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Emerging Markets
**GEMS**

# Emerging Markets Macro and Strategy Outlook

## Prospects For 2015 And Beyond

- EM's prospects in 2015 are set to be governed by familiar themes: i) China's slowdown and its consequences; ii) the impact of falling commodity prices; and iii) the prospect of US monetary tightening. EM should face a challenging, though not insurmountable, year. After all, returns from (and flows into) EM were positive in 2014 in spite of a wide set of challenges.
- One of the most important changes for EM, we think, is that economic developments in China are becoming increasingly less EM-friendly. Chinese income growth has fallen as the authorities try to manage the economy's high leverage, and the consequent fall in Chinese import growth has been associated with much weaker global commodities inflation. And as the economy rebalances, there is also evidence of a fall in China's marginal propensity to import.
- Falling commodity prices is an important consequence of all this. The fall in commodity prices generally – and oil prices specifically – was a defining feature of EM in 2014, and we suspect that this will continue to shape EM in 2015 and beyond. Weaker commodity prices in EM the last few quarters have had a notable effect on macroeconomic performance across the group of EM commodity exporters; such that it is now possible to argue that a principal dividing line in EM is between manufacturing-based economies and commodity-based ones.
- Uncertainty about capital flows will remain next year, we believe. Flows into EM have some cyclical characteristics, and the prospect of US monetary tightening will not help. Yet there are reasons not to be too pessimistic. There is evidence, for example, of a structural decline in 'home bias' in recent years, which should support demand for EM assets. And the prospect of higher US rates may be offset to some extent by monetary loosening by ECB and BOJ. Yet net FDI flows to EM fell below 1% GDP for the first time in 15 years, so EM capital accounts could be more fragile.
- Capital outflow from China is a theme worth monitoring, since the scale of speculative inflows to China in recent years has been exceptional. Although there is little risk of a balance of payments crisis, large capital outflows could pose an additional threat to growth, as well as helping to bias RMB towards weakening.
- Another theme worth watching is the potential for deflation in EM as commodity prices fall. We highlight parts of Asia – including China – as having high vulnerability to deflation, in addition to those countries in EM that are already there. A deflation scenario in China would also raise the chance of a weaker RMB.
- On balance we expect EM spreads to widen by 15bp next year but with significant volatility, and with particular difficulty for quasi-sovereigns. In local markets, our themes are broadly negative on EMFX and more constructive on duration.

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*With thanks to*
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# Prospects for 2015 and beyond

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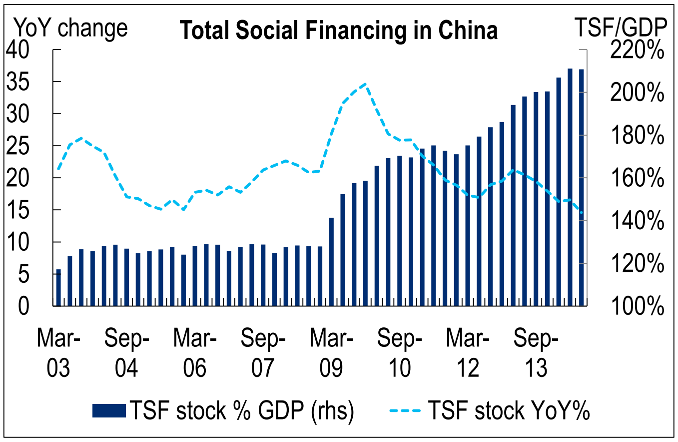
**EM's prospects in 2015 are set to be governed by familiar themes: i) China's slowdown and its consequences; ii) the impact of falling commodity prices; and iii) the prospect of US monetary tightening**. Perhaps the most reliable observation one can make about all three of these forces is that they will continue to pressure emerging economies to find a 'new model' for GDP growth. The biggest rewards will be for countries making effort to introduce structural reforms. That helps explain why Mexico and India – the two most promising reform stories in EM these days – are likely to see some of the biggest gains in GDP growth over the next two years.

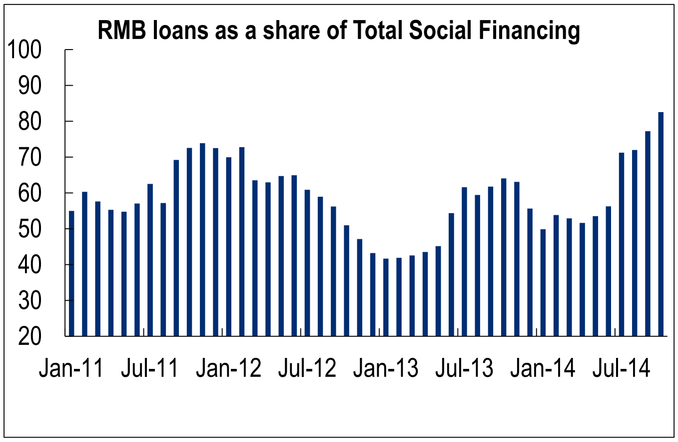
**Economic developments in China are becoming increasingly less EM-friendly**. One puzzle in 2014 was this: why did Chinese policymakers fail to implement a bigger stimulus when it was clear that GDP growth would undershoot the 7.5% target which, earlier in the year, had seemed so important to them? There are two likely answers to the puzzle, neither of which is very promising for EM. The first is that Chinese policymakers are making a more serious effort to defuse the risk of a recession by managing down the rate of credit growth in an orderly way. There's certainly some evidence of this. The flow of Total Social Financing in the first 10 months of 2014, for example, was 26% of GDP, down from 31% in the same period of 2013. Figures 1 and 2 further help to illustrate what's going on. The challenge of course lies in the fact that the stock of credit rose from 128% of GDP in 2007 to 200% in 2013. This is making it imperative to manage down the rate of credit growth (Figure 1) and to 'clean up' the composition of Chinese financing, which is evidently coming out of the 'shadows': in recent months, plain vanilla yuan loans have made up over three-quarters of total financing, while that ratio was less than a half in late 2012 and early 2013.

Figure 1. Chinese credit growth is under downward pressure, a sensible response to the rise in the stock of 'TSF'…




Source: CEIC, Citi Research

Figure 2. …while at the same time the composition of Chinese financing is becoming more 'plain vanilla'

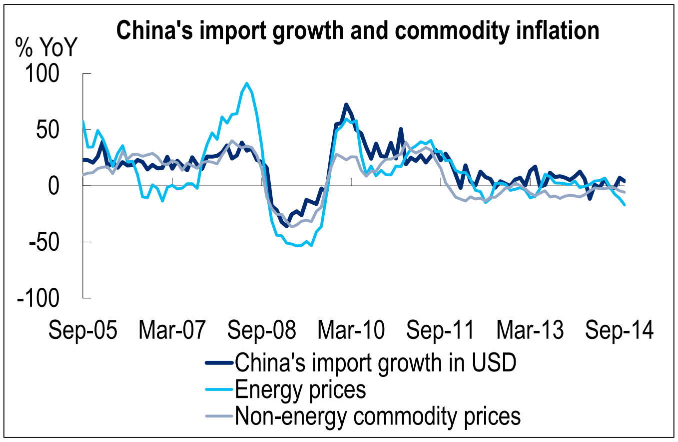



Source: CEIC, Citi Research

**China seems to be managing down its 'bubble' risks.** And another possible answer to the 'China puzzle' this year is that employment growth has been very strong: 10.8 million jobs were created in the first nine months of the year, surpassing the 10 million target set for the whole of 2014. If Chinese policymakers can achieve their employment targets with slower GDP growth, then a slowdown may be more tolerable to them. Conceivably such strong job creation – in spite of the fact that China is set to become home to the world's biggest population of industrial robots – may reflect the strong performance of the under-recorded services sector: Chinese services growth has been faster than industrial growth since 2012.

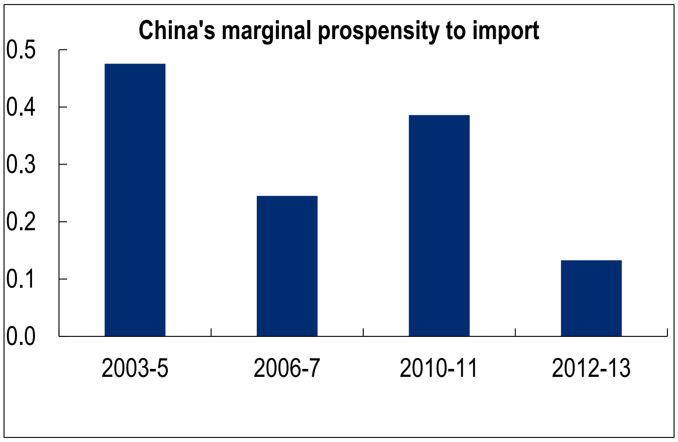
**The consequence of diminished Chinese credit stimulus and a stronger services sector weakens the links between China and EM**. As credit stimulus diminishes, so does import growth, and Figure 3 highlights the link between declining Chinese import growth and the fall in global commodity price inflation. In addition to this, we think the rise of China's services sector may be leading to a change in the entire relationship between Chinese income growth and import growth: the marginal propensity to import is falling (Figure 4). One further implication of the rise in China's services sector is that it provides some evidence of a 'domestic rebalancing' of the Chinese economy, by which the economy becomes less investment-driven over time, while the ratio of consumer spending to GDP rises. Indeed, the data up to 2012 – the latest for which we have a breakdown – suggests that imports of consumer goods has been growing more rapidly than imports of capital goods. And since the biggest suppliers of consumer goods to China are to be found in DM rather than EM, it makes sense to expect China to be a less friendly factor for EM in the next few years.

**Figure 3. Not only is weaker Chinese import growth contributing to lower commodity prices…**




Source: Citi Research based on data provided by Haver Analytics

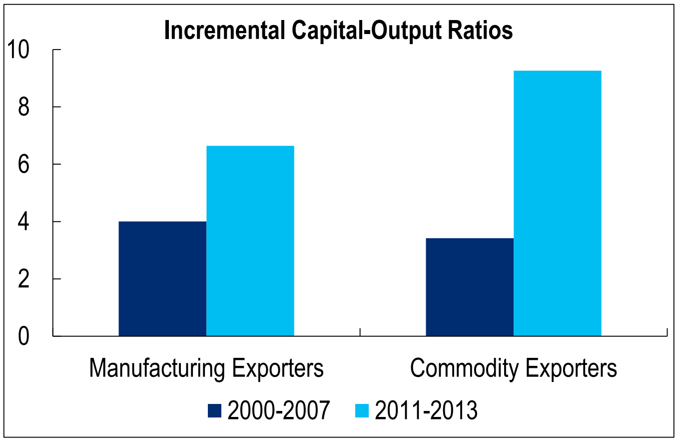
**Figure 4. …but the entire relationship between Chinese income growth and Chinese imports is becoming less EM-friendly**




Source: Citi Research

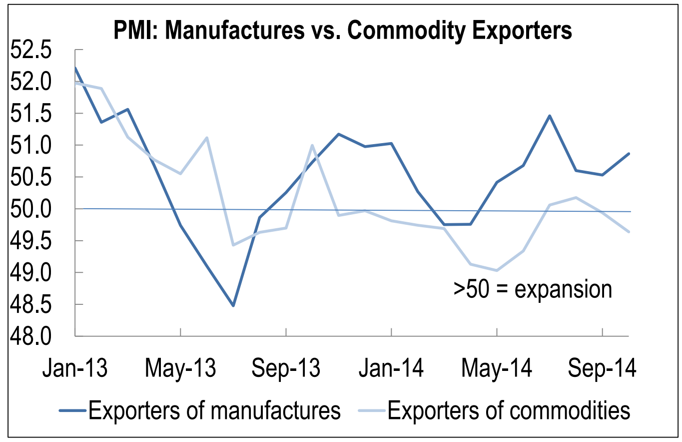
**Falling commodity prices is a very important consequence of all this**. The fall in commodity prices generally – and oil prices specifically – was a defining feature of EM in 2014, and we suspect that this will continue to shape EM in 2015 and beyond. The significance of weaker commodity prices in EM in the last few quarters has had a notable effect on macroeconomic performance across the group of EM commodity exporters. As a rule, EM's commodity exporters are suffering weaker economic activity, lower export growth, worse current account balances, greater currency pressure, higher inflation, lower investment efficiency and bigger risk premia than EM's manufacturing economies. Figure 5 illustrates these gaps in performance, by showing how commodity exporters have suffered a bigger increase in the Incremental Capital-Output Ratio than exporters of manufactured goods since 2011. A lower level of investment efficiency among commodity exporters is particularly unpleasant when combined with weaker economic dynamism (Figure 6).

**Figure 5. Here is an illustration of the greater challenges being faced by commodity exporters…**




Source: Citi Research. Manufacturing exporters are China, Czech, Hungary, India, Israel, Korea, Malaysia, Mexico, Philippines, Poland, Romania, Thailand, Turkey; commodity exporters are Argentina, Brazil, Chile, Colombia, Indonesia, Peru, Russia, South Africa.

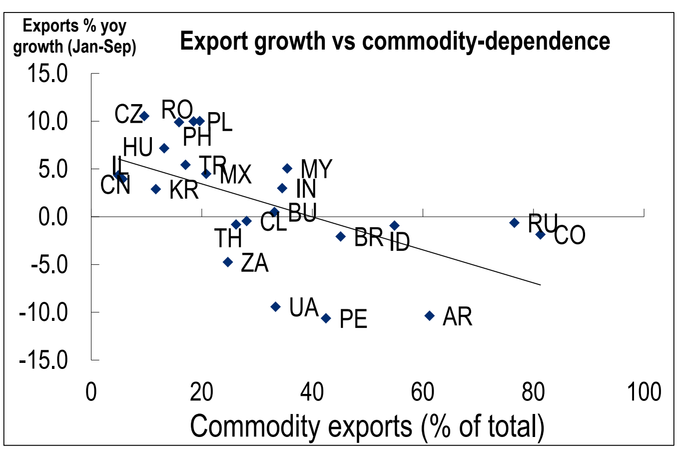
**Figure 6. …which might help explain why commodity exporters' economic performance seems weaker than others**




Source: Citi Research

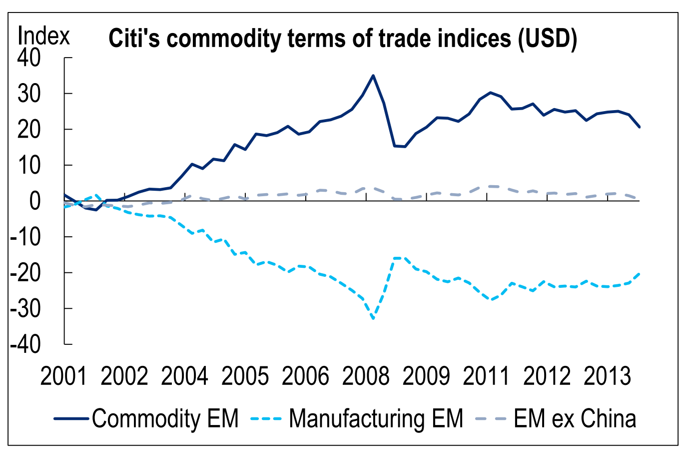
**It has become clear this year that the more commodity-dependent an economy is, the worse its export performance is likely to have been.** (See Figure 7). This partly explains why, among the 'Fragile 5' for example, it is only the manufacturing exporters – India and Turkey – that have been able to reduce their current account deficits since the 'taper shock' of May 2013). Further weakness in commodity prices is likely to keep these trends intact, not least because, as Figure 8 shows, the terms of trade for EM's commodity exporting countries is still quite elevated in historical terms. This reflects the fact that, for example, the real price of metals is still over 50% higher than its 20-year average; while the real price of energy is over 70% higher. In other words, the deflation of a long-established commodities boom is likely to play out over an extended period, and the full effects on EM have still to play out. In this environment, it is likely to be commodity-importing EM – those with deficits and with surpluses – that benefit.

**Figure 7. The more commodity-dependent you were in 2014, the worse your export growth is likely to have been…**




Source: Citi Research

**Figure 8. …and the decline in the terms of trade for commodity exporting EMs may still be in its early stages**




Source: Citi. 'Commodity EM' is a GDP-weighted average of Brazil, Chile, Colombia, Peru, Argentina, Indonesia, South Africa, Russia; 'Manufacturing EM' is a GDP-weighted average of Czech, Hungary, Poland, Turkey, Israel, India, Philippines, Korea, Thailand, Malaysia, Mexico. A change of +5 in the in the index between any two dates means that export prices have outperformed import prices by 5% in this period.

**Commodity-exporting emerging economies with current account deficits are likely to remain in the spotlight**. In 2013, the most relevant distinction within emerging markets was that between countries with current account deficits and those with current account surpluses. Because capital flows to EM were threatened by the 'taper shock' of May last year, the countries most exposed were those with the largest external financing needs (a proxy for which is the current account deficit). What's happened in 2014 is that another distinction has become relevant: that between commodity-exporting EMs and manufactured-exporting EMs. We think this distinction will remain relevant in 2015, and it makes room for a conceptualization of EM along the lines presented in Figure 9. It seems intuitive that the countries least likely to suffer capital outflows or macroeconomic disruption are those in the upper-right-hand quadrant: manufacturing economies with current account surpluses. Equally, it seems intuitive that the most vulnerable countries in EM will remain those in the lower-left-hand quadrant, commodity exporters with current account deficits. A trickier question is: how to evaluate the relative vulnerability of the intermediate quadrants? In general we think that commodity-exporting economies – regardless of whether they are running current account surpluses or deficits – will have to go through a potentially painful adjustment process.

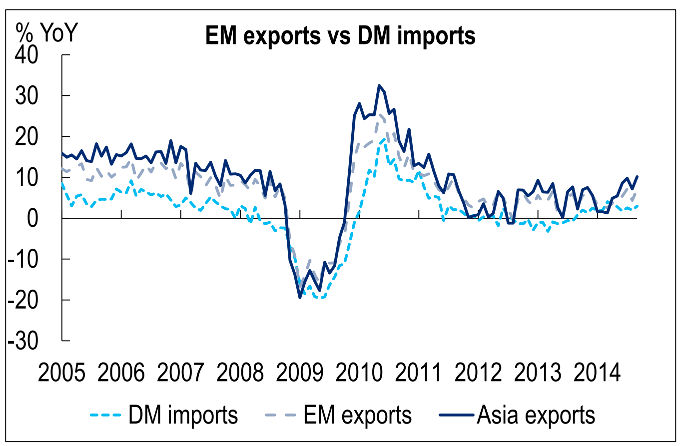
**Manufacturing economies by contrast – especially those in Asia – are making the most of relatively weak external demand conditions.** Figure 10 shows that the prospects for export-led growth are not great, but not traumatically bad (and probably not as bad as we had assumed a year ago). Import volume growth in DM is far from robust, compared to the years before the Lehman crisis, but at least it's positive, in contrast to most of 2013. And EM export growth overall is stronger than DM import growth, implying a rise in market share. However, Figure 10 illustrates that this is substantially an Asian story, and therefore one associated with manufactured goods, not commodities. Asian exporters have been able to stage strong sales growth – which helps to explain the marked rise in China's and Korea's trade surpluses – and flows of FDI from China could well help support this story. China's outward direct investment to Asia last year was $75bn, from near-zero 10 years ago.

**Figure 9. Commodity exporters with current account deficits seem likely to remain among the most vulnerable countries within EM…**

| | Commodity Exporting | Manufactures-exporting |
|---|---|---|
| Current Account Surplus | Russia<br>Nigeria<br>Venezuela | Korea<br>Hungary<br>Poland<br>Israel |
| Current Account Deficit | South Africa<br>Brazil<br>Indonesia<br>Peru | India<br>Turkey |

Source: Citi Research

**Figure 10. …while a strong performance in Asia is helping EM exports grow more strongly than DM imports in recent months**

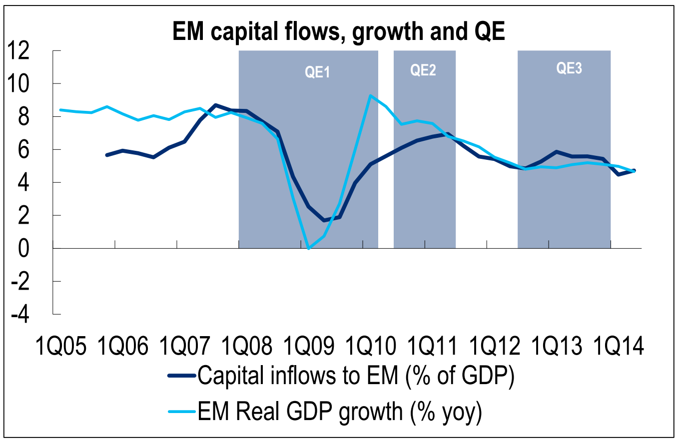



Source: CPB; Citi Research

**The vulnerability of fragile EMs – whether that fragility is expressed in the current account balance or in a country's commodities-dependence – will depend on the outlook for capital flows, and here the question is: what impact will an imminent US rate hike have on capital flows to EM?** While it is true that we are not expecting US monetary tightening until late-2015, the increasing proximity of a

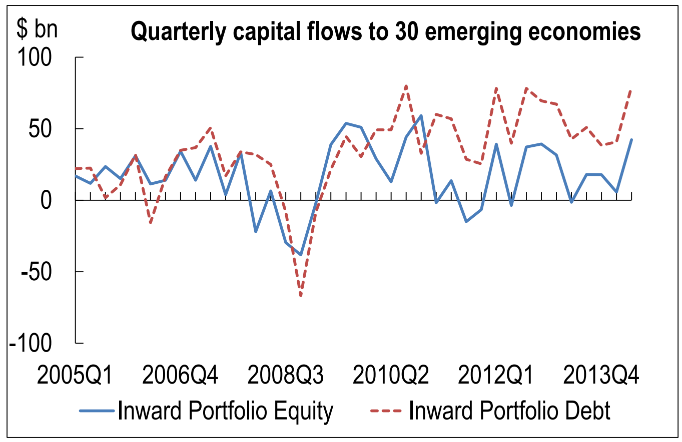
US rate hike will make this a dominant theme in 2015. On balance, we think that US monetary tightening in late 2015 will cloud the outlook for capital flows to EM, but is unlikely to be a catastrophe. The experience of the past 40 years suggests that capital flows to EM can go into reverse during periods of US monetary tightening. Figure 11 suggests that private capital flows to EM have been supported by successive rounds of QE in the past five years, with the implication that the end of QE and its aftermath might create a more stressful environment for these flows. And Figure 12 adds an important layer to this by showing that debt flows have held up better than equity flows since 2011, which marked the beginning of the EM growth slowdown. Debt flows seem – by definition – more sensitive to interest rate differentials, and so those flows were sustained even as EM's growth outlook deteriorated in 2011. In other words: if US monetary tightening threatens to shrink interest differentials after a long period of US rates at the zero lower bound, then debt inflows could be threatened.

**Figure 11. Private capital flows to EM do seem to have some cyclical characteristics…**




Source: Institute of International Finance; Citi Research

**Figure 12. …and portfolio fixed income flows have held up better than equity flows against the background of falling EM growth since 2011.**




Source: IIF; Citi Research

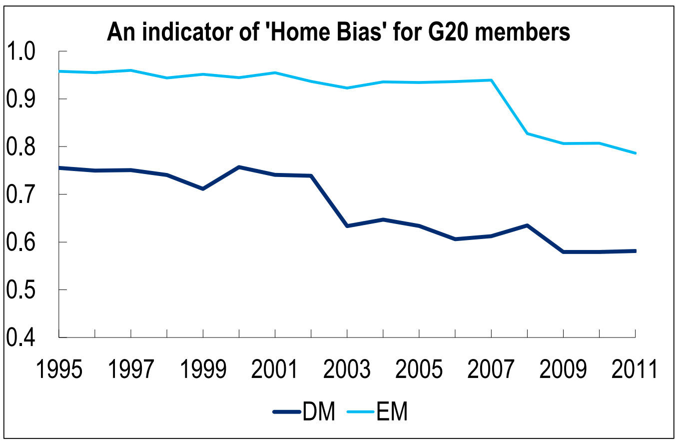
**That said, we think there are three factors that argue against a catastrophic view about the outlook for capital flows to EM**. The first 'optimistic' argument about the future of capital flows to EM relies on a change in the composition of capital flows in the past couple of decades: commercial banks are no longer the dominant supplier of cross-border flows to EM; institutional investors are. In the late 70s/early 80s, commercial banks accounted for half of the net private capital flows to emerging economies; yet in the past four years this ratio has been closer to 10%. This is important because commercial banks are the creditors most likely to have the highest degree of sensitivity to an increase in the front-end of the US curve; they fund themselves largely with deposits. Though, as we discuss below, commercial bank flows to China have been exceptionally large in recent years, and a capital outflow from China could affect EM negatively by creating a threat to Chinese growth.

