-1.8	-2.7
Ukraine	0.2	-1.3	1.6	0.6	-0.1	3.0	-8.4	-8.4	-5.9	-5.6	-6.7	-6.3
Africa/Mideast	4.9	4.7	5.4	4.6	5.2	5.6	13.8	12.4	10.7	3.3	0.4	-1.0
Bahrain	3.4	3.6	4.4	2.8	4.0	2.5	6.4	3.8	1.9	-2.0	-1.1	-0.3
Egypt	2.2	1.1	2.3	7.1	9.0	7.7	-3.0	-2.3	-2.3	-10.9	-12.9	-12.3
Ghana	7.9	6.7	6.8	9.2	10.7	9.3	-12.1	-11.2	-11.5	-12.4	-10.1	-8.5
Iraq	9.7	5.4	9.6	6.1	6.0	6.0	30.8	23.2	21.3	6.9	-1.4	1.0
Israel	3.0	3.3	3.4	1.7	1.6	2.3	-0.1	1.6	1.7	-3.7	-4.3	-3.0
Jordan	2.7	3.0	4.0	4.8	5.5	5.0	-18.2	-13.4	-11.5	-8.3	-8.2	-8.2
Kenya	4.6	5.5	6.1	9.4	5.6	6.6	-10.5	-10.1	-9.5	-9.0	-7.0	-5.5
Kuwait	7.6	3.6	3.7	2.9	5.0	5.0	42.9	47.7	45.0	27.8	22.6	18.8
Lebanon	1.5	2.0	4.5	6.4	5.0	5.0	-14.6	-15.7	-15.8	-8.8	-10.2	-10.5
Nigeria	7.4	6.5	6.5	12.2	8.2	8.4	4.0	2.3	0.4	-2.8	-2.6	-2.9
Oman	7.1	6.7	6.7	2.9	3.0	3.0	15.2	10.3	8.1	3.6	1.5	0.2
Qatar	6.0	8.3	7.2	1.9	3.0	3.0	31.0	21.8	13.9	5.5	3.2	1.5
Saudi Arabia	5.1	6.1	6.6	2.9	6.0	8.0	23.3	17.9	13.0	14.0	7.7	2.3
South Africa	2.5	2.1	2.9	5.7	5.9	5.5	-6.1	-5.9	-5.4	-4.4	-5.0	-4.8
Tanzania	6.9	6.8	7.0	16.0	7.7	5.1	-11.9	-10.2	-13.3	-5.4	-5.0	-5.6
UAE	4.4	4.6	4.9	0.7	0.8	1.0	30.1	33.7	36.8	NA	NA	NA
Uganda	2.6	5.0	5.6	14.0	5.9	8.7	-9.7	-12.9	-14.8	-3.6	-3.4	-3.3
Zambia	7.3	6.9	7.5	6.6	7.1	7.0	-3.4	-0.5	2.7	-4.5	-6.6	-4.1
Total	4.6	4.6	4.9	4.6	4.7	4.7	2.1	1.8	1.4	-1.7	-2.1	-2.2

Note: *We use the wholesale price index for inflation in India. Source: National sources, Citi Research

Economic Framework

Figure 19. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Global	2.5	3.2	3.4	2.6	3.0	3.2	0.7	0.6	0.3	-3.5	-3.0	-2.6
Based on PPP weights	*3.0*	*3.6*	*3.9*	*3.1*	*3.4*	*3.7*	*0.5*	*0.4*	*-10.5*	*-3.5*	*-3.1*	*-2.8*
Industrial Countries	1.2	2.0	2.2	1.3	1.9	1.5	-0.1	-0.1	-0.1	-4.4	-3.6	-2.9
United States	1.7	2.7	3.2	1.2	1.9	2.1	-2.8	-2.8	-3.0	-4.8	-4.3	-3.8
Japan	2.0	1.8	1.0	0.0	2.1	0.7	1.5	2.4	1.8	-9.8	-8.0	-6.2
Euro Area	-0.3	0.7	1.0	1.5	1.5	1.4	2.5	2.3	2.3	-2.9	-2.5	-2.0
Canada	1.7	2.5	3.0	1.1	1.8	1.9	-3.0	-2.9	-2.8	-1.0	-0.3	0.0
Australia	2.5	3.0	3.0	2.2	2.9	2.5	-2.3	-3.3	-3.5	-2.5	-1.9	-1.5
New Zealand	2.6	3.0	2.0	0.9	1.9	2.4	-6.1	-10.3	-9.6	-2.6	-1.7	-0.5
Germany	0.6	1.8	1.8	1.6	2.0	1.8	6.8	5.9	5.3	0.0	0.1	0.1
France	0.2	0.8	0.9	1.1	1.7	1.4	-1.5	-0.8	-0.1	-4.1	-3.5	-3.1
Italy	-1.7	0.1	0.0	1.6	1.3	0.6	1.1	1.4	1.4	-3.6	-2.8	-2.6
Spain	-1.3	-0.2	0.4	1.8	0.9	0.7	1.3	1.9	2.6	-6.8	-6.0	-5.0
Greece	-3.8	-2.9	-1.4	-0.5	-1.1	-0.7	-0.4	0.8	1.4	-4.7	-4.0	-2.8
Ireland	-0.5	2.7	2.4	-0.6	1.4	1.6	8.8	11.2	11.8	-8.6	-5.6	-3.6
Portugal	-1.9	-0.8	0.1	0.5	-0.1	-0.2	1.2	3.2	3.6	-6.0	-5.4	-4.1
Netherlands	-1.3	0.3	0.9	2.9	1.7	1.5	9.4	8.9	9.5	-3.9	-3.4	-2.9
Belgium	0.0	0.5	1.0	1.2	1.8	1.8	-2.0	-1.6	-1.0	-3.0	-2.6	-1.8
Denmark	0.2	0.9	1.4	0.7	1.5	1.7	5.6	4.9	4.2	-2.0	-1.5	-1.0
Norway	1.9	2.4	2.6	2.1	1.6	2.0	12.8	13.2	13.5	13.1	13.0	14.0
Sweden	0.6	2.2	2.5	0.2	1.1	1.9	5.9	5.6	5.3	-1.4	-1.5	-0.4
Switzerland	1.7	1.5	1.7	-0.2	0.3	1.2	12.9	13.0	12.9	0.7	0.9	0.8
United Kingdom	1.4	3.0	3.1	2.6	2.0	2.2	-3.2	-2.8	-2.8	-6.4	-5.1	-4.1

Source: National sources and Citi Research

Figure 20. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 25 September 2013

	25 Sep 2013	4Q 13F	1Q 14F	2Q 14F	3Q 14F	4Q 14F	1Q 15F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	2.72	2.70	2.78	2.98	3.15	3.25	3.40
Euro Area: US$/€	1.35	1.37	1.36	1.36	1.37	1.38	1.38
Euro Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10-Yr. Bunds (Period Average)	1.88	1.80	1.80	1.80	1.80	1.90	2.00
Japan: Yen/US$	99	101	103	105	106	107	108
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.68	0.65	0.60	0.50	0.60	0.70	0.80

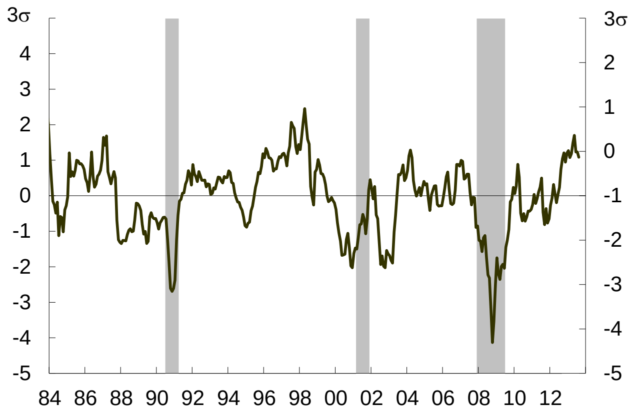
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	4Q 13	1Q 14	2Q 14	3Q 14	4Q 14	Current	4Q 13	1Q 14	2Q 14	3Q 14	4Q 14
United States	NA	NA	NA	NA	NA	NA	86	92	100	120	137	138
Japan	-209	-212	-230	-240	-247	-248	-123	-120	-130	-120	-110	-110
Euro Area	-86	-92	-100	-120	-137	-138	NA	NA	NA	NA	NA	NA
Canada	-12	-5	-3	-3	0	0	74	87	97	117	137	138
Australia	105	132	134	114	117	127	191	224	234	234	255	265
New Zealand	207	209	216	216	230	240	293	301	316	337	367	378
France	-35	-32	-30	-40	-57	-58	49	60	70	80	80	80
Italy	151	158	175	155	113	112	235	250	275	275	250	250
Spain	154	158	175	130	113	112	238	250	275	250	250	250
Netherlands	-50	-47	-55	-80	-97	-98	34	45	45	40	40	40
Belgium	-10	3	0	-10	-32	-38	74	95	100	110	105	100
Austria	-48	-47	-55	-80	-97	-98	36	45	45	40	40	40
Finland	-64	-62	-70	-90	-107	-108	20	30	30	30	30	30
Ireland	115	108	75	55	38	37	199	200	175	175	175	175
Denmark	-71	-82	-90	-110	-127	-128	13	15	10	10	10	10
Switzerland	-170	-177	-177	-197	-214	-218	-86	-85	-77	-77	-77	-80
United Kingdom	15	10	7	7	0	0	99	102	107	127	137	138

Note: Spreads calculated on annual basis (except those of the United Kingdom, Canada, Australia and New Zealand over the United States). Source: Citi Research

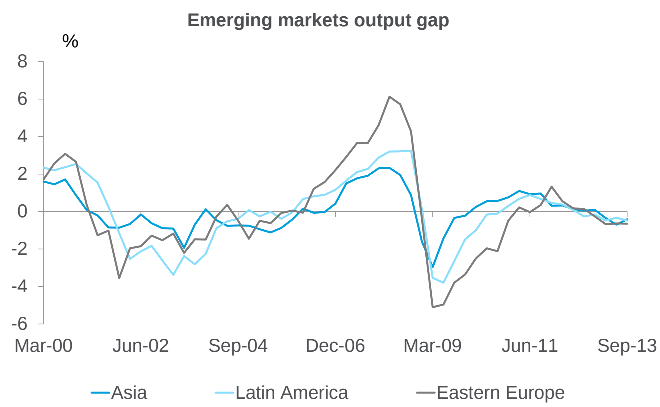
Regional Indicators

Figure 21. • We think improved fundamentals and unusually supportive financial conditions could still resolve the start of tapering by December, with a meaningful chance that fiscal debate could delay a decision until January



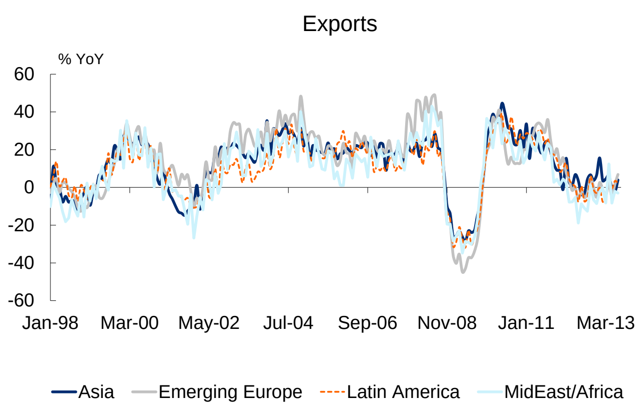
Source: Haver Analytics, Citi Research. Note: Shaded sections mark recession periods.

Figure 22. The small output gap should remain in the next few quarters



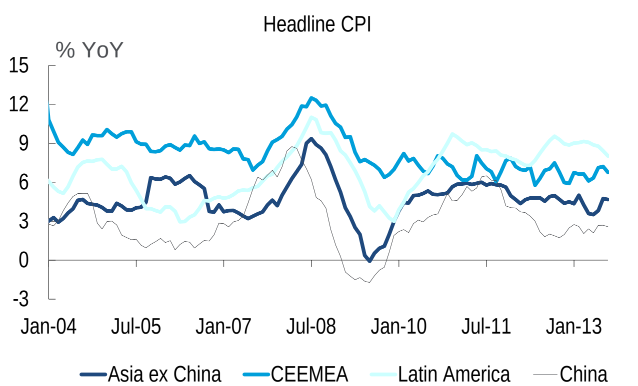
Source: Haver Analytics, Citi Research

Figure 23. Exports need a boost



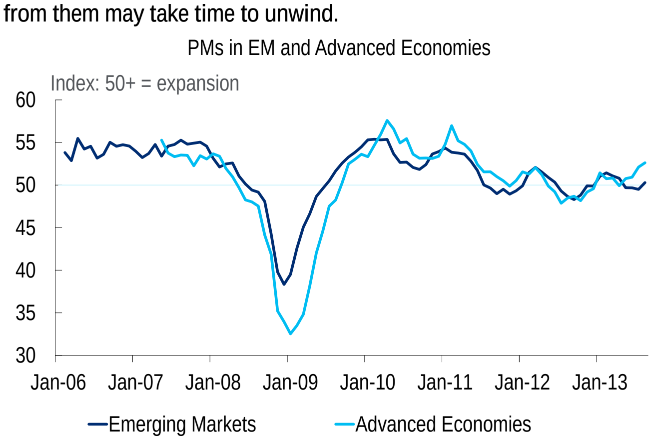
Source: Haver Analytics, Citi Research. F = forecast

Figure 24. CPI continue to stay range-bound, though beginning to be a source of concern in particular countries e.g. Russia, S. Africa, Turkey



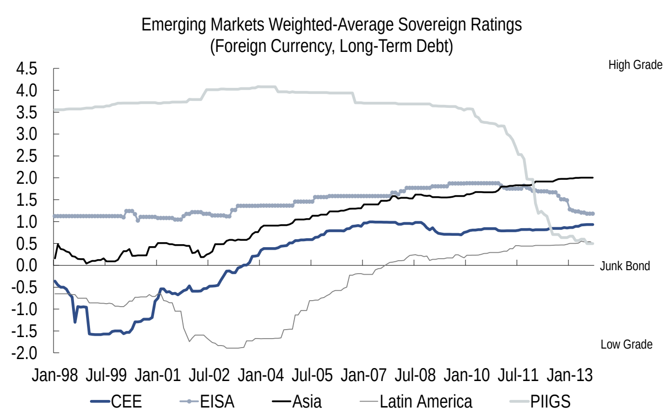
Source: Haver Analytics, Citi Research

Figure 25. Economies in G10 are advancing, but import compression from them may take time to unwind.



Source: Haver Analytics, Citi Research

Figure 26. Sovereign ratings, on the whole, continue to improve.



Source: Bloomberg, Citi Research. Note: EISA = Egypt, Israel, South Africa.

Monetary Policy Watch

Figure 27. Asia Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2013
			Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.00	Jul-12	-25	Dec-14	+25	3.00
India	Repo Rate	7.50	Sep-13	+25	Nov-13	+25	7.75
Indonesia	FasBI	5.50	Sep-13	+25	Oct-13	+25	5.75
Korea	BOK Policy Rate	2.50	May-13	-25	Mar-15	+25	2.50
Malaysia	Overnight Policy Rate	3.000	May-11	+25	Jun-14	+25	3.00
Philippines	Overnight Policy Rate	3.50	Oct-12	-25	Mar-14	+25	3.50
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-14	+12.5	1.875
Thailand	Overnight Repo Rate	2.50	May-13	-25	Sep-14	-25	2.50

Source: Bloomberg, Citi Research

Figure 28. CEEMEA Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2013
			Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.05	Nov-12	-20	1Q15	+20	0.05
Hungary	14-Day Repo Rate	3.60	Sep-13	-20	Oct-13	-20	3.25
Israel	Base Rate	1.00	Sep-13	-25	4Q14	+25	1.00
Poland	7-Day Repo Rate	2.50	Jul-13	-25	Jul-14	+25	2.50
Romania	Refinancing Rate	4.50	Aug-13	-50	Sep-13	-25	4.25
Russia	Refinancing Rate	8.25	Sep-12	+25	Mar-14	-25	8.25
S. Africa	Average Repo rate	5.00	Jul-12	-50	1Q15	+50	5.00
Turkey	1-week repo rate	4.50	May-13	-50	3Q14	+50	4.50
Ukraine	Discount Rate	6.50	Aug-13	-50	Mar-14	-25	6.50

Source: Bloomberg, Citi Research

Figure 29. Latin America Policy Rates and Movement

		Spot	Last Move		Likely Next Move		End-2013
			Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	9.00	Aug-13	+50	Oct-13	+50	9.75
Chile	CAMARA (Overnight)	5.00	Jan-12	-25	Jan-14	-25	5.00
Colombia	Central Bank Repo Rate	3.25	Mar-13	-50	Mar-14	+25	3.25
Mexico	Official Overnight Rate	3.75	Sep-13	-25	Oct-14	-25	3.50
Peru	Reference Rate	4.25	May-11	+25	Jun-15	-25	4.25

Source: Bloomberg, Citi Research

FX Views

Figure 30. Asian Currencies Exchange Rates

		4Q13			1Q14			4Q14		
	25 Sep	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
China yuan	6.12	6.1	6.16	0.5	6.2	6.17	0.2	6.1	6.21	1.8
Hong Kong dollar	7.75	7.8	7.75	-0.1	7.8	7.75	-0.1	7.8	7.75	-0.1
India rupee	62.44	61.9	64.23	3.6	63.0	65.58	3.9	61.4	68.57	10.4
Indonesia rupiah	11488	11240	11908	5.6	11537	12178	5.3	11459	-	-
Korea won	1077	1047	1083	3.4	1043	1089	4.2	1021	1098	7.1
Malaysia ringgit	3.22	3.2	3.24	1.6	3.2	3.25	0.7	3.2	-	-
Philippines peso	43.4	42.2	43.3	2.7	42.3	43.3	2.3	41.8	43.6	4.1
Singapore dollar	1.25	1.2	1.3	1.1	1.2	1.3	1.1	1.2	1.3	2.8
Taiwan dollar	29.6	29.4	29.48	0.4	29.5	29.37	-0.6	29.4	29.10	-1.0
Thailand baht	31.3	31.3	31.42	0.4	31.7	31.57	-0.3	31.1	-	-

Note: Returns are calculated as ratio of forwards to our forecasts. Source: Bloomberg, Citi Research

Figure 31. CEEMEA Currencies Exchange Rates

		4Q13			1Q14			4Q14		
	25 Sep	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs EUR				(%)			(%)			(%)
Czech Republic koruna	25.8	25.9	26	-0.4	25.9	25.8	-0.2	25.1	25.8	2.6
Hungary forint	299	302	302	0.3	303	302	-0.3	307	302	-1.6
Poland zloty	4.22	4.18	4.22	0.9	4.22	4.22	0.0	4.14	4.22	1.8
vs USD										
Israel shekel	3.55	3.51	3.56	1.4	3.58	3.56	-0.5	3.69	3.58	-3.2
Russia ruble	32.0	32.1	32.5	1.2	32.7	33.0	1.0	32.9	34.4	4.3
Turkey new lira	2.00	2.01	2.04	1.2	2.05	2.07	1.1	2.08	2.19	5.1
S. Africa rand	9.92	9.79	10.08	2.9	9.90	10.21	3.1	10.21	10.55	3.2

Note: Returns are calculated as ratio of forwards to our forecasts. Source: Bloomberg, Citi Research

Figure 32. Latin American Currencies Exchange Rates

		4Q13			1Q14			4Q14		
	25 Sep	Forecast	Forward	Returns	Forecast	Forward	Returns	Forecast	Forward	Returns
vs USD				(%)			(%)			(%)
Brazil reais	2.23	2.26	2.27	0.4	2.33	2.31	-0.9	2.42	2.47	2.0
Chile peso	501	500	507	1.4	511	513	0.5	511	529	3.3
Colombia peso	1891	1915	1908	-0.4	1934	1923	-0.6	1961	1969	0.4
Mexico new peso	12.9	12.7	12.9	2.0	12.5	12.9	3.1	12.4	12.9	4.5

Note: Returns are calculated as ratio of forwards to our forecasts. Forward in Brazil is only the spot plus interest rate. Since interest rate is very high in Brazil, forward will always look less robust than our forecasts. Source: Bloomberg, Citi Research

Asia Pacific

China

- **Summary view** – Given better-than-expected real activity in Jul-Aug, we expect growth to rebound to 7.8%YoY in 3Q and hence upgrade 2013 GDP to 7.6%. But growth downturn may resume toward year end due to a less accommodative policy and a short-term negative impact from reform measures.

- **Things to watch** – Reform initiatives seem to be gaining momentum of late, featured by lending rate liberalization, the launch of the China (Shanghai) Free Trade Zone, and health-industry reforms. A reform agenda is likely to be introduced in the 3rd Plenary Session of the 18th Party Congress, but we remain cautiously constructive on the reform outlook.

- **Strategy** – Fed tapering, while delayed, could still weigh on financial market sentiment. Shadow banking gained some momentum in August, but eased liquidity conditions only at the margin. The cost of capital will likely inch up through the year-end unless exports and monetary policy surprise to the upside.

Expecting a transitory growth rebound

We revise up our growth forecast…– We have upgraded our growth forecast on better-than-expected real activity in 3Q. Economic data released since the beginning of Jul have been generally positive, with industrial production and fixed-asset investment picking up speed on a YoY basis. If the positive momentum in the last two months is sustained in Sep, we may see a modest MoM pickup translate into more significant YoY improvement this quarter, partly due to the low base last year. We estimate that IP growth will reach about 10%YoY in 3Q. Based on the recent relationship between IP and GDP, we expect 3Q growth to be around 7.8%YoY, higher than our previous estimate of 7.4%YoY. Correspondingly, we upgrade 2013 growth from 7.4% to 7.6%, and 2014 growth from 7.1% to 7.2%.

…**but see the recent rebound as transitory.** The overall policy stance will likely be less accommodative in 2H. The current rebound has benefited from quite loose monetary and credit conditions in the first five months. Since Jun, credit conditions have already been tightened, as evidenced in the monetary data and the PBOC's 3Q survey of entrepreneurs and bankers. In this context, we see the total social financing rebound in Aug as a temporary deviation from a shift to a neutral policy stance. Recent remarks by the Premier and PBOC suggest little room for monetary loosening. In addition, the Minister of Finance has made it clear that the budget deficit for 2013 will not be increased. According to our estimate, fiscal policy will not be more expansionary than last year even if the budget is fully utilized. As a result, we think the current rebound is transitory, and growth may resume its downturn in 4Q.

Reform prospects for next five years

Reforms are gaining momentum in the context of stable growth. The recent steps taken by the government, including the launch of the China (Shanghai) Free Trade Zone, VAT reform, and elimination of the lending rate floor, suggest the government is laying the groundwork for substantial reforms, and a comprehensive reform agenda is expected to be introduced during the Third Plenary Session of the Communist Party in November. The coming Third Plenary Session in Nov should mark the beginning of a brand new round of reform and opening up in China's history. The reforms are unlikely to be a 'big bang', and would be partly planned and partly forced. The next 3-5 years will be a critical window for reform, determining whether China can escape the middle-income trap and upgrade itself to an advanced economy.

China's economic reforms aim to improve the quality of growth, invent new growth drivers. Premier Li Keqiang has pledged to upgrade the Chinese economy by exploring reform dividend, domestic demand potential and innovative ability. But it is critical to prioritize the different parts of reform. We divide reforms into three key areas: boosting demand, enhancingproductivity and de-leveraging. De-leveraging will likely pull down growth and is more likely to take place after domestic demand is boosted and productivity is enhanced. Following this order of reform, the economy may still weaken in the near-term, but a hard landing could be avoided.

Boosting demand

China has shifted from being a supply-constrained economy to a demand-constrained one, and thus manufacturing output can't continue its rapid growth without additional external or domestic demand. External demand may remain weak due to de-globalization (e.g., US's re-industrialization, high jobless rate and prudential consumer spending in DM, and strong RMB), dragging down China's export growth to single digits. In order to keep growth in the manufacturing sector up, it needs to boost domestic demand including investment and consumption. On the one hand, investment is still needed, but the structure and efficiency of investment would have to be improved. On the other hand, consumption growth should stabilize through better income and wealth redistribution and consumption upgrades. Boosting demand can help create growth drivers and improve the quality of growth.

Enhancing productivity

The ultimate target of reform is to improve the productivity gains when China faces structurally funding constraints during the transition. More importantly, China is gradually moving from industrialization to service-oriented growth. This could mean it is productivity-negative, a sharp reversal from the productivity gains while labor migrated from farming to manufacturing. Recent estimations show that productivity growth was falling nationwide but, during 2006-10, growth in the non-tradable sector was 2.8ppts lower than the tradable sector, which was mostly dominated by manufacturing goods. In the manufacturing sector alone, industrial upgrades and innovation are needed to increase productivity gains. The overall productivity gain in China is one way of escaping the middle-income trap.

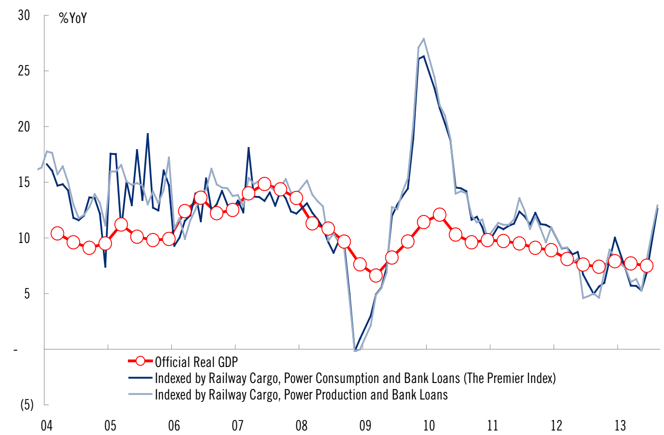
De-leveraging

De-leveraging is needed to avoid a financial crisis in next few years. Global experiences suggest that rising leverage ratios often end in a crisis and sharp economic adjustment. Two sectors highly leveraged in China are local govts and SOEs, but both have been key drivers of economic recovery in 2H12 and this year. De-leveraging would pressure China's growth, as shown in our CTI. This is likely to be a painful process and would involve bankruptcies (at least technically) of firms, local governments and financial institutions.

Key messages from the Nov meeting could include: 1) Whether the gov't will accept short-term or longer-term pain. ST pain could mean GDP growth of 5-6%; LT pain could mean hard landing in the next 3-5 years with possible negative growth. 2) Whether GDP growth or jobs will be defended. Due to distorted growth, defending growth may not necessarily secure jobs. 3) Whether SOE reform is on the agenda.

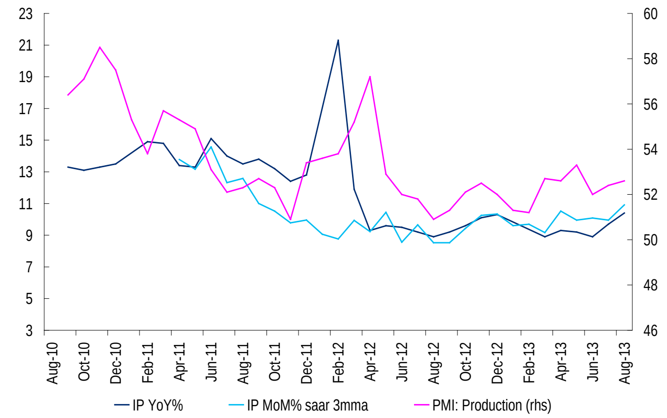
We highlight 10 most possible reforms in next 5 years: 1) Relaxing the one-child policy to two children; 2) deposit rate liberalization; 3) hukou reform; 4) service sector deregulation; 5) securitization; 6) fiscal reform; 7) property tax; 8) negative list; 9) local government debt restructuring; and 10) land monetization.

Figure 33. Growth will likely rebound in 3Q



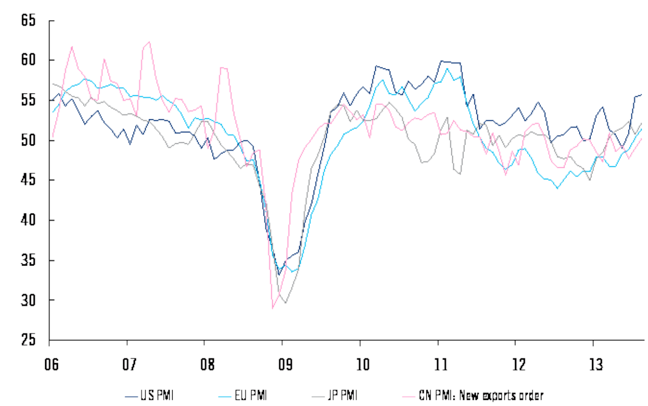
Source: CEIC, Citi Research

Figure 34. IP growth reached 17-month high



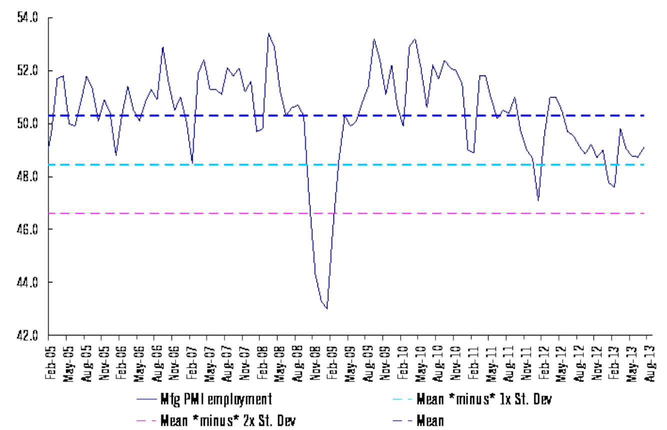
Source: CEIC, Citi Research

Figure 35. Downside risks reduced by improving external environment



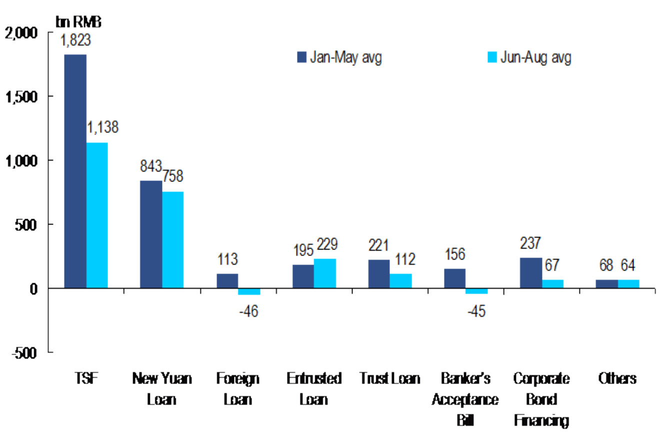
Source: CEIC, Citi Research

Figure 36. PMI employment index indicates the job market is normal



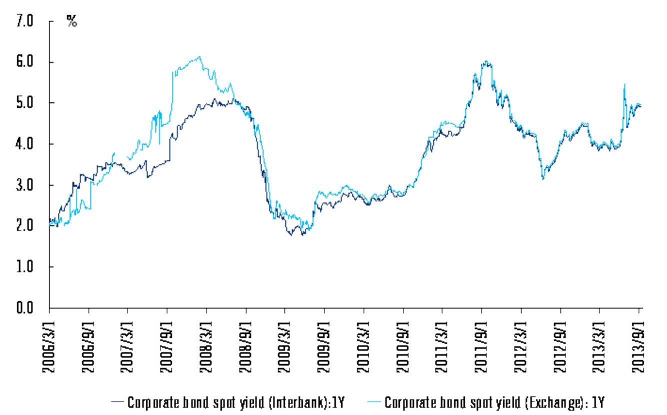
Source: CEIC, Citi Research

Figure 37. Monthly TSF was much lower in Jun-Aug relative to Jan-May



Source: CEIC, Citi Research

Figure 38. Rising cost of capital suggests tight liquidity



Source: WIND, Citi Research

Figure 39. China Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	2,787.2	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,243.1	10,278.8
Nominal GDP, local currency bn	22,224	26,583	31,490	34,632	40,151	47,310	51,894	56,976	62,289
GDP per capita, US$	2,120	2,645	3,422	3,800	4,424	5,432	6,084	6,799	7,531
Population, mn	1,314.5	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,359.5	1,364.9
Unemployment, % of labour force	4.1	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2
Economic Activity									
Real GDP, % yoy	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.6	7.2
Real investment growth % yoy	13.3	14.4	11.0	19.2	11.9	9.4	8.1	7.4	7.0
Real consumption growth % yoy	9.8	11.0	8.5	9.4	9.2	10.9	8.3	7.1	7.3
private consumption growth % yoy	11.3	11.1	9.2	10.3	8.5	18.2	8.5	7.3	7.5
Real export growth, % yoy	--	--	--	--	--	--	--	--	--
Real import growth, % yoy	--	--	--	--	--	--	--	--	--
Prices, Money & Credit									
CPI, % yoy	2.8	6.5	1.2	1.9	4.6	4.1	2.5	3.0	3.5
CPI, % avg	1.5	4.8	5.9	-0.7	3.3	5.4	2.6	2.7	3.0
Nominal wages, % yoy	14.6	18.5	16.9	11.6	13.3	17.8	9.7	9.8	9.3
Credit extension to private sector, % yoy	14.3	19.3	14.0	33.2	20.3	15.1	14.8	15.3	13.7
Policy interest rate, % eop	2.52	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.25
1 month inter-bank rate, % eop	2.58	3.61	1.23	1.79	6.17	6.00	4.90	3.80	4.05
Long term yield, % eop	2.62	4.19	1.80	3.06	3.61	3.27	3.33	3.32	3.57
lc/US$, eop	7.81	7.30	6.82	6.83	6.59	6.29	6.23	6.16	6.09
lc/US$, avg	7.97	7.61	6.95	6.83	6.77	6.46	6.31	6.17	6.14
Balance of Payments, US$ bn									
Current account	231.8	353.2	420.6	243.3	237.8	136.1	193.1	203.3	205.6
% of GDP	8.3	10.1	9.3	4.8	4.0	1.9	2.3	2.2	2.0
Trade balance	177.5	264.3	298.1	195.7	181.5	154.9	231.1	276.9	293.0
Exports	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.9	2,224.6	2,296.4
Imports	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,817.8	1,947.8	2,003.4
Service balance	-8.8	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.5
Income balance	-5.1	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6
FDI, net	100.1	139.1	114.8	87.2	185.7	231.7	191.1	147.0	99.9
International reserves	1,066.3	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,692.6	3,925.4
Total Amortisations	17.9	20.3	23.3	34.2	27.2	33.2	38.8	41.8	46.0
Public Finances, % of GDP									
Consolidated government balance	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0
Consolidated gov primary balance	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-1.6	-1.6	-1.6
Public debt	18.6	39.0	37.4	47.8	49.2	44.3	45.0	45.1	45.3
of which Domestic	17.4	38.0	36.6	47.0	48.6	43.7	44.5	44.6	44.8
Foreign Assets & Liabilities, US$ bn									
External debt	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9	925.0
Private	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7	875.3
Public	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.2	49.7
External debt / GDP	12.1	11.1	8.6	8.5	9.3	9.5	9.3	9.1	9.0
External debt / XGS	31.9	29.0	24.7	32.2	31.5	33.4	34.0	34.4	36.7
Short-term debt	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5	633.1
Short-term debt/International Reserves (%)	18.7	15.4	11.6	10.8	13.2	15.0	15.8	15.6	16.1

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	7.8	7.4	7.2	7.0	7.1	7.5	7.2
CPI, % yoy	2.1	2.7	2.7	3.0	2.9	2.5	3.0	3.5	3.7
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50
1 month inter-bank rate, % eop	3.40	7.35	3.80	3.80	3.80	3.80	3.80	4.05	4.30
Long term yield, % eop	3.36	3.32	3.32	3.32	3.32	3.32	3.32	3.57	3.82
lc vs USD, eop	6.21	6.14	6.15	6.16	6.17	6.16	6.13	6.09	6.05

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt includes the debt of central, local govt and Ministry of Railway. Long term yield refers to 5Y Sovereign Bond yield. External debt is based on the residency of the holder of the debt (not by currency denomination).

Hong Kong

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- **Summary view** – The economy is steadily recovering, with July trade improvement encouraging. Further cooperation between China and HK businesses granted with the signing of annex 10 of the CEPA trade pact. Policymakers reiterate intention to retain the cooling measures.

- **Things to watch** – 1) The pace of inflation pick-up; 2) pace of trade recovery; 3) fund flows pattern in light of Fed tapering before Jan14 and a managed China slowdown; 4) property market reactions; 5) tourist shopping trends following China's anti-graft measures.

Fund flows and macro trends amid global dynamics

Global backdrop: deferred Fed tapering plus signs that China's growth is stabilizing. We expect the Fed's decision to maintain peak accommodation will prevent any economic fallout from higher interest rates and fiscal tightening, which in turn will provide some near-term offset to the effects of a managed slowdown of the Chinese economy. Our China economists think that the rebound we see in China in 3Q is likely transitory, as the Chinese economy faces tighter funding impact in 4Q, along with the need to address past excesses and initiate structural reforms to sustain long-term growth by making short-term sacrifices.

Fund flows trend: We have seen sharper fund outflows since June (latest available data), as noted in the sizable drop in net spot foreign currency positions in the month, which reflects worries of China's slowdown and June's Shibor surge. This was also seen in equities' price drop, with the HSI and HSCEI down by 11.3% and 16.3%, respectively, during the first three weeks of June. Subsequently, with the equity market recovering sharply from June's bottom, fund outflows are likely to have calmed down. However, we think financial markets volatility in coming months is unavoidable given that the markets would continue to guess on the timing of the eventual start of Fed tapering.

HKD: The other indicator that we usually track for liquidity flows has made repeated attempts to strengthen since June, as initially banks increased demand for the HKD on stronger liquidity needs towards the half-yearly closing (according to HKMA) and interests in equity market returns. We expect this trend to prevail in the near term.

Interest rate trend: Given the HKD peg linkage with the USD, the likely move of the Fed to delay rate hikes till the US jobless rate is closer to 6% will in turn help keep HKD interest rates ultra low for an extended period of time. Such pass-on of extended accommodation should also defer HK's mortgage rate hikes. Our property analyst Ken Yeung thinks that "originally the market expected mortgage rate hikes to come in 2H14 with a cumulative 300-400bps rate increase towards 2016. Now, rate hike expectations have been deferred to 2015 with only a 200bps hike to 2016." As for EFN yields, after the recent repricing for the delayed Fed tapering schedule, we expect them to again start creeping up from 4Q onwards.

The economy is steadily recovering, **with July trade improvement particularly encouraging.** Headline export and import growth rose by 10.6%YoY and 8.3%YoY, respectively, with the trade deficit narrowing to HK$37.2bn. Exports to China rebounded from negative growth to 14.5%YoY and 14.5%mom in Aug, which allayed previous worries of imminent economic fallout in China. Going forward, we expect trade recovery to be bumpy. For example, Aug data will face a difficult base effect, but we expect better overseas demand in developed countries coinciding with year-end new product launches, which could boost 4Q trade performance.

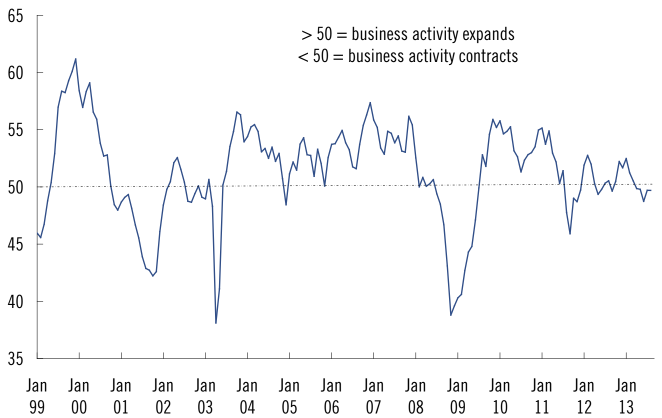
Inflation likely to stay elevated after the abnormal July surge to 6.9%YoY (due to a one-off statistical distortion). Aug headline and underlying CPI grew 4.5%YoY and 4.3%YoY, respectively, mainly reflecting continued pass-through of increases in private housing and package tour charges. Given upcoming taxi/tunnel fee hikes, general warming of economic activities and a tight labor market, our full-year average forecast remains 4.3%YoY.

Policymakers remain vigilant on property price rise. The official property price index pointed to renewed increases in lower-end home prices in Jul 13, at 207.5 (much higher than 1997's peak of 180.7, although the more up-to-date Centa City Leading Index indicated a mild pullback in Aug). The HKMA in its half-year report summarized that the HK "housing market is expected to see consolidation in the period ahead", "property valuations remain highly stretched, property market imbalances are still elevated and continue to entail macroeconomic and financial stability risks for HK". In particular the current price-to-income ratio (14.7 as of mid-2013) and income-gearing ratio at 65% (in June) were above peak levels of 1997 and long-term averages. The HKMA has warned that a 3%pt increase in mortgage rate would push the income-gearing ratio to 84%. This tone has been repeatedly echoed by the Chief Executive and other key senior officials, in particular aiming to quell recent hopes of near term lifting of the special stamp duty and property-related prudential measures. Especially in light of recent dovishness of the Fed officials both in terms of tapering and forward guidance for rates, HK policymakers will be vigilant to prevent any heating of market activities before supply can play catch-up.

More incremental CEPA benefits

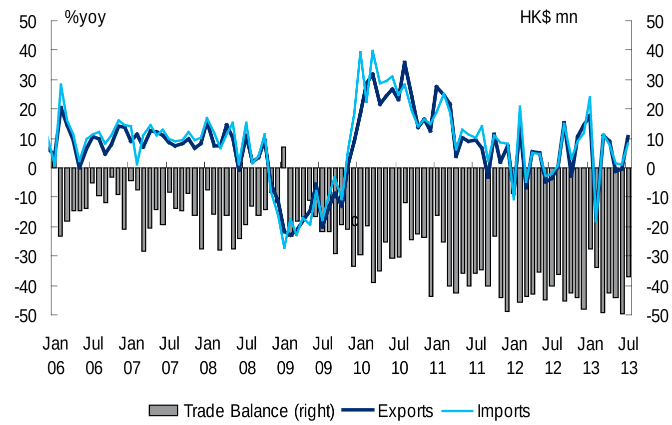
CEPA Supplement X to push for further business expansion into the Mainland. This CEPA supplement (effective in 1st Jan 2014) significantly expands scope, encourages labor mobility and upgrades benefits for HK businesses to tap the Pearl River Delta market. Several noteworthy amendments include: 1) allowing HK service suppliers to establish JVs in Guangdong Province of up to 55% equity ownership; 2) introduces a new concept of "contractual service providers" which allows HK service providers that do not have a commercial presence in the Mainland to send HK employees to work in the Mainland; 3) allowing HK banks subsidiaries in the Mainland to operate RMB businesses to serve HK enterprises and Mainland enterprises that are owned by HK investors; 4) granting HK fund houses to set up fully-licensed JV securities companies in Shanghai, Guangdong Province and Shenzhen, with a max 51% ownership; 5) expanding the scope of testing & certification services from food to other areas of voluntary product certification on a pilot basis in Guangdong Province; and 6) allowing HK's co-/solely-produced Cantonese films to be distributed and screened in the Mainland. [#3 and #4 are liberalization measures that Mainland had granted to Taiwan in late June and now also offered to HK.] According to official stats, CEPA in its 10 years lifetime thus far had granted 2700+ HK service suppliers certificates, allowed 4400+ HK residents to set up individually owned stores in the Mainland; and >$52.4bn of goods exports enjoyed zero tariff and tariff savings amounted to RMB3.6bn.

Figure 40. PMI improved, but still in contraction zone



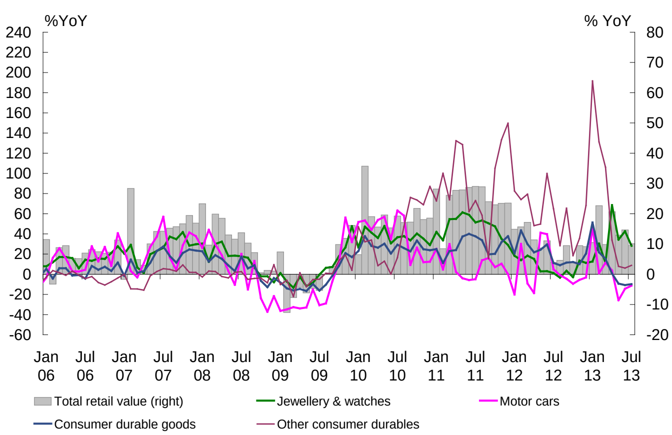
Source: Markit, Haver, Citi Research

Figure 41. Exports rebounded in July



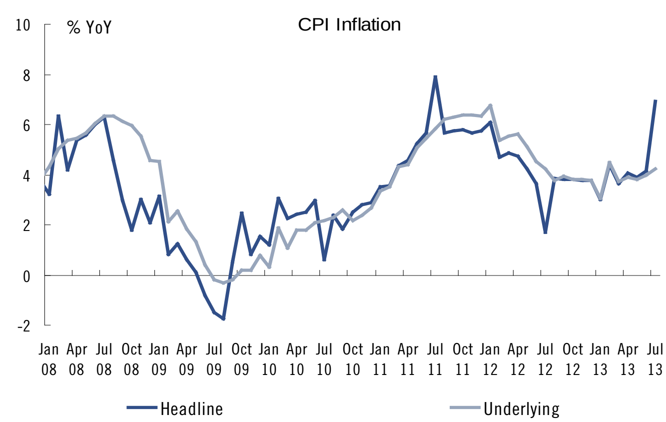
Source: CEIC, Citi Research

Figure 42. Retail sales still weak as of Jul 13



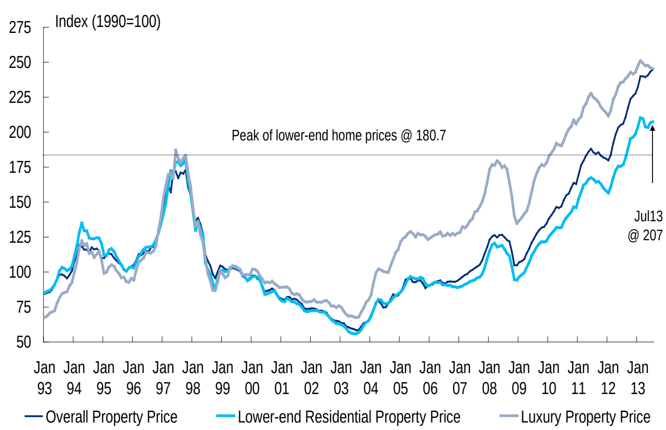
Source: CEIC, Citi Research

Figure 43. CPI likely peaked in July, but underlying on a gradual climb



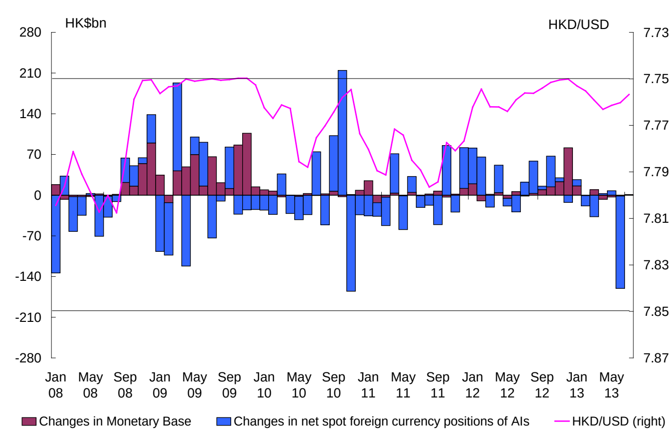
Source: CEIC, Citi Research

Figure 44. Property price for lower-end on a renewed rise as of Jul13



Source: CEIC, Citi Research

Figure 45. HK saw sizeable capital outflows in Jul13



Source: HKMA, CEIC, Citi Research

Figure 46. Hong Kong Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	193.5	211.6	219.3	214.0	228.7	248.7	263.3	282.5	302.5
Nominal GDP, local currency bn	1,503	1,651	1,707	1,659	1,777	1,936	2,042	2,192	2,347
GDP per capita, US$	28,031	30,497	31,488	30,594	32,429	34,971	36,697	39,067	41,499
Population, mn	6.9	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.3
Unemployment, % of labour force	4.8	4.1	3.4	5.2	4.4	3.5	3.3	3.4	3.2
Economic Activity									
Real GDP, % yoy	7.0	6.5	2.1	-2.5	6.8	4.9	1.5	3.0	3.4
Real investment growth % yoy	8.4	7.9	-0.3	1.0	11.1	2.2	5.2	3.1	3.6
Real consumption growth % yoy	5.4	7.9	1.9	1.0	5.9	8.2	3.2	3.8	2.1
private consumption growth % yoy	6.1	8.6	1.9	0.8	6.3	9.0	3.2	4.1	2.2
Real export growth, % yoy	9.4	8.3	2.5	-10.2	16.8	3.7	1.8	6.8	5.3
Real import growth, % yoy	9.1	9.1	2.2	-9.0	17.4	4.6	2.8	7.1	4.9
Prices, Money & Credit									
CPI, % yoy	2.3	3.8	2.1	1.5	2.9	5.7	3.8	4.2	3.6
CPI, % avg	2.1	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.6
Nominal wages, % yoy	2.1	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5
Credit extension to private sector, % yoy	2.3	15.2	11.0	-2.1	20.9	12.5	7.0	8.0	8.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	3.84	3.31	0.89	0.13	0.33	0.33	0.50	0.45	0.90
Long term yield, % eop	3.69	3.10	1.19	1.93	1.76	0.96	0.32	1.30	2.10
lc/US$, eop	7.78	7.80	7.75	7.75	7.77	7.77	7.75	7.76	7.75
lc/US$, avg	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76
Balance of Payments, US$ bn									
Current account	24.6	27.6	32.9	20.3	15.0	11.9	2.9	6.3	11.2
% of GDP	12.7	13.0	15.0	9.5	6.6	4.8	1.1	2.2	3.7
Trade balance	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-61.6	-62.1	-60.5
Exports	316.8	344.7	363.0	318.7	390.4	429.2	443.1	464.3	505.6
Imports	334.7	368.2	388.9	347.6	433.5	484.0	504.7	526.4	566.1
Service balance	-9.3	-4.3	-2.7	3.4	10.1	16.3	22.8	23.0	23.4
Income balance	4.6	6.8	12.9	6.4	4.8	6.8	5.6	5.7	5.8
FDI, net	-15.5	-19.0	-8.9	-6.4	-10.5	-8.7	-9.0	-10.0	-11.0
International reserves	133.2	152.6	182.5	255.7	268.6	285.3	317.2	320.0	340.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	3.8	7.3	0.1	1.5	4.1	3.8	3.3	1.8	1.0
Consolidated gov primary balance	3.9	7.4	0.1	1.6	4.2	3.8	3.3	1.8	1.1
Public debt	1.4	1.2	1.0	0.7	0.6	0.6	0.5	1.0	1.3
of which Domestic	0.6	0.4	0.2	0.1	0.0	0.0	0.1	0.2	0.3
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.9	3.3	3.1	3.0	3.2	3.4	3.4	3.6	3.7
CPI, % yoy	3.6	4.2	4.4	4.2	4.0	3.7	4.1	3.6	3.9
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.21	0.21	0.21	0.30	0.50	0.55	0.65	0.75	0.85
Long term yield, % eop	0.51	1.12	1.19	1.30	1.50	1.70	1.90	2.10	2.30
lc vs USD, eop	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.75	7.75

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is general government debt.

India

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- **Summary view** – India's economic activity has been decelerating for over two years on an investment slowdown and a slump in the industrial sector. The upheaval in financial markets that began with tapering talk and consequent monetary tightening has hurt recovery further. With neither monetary policy nor the fiscal policy having enough space to stimulate demand, we revise down our FY14 GDP estimate to 4.8%YoY from 5.4% earlier.

- **Things to watch** – After a US$13bn portfolio outflow in June-August, flows are showing signs of stabilization with September flows a positive US$1.8bn so far. But it may still be too early to say that it has turned a corner, as taper risks could resurface in 2H FY14. Domestically, with key state elections due in December, necessary fiscal adjustments may get delayed and influence business climate.

- **Strategy** – With a 25bps hike in the repo rate, the RBI in its September policy signaled a swift reversal of the easing cycle. We now expect the RBI to hike repo rates by 25-50bps in 2HFY14 on elevated CPI and high inflationary expectations. The central bank may simultaneously normalize money market conditions by reducing marginal standing facility rates by 50-75bps.

Fallout of twin deficits

The capital outflows that began with taper talk exposed several of India's vulnerabilities, more importantly the twin deficits on current account and fiscal balances. The sharp rupee depreciation and a consequent rise in headline inflation led to swift reversal of monetary easing cycle even though GDP growth dropped to a 4-year low of 4.4% in 1QFY14. The RBI raised repo rates by 25bps in its *mid quarter policy*, ending an interest rate cutting cycle that started in April 2012.

Besides monetary tightening, policy makers took other administrative measures to mitigate the heightened exchange rate volatility on both the current account and capital account fronts. The government clamped down on gold imports while the RBI offered swap concessions on NRI deposits and overseas borrowing. The delay in Fed taper provided further relief to currency markets. Due to these developments, INR reversed more than a third of its depreciation since May 22nd. But it may still be early to say that a corner has been turned as Fed taper has only been postponed and structural impediments such as twin deficits remain a concern.

Downgrade GDP estimate to 4.8% in FY14

GDP growth at a four-year low of 4.4%YoY: The deceleration in activity continued into 1QFY14, with the industrial sector pulling the GDP growth down to 4.4%YoY. Since then there has been some improvement in industrial output and exports data (see *July IIP*). Combined with a pick-up in agriculture output on good monsoon, we see some acceleration in activity in upcoming quarters.

Recovery slow in the absence of expansionary policy: With neither monetary policy nor the fiscal front having enough space to stimulate demand, we expect recovery to be tepid, at best. Investment demand is likely to remain sluggish ahead of elections even though consumption could rise. On balance, we *forecast FY14 GDP* at factor cost to expand 4.8%YoY, down from our earlier estimate of 5.4%

External sector rebalancing under way

CAD to compress on policy measures: The trade gap has narrowed in recent months due to a sustained policy focus to compress gold imports and improving export demand in developed markets. Gold imports may go up briefly on festive demand in coming months, but the soft patch will likely continue in FY14. We now expect the CAD to narrow to US$68.4bn (3.7% GDP) in FY14.

Exchange rate continues to dominate the market and policy focus: Despite some narrowing in the current-account deficit, the rupee continues to face a challenging market environment. The financing need remains large amid volatile capital flows, and while the rupee is close to 10% below fair value in REER based on WPI inflation, it is still marginally overvalued based on CPI inflation. Also, the rupee has benefited temporarily from RBI support on account of swap concessions and the separate oil window, and the volatility could resurface when these measures are withdrawn

Inflation: higher on food, fuel, rising importance of CPI

Expect moderation in WPI & CPI: The recent acceleration in WPI inflation to 6.1% and CPI to 9.5% has largely been on account of sharp increases in food and fuel prices. But we expect food inflation to turn soft with fresh crop arrivals in October; and after factoring in a decline in crude prices in rupee terms, the headline inflation is likely to trend lower towards an 8.7% average on CPI and 5.5% on WPI in FY14.

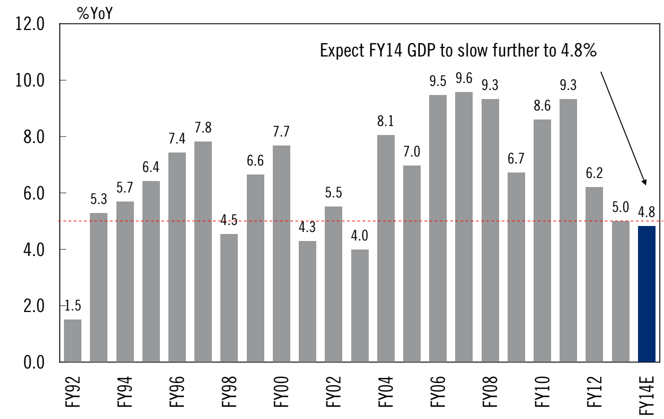
Policy implications: The trajectory of policy rates would depend on the choice of the nominal anchor going forward but clearly the governor has hinted at increasing importance of CPI in policy formulation. Still we expect the rate hike cycle to be short given a persistently large negative output gap and therefore we expect 1) 25-50bps hike in the repo rate in 2HFY14, and 2) MSF to come down by 50-75bps. Despite the hike in repo rates, interbank call money rates will likely progressively drift downwards towards the repo rate from the MSF rate of 9.5% currently

Fiscal deficit: marginal slippage of 0.2% of GDP

Lower revenue, higher subsidies: We estimate marginal slippage in fiscal deficit to 5% of GDP due to a shortfall in revenue and an overshoot in subsidies and even after adjusting for cuts in plan expenditure. We estimate tax revenues to be lower by 0.5%GDP – at 10.4%GDP vs. 10.9% budgeted on account of shortfall in excise and services tax collections. The oil subsidies are likely to overshoot the budget estimate by ~Rs200bn due to large under-recoveries. The implementation of the food security bill can also put additional pressure on food subsidy to the tune of ~Rs100bn.

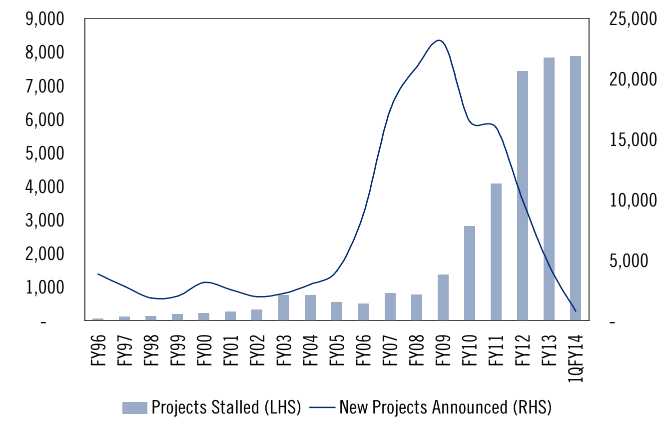
Savings likely in plan expenditure: Similar to the last fiscal, there is room for plan expenditure to be pruned by close to Rs600bn this year. The savings arising from plan expenditure is likely to restrict slippage to 0.2% of GDP. Despite a marginal slippage this year, the chances of sovereign downgrade are low as long as government sticks to the fiscal consolidation roadmap in the context of a strong medium-term growth outlook.

Figure 47. GDP – Expect FY14 GDP at 4.8%YoY



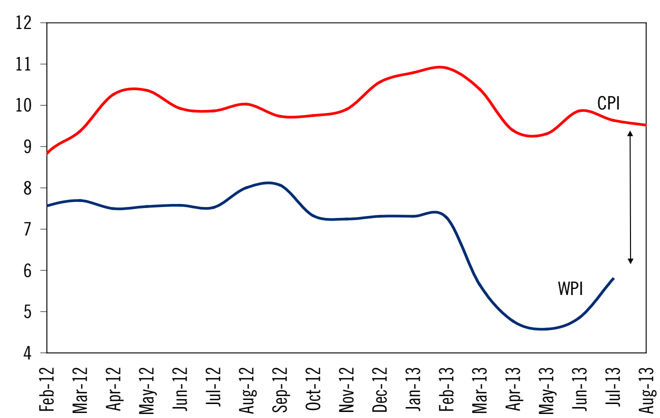
Source: CSO; Citi Research

Figure 48. Trends in investment projects remain dismal (Rs bn)



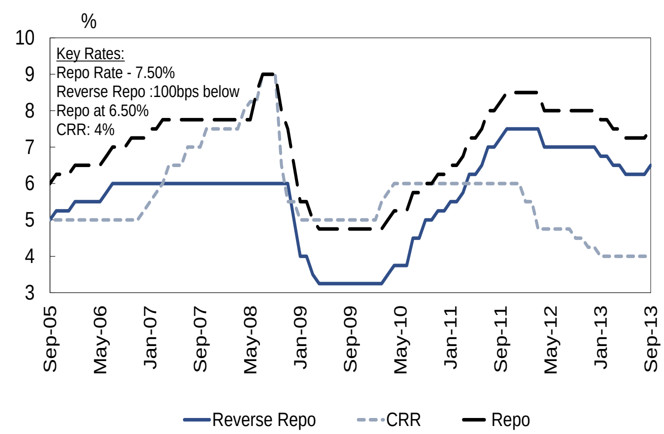
Source: CMIE

Figure 49. Trends in headline and core inflation (% YoY)



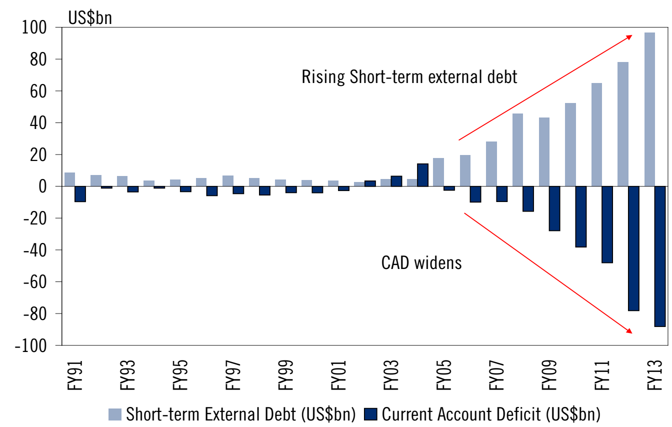
Source: Office of the Economic Advisor

Figure 50. Rupee volatility leads to reversal of rate easing cycle



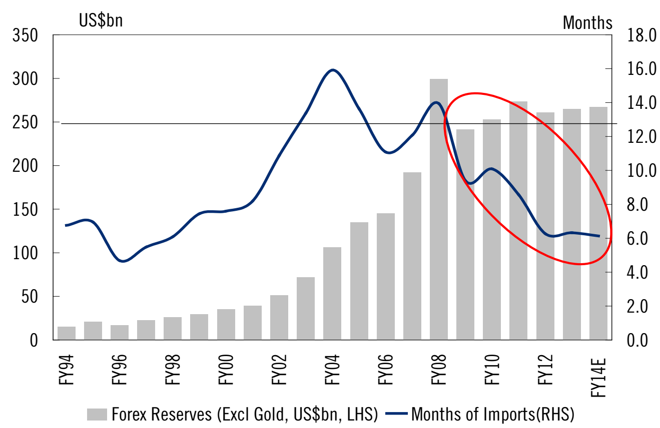
Source: Bloomberg

Figure 51. External financing requirements remain high



Source: Budget Documents; Citi Research

Figure 52. Trends in forex reserves and import cover (US$bn, Months)



Source: RBI; Citi Research

Figure 53. India Economic Indicators

	FY07	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F	FY15F
Summary Data									
Nominal GDP, US$ bn	950.2	1,240.6	1,223.9	1,366.6	1,710.2	1,865.9	1,855.7	1,836.3	2,299.0
Nominal GDP, local currency bn	42,947	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743
GDP per capita, US$	847	1,090	1,061	1,168	1,442	1,552	1,521	1,483	1,829
Population, mn	1,122.0	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9
Unemployment, % of labour force	--	--	--	--	--	--	--	--	--
Economic Activity									
Real GDP, % yoy	9.6	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6
Real investment growth % yoy	13.4	18.1	-5.2	16.7	16.2	1.5	5.1	1.9	4.5
Real consumption growth % yoy	7.9	9.3	7.6	8.2	8.1	8.1	3.9	5.6	6.4
private consumption growth % yoy	8.7	9.2	7.1	7.1	8.6	8.0	4.0	5.3	6.5
Real export growth, % yoy	19.9	5.9	15.2	-4.7	19.7	15.3	3.0	5.2	11.0
Real import growth, % yoy	21.3	10.2	23.0	-2.1	15.8	21.5	6.8	5.0	9.5
Prices, Money & Credit									
WPI, % yoy	6.8	7.7	1.5	10.6	9.7	7.7	6.0	5.5	5.0
WPI, % avg	6.5	4.8	8.1	3.8	9.6	8.9	7.3	5.5	5.0
Nominal wages, % yoy	--	--	--	--	--	--	--	--	--
Credit extension to private sector, % yoy	28.5	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.50	7.75	5.00	5.00	6.75	8.50	7.50	7.75	7.75
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50
Long term yield, % eop	7.98	7.96	7.01	7.83	7.99	8.56	8.00	8.25	8.25
lc/US$, eop	44.12	39.41	48.62	46.41	44.71	53.02	55.00	63.88	61.49
lc/US$, avg	45.19	41.18	43.42	48.30	45.68	46.63	53.38	60.17	63.33
Balance of Payments, US$ bn									
Current account	-9.6	-15.7	-27.9	-38.2	-48.1	-78.2	-88.2	-68.4	-60.4
% of GDP	-1.0	-1.3	-2.3	-2.8	-2.8	-4.2	-4.8	-3.7	-2.6
Trade balance	-61.8	-91.5	-119.5	-118.2	-127.3	-189.8	-195.7	-173.8	-173.2
Exports	128.9	166.2	189.0	182.4	256.2	309.8	306.6	323.4	368.7
Imports	190.7	257.6	308.5	300.6	383.5	499.5	502.2	497.2	542.0
Service balance	29.5	38.9	53.9	35.8	44.1	64.1	64.9	63.6	69.1
Income balance	-7.3	-5.1	-7.1	-8.0	-18.0	-16.0	-21.5	-24.0	-24.0
FDI, net	7.7	15.9	19.8	18.0	11.8	22.1	19.8	21.0	18.0
International reserves	191.9	299.1	241.6	252.8	273.7	260.9	264.7	259.8	274.9
Total Amortisations	11.4	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9
Public Finances, % of GDP									
Consolidated government balance	-5.4	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.7	-6.4
Consolidated gov primary balance	0.0	-1.1	3.4	4.6	2.7	2.2	--	--	--
Public debt	79.9	76.1	76.8	75.8	70.7	69.9	67.6	66.8	66.2
of which Domestic	74.7	71.4	72.2	70.8	66.0	65.9	63.2	63.0	62.8
Foreign Assets & Liabilities, US$ bn									
External debt	172.4	224.4	224.5	260.9	305.9	345.5	390.0	405.0	420.0
Private	123.0	166.3	168.6	193.9	227.8	263.6	308.4	321.4	334.4
Public	49.4	58.1	55.9	67.1	78.1	81.9	81.7	83.7	85.7
External debt / GDP	18.1	18.1	18.3	19.1	17.9	18.5	21.0	22.1	18.3
External debt / XGS	86.1	88.5	77.7	95.2	81.5	77.5	88.2	89.2	72.0
Short-term debt	28.1	45.7	43.3	52.3	65.0	78.2	96.7	101.7	106.7
Short-term debt/International Reserves (%)	14.7	15.3	17.9	20.7	23.7	30.0	36.5	39.1	38.8

Quarterly Economic Indicators	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.8	4.4	4.6	5.0	5.2	5.2	5.6	5.8	5.8
WPI, % yoy	5.7	5.2	6.0	5.6	5.5	5.3	5.1	5.0	5.0
Policy interest rate, % eop	7.50	7.25	7.50	7.75	7.75	7.75	7.75	7.75	7.75
1 month inter-bank rate, % eop	9.30	8.05	10.50	9.00	8.00	8.00	8.00	8.00	8.00
Long term yield, % eop	8.00	7.50	8.40	8.50	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	54.29	59.53	63.12	63.88	64.62	64.31	62.90	61.49	60.11

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Indonesia

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- **Summary view** – Our GDP growth forecast has been further lowered to 5.3% for 2014 from 5.6%. FX volatility since August has cast more clouds on the near term growth outlook. However, we generally think that the sensitivity of growth to IDR/USD depreciation could be milder this time compared to 2008.
- **Things to watch** – We expect YoY inflation to still rise towards 9.2% by YE13, before receding towards 4.9% in YE14. Although credit growth deceleration is already under way, we think current-account adjustment will not be swift and the risk of growth overkill from monetary policy is not alarmingly high.
- **Strategy** – In recent weeks, policy variables have taken a turn in the right direction with the FasBI and BI rate having been raised to 5.5% and 7.25%, respectively. We see the possibility of a further 25bp interest rate hike in 4Q13 and another 25bps in 1Q14 (bringing the total rate hike in the cycle to 200bps).

IDR depreciation: Impact creeping through

Overall GDP growth outlook has undoubtedly weakened but no free fall expected. This month we further downgraded our FY13 and FY14 GDP growth forecasts to 5.7% and 5.3%, respectively (prev. 5.8% and 5.6%). We expect the weaker IDR to impact growth of household consumption and also fixed investments. With rising prices of e.g. construction materials and capital goods, the cost of business investment will undoubtedly increase while the revenue projections for domestic market sales will be declining or at best stable. We expect therefore many companies will have to review their upcoming expansion plans, leading to project delays and a slowdown in fixed investments in coming quarters. However, we do not expect the 2008 widespread halts to ongoing expansion projects.

Trade-weighted exchange rate depreciation finally occurring. As of Aug, Indonesia's nominal effective exchange rate saw further depreciation, after appreciating from Jan-May. It is not too far off from the lows seen in 4Q08. Note that we prefer now to look at the nominal instead of real trade weighted exchange rate (NEER vs. REER) because since the June fuel price hikes, the latter has been distorted by public bus tariffs and spice price increases which have little to do with trade competitiveness. However, anecdotally we also estimate the IDR prices of various imports using sectoral producer price indexes in the origin countries. It can be seen that some imports from Japan e.g. steel and general machinery may not have become far too expensive compared to a year ago, given the depreciation of the Yen against the IDR in late 2012 - early 2013.

FX depreciation impact has started to creep through to domestic prices. Following the increased FX depreciation momentum since July, the wholesale price index of imported goods rose 7.6% YoY in July, up from just 3% in May. Our indicators show rising momentum in the rupiah prices of various Chinese imports such as metals, electrical machinery, telecom equipment, garments etc. Meanwhile data as of August also shows prices of key construction materials on the rise, although still milder vs. that seen in 2008. We have also seen the exchange rate impact creeping through to the consumer price index, through prices of e.g. imported foods and gold. Further adjustments are probably on the way on durable goods prices. We expect inflation to rise towards 9.2% by YE13, before subsiding back to 4.9% by YE14.

Current-account adjustment may take time

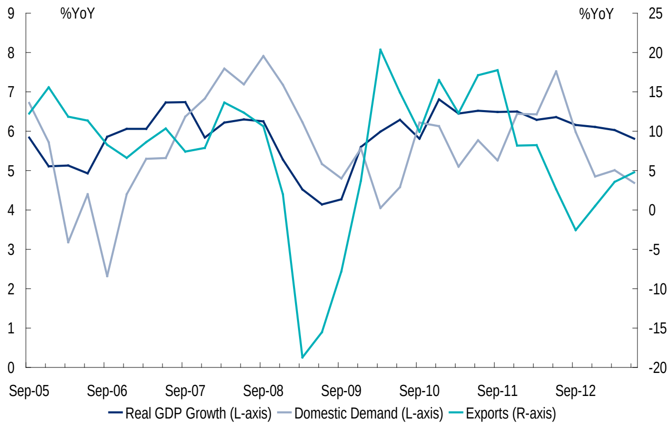
Growth in high import content industries should be closely watched as a leading indicator for imports. In *Indonesia Macro View - Assessing the Impact of IDR Depreciation*, we identified the industries with high import content but which sell their products mainly to the domestic market. Among them are heavy industries such as vehicle, metals, chemicals and pharmaceuticals manufacturing. We also identified the building construction and automotive sectors as key users of steel (which is the second largest raw material import after petroleum and has been stubbornly growing).

In 2008 growth in high import sectors immediately collapsed after IDR depreciation, but can it now be stickier? In 2008, the rise in construction material prices was very strong, reaching a high of 32% YoY. Apart from FX depreciation, it was also amplified by rising prices of global commodities such as oil, coal and iron ore. The latter pressures are now less profound. Furthermore, net profit margins of major construction companies, especially the privately owned, appear to be higher in recent quarters compared to 2008. This means that there could be a longer lag before the rise in construction material prices is passed through to selling prices and affects final demand. Separately the launch of affordable car line-ups can also cushion the decline in auto sales. In Aug, 4W vehicle sales already dropped by about 6% YoY. But a number of Japanese carmakers have already started introducing their line ups of affordable small-cars, qualifying for tax breaks under the government's "low cost green car (LCGC)" program. This may be able to cushion the drop. Whereas in 2008 car sales volume growth dipped 20%, Citi still expects positive growth of car sales in 2014, supported by the LCGC. **Given the lower elasticity of growth to FX depreciation, we think the adjustment in the current account will probably be gradual and not coming in a straight-line. In this regard, we think the exchange rate will still be prone to two-way volatility.**

Monetary policy needs to continue playing a role in restoring the external imbalance; and the risk of growth overkill is not dramatically high in our view. In order to reduce imports and restore the external balance, we think that economic growth would have to slow further. Tighter monetary policy (i.e. both interest rates and macroprudential regulations) has a role to play because if the adjustment is left mainly to the exchange rate alone, the necessary magnitude may have to be larger. And a too strong adjustment in the exchange rate risks weakening corporate balance sheets by inflating the value of foreign debt. We think this is a costlier option in the longer term because strong balance sheets are needed to allow for a faster growth recovery when the time comes.

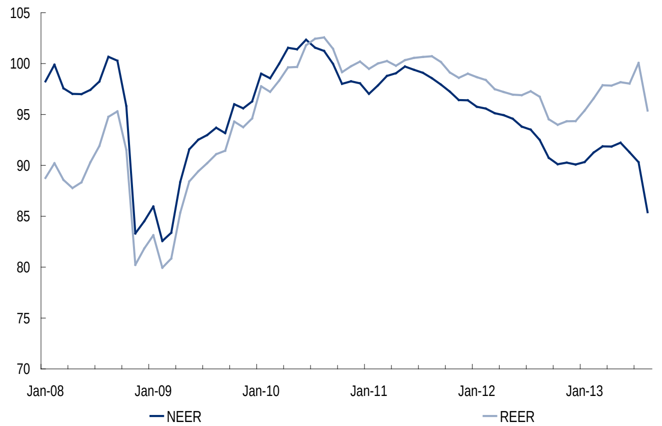
Policy implication: September rate hike probably not the last. Year to date, the BI rate and FasBI rate have been raised by 150bps, while the repo rate has only been increased by 50bps. Policymakers have been mindful of financial sector stability, in regard to previous experiences whereby liquidity can move towards larger banks during volatile times. Yet in spite of this, anecdotally we sense that the degree of risk aversion among banks so far has not been as high as in 2008. From current levels of 5.75% and 7.25% in the FasBI and BI rates, we expect another 2 x 25bps policy rate hikes in 4Q13 and 1Q14, bringing the total rate hike in the cycle to 200bps. This will come along with further intensification of macro-prudential measures to slow loans growth to high-import sectors e.g. property.