**A second 'optimistic' argument comes from the idea that 'home bias' among institutional investors has declined consistently over time**. We follow the Bank of England's methodology in calculating 'home bias' for institutional investors in equity markets, relying on the 'External Wealth of Nations' database[1]. On a scale of 1 to 0, where 1 represents complete 'home bias' and 0 its complete absence, the

[1] Available at http://www.philiplane.org/EWN.html. The indicator of home bias is given by: 1 – [country holdings of foreign equity compared to country's total holdings of equity / other countries' total share of world equity market capitalization]

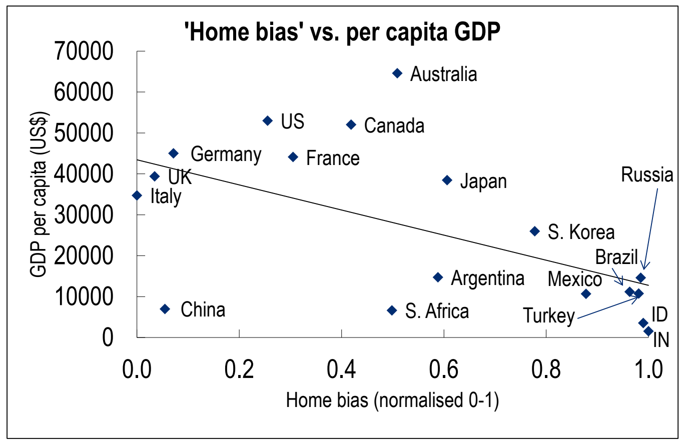
advanced economy members of the G20 have seen their home bias fall sharply in recent years: from 0.76 in 1995 to 0.58 in 2011 (Figure 13)[2]. This is likely to be a structural change, albeit one that is sensitive to growth. Figure 14 shows that the decline in home bias is heavily influenced by growth of per capita GDP, and the increase in DM's home bias in the early 2000s (Fig 13 again) was prompted by weak growth during that period. Equally, though, the decline in 'home bias' among emerging members of the G20 – China in particular – could help support the structural increase in the demand for EM assets, though as we argue below, capital outflows from China seem more likely to be a threat to EM risk appetite than a boon.

**Figure 13. 'Home bias' has declined in a steady fashion, particularly among institutional investors in advanced economies…**




Source: Citi Research, based on Bank of England methodology

**Figure 14. …though further declines in 'home bias' are likely to require increases in per capita GDP**

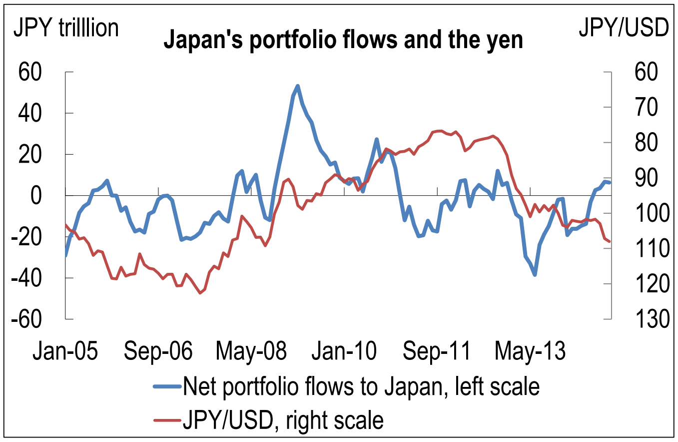



Source: Citi Research, based on Bank of England methodology

**A third 'optimistic' argument comes from the fact that US monetary tightening in 2015 will be taking place against a background of 'monetary policy divergence'**. US monetary tightening in 2015 is set to take place against a background of 'monetary policy divergence' in the advanced economies: the fact that rates in Japan and the Eurozone should stay very low will help to mitigate the impact of rising US rates. Yet the full impact of this divergence is unclear. The dollar still plays an exceptionally important role in shaping overall risk appetite, particularly towards EM. In addition, we have evidence from April-May 2013: the announcement of monetary expansion in Japan was insufficient to offset a negative surprise from the Fed just a few weeks after. Moreover, it isn't clear that monetary loosening in Japan has been associated with a large surge in capital outflows to any recipient, let alone EM. Figure 15 shows no consistent pattern of net outflows in the aftermath of Japanese monetary loosening in the past 18 months.

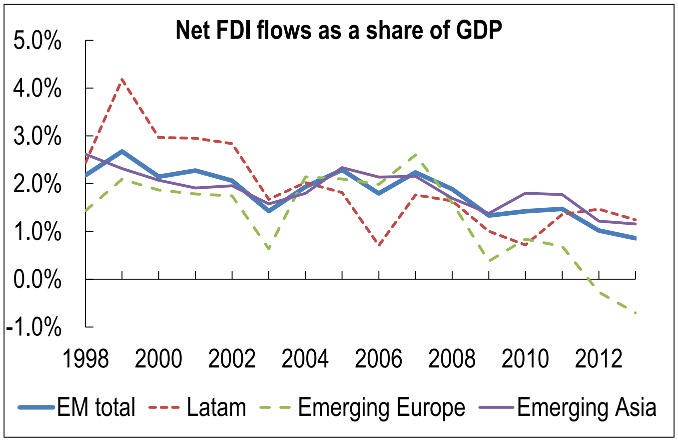
[2] See Bank of England Speech, 'The Big Fish Small Pond Problem', Andrew Haldane, April 2011. http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech489.pdf

Figure 15. Japanese monetary loosening has not produced large capital outflows, limiting EM's gain from G3 monetary divergence...




Source: BoJ, Citi Research

Figure 16. ...and meanwhile net FDI inflows to EM seem to in a state of decline, falling below 1% GDP last year for the first time in 15 years




Source: IMF, Citi Research

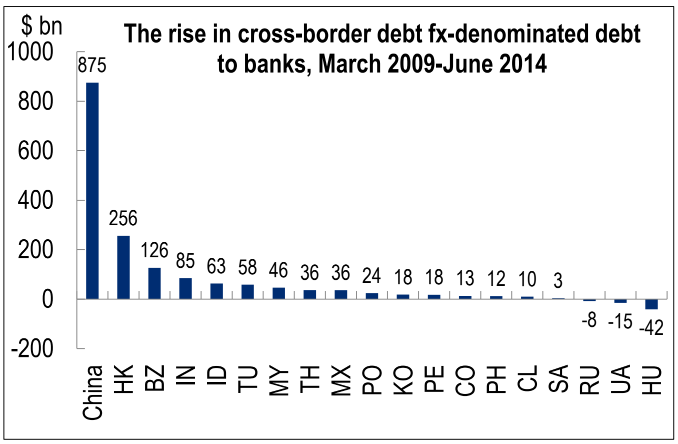
**But none of these factors argues for any surge in capital flows to EM, and meanwhile FDI flows seem rather weak**. 2013 saw net FDI inflows to EM fall below 1% of aggregate GDP for the first time in 15 years. Indeed, the fall in FDI flows to EM isn't something that's happened all of a sudden, but is rather the continuation of a trend (Figure 16). What explains net FDI flows to EM is a complicated business. One concern is that what used to be a virtuous circle – high net FDI flows and high growth – may be turning into something more like a vicious one. But our immediate concern is that a weaker level of FDI flows leaves emerging economies that much more vulnerable to a withdrawal of capital by other creditors, namely banks and institutional investors.

**One country where the risk of capital outflows might be worth watching is China**. We made the point above that commercial banks are no longer a dominant supplier of cross-border funding to EMs, as they were 20 or 30 years ago. Yet China has been on the receiving end of an exceptionally large inflow from banks. Data from the BIS on cross-border bank lending to EM show that international lending to China has risen very dramatically in the past few years (Figure 17). Since the first round of QE, China's international debt to banks has risen by almost $900bn, creating a stock of external bank debt of over $1 trillion (more than half of this rise took place in the past 2 years), some 10% GDP. Of this stock, 80% has original maturities of less than one year. As Figure 18 shows, China relies more heavily on short-term external borrowing than any other country bar Hong Kong (whose own short-term borrowing is helping to fund short-term lending to China, which sources over 40% of its borrowing from HK). So the question is: what is a country with a current account surplus doing borrowing so many dollars at such short maturities? One possible answer, often cited, is that it relates to trade finance. Yet China's international borrowing has risen considerably faster than its trade flows have in the past few years: BIS-reported claims on China were equal to 56% of its trade flows in 2011, but that multiple had risen to 100% in June 2014. A better explanation of these capital flows, we think, is that they are largely speculative.

**It is sensible to argue that the vast bulk of this largely short-term debt has been accumulated in the context of speculative capital inflows: China's currency has had 'one-way-call' characteristics since 2010, and dollar funding costs have been exceptionally low**. Now these two factors are in transition: the Chinese currency has been exhibiting more two-way risk in recent months and, as US rates rise, there is a much greater chance that China suffers speculative

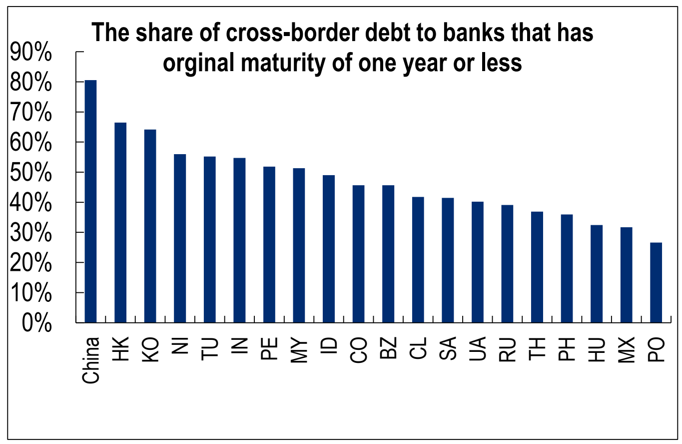
outflows rather than speculative inflows – as has been the case in the past few months – particularly if Chinese rates continue to fall next year, as we expect. A large speculative outflow from China can easily be financed by the central bank. But a large capital outflow could, we think, increase some of the downside risks to Chinese growth: large capital outflows wouldn't easily be consistent with the kind of risk appetite that's needed to support lending in a very credit-dependent growth model. At the same time, sustained capital outflows – of which there has already been some evidence since May 2014 – could also set the stage for a more depreciated renminbi (which is in Citi's forecasts). And another factor to consider in thinking about the renminbi next year is the risk of deflation: if prices fall, currency depreciation could become an attractive policy tool, as it seems to be for many other economies these days.

**Figure 17. China's rise in short-term debt to banks may presage the risk of capital outflows…**




Source: Bank for International Settlements; Citi Research

**Figure 18. …especially given China' reliance on *short term* borrowing**




Source: BIS, Citi Research

**Is there deflation risk in EM?** One of the consequences of falling commodity prices – and in particular, falling energy prices – is that it can increase the chance of a falling price level. Of course, falling commodity prices isn't the only deflationary force around, but there is a sense in which the fall in these prices can help to tip consumer price inflation into negative territory. A temporary fall in the price level induced by falling oil prices may not be of much concern, but to capture the extent of the deflationary risk in China specifically – and in EM generally – we have adapted an approach developed by the IMF[3] which attempts to rank countries' vulnerability to deflation. The model scores countries across 13 variables, including the output gap; developments in consumer, core, and producer inflation; the evolution of the real exchange rate; credit and money growth; and asset prices. A summary of the model's results is in Figure 19, and assigns relatively high deflation risk to countries already in deflation – Poland, Czech, Hungary, Israel – as well as some others, in Asia especially. What's striking though is that inflation expectations (Figure 20) do not seem to have adjusted to the possibility of deflation in these countries.

[3] See 'Gauging Risks for Deflation', IMF Staff Position Note SPN/09/01, January 2009. https://www.imf.org/external/pubs/ft/spn/2009/spn0901.pdf

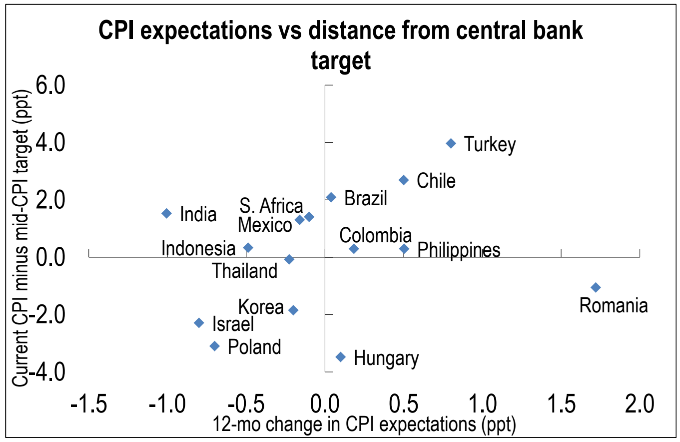
**Figure 19. A summary of 'deflation risk' in EM shows that parts of Asia are at risk of joining Czech, Hungary, Israel and Poland into deflation…**

**Index of Deflation Risk**

| Minimal <0.2 | Low 0.2 to 0.3 | Moderate 0.3 to 0.5 | High >0.5 |
|---|---|---|---|
| India<br>Indonesia<br>Mexico | Argentina<br>Brazil<br>Philippines<br>Russia<br>S. Africa<br>Turkey | Chile<br>China<br>Korea<br>Malaysia<br>Peru<br>Thailand | Czech<br>HK<br>Hungary<br>Israel<br>Poland<br>Singapore<br>Taiwan |

Source: Citi Research

**Figure 20. …and while inflation expectations have fallen most in countries with low inflation, there might be more to come**




Source: Citi Research

**Our model (reassuringly) assigns high deflation risk to countries already in deflation – Poland, Czech, Hungary, Israel – as well as others in Asia**. The model doesn't particularly discriminate between those countries already in deflation and some others that might suffer it: Hong Kong, Singapore, Taiwan, China and Korea. Technically speaking, China's deflation risk is 'moderate' according to this analysis, but on the very edge of 'high' risk, thanks to its slowdown, producer price deflation, real exchange rate appreciation, and previous episodes of very low inflation. (At two decimal points, China and Korea score 0.46, while Hong Kong and Singapore both score 0.54. The full breakdown is shown in Figure 21).

**Figure 21. An indicator of 'deflation vulnerability'**

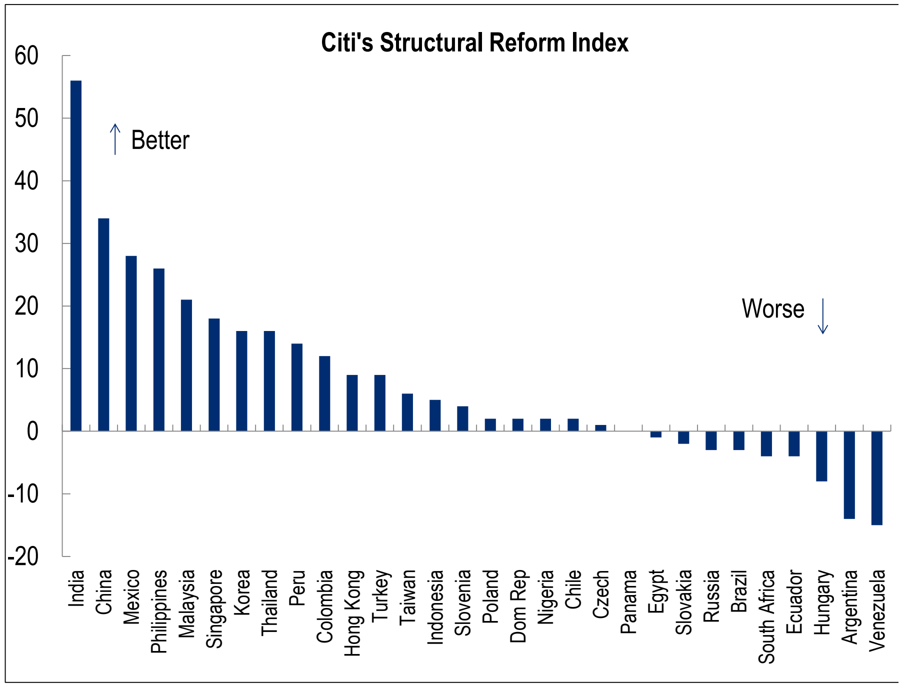
| | CZ | HK | SG | TW | HU | PO | IS | CN | KO | CH | MY | TH | PE | RU | TU | SA | PH | AR | BZI | IN | MX | ID |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| CPI has been below < 0.5% since 2008? | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 1 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 |
| Core CPI has been < 0.5% since 2008? | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| GDP deflator < 0.5% since 2008? | 1 | 1 | 1 | 1 | 0 | 0 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 |
| Property inflation < 0 5% since 2008? | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 0 | 1 | 0 | 1 | 0 | 1 | 1 | 0 | 0 | 0 | 0 | 0 |
| Producer prices <0.5% since 2008? | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 0 | 0 | 1 |
| Output gap up > 1ppt in past year? | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 1 | 1 | 0 | 0 | 0 |
| 4Q14F output gap lower than -2%? | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2012-2014 GDP growth < 10y average? | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 1 | 1 | 0 | 0 |
| Stock market down >30% since 2012? | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| REER appreciated by 4% (Oct14, yoy) | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 |
| Credit growth < nominal GDP growth? | 1 | 0 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 |
| 3-year credit growth rate < 10%? | 1 | 0 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 'Broad' – 'narrow' money growth < 2ppt, past 2 years? | 1 | 0 | 1 | 1 | 1 | 1 | 1 | 0 | 1 | 0 | 1 | 0 | 1 | 0 | 1 | 1 | 0 | 0 | 0 | 0 | 1 | 0 |
| **Total 'deflation vulnerability score'** | **0.69** | **0.54** | **0.54** | **0.54** | **0.54** | **0.54** | **0.54** | **0.46** | **0.46** | **0.46** | **0.38** | **0.38** | **0.38** | **0.31** | **0.31** | **0.31** | **0.23** | **0.23** | **0.23** | **0.15** | **0.15** | **0.08** |

Source: Citi Research, following IMF methodology (see Footnote 3)

**Deflation risk for China is a scenario worth considering, since China's policy response will matter a lot.** We argued above that there might be pressure on the renminbi to weaken if capital flows out of China in the next year or so. The same pressure might result if China suffers a sustained episode of deflation. Although China suffered deflation in 2009, debt levels in the economy were considerably lower then. With higher debt levels today, Chinese policymakers might have more to fear from deflation than 5 years ago, while at the same time enjoying fewer policy options now that there has been a sharp rise in the public sector's contingent liabilities. These

factors might incline Chinese policymakers to think that a weaker currency might be the best solution for a deflation problem. That in turn would be bad news for EM: it would increase risk aversion towards EM in general, adding to the pressure that already results from China's slowdown, and its contribution to weaker commodity prices and lower growth across some parts of the emerging world.

**Figure 22. Citi economists surveyed on structural reform progress**




Source: Citi Research

**All these risks will raise the importance of structural reforms in EM**. Figure 22 shows the results of a survey of Citi's EM economists who were asked to express their opinion of the status of the reform process in each country, across a number of structural variables in categories such as trade arrangements, domestic financial freedom, labour and tax regimes, land use and the clarity of property rights. To some extent the results are intuitive. The two most obvious reformers in EM – Mexico and India – score well, as does China in view of the implementation of the reforms outlined at the 3rd Plenum of the 18th Central Committee last year. So, the structural story isn't bad in EM, though it seems the countries where structural reform is probably needed most – Russia, Brazil, South Africa, Argentina, Venezuela – are getting it least.

**And we still think there is much uncertainty about what the future will be for EM's 'growth model'**. It seems reasonable to suppose that 'net exports' will not be contributing strongly to EM growth in the way that it did before the Lehman crisis. In the summer of 2014, the growth rate of world import volume fell below the growth rate of world industrial production. If that trend continues, the scope for strong export-led growth will be eroded further. But the capacity of EM to rely enthusiastically on domestic drivers of growth is not self-evident. The history of credit booms in a number of countries means that the scope for strong rates of domestic credit creation is relatively limited. That could limit the scope of private domestic spending growth. Equally, while EM sovereign balance sheets are historically quite strong, the scope for looser fiscal policy is constrained. Brazil's recent experience is an illustration: fiscal policy has been notably loosened in recent years, without doing much for GDP growth, but securing a sovereign rating

downgrade from S&P as well as the need for exceptionally high real interest rates. Even if more public spending were to be concentrated on investment spending – in infrastructure, say – it is not clear that growth will accelerate easily. Overall we agree with the IMF's recent assessment: "…the past strong growth momentum is unlikely to be sustained going forward"[4].

## EM Strategy Outlook 2015: Testing Times

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**Emerging markets should face a challenging, though not insurmountable, 2015**. The important macroeconomic themes of the last few months are likely to continue conditioning the asset class throughout the year: wobbly G10 growth and monetary policy divergence; low inflation with the risk of deflation in some corners; China slowdown; and weak commodity prices. These economic forces are likely to be peppered, as always, by geopolitical issues and social and political difficulties in several countries. Nevertheless, none of that is new and, frankly, the list of issues would have been comparable at the end of 2013. Despite these concerns, 2014 proved to be an acceptable year for EM. Flows into the asset class were still positive – moderate but positive – and returns in most of the space were positive. EM credit returned +9.4%ytd, local bond portfolios (unhedged) +3.11% ytd, in equities returns were 0.65% in the MSCI-EM, and only EMFX depreciated 7.63%. As we peek into 2015's outlook, we think the best way to organize ideas is consider a few themes that could mark the year in credit, rates and FX.

### EM Credit

We organize our thoughts around a couple of top-down ideas and a few bottom-up themes. All in all, we conclude that 2015 ought to be a year with flattish performance for spread product.

- **Theme 1: It's not monetary policy that matters, it is G10 growth.**

The divergence in global monetary policy emerges from a fundamentally different stage of the growth path and past policy stance across the G-3. As we go into 2015, we anticipate the ECB to pursue an aggressive balance sheet expansion and the Bank of Japan to, at a minimum, continue its new expanded policy impulse. Meanwhile, we expect the US Fed will only begin hiking rates in December 2015 and to proceed at a very moderate pace.

Long-term interest rates are likely to remain moderate due to very low term-premia. Term premia are expected to be low for three fundamental reasons: (1) Balance sheet expansion policies in Japan and Europe will depress long-term yields with spill-over effects to US rates. (2) Low inflation across the advanced economies (and several EM ones) reduce the risk of large jumps in inflation rates above target and thus reduce inflation risk premia. And, (3) the policy-put seems to be much in place with central banks ready to step-up their accommodative policies in case output declines turning bond prices countercyclical and lowering term premia.

We estimate a simple model with G10 output growth, oil price changes, a proxy for risk aversion (VIX), short-term US interest rates (2-year US Treasury rates) and 10-2 UST slopes to capture medium-term inflation and term premia. The results show that over four quarters the only shocks with lasting impact on EM spreads are changes in G10 growth rates and movements in risk aversion. A large 30bp unanticipated jump in

[4] 'Slowdown in Emerging Markets: Sign of a Bumpy Road Ahead?', IMF Working Paper WP/14/205, November 2014. http://www.imf.org/external/pubs/ft/wp/2014/wp14205.pdf

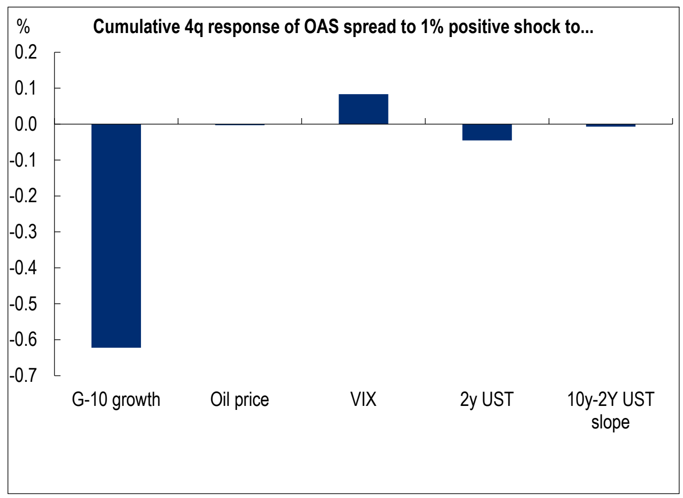
G10 growth results in 20bp tighter spreads after 4 quarters. In turn, an unanticipated increase in VIX of 5pp leads to 40bp higher spreads. Unsurprisingly, given the lack of historical co-movement (Figure 23), the estimated model results in a (statistically not-significant) coefficient for short rates and the slope of the yield curve (Figure 24).

Our forecasts for G10 growth in 2015 are up when compared to 2014 but they are slightly lower than the Bloomberg consensus numbers by 5bp. In turn, while Citi equity strategists do not forecast VIX, the current level appears to be approximately 1.5pp below the current year's average. If Citi's views come through, then spreads would be forecasted to result in some 10-15bp wider spreads.

**Figure 23. EM Spreads and UST slope seemed to move together during Tapering, but there is no correlation in other periods**


Source: Bloomberg, Citi Research

**Figure 24. How do EM spreads respond to Global Macro shocks? Strongly to growth and risk aversion, no response to rates and oil**




Source: Bloomberg, Haver Analytics, Citi Research

## ■ Theme 2: Does the current level of EM-credit risk warrant low returns?

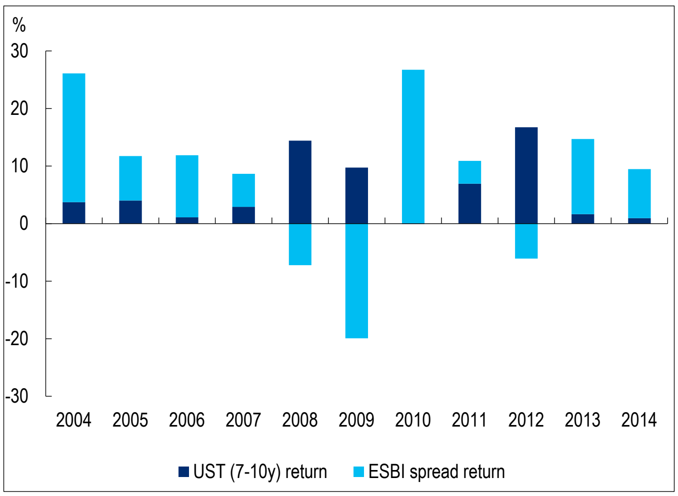
What risks drive EM credit returns? Changes in returns in EM credit reflect changes in the price of risk in core markets and in the probability of default (and recovery rates). Given the tight levels of advanced economy risk premia, a natural question is whether the expected returns in EM ought to mean-revert and turn negative.

We look at a number of variables that are good candidates to provide information on the relevant components of returns in dollar-denominated risky EM debt. Past research has found that the term structure of US interest rates is a good proxy for movements in bond returns. Also, the corporate-bonds literature finds that the default spread tracks the US corporate bond returns, suggesting that in EM the OAS spread ought to have predictive value for the default component. Finally, the literature has also found that stock market valuation ratios (such as dividend yield or inverse P/E) help predict bond returns. We find these variables have strong predictive power for EM credit returns.[5]

[5] The model we fit is a forecasting regression of (future) annual return on ESBI total return index on: a) current, time to UST 1y forward rates (1y zero-coupon yield, 1y rate from year 4 to year 5, and 1y rate from year 9 to year 10); b) current OAS spread on ESBI; and c) earnings yield on S&P500. The estimates yield a good fit, for models of this kind. In the 2001-2014 sample (this is what's used in the chart) the $R^2$ is 0.42. If the GFC period is excluded, the $R^2$ rises to 0.6 (2001-2007 period) and 0.71 (2010-2014 period). For the 2001-2014 version the out-of-sample $R^2$ is 0.27, a number that is still high considering the large weight given to the forecast errors from the GFC period and QE.

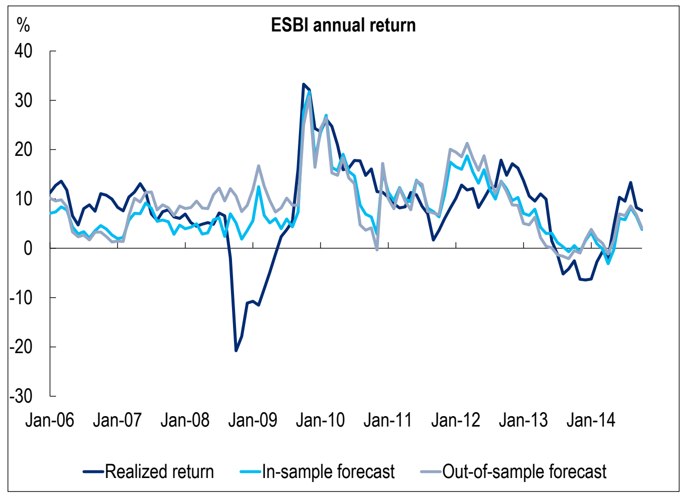
As Figure 25 suggests, the estimated model performs well, only missing those periods with large unanticipated shocks. Indeed, the model misses the global financial crisis and under-predicts returns during QE3 and the tapering shock. Leaving those surprises aside, the model tends to perform rather well. If 2015 is devoid of large financial surprises, our model predicts for 2015 total returns in EM sovereign debt to be marginally positive at 1.2%. Given Citi's estimates of the returns on the relevant duration adjusted UST (-3.1%) the expected return for the spread component of the index – the one more relevant to EM investors – is predicted to be 4.3%. A result somewhat more optimistic than the global macro model above suggested.

**Figure 25. Returns on EM sovereign credit have tended to be positive, except for the unexpected Global Financial Crisis and Tapering.**




Source: Citi Research

**Figure 26. Forecasting credit returns with the US yield curve, US equities earnings yield and current EM spread has strong predictive power.**




Source: Bloomberg, Citi Research

## ■ Theme 3: The downgrade of the asset class

Over the period 2003-2012 a clear trend towards an upgrade in the asset class developed (Figure 40) and a significant fraction of the asset class became investment grade. As was to be expected, commodity producers improved the most in ratings as high prices caused improvements in fiscal and external indicators, as well as growth. However, the last two years have witnessed a flattening of that trend, if not a marginal reversal. Looking forward, a meaningful risk looms if the borderline investment grade names suffer a downgrade as many of them carry significant weight in the asset class.

Our concern is not of an immediate downgrade of large EM's below IG. Rather, we worry that in 2015 the market may start pricing a growing probability of that event. We have constructed a list of "borderline" large EM sovereigns and tabulated some crucial macro-variables that drive ratings (Figure 27). Many commodities producers face some risk of losing IG. South Africa is somewhat more comfortable in its current distance to the IG threshold (two notches above by two agencies and one notch by the other) but its ballooning balance sheet, low growth and fiscal position make it a serious candidate for a sequence of downgrades. In Russia, while international reserves look healthy today, the troubled external indebtedness of corporates ($107bn maturing in 2015 against $420bn in reserves) plus the double whammy of oil shocks and international sanctions significantly increase the risk of a sub-IG rating. In Brazil, where one agency has the country on negative outlook, the

split rating could turn into a true borderline case. Minimal expected growth in 2015 and the need for a significant fiscal adjustment increases the risk of slippage. Finally Turkey, outside the commodity producing circle, is another case of slower expected growth, with some room for fiscal slippage in an electoral year, and a wobbly rating position.

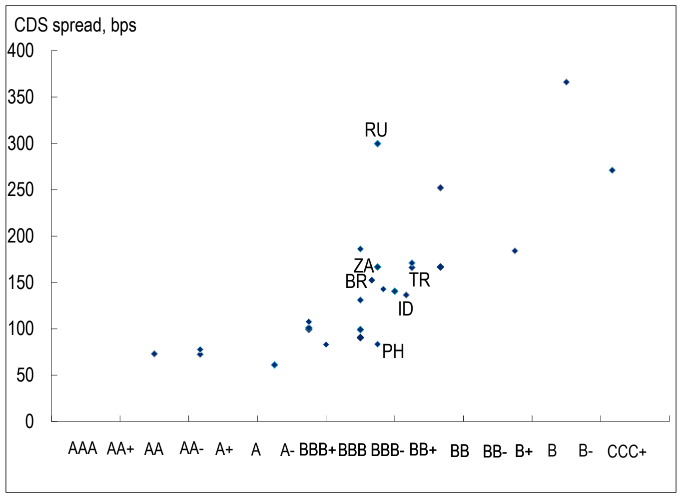
We expect all the countries in this sample to attempt policy initiatives to avoid losing their IG. For instance, Brazil has announced a seemingly more credible economic cabinet and a fiscal path that, if delivered, could buy the sovereign some room. For these reasons, we do not consider a rapid sequence of downgrades a high probability event. Nevertheless, growth in 2015 may surprise on the downside and the needed policies might become difficult to sustain. We suspect markets will not wait for downgrades to sub-IG ratings before repricing. We imagine that in the event that downgrades become more likely spreads in credits such as South Africa, Brazil, or Turkey would move towards 200bp (Figure 28). However, given the large share of the index at risk (chances of 25%+ of the index losing IG status may be low, but non-trivial) this move could prove a discrete shock to the asset class, causing across the board spread widening.

**Figure 27. There are several borderline IG EM-sovereigns whose ratings might be at risk in the next two years.**

| | Market Weight (%) | Ratings | Real Growth '15F | Fiscal Bal % GDP '15F | Public Debt % GDP '15F | Public Debt (2Yr Change) |
|---|---|---|---|---|---|---|
| Brazil | 7.2 | 2BBB, 1BBB- | 0.5 | -4.7 | 64.6 | 7.9 |
| Russia | 8.1 | 2BBB,1BBB- | -1.0 | -1.0 | 12.7 | 1.5 |
| South Africa | 2.4 | 2BBB,1BBB- | 2.2 | -4.1 | 50.8 | 46.1 |
| Turkey | 9.5 | 2BBB-, 1BB+ | 3.3 | -2.9 | 35.7 | -2.9 |

Source: S&P, Citi Research

**Figure 28. Some borderline cases could suffer spread widening, if downgrades are not avoided.**




Source: S&P, Citi Research

## ■ Theme 4: Trouble in quasi-sovereigns

Quasi-sovereign corporate credit has played a key role in EM credit portfolios in the last few years. Sovereign portfolio managers use them to pick up some yield while in pure corporate portfolios, quasi-sovereigns are a large part of the index and very active issuers. Therefore, the way quasi-sovereigns go, the credit asset class goes.

Quasi-sovs tend to be dominated by commodity related Corporations and Financials, two sectors likely affected by the new global configuration: the decline in commodity prices cum FX depreciation generating negative balance sheet effects; the slowdown in economic activity affecting the quality of loan portfolios or the ability of sovereigns to support the quasi-sovereigns through capital injections; And, finally, the potential downgrade of sovereigns impacting the rating ceilings.

A significant decline in average oil prices can be quite meaningful for a few Quasi-sovs (Figure 29 provides an illustrative example). Pertamina and Petrobras look particularly vulnerable as a reflection of their relatively high initial levels of leverage. On the other hand, companies like Sinopec, Ecopetrol and CNOOC seem to have solid financials

with limited impact from oil price declines. Interestingly, Gazprom and Rosneft appear less impacted by the decline in oil prices than by international sanctions that make rollover of their debt difficult and expensive. Furthermore, in the case of countries where a meaningful fraction of oil gets sold in domestic markets at regulated prices, the depreciation of the domestic currency may further weaken their balance sheet. In the case of Pertamina, the recent increase in domestic fuel prices should help reduce some of the very high burden that a decline in oil prices and the devaluation could create.

**Figure 29. EM Oil & Gas Quasi-Sovereigns response to a decline to $80 Brent oil prices**

| | Petrobras | Ecopetrol | Gazprom | Rosneft | Sinopec | CNOOC | Pertamina |
|---|---|---|---|---|---|---|---|
| Country | Brazil | Colombia | Russia | Russia | China | China | Indonesia |
| Sovereign Ownership | 46% | 90% | 50% | 70% | 100% | 100% | 100% |
| Sovereign Controlled | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| **Financial Summary** | **2Q14** | **3Q14** | **2Q14** | **3Q14** | **1S14** | **1S14** | **4Q13** |
| EBITDA Margin | 18.40% | 37.30% | 33.80% | 21.20% | 6.90% | 48.00% | 8.10% |
| Gross debt/EBITDA (x) | 5.4 | 1.1 | 1 | 1.9 | 1.7 | 1 | 2.6 |
| Net debt/EBITDA (x) | 4.4 | 0.6 | 0.5 | 1.3 | 1.7 | 0.2 | 1.7 |
| **Adjusted for commodity price change** | **2Q14** | **3Q14** | **2Q14** | **3Q14** | **1S14** | **1S14** | **4Q13** |
| Net debt/EBITDA (x) | 4.9 | 0.7 | 0.6 | 1.5 | 1 | 0.4 | 3.8 |
| **Net Leverage Change with blended price change** | **0.6** | **0.1** | **0.1** | **0.2** | **-0.7** | **0.2** | **2.1** |

Source: Company Reports, Bloomberg, Citi Research

Quasi-sovereign credits are strategically important to their host sovereigns with a high probability they will receive government support in the event of financial distress. Therefore, the debt of quasi-sovs ought to be priced relative to sovereigns with some time-varying liquidity and solvency risk premia. Here, we will only look at the recent spread to sovereign history for the senior notes of the main Brazilian state owned banks (BANBRAS, CAIXBR) and Russia (SBERRU and VEBBANK).[6]

In the last few months, there has been a marked rise in the spread to sovereign for Russian credits GAZPRU and ROSNM, as well as high volatility in PETBRA (Figure 30). Given the fall in oil prices and sanctions, plus high corporate maturities in 2015, it is not surprising this is the case for Russia. Similarly, the high leverage, fall in oil prices and the corruption scandals have also pressured Petrobras. The spread to sovereign may not be finished widening however, given the growing challenges ahead for these companies and countries. On the other hand Colombia's Ecopetrol spread to sovereign appears wide. While oil prices are probably at the center of the widening, it may be worth to take another look at the strength of the company's balance sheet. This suggests that the spread is overdone.

**Figure 30. Oil & Gas Quasi-Sovs spread to Sovereign (2013-2014)**

| | PETBRA | ECOPET | GAZPRU | ROSNRM | PERTIJ |
|---|---|---|---|---|---|
| Current | 174 | 53 | 127 | 196 | 75 |
| Min | 102 | 17 | 76 | 93 | 28 |
| Max | 201 | 132 | 164 | 228 | 109 |
| Mean | 135 | 64 | 111 | 139 | 81 |
| Std Dev | 15 | 22 | 15 | 29 | 14 |

Source: Bloomberg, Citi Research

**Figure 31. State Bank Senior Debt spread to Sovereign (2013-2014)**

| | CAIXBR | BANBRA | SBERRU | VEBBNK |
|---|---|---|---|---|
| Current | 134 | 84 | 163 | 219 |
| Max | 217 | 172 | 186 | 285 |
| Min | 84 | 44 | 79 | 98 |
| Mean | 148 | 104 | 123 | 164 |
| Std Dev | 32 | 29 | 20 | 39 |

Source: Bloomberg, Citi Research

State-owned banks are also trading in the upper half of their 12-month trading ranges relative to the sovereign (Figure 31). However, the spread to sovereign seems relatively tight when compared to the oil & gas companies, despite the fact that a slowdown in growth and potential risk from a credit downgrade could have a meaningful impact on the quality of their balance sheet. This seems most pronounced in Brazil, where state banks BANBRA and CAIXBR appear overvalued.

[6] In the case of banks, there is a somewhat trickier problem with subordinated debt as the chance that capital securities are treated like equity increases with the probability of sovereign downgrades.

■ **Theme 5: Will the high betas continue to be the high betas?**

The High betas will face testing times. While these credits have a moderate share of the index, their high and volatile spreads could continue to contribute a disproportionate fraction of the index returns. Below, we just concentrate on Argentina and Venezuela.

From a credit market perspective, Argentina's fate depends on a possible early settlement with holdouts. The market generally expects that negotiations will launch in January and be completed expeditiously. In our opinion, conversations between Argentina and its creditors will resume early in 2015, but it is not clear that they will lead to an effective resolution. In fact, we think that Argentina's approach will depend on the state of the domestic economy and the government's perception of the feasibility of a resolution that helps stabilize expectations at home. This is less an access to market issue than a domestic stability one for the government. Argentina is able to find moderate amounts of financing by issuing local law securities. They have recently raised more than $1.6bn in dollar-linked bonds and they could, if they need to, issue more traditional dollar-denominated local law bonds like the Bonar 24 (with yields below 10%).

Argentina's debt is not expensive, in our view, but the risks are quite large. Considering the accrued coupon on Argentina's defaulted debt, dollar discounts seem to be priced near 85.5%. At that level, market prices appear to reflect a probability of a settlement in H1 less than 50%. Our assessment is that this is not an unreasonable (though perhaps slightly optimistic) assumption. However, come Q2, Argentina could be trading at or below 600bp spreads or above 1200bp (assuming that past due coupons get paid in 2016): a very volatile scenario.

Venezuela's problems are not just oil prices, though at current levels (and even at higher than current levels) the problems appear severe. Venezuela has entered in full force a sequence of three years with very debt maturities at a time of extraordinarily scarce FX availability. Stabilization funds and international reserves seem insufficient to maintain the current level of effort and, therefore, the government will likely need to make very difficult decisions. In the (optimistic?) case that Brent oil prices average $80 in 2015, Venezuela may well face a shortage of dollars of nearly $16-18bn, even assuming significant additional domestic adjustment.[7] The choice is, therefore, to continue pursuing radical domestic adjustment or transfer some of that pain to external creditors.

Timing political decisions of that nature is always difficult and depends on several factors, including oil prices. It is likely that the government will attempt to delay decisions until after the National Assembly elections. But, with oil prices below $80, the October election seems ages away. What might Venezuela do in the meantime? Further build arrears with PDVSA suppliers and other importers, some rebalancing in domestic oil prices and the FX (though an unpopular move), and use international reserves and special funds (which may include the sale of CITGO).

Is Venezuela already pricing a high enough probability of default? To answer the question one needs to make some assumptions on the potential recovery rate. This, however, requires making assumptions on the politics and approach taken by the government after the elections. If the authorities were to resort to a moratorium, would it be on all debts or on PDVSA or the sovereign alone? Would the debt be repudiated, therefore postponing a restructuring for many years? Or would there be

[7] The assumed adjustment implies a reduction in imports that will be 150% the reduction observed in 2014, a reduction in $2bn in PetroCaribe –which may alternatively be the monetization of some of the claims PetroCaribe holds on other nations- and the full use of the facilities afforded by the renegotiation of the loan contracts with China.

a quick negotiation to reach an effective rescheduling that buys the country significant time providing some relief? What would be the impact on oil sales? The uncertainty around these issues is extreme and it is difficult to handicap them. Thus, we imagine that the lack of an effective probabilistic anchor will imprint very high volatility on the credit in 2015 or until credible medium term decisions are made.

All in all, the high betas promise quite a lot of volatility through 2015 and “binomial” scenarios, with very different outcomes are possible. The pressure on EM index spread volatility is likely to be significant.

**Putting it all together**

The top-down themes suggest that EM credit might still promise somewhat positive returns on their spread component. However, the bottoms-up themes that we think could mark 2015 suggest that spreads could widen somewhat. We estimate the index to widen in 2015 by 15bp but, more importantly, to have significant volatility. The risk of a potential re-rating of the asset class, the binomial nature of risks in the high betas, and the potential widening of the quasi-sov/sovereign spreads augur a more difficult year for credit portfolio managers than 2014.

## FX and Rates

- **Theme 6: Diverging Monetary Policies in G3**

The theme of diverging monetary policies is already somewhat mature. Nonetheless, we think that it will stay relevant for another 6-12 months. In the developed market context Citi calls for sovereign QE by the ECB on the one hand, and for Fed hikes starting in December of 2015 on the other. And even though the BOJ just acted, it is plausible that the BOJ will have to act again later next year. As a result, it is likely that we will stay in a strong USD environment, which results in negative EMFX performance.

One question is if a rolling push-out of the first Fed hike can undermine the long USD trade. To us the current situation smells like 1997 when a strong US economy ran into global headwinds, cutting short the Fed hiking cycle. In 1997 this environment led to a strong USD. This time around a weaker US would also be a highly negative outcome for Europe, necessitating additional European easing. If we are wrong, upside risks to the short end of the US curve would only add to the strong USD case.

As is illustrated by Figure 32, the EMFX pairs most at risk in an environment of USD strength are typically in CEEMEA, given strong links to the EUR. Generally low nominal interest rates in Central Europe create an embedded downside bias in PLN, HUF and CZK. Latam typically also performs poorly, partially because commodities usually underperform in a strong USD environment. Asia is usually a relative safe haven.

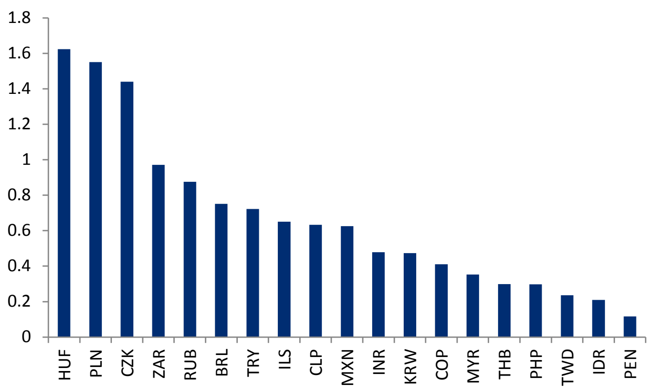
There is an interesting discussion if Asia FX should be impacted by a weaker JPY. This is obvious in Korea but is also being felt in Taiwan – both countries’ exports compete with Japan’s. We think it is premature to fade these moves: as long as there remains credible risk of a policy response (continuing intervention, or rate cuts), markets will keep the fortunes of these currencies closely tied to the yen's. In this regard, it is useful to note that global disinflation strengthens fears of competitive devaluation (by enabling more aggressive monetary policy).

**FX Trades for Theme 6: We prefer USD longs in CEEMEA, where we are long USDPLN and USDHUF in our model portfolio. In Latam we are underweight COP and PEN in our EM bond portfolio.**

On the interest rate side it is much more important when the Fed is going to move, as a lot will depend on that. With Citi's new call for hikes to start only in December, the ECB may set the direction of interest rates for now. Given Citi's call for sovereign QE early next year, this is likely a constructive environment for duration, at least in countries where FX weakness is not typically impacting interest rates too severely. Duration in CEMEEA is likely to do especially well, taking its cue from core rates in Europe. Figure 33 illustrates the betas of EM rates to both US Treasuries and Bunds. As can be seen the key countries where betas with Bunds are comparable (or even higher) than for US Treasuries are concentrated in CEEMEA, i.e. PLN and CZK.

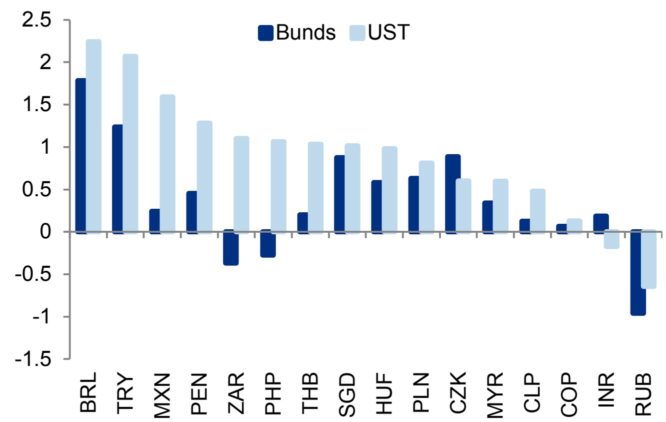
**Rates trades for Theme 6: We are overweight duration in Hungary and Poland in our EM bond portfolio. We are also received in Korean swaps and are long 10y PLGBs, FX hedged.**

Figure 32. Beta of EMFX to DXY




Source: Bloomberg, Citi Research

Figure 33. Beta of EM rates to UST and Bunds




Source: Bloomberg, Citi Research

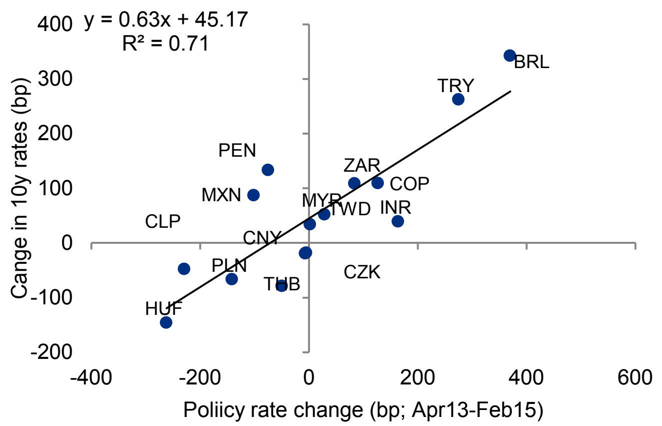
## Theme 7: Diverging Monetary Policies in EM

There is also divergence in monetary policies among emerging markets. For most emerging markets changes in rate differentials are not major drivers for currencies. However, differential central bank actions drive relative interest rate performance. Figure 34 illustrates the extent to which the 10yr rate in EM has sold off since the start of the tapering sell-off in April 2013 as a function of how much the central bank changed monetary policy rates. With policy action explaining 73% of the variance, we want to focus our long duration calls in countries where the last cut (or the first hike) of the cycle is not in the market's field of vision yet. Figure 35 shows the Citi forecasts for monetary policy action in 2015 next to swap pricing (where available). Markets with rate cuts left are Russia, India, China, Korea and Poland (though we note that deposit rate cuts in China do not always translate one for one in lower yields). Of the ones where we forecast no change, risks for cuts are present in Chile (only partially priced), Colombia, Peru and Thailand. We would also note that in Asia we like duration in Indonesia, where nothing is priced, and Malaysia, where the penciled in hikes could be at risk. We avoid Russia given the continued sanction risks and think too much is priced in India, where we prefer a steepener. Meaningful hikes are seen in Turkey, South Africa, Romania, Mexico and Brazil. We are underweight duration in Mexico as a portfolio hedge in our EM bond portfolio. But in Brazil meaningfully more is priced than we expect, and, especially in the aftermath of the announcement of the new economic team, we are actually receiving the backend in Brazil. In South Africa and Turkey we see downside risks to CPIs.