Figure 54. GDP growth is decelerating



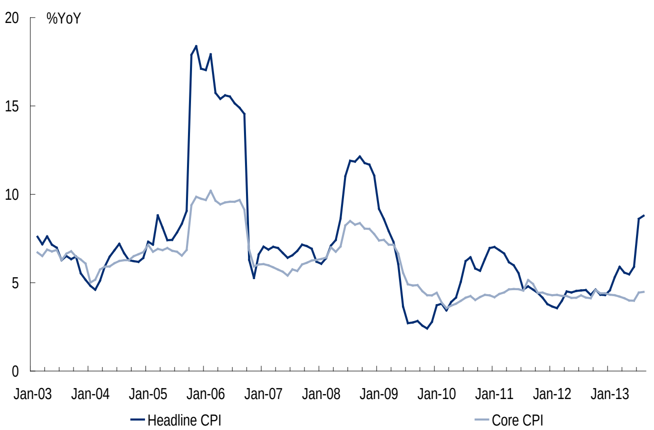
Source: CEIC, Citi Research

Figure 55. IDR has started to weaken on a trade weighted basis



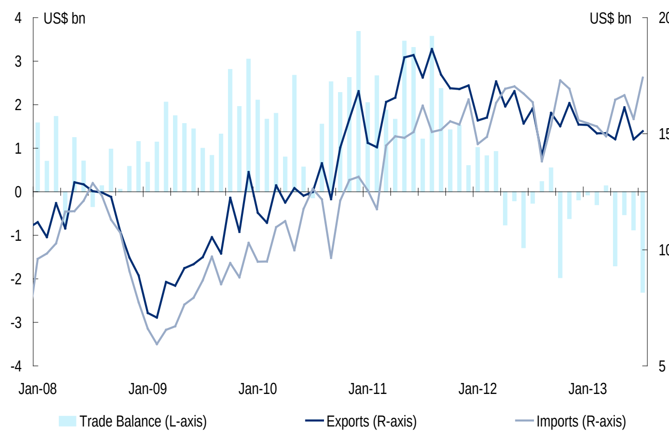
Source: CEIC, Citi Research

Figure 56. Headline inflation jumped, but rise in core has been milder



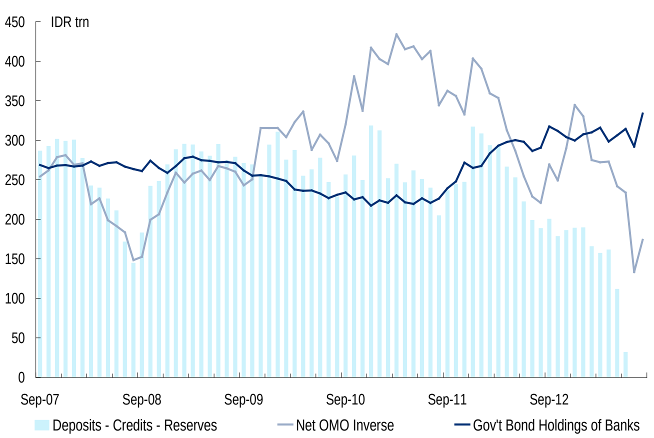
Source: CEIC, Citi Research

Figure 57. Record trade deficit in Jul



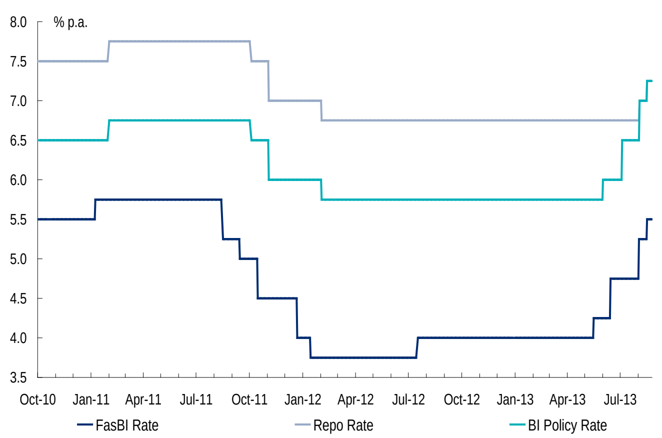
Source: CEIC, Citi Research

Figure 58. Pool of excess liquidity has been shrinking



Source: CEIC, Citi Research

Figure 59. BI rate has been raised 150bps in the cycle



Source: CEIC, Citi Research

Figure 60. Indonesia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	364.4	432.2	510.7	538.6	709.5	845.8	878.3	898.5	915.7
Nominal GDP, local currency bn	3,339,217	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,365,180	10,621,769
GDP per capita, US$	1,636	1,915	2,235	2,328	2,986	3,486	3,596	3,645	3,672
Population, mn	222.8	225.6	228.5	231.4	237.6	242.6	244.2	246.5	249.4
Unemployment, % of labour force	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9	5.9
Economic Activity									
Real GDP, % yoy	5.5	6.3	6.0	4.6	6.2	6.5	6.2	5.7	5.3
Real investment growth % yoy	1.3	1.9	12.4	2.4	8.8	10.5	16.9	4.5	3.5
Real consumption growth % yoy	3.9	4.9	5.9	6.2	4.1	4.5	4.8	4.7	4.9
private consumption growth % yoy	3.2	5.0	5.3	4.9	4.7	4.7	5.3	5.0	4.7
Real export growth, % yoy	9.4	8.5	9.5	-9.7	15.3	13.6	2.0	4.2	6.0
Real import growth, % yoy	8.6	9.1	10.0	-15.0	17.3	13.3	6.6	0.6	4.1
Prices, Money & Credit									
CPI, % yoy	6.6	5.8	11.1	2.8	7.0	3.8	4.3	9.2	4.9
CPI, % avg	13.1	6.3	9.9	4.8	5.1	5.4	4.3	7.2	6.6
Nominal wages, % yoy	6.3	4.2	7.6	5.3	12.2	3.4	12.7	28.0	15.0
Credit extension to private sector, % yoy	12.1	22.4	30.7	18.0	20.6	25.9	22.1	18.0	16.0
Policy interest rate, % eop	4.75	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00
1 month inter-bank rate, % eop	5.75	3.35	9.44	6.39	5.66	4.57	4.24	6.65	6.90
Long term yield, % eop	10.18	10.02	11.92	10.07	7.83	6.05	5.39	8.50	8.00
lc/US$, eop	8994	9393	10900	9425	9010	9068	9638	10438	10375
lc/US$, avg	9171	9140	9673	10376	9078	8763	9361	10135	10462
Balance of Payments, US$ bn									
Current account	10.9	10.5	0.1	10.6	5.1	1.7	-24.4	-31.3	-24.6
% of GDP	3.0	2.4	0.0	2.0	0.7	0.2	-2.8	-3.5	-2.7
Trade balance	29.7	32.8	22.9	30.9	30.6	34.8	8.6	2.2	5.5
Exports	103.5	118.0	139.6	119.6	158.1	200.8	188.5	178.1	192.8
Imports	73.9	85.3	116.7	88.7	127.4	166.0	179.9	175.9	187.3
Service balance	-9.9	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-10.1	-9.6
Income balance	-13.8	-15.5	-15.2	-15.1	-20.8	-26.7	-26.7	-25.3	-24.0
FDI, net	2.2	2.3	3.4	2.6	11.1	11.5	14.0	12.0	11.0
International reserves	42.6	56.9	51.6	66.1	96.2	110.1	112.8	90.9	84.9
Total Amortisations	16.4	18.8	16.7	20.4	24.0	25.1	40.3	41.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-0.9	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.1	-1.8
Consolidated gov primary balance	1.5	0.8	1.7	0.1	0.6	0.1	-0.6	-1.1	-0.2
Public debt	39.6	34.1	29.3	31.4	26.4	23.6	23.6	25.0	26.0
of which Domestic	22.6	19.7	16.2	19.3	16.7	15.5	16.1	15.6	15.6
Foreign Assets & Liabilities, US$ bn									
External debt	132.6	141.2	155.1	172.9	202.4	225.4	252.4	270.0	297.0
Private	56.8	60.6	68.5	73.6	83.8	106.7	126.2	131.5	155.0
Public	75.8	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0
External debt / GDP	36.4	32.7	30.4	32.1	28.5	26.6	28.7	30.1	32.4
External debt / XGS	115.3	108.2	100.1	130.2	115.8	101.8	119.3	133.7	136.4
Short-term debt	12.2	18.7	20.5	24.0	31.6	36.6	43.4	44.0	47.0
Short-term debt/International Reserves (%)	28.7	32.8	39.7	36.4	32.8	33.2	38.4	48.4	55.4

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	6.0	5.8	5.5	5.6	5.2	5.1	5.3	5.6	5.4
CPI, % yoy	5.9	5.9	9.0	9.2	7.8	7.7	5.1	4.9	5.2
Policy interest rate, % eop	4.00	4.25	5.50	5.75	6.00	6.00	6.00	6.00	6.00
1 month inter-bank rate, % eop	4.18	4.45	6.40	6.65	6.90	6.90	6.90	6.90	6.90
Long term yield, % eop	5.74	7.21	8.25	8.50	8.25	8.25	8.00	8.00	8.00
lc vs USD, eop	9718	9925	10362	10438	10512	10516	10445	10375	10306

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Malaysia

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- **Summary view** – An export-led recovery in 3Q GDP suggests the CA surplus could stabilize at 1-1.5% of GDP. Fuel price hikes should push inflation to above 3% by 2H14, and we tentatively expect BNM to hike 50bps starting 2Q14.
- **Things to watch** – (1) UMNO General Assembly; (2) Fiscal reforms in the Oct 25th Budget; (3) Deferral of public sector projects; (4) Sept CPI.
- **Strategy** – Amidst Fed taper delay, CA stabilization, likely reforms in the Budget and some fall in foreign MGS holdings to 42.8% of outstanding (from a peak of 49.5% in May), we turn more neutral on the MYR near term.

Strong start to 3Q GDP

Jul-Aug data hint at strong start to 3Q GDP on manufacturing restocking. Corroborating a strong 5.2%MoM SA (Jun: -1.7%) rise in exports, Jul IP rose 1.9%MoM SA (Jun: 0.5%) led by Manufacturing on Petroleum, Chemical, Rubber and Plastic Products; Food, Beverages and Tobacco, and Transport Equipment and Other Manufactures; as well as Electrical & Electronics (E&E). These offset sequential declines in Mining and Electricity IP. Overall, Jul headline and manufacturing IP seasonally-adjusted levels are now 2.1% and 1.7% above the 2Q13 averages respectively, though Mining and Electricity IP levels at 0.9% and 0.4% below 2Q13 could provide small drags. Jul-Aug Bursa Malaysia turnover volumes remain elevated while the decline in gross fundraising in capital markets eased sharply in Jul, suggesting a boost from financial services, while outstanding loans to the construction sector have been climbing since the start of the year.

Signs of re-stocking in E&E. E&E production rose sequentially for the first time in three months, confirming the sequential gain in Jul E&E exports, which we estimate rose 5.3%MoM SA in Jul. Jul seasonally-adjusted E&E IP levels are 1.8% above the 2Q13 average. Tech indicators also remain fairly supportive – in Jul, 4 out of 9 tech indicators showed MoM increases while 2 out of 3 available tech indicators for Aug expanded. There are also further signs of re-stocking in anticipation of further pick-up in exports for 2H13.

3Q GDP growth of above 5% looks possible. Overall, the turnaround in Jul IP and trade data substantiates BNM's slightly more confident assessment of the external environment in the Sept MPC statement, and is also consistent with earlier signals of a bottoming in exports from the surge in intermediate goods imports in 2Q. With the positive Jul IP and trade data, 3Q GDP growth of 5%YoY looks possible, supported by export-led manufacturing re-stocking. With election uncertainties behind us, a post-election rebound in housing and construction activities also is likely, as housing approvals for construction by private developers (leading indicator) rebounded strongly in May-Jun, after falling to 4-year low in Apr.

CA surplus could improve marginally in 3Q in line with better exports, but full year 2013 surplus will likely still be substantially narrower at 2.7% of GDP (2012: 5%). The magnitude of any improvement will likely be capped by still robust domestic demand and capital goods imports. A key development to watch would be the deferring of public sector construction projects with high import content, which could be announced in the Budget and may reduce the sensitivity of imports to domestic demand. Together with a substantial fall in foreign MGS holdings to 42.8% of outstanding and a delay in Fed tapering, we turn near term neutral on the MYR.

Bringing forward rate hikes amidst subsidy cuts

Inflation could approach 3% by early 2014 after Sept fuel price hike Notwithstanding the lower than expected Aug headline CPI inflation print of 1.9% (consensus: 2.0%), core inflation ticked up to 1.3% YoY (Jul 1.2%). The 20sen/ltire hikes in RON95 and diesel prices in early Sep should impute a direct 0.6%MoM shock to Sep CPI. But taking cue of the second round effects from the Jun 2008 80sen/litre hike and adjusting proportionately, we think the overall impact could be larger at 0.9%MoM. Hence Sep CPI inflation could rise to 2.6% YoY and further second-round effects could push inflation figure to approach 3% by early 2014

We tentatively bring forward our rate hike forecast to 2Q14 for now (prev: 2H14), though this is contingent upon a number of assumptions. Apart from the magnitude of the Sept fuel price hike inflation impact and the extent of second round price effects, our interest rate path is also dependent on the timing of further subsidy rationalization – we assume another two 10sen RON95 fuel price hikes in June and December next year. While the Sept MPC statement took a less dovish tone, we suspect the MPC is in no hurry to hike – the external environment has yet to turn convincingly, and with inflation hovering around 3% in 1H14, the current 3% OPR would still not turn negative in real terms through 1H14. To prevent the real OPR rate from turning negative, we however expect BNM to hike in 2Q14 in anticipation of a further RON95 price hike in Jun 2014 which would pushes headline inflation decisively above 3% The MPC will likely be watching the Sept CPI figure and the Budget announcement on further price hikes for greater clarity on the inflation profile going forward before making a decision on rate hikes

Oct 25th Budget focused on fiscal reform

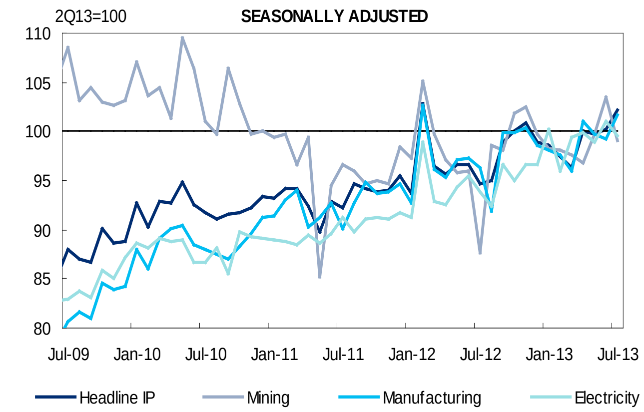
With Najib's position as UMNO president unchallenged, the overriding priority of the Budget will be to fend off the threat of credit rating downgrades. The 2013 fiscal deficit will likely come in at 4.2% of GDP, slightly above the Budget target of 4%, as revenue overshoots may be insufficient to cover election related operating expenditure overshoots. In line with the target of cutting the deficit to 3% of GDP by 2015, the 2014 deficit target could be cut to 3.5% of GDP, assuming efficiency gains in corporate and personal tax collections, cuts in fuel subsidies and development expenditure

Given the political sensitivities, GST will likely be initially implemented after 14 months at a rate of 4-5% and with exemptions of essential items. As GST will replace the 5% sales and service tax, the net fiscal impact in 2015 will be only around RM3-5bn. Given the minimal net revenue impact from 4-5% GST rate, and given pressure on sovereign ratings, personal tax cuts could be deferred for now.

Fuel subsidy rationalization timeline and BR1M details to be announced. A timetable closer to the original Pemandu plan for hikes of around 10sen/litre every six months is likely, starting in Jun 2014. To offset the impact on the lower income groups, BR1M handouts will likely be increased. Our sense is that BR1M handouts could be around RM2bn, and with the earlier 20sen/litre hike generating RM3.3bn of savings, further fuel price hikes in 2014 are likely for savings to be meaningful.

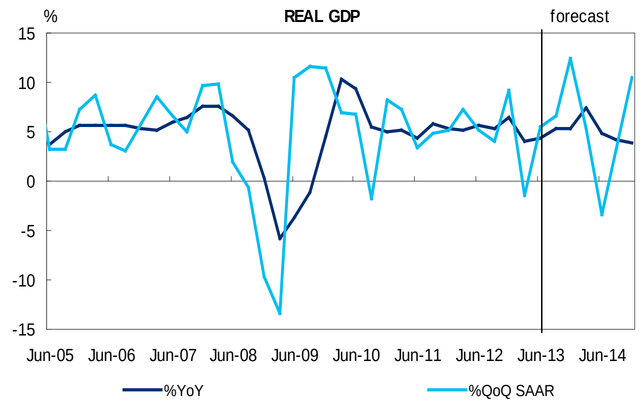
We also expect hikes in sin taxes with further property tightening measures on the demand side – including RPGT and/or credit measures could be announced to curb speculative demand. However, given the supply shortage, demand side measures are more likely politically expedient rather than economically effective.

Figure 61. Strong start to 3Q GDP on manufacturing restocking



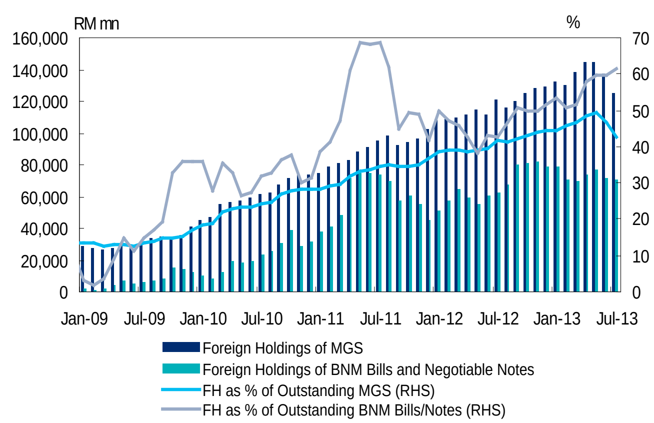
Source: CEIC, Citi Research

Figure 62. 3Q GDP growth of above 5% looks possible



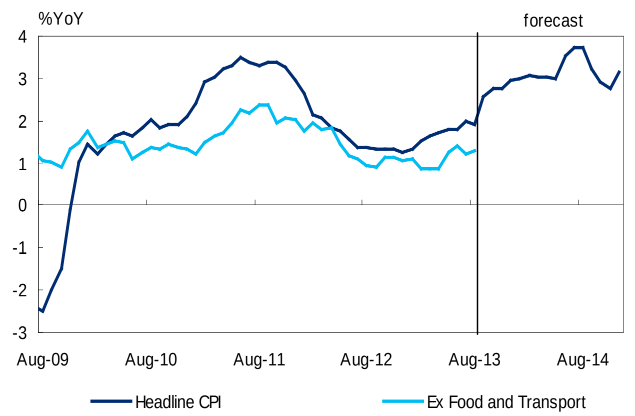
Source: CEIC, Citi Research

Figure 63. Foreign MGS holdings have fallen to 42.8% of outstanding



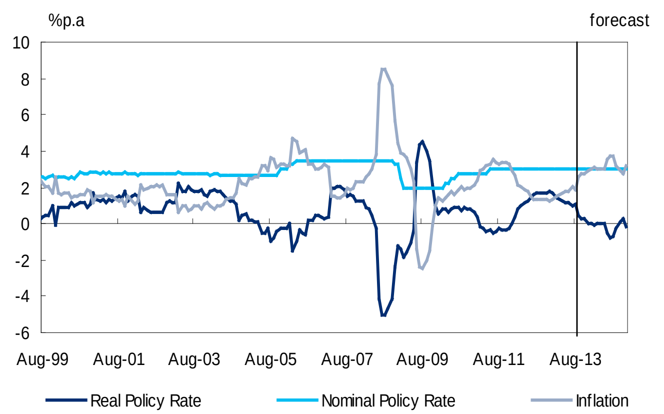
Source: CEIC, Citi Research

Figure 64. Inflation could approach 3% by early 2014



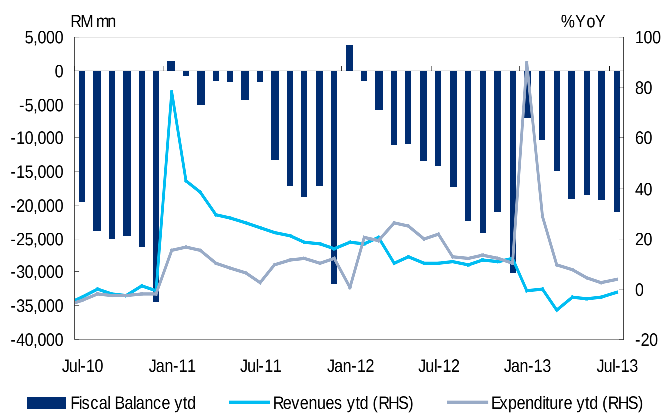
Source: CEIC, Citi Research

Figure 65. Real OPR would turn negative in 2Q14 *unless* rates are hiked



Source: CEIC, Citi Research
Note: The chart shows the real OPR if rates are not hiked (our forecast is for a hike in 2Q14). Prior to April 2004, BNM used the Intervention Rate to affect the Base Lending Rate; however since Apr 2004 it has used the Overnight Policy Rate.

Figure 66. Revenue overshoots may be insufficient to cover spending



Source: CEIC, Citi Research

Figure 67. Malaysia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	162.8	193.7	231.1	202.4	247.7	289.3	305.0	313.1	328.9
Nominal GDP, local currency bn	597	665	770	713	797	884	941	986	1,059
GDP per capita, US$	6,067	7,123	8,393	7,255	8,664	9,987	10,398	10,472	10,783
Population, mn	26.8	27.2	27.5	27.9	28.6	29.0	29.3	29.9	30.5
Unemployment, % of labour force	3.3	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9
Economic Activity									
Real GDP, % yoy	5.6	6.3	4.8	-1.5	7.4	5.1	5.6	4.8	5.0
Real investment growth % yoy	8.6	9.1	1.8	-9.4	25.3	2.3	22.3	10.6	4.6
Real consumption growth % yoy	6.4	9.7	8.4	1.4	6.2	8.6	7.1	6.0	4.8
private consumption growth % yoy	6.6	10.4	8.7	0.6	6.9	6.8	7.7	7.0	6.2
Real export growth, % yoy	6.7	3.8	1.6	-10.9	11.1	4.6	-0.1	-1.4	4.3
Real import growth, % yoy	8.2	5.9	2.3	-12.7	15.6	6.1	4.7	0.8	3.9
Prices, Money & Credit									
CPI, % yoy	3.1	2.3	4.5	1.0	2.1	3.0	1.2	3.0	3.2
CPI, % avg	3.6	2.0	5.4	0.6	1.7	3.2	1.6	0.0	0.0
Nominal wages, % yoy	2.1	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0
Credit extension to private sector, % yoy	6.8	9.2	10.2	6.8	10.9	12.4	12.1	11.0	11.0
Policy interest rate, % eop	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50
3 month inter-bank rate, % eop	3.71	3.61	3.37	2.17	2.98	3.22	3.21	3.21	3.70
Long term yield, % eop	3.70	3.78	3.00	3.79	3.39	3.23	3.24	3.60	4.00
lc/US$, eop	3.53	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.15
lc/US$, avg	3.67	3.44	3.33	3.52	3.22	3.06	3.09	3.21	3.21
Balance of Payments, US$ bn									
Current account	26.2	29.7	39.4	31.4	27.1	33.5	18.6	7.2	6.6
% of GDP	16.1	15.4	17.1	15.5	10.9	11.6	6.1	2.3	2.0
Trade balance	38.0	38.1	51.1	39.8	42.5	49.6	40.7	26.2	27.0
Exports	161.5	176.5	198.9	157.0	199.2	228.8	227.9	236.2	242.0
Imports	123.5	138.5	147.7	117.1	156.7	179.2	187.2	210.0	215.0
Service balance	-2.6	0.4	0.5	1.2	-0.4	-2.1	-4.5	-1.0	-3.0
Income balance	-9.3	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-18.0	-17.4
FDI, net	0.0	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-2.0	-1.0
International reserves	82.5	101.3	91.5	96.7	106.5	133.6	139.7	151.0	157.0
Total Amortisations	5.3	7.8	6.3	9.8	11.3	9.0	9.3	10.0	10.0
Public Finances, % of GDP									
Consolidated government balance	-3.2	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.2	-3.5
Consolidated gov primary balance	-1.1	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-2.2	-2.2
Public debt	40.6	40.1	39.8	50.8	51.1	51.6	53.3	53.7	53.0
of which Domestic	36.4	37.1	37.2	48.9	49.0	49.5	51.5	52.0	51.5
Foreign Assets & Liabilities, US$ bn									
External debt	52.0	56.2	66.6	68.3	72.6	81.5	82.8	94.7	98.5
Private	30.8	37.8	41.5	41.9	44.7	53.7	55.6	89.0	93.0
Public	21.2	18.4	25.2	26.3	27.9	27.8	27.1	5.7	5.5
External debt / GDP	32.0	29.0	28.8	33.7	29.3	28.2	27.1	30.2	29.9
External debt / XGS	28.5	27.4	29.0	36.9	31.4	30.7	31.1	33.9	34.3
Short-term debt	12.1	16.3	22.5	22.7	25.4	32.9	30.4	40.0	42.0
Short-term debt/International Reserves (%)	14.6	16.1	24.6	23.5	23.8	24.6	21.8	26.5	26.8

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.1	4.3	5.4	5.3	7.5	4.8	4.2	3.8	5.1
CPI, % yoy	1.6	1.8	2.6	3.0	3.0	3.5	3.2	3.2	3.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50
3 month inter-bank rate, % eop	3.21	3.20	3.21	3.21	3.20	3.45	3.70	3.70	3.70
Long term yield, % eop	3.22	3.20	3.35	3.60	3.70	3.80	3.90	4.00	4.10
lc vs USD, eop	3.09	3.16	3.30	3.28	3.26	3.23	3.19	3.15	3.11

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Wage is based on Citi Research estimates of average manufacturing sector wage. Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Philippines

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- **Summary view** – In Aug, we upgraded our 2013 GDP growth forecast to 7.3% due to stronger 1H growth (7.6%). Fiscal spending is still the primary catalyst. Weak PHP firmed up purchasing power of remittances. Weak consumer sentiment driven by higher inflation expectations and unemployment remains an issue.

- **Things to watch** – Whether primary spending eases on public outcry for scrapping of 'pork barrel' funds. Negative impact of Zamboanga city conflict on regional gains. Whether disinflation cycle ends in 3Q13 and corresponding BSP signals. BSP's sterilization bias likely to intensify and stall rapid PHP appreciation.

- **Strategy** – PHP in the 42.20 range by end-Dec on resilient but lower current account surplus, declining external debt stock and ratios, favorable growth momentum in 2H although not as robust, and end to disinflation cycle. Duration risk preference would be determined by end to disinflation and monetary signals.

Identifying the spending catalysts and downside risks

Our forecast of 2013 GDP growth of 7.3% rests largely on strong 1H13 growth (7.6%YoY) while assuming easing 2H gains (7%YoY). Primary fiscal spending remains the undisputed growth catalyst as it posted 30%YoY growth in July. Government released Php1bn in Aug to support 175 project loans under the Social Housing Financing Corp's community mortgage program. Investigation of the Php10bn 'pork barrel scam' and the military conflict in Zamboanga city may be a distraction to fiscal spending although the latter event would suggests increased public spending particularly infra rehabilitation in the beleaguered city, when the conflict ends and stability returns. Real purchasing power of OFW remittances rose 7.5%YoY in July (vs +3.3%YoY in June)—a product of weak PhP and disinflation. Both these catalysts bode well for basic consumption and construction in 3Q13.

Exports continue to post subdued gains in June-July that doesn't seem to bother manufacturing activity. Exports grew 2.3%YoY in July following 4.1%YoY gain in June. We may be in the midst of mild export recovery particularly for tech exports since it has posted 5 straight seasonally adjusted monthly gains since Feb although the YoY comparison remains bland. Semi-con exports in July languished in negative territory (-12.6%YoY) while non, semi-con tech exports grew by 26.6%YoY with its uptrend intact. Non-tech exports eg ignition wiring sets, face base effects in 2H13 but expected monthly earnings could still fall in the high range of US$1.7bn-US$2bn. Despite mixed export readings, the mfg index grew by 12%YoY in July due to 11 out of 20 industries posting gains consistent with upbeat sales (+23%YoY). If the mfg trend for Jan-July remains intact, 2-digit gains may be in store for the index in 2H to confirm favorable domestic demand and a few export industries performing well, benefiting from real exchange rate weakness.

Consumer sentiment retreating in 3Q coupled with an elevated jobless rate at 7.3% in July poses a challenge to prospects. Job creation amounted to 620K but failed to lower the unemployment rate. Farm sector contributed 173K jobs with industrial jobs at 63K and services jobs at 384K. Mfg (-32K) and mining (-9K) shed jobs coincident with lackluster exports. Construction jobs of +96.5K remain lackluster compared to previous quarters' job creation (>100K). Consumer sentiment in 3Q13 fell to -7.9% from -5.7% in 2Q with a higher share of respondents (43.4%) expecting higher unemployment. Inflation expectations edged up to 7.9% from 7.5% in 2Q that may have been triggered by weak PHP. A lower share of survey respondents expects higher interest rates (30.6%) and PHP appreciation (3.6%).

Expecting benign price upticks in Dec as disinflation ends

CPI at 2.1%YoY in Aug may be the bottom of the disinflation cycle. One potential upside risk – though more a one-off knock-on effect – is higher raw food CPI in Sep from logistical bottlenecks due to recent flooding in Metro Manila. Hefty fuel price adjustments recently exceeding PHP1/liter on average were undertaken due to the weak PHP and oil prices edging up due to geopolitical risks in Syria. Policymakers noted the 'balance of risk to the inflation outlook shifted slightly toward the upside as oil prices have become more volatile amid ongoing Middle East geopolitical tensions'. A sustained softer oil price outlook may no longer be a safe assumption with the US and Japan's prospects firming up, the Eurozone recession at an end and China's Aug PMI surprising on the upside. BSP's business sentiment survey flagged inflation expectations in excess of 3% in 4Q13 consistent with higher inflation expectations in the consumer survey. Our updated monthly extrapolation also indicated inflation of 2.7-2.8%YoY by Dec which, while benign, would be on an upswing. The macro backdrop may not be as robust as in 1Q13 but it could nurture a faster cost-push pass-through environment.

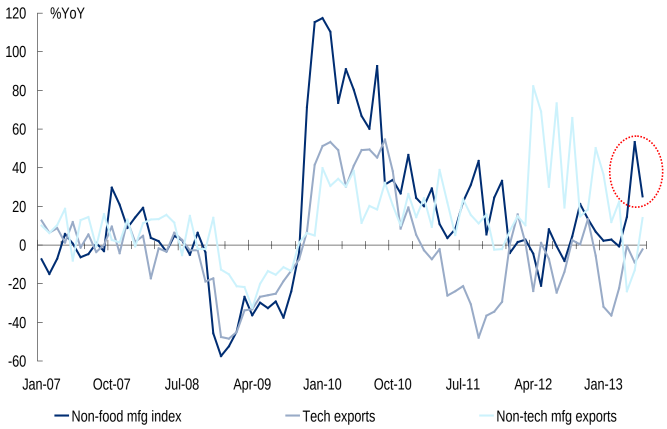
Waning BSP losses enhanced its sterilization capacity

Compression of BSP's losses (Php19bn as of July down 61%YoY) implies a stronger sterilization capacity. BSP can intervene materially in the spot market and neutralize liquidity created by its forex operations particularly on USD buying without resulting in significant costs. Having a positive bottom line after monetary operations is ideal for any central bank, though this ideal has to be neither pursued aggressively nor prioritized over inflation and monetary stability. Even with modest losses, BSP is better poised now to manage the exchange rate post-FOMC's non-tapering decision which has already spawned EM currency rallies against USD. Costs associated with FX/monetary operations should not be significant, unlike those incurred in 2011-12. Between FX losses & sterilization costs, we believe the latter remains key to ensuring financial pressures do not handicap BSP's FX operations and monetary management. BSP's FX losses associated with FX rate fluctuations are paper losses while interest expenses in servicing SDA and its forward book result in actual payments which could lead to money creation, if not erode BSP's retained cash holdings. Between a lower SDA rate and collapsed SDA balances, the latter would have a larger impact on BSP's interest expense. A plot of both variables indicated declining SDA yields (from 7.74% in 2006 to 3.58% in 2012) against rising SDA balances. This pattern resulted in waning BSP income prior to FX losses in 2011, only to deteriorate to a net loss of Php45bn in 2012.

Expecting PHP at 42 in 0-3 months

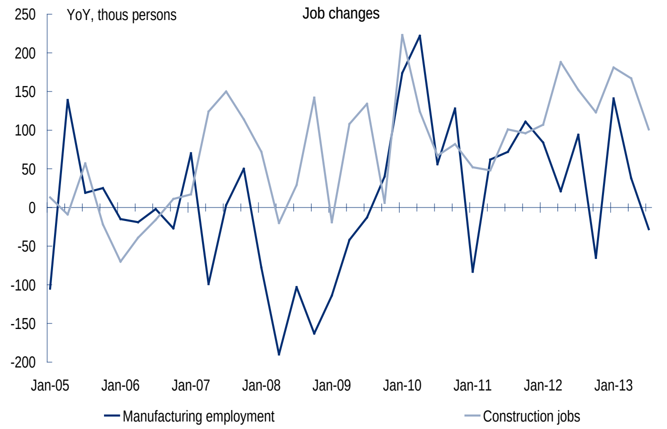
Despite the Fed taper risk in 4Q13, we believe the following factors underpin a stronger PHP average at 42.20 by YE 2013: Current account surplus likely intact due to resilient remittance flows, domestic demand upbeat although not as robust, declining external debt stock and ratios that affirm less dependence on external funding, and end to disinflation cycle. These factors also underpin Moody's credit rating upgrade event in 4Q13. Net debt repayments and negative revaluations due to a weak JPY led to US$3.2bn contraction in the external debt stock to US$58bn as of end-June (21.8% of GDP). Declining stock and ratio of external debt confirms limited dependence of the domestic economy on external financing for imports and growth while there's abundant 'bottled up' onshore liquidity that can be availed of for working and investment capital at affordable rates. BSP may relent to USD's retreat with an end to the disinflation cycle. PHP's recent rally to 43.05 with QE3 still in place firmed up bond market sentiment. Duration risk preference would be determined by disinflation cycle ending and monetary tightening signals to follow.

Figure 68. Correlation of non-food mfg with tech exports persisted



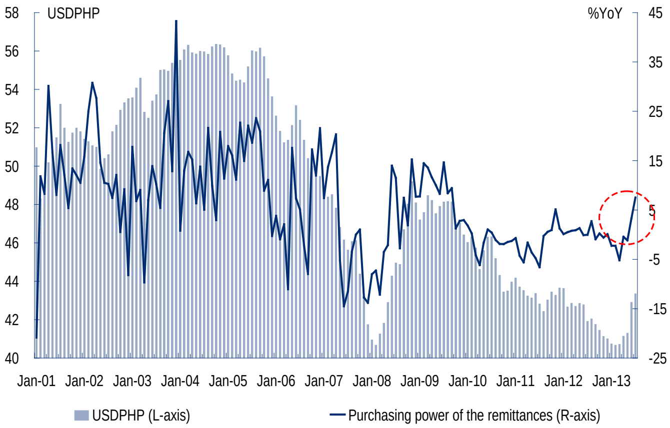
Source: CEIC, Citi Research

Figure 69. Construction jobs were <100K in Jul while mfg jobs declined



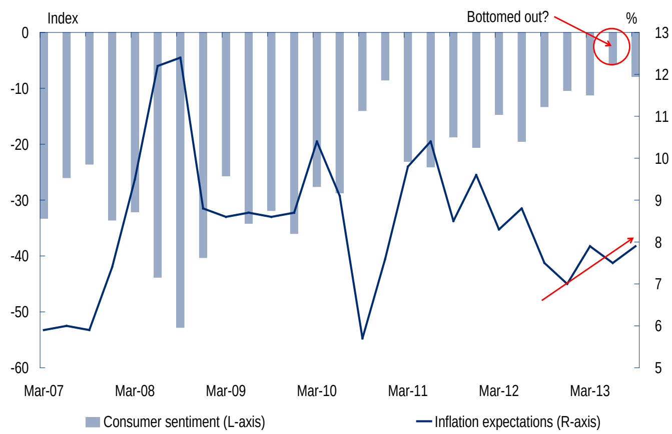
Source: CEIC, Citi Research

Figure 70. Real appreciation strengthened peso value of remittances



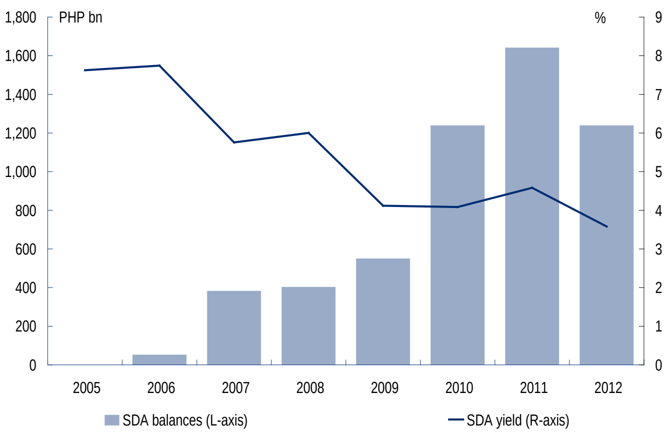
Source: CEIC, Citi Research

Figure 71. Rising inflation outlooks weighed on consumer sentiment



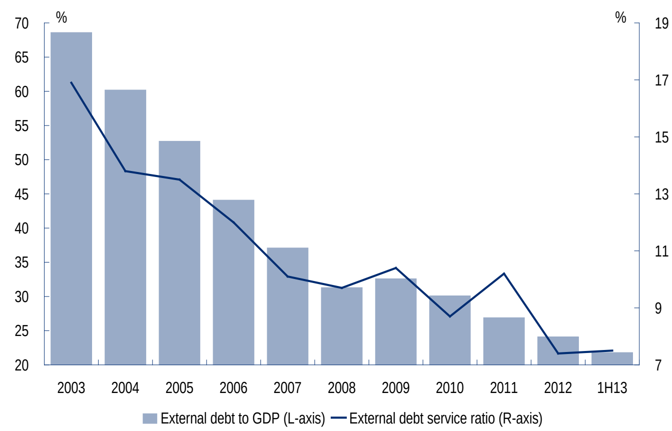
Source: BSP, CEIC, Citi Research

Figure 72. BSP's financial losses driven by expanding SDA balances



Source: CEIC, Citi Research

Figure 73. Declines in the external debt stock and ratios in June



Source: CEIC, Citi Research

Figure 74. Philippines Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	122.4	150.2	173.4	168.6	200.0	224.1	250.5	274.1	303.3
Nominal GDP, local currency bn	6,271	6,893	7,721	8,026	9,003	9,706	10,565	11,636	12,834
GDP per capita, US$	1,408	1,693	1,917	1,829	2,127	2,339	2,567	2,759	2,999
Population, mn	87.0	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2
Unemployment, % of labour force	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0
Economic Activity									
Real GDP, % yoy	5.2	6.6	4.2	1.1	7.6	3.6	6.8	7.3	6.9
Real investment growth % yoy	-15.1	-0.5	23.4	-8.7	31.6	2.0	-3.2	18.7	7.8
Real consumption growth % yoy	4.9	4.9	3.3	3.3	3.4	5.2	7.3	6.7	6.3
private consumption growth % yoy	4.2	4.6	3.7	2.3	3.4	5.7	6.6	5.7	6.0
Real export growth, % yoy	12.6	6.7	-2.7	-7.8	21.0	-2.8	8.9	-3.8	3.1
Real import growth, % yoy	3.5	1.7	1.6	-8.1	22.5	-1.0	5.3	-0.6	2.5
Prices, Money & Credit									
CPI, % yoy	4.3	3.9	8.0	4.3	3.6	4.2	3.0	2.7	3.5
CPI, % avg	6.3	2.8	9.3	3.2	4.1	4.7	3.2	2.7	3.2
Nominal wages, % yoy	7.7	3.4	5.5	0.0	5.8	5.4	7.0	6.5	6.0
Credit extension to private sector, % yoy	9.0	10.6	12.8	4.3	13.8	15.8	14.4	11.3	15.0
Policy interest rate, % eop	7.50	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.50
1 month Philippine Reference rate, % eop	6.35	6.03	5.20	4.11	0.75	1.68	-1.38	0.50	2.75
Long term yield, % eop	5.99	5.70	6.55	6.25	4.78	4.21	3.70	3.25	4.00
lc/US$, eop	49.05	41.23	47.47	46.50	43.65	43.84	41.06	43.34	41.65
lc/US$, avg	51.28	46.05	44.48	47.56	45.06	43.29	42.22	42.80	42.19
Balance of Payments, US$ bn									
Current account	5.3	7.1	3.6	9.4	8.9	7.0	7.1	10.0	10.1
% of GDP	4.4	4.7	2.1	5.5	4.5	3.1	2.8	3.6	3.3
Trade balance	-9.0	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-12.8	-14.0
Exports	32.4	34.1	35.2	29.8	37.6	38.3	46.3	48.2	51.6
Imports	41.4	44.4	49.5	39.4	49.9	55.2	61.5	61.0	65.6
Service balance	2.4	4.2	2.6	2.9	4.1	5.3	3.9	3.3	3.3
Income balance	11.9	13.3	15.4	16.1	17.2	18.7	18.4	19.0	20.4
FDI, net	-2.8	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0
International reserves (ex-gold)	23.0	33.8	37.6	44.2	62.4	75.3	83.8	88.0	93.5
Total Amortisations	9.4	6.3	8.2	6.4	9.5	7.3	8.5	9.3	9.7
Public Finances, % of GDP									
Consolidated government balance	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-2.3	-2.0
Consolidated gov primary balance	3.9	3.7	2.6	-0.2	-0.2	0.8	0.7	0.7	1.0
Public debt	61.4	53.9	54.7	54.8	52.4	51.0	51.5	50.0	49.5
of which Domestic	34.3	31.9	31.3	30.8	30.2	29.6	32.8	32.5	32.0
Foreign Assets & Liabilities, US$ bn									
External debt	53.9	55.5	54.3	54.9	60.0	60.4	60.3	65.0	68.7
Private	16.5	17.5	13.7	11.6	13.9	14.1	15.2	17.0	21.2
Public	37.4	38.0	40.6	43.2	46.2	46.4	45.2	48.0	47.5
External debt / GDP	44.0	36.9	31.3	32.5	30.0	27.0	24.1	23.7	22.6
External debt / XGS	131.0	120.9	117.0	131.8	113.3	107.7	93.0	96.0	95.5
Short-term debt	5.0	7.1	7.0	4.0	6.3	7.0	8.5	10.5	11.8
Short-term debt/International Reserves (%)	21.8	21.0	18.6	9.0	10.1	9.3	10.1	11.9	12.6

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	7.7	7.5	6.9	7.1	6.8	7.3	7.0	6.6	6.5
CPI, % yoy	3.2	2.7	2.2	2.6	2.8	3.1	3.3	3.5	3.6
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.75	4.25	4.50	4.50	4.50
1 month Philippine Reference rate, % eop	-0.36	0.26	-1.00	0.50	1.25	1.50	2.00	2.75	2.75
Long term yield, % eop	2.93	2.80	3.00	3.25	3.50	3.75	4.00	4.00	4.00
lc vs USD, eop	40.85	43.10	43.91	43.34	42.79	42.33	41.99	41.65	41.31

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is central government debt excludes contingent liabilities, and external debt is based on the residency of the holder of the debt (not by currency denomination).

Singapore

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- **Summary view** – Upside growth surprises and downside inflation surprises (though bottomed) leave little reason to change MAS policy. Domestic disinflationary risks will likely be tackled largely with non-monetary measures, unless triggered by a broader macro downturn.
- **Things to watch** – (1) Near-term export momentum, especially electronics; (2) trajectory of COE premiums which could influence headline; (3) housing market developments; (4) labour market developments; (5) household leverage.
- **Strategy** – The upward trajectory of core inflation amidst a delay in Fed tapering would favour the NEER staying in the upper half of the policy band near term. With the Fed still expected to start tapering by Dec, we would be cautious in chasing the recent rally in 10Y SGS.

Upside surprises in GDP levels despite 3Q pullback

Since Apr, 1H13 growth has been better than expected, led by stronger than expected G3 (and more recently Chinese) demand offsetting weaker demand from Asia, amid MAS's upbeat assessment of G3 and IT demand in its latest *Recent Economic Developments* released on Sep 5th. While the MAS expects only a "mild expansion" path in 2H13 after "strong" growth in 1H13, the full-year growth forecast was upgraded to 2.5-3.5% in Aug, from 1-3% previously.

Thus, GDP levels are higher than implied in MAS's Apr expectations of a "gradual" recovery. Despite an expected sequential deceleration in 2H13 to just -5.0 to 0%QoQ SAAR on average implied by the new full-year GDP forecast range of 2.5-3.5%, the stronger than expected growth in 2Q13 implies that the *level* of economic activity has been higher – and could stay higher – than that expected in Apr. Qualitatively, MAS's Sep 5th assessment of the domestic economy is also more upbeat than in Apr.

Overall, despite a likely pullback in 3Q13 GDP at 1-2%QoQ SAAR, this comes from elevated levels in 2Q. Up to Aug, NODX has seen two straight months of sequential decline, bringing average Jul-Aug seasonally-adjusted NODX to 3.5% below average 2Q levels; Jul IP also contracted sequentially to 2.7% below 2Q levels. But even this sequential contraction would still put 3Q GDP levels higher than the earlier forecast range of 1-3%. Further considering the possibility that GDP levels may overshoot the official forecast if 4Q GDP rebounds, this would suggest that GDP levels in 2H13 could be higher than initially anticipated. This should keep the output gap positive with the labour market still tight into early 2014.

Historical inflation downside surprises (have bottomed)

Headline inflation has been lower than expected since Apr. With 1H13 inflation already at 2.8%, 2H13 inflation would have had to average 3.2% to hit the lower end of MAS's previous forecast range of 3-4% – a highly unlikely scenario – culminating in a 1%pt cut in the forecast to 2-3% in Jul. With the new lower bound of the MAS forecast range implying 2H13 inflation of just 1.2% and with Jul-Aug inflation already averaging 1.9%YoY, assuming a gradual rise in private road transport prices for the rest of the year, we expect full-year headline inflation to fall in the middle of the forecast range at 2.5%.

Meanwhile MAS core inflation has been largely within Apr expectations. 1H13 core averaged 1.6%, consistent with the MAS's expectation for core to stay "slightly above 1.5%", while Jul-Aug core averaged 1.7%, still within the expectations to rise to around 2% by the end of the year. ,

…Leave little reason to change MAS Policy

Two conditions have to be met before the MAS would ease policy. First, realized *historical* inflation data must surprise on the downside relative to MAS's earlier expectations. Second, there must be strong reasons for the MAS to downgrade its *forward*-looking inflation forecast, including a sharper than expected growth contraction that causes the output gap to turn negative. Similar to the situation in Apr, while the first condition of historical disappointments has been met for headline inflation, the second condition has not been met, with a likely rise especially in core inflation in line with Apr expectations.

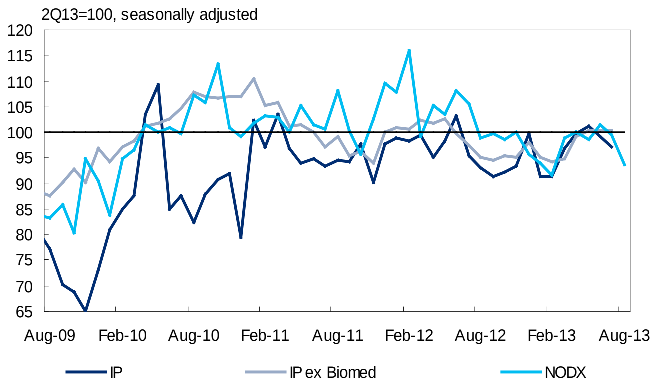
While the first condition has been met, the second has not and thus MAS could stand pat in Oct. Even as pressures from housing prices and COE remain under control, core inflation could climb to 2-2.5% in 2014, partly driven by cyclical output gap dynamics but also possibly the lagged impact of recent SGD weakness on import prices. Despite the cut in MAS's inflation forecast on historical downside surprises, aiming for downside inflation surprises relative to upwardly biased inflation forecasts appears to be part of MAS's strategy to anchor inflation expectations and thus should not trigger policy easing. While we expect core inflation to rise to 2-2.5% by early 2014 on the cyclical expansion, this rise is expected and still falls within the range of MAS (higher) tolerance thresholds. Alongside near term disinflationary forces from softer housing rentals, headline inflation should stay at 2-2.5% range through early 2014. Out of ten episodes when inflation forecasts were lowered since 2001, MAS only eased in four and even tightened in one.

Medium-term domestic disinflationary risks

We see three potential sources of medium-term disinflationary or even deflationary risks that need to be watched. [1] Cost competitiveness strains and supply constraints from economic restructuring could potentially temper the pace of recovery and core inflation as FDI slows and the SME sector consolidates. [2] Significant pipeline of housing supply from 2014 onwards may pressure property prices and rentals downwards. [3] Deleveraging in certain over-indebted segments of households could slow consumption spending, especially when interest rates rise (likely in 2015).

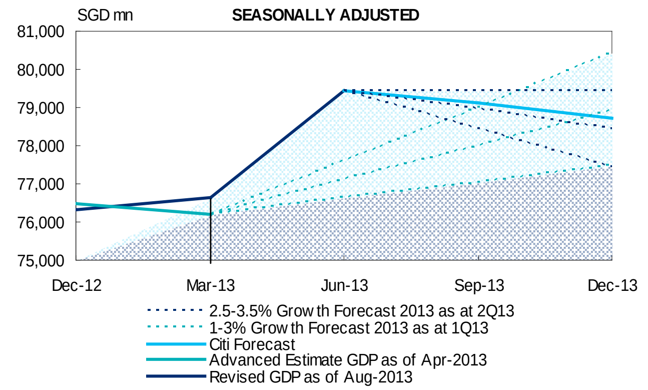
Only the first risk is likely to directly trigger a monetary policy response (which is less likely if the external recovery materializes). The latter two risks have in recent times coincided with periods of recessions and MAS easing, but if broader growth holds up this time, these will likely be tackled via sector-specific administrative and supply side measures. Any further delay of QE tapering may weaken the argument for MAS easing, as it could add to domestic liquidity risks amidst a tide of capital inflows. Indeed, a firmer recovery in external demand that offsets these domestic forces may even provide flexibility for MAS to tighten if core inflation breaches tolerance thresholds, more so that financial conditions remain accommodative while the recent imposition of TDSR will limit unintended consequences of low short-term rates from slope steepening.

Figure 75. Despite a likely pullback in 3Q13 GDP…



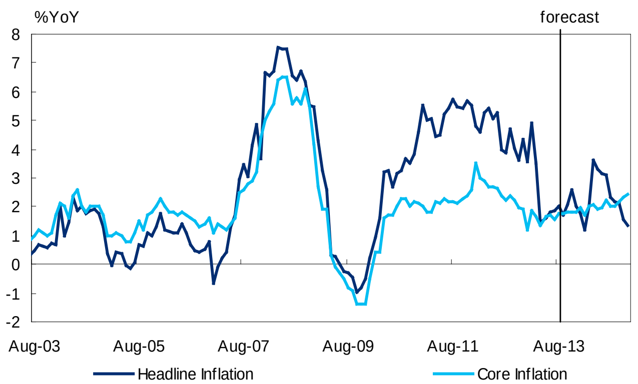
Source: CEIC, Citi Research

Figure 76. …this comes from elevated levels in 2Q



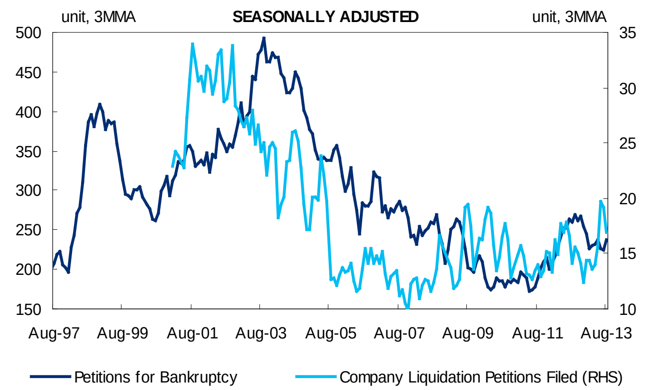
Source: CEIC, MTI, Citi Research. Note: MAS had projected 1-3% full-year 2013 growth as of Apr-2013 – we estimate the implied 1Q13 GDP levels based on GDP data as of 4Q12 adjusted by 1Q13 Advance Estimates. GDP data was subsequently revised as of 2Q13 and we estimate the implied straight-line GDP level projections to achieve the revised 2.5-3.5% full-year growth target in 2013.

Figure 77. Core inflation likely remains on an upward trajectory



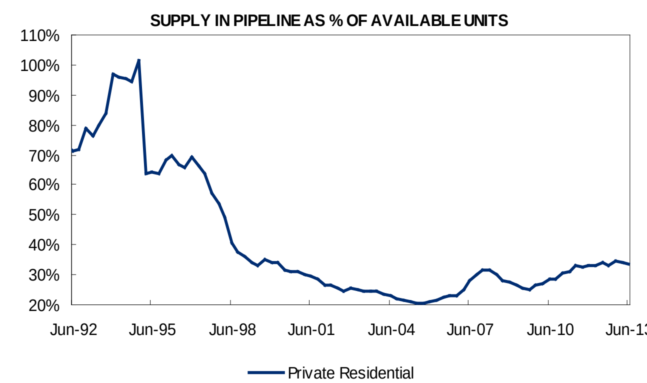
Source: CEIC, Citi Research

Figure 78. Strains from economic restructuring are showing



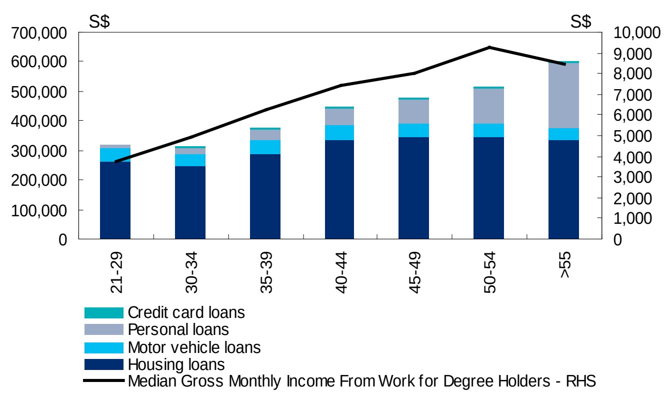
Source: CEIC, Citi Research

Figure 79. Potential supply of private residential property has risen



Source: CEIC, Citi Research

Figure 80. Certain segments of the population may be over-indebted



Source: Credit Bureau, Citi Research. Note: The graph depicts the relative size of the four major types of loans (using average loan value for each loan type) for each age group, and an average individual may not be exposed to all four types of loans. The median gross monthly income excludes employer CPF and sample only includes full-time employed residents, as of June 2012. For age group between 21-29, median income for degree holders aged 25-29 is used. For age group >55, median income for degree holders aged 55-59 is used.

Singapore

Figure 81. Singapore Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	145.8	178.2	190.8	189.4	232.2	265.8	276.8	290.1	315.7
Nominal GDP, local currency mn	231	268	270	275	316	334	346	363	388
GDP per capita, US$	33,131	38,827	39,434	37,970	45,741	51,275	52,098	53,695	57,400
Population, mn	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5
Unemployment, % of labour force	2.7	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8
Economic Activity									
Real GDP, % yoy	8.6	9.0	1.7	-0.8	14.8	5.2	1.3	3.2	4.0
Real investment growth % yoy	17.2	16.8	28.5	-21.0	5.4	12.7	26.8	1.9	-3.2
Real consumption growth % yoy	4.5	5.9	3.6	0.5	7.2	3.7	0.9	4.0	2.6
private consumption growth % yoy	4.5	6.7	2.9	-0.5	6.2	4.6	2.2	1.8	1.9
Real export growth, % yoy	10.8	9.0	5.0	-7.6	18.6	3.5	0.3	1.5	3.8
Real import growth, % yoy	11.1	8.1	9.6	-11.2	15.9	3.6	3.2	1.7	2.9
Prices, Money & Credit									
CPI, % yoy	0.8	3.7	5.5	-0.5	4.6	5.5	4.3	2.0	1.4
CPI, % avg	1.0	2.1	6.6	0.6	2.8	5.2	4.6	2.4	2.3
Nominal wages, % yoy	3.2	6.2	5.4	-2.7	5.6	6.0	2.3	5.0	5.5
Credit extension to private sector, % yoy	4.9	16.9	15.2	2.0	13.4	18.6	13.3	12.0	11.0
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
3 month inter-bank rate, % eop	3.44	2.38	1.00	0.69	0.44	0.38	0.38	0.35	0.40
Long term yield, % eop	3.05	2.68	2.05	2.66	2.71	1.63	1.30	2.50	3.00
lc/US$, eop	1.53	1.44	1.43	1.41	1.28	1.30	1.22	1.27	1.23
lc/US$, avg	1.59	1.51	1.41	1.45	1.36	1.26	1.25	1.26	1.25
Balance of Payments, US$ bn									
Current account	36.1	46.4	28.8	33.5	62.1	65.4	51.5	40.6	42.6
% of GDP	24.8	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5
Trade balance	50.6	57.8	42.8	49.3	66.0	72.7	61.0	59.8	66.0
Exports	281.0	312.5	354.5	288.6	371.2	434.4	436.0	443.9	456.0
Imports	230.4	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0
Service balance	-7.3	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.4	2.0
Income balance	-7.2	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-18.7	-24.0
FDI, net	18.1	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0
International reserves	136.3	163.0	174.2	187.8	225.8	237.7	259.3	260.0	270.0
Total Amortisations	--	--	--	--	--	--	--	--	--
Public Finances, % of GDP									
Consolidated government balance	0.0	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5
Consolidated gov primary balance	0.6	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0
Public debt	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
of which Domestic	89.2	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0
Foreign Assets & Liabilities, US$ bn									
External debt	--	--	--	--	--	--	--	--	--
Private	--	--	--	--	--	--	--	--	--
Public	--	--	--	--	--	--	--	--	--
External debt / GDP	--	--	--	--	--	--	--	--	--
External debt / XGS	--	--	--	--	--	--	--	--	--
Short-term debt	--	--	--	--	--	--	--	--	--
Short-term debt/International Reserves (%)	--	--	--	--	--	--	--	--	--

Quarterly Economic Indicators	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.2	3.8	4.9	3.9	4.2	2.2	4.7	4.9	3.4
CPI, % yoy	3.5	1.8	1.7	2.0	2.0	3.1	2.2	1.4	0.4
Policy interest rate, % eop	--	--	--	--	--	--	--	--	--
1 month inter-bank rate, % eop	0.38	0.38	0.35	0.35	0.35	0.35	0.35	0.40	0.45
Long term yield, % eop	1.54	2.51	2.50	2.50	2.60	2.75	2.90	3.00	3.00
lc vs USD, eop	1.24	1.27	1.27	1.27	1.27	1.26	1.25	1.23	1.21

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is general government debt.

South Korea

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- **Summary view** – Resilient job growth and a steady rise in nominal wage have been supporting a recovery in consumption. On the back of continued smartphone demand, exports outperformed expectations and imports of durable goods increased, sending a positive signal to investment.

- **Things to watch** – Housing market measures should be carried out without delay to secure the improving trend of the market. Besides cutbacks in welfare plans, the government could face more struggles between boosting the economy and keeping its pledges amid tax revenue deficiency.

- **Strategy** – While concerns over Fed tapering impact will likely continue, we expect the KRW to further gain against the USD to 1,050 in 0-3 months and to 1,040 in 6-12 months. Expecting continued economic rebound and subdued inflation, the BoK will likely keep the policy rate unchanged this year at the least.

Signs of consumption and investment recovery

Resilient job growth supports consumption pickup. Year-on-year job growth in Aug reached up to over 400K in eleven months, with the number of employed persons increasing sequentially for three consecutive months. The 3-month moving average of seasonally adjusted MoM job growth stayed in positive terrain since Feb this year. The services sector has been at the forefront of resilient job growth recently. In particular, jobs in human health and social work activities have shown a steady increase in tandem with government support on welfare such as childcare. We think solid job growth along with a steady rise in nominal wage gave momentum to consumption recovery. With broad-based gains in durables (especially autos), semi-durables, and non-durables, retail sales growth in July accelerated on MoM sa and YoY terms.

Aug trade data bode well for investment. Aug export growth came in stronger than expected at 7.7%YoY, up from 2.6% in Jul. Exports of IT goods continued to be driven by smartphone demand and auto and shipbuilding exports surged albeit partly on low base of a year ago. Amid concerns about the Fed tapering impact on Asian EM countries, exports to ASEAN rather saw a positive turnaround. Meanwhile, low raw materials price played the main role in slowing import growth to1.0%YoY from 3.2% in Jul. However, imports of capital goods – e.g. machineries and semiconductor manufacturing equipment – and consumer goods maintained positive growth, hinting at recovery of investment and consumption.

KRW to strengthen on sound economic fundamentals and external position. Despite worries over Fed tapering, the KRW has strengthened against the USD by about 4.5%, sliding down to 1,070 levels on 23 Sep from its previous peak of 1,123 on Aug 22nd. KRW even outperformed other EM currencies though some of them also gained against the USD. The main backdrop for the outperformance of KRW appears to be a continued large current account surplus, foreign net-purchase at stock markets (US$7.5bn during Aug 23rd-Sep 23rd), recent macro data confirming an economic recovery trend, and changes in composition of external debt (decreasing share of short-term debt and increasing share of long-term debt). We expect the recent trend to continue, with USD/KRW falling to 1,050 over the next three months and further to 1,040 in 6-12 months. However, the BoK may intervene via smoothing operation especially when USD/JPY rises further to over 100.

Housing market recovery riding government measures

Housing prices rising again on additional measures. Following the first round of government measures introduced on Apr 1st to normalize the housing market, housing prices and transactions picked up but retreated in Jul-Aug after the termination of acquisition tax cut at the end of Jun. Amid fear of housing price declines, potential homebuyers have delayed purchases of homes and their preference for Jeonse – Korea's unique type of home lease which requires to put down a lump-sum deposit which will be paid back when lease contract expires - has further pushed up Jeonse prices. On top of this, low interest rates leading landlords to switchover from Jeonse to monthly rent has exacerbated the shortage of Jeonse. However, since the government drew up a plan to stabilize the Jeonse/rental market on Aug 28th, housing prices recovered in the first two weeks of Sep, with increased transactions of first-time homebuyers.

Government plan should be carried out without setbacks to secure recovery. The outline of the bill proposed in late Aug includes carrying out market stabilizing measures to convert Jeonse demand to purchasing demand, increasing supply of public/private rental housing, reducing financial burdens of leaseholders, and resolving difficulties of tenants during the moving season in autumn. However, potential homebuyers are waiting for approval by the National Assembly on some of the stimulus measures proposed in Apr, e.g. vertical extensions of apartment buildings, and the permanent cut in property acquisition tax rate proposed in the additional plan. Though the government's introduction of additional measures had a positive impact on housing price recently, the National Assembly needs to pass the related laws as soon as possible to avoid setbacks and delays in implementation.

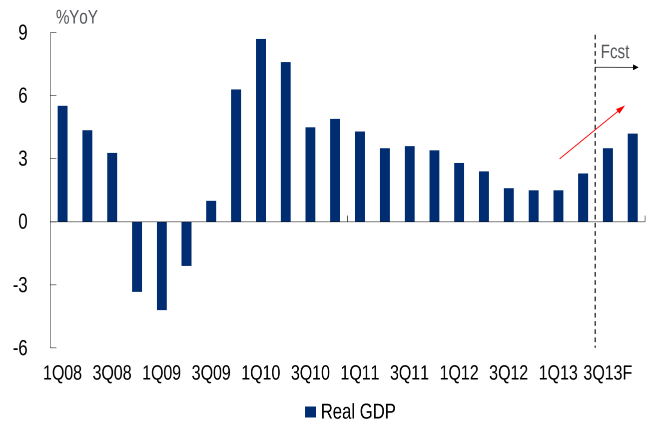
We continue to expect no policy rate change this year

Prospect of continued economic rebound and low inflation back rate hold. Despite heightened concerns over Fed tapering impact on market volatility and the Middle East geopolitical risk, the BoK left the policy rate unchanged at 2.50% for the fourth month in Sep, maintaining its view of continued economic recovery and subdued inflation going forward. CPI rose faster in Aug at 0.3%MoM but YoY inflation eased to 1.3%, and inflationary pressures from planned public tariff hikes in 2H – e.g. taxi and city bus fares, and electricity rates – will likely be offset by disinflationary pressures from commodities due to low raw materials price and strong KRW. We expect inflation to stay below the lower level of BoK's inflation target band (2.5-3.5%) and resilient job growth and steady, albeit gradual, rebound of exports to continue to maintain recovery in 2H. We maintain our view that the BoK will leave the policy rate unchanged for the remainder of the year.

Government confronts tax revenue shortfall

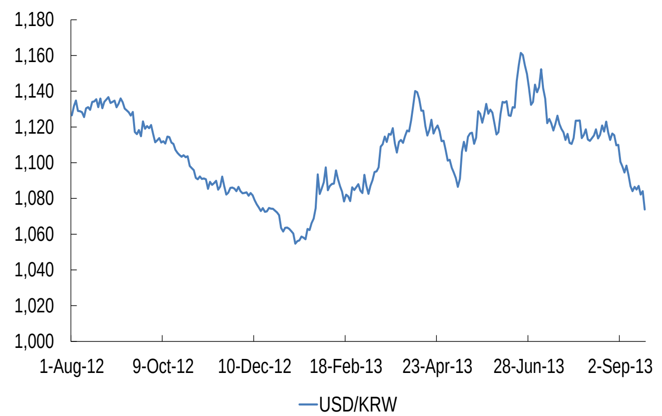
Tax revenue shortfall leads the government to scale back its welfare pledges. Tax revenues in 1H13 were down by KRW10.1trn compared to 1H12, with a fall in corporate tax and VAT revenues. As debate on corporate tax increases reignited, Finance Minister and Deputy Prime Minister Hyun Oh-seok asserted that tax increases could dampen economic recovery. Instead, while the government is drawing up a budget plan for 2014 assuming real GDP growth of 3.9%, the budget for education and welfare – particularly basic pension benefits for the elderly and full coverage of four major diseases – is to be trimmed to cope with the tax revenue deficiency. The government may face more struggles to keep its pledges if downside risks weigh on economic recovery.

Figure 82. We expect economic rebound to continue in 2H at 3.8%YoY



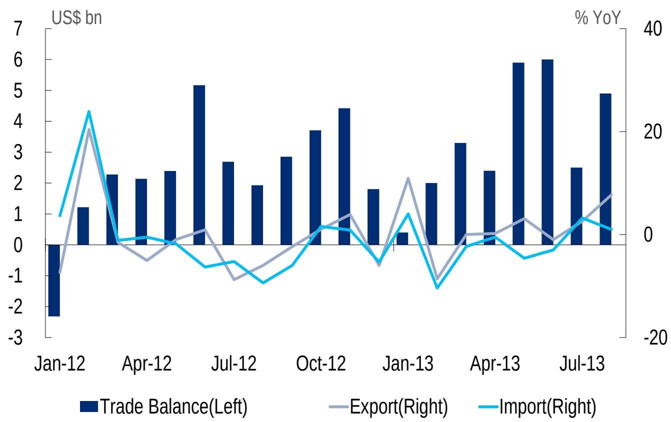
Source: Bank of Korea, Citi Research

Figure 83. KRW gained against USD on large current account surplus



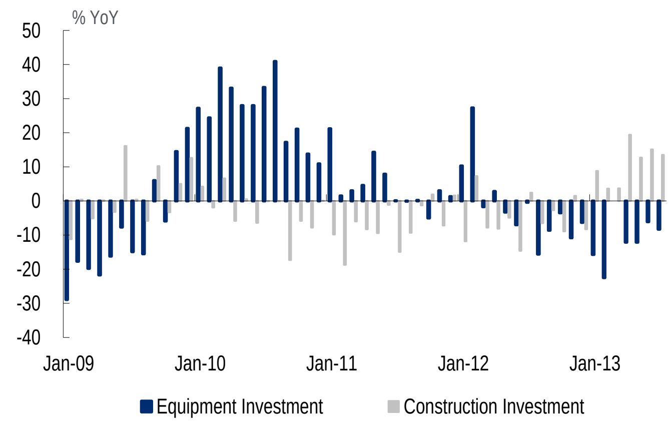
Source: Bank of Korea, CEIC, Citi Research

Figure 84. Better than expected exports bode well for investment



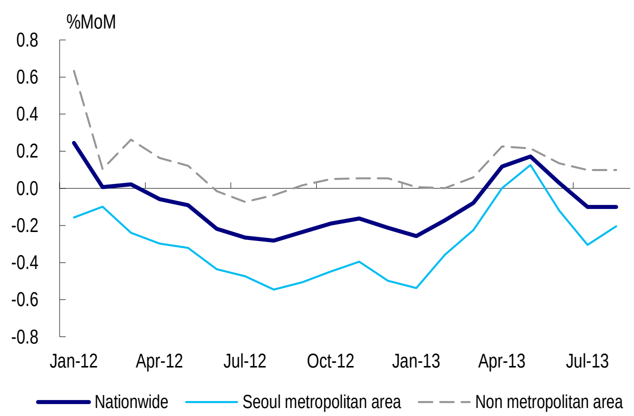
Source: Korea International Trade Association, Citi Research

Figure 85. Equipment investment sluggish but construction expanded



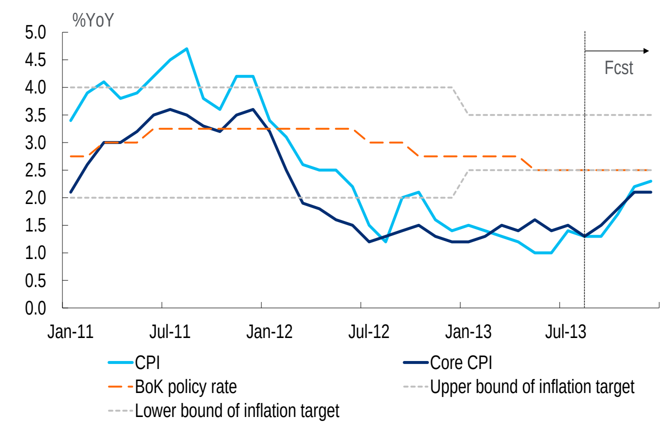
Source: Statistics Korea, Citi Research

Figure 86. Nationwide housing price fell after acquisition tax cut ended



Source: Korea Appraisal Board, Citi Research

Figure 87. Subdued inflation and policy rate to be on hold this year



Source: Bank of Korea, Citi Research Estimates

Figure 88. Korea Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	954.0	1,048.0	929.1	834.7	1,014.9	1,114.8	1,129.3	1,213.1	1,357.6
Nominal GDP, local currency bn	908,744	975,013	1,026,452	1,065,037	1,173,275	1,235,161	1,272,460	1,323,260	1,402,706
GDP per capita, US$	19,722	21,565	18,981	16,972	20,540	22,395	22,584	24,156	26,924
Population, mn	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4
Unemployment, % of labour force	3.5	3.2	3.2	3.6	3.7	3.4	3.2	3.2	3.2
Economic Activity									
Real GDP, % yoy	5.2	5.1	2.3	0.3	6.3	3.7	2.0	2.9	3.7
Real investment growth % yoy	4.4	3.5	0.0	-13.5	15.8	1.4	-1.8	1.6	3.5
Real consumption growth % yoy	5.1	5.1	2.0	1.2	4.1	2.3	2.2	2.2	2.8
private consumption growth % yoy	4.7	5.1	1.3	0.0	4.4	2.4	1.7	1.7	2.9
Real export growth, % yoy	11.4	12.6	6.6	-1.2	14.7	9.1	4.2	5.7	6.2
Real import growth, % yoy	11.3	11.7	4.4	-8.0	17.3	6.1	2.5	4.6	6.1
Prices, Money & Credit									
CPI, % yoy	2.1	3.6	4.1	2.8	3.0	4.2	1.4	2.3	2.6
CPI, % avg	2.2	2.5	4.7	2.8	3.0	4.0	2.2	1.5	2.5
Nominal wages, % yoy	5.7	5.6	-4.1	2.6	6.8	1.0	5.3	4.3	5.2
Credit extension to private sector, % yoy	14.7	12.4	15.0	2.3	3.6	5.1	1.9	5.3	7.0
Policy interest rate, % eop	4.50	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50
91-Day CD Rate, % eop	4.76	5.73	4.68	2.82	2.80	3.55	2.89	2.70	2.75
Long term yield, % eop	5.00	5.78	3.77	4.92	4.08	3.46	2.97	3.35	3.65
lc/US$, eop	930	936	1263	1166	1121	1159	1064	1127	1052
lc/US$, avg	955	929	1102	1275	1156	1108	1127	1130	1086
Balance of Payments, US$ bn									
Current account	14.1	21.8	3.2	32.8	29.4	26.1	43.1	51.9	32.7
% of GDP	1.5	2.1	0.3	3.9	2.9	2.3	3.8	4.3	2.4
Trade balance	16.1	14.6	-13.3	40.4	41.2	30.8	28.3	31.5	17.9
Exports	325.5	371.5	422.0	363.5	466.4	555.2	547.9	557.9	587.4
Imports	309.4	356.8	435.3	323.1	425.2	524.4	519.6	526.4	569.5
Service balance	-13.3	-12.0	-5.7	-6.6	-8.6	-5.8	2.7	5.9	7.8
Income balance	-4.0	-3.4	3.8	1.6	-2.1	0.3	2.1	3.1	0.3
FDI, net	-7.6	-17.9	-16.9	-14.9	-22.2	-16.4	-18.6	-12.5	-8.6
International reserves	238.9	262.2	201.1	270.0	291.5	304.2	323.2	331.1	345.7
Total Amortisations	17.7	43.8	42.9	43.6	40.0	42.0	46.0	44.0	41.0
Public Finances, % of GDP									
Consolidated government balance	0.4	3.5	1.2	-1.7	1.4	1.5	1.5	0.9	2.3
Consolidated gov primary balance	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.3	3.7
Public debt	30.1	29.7	29.0	32.5	31.9	32.6	33.0	35.0	33.0
of which Domestic	28.9	28.6	28.1	31.4	31.0	31.8	32.6	34.4	32.3
Foreign Assets & Liabilities, US$ bn									
External debt	225.2	333.4	317.4	345.7	359.8	398.7	413.6	426.0	441.8
Private	225.0	333.1	317.1	345.4	359.4	358.3	373.4	384.8	399.6
Public	0.2	0.3	0.3	0.3	0.4	40.4	40.2	41.2	42.2
External debt / GDP	23.6	31.8	34.2	41.4	35.5	35.8	36.6	35.1	32.5
External debt / XGS	58.9	75.0	61.9	79.1	65.0	61.3	63.0	63.4	61.7
Short-term debt	113.8	160.3	149.9	149.2	139.8	137.4	126.7	130.3	140.4
Short-term debt/International Reserves (%)	47.6	61.1	74.5	55.3	48.0	45.2	39.2	39.4	40.6

Quarterly Economic Indicators

	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.5	2.3	3.5	4.2	4.0	3.7	3.7	3.4	3.7
CPI, % yoy	1.3	1.0	1.3	2.3	2.1	2.7	2.6	2.6	3.0
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75
91-Day CD Rate, % eop	2.81	2.69	2.70	2.70	2.75	2.75	2.75	2.75	2.90
Long term yield, % eop	2.58	3.14	3.30	3.35	3.45	3.60	3.65	3.65	3.75
lc vs USD, eop	1111	1142	1138	1127	1116	1099	1076	1052	1030

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Taiwan

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- **Summary view** – Recovery momentum could pick up in 4Q on the back of stronger semiconductor sales. Fed postponing tapering and China stabilization are positive for Taiwan exports. August deflation print likely to be a temporary phenomenon but inflation will be kept benign with nascent macro recovery.