Romania is another case of a curve that should benefit from a dovish ECB. Overall, we don't think that it is the right time to pay in those three countries. Tactically, even receivers may still work.

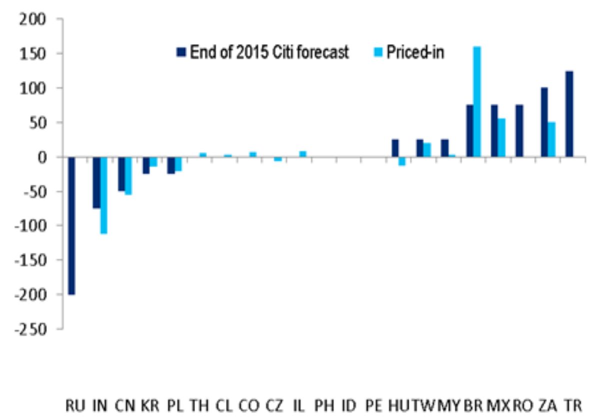
**Trades for Theme 7: We are overweight duration in Poland, Peru, Colombia, Indonesia and Malaysia, and underweight in Mexico (as a portfolio hedge) in the EM bond portfolio. We outright receive rates in China and Korea and are long 10yr POLGB, fx hedged.**

Figure 34. 10yr rates and central bank action




Source: Central banks, Citi Research

Figure 35. Citi forecast of change of target rate for 2015




Source: Citi Research

## Theme 8: China and Commodity Risks

The risks to commodity exporters from a China slowdown have been flagged for a long time. With the Chinese leadership appearing comfortable with a gradual moderation in growth, and – more importantly – with growth drivers in China shifting away from commodity-intensive infrastructure and construction projects, these risks to commodity exporters are likely to become even more acute rather than less so.

Even though some investors worried about a Chinese 'hard landing', the relatively cautious policy response to contain the growth slowdown this year has presented commodity exporters with an unexpectedly bearish environment. And if China's services sector can help replenish demand for labor, policymakers may remain tolerant of – or they may even encourage – slower growth in the more credit- and commodity-intensive parts of the economy. If the economy continues to evolve around the contours of 2014's experience, this may allow China to gradually normalize the extraordinarily high credit- and commodity-intensity of growth. This will, however, result in a permanent demand-shock for commodity-exporting economies, most of which are in the emerging markets.

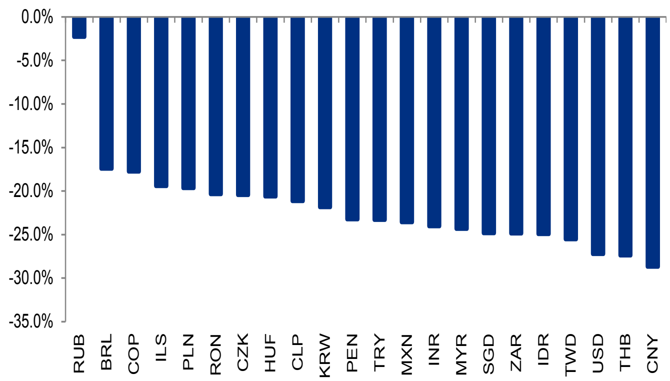
Our commodity team suggests downside risks to several commodities for H1 2015. The main major commodity with highly negative price forecasts is iron ore. This would impact BRL the most negatively in the EMFX universe. For Brent, forecasts are not that different from spot prices post OPEC. If those forecasts should be too benign, RUB, COP and to a lesser extent MXN would be negatively impacted. But a lot of weakness is already in the oil price post OPEC. CLP and ZAR should actually outperform other commodity currencies, given the more bullish forecast on copper and platinum, respectively, and as they benefit from lower oil. In the RUB, after so many shocks in USDRUB and RUB/basket, the Central Bank and Ministry of Finance chose to increase the supply of FX financing in the local markets, via auctions of FX-swaps. But RUB remains weak. In South

Africa, the effect of lower energy costs is at least partially offset by the ongoing poor price action in mineral and mining commodities (the bulk of South Africa's export base).

There is also a rates impact, in particular from the fall in oil. Here the theme may not be quite as mature as it takes time for the lower oil prices to filter through into CPI prints and central bank behavior. Even in local currency terms energy costs have fallen significantly given that oil is more volatile than most FX. Since January the strongest moves have been in Asia, as can be seen in Figure 36. This may be especially impactful on monetary policy where inflation is still above target and where no cuts are priced. Figure 37 plots the correlation of 2yr rates and oil on the x axis and priced-in rate moves on the y axis. The quadrant with potential to receive is the upper right quadrant. Thailand, Taiwan, Korea and Chile screen well.

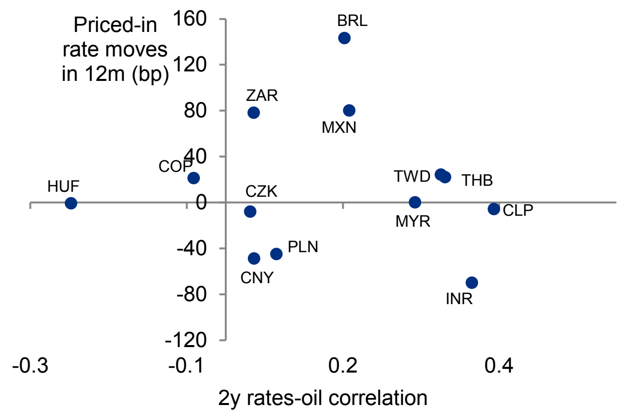
**Rates trades for Theme 8: We are overweight duration in Thailand and Malaysia in our EM bond portfolio, and are outright received Korea and China. We would receive Chile on a pull-back.**

Figure 36. Change of oil prices in local currency terms




Source: Bloomberg, Citi Research

Figure 37. Priced-in rate moves in next 12m against 2yr rates – oil correlation




Source: Bloomberg, Citi Research

## ■ Theme 9: The Japanification of EM

Much has been made about the "Japanification" of Europe, usually meaning a combination of weak growth, driven by both weak demographics and a debt overhang, and very low inflation, in turn driven by both the weak growth and reinforced by weak wages. The result of this Japanification is often seen in terms of extremely low nominal interest rates, while real rates may actually be higher than desired due to extremely low inflation.

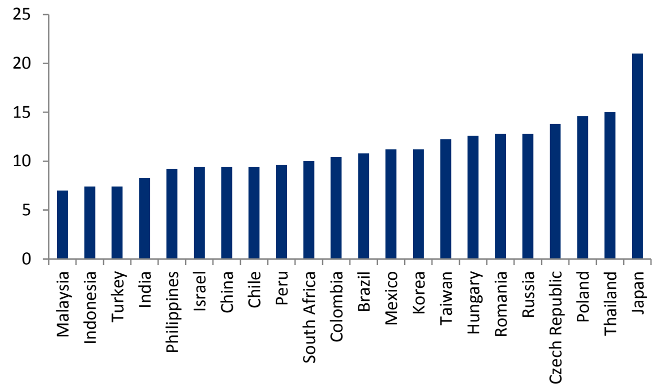
This theme is also relevant in selected emerging markets. Figure 38 shows where such pressures are the most extreme. It is constructed by ranking 2014 forecasts for GDP growth, population growth, private sector credit as % of GDP, inflation and wage growth across all EM (and Japan during 2012, i.e. before Abenomics). On this ranking, Japan is obviously most Japanified and is in a class of its own, but many Asian and Eastern European also are moving in this direction.

Within Asia, Korea is often associated by investors as being the next Japan, mainly owing to its imminent demographic cliff, high household leverage and persistently weak domestic demand. Less well-known is that Thailand isn't too far behind.

Figure 39 relates the Japanification index to nominal interest rates, adjusted for CDS. Reassuringly, there is a correlation, as one would expect, and our index explains 28% of the variation in nominal rates. For the high Japanification countries, Thailand and Poland have still relatively high rates.

**Trades for Theme 9: We are bullish duration in Thailand and Poland, and are received 10y IRS in Korea and long 10y POLGBs, fx hedged.**

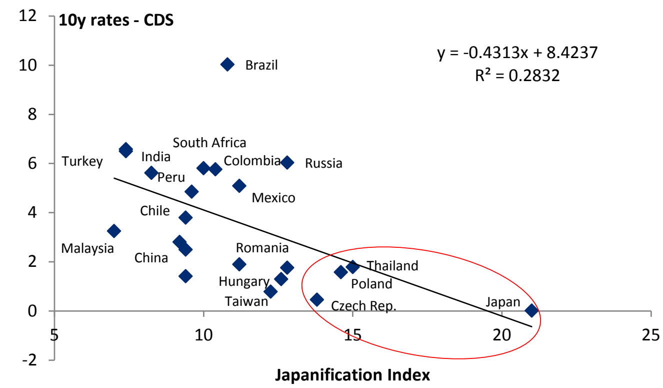
Figure 38. Who is Getting Japanified? (High number -> more 'Japanified')




Source: Citi Research

Index created by taking the average relative rank of each country in 5 different measures: GDP growth, inflation, population growth, wage increase, and credit extension to private sector. 2012 data used for Japan.

Figure 39. Nominal 10yr rates – CDS vs. Japanification index




Source: Bloomberg, Citi Research

## ■ Theme 10: Peaking Credit Cycle

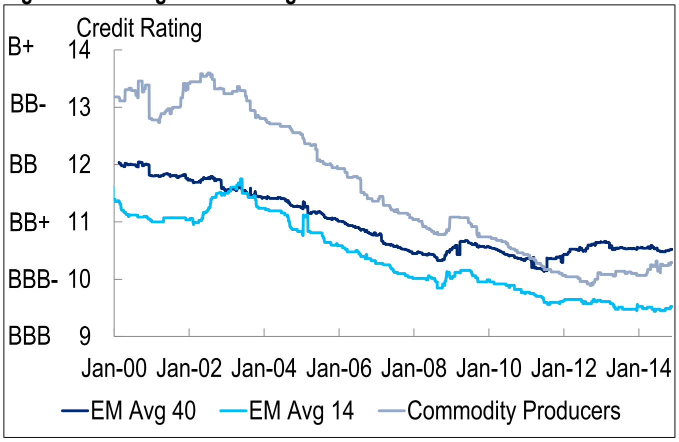
Another less mature theme is that the credit cycle in emerging markets has likely turned. Figure 40 shows that the improvements in average credit ratings for the largest 14 emerging markets have likely troughed after a relentless rally starting in 2002. While so far ratings have not yet deteriorated much, we would note that a broader set of credits (the top 40 emerging markets) already shows more deterioration. For commodity producers the deterioration has also already been more extreme. Given the negative view on commodities from our commodity colleagues we think the credit deterioration will likely continue, at least in pockets.

Figure 41 shows for which FX and shapes of local rate curves the weekly correlation (since 2009) with the countries CDS is most extreme. This chart suggests that a more negative credit environment tends to have a large impact on MXN, TRY, BRL, ZAR, RUB, PEN, COP, CLP, i.e. mostly commodity names and high yielders, but, importantly, MXN also shows up, maybe because of its status as a hedging instrument for other EM risk.

**FX trades for Theme 10: We are underweight RUB, COP and PEN in our EM Bond portfolio.**

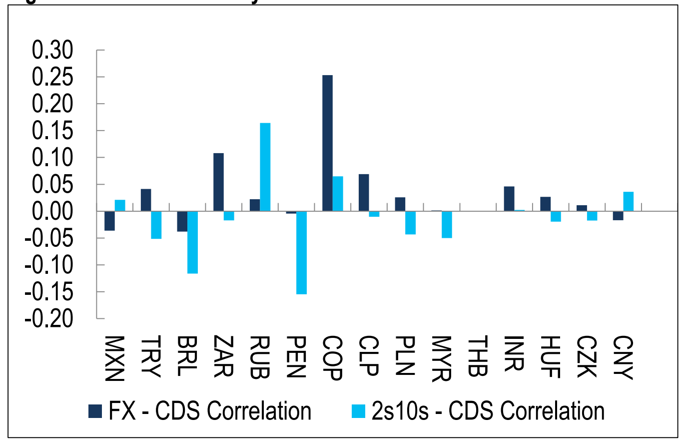
In terms of curves, the correlations are lower. But Mexico, Brazil and South Africa stand out as curves where the credit component is correlated with the steepness of the curves. But we would note that the overall duration friendly environment may more than offset the credit deterioration.

**Figure 40. Average credit ratings**




Source:Bloomberg, Citi Research

**Figure 41. Correlation of 5yr CDS with 2s/10s and FX**




Source:Bloomberg, Citi Research

## Pulling it all together

Our themes are broadly negative on EMFX and more constructive on duration. A lot of themes result in similar trades, which is encouraging. The tables below aggregates the trades for the themes listed above. We would note that most of the themes have already been implemented in our more medium term EM bond portfolio. Our shorter-term trades do not necessarily include trades for every theme as the entry point will be fine-tuned in line with shorter-term developments. We would also note that we have trades outstanding that do not correspond to any of the themes. For those trades, please refer to our latest weekly publication.

**Figure 42. EM FX and Rates Trades by Theme**

| |
|---|
| **Theme 6 - Diverging Monetary Policies in G3** |
| Long USDHUF |
| Long POLGB 10yr, FX hedged |
| **Theme 7 - Diverging Monetary Policies in EM** |
| Receive 5yr China repo |
| Long POLGB 10yr, FX hedged |
| **Theme 8 - China and Commodity Risks** |
| Receive 5yr China repo |
| **Theme 9 - The Japanification of EM** |
| Long POLGB 10yr, FX hedged |
| **Theme 10 - Peaking Credit Cycle** |

Source: Citi Research:

**Figure 43. EM Bond Portfolio Allocations by theme**

| |
|---|
| **Theme 6 - Diverging Monetary Policies in G3** |
| HUF: 1% underw eight |
| PLN: 1% underw eight |
| COP: 1% underw eight |
| PEN: 1% underw eight |
| HUF: +0.18 ctd |
| PLN: +0.5 ctd |
| **Theme 7 - Diverging Monetary Policies in EM** |
| PLN: +0.2 ctd |
| THB: + 0.2 ctd |
| COP: + 0.1 ctd |
| PEN: +0.05 ctd |
| MXN: -0.15 ctd |
| **Theme 8 - China and Commodity Risks** |
| THB: +0.2 ctd |
| MYR: +0.2 ctd |
| **Theme 9 - The Japanification of EM** |
| THB: +0.2 ctd |
| PLN: +0.5 ctd |
| **Theme 10 - Peaking Credit Cycle** |
| RUB: 2.3% underw eight |
| COP: 1% underw eight |
| PEN: 1% underw eight |

Source: Citi Research

# Monetary Policy Watch

**Figure 44. Asia Policy Rates and Movement**

| | | | Last Move | | Likely Next Move | | End-2015 |
|---|---|---|---|---|---|---|---|
| | | Spot | Date | Amount (bp) | Date | Amount (bp) | Forecast |
| China | 1-Year Deposit Rate | 2.75 | Nov-14 | -25 | Dec-14 | -25 | 2.25 |
| India | Repo Rate | 8.00 | Jan-14 | +25 | Mar-15 | -25 | 7.25 |
| Indonesia | FasBI | 5.75 | Nov-13 | +25 | 2016 | +25 | 5.75 |
| Korea | BOK Policy Rate | 2.00 | Oct-14 | -25 | Mar-15 | -25 | 1.75 |
| Malaysia | Overnight Policy Rate | 3.25 | Jul-14 | +25 | Sep-15 | +25 | 3.50 |
| Philippines | Overnight Policy Rate | 4.00 | Sep-14 | +25 | Mar-16 | +50 | 4.00 |
| Taiwan | Discount Rate | 1.875 | Jun-11 | +12.5 | Mar-16 | +12.5 | 1.875 |
| Thailand | Overnight Repo Rate | 2.00 | Mar-14 | -25 | Dec-14 | -25 | 1.50 |

Source: Bloomberg, Citi Research

**Figure 45. CEEMEA Policy Rates and Movement**

| | | | Last Move | | Likely Next Move | | End-2015 |
|---|---|---|---|---|---|---|---|
| | | Spot | Date | Amount (bp) | Date | Amount (bp) | Forecast |
| Czech Republic | 2 Week Repo Rate | 0.05 | Nov-12 | -20 | 1Q17 | +45 | 0.05 |
| Hungary | 14-Day Repo Rate | 2.10 | Jul-14 | -20 | Mar-16 | +25 | 2.10 |
| Israel | Base Rate | 0.25 | Jul-14 | -25 | Dec-14 | -25 | 0.25 |
| Poland | 7-Day Repo Rate | 2.00 | Oct-14 | -50 | 3Q16 | +25 | 2.00 |
| Romania | Refinancing Rate | 2.75 | Nov-14 | -25 | 1Q16 | +50 | 2.75 |
| Russia | Refinancing Rate | 9.50 | Oct-14 | +150 | Jul-15 | -100 | 8.50 |
| S. Africa | Average Repo rate | 5.75 | Jul-14 | +25 | Jan-16 | +25 | 5.75 |
| Turkey* | Average Funding rate | 8.27 | | | by end-2Q15 | -80 | 9.00 |
| Ukraine | Discount Rate | 14.00 | Nov-14 | +150 | 4Q15 | -200 | 12.00 |

Source: Bloomberg, Citi Research.

Note: *For Turkey we use the average funding rate of the CBT instead of the 1-week repo rate.

**Figure 46. Latin America Policy Rates and Movement**

| | | | Last Move | | Likely Next Move | | End-2015 |
|---|---|---|---|---|---|---|---|
| | | Spot | Date | Amount (bp) | Forecast | Amount (bp) | forecast |
| Brazil | SELIC | 11.25 | Oct-14 | +25 | Dec-14 | +50 | 12.00 |
| Chile | CAMARA (Overnight) | 3.00 | Oct-14 | -25 | Mar-16 | +25 | 3.00 |
| Colombia | Central Bank Repo Rate | 4.50 | Aug-14 | +25 | Apr-16 | -25 | 4.50 |
| Mexico | Official Overnight Rate | 3.00 | May-14 | -50 | Oct-15 | +25 | 4.25 |
| Peru | Reference Rate | 3.50 | Sep-14 | -25 | Jun-17 | +25 | 3.50 |

Source: Bloomberg, Citi Research

# FX Views

Figure 47. Asian Currencies Exchange Rates

| | | Mar-15 | | | Jun-15 | | | Dec-15 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 27-Nov | Forecast | Forward | Returns | Forecast | Forward | Returns | Forecast | Forward | Returns |
| vs USD | | | | (%) | | | (%) | | | (%) |
| China yuan | 6.14 | 6.19 | 6.18 | -0.2 | 6.23 | 6.21 | -0.4 | 6.18 | 6.27 | 1.5 |
| Hong Kong dollar | 7.75 | 7.78 | 7.75 | -0.3 | 7.79 | 7.75 | -0.5 | 7.79 | 7.75 | -0.4 |
| India rupee | 61.88 | 62.21 | 63.00 | 1.3 | 62.39 | 63.92 | 2.4 | 62.64 | 65.67 | 4.6 |
| Indonesia rupiah | 12177 | 12265 | 12398 | 1.1 | 12414 | 12599 | 1.5 | 12500 | n.a. | n.a. |
| Korea won | 1098 | 1107 | 1103 | -0.4 | 1119 | 1105 | -1.2 | 1122 | 1108 | -1.3 |
| Malaysia ringgit | 3.35 | 3.37 | 3.38 | 0.1 | 3.39 | 3.40 | 0.2 | 3.39 | n.a. | n.a. |
| Philippines peso | 44.9 | 45.3 | 45.0 | -0.6 | 45.6 | 45.2 | -1.0 | 45.5 | n.a. | n.a. |
| Singapore dollar | 1.30 | 1.31 | 1.30 | -1.0 | 1.32 | 1.30 | -1.8 | 1.33 | 1.30 | -2.6 |
| Taiwan dollar | 30.9 | 31.09 | 30.83 | -0.8 | 31.35 | 30.78 | -1.9 | 31.07 | 30.67 | -1.3 |
| Thailand baht | 32.8 | 33.25 | 33.06 | -0.6 | 33.47 | 33.24 | -0.7 | 33.43 | n.a. | n.a. |

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

Figure 48. CEEMEA Currencies Exchange Rates

| | | Mar-15 | | | Jun-15 | | | Dec-15 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 27-Nov | Forecast | Forward | Returns | Forecast | Forward | Returns | Forecast | Forward | Returns |
| vs EUR | | | | (%) | | | (%) | | | (%) |
| Czech Republic koruna | 27.6 | 27.9 | 28 | -1.0 | 28.0 | 27.6 | -1.6 | 27.8 | 27.5 | -0.9 |
| Hungary forint | 307 | 312 | 310 | -0.6 | 314 | 310 | -1.2 | 316 | 310 | -2.0 |
| Poland zloty | 4.18 | 4.22 | 4.18 | -1.1 | 4.21 | 4.18 | -0.7 | 4.17 | 4.18 | 0.2 |
| vs USD | | | | | | | | | | |
| Israel shekel | 3.89 | 3.81 | 3.89 | 2.0 | 3.87 | 3.88 | 0.4 | 3.90 | 3.87 | -0.8 |
| Russia ruble | 48.6 | 49.4 | n.a. | n.a. | 50.2 | n.a. | n.a. | 51.2 | n.a. | n.a. |
| Turkey new lira | 2.21 | 2.35 | 2.22 | -6.0 | 2.45 | 2.30 | -6.3 | 2.53 | 2.39 | -6.0 |
| S. Africa rand | 10.98 | 11.22 | 11.04 | -1.6 | 11.34 | 11.38 | 0.4 | 11.43 | 11.62 | 1.6 |

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

Figure 49. Latin American Currencies Exchange Rates

| | | Mar-15 | | | Jun-15 | | | Dec-15 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 27-Nov | Forecast | Forward | Returns | Forecast | Forward | Returns | Forecast | Forward | Returns |
| vs USD | | | | (%) | | | (%) | | | (%) |
| Brazil reais | 2.52 | 2.69 | 2.61 | -3.3 | 2.73 | 2.68 | -2.0 | 2.79 | 2.81 | 0.5 |
| Chile peso | 601 | 611 | 608 | -0.5 | 617 | 613 | -0.7 | 620 | 622 | 0.3 |
| Colombia peso | 2163 | 2185 | 2188 | 0.2 | 2207 | 2208 | 0.0 | 2214 | 2248 | 1.5 |
| Mexico new peso | 13.8 | 13.5 | 13.8 | 1.9 | 13.4 | 13.8 | 2.4 | 13.3 | 13.8 | 3.6 |

Note: Returns are calculated as ratio of forwards to our forecasts. Forward in Brazil is only the spot plus interest rate. Source: Bloomberg, Citi Research

# Global Assumptions

### Macroeconomic Forecasts

| | GDP Growth (% YoY) | | | CPI Inflation (% YoY) | | | Current Balance (% of GDP) | | | Fiscal Balance (% of GDP) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2015F | 2016F | 2017F | 2015F | 2016F | 2017F | 2015F | 2016F | 2017F | 2015F | 2016F | 2017F |
| **Global** | 2.7 | 3.1 | 3.4 | 2.7 | 2.5 | 2.8 | 0.8 | 0.8 | 0.8 | -3.2 | -3.1 | -3.0 |
| **Industrial Countries** | 1.7 | 2.1 | 2.3 | 1.4 | 1.3 | 1.7 | -0.1 | 0.3 | 0.4 | -3.8 | -3.3 | -3.2 |
| United States | 2.3 | 3.0 | 2.8 | 1.4 | 1.4 | 1.8 | -2.2 | -1.2 | -0.8 | -4.4 | -4.1 | -4.5 |
| Japan | 0.3 | 0.9 | 1.8 | 2.9 | 1.4 | 1.1 | 0.1 | 0.7 | 0.4 | -8.0 | -6.5 | -6.4 |
| Euro Area | 0.8 | 1.1 | 1.6 | 0.5 | 0.8 | 1.5 | 2.7 | 3.0 | 2.8 | -2.5 | -2.3 | -1.9 |
| Germany | 1.5 | 1.1 | 1.6 | 0.9 | 1.1 | 1.8 | 7.4 | 7.7 | 6.7 | 0.3 | 0.2 | 0.0 |
| United Kingdom | 3.0 | 3.0 | 3.0 | 1.5 | 1.3 | 2.0 | -4.7 | -4.2 | -4.3 | -5.6 | -4.8 | -3.2 |

### G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 28 November 2014

| | 1Q 15F | 2Q 15F | 3Q 14F | 4Q 15F | 1Q 16F | 2Q 16F |
|---|---|---|---|---|---|---|
| United States: Federal Funds | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.75 |
| 10-Yr. Treasuries (Period Ave.) | 2.70 | 2.85 | 2.90 | 2.95 | 3.00 | 3.05 |
| Euro Area: US$/€ | 1.16 | 1.12 | 1.09 | 1.07 | 1.05 | 1.02 |
| Euro Repo Rate | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| 10-Yr. Bunds (Period Average) | 0.65 | 0.85 | 1.00 | 1.15 | 1.25 | 1.25 |
| Japan: Yen/US$ | 121 | 124 | 126 | 128 | 130 | 132 |
| Call Money | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 10-Yr. JGB (Period Average) | 0.45 | 0.45 | 0.55 | 0.55 | 0.60 | 0.60 |

### Industrialised Countries 10-Year Yield Spreads (Period Average)

| | Spread vs. US$ | | | | | | Spread vs. Germany | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F | Current | 1Q 15F | 2Q 15F | 3Q 15F | 4Q 15F | 1Q 16F |
| United States | NA | NA | NA | NA | NA | NA | 152 | 207 | 202 | 192 | 182 | 177 |
| Japan | -178 | -227 | -242 | -237 | -242 | -242 | -26 | -20 | -40 | -45 | -60 | -65 |
| Euro Area | -152 | -207 | -202 | -192 | -182 | -177 | NA | NA | NA | NA | NA | NA |
| United Kingdom | -30 | -46 | -41 | -35 | -35 | -20 | 121 | 161 | 162 | 157 | 147 | 157 |

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

### Commodities Price Outlook

| | | 3M | 6-12M | LT |
|---|---|---|---|---|
| **Metals and Bulks** | | | | |
| Gold Price | US$/oz | 1200 | 1240 | 1050 |
| Silver Price | US$/oz | 18.30 | 18.70 | 16.50 |
| Platinum Price | US$/oz | 1400 | 1500 | 1763 |
| **Energy** | | | | |
| WTI Oil Price | US$/bbl | 73 | 75 | 81 |
| Brent Oil Price | US$/bbl | 80 | 82 | 85 |
| Henry Hub Gas Price | US$/MMbtu | 4.20 | 3.50 | 5.50 |
| **Agriculture** | | | | |
| CBOT Corn - North America | US¢/bu | 360 | 388 | |
| CBOT Wheat - North America | US¢/bu | 515 | 540 | |
| CBOT Soybeans - North America | US¢/bu | 1000 | 980 | |
| CBOT Rice - North America | US¢/cwt | 13.00 | 14.00 | |

Source: Citi Research

# EM: Key Forecasts

Figure 50. Emerging Markets – Economic Forecasts, 2014F-2016F

| | GDP Growth | | | CPI Inflation | | | Current Balance (% of GDP) | | | Fiscal Balance (% of GDP) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| **Asia** | **6.1** | **6.1** | **6.1** | **3.0** | **2.8** | **2.9** | **2.6** | **2.7** | **2.4** | **-2.5** | **-2.6** | **-2.5** |
| China | 7.3 | 6.9 | 6.7 | 2.0 | 1.9 | 2.2 | 2.5 | 2.7 | 2.5 | -2.1 | -2.5 | -2.5 |
| Hong Kong | 2.3 | 2.6 | 3.0 | 4.4 | 4.2 | 3.8 | 2.6 | 4.1 | 5.5 | 1.3 | 0.7 | 1.0 |
| India* | 5.6 | 6.5 | 7.0 | 7.2 | 6.2 | 6.0 | -1.6 | -1.3 | -1.3 | -6.7 | -6.4 | -6.1 |
| Indonesia | 5.1 | 5.1 | 5.3 | 6.3 | 7.2 | 4.6 | -3.1 | -2.7 | -2.7 | -2.4 | -2.0 | -1.8 |
| Korea | 3.4 | 3.5 | 3.7 | 1.3 | 1.6 | 2.6 | 6.2 | 5.9 | 5.3 | 0.9 | 0.3 | 0.3 |
| Malaysia | 6.0 | 5.3 | 5.1 | 3.2 | 3.9 | 3.3 | 5.7 | 4.5 | 5.0 | -3.5 | -3.0 | -2.5 |
| Mongolia | 6.5 | 9.0 | 8.0 | 13.0 | 12.6 | 10.4 | -9.7 | -8.6 | -12.5 | -7.9 | -6.9 | -6.5 |
| Pakistan | 5.4 | 4.5 | 4.3 | 8.6 | 7.0 | 7.5 | -1.8 | 0.0 | -1.3 | -7.9 | -8.2 | -7.5 |
| Philippines | 6.3 | 6.5 | 7.3 | 4.3 | 3.5 | 3.6 | 4.3 | 4.3 | 4.2 | -1.1 | -1.3 | -1.2 |
| Singapore | 2.9 | 3.0 | 3.0 | 1.1 | 0.6 | 1.4 | 18.0 | 18.0 | 17.0 | -0.3 | 0.2 | 1.5 |
| Sri Lanka | 7.7 | 7.8 | 7.6 | 3.4 | 4.6 | 6.0 | -2.7 | -2.6 | -2.1 | -5.4 | -5.2 | -4.5 |
| Taiwan | 3.6 | 3.6 | 3.8 | 1.4 | 1.7 | 2.0 | 12.0 | 11.0 | 8.0 | -1.4 | -1.6 | -1.3 |
| Thailand | 0.5 | 3.0 | 3.8 | 1.9 | 1.3 | 2.0 | 2.6 | 2.2 | 2.0 | -2.7 | -2.2 | -1.8 |
| Vietnam | 5.7 | 5.9 | 6.2 | 4.3 | 5.0 | 5.7 | 4.9 | 3.9 | 3.2 | -6.4 | -6.0 | -5.7 |
| **Latin America** | **0.9** | **1.6** | **2.8** | **7.6** | **7.6** | **8.0** | **-2.8** | **-3.0** | **-2.9** | **-4.4** | **-4.2** | **-3.9** |
| Argentina | 0.0 | -1.0 | 1.0 | | 22.6 | 34.8 | -1.0 | -1.4 | -1.2 | -3.7 | -4.7 | -3.7 |
| Brazil | 0.1 | 0.5 | 1.8 | 6.3 | 6.5 | 6.1 | -4.0 | -4.1 | -3.9 | -5.5 | -4.7 | -4.4 |
| Chile | 1.5 | 2.5 | 4.0 | 4.4 | 3.5 | 3.1 | -1.9 | -2.8 | -3.0 | -2.0 | -1.6 | -0.7 |
| Colombia | 4.8 | 4.5 | 4.5 | 2.8 | 3.0 | 3.1 | -4.5 | -4.5 | -4.5 | -1.6 | -1.5 | -0.3 |
| Costa Rica | 3.0 | 2.5 | 3.5 | 4.5 | 4.8 | 4.6 | -5.5 | -5.3 | -5.0 | -6.7 | -7.3 | -8.0 |
| Dominican Republic | 6.8 | 5.0 | 4.5 | 3.1 | 2.4 | 3.3 | -3.7 | -3.4 | -3.3 | -4.0 | -3.6 | -4.5 |
| El Salvador | 2.0 | 2.2 | 2.5 | 1.3 | 1.6 | 1.9 | -6.0 | -5.8 | -6.0 | -3.4 | -3.6 | -3.5 |
| Mexico | 2.4 | 3.9 | 4.4 | 4.0 | 3.5 | 3.6 | -2.2 | -2.0 | -2.4 | -3.6 | -3.5 | -3.5 |
| Panama | 6.2 | 5.5 | 6.5 | 2.8 | 1.5 | 2.2 | -9.0 | -8.6 | -7.0 | -4.5 | -3.5 | -3.0 |
| Peru | 2.5 | 3.8 | 4.6 | 3.3 | 2.6 | 2.6 | -5.6 | -4.8 | -5.9 | 0.5 | -2.7 | -1.7 |
| Venezuela | -4.0 | -2.2 | 1.9 | 61.3 | 70.3 | 80.0 | 4.4 | 2.4 | 4.1 | -12.3 | -12.6 | -12.7 |
| **Europe** | **1.4** | **1.1** | **2.6** | **6.0** | **5.9** | **5.2** | **0.2** | **-0.1** | **-0.6** | **-1.6** | **-2.0** | **-1.7** |
| Bulgaria | 1.5 | 2.0 | 2.5 | -1.2 | 1.4 | 1.3 | 0.5 | -0.5 | -1.5 | -3.7 | -3.8 | -2.0 |
| Croatia | -0.7 | 0.3 | 1.3 | -0.1 | 1.5 | 1.6 | 1.0 | 0.8 | -0.5 | -5.5 | -5.6 | -5.4 |
| Czech Republic | 2.3 | 2.3 | 3.0 | 0.4 | 1.2 | 2.1 | 0.2 | -0.6 | -1.1 | -1.9 | -2.3 | -2.0 |
| Hungary | 3.3 | 2.5 | 1.8 | 0.0 | 1.7 | 2.8 | 4.3 | 3.8 | 3.3 | -2.8 | -2.4 | -2.1 |
| Kazakhstan | 4.0 | 4.3 | 5.0 | 6.6 | 6.4 | 5.7 | 2.3 | 1.8 | 2.1 | -2.4 | -2.2 | -1.9 |
| Poland | 3.3 | 3.4 | 3.6 | 0.0 | 0.8 | 2.4 | -1.8 | -3.2 | -3.9 | -2.9 | -2.4 | -2.2 |
| Romania | 2.8 | 3.0 | 3.0 | 1.2 | 2.2 | 2.6 | -1.2 | -2.0 | -2.2 | -1.7 | -2.0 | -2.5 |
| Russia | 0.5 | -1.0 | 1.7 | 7.5 | 7.6 | 5.8 | 3.3 | 3.5 | 2.7 | 0.0 | -1.0 | -0.6 |
| Serbia | -2.0 | -0.5 | 1.5 | 2.2 | 3.5 | 4.3 | -5.3 | -4.8 | -4.5 | -7.8 | -6.0 | -4.5 |
| Slovakia | 2.4 | 2.5 | 3.1 | -0.1 | 1.1 | 2.3 | 1.5 | 0.5 | 0.5 | -2.9 | -2.8 | -2.1 |
| Turkey | 3.1 | 3.3 | 3.4 | 8.9 | 6.7 | 7.0 | -5.5 | -5.1 | -5.5 | -2.0 | -2.9 | -3.0 |
| Ukraine | -6.4 | -2.4 | 1.6 | 12.1 | 16.2 | 8.4 | -3.2 | -2.7 | -2.1 | -10.0 | -6.0 | -4.0 |
| **Africa/Mideast** | **3.9** | **4.5** | **5.1** | **4.5** | **5.1** | **5.1** | **8.8** | **3.9** | **4.5** | **0.1** | **-3.4** | **-2.8** |
| Bahrain | 4.8 | 4.4 | 4.4 | 2.5 | 2.1 | 2.2 | 5.2 | -5.0 | -4.1 | -4.1 | -5.9 | -4.5 |
| Egypt | 2.4 | 3.2 | 5.2 | 10.7 | 12.4 | 10.5 | -2.1 | -2.3 | -2.8 | -11.7 | -9.4 | -7.8 |
| Ghana | 4.6 | 4.0 | 6.0 | 15.2 | 13.2 | 8.0 | -8.9 | -7.8 | -8.3 | -9.8 | -7.6 | -6.5 |
| Iraq | 0.1 | 8.9 | 10.4 | 2.5 | 5.0 | 5.0 | 9.3 | 2.5 | 5.2 | -4.2 | -4.8 | -0.9 |
| Israel | 2.3 | 2.2 | 2.5 | 0.5 | 0.3 | 1.0 | 2.0 | 1.8 | 3.3 | -3.0 | -3.3 | -2.5 |
| Jordan | 3.6 | 3.8 | 4.3 | 3.0 | 4.0 | 4.2 | -9.2 | -2.7 | -2.0 | -6.4 | -6.8 | -6.8 |
| Kenya | 5.4 | 6.0 | 6.2 | 7.3 | 7.3 | 6.6 | -7.6 | -7.5 | -8.0 | -6.0 | -5.8 | -5.6 |
| Kuwait | 3.8 | 3.9 | 2.7 | 3.0 | 3.5 | 3.5 | 36.9 | 27.4 | 27.5 | 25.2 | 3.5 | 2.6 |
| Lebanon | 3.6 | 9.8 | 5.8 | 1.6 | 2.3 | 2.5 | -14.9 | -9.6 | -8.4 | -9.5 | -8.9 | -8.6 |
| Nigeria | 6.2 | 4.8 | 6.3 | 8.1 | 9.9 | 9.3 | 2.4 | -0.9 | 0.6 | -2.0 | -2.4 | -2.0 |
| Oman | 4.1 | 2.7 | 2.3 | 1.0 | 0.9 | 1.2 | 6.5 | -1.8 | -0.4 | -2.7 | -5.4 | -4.6 |
| Qatar | 5.4 | 5.5 | 5.4 | 3.0 | 3.5 | 4.5 | 29.4 | 23.3 | 23.6 | 9.6 | 3.6 | 1.0 |
| Saudi Arabia | 4.8 | 5.1 | 5.5 | 2.9 | 3.0 | 3.4 | 13.4 | 4.4 | 6.0 | 4.7 | -3.4 | -2.6 |
| South Africa | 1.4 | 2.2 | 2.8 | 6.1 | 5.6 | 5.2 | -5.3 | -4.7 | -4.1 | -4.1 | -4.1 | -3.5 |
| Tanzania | 7.1 | 7.2 | 6.4 | 6.4 | 6.2 | 6.8 | -13.9 | -12.9 | -12.1 | -6.2 | -6.5 | -5.5 |
| UAE | 4.0 | 4.0 | 4.4 | 2.0 | 2.4 | 2.9 | 22.0 | 13.6 | 11.8 | NA | NA | NA |
| Uganda | 6.1 | 6.5 | 6.9 | 4.6 | 4.9 | 4.7 | -9.7 | -10.1 | -11.0 | -5.3 | -5.6 | -5.3 |
| Zambia | 6.5 | 6.3 | 6.1 | 7.8 | 7.5 | 6.8 | 1.5 | 1.8 | 1.0 | -5.3 | -4.4 | -5.2 |
| **Total** | **4.2** | **4.4** | **4.9** | **4.4** | **4.3** | **4.3** | **2.1** | **1.5** | **1.4** | **-2.4** | **-2.9** | **-2.7** |

Source: National sources, Citi Research forecasts

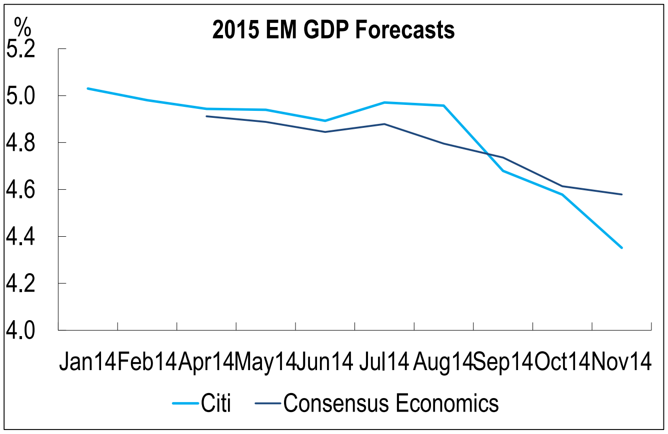
# Our Forecasts vs. Consensus

**Figure 51. Citi vs Consensus Forecasts**

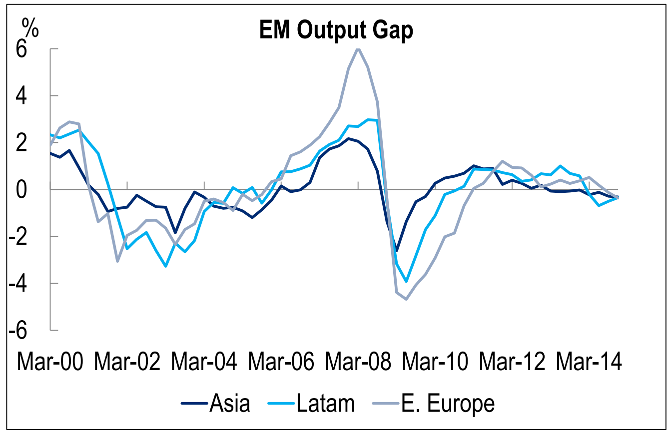
| | GDP Growth (%) | | | | CPI Inflation (%) | | | | Current Account Balance (US$ bn) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | Consensus | 2015F | Consensus | 2014F | Consensus | 2015F | Consensus | 2014F | Consensus | 2015F | Consensus |
| **Asia** | **6.1%** | **6.2%** | **6.1%** | **6.2%** | **2.9%** | **3.0%** | **2.8%** | **3.1%** | **448** | **421** | **484** | **409** |
| China | 7.3 | 7.4 | 6.9 | 7.1 | 2.0 | 2.1 | 1.9 | 2.4 | 251 | 242 | 291 | 246 |
| Hong Kong | 2.3 | 2.2 | 2.6 | 2.8 | 4.4 | 3.9 | 4.2 | 3.4 | 7 | 3 | 12 | 5 |
| India | 5.6 | 5.6 | 6.5 | 6.3 | 7.2 | 7.3 | 6.2 | 6.5 | -33 | -38 | -30 | -48 |
| Indonesia | 5.1 | 5.1 | 5.1 | 5.4 | 6.3 | 6.1 | 7.2 | 6.2 | -27 | -25 | -25 | -22 |
| South Korea | 3.4 | 3.5 | 3.5 | 3.7 | 1.3 | 1.4 | 1.6 | 2.0 | 88 | 80 | 82 | 74 |
| Malaysia | 6.0 | 5.7 | 5.3 | 5.2 | 3.2 | 3.2 | 3.9 | 4.0 | 18 | 18 | 15 | 17 |
| Philippines | 6.3 | 6.2 | 6.5 | 6.2 | 4.3 | 4.3 | 3.5 | 3.7 | 12 | 10 | 13 | 11 |
| Singapore | 2.9 | 3.1 | 3.0 | 3.6 | 1.1 | 1.3 | 0.6 | 1.5 | 54 | 57 | 53 | 59 |
| Sri Lanka | 7.7 | 7.3 | 7.8 | 7.1 | 3.4 | 4.6 | 4.6 | 5.7 | -2 | -3 | -2 | -4 |
| Taiwan | 3.6 | 3.6 | 3.6 | 3.6 | 1.4 | 1.4 | 1.7 | 1.6 | 60 | 59 | 58 | 58 |
| Thailand | 0.5 | 1.1 | 3.0 | 4.1 | 1.9 | 2.1 | 1.3 | 2.2 | 10 | 10 | 9 | 7 |
| Vietnam | 5.7 | 5.6 | 5.9 | 5.9 | 4.3 | 4.7 | 5.0 | 5.7 | 8 | 7 | 7 | 6 |
| **Latin America** | **1.0%** | **0.9%** | **1.7%** | **1.9%** | **9.9%** | **10.4%** | **10.4%** | **9.6%** | **-143** | **-141** | **-151** | **-146** |
| Argentina | 0.0 | -1.7 | -1.0 | -0.7 | 24.2 | 26.5 | 30.1 | 26.4 | -5 | -6 | -7 | -7 |
| Brazil | 0.1 | 0.2 | 0.5 | 0.8 | 6.4 | 6.4 | 6.8 | 6.3 | -86 | -82 | -85 | -79 |
| Chile | 1.5 | 1.8 | 2.5 | 2.9 | 4.8 | 5.0 | 3.0 | 2.9 | -5 | -4 | -7 | -5 |
| Colombia | 4.8 | 4.9 | 4.5 | 4.5 | 3.2 | 3.3 | 3.0 | 3.2 | -17 | -15 | -17 | -16 |
| Mexico | 2.4 | 2.3 | 3.9 | 3.7 | 3.9 | 4.0 | 3.3 | 3.5 | -28 | -25 | -28 | -29 |
| Panama | 6.2 | 6.8 | 5.5 | 6.2 | 2.0 | 3.0 | 1.8 | 3.4 | -4 | -5 | -4 | -5 |
| Peru | 2.5 | 2.9 | 3.8 | 4.7 | 3.3 | 3.1 | 2.6 | 2.6 | -11 | -10 | -10 | -10 |
| Venezuela | -4.0 | -3.2 | -2.2 | -1.7 | 64.0 | 68.5 | 75.0 | 69.1 | 15 | 7 | 7 | 4 |
| **Europe** | **1.4%** | **1.3%** | **1.1%** | **1.6%** | **5.9%** | **6.2%** | **5.8%** | **5.4%** | **11.5** | **-2.5** | **-2.0** | **-15.5** |
| Bulgaria | 1.5 | 1.6 | 2.0 | 2.0 | -1.2 | -1.1 | 1.4 | 1.4 | 0.3 | 0.3 | -0.2 | -0.2 |
| Croatia | -0.7 | -0.6 | 0.3 | 0.4 | -0.1 | 0.0 | 1.5 | 1.5 | 0.6 | 0.5 | 0.4 | 0.3 |
| Czech R | 2.3 | 2.4 | 2.3 | 2.5 | 0.4 | 0.4 | 1.2 | 1.5 | 0.4 | -0.9 | -1.3 | -2.0 |
| Hungary | 3.3 | 3.3 | 2.5 | 2.2 | 0.0 | 0.0 | 1.7 | 2.0 | 5.6 | 4.2 | 4.4 | 3.4 |
| Kazakhstan | 4.0 | 4.4 | 4.3 | 4.8 | 6.6 | 6.8 | 6.4 | 6.4 | 4.7 | 2.8 | 4.0 | -0.5 |
| Poland | 3.3 | 3.2 | 3.4 | 3.2 | 0.0 | 0.1 | 0.8 | 1.1 | -9.5 | -6.6 | -14.9 | -9.2 |
| Romania | 2.8 | 2.1 | 3.0 | 2.9 | 1.2 | 1.2 | 2.2 | 2.2 | -2.3 | -2.6 | -3.5 | -3.3 |
| Russia | 0.5 | 0.3 | -1.0 | 0.1 | 7.5 | 8.2 | 7.6 | 6.7 | 60.3 | 51.3 | 53.3 | 47.2 |
| Serbia | -2.0 | -0.9 | -0.5 | 1.3 | 2.2 | 2.5 | 3.5 | 4.3 | -2.1 | -2.4 | -1.6 | -2.3 |
| Slovak Rep | 2.4 | 2.4 | 2.5 | 2.8 | -0.1 | 0.1 | 1.1 | 1.3 | 1.5 | 2.0 | 0.4 | 1.7 |
| Turkey | 3.1 | 3.0 | 3.3 | 3.3 | 8.9 | 9.0 | 6.7 | 7.2 | -44.0 | -46.6 | -40.1 | -46.5 |
| Ukraine | -6.4 | -7.3 | -2.4 | -1.2 | 12.1 | 11.5 | 16.2 | 12.2 | -4.0 | -4.5 | -2.9 | -4.1 |
| **MEA** | **4.0%** | **3.8%** | **4.0%** | **4.2%** | **5.3%** | **5.3%** | **6.0%** | **5.9%** | **96.4** | **102.8** | **8.2** | **61.8** |
| Egypt | 2.4 | 2.3 | 3.2 | 3.2 | 10.7 | 10.2 | 12.4 | 10.5 | -6.0 | -3.8 | -7.2 | -9.7 |
| Israel | 2.3 | 2.4 | 2.2 | 3.0 | 0.5 | 0.6 | 0.3 | 2.6 | 5.9 | 6.0 | 5.2 | 6.7 |
| Nigeria | 6.2 | 6.3 | 4.8 | 6.4 | 8.1 | 8.4 | 9.9 | 9.0 | 13.6 | 11.2 | -5.4 | 7.8 |
| S. Africa | 1.4 | 1.5 | 2.2 | 2.7 | 6.1 | 6.2 | 5.6 | 5.7 | -17.7 | -19.6 | -16.6 | -18.3 |
| S. Arabia | 4.8 | 4.3 | 5.1 | 4.1 | 2.9 | 2.9 | 3.0 | 3.3 | 100.5 | 109.0 | 32.2 | 75.3 |
| **Above Total** | **4.2%** | **4.2%** | **4.4%** | **4.6%** | **4.9%** | **5.1%** | **4.9%** | **4.9%** | **418.7** | **383.7** | **346.4** | **319.1** |