- **Things to watch** – 1) September political fallout could delay ECFA of services & key policies; 2) Potential revisions on the luxury tax; 3) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for the broader goods; 4) FTA signing with Singapore; 5) Pension reform; 6) 2014's “7-in-1” local elections.

- **Strategy** – Recent foreign equity interests in the local stock market and reversal in EM FX weakness likely to provide near term support to the TWD. 10Y gvt bond yields retreated in the latest auction and higher risk appetite post US’s delay in tapering. Our equity strategist has a TAIEX year end target of 8,500.

Trade sponsored recovery intact for rest of the year

GDP recovery likely to pick up pace in 2H, especially with 4Q potentially benefiting from a more meaningful trade recovery, against the backdrop of China’s economy stabilizing somewhat and the Fed’s extended accommodation. Net trade recovery in 3Q appears associated with chemical exports and imports slowdown due to falling commodity prices, but 4Q recovery is likely to be more driven by an increase in tech exports. We think exports of components of the various new tech products will increase in coming months, especially as Taiwanese firms have won a larger mandate for semiconductor production at year-end. Also recent stabilization of the Chinese economy (albeit 3Q outperformance has been boosted by favorable base) adds some comfort to near term Taiwanese exports to China; however, as we maintain our house view that 4Q Chinese economy could see more downside risk, we will need to monitor closely whether 4Q could see better prospects beyond just the semiconductor boost. Meanwhile, TIER’s July survey indicated that petroleum/coal production, securities, retails, transportation and storage businesses are more optimistic on outlook.

Politics could delay pro-investment policies

September's political struggle. In early September, President Ma, in his capacity as KMT chairman, had demanded that the KMT disciplinary committee to revoke Wang Jin-pyng's party membership, and hence remove him from the post of the legislative yuan speaker. The denunciation was based on Wang’s alleged influence peddling in the court proceedings in a case involving a prominent opposition legislator. A subsequent court injunction was granted to Wang to temporarily allow him to stay as a KMT member and speaker of the legislature, which the injunction would undergo high-court hearing this week.

Politics instability adds challenges to cross-strait cooperation. The immediate impact of this series of political events was the delay in the debate between the two parties on ECFA of services (an agreement that was signed back in June, but implementation is pending this debate and approval by Legislative Yuan). If serious further delays were to happen for the implementation of ECFA of services, this could in turn weigh on the timing of cross-strait agreement on ECFA for the broader goods list (although cross-strait negotiations are still ongoing). Other key policies initiatives to invigorate the economy, namely the free economic zone (FEZ), could subsequently be postponed. These together could put Taiwanese businesses’ expansion plans on hold, as the anticipated larger customer base post ECFA tariff reduction and liberalization in FEZ are now further in reach.

New FSC chairman pro financial liberalization stance

Positive market reaction towards Mr. Tseng Ming-chung as new FSC chairman. In the latest cabinet reshuffle, previous vice finance minister Tseng replaced Mr. Chen Yuh-chang as chairman of the FSC. This move boosted hopes that Tseng will be more aggressive than Chen in pushing for financial market liberalization and allowing more market friendly practices in Taiwan. Indeed, Tseng, at his swearing-in ceremony, said he aims to push for consolidation in the local banking industry to strength the sector's competitive edge. Since Tseng took office, the FSC has unveiled three de-regulating measures to help spur stock market activity: 1) allow same day trading starting early Jan14; 2) allow eligible securities to be shorted lower than their previous closing prices; 3) install a temporary measure till Mar 8, 2014 for brokerage firms to trade securities on their own account at +/-7% previous closing prices. In addition, FSC has disclosed that they will allow insurance companies to sell RMB denominated life insurance policies before year end. Proactive policy changes by the FSC and the continual theme of RMB banking and greater business opportunities in China for Taiwanese banks and brokerages appear to be generating foreign interest in Taiwanese financial equities. See also our banking analyst Bradford Ti's note: Taiwan Financials - FINI Buy & Sell: Inflows Resume MTD Sep, but Select Names Benefit More than Most.

Fund flows with China's tightening and Fed's non-tapering

Taiwanese bank providing offshore funding to China: Loan growth picked up in June and July at 2.9%YoY and 3%YoY, respectively, higher than the 2% average seen in the first five months of the year, as much more loans were made out in June (NT$106.3bn) and July (NT$175.1bn). We note that this coincides with funding tightness seen in China which was amplified in June with the Shibor surge.

Portfolio fund flows: Since late August we have seen US$3.7bn of foreign net purchase in Taiwan equities, which brings the YTD net buy to US$4.1bn. This has come as Fed tapering speculation led money out of countries in ASEAN and India, to places with high foreign reserves like Taiwan and Korea.

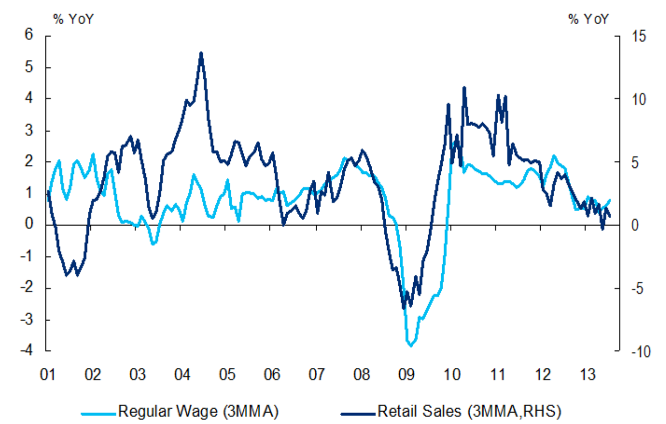
Near term NTD could strengthen to 29.2/USD in 0-3 months given better 2H economic prospects, China economy stabilizing, Fed's non-tapering, some reversal in EM weakness, plus foreign interests in Taiwanese equity market.

10Y government bond yield still on a gradual uptrend, despite recent pullback. We have adjusted downwards our forecasts to reflect spot started coming off since latest 10Y bond auction, and further retreated with surprise FOMC result; however, with Fed tapering still likely before Jan14 and better domestic economic fundaments market rates will again start to edge up in our forecast horizon.

Low inflation (but no deflation) prospects

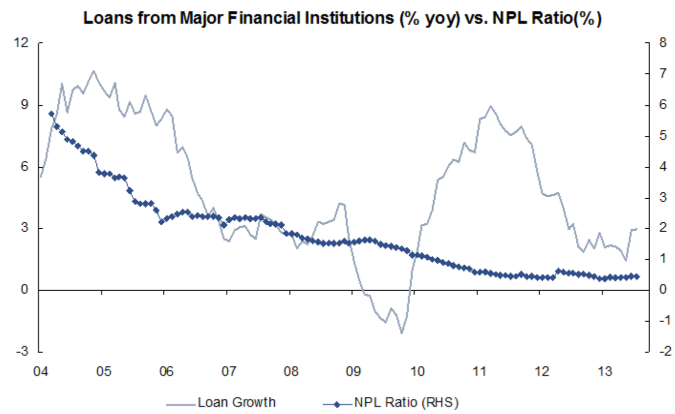
Aug CPI deflation likely temporary. Aug CPI inflation posted a drop of -0.79% YoY, on lower food and electronics prices. The unexpected deflation print was due to a weather-related distortion to fruits and vegetable prices as damage from last year's typhoons had a worse impact on crop prices. However, intense competition of electronics vendors has led to continuous discounts/promotions for many electronics and this will likely continue to drive disinflation. With the upcoming launches of various new electronics products, the trend can be reversed. Looking at the core CPI (which is ex-food and energy), inflation is relatively stable as it only mildly retreated by 0.02ppt in Aug to 0.48%YoY from 0.5%YoY in Jul. The second phase of electricity hike (+8.49% on average) will add 0.19ppt to the inflation bill in Oct and 0.05ppt in 2013, according to DGBAS estimate.

Figure 89. Wage growth improving gently, consumption lags



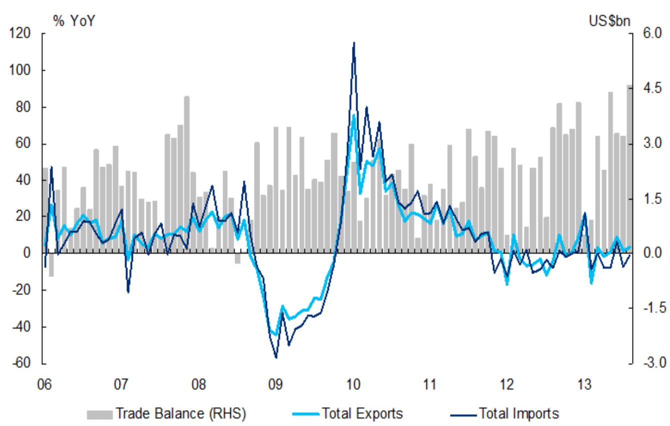
Source: CEIC, Citi Research

Figure 90. Loan growth picking up since June Shibor surge in China



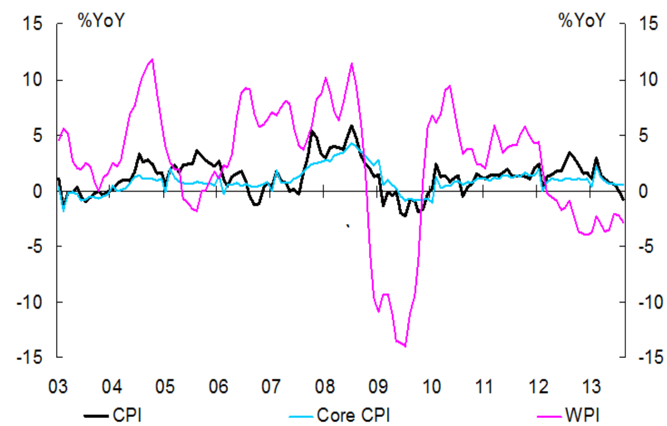
Source: CEIC, Citi Research

Figure 91. Trade is on a bumpy but recovering ride



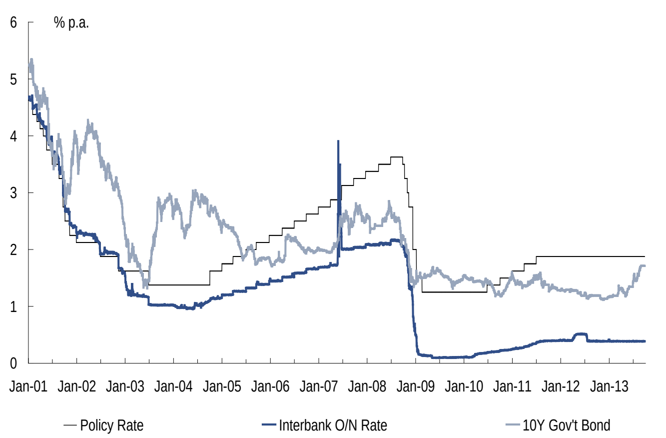
Source: CEIC, Citi Research

Figure 92. Deflation seen in Aug likely temporary



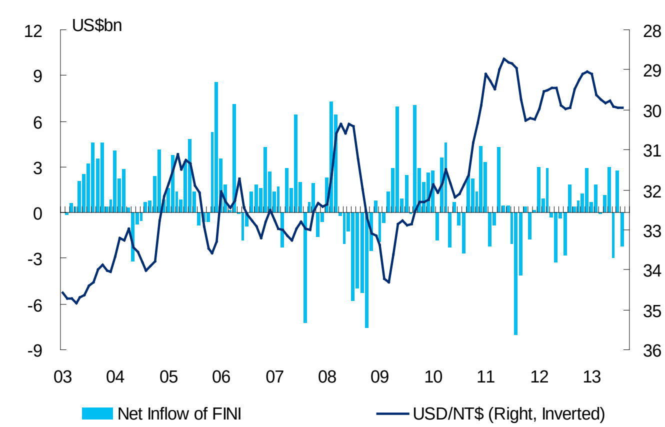
Source: CEIC, Citi Research

Figure 93. 10Y gvt bonds lowered post auction & Fed no-tapering



Source: CEIC, Citi Research

Figure 94. TWD seeing support from FINI inflows in Sep



Source: CEIC, Citi Research

Figure 95. Taiwan Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	376.3	393.1	400.2	377.6	428.2	464.0	474.0	491.5	520.3
Nominal GDP, local currency bn	12,243	12,911	12,620	12,481	13,552	13,674	14,037	14,569	15,369
GDP per capita, US$	16,513	17,191	17,444	16,404	18,574	20,078	20,437	21,151	22,345
Population, mn	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.2	23.3
Unemployment, % of labour force	3.9	3.9	4.1	5.8	5.2	4.4	4.2	4.1	4.0
Economic Activity									
Real GDP, % yoy	5.4	6.0	0.7	-1.8	10.8	4.1	1.3	2.6	3.8
Real investment growth % yoy	0.5	-0.7	-7.9	-21.2	36.8	-7.5	-4.2	2.9	5.0
Real consumption growth % yoy	1.1	2.1	-0.6	1.3	3.3	3.0	1.3	1.5	2.3
private consumption growth % yoy	1.5	2.1	-0.9	0.8	4.0	3.1	1.5	1.7	2.7
Real export growth, % yoy	11.4	9.6	0.9	-8.7	25.6	4.4	0.1	5.2	4.8
Real import growth, % yoy	4.6	3.0	-3.7	-13.1	27.7	-0.5	-1.9	4.9	3.8
Prices, Money & Credit									
CPI, % yoy	0.7	3.3	1.3	-0.2	1.2	2.0	1.6	2.3	1.7
CPI, % avg	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	1.2	1.7
Nominal wages, % yoy	0.8	2.1	0.0	-4.9	5.5	2.7	0.3	1.8	3.0
Credit extension to private sector, % yoy	4.7	3.9	2.7	-0.8	6.7	5.7	4.2	5.5	7.0
Policy interest rate, % eop	2.75	3.38	2.00	1.25	1.63	1.88	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.69	2.04	1.02	0.57	0.74	0.87	0.87	0.87	1.05
Long term yield, % eop	1.99	2.53	1.44	1.47	1.47	1.27	1.15	1.68	2.18
lc/US$, eop	32.59	32.43	32.78	32.23	29.17	30.29	29.06	30.07	29.45
lc/US$, avg	32.52	32.85	31.58	33.04	31.50	29.40	29.57	30.01	29.71
Balance of Payments, US$ bn									
Current account	26.3	35.2	27.5	42.9	39.9	41.2	49.9	49.6	46.8
% of GDP	7.0	8.9	6.9	11.4	9.3	8.9	10.5	10.1	9.0
Trade balance	11.6	16.8	4.4	20.3	11.0	11.3	14.4	27.2	48.2
Exports	213.2	235.1	243.8	193.8	261.6	291.9	284.2	294.4	317.3
Imports	201.6	218.2	239.5	173.5	250.5	280.6	269.8	267.2	269.1
Service balance	-3.5	-1.6	1.9	2.0	2.5	3.9	6.1	11.2	-3.6
Income balance	9.6	10.1	10.0	12.5	13.6	13.2	15.3	17.5	19.0
FDI, net	0.0	-3.3	-4.9	-3.1	-9.1	-14.7	-9.8	-8.5	-7.0
International reserves	266.1	270.3	291.7	348.2	382.0	385.5	403.2	420.0	440.0
Total Amortisations	5.8	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0
Public Finances, % of GDP									
Consolidated government balance	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.2	-1.3
Consolidated gov primary balance	1.2	1.3	0.5	-2.5	-1.5	-1.0	-0.7	-0.4	-0.6
Public debt	34.2	33.3	34.7	38.0	38.3	40.1	40.9	41.1	41.0
of which Domestic	34.1	33.3	34.7	38.0	38.2	40.1	40.9	41.1	41.0
Foreign Assets & Liabilities, US$ bn									
External debt	85.8	94.5	90.4	82.0	101.6	122.5	130.8	132.8	134.3
Private	75.2	91.1	88.9	76.0	93.5	118.0	127.5	129.1	130.3
Public	10.6	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0
External debt / GDP	22.8	24.0	22.6	21.7	23.7	26.4	27.6	27.0	25.8
External debt / XGS	33.5	33.4	30.9	34.7	32.1	34.7	37.5	35.8	33.9
Short-term debt	74.2	83.3	78.8	68.2	83.7	107.8	116.5	115.0	110.0
Short-term debt/International Reserves (%)	27.9	30.8	27.0	19.6	21.9	28.0	28.9	27.4	25.0

Quarterly Economic Indicators	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.6	2.5	2.9	3.4	3.1	4.7	3.9	3.7	4.0
CPI, % yoy	1.8	0.8	1.3	2.3	2.6	1.6	1.4	2.4	3.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13	2.25
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.93	0.99	0.99	1.05	1.05	1.11
Long term yield, % eop	1.31	1.41	1.63	1.68	1.78	1.88	2.03	2.18	2.33
lc vs USD, eop	29.83	29.96	30.18	30.07	29.96	29.81	29.63	29.45	29.27

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Thailand

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- **Summary view** – Our GDP forecasts of 4.1% in 2013 and 4.4% in 2014 are unchanged. Strong pressure on public investments to deliver in 2H13. Roll out of hefty FDI approvals timed with export recovery could be another upside. Car sales growth of 6.3%MoM SA in Aug may signal durable goods demand upturn.

- **Things to watch** – Core disinflation still has room to go. Accommodative policy rate to stay as well as preference for weak THB. Sizeable FDI approvals but roll-out still awaited. Whether the legal challenge following approval of Bt2tn public investment program would delay public investments.

- **Strategy** – Lackluster THB prospects to stay unless downside growth risk eases and export recovery mitigates current account deficit risk. Likely peak of THB weakness is 2Q14 close to 32. Benign FY14 fiscal deficit outlook provides bond market relief although wary of SBI debt flare up and fiscal funding implications.

Persistent downside risk to 2H growth

We are maintaining our FY13 GDP growth forecast of 4.1% and our FY14 GDP forecast of 4.4%. With exports continuing to underperform, there is more pressure on the fiscal side and other domestic demand components to uplift 2H growth. Downside risk to growth would probably extend in 3Q13 although not as severe as in 2Q13 when central government spending appeared lost amid a primary fiscal surplus that ballooned to Bt171bn. Fiscal expenditures seasonally ease (or primary surpluses built up in the 2H of government's fiscal year. Extending the 10-month fiscal data trend, we obtain primary fiscal spending growth of 8.9%YoY in 3Q13 (4QFY13) probably be dominated by cash transfers/subsidies.

Further scrutiny of fiscal data indicated likelihood that the cash disbursements under the FY13 budget probably depicted infra 'underspending' coupled with current expenditures 'overshooting' the FY13 target. Using the existing Oct-July FY13 fiscal data and comparing this with the published annual program targets, cash disbursements for infra spending probably fell short of the FY13 infra spending target of Bt450bn by Bt200bn. Admittedly capex of state owned enterprises (SOE) may be included in this infra spending target but bulk of this should be central government. SOE may be the saving grace if we base it on 2Q13 GDP accounts that highlighted 50% growth of SOE capex that uplifted public investments by 14.8%YoY. SOE's construction expanded 12%YoY while central/local governments' construction expenditures fell 2.6%YoY in 2Q13.

Rather than allow this to translate into a FY surplus, available resources due to slippage on fiscal investments in FY13 may have been diverted to current expenditures ex-interest. This net fiscal item could swell past the FY13 program by Bt304bn in our estimate although there are strong indications that government may want to phase out/down some of these costly stimulus programs eg rice subsidy/rubber subsidies. This still highlights fiscal preference in FY13 to downplay infra spending for quick disbursing current expenditures, eg 'economic grants'.

Underperforming exports reinforced much of de-stocking bias in manufacturing. Broad manufactured exports fell 1.2%YoY in July, led by a 3.1%YoY decline in industrial exports. The mfg output of the export cluster declined by 8.1%YoY in July or more than the export drop to highlight severe inventory adjustments rather than cut labor for now. Lacking material improvement in external demand amid fiscal spending on the current expenditures probably close to being maxed out, downside risk to our 2H13 forecasts remains elevated.

Car sales up 6.3%MoM SA in Aug that may signal recovery

Consumer backdrop doesn't appear as upbeat if one were to consider downbeat consumer sentiment in Aug for the 5th straight month alongside car sales decline by over 20%YoY for the 2nd straight month in Aug. In the survey consumer respondents expressed deteriorating future expectations (-1.2ppt) compared to the current period (-0.7ppt), which has been a firm trend since Apr. Lackluster sentiment was coincident with a technical recession in 2Q13 driven by declining real consumption (-1.9%QoQ SA) that extended 1Q weakness (-1.3%QoQ SA). Behind declining consumption was a 16.6%QoQ SA contraction in durable goods demand. However in Aug, we estimated seasonally adjusted car sales rose sharply 6.3%MoM SA to snap out of 4 straight monthly declines. Despite phase out of government's first car, tax rebate program amid BoT's warning of rising HH debt, consumer credit still posted 13.6%YoY growth in July although at a slower pace, that can support fledgling recovery in car demand.

FDI approvals at Bt349bn as of Aug

FDI approvals continue to climb as of Aug although down only by 1.6%YoY from last year's record pace. Current FDI approvals did not shrink materially after last year's record high (~5% of GDP) owing to the post-deluge spending to rehabilitate damaged production capacity. Problem is that roll out of these FDI approvals appear to be at a slow pace largely due to export slack in our view. Export recovery could be coincident with faster capex. Alongside private construction flagged by buoyant cement sales and construction permits that bucked the capex slowdown, we sense upside risk to 2H13 investment outlook.

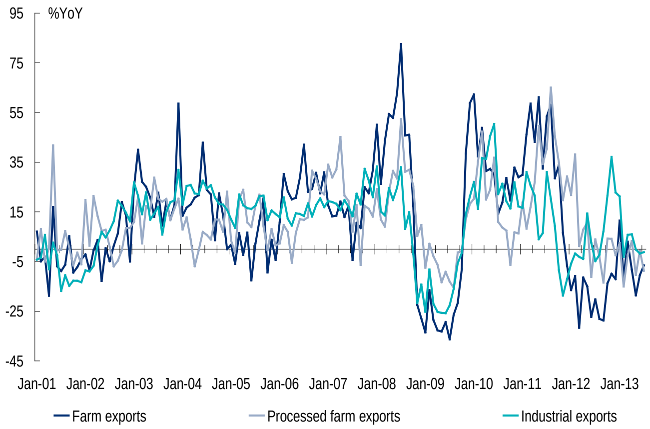
Benign fiscal deficit outlook in FY14

We expect to see an FY13 budget deficit at Bt308bn (2.6% of FY13F GDP) likely to breach the FY13 fiscal gap target of Bt251bn (ex-repayments). The planned FY14 budget entails a lower fiscal deficit target of Bt250bn. Ex-principal payments, the fiscal deficit target narrows to Bt184bn, down 26.7%. Benign FY14 fiscal deficit target could signal gradual 'expensing out' of potential fiscal losses from the off-budget spending. Government expenditures ex-repayment would be expanding (4.6%) by less than the planned revenue target (8.3%). The capital outlay target of Bt442bn would be 2% less than the FY13 infra spending target. We don't expect to see a repeat of overspending in the current expenditures coupled with infra underspending with government's planned shift to more public investments over the medium-term (Bt2tn public investment program). Lacking 'off-budget' spending dynamics with more emphasis on pubic investments that's in the soon to be approved budget, would help improve market sentiment on fiscal debt.

Maintaining lackluster THB view

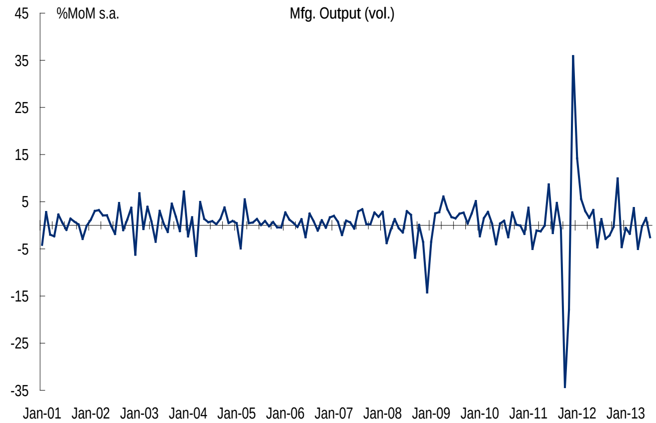
Unless growth headwinds dissipate and export recovery mitigates current account funding risk, THB could stay vulnerable to strong USD/Fed taper risk. We expect THB weakness to peak at 31.90 in 2Q14 before correction to the 30-31 range materializes. While current account funding risk is not due to trade deterioration but steady net outflows from services and income accounts traced to familiar freight payments and profit/divided repatriation owing to Thailand's huge multinational base, THB remains handicapped by the twin deficit risk during a period of tightening global liquidity. Amid fiscal dynamics of infra underspending and current expenditures overshooting in FY13, government resorted to cash drawdowns in funding the fiscal gap while curbing fiscal borrowings (-51%YoY for Oct-July). Benign FY14 fiscal deficit outlook provides near-term market relief while wary of SFI debt (+98.9%YoY as of June) due to effects of off-budget spending.

Figure 96. Exports still mired in negative territory despite its diversity



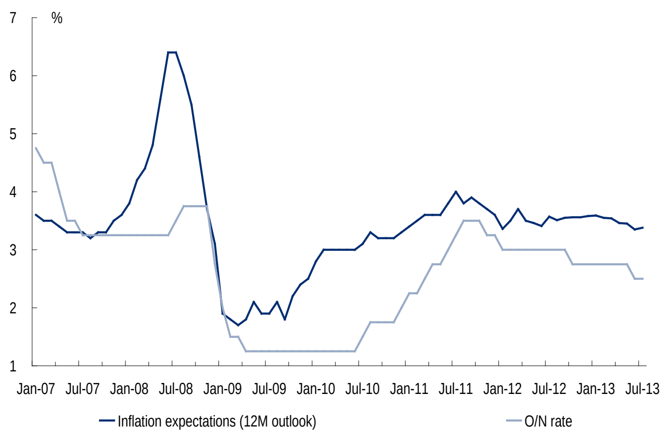
Source: CEIC, Citi Research

Figure 97. ...as such, mfg. index continues to flag shallow weakness



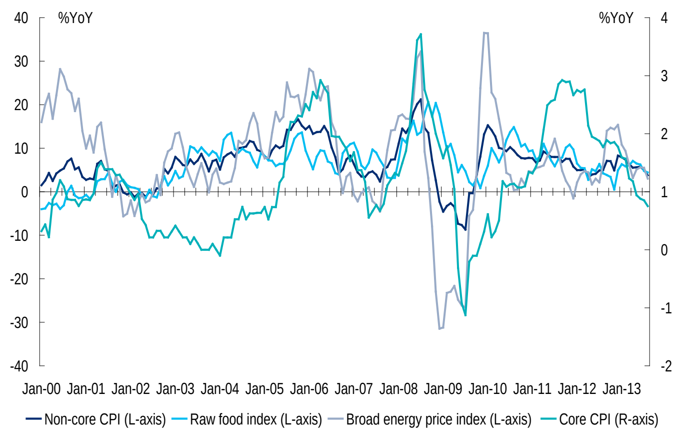
Source: CEIC, Citi Research

Figure 98. Inflation outlooks inched up in Jul to disrupt waning trend



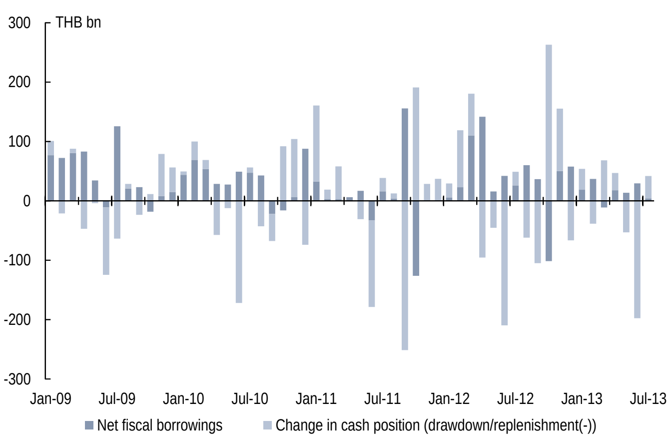
Source: CEIC, Citi Research

Figure 99. Resilient Aug core disinflation despite non-core CPI upticks



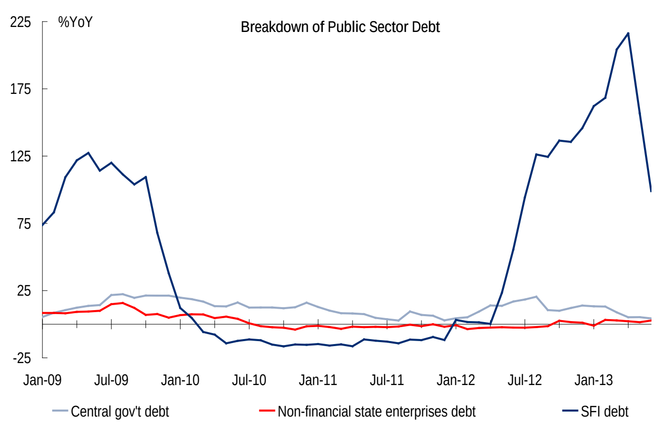
Source: CEIC, Citi Research

Figure 100. Net fiscal borrowings fell 51%YoY in the ten months to Jul



Source: CEIC, Citi Research

Figure 101. SFI debt explosion behind rising public sector debt



Source: CEIC, Citi Research

Figure 102. Thailand Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, US$ bn	207.4	265.2	276.1	263.8	319.3	346.1	366.4	390.7	404.9
Nominal GDP, local currency bn	7,845	8,525	9,080	9,042	10,105	10,540	11,375	12,120	12,942
GDP per capita, US$	3,301	4,207	4,355	4,153	4,998	5,401	5,685	6,031	6,219
Population, mn	62.8	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1
Unemployment, % of labour force	1.5	1.4	1.4	1.5	1.0	0.7	0.7	0.8	1.0
Economic Activity									
Real GDP, % yoy	5.1	5.0	2.5	-2.3	7.8	0.1	6.5	4.0	4.4
Real investment growth % yoy	-3.6	1.0	8.1	-25.2	28.7	0.1	16.8	5.4	13.3
Real consumption growth % yoy	3.0	2.9	2.9	0.1	5.1	1.3	6.8	3.2	3.4
private consumption growth % yoy	3.2	1.8	2.9	-1.1	4.8	1.3	6.7	3.1	3.3
Real export growth, % yoy	9.1	7.8	5.1	-12.5	14.7	9.5	3.1	5.8	5.4
Real import growth, % yoy	3.3	4.4	8.9	-21.5	21.5	13.7	6.2	5.8	8.2
Prices, Money & Credit									
CPI, % yoy	3.6	3.1	0.4	3.5	3.1	3.5	3.6	2.1	2.6
CPI, % avg	4.6	2.2	5.5	-0.9	3.3	3.8	3.0	2.4	2.3
Nominal wages, % yoy	5.8	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0
Credit extension to private sector, % yoy	4.5	29.3	6.3	2.5	18.9	18.2	13.7	13.5	11.5
Policy interest rate, % eop	5.00	3.25	2.75	1.25	2.00	3.25	2.75	2.50	3.00
1 month inter-bank rate, % eop	5.22	3.74	3.07	1.28	2.03	3.26	2.79	2.55	3.15
Long term yield, % eop	5.04	5.13	2.84	4.37	3.74	3.28	3.55	3.85	4.00
lc/US$, eop	35.45	30.05	34.79	33.36	30.07	31.57	30.60	31.55	30.95
lc/US$, avg	37.93	32.33	33.03	34.33	31.71	30.48	31.08	30.78	31.49
Balance of Payments, US$ bn									
Current account	2.3	15.7	2.2	21.9	10.0	5.9	0.2	-3.3	-4.2
% of GDP	1.1	5.9	0.8	8.3	3.1	1.7	0.0	-0.8	-1.0
Trade balance	13.7	26.6	17.3	32.6	29.8	17.0	6.0	1.8	-0.3
Exports	127.9	151.3	175.2	150.8	191.6	219.1	225.9	233.8	253.2
Imports	114.3	124.6	157.9	118.2	161.9	202.1	219.9	232.0	253.5
Net service and Transfer accounts	-8.0	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	-2.5	-3.0
Income balance	-3.4	-3.0	-2.3	-4.4	-9.0	-0.5	-2.4	-2.6	-0.9
FDI, net	8.5	8.3	4.4	0.7	4.5	-0.4	-4.9	-0.7	2.2
International reserves	67.0	87.5	111.0	138.4	172.1	175.1	181.6	185.0	197.8
Total Amortisations	12.8	20.5	15.0	10.7	9.4	8.9	17.3	18.0	19.0
Public Finances, % of GDP									
Consolidated government balance	-0.7	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-2.6	-2.3
Consolidated gov primary balance	0.9	-0.3	0.2	-4.5	1.2	0.2	-0.8	-1.7	-1.3
Public debt	40.3	37.4	38.2	43.9	42.4	40.8	43.6	47.5	48.0
of which Domestic	34.3	32.7	33.7	39.7	38.8	37.5	40.5	41.2	42.3
Foreign Assets & Liabilities, US$ bn									
External debt	70.0	74.4	76.1	75.3	100.6	104.6	133.2	132.3	135.0
Private	64.7	71.6	72.7	69.4	87.9	88.4	107.0	106.7	108.4
Public	5.2	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6
External debt / GDP	33.7	28.1	27.6	28.5	31.5	30.2	36.4	33.9	33.3
External debt / XGS	45.9	41.0	36.5	41.6	44.5	40.1	48.4	46.0	43.4
Short-term debt	27.2	34.0	33.6	33.1	50.7	47.3	60.6	60.0	59.8
Short-term debt/International Reserves (%)	40.7	38.9	30.3	23.9	29.4	27.0	33.4	32.4	30.2

Quarterly Economic Indicators	2013 Q1	2013 Q2	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	5.4	2.8	3.8	4.2	3.9	4.2	4.6	4.8	5.0
CPI, % yoy	2.7	2.3	2.2	2.1	2.1	2.3	2.4	2.6	2.8
Policy interest rate, % eop	2.75	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00
1 month inter-bank rate, % eop	2.79	2.53	2.55	2.55	2.55	2.60	2.85	3.15	3.15
Long term yield, % eop	3.54	3.78	4.00	3.85	4.25	4.25	4.00	4.00	3.75
lc vs USD, eop	29.29	31.14	31.25	31.55	31.85	31.79	31.37	30.95	30.53

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates
*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Frontier Asia

Mongolia

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Five pending breakthroughs: Mongolia is at a crossroads now. Since our last update (Mongolia Macro View - Takeaways from Ulaanbaatar: Need to Unlock Bottlenecks Quickly), the government seems to have picked up pace at addressing key issues at hand. First, the special parliament session will repeal the New Investment Law (allowing equal treatment to foreign investment as local's; simplified approval process by Ministry of Economic Development that involves foreign SOEs; and requiring 2/3 of parliament to change this law in the future); update the 'Long Name Law' to allow legal (gold) mining activities near rivers, forests and protected areas; and decide to keep using the existing mining law (i.e. no re-draft and new exploration licenses could be issued). Second, secure funding for its investment needs by an expected samurai bond issuance by DBM. Third, Finance Minister to cut spending to reduce structural deficit to 2% of GDP for this year. Four, PBOC grants BoM's request to double its 10bn RMB swap line. Fifth, to reach an agreement with Rio to restart OT Phase II development. We ranked these five items in descending order of the likelihood of accomplishing in the near term.

Market sentiment improved slightly in light of these potential breakthroughs: The MNT has recovered ~5% (after reaching 1712/USD on 11 Sep (-23.1% YTD)), and Z-spreads of the 10Y sovereign and 5Y quasi-sovereign bond have also recovered ~80bps and ~170bps to 461bps and 651bps (as of Sep 23), respectively.

Macro data wise, exports on a YoY grew 4.9% in Aug but an increase in copper exports from OT production was noted. Still low FDI and a decline in FX reserves as of Aug continue to catch attention. CPI started to edge up from its low of 8.3% to 9.4% in Aug, as import prices (petrol and food, especially) are rising with MNT depreciation, suggesting BoM may need to enhance its price stabilization program if BoM is determined to maintain its 8% inflation target for the year.

Sri Lanka

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Growth surprised to the upside in 2Q13; slight nudge higher to our growth forecast. Sri Lanka's 2Q13 growth accelerated to 6.8%, beating expectations, driven by a rebound in industry and services, with the former driven by surprisingly strong construction activity even as manufacturing growth remained tepid, decelerating alongside lackluster exports. We think this pick-up in construction is likely dominated by public sector related investment projects since private sector loan pick-up remained very subdued in 2Q13. We don't think public spending, especially the portion that is on-budget (NSB's $750mn issuance, half of which to fund government related projects is likely going to be off-budget) is sustainable given the sharp deterioration in revenue collection that is challenging its deficit target this year. We slightly upgrade our growth forecast for this year to 6.5% (from 6.4%) and expect headline growth to pick up above 7% in 3Q13 on the back of a favorable base effect before coming off in 4Q13.

CBSL on hold for now, but should be on guard to FX pressures. Inflation has been well contained with core inflation pressures being subdued for the most part of last year despite periodic supply-side administered adjustment to energy prices. However, we expect headline inflation has already bottomed as favorable base effect reverses. Lagged impact of monetary easing and the recent liquidity injection via SLR cut had a material impact on private sector loans in July, and thus, alongside subdued export performance, external imbalances will likely remain a challenge. We expect CBSL to remain on hold this year, but do not preclude the possibility that CBSL could tighten monetary policy by 1H14 if FX stability is challenged by renewed taper-led volatility impacting portfolio flows.

Sri Lanka's external funding picture still looks challenging over the medium term. We expect the current account deficit to stay above 5% of GDP this year with rising income deficit and sticky goods trade deficit offsetting improving balance on services and transfers. While net FDI is up 20%YoY in 1H13, and there seems to be some stepped up effort to mobilize "official" funding sources, Sri Lanka remains exposed to global risk sentiment impacting portfolio flows. The FX reserve coverage ratio looks low and very reliant on pursuing continued debt-related inflows. While we may have some short-term risk bounce on EM credits after Sri Lanka dollar bonds underperformed on new supply, the longer term external refinancing pressure will likely keep spreads wide to the likes of Vietnam. LKR bonds still have some support given the yield buffer, but we remain biased on the short-end.

Vietnam

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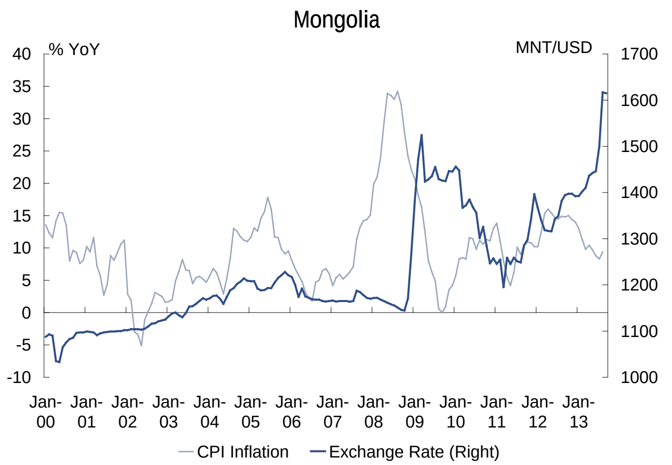
We expect only a very limited economic rebound in 2H13. After very subdued growth of 4.9% in 1H13 and PMI hitting a trough in June, this has started to rise gradually, but looking at high-frequency data like (real) retail sales, industrial production and trade, it does not seem to show much pick-up though PMI had started to rise very gradually (though still at 49.4 in Aug). The main driver of our expectation of a slight pick-up in 2H13 is on both net exports and impact of lagged monetary accommodation. After 800bps of cuts since early last year, pace of bank deleveraging seems to be slowing somewhat with credit growth picking up above our earlier expectations – we revise up our credit growth forecast by year-end to 12% from 8%, but we are somewhat disappointed by the slow pace of export pick-up. We maintain our GDP growth forecast at 5.1% this year, lower than the government's "downwardly adjusted" 2013 forecast of 5.4%.

Inflation remains a concern, but we don't think this precludes one more rate cut. Headline inflation eased to 6.3%YoY in September (vs Aug: 7.5%) due to a favorable base effect and normalizing transportation costs after two rounds of fuel price adjustments in June and July, as well as reversal of healthcare increase in Aug. Despite the lower YoY inflation, MoM inflation stayed elevated (Sep: 1.06%; Aug: 0.83%) amid seasonal spikes in education costs, and persistent inflation on food. We think Vietnam could still ease monetary policy further given anemic domestic demand, lack of credit intermediation, and comfortable external balance sheet. We revised up our current account surplus estimate in 2012, hitting about 6% of GDP after IMF released its latest data, and we expect this to narrow to 4.2% of GDP in 2013F. With limited external vulnerabilities, we slightly adjust our VND forecast towards more stability.

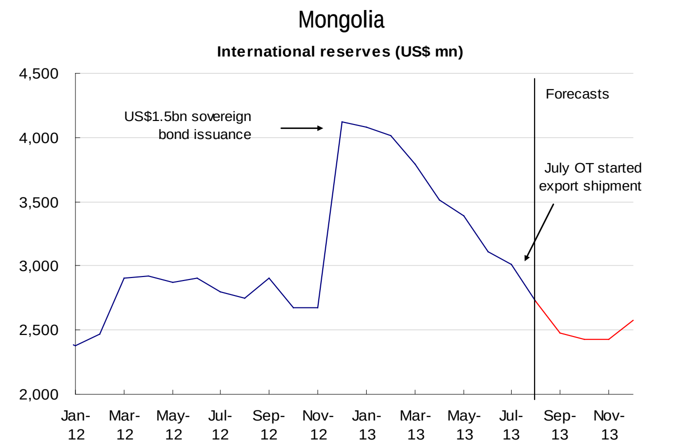
Bank sector problems continue to fester for awhile. After the Vietnam Asset Management Company (VAMC) was set up in July, it has yet to be operational (targeted to start this month) in buying bad debts. The government has an unrealistic goal that VAMC can purchase at least VND30trillion ($1.4bn) of bad debt this year, or 19-20% of SBV's estimated outstanding NPLs in the banking system – SBV reported recently that the NPL ratio is at 4.68% of total loans in July, a much smaller figure than outside estimates and their earlier estimate of 8.8% in September 2012. However, we still remain skeptical that we will get quick resolution – banks' participation in offloading NPLs to VAMC is voluntary and feedback seems very mixed, banks still have to provision for 20% of the bad debts exchanged every year (so only buys banks time), recovery rate is unclear and we are still missing a crucial fresh capital injection in the banking system which the government remains very hesitant to do. Thus, subpar domestic growth will likely persist for awhile, in contrast to a more buoyant export-manufacturing sector.

Figure 103. Mongolia – MNT depreciation will add inflation pressures



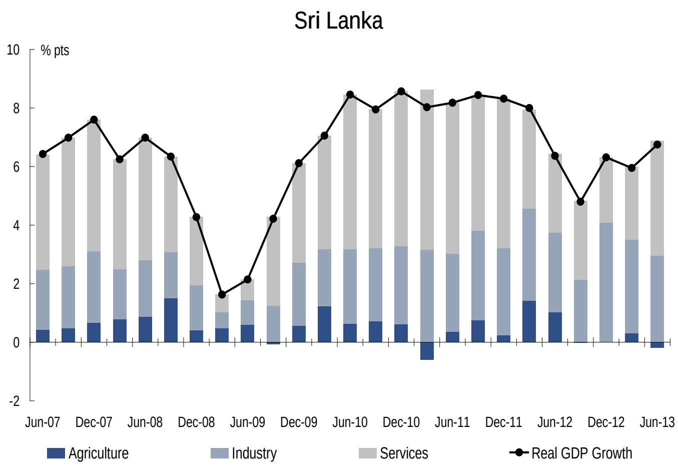
Source: BoM, CEIC and Citi Research

Figure 104. FX reserves decline would not arrest till sizeable FDI returns



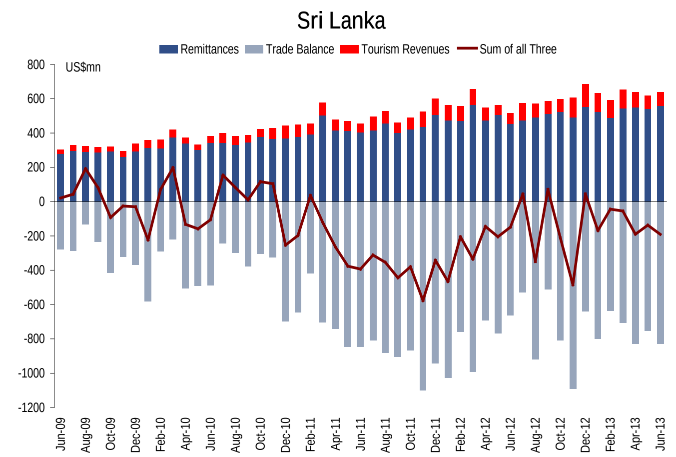
Source: BoM, CEIC and Citi Research

Figure 105. Sri Lanka – Real GDP growth in 2Q13 surprised to the upside



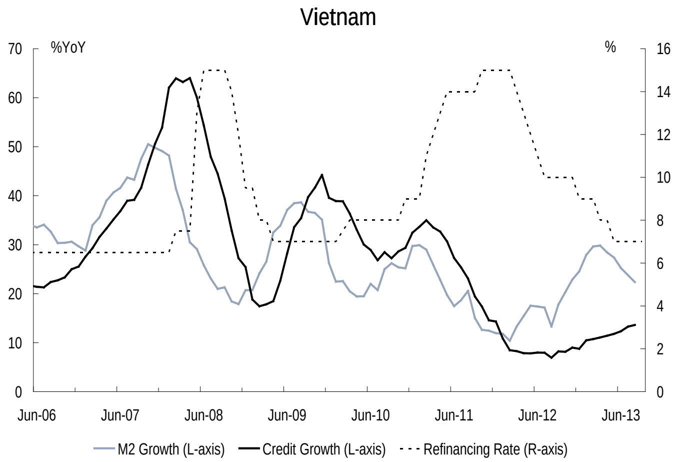
Source: CBSL, CEIC, Citi Research

Figure 106. High frequency data still show a challenging backdrop to the current account



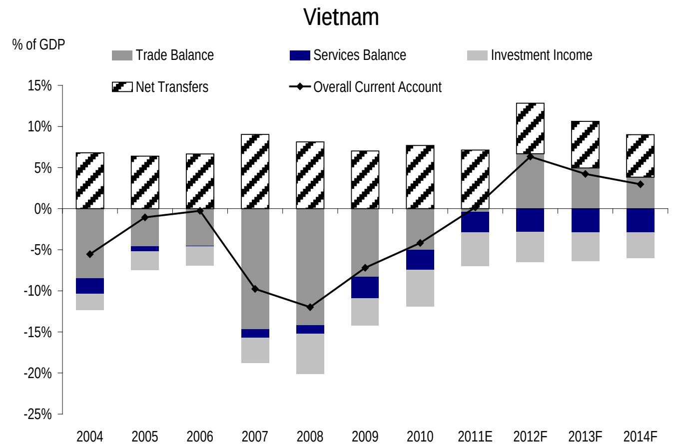
Source: CBSL, CEIC, Citi Research

Figure 107. Vietnam – Bank credit very modestly showing signs of life; deleveraging is slowing



Source: CEIC, GSO, SBV, Citi Research

Figure 108. Current account surplus remains at comfortable levels



Source: CEIC, IMF, Citi Research

Figure 109. Asia Frontier Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Mongolia									
Nominal GDP, US$ bn	3.4	4.2	5.6	4.6	6.2	8.8	10.3	11.3	13.2
GDP per capita, US$	1334	1629	2138	1717	2287	3186	3593	3889	4481
Population, mn	2.6	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0
Real GDP, % yoy	8.6	10.2	8.9	-1.3	6.4	17.5	12.4	13.8	11.0
CPI, % yoy	8.1	15.1	22.1	4.2	13.0	10.2	14.0	10.0	10.0
CPI, % avg	4.5	--	28.0	8.0	10.1	9.2	14.3	9.9	10.0
Policy interest rate, % eop	--	8.40	9.75	10.00	11.00	12.25	13.25	10.00	10.50
Long term yield, % eop	26.93	21.83	20.58	21.67	20.07	16.61	18.11	15.61	16.81
lc/US$, eop	1164	1172	1275	1433	1233	1378	1378	1630	1560
lc/US$, avg	1181	1171	1167	1434	1349	1256	1353	1530	1583
Current account (US$ bn)	0.2	0.3	-0.7	-0.4	-0.9	-2.8	-3.2	-2.8	-1.8
% of GDP	6.5	6.3	-12.8	-8.9	-15.0	-31.5	-31.2	-24.5	-13.6
Trade balance (US$ bn)	0.1	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-1.5	-0.4
Exports (US$ bn)	1.5	1.9	2.5	1.9	2.9	4.8	4.4	5.0	6.5
Imports (US$ bn)	1.5	2.2	3.2	2.1	3.2	6.6	6.7	6.6	6.8
FDI, net (US$ bn)	--	0.4	0.8	0.6	1.6	4.6	3.9	3.0	3.5
International reserves (US$ bn)	0.6	0.8	0.6	1.3	2.2	2.3	3.9	2.7	3.2
Consolidated government balance (% of GDP)	7.6	2.6	-4.5	-5.2	0.5	-6.9	-8.3	-7.8	-5.8
Public debt (% of GDP)	40.6	36.0	30.6	48.7	42.1	55.0	47.8	50.0	40.0
Sri Lanka									
Nominal GDP, US$ bn	28.3	32.4	40.7	42.1	49.6	59.2	59.4	66.1	75.6
GDP per capita, US$	1422	1615	2014	2057	2400	2836	2816	3099	3504
Population, mn	19.9	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6
Real GDP, % yoy	7.7	6.8	5.9	3.5	8.0	8.2	6.4	6.5	6.8
CPI, % yoy	13.5	18.8	13.9	5.0	6.8	4.9	9.2	6.3	7.8
CPI, % avg	10.0	15.8	22.5	3.6	6.2	6.8	7.5	7.3	7.0
Policy interest rate, % eop	11.50	12.00	12.00	9.75	9.00	8.50	9.50	8.75	9.00
Long term yield, % eop	12.98	19.96	19.12	9.33	7.55	9.31	11.54	10.50	10.50
lc/US$, eop	107.5	108.7	113.0	114.4	110.9	113.9	127.7	133.0	130.0
lc/US$, avg	103.9	110.6	108.3	114.9	113.0	110.5	127.2	130.6	130.0
Current account (US$ bn)	-1.5	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-3.5	-2.6
% of GDP	-5.3	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-5.3	-3.4
Trade balance (US$ bn)	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-9.7	-11.0
Exports (US$ bn)	6.9	7.6	8.1	7.1	8.6	10.6	9.8	10.1	11.0
Imports (US$ bn)	10.3	11.3	14.1	10.2	13.5	20.3	19.2	19.8	21.9
FDI, net (US$ bn)	0.5	0.5	0.7	0.4	0.4	0.9	0.8	1.0	1.0
International reserves (US$ bn)	2.5	3.1	1.8	5.1	6.6	6.0	6.9	6.6	7.7
Consolidated government balance (% of GDP)	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4	-6.2	-5.7
Public debt (% of GDP)	87.9	85.0	81.4	86.1	81.9	78.4	79.1	78.0	76.0
Vietnam									
Nominal GDP, US$ bn	60.9	71.2	90.0	91.9	102.4	121.7	141.5	156.2	173.8
GDP per capita, US$	724	836	1044	1054	1163	1367	1572	1718	1893
Population, mn	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9	91.8
Real GDP, % yoy	7.0	7.1	5.7	5.4	6.4	6.2	5.3	5.1	5.4
CPI, % yoy	6.6	12.6	19.9	6.5	11.7	18.1	6.8	6.6	8.1
CPI, % avg	7.5	8.5	23.2	7.0	9.2	18.6	9.3	6.6	7.1
Policy interest rate, % eop	6.50	6.50	9.50	8.00	9.00	15.00	9.00	6.00	7.00
Long term yield, % eop	8.29	8.73	10.00	11.68	11.50	12.55	9.75	8.50	9.00
lc/US$, eop	16056	16028	17483	18474	19498	21034	20840	21150	21388
lc/US$, avg	15990	16081	16445	17806	19123	20648	20875	21104	21348
Current account (US$ bn)	-0.2	-7.0	-10.7	-7.2	-4.3	0.2	9.0	6.6	5.2
% of GDP	-0.3	-9.8	-11.9	-7.8	-4.2	0.2	6.3	4.2	3.0
Trade balance (US$ bn)	-2.8	-10.4	-12.8	-8.3	-5.1	-0.5	9.5	7.7	6.7
Exports (US$ bn)	39.8	48.6	62.7	57.1	72.2	96.9	114.5	131.6	155.3
Imports (US$ bn)	42.6	58.9	75.5	65.4	77.4	97.4	105.0	123.9	148.7
FDI, net (US$ bn)	2.3	6.6	9.3	6.9	7.1	7.3	7.0	7.0	7.0
International reserves (US$ bn)	13.4	23.5	23.9	16.4	12.5	13.5	25.6	35.8	38.3
Consolidated government balance (% of GDP)	-1.1	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-4.8	-4.0
Public debt (% of GDP)	37.5	39.0	34.9	40.0	45.5	45.9	43.1	41.0	41.5

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates

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CEEMEA

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- **Summary view** — After slightly weaker data from the real economy, we have edged down our GDP forecast to -1.1%YoY in 2013 and kept the 2014 forecast at 1.6% with a downside risk due to the current political situation, which is offset by upside risk due to better outlook on foreign demand.
- **Things to watch** — CNB policy and the early election on 25-26 October will be key for both near- and long-term economic developments as FX interventions remain a close call and based on poll data we think we are probably heading toward the first regular left-wing(-centrist) government since 2006.
- **Strategy** — If the koruna strengthens below 25.6, we see a higher chance some CNB Board members will join the three members who probably already voted for FX interventions to ease monetary conditions which have tightened slightly.

Election outcome unclear as campaign stops next year

The early election will take place on 25-26 October, just the weekend ahead of state holidays on 28 October, which will probably be one of factors that could influence the election participation and potentially the outcome. The other factors that could influence the result are recent corruption scandals, previous fiscal consolidation that, though was successful in keeping the long-term interest rates lows, was negatively viewed by both left- and right-wing voters. We believe this could lead to a high-share of voters who will not go to vote or do not see any choice among parties or are undecided. The outcome of the election remains unclear as there are four parties well above the 5% threshold, but there are four-five smaller parties, which are around the threshold and, moreover, there some three-four parties that could also attract some votes, which can influenced the election outcome as we surprisingly saw in 2010. The impaired reputation of traditional parties on one side and a long-term bad experience with small parties, which used to show a weak internal integrity and coalition loyalty, on the other side, make the situation more complicated.

The number of possible post-election coalitions has increased to six, but only three or four seem most likely. What are the main obstacles? The new possibility of right-centrist coalition (now with 48% of votes) is very limited as it would consist of four parties that would mirror the permanently collapsing “strong” coalition after 2010 election. The new, quite strong, potential from recent poll data is for two left-centrist coalitions, consisting of four parties (socialist, Christians and presidential SPOZ or new ANO, potentially greens). The other possibilities are a left-wing government (socialists CSSD with communists KSCM) or a grand coalition (socialists, TOP09), of which the first is more likely in our view. This is because socialists would likely be very heavily penalized if they were to join a grand collation with the stronger right-wing party T0P09 ahead of local elections in autumn 2014 – more so than if they create minority government (maybe including some presidential) support by communists or even if they create regular coalition with them. The likely political change will probably lead to new pro-growth measures due to larger government investment, but the impact is likely to be greater given limited prospects for higher tax revenues (where we expect a change in redistribution) and EU fiscal rules, where the signing of the Fiscal Compact will become more likely. Major fiscal changes like higher PIT for high earners, return of CIT to 20-21% and higher CIT rate for regulated industries, lower VAT for basic products, and hike in minimum wage are likely from 2015 in our view.

We slightly cut our GDP forecast

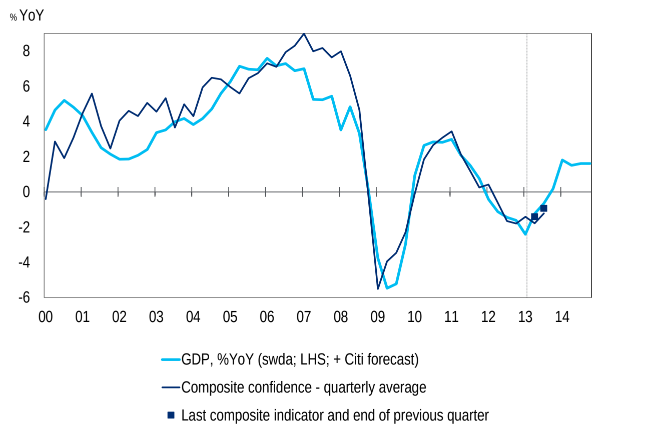
However September confidence points to positive GDP growth in 4Q13. September sentiment indicator improved to levels last seen in March 2012, which is supportive for our forecast of easing in GDP contraction to -0.7%YoY in 3Q13 after -1.3% in 2Q13 and to +0.1%YoY in 4Q12. The downside risk from milder industrial output in July was offset by the largest gain in September industrial confidence since December 2010. In our view, suggests an easing of contraction in industrial output to zero in September from -2.9%YoY in July, which is in line with our forecast (we expect it at 2.2%YoY in 4Q13 and -1.1% for 2013E after -0.8% in 2012, followed by 3.2% in 2014). There was improvement in confidence in all tertiary sectors (retail, services and consumers), which should be supportive for retail sales, which could show a mild YoY increase, but, consumer intentions for larger purchases did not improve in September.

Mixed July data and 2Q's GDP details are rather supportive for CNB's doves though the better foreign leading indicators are likely to keep the hawks' stance resistant in September. First, there was a milder gain in industrial production, likely only temporary surge in construction output in July (due to post-flood reconstruction not supported by permits), improved (but less than expected) July retail sales with subdued outlook, the real wage growth in 2Q13 below the CNB's forecast, larger drop in imports and weak export in real terms in July, slightly higher seasonally adjusted unemployment rate and were weaker private loans in August. Second, though the GDP growth at 0.6%QoQ in 2Q13 was solid, the effective demand was back in recession as the growth was driven by net exports (1%pt due to a stronger contribution from exports at 2.8%pt) and by inventories (0.3%pts), while fixed investment (-0.3%pt) and private consumption (-0.2%pt vs. +0.7% in 1Q13) and government consumption (-0.1%) contributed negatively. Short-term outlook remains positive, supported by foreign demand, but domestic demand is likely to remain subdued. GDP YoY contraction at -1.3% was milder than the CNB expected (-1.7%YoY), but effective demand was weaker than the CNB expected, though mixed as main difference was in weaker fixed investment, which is still viewed as inflationary impact in CNB's model despite large output gap. Mixed implications are also from stronger exports that could suggest a downward revision to the CNB's EURCZK forecast, which could tighten the monetary conditions index and keep the CNB's Bank Board dovish. Third, this is more likely if the current low inflation outlook persists, which looks to be supported by another undershooting of CNB's inflation forecast in August, with the monetary relevant CPI is below the CNB's target for seven months in row and there are downward pressures owing to the energy price outlook.

Board still divided on the trigger for interventions

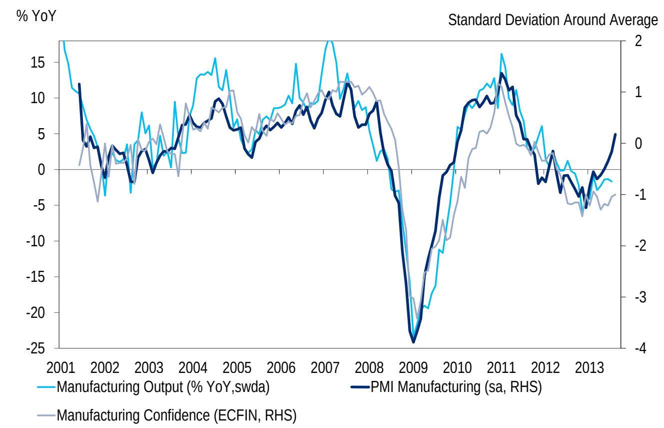
We believe the Board members who voted for starting koruna's sales are likely to vote again in September, and also remain in a slight minority (3 vs. 4). On the basis of their public commentary we think that these three board members are Singer, Tomsik and Lizal. Though it seems that four members are hawkish, or better said, they do not see strong reason to intervene against the koruna, it does not mean that they are against the FX interventions in our view, particularly if koruna strengthens below the CNB's forecast. Maybe, below the range of EURCZK at 25.6-26.0, which prof. Janacek found "satisfactory" in June and probably also in September as he said that "The koruna is moving around 25.8 to the euro and exporters aren't complaining about its strength" (Bloomberg, 12 September), which he found "very slightly overvalued".

Figure 110. September confidence improved, supporting our forecast...



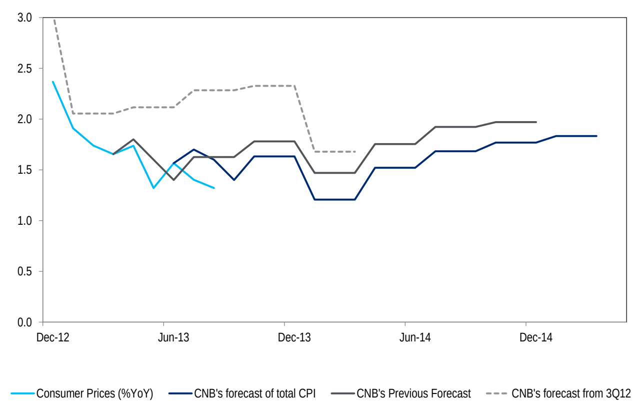
Source: Czech Statistical Office, Citi Research

Figure 111. ... and industrial confidence remains below PMI



Source: CZSO, Haver Analytics, Citi Research

Figure 112. CPI has continued to undershot CNB's forecast



Source: CZSO, CNB, Citi Research

Figure 113. Election campaign will stop in autumn 2014 for two years

Events - Elections & Nominations	Date
Presidential election	*January 11, 2013*
President Vaclav Klaus finished his 2nd term	*March 7, 2013*
Lower House of Parliament (Early Elections)	October 25-26, 2013
CNB's Zamrazilova - 1st term ends	Mar/2014
European Parliament	Jun/2014
Local Councils + Prague + 1/3 of Upper House	Oct/2014
CNB's Governor Singer - 2nd term ends	Jul/2016
CNB's Janacek - 1st term ends	Jul/2016
Regional Councils + 1/3 of Upper House	Oct/2016
CNB's Lizal - 1st term ends	Feb/2017
CNB's Rezabek - 2nd term ends	Feb/2017
CNB's Tomsik & Hampl - 2nd term ends	Nov/2018

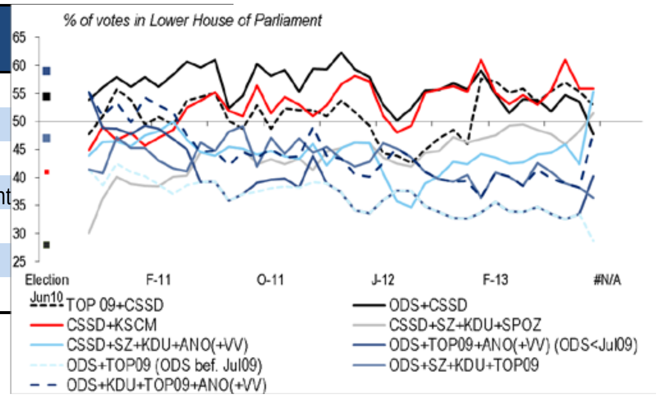
Source: CNB, CZSO, Citi Research

Figure 114. CNB's Bank Board looks to be still divided on the trigger

CNB's Board Member	Risk of ... to trigger FX intervention
Singer (G)	Undershooting of target
Hampl (VG)	Deflation
Tomsik (VG)	Undershooting of target
Zamrazilova	Stronger koruna unwarranted by (economic) fundament
Rezabek	Deflation
Janacek	Deflation (initially undershooting)
Lizal	Undershooting of target

Source: Citi Research. Note: Bolded – members who probably voted and will vote for the FX intervention to weaken the koruna.

Figure 115. Six possible coalitions, but only three or four are likely



Source: Citi Research estimate based on CVVM, Median, Factum and STEM surveys. Note: The threshold is set at 4%. Right: TOP09, ODS. Centrists (from right to left): ANO, VV, KDU, SZ. Left: CSSD, SPOZ, KSCM.

Figure 116. Czech Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	148	180	225	197	198	216	196	200	209
Nominal GDP, local currency bn	3,353	3,663	3,848	3,759	3,791	3,823	3,831	3,915	4,081
GDP per capita, USD	14,452	17,484	21,614	18,795	18,873	20,584	18,620	19,032	19,820
Population, mn	10.3	10.3	10.4	10.5	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	7.2	5.3	4.4	6.7	7.3	6.7	7.0	7.1	6.4
Economic Activity									
Real GDP, yoy avg	7.0	5.7	3.1	-4.5	2.2	2.1	-1.2	-1.1	1.6
Real investment growth % yoy	10.2	15.5	1.9	-20.2	5.4	0.8	-4.1	-7.6	3.3
Real consumption growth % yoy	2.9	3.1	2.3	1.3	0.7	-0.4	-2.2	0.2	1.6
private consumption growth % yoy	4.4	4.2	2.8	0.2	0.9	0.5	-3.3	0.3	1.4
Real export growth, % yoy	13.8	11.2	4.0	-10.9	15.4	9.5	4.0	1.0	5.4
Real import growth, % yoy	10.8	12.8	2.7	-12.1	15.4	7.0	2.3	0.6	7.3
Prices, Money & Credit									
CPI, % yoy	1.7	5.5	3.6	1.0	2.3	2.4	2.4	1.5	1.4
CPI, % avg	2.5	2.9	6.3	1.0	1.5	1.9	3.3	1.5	1.3
Nominal wages, % yoy	6.5	7.2	7.9	3.4	2.2	2.5	2.7	0.9	2.5
Credit extension to private sector, % yoy	20.5	26.6	16.1	0.8	3.0	5.5	2.6	2.9	5.5
Policy Interest Rate, % eop	2.50	3.50	2.25	1.00	0.75	0.75	0.05	0.05	0.05
1 month inter-bank rate, %, eop	2.52	3.94	3.21	1.29	0.99	0.94	0.33	0.30	0.25
Long-term yield, %, eop	3.68	4.64	4.15	4.01	3.86	3.69	1.90	2.20	2.10
CZK/US$, eop	20.8	18.2	19.2	18.4	18.7	19.8	19.0	19.0	18.2
CZK/US$, avg	22.5	20.2	17.0	19.0	19.1	17.7	19.5	19.5	18.7
CZK/EUR, eop	27.5	26.5	26.8	26.4	25.0	25.6	25.1	25.9	25.1
CZK/EUR, avg	28.3	27.8	25.0	26.4	25.3	24.6	25.1	25.9	25.5
Balance of Payments, USD bn									
Current account	-3.1	-7.9	-4.8	-4.8	-7.6	-6.1	-4.7	-1.9	-3.3
% of GDP	-2.1	-4.4	-2.1	-2.5	-3.8	-2.8	-2.4	-1.0	-1.6
Trade balance	2.6	2.2	1.7	4.6	2.8	5.1	7.5	9.5	7.5
Exports	85.6	106.5	125.1	99.1	114.0	136.3	131.7	132.8	138.2
Imports	83.0	104.3	123.4	94.6	111.2	131.2	124.2	123.4	130.7
Service balance	2.2	2.9	4.4	3.9	3.9	3.3	2.5	3.3	3.0
Income balance	-7.4	-12.7	-10.6	-13.2	-14.8	-14.7	-14.7	-15.0	-14.0
FDI, net	4.0	9.0	2.3	2.0	4.9	2.6	9.2	4.4	4.6
International reserves	31.1	34.4	36.5	39.7	40.3	37.9	42.4	44.3	45.0
Total amortisations	6.0	6.0	7.7	10.1	9.9	12.9	13.7	11.5	14.2
Public Finances, % of GDP									
Consolidated government balance	-2.4	-0.7	-2.2	-5.8	-4.8	-3.3	-4.4	-2.8	-2.9
Consolidated gov primary balance	-1.3	0.4	-1.2	-4.5	-3.4	-1.9	-2.9	-1.1	-1.2
Public debt	28.3	27.9	28.7	34.2	37.9	41.0	45.9	47.8	48.6
of which Domestic	21.0	20.3	20.7	24.1	25.5	28.6	31.7	32.9	33.6
Foreign Assets & Liabilities, USD bn									
External debt	57.3	76.2	84.2	89.2	94.2	94.2	92.8	98.2	106.5
Public	12.0	15.0	15.3	19.8	24.0	22.6	30.3	32.2	36.5
External debt / GDP	38.6	42.2	37.4	45.3	47.5	43.6	47.4	49.1	51.0
External debt / XGS	57.4	61.5	57.3	75.3	69.8	59.0	60.4	63.0	65.7
Short-term debt	15.4	22.6	27.1	23.9	23.6	27.1	24.5	26.0	27.0
Short-term debt/International reserves (%)	49.6	65.5	74.2	60.2	58.5	71.5	57.8	58.7	60.0

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	-2.4	-1.3	-0.7	0.1	1.7	1.5	1.6	1.6	1.9
CPI, % yoy	1.6	1.6	1.3	1.4	1.0	1.2	1.0	1.2	1.8
Policy interest rate, %, eop	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.25
Short-term market rate, % eop	0.31	0.31	0.30	0.30	0.25	0.25	0.25	0.25	0.35
Long-term yield, %, eop	1.86	2.14	2.30	2.20	2.18	2.15	2.13	2.10	2.20
CZK/EUR, eop	25.74	25.99	25.86	25.94	25.87	25.76	25.44	25.12	24.80

Source: National Sources, Citi Research

Egypt

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- **Summary view** — The military's political roadmap towards holding parliamentary elections is now taking shape. The next step is to pass a new constitution and outline a detailed timetable for holding elections.
- **Things to watch** — Gulf support has helped stabilize the exchange rate and eased, but not eliminated, foreign exchange shortages. But it is not a long term solution to stabilizing the currency and further weakness is possible in our view.
- **Strategy** — Short term external support from the Gulf looks set to provide crucial financial support until a more coherent economic policy is in place. But it seems unlikely, as we outline below, that any government will seek an agreement with the IMF, instead opting for a more cautious, "home grown" programme of economic reform.

The emerging roadmap

After half a year of political uncertainty against the background of economic stagnation, the prospects for a period of greater political stability are now re-emerging. With the country now run by a civilian government led by interim president, Adly Mahmud Mansour, and the military, the goal is to draft a new constitution and then to outline a clear timetable for holding presidential and parliamentary elections. We expect this to be announced in late 2013 with elections held in 1H 2014.

There has been a major clampdown on the Muslim Brotherhood (MB). The extent to which this pushes the MB underground and risks the return to the low level insurgency of the 1990s is unclear, but cannot be excluded as a possibility. Meanwhile, attempts by the MB to re-ignite protests against the new political regime have not been successful since mid-August and it seems from opinion poll data that the MB is increasingly seen as the cause of the political violence that swept the country in early 2013 which has undermined some of its support. There certainly seems strong support within Cairo for the return to normality on the streets as shown by the recent push back in the curfew from dusk to 11pm.

The need to keep the Islamist political community on side

But despite the clampdown on the MB, the military is keen to keep significant elements of the Islamist political community on side during the transition. Without this, any democratic transition will lack wider political legitimacy. At present, although the position of the Nour party is complicated, it seems willing to support the transition, and blame the MB for putting paid to the Political Islam Project to succeed the MB as the main Islamic political voice in the country.

Although it remains unclear who will stand in the presidential elections at present, it seems likely that all candidates will have to have the tacit support of the military. We would also expect that the parliamentary vote is quite widely split over a range of parties, meaning that a coalition government of some sort will have to be formed by the president. This outcome is likely to be supported by most foreign governments, although it is clear that the political environment has changed in recent months, with the Gulf States now taking the lead in supporting Egypt's political transition while Western powers have apparently lost influence as they took their time in deciding the position they should take over political developments since June.

The re-emergence of a fragile stability…

The shift in external political support has also been positive for the economy as Gulf states, led by Saudi Arabia, have provided significant external support for the new government. This has allowed the Central Bank of Egypt (CBE) to stabilise reserves and reduce foreign currency shortages which has translated into a more stable EGP since July. But it is also clear that the economy remains very weak with consumption under pressure and investment low. Moreover, inflows from the Gulf are still likely to be irregular which makes planning harder and can drive periodic shortages of foreign exchange. But, if the emergence of greater political and economic stability in recent months continues into 2014 it should help the economy as investment and tourism start to recover.

…but a more comprehensive reform programme is still desperately needed

But even if a weak economic recovery is possible in 2014, we still think that a new government will have to think more comprehensively about economic policy at some point. In particular, the root cause of many economic problems remains the fiscal deficit which has been widening steadily since 2008 and looks set to remain firmly in double digits in 2014. The fiscal deficit rose to 11.2% of GDP in calendar year 2012 and provisional data for 1H 2013 show that there could be a worse outcome this year.

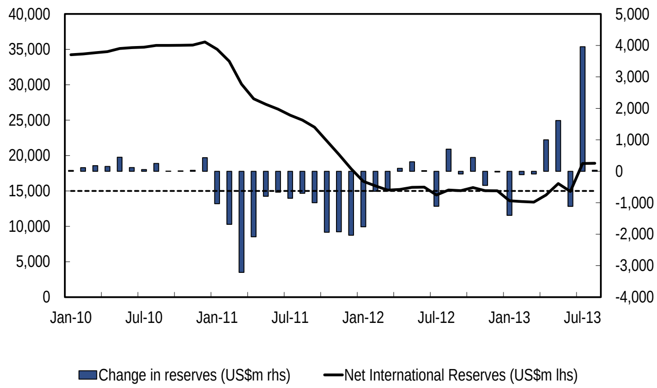
On a more positive note, a more stable exchange rate and a weak growth environment mean that inflation is unlikely to rise sharply in the coming 12 months. In fact, weak inflationary pressures have allowed the Central Bank of Egypt (CBE) to cut the Overnight Deposit Rate (ODR) twice this year. While a further cut in the final months of 2013 may be premature, we think inflationary pressures will remain subdued in 1H 2014 allowing further cautious cuts in the ONR to help support growth and to ease the local cost of funding the deficit.

But a longer term solution to reducing the fiscal deficit is only possible with real fiscal sector reform. This would involve a programme to reduce subsidies on food and energy, firm control of the public sector wage bill and the return of growth to boost domestic revenue collection. As such while there may be a modest fall back in the deficit going forward, the prospects for more fundamental fiscal consolidation seem unlikely for some time in our view, given current political agenda.

A homegrown reform programme

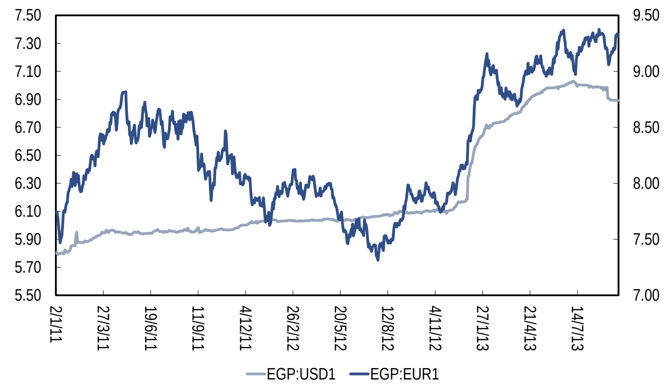
Having said that, the provision of Gulf support means that such difficult choices can be put off and the government can continue to operate in muddle through fiscal mode, probably well into 1H 2014. But at some point, the government will have to think about a more comprehensive reform programme. While this could potentially be based around a deal with the IMF, we think it is more likely to be a homegrown economic reform programme with IMF buy in and more logical external financing, of which a large part would be Gulf funding. But whichever route is chosen, the goal would be for external support to help fund infrastructural spending, which should start to help boost growth, investment and employment in 2H 2014, while outlining a slow programme of fiscal consolidation over the medium term.

Figure 117. Reserves tentatively start to stabilise



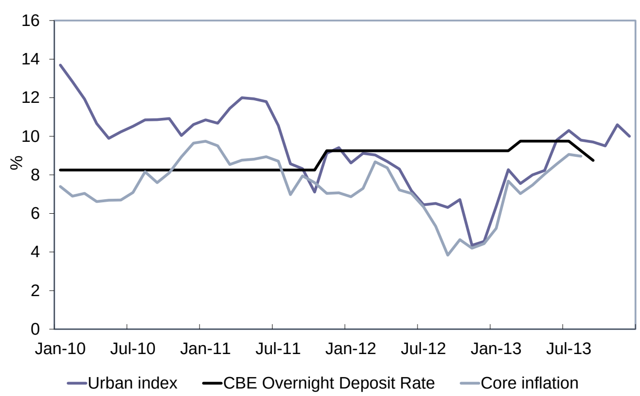
Source: Central Bank of Egypt, Haver Analytics

Figure 118. The EGP also starts to stabilise against the US dollar



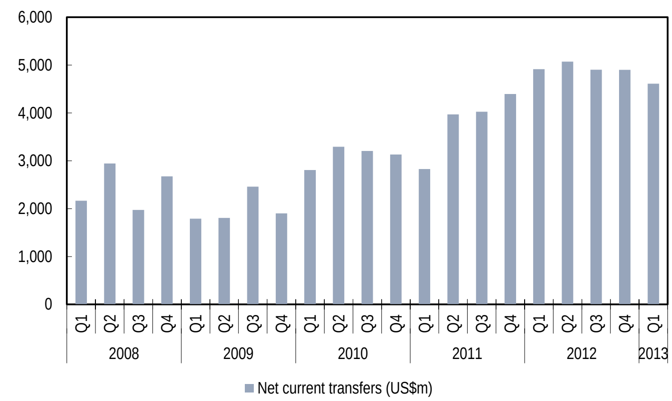
Source: Reuters

Figure 119. Inflationary pressures ease and the CBE cuts rates modestly



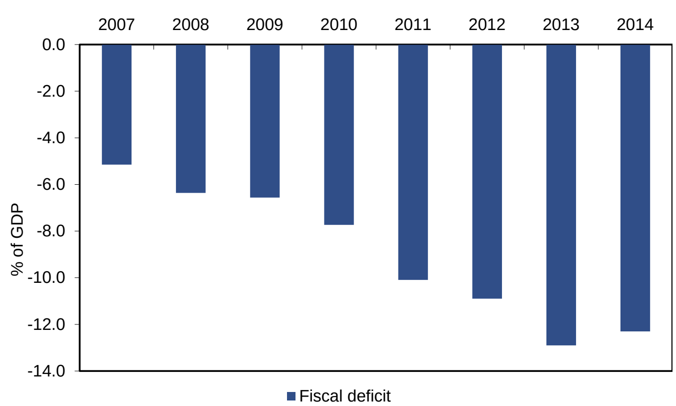
Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

Figure 120. Robust transfers have limited the deterioration in the current account and help support consumption



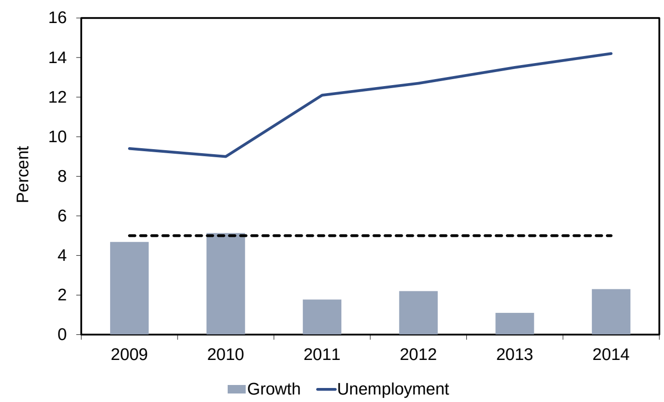
Source: Central Bank of Egypt, Haver Analytics

Figure 121. The fiscal deficit remains large and is a problem



Source: Haver Analytics and Citi forecasts for 2013

Figure 122. A weak recovery is now possible in 2014



Source: Haver Analytics and Citi forecasts for 2013-14

Figure 123. Egypt Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	108	132	165	188	214	231	254	246	261
Nominal GDP, local currency bn	618	745	896	1,042	1,207	1,371	1,542	1,699	1,868
GDP per capita, USD	1,479	1,783	2,187	2,454	2,755	2,919	3,164	3,015	3,142
Population, mn	73.0	74.1	75.4	76.6	77.8	79.1	80.4	81.7	83.1
Unemployment, % of labour force	10.6	8.9	8.7	9.4	9.0	12.0	12.7	13.5	14.2
Economic Activity									
Real GDP, yoy avg	6.8	7.1	7.2	4.7	5.1	1.8	2.2	1.1	2.3
Real investment growth % yoy	13.8	23.7	15.5	-9.1	8.0	-2.1	8.0	-6.5	2.3
Real consumption growth % yoy	5.9	7.6	5.2	5.7	4.2	5.3	5.5	-2.2	1.5
private consumption growth % yoy	6.4	8.8	5.7	5.7	4.1	5.5	5.9	-3.7	2.5
Real export growth, % yoy	21.2	20.2	28.8	-14.5	-3.0	1.2	-2.3	2.9	6.1
Real import growth, % yoy	21.7	30.5	26.3	-17.9	-3.2	8.4	10.8	-10.5	3.6
Prices, Money & Credit									
CPI, % yoy	12.3	6.9	18.4	13.2	10.6	9.5	4.7	10.0	8.3
CPI, % avg	7.6	9.5	18.3	11.8	11.1	10.1	7.1	9.0	7.7
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	10.3	10.0	12.0	3.0	6.7	6.1	7.6	3.0	4.5
Policy Interest Rate, % eop	8.75	8.75	11.50	8.25	8.25	9.25	9.25	8.75	7.50
1 month inter-bank rate, %, eop	9.00	8.75	11.95	8.30	8.30	10.05	10.10	10.43	8.75
Long-term yield, %, eop	10.75	9.50	9.00	9.00	9.00	9.50	0.00	13.50	11.00
EGP/US$, eop	5.71	5.53	5.50	5.48	5.81	6.03	6.36	7.00	7.40
EGP/US$, avg	5.74	5.64	5.44	5.55	5.63	5.94	6.07	6.89	7.16
Balance of Payments, USD bn									
Current account	2.5	0.2	-1.3	-3.2	-5.6	-7.6	-7.6	-5.7	-6.1
% of GDP	2.3	0.2	-0.8	-1.7	-2.6	-3.3	-3.0	-2.3	-2.3
Trade balance	-12.7	-20.8	-26.8	-22.5	-27.7	-28.2	-33.8	-31.1	-32.4
Exports	20.5	24.5	29.8	23.1	25.0	27.9	25.9	27.0	27.8
Imports	33.3	45.3	56.6	45.6	52.7	56.1	59.7	58.1	60.2
Service balance	9.5	12.7	15.7	11.3	9.6	5.4	6.4	7.1	7.8
Income balance	-	-	-	-	-	-	-	-	-
FDI, net	9.9	10.9	7.6	6.1	5.2	-1.1	3.5	5.4	2.0
International reserves	26.1	31.7	34.2	34.2	36.0	18.1	15.0	18.5	19.8
Total amortisations	2.5	2.3	2.1	2.1	1.0	1.0	1.2	1.5	2.0
Public Finances, % of GDP									
Consolidated government balance	-7.7	-5.2	-6.4	-6.6	-7.7	-10.1	-10.9	-12.9	-12.3
Consolidated gov primary balance	-2.1	0.0	-1.8	-2.4	-2.6	-4.5	-4.8	-8.9	-8.6
Public debt	62.8	64.2	53.5	54.0	59.8	69.0	79.4	80.9	81.6
of which Domestic	62.8	64.2	53.5	54.0	59.8	69.0	79.4	80.9	81.6
Foreign Assets & Liabilities, USD bn									
External debt	29.0	32.8	32.1	33.3	35.0	33.7	38.8	34.3	31.8
Public	19.0	21.6	26.0	27.2	28.3	27.4	32.8	31.5	31.5
External debt / GDP	26.8	24.8	19.5	17.7	16.3	14.6	15.3	13.9	12.2
External debt / XGS	73.9	68.8	55.6	73.0	70.9	71.1	81.1	68.8	61.7
Short-term debt	1.7	2.2	2.8	2.6	3.1	3.0	6.7	6.7	6.7
Short-term debt/International reserves (%)	6.6	7.0	8.3	7.5	8.7	16.7	44.3	35.9	33.6

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.2	1.0	1.0	1.1	1.5	1.8	3.0	3.2	3.0
CPI, % yoy	7.6	9.8	9.7	10.0	7.7	6.5	8.3	8.3	6.8
Policy interest rate, %, eop	9.75	9.75	8.75	8.75	8.00	7.50	7.50	7.50	7.00
Short-term market rate, % eop	10.00	-	10.14	10.43	8.20	6.92	8.75	8.75	7.25
Long-term yield, %, eop	10.25	12.00	13.50	13.50	13.50	13.50	13.00	12.50	12.00
EGP/US$, eop	6.80	7.02	6.90	7.00	7.00	7.00	7.30	7.40	7.50

Source: National Sources, Citi Research

GCC

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Saudi Arabia

Over the summer, Saudi Arabia has intervened aggressively in global oil markets to try to quell the steep rise in prices triggered by global supply pressures and concerns regarding a regional escalation in the Syrian conflict. Brent prices have risen to the US$110 per barrel range, well in excess of the US$100 per barrel the Kingdom has in the recent past signaled it would consider the fair price of oil. In response, Saudi raised production in July and August to close to the 10 mbpd mark, the highest level of output since the Iranian revolution over 30 years ago. Part of the rise is in response to peak summer demand which we would expect to recede in the coming months, but we now revise our average production figure for Saudi to 9.5mbpd for 2013, from 9.0mbpd previously.

Combined with a rise in our expected Brent price for 2013 from US$104 per barrel to US$109 per barrel, the effect on macro outturns this year is likely to be significant. The budget surplus will approach 8% (from 1.1% previous forecast), expected economic growth rises to 6.1% (from 5.1%), and the breakeven oil price for 2013 falls to US$88 per barrel (from US$94).

United Arab Emirates

Dubai's economic recovery continues in full swing, grounded in the Emirate's fundamental strengths in the tourism, travel and logistics sectors, as well as in its success in creating a commercial hub for the region. In our view, there is no doubting the strength of the recovery in Dubai, but we are equally wary of signs of exuberance in asset prices, and the potential for bubbles to form.

The real estate market is a particular area of concern in our view. Cluttons data show that the average selling price of mid-range villas in August has risen 34% since the start of the year, and 50% compared with the same period a year earlier. The announcement of new real estate projects capitalizing on the resurgence of the property market continues unabated. For now, construction activity remains contained to new developments in prime locations, such as on the Palm or in the Downtown area. Should we see a surge in construction activity in less prime areas, accompanied by aggressive off-plan sales strategies, we believe the potential for another cycle of property-led volatility in Dubai will become increasingly likely.

Kuwait

The political scene has been relatively quiet in recent weeks, since parliamentary elections at the end of July yielded a parliament that is largely devoid of opposition and relatively pro-government. This is in contrast with the turbulence of the past six years, which has seen a hostile national assembly at odds with the government on a regular basis, leading to the resignation of nine government and the dissolution of six parliaments since 2006.

That said, we think it is still too early to say whether the semblance of political quiet will endure, or whether this will be the turning point for the implementation of the US$104bn development plan, which had previously been hindered by the political turmoil. The national assembly so far has been relatively inactive, awaiting the results of a national survey of citizens' priorities, which will be published at the end of September. This will allow parliamentarians to set out the legislative agenda, at which point frictions with the government could well once more arise. Moreover, the trial of a number of MPs and activists who stand accused of invading parliament at the end of last year is ongoing, and has

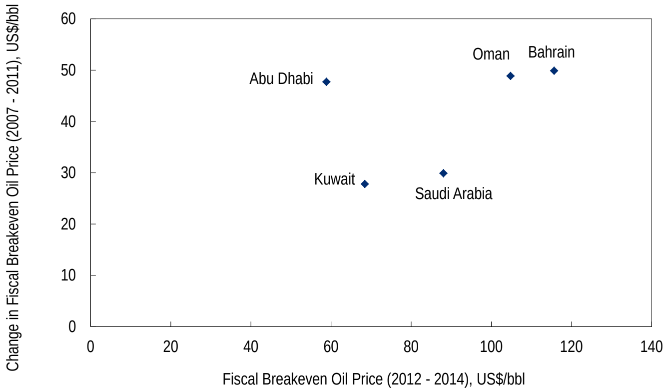
been adjourned until mid-November. We believe this is likely to act as a flashpoint for ongoing anti-government and pro-reform movements in the country.

Bahrain, Qatar and Oman

The 5 Bahrain opposition groups represented in the National Dialogue have suspended their participation over the detention of a senior opposition member, and have threatened to pull out of the process entirely. The National Dialogue, a forum for talks between the government and opposition, has been fraught with difficulties since its inception in February. Opposition politicians have suspended participation more than once previously, generally due to frustrations that the government is not engaging fully with the process and continues to carry out security operations against protestors and activists, whom the government labels as terrorists. The suspension occurs amid ongoing violence in the gulf island. The government recently announced the death of a policeman who had been injured in a bomb blast in August. He is the third policeman to die this year in clashes with opposition activists. We do not expect the national dialogue to bear fruit, and anticipate continued sporadic low-intensity clashes between security forces and opposition for the foreseeable future. These clashes tend to occur outside the capital, Manama, and thus are less likely to disrupt economic activity in our view than the full-scale protest movement that occurred during the spring of 2011.

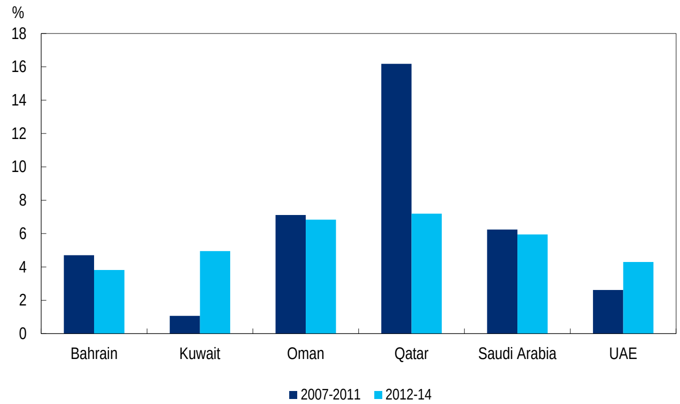
Credit growth in Qatar has decelerated sharply thanks to a significant mopping up of excess liquidity earlier this year through a US$4bn central bank domestic issuance. Annual credit growth in July halved to 15%YoY, from an average of 30% pre-March. Along with a modest fall in food price rises, the slowdown in domestic credit growth has helped to keep a lid on inflation, which had begun to creep up in recent months, peaking at 3.7% in April but which fell to 2.7% in August. That said, we do see inflationary pressures building, particularly from the housing market. Since the beginning of 2009 property prices and rents had been on a steady decline, keeping overall inflation subdued, and sometimes even negative. Since October of last year, however, rent inflation has registered in positive territory on a YoY basis, and jumped to almost 7% in August 2013. While we continue to see fundamental weakness in the real estate market emanating from a large supply overhang which will be exacerbated with the completion of further ambitious projects, prices have recovered in the past year mainly thanks to the surge in the Dubai property market, in our view, which acts as a weathervane for property investor sentiment in the region. We expect prices to continue to rise over a one- to two-year horizon, putting further upward pressure on the CPI going forward.

Figure 124. Fiscal breakeven oil prices on the rise



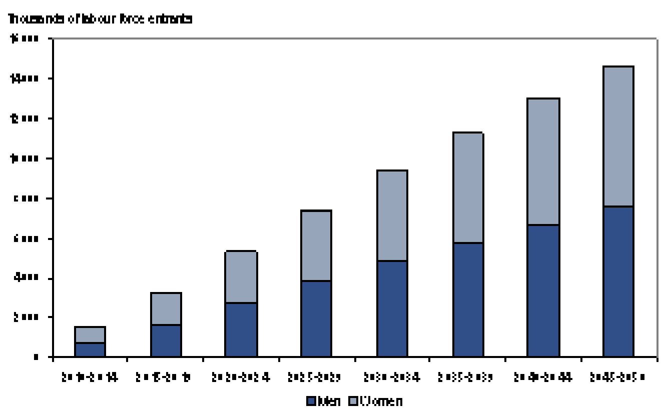
Source: Citi Research estimates

Figure 125. Economic growth will be uneven going forward



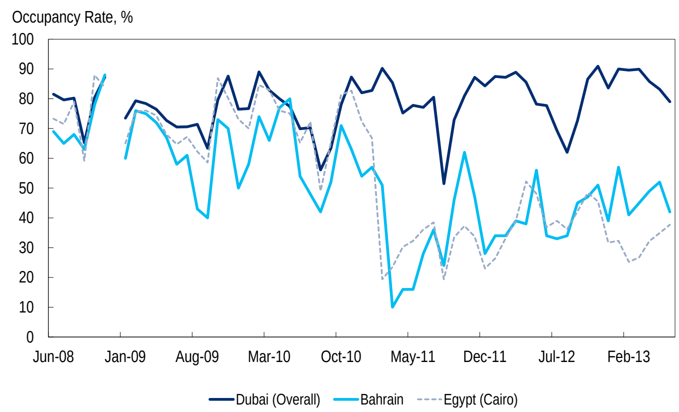
Source: Haver Analytics, Citi Research

Figure 126. 3.3 million entrants in Saudi job market by end of decade



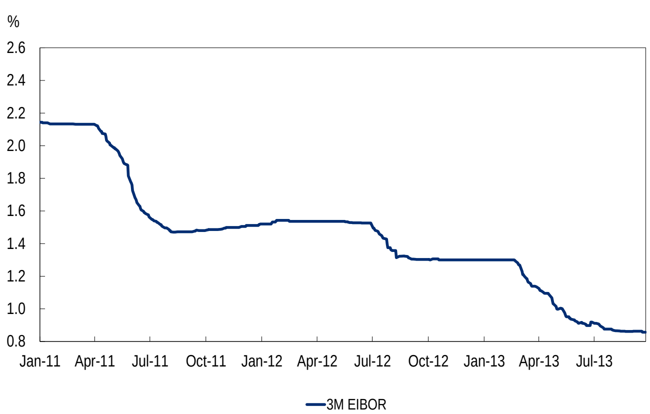
Source: Saudi Central Statistics Office, Citi Research

Figure 127. Dubai hotel occupancy continues to outperform its peers



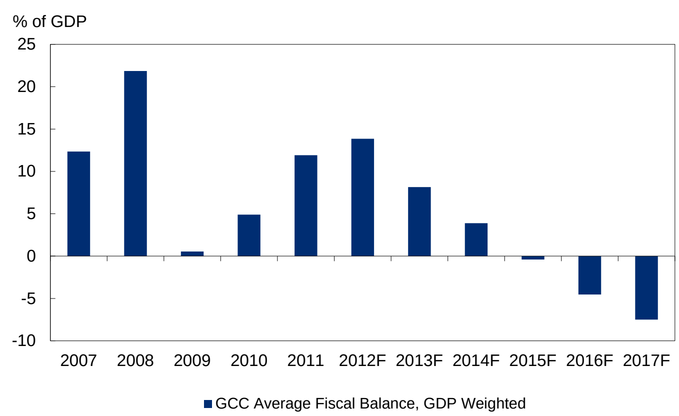
Source: Ernst & Young, Citi Research

Figure 128. EIBOR rates have begun to decline again



Source: Haver Analytics

Figure 129. High government expenditure will drive balances lower



Source: Haver Analytics, Citi Research estimates

Figure 130. GCC Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
BAHRAIN									
Nominal GDP, USD bn	18.5	21.7	25.6	22.9	25.6	29.0	30.3	34.7	37.5
GDP per capita, USD	19,406	21,072	22,983	19,192	20,482	22,401	22,517	24,792	25,771
Real GDP, yoy avg	-	8.3	6.2	2.5	4.3	2.1	3.4	3.6	4.4
CPI, % avg	2.0	3.3	3.5	2.8	1.9	-0.4	2.8	4.0	2.5
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account	2.0	2.8	2.1	0.4	0.6	3.0	2.0	1.3	0.7
% of GDP	11.1	12.7	8.1	1.7	2.3	10.3	6.4	3.8	1.9
Consolidated government balance	4.0	2.7	6.4	-4.3	-4.8	-0.3	-2.0	-1.1	-0.3
KUWAIT									
Nominal GDP, USD bn	101.6	114.6	147.3	105.8	119.8	160.7	183.9	171.8	174.5
GDP per capita, USD	42,016	44,851	54,520	37,123	40,041	51,411	57,140	51,826	51,114
Real GDP, yoy avg	7.5	6.0	2.5	-7.1	-2.4	6.3	7.6	3.6	3.7
CPI, % avg	3.1	5.5	10.6	4.0	4.0	4.7	2.9	5.0	5.0
KWD/US$, avg	0.29	0.28	0.27	0.29	0.29	0.28	0.28	0.29	0.29
Current account	45.5	43.0	58.5	28.3	37.7	66.5	78.9	81.9	78.5
% of GDP	44.8	37.5	39.7	26.8	31.4	41.4	42.9	47.7	45.0
Consolidated government balance	18.1	22.2	14.4	13.9	11.4	22.9	27.8	22.6	18.8
OMAN									
Nominal GDP, USD bn	36.8	41.9	59.9	53.4	53.4	53.4	53.4	87.6	94.4
GDP per capita, USD	14,386	15,259	20,887	18,015	17,438	16,881	16,180	25,324	26,126
Real GDP, yoy avg	3.7	10.4	14.6	9.5	-0.5	1.5	7.1	6.7	6.7
CPI, % avg	3.0	5.9	12.5	3.6	3.2	4.0	2.9	3.0	3.0
OMR/US$, avg	0.38	0.38	0.38	0.38	0.38	0.39	0.39	0.39	0.39
Current account	5.7	2.5	5.0	-0.5	5.0	9.0	8.1	9.1	7.7
% of GDP	15.4	5.9	8.4	-0.9	9.4	16.8	15.2	10.3	8.1
Consolidated government balance	-0.4	3.4	0.3	0.2	3.5	-0.4	3.6	1.5	0.2
QATAR									
Nominal GDP, USD bn	60.5	80.8	110.7	98.3	98.3	171.5	198.5	218.6	247.6
GDP per capita, USD	72,192	86,829	100,831	80,717	72,717	114,241	122,429	124,879	130,923
Real GDP, yoy avg	26.2	18.0	17.7	12.0	15.2	18.1	6.0	8.3	7.2
CPI, % avg	11.8	13.6	15.2	-4.9	-2.4	1.9	1.9	3.0	3.0
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64
Current account	9.5	11.5	26.6	6.4	24.0	52.0	61.6	44.6	29.7
% of GDP	15.6	14.2	24.0	6.5	24.4	30.3	31.0	20.4	12.0
Consolidated government balance	8.5	10.9	9.8	13.4	2.7	8.7	5.5	2.4	0.5
SAUDI ARABIA									
Nominal GDP, USD bn	376.4	415.6	519.4	429.0	526.8	669.5	710.9	741.6	793.6
GDP per capita, USD	15,882	17,111	20,861	16,811	20,178	25,645	26,699	27,305	28,646
Real GDP, yoy avg	5.6	6.0	8.4	1.8	6.4	8.6	5.1	6.1	6.6
CPI, % avg	2.3	4.1	9.9	5.1	5.3	3.9	2.9	6.0	8.0
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Current account	99.6	94.3	133.0	21.5	67.4	159.3	165.7	133.0	102.9
% of GDP	26.5	22.7	25.6	5.0	12.8	23.8	23.3	17.9	13.0
Consolidated government balance	19.9	11.3	29.8	-5.4	4.4	11.6	14.0	7.7	2.3
UNITED ARAB EMIRATES									
Nominal GDP, USD bn	222.1	257.9	315.5	254.8	287.4	348.6	383.7	417.0	454.2
GDP per capita, USD	52,524	57,474	66,202	51,915	56,859	66,942	70,668	73,329	76,383
Real GDP, yoy avg	9.8	3.2	3.2	-4.8	1.7	3.9	4.4	4.6	4.9
CPI, % avg	-	-	-	1.6	0.9	0.9	0.7	0.8	1.0
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account	33.9	15.5	66.8	7.9	13.7	80.9	115.5	140.6	167.3
% of GDP	15.2	6.0	21.2	3.1	4.8	23.2	30.1	33.7	36.8

Source: National Sources, Citi Research

Hungary

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- **Summary view**— Monetary and fiscal stimulus may help to accelerate growth in 2014 but growth impacts may be short lived.
- **Things to watch** — Discussions about a new FX mortgage aid program, populist fiscal measures in the run up to the spring 2014 elections and impacts of the extended FGS may be key domestic factors to watch.
- **Strategy** — Further rate reductions and the NBH's BS expansion may steepen the front end of the yield curve and deliver a weaker FX, especially as core yields rise.

Growth stimulus to strengthen in the run up to elections

Domestic demand contribution to growth turned positive in 2Q13 for the first time since 2010. Rising net real wages supported by low inflation and populist government rhetoric has helped to boost consumer confidence despite the absence of any meaning improvement on the labour market (see Figure 1). Although the unemployment ratio may drop further below 10% this year on ambitious government plans to increase the number of public fostered work programs, there hasn't been any significant job creation in the private sector apart from strong seasonal employment in agriculture and service industrial in the summer months. Household consumption may get further support by the extension of family tax credits and child benefits from 2014 and the announced second round of retail electricity and gas price cuts in November. These may be potentially followed by further regulative price cuts next year, according to political communication.

We have upped our 2014 GDP forecast from 1.4% to 1.8% based on the NBH's extended SME lending program. The NBH has announced in September that it would extended the Funding for Growth Scheme (FGS) up to HUF 2trn by end-2014 following the allocation of the first HUF 750bn program in June-Aug. The FGS offers funding to SMEs at 2.5%, significantly lower than the market borrowing rates. The NBH allocates free funds to banks that can lend the funds to SMEs with 2.5% capped margin. If fully implemented, the program would increase the NBH BS by 20% and would add about 0.25% of GDP annually to fiscal sterilization costs until the loans run out due to an increase in 2-week NBH bills on the liability side. We believe the impact to growth is likely to be limited to around 0.5-0.8% of GDP as we only expect a small fraction of the funds to finance new investments. Given that positive impacts to growth may be short lived, we believe the key risk is that the NBH may further extend the FGS beyond 2014. This may lead tosharp rise in NBH BS and constantly loosening monetary conditions posing risks to permanent FX weakening.

Fiscal costs of the FGS may strengthen the MPC's motivation to continue rate cuts. The implementation of additional utility price cuts in November is likely to push inflation close to 1% by year-end and provide room for further reduction in short term interest rates if the external environment remains supportive. We believe excess liquidity provided by the FGS may also drive the short end of the yield curve lower. We project rate cuts to continue in 4Q13 and rates to bottom out around 3.25%. Based on the outlook of CPI rising to 3% by 4Q14, we believe the currently priced forward interest rates seem too low and we expect that the NBH would have to reverse part of the rate cuts and hike the base rate to 4.25% by end-2014.

Fiscal correction may be needed after the elections

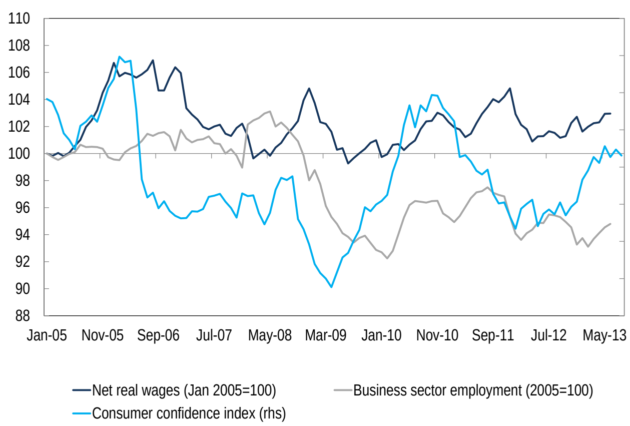
The proposed fiscal loosening measures may widen budget deficit to around 3.3-3.5% of GDP from 3.0% in 2013, according to our estimates. The government has upped the official deficit target from 2.7% to 2.9% of GDP for both 2013 and 2014. 2013 deficit is may still remain below 3% of GDP but there are upside risks to the deficit related to the accounting of equity transfers and the impact of lower EU fund disbursement due to temporary suspensions on technical breaches. The proposed VAT cuts, family tax credit and child benefit extension and the elimination of one-off financial transaction duty (0.25% of GDP in 2013) is unlikely to be fully compensated by the positive budget impacts of growth acceleration in 2014. Therefore we project the 2014 fiscal deficit around 3.3-3.5% of GDP without corrective measures. Although Hungary has exited the EDP in July, the EU may still restart the procedure if there is clear evidence of breaching the 3% deficit threshold. With this in mind we expect that the government will be likely forced to take corrective steps after the elections next year.

FX mortgage aid scheme may add to external vulnerability

Discussions about the next FX mortgage aid scheme are likely to remain in the focus of domestic news flow in the coming month. After various aid schemes the government is seeking a solution that would fully eliminate households' exposure to FX risk. Given that about one fifth of Hungarian households have FX mortgage debt, the government will likely keep the bailout issue in the focus in the coming month and not seeking a quick solution ahead of the elections. In our view, financial stability concerns and banks contribution to fiscal tax revenues will likely keep radical solutions with upfront burden on banks off the table. Based on government officials' comments so far the scheme will likely target 15-20% reduction in FX mortgage installments to bring the level of monthly installments in line with similar HUF denominated loans rather than offsetting the full, close to 45% equity loss on average CHF denominated contracts. Losses may be spread over the remaining maturities to avoid a hit on banks capital position but the bulk of the burden is likely to be shifted on banks.

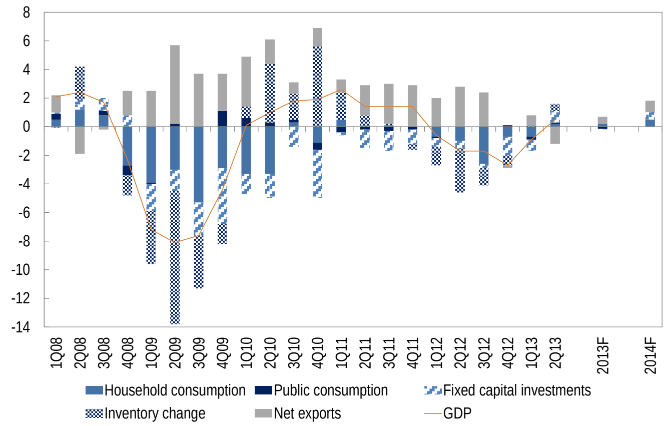
The FX mortgage aid scheme will likely include some form of conversion of hedging as the political target is to eliminate the open FX exposure from household balance sheets. Even if no spot conversion will be involved, banks would need to hedge FX exposure due to risk considerations. In order to avoid market pressure the NBH may provide FX for banks from its reserves. Based on the FX reserve coverage of short term external debt and the 5% of GDP surplus in current and capital accounts Hungary seems to be well protected against risks of intensified outflows from the EM. FX reserves however are small compared to the stock of external portfolio debt. Therefore the utilization of FX reserves to hedge households FX risks may increase external vulnerability, especially as the NBH eases monetary conditions further.

Figure 131. Household consumption may pick up...



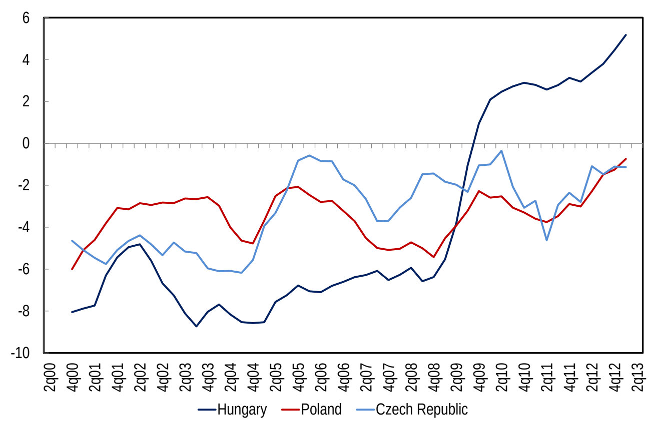
Source: Hungarian CSO, GKI, Citi Research

Figure 132. ...helping to lift domestic demand contribution to growth



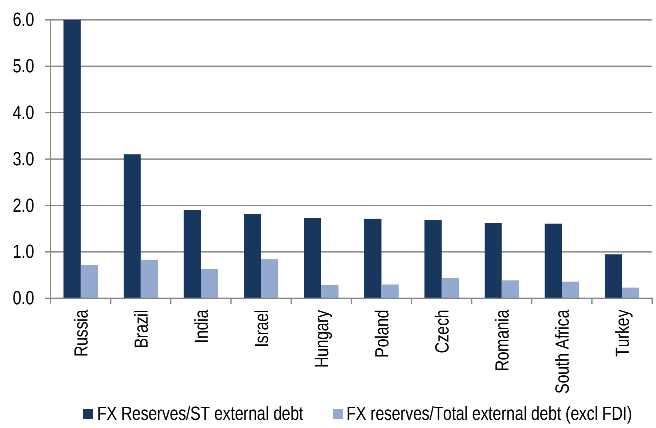
Source: Hungarian CSO, Citi Research

Figure 133. CA plus capital account balance (4q rolling, % of GDP)



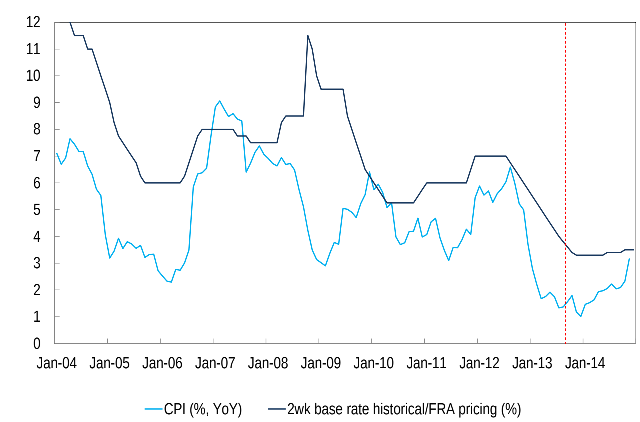
Source: Haver, Citi Research

Figure 134. Hungary's FX reserve coverage may decline on mortgage aid



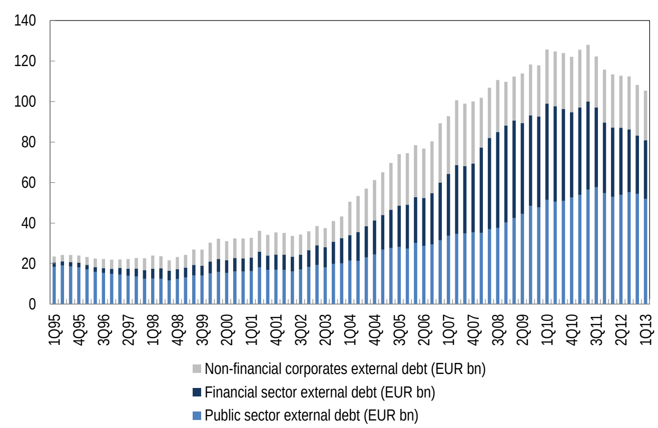
Source: Bloomberg, Haver, Moody's, Citi Research

Figure 135. CPI outlook versus interest rates priced by FRAs



Source: National Bank of Hungary, Citi Research

Figure 136. Public sector still exposed to 50% of GDP external debt



Source: National Bank of Hungary, Citi Research

Figure 137. Hungary Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	124	145	141	136	128	116	128	133	138
Nominal GDP, local currency bn	23,798	25,134	26,565	25,751	26,697	27,971	28,341	29,288	30,778
GDP per capita, USD	12,277	14,416	14,095	13,623	12,773	11,626	12,863	13,368	13,902
Population, mn	10.1	10.0	10.0	10.0	10.0	10.0	10.0	9.9	9.9
Unemployment, % of labour force	7.5	7.4	7.8	10.0	11.2	11.0	10.9	10.6	10.2
Economic Activity									
Real GDP, yoy avg	3.9	0.1	0.9	-6.8	1.3	1.6	-1.7	0.6	1.8
Real investment growth % yoy	-0.3	-1.5	3.7	-29.6	7.6	-0.4	-11.5	-0.2	3.1
Real consumption growth % yoy	2.2	-1.4	-0.2	-4.5	-2.3	0.3	-1.7	0.0	0.7
private consumption growth % yoy	1.7	1.1	-0.7	-6.6	-3.0	0.5	-1.4	0.4	1.0
Real export growth, % yoy	19.1	15.0	5.7	-10.2	14.2	6.3	2.0	2.4	3.5
Real import growth, % yoy	15.1	12.8	5.5	-14.8	12.7	5.0	0.1	2.1	3.1
Prices, Money & Credit									
CPI, % yoy	6.6	7.4	3.4	5.4	4.6	4.1	5.1	1.2	3.2
CPI, % avg	4.0	7.9	6.0	4.0	4.7	3.9	5.7	1.9	2.0
Nominal wages, % yoy	8.2	8.0	7.4	0.5	1.3	5.2	4.6	3.8	4.4
Credit extension to private sector, % yoy	16.7	18.8	21.7	-2.7	4.1	-0.5	-10.1	-1.7	2.1
Policy Interest Rate, % eop	8.00	7.50	10.00	6.25	5.75	7.00	5.75	3.25	4.25
1 month inter-bank rate, %, eop	8.08	7.50	10.00	6.25	5.75	7.08	5.75	3.25	4.25
Long-term yield, %, eop	6.71	7.08	8.28	7.99	7.97	9.75	6.11	5.80	6.60
HUF/US$, eop	190	173	190	189	208	244	221	221	223
HUF/US$, avg	210	183	171	201	208	201	225	226	223
HUF/EUR, eop	251	253	266	271	278	315	291	302	307
HUF/EUR, avg	264	251	252	280	275	279	289	300	305
Balance of Payments, USD bn									
Current account	-8.3	-9.9	-11.4	-0.3	1.4	1.1	2.1	2.4	2.4
% of GDP	-6.7	-6.8	-8.1	-0.2	1.1	1.0	1.6	1.8	1.8
Trade balance	-3.1	-0.9	-1.8	3.3	4.3	4.7	5.2	5.6	5.5
Exports	73.3	93.0	106.1	80.0	91.5	104.7	98.5	104.1	110.9
Imports	76.4	93.9	107.9	76.7	87.2	100.0	93.2	98.4	105.4
Service balance	1.8	1.8	2.2	2.8	3.9	4.4	4.4	4.4	4.7
Income balance	-6.7	-10.1	-11.0	-6.9	-7.3	-8.7	-8.2	-8.3	-8.4
FDI, net	2.9	0.3	3.9	0.2	1.0	0.8	2.9	2.7	3.1
International reserves	20.9	23.2	33.2	41.1	43.1	45.4	43.5	46.8	51.3
Total amortisations	7.7	9.3	15.2	16.1	15.2	14.1	16.6	15.3	15.3
Public Finances, % of GDP									
Consolidated government balance	-9.4	-5.1	-3.7	-4.6	-4.3	4.3	-1.9	-2.9	-3.3
Consolidated gov primary balance	-5.5	-1.0	0.5	0.0	-0.1	8.5	2.5	1.2	0.7
Public debt	65.7	67.0	72.3	78.4	80.2	81.4	79.4	79.1	78.2
of which Domestic	35.9	36.1	37.5	37.0	40.9	40.6	43.5	44.8	45.5
Foreign Assets & Liabilities, USD bn									
External debt	114.4	151.7	172.6	196.3	184.9	171.4	202.6	186.9	185.9
Public	41.3	51.5	56.1	68.3	70.3	70.8	71.7	74.2	75.1
External debt / GDP	92.6	104.8	122.2	144.1	145.0	147.9	158.3	140.8	134.7
External debt / XGS	131.5	137.7	136.5	199.2	166.7	135.2	170.4	149.1	139.5
Short-term debt	22.6	32.9	27.5	28.0	32.8	31.7	22.8	20.5	19.3
Short-term debt/International reserves (%)	108.2	141.7	82.8	68.2	76.1	69.8	52.5	43.9	37.6

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	-0.9	0.5	0.9	1.4	2.0	2.0	1.7	1.5	1.2
CPI, % yoy	2.2	1.9	1.4	1.2	1.5	2.0	2.0	3.2	3.4
Policy interest rate, %, eop	5.00	4.25	3.60	3.25	3.25	3.25	3.50	4.25	4.75
Short-term market rate, % eop	5.00	4.25	3.60	3.25	3.25	3.25	3.50	4.25	4.75
Long-term yield, %, eop	6.27	6.12	5.80	5.80	6.00	6.20	6.50	6.60	6.60
HUF/EUR, eop	304	295	298	302	303	305	306	307	308

Source: National Sources, Citi Research

Israel

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- **Summary view** — We think Israel will stay stuck in a relatively low-growth equilibrium for the next couple of years, caught between weak global demand growth and weak consumer confidence.
- **Things to watch** — The Bank of Israel remains very concerned about the risk that a strong shekel might pose to the economy's recovery, and cut its rate to 1% for next month, which helps to complement measures introduced earlier this year to accumulate fx reserves and prevent ILS appreciation. It remains to be seen if the new BOI governor – still to be announced – will intensify this policy.
- **Strategy** — The interest rate cycle has probably now bottomed, since inflation expectations are stuck in the upper half of the 1-3% inflation target. But the Bank's policy rate will likely stay at 1% for the foreseeable future, and we expect strong effort to avoid ILS appreciation.

A false dawn in Q2 data

A sharp increase in Q2 GDP is probably not sustainable. The economy seemed to bloom in Q2, with GDP growing 4.9% QoQ, but we believe that pace is unlikely to be sustained. The Q2 data were inflated not only by the start of gas production in April, but also by front-loading of consumer purchases in the run-up to a VAT increase in June. The underlying picture for the Israeli economy remains relatively gloomy. The PMI has stayed below 50 for five consecutive months; credit growth has fallen sharply; industrial production growth went negative in July; and the weak external demand picture has kept export growth negative in 7 of the past 12 months. In view of all this – in particular the weak outlook for net exports - the Bank of Israel has cut its growth forecast for 2013 from 3.8% (which includes the impact of gas production) to 3.6%. The Bank is slightly more optimistic about 2014, for which it has increased its forecast 20bp to 3.4% (again including gas)

The external sector remains a focus for policymakers…

'Dutch disease' risks are still a concern. Like many other countries, Israel has suffered a shock to export growth in 2012 and 2013, in spite of the fact that the shekel gained competitiveness over many other emerging economies. One of Israel's problems in this regard is that the destination of much of its exports remains the US and EU, with relatively little trade exposure to Asia (although this has been growing). So the Bank of Israel remains concerned about the need to maintain as competitive an exchange rate as possible, particularly because of the impact of gas production: Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April. Gas from Tamar is likely to substitute some US$2.1bn of energy imports in 2013, with the result that Israel's current account deficit, which was a drain on investor enthusiasm towards the shekel last year, will disappear, and there are good chances that Israel will sustain a long run of current account surpluses in the foreseeable future. Since these current account surpluses have increased investors' enthusiasm to own the shekel, the Bank of Israel remains very concerned that gas-driven shekel appreciation could threaten Israel's recovery. We think the Bank has some good reason to be worried: the real effective exchange rate appreciated by 7% in the first eight months of the year. And the Bank now has a long track record, dating back to 2008, of aggressively seeking to avoid shekel appreciation to minimize the threats to the real economy.

…and the problem won't go away

In the medium term, the outlook for Israel's balance of payments is exceptionally good, due to very large offshore gas discoveries in the past couple of years. In addition to Tamar (1.6bn barrels of oil-equivalent), Leviathan (3bn barrels equivalent), which goes into production in 3-4 years, should have a transformative effect on the economy. At a rough guess, gas production from these two fields will add around 2% GDP per year to Israel's balance of payments (both through import-substitution as well as exports). The government is in the process of creating a Sovereign Wealth Fund to capture the net income from gas production, and it reckons that the Fund will reach over US$80bn by 2040 (Israel's GDP this year is around US$230bn). We think it's worth assuming that more gas and oil will be discovered in the Eastern Mediterranean, and so Israel's emergence as an energy exporter is likely to become a an even stronger story than it is at the moment: the US Geological Survey estimates that the Levantine Basin – 40% of which is in Israeli waters – contains more than 3.4 trillion cubic meters of gas. The so-far-discovered reserves of Tamar and Leviathan are only around 700 billion cubic meters, which suggests that Israel might end up with twice the amount of gas that it has found to date.

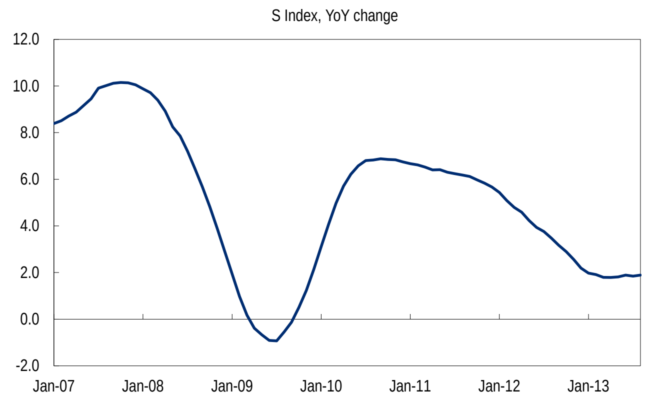
Interest rates are becoming a less effective tool

The Bank of Israel cut its rate twice in May by a total of 50bp to 1.25%, and cut again this month to 1%. In all of these exercises the main objective has been consistently to prevent the shekel from appreciating. The most recent cut was motivated also by signs that economic activity in August was particularly weak: VAT revenues rose by only 1%YoY, for example, and the boost to investment from the gas industry and from Intel's Israel operation can no longer be relied on. However, the closer Israel is to the zero lower bound, the less effective further interest rate cuts will be, and since longer-term inflation expectations are stuck around 2.5%, we think the Bank will probably not cut rates further, particularly since household credit – especially for housing – remains buoyant. While the Bank is probably right to think that this problem is best addressed through macro-prudential measures – which were tightened in August – further rate cuts could create dangers. For that reason, efforts to weaken the shekel will rely more on fx intervention we think.

A better fiscal outlook, but Fed tapering could hurt

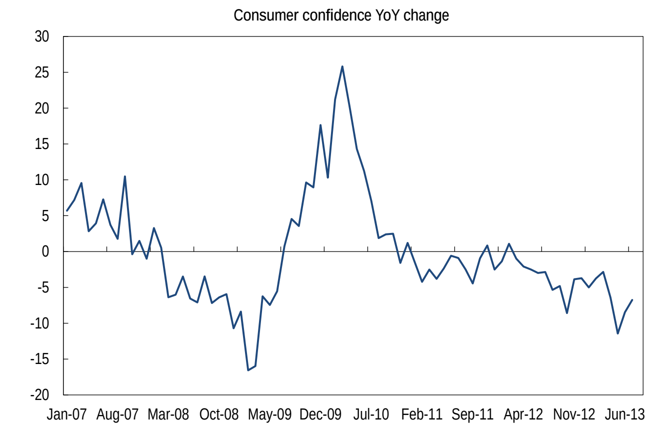
One of the factors that has facilitated a more aggressive stance by the BOI is that fiscal uncertainties have eased somewhat. Although fiscal performance in August was poor, the overall fiscal picture isn't as bad as previously feared. Thanks to some expenditure restraint, the deficit now seems headed for 4% GDP this year, compared to the 4.65% deficit that was forecast earlier. In addition, changes in national accounting methodology have pushed GDP up by around 7% compared to the previous data, which has reduced the end-2012 debt/GDP ratio from 73.5% to 68.4%. Nonetheless, programmed spending plans by the government are likely to push the public debt up moderately over the next few years, and this leaves little room for the Israeli yield curve – very steep by international standards – to flatten. And given the strong correlation between Israeli and US yields, Citi's forecast that the US 10-year yield will rise above 3% means that further steepening is probably on the cards.

Figure 138. Economic activity is stabilizing at a weak level, partly thanks to what the BOI describes as a 'virtual standstill' in world trade…



Source: Haver Analytics, Citi Research

Figure 139. …and consumer confidence is fragile even though household borrowing has been relatively robust

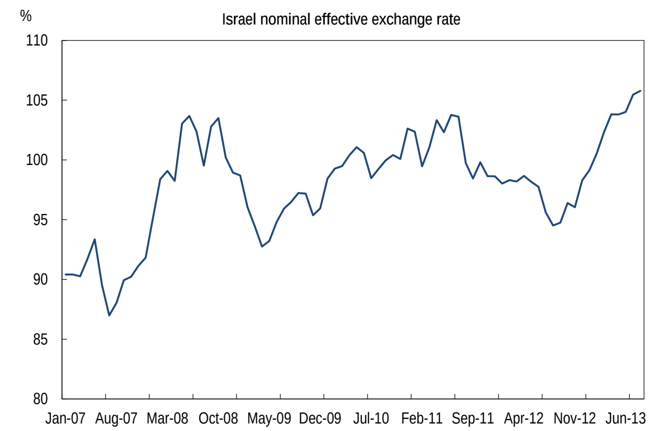


Source: Haver Analytics, Citi Research

Figure 140. Inflation expectations have picked up a bit since earlier this year…

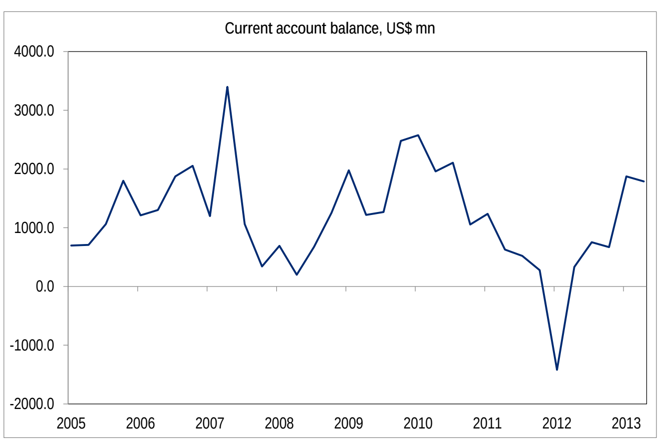
Source: Haver Analytics, Citi Research

Figure 141. …but the shekel has strengthened sharply in nominal terms in the past year…



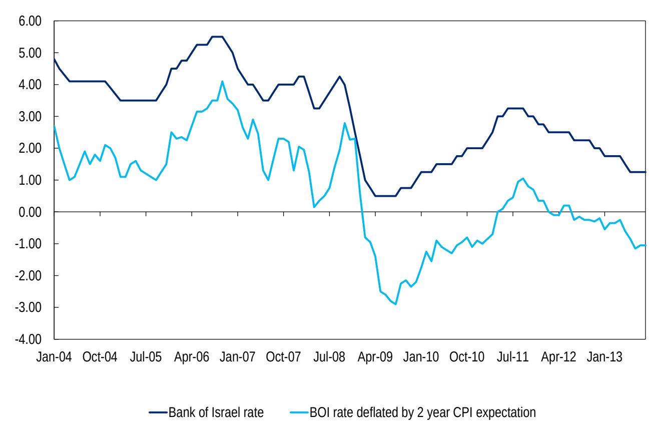
Source: Haver Analytics, Citi Research

Figure 142. …on the back of a sharply improving current account balance…



Source: Bloomberg, Citi Research

Figure 143. …but the Bank of Israel doesn't have much room to cut rates further



Source: Bloomberg, Citi Research

Figure 144. Israel Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	145	166	202	195	218	244	241	276	286
Nominal GDP, local currency bn	648	685	722	766	814	872	929	986	1,045
GDP per capita, USD	21,484	24,038	28,416	26,824	28,317	28,006	30,512	34,100	34,923
Population, mn	6.8	6.9	7.1	7.3	7.7	8.7	7.9	8.1	8.2
Unemployment, % of labour force	10.5	9.2	7.7	9.4	8.3	7.1	6.9	6.5	6.5
Economic Activity									
Real GDP, yoy avg	5.6	5.5	4.6	0.7	5.2	4.7	3.0	3.3	3.4
Real investment growth % yoy	11.7	12.5	4.4	-3.4	11.2	17.5	3.8	-2.7	5.6
Real consumption growth % yoy	4.4	6.8	1.7	2.0	4.4	1.8	0.9	2.0	3.0
private consumption growth % yoy	5.1	8.3	1.6	2.1	4.9	1.4	0.0	2.8	3.0
Real export growth, % yoy	5.2	9.8	6.8	-12.2	14.9	5.1	0.1	3.8	3.4
Real import growth, % yoy	2.7	11.7	2.5	-13.9	12.4	11.5	3.8	-6.5	1.6
Prices, Money & Credit									
CPI, % yoy	-0.1	3.4	3.8	3.9	2.7	2.2	1.6	2.1	2.4
CPI, % avg	2.1	0.5	4.6	3.3	2.7	3.5	1.7	1.6	2.3
Nominal wages, % yoy	-	4.1	-0.2	1.7	4.7	3.1	5.5	7.2	7.3
Credit extension to private sector, % yoy	6.3	7.6	12.2	5.0	6.0	6.3	6.1	6.9	6.5
Policy Interest Rate, % eop	4.50	4.25	2.50	1.00	2.00	2.75	2.00	1.00	1.50
1 month inter-bank rate, %, eop	5.03	4.50	1.90	1.31	2.06	2.74	1.75	1.00	1.50
Long-term yield, %, eop	5.61	6.17	4.72	5.11	4.75	4.24	3.62	4.20	4.50
ILS/US$, eop	4.22	3.86	3.78	3.79	3.52	3.81	3.73	3.51	3.69
ILS/US$, avg	4.46	4.11	3.58	3.93	3.73	3.58	3.85	3.57	3.65
Balance of Payments, USD bn									
Current account	7.0	4.6	2.2	7.3	8.1	3.4	-0.2	4.5	4.9
% of GDP	4.8	2.7	1.1	3.8	3.7	1.4	-0.1	1.6	1.7
Trade balance	-3.2	-5.2	-6.3	0.8	-1.7	-7.8	-9.9	-8.0	-5.0
Exports	43.9	50.8	58.1	46.8	56.4	64.2	61.5	66.0	71.0
Imports	47.2	56.0	64.4	46.0	58.1	72.0	71.4	74.0	76.0
Service balance	3.6	2.7	4.1	4.3	6.5	7.4	9.2	8.0	8.0
Income balance	-0.8	-0.3	-4.1	-5.2	-5.1	-4.9	-7.6	-3.0	-6.1
FDI, net	-0.2	0.2	3.7	2.7	-3.6	7.8	7.2	2.5	4.0
International reserves	29.1	28.6	42.5	60.6	70.9	74.9	76.0	75.0	75.0
Total amortisations	5.3	5.6	4.7	4.5	5.0	5.0	4.0	3.8	4.2
Public Finances, % of GDP									
Consolidated government balance	-0.4	0.5	-1.2	-4.4	-3.0	-2.6	-3.7	-4.3	-3.0
Consolidated gov primary balance	6.0	6.5	4.3	1.0	2.4	2.7	1.5	0.9	3.0
Public debt	83.2	76.5	75.6	77.9	79.2	78.2	77.5	76.6	74.2
of which Domestic	62.4	59.4	60.6	63.5	61.4	60.8	60.3	58.9	56.4
Foreign Assets & Liabilities, USD bn									
External debt	87.5	90.8	88.4	93.3	106.5	102.8	93.6	102.0	104.0
Public	33.4	32.0	28.2	31.2	40.3	36.5	37.0	38.0	40.0
External debt / GDP	60.3	54.6	43.8	47.9	48.9	42.2	38.8	36.9	36.3
External debt / XGS	140.5	127.9	107.7	136.5	131.9	113.0	102.7	106.3	99.0
Short-term debt	37.0	39.9	40.3	42.2	54.4	49.6	44.0	45.0	45.0
Short-term debt/International reserves (%)	127.3	139.6	94.7	69.7	76.7	66.2	57.9	60.0	60.0

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	3.2	3.7	3.5	3.2	3.2	3.0	3.0	3.0	3.5
CPI, % yoy	1.3	2.0	2.2	2.1	2.8	2.8	2.7	2.4	2.5
Policy interest rate, %, eop	1.75	1.25	1.00	1.00	1.00	1.00	1.00	1.50	1.50
Short-term market rate, % eop	1.75	1.22	1.00	1.00	1.00	1.00	1.00	1.50	1.50
Long-term yield, %, eop	3.00	3.20	3.20	3.50	4.75	4.75	4.75	4.75	4.75
ILS/US$, eop	3.65	3.64	3.48	3.51	3.58	3.65	3.67	3.69	3.71

Source: National Sources, Citi Research

Levant

Iraq

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Iraq's oil exports are likely to dip significantly during September and October as major construction works are carried out to install a new metering platform near the Basra oil terminal. Two of the four berths on the terminal will be out of service for around four weeks, implying a loss of half of the 1.2mbpd that is exported through it. Whether the net loss to exports will be as high as that is unclear, however, as some crude oil may be diverted to the 2 single point mooring (SPM) terminals, currently exporting at less than half their operational capacity (combined exports average 800kbpd while capacity is around 1.8mbd).

The installation of the new metering stations will, however, enable the final two SPMs installed during 2012 to begin operating, bringing the total export capacity out of the South to over 4.5mbpd, or double current exports. In reality, however, there remain several obstacles to achieving exports of that magnitude. Crude supply remains hampered by the slow pace of on-shore infrastructure development by the government (especially pipes and water injection), on-shore storage facilities have yet to be fully completed, and the system still lacks the pumps to raise the pressure to achieve maximum capacity output. However, the completion of the works will nonetheless mark a major milestone in the development of Iraq's export infrastructure, and is supportive of economic growth and public finances going forward.

Violence continues in Iraq's Sunni-dominated provinces and in Baghdad. It is difficult to disentangle the causes for the upsurge in violence, as both the increasingly divisive governing style of PM Nouri al Maliki and the ongoing civil war in neighbouring Syria seem to be playing their part. That said, we do not expect the situation to escalate to all out civil war as witnessed in 2006/2007. Then, the violence was the result of fierce competition between Sunni insurgents and Shia militia, but also reflected intra-sectarian fighting, mainly between rival Shia militias. Today, the situation has changed. The main Shia militias (Mehdi army and Badr brigades) have disbanded, either joining the political mainstream or the security forces of the interior ministry. Moreover, the Sunni insurgency, while somewhat revived for the reasons described above, remains less potent than it was. Finally, US troop withdrawal at the end of 2011 eliminates a major casus belli, namely foreign occupation. In short, while the threat of increased violence is real, this will likely pitch Sunni insurgency against the federal government, a somewhat different dynamic to the 2006/2007 violence.

Jordan

Jordan's fiscal position remains vulnerable despite an improvement in the headline deficit number, which has gone from 4.2% of GDP (annualized) in the first six months of 2012, to 2.1% in the same period this year. The improvement, however, is entirely down to an increase in international grants, with the total pledged to the Jordanian government in the first half of the year standing at JD433m. Grants stood at just JD25m in the same period last year, and at JD327m for the entire year. Excluding grants, the deficit actually ballooned from 4.4% to 7.0% (both annualized). Indeed, international support has become increasingly important to the Kingdom's economic position: the United States will be providing a sovereign debt guarantee, and external grants have helped the reserve position reverse its downward trajectory, rising to US$9.4bn in June from US$7.3bn last December.

A significant source of economic weakness is energy, including Jordan's reliance on fuel imports, and the large losses at the state electricity provider due to subsidized domestic energy tariffs. Gas imports from Egypt, which used to account for 80% of Jordan's electricity generation feedstock, once again ground to a halt after the Sinai pipeline which transports the gas was bombed in July for the 16th time in the past 3 years. As supplies from Egypt even in the absence of the bombing had dwindled, forcing Jordan to import more expensive diesel from elsewhere. Aside from foreign assistance, we see little relief to Jordan's energy predicament in the near- to medium-term, and losses to the government arising from it are being limited by a controversial IMF-backed 5-year plan to lift domestic energy subsidies.

Jordan's economy has also been affected by a wave of around 500,000 refugees from Syria, although the net impact is unclear. On the one hand, the refugees, most of which live in Jordanian urban centres, put further strain on Jordan's limited resources. On the other, their presence, along with that of the NGO community which has swelled as a result of the conflict, is supporting domestic demand and motivating an increase in aid flows to the Kingdom.

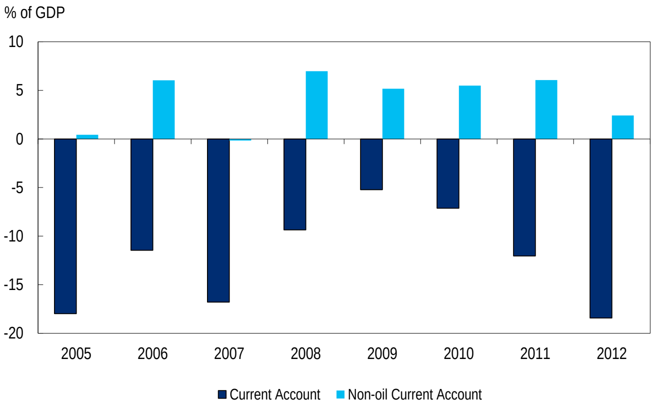
Lebanon

Sectarian tensions remain high with occasional violence spilling over from Syria into Lebanon. Tit for tat mosque car bombings left around 70 people dead in a Shia stronghold in Beirut and in the Sunni-dominated city of Tripoli. Perennial sectarian tensions have spilled over into violence since the outbreak of civil war in Syria, and in particular since Hizbollah leader Sayyed Hasan Nasrallah publicly acknowledged in May the direct role his militants were playing there.

Despite the rising tensions, we maintain our view that Hizbollah's military dominance within Lebanon makes widespread and prolonged domestic sectarian fighting unlikely. This could change, depending in large part on what happens in Syria and the will of external powers to provide material support to anti-Hizbollah factions, but there is no evidence of this for the time being. We consequently do not expect a descent into civil strife in Lebanon at this stage, although an continued violence and sporadic attacks is inevitable, in our view.

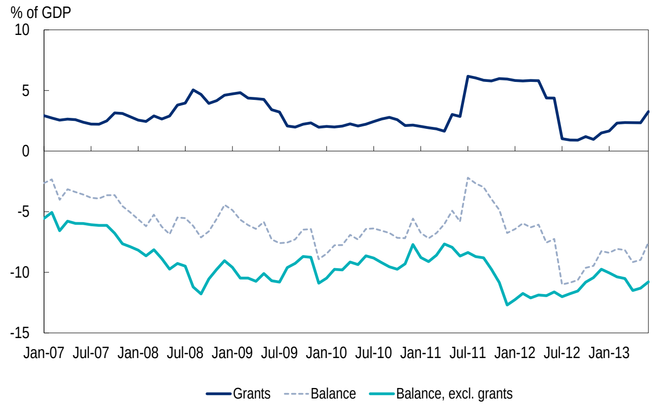
Prime Minister designate Tammam Salam continues to be frustrated in his efforts to form a new government, six months after the resignation of the previous government. This is not the first time that Lebanon has lacked a government for an extended period of time: indeed, it took Nagib Mikati five months to cobble together the previous government. However, there are a number of critical differences that make the current political impasse particularly detrimental to the country's socio-economic stability. First, the level of violence and insecurity in Lebanon has risen dramatically. Second, the lack of a government has coincided with a de facto lack of parliament, as the boycott by March 14 and affiliates has prevented parliament convening since its term was extended in June due to lack of quorum. Day to day management of the country's affairs, such as approval of civil servant salaries, has become difficult and often reliant on presidential decree. The prospect of a government forming in the near future does not appear to be improving, with March 8 and March 14 blocs holding to opposing views on fundamentals, such as the allocation of numbers, individual ministries and the cabinet statement.

Figure 145. Jordan current account dominated by oil imports ...



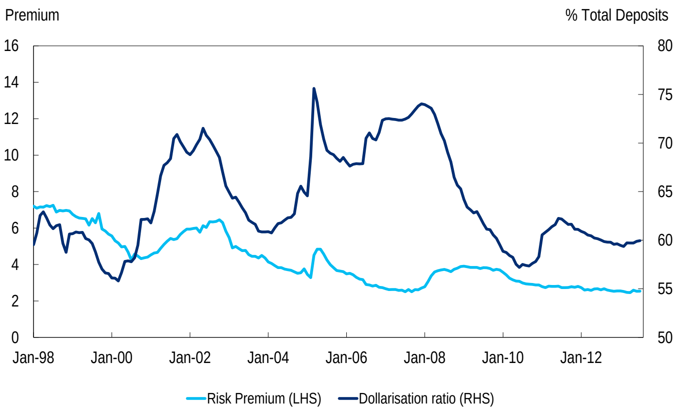
Source: Haver Analytics, Citi Research

Figure 146. Without grants Jordan's fiscal situation would be worse



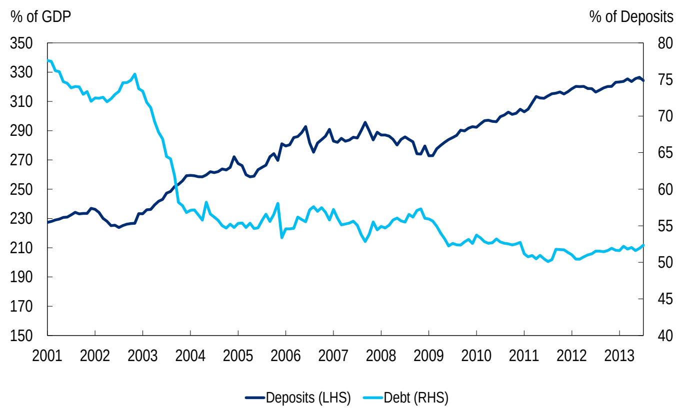
Source: Haver Analytics, Citi Research

Figure 147. Lebanon dollarization has gone up, but risk premium stable



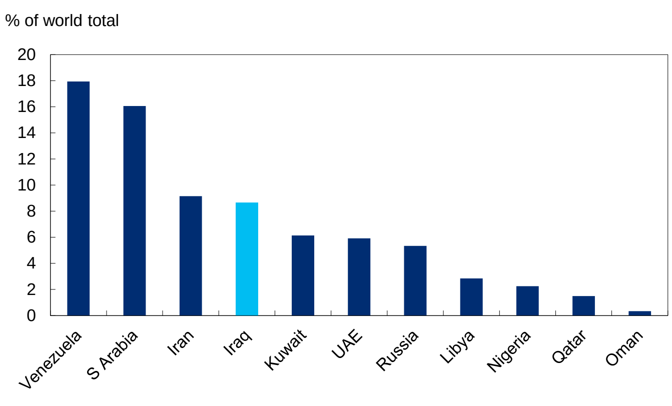
Source: Haver Analytics, Citi Research

Figure 148. Deposit growth slows, but still plenty of capacity



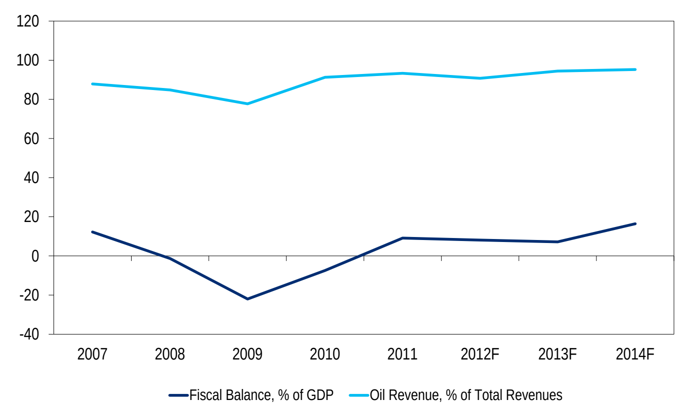
Source: Haver Analytics, Citi Research

Figure 149. Iraq has world's fourth largest proven oil reserves and ...



Source: BP, Citi Research

Figure 150. ... public finances to strengthen on greater oil revenues



Source: IMF, Citi Research

Figure 151. Levant Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
IRAQ									
Nominal GDP, USD bn	65.1	58.8	85.8	65.5	78.1	97.0	106.0	119.5	139.1
GDP per capita, USD	2,321	2,047	2,916	2,172	2,523	3,055	3,257	3,579	4,062
Real GDP, yoy avg	10.1	1.4	7.2	4.2	5.9	4.3	9.7	7.8	10.1
CPI, % avg	-	32.6	2.8	-2.8	2.4	5.6	6.1	6.0	6.0
IQD/US$, avg	1,463	1,253	1,189	1,156	1,167	1,171	1,164	1,162	1,162
Current account	1.3	20.0	28.4	-1.3	6.3	26.2	36.2	39.5	49.6
% of GDP	1.9	34.1	33.1	-2.0	8.1	27.0	34.2	33.0	35.7
Consolidated government balance	-	12.2	-1.4	-22.0	-7.4	9.1	8.1	7.2	16.4
JORDAN									
Nominal GDP, USD bn	15.0	17.1	22.0	23.9	26.5	28.9	30.9	32.7	34.3
GDP per capita, USD	2,736	3,023	3,764	3,962	4,282	4,558	4,758	4,908	5,027
Real GDP, yoy avg	8.1	8.2	7.2	5.5	2.3	2.6	2.7	3.0	4.0
CPI, % avg	6.3	4.7	13.9	-0.7	5.0	4.4	4.8	5.5	5.0
JOD/US$, avg	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Current account	-1.7	-2.9	-2.1	-1.2	-1.9	-3.5	-5.6	-4.4	-3.9
% of GDP	-11.5	-16.8	-9.3	-5.2	-7.1	-12.0	-18.2	-13.4	-11.5
Consolidated government balance	-4.2	-5.1	-4.4	-8.9	-5.6	-6.8	-8.3	-8.2	-8.2
LEBANON									
Nominal GDP, USD bn	22.2	25.0	29.7	34.7	37.1	39.0	41.3	43.8	47.6
GDP per capita, USD	5,903	6,640	7,795	8,984	9,499	9,857	10,241	10,643	11,321
Real GDP, yoy avg	1.4	8.4	8.6	9.0	7.0	1.5	1.5	2.0	4.5
CPI, % avg	5.6	4.1	10.8	1.2	4.0	5.1	6.4	5.0	5.0
LBP/US$, avg	1,508	1,512	1,507	1,504	1,502	1,506	1,504	1,508	1,508
Current account	-1.1	-1.4	-4.1	-6.7	-7.6	-4.8	-6.0	-6.9	-7.5
% of GDP	-5.2	-5.5	-14.0	-19.5	-20.4	-12.3	-14.6	-15.7	-15.8
Consolidated government balance	-13.6	-10.2	-9.8	-8.5	-7.8	-6.0	-8.8	-10.2	-10.5

Source: National Sources, Citi Research

Nigeria

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- **Summary view** — While political uncertainty is set to rise steadily in 2014, we still expect growth to remain just over 6% in 2H 2013 and in 2014 driven by strong consumption and agricultural sector growth. But the fiscal picture could deteriorate and inflation start to rise back into double digits in 2H 2014.
- **Things to watch** — The pressure on the naira since June highlights that it is vulnerable to sentiment: both Nigeria specific and towards emerging markets in general. If oil prices or production, or reserves, were to fall sharply, the pressure on the naira could intensify sharply in our view.
- **Strategy** — With Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, Nigeria has a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies and improved fiscal discipline.

The looming election will start to be more important

Although Nigeria will not hold presidential and parliamentary elections until early 2015, 2014 is essentially a pre-election year. This is already clear from the recent very public divisions within the ruling People's Democratic Party (PDP) about its potential presidential candidate. And the political tension could well mount in 4Q 2013 in the debate over the 2014 budget in the National Assembly. Ms Okonjo-Iweala is clearly pushing hard to maintain a tight fiscal stance, but this is already running up against political demands for higher spending. All this would imply a major political battle over the budget and it may well be that a final version of the budget is not approved until early 2014. On a positive note, a significant delay in passing the budget could partially limit fiscal slippage in 1H 2014.

In addition, the approaching elections probably mean that the economic reform programme which slowly gathered momentum in 2012-13 will end up on the backburner. We expect only very limited progress in the passage of the proposed Petroleum Industry Bill (PIB) and Sovereign Wealth Fund (SWF). However, there could be some further progress with reforms in the electricity sector as this is a crucial platform for the president, Goodluck Jonathan, if he really intends to seek re-election 2015 as it would provide a concrete sign of what he has actually achieved while in office.

But growth should remain robust

But while a deteriorating political environment is not good for growth, we do expect it to remain around the 6% level supported by a pick-up in agricultural sector growth which has become a policy priority. Although agricultural production was negatively impacted in 2012 by the instability caused by Boko Haram and floods, both have become less important in 2013. An improved supply of fertilizer could also potentially significantly boost output in the coming 18 months. Recovery in agricultural sector growth will be supported by strong service sector growth, but overall growth will still be constrained by only very limited increases in oil production given recent problems with production and with the approaching elections raising political tensions in the Niger Delta.