Source: Consensus Economics, National Sources, Citi Research forecasts

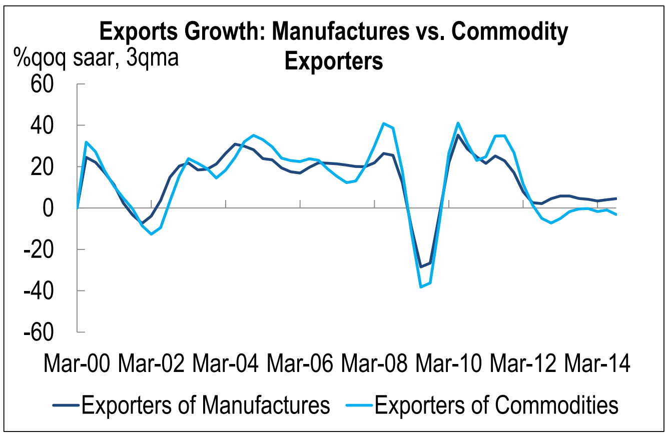
# EM most requested regional charts



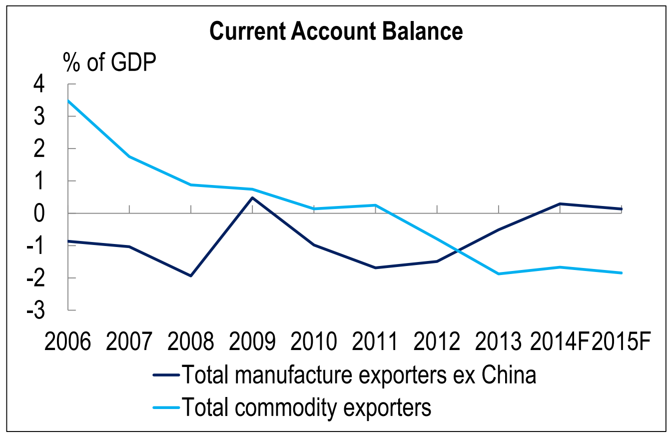

Source: Haver Analytics, Citi Research



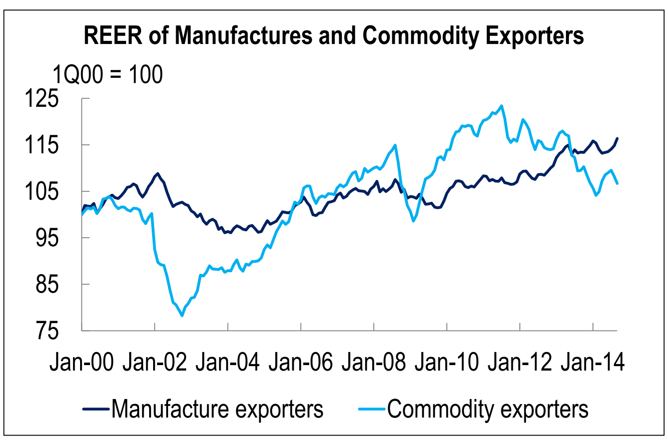

Source: Haver Analytics, Citi Research



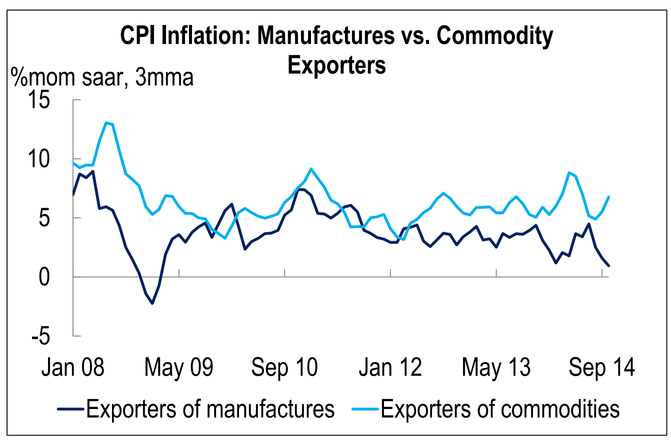

Source: Haver Analytics, Citi Research




Source: Haver Analytics, Citi Research




Source: Haver Analytics, Citi Research




Source: Central banks, Haver Analytics, Citi Research

# Asia Pacific

# China

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- **Summary view** – The Chinese economy is likely entering a new cycle of 6-7% growth. Recent policy-rate cuts with another step of interest rate liberalization have set the stage for a possible combination of more aggressive easing and decisive reform in 2015 to achieve around 7% growth.
- **Things to watch** – The property sector correction remains top risk for the Chinese economy. The stabilization of its transaction volume shall determine the direction of GDP growth and monetary policy. Fiscal reform is likely to lead the policy breakthroughs and contain the default risk of local debts.
- **Strategy** – After recent rate cut, we expect two more cuts, 25bps each, before mid-2015 in order to reduce the cost of capital. The slow growth, low inflation and lower rate environment shall weaken the USDCNY to 6.25 in next 6-12 months. The proposed fiscal reform shall lead to bond market expansion in coming years.

## Prospects for 2015 & Beyond: New Normal, New Cycle

China's investment-led growth has probably ended in 2014. This is the first year since 2003 seeing fixed asset investment (FAI) growth significantly below 20%, 15.9% yoy in the first 10 months this year vs. 26.5% annualized growth between 2003 and 2013. This downward trend will most likely continue next year, in our view. Part of the slowdown was intended. Regulation tightening in the shadow banking sector and slow paced monetary policy easing had weighed on growth. Disinflation (i.e., headline CPI at 1.6% yoy in Sept and Oct) is indicative of a negative output gap in the economy, but the government was hesitant to stimulate the economy, until recently. Chinese leaders might have realized that they have to tolerate slower growth and accommodate more structural changes. Changing dynamics in the labor market this year had also reduced government obsession with high-speed growth. President Xi Jingping had reckoned that the economic growth shall level down from the "high speed growth" to a new phase of "medium-to-high speed growth". A new cycle of medium-speed growth is unfolding.

The government may lower the growth target to 7% for 2015, but we do think it's possible that this target could be breached again and the reported growth would be 6.9%. Recent growth downturn was driven by investment. Rising cost of capital and falling inflation are both rooted in China's over-levered and over-supplied old normal. Since the global financial crisis, the economy has been levering up quickly with its total debt to GDP surged from 179% in 2007 to 233% in 2013 led by local governments and SOEs. Non-financial corporate debt was 124% of GDP in 2013, topping major economies in the world, and according to our estimation, 44.6% of it accumulated in the SOE sector. Those less productive sectors have crowded out credit in the non-SOE and consumer sectors, suppressed productivity growth, and pushed up the cost of funding. An over-leveraged economy is also over-supplied, two sides of the same coin. The sharp slowdown in the Chinese economy in the past seven years has intensified the over-capacity problem, PPI deflation in the past 32 months and disinflation recently. High cost of capital and disinflation could be re-enforced with each other and exacerbated by deflation imported from Japan and euro area.

Recent policy developments suggest that the Chinese leaders are keen to tackle the core problems of old normal. On one hand, despite a slow start, China is launching fiscal reform and SOE reform to tackle the debt problems. On the other hand, it pursues an aggressive strategy to bid for Asian Infrastructure Investment.

Bank, FTAAP, and new Silk Road Plan to export excess capacity. Four new trends are emerging.

- First, debt regionalization and nationalization will lead to local deleveraging and central re-leveraging. Banks, PPP and the bond market may share the funding needs of about Rmb7tn amid local government de-levering in 2015, reducing the risk of local defaults. Both PPP boom and bond market expansion are natural consequences of the fiscal reform while local government financing vehicles will cease functioning by the end of 2015.

- Second, SOEs will start to implement the “asset light” strategy to comply with rising cost of capital in the longer term. This could liquidate or securitize trillions of assets out of its total of Rmb104.1tn, and with a few assumptions, the size could go as high as Rmb20tn, positive for ROEs. According to our estimation, SOEs have contributed Rmb31.5tn to the debt of non-financial corporates.

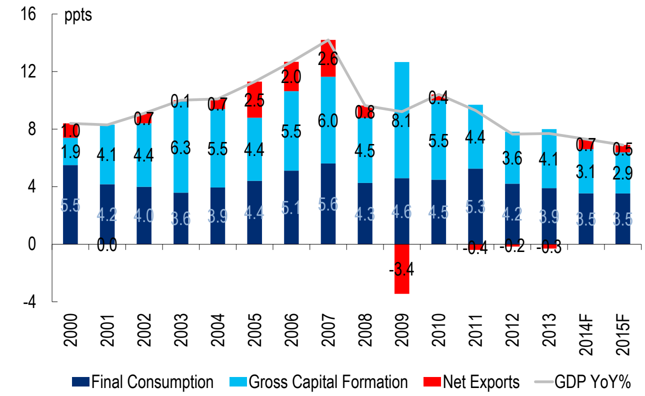
- Third, the adoption of new GDP measurement method will reveal that the Chinese economy is less distorted than current statistics suggest, and the quality of growth may improve, albeit slowly. China’s nominal GDP may be scaled up by 2.5-5% after the change in GDP calculation method next year, indicating China’s household consumption share in GDP could be 1~3 ppts higher than current data had suggested.

- Fourth, the “go overseas” approach will export excess capacity to countries that are supplementary in growth stages and running trade surplus with China. This will likely be gradual alongside the rise of Chinese multinational companies and RMB internationalization.

The Chinese GDP growth rate is already half of the rate seen seven years ago in 2007. We argue that compared to the sharp slowdown in the past seven years, it’s more likely the economic growth rate will stabilize within the range of 6-7% in the coming new cycle. Chinese leaders vowed to double 2010 GDP in real terms by 2020 which requires 6.8% annualized growth from now to 2020. We believe that China’s economy can still grow by more than 7% for a few years without causing inflationary pressures, if production capacity can be utilized more fully. We estimate China’s potential growth at around 7.4% for 2015 and 6.4% for 2020. However, the uncertain global outlook and the property market correction may weaken both external and domestic demands in 2015. The self-sustained growth is estimated at 6.0-6.5% by 2020 due to weak demand, a result of over-investment creating excess capacity. The economy may run below potential during 2014-16, depressing CPI inflation to around 2%.

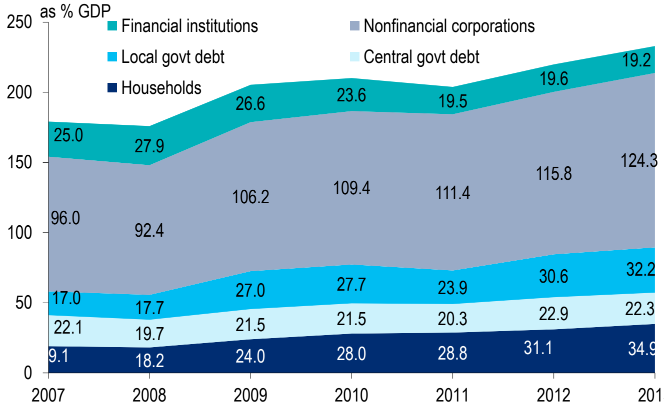
Chinese policymakers are fighting two battles simultaneously, defending the near-term growth bottom-line with accommodative monetary and fiscal policies, and achieving necessary structural reform to tackle longer-term concerns. Recent policy-rate cuts with another step of interest rate liberalization have set the stage for a possible combination of more aggressive easing (e.g., two more rate cuts) and decisive reform (led by fiscal reform) in 2015 to achieve around 7% growth. In order to cement stable growth, we expect two more rate cuts by mid-2015 and believe that RRR cuts are conditional on the pace of capital outflows. We expect fiscal policy to be expansionary next year with fiscal deficits up to 2.5% of GDP. In an environment of slow growth, lower inflation and rates, and stronger US dollar, the RMB may reverse its recent course of appreciation against the dollar and weaken to 6.25 in next 6-12 months. It shall remain a two-way bet within the range of 6-6.3.

### Figure 52. GDP contribution with forecast




Source: CEIC, NBS and Citi Research

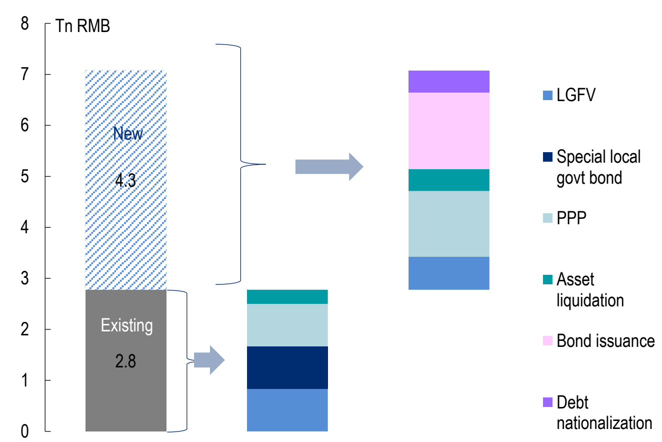
### Figure 53. China's leverage ratio by key breakdown




* Note local government debt number for 2012 and 2013 are based on four level local governments -- provincial, municipal, county and village/town.

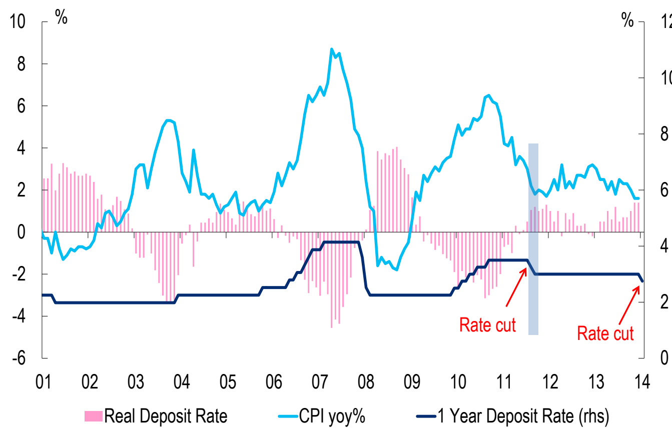
Source: MoF, PBOC, CEIC, NAO and Citi Research

### Figure 54. Possible funding structure of local government debts in 201



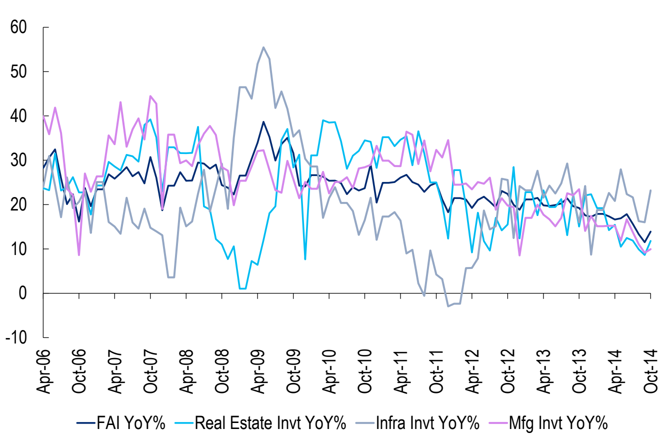

Source: MOF, NAO and Citi Research

### Figure 55. Real deposit rate vs. Rate cut cycle



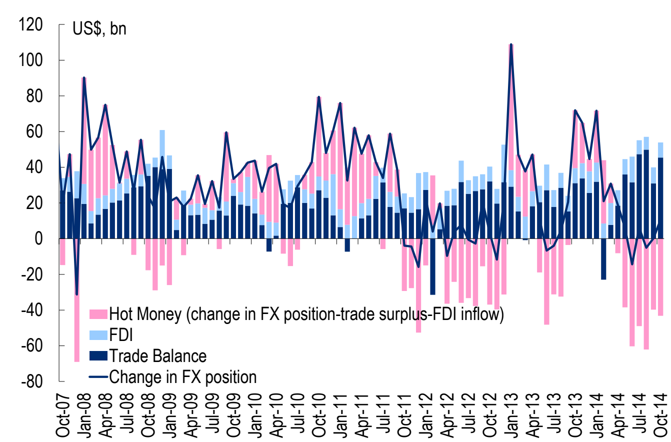

Source: NBS and Citi Research

### Figure 56. FAI growth by key sectors




Source: WIND, NBS and Citi Research

### Figure 57. Hot money flow




Source: CEIC and Citi Research

**Figure 58. China Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 4,544.0 | 5,070.5 | 5,932.5 | 7,319.0 | 8,246.9 | 9,245.4 | 10,038.1 | 10,784.6 | 11,749.2 |
| Nominal GDP, local currency bn | 31,490 | 34,632 | 40,151 | 47,310 | 51,947 | 56,885 | 61,765 | 66,662 | 72,243 |
| GDP per capita, US$ | 3,422 | 3,800 | 4,424 | 5,432 | 6,091 | 6,794 | 7,348 | 7,873 | 8,555 |
| Population, mn | 1,328.0 | 1,334.5 | 1,340.9 | 1,347.4 | 1,354.0 | 1,360.7 | 1,366.2 | 1,369.7 | 1,373.4 |
| Unemployment, % of labour force | 4.2 | 4.3 | 4.1 | 4.1 | 4.1 | 4.1 | 4.1 | 4.1 | 4.3 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 9.6 | 9.2 | 10.4 | 9.3 | 7.7 | 7.7 | 7.3 | 6.9 | 6.7 |
| Real investment growth % yoy | 11.0 | 19.2 | 11.9 | 9.4 | 8.1 | 8.7 | 6.5 | 6.1 | 6.4 |
| Real consumption growth % yoy | 8.5 | 9.4 | 9.2 | 10.9 | 8.3 | 7.9 | 7.1 | 7.1 | 7.1 |
| private consumption growth % yoy | 9.2 | 10.3 | 8.5 | 18.2 | 7.8 | 7.2 | 7.3 | 7.3 | 7.3 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 1.2 | 1.9 | 4.6 | 4.1 | 2.5 | 2.5 | 1.9 | 2.3 | 2.5 |
| CPI, % avg | 5.9 | -0.7 | 3.3 | 5.4 | 2.6 | 2.6 | 2.0 | 1.9 | 2.2 |
| Nominal wages, % yoy | 16.9 | 11.6 | 13.3 | 14.4 | 11.9 | 10.1 | 9.1 | 8.4 | 8.9 |
| Credit extension to private sector, % yoy | 14.0 | 33.2 | 20.3 | 15.1 | 15.6 | 14.1 | 13.3 | 12.8 | 12.4 |
| Policy interest rate, % eop | 2.25 | 2.25 | 2.75 | 3.50 | 3.00 | 3.00 | 2.75 | 2.25 | 2.25 |
| Short-term market rate, % eop | 1.78 | 1.83 | 4.62 | 5.47 | 3.90 | 5.56 | 4.75 | 4.25 | 4.46 |
| Long term yield, % eop | 1.80 | 3.06 | 3.61 | 3.27 | 3.33 | 4.49 | 3.04 | 3.89 | 3.99 |
| lc/US$, eop | 6.82 | 6.83 | 6.59 | 6.29 | 6.23 | 6.05 | 6.15 | 6.18 | 6.00 |
| lc/US$, avg | 6.95 | 6.83 | 6.77 | 6.46 | 6.31 | 6.15 | 6.18 | 6.21 | 6.06 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 420.6 | 243.3 | 237.8 | 136.1 | 215.4 | 182.8 | 251.0 | 291.2 | 293.7 |
| % of GDP | 9.3 | 4.8 | 4.0 | 1.9 | 2.6 | 2.0 | 2.5 | 2.7 | 2.5 |
| Trade balance | 298.1 | 195.7 | 181.5 | 154.9 | 230.3 | 259.2 | 357.3 | 434.1 | 481.8 |
| Exports | 1,430.7 | 1,201.6 | 1,577.8 | 1,898.4 | 2,048.7 | 2,209.5 | 2,345.4 | 2,501.7 | 2,632.1 |
| Imports | 1,132.6 | 1,005.9 | 1,396.2 | 1,743.5 | 1,818.4 | 1,950.3 | 1,988.1 | 2,067.6 | 2,150.3 |
| Service balance | -11.8 | -29.4 | -31.2 | -61.6 | -89.7 | -124.5 | -92.8 | -123.7 | -154.3 |
| Income balance | 28.6 | -8.5 | -25.9 | -70.3 | -19.9 | -43.8 | -13.6 | -19.2 | -33.7 |
| FDI, net | 114.8 | 87.2 | 185.7 | 231.7 | 176.3 | 185.0 | 157.4 | 97.7 | 26.4 |
| International reserves | 1,946.0 | 2,399.2 | 2,847.3 | 3,181.1 | 3,311.6 | 3,821.3 | 4,011.0 | 4,302.8 | 4,531.0 |
| Total Amortisations | 23.3 | 34.2 | 27.2 | 33.2 | 33.0 | 39.2 | 41.2 | 45.3 | 49.9 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -0.4 | -2.2 | -2.2 | -1.3 | -2.0 | -1.9 | -2.1 | -2.5 | -2.5 |
| Consolidated gov primary balance | 0.1 | -1.8 | -1.7 | -0.9 | -1.5 | -1.4 | -1.6 | -2.0 | -1.5 |
| Public debt | 37.4 | 47.8 | 49.2 | 44.3 | 53.5 | 54.6 | 55.2 | 56.1 | 56.5 |
| of which Domestic | 36.6 | 47.0 | 48.6 | 43.7 | 53.0 | 54.2 | 54.8 | 55.7 | 56.1 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 390.2 | 428.6 | 548.9 | 695.0 | 737.0 | 863.2 | 949.5 | 1,044.4 | 1,148.9 |
| Private | 356.9 | 391.8 | 510.1 | 657.6 | 700.4 | 828.8 | 911.7 | 1,002.9 | 1,103.2 |
| Public | 33.3 | 36.9 | 38.8 | 37.4 | 36.6 | 34.3 | 37.8 | 41.5 | 45.7 |
| External debt / GDP | 8.6 | 8.5 | 9.3 | 9.5 | 8.9 | 9.3 | 9.5 | 9.7 | 9.8 |
| External debt / XGS | 24.7 | 32.2 | 31.5 | 33.4 | 32.8 | 35.6 | 36.9 | 38.0 | 39.8 |
| Short-term debt | 226.3 | 259.3 | 375.7 | 500.9 | 540.9 | 676.6 | 744.3 | 818.7 | 900.6 |
| Short-term debt/International Reserves (%) | 11.6 | 10.8 | 13.2 | 15.7 | 16.3 | 17.7 | 18.6 | 19.0 | 19.9 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 7.5 | 7.3 | 7.1 | 6.7 | 6.8 | 7.0 | 7.1 | 7.0 | 6.8 |
| CPI, % yoy | 2.3 | 1.6 | 1.9 | 1.8 | 1.5 | 1.9 | 2.3 | 2.2 | 2.0 |
| Policy interest rate, % eop | 3.00 | 3.00 | 2.75 | 2.50 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 |
| Short-term market rate, % eop | 4.75 | 4.54 | 4.75 | 4.04 | 4.10 | 3.94 | 4.25 | 3.95 | 4.29 |
| Long term yield, % eop | 3.84 | 3.90 | 3.04 | 3.46 | 3.19 | 3.63 | 3.89 | 4.11 | 3.84 |
| lc vs USD, eop | 6.20 | 6.14 | 6.15 | 6.19 | 6.23 | 6.23 | 6.18 | 6.13 | 6.08 |

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** – We see three themes in the likely bumpy year of 2015: 1) Slower consumption in 1H and better trade in 2H likely to achieve a 2.6%yoy moderate GDP recovery, 2) Liquidity likely abundant in 1H15, and 3) Heightened politics and governance difficulty making populist policies the focus.
- **Things to watch** – 1) Liquidity flow patterns; 2) Trade recovery & property market adjustment; 3) Tourist shopping (lower volume & value/pax); 4) Electoral reforms and protests; 5) Co-operating measures with Qianhai and Shanghai FTZ; 6) Expansion of Stock Connect; 8) More RQFII quota.
- **Strategy** – Pressure for interest rate increase would resurface with Fed hikes in 2H15E. HKD could move towards HK$7.8/USD on the strong USD and spurts of RMB depreciation in 6-12M. Citi expects mass market home prices would rise by 8% in 2015E; and the HSI target for 2015 year-end is 25,000.

## Busy navigation in 2015

**We expect another bumpy 2015 with overall moderate growth recovery of 2.6%yoy (vs. 2014E: 2.3%yoy), with 1H GDP starting low at 2%yoy**. Given many external dynamics will play out in early 2015, HK being a small open economy have to operate according to this volatile backdrop. We see three themes for 2015:

## #1: Slower consumption in 1H15E, better trade in 2H15E

**Lower consumption:** We consider China's anti-corruption exercise have turned into a structural change of no gift giving policy that will remain a major hit to HK luxury retailers. The combination of lesser Mainland tourist arrivals and lesser spending per tourist is likely to hurt HK's mid-to-low end retailers. These trends are already affecting sales profits, shop rentals and more importantly staff hiring. We expect these impacts will intensify in 2015E. Given that tourist related hiring accounts for ~16% of employment and ~9% of GDP, we expect growth will be dampened and there will be lesser jobs in these sectors. We have already noted employment declining and underemployment rising since Aug14, we therefore expect unemployment rate to rise to 3.7% by mid-2015E. We believe this reduction in tourism and retail related jobs will more than offset the benefits from the increase in minimum wage expected in May. In our view, the Occupy Movement impact on local consumption probably is most visible in 4Q14E. Even if the occupying activities drag on or reignite in 2015, we believe local consumption likely to resume after this one quarter shock as local residents adapt to traffic inconveniences.

**Higher global trade activities & local constructions:** For 2015, we see US led global trade to benefit the trading & logistic sector of HK, especially in 2H; while construction works for public infrastructure and private housing developments likely remain vibrant. Trading/logistic and construction sectors respectively account for ~26% and ~8% of the workforce; and ~31% and ~4% of GDP.