We expect the GDP rebasing exercise to be implemented in December 2013. This is likely to result in the value of GDP being increased around 40% and the overall trend of greater service sector driven growth further confirmed with the importance of the oil sector downgraded.

Rates, reserves and a stable naira

Since mid-2012 the CBN has been able to maintain a stable naira on the back of strong portfolio inflows. These have been attracted by the tight monetary policy and high nominal interest rates, oil prices over US$100/barrel and the inclusion of Nigerian in various EM bond indexes and a robust economic management story. Moreover, the tight monetary policy has been justified by high inflation and levels of government spending.

But we think this policy will become more complicated over the next nine months as inflation has remained firmly fixed in single digits in 2013 and growth been less robust in 1H. This would seem to supporting the case for an easing of monetary policy, but we think a cut unlikely (if it happens, it will be very modest). This reflects the fact that the CBN not only considers inflationary trends when setting the MPR, but wider factors including a commitment to broad naira stability. And a key part of achieving in the last nine months this has been the re-building reserves to give additional confidence in the currency a policy predicated on the tight monetary policy.

But it is also increasingly clear that Mr Sanusi is not going to seek a second term and will leave office in mid-2014. His potential successor will also face the problem of rising inflation a deteriorating fiscal position and even a weakening oil price. This will put the naira under pressure and also provides a further justification for not prematurely easing monetary policy at any time soon. It also highlights the need for a more coherent and logical method of changing the governor than has been historically the case. If agreed, this may see the announcement of his replacement as early as March 2014 which would clearly be a positive in terms of improving policy continuity.

The oil price-production question and reserves

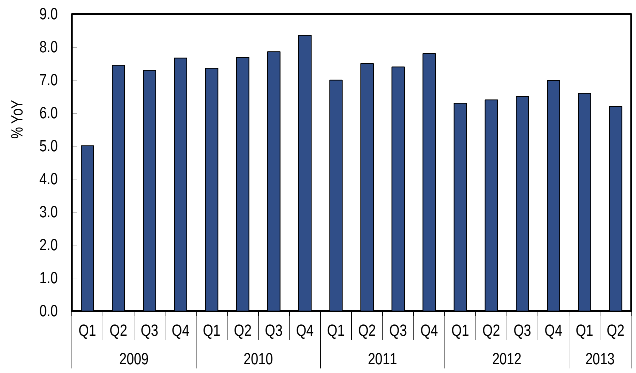
The other variable to consider when thinking about the naira outlook is both the oil price and the level of production. So far in 2013 production has been under pressure, but this has been offset by a high oil price of well over US$100/barrel. This equation could be reserved as 2014 progresses with rising oil production offsetting an easing price, but if either, or both, were to come under more sustained pressure, the current governor has made it clear that CBN would have to revisit its current exchange rate policy.

We also think the response of the CBN to naira pressure will be driven by the rate of reserve burn and the potential emergence of differential between the parallel and official exchange rates. In particular, we think that once reserves fall towards around the US$35bn level, the CBN would have to more actively consider the prospects of devaluing the naira.

Macroeconomic and naira stability for now

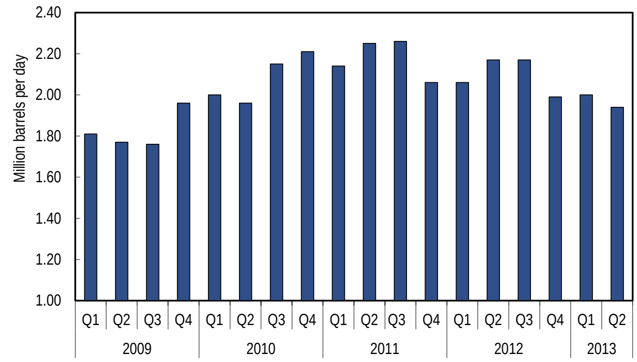
We expect that the current economic management team will be able to maintain macroeconomic and naira stability in 1H 2014. But in 2H the overall macroeconomic and political outlook will become distinctly more complicated as the pace of electioneering is bound to gather pace as Nigeria rapidly heads to elections in early 2015. But we still expect broad naira stability, unless there was a major change to the oil price-production equation or reserves really came under pressure. But while the naira will be under pressure, the positive aspect of this is that the political outlines of the polls should start to become much clearer in 2H 2014 and if the elections pass off successfully the prospects of further stability seem good in our view.

Figure 152. Growth, although robust, has been under some pressure since 2012



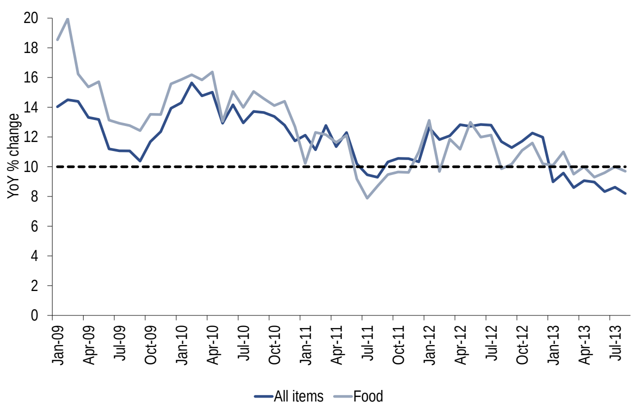
Source: National Bureau of Statistics

Figure 153. Oil production has been stuck around the 2m b/d level since late 2012



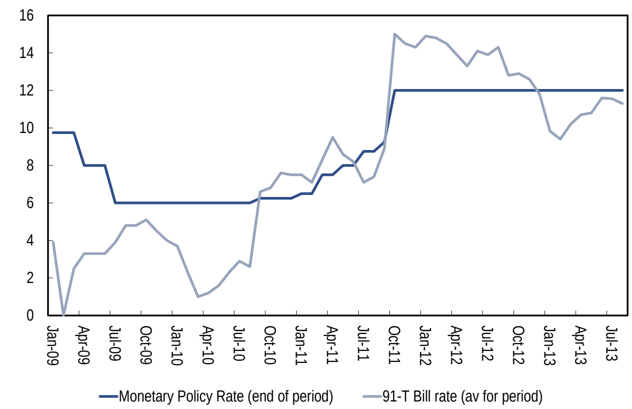
Source: International Energy Agency

Figure 154. Inflation has been in single digits during 2013



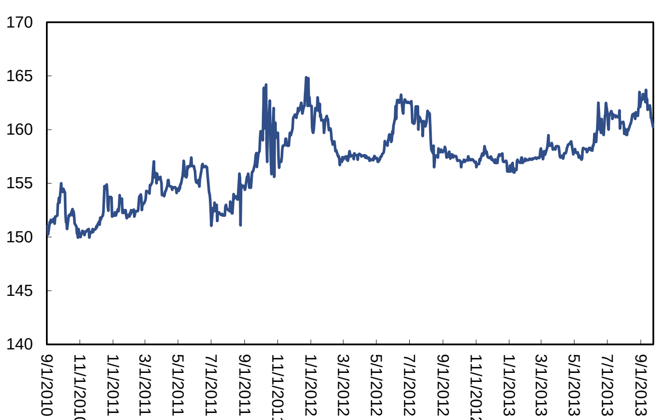
Source: National Bureau of Statistics and Citi forecasts

Figure 155. The MPR has been left unchanged since October 2011



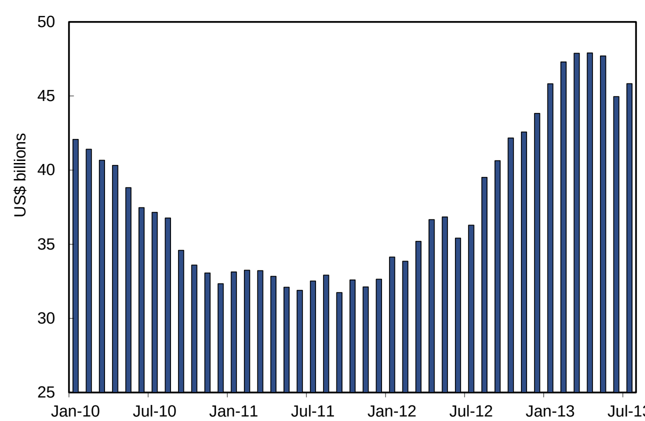
Source: Central Bank of Nigeria

Figure 156. The naira has been under pressure since May



Source: Reuters

Figure 157. Reserves have been rebuilt, but come under pressure in recent months



Source: Haver Analytics and Central Bank of Nigeria

Figure 158. Nigeria Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	144	164	204	166	193	239	281	320	360
Nominal GDP, local currency bn	18,565	20,657	24,296	24,794	29,206	37,303	40,064	42,687	45,451
GDP per capita, USD	1,008	1,119	1,357	1,074	1,224	1,479	1,695	1,886	2,065
Population, mn	143.3	146.8	150.4	154.1	157.9	161.8	165.8	169.9	174.1
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-
Economic Activity									
Real GDP, yoy avg	6.0	6.4	6.0	7.0	7.9	7.5	7.4	6.5	6.5
Real investment growth % yoy	59.3	24.5	-6.8	9.1	-3.6	2.9	-	-	-
Real consumption growth % yoy	-9.7	27.6	-19.9	-0.6	-6.7	-1.4	-	-	-
private consumption growth % yoy	-18.7	6.6	-34.3	6.4	-26.7	-10.0	-	-	-
Real export growth, % yoy	60.2	-11.7	43.4	-30.0	11.4	-9.1	-	-	-
Real import growth, % yoy	10.8	54.4	-18.8	-15.8	-15.3	-15.4	-	-	-
Prices, Money & Credit									
CPI, % yoy	8.5	6.6	15.1	13.9	11.7	10.3	12.0	7.2	7.2
CPI, % avg	8.2	5.4	11.6	12.5	13.7	10.8	12.2	8.2	8.4
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	27.8	97.1	59.4	26.6	-4.9	46.2	38.0	16.0	14.0
Policy Interest Rate, % eop	10.00	9.50	9.75	6.00	6.25	12.00	12.00	11.75	11.75
1 month inter-bank rate, %, eop	12.00	12.50	18.00	15.79	13.07	17.17	14.39	15.00	14.00
Long-term yield, %, eop	-	9.25	9.25	11.80	8.50	8.00	14.00	13.00	12.00
NGN/US$, eop	129	118	138	150	152	162	156	161	165
NGN/US$, avg	128	126	119	150	151	156	159	160	164
Balance of Payments, USD bn									
Current account	36.5	27.6	29.1	13.8	13.3	8.8	11.3	7.4	1.3
% of GDP	25.3	16.8	14.3	8.3	6.9	3.7	4.0	2.3	0.4
Trade balance	34.9	37.8	45.9	25.3	30.3	30.9	33.0	31.0	24.3
Exports	56.9	66.1	85.7	56.1	76.5	92.5	97.5	96.5	90.5
Imports	22.0	28.3	39.8	30.8	46.2	61.6	64.5	65.5	66.2
Service balance	-11.6	-16.9	-22.1	-16.5	-18.3	-21.2	-21.0	-21.9	-23.8
Income balance	-4.6	-11.8	-15.1	-14.4	-19.4	-22.8	-21.1	-21.4	-19.6
FDI, net	-	-	-	-	-	-	-	-	-
International reserves	42.3	51.3	53.0	42.4	32.3	32.9	43.8	48.3	45.8
Total amortisations	6.5	0.9	0.6	0.5	0.5	0.4	0.3	0.3	0.3
Public Finances, % of GDP									
Consolidated government balance	-0.5	-0.6	-0.2	-3.3	-3.3	-3.1	-2.8	-2.6	-2.9
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	9.6	10.9	8.5	13.0	13.3	14.5	14.3	14.3	14.4
Foreign Assets & Liabilities, USD bn									
External debt	3.5	3.4	3.7	4.6	4.6	5.7	7.1	8.5	9.9
Public	2.9	3.0	3.2	3.9	4.4	4.6	5.2	6.5	7.2
External debt / GDP	2.5	2.1	1.8	2.8	2.4	2.4	2.5	2.6	2.7
External debt / XGS	6.0	5.0	4.2	7.8	5.8	6.1	7.2	8.8	10.9
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research

Poland

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- **Summary view** — Pension system changes should improve fiscal ratios and should give some fiscal space for the government, which will likely support economic recovery. GDP growth will probably remain below potential in the next quarters, while slowly increasing inflation will remain below NBP target, which will allow MPC to leave rates unchanged at least till mid-2014 or longer in our view.

- **Things to watch** — Support for the ruling party is falling and coalition majority in the parliament is narrowing ahead of busy election calendar in 2014-2015.

- **Strategy** — Zloty vulnerability to jumps in risk aversion declined due to significant external adjustment, high real rates and improving prospects of the euro zone but we do not expect any large PLN appreciation anytime soon.

Pension system changes should lower fiscal ratios

The government announced key assumptions behind a long awaited and debated pension system reform. The plan assumes that 51.5% of pensions fund assets (around PLN 140bn, i.e. around 8% of GDP) comprising mainly government bonds, bonds guaranteed by the State and cash will be transferred to State Insurance Institution ZUS. With regards to future pension contribution flows each person will have a right to choose between private OFEs and ZUS. We expect that the future flow of contributions to OFEs will be cut substantially from approx. PLN 12 bn expected in 2014 . Moreover, each year pension funds will transfer gradually to ZUS the funds of people that have less than 10 years until retirement.

The proposed changes in pension funds system are likely to improve substantially key fiscal ratios. According to our estimates the official public debt will be cut by around 7-8% of GDP to around 48% of GDP next year. At the same time cancelled bonds will be replaced with long term off balance sheet pension liabilities of the government thus leaving total debt hardly changed assuming no change in the future expected replacement rate. The general government deficit may fall roughly by at least 0.5% of GDP in the coming years vs. earlier estimates. The deficit reduction will be due to lower debt service costs as well as a transfer of assets of people who have 10 years left until retirement age. Furthermore, if the one-off capital transfer is accounted as part of revenues this would also allow Poland to record large (approx. 4% of GDP) fiscal surplus in 2014. Moreover, the finance minister declared that the reduction of public debt will be accompanied by lowering of threshold ratios, which would lower market concerns that fiscal space created could be fully consumed through more spending and debt would go back to current levels soon. However, we believe leaving some fiscal room would be advisable taking into account still weak domestic demand and fragile prospects of economic growth recovery abroad.

… and support GDP growth recovery

We believe that the fiscal space resulting from changes in the pension system will allow the government to support the economy. In our view the government is likely to increase general government spending at least slightly in the busy election calendar in the next 2 years especially as support for the ruling party is falling and majority in the parliament is narrowing (currently coalition has only 2 votes majority). Therefore, we stick to our above-consensus forecast of 2.8% GDP growth in 2014. Our view is also backed by the most recent PMI reading, which significantly surprised to the upside and improving prospects for the euro zone.

We expect economic growth recovery in 2H. Although the data from the real economy slightly disappointed in August (industrial and construction output growth, wage growth) we still expect the 2H13 should be much better in terms of economic activity as compared to 1H and we forecast gradual acceleration of GDP growth in second half of this year to around 1.5-2%YoY from 0.5% in 1Q and 0.8% in 2Q. We expect gradual improvement in output growth resulting from recovery in both domestic and export orders. We also assume slow improvement in construction output backed by very low base in 2H12 and start of roads and energy sector investment projects, which can lower the scale on investments decline, though we do not expect positive growth rate in construction till the turn of the year. Our estimates also incorporate further acceleration of private consumption growth thanks to stabilization and improvement in the labour market and some acceleration of loans growth.

Rates to stay at record low level at least till mid-2014

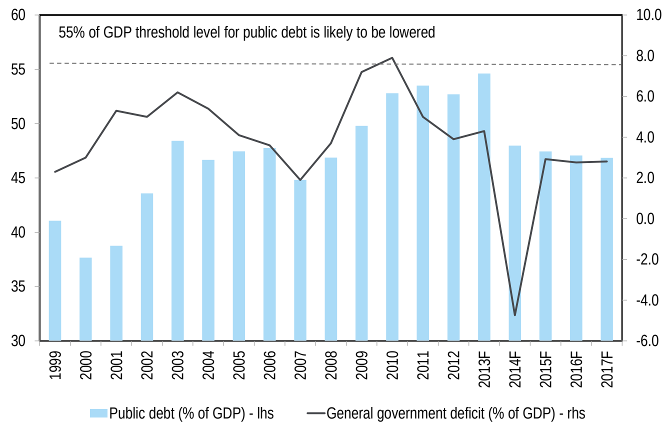
Inflation is likely to stay under control in the coming quarters amid limited demand pressures. Currently there seems to be no serious risks to NBP inflation target in the medium term. Inflation stabilized in August at 1.1%YoY after a large jump in July from 0.2% that resulted mostly from one-off factors (changes in administratively controlled prices of rubbish/waste collection services). In the coming months we expect only gradual increase of inflation toward 1.5%YoY at the year-end. In 2014 inflation is likely to reach inflation target in the middle of the year, though in 2H it will most probably decline and will stay below the target in annual average terms in our view.

As far as monetary policy is concerned we expect the central bank's base rate will remain on hold at least until mid-2014 and any rate hikes thereafter will be gradual. The MPC' s official communique for September and following Council members' comments clearly stated that the interest rates will remain unchanged at least until the end of this year. Moreover, the most dovish MPC members suggest that rates could stay at the current levels even until the end of 2014. Taking into account our forecasts assuming only gradual increase of inflation and still below-potential GDP growth we expect that interest rates will remain unchanged till mid-2014 but we see asymmetric risk the first rate hikes can come even later.

PLN less vulnerable but large appreciation rather unlikely

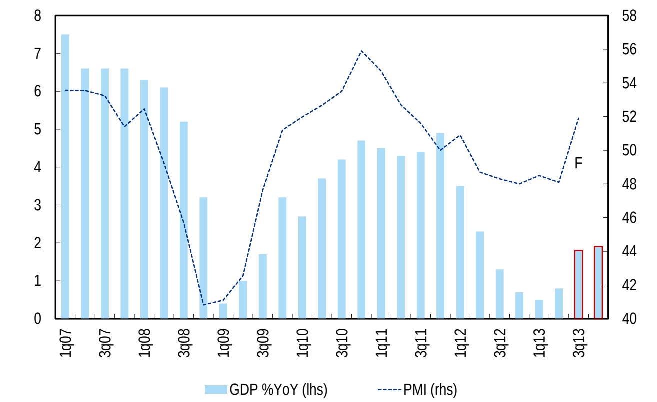
After substantial decline of current account deficit and external borrowing needs in the recent quarters zloty seems to be less vulnerable to deterioration of market sentiment than a few years ago and as compared to some other EM currencies. Zloty is also likely to benefit from economic activity improvement in the euro zone and still relatively high real interest rates. However, we do not expect any substantial appreciation of the zloty in the short term as the domestic demand is still very weak and the economic growth is still dependent on net exports. Therefore any excessive strengthening of the domestic currency would probably result in some kind of intervention from the central bank (initially probably only verbal intervention). In our view the NBP finds value in keeping relatively stable exchange rate and will probably be willing to enter the market if zloty FX movements are excessive (we believe a desirable range for EURPLN would probably be 4.00-4.50, though the central bank is unlikely to commit to this). When Fed finally decides to pursue reduction of asset purchases the zloty could be under pressure. However, as pointed out above in our view zloty would be rather less vulnerable than many other EM currencies mainly due to large external adjustment in the last few years.

Figure 159. Pension system changes will improve fiscal ratios in 2014



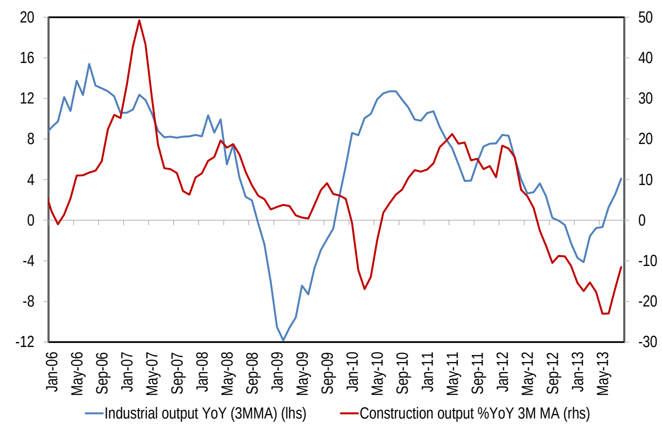
Source: Source: CSO, Eurostat, Citi Research forecast. Note: public debt based on domestic methodology, 55% threshold level corresponds to public debt according to Polish methodology

Figure 160. PMI points to gradual recovery of economic growth in 2H13



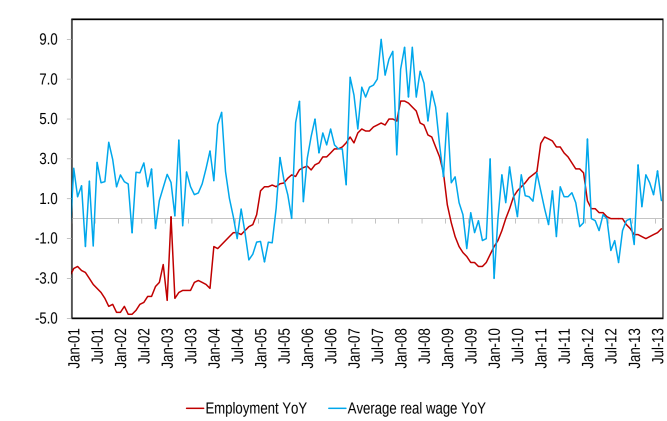
Source: CSO, Citi Research forecast.

Figure 161. Output growth is likely to gradually recover



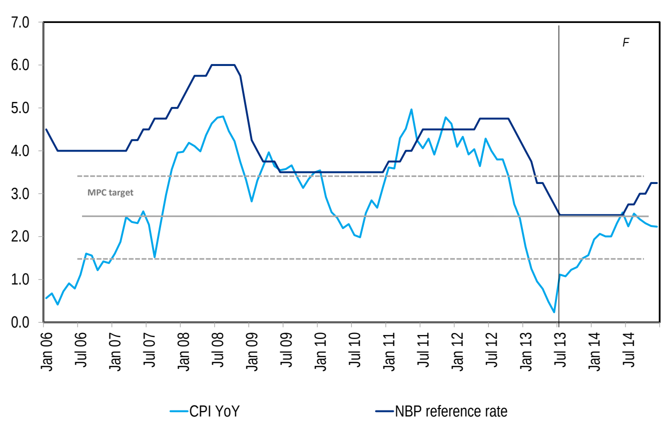
Source: CSO

Figure 162. Labour market improvement should support consumption



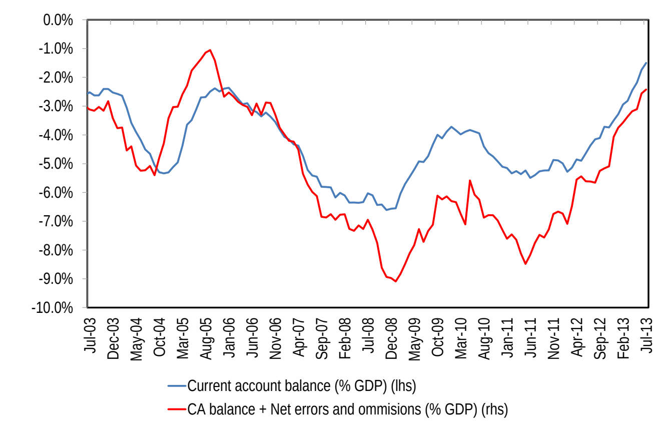
Source: CSO

Figure 163. Inflation will likely only reach inflation target in mid-2014



Source: CSO, Citi Research forecasts

Figure 164. External adjustment is likely to limit zloty's vulnerability



Source: NBP, CSO, Citi Research

Figure 165. Poland Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	342	426	534	433	470	517	490	516	561
Nominal GDP, local currency bn	1,059	1,175	1,275	1,343	1,414	1,526	1,594	1,638	1,723
GDP per capita, USD	8,969	11,185	13,994	11,347	12,210	13,404	12,722	13,378	14,575
Population, mn	38.1	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	14.9	11.2	9.5	11.9	12.2	12.2	12.2	14.2	13.4
Economic Activity									
Real GDP, yoy avg	6.2	6.8	5.1	1.6	3.9	4.5	1.9	1.3	2.8
Real investment growth % yoy	16.1	24.3	4.0	-11.5	9.3	11.2	-3.3	-3.8	3.1
Real consumption growth % yoy	5.2	4.6	6.1	2.0	3.4	1.6	0.6	1.0	2.1
private consumption growth % yoy	5.0	4.9	5.7	2.1	3.2	2.6	0.8	1.0	2.2
Real export growth, % yoy	14.6	9.1	7.1	-6.8	12.1	7.7	2.8	3.1	4.0
Real import growth, % yoy	17.4	13.7	8.0	-12.4	13.9	5.5	-1.8	0.3	2.9
Prices, Money & Credit									
CPI, % yoy	1.4	3.9	3.4	3.7	3.2	4.6	2.4	1.6	2.2
CPI, % avg	1.0	2.5	4.2	3.5	2.6	4.3	3.7	1.1	2.2
Nominal wages, % yoy	5.0	9.1	10.5	4.2	3.6	4.9	3.4	2.6	4.2
Credit extension to private sector, % yoy	24.6	32.1	37.0	6.9	8.6	13.8	4.5	0.5	5.6
Policy Interest Rate, % eop	4.00	5.00	5.00	3.50	3.50	4.50	4.25	2.50	3.25
1 month inter-bank rate, %, eop	3.96	5.37	5.41	3.56	3.46	4.57	4.01	2.62	3.57
Long-term yield, %, eop	5.20	5.93	5.46	6.24	6.07	5.91	3.73	4.40	4.80
PLN/US$, eop	2.90	2.47	2.97	2.87	2.97	3.45	3.09	3.06	3.01
PLN/US$, avg	3.10	2.76	2.39	3.10	3.01	2.96	3.25	3.18	3.07
PLN/EUR, eop	3.83	3.60	4.15	4.10	3.97	4.47	4.08	4.18	4.14
PLN/EUR, avg	3.90	3.78	3.52	4.32	3.99	4.12	4.18	4.22	4.20
Balance of Payments, USD bn									
Current account	-13.2	-26.5	-34.9	-17.3	-24.1	-25.0	-17.3	-10.9	-17.9
% of GDP	-3.8	-6.2	-6.5	-4.0	-5.1	-4.8	-3.5	-2.1	-3.2
Trade balance	-7.4	-19.1	-30.7	-7.6	-11.8	-14.1	-7.1	-0.7	-4.3
Exports	117.4	145.3	178.7	142.1	165.9	195.2	187.6	199.4	214.8
Imports	124.8	164.4	209.4	149.7	177.7	209.3	194.8	200.2	219.1
Service balance	0.7	4.8	5.0	4.8	3.1	5.7	6.2	7.4	8.5
Income balance	-9.7	-16.4	-12.8	-16.6	-19.1	-22.9	-21.9	-22.6	-25.8
FDI, net	10.7	18.0	10.4	8.5	6.9	11.6	3.1	6.5	8.0
International reserves	45.1	54.6	57.2	69.7	81.4	86.8	96.1	102.0	104.0
Total amortisations	23.5	30.2	32.4	32.8	32.1	37.6	39.6	41.1	44.3
Public Finances, % of GDP									
Consolidated government balance	-3.6	-1.9	-3.7	-7.4	-7.9	-5.0	-3.9	-4.3	4.7
Consolidated gov primary balance	-1.0	0.4	-1.5	-4.8	-5.2	-2.3	-1.1	-1.6	7.3
Public debt	47.8	44.8	46.9	49.8	52.8	53.5	52.7	54.6	48.0
of which Domestic	35.6	34.3	34.8	36.7	38.4	36.5	36.1	37.3	30.8
Foreign Assets & Liabilities, USD bn									
External debt	169.8	233.3	244.8	280.2	315.3	324.5	355.5	374.5	395.5
Public	69.1	86.8	69.4	92.2	116.5	120.2	134.5	141.7	149.6
External debt / GDP	49.6	54.7	45.9	64.7	67.0	62.8	72.5	72.6	70.5
External debt / XGS	123.0	133.9	114.2	163.8	158.7	139.4	157.5	156.6	152.9
Short-term debt	34.6	60.9	65.9	70.0	76.5	73.0	80.0	84.0	88.0
Short-term debt/International reserves (%)	76.7	111.4	115.1	100.4	93.9	84.1	83.2	82.3	84.6

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.6	0.8	1.8	1.9	2.3	2.6	3.1	3.3	3.2
CPI, % yoy	1.0	0.2	1.2	1.6	2.0	2.6	2.4	2.2	2.5
Policy interest rate, %, eop	3.25	2.75	2.50	2.50	2.50	2.50	3.00	3.25	3.50
Short-term market rate, % eop	3.28	2.66	2.61	2.62	2.62	2.80	3.17	3.57	3.65
Long-term yield, %, eop	3.94	3.99	4.25	4.40	4.55	4.60	4.70	4.80	4.90
PLN/EUR, eop	4.18	4.32	4.18	4.18	4.22	4.24	4.19	4.14	4.09

Source: National Sources, Citi Research

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- **Summary view** — The new precautionary IMF-EU supported program for 24-months, worth €4bn, which should bolster policy predictability, bodes well for improving investor sentiment.
- **Things to watch** — Political stability and the November Inflation Report deserve close monitoring, as the markets ponder whether the NBR will ease in November—the last meeting of the year—after the likely cut at the September Board meeting.
- **Strategy** — Although the authorities' decision to opt for a new IMF program and signs of a pick-up in capital inflows bode well for the leu outlook, the possibility of the NBR cutting interest rates more aggressively than warranted by fundamentals overshadows the currency outlook.

Net exports still remain as the key engine of growth…

Net exports continue to be the main driver of growth, as domestic demand struggles to gain traction. The fact that seasonally adjusted quarter-over-quarter change in private spending remains flat and that private investment growth still remains in negative territory don't paint a comforting picture for economic recovery prospects. The recent high frequency indicators such as industrial production and retail sales—along with sentiment indicators—lead us to remain cautious on the growth outlook. Specifically, we are concerned about the excessive reliance on exports, which, in turn, raises questions about the sustainability of the country's fragile recovery. With this caveat in mind, we keep our 2013 GDP forecast at 1.6%.

We welcome the new precautionary IMF-EU supported program for 24-months worth €4bn. In our view, the new arrangement should bolster policy predictability and anchor expectations. Under the umbrella of the new program, the government aims to: (i) safeguard sound public finances, (ii) continue monetary and financial sector policies that preserve buffers and increase the resilience against external shocks, and (iii) reduce bottlenecks to potential growth through structural reforms. The IMF Executive Board meeting on the new arrangement will take place on September 23.

…as year-end inflation is on track to reach 3%

At 3.7%YoY, the inflation outturn in August came in line with the consensus. Using seasonally adjusted data, the August print translates into a rise of about 0.1%MoM, compared with a drop of 0.2%MoM and an increase of 0.3%MoM in July and June, respectively. A quick glance at the momentum of the key components suggest that while food and non-food prices are providing a strong support to the disinflation process, service prices seem to be somewhat sticky.

We believe that year-end inflation is on track to be around 3%, which is in line with the NBR's most recent forecast but above the 2.5% target. This projection is underpinned by benign food prices, the recent reduction in the VAT on bread as well as flour and the continued improvement in inflation expectations. The possibility of a reversal in food inflation, the uncertainty surrounding the pass-through from the VAT reduction and a weaker leu emerge as the key risk factors that require close monitoring.

A 25bp cut at the September meeting is likely

Developments to date lead us to look for a 25bp rate cut at the September Board Meeting, bringing the policy rate to 4.25%. Specifically, the absence of a meaningful pick-up in economic activity and the fact that inflation is on track to be around 3%, which is in line with the NBR's most recent forecast, raise the likelihood of a 25bp easing on September 30. The NBR's inclination to keep money market rates below the policy rate also lends support to this conjecture.

In our view, whether the NBR will opt for further easing at the last rate meeting of the year on November 5 will depend on the evolution of the leu. In this regard, if the leu holds up well following the likely easing at the September meeting, concerns over the strength of the recovery may lead the NBR to carry out another 25bp easing that would bring the policy rate to 4.0% by the end of 2013 instead of our base case of 4.25%.

Budget gap remains in check…

Standing at around RON 6.0 billion, the budget gap in the first seven months of the year compares favorably with the deficit seen in the same period of 2012 (RON 7.0bn). While revenues during the period under consideration increased by about 5.0%YoY, expenditures were up by about 4.0%. The new IMF-EU supported program envisions the continuation of gradual fiscal consolidation, with the aim of reaching a 2013 deficit target of 2.3% of GDP in cash terms and 2.4% of GDP in European System of Accounts (ESA) terms and achieving a structural deficit of not more than 1% of GDP by 2015. The quality and soundness of fiscal policy will be bolstered by institutional reforms, including measures to foster medium-term planning, strengthen administrative capacity, accelerate the absorption of EU funds, strengthen tax administration and fiscal governance, and better control arrears.

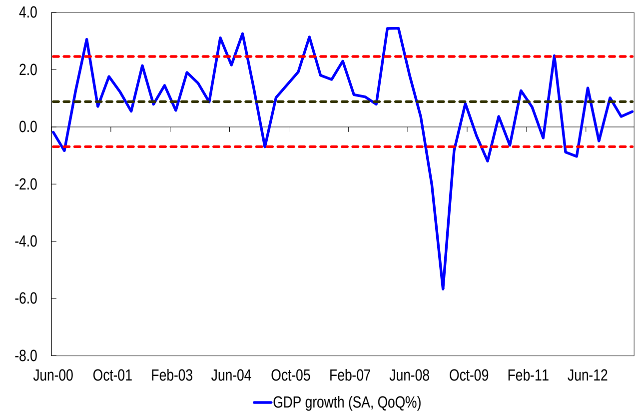
…as the current account balance continues to improve…

Standing at €0.5bn, the current account surplus in the first seven months of the year compares favorably with the same period of 2012 during which the current account balance registered a deficit of €3.0bn. The noted outturn is largely driven by robust exports, as imports continue to remain relatively soft. In line with our expectations of a sluggish recovery in domestic demand and limited scope for private credit growth, we expect the current account deficit to remain around 1.5% of GDP this year. There are nascent signs of a pick-up in capital inflows, which, if sustained, bodes well for the currency outlook.

Leu is likely to remain range bound during rest of the year

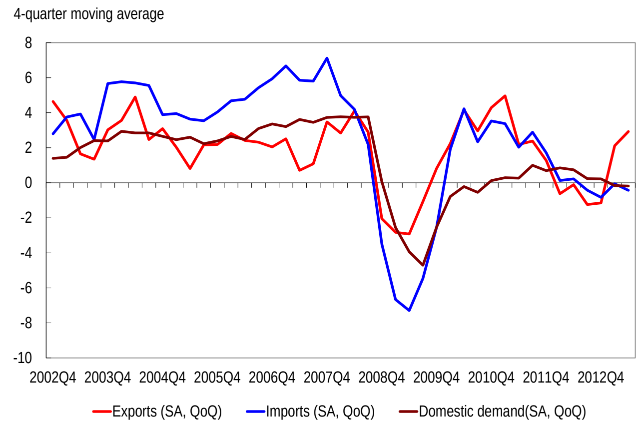
During the recent EM sell-off, the leu has performance somewhat worse than its peers in the region—PLN and CZK in particular. Moreover, the leu volatility seems to have pick up recently, which may, in part, reflect the NBR's increased tolerance for FX volatility. In our view, the noted backdrop is in part due to the NBR's accommodative stance, as money market rates remain considerably below the policy rate. From this angle, while the authorities' decision to opt for a new IMF program and signs of a pick-up in capital inflows bode well for the leu outlook, the possibility of the NBR cutting interest rates more aggressively than warranted by fundamentals overshadows the currency outlook.

Figure 166. Recovery is yet to gain traction…



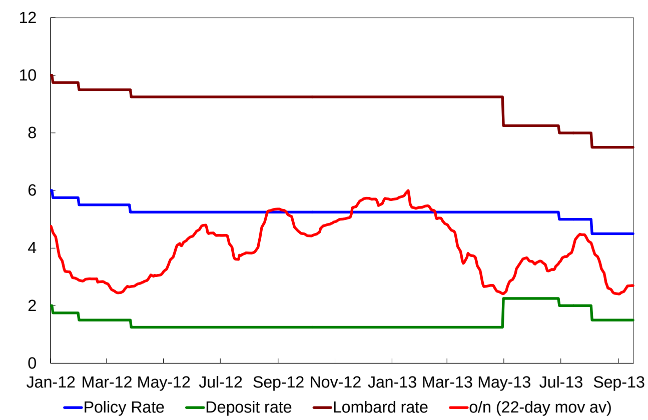
Source: Haver Analytics

Figure 167. …as weak domestic demand warrants concerns



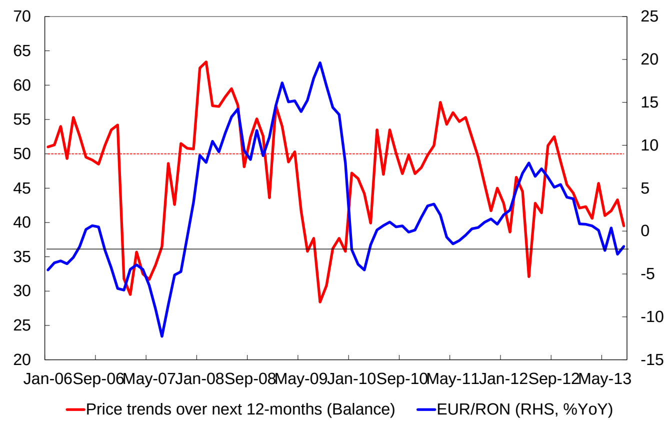
Source: Haver Analytics and Citi Research

Figure 168. NBR's stance signals that further easing is on the way…



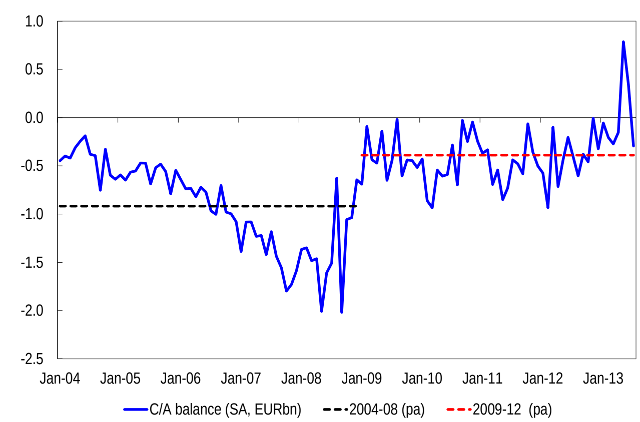
Source: Haver Analytics

Figure 169. …thanks to benign inflation expectations and the leu



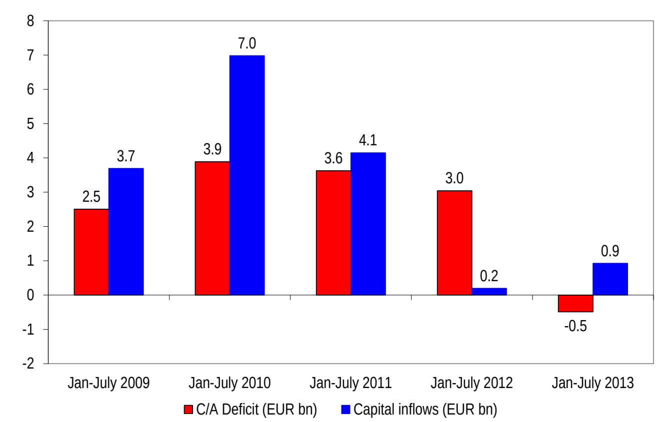
Source: Haver Analytics and Citi Research

Figure 170. Impressive external adjustment continues…



Source: Haver Analytics. Note: May 1, 2013=100

Figure 171. …as nascent signs of a pick up in capital inflows offer hope



Source: Haver Analytics and Citi Research

Figure 172. Romania Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	123	171	204	165	165	183	172	187	201
Nominal GDP, local currency bn	345	416	515	501	524	557	595	623	659
GDP per capita, USD	5,496	7,653	9,176	7,397	7,413	8,236	7,747	8,463	9,128
Population, mn	22.3	22.3	22.3	22.2	22.2	22.2	22.1	22.1	22.1
Unemployment, % of labour force	5.4	4.3	4.0	6.3	7.6	5.4	5.1	5.2	5.5
Economic Activity									
Real GDP, yoy avg	8.7	6.3	7.9	-6.8	-0.9	2.3	0.4	1.6	2.8
Real investment growth % yoy	34.9	40.6	4.0	-33.4	9.1	12.9	1.0	-0.3	2.9
Real consumption growth % yoy	10.7	10.6	9.3	-9.0	-0.8	1.2	1.0	0.5	2.3
private consumption growth % yoy	12.8	12.0	9.5	-10.4	-0.3	1.2	1.0	0.5	2.4
Real export growth, % yoy	9.9	7.7	7.6	-6.3	14.2	10.9	-3.1	4.2	4.0
Real import growth, % yoy	22.6	27.8	7.6	-21.4	12.5	10.3	-0.8	1.2	3.0
Prices, Money & Credit									
CPI, % yoy	4.9	6.6	6.3	4.7	8.0	3.1	5.0	3.0	3.5
CPI, % avg	6.6	4.8	7.9	5.6	6.1	5.8	3.3	4.4	2.8
Nominal wages, % yoy	18.9	22.6	23.6	8.4	2.5	4.9	5.0	5.4	5.0
Credit extension to private sector, % yoy	54.5	60.4	33.7	0.9	4.7	6.6	1.3	-2.0	6.9
Policy Interest Rate, % eop	8.75	7.50	10.25	8.00	6.25	6.00	5.25	4.25	4.00
1 month inter-bank rate, %, eop	8.67	8.24	15.35	10.60	4.05	5.72	6.04	4.85	4.60
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/US$, eop	2.56	2.47	2.89	2.96	3.17	3.33	3.37	3.26	3.27
RON/US$, avg	2.80	2.43	2.50	3.04	3.17	3.04	3.46	3.33	3.27
RON/EUR, eop	3.38	3.61	4.03	4.24	4.24	4.32	4.45	4.45	4.50
RON/EUR, avg	3.52	3.33	3.68	4.24	4.21	4.24	4.46	4.42	4.48
Balance of Payments, USD bn									
Current account	-12.8	-22.9	-23.8	-6.8	-7.3	-8.3	-6.6	-2.8	-8.1
% of GDP	-10.4	-13.4	-11.6	-4.2	-4.4	-4.5	-3.9	-1.5	-4.0
Trade balance	-14.8	-24.4	-28.1	-9.6	-10.1	-10.3	-9.5	-7.1	-10.6
Exports	32.5	40.5	49.6	40.5	49.6	63.0	57.9	62.6	69.4
Imports	47.2	64.9	77.7	50.1	59.6	73.3	67.4	69.7	79.9
Service balance	0.0	0.6	1.0	-0.4	0.5	0.5	0.7	2.1	0.6
Income balance	-4.1	-5.7	-5.4	-2.6	-2.5	-3.1	-2.1	-2.1	-3.1
FDI, net	11.0	9.7	13.7	5.0	3.0	2.6	2.2	1.7	2.5
International reserves	28.1	37.3	36.5	39.4	42.3	42.4	41.6	45.9	49.3
Total amortisations	8.6	12.2	18.1	17.7	19.7	19.6	23.4	23.9	23.7
Public Finances, % of GDP									
Consolidated government balance	-1.7	-2.3	-4.8	-7.3	-6.4	-4.3	-2.2	-2.2	-2.5
Consolidated gov primary balance	-0.6	-1.5	-3.9	-5.7	-4.9	-2.6	-0.4	-0.4	-0.7
Public debt	18.4	19.8	21.3	29.4	37.1	40.1	40.5	39.9	39.0
of which Domestic	6.7	10.2	12.6	15.4	19.8	22.0	20.1	20.1	19.6
Foreign Assets & Liabilities, USD bn									
External debt	51.7	80.3	105.8	113.0	122.4	137.3	128.8	138.4	145.0
Public	13.1	13.9	14.2	19.6	24.8	28.9	31.0	32.8	34.4
External debt / GDP	42.1	47.0	51.8	68.7	74.3	75.2	75.1	74.0	72.0
External debt / XGS	131.0	160.8	169.4	224.4	209.7	187.8	190.1	188.6	178.4
Short-term debt	16.7	28.7	28.5	22.5	26.2	29.5	28.9	30.1	31.7
Short-term debt/International reserves (%)	59.6	77.1	78.1	57.0	61.9	69.7	69.5	65.6	64.2
Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.2	1.5	1.6	1.4	1.8	2.2	3.0	3.8	3.8
CPI, % yoy	5.3	5.4	2.7	3.0	2.4	2.6	3.3	3.5	3.3
Policy interest rate, %, eop	5.25	5.25	4.25	4.25	4.00	4.00	4.00	4.00	4.50
Short-term market rate, % eop	5.75	5.75	4.75	4.75	4.50	4.50	4.50	4.50	5.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
RON/EUR, eop	4.42	4.46	4.46	4.45	4.45	4.47	4.48	4.50	4.48

Source: National Sources, Citi Research

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With Thanks To
Adrian Thomas

Russia

- **Summary view** — Weak growth is raising the pressure for some sort of policy response. Ideally this would involve a 'positive shock' to the investment climate, but the more likely response is easier monetary conditions and a rise in the public debt/GDP ratio in our view.
- **Things to watch** — Has the fall in growth bottomed? Although the external environment seems to be improving, the investment climate in Russia doesn't generate much optimism for a rise in 'animal spirits'.
- **Strategy** — Like other EM currencies the RUB has rallied since early September, but a renewal of the tapering debate is likely to put pressure on the currency once again. Against its basket, the RUB, now at 37, should weaken to 38.5 within the next six months.

The deceleration in economic activity is a concern

The outlook for GDP has become progressively grimmer. Q2 GDP growth fell to 1.2%, down from 4.3% a year earlier. And data since then gives no cause for optimism. Car sales data, for example, have shown a YoY fall in each of the past six months; and industrial production barely exists, while the manufacturing sector remained in recession through to August. Some of the problem lies in weak external demand, which is affecting many other emerging economies, but since G10 GDP growth staged a recovery in Q2, it is a puzzle why Russian activity remains quite so weak. One problem is that Russian domestic demand is also under pressure, and this is becoming evident in the growth rates of domestic credit, which has been slowing markedly (not that the previously rapid pace of credit growth had done much to support GDP). Weak credit demand and slower activity growth have begun to pose threats to the quality of banks' portfolios, which could in turn reduce further the supply of credit. The Central Bank is growing concerned about this problem, and has asked banks to increase their provisioning levels from next March. In any case, relying on credit to boost GDP growth above potential is likely to be counter-productive. As a result of all this, GDP growth for 2013 looks likely to be close to 1.5%, below the Economy Ministry's forecast of 1.8%.

There are elements of stagflation in Russia's macro story, which could create a dilemma for the central bank. Inflation has been between 6.5-7.5% since last September, uncomfortably high, particularly in the context of the Central Bank's inflation goal of 5-6%, and its desire to target future inflation at 4.5% +/- 150bp. This has made it difficult for the Central Bank to justify a loosening of monetary policy, The most direct form of loosening has taken place through the exchange rate, which in real terms has depreciated by around 5% since Q1. Going into next year, the case for some more formal monetary loosening – through interest rate cuts – is mixed. On the one hand, lower inflation should be supported by the government's decision to freeze the utility tariffs paid by industry next year, and to charge households an increase which is 0.7 times the CPI. While this is a less generous deal on tariffs than the government had previously suggested – when it had proposed a freeze for households – the deal is likely to be sufficient to push inflation towards 5% in 2014, from just over 6% at the end of this year.

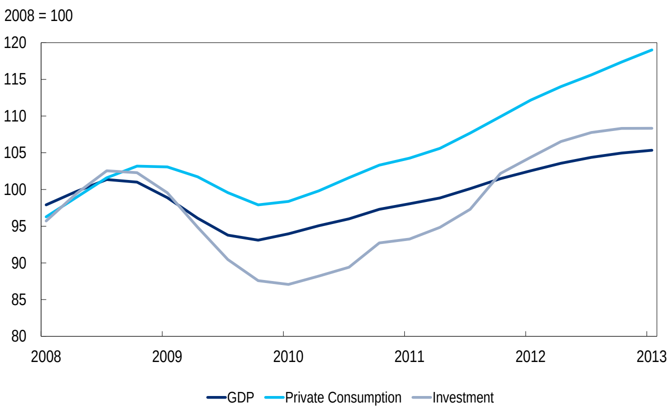
Russia still lacks a reliable growth model

So far the Russian slowdown hasn't had a hugely negative impact on public finances, but this could change. The budget has fallen into deficit due to weak non-oil revenue growth, and while the government has announced some spending cuts to offset the revenue shortfall, the deficit will probably exceed the 0.8% GDP budgeted for the whole year - expenditures tend to accelerate at year-end. Russia's public debt burden remains very low, and so there is plenty of fiscal space, but the Finance Ministry's newly adopted fiscal rules look set to be challenged, not least because the President has suggested that the growth is the main priority of fiscal policy. In the longer term, the challenge to the Ministry's tight fiscal rules is likely to come from the absence of a reliable growth model in Russia. Indeed, there are already signs that the public sector balance sheet is being relied on more and more to absorb the shock of weak private demand.

There is plenty of discussion within the administration about what needs to be done to raise Russia's growth potential. The Economy Ministry forecasts an acceleration of growth next year to 3%, based on an expected rise in investment spending. Yet it is difficult to see what will generate optimism among holders of capital without deep reforms to Russia's investment climate, and it is difficult to identify exactly what reforms will be implemented to achieve this. Although President Putin has targeted a very ambitious increase in Russia's ranking in the World Bank's Doing Business Survey, the improvement in the investment climate needed to achieve this will be difficult to generate: the UN, for example, forecasts a roughly 1% annual decline in Russia's working-age population for the foreseeable future. What this means, in all probability, is that a greater claim on Russia's fiscal resources will be made, to support consumption growth in the short term. In addition to the measures described in the above paragraph, there is likely to be more social spending – on child allowances for example – and more defence spending.

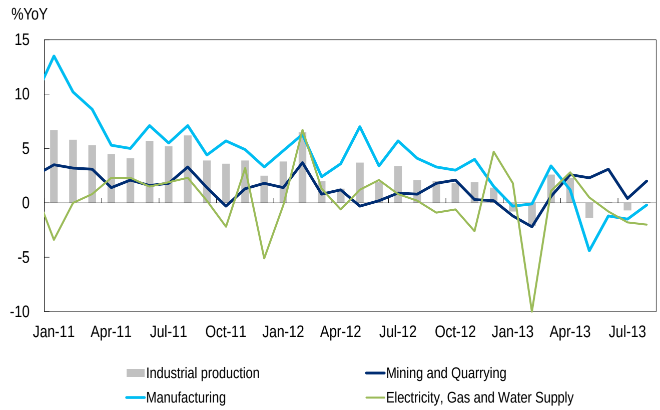
The rouble will be even more sensitive than usual to downside oil price risks. While we don't forecast oil prices to fall in 2014, the high propensity to import – which probably explains the link between high credit growth and weak GDP growth – suggests that the rouble could become vulnerable in a scenario where commodity prices fall, particularly since the CBR seems inclined to let the market reprice the currency when the balance of payments weakens. And if the US tapering renews the threat to capital inflows to EM as a whole, the large previous inflows into the OFZ market could become an additional problem for the nominal exchange rate. We expect the current level of the rouble, at 37 to the basked, to be as strong as it gets in the near term, and another breach of 38 is likely in the next few months. For the time being, the trade surplus has been supported if anything by the relative weakness of domestic spending – monthly surpluses of US$14 bn or so have been common the past few months. But as the Central Bank itself acknowledges, even with an oil price at US$101 next year, the current account surplus could be as low as US$25bn, a level not seen since the late 1990s. With a likely deterioration in both the public sector balance sheet and the external balance sheet over the next few years, the market is likely to engage in some debate about whether the real effective exchange rate – which is still some 45% more appreciated than it was, on average, between 2003-2005, is correctly priced to support Russian GDP growth and the balance of payments.

Figure 173. The post-crisis catch up is largely over ...



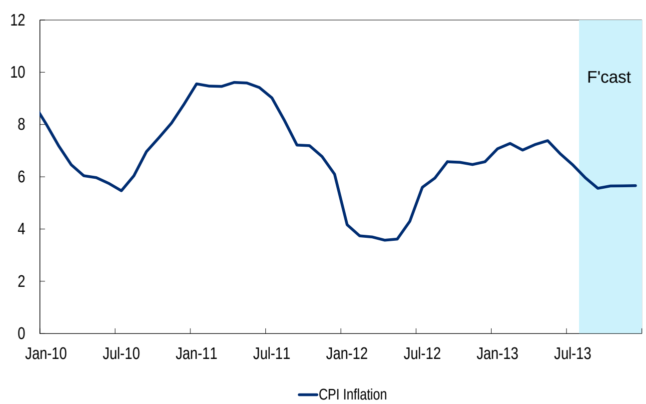
Source: Rosstat, Citi Research

Figure 174. ... with no support from weak industrial activity



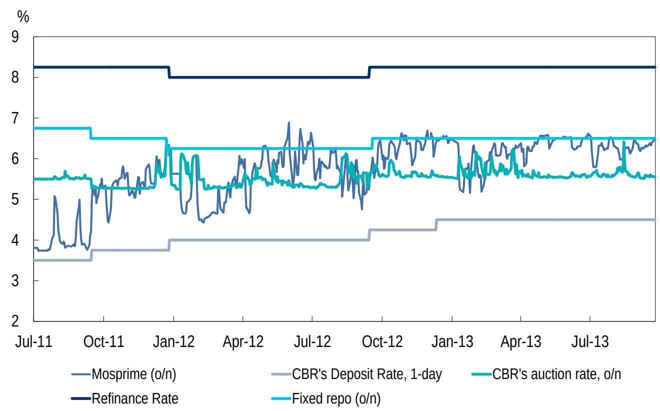
Source: Haver Analytics, CBR, Citi Research

Figure 175. Inflation is likely to stay near 6.5% in 2013



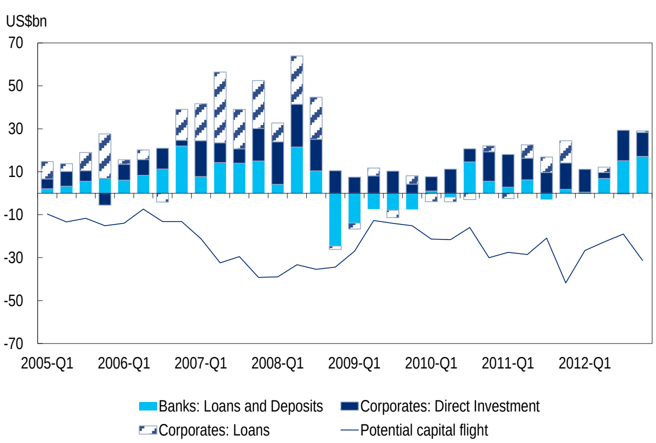
Source: Haver Analytics, Citi Research

Figure 176. CBR on hold for now



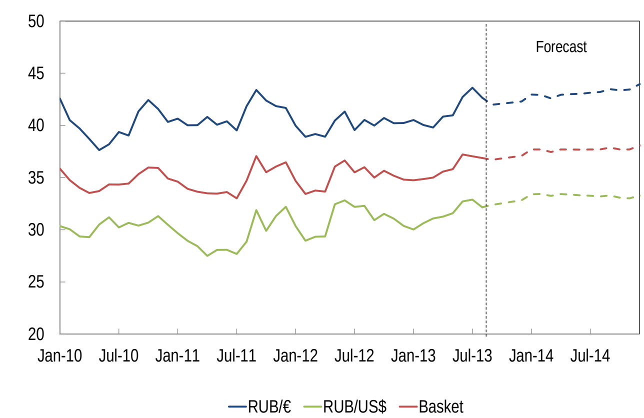
Source: Bloomberg, Citi Research

Figure 177. While higher external borrowing helped cover capital outflows



Source: CBR, Citi Research

Figure 178. ...we are looking for weaker ruble in 2H



Source: Bloomberg, Citi Research

Figure 179. Russia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	992	1,304	1,665	1,229	1,524	1,897	2,012	2,149	2,296
Nominal GDP, local currency bn	26,917	33,247	41,277	38,807	46,309	55,800	62,599	69,361	76,392
GDP per capita, USD	6,906	9,081	11,585	8,554	10,611	13,227	14,055	15,045	16,113
Population, mn	143.7	143.7	143.7	143.7	143.6	143.4	143.2	142.8	142.5
Unemployment, % of labour force	7.2	6.1	6.4	8.4	7.5	6.6	5.5	6.5	7.0
Economic Activity									
Real GDP, yoy avg	8.2	8.5	5.2	-7.8	4.5	4.3	3.4	2.1	2.8
Real investment growth % yoy	17.7	22.0	10.5	-41.0	28.5	22.6	6.6	4.3	6.1
Real consumption growth % yoy	8.8	10.7	8.4	-3.9	3.5	4.8	5.0	3.0	3.0
private consumption growth % yoy	11.9	14.2	10.4	-5.1	5.5	6.3	6.7	3.5	3.6
Real export growth, % yoy	7.3	6.3	0.6	-4.7	7.0	0.3	1.4	0.5	1.7
Real import growth, % yoy	21.3	26.2	14.8	-30.4	25.8	20.3	9.5	4.5	4.5
Prices, Money & Credit									
CPI, % yoy	9.0	11.9	13.3	8.8	8.8	6.1	6.6	5.7	5.0
CPI, % avg	9.7	9.0	14.1	11.6	6.8	8.4	5.1	6.5	5.1
Nominal wages, % yoy	25.5	26.0	27.4	9.1	12.8	11.7	13.3	8.0	7.0
Credit extension to private sector, % yoy	48.7	49.3	37.2	2.6	12.9	28.1	19.4	18.0	15.0
Policy Interest Rate, % eop	11.00	10.00	13.00	8.75	7.75	8.00	8.25	7.50	7.50
1 month inter-bank rate, %, eop	5.71	6.09	20.20	6.32	3.78	6.37	6.90	6.24	4.99
Long-term yield, %, eop	6.60	6.58	10.90	9.45	8.23	8.77	7.04	7.14	6.99
RUB/US$, eop	26.3	24.6	30.5	30.3	30.6	32.2	30.6	32.1	32.9
RUB/US$, avg	27.2	25.6	24.9	31.7	30.4	29.4	31.1	31.9	32.9
RUB/EUR, eop	34.7	35.9	42.7	43.4	40.9	41.7	40.3	43.9	45.3
RUB/EUR, avg	34.2	35.1	36.6	44.2	40.3	41.0	40.0	42.4	45.0
Balance of Payments, USD bn									
Current account	92.3	72.2	103.9	50.4	67.5	97.3	71.4	60.2	20.6
% of GDP	9.3	5.5	6.2	4.1	4.4	5.1	3.5	2.8	0.9
Trade balance	134.3	123.4	177.6	113.2	147.0	196.9	192.3	178.6	141.0
Exports	297.5	346.5	466.3	297.2	392.7	515.4	528.0	523.6	520.0
Imports	163.2	223.1	288.7	183.9	245.7	318.6	335.7	345.0	379.0
Service balance	-10.6	-16.7	-20.4	-17.6	-26.1	-33.5	-46.5	-46.8	-48.4
Income balance	-28.8	-28.8	-46.5	-39.7	-47.1	-60.4	-68.3	-67.6	-67.0
FDI, net	7.6	11.1	19.1	-6.7	-9.4	-11.8	-18.1	12.4	22.3
International reserves	295.3	466.4	410.7	405.8	432.9	441.2	473.1	484.5	495.1
Total amortisations	0.4	0.4	30.4	117.0	90.0	60.0	50.0	72.7	75.0
Public Finances, % of GDP									
Consolidated government balance	9.2	6.7	5.2	-5.7	-3.2	2.1	-0.7	-2.0	-4.2
Consolidated gov primary balance	9.2	7.1	5.6	-5.2	-2.7	2.5	-0.1	0.3	-2.1
Public debt	8.3	6.6	5.2	7.3	7.6	8.3	7.8	7.6	10.1
of which Domestic	3.8	3.8	3.4	4.7	5.3	6.4	5.8	5.4	7.8
Foreign Assets & Liabilities, USD bn									
External debt	308.8	471.2	480.6	467.3	488.9	541.9	551.9	539.2	524.2
Public	44.7	37.4	29.5	31.3	34.5	37.8	41.1	45.9	53.3
External debt / GDP	31.1	36.1	28.9	38.0	32.1	28.6	27.4	25.1	22.8
External debt / XGS	92.7	120.7	91.8	136.3	110.7	94.5	93.5	93.0	91.4
Short-term debt	56.6	99.7	73.6	52.7	60.2	68.2	75.7	77.5	78.8
Short-term debt/International reserves (%)	19.2	21.4	17.9	13.0	13.9	15.5	16.0	16.0	15.9

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.6	1.8	2.5	2.9	3.2	3.0	2.7	2.5	0.0
CPI, % yoy	7.0	6.9	5.6	5.7	5.3	4.8	5.5	5.0	5.0
Policy interest rate, %, eop	8.25	8.25	7.75	7.50	7.50	7.50	7.50	7.50	7.00
Short-term market rate, % eop	6.45	6.71	5.42	6.24	5.42	4.99	4.99	4.99	4.70
Long-term yield, %, eop	7.39	7.93	6.47	7.14	7.02	6.99	6.99	6.99	7.00
RUB/US$, avg	30.4	31.7	31.7	32.1	32.7	33.1	33.0	32.9	32.8

Source: National Sources, Citi Research

Slovakia

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- **Summary view** — We keep our GDP growth forecast at 0.8% this year, followed by 1.8% next year and then averaging 2.6% in 2015-16.
- **Things to watch** — A narrowing of government deficit eased concerns, but there is still a risk of a wider deficit by 0.3% of GDP compared to the planned 4.2%.
- **Strategy** — ARDAL returned to market after a two-month pause and demand exceeded the plan by 4x and the bid-to-ratio reached 4.2x on the auction day

Milder GDP growth likely to continue during 2H13

We expect Slovak GDP to increase 0.3% cumulatively in 2H13 after 0.3%QoQ in 2Q13, which is likely to keep GDP growth at 0.8%YoY in 2H13 (same in 1H13) from 2% in 2012 (we assume weaker exports and industrial activity due to strong base effects and weaker fixed investment owing to lower utilization of production capacities reported in July) before its recovery to 1.8% growth next year reflecting a better outlook for foreign demand. Our monthly index of real economy activity suggests an acceleration of YoY GDP growth. In its new forecast MinFin expects GDP growth will accelerate to 2.2%YoY in 2014 after 0.8% this year and further to 2.9% and 3.1% in 2015 and 2016, which is below our forecast of 0.8% and 1.8% this and next year followed by 2.4% and 2.9% in 2015 and 2016.

Economic sentiment indicator improves for second month in a row in August, but industry disappoints. Overall sentiment improved due to better sentiment in the retail and services sectors. However, industrial and consumer confidence worsened after the July gains, while the construction sector remains just above long-term lows. Industrial confidence suffered from higher inventories and lower export order-books (the lowest since March this year), which kept total order-books and production expectations stable, but weak. Given that expectation of recent production decreased back to the level seen in April this year, we keep our forecast of further deceleration in industrial production to 0%-1% YY, which we expect during 3Q13 after a probable deceleration to 2.3% YY in 2Q13 from 6% in 1Q13. By contrast, combined trade and consumer confidence improved in August, which eased our concerns about the recovery in retail sales (ex. cars), which we have seen during 1H13 to 0.7% YY in 2Q13 from -1.1% in 2012.

Industry down and orders suggests it stable, but weak

Industrial production decelerated to 2%YoY in July from a 12% increase a year ago after it was flat on a monthly basis. Industry-wise, total production was supported by textiles, chemical and electronics industries, while a 5%YoY fall in car output and a 12% drop in refinery output were the main headwinds. As the monthly dynamics were in line with our expectations, after a 0.9% QoQ gain in 2Q13, we are not changing our forecast of a further deceleration of industrial production in seasonally adjusted terms to 0.9% YoY in 3Q13 from 2.3% a quarter ago and 7.9% a year ago. We argue that industrial confidence worsened after July gains due to higher inventories and lower export order books (the lowest since March this year), which kept total order books and production expectations stable, but weak. Exports have continued to disappoint, though it improved to -0.7%YoY in July due to more working days. However, imports improved in July, which can be a sign of recovery, but it suggests a negative contribution of net exports to GDP in 3Q13. The trade surplus (12 months cumulative) has slightly decreased to 6.2% of GDP in July from 6.5% a month ago, but remained well above 4.2% a year ago.

Labour market remains pain for domestic demand

The unemployment rate decreased in August on seasonal factors. The August unemployment rate eased to 13.7% from 14% a month ago, consensus was at 14%, and we were at 13.8%. However, the unemployment rate remains above the 13.2% seen a year ago. Although it declined on a monthly basis and its negative YY dynamics eased, we estimate on a seasonally adjusted basis, it remained stable at 14.1% – above the 13.6% seen last year. Though employment expectations improved in industry in August, they partly corrected a July drop and, although slightly worse than in June, they improved compared to what we saw in 1H13. However, we have not seen this development in other sectors and hence, we estimate employers' employment expectations to be virtually unchanged compared to 1H13, and that total expectations have been stable in recent months after consumer expectations stabilized, but remain below the long-term average. We expect an unemployment rate of around 14.3% this year and also next year after 13.6% in 2012. This is in line with MinFin's new forecast for 2014, which expects a decline to 13.6% in 2015 and 12.7% in 2016, which is slightly below our forecast of 13.7% and 12.9%, respectively. This difference reflects MinFin's slightly more positive GDP expectations compared to our forecast.

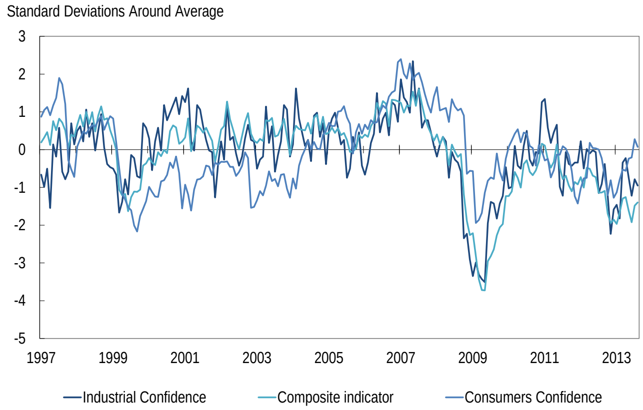
While construction confidence has dipped in August after the improvement in 2Q13, the carry-over effect suggests an easing of YoY contraction in construction output to zero in May next year after it probably contracted by 9% YoY in July after the working day adjustment.

Budget improved further in August

The 12m cumulative central government deficit narrowed to 4.2% of GDP in August, which is the lowest ratio since November 2009. The year-to-date deficit reached €1.9bn in August 2013, narrower by €0.8bn compared to the same period in 2012 – suggesting an ongoing improvement given the May deficit was narrower by €0.6bn and April only by €100mn. The improvement reflects a 9% contraction in year-to-date expenditures, while a year ago expenditure increased by 2%. However, weaker economic growth is also reflected in lower revenue growth, which fell 2%, milder than the -3% in June this year. The contraction on the revenue side reflects a lower inflow from EU funds, while higher VAT and CIT collection is supportive. A recent narrowing of deficits eased concerns from larger deficit this year owing to underperformance on revenue side that was initially expected to increase by 4% this year. However, there is still some risk of a wider deficit, though quite mild at 0.3% of GDP, if the government is able to keep the expenditure side under control as it has so far done.

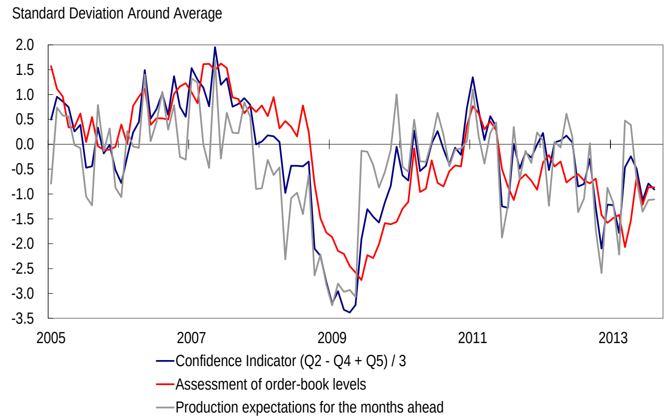
ARDAL returned to the market with bond issuance after a two-month pause due to high coverage of borrowing requirements this year (90% in Sep). ARDAL issued €108mn, which, though it was the lowest issuance this year, it slightly exceeded its plan at €100mn. Moreover, demand exceeded the plan by 4x and the bid-to-ratio reached 4.2x on the auction day, which is above the average reached this year at 1.9x, which reflects a weaker demand in 1Q13. ARDAL made €131mn in buybacks of bonds maturing in 2014 in August, and will continue to buyback for the rest of 2H13. For the time being, ARDAL has in its portfolio €150mn, but there will be redemption of bonds at €3.8bn during Feb-May next year (of which more than 50% was issued in 2004 that suggest a 25% savings due to stronger irrevocable parity of Slovak koruna). Moreover, there is a small T-bill redemption (€75mn) in Apr14.

Figure 180. Consumer confidence improved in August, while industry did not



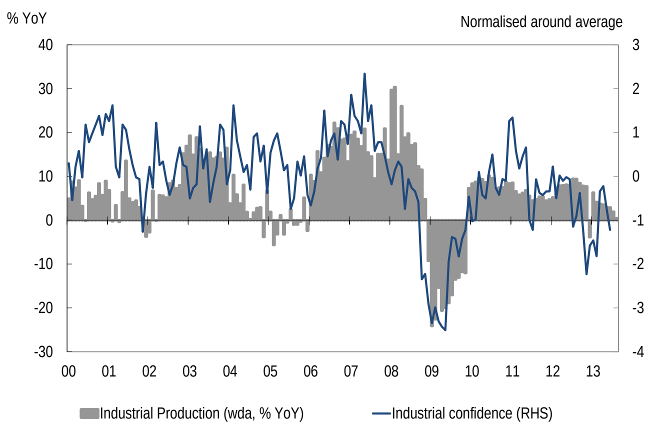
Source Statistical Office of the Slovak Republic, Citi Research

Figure 181. ... that was accompanied by stable, but weak orders



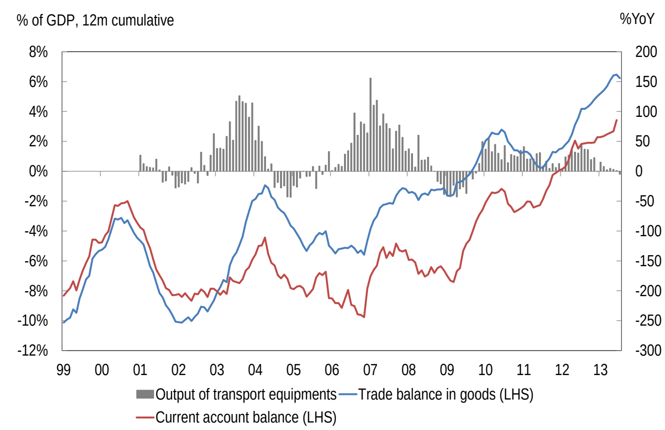
Source: Statistical Office of the Slovak Republic, EC, Citi Research

Figure 182. Industrial confidence points to milder growth in production



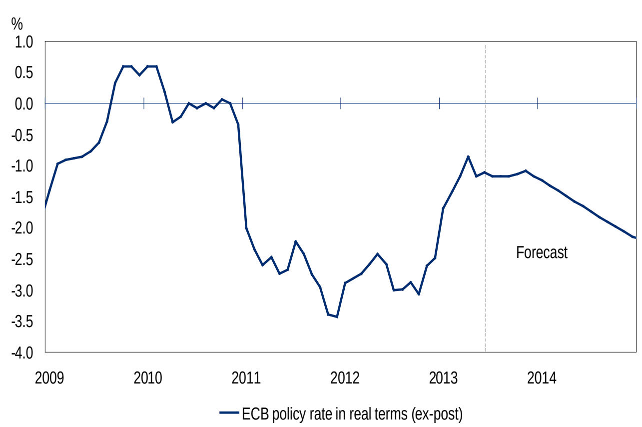
Source: Statistical Office of the Slovak Republic, EC, Citi Research

Figure 183. Trade surplus wider though car production eased



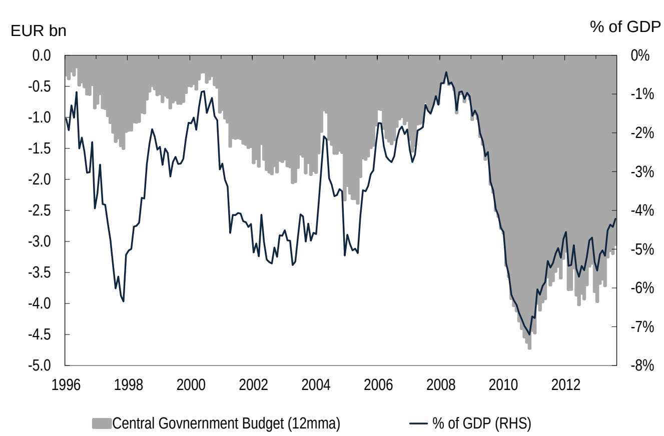
Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 184. Recent disinflation has increased the real interest rate



Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

Figure 185. August central gov't deficit improved, but still slightly worse



Source: Haver Analytics and Citi Research calculations

Figure 186. Slovakia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	56	75	95	88	87	96	92	94	100
Nominal GDP, local currency bn	55	61	67	62	66	69	71	71	76
GDP per capita, USD	10,371	13,872	17,410	16,076	15,995	17,585	16,763	17,139	18,260
Population, mn	5.4	5.4	5.4	5.5	5.5	5.5	5.5	5.5	5.5
Unemployment, % of labour force	10.4	8.4	7.7	11.4	12.5	13.2	13.6	14.3	14.3
Economic Activity									
Real GDP, yoy avg	8.3	10.5	5.8	-4.9	4.4	3.2	2.0	0.8	1.8
Real investment growth % yoy	6.1	9.7	4.7	-31.5	19.9	10.2	-10.3	-23.9	-2.9
Real consumption growth % yoy	6.6	5.1	6.1	1.6	-0.3	-1.5	-0.6	0.0	0.7
private consumption growth % yoy	5.9	6.8	6.1	0.2	-0.7	-0.5	-0.6	0.1	0.9
Real export growth, % yoy	21.0	14.3	3.1	-16.3	16.0	12.7	8.6	4.5	5.8
Real import growth, % yoy	17.8	9.2	3.1	-18.9	14.9	10.1	2.8	2.3	5.6
Prices, Money & Credit									
CPI, % yoy	4.2	3.4	4.4	0.5	1.3	4.4	3.2	1.4	2.4
CPI, % avg	4.5	2.8	4.6	1.6	1.0	3.9	3.6	1.7	1.9
Nominal wages, % yoy	8.6	7.5	8.2	3.0	3.3	3.0	2.2	2.3	2.3
Credit extension to private sector, % yoy	23.7	22.7	17.4	0.8	4.8	8.6	2.8	-0.6	7.4
Balance of Payments, USD bn									
Current account	-5.0	-4.1	-5.9	-2.3	-3.3	-1.9	2.1	3.8	3.5
% of GDP	-8.9	-5.4	-6.2	-2.6	-3.7	-2.0	2.2	4.0	3.5
Trade balance	-3.2	-1.0	-1.1	1.3	1.0	1.4	4.6	6.2	4.0
Exports	51.4	64.9	72.9	55.4	64.0	79.0	80.8	86.9	94.5
Imports	54.6	65.9	74.0	54.1	63.0	77.6	76.2	80.6	90.6
Service balance	0.8	0.5	-0.7	-1.4	-1.0	-0.5	0.4	0.5	3.0
Income balance	-2.5	-3.2	-2.8	-1.2	-2.7	-2.3	-2.1	-2.4	-2.9
FDI, net	4.2	3.0	4.3	-0.9	0.8	1.7	1.5	1.2	1.0
Total amortisations	1.6	1.7	1.7	1.8	2.1	2.1	2.3	2.5	2.6
Public Finances, % of GDP									
Consolidated government balance	-2.6	-1.6	-2.0	-8.0	-7.7	-5.1	-4.3	-3.5	-3.2
Consolidated gov primary balance	-1.7	-0.4	-0.8	-6.6	-6.3	-3.5	-2.9	-2.1	-1.7
Public debt	30.5	29.6	27.9	35.6	41.0	43.3	52.1	56.8	57.4
of which Domestic	22.5	20.1	19.1	20.3	25.5	30.6	33.7	37.3	38.3
Foreign Assets & Liabilities, USD bn									
External debt	32.2	44.3	52.5	65.3	65.8	68.5	76.3	80.8	84.8
Public	7.7	9.5	10.3	11.4	13.3	15.5	17.7	19.7	20.8
External debt / GDP	57.3	58.8	55.5	74.5	75.3	71.2	83.1	85.9	84.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	11.1	17.4	20.1	30.3	29.9	29.8	34.6	34.9	36.7

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.8	0.8	0.7	0.8	1.2	1.4	2.0	2.7	2.6
CPI, % yoy	1.9	1.6	1.6	1.4	1.7	1.9	2.1	2.4	2.5
Short-term market rate, % eop	0.12	0.12	0.08	0.16	0.19	0.24	0.24	0.27	0.30
Long-term yield, %, eop	3.01	2.64	2.95	2.60	2.52	2.42	2.52	2.51	2.53

Source: National Sources, Citi Research

South Africa

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- **Summary view** — We downgrade our 2013 GDP forecast on the basis of lower consumption growth and less inventory accumulation. Against poorer growth forecasts, inflationary pressures create a policy dilemma for the SARB.
- **Things to watch** — The wide current account deficit and upcoming Medium-Term Budget in October will reinforce the vulnerability of running a twin deficit. The upcoming April 2014 National Elections means politicking will be rife.
- **Strategy** — Constrained fiscal policy and rising government debt ratio leaves rating agencies watchful. Add to this limited monetary policy, sub-par growth and political uncertainties and we think the ZAR remains vulnerable.

2013 GDP looking poorer

We downgrade our 2013 GDP forecast slightly and now look for 2.1% growth (from 2.3% previously). The first revision is to inventory accumulation, typically a sign of confidence in production and investment. which unfortunately is lacking. Production problems remain significant: labour unrest, rising input costs, high wages, difficult logistics and low global demand. For manufacturers, the recent rise in the PMI is not enough to convince us that Q3 will sustain its Q2 rebound (of 11.5% QoQ saar) given strikes in vehicle manufacturing. Similarly, having dropped by 5.6% QoQ saar in Q2, mining production was struck again by work stoppages during the September strikes in the gold industry. What's more, the counterbalance of a weaker currency is not clear, providing little incentive to companies to accumulate inventories or invest. Already in Q2, inventory accumulation was slower (falling to R2.7bn from R4bn) and with business confidence down in Q3, inventories are not expected to pick up significantly in H2 13.

The second revision is to household consumption. Q2 HCE was surprisingly robust, growing 2.5 q/q saar driven by durable and semi-durable goods. However, the discretionary nature of this spending leads us to believe softer growth is likely from here on, as these items are significantly leveraged to real income growth, particularly when it is ZAR-driven inflation. Telling of consumer vulnerability, spending on services fared poorly, falling 1.9% QoQ saar. Reinforcing that the consumer pocketbook has little space to manoeuvre, the household debt to disposable income ratio rose to 75.8%. A weaker currency and its ability to erode nominal incomes (particularly in the face of little employment creation) is key to why we only expect household consumption to grow by 2.6% in 2013 (3.5% in 2012). Certainly the clampdown on unsecured lending does consumption no favours.

Current account will narrow, but only slightly and only slowly. Echoing our thoughts on the problems with production, the trade deficit hit an all-time record in Q2, allowing the current account deficit to widen to 6.5% of GDP. Exacerbating the problem, the income deficit widened again, suggesting that the dividend repatriation in Q1 was not sustainable. Looking to H2 13, scant production means a sticky trade deficit as imports remain resilient in the face of public sector infrastructure demands. While our downward revision in consumption will provide some reprieve, the current account deficit is still expected to remain a considerable 5.9% in 2013. The financing of the deficit remains questionable given shaky risk appetite ahead of Fed tapering and lack of FDI in the face of sub-par growth. For this reason, the ZAR should react unfavourably to any worse-than-expected monthly trade figures in H2.

The ZAR has raised inflation risk

Inflation has risen a full percentage point since January, measuring 6.4%YoY in August (which we believe is the peak). Transport and housing have contributed the most to inflation through the year due to a respective 14% rise in the petrol and electricity tariff increases and rental inflation. While CPI food has risen (7.4%YoY in August), low global food inflation has been a helpful offset. Considering the ZAR, its impact is only obvious on first-order inflationary items, such as transport. Second-round effects are never easy to pin down. Historically it has taken about 10 months for the full impact of a currency move to show up in CPI, however, the leisurely rise in core inflation to 5.1%YoY most recently suggests it is taking somewhat longer this time. While we believe the explanation lies in a still-wide output gap, this is also why we continue to expect upside ZAR-driven inflation pressure for the rest of the year, keeping CPI just on 6.0% in H2 13.

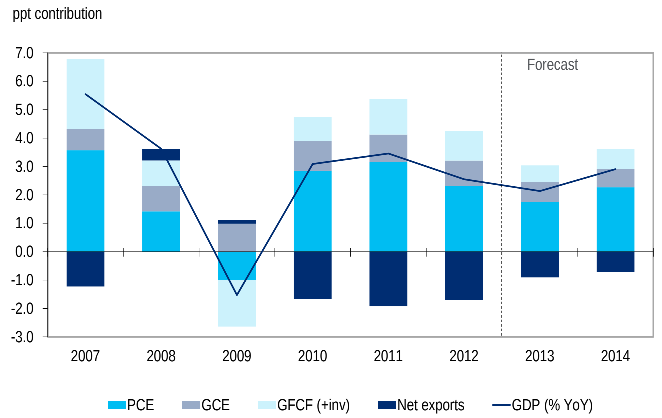
This aligns to the SARB's regular comments that currency weakness is the most significant inflation risk. Yet despite markets being quick in pricing in rate hikes, we think this is incorrect. Our sub-par GDP outlook coupled with inflation risks leaves the SARB in a policy predicament that looks dangerously like stagflation. For this reason we forecast an unchanged repo rate of 5.0% until at least Q1 15.

Fiscal policy in a straightjacket

Next month National Treasury will present its Medium-Term Budget (23 October). In February, weaker macro forecasts left the main budget balance wider at -5.7% of GDP in FY12/13. Worryingly, the first four months of the current fiscal year show a budget deficit that already amounts to R96.5bn – more than half of February's projected deficit of R184.5bn. This, together with a downgrade in the GDP consensus (to 2.0% in 2013) suggests that the path of fiscal consolidation will likely be pushed out further. Given the watchful eye of rating agencies and investors, we believe only a serious reprioritization of spending towards infrastructure would pardon a wider budget deficit but unfortunately this looks ever-more unlikely given the upcoming April 2014 National Elections. Government debt is already projected at 40% of GDP and so, further issuance would raise the probability of a further ratings downgrade, adding to ZAR-risk. To make matters worse, a tax review, to assess whether revenues are able to meet expenditure needs, is underway and in our opinion, any suggestion that taxes may rise would prove market-unfriendly.

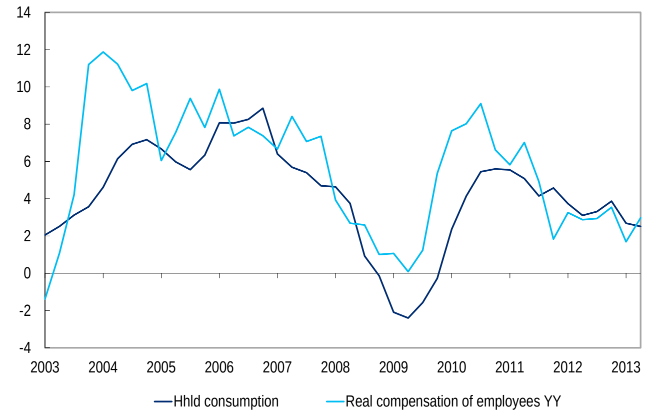
National Elections take place in April 2014 and as a result, one should expect much politicking. Surveys show that more than half the population are unhappy with service delivery. This is not surprising given the backlog of service delivery in South Africa. For example, 27% of household should have electricity, but do not, while 40% of households that should have access to refuse removal, do not. It is because of this poor provision of basic services that we believe the voter turnout in the 2011 local elections increased significantly and why the ANC will be under pressure to keep its 66% majority rule in parliament this time round. In response, new opposition parties have emerged: most notably, Agang and the Economic Freedom Fighters. While the Democratic Alliance is likely to remain the main opposition in the coming election, a coalition of opposition parties by 2017 cannot be ruled out. In our view, this may be the type of political competition that service delivery sorely needs.

Figure 187. GDP to remain lackluster in 2013 and 2014



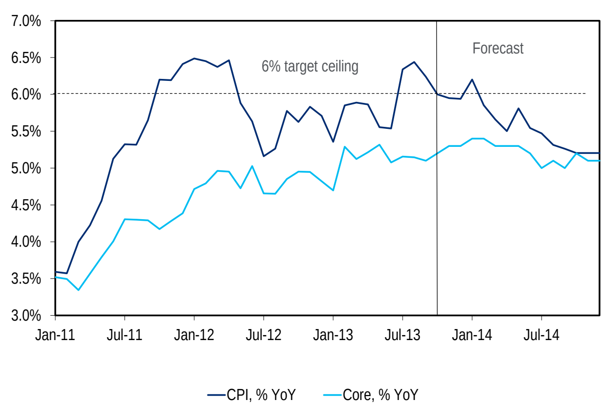
Source: SARB, Citi Research Projections

Figure 188. Consumption is slowing as real incomes decelerate



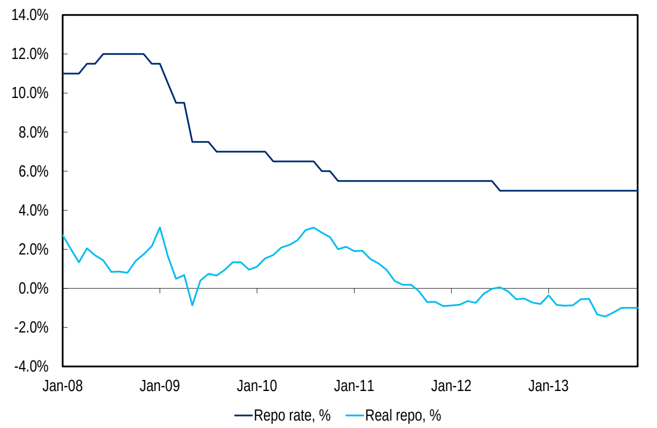
Source: SARB, Citi Research calculations

Figure 189. The CPI will remain at the top of the SARB ceiling in 2H 2013



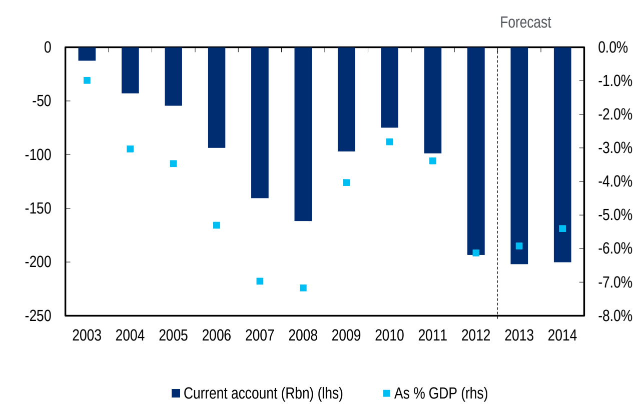
Source: Stats SA, Citi Research projections

Figure 190. Rand volatility suggests further Repo rates cuts are unlikely



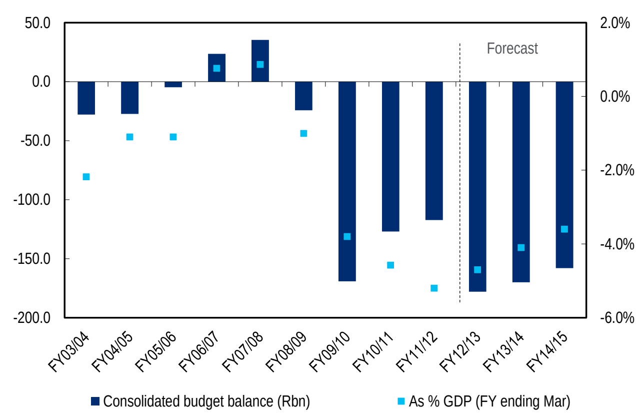
Source: SARB. Stats SA

Figure 191. No meaningful narrowing in the current account deficit



Source: SARB, Citi Research projections

Figure 192. Fiscal consolidation will likely be slow



Source: National Treasury, Haver Analytics, Citi Research projections

Figure 193. South Africa Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	261	286	273	287	364	402	384	353	368
Nominal GDP, local currency bn	1,767	2,016	2,256	2,406	2,659	2,918	3,155	3,410	3,705
GDP per capita, USD	5,511	5,993	5,613	5,820	7,272	8,039	7,685	7,035	7,323
Population, mn	47.3	47.7	48.7	49.3	50.0	50.0	50.0	50.2	50.3
Unemployment, % of labour force	23.9	23.3	22.9	24.0	24.9	24.9	25.1	25.5	26.2
Economic Activity									
Real GDP, yoy avg	5.6	5.5	3.6	-1.5	3.1	3.5	2.5	2.1	2.9
Real investment growth % yoy	12.9	12.0	4.4	-8.6	4.5	6.3	5.1	2.8	3.4
Real consumption growth % yoy	7.5	5.2	2.8	-0.1	4.6	4.8	3.7	2.8	3.3
private consumption growth % yoy	8.3	5.5	2.2	-1.6	4.4	4.8	3.5	2.6	3.4
Real export growth, % yoy	7.5	6.6	1.8	-19.5	4.5	5.9	0.1	4.0	4.9
Real import growth, % yoy	18.3	9.0	1.5	-17.4	9.6	9.7	6.3	4.8	6.2
Prices, Money & Credit									
CPI, % yoy	4.8	7.6	9.3	6.0	3.4	6.4	5.7	6.0	5.2
CPI, % avg	3.2	6.2	10.0	7.2	4.1	5.0	5.7	5.9	5.5
Nominal wages, % yoy	11.2	7.9	12.8	11.8	13.5	7.2	7.6	14.0	9.0
Credit extension to private sector, % yoy	25.8	21.5	13.6	-0.1	5.5	6.2	10.1	7.5	8.2
Policy Interest Rate, % eop	9.00	11.00	11.50	7.00	5.50	5.50	5.00	5.00	5.00
1 month inter-bank rate, %, eop	8.98	11.18	11.35	6.94	5.44	5.47	5.02	5.10	5.10
Long-term yield, %, eop	7.86	8.58	7.33	9.05	8.14	7.93	6.39	8.00	8.00
ZAR/US$, eop	7.01	6.87	9.49	7.41	6.62	8.09	8.46	9.79	10.21
ZAR/US$, avg	6.77	7.05	8.27	8.41	7.32	7.26	8.21	9.65	10.06
Balance of Payments, USD bn									
Current account	-13.8	-19.9	-19.6	-11.6	-10.2	-13.6	-23.6	-20.9	-19.9
% of GDP	-5.3	-7.0	-7.2	-4.0	-2.8	-3.4	-6.1	-5.9	-5.4
Trade balance	-4.3	-5.2	-4.3	0.3	3.7	2.3	-9.2	-9.0	-9.9
Exports	66.1	76.2	85.3	66.4	85.5	102.8	93.4	89.6	89.0
Imports	70.4	81.4	89.6	66.1	81.8	100.6	102.6	98.6	98.9
Service balance	-2.1	-2.7	-4.1	-2.8	-4.4	-4.7	-2.5	-2.6	-3.0
Income balance	-5.1	-9.8	-8.9	-6.4	-7.2	-9.2	-8.0	-6.2	-4.5
FDI, net	-6.6	1.8	12.5	4.2	4.8	4.8	4.2	3.0	3.0
International reserves	23.1	29.6	30.6	35.3	38.2	42.6	44.0	52.8	54.0
Total amortisations	2.0	1.8	2.0	2.5	1.4	1.4	1.4	4.2	4.0
Public Finances, % of GDP									
Consolidated government balance	0.8	0.9	-1.0	-5.3	-4.9	-4.0	-4.4	-5.0	-4.8
Consolidated gov primary balance	3.6	3.3	2.4	-3.1	-2.7	-1.7	-1.9	-1.9	-1.7
Public debt	32.6	28.3	27.8	31.3	35.8	39.6	40.7	43.2	44.7
of which Domestic	28.1	24.5	23.4	27.7	32.5	35.8	36.5	38.9	40.6
Foreign Assets & Liabilities, USD bn									
External debt	51.2	63.0	60.4	63.8	80.6	89.7	113.7	91.8	95.0
Public	30.5	43.5	42.3	41.2	44.8	48.2	57.8	36.0	33.8
External debt / GDP	19.6	22.0	22.1	22.2	22.2	22.3	29.6	26.0	25.8
External debt / XGS	65.4	70.0	61.6	81.4	81.1	76.2	104.7	89.0	92.7
Short-term debt	20.6	24.0	25.5	21.3	21.7	20.5	27.9	19.8	20.0
Short-term debt/International reserves (%)	89.1	81.2	83.2	60.4	56.9	48.2	63.3	37.5	37.0

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.9	2.0	1.7	2.7	2.8	3.0	3.1	2.8	3.0
CPI, % yoy	5.9	5.5	6.2	6.0	5.7	5.5	5.3	5.2	5.5
Policy interest rate, %, eop	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.50
Short-term market rate, % eop	5.03	5.05	5.10	5.10	5.10	5.10	5.10	5.10	5.60
Long-term yield, %, eop	6.51	7.58	7.80	8.00	7.45	7.60	7.70	8.00	8.00
ZAR/US$, eop	9.24	9.88	9.70	9.79	9.90	10.01	10.11	10.21	10.31

Source: National Sources, Citi Research

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- **Summary view** — Although the Fed's surprising decision to keep its bond-purchase stimulus plan intact has given some breathing room to the CBT, monetary policy stance remains too accommodative, in our view.
- **Things to watch** — The October Inflation Report (to be released on October 31) and political developments owing to the upcoming elections (local elections in March 2014, Presidential elections in August 2014 and general elections in June 2015) require close monitoring.
- **Strategy** — The CBT's apparent reluctance to hike rates and normalize monetary policy render the lira vulnerable.

2Q reading may alleviate growth concerns, for now…

At 4.4% YoY, GDP growth in the second quarter came in considerably stronger than expected (3.5%). The contribution of private consumption and public investment to GDP growth in 2Q stood at 3.4pp and 1.4pp, respectively. In parallel, net exports shaved 3pp off GDP growth in 2Q due probably to the marked reversal in net gold exports. In our view, the composition of growth in 1H doesn't paint a comforting picture for the outlook. Specifically, standing at 2.6pp, the contribution of the public sector to GDP growth in 1H (3.7%YoY) was unusually high. Moreover, private consumption, which grew by 4.2%YoY in 1H, is likely to weaken in 2H on the back of higher interest rates and the lira depreciation. Against this backdrop, we keep our 2013 GDP growth estimate at 3.5% and continue to monitor the key risk factors such as higher oil prices, further declines in capital inflows and geopolitical developments that could affect domestic sentiment.

…but mind the quality of external financing

At US$5.8 billion, the current account deficit in July came in wider than the consensus (US$5.5bn), bringing the 12-month rolling current account gap to US$55.8bn from US$44.0bn in June. Although the annualized seasonally adjusted current account gap in July (around US$70bn) points to a wider deficit for 2013, we keep our estimate of 7% of GDP for at least two reasons. First, the marked reversal in net gold exports is likely to lose steam. Second, domestic demand is likely to weaken in 2H owing to higher rates and the lira's depreciation. On the capital account front, the marked deterioration in the quality of external financing has become more evident in July with errors and omissions and the decline in CBT's reserves combined amounting to US$6.6bn, or 73% of the sum of Turkey's current account deficit (US$5.8bn) and MLT debt service (US$3.1bn).

Underlying inflation continues to deteriorate…

At 8.2%YoY, the August inflation reading came in line with the consensus. Using seasonally adjusted data, the August inflation print translates into a rise of around 0.4%MoM, compared with 1.0% in July and 1.5% in June. The deterioration in core measures in August suggests that the depreciation of the lira has already begun to bite. This, in turn, leads us to believe that the CBT's revised year-end inflation forecast of 6.2% has become even less credible than before. Moreover, we believe that the recent deterioration in inflation expectations will further complicate inflation dynamics. In light of the noted backdrop, we expect year-end inflation to be around 7.5%, well above the 5% target.

…as the CBT is saved by the Fed, again

In our view, the Fed's surprising decision to keep its bond-purchase stimulus plan intact has given some breathing room to the CBT. Nonetheless, we believe that monetary policy stance still remains too accommodative. Our analysis suggests that bringing the CBT's policy rate in line with the EM average (in real terms, ex post) would require an increase of about 200bp in the effective funding rate. Alternatively, if one uses the current 12-month ahead inflation expectations (6.64%), the average effective funding rate needs to be around 7% – compared with 6.5% (month-to-date average in September) – in order to, at least, align the CBT's policy stance with its peers. This – along with the decline in the quality of Turkey's external financing, the marked deterioration in underlying inflation and the CBT's limited firepower – raises further questions about the feasibility of the Governor's pledge to keep interest rates unchanged in the foreseeable future.

Tax-and-spend budget firmly remains in place

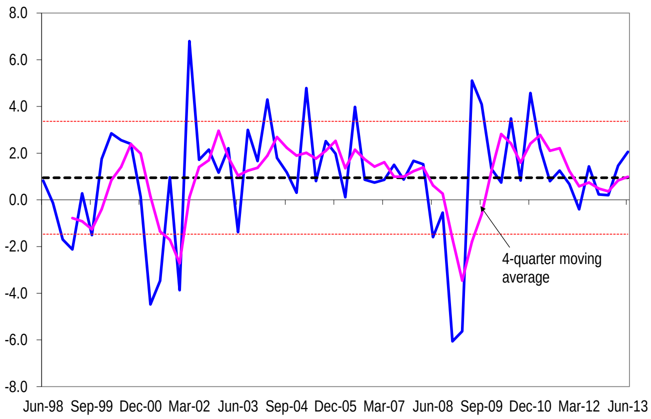
The central government budget registered a surplus of TRY 0.2bn in the first 8 months of the year, which compares favorably with the same period of 2012 during which it printed a deficit of TRY8.5bn. The strong budget performance was largely driven by robust revenues. Specifically, tax revenues were up by 19%YoY during the period under consideration, while, standing at TRY8.3bn, privatization revenues already exceeded the budget target of TRY 4bn. Concurrently, non-interest expenditures, which rose by 15%YoY in the first 8 months of the year, continue to display a marked upward trend. As public spending tends to accelerate toward the end of the year, the budget surplus is unlikely to be maintained. Against this backdrop, while we believe that the budget deficit this year is likely to be narrower than the target of 2.2% of GDP, fiscal policy stance remains excessively accommodative in the context of the wide current account gap.

Lira is not off the hook yet

When compared with other EM countries, Turkish assets have underperformed during the recent EM sell-off. In our view, the noted underperformance can be attributed to: (i) rising political risks; (ii) the uncertainty surrounding monetary policy; and Turkey's high external financing requirements. In view of Turkey's election-heavy calendar (local elections in March 2014, Presidential elections in August 2014 and general elections in June 2015), we believe that political noise may increase going forward. Concerning the CBT's unconventional monetary strategy, evidence to date suggests to us that the Bank remains reluctant to normalize its policy and carry out further hikes despite the deterioration in underlying inflation dynamics. Against this backdrop, we believe that the lira is likely to remain vulnerable unless there is a visible improvement in the above-noted issues that have undermined the performance of Turkish assets during the recent sell-off.

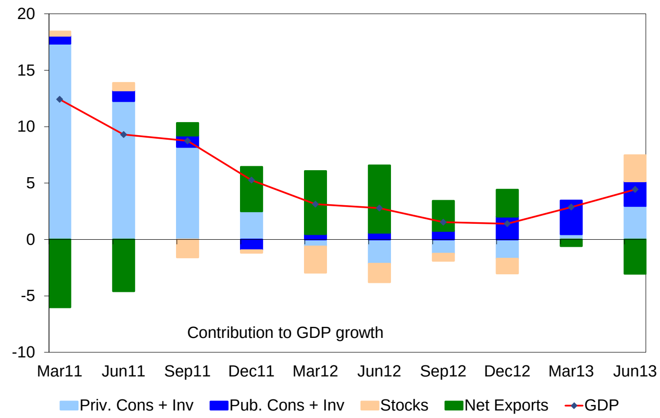
Turning to bonds, our analysis suggests that that the main determinants of the 10-year bond yields have changed markedly in recent months. The 10-year bond yields seem to be primarily influenced by developments in Turkey's risk premium and the exchange rate. However, the short-end remains to be primarily influenced by funding costs. Although the recent market moves have alleviated valuation concerns somewhat, the uncertainty surrounding monetary policy, and the challenging inflation outlook overshadow the fixed income market outlook.

Figure 194. Economic activity seems to be gaining some momentum…



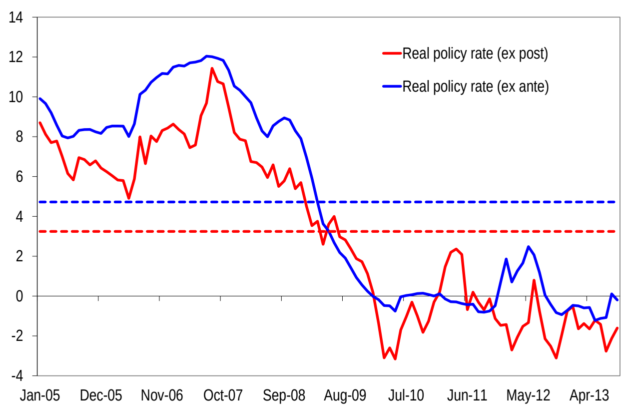
Source: Haver Analytics and Citi Research

Figure 195. … but there are sustainability concerns



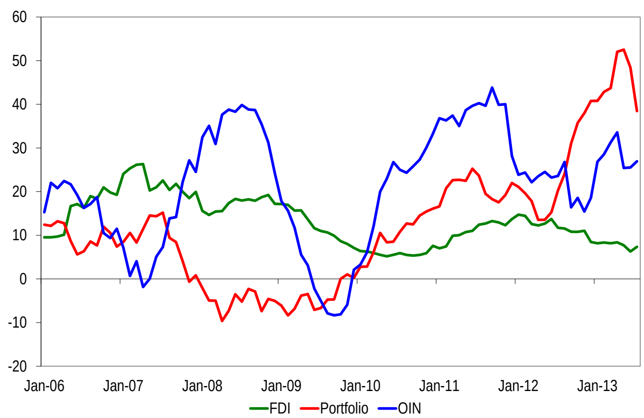
Source: Haver Analytics and Citi Research

Figure 196. CBT's accommodative stance warrants concern…



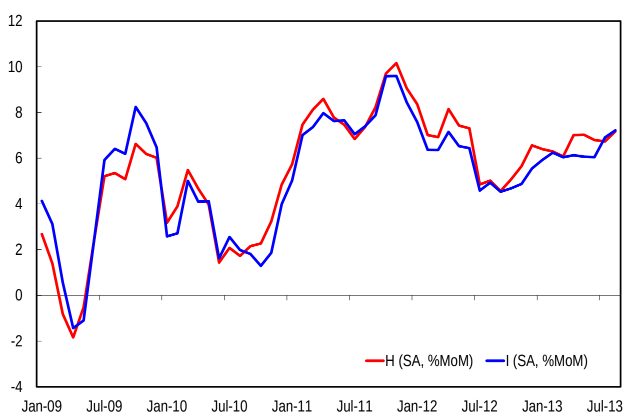
Source: Haver Analytics and Reuters

Figure 197. … due to the deterioration in the quality of external financing



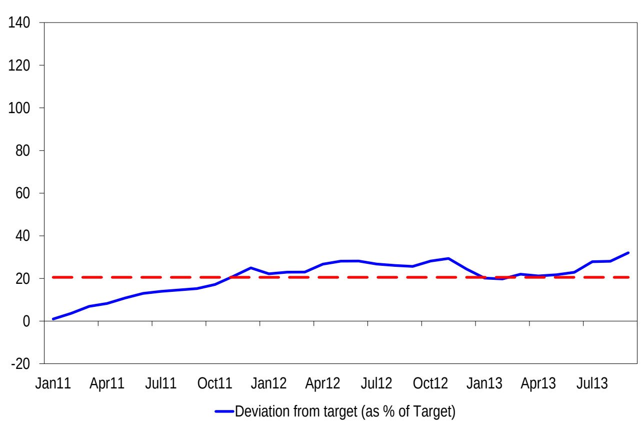
Source: Bloomberg and Citi Research

Figure 198. …underlying inflation…



Source: Bloomberg and Citi Research Note: 3-month moving average

Figure 199. …and forward-looking expectations



Source: Bloomberg and Citi Research Note: Deviation of 12-m Ahead Inf. Expectations from Target

Figure 200. Turkey Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	529	646	731	615	731	775	788	815	848
Nominal GDP, local currency bn	758	843	951	953	1,099	1,298	1,416	1,573	1,756
GDP per capita, USD	7,624	9,207	10,282	8,530	10,016	10,473	10,523	10,658	10,973
Population, mn	69.4	70.2	71.1	72.1	73.0	74.0	74.9	76.5	77.3
Unemployment, % of labour force	10.2	10.3	11.0	14.0	12.0	9.8	9.2	9.5	9.5
Economic Activity									
Real GDP, yoy avg	6.9	4.7	0.7	-4.8	9.2	8.8	2.2	3.5	4.0
Real investment growth % yoy	13.3	5.8	-4.8	-28.6	48.4	16.8	-8.3	4.1	0.9
Real consumption growth % yoy	5.1	5.6	-0.1	-1.0	6.0	7.3	0.3	4.3	4.0
private consumption growth % yoy	4.6	5.5	-0.3	-2.3	6.7	7.7	-0.6	3.8	3.8
Real export growth, % yoy	6.6	7.3	2.7	-5.0	3.4	7.9	16.7	1.5	4.3
Real import growth, % yoy	6.9	10.7	-4.1	-14.3	20.7	10.7	-0.3	4.1	1.6
Prices, Money & Credit									
CPI, % yoy	9.7	8.4	10.1	6.5	6.4	10.4	6.2	7.5	7.0
CPI, % avg	9.6	8.8	10.4	6.3	8.6	6.5	8.9	7.3	7.3
Nominal wages, % yoy	10.9	9.5	11.5	9.9	11.8	8.0	9.9	8.5	7.5
Credit extension to private sector, % yoy	36.1	27.8	22.4	13.4	40.4	32.8	19.8	20.0	13.0
Policy Interest Rate, % eop	15.60	17.23	16.00	9.16	6.50	5.75	5.50	4.50	6.00
1 month inter-bank rate, %, eop	19.58	17.21	17.16	7.20	6.89	11.54	5.80	7.75	7.55
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.41	1.17	1.54	1.50	1.54	1.89	1.78	2.01	2.08
TRY/US$, avg	1.44	1.31	1.31	1.55	1.51	1.68	1.80	1.93	2.07
TRY/EUR, eop	1.87	1.70	2.15	2.15	2.06	2.44	2.35	2.75	2.86
TRY/EUR, avg	1.81	1.79	1.92	2.17	2.00	2.34	2.32	2.56	2.83
Balance of Payments, USD bn									
Current account	-31.8	-37.8	-40.4	-11.0	-44.7	-73.6	-45.4	-56.3	-56.9
% of GDP	-6.0	-5.8	-5.5	-1.8	-6.1	-9.5	-5.8	-6.9	-6.7
Trade balance	-41.1	-46.9	-53.0	-24.9	-56.4	-89.1	-65.3	-75.1	-78.5
Exports	93.6	115.4	140.8	109.6	120.9	143.4	163.2	173.1	191.8
Imports	134.7	162.2	193.8	134.5	177.3	232.5	228.6	248.3	270.3
Service balance	14.0	14.0	18.8	18.6	16.7	20.1	22.9	21.1	23.2
Income balance	-6.7	-7.1	-8.4	-7.1	-6.5	-6.3	-4.3	-3.7	-3.1
FDI, net	19.3	19.9	17.2	7.1	7.6	13.7	8.4	8.8	13.5
International reserves	60.9	73.3	71.0	70.7	80.7	78.5	99.9	105.7	117.9
Total amortisations	30.3	37.6	41.1	47.3	45.0	37.7	33.3	38.2	45.0
Public Finances, % of GDP									
Consolidated government balance	-0.6	-1.6	-1.8	-5.5	-3.6	-1.3	-2.0	-1.8	-2.7
Consolidated gov primary balance	5.4	4.1	3.5	0.1	0.8	1.8	1.4	1.5	0.3
Public debt	46.4	40.4	41.2	47.7	44.4	41.2	38.8	37.5	37.2
of which Domestic	33.2	30.3	28.9	34.6	32.1	28.4	27.3	26.0	25.5
Foreign Assets & Liabilities, USD bn									
External debt	208.4	250.4	281.1	269.1	292.0	304.4	337.5	373.8	419.4
Public	87.3	89.3	92.4	96.6	100.6	91.6	105.6	120.4	139.4
External debt / GDP	39.4	38.7	38.5	43.8	39.9	39.3	42.8	45.9	49.4
External debt / XGS	174.0	172.4	158.1	185.2	185.8	165.4	163.3	173.3	176.1
Short-term debt	42.9	43.2	52.5	49.0	77.3	81.9	100.8	117.8	131.8
Short-term debt/International reserves (%)	70.4	58.9	74.0	69.3	95.8	104.4	100.9	111.5	111.8

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.9	4.4	3.3	3.6	2.6	3.9	4.6	5.4	4.3
CPI, % yoy	7.3	8.3	7.1	7.5	7.5	7.3	7.3	7.0	7.0
Policy interest rate, %, eop	5.50	4.50	4.50	4.50	4.50	4.50	5.00	6.00	6.50
Short-term market rate, % eop	6.72	7.24	7.75	7.75	8.00	7.79	7.76	7.55	7.53
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
TRY/US$, eop	1.81	1.93	1.97	2.01	2.05	2.08	2.08	2.08	2.07

Source: National Sources, Citi Research

Ukraine

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With thanks to
Adrian Thomas

- **Summary view** — Loss of fx reserves has already prompted a downgrade by Moody's and the other two rating agencies seem likely to follow. Without access to international capital markets, an IMF deal seems the only way to achieve financial stability, but it might come at great cost to the government's popularity unless the IMF is prepared to lighten its conditionality.

- **Things to watch** — Accelerated loss of fx reserves will be the critical variable that might trigger capital flight and further rating downgrades. But an IMF mission to Kiev in October might generate some positive noise, as might a deal to release the imprisoned Yulia Timoshenko in the run up to the November Summit in Vilnius, at which the government hopes to sign an EU Association Agreement.

- **Strategy** — Risks of 10-15% correction in the exchange rate over the next 3-6 months remain high: Ukraine's capital markets access has disappeared, and exchange rate flexibility is likely to be a requirement of any IMF deal.

Stuck in recession

The economy is in recession, and there seems little way out in the short run. The economy has now racked up four consecutive quarters of negative YoY GDP growth, and data since June doesn't point to any improvement. Industrial production continued to contract in July and August, continuing an industrial recession that first appeared in August 2012. Although retail sales growth remains relatively buoyant, it too has fallen compared to last year. In addition, external demand conditions are particularly unfavourable. Ukraine trades more or less equally with Russia and the EU. Trade with Russia has been very badly hit by Ukraine's pursuit of an Association Agreement with the EU; and the Eurozone's shift towards a large current account surplus is not conducive to Ukrainian export growth.

Ukrainian policymakers' anchor seems to be financial and exchange rate stability. An important part of the background in understanding Ukraine's weak growth outlook is the authorities' desire to avoid an exchange rate collapse due to the likely impact this would have on the banking system. The hryvnia (UAH) is essentially pegged to the USD. For that reason, real interest rates have been kept exceptionally high for an economy that isn't growing, with a view to maintaining fx stability. In addition, the NBU continues to impose restrictions on the availability of foreign exchange. Although a depreciation of the UAH might well be contractionary for the economy – given the private sector still has large net fx liabilities – the determination to preserve fx stability undoubtedly comes at a cost to growth.

Access to capital markets has disappeared, precipitating further loss of fx reserves. Although Ukrainian borrowers had plenty of capacity to borrow internationally in early 2013, that access to capital markets is no longer, and capital outflows are now threatening fx reserves, which have fallen to $21.6bn from $30bn a year ago. Although the year-to-date current account is slightly smaller than it was in 2012, Ukraine's trade dynamics are very poor: export growth has been negative this year, and so the improvement in the current account has only been possible thanks to a heavy dose of import compression, which in turn weakens the economy's supply capacity. Event without 'capital flight', reserves will be further threatened by repayments to the IMF in October and November ($1.6bn).

IMF and EU relations will move to centre-stage

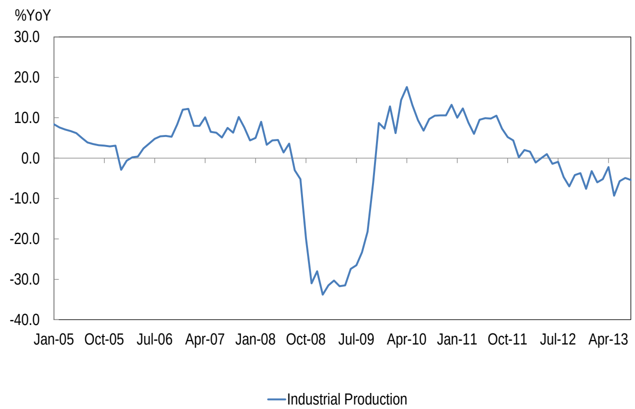
None of the choices facing the government are pleasant. The absence of market access, and the continuing repayment of external debt to banks, means that the only real substitute supplier of foreign exchange will be the IMF, but the government's apparent reluctance to adjust domestic gas tariffs – an essential condition of an IMF deal – means this process will not be smooth. Gas subsidies are estimated at 87% of the import costs and about 5% of GDP. A rise in tariffs would certainly boost inflation, which has been negative since May 2012. But the bigger obstacle is political, since Ukraine's leaders have stated clearly that they don't plan to agree to a hike in domestic energy prices. Other likely requirements of an IMF agreement – public wage restraint, exchange rate flexibility and an absence of any cuts in indirect taxes – are equally unlikely to be popular in the run up to a 2015 election. An IMF mission to Kiev is apparently scheduled for October. One possibility is that the IMF might soften its requirement for a gas tariff adjustment in the context of an improvement in the relationship between Ukraine and the EU.

Attention to Ukraine's relationship with the EU will grow. The government hopes to sign an EU Association Agreement – which provides for legal, regulatory and political convergence with the EU – and the late-November Eastern Partnership Summit in Vilnius. Yet here too the path is not clear, since the EU will likely require some form of concession from the government regarding the fate of the imprisoned former Prime Minister Yulia Timoshenko. And even if that is forthcoming, Ukraine might need to brace itself for an aggressive response by the Russian government, which imposed draconian customs requirements on Ukrainian exports in July and August, apparently in response to Ukraine's pursuit of closer EU relations. Yet the relationship with Russia remains ambiguous: the state-owned Sberbank syndicated a $750 million loan for Ukraine this month.

Meanwhile, Ukraine's fiscal position is deteriorating. The consolidated budget deficit was 5.8% in 2012, and fiscal dynamics have worsened: in January-July, public spending was up 9.6%, while revenue only grew by 2.6%. The government is relying on advance tax payments from large firms, which erodes future fiscal health. Although the public debt is relatively low, at 38% GDP, the high interest rate environment needed to stabilize the fx market is not helping Ukraine's debt dynamics. To minimize that risk, the National Bank holds around half of the stock of government securities.

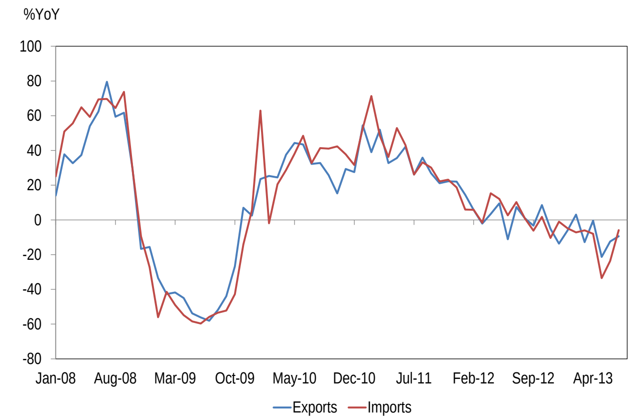
Risks of 10-15% FX correction over the next 3-6 month seem high. Either with or without an IMF agreement, the UAH seems more and more vulnerable. NBU data suggest that external debt with less than a year's maturity stands at over $62bn. Although this overstates the refinancing need that is at risk – since intra-company loans are more or less automatically refinanced – the threats to financial stability in Ukraine have mounted sharply since capital started flowing out of EM in early May this year, and there is no easy way of minimizing those threats, in our view.

Figure 201. The economy is in recession…



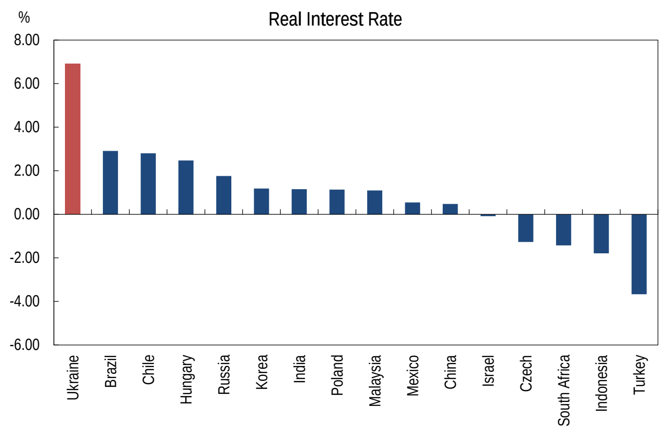
Source: Haver Analytics

Figure 2022. …and trade dynamics have deteriorated



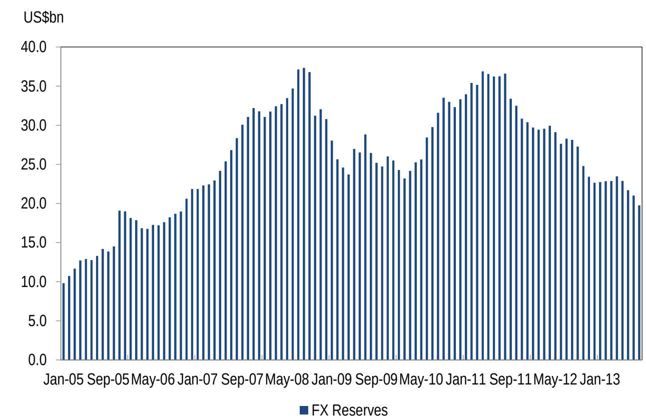
Source: Haver Analytics

Figure 203. Very high real interest rates are needed to preserve fx stability…



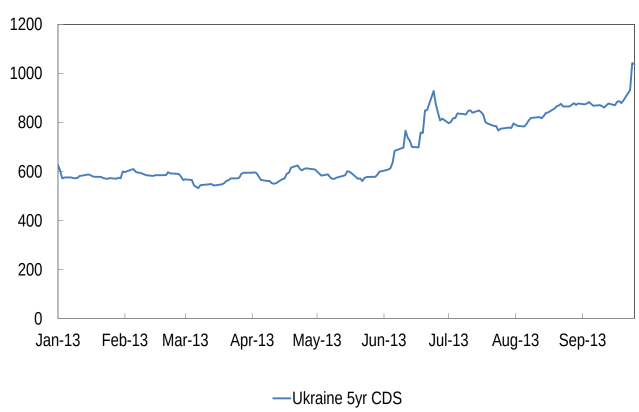
Source: Citi Research

Figure 204. …but that hasn't prevented reserves loss



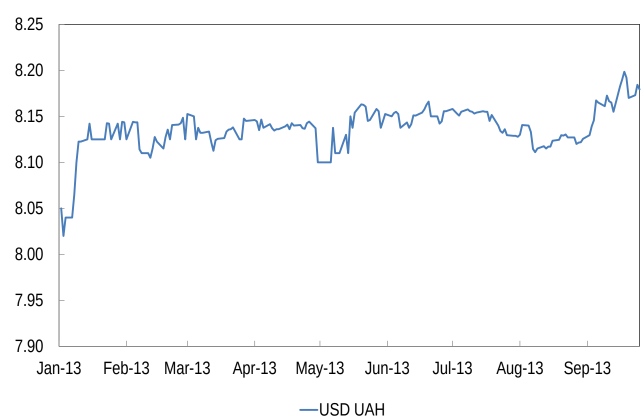
Source: Haver Analytics

Figure 205. Perceptions of Ukraine risk have deteriorated…



Source: Bloomberg

Figure 206.… and the exchange rate has come under a bit of pressure.



Source: Haver Analytics

Figure 207. Ukraine Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	108	143	180	117	136	163	176	142	154
Nominal GDP, local currency bn	541	715	946	913	1,080	1,294	1,408	1,591	1,848
GDP per capita, USD	2,313	3,084	3,914	2,566	3,006	3,624	3,936	3,199	3,478
Population, mn	46.6	46.3	46.0	45.7	45.4	45.1	44.8	44.5	44.2
Unemployment, % of labour force	6.9	6.4	6.4	8.8	8.1	7.9	8.0	7.9	7.9
Economic Activity									
Real GDP, yoy avg	7.4	7.6	2.3	-14.8	4.1	5.2	0.2	-1.3	1.6
Real investment growth % yoy	17.9	26.6	1.8	-57.1	15.9	18.0	-13.9	-35.1	48.5
Real consumption growth % yoy	12.2	13.1	10.1	-12.3	6.4	11.3	9.7	1.8	4.3
private consumption growth % yoy	15.4	17.0	12.8	-14.9	7.1	15.5	11.6	2.0	5.0
Real export growth, % yoy	-5.8	2.8	5.7	-22.0	3.9	4.3	-7.7	-18.7	3.0
Real import growth, % yoy	8.3	23.9	17.0	-38.9	11.3	17.7	1.9	-22.5	5.0
Prices, Money & Credit									
CPI, % yoy	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	3.8
CPI, % avg	9.1	12.8	25.2	15.9	9.4	8.0	0.6	-0.1	3.0
Nominal wages, % yoy	29.4	29.7	33.7	5.5	17.7	17.5	14.9	9.0	12.0
Credit extension to private sector, % yoy	69.8	73.7	67.1	-4.2	0.7	8.9	2.8	7.0	20.0
Policy Interest Rate, % eop	8.50	8.00	12.00	10.25	7.75	7.75	7.50	6.50	7.00
1 month inter-bank rate, %, eop	-	8.41	23.78	19.10	10.75	20.25	25.00	6.50	7.70
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.05	5.05	8.05	8.05	7.97	8.01	8.05	9.30	9.40
UAH/US$, avg	5.04	5.03	5.16	8.06	7.97	7.99	8.08	8.64	9.27
UAH/EUR, eop	6.67	7.37	11.25	11.53	10.66	10.37	10.62	11.98	12.41
UAH/EUR, avg	6.32	6.89	7.60	11.21	10.55	11.11	10.39	11.17	12.01
Balance of Payments, USD bn									
Current account	-1.6	-5.3	-12.8	-1.7	-3.0	-10.2	-14.8	-11.9	-9.1
% of GDP	-1.5	-3.7	-7.1	-1.5	-2.2	-6.3	-8.4	-8.4	-5.9
Trade balance	-5.2	-10.6	-16.1	-4.3	-8.4	-16.3	-20.5	-16.9	-15.4
Exports	38.9	49.8	67.7	40.4	52.2	69.4	69.8	71.9	76.0
Imports	44.1	60.4	83.8	44.7	60.6	85.7	90.3	88.7	91.3
Service balance	2.1	2.4	1.7	2.4	4.4	6.1	5.7	4.6	6.0
Income balance	-1.7	-0.7	-1.5	-2.4	-2.0	-3.8	-3.0	-2.9	-3.0
FDI, net	5.7	9.2	9.9	4.7	5.8	7.0	6.6	7.8	8.0
International reserves	22.4	32.5	31.5	26.4	34.6	31.8	24.5	18.5	17.2
Total amortisations	7.0	8.5	13.9	17.9	23.4	23.6	20.1	21.5	20.8
Public Finances, % of GDP									
Consolidated government balance	-0.6	-0.8	-1.2	-7.3	-8.8	-3.9	-5.6	-6.7	-6.3
Consolidated gov primary balance	0.2	-0.3	-0.7	-6.2	-7.6	-2.9	-4.7	-5.3	-5.3
Public debt	13.2	10.8	14.4	25.5	31.5	28.3	29.0	30.8	32.0
of which Domestic	3.1	2.5	4.7	10.0	13.1	12.4	13.5	16.4	18.8
Foreign Assets & Liabilities, USD bn									
External debt	54.5	80.0	101.7	103.4	117.3	126.2	135.0	144.5	142.6
Public	11.8	12.3	16.7	24.0	32.5	33.4	32.2	30.5	27.2
External debt / GDP	50.6	56.0	56.5	88.2	86.0	77.2	76.6	101.5	92.7
External debt / XGS	108.5	124.9	118.7	190.6	169.4	142.1	150.4	153.6	143.9
Short-term debt	15.2	20.7	20.3	19.0	23.5	30.7	33.2	33.6	34.0
Short-term debt/International reserves (%)	68.0	63.7	64.4	72.0	68.1	96.7	135.2	181.3	197.6

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	-1.1	-1.3	-1.6	-1.1	-0.4	0.2	2.5	3.7	3.9
CPI, % yoy	-0.8	-0.1	0.2	0.5	2.8	3.1	3.7	3.8	3.2
Policy interest rate, %, eop	7.50	7.00	6.50	6.50	7.00	7.00	7.00	7.00	6.50
Short-term market rate, % eop	4.90	5.40	6.50	6.50	7.00	7.70	7.70	7.70	8.13
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
UAH/US$, eop	8.14	8.16	9.35	9.30	9.20	9.20	9.30	9.40	8.80

Source: Citi Research

Other Africa

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Ghana

- In the coming months all eyes will be on the 2014 budget presentation in parliament. Recent IMF estimates indicated that the deficit may only fall to around 10%, which would imply that any fiscal consolidation during the current electoral cycle will be really under pressure. Having said that the government does increasingly seem to be feeling the pressure to make progress on fiscal consolidation.

- This at least in part reflects the ongoing weakness of the cedi through 2012 and 2013 and the low level of foreign exchange reserves. To counter this, the Bank of Ghana (BoG) has continued to run a tight monetary policy, which has also helped keep inflation in low double digits so far in 2013 despite the cedi weakness but meant that the cost of servicing debt has been high. And despite the policy imbalances, GDP growth looks set to remain robust in 2013-14.

- The real question in 2014 will be whether progress in fiscal consolidation, rising oil production, the start of gas production, robust growth and the end to political uncertainty means that we enter a new period of cedi stability. The length of this will ultimately depend on progress with fiscal consolidation and the assumption that the BoG does not get pushed into easing monetary policy prematurely.

Kenya

- The peaceful conduct of the March 2013 elections should provide a major fillip to the private sector and we expect it to drive a strong rebound in growth in the coming years. The key economic questions facing the government of the new president, Uhuru Kenyatta, is can the fiscal and current account deficits be brought under control.

- Despite the cost of implementing the new constitution, we do expect some postelection fiscal consolidation in the coming years. But with growth picking up and sucking in imports, reducing the current account deficit is likely to prove much harder. At present capital inflows have remained robust and if this continues, it means that Kenyan shilling (KES) depreciation may be limited. We think the weakening of KES in June-July is more a re-adjustment after it appreciated too strongly in the wake of the peaceful election outcome.

- But, the policy balancing act facing the Central Bank of Kenya (CBK) will become harder in 2H 2013 and into 2014. We expect inflation to pick up in 2H 2013 to the top end of its inflation target (5%, +/- 2.5pp), which will limit its scope to further loosen monetary policy. If high rates continue to attract capital inflows, it may become concerned about KES strength. But a sharp easing of monetary policy against the background of the large current account deficit and rising growth could create inflationary pressures and the too rapid KES depreciation.

Tanzania

- The review of Tanzania's constitution will continue into 2014 following the creation of a Constitutional Review Commission. However, the main focus of the government will be on economic reform, and crucially the implementation of policy. The most immediately pressing priorities are resolving the ongoing power sector crisis, which has led to prolonged electricity shutdowns in major urban centres acting as a brake on growth, and bringing down the inflation rate, which has fallen more slowly than in the rest of East Africa since 2012.

- Growth should continue to be robust in 2013-14, although for it to really pick up into double digits the government will have to make real progress in implementing its Kilimo Kwanza (Agriculture First) policy. The current account deficit is set to remain substantial despite ongoing increases in gold exports, but with aid and FDI inflows, increasingly into the gas sector, remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda, especially if the government does issue a Eurobond in 2H 2013.

- Given the fiscal and current account deficits and relatively high inflation rate, it is not surprising the Tanzanian shilling came under pressure again in late 2012. Although this moderated in early 2013 unless the deficits are substantially reduced, or monetary policy kept very tight, the shilling will continue to weaken in 2H 2013 and into 2014.

Uganda

- Growth slowed sharply in 2012 to its lowest level for over a decade. Coupled with the sharp rise in inflation in 2011-12, which undermined household incomes, delays to oil production and various spats with donors in 2H 2012 this seems to have created a new drive within the government to return to a more orthodox economic policy.

- Not only has the Bank of Uganda (BoU) maintained a tight monetary policy since throughout 2013, but the ministry of finance also outlined a relatively tight budget for the 2013/14 fiscal year (starts July 1) and a more restrained fiscal stance going forward. The combination of these trends has led to considerable Uganda shilling (UGX) stability in 2013 despite large current account deficit, a trend likely to be maintained into 2014 as long as the current account deficit can be relatively easily financed.

- At some point in the next five years, Uganda will become an oil producer, although the impact on growth and government revenue will, initially, be minimal given that production will be limited. While the development of the fields will push up the current account deficit, it should be largely funded through FDI.

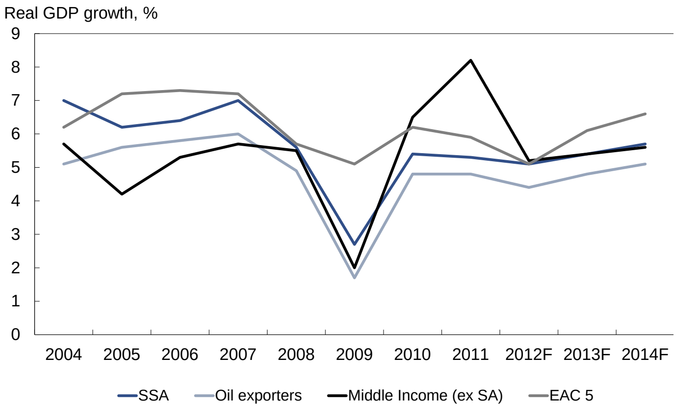
Zambia

- We expect a rise in government spending over the next few years initially funded from the US$750m debut Eurobond and then from rising tax revenues, notably from the mining sector. But while government spending is set to increase, the rise may be slower than budgeted for as the new government struggles to implement projects given the general inexperience of many of the new ministers.

- Having plateaued at around 850,000 tonnes in 2010-12, copper production has picked up again in 1H 2013 helping underpin growth. With strong growth continuing to suck in imports, the current account did move into a deficit in 2012-13 and with rising government spending, this has at least in part helped explain the slow depreciation of the kwacha until mid-2013. In addition, the introduction of measures to reduce dollarization and increase foreign currency inflows negatively impacted on kwacha sentiment. Although the legislation is potentially kwacha positive, the way the legislation was introduced created concerns about the overall policy direction in Zambia.

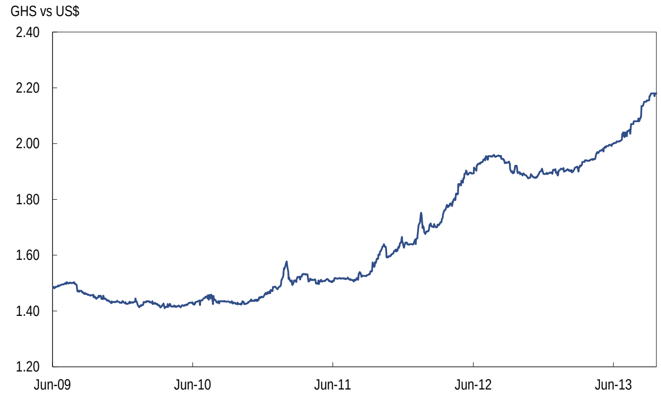
- Having said that, there have been strong signs in 2H 2013 that the economy has partially adjusted to lower global copper prices and the different macroeconomic policy environment potentially ushering in a new period of greater kwacha stability.

Figure 208. Growth should be robust in 2013-14



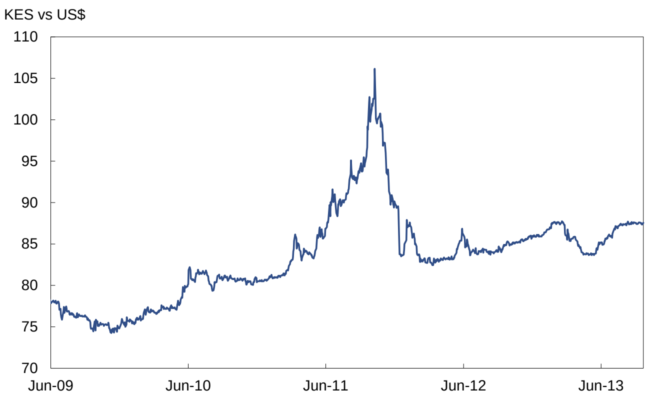
Source: IMF

Figure 209. The cedi crosses the GHS2:US$1 level



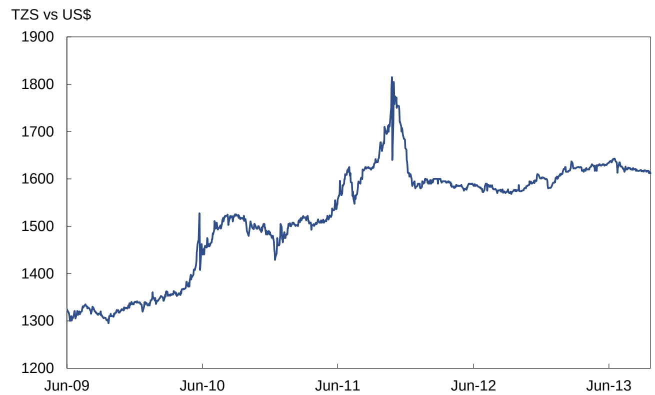
Source: Haver Analytics

Figure 210. The post election Kenyan shilling rally has ended



Source: Haver Analytics

Figure 211. Is the Tanzanian shilling now too strong?

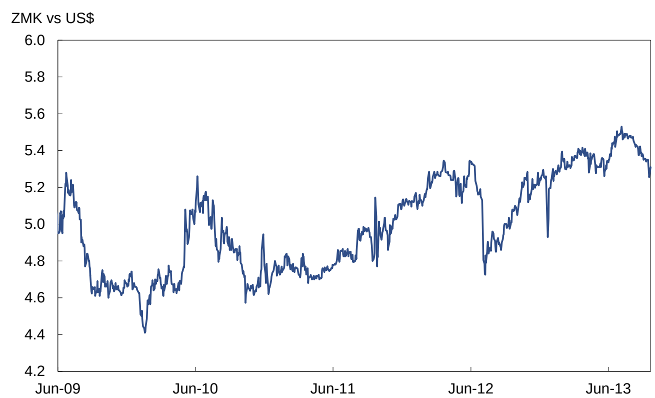


Source: Haver Analytics

Figure 212. Pressure on the Ugandan shilling has eased in 2013

Source: Haver Analytics

Figure 213. The roller coaster ride for the kwacha continues



Source: Haver Analytics

Figure 214. Other Africa Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
GHANA									
Nominal GDP, USD bn	20.4	24.8	28.5	26.0	32.2	39.6	40.7	42.9	43.6
GDP per capita, USD	930	1,099	1,234	1,096	1,326	1,594	1,605	1,655	1,649
Real GDP, yoy avg	6.1	6.5	8.4	4.0	8.0	15.0	7.9	6.7	6.8
CPI, % avg	11.7	10.8	16.5	19.2	10.7	8.7	9.2	10.7	9.3
Policy Interest Rate, % eop	12.5	13.5	17.0	18.0	13.5	12.5	15.0	16.0	14.0
GHS/US$, avg	0.91	0.95	1.07	1.43	1.43	1.55	1.85	2.04	2.36
Current account	-1.0	-2.1	-3.5	-1.6	-2.6	-3.5	-4.9	-4.8	-5.0
% of GDP	-5.1	-8.6	-12.4	-6.2	-8.2	-9.0	-12.1	-11.2	-11.5
Consolidated government balance	-5.0	-6.1	-8.5	-5.8	-7.2	-4.8	-12.4	-10.1	-8.5
KENYA									
Nominal GDP, USD bn	22.5	28.5	30.4	30.6	32.2	34.0	41.1	44.6	52.2
GDP per capita, USD	612	754	785	769	786	810	953	1,005	1,146
Real GDP, yoy avg	6.3	7.0	1.5	2.7	5.8	4.4	4.6	5.5	6.1
CPI, % avg	6.0	4.3	15.1	10.6	4.1	14.0	9.4	5.6	6.6
Policy Interest Rate, % eop	10.0	8.8	8.5	7.0	6.0	18.0	11.0	8.5	8.0
KES/US$, avg	72.1	67.3	68.8	77.3	79.2	88.4	84.5	86.6	90.1
Current account	-0.5	-1.0	-2.0	-1.7	-2.4	-3.3	-4.3	-4.5	-5.0
% of GDP	-2.3	-3.6	-6.5	-5.5	-7.4	-9.8	-10.5	-10.1	-9.5
Consolidated government balance	-1.9	-4.2	-3.5	-6.2	-4.7	-5.5	-9.0	-7.0	-5.5
TANZANIA									
Nominal GDP, USD bn	14.3	16.8	20.7	21.4	22.9	23.7	29.1	31.9	34.9
GDP per capita, USD	359	409	489	490	509	510	609	647	689
Real GDP, yoy avg	6.7	7.1	7.4	6.0	7.0	6.4	6.9	6.8	7.0
CPI, % avg	7.3	7.0	10.3	12.1	7.2	12.7	16.0	7.7	5.1
TZS/US$, avg	1,249	1,237	1,198	1,324	1,439	1,582	1,586	1,608	1,783
Current account	-1.7	-2.3	-3.2	-2.5	-2.7	-4.6	-3.5	-3.3	-4.6
% of GDP	-11.6	-13.9	-15.2	-11.5	-11.9	-19.3	-11.9	-10.2	-13.3
Consolidated government balance	-4.5	-1.9	-2.6	-6.0	-6.5	-5.0	-5.4	-5.0	-5.6
UGANDA									
Nominal GDP, USD bn	10.8	12.9	15.9	16.0	17.0	18.4	21.6	21.4	22.7
GDP per capita, USD	363	418	499	487	500	522	594	568	584
Real GDP, yoy avg	9.5	8.6	7.7	7.1	5.6	6.7	2.6	5.0	5.6
CPI, % avg	7.2	6.1	12.0	13.0	4.0	18.7	14.0	5.9	8.7
UGX/US$, avg	1,830	1,723	1,714	2,025	2,173	2,511	2,501	2,598	2,729
Current account	-0.3	-0.6	-1.3	-1.1	-1.7	-2.1	-2.1	-2.8	-3.4
% of GDP	-3.1	-4.9	-8.0	-6.8	-10.2	-11.4	-9.7	-12.9	-14.8
Consolidated government balance	-0.7	-1.1	-2.8	-2.4	-6.7	-3.2	-3.6	-3.4	-3.3
ZAMBIA									
Nominal GDP, USD bn	10.7	11.5	14.6	12.8	16.2	19.2	21.6	23.6	26.1
GDP per capita, USD	908	953	1,175	998	1,225	1,408	1,534	1,620	1,736
Real GDP, yoy avg	6.2	6.2	5.7	6.4	7.6	6.8	7.3	6.9	7.5
CPI, % avg	9.1	10.6	12.4	13.4	8.5	6.4	6.6	7.1	7.0
ZMK/US$, avg	3,554	3,992	3,702	5,020	4,791	4,861	5,139	5	6
Current account	-0.1	-1.0	-1.4	0.2	0.9	0.1	-0.7	-0.1	0.7
% of GDP	-0.6	-8.4	-9.3	1.9	5.7	0.4	-3.4	-0.5	2.7
Consolidated government balance	20.2	-1.3	-0.8	-2.5	-3.0	-2.2	-4.5	-6.6	-4.1

Source: National Sources, Citi Research

Other Europe

Bulgaria

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The second quarter GDP print suggests to us that the growth outlook will remain challenging during the rest of the year. GDP contracted by 0.2%YoY in the second quarter, which represents the first drop since end-2009. Despite the positive contribution of net exports of about 1.8pp, the noted decline in GDP was mainly driven by tepid growth in final consumption expenditures and relatively sharp fall in gross fixed investment by 2.6%YoY (or 2.4%QoQ SWDA). It is worth noting that recent high frequency recent indicators suggest that economic activity may gain traction in the third quarter. Particularly, the retail trade excluding motor vehicles rose by 1.0%MoM (SA) in July compared with the monthly average of about 0.5% in 1H 2013. Similarly, the industrial production rose by 1.8%MoM (SA) in July following a 0.8%MoM rise and a 2.1%MoM drop in June and May, respectively.

Despite the noted upbeat start to 3Q, there are signs suggesting that growth will lose momentum in the coming months. The lingering uncertainty in the political sphere may adversely affect the recent recovery in consumer confidence, thereby hurting domestic demand. In parallel, we think that the weak support for the government doesn't bode well for pursuing the much-needed critical reform agenda on key areas. Against this backdrop, we revise down our 2013 GDP growth forecast to 0.5% (from 1% GDP), as we maintain our 2014 growth forecast at 2%. In terms of important obstacles to growth, it is worth highlighting that "corruption" is identified as the most problematic factor for doing business in Bulgaria, according to the WEF Global Competitiveness Report 2013-14, followed by "access to financing" and "inefficient government bureaucracy". Consequently, progress on these areas will be crucial in improving the country's growth prospects.

Croatia

Recent data support our view that the economy will likely to contract in the third quarter as well. GDP fell by 0.7%YoY in second quarter following a 1.5%YoY drop in 1Q, which marks the seventh consecutive year-over-year contraction. While the contribution of domestic demand to GDP growth stood at 0.8pp in the second quarter, net exports shaved 1.9 pp off the 2Q GDP growth, as imports rose by a whopping 2.2%YoY – the highest since 3Q 2008. Despite the noted strength in domestic demand and imports, however, we still think that a sustained rise in private spending in the near future is unlikely given the high level of unemployment and the anemic credit growth. In fact, recent high frequency indicators already point to a softer demand in early third quarter. For example, retail trade volume fell by 0.2%MoM in July following a 0.7%MoM drop in June and 3.4% rise in May.

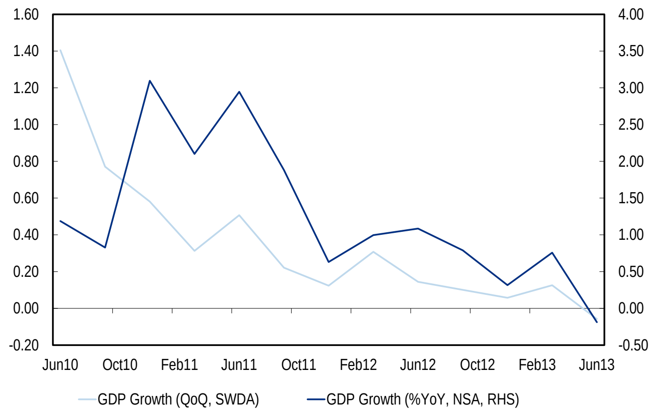
We think that the EU accession will not lead to a meaningful rise in exports due to the weak growth prospects in the Euro zone and the competitiveness issues. According to the most recent WEF Competitiveness Report, Croatia ranks 75 among 148 countries, as the country has a competitiveness gap in key areas such as goods market efficiency (ranks 111) and labor market efficiency (ranks 114). Moreover, we are concerned that the EU membership may thwart exports in the short-term, as the country's CEFTA membership ended with the EU accession. Against this backdrop, we think that Croatian economy is likely to remain in recession until the last quarter of 2013, as we now expect the GDP to contract by 1.0% in 2013. Looking ahead, a gradual improvement in the Euro zone, rising tourism revenues and capital inflows after the EU accession underpin our expectation of a 1.2% GDP growth in 2014.

Serbia

While the recent data provide mixed signals, we remain cautiously optimistic about near-term growth outlook. GDP growth fell by 0.7%YoY in 2Q from 2.1% in the first quarter. In terms of growth momentum, seasonally adjusted GDP data points to a flattish growth in 2Q following a rise of 2.7%QoQ in 1Q. We believe that economic growth during the remainder of the year will be mainly shaped by a pick-up in manufacturing activity and export growth. In fact, the recent data point to a relatively strong start in 3Q with industrial production rising by 8.3%MoM (sa) in July compared with an average monthly industrial production growth of about 0.2%(sa) in the first half of the year. Similarly, export growth accelerated to 6.0%MoM in July compared with average growth of about 2.1%MoM in the first half of the year. Turning to key domestic demand indicators, the recent data point to a considerably slower start in the 3Q with the retail trade dropping by almost 5%MoM (sa) in July. In addition, our analysis suggests that while import growth in July remained strong at around 7.8%MoM (sa), imports fail to display any secular pick up since the beginning of year. All in all, we expect GDP growth to be around 2.3% this year thanks mainly to the strong export performance.

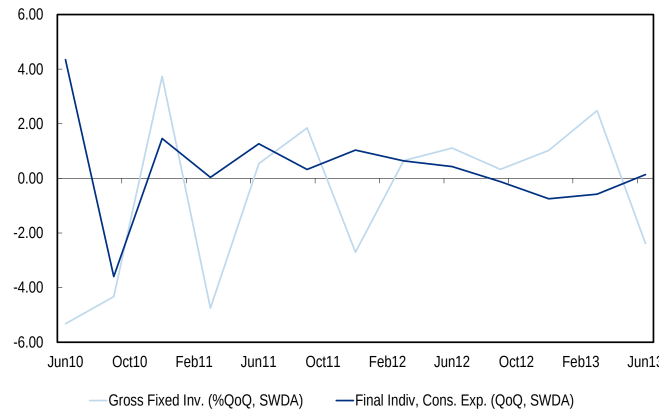
The NBS surprised the markets at the September MPC meeting by holding the key policy rate unchanged at 11%. The NBS expects the downward trend in inflation to continue on the back of low aggregate demand and benign food prices, which is broadly in line with our forecast trajectory. As was underlined by the NBS, its decision to keep rates on hold in September was mainly driven by global economic developments (the Fed's taper talk and higher oil prices). Nonetheless, we believe that the continued disinflation, coupled with the relatively weak domestic demand, will likely lead the NBS to resume easing cycle in the coming months. In this respect, let's note that our analysis suggests that the annual inflation, which fell to 7.5%YoY (HICP) in August from 8.8%YoY in July, will continue to decelerate going forward, ending the year at around 5.5%YoY (compared with 12.6% in 2012). We believe that the EU's decision to start accession talks with the country and the possibility of a new arrangement with the IMF can be additional catalysts for further policy easing. A sustained weakness in RSD, which has already depreciated by more than 3.0% during the recent EM sell-off, emerges as the main risk factor associated with our rate outlook. With this caveat in mind, we expect the NBS to carry out an additional 100bp cuts in the rest of the year, bringing the policy rate to around 10% by end-year.

Figure 215. Bulgaria: 2Q GDP reading suggest that economic activity is struggling to gain momentum...



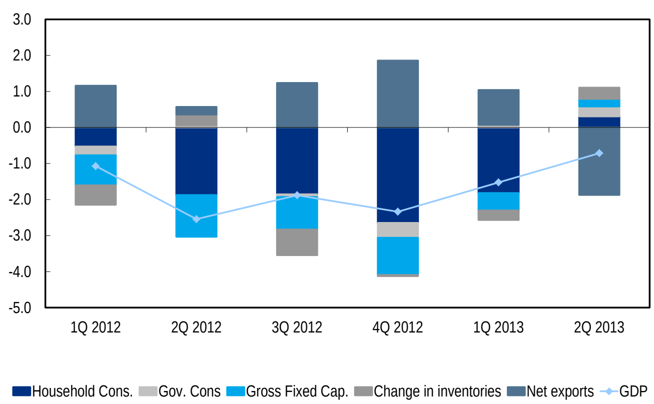
Source: Haver Analytics and Citi Research

Figure 216. ... as domestic demand remains weak



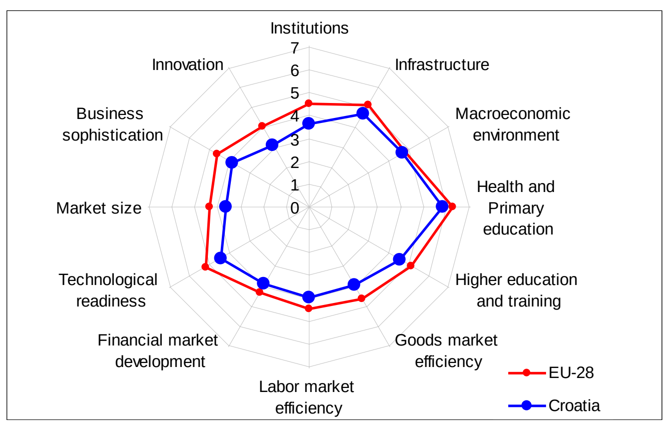
Source: Haver Analytics and Citi Research

Figure 217. Croatia: Still contracting on y-o-y basis...