## #2: Liquidity likely abundant in 2015, at least for 1H

**Mostly inflows in 2014 thus far:** YTD Aug 2014, aside from Jan & Feb, more liquidity entered the HK economy initially as seen by bank's increases in net FX positions and in Aug we saw a rise in the monetary base. We believe HK's liquidity flow patterns are ultimately dependent on the China growth story, with interests reignited on China's target easing measures and Shanghai-HK Stock Connect.

**We see capital inflows at least in 1H15E:** The market likely interpreted China's recent first rate cut as a monetary stance shift from tightening to neutral, and our house view expects another two rate cuts in 1H15E. We believe the China story under various easing moves will again be explored in HK in the upcoming quarters. Meanwhile, our house view of a delayed Fed first rate hike of 25bps in 4Q15E and QEs from ECB and BOJ are likely supportive to capital inflows into HK in 1H15E, before investors adjust positions nearer to the actual Fed hike. Credit growth likely to slow but remain elevated in 2015E at 8%yoy, vs. loan growth of 12.7%yoy and LDR ratio of 81.8%, as of Sep14. Slower lending and abundant liquidity likely keep HK interest rates low in 2015E, with EFN rates largely following US Treasury yields' gradual uptrend.

**Stock Connect sets a new paradigm for HK as an offshore RMB center:** Although trading volumes have been smaller-than-expected at the beginning of the pilot Stock Connect, we expect higher volumes could come after the system is proven to run smoothly and more brokerage/funds utilize this new system. The perception of higher northbound trades against southbound trades materialized in the first week of launch. However, we believe the quota system will prevent massive drain of HK's liquidity to onshore. We also anticipate further enhancement to the Connect is expected in 2015 and cooperation with Qinghai is being discussed.

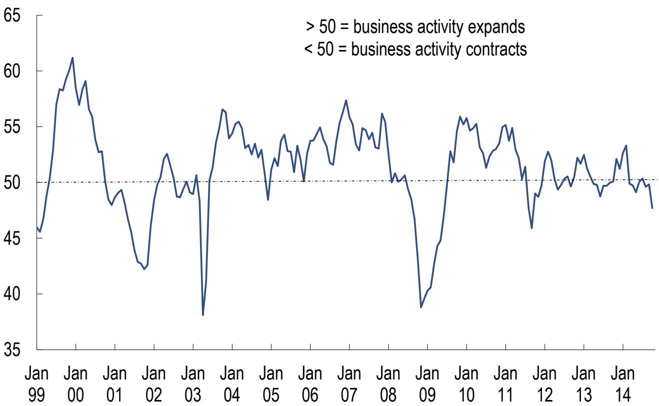
**HKD peg to stay status quo until a one-off re-peg to a fully convertible RMB:** The accumulation of RMB deposits either via institution or residents conversions in CNH market should be regarded as a normal FX play and would not undermine the sustainability of the HKD peg.

**A stable housing market is expected in 2015E:** We believe overall residential property price downward adjustments likely remain limited by supply constraints and limited turnover. Our property analyst Ken Yeung thinks that Rate Hike No Game Changer for Rising Home Prices, and mass market residential prices would actually climb by 8%yoy in 2015E, as end-demand remain strong amid a mild interest rate rising cycle, decent wage/job outlook, primary market shortage and low secondary-market supply. While offices and shops rentals are expected to see flat growth on average in 2015E, with shops in malls likely to suffer in rental rises and street level shops (esp. those affected by protests) to see downward rental adjustments.

## #3: Protests could be ongoing affair affecting governance

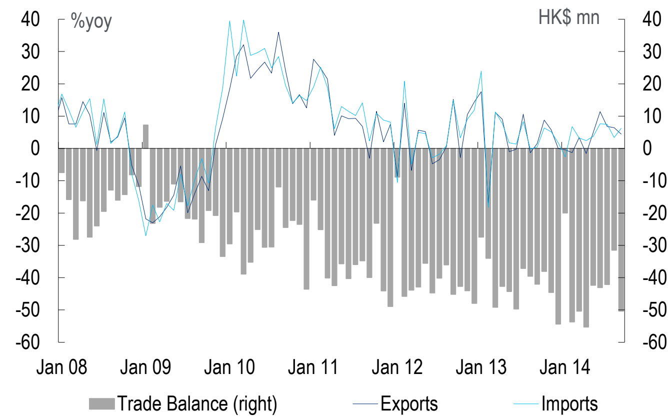
**Governance issues leave only populist measures viable:** No matter how the remaining Occupy Movement ends, we believe the intensity of political dissatisfaction will remain elevated especially with China and HK Governments taking a hard liner approach. The supplementary report submission to China's Liaison Office, the 2nd phase of political consultation, the Legco voting of the final election reform proposal, the submission of the final report to the State Council, and any arrest of key Occupy Movement activists, could all be political trigger points that can potentially amass people to street protests. HK risk premium/operational risks rise on fear that future protests could be frequent and/or disruptive. The fragile Executive and Legislative relationship has deteriorated with Democratic Party vowing to be non-cooperative, therefore likely delay or stalling key policies, and leaving only populist measures as the ones that can be easily passed. Filibuster can be expected at Jan/Feb Policy Address (PA) and Budget Speech and the subsequent budget approval meetings. The usual housing supply update will be mentioned at the PA, but we do not expect any unwinding of the previous installed tightening measures in 2015E. Near term market moving measures are likely limited, instead the policy focus likely on people's livelihood amidst the intense political backdrop, an aging society and concerns of youth related issues.

**Figure 59. HK contracts on protests hurt & external risks, says PMI**



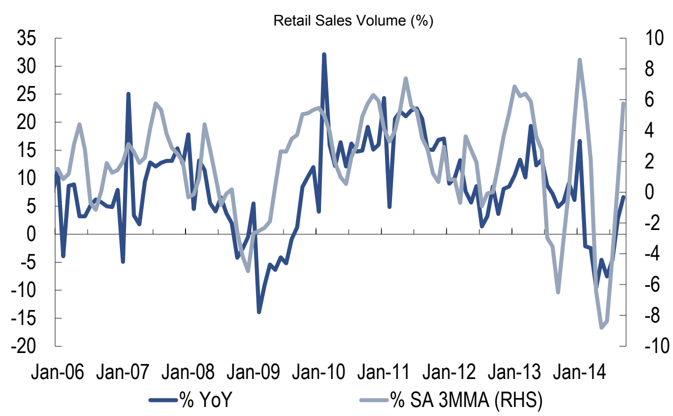

Source: Markit, Haver, Citi Research

**Figure 60. Trade fragilities persist, and probably more evident in 1Q15E**



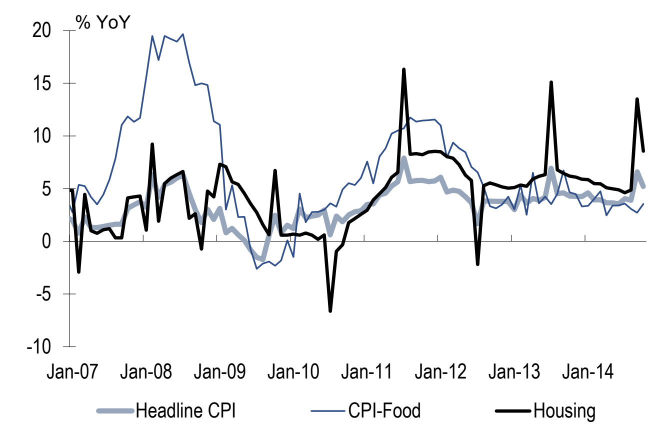

Source: CEIC, Citi Research

**Figure 61. Retail sales to slow on selective local/foreign spending**



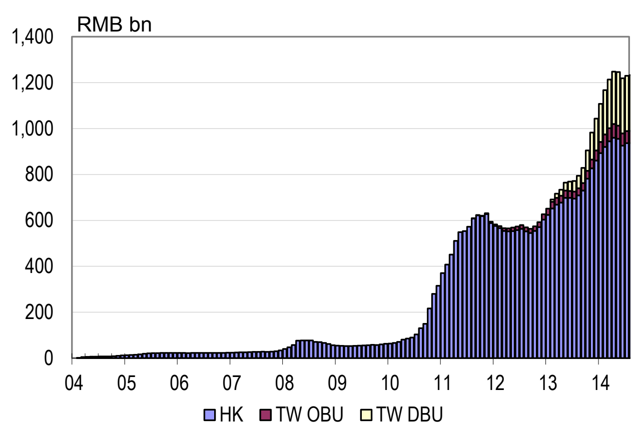

Source: CEIC, Citi Research

**Figure 62. Mild price pressures with tame private rentals& food prices**



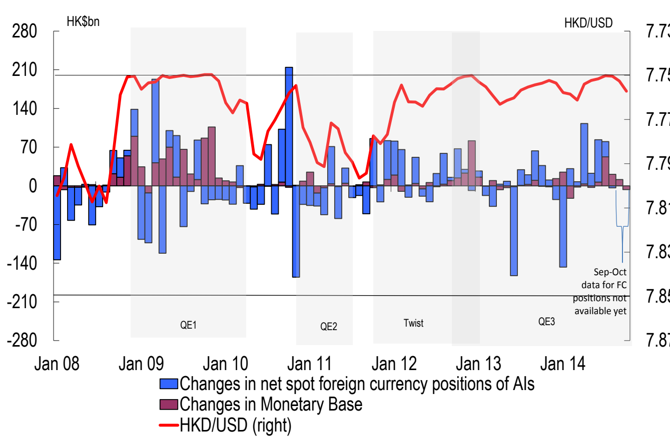

Source: CEIC, Citi Research

**Figure 63. Offshore RMB deposits continue to build**




Source: CEIC, Citi Research

**Figure 64. Net inflows continued in Aug14**




Source: CEIC, Citi Research

### Figure 65. Hong Kong Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 219.3 | 214.1 | 228.7 | 248.5 | 262.6 | 274.0 | 283.2 | 296.3 | 311.1 |
| Nominal GDP, local currency bn | 1,707 | 1,659 | 1,776 | 1,934 | 2,037 | 2,125 | 2,195 | 2,296 | 2,411 |
| GDP per capita, US$ | 31,491 | 30,595 | 32,424 | 34,941 | 36,587 | 37,942 | 39,140 | 40,881 | 42,845 |
| Population, mn | 7.0 | 7.0 | 7.1 | 7.1 | 7.2 | 7.2 | 7.2 | 7.2 | 7.3 |
| Unemployment, % of labour force | 3.5 | 5.3 | 4.3 | 3.4 | 3.3 | 3.4 | 3.3 | 3.6 | 3.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 2.1 | -2.5 | 6.8 | 4.8 | 1.5 | 2.9 | 2.3 | 2.6 | 3.0 |
| Real investment growth % yoy | -0.3 | 1.0 | 11.1 | 2.3 | 3.5 | 3.7 | 1.1 | 0.6 | 2.7 |
| Real consumption growth % yoy | 1.9 | 0.5 | 5.8 | 7.6 | 4.0 | 4.0 | 2.0 | 1.6 | 1.4 |
| private consumption growth % yoy | 1.9 | 0.2 | 6.1 | 8.4 | 4.1 | 4.2 | 1.9 | 1.7 | 1.5 |
| Real export growth, % yoy | 2.5 | -10.0 | 16.8 | 3.9 | 1.9 | 6.5 | 2.3 | 4.4 | 5.0 |
| Real import growth, % yoy | 2.2 | -9.0 | 17.4 | 4.6 | 2.9 | 6.9 | 2.1 | 3.9 | 4.5 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 2.1 | 1.5 | 2.9 | 5.7 | 3.8 | 4.3 | 4.7 | 3.4 | 4.3 |
| CPI, % avg | 4.3 | 0.6 | 2.3 | 5.3 | 4.1 | 4.3 | 4.4 | 4.2 | 3.8 |
| Nominal wages, % yoy | 3.4 | -1.0 | 2.5 | 8.1 | 5.7 | 4.7 | 4.5 | 4.5 | 4.0 |
| Credit extension to private sector, % yoy | 11.0 | -2.1 | 20.9 | 12.5 | 7.0 | 10.6 | 11.0 | 8.0 | 6.0 |
| Short-term market rate, % eop | 0.95 | 0.14 | 0.28 | 0.38 | 0.40 | 0.38 | 0.37 | 0.60 | 1.30 |
| Long term yield, % eop | 1.19 | 1.93 | 1.76 | 0.96 | 0.32 | 1.40 | 1.35 | 1.90 | 2.30 |
| lc/US$, eop | 7.75 | 7.75 | 7.77 | 7.77 | 7.75 | 7.75 | 7.76 | 7.79 | 7.75 |
| lc/US$, avg | 7.79 | 7.75 | 7.77 | 7.78 | 7.76 | 7.76 | 7.76 | 7.79 | 7.76 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 32.9 | 21.2 | 16.0 | 13.8 | 4.1 | 5.1 | 7.3 | 12.1 | 17.1 |
| % of GDP | 15.0 | 9.9 | 7.0 | 5.6 | 1.6 | 1.9 | 2.6 | 4.1 | 5.5 |
| Trade balance | -25.8 | -28.8 | -43.0 | -54.9 | -61.6 | -64.6 | -68.4 | -70.2 | -69.1 |
| Exports | 362.7 | 318.5 | 390.2 | 428.7 | 442.8 | 458.9 | 477.6 | 498.9 | 532.5 |
| Imports | 388.6 | 347.3 | 433.1 | 483.6 | 504.3 | 523.5 | 546.0 | 569.1 | 601.7 |
| Service balance | -2.7 | 3.6 | 10.1 | 17.0 | 21.9 | 28.5 | 30.0 | 29.6 | 28.1 |
| Income balance | 12.9 | 6.4 | 4.8 | 6.8 | 3.8 | 5.4 | 13.3 | 6.4 | 3.1 |
| FDI, net | -8.9 | -6.4 | -10.5 | -8.7 | -11.2 | -10.9 | -11.0 | -12.0 | -13.0 |
| International reserves | 182.5 | 255.7 | 268.6 | 285.3 | 317.2 | 311.1 | 330.0 | 355.0 | 370.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 0.0 | 1.5 | 4.1 | 3.8 | 3.1 | 1.0 | 1.3 | 0.7 | 1.0 |
| Consolidated gov primary balance | 0.0 | 1.6 | 4.2 | 3.8 | 3.2 | 1.0 | 1.3 | 0.7 | 1.1 |
| Public debt | 1.5 | 3.9 | 4.9 | 4.3 | 4.5 | 4.2 | 3.3 | 3.5 | 3.5 |
| of which Domestic | 0.7 | 3.3 | 4.3 | 3.7 | 4.0 | 3.6 | 2.8 | 3.0 | 3.0 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 1.8 | 2.7 | 2.0 | 1.7 | 2.0 | 3.4 | 3.2 | 3.0 | 2.6 |
| CPI, % yoy | 3.6 | 6.6 | 4.7 | 4.9 | 5.0 | 4.1 | 3.4 | 3.5 | 3.6 |
| Short-term market rate, % eop | 0.38 | 0.38 | 0.37 | 0.40 | 0.40 | 0.50 | 0.60 | 0.70 | 0.85 |
| Long term yield, % eop | 1.36 | 1.47 | 1.35 | 1.50 | 1.70 | 1.80 | 1.90 | 2.00 | 2.10 |
| lc vs USD, eop | 7.75 | 7.77 | 7.76 | 7.78 | 7.79 | 7.80 | 7.79 | 7.78 | 7.77 |

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** – 2014 has been transformative for India given the (1) Decisive mandate for the Modi government. (2) Changes in the monetary policy framework and (3) Sharp decline in commodity prices. Macro normalization is likely to continue with growth likely to pick up from 5.6% in FY15 to 7% by FY17.
- **Things to watch** – The budget in February will be significant from the perspective of fiscal consolidation, reforms and clarity on retrospective taxation. Other industry friendly reforms to watch out would be GST, labor and land laws. Global trends in commodity prices and Fed rate hike will be key in 2015.
- **Strategy** – With CPI trends consistently undershooting RBI's expectations, we expect conditions to become conducive for a cumulative easing of 100bps by the end of FY16. In line with the rates view, bond yields are likely to soften towards 7.75% by end 2015. We expect stable trends in INR to continue in 60-63 range.

## Macro stabilization likely to continue into FY16

**2014: A transformative year:** The year 2014 has been transformative for India. The most significant change has been in political environment, with the business-friendly Modi government winning the largest mandate in 30 years. Another key development is the RBI adopting a new monetary policy framework and its push for financial sector reforms. Last but not the least, the sharp drop in commodity prices has benefited India, given its large energy dependency.

**Normalization to continue:** Going forward, as mentioned in our latest Macroscope, we expect the process of normalization to continue. A quick recap: in 2013 it was the CAD that came down from 4.7% of GDP to 1.7%; in 2014 it was inflation which fell from a peak of 11% to 5.5% currently, and in 2015 we believe it will show up in interest rates and growth. While there is plenty of debate on pace and timing, we re-iterate our view that India is on its way back to 7% growth and 6% inflation

## GDP to revive to 6.5% by FY16; reforms gain momentum

**Reform momentum gathers pace:** As expected, the pace of reforms have picked up recently after the state assembly elections. The govt announced the much anticipated fuel reforms – diesel price deregulation, gas price hike, and direct benefit transfers in LPG. It also made further progress on labor reforms especially in Rajasthan which could emulated in other states. Over a longer term, government's flagship initiatives such as Make in India, Jan-dhan financial inclusion scheme, project facilitation by PMG could help revive the economic activity.

**Early signs of recovery in FY15, to pick up to 6.5% by FY16:** GDP growth is estimated to increase in FY15 to 5.6% compared to 4.7% last year with encouraging trends across supply and demand side components. Government efforts on project clearances through PMG coupled with improved business sentiment, will be a key driver for growth going forward. The recovery will thus be both investment and consumption-led. We expect GDP growth to pick up to 6.5% in FY16 and gradually improve towards 7% by FY17.

## Disinflation trends continue; RBI's glide path targets to be met – 100bps rate cut by FY16

**Headline inflation eases, disinflationary trends to continue:** On inflation, normalization has been faster-than-expected, with latest CPI inflation down to 5.5% from double digits last year. We expect CPI to glide towards RBI's 6% target by Jan-16 on continued supply side efforts by government, softer commodity prices and RBI's anti-inflation stance.

**Expect 100bps cut in policy rates by FY16:** Given the sharper-than-expected normalization in inflation versus that in growth, we expect conditions to turn conducive for easing in the coming months resulting into a cumulative 100bps cut in repo rates by FY16. As repo rate eases to 7% from current level of 8%, the real rate will be atleast 100bps over RBI's inflation target. In line with our rate view, we expect bond yields to soften towards 7.75% by end 2015.

## External sector to remain stable; current account deficit to be contained at 1.3% of GDP in FY16

**CAD in check; lower oil imports to offset weak exports:** We expect stable trends to continue in FY16 with the current account deficit (CAD) within 1.3% GDP or US$30bn. The risk on the CAD is balanced, with a lower import bill due to softer commodity prices largely being offset by the weaker export outlook to Europe and China.

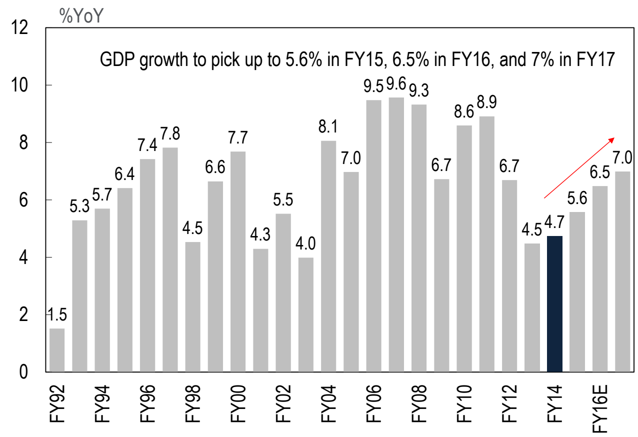
**INR view: range bound in 60-63:** Thanks to stable CAD and slowing inflation, the fundamentals for INR remain supportive. While there could be occasional bouts of EM volatility, the adequate reserves (US$316bn) and long forward position (+US$8.4bn by end Sep) built by RBI is likely to help contain the volatility. We expect INR to remain anchored around its fair value of 60-63 based on productivity adjusted REER values.

## Fiscal consolidation to continue, GST key; ratings upgrade likely

**FY15 fiscal deficit target challenging but achievable:** Revenue trends in 1HFY15 have been lackluster, with the fiscal deficit widening to Rs 4388bn or 83% of BE. Thus, FY15 targets currently appear challenging. However, recent steps on fuel reforms and austerity measures could enable the govt to meet its fiscal deficit target of 4.1%of GDP. Fuel reforms coupled with lower crude prices are expected to reduce the govt's fuel subsidy bill by 0.4%-0.5% of GDP. As regards austerity, the govt announced a uniform 10% reduction in non-plan expenditure which could lead to expenditure cut of ~ 0.3% of GDP.

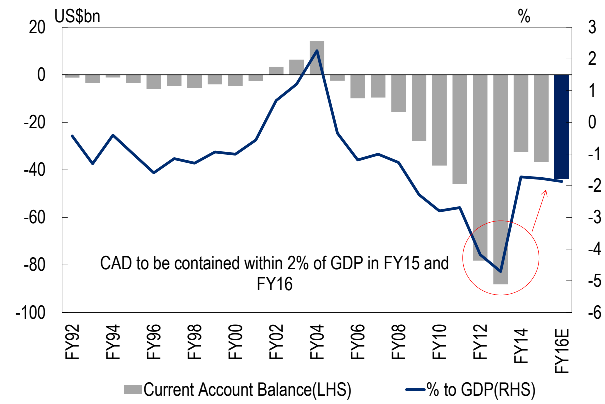
**India's ratings / outlook could Improve further:** The ongoing trends in fiscal consolidation has led to S&P revising India's sovereign rating outlook to 'Stable' from 'Negative'. Going forward, implementation of GST, direct cash transfer for subsidies and expenditure rationalization could improve fiscal balances even further, increasing the likelihood of ratings upgrade.