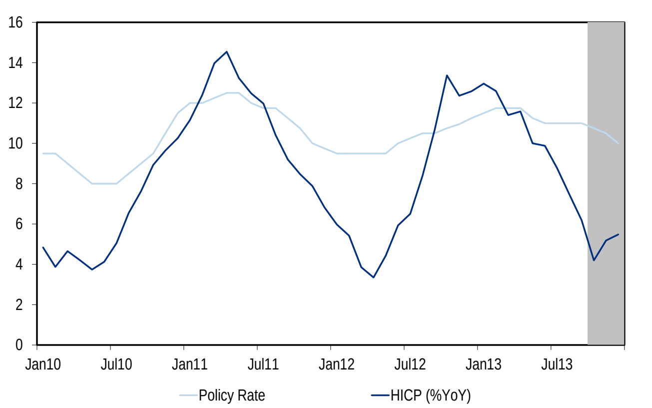
Source: Haver Analytics and Citi Research

Figure 218. ... as the country's competitiveness gap continues to overshadow the growth outlook



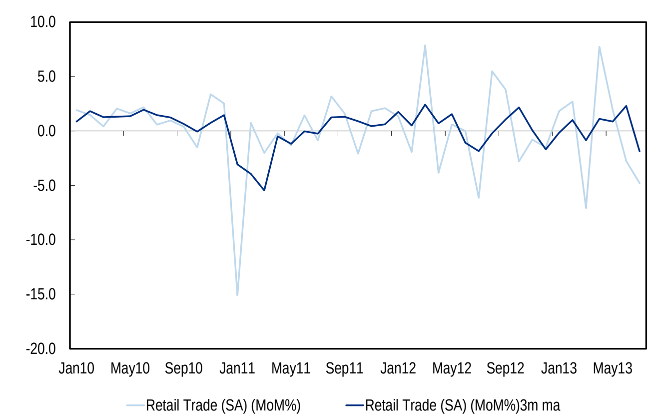
Source: WEF Competitiveness Report 2013-14.

Figure 219. Serbia: NBS is set to ease on the back of the benign inflation prospects...



Source: Haver Analytics and Citi Research

Figure 220. ...and relatively weak domestic demand



Source: Bloomberg and Citi Research

Figure 221. Other Europe Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
BULGARIA									
Nominal GDP, USD bn	33.2	42.1	51.8	48.6	47.7	53.5	51.0	54.1	59.1
GDP per capita, USD	4,325	5,512	6,812	6,421	6,360	7,307	7,000	7,540	8,276
Real GDP, yoy avg	6.5	6.4	6.2	-5.5	0.4	1.8	0.8	0.5	2.0
CPI, % avg	7.3	8.4	12.3	2.8	2.4	4.2	3.0	1.6	3.9
BGN/US$, avg	0.91	0.95	1.07	1.43	1.43	1.55	1.85	2.04	2.36
Current account	-5.9	-10.8	-11.9	-4.3	-0.8	0.2	-0.7	-0.7	-1.2
% of GDP	-17.7	-25.6	-23.0	-8.8	-1.6	0.3	-1.5	-1.2	-2.1
Consolidated government balance	3.4	3.3	2.9	-0.9	-4.0	-2.0	-0.5	-1.5	-0.7
CROATIA									
Nominal GDP, USD bn	49.9	59.3	69.6	62.2	58.9	61.8	56.4	58.8	62.3
GDP per capita, USD	11,229	13,376	15,694	14,044	13,331	14,036	12,867	13,696	14,583
Real GDP, yoy avg	4.9	5.1	2.1	-6.9	-2.3	0.0	-2.0	-1.0	1.2
CPI, % avg	3.2	2.9	6.1	2.4	1.0	2.3	3.4	2.5	3.0
Policy Interest Rate, % eop	4.50	9.00	9.00	9.00	9.00	7.00	7.00	7.00	7.00
HRK/US$, avg	72.1	67.3	68.8	77.3	79.2	88.4	84.5	86.6	90.1
Current account	-3.2	-4.3	-6.1	-3.0	-0.9	-0.4	0.0	-0.1	-0.3
% of GDP	-6.5	-7.3	-8.7	-4.9	-1.5	-0.7	0.1	-0.1	-0.5
Consolidated government balance	0.6	1.4	0.4	-2.0	-3.6	-3.6	-2.4	-4.5	-4.0
SERBIA									
Nominal GDP, USD bn	29.2	39.0	47.8	40.2	37.1	43.7	38.5	44.0	46.3
GDP per capita, USD	3,943	5,279	6,500	5,497	5,085	6,027	5,332	6,124	6,472
Real GDP, yoy avg	3.6	5.4	3.8	-3.5	1.0	1.6	-1.7	2.3	2.0
CPI, % avg	-	5.6	11.9	8.7	6.1	11.0	7.8	8.8	7.2
Policy Interest Rate, % eop	14.00	10.00	17.75	9.50	11.50	9.75	11.25	10.00	8.50
RSD/US$, avg	1,249	1,237	1,198	1,324	1,439	1,582	1,586	1,608	1,783
Current account	-4.0	-6.9	-10.4	-2.9	-2.8	-4.0	-4.1	-2.9	-3.7
% of GDP	-13.6	-17.7	-21.8	-7.1	-7.5	-9.1	-10.6	-6.5	-8.0
Consolidated government balance	1.5	0.6	-1.8	-3.5	-3.5	-4.1	-5.7	-5.0	-5.0

Source: National Sources, Citi Research

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- **Summary view** — Potentially negative mid-term election results are unlikely to result in a change of economic policies. We expect the drain in international reserves to push the government to tighten FX controls after the elections. We have revised our forecast for non-official real GDP growth for 2013 to 2.7%. We continue to see 0.5% real GDP growth next year. Lastly, we do not expect major changes in BCRA's exchange rate policy, and thus we see the official USDARS at 6.15 and 8.15 by the ends of 2013 and 2014, respectively.

- **Things to watch** — The October 27 midterm elections are getting closer. Keep an eye on the debt legal vicissitudes and how the government responds to the most tangible imbalance: the FX market. The drain in reserves, which has exacerbated in 2013, poses an additional risk for the country's outlook.

- **Strategy** — A GDP warrant payment in 2014 is likely to accrue. We see the USDARS at 6.15 and 8.15 by the ends of 2013 and 2014, respectively.

October-electoral-fest

Will the October 27 midterm elections differ significantly from the August 11 primaries? In our view, the answer to this question is "not meaningfully". The polls show the government's candidates' vote intention relatively unchanged when compared to the August 11 primaries. While the August 11 poor showing could cost the incumbent Frente para la Victoria (FpV) support from some of its allies, the recent economic and security initiatives are likely enough to offset this effect. Furthermore, we believe the government is likely to use the information gathered in the primaries to adjust its political machinery (i.e., improve the targeting of transfers to provincial and municipal governments in exchange for their support).

After the elections, our base scenario assumes no significant changes in the conduct of economic policies. In our opinion, the election results will constrain the government’s political capital increasing its reluctance to undertake large policy changes (a step-devaluation, a change in the FX regime, large reductions in subsidies or a fiscal contraction to reduce central bank financing). Our prognosis is mainly based on three factors. First, in anticipation of the election results, the government is getting ready to pass, before October 27, many of the necessary bills to fiscally control the economy during the next two years, limiting congressional controls. Second, the country's current fiscal structure provides the Federal Government several tools to keep the provinces' governors in check. Third, the government's approval ratings remain fairly positive.

BCRA reserves and FX policy

The FX front continues to deteriorate. BCRA reserves currently stand at USD35bn, their lowest level since early 2007, having dropped USD8.3bn year-to-date and USD10.2bn during the last 12 months. While we acknowledge that simply looking at the evolution of BCRA reserves may be misleading, as they have been affected by some extraordinary factors (for further details please refer to our Argentina Macro View - It’s All About Reserves), it is also true that the BCRA faces growing difficulties to purchase foreign currency in the FX market. BCRA's foreign currency purchases stood at only USD0.5bn year-to-September 13, compared to USD7.9bn during the same period of 2012. If we extend the period to the last twelve months, the data further highlights the negative trend with USD1.8bn purchases during the last 12 months. BCRA's foreign reserve position begins to dwindle when compared to debt payments in foreign currency.

This situation is increasingly becoming a central focus for policymakers and markets. We do not expect the government's measures to address the underlying problem, which is a meaningful monetary overhang consequence of extreme fiscal dominance of monetary policy, but to attack the consequences (i.e., the lack of BCRA foreign currency purchases). Monetary policy appears deceivingly contractionary: money growth has slowed only because of much smaller FX purchases while, at the same time, it grows more strongly as a result of support to the Treasury. To maintain the overhang (or even grow it) and prevent a speeding of reserve drainage, we expect a tightening of FX controls, particularly on items such as tourism, non-fuel imports and, to a lesser extent, dividend. In other words, we expect 2013-2014 to be a "copy-paste" of 2011-12: a pre-elections period with steep drain in reserves, followed by increased FX controls and growth stagnation.

No step-devaluation or a change in plan, but adapting the pace of crawl to the new circumstances. The last few months have shown a central bank more willing to speed up the pace of depreciation of the currency. In our view, this is mostly a response to an attempt at preventing further real effective exchange rate appreciation: if the Brazilian Real depreciates, the peso is likely to follow. We expect the official USDARS to continue increasing at a higher annualized rate than during 1H13, but we do not expect this rate to surpass 40% (for a prolonged period of time). As shown below, the recent higher ARS depreciation combined with the BRL strengthening has led to a slight depreciation of the country's real effective exchange rate (REER). However, the current level remains in line with its two year moving average. We think that the authorities feel comfortable with this level, as they have been managing the USDARS to keep the REER close to it. All in all, we now see the official USDARS at 6.15 and 8.15 by the ends of 2013 and 2014, respectively.

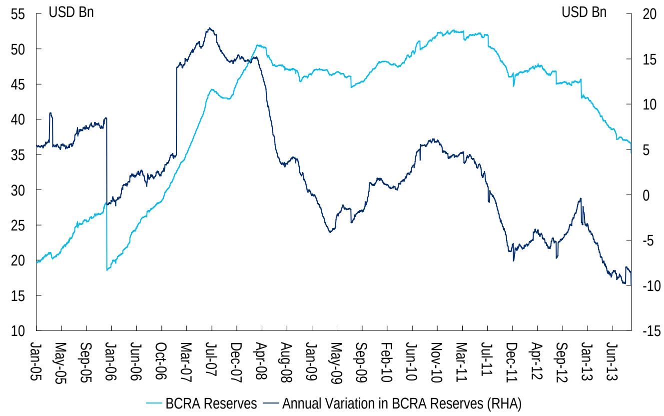
Activity growth, or the lack thereof

Stagflation rears its ugly face, again. After a short rebound in growth, mainly due to an exogenous one-off improvement in the 2012/13 crop, activity has stagnated since last May, as per our Citi's Argentina Activity Indicator (CAAI). While we were expecting the effects of the 2012/13 on activity to be short-lived, the slowdown in growth came sooner than what we were expecting. Thus, we are reducing our forecast for non-official real GDP growth for 2013 from 3% down to 2.7%. As this new forecast implies a lower statistical carryover for next year, we think that there is a downside risk to our 0.5% growth forecast for next year. For 2015, we expect a 1% increase in our CAAI.

In contrast, INDEC presents a surprisingly optimistic outlook. While most private sector measures of growth have disappointed recently, the National Statistics Institute (INDEC) reported that real GDP grew 8.3% YoY and 2.6% QoQ SA in 2Q13. These results imply a 5.5% statistical carryover for 2013 as a whole, making a GDP warrants payment in December 2014 very likely (leaving aside potential legal or methodological issues[1]). According to our estimates, for official growth to fall below 3.22% in 2013, official real GDP would have to plummet at an annualized rate of around 11% during 2H13! Regarding 2014 official real GDP growth, we continue to expect it to fall below the 3.02% threshold necessary to trigger a GDP warrants payment in 2015, even despite a budget bill that assumes 6.2% real GDP growth rate.

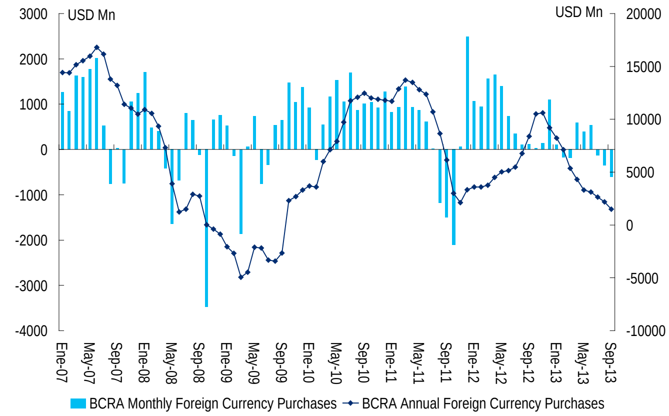
[1] Some analysts and journalists have been suggesting that, in order to avoid a 2014 GDP warrants payment, the authorities could revise the base year used for the national accounts statistics.

Figure 222. BCRA reserves nosedive



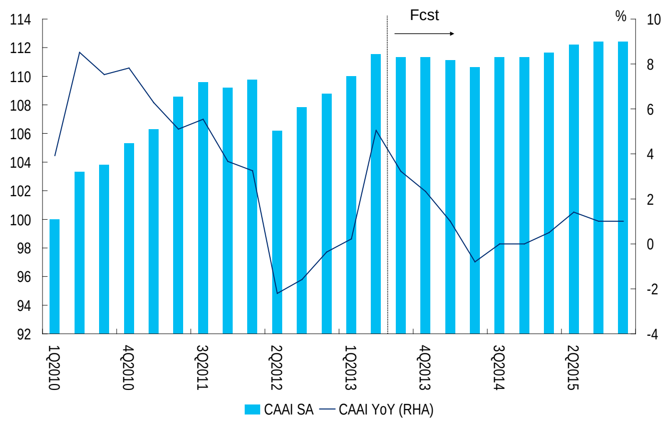
Source: BCRA and Citi Research

Figure 223. BCRA's inability to purchase foreign currency is increasing



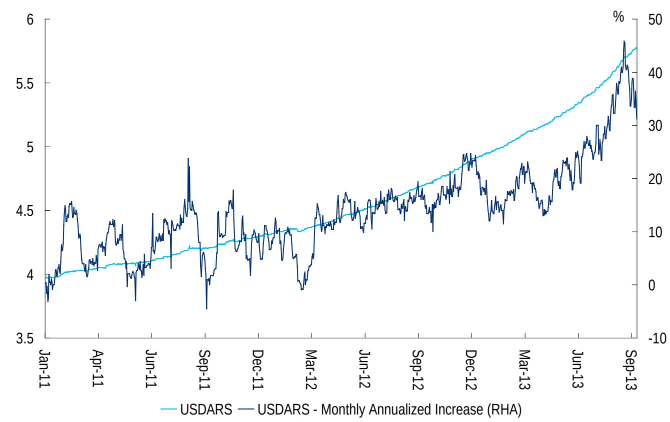
Source: BCRA and Citi Research

Figure 224. Citi sees sluggish activity growth ahead



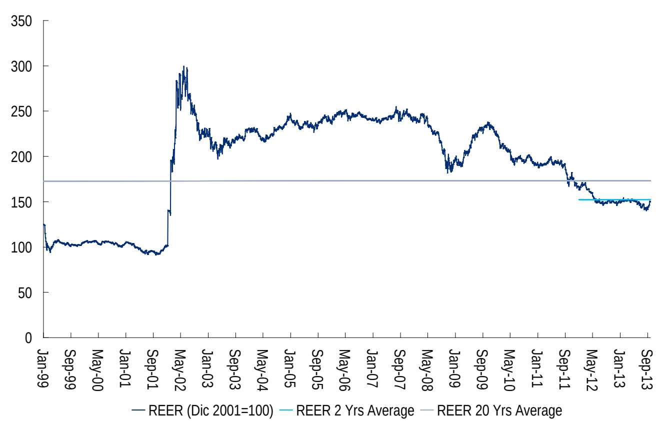
Source: Citi Research

Figure 225. The BCRA has increased ARS depreciation



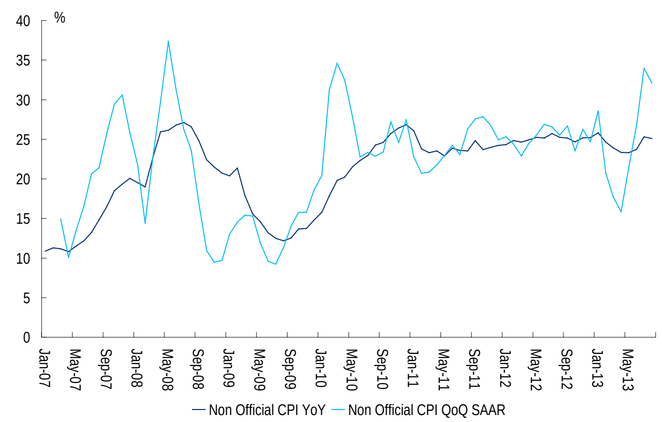
Source: Bloomberg and Citi Research

Figure 226. The REER has depreciated in the past few weeks



Source: Bloomberg and Citi Research

Figure 227. Seasonally-adjusted inflation has been increasing



Source: MyS Consultores and Citi Research

Figure 228. Argentina Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	214	262	329	308	370	448	477	492	464
Nominal GDP, local currency bn	654	812	1,033	1,145	1,443	1,842	2,164	2,690	3,355
GDP per capita, USD	5,498	6,666	8,271	7,683	9,131	10,948	11,541	11,789	11,021
Population, mn	39.0	39.4	39.7	40.1	40.5	40.9	41.3	41.7	42.1
Unemployment, % of labour force	10.2	8.5	7.9	8.7	7.8	7.2	7.2	7.6	7.8
Economic Activity									
Real GDP, yoy avg	8.3	8.5	3.0	-3.8	7.0	5.1	-0.3	2.7	0.5
Real investment growth % yoy	17.8	14.8	15.4	-9.1	19.6	10.7	-7.7	5.2	2.0
Real consumption growth % yoy	7.4	8.8	6.6	1.5	9.1	10.7	4.8	6.6	3.0
private consumption growth % yoy	7.8	9.0	6.5	0.5	9.0	10.7	4.4	6.5	3.0
Real export growth, % yoy	7.3	9.1	1.2	-6.4	14.6	4.3	-6.6	0.0	-2.0
Real import growth, % yoy	15.4	20.5	14.1	-19.0	34.0	17.8	-5.2	8.3	-2.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	-	20.1	20.7	14.8	26.8	24.2	25.2	26.0	30.0
CPI, % avg	-	-	-	-	-	-	-	-	-
Nominal wages, % yoy	18.0	20.3	22.4	20.0	21.7	27.5	27.1	24.7	26.5
Credit extension to private sector, % yoy	37.6	25.4	10.5	11.5	31.6	34.6	39.0	31.0	37.0
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	9.88	13.63	19.75	10.00	11.25	17.19	15.44	19.00	24.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	3.06	3.15	3.45	3.80	3.97	4.30	4.92	6.15	8.15
ARS/USD, avg	3.07	3.12	3.16	3.73	3.91	4.13	4.54	5.51	7.23
Balance of Payments, USD bn									
Current account	7.8	7.4	6.8	11.0	1.4	-2.4	-0.1	-2.5	-3.0
% of GDP	3.6	2.8	2.1	3.6	0.4	-0.5	0.0	-0.5	-0.6
Trade balance	14.0	13.5	15.4	18.5	14.3	12.9	15.4	12.0	10.8
Exports	46.5	56.0	70.0	55.7	68.1	84.1	80.9	84.4	82.7
Imports	32.6	42.5	54.6	37.1	53.9	71.1	65.6	72.4	71.9
Service balance	-0.5	-0.5	-1.3	-1.3	-1.2	-2.2	-3.6	-2.2	-0.7
Income balance	-6.2	-5.9	-7.6	-9.0	-11.3	-12.6	-11.5	-11.8	-12.3
FDI, net	5.5	6.5	9.7	4.0	7.8	9.9	12.1	10.2	10.0
International reserves	32.0	46.2	46.4	48.0	52.2	46.4	43.3	36.5	33.0
Total amortisations	14.8	5.2	4.7	11.2	10.7	12.0	11.9	12.2	12.2
Public Finances, % of GDP									
Consolidated government balance	1.7	1.1	1.4	-0.6	0.2	-1.7	-2.6	-2.1	-2.8
Consolidated gov primary balance	3.5	3.1	3.1	1.5	1.7	0.3	-0.2	-0.8	-0.8
Public debt	63.8	55.2	44.4	47.7	44.4	40.0	38.5	38.7	41.9
of which Domestic	35.3	28.2	24.8	27.7	25.6	23.6	23.5	23.6	25.9
Foreign Assets & Liabilities, USD bn									
External debt	108.8	124.5	124.9	115.6	129.3	141.1	140.9	144.1	140.5
Public	61.1	70.8	64.4	61.8	69.5	73.2	71.6	74.0	74.5
External debt / GDP	50.8	47.5	38.0	37.5	35.0	31.5	29.6	29.3	30.3
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.3	5.0	3.0	2.4	1.2	0.0	0.6	0.3	0.8
CPI, % yoy	23.9	25.0	25.1	26.0	28.0	28.8	29.6	30.0	30.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	14.88	17.13	18.00	19.00	20.00	21.00	22.40	24.00	24.00
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ARS/USD, eop	5.12	5.39	5.80	6.15	6.65	7.15	7.65	8.15	8.75

Source: National Sources, Citi Research

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Summary view — We now expect 2013 GDP growth to reach 2.6%, decelerating to 2.0% in 2014. CPI inflation should be 5.9% in 2013 and 6.2% next year. Under this scenario, the Copom will likely hike the Selic rate until 9.75%. We keep our skeptical view about fiscal policy, expecting a primary surplus of 1.5% of GDP. We see the external accounts improving during next year.

Things to watch — Changes in CB's FX interventions are possible if BRL appreciation continues. The possible announcement of a gasoline price increase is crucial for the inflation outlook and to show less policy intervention in the economy. In addition, activity data deserves attention in order to evaluate the effect of the drop in confidence on 3Q13 GDP growth.

Strategy — On the FX front, the FOMC's decision of postponing the tapering favors the BRL in the near term. However, gradual deterioration of domestic fiscal fundamentals points to a higher USDBRL in the medium/long term. Our call for hikes in the Selic rate to 9.75% suggests premium in receiving Jan15PreDI. Futures trading involves substantial risk of loss.

Economic Slowdown Ahead

Dilma's popularity recovered partially after the sharp decline seen in July. After the several demonstrations seen in June-July period, the government's approval index (excellent/good less bad/horrible) plummeted significantly in July to levels around 0% (from 48% in early June). However, some of these indicators recovered somewhat in August, with the government's approval index increasing to 14%. Overall, despite being still below its pre-demonstrations level, Dilma's popularity is currently between the levels reached by FHC in June 1997 (23%) and Lula in August 2005 (5%). In both cases, their levels of approval were enough to ensure a second term in the following year's presidential election. Therefore, we keep our view that a second term for Dilma is still the most likely scenario.

We expect fiscal policy to remain loose in the near term. The primary surplus continues declining, having reached 1.9% of GDP in July. After increasing evidence that the budget freeze announced in July will not be enough to offset the regional governments' underperformance, authorities are counting on extraordinary revenues to reach the 2.3% of GDP target, or else they may deliver a lower primary surplus. Moreover, the 2014 budget law proposal sent to Congress does not represent a change in the fiscal stance, reducing the primary surplus to 2.1% of GDP (from 2.3% in 2013). As, in our view, the proposal overestimates both revenues and the regional government's surplus, we do not expect this target to be fulfilled. Thus, we continue to forecast the primary surplus at 1.5% of GDP in 2013 and 2014. As a result, we expect net public debt-to-GDP ratio to increase slightly.

We expect 2013 GDP growth to reach 2.6%, decelerating to 2.0% in 2014. The strong 2Q13 GDP growth of 1.5% QoQ SA has not modified our view that economic growth will likely decelerate moving forward. Our prognosis is based on the view that agriculture/livestock and industrial sectors will likely show contractions in 3Q13, while the increase in real interest rates should constrain services sector expansions in coming quarters. Overall, considering our potential growth estimate of 2.5%-3% annually, our quarterly GDP growth forecasts are consistently below this range in 2H13 and thereafter, ensuring a steady widening of the output gap. Therefore, the unemployment rate should show a slight upward trend moving forward, although remaining below its natural level. Regarding the credit market, the steady increase of loans outstanding at around 16% YoY hides the decoupling between earmarked credit growth (26.6% y/y) and non-earmarked credit expansion (9.2% y/y).

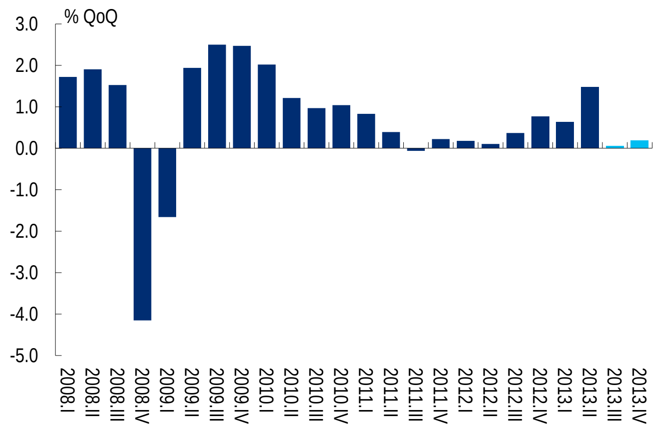
We reduced our 2013 yearend CPI inflation forecast to 5.9% (from 6.2%) while increasing our 2014 forecast to 6.2% (from 6.1%). The updated forecasts reflect the new path expected for the BRL, after the Fed decision to postpone the tapering. The recent BRL appreciation points to lower exchange rate pass-through in the near term. Despite that, the current level of exchange rate still indicates upward pressure on inflation in the next few months. So far, while the pass-through is still limited at the consumer level, stronger wholesale price increases, which also reflect new supply shocks on food prices, reinforce the expectation of upward pressures ahead. The recent improvement in the scenario opens more room for a hike in gasoline prices in order to reduce the gap with international prices without compromising the inflation target. Therefore, we continue to believe that a hike in gasoline prices is highly likely before yearend, although we no longer expect another one in 2014. Looking ahead, given the expectation of stronger currency depreciation next year, we raised our 2014 CPI inflation forecast to 6.2% (from 6.1%).

We expect the Selic rate at 9.75% at the end of this and next year. The minutes from the last Copom meeting reinforced the expectation of another 50bp hike at the next meeting in October. However, given that the central bank has become more optimistic regarding the fiscal scenario, seeing conditions for the fiscal policy to move to a neutral zone, we considered the minutes slightly dovish for the total cycle. We still believe that the exchange rate path will be crucial for the inflation scenario and, consequently, for the next steps of the monetary policy. In this case, the recent appreciation indicates risks to the dovish side, depending on the effects on inflation expectations. So far, we are comfortable with our call that the Copom will raise the Selic rate up to 9.75%, with another 50bp hike on October 9 and an additional 25bp on November 27, with BRL and inflation expectations being the main variables to be monitored. We believe that the likelihood that the Selic rate reaches double-digits has fallen.

Tapering postponement should guarantee a stronger BRL in the near term, but does not alter our view of a depreciating trend ahead. The surprising FOMC decision of not initiating tapering in September meant further pressure for BRL appreciation in the near term. However, the steady deterioration of domestic fiscal fundamentals and the unavoidable scenario of reducing global liquidity at some point suggest a weaker BRL in the medium/long term. The threat of S&P downgrading Brazil's sovereign credit rating is another factor reinforcing the scenario of higher USD/BRL ahead compared to current levels. In the near term, market analysts will also be sensitive to the possibility of the central bank reducing FX interventions, which have already surpassed USD50 billion. All in all, we expect the USD/BRL to be 2.26 and 2.42 at 2013 and 2014 year ends, respectively. In terms of external accounts, the real exchange rate is expected to be, on average, at a more depreciated level next year, ensuring some improvement in trade balance/current accounts figures ahead.

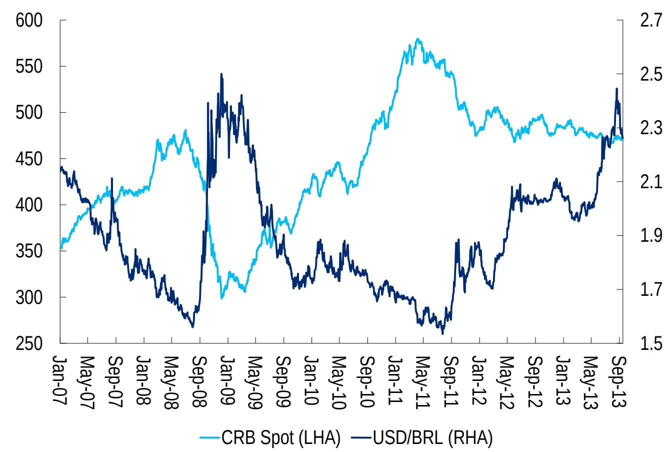
Despite the better near-term outlook for the BRL, we continue to see the USD/BRL higher in the medium/long term. The FOMC's decision to postpone the tapering contributed to a boost in capital inflows to emerging countries, and an appreciating BRL. In spite of that, we do not see any reversal in the deteriorating trend of fiscal accounts ahead, reinforcing our view that the USD/BRL should increase in the medium/long term. Regarding interest rates, the market is currently pricing in more Selic rate hikes than our call of stabilization at 9.75%. Therefore, our base case scenario for monetary policy embeds a premium of around 35bp in receiving Jan15PreDI. Futures trading involves substantial risk of loss.

Figure 229. We expect GDP growth to decelerate



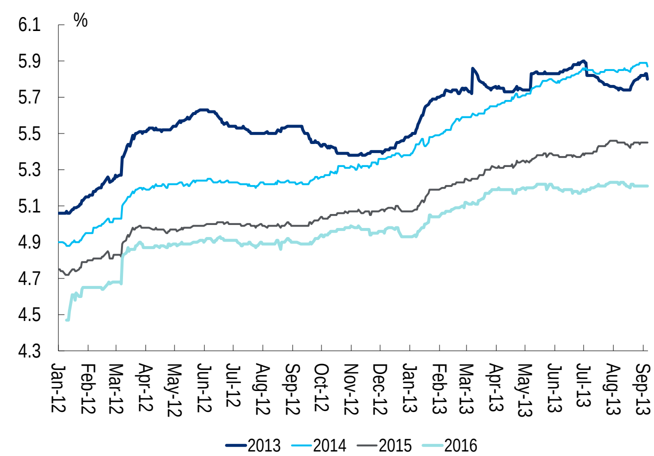
Sources: Citi Research and IBGE

Figure 230. Recent BRL movements were not led by commodity prices



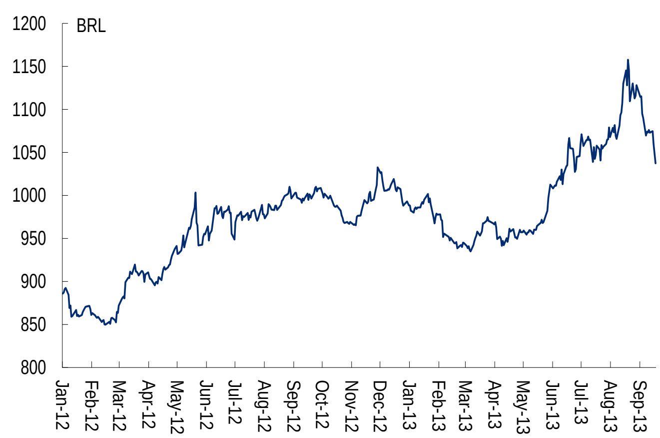
Sources: Citi Research and BCB

Figure 231. Inflation expectations remain high



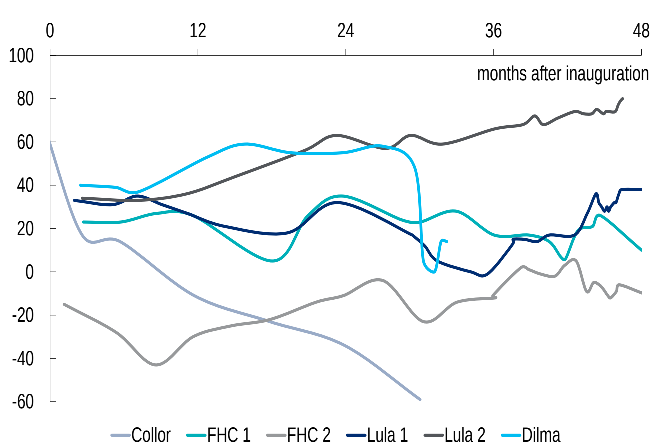
Sources: Citi Research and BCB

Figure 232. Pressures from international prices (CRB) have receded



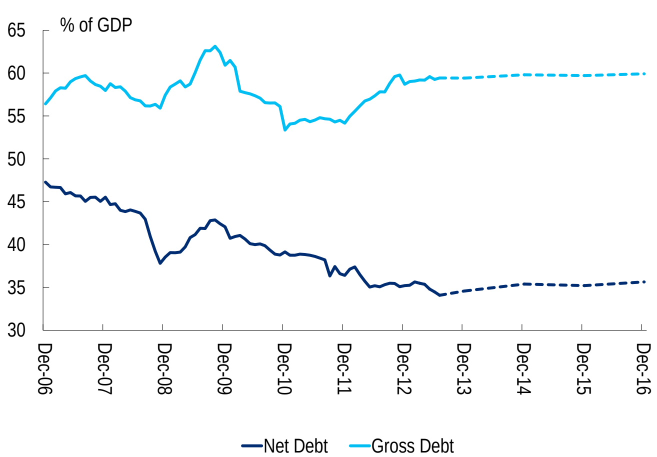
Sources: Citi Research and BCB

Figure 233. President Dilma's approval recovered partly in August



Sources: Citi Research and Datafolha

Figure 234. We expect public debt/GDP ratio to increase slightly



Sources: Citi Research and BCB

Figure 235. Brazil Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	1,089	1,375	1,678	1,622	2,142	2,475	2,252	2,224	2,185
Nominal GDP, local currency bn	2,369	2,661	3,032	3,239	3,770	4,143	4,403	4,801	5,193
GDP per capita, USD	5,815	7,258	8,760	8,379	10,955	12,536	11,305	11,063	10,776
Population, mn	187.3	189.5	191.5	193.5	195.5	197.4	199.2	201.0	202.8
Unemployment, % of labour force	10.0	9.3	7.9	8.1	6.7	6.0	5.5	5.6	5.8
Economic Activity									
Real GDP, yoy avg	4.0	6.1	5.2	-0.3	7.5	2.7	0.9	2.6	2.0
Real investment growth % yoy	9.9	16.9	16.4	-16.0	33.4	4.0	-8.1	9.9	0.4
Real consumption growth % yoy	4.5	5.8	5.1	4.1	6.3	3.6	3.1	2.1	2.2
private consumption growth % yoy	5.2	6.1	5.7	4.4	6.9	4.1	3.1	1.9	1.9
Real export growth, % yoy	5.0	6.2	0.5	-9.1	11.5	4.5	0.5	1.9	6.3
Real import growth, % yoy	18.4	19.9	15.4	-7.6	35.8	9.7	0.2	8.0	3.9
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	3.1	4.5	5.9	4.3	5.9	6.5	5.8	5.9	6.2
CPI, % avg	4.2	3.6	5.7	4.9	5.0	6.6	5.4	6.2	6.1
Nominal wages, % yoy	7.4	7.0	10.4	4.8	12.7	8.9	10.7	10.8	10.7
Credit extension to private sector, % yoy	-	-	30.9	15.1	20.6	19.0	16.4	15.4	14.7
Policy Rate (eop)	13.25	11.25	13.75	8.75	10.75	11.00	7.25	9.75	9.75
1 month inter-bank rate, %, eop	13.07	11.11	13.49	8.61	10.64	10.87	6.59	9.75	9.75
Long-term yield, %, eop	12.33	12.95	12.27	12.25	12.24	10.66	7.96	10.50	13.00
BRL/USD, eop	2.14	1.78	2.31	1.74	1.66	1.86	2.05	2.26	2.42
BRL/USD, avg	2.18	1.95	1.84	2.00	1.76	1.67	1.95	2.18	2.39
Balance of Payments, USD bn									
Current account	13.6	1.6	-28.2	-24.3	-47.3	-52.5	-54.2	-79.1	-72.0
% of GDP	1.3	0.1	-1.7	-1.5	-2.2	-2.1	-2.4	-3.6	-3.3
Trade balance	46.5	40.0	24.8	25.3	20.1	29.8	19.4	0.8	9.2
Exports	137.8	160.6	197.9	153.0	201.9	256.0	242.6	242.3	257.0
Imports	91.4	120.6	173.1	127.7	181.8	226.2	223.2	241.5	247.8
Service balance	-9.6	-13.2	-16.7	-19.2	-30.8	-37.9	-41.0	-44.4	-44.8
Income balance	-27.5	-29.3	-40.6	-33.7	-39.5	-47.3	-35.4	-38.9	-40.0
FDI, net	18.8	34.6	45.1	25.9	48.5	66.7	64.7	62.0	60.0
International reserves	85.8	180.3	206.8	239.1	288.6	352.0	378.6	371.1	371.1
Total amortisations	44.1	38.2	22.4	30.1	33.8	29.8	35.8	41.8	47.8
Public Finances, % of GDP									
Consolidated government balance	-3.6	-2.8	-2.0	-3.3	-2.6	-2.6	-2.5	-3.8	-3.7
Consolidated gov primary balance	3.8	3.8	3.9	2.0	2.7	3.1	2.4	1.5	1.5
Public debt	55.1	55.0	55.9	60.9	53.4	54.2	58.7	59.4	59.8
of which Domestic	48.9	50.9	51.2	57.5	50.5	51.5	55.8	56.4	-
Foreign Assets & Liabilities, USD bn									
External debt	172.5	193.6	198.3	198.2	256.8	298.2	312.9	318.9	324.9
Public	89.2	86.0	84.2	93.7	103.7	102.3	112.9	107.6	107.4
External debt / GDP	15.8	14.1	11.8	12.2	12.0	12.1	13.9	14.3	14.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	20.3	38.9	36.4	31.0	57.3	40.1	37.2	40.0	42.0
Short-term debt/International reserves (%)	23.7	21.6	17.6	13.0	19.9	11.4	9.8	10.8	11.3

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	1.9	3.3	3.0	2.4	2.2	1.3	2.0	2.4	2.2
CPI, % yoy	6.6	6.7	5.8	5.9	5.8	6.0	6.2	6.2	6.0
Policy interest rate, %, eop	7.25	8.00	9.00	9.75	9.75	9.75	9.75	9.75	10.75
Short-term market rate, % eop	6.99	7.72	9.00	9.75	9.75	9.75	9.75	9.75	10.75
Long-term yield, %, eop	8.28	8.68	8.91	8.57	11.00	12.50	13.00	13.00	13.00
BRL/USD, eop	2.02	2.23	2.20	2.26	2.33	2.40	2.41	2.42	2.43

Source: National Sources, Citi Research

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- **Summary view** — Michelle Bachelet will likely become the next president, but it is uncertain if she can secure a victory in the first round. A longer electoral period could reduce not only her political power to push for a controversial fiscal reform, but also could become an unusual input in monetary policy.

- **Things to watch** — Activity (IMACEC) and consumption (retail sales) indicators could lead the BCCh to cut rates. We also think that the potential approval of the Ley Unica de Fondos will put back Chile in the spotlight.

- **Strategy** — With the Ley Unica de Fondos it will be easier for offshore investors to access the local bond market. We would expect this to expand the local issuers' investor base.

Everyone involved in Chile seems to be in a wait-and-see mode. For example, we are waiting for the election to see whether former President Michelle Bachelet will need a second round to move back into La Moneda. We are also waiting for the alleged slowdown in consumption to arrive. This slowdown would eventually deliver the long-awaited rate cuts. We are also waiting for the approval of the Ley Unica de Fondos, which is expected to promote the country as an exporter of financial services. It is just a matter of time before some of these things to materialize, so the relevant question in Chile is not how, or by how much, but when.

Michelle Bachelet (Nueva Mayoria) will most likely become the next President. The most recent poll (July-August) by CEP (Centro de Estudios Publicos) shows that 75% percent of citizens expect Mrs. Bachelet to become the next president and about 44% would like her to be next President. However, it is not clear if Evelyn Matthei (Alianza) and several other candidates will be able to get enough votes to force a second round. Mrs. Bachelet has a very positive image among citizens, while Mrs. Matthei seems to lack the same appeal (graphs below). The first round is scheduled for November 17 and a second round (if needed) for December 15.

The speed of Mrs. Bachelet likely victory and the congressional election could set up the tone of the first days of her new term. On November 17, Chileans will also elect the totality of the Lower House seats (120) and 20 out of 38 Senate seats. The potential composition of Congress is not trivial when we begin to think about Mrs. Bachelet's fiscal reform. Although we expect her to become the next president, we do not know how much political clout she will have to push for the controversial fiscal reform. We will have to wait and see what the likely composition of the Lower House will be. For the moment, we think there is not enough information to have a strong view on that.

We expect Mrs. Bachelet's likely second term to be a little more to the left than the first one. Both the tone of her campaign and her fiscal reform proposal lead us to think that way. Mrs. Bachelet's fiscal proposal looks to increase tax collection by 2.5% of GDP and to reduce tax evasion by 0.5% of GDP. The cornerstone of the fiscal proposal seeks to raise the corporate tax rate to 25% from 20% over a period of four years. At the same time, it looks to reduce the ceiling on the income tax rate to 35% from 40%. The combination of these two modifications (1.92% of GDP) accounts for roughly ¾ of the aforementioned increase in tax collection. Although some of the new tax collection could be used to reduce the fiscal deficit and push the structural deficit down, we think that most of the resulting revenue will be used for Mrs. Bachelet's heavy social agenda. Probably, all that money is not even enough for her dense social agenda.

The elections arrive at a time in which the BCCh has opened the door for cutting the overnight rate. The Central Bank of Chile (BCCh) has been talking about the possibility of "adjusting" the policy rate for a few months. The central bank adopted this language after growth began to decelerate. Most of this slowdown has been led by lower metal prices — particularly copper — that have hit exports. However, the central bank has refrained from undertaking an easing cycle to lend a hand to growth as consumption has not yet slowed down significantly. On previous occasions, some consumer confidence indicators have predicted a slowdown in consumption and that is the basis to expect that this time around it will be no different. Growth in loans has been decelerating steadily and it is now at single digit levels again.

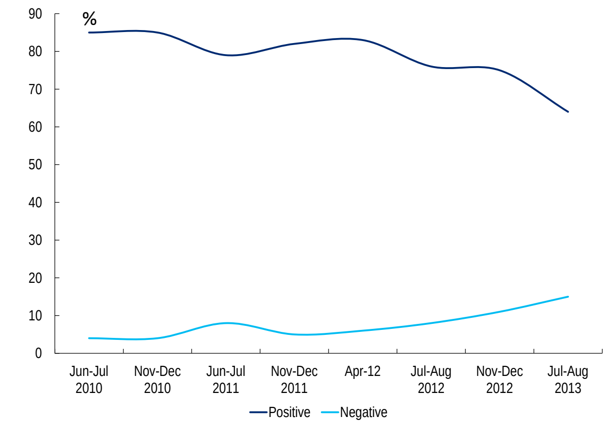
This time around the electoral calendar adds an additional input for timing the likely rate cuts. In our view, the BCCh is a totally independent central bank. We think that the investor community also shares this view. Unfortunately, acting (meaning cutting the rate) too close to an election might bring unnecessary interpretations of that policy action. In our view there is no need to bring that kind of attention. In turn, we would expect the BCCh to cut only after the election is behind us. But of course, for a rate cut to materialize we would need a disappointing IMACEC or retail sales print. Without this the BCCh is likely not to cut regardless on the status of the election.

Of course, we would not be talking about cuts if inflation expectations were not well anchored. Breakeven inflation stands below 3% in the 1- and 2-year tenors. In addition, 1- and 2-year ahead inflation expectations are at roughly 3%. Core inflation is slightly above 2%, after being for a while below that level. In our view, actual and expected inflation should not be a problem for the central bank to cut. We expect inflation to rise as a result of a limited (and not worrisome) pass-through from FX to inflation. As of August, tradable inflation was running at 1.2%. Even if the pass-through effect were to be higher than what we are expecting, there is room for tradable inflation to increase without jeopardizing the inflation target and, consequently, without eroding the dovish bias that the BCCh currently has. The main risks we see to headline inflation at this time are electricity prices.

In an outlook of moderate cuts in interest rates, a natural question that usually follows in Chile is associated with the current account. That question has usually reflected the concern that cuts may push up import growth The current account deficit is running at manageable levels and we would expect it to remain in that comfort zone. At one point, lower actual and expected copper prices raised some concerns about a widening in the current account deficit. However, during the past few months, import growth has fallen below that of exports. Intermediate goods import growth has played an important role in that trend. We do not expect the current account to become a concern under a rate cut scenario.

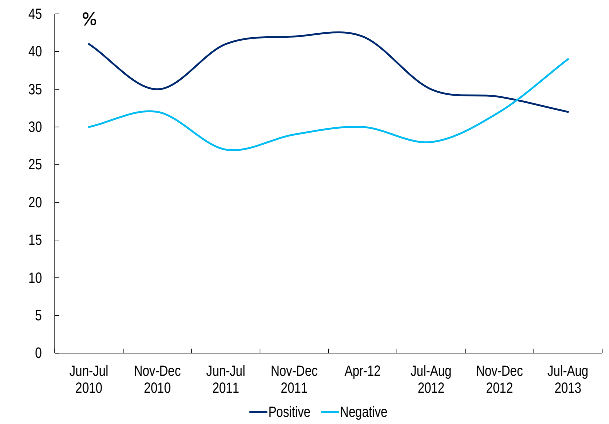
We think that high interest rates and the Ley Unica de Fondos would put Chile back into the spotlight. The Lower House has already approved the Ley Unica de Fondos, and the Senate is expected to pass it shortly. The purpose of this new Law is to make Chile an "exporter" of financial services. As a result it will be easier for offshore investors to access the local bond market. We would expect this to expand the local issuers' investor base and to put the country back into the spotlight.

Figure 236. Citizens still have a high positive opinion of Bachelet



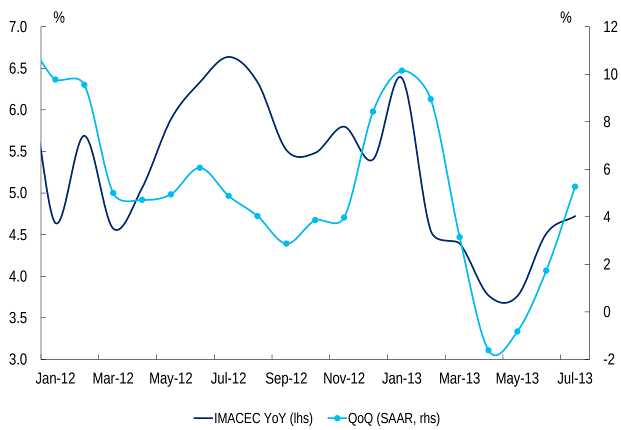
Source: CEP and Citi Research

Figure 237. In the case of Matthei, the negative opinion is higher



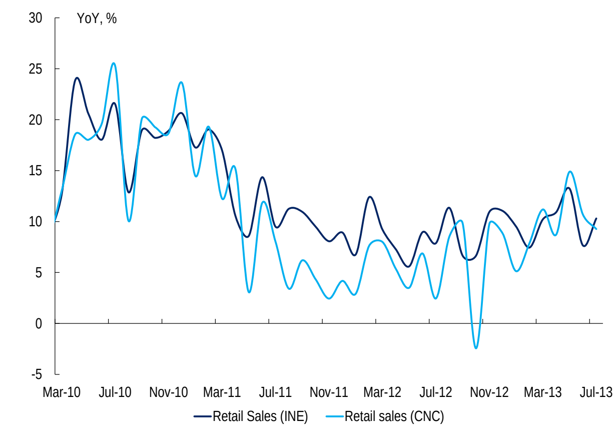
Source: CEP and Citi Research

Figure 238. Activity growth has converged to potential



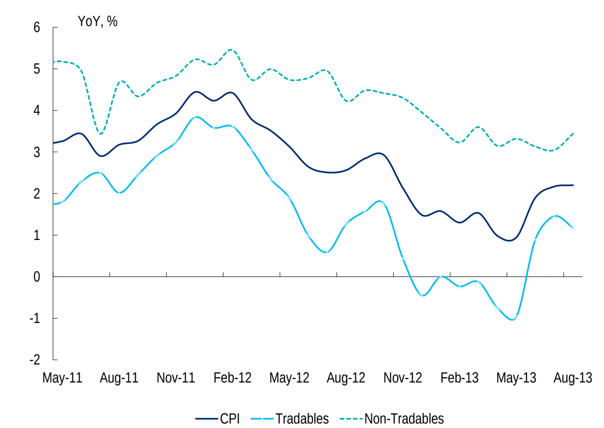
Source: BCCh, Haver and Citi Research

Figure 239. Consumption has remained "dynamic"



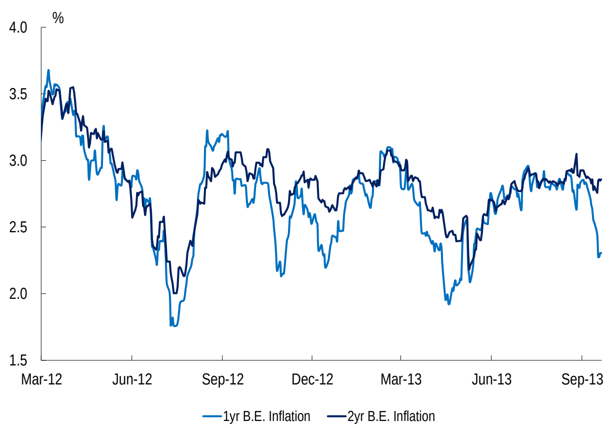
Source: INE, CNC, Haver and Citi Research

Figure 240. Inflation in tradables is picking up from low levels



Source: INE, Haver and Citi Research

Figure 241. Inflation expectations remain well contained



Source: Bloomberg and Citi Research

Figure 242. Chile Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	155	173	183	173	218	251	268	289	306
Nominal GDP, local currency bn	82	90	94	96	111	121	131	139	150
GDP per capita, USD	9,384	10,414	10,876	10,199	12,861	14,649	15,509	16,516	17,355
Population, mn	16.5	16.6	16.8	17.0	17.0	17.1	17.3	17.5	17.7
Unemployment, % of labour force	7.9	7.1	7.8	10.8	8.2	7.1	6.4	6.2	6.5
Economic Activity									
Real GDP, yoy avg	5.7	5.2	3.3	-1.0	5.8	5.9	5.6	4.0	4.5
Real investment growth % yoy	9.1	6.4	20.8	-23.5	33.4	10.9	12.9	6.6	5.6
Real consumption growth % yoy	7.5	7.5	4.4	0.8	9.8	7.9	5.8	5.4	5.2
private consumption growth % yoy	7.8	7.6	5.2	-0.8	10.8	8.9	6.1	5.9	5.4
Real export growth, % yoy	5.1	7.2	-0.7	-4.5	2.3	5.2	1.0	2.2	3.5
Real import growth, % yoy	11.4	14.3	11.2	-16.2	25.9	14.5	4.9	5.5	4.4
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	2.6	7.8	7.1	-1.5	3.0	4.4	1.5	2.6	3.0
CPI, % avg	3.4	4.4	8.7	1.5	1.4	3.3	3.0	1.7	3.1
Nominal wages, % yoy	5.5	7.1	8.5	5.8	3.5	5.8	6.3	5.0	4.5
Credit extension to private sector, % yoy	16.8	21.0	18.7	-1.4	7.1	16.9	12.1	6.4	7.3
Policy Rate (eop)	5.25	6.00	8.25	0.50	3.25	5.25	5.00	5.00	4.50
1 month inter-bank rate, %, eop	5.36	5.93	8.24	0.45	3.13	5.23	4.99	5.00	4.50
Long-term yield, %, eop	-	6.30	5.93	5.38	5.81	4.92	5.45	5.10	5.25
CLP/USD, eop	532	498	638	507	468	520	479	500	511
CLP/USD, avg	530	522	524	559	510	484	486	494	514
Balance of Payments, USD bn									
Current account	7.1	7.1	-5.8	3.5	3.2	-3.3	-9.5	-11.5	-13.0
% of GDP	4.6	4.1	-3.2	2.0	1.5	-1.3	-3.5	-4.0	-4.2
Trade balance	22.9	24.1	6.1	15.4	15.6	10.5	3.4	-0.1	0.2
Exports	59.4	68.6	64.5	55.5	71.1	81.5	78.3	79.0	86.0
Imports	36.4	44.4	58.4	40.1	55.5	70.9	74.9	79.1	85.8
Service balance	-0.9	-1.3	-1.2	-2.0	-2.1	-2.6	-2.4	-2.4	-0.6
Income balance	-18.4	-18.9	-13.6	-11.4	-14.7	-14.1	-12.7	-11.1	-15.1
FDI, net	7.4	12.6	15.5	12.9	15.4	22.9	30.3	16.9	18.7
International reserves	19.4	16.9	23.2	25.4	27.9	42.0	41.6	42.9	45.5
Total amortisations	12.5	9.7	14.3	16.4	12.3	12.8	22.4	22.7	22.8
Public Finances, % of GDP									
Consolidated government balance	7.9	8.4	4.3	-4.3	-0.3	1.4	0.6	-0.3	-0.4
Consolidated gov primary balance	8.5	9.0	4.8	-3.8	0.2	2.0	1.1	0.2	0.0
Public debt	-	-	-	-	-	-	-	-	-
of which Domestic	2.3	2.0	2.4	4.9	7.4	7.7	6.3	5.5	5.4
Foreign Assets & Liabilities, USD bn									
External debt	48.3	53.4	63.7	71.9	84.5	98.7	117.8	125.6	133.2
Public	4.5	4.0	3.3	4.0	5.6	7.1	7.9	4.4	4.5
External debt / GDP	31.2	30.8	34.9	41.5	38.7	39.3	43.9	43.5	43.5
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	8.1	9.0	14.0	15.8	16.2	19.6	22.8	22.4	23.4
Short-term debt/International reserves (%)	41.7	53.4	60.6	62.4	58.3	46.6	54.9	52.3	51.4

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.5	4.1	4.0	3.3	3.4	4.1	5.2	5.4	5.1
CPI, % yoy	1.5	1.9	1.8	2.6	2.6	3.2	3.2	3.0	3.0
Policy interest rate, %, eop	5.00	5.00	5.00	5.00	4.50	4.50	4.50	4.50	4.50
Short-term market rate, % eop	5.00	5.00	5.00	5.00	4.50	4.50	4.50	4.50	4.50
Long-term yield, %, eop	5.43	5.24	5.13	5.10	5.00	5.00	5.15	5.25	5.25
CLP/USD, eop	472	508	494	500	511	520	515	511	508

Source: National Sources, Citi Research

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- **Summary view** — As the region loses some if its shine, we would expect the fiscal story to return to the spotlight in some countries. Some of those fiscal concerns will be the main inheritance for the next administrations. It is worth remembering that three countries will hold elections next year.
- **Things to watch** — The region enters into the annual cycle of presenting and negotiating next year's budgets. As we get closer to next year, we would expect politics to heat up.
- **Strategy** — The Dominican Republic is looking for external financing[2]. The BCRD will likely use the accumulation of reserves associated with issuance to further calm the FX market.

Some countries in the Caribbean and Central America are losing some of their shine. Growth in Panama is decelerating rapidly as a result of lower traffic and, consequently, lower revenue in the Panama Canal. In addition, private consumption seems to have lost some if its inertia in Panama. Construction remains as a major underpinning to growth, but as we get closer to the end of the Panama Canal expansion, we would expect this sector to begin losing steam. In the case of the Dominican Republic, the government not only tightened its belt to reduce the fiscal deficit, but also hiked its policy rate to prevent the local currency from depreciating further. As surprising as it may seem, we think that the monetary transmission mechanism associated with the credit channel actually works in the Dominican Republic and therefore the recent hike in rates should slow down growth in domestic demand.

As growth slows down in Panama and the Dominican Republic, questions associated with the fiscal stance naturally pop up. In the case of Panama, the country did not take full advantage of its growth to put fiscal accounts on balance. We think that the current administration lost a unique opportunity and as we move into a lower growth scenario, we would expect fiscal accounts to come back into the spotlight. In the case of the Dominican Republic, the commitment to turn around last year's fiscal disorder has pulled down growth. We think that fiscal concerns would be on hold for a while — probably until we get closer to the 2016 election. In the Dominican Republic the fiscal cycle is closely related to the electoral cycle.

Costa Rica and El Salvador are not losing too much shine because there is not much of it to begin with. The main driver of ups and downs in Costa Rica is the manufacturing sector — particularly the high-tech sector. It seems that manufacturing is growing again, but we will have to wait for quite some time before it begins to push up growth significantly — probably until next year. Growth in El Salvador seems to remain trapped below 2%, and probably will remain there until we witness a meaningful change in confidence and in political risk.

In Costa Rica and El Salvador, there are also fiscal concerns, but with a different flavor. Costa Rica has delayed for years a fiscal adjustment and a fiscal reform. In our view, the political outlook suggests that this administration has no political capital to push for a turnaround in fiscal accounts and to pass a comprehensive fiscal reform. El Salvador has been trying to improve the fiscal stance, but it has simply not been enough. After two fiscal reforms, the government has been unable to put fiscal accounts to a point at which debt remains stable.

[2] As mentioned in local newspaper Listin Diario (September 11, 2013).

Fiscal accounts will be a key topic to watch in the three countries that will hold elections next year. Costa Rica, El Salvador and Panama will hold elections in 2014. In none of these countries are we expecting a spending feast *à la* the Dominican Republic and, therefore, our concerns are more for the medium term. In the case of Panama, we have yet to see if the next administration will try to recover the original spirit of the fiscal responsibility law. In Costa Rica, we believe this will likely be the second consecutive administration that chooses to kick forward the fiscal bomb, which can only be deactivated through a meaningful fiscal reform. In El Salvador, the next administration will have to decide how much fiscal effort is politically sustainable.

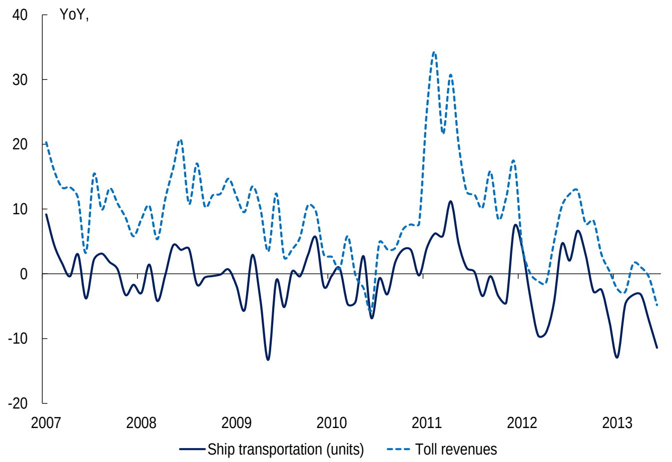
Of those three elections, El Salvador is the only one we think has some political risk attached to it. In Costa Rica, it seems that Johnny Araya (PLN) faces little opposition in the presidential race and will likely win the election. The opposition is fragmented and their experiments as a coalition were not a pleasant experience. In Panama, Jose Domingo Arias (CD) is ahead of both Juan Carlos Navarro (PRD) and Juan Carlos Varela (PPA) in the presidential race, but in terms of political risk it really does not matter who wins, in our view. That is not the case in El Salvador, as we consider Norman Quijano (ARENA) to be significantly more market-friendly that Salvador Sanchez Ceren (FMLN). Although Mr. Quijano is ahead of Mr. Sanchez Ceren in the polls, former President Antonio “Tony” Saca (UNIDAD) may take some votes away from ARENA. We would expect Mr. Saca’s followers to vote in favor of ARENA in a likely second round. However, with still some months ahead of us, we cannot take for granted a victory by Mr. Quijano.

In the case of the Dominican Republic, the political concerns are not domestic but external. As the Venezuelan economy deteriorates further, it is natural to be concerned about changes to Petrocaribe. Venezuela would be more prone to cut financing to the Dominican Republic than to those who play a much more important geopolitical role. We are not worried about Venezuela increasing interest rates for Petrocaribe financing, but rather on the amount of new financing available to the Dominican Republic. If the Dominican Republic were to lose all its Petrocaribe financing, the market would have to price in that the country would need to seek, at least, one additional benchmark issuance per year.

Regardless of Petrocaribe, the Dominican Republic is looking for external financing. The government is trying to change this year’s composition of its financing to bring more hard currency to the local market. This could lend a hand in bringing down the USDDOP, after it moved significantly away from the central bank’s comfort zone. It is worth remembering that the FX is a “neuralgic” variable in the Dominican Republic — probably much more than in most of Latin America. As such, the BCRD will likely use the accumulation of reserves associated with issuance to further calm the FX market.

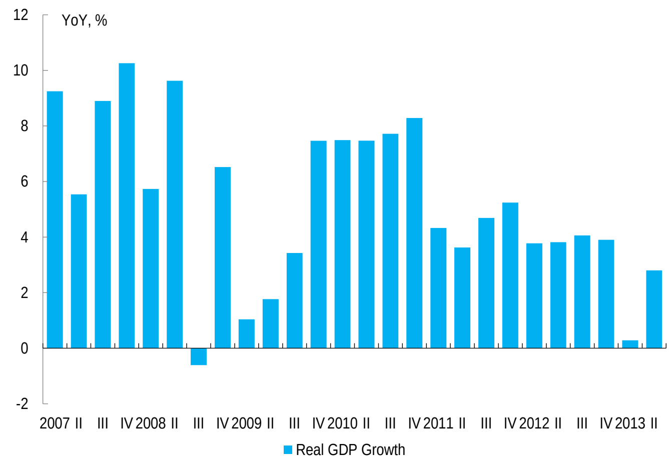
Other countries will likely tap markets over the next 12 months. In El Salvador, the amount outstanding of Letes (short-term local currency debt) remains high. That stock of debt has usually been the driver of external debt issuance. In addition, the government has to refinance debt associated with healthcare and education programs. In Costa Rica, the fiscal stance calls for tapping global markets again. For the remainder of the year Costa Rica cannot issue, as they maxed out this year’s limit on external financing. However, early next year they will likely come to the market again.

Figure 243. Panama: Traffic in and revenues from the Canal are falling



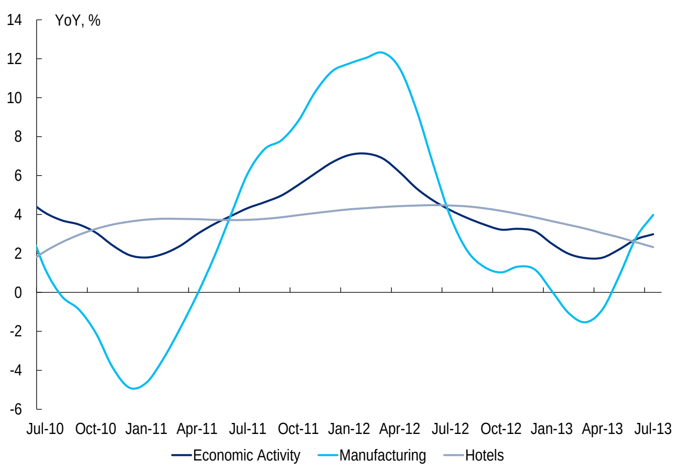
Source: ACP, Contraloria, Haver and Citi Research

Figure 244. DomRep: Growth slowed down significantly in 1H13



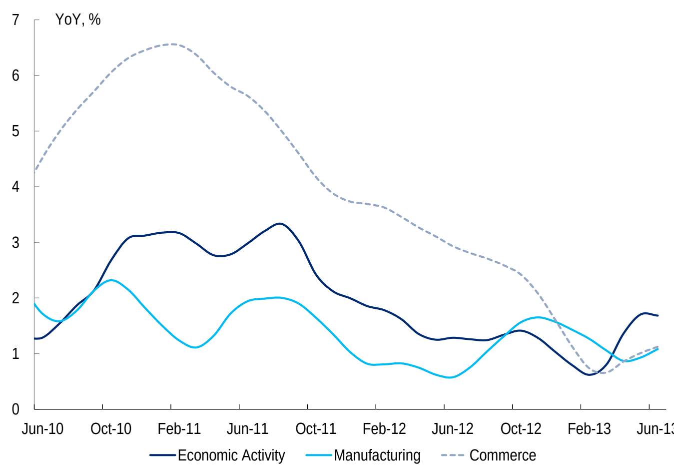
Source: BCRD, Haver and Citi Research

Figure 245. Costa Rica: Manufacturing drives growth swings



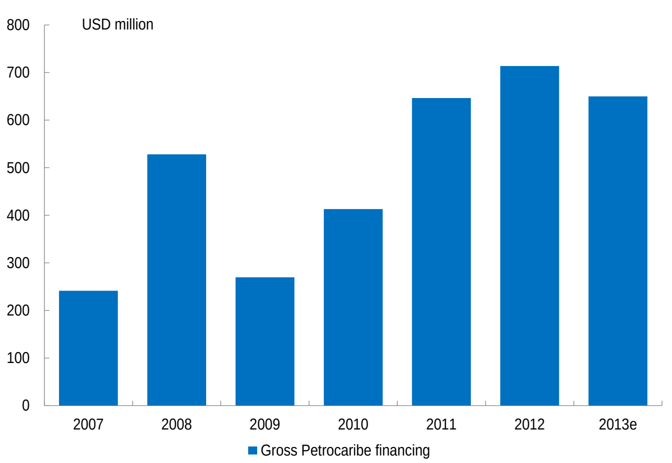
Source: BCCR, Haver and Citi Research

Figure 246. El Salvador: Growth remain at modest levels



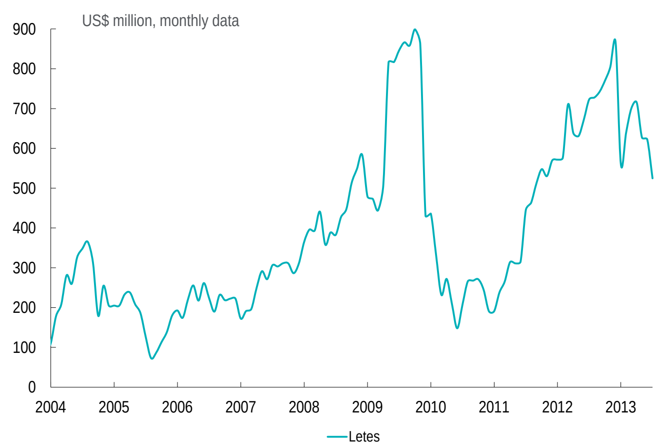
Source: BCRES, Haver Citi Research

Figure 247. DomRep: Petrocaribe financing has become more important



Source: Ministerio de Hacienda and Citi Research Citi Research

Figure 248. El Salvador: Letes usually drive issuance



Source: BCRES and Citi Research

Figure 249. CCA Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Costa Rica									
Nominal GDP, USD bn	22.5	26.4	29.8	29.4	36.4	40.9	45.1	48.9	52.3
GDP per capita, USD	5,174	5,941	6,582	6,366	7,988	8,892	9,602	10,399	10,890
Real GDP, yoy avg	8.8	7.9	2.7	-1.0	5.0	4.4	5.1	3.0	4.0
CPI, % avg	11.5	9.4	13.4	7.8	5.7	4.9	4.5	5.6	3.9
CRC/US$, avg	511	517	525	570	521	502	503	505	510
Current account	-1.0	-1.6	-2.8	-0.6	-1.3	-2.2	-2.3	-2.7	-2.7
% of GDP	-4.5	-6.2	-9.3	-2.0	-3.5	-5.4	-5.2	-5.6	-5.2
Consolidated government balance	-0.4	0.8	0.5	-3.9	-6.0	-5.6	-5.7	-6.0	-6.5

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Dominican Republic									
Nominal GDP, USD bn	36.0	41.3	45.8	46.8	51.8	55.8	59.0	60.2	63.5
GDP per capita, USD	3,910	4,414	4,807	4,822	5,241	5,544	5,770	5,844	6,167
Real GDP, yoy avg	10.7	8.5	5.3	3.5	7.8	4.5	3.9	2.0	4.0
CPI, % avg	7.6	6.1	10.6	1.4	6.3	8.5	3.7	5.3	4.9
Policy Interest Rate, % eop	-	7.00	9.50	4.00	5.00	6.75	5.00	4.25	4.25
DOP/US$, avg	32.8	32.8	34.4	35.9	36.8	38.0	39.2	41.3	42.8
Current account	-1.3	-2.2	-4.5	-2.3	-4.3	-4.4	-4.2	-3.7	-3.6
% of GDP	-3.6	-5.2	-9.9	-5.0	-8.4	-7.9	-7.2	-6.1	-5.7
Consolidated government balance	-3.8	-1.7	-4.3	-4.8	-3.7	-3.8	-7.9	-4.7	-4.0

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
El Salvador									
Nominal GDP, USD bn	18.6	20.1	21.4	20.7	21.4	23.1	23.8	24.4	25.4
GDP per capita, USD	3,252	3,500	3,705	3,548	3,653	3,912	4,001	4,063	4,228
Real GDP, yoy avg	3.9	3.8	1.3	-3.1	1.4	2.0	1.6	1.5	2.0
CPI, % avg	4.0	4.6	7.3	0.5	1.2	5.1	1.8	1.0	2.0
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
SVC/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-0.8	-1.2	-1.5	-0.3	-0.6	-1.1	-1.3	-1.3	-1.3
% of GDP	-4.1	-6.1	-7.1	-1.5	-2.7	-4.6	-5.3	-5.3	-5.1
Consolidated government balance	-2.3	-1.9	-2.8	-5.5	-4.4	-4.0	-3.5	-3.6	-3.4

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Panama									
Nominal GDP, USD bn	17.1	19.8	23.0	24.2	27.1	31.3	36.3	41.0	45.8
GDP per capita, USD	5,218	5,921	6,759	6,973	7,670	8,699	10,070	11,206	12,365
Real GDP, yoy avg	8.7	12.1	10.1	3.9	7.6	10.6	10.7	8.0	7.0
CPI, % avg	2.5	4.2	8.8	2.4	3.5	5.9	5.7	4.6	4.4
Policy Interest Rate, % eop	-	-	-	-	-	-	-	-	-
PAB/US$, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Current account	-0.4	-1.4	-2.7	-0.2	-2.8	-3.8	-3.3	-5.8	-6.0
% of GDP	-2.2	-7.2	-11.8	-0.7	-10.2	-12.2	-9.0	-14.2	-13.1
Consolidated government balance	0.5	3.5	0.4	-1.0	-1.9	-2.2	-2.1	-3.0	-3.0

Source: National Sources, Citi Research

Colombia

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- **Summary view** — On a surprising note, the first half of the year showed a slower-than-expected deceleration, with 2Q13's GDP growing above expectations. Nevertheless, uncertainty associated to civil works leads us to maintain our 3.8% annual GDP growth forecast for 2013. For next year the economy is expected to display a 4.5% growth. Regarding monetary policy, the Central Bank will continue in a data-dependent-mode, with the most likely scenario being a stable interest repo rate for the rest of the year and the first increases taking place at some point during March or April of 2014. Fiscal figures should continue without major surprises, although 2013 should be the last year of better-than-expected revenues.

- **Things to watch** — Watch for the evolution of the peace process in Cuba and the government efforts in 2H13 to boost infrastructure projects.

- **Strategy** — Local fundamentals continue to be somewhat supportive, but in our view, the evolution of the TES market and the dynamics of the USDCOP will depend heavily of the external outlook.

The economy displayed a sooner-than-expected recovery in 2Q13. The National Statistics Department announced that in the second quarter of this year GDP grew at a yearly 4.2% rate. The 2Q13 print stood above market expectations and our own forecast. On the supply side, the best performers for the 2Q13's result were the agricultural sector with a 7.6% YoY growth, the construction sector with a 6.4% YoY increase and social services which improved 4.7% YoY. The worst performers were manufacturing (1.2% YoY) and the transportation sector (2.8% YoY), although both remained in positive terrain. On the demand side, consumption (consumer and government) grew by a yearly 4.6%. Gross fixed capital formation increased 2.9% year over year. Finally, exports presented a 7.6% annual change while imports increased 1.3%. Although early indicators for 2Q13 showed a relatively weak macroeconomic performance, the results in agriculture and civil works lead to a pick up in GDP prints.

We continue to believe that the second half of the year will exhibit higher growth prints than the first half, but we maintain our 3.8% GDP growth expectation. During 3Q13 and 4Q13 we expect a rebound in activity with GDP growth of 4.0% and 4.5%, respectively. In our view, this represents a significant rebound during the second half of the year as it already contemplates the fact that the government will boost public investment. Not only that, but using previous growth data and looking at periods where the first half of the year was weak and the second half showed a better-than-expected behavior, we conclude that it is difficult for the economy to grow around 4.5% this year as the government suggests, with a more likely range of 3.8% to 4.2%. Nonetheless, the uncertainty regarding the speed in which civil works spending will be made, the strikes that took place in August, along with shocks in coal production moderate our optimism. That is why we maintain our call for a GDP growth of 3.8% in 2013.

Inflation continues to be under control and should not pose any risk during the rest of the year. Up to August, the behavior of inflation has been favorable, with both core and food inflation displaying muted prints. We expect this situation to continue during the rest of the year, although we expect some moderate pickup in prices during 2H13 driven by demand pressures. This will take headline inflation to 2.4% by yearend, up from the current 2.27% annual print but lower than the 3.0% mid-point target.

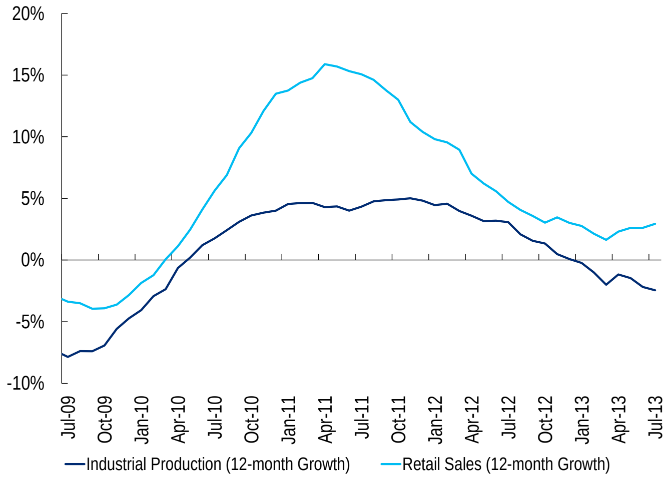
Although the economy should be picking up during the second half of the year, Banrep has enough leeway to keep its reference interest rate on hold for the rest of the year. Although the rebound in economic activity, expected inflation levels will allow the central bank to keep its policy rate on hold for the rest of 2013, and it will only start considering increases at some point between March and April of next year, when the recovery trend of the economy gets steeper. Nonetheless, it is important to note that the CB will be acting on a highly data-dependent-mode.

COP depreciation: Moving with the tide. As we have always said, FX intervention by Banrep is associated to pre-specified undisclosed levels. Currently, we believe that USDCOP below 1,900 is the level that triggers intervention by Banrep. In other words, the decision on intervention is dependent on the level. Hence, although we think Banrep wants to stop its USD purchases, the current USDCOP level below 1,900 will make it continue with its intervention program on a month to month basis. Regarding local fundamentals, we expect some moderation in FDI inflows although they will continue at favorable levels. Thus, we expect the exchange rate to fluctuate around 1890-1950 for the rest of the year, which implies not only a depreciation of the COP but also an increase in volatility.

Political outlook. August was characterized by several protests, particularly arising from the agricultural sector. As we have mentioned before (see our Colombia Macro View - Colombia: Assessing the economic impact of protests) the nature of the recent protests and some mismanagement from the authorities at the beginning of the events led to a difficult environment for the government to find a quicker solution. These events translated into a sharp decline in President Santos' popularity, making the analysis of the political arena more relevant, particularly with presidential elections next year and with the ongoing peace talks with the guerilla group FARC in Cuba. Although a point does not make trend, and the most likely situation is that in the coming surveys the president's popularity will show some improvement, it is important to note that President Santos will face important challenges once he announces he will run for a second term in office, something we expect to happen by late November.

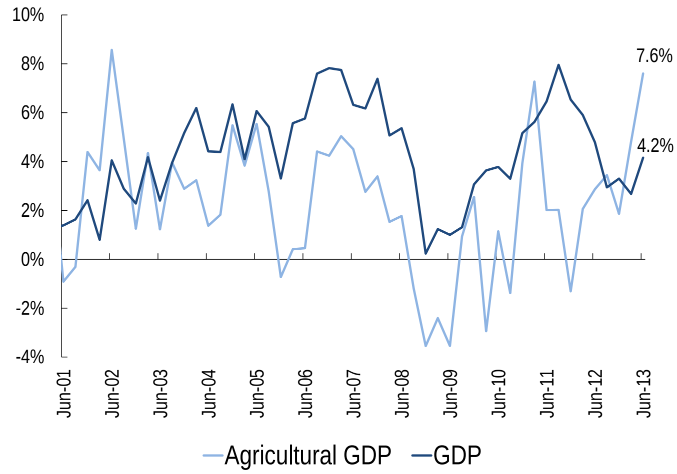
The political outlook going forward: House of cards… The big contenders in the upcoming presidential race can be divided into those who belong to the incumbent government and the opposition, which is led by former president Alvaro Uribe - who has already decided to run for Congress seat under a new political force called Centro Democrático (Democratic Center). The main difference between these two forces lies in the approach they are willing to take with the FARC rebel group. In particular, the opposition is not in favor of the current peace talks that President Juan Manuel Santos is having with FARC. Apart from that, we do not see significant differences in the economic or social front. Nevertheless, recognizing that the timing of the latest survey coincided with a particularly challenging period during President Santos' tenure, we expect that this situation will prompt the government to be more politically active if the goal is the reelection. That being said, we think Mr. Santos' administration will try to focus on two fronts in order to improve his chances of running for a second term. First, Mr. Santos will try to consolidate an eventual reelection team and at the same time will try to calm public opinion after the perception of how the protests were handled. On the other hand, the government may try to speed up the peace talks, which could dramatically change Mr. Santos' popularity ahead of the elections.

Figure 250. The manufacturing sector is expected to rebound in 2H13…



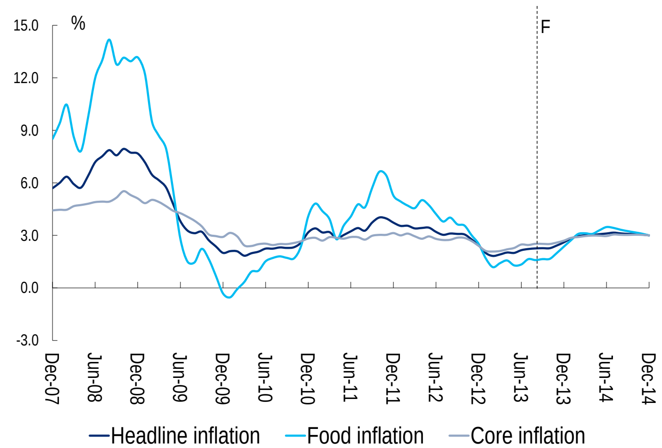
Source: DANE and Citi Research

Figure 251. 2Q13 GDP growth was driven by the agricultural sector



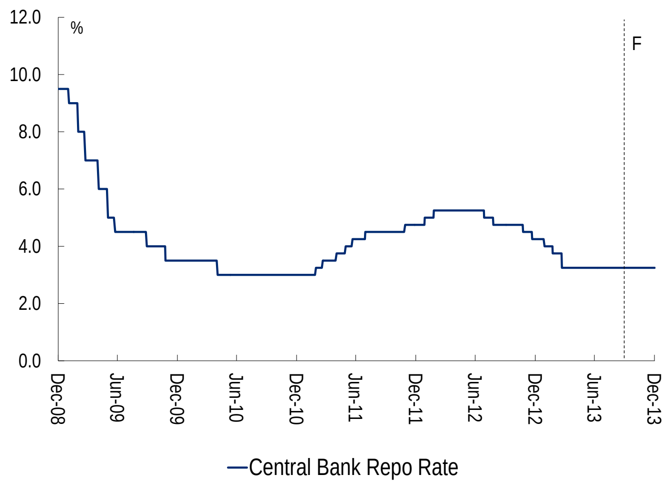
Source: DANE and Citi Research

Figure 252. With inflation below 3%...



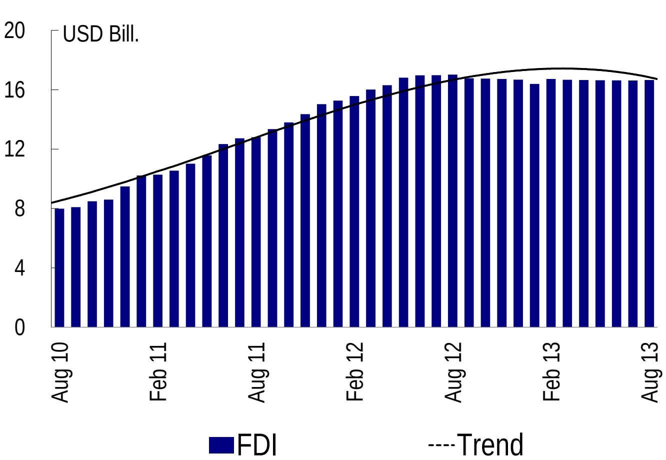
Source: Banrep and Citi Research

Figure 253. …The CB still has enough leeway to keep its repo rate



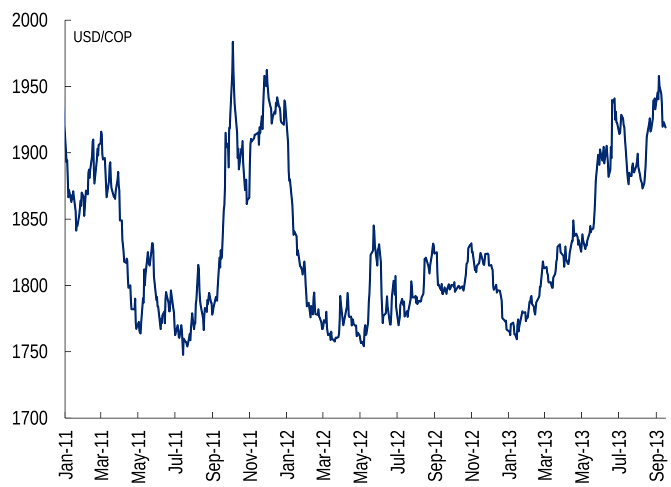
Source: Banrep and Citi Research

Figure 254. FDI series show that inflows are moderating



Source: Bloomberg and Citi Research

Figure 255. USDCOP, moving with the tide



Source: Bloomberg and Citi Research

Figure 256. Colombia Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	163	208	242	231	285	335	369	389	393
Nominal GDP, local currency bn	384	431	480	505	545	622	665	732	765
GDP per capita, USD	3,744	4,726	5,447	5,136	6,262	7,289	7,943	8,254	8,269
Population, mn	43.4	43.9	44.5	45.0	45.5	46.0	46.5	47.1	47.6
Unemployment, % of labour force	12.9	11.4	11.5	13.0	12.4	11.5	11.2	10.9	10.9
Economic Activity									
Real GDP, yoy avg	6.7	6.9	3.5	1.7	4.0	6.6	4.2	3.8	4.5
Real investment growth % yoy	19.2	12.8	9.0	-3.9	7.7	18.2	7.3	3.1	4.1
Real consumption growth % yoy	6.3	7.0	3.5	1.6	5.1	5.4	4.8	4.1	4.7
private consumption growth % yoy	6.4	7.3	3.5	0.6	5.0	5.9	4.7	4.0	4.7
Real export growth, % yoy	8.6	6.9	4.5	-2.8	1.3	12.9	5.4	4.7	10.4
Real import growth, % yoy	20.0	14.0	10.5	-9.1	10.8	21.2	9.1	3.3	8.8
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.5	5.7	7.7	2.0	3.2	3.7	2.4	2.4	3.0
CPI, % avg	4.3	5.5	7.0	4.2	2.3	3.4	3.2	2.1	2.9
Nominal wages, % yoy	9.2	5.4	19.1	3.0	4.1	4.2	4.3	4.4	4.5
Credit extension to private sector, % yoy	18.5	19.9	14.3	6.8	9.8	18.3	10.0	12.8	14.0
Policy Rate (eop)	7.50	9.50	9.50	3.50	3.00	4.75	4.25	3.25	4.50
1 month inter-bank rate, %, eop	7.50	9.35	8.87	3.10	3.00	4.81	4.27	3.30	4.52
Long-term yield, %, eop	9.00	10.27	12.76	8.47	7.70	7.60	5.86	6.20	7.42
COP/USD, eop	2,239	2,018	2,249	2,043	1,920	1,939	1,767	1,915	1,961
COP/USD, avg	2,360	2,076	1,968	2,154	1,898	1,848	1,798	1,889	1,950
Balance of Payments, USD bn									
Current account	-3.0	-6.0	-6.7	-5.0	-8.8	-9.6	-11.9	-12.3	-12.7
% of GDP	-1.8	-2.9	-2.8	-2.1	-3.1	-2.9	-3.2	-3.2	-3.2
Trade balance	0.3	-0.6	1.0	2.5	2.4	6.1	4.9	4.4	5.1
Exports	25.2	30.6	38.5	34.0	40.8	58.3	61.6	61.4	65.3
Imports	24.9	31.2	37.6	31.5	38.5	52.2	56.7	57.0	60.2
Service balance	-2.1	-2.6	-3.1	-2.8	-3.6	-4.6	-5.5	-4.1	-3.8
Income balance	-5.9	-8.0	-10.2	-9.3	-12.0	-16.0	-15.9	-17.4	-18.9
FDI, net	6.7	9.0	10.6	7.1	6.8	13.4	15.6	15.4	15.8
International reserves	15.4	20.9	24.0	25.4	28.5	32.3	37.5	44.9	49.7
Total amortisations	8.0	5.7	5.1	5.8	6.5	6.3	12.1	8.4	8.2
Public Finances, % of GDP									
Consolidated government balance	0.7	-0.6	-0.1	-2.7	-3.3	-2.9	0.3	-1.1	-0.7
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	37.5	32.9	34.0	36.7	37.2	34.5	32.0	33.3	31.6
of which Domestic	23.8	21.9	22.6	24.9	26.3	24.2	23.1	21.1	20.0
Foreign Assets & Liabilities, USD bn									
External debt	40.1	44.6	46.4	53.7	64.1	75.9	78.6	82.1	82.3
Public	26.3	28.8	29.4	37.1	38.9	42.8	46.4	45.6	45.3
External debt / GDP	24.7	21.5	19.1	23.2	22.5	22.6	21.3	21.1	20.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	4.6	5.1	5.7	3.9	8.1	10.8	9.8	10.3	10.4
Short-term debt/International reserves (%)	29.6	24.6	23.5	15.6	28.3	33.4	26.2	23.0	21.0

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	2.7	4.2	4.0	4.5	3.3	5.5	5.0	4.3	4.8
CPI, % yoy	1.9	2.2	2.1	2.4	2.8	3.0	3.1	3.0	3.0
Policy interest rate, %, eop	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.50	4.75
Short-term market rate, % eop	3.22	3.17	3.29	3.30	3.27	3.77	3.77	4.52	4.52
Long-term yield, %, eop	4.96	6.42	6.92	6.20	6.17	6.67	6.67	7.42	7.42
COP/USD, eop	1,825	1,922	1,894	1,915	1,934	1,951	1,956	1,961	1,966

Source: National Sources, Citi Research

Ecuador

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- **Summary view** — Economic activity displayed a deceleration during 1H13 which took GDP growth to 3.5% YoY, according to our estimates. Nonetheless, we expect for this situation to revert in 3Q13 and GDP to growth 4% for the year as a whole. On the inflation front, there should be no major surprises. Nevertheless, we think that the low inflation prints observed over the last months are temporary and we expect demand-side inflationary pressures to bring yearend inflation up to 3.7%. During the rest of the year, the government is expected to continue promoting the controversial projects in the Ishpingo-Tambococha-Tiputini oilfields. It is important to note that despite the fact that this announcement by Mr. Correa could have a positive effect in terms of increases in oil reserves and production, the government has yet to convince international investors that there are enough guarantees for them to come into the country.

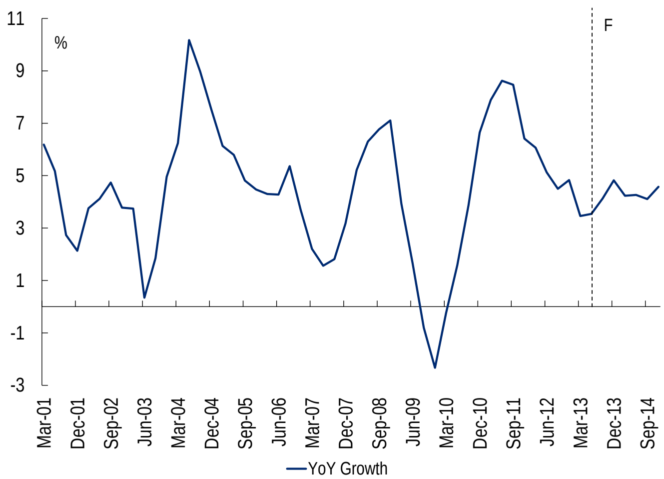
- **Things to watch** — Watch for the 2Q13 GDP result to be published by the end of the month.

Despite the expected GDP growth deceleration for 2013 as a whole, we expect to see a better 2H13. Although 2013 will be characterized by an important deceleration in economic activity, we expect a second half of the year with better results. The latter will be particularly driven by a pick-up in public investment. According to our expectations, GDP growth for 2013 should stand at 4%, with public spending as the main driver of growth with a 5.8% YoY increase. On the other hand, consumption should expand 4.9% YoY while investment will expand at an annual 3.2%. On the inflation front, both demand and supply side pressures continued subdued with the latest annual inflation print currently standing at 2.3%. Nonetheless, we expect consumer inflation to increase throughout the second half of the year as demand pressures increase.

We expect the current account deficit to widen. The favorable outlook for oil prices this year has helped Ecuador to keep revenues from exports at adequate levels. In particular, we expect oil exports to stand at USD14.6 billion this year, taking total exports to USD25 billion. Nonetheless, the recent dynamics of imports and the closure of Ecuador's largest refinery (which continues to create pressures in refined fuels imports) will likely translate into an increase in the trade balance deficit, and consequently into a current account deficit which we anticipate to stand at -1.0% of GDP this year.

Political outlook. In mid-August, president Correa made an announcement in which the government was allowing for the exploration and exploitation of oil fields in some parts of the Ecuadorian Amazons. This announcement came after several years and many attempts by the government to raise resources from the international community in exchange for not exploiting the aforementioned areas. Although the announcement turned out to be widely unpopular, Mr. Correa's administration managed to stay together and no division among his cabinet members has occurred. Although a consequence of this announcement could be an increase in investment if the government is able to find some interested investors, the problem for Mr. Correa administration is that he would have to prove that there is a change in approach towards foreign investors, something we believe the government is interested in but that will take some time.

Figure 257. GDP is expected to rebound in 2H13

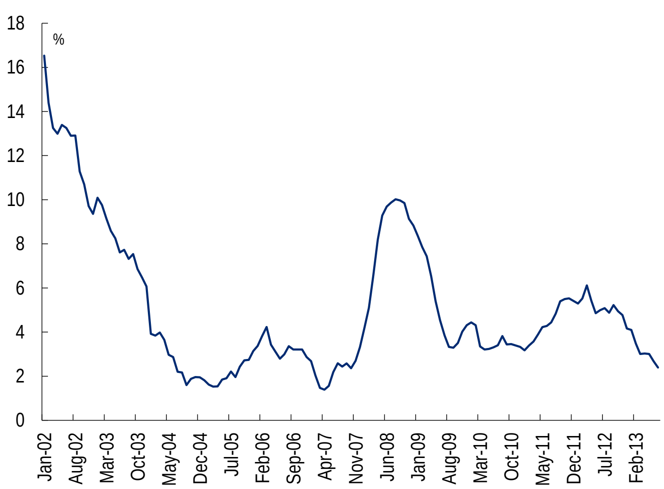


Source: DANE and Citi Research

Figure 258. Unemployment rate

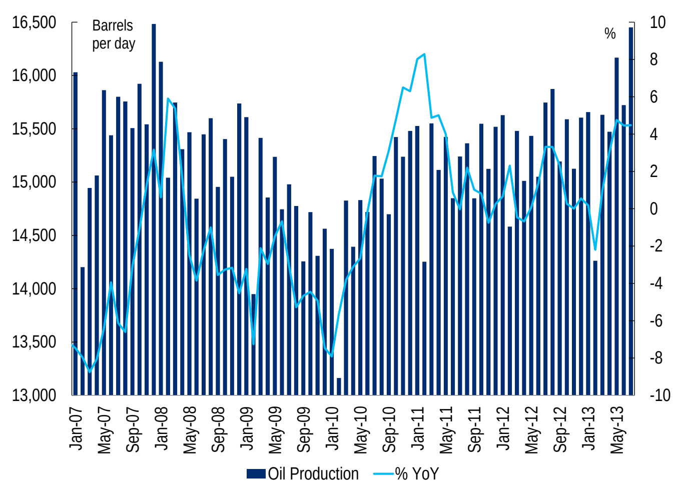
Source: DANE and Citi Research

Figure 259. Inflation rate



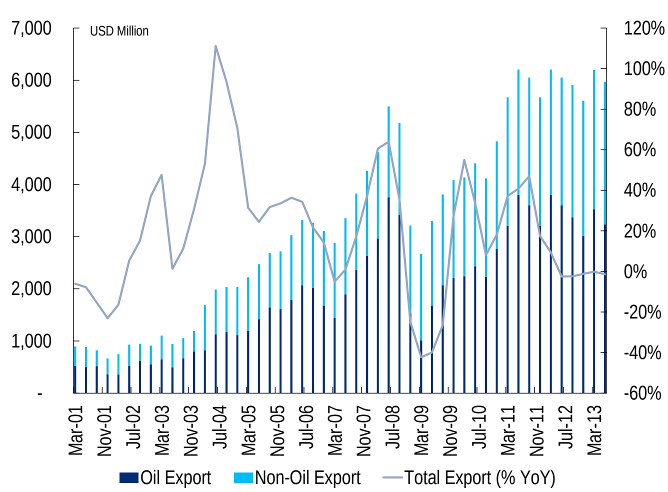
Source: Banrep and Citi Research

Figure 260. Oil production



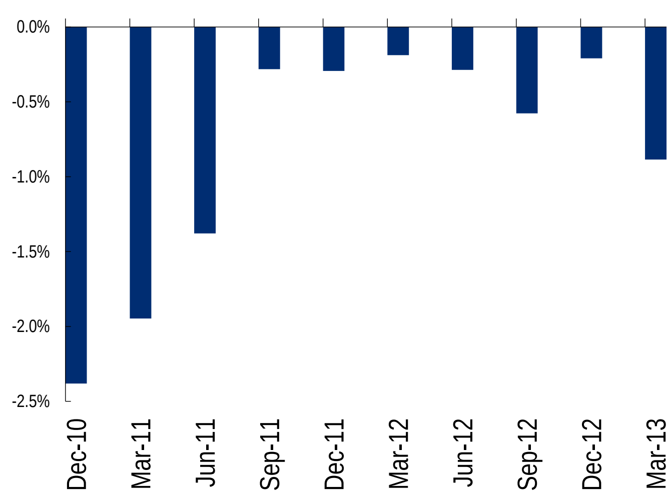
Source: Banrep and Citi Research

Figure 261. Exports breakdown



Source: Bloomberg and Citi Research

Figure 262. Current account



Source: Bloomberg and Citi Research

Figure 263. Ecuador Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	47	51	62	63	68	77	84	90	97
Nominal GDP, local currency bn	47	51	62	63	68	77	84	90	97
GDP per capita, USD	1,731	1,856	2,211	2,203	4,501	5,035	5,425	5,707	6,045
Population, mn	27.0	27.5	27.9	28.4	15.0	15.2	15.5	15.8	16.1
Unemployment, % of labour force	0.0	6.1	7.3	7.9	6.1	5.1	5.0	5.2	5.0
Economic Activity									
Real GDP, yoy avg	3.7	3.2	7.1	-2.3	6.6	6.4	4.8	4.8	4.6
Real investment growth % yoy	4.9	10.6	23.3	-8.7	19.7	9.2	0.1	5.1	6.5
Real consumption growth % yoy	4.6	3.6	7.4	0.1	5.6	5.1	5.0	5.4	5.0
private consumption growth % yoy	4.1	4.4	5.9	-2.3	7.1	5.0	4.2	5.3	5.0
Real export growth, % yoy	6.8	0.0	-0.9	-1.6	4.0	3.9	1.9	3.9	4.7
Real import growth, % yoy	10.6	6.2	11.7	-1.1	11.8	3.4	-1.6	5.6	7.5
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	2.9	3.3	8.8	4.3	3.3	5.4	4.2	3.7	3.5
CPI, % avg	3.3	2.3	8.4	5.2	3.6	4.5	5.1	2.9	4.0
Nominal wages, % yoy	6.7	6.3	17.6	9.0	10.1	10.0	10.6	8.0	8.5
Credit extension to private sector, % yoy	-	-	34.3	13.0	7.9	12.4	19.2	22.0	21.9
Policy Rate (eop)	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	5.09	0.20	0.20	0.20	0.20	0.20	0.20
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-
ECD/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn									
Current account	1.6	1.6	1.3	-0.3	-1.6	-0.2	-0.2	-0.9	-1.1
% of GDP	3.5	3.1	2.1	-0.5	-2.4	-0.3	-0.2	-1.0	-1.1
Trade balance	1.8	1.8	1.4	-0.1	-1.5	-0.2	0.1	-0.9	-1.0
Exports	13.2	14.9	19.1	14.2	18.1	23.1	24.7	27.1	27.5
Imports	11.4	13.0	17.8	14.3	19.6	23.2	24.6	28.0	28.5
Service balance	-1.3	-1.4	-1.6	-1.3	-1.5	-1.6	-1.4	-1.1	-1.2
Income balance	-1.9	-2.0	-1.5	-1.4	-1.0	-1.2	-1.3	-1.3	-1.3
FDI, net	0.3	0.2	1.0	0.3	0.2	0.6	0.6	0.5	0.5
International reserves	37.4	34.3	43.1	35.8	2.6	3.0	26.5	3.8	4.0
Total amortisations	10.1	11.8	9.5	8.6	7.5	7.4	3.4	6.5	6.6
Public Finances, % of GDP									
Consolidated government balance	-	-	-	-	-	-	-	-	-
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-
Public debt	28.8	27.2	22.2	16.4	19.8	19.0	22.2	21.9	20.4
of which Domestic	7.0	6.4	5.9	4.5	6.9	5.9	9.3	8.8	8.2
Foreign Assets & Liabilities, USD bn									
External debt	17.1	17.5	16.9	13.4	13.9	15.3	16.0	17.2	17.4
Public	10.2	10.6	10.1	7.4	8.7	10.1	10.9	11.8	11.9
External debt / GDP	36.5	34.3	27.4	21.5	20.5	20.0	19.1	19.1	17.8
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	3.5	3.5	4.1	4.8	4.2	4.3	4.1	4.6	4.0
CPI, % yoy	3.0	2.7	2.0	3.7	3.4	4.5	4.4	3.5	3.5
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-

Source: National Sources, Citi Research

Mexico

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- **Summary view —** The economic slowdown was sharper-than-expected in 1H13. We have therefore adjusted down our GDP growth forecast for 2013 (to 1.2%). Banxico surprised us by cutting its reference rate by 25bp at its September meeting in response to weak economic activity numbers, and we think it could opt for an additional 25bp rate cut on October 25.

- **Things to watch —**Structural reforms proposed by the Federal Government, are likely to be voted on by Congress in the short-term. Keep an eye on economic activity in the context of the recent changes in public policy and the U.S. better performance.

- **Strategy —** After the Fed opted for postponing the "tapering", we have placed our USDMXN 0-3 month projection at 12.8. We do not see USDMXN fully retracting lower in the short-term. Reasons include that much of the "good news" on reforms looks to be priced in MXN already, and the central bank has turned dovish.

Downside risks to growth: just your average EM country?

Activity in 1H13 surprised on the downside and we now expect 2013 GDP growth at 1.2%. This figure compares with a 3.6% forecast at the beginning of the year, when we were assuming a mild deceleration driven by a slowdown in US manufacturing. But economic activity fared much worse in the first half than we expected; and the trough of the slowdown, which we originally expected in 1Q13, actually seems to have occurred in 2Q13, SAAR growth stood at 0.1% and -2.9%, respectively. As these figures show, at some point in 1H13 the economy was bordering on recessionary territory. Thus, our expectation that the Mexican economy would be outperforming other EM countries this year in terms of GDP growth is now gone: our current 1.2% GDP growth forecast for this year compares with a 4.7% average for the emerging markets.

We think five factors are the most relevant in explaining the disappointing economic performance. 1) The slowdown in global growth, especially slower dynamism in U.S. manufacturing. 2) An unexpected 3%YoY fall in public spending in 1H13. 3) A 0.2%YoY average decline in gross fixed investment during the first half of the year, with public investment spending down by an average 7.4%YoY. 4) A sharper slowdown than expected in some determinants of consumption, mainly job creation, which grew by 3.1%YoY in August versus 4.6%YoY at year-end 2012. Finally, 5) the change in base year and the update in methodology used to measure the national accounts, implying that activity in the first half of 2013 was even weaker than previously reported. All in all, these factors are associated with seasonal and cyclical effects rather than with structural ones. The good news therefore is that we do not see any significant supply-side restrictions – in the absence of inflationary pressures – while the issue is one of stimulating demand.

Left to its own devices, economic activity should recover, albeit gradually. 2Q data show positive and encouraging evidence of a rebound in exports (+4.8%QoQ SAAR) supported by stronger economic activity in the U.S. Better prospects for external demand should have a spillover effect on the local economy, eventually strengthening the still-weak local demand. The most recent data for 2Q was particularly worrying as domestic demand fell by 3.8% SAAR. From 2H2013 we are expecting a rebound in U.S. economic activity, which should boost Mexico's economic recovery in coming months. Given these circumstances and based purely on recent trends, we now predict GDP growth at 3.8% for next year, down from 4.2% in our previous quarterly revision.

Mexico departs from other EMs in its ability to stage a policy response

In the last month, Mexico's (monetary and fiscal) policy mix has changed greatly in response to weak economic activity. This response has into two parts. 1) Banxico surprised by cutting its reference rate by 25bps in September, responding mainly to rapid economic slowdown. The output gap widened in negative territory – and is expected there for some time, against a background of historically low headline and core inflation. We expect an additional 25bps cut at Banxico's October 25 meeting, given weak economic data and low inflationary effects associated with the fiscal reform now under discussion. Moreover, we think this expectation of another cut has been reinforced in the aftermath of the Fed's postponed tapering. Thus, we see the policy rate at 3.5% by yearend. 2) President Peña's fiscal reform proposal may involve countercyclical fiscal policy. His original 2013 plan for a balanced budget (0% deficit) was dropped after a sharp economic slowdown, and a new proposal submitted to hold spending unchanged, despite lower revenues (due to lower activity). The government is also allowing a 0.4% of GDP rise in the fiscal deficit – rather than another stimulus, this aims to avoid more deterioration, limiting downside risks on the current 2013 GDP forecast (1.2% in our case). For 2014, a fiscal deficit of 1.5% of GDP is proposed that could significantly stimulate the economy. Also, the impact of taxes on consumption is expected to be low as the reform has focused on income tax rather than VAT adjustments.

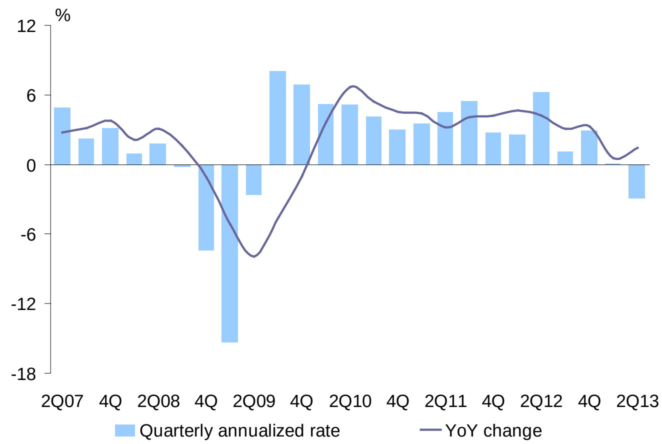
The next two months will define the 2014 outlook. With no policy responses, we estimate downside risks to economic growth would rise sharply. The Government estimates a 0.4pp impact – the difference between the inertial and reform-plus GDP growth (3.5% versus 3.9%). But with monetary easing and fiscal stimulus these figures are quite conservative. The fourth quarter will be the key to the reform process. We think fiscal reform will be modest in scope, while energy reform will be a game-changer. We are optimistic about its final outcome, likely to be defined by the PAN-PRI proposals: the State as owner of the resources and PEMEX, but private participation via concessions (PAN) or profit-sharing (PRI). We also think the reform may be approved very soon, with secondary laws passed before December and full implementation in 1H14.

The 2014 Budget and Reforms Negotiations Underway

Enough legislative support seems to exist for both fiscal and energy reforms, even if not under the all-out Pact for Mexico coalition used so far. On fiscal reform, we expect the PRI and PRD to form a winning coalition. PAN legislators will support parts of the proposal and will likely win concessions (e.g. dropping VAT on school fees). Our base scenario is for all fiscal measures to be passed by November 15, when the approval process for the income law and the budget decree ends. But the President's proposal includes a constitutional amendment to link the tax collection results to gradually implement a new, universal social security system. A constitutional change like this needs PAN support, which would not be automatic. However, the rest of the reform could go ahead without it.

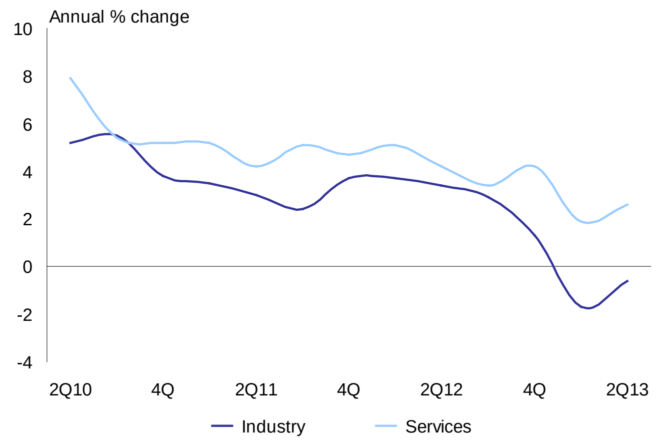
On energy reform, we think the PRI and PAN will agree not only to the constitutional amendment proposed in their Bills – by lifting the constitutional restriction on private investment in the energy sector – but also on a compromise view of the institutional framework for this. We expect the reform's constitutional part to be passed in October. Right now, we think it will be possible for the PRI-PAN energy coalition to offer legislation for the secondary laws needed by December or by the first weeks of January.

Figure 264. GDP slowdown intensified in 2Q13



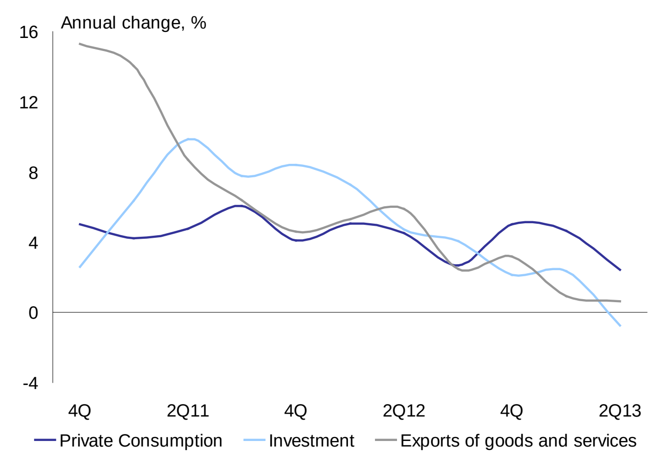
Source: INEGI and Banamex

Figure 265. Industry and Services seem to be rebounding now



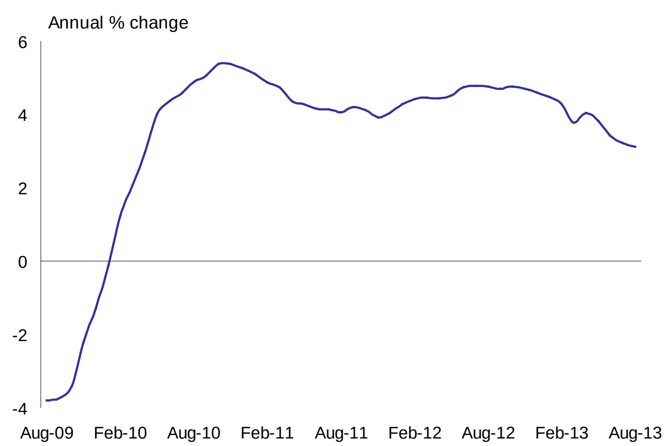
Source: INEGI and Banamex

Figure 266. Local demand lost momentum in 2Q13



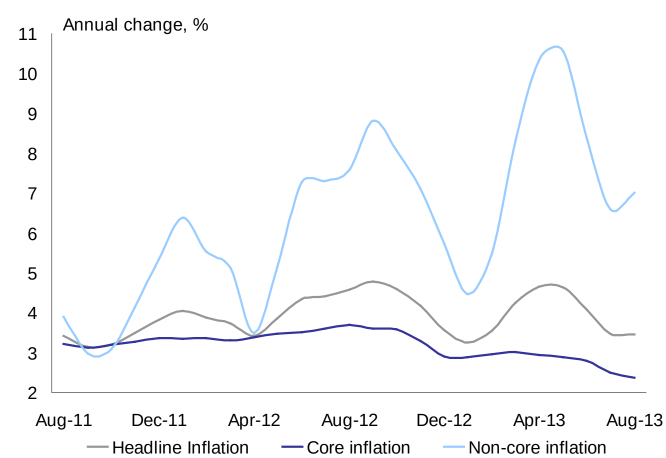
Source: INEGI and Banamex

Figure 267. Formal sector job growth still on a positive path



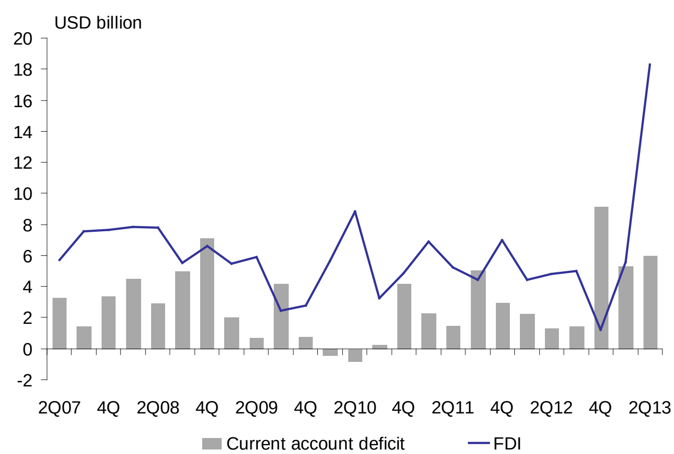
Source: IIMSS and Banamex

Figure 268. Inflation probably near its minimum now



Source: Banxico and Banamex

Figure 269. External deficit remains at manageable levels



Source: Banxico and Banamex

Figure 270. Mexico Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	966	1,044	1,109	897	1,048	1,161	1,178	1,279	1,420
Nominal GDP, local currency bn	10,533	11,404	12,257	12,094	13,229	14,424	15,506	16,112	17,373
GDP per capita, USD	8,911	9,508	9,966	7,952	9,169	10,042	10,077	10,823	11,906
Population, mn	108.4	109.8	111.3	112.9	114.3	115.6	116.9	118.1	119.3
Unemployment, % of labour force	3.6	3.7	4.0	5.5	5.4	5.2	5.0	5.0	4.8
Economic Activity									
Real GDP, yoy avg	5.0	3.1	1.4	-4.7	5.1	4.0	3.8	1.2	3.8
Real investment growth % yoy	11.1	3.7	6.2	-13.3	4.5	5.4	4.6	0.0	6.0
Real consumption growth % yoy	5.2	3.0	2.1	-5.2	5.1	4.5	4.3	2.2	3.6
private consumption growth % yoy	5.5	3.0	1.9	-6.5	5.6	4.8	4.6	2.5	4.0
Real export growth, % yoy	7.7	3.6	-1.3	-11.8	20.5	8.2	4.2	2.6	8.0
Real import growth, % yoy	10.2	5.9	4.4	-17.6	20.5	8.0	6.0	3.0	8.5
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	4.1	3.8	6.5	3.6	4.4	3.8	3.6	3.5	3.7
CPI, % avg	3.6	4.0	5.1	5.3	4.2	3.4	4.1	3.7	3.4
Nominal wages, % yoy	5.1	5.4	5.3	4.2	3.0	5.4	4.4	4.6	4.2
Credit extension to private sector, % yoy	11.4	12.0	9.6	0.6	5.6	7.4	6.8	7.0	7.9
Policy Rate (eop)	7.05	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50
1 month inter-bank rate, %, eop	7.05	7.50	8.25	4.50	4.50	4.50	4.50	3.50	3.50
Long-term yield, %, eop	7.46	8.03	8.35	7.99	6.95	6.51	5.38	6.40	7.00
MXN/USD, eop	10.80	10.91	13.67	13.06	12.36	13.95	12.87	12.68	12.36
MXN/USD, avg	10.91	10.93	11.16	13.50	12.63	12.44	13.16	12.68	12.42
Balance of Payments, USD bn									
Current account	-7.7	-14.3	-19.6	-7.5	-2.0	-9.9	-11.1	-19.7	-19.3
% of GDP	-0.8	-1.4	-1.8	-0.8	-0.2	-0.9	-0.9	-1.5	-1.4
Trade balance	-6.1	-10.1	-17.3	-4.7	-3.0	-1.5	0.0	-7.7	-9.0
Exports	249.9	271.9	291.3	229.7	298.5	349.4	370.7	383.4	418.0
Imports	256.1	281.9	308.6	234.4	301.5	350.8	370.8	391.1	427.0
Service balance	-7.3	-7.6	-8.2	-10.0	-10.0	-14.2	-13.8	-13.5	-12.7
Income balance	-20.2	-23.0	-19.5	-14.4	-10.5	-17.2	-19.9	-19.9	-20.2
FDI, net	20.2	31.5	27.6	16.5	21.9	21.6	13.4	38.6	22.1
International reserves	67.7	78.0	85.4	90.8	113.6	142.5	163.5	179.9	197.0
Total amortisations	22.8	26.2	30.1	27.7	32.4	51.5	50.2	52.7	51.6
Public Finances, % of GDP									
Consolidated government balance	0.1	0.0	-0.1	-2.3	-2.8	-2.5	-2.6	-2.1	-2.0
Consolidated gov primary balance	2.5	2.2	1.8	-0.1	-0.9	-0.6	-0.6	0.0	-
Public debt	33.7	33.7	36.5	40.3	38.8	39.6	39.5	38.2	38.1
of which Domestic	22.8	22.0	24.7	26.7	23.9	23.8	21.4	21.0	21.4
Foreign Assets & Liabilities, USD bn									
External debt	171.4	196.8	205.3	195.0	247.6	281.0	314.9	333.9	354.1
Public	104.2	121.0	129.3	120.9	155.1	183.0	214.6	226.8	240.9
External debt / GDP	17.7	18.9	18.5	21.7	23.6	24.2	26.7	26.1	24.9
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	25.6	26.1	25.1	21.3	21.3	22.8	22.4	21.3	22.0
Short-term debt/International reserves (%)	37.8	33.4	29.4	23.5	18.8	16.0	13.7	11.9	11.2

Quarterly Economic Indicators	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.6	1.5	0.9	2.1	4.5	3.2	4.2	3.4	-
CPI, % yoy	4.3	4.1	3.4	3.5	2.9	3.4	3.7	3.7	-
Policy interest rate, %, eop	4.00	4.00	3.75	3.50	3.50	3.50	3.50	3.50	-
Short-term market rate, % eop	4.00	4.00	3.75	3.50	3.50	3.50	3.50	3.50	-
Long-term yield, %, eop	4.95	5.92	6.30	6.40	6.55	6.70	6.85	7.00	-
MXN/USD, eop	12.32	12.95	12.76	12.68	12.53	12.40	12.38	12.36	12.34

Source: National Sources, Citi Research

Peru

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- **Summary view** — As Peru moves towards a lower stage of growth, locals seem to begin losing their optimism. Not only is the loss associated with the economy, but also with politics. We must note, however, that the most serious concern about political risk has virtually evaporated.
- **Things to watch** — Surveys about confidence and the potential pickup in export volumes suggest the economy could avoid slowing down further from the 5% “psychological” growth threshold.
- **Strategy** — Now that global noise has calmed down, we would expect the local currency to appreciate moderately again. We do not expect the BCRP to buy hard currency if the appreciation continues to be smooth.

The drivers of growth are changing in Peru. In previous comments we have been saying that the country is transitioning into a new phase. In this phase, potential output would be lower as a result of a more moderate impulse from external demand and lower terms of trade. In such an environment, domestic demand would begin having a much more important weight as a driver of economic growth.

It seems that 5% has become a psychological growth threshold in Peru. Three months ago we began talking about the perception that potential growth in Peru was no longer close to 7%, but rather 6%. However, the “disappointing” prints in growth during May, June and July have raised concerns again about the country’s outlook. During those three months growth was below 5%. It seems that growth below 5% is unable to translate into an improvement in standards of living. During the past few years, households have gotten used to seeing an increase in their well-being and an expansion of the middle-class in Peru.

The export outlook might improve in late 2013 and early 2014. Our understanding is that export volumes could pick up as a result of previous investments in mining. This pick up would not necessarily be large enough to compensate for the less favorable terms of trade. Exports annual growth has been falling, while growth in imports continues to be positive. Even with the expected pick up in export volumes, we would still expect import growth to continue outperforming that of exports. Foreign direct investment (FDI) will probably be lower in 2013 and will decrease further in 2014, but will likely remain high enough to continue financing the current account deficit.

We feel that a major headwind against growth is the lower level of confidence among households and firms. In our view, the Petroperu affair was the beginning of this loss of confidence. We believe the unpleasant way in which the political establishment and Congress negotiated some major government appointments did not help either. Of course the global environment and lower commodity prices added some concerns too. Something that probably prevented a further loss of confidence was the First Lady’s announcement that she will not seek the presidential nomination for the next election.

Turning around a loss of confidence is difficult, but not impossible. President Ollanta Humala’s approval rate hit an all-time low in September. With much less political capital of what he had just a few months ago, it would be extremely difficult to undertake a serious reform agenda that could push up confidence and growth again. For the time being, what we are seeing in the government is an effort to make easier for any businessman to undertake projects. This might help at the margin, but is difficult for this by itself to turn around the whole growth story.

Under such an outlook, we would expect the fiscal surplus to narrow. Lower growth and lower tax revenue associated with mining would prevent the government from keeping the fiscal surplus intact. It should not go overlooked, however, that the incentives to push up expenditures decreased substantially after the First Lady's announcement. A few months ago we were worried that the political outlook could become a major risk to fiscal soundness. Now, it seems that there is not much to gain (and much to lose) by jeopardizing fiscal prudence. Overall, we still expect the fiscal surplus to decrease, but that is unlikely to be a major concern or to raise eyebrows among the investor community.

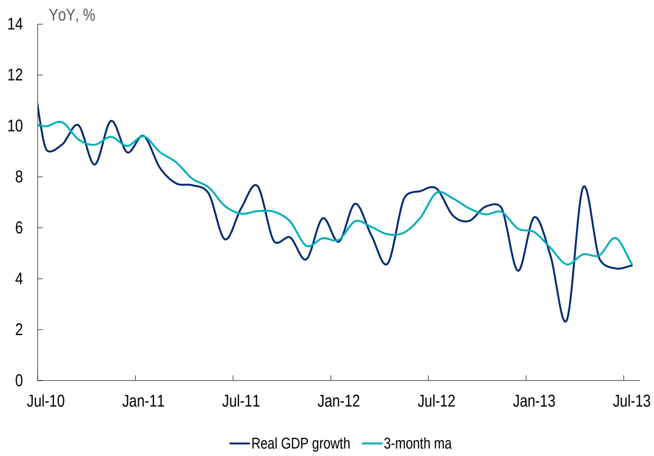
In the meantime, the BCRP has to deal with lower growth, but with slightly higher inflation. In our view, growth continues to be the primary concern within authorities — including the Central Bank of Peru (BCRP). During the past few months, the loosening of the reserve requirements scaffold has been the central bank's main policy tool to lend a hand to growth. Nonetheless, credit growth continues to slowdown and we would expect it to continuing doing so.

Nevertheless, we have not yet reached a point at which the central bank wants to use its policy rate. The transition to lower stages of growth gives room for the central bank to cut its policy rate to try to push up credit growth again. Moreover, the recent FOMC meeting gives room to the BCRP to begin thinking about a small easing cycle. However, actual inflation has not given any room to the BCRP to begin talking about rate cuts.

Inflation is unlikely to set the stage for the central bank to undertake a small easing cycle — at least in the very short term. Headline and core (CPI excluding food, energy and transportation) inflation are running above 3%. Although inflation in tradables is running at 2.2%, we would expect it to increase slightly as a result of the selloff in the PEN. Inflation in nontradables is at almost 4%, but we expect it to move closer to 3% over the next few months. The BCRP argues that inflation will get back to the target range, but we think that in the meantime it does not give enough room to make the case for cuts. Inflation expectations have increased slightly, but have not yet breached the 3% threshold. Now that the FX markets have calmed down, a meaningful deterioration in inflation expectations is unlikely.

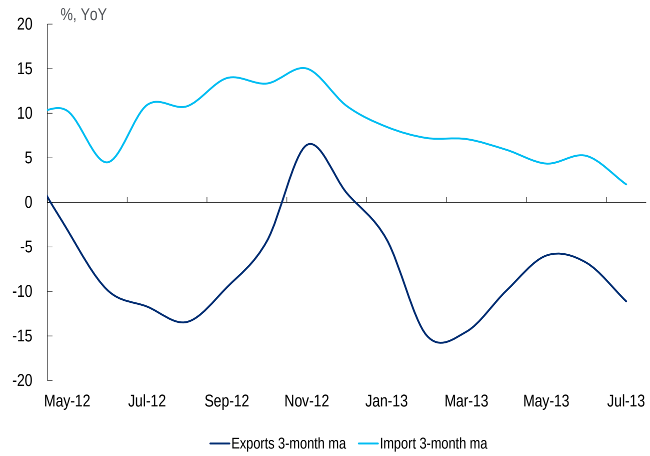
Markets will likely cause fewer headaches at the central bank. The BCRP had to intervene timidly by selling hard currency in July, but intensified it in August. Now that global noise has calmed down we would expect the local currency to appreciate moderately again. We do not expect the BCRP to buy hard currency if the appreciation continues to be smooth (by Peruvian FX market standards). In the case of local rates, the yield compression will likely put on the back burner any potential purchase of local bonds by local authorities. We think that the government would fine tune all the mechanisms to set up a purchase program. The latter would allow it to purchase bonds in case we witness another selloff in the local yield that could affect lending rates across the country.

Figure 271. The last few months have been "disappointing"



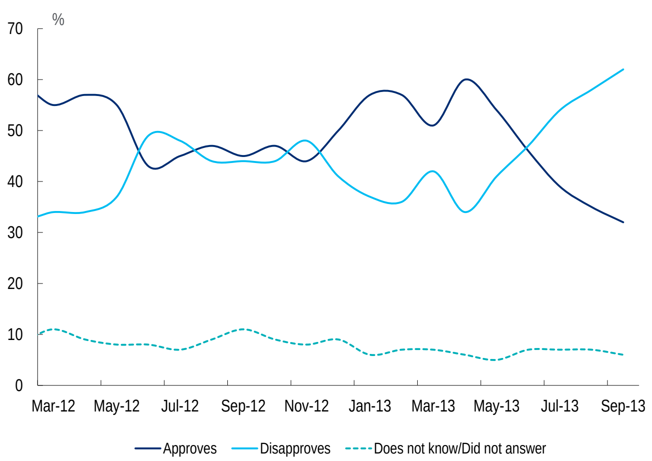
Source: INEI, Haver and Citi Research

Figure 272. Exports' annual growth has continued falling



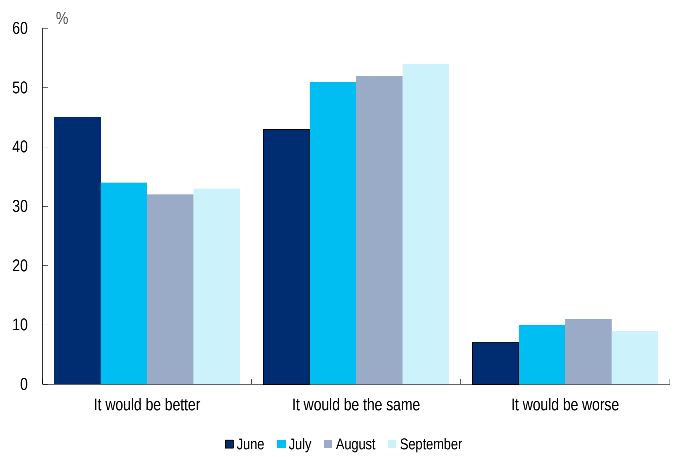
Source: BCRP, Haver and Citi Research

Figure 273. Humala's approval rates hit new lows



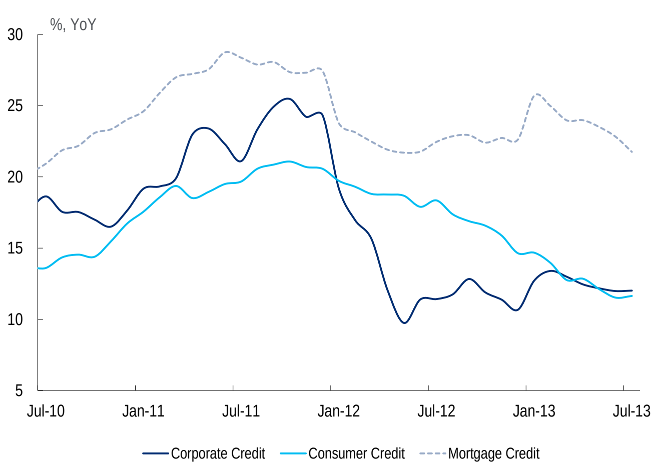
Source: Datum and Citi Research

Figure 274. Fewer households expect their economic condition to improve



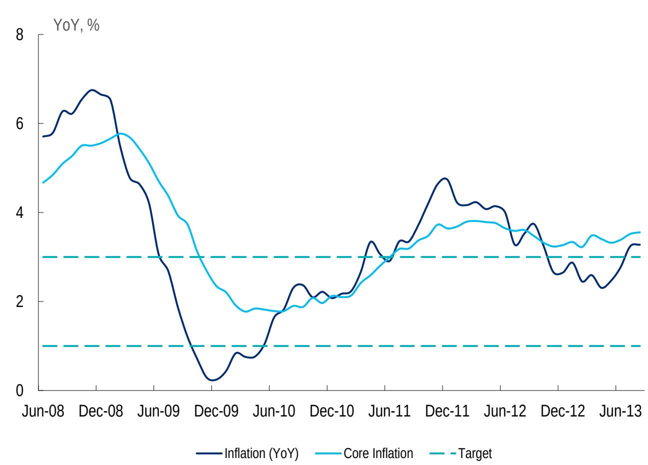
Source: Datum and Citi Research

Figure 275. Credit growth is slowing down



Source: Citi Research

Figure 276. Inflation is running above the 3% ceiling



Source: Citi Research

Figure 277. Peru Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	92	107	127	127	153	176	199	212	227
Nominal GDP, local currency bn	302	336	371	382	435	486	526	566	611
GDP per capita, USD	3,415	3,906	4,562	4,482	5,344	6,033	6,718	7,026	7,430
Population, mn	27.0	27.4	27.8	28.3	28.7	29.2	29.7	30.1	30.6
Unemployment, % of labour force	8.5	8.4	8.4	8.4	7.9	7.7	6.8	7.1	7.4
Economic Activity									
Real GDP, yoy avg	7.7	8.9	9.8	0.9	8.8	6.9	6.3	5.1	5.3
Real investment growth % yoy	26.5	25.8	25.8	-20.6	35.9	9.6	10.4	8.8	5.3
Real consumption growth % yoy	6.6	7.9	8.0	3.9	6.5	6.2	6.3	5.3	5.5
private consumption growth % yoy	6.4	8.3	8.7	2.4	6.3	6.2	5.8	5.1	5.2
Real export growth, % yoy	0.8	6.9	8.2	-3.2	1.3	8.8	4.8	0.0	5.3
Real import growth, % yoy	13.1	21.4	20.1	-18.6	24.0	9.8	10.4	6.7	5.9
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	1.1	3.9	6.7	0.2	2.1	4.7	2.6	3.7	2.2
CPI, % avg	2.0	1.8	5.8	2.9	1.5	3.4	3.7	3.0	3.0
Nominal wages, % yoy	7.1	5.0	12.8	23.1	-8.8	15.1	5.4	5.0	5.0
Credit extension to private sector, % yoy	15.9	29.9	14.3	10.4	20.1	14.2	13.8	10.5	6.5
Policy Rate (eop)	4.50	5.00	6.50	1.25	3.00	4.25	4.25	4.25	4.25
1 month inter-bank rate, %, eop	5.35	5.51	6.68	1.28	3.20	4.17	4.22	4.25	4.25
Long-term yield, %, eop	-	6.44	7.69	6.31	6.34	6.16	4.24	4.90	5.25
PEN/USD, eop	3.20	3.00	3.13	2.89	2.81	2.70	2.55	2.65	2.70
PEN/USD, avg	3.27	3.13	2.92	3.01	2.82	2.75	2.64	2.68	2.69
Balance of Payments, USD bn									
Current account	2.9	1.5	-5.3	-0.7	-3.8	-3.3	-7.1	-9.8	-10.9
% of GDP	3.2	1.4	-4.2	-0.6	-2.5	-1.9	-3.6	-4.6	-4.8
Trade balance	9.0	8.5	2.6	6.0	6.8	9.3	4.5	1.3	0.8
Exports	23.8	28.1	31.0	27.0	35.6	46.3	45.6	38.2	44.9
Imports	14.8	19.6	28.4	21.0	28.8	37.0	41.1	36.9	44.1
Service balance	-0.7	-1.2	-2.1	-1.2	-2.3	-2.1	-2.3	-2.1	-2.7
Income balance	-7.5	-8.3	-8.7	-8.4	-11.2	-13.7	-12.7	-12.7	-13.2
FDI, net	3.5	5.5	6.9	6.4	8.5	8.2	12.2	11.0	11.5
International reserves	17.3	27.7	31.2	33.1	44.1	48.8	64.0	68.8	68.2
Total amortisations	1.6	6.8	3.3	2.2	4.1	1.4	4.0	4.1	4.5
Public Finances, % of GDP									
Consolidated government balance	1.9	2.6	2.3	-1.6	-0.3	1.8	1.9	-0.6	-2.0
Consolidated gov primary balance	3.8	4.4	3.8	-0.3	0.8	2.9	2.9	0.3	-1.2
Public debt	33.1	29.8	24.1	27.2	23.5	21.8	19.9	17.4	17.4
of which Domestic	9.3	11.1	9.0	10.9	10.5	10.3	10.3	9.0	9.0
Foreign Assets & Liabilities, USD bn									
External debt	28.7	31.8	34.0	35.5	40.6	43.9	51.5	53.6	57.7
Public	22.0	20.1	19.2	20.6	19.9	20.2	19.0	17.7	19.0
External debt / GDP	31.2	29.8	26.8	28.0	26.4	24.9	25.8	25.3	25.4
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	21.6	20.6	19.5	20.1	22.9	24.2	26.3	28.7	31.0
Short-term debt/International reserves (%)	125.0	74.2	62.5	60.7	52.0	49.6	41.1	41.8	45.4

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	4.6	5.6	4.8	5.2	5.3	5.0	5.3	5.5	5.0
CPI, % yoy	2.6	2.8	3.2	3.7	3.5	3.2	2.6	2.2	2.0
Policy interest rate, %, eop	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Short-term market rate, % eop	4.22	4.31	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Long-term yield, %, eop	4.21	5.05	5.00	4.90	5.10	5.25	5.25	5.25	5.25
PEN/USD, eop	2.59	2.78	2.65	2.65	2.65	2.70	2.70	2.70	2.75

Source: National Sources, Citi Research

Venezuela

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- **Summary view** — Macroeconomic fundamentals continue to be weak although GDP growth in 2Q13 turned out better than expected. On the macroeconomic front, the main concerns continue to be the high level of annual inflation and USD scarcity for the private sector. That being said, the government is currently studying the creation of an additional FX market for importers which will complement CADIVI and SICAD. The announcement of this new FX mechanism along with the sources of USD that will be feed it will constitute the main economic development during the rest of the year. On the political front, we expect the government to intensify the confrontation with the opposition as the regional elections date approaches.

- **Things to watch** — Watch for measures aimed at solving the USD shortage experienced by the private sector.

- **Strategy** — In our view, the announcement of this new FX mechanism along with the sources of USD supply that will feed it will constitute the main economic development during the rest of the year.

Macroeconomics' blurred lines

We made an upward revision to our GDP projection after the positive 2Q13 GDP results, but still it is important to note that there are several risks on GDP performance. During 2Q13 GDP growth stood at 2.6% YoY, with the oil sector expanding 1.3% YoY and non-oil related activities expanding 2.9% YoY. In terms of sectors, it is worth mentioning the good results in manufacturing, which posted annual growth of 5.7% which contrasts with the negative results observed in the construction sector which fell 6%. The result came as a surprise to the market as expectations for growth were at -0.8% YoY. The better-than-expected result in manufacturing is puzzling though, as throughout the second quarter there were significant increases in goods' scarcity and inflation. These results lead us to revise our GDP growth projection up to 2.3%, which is the result of consumption expanding at a 3.8% annual rate, government spending growing 3.0% and investing contracting 2.4%. For next year, we expect GDP to post a 2.8% expansion, with consumption growing 3.1%, government spending increasing 3.3% and investment at a timid 0.10%. It is important to note that GDP performance still faces important downward risks, namely the bottlenecks in domestic production and USD scarcity.

Inflation: 40s are the new 20s.

In August, the National CPI figure displayed a monthly change of 3.0% MoM taking the annual print to 45.4%. As we have mentioned before, the increase in prices is a complex process that seems to be driven by supply rather than demand factors, plus the scarcity of foreign currency. Our forecasts show annual inflation should reach its peak in September-October with some mild deceleration in November and December. Nonetheless, this will not be enough to take inflation figures below 40%. That being said, our expectations for annual CPI inflation now stand at 42% by yearend. Going forward, the most important announcement to fight inflation will be the evolution of SICAD auctions, the speed at which CADIVI disbursements are made to the private sector and the creation of an alternative FX mechanism to supply USD to importers.

The new FX mechanism

Although President Maduro mentioned that the features of the new market will be announced after his visit to China, at the time of this writing no official information regarding the reach and the scope of this platform had been provided. In our view, this announcement has to come with the modification of the FX transaction and Capital Market laws, something we believe will be easily approved by the National Assembly once the government presents the final bill. In our view, the announcement of this new FX mechanism along with the sources of USD supply that will feed it will constitute the main economic development during the rest of the year.

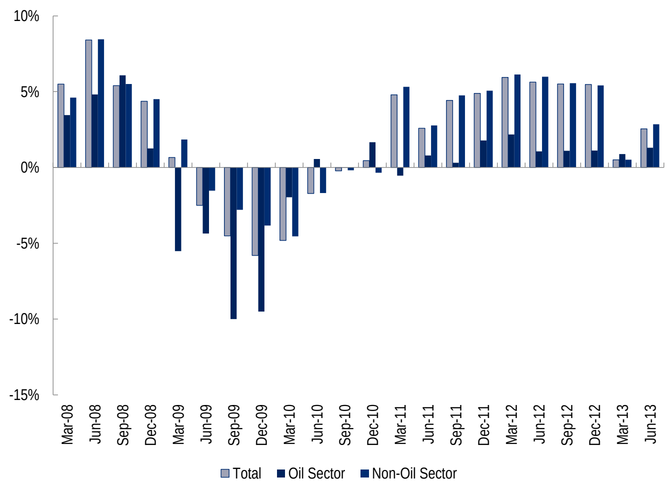
We believe that the main variables to follow for the rest of the year are the evolution of oil prices, international reserves and government's special funds. With no fundamental changes in the fiscal or external imbalances in the near future, the main variables to assess vulnerabilities in the overall macroeconomic outlook should be focused on two fronts: oil revenue and government resources.

Regarding oil revenue, it should rely almost exclusively on oil prices, at least in the short term. According to September's monthly oil market report released by OPEC, Venezuela's crude oil production stood at 2.35 million barrels per day (tbpd) in August, which represents a 5.8 tbpd day increase in August when compared to July's print. In addition, based on secondary sources, this report continues to show that Venezuelan oil production represented 7.8% of OPEC's production. In contrast, with information gathered by the Venezuelan government, oil production stands at 2.77 million of barrels per day, increasing 19.3 thousand barrels per day in the same month of August. As we have mentioned before, we expect OPEC's oil production data for Venezuela to oscillate around 2.35 million barrels per day in 2013. Any long-term increase in Venezuelan oil production relies on the evolution of the Orinoco Basin projects.

In addition to oil prices, the of trend government resources should be an important element to asses Venezuela's external vulnerabilities. In our view, the sharp contraction in these resources signals Venezuela's strong external imbalances and the government's limited room to conduct an expansive fiscal policy this year. Our estimations suggest that liquid government resources peaked in 2H11 and have been showing a significant downtrend since then. We think that the evolution of this variable is an important indicator that should be followed, since it has repercussions for both government solvency and its ability to provide (or not) more resources for imports, given the strong USD shortages being experienced by the private sector.

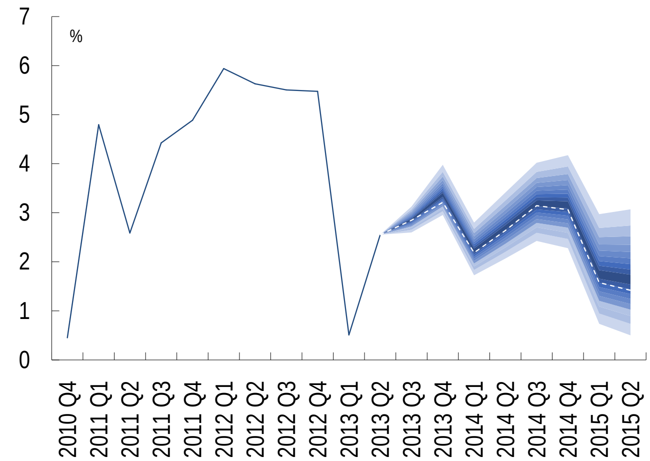
Political outlook. There should be no major highlights in the political front until the regional elections for majors, scheduled for December. The regional elections could be an important opportunity for the opposition to partially leverage the tights results obtained in the presidential elections. In our view, the opposition strategy will focus on obtaining more votes than the incumbent government's party, which not necessarily translates into winning the majority of cities. Nonetheless, the PSUV and its approved candidates have strong support from the incumbent government, making the elections challenging for opposition candidates. As the election date approaches we should expect an intensification in the confrontational speech of the two political colliding forces from President Maduro and the opposition's leader Henrique Capriles.

Figure 278. 1Q13 GDP growth displayed higher-than-expected results



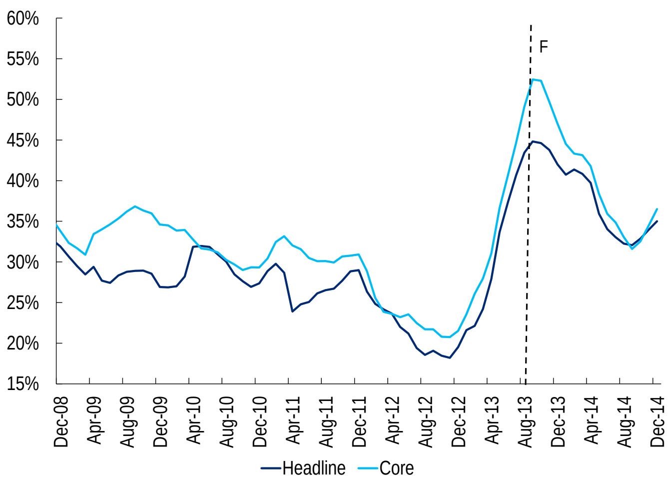
Source: BCV and Citi Research

Figure 279. ... Which lead to a GDP forecast change



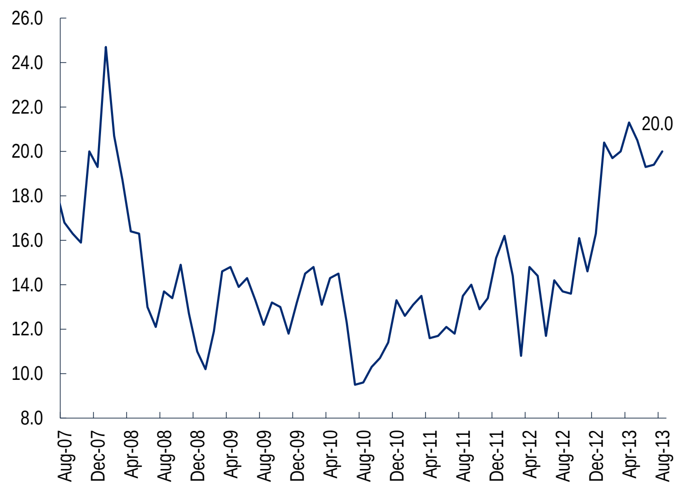
Source: BCV and Citi Research

Figure 280. The inflation outlook is not favorable...



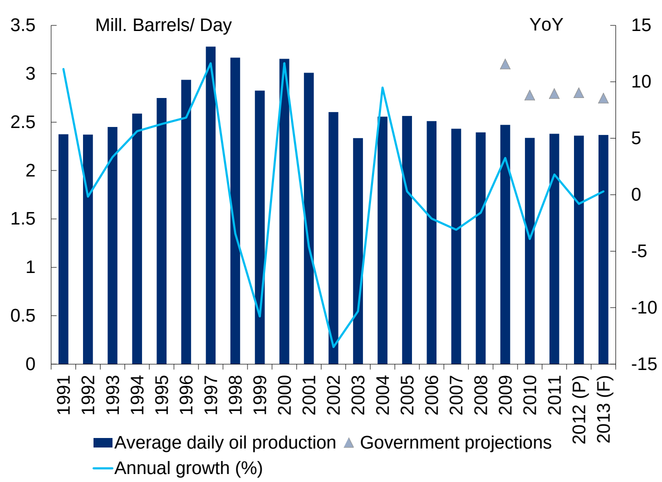
Source: BCV and Citi Research

Figure 281. ... As a result of supply constraints



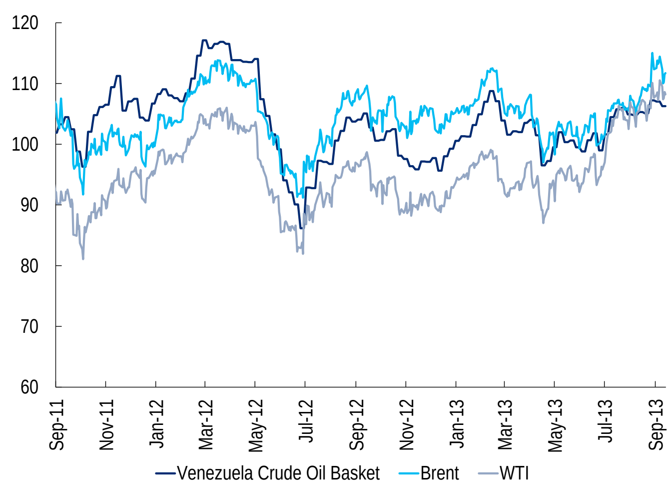
Source: BCV and Citi Research

Figure 282. Oil production should remain relatively constant



Source: Bloomberg and Citi Research

Figure 283. ... Making oil prices the main driver of oil revenue



Source: Bloomberg and Citi Research

Figure 284. Venezuela Economic Indicators

	2006	2007	2008	2009	2010	2011	2012	2013F	2014F
Summary Data									
Nominal GDP, USD bn	188	213	298	284	257	298	361	349	344
Nominal GDP, local currency bn	394	495	678	707	1,017	1,357	1,642	2,385	3,309
GDP per capita, USD	6,940	7,738	10,683	9,996	8,925	10,188	12,141	11,582	11,236
Population, mn	27.0	27.5	27.9	28.4	28.8	29.3	29.7	30.2	30.6
Unemployment, % of labour force	8.4	6.2	6.1	6.6	6.5	6.5	5.9	5.9	6.1
Economic Activity									
Real GDP, yoy avg	9.9	8.8	5.3	-3.2	-1.5	4.2	5.6	2.3	2.8
Real investment growth % yoy	36.3	28.2	2.2	-19.1	1.0	15.2	24.1	-2.4	0.1
Real consumption growth % yoy	14.3	16.3	6.0	-2.1	-1.1	4.4	6.9	3.7	3.2
private consumption growth % yoy	15.5	16.9	6.3	-2.9	-1.9	4.0	7.0	3.9	3.1
Real export growth, % yoy	-3.0	-7.6	-1.0	-13.7	-12.9	4.7	1.6	0.0	4.1
Real import growth, % yoy	34.8	33.0	1.4	-19.6	-2.9	15.4	24.4	-0.3	1.3
Prices, Money & Credit									
CPI, % yoy (Citi estimates)	17.0	22.5	31.9	26.9	27.4	29.0	19.5	42.0	35.0
CPI, % avg	13.7	18.7	31.4	28.6	29.1	27.1	21.1	35.9	35.6
Nominal wages, % yoy	19.3	20.7	25.0	23.7	24.5	27.0	30.0	35.0	30.0
Credit extension to private sector, % yoy	94.0	43.3	30.6	18.0	27.6	36.8	55.3	71.0	64.0
Policy Rate (eop)	5.90	18.00	28.10	14.00	12.50	-	-	-	-
1 month inter-bank rate, %, eop	5.90	18.00	28.10	11.30	12.30	14.50	14.50	14.50	14.50
Long-term yield, %, eop	5.41	12.00	12.00	14.38	13.02	13.93	9.30	9.09	8.90
VEF/USD, eop	2.15	2.15	2.15	2.15	4.29	4.29	4.29	6.30	9.50
VEF/USD, avg	2.15	2.15	2.15	2.15	4.20	4.29	4.29	6.13	9.50
Balance of Payments, USD bn									
Current account	26.5	18.1	37.4	8.6	12.1	27.3	11.0	12.9	28.6
% of GDP	14.1	8.5	12.5	3.0	4.7	9.1	3.1	3.7	8.3
Trade balance	32.0	23.0	45.7	19.2	27.1	46.4	38.0	36.1	47.3
Exports	65.6	69.0	95.1	57.6	65.7	92.7	97.3	90.2	92.1
Imports	33.6	46.0	49.5	38.4	38.6	46.2	59.3	54.1	44.8
Service balance	-4.4	-7.0	-8.4	-7.6	-9.2	-10.7	-16.0	-12.0	-7.7
Income balance	-1.0	2.5	0.7	-2.7	-5.3	-7.9	-10.0	-10.3	-10.5
FDI, net	-2.0	1.0	-0.9	-4.9	-1.5	5.1	0.8	0.2	-3.4
International reserves	37.4	34.3	43.1	35.8	30.3	29.9	26.5	25.0	23.5
Total amortisations	7.4	4.0	7.5	4.3	6.9	11.0	4.1	6.8	4.5
Public Finances, % of GDP									
Consolidated government balance	-1.5	-2.6	-2.6	-5.8	-6.0	-5.0	-5.0	-4.0	-4.0
Consolidated gov primary balance	0.6	-1.0	-1.2	-4.4	-5.5	-3.5	-3.5	-2.5	-2.5
Public debt	23.4	25.5	21.6	31.3	42.0	44.2	43.4	44.0	45.3
of which Domestic	9.2	7.3	4.5	7.5	8.9	11.4	14.1	13.1	12.7
Foreign Assets & Liabilities, USD bn									
External debt	41.8	56.3	66.4	81.9	97.1	110.7	118.9	121.8	126.0
Public	26.6	38.7	50.9	67.4	85.3	98.0	105.8	108.0	112.0
External debt / GDP	22.3	26.5	22.2	28.9	37.7	37.1	33.0	34.9	36.6
External debt / XGS	-	-	-	-	-	-	-	-	-
Short-term debt	11.5	18.1	19.9	17.4	16.8	16.7	21.1	20.4	20.1
Short-term debt/International reserves (%)	30.8	52.8	46.1	48.4	55.3	55.8	79.6	81.7	85.5

Quarterly Economic Indicators									
	2013 Q1F	2013 Q2F	2013 Q3F	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F
GDP, % yoy	0.5	2.6	2.7	3.2	2.3	2.8	2.9	3.1	2.9
CPI, % yoy	24.2	37.3	44.8	42.0	40.8	34.0	32.1	35.0	36.4
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
Short-term market rate, % eop	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	9.22	10.95	14.50	15.00	15.50	15.00	14.40	14.50	-
VEF/USD, eop	6.29	6.29	6.30	6.30	9.50	9.50	9.50	9.50	9.75

Source: National Sources, Citi Research

Notes

Appendix A-1

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Rohini Malkani is on a three months leave of absence for the period July 15 2013 to October 14 2013. During this period, she will be working for the Ministry of Finance, India and she will cease all normal course business activity as an Economist at Citi.

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