**Figure 66. Trends in Annual GDP growth (%YoY)**



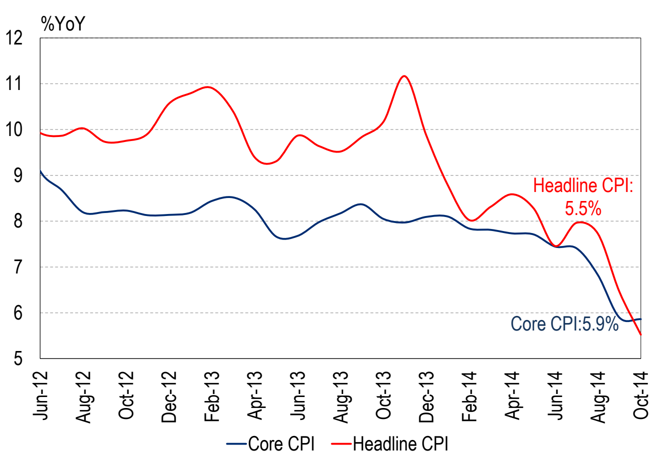

Source: CSO, Citi Research

**Figure 67. Trends in Current Account Deficit (US$bn, %GDP)**



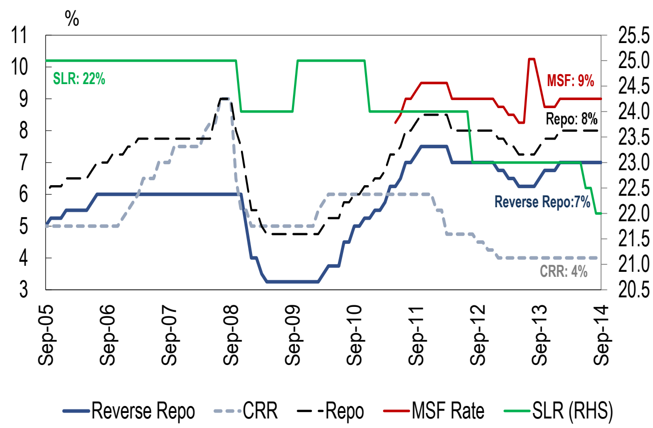

Source: CSO, Citi Research

**Figure 68. Trends in Headline CPI and Core CPI (%YoY)**



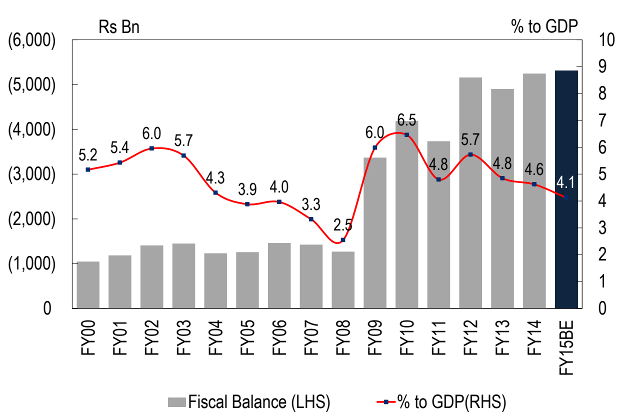

Source: CSO

**Figure 69. Trends in Key Policy Rates (%)**



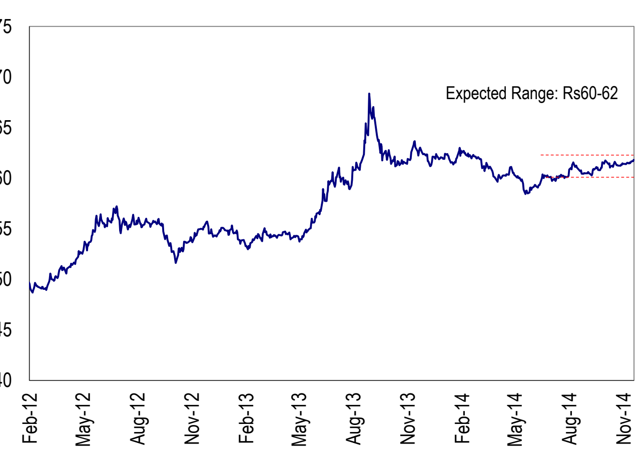

Source: Budget Documents, CGA

**Figure 70. Trends in Fiscal Deficit (Rs bn, %GDP)**




Source: Budget Documents

**Figure 71. Trends in US$ / INR**




Source: Bloomberg

**Figure 72. India Economic Indicators**

| | FY09 | FY10 | FY11 | FY12F | FY13F | FY14F | FY15F | FY16F | FY17F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 1,223.9 | 1,366.6 | 1,707.8 | 1,873.1 | 1,872.8 | 1,880.0 | 2,069.6 | 2,359.3 | 2,668.8 |
| Nominal GDP, local currency bn | 56,301 | 64,778 | 77,841 | 90,097 | 101,133 | 113,551 | 128,312 | 146,276 | 165,467 |
| GDP per capita, US$ | 1,061 | 1,168 | 1,440 | 1,558 | 1,539 | 1,522 | 1,651 | 1,854 | 2,066 |
| Population, mn | 1,154.0 | 1,170.0 | 1,186.0 | 1,202.0 | 1,217.0 | 1,235.3 | 1,253.8 | 1,272.6 | 1,291.7 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 6.7 | 8.6 | 8.9 | 6.7 | 4.5 | 4.7 | 5.6 | 6.5 | 7.0 |
| Real investment growth % yoy | -5.2 | 17.3 | 14.1 | 3.9 | 4.9 | -2.5 | 4.8 | 5.7 | 7.5 |
| Real consumption growth % yoy | 7.7 | 8.4 | 8.2 | 8.9 | 5.2 | 4.7 | 5.6 | 6.8 | 6.8 |
| private consumption growth % yoy | 7.2 | 7.4 | 8.7 | 9.3 | 5.0 | 4.8 | 5.5 | 7.0 | 7.0 |
| Real export growth, % yoy | 14.6 | -4.7 | 19.6 | 15.6 | 5.0 | 8.4 | 11.0 | 9.3 | 9.0 |
| Real import growth, % yoy | 22.7 | -2.1 | 15.6 | 21.1 | 6.6 | -2.5 | 9.5 | 9.0 | 9.3 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 8.0 | 14.9 | 8.8 | 9.0 | 10.4 | 8.3 | 7.5 | 6.2 | 6.0 |
| CPI, % avg | 9.1 | 12.4 | 10.4 | 8.4 | 10.2 | 9.5 | 7.2 | 6.2 | 6.0 |
| Credit extension to private sector, % yoy | 19.0 | 16.0 | 17.0 | 17.5 | 17.5 | 17.5 | 17.5 | 17.5 | 18.5 |
| Policy interest rate, % eop | 5.00 | 5.00 | 6.75 | 8.50 | 7.50 | 8.00 | 7.75 | 7.00 | 7.00 |
| Short-term market rate, % eop | 5.68 | 4.49 | 9.54 | 10.90 | 9.30 | 8.36 | 7.85 | 7.10 | 7.10 |
| Long term yield, % eop | 7.01 | 7.83 | 7.99 | 8.56 | 8.00 | 8.50 | 8.25 | 7.50 | 7.50 |
| lc/US$, eop | 48.62 | 46.41 | 44.71 | 53.02 | 55.00 | 61.81 | 62.02 | 62.64 | 62.66 |
| lc/US$, avg | 43.42 | 48.30 | 45.68 | 46.63 | 53.38 | 58.57 | 60.96 | 62.45 | 62.80 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | -27.9 | -38.2 | -45.9 | -78.2 | -88.2 | -32.4 | -33.2 | -30.0 | -34.4 |
| % of GDP | -2.3 | -2.8 | -2.7 | -4.2 | -4.7 | -1.7 | -1.6 | -1.3 | -1.3 |
| Trade balance | -119.5 | -118.2 | -130.6 | -189.8 | -195.7 | -147.6 | -144.1 | -146.2 | -155.8 |
| Exports | 189.0 | 182.4 | 250.5 | 309.8 | 306.6 | 318.6 | 336.1 | 358.0 | 393.8 |
| Imports | 308.5 | 300.6 | 381.1 | 499.5 | 502.2 | 466.2 | 480.2 | 504.2 | 549.6 |
| Service balance | 53.9 | 36.0 | 48.8 | 64.1 | 64.9 | 73.0 | 72.6 | 78.4 | 84.6 |
| Income balance | -7.1 | -8.0 | -17.3 | -16.0 | -21.5 | -23.0 | -28.0 | -30.0 | -32.0 |
| FDI, net | 22.4 | 18.0 | 9.4 | 22.1 | 19.8 | 21.6 | 24.6 | 27.6 | 32.6 |
| International reserves | 241.6 | 252.8 | 273.7 | 260.1 | 259.7 | 276.4 | 323.7 | 378.2 | 426.4 |
| Total Amortisations | 15.6 | 19.1 | 18.7 | 22.8 | 23.0 | 18.7 | 19.9 | 21.0 | 14.5 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -8.3 | -9.3 | -6.9 | -8.1 | -7.2 | -6.8 | -6.7 | -6.4 | -6.1 |
| Consolidated gov primary balance | 3.3 | 4.5 | 2.4 | 3.6 | -- | -- | -- | -- | -- |
| Public debt | 76.8 | 75.5 | 70.2 | 69.6 | 69.8 | 69.4 | 68.3 | 66.0 | 64.5 |
| of which Domestic | 72.2 | 70.6 | 65.6 | 65.9 | 65.4 | 65.2 | 64.4 | 62.9 | 61.8 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 224.5 | 260.9 | 317.9 | 360.8 | 409.4 | 442.2 | 450.1 | 465.1 | 480.1 |
| Private | 168.6 | 193.9 | 239.8 | 278.9 | 327.8 | 360.6 | 389.2 | 402.2 | 415.2 |
| Public | 55.9 | 67.1 | 78.1 | 81.9 | 81.7 | 81.7 | 60.9 | 62.9 | 64.9 |
| External debt / GDP | 18.3 | 19.1 | 18.6 | 19.3 | 21.9 | 23.5 | 21.8 | 19.7 | 18.0 |
| External debt / XGS | 77.7 | 95.2 | 84.7 | 80.7 | 91.1 | 94.8 | 84.7 | 74.8 | 63.8 |
| Short-term debt | 43.3 | 52.3 | 65.0 | 78.2 | 96.7 | 89.2 | 87.9 | 92.9 | 97.9 |
| Short-term debt/International Reserves (%) | 17.9 | 20.7 | 23.7 | 30.1 | 37.2 | 32.3 | 27.2 | 24.6 | 23.0 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 5.7 | 5.0 | 5.5 | 5.9 | 6.0 | 6.2 | 6.6 | 7.0 | 7.0 |
| CPI, % yoy | 8.1 | 7.4 | 5.6 | 7.5 | 7.0 | 6.0 | 6.3 | 5.6 | 5.6 |
| Policy interest rate, % eop | 8.00 | 8.00 | 8.00 | 7.75 | 7.50 | 7.50 | 7.25 | 7.00 | 7.00 |
| Short-term market rate, % eop | 8.25 | 8.25 | 8.10 | 7.85 | 7.60 | 7.60 | 7.35 | 7.10 | 7.10 |
| Long term yield, % eop | 8.75 | 8.50 | 8.50 | 8.25 | 8.00 | 8.00 | 7.75 | 7.50 | 7.50 |
| lc vs USD, eop | 60.06 | 61.94 | 62.02 | 62.21 | 62.39 | 62.54 | 62.64 | 62.74 | 62.84 |

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** – Despite a sub-optimal political landscape, we think the government will be able to deliver quick wins on reform. However growth momentum will remain curbed as the energy subsidy reduction impacts household purchasing power.
- **Things to watch** – Growth is likely to be weakest in the first quarter, as households would have just been hit and government spending would still be weak. The trade balance may initially improve on weak domestic demand, although imports may rebound in 2H as investment growth gathers momentum.
- **Strategy** – We expect the policy rate to be on an extended pause. Meanwhile the budget deficit target may be moderately cut in early 2015. Meanwhile pressure on the IDR is expected to subside in 1Q on improved trade dynamics, but weakening is expected further out.

## Politics fragile, but quick wins possible

**Despite sub-optimal political landscape, new administration is not in a paralysis:** Without majority support in parliament, the new administration may often have to deal with challenges from an unsupportive parliament. However we think the chances of reform delivery are still high in the first year. The government can capitalize from a stronger fiscal budget (following the reallocation of subsidy spending towards infrastructure). It can also utilize the 2012 land acquisition law, which comes into full effect in 2015, to kickstart stalled infrastructure projects. The bureaucracy reform agenda should also progress given the stronger leadership.

**Can results emerge as soon as in 2015?:** In targeting lower hanging fruits on infrastructure, the government can start with projects that are already in the implementation stage but stalled due to land acquisition and interagency coordination issues. We believe logjams here can be unlocked relatively quickly. Meanwhile administration's new initiatives may take longer but are also not in the realm of multiple years, in our view. Many of the new administration's "new" programs actually involve rebranding and reprioritizing many existing ones that have been slow or stalled in implementation. The government can utilize various masterplans and project designs from the SBY era, so they need not start from scratch. We think the new initiatives may start bearing fruit in late 2015 if not 2016.

**Risks on the political front: deliberation deadlocks, controversial laws from parliament and internal resistance:** Despite our optimism, the political scenery in the onset of the administration's five-yr life would still be eventful. We do not believe that budget discussions will be deliberately delayed by parliament, but deadlocks can happen as a result of one party withholding the interests of the other. Another risk is that efforts are put to push controversial (e.g. nationalistic) laws in parliament, which actually are aimed to benefit certain business interests. The government must also tread carefully to manage dissent from within their supporting coalition, particularly from disgruntled supporters which have not managed to obtain positions in the government. Yet in spite of the aforementioned risks and challenges, we also think there is a silver lining. Although no imminent change in the coalition posture is visible, we think the size of the supporting coalition will eventually grow if public support is high after 2015.

## Growth rebalancing expected

**Reform impact will not be all pretty in the short term:** Amid a still weak outlook on exports, consumption growth will be impacted by subsidy reforms. BI's consumer confidence survey currently is higher compared to Jun-13. However we think the impact of the subsidy adjustments to household purchasing power will be stronger than in the fuel price hike episode of 2013. Households will enter the year having been hit by electricity, LPG and most importantly fuel price hikes which is expected to push up inflation to above 7%. Discretionary spending would also be hit, especially in the first semester.

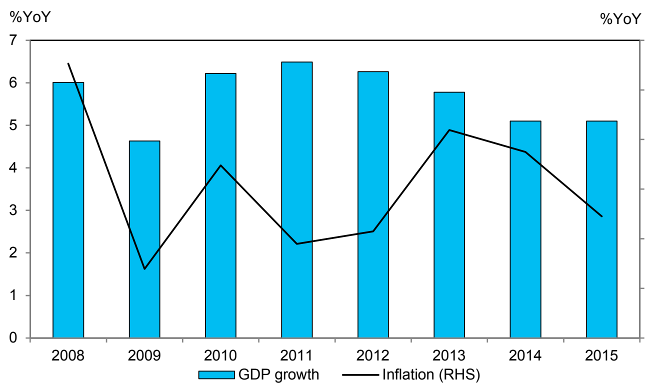
**That said, business investment and FDI may start to rebound and cushion the consumption slow-down:** We expect growth in fixed capital investments to rebound next year, although nowhere near the levels seen in the heydays of 2011. The rebound would first be driven by expansion of business capacity, given high capacity utilization in certain industries e.g. F&B, textiles. And this would be coupled by stronger growth in government investment in 2H15, as the subsidy reallocation benefits are felt. Overall we expect flat GDP growth in 2015 vs. 2014.

**Current account (CA) outlook to remain a key element in policymaking:** The CA deficit may improve vs. 2014 and the portion of consumption-related goods in imports could also decline, allaying investor concerns. But the CA deficit will remain above levels deemed comfortable by policymakers. (We are expecting a modest reduction in the overall CA deficit from 3.1% GDP in 2014 to 2.7% GDP in 2015. As forthcoming investments in manufacturing capacity and infrastructure will require imports, policymakers will need to keep consumption growth at bay in order to avoid CA deterioration. The rise of external liabilities relative to exports will also be monitored as it may weaken debt servicing capacity in the medium term.

**Fiscal reform on the right track, but reallocation of spending will be prioritized over deficit reduction:** Energy subsidy reduction should continue next year, possibly along with a move towards a floating price system for fuel. Further space in the budget could be cleared up; however financing needs for infrastructure and social programs are still high. Note that without subsidy reallocation, capital & infrastructure spending has been on a downward trend. Even a reallocation of 1/3 of the expected subsidy savings would only bring the capex budget back to 2013 levels. Overall we expect the fiscal deficit to ease just modestly towards around 2% GDP in 2015, vs. the current plan of 2.2%.

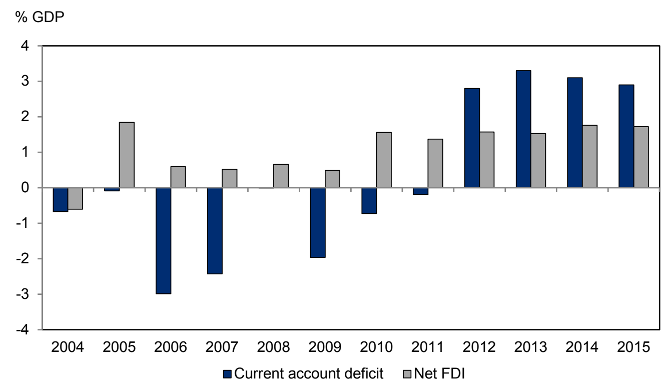
**Policy and market implications:** We expect the policy rate to be on an extended pause in 2015. Meanwhile for USDIDR in the near term (0-3M), improved trade dynamics in 1Q should hold sharp upward moves. However as foreign reserve accumulation remains a necessity, downside is limited in our view. Further out, IDR weakening is expected on our global calls for Fed tightening, higher UST yields.

Figure 73. Indonesia GDP growth and inflation



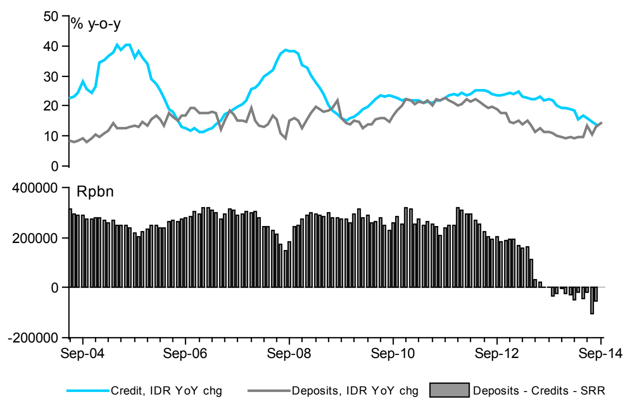

Source: CEIC, Citi Research; 2014 & 2015: Citi Estimates

Figure 74. Current account deficit may see modest decline



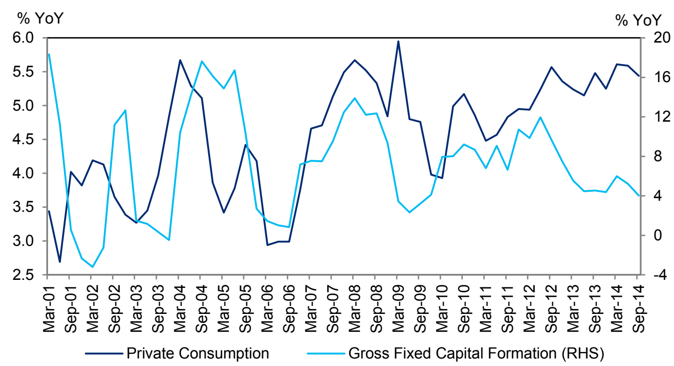

Source: CEIC, Citi Research; 2014 & 2015: Citi Estimates

Figure 75. Credit growth may not see strong rebound



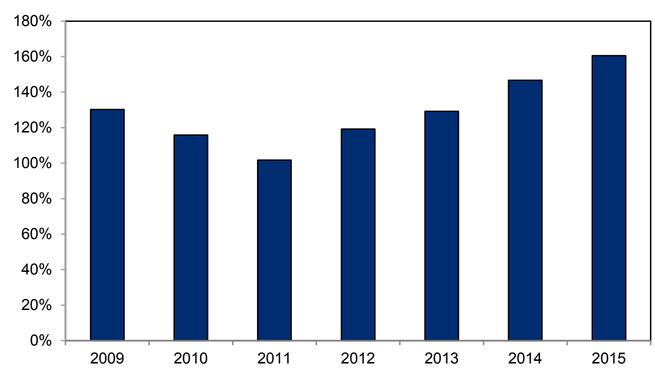

Source: CEIC, Citi Research

Figure 76. Investment and consumption should see a rebalancing



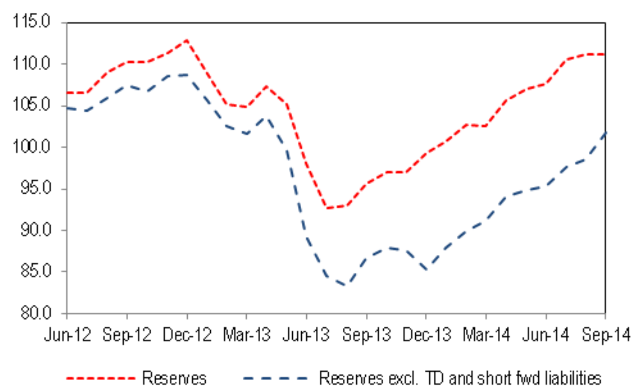

Source: CEIC, Citi Research

Figure 77. External debt (% exports) expected to rise




Source: CEIC, Citi Research; 2014 & 2015: Citi Estimates

Figure 78. Foreign reserves (US$bn) should increase further




Source: Bank Indonesia, Citi Research

**Figure 79. Indonesia Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 510.7 | 538.6 | 709.5 | 845.4 | 876.9 | 868.5 | 849.9 | 922.9 | 1,045.1 |
| Nominal GDP, local currency bn | 4,948,688 | 5,606,203 | 6,446,852 | 7,419,187 | 8,229,439 | 9,083,972 | 10,064,314 | 11,196,463 | 12,580,464 |
| GDP per capita, US$ | 2,207 | 2,292 | 2,975 | 3,493 | 3,573 | 3,491 | 3,370 | 3,612 | 4,040 |
| Population, mn | 231.4 | 235.0 | 238.5 | 242.0 | 245.4 | 248.8 | 252.2 | 255.5 | 258.7 |
| Unemployment, % of labour force | 8.4 | 7.9 | 7.1 | 6.6 | 5.8 | 5.8 | 5.9 | 6.1 | 6.0 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 6.0 | 4.6 | 6.2 | 6.5 | 6.3 | 5.8 | 5.1 | 5.1 | 5.3 |
| Real investment growth % yoy | 12.4 | 2.4 | 8.8 | 10.1 | 16.3 | 4.9 | 6.1 | 5.6 | 5.8 |
| Real consumption growth % yoy | 5.9 | 6.2 | 4.1 | 4.5 | 4.8 | 5.2 | 5.0 | 4.2 | 4.4 |
| private consumption growth % yoy | 5.3 | 4.9 | 4.7 | 4.7 | 5.3 | 5.3 | 5.3 | 4.1 | 4.4 |
| Real export growth, % yoy | 9.5 | -9.7 | 15.3 | 13.6 | 2.0 | 5.3 | -1.3 | 4.2 | 4.1 |
| Real import growth, % yoy | 10.0 | -15.0 | 17.3 | 13.3 | 6.7 | 1.2 | -4.0 | 2.5 | 2.6 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 11.1 | 2.8 | 7.0 | 3.8 | 3.7 | 8.1 | 7.3 | 5.1 | 4.0 |
| CPI, % avg | 9.9 | 4.8 | 5.1 | 5.3 | 4.0 | 6.4 | 6.3 | 7.2 | 4.6 |
| Nominal wages, % yoy | 5.0 | 6.3 | 18.2 | -2.9 | 20.0 | 12.4 | 17.1 | 13.0 | 11.0 |
| Credit extension to private sector, % yoy | 30.7 | 18.0 | 20.6 | 25.9 | 22.3 | 19.5 | 13.0 | 14.0 | 16.0 |
| Policy interest rate, % eop | 8.75 | 6.00 | 5.50 | 4.50 | 4.00 | 5.75 | 5.75 | 5.75 | 5.75 |
| 1 month interbank rate, % eop | 12.13 | 7.06 | 6.64 | 5.27 | 5.02 | 7.84 | 7.50 | 7.25 | 7.25 |
| Long term yield, % eop | 11.92 | 10.07 | 7.83 | 6.05 | 5.39 | 8.60 | 7.75 | 8.25 | 8.50 |
| lc/US$, eop | 10,900 | 9,425 | 9,010 | 9,068 | 9,638 | 12,170 | 12,116 | 12,500 | 12,482 |
| lc/US$, avg | 9,673 | 10,376 | 9,078 | 8,763 | 9,361 | 10,449 | 11,885 | 12,420 | 12,495 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 0.1 | 10.6 | 5.1 | 1.7 | -24.4 | -29.1 | -26.7 | -25.4 | -27.9 |
| % of GDP | 0.0 | 2.0 | 0.7 | 0.2 | -2.8 | -3.3 | -3.1 | -2.7 | -2.7 |
| Trade balance | 22.9 | 30.9 | 30.6 | 34.8 | 8.6 | 6.0 | 6.4 | 9.3 | 9.0 |
| Exports | 139.6 | 119.6 | 158.1 | 200.8 | 188.5 | 183.3 | 176.2 | 174.0 | 180.0 |
| Imports | 116.7 | 88.7 | 127.4 | 166.0 | 179.9 | 177.3 | 169.8 | 164.7 | 171.0 |
| Service balance | -13.0 | -9.7 | -9.3 | -10.6 | -10.3 | -12.1 | -10.3 | -11.1 | -11.8 |
| Income balance | -15.2 | -15.1 | -20.8 | -26.7 | -26.8 | -27.0 | -27.4 | -28.5 | -30.8 |
| FDI, net | 3.4 | 2.6 | 11.1 | 11.5 | 13.7 | 13.7 | 15.0 | 16.5 | 17.5 |
| International reserves | 51.6 | 66.1 | 96.2 | 110.1 | 112.8 | 99.4 | 112.6 | 123.6 | 134.8 |
| Total Amortisations | 16.7 | 20.4 | 24.0 | 25.2 | 29.4 | 41.0 | 42.0 | 42.0 | 43.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -0.1 | -1.6 | -0.7 | -1.1 | -1.9 | -2.2 | -2.4 | -2.0 | -1.8 |
| Consolidated gov primary balance | 1.7 | 0.1 | 0.6 | 0.1 | -0.6 | -0.9 | -1.2 | -0.8 | -0.6 |
| Public debt | 29.3 | 31.4 | 26.4 | 23.6 | 23.3 | 22.4 | 26.0 | 26.5 | 26.7 |
| of which Domestic | 16.2 | 19.3 | 16.7 | 15.5 | 16.1 | 15.7 | 15.6 | 16.0 | 16.0 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 155.1 | 172.9 | 202.4 | 225.4 | 252.4 | 265.9 | 295.0 | 333.4 | 366.7 |
| Private | 68.5 | 73.6 | 83.8 | 106.7 | 126.2 | 142.4 | 165.5 | 197.8 | 224.2 |
| Public | 86.6 | 99.3 | 118.6 | 118.6 | 126.1 | 123.5 | 129.5 | 135.5 | 142.5 |
| External debt / GDP | 30.4 | 32.1 | 28.5 | 26.7 | 28.8 | 30.6 | 34.7 | 36.1 | 35.1 |
| External debt / XGS | 100.1 | 130.2 | 115.8 | 101.8 | 119.3 | 129.3 | 146.6 | 166.6 | 177.2 |
| Short-term debt | 20.5 | 24.0 | 31.6 | 36.6 | 43.4 | 42.9 | 50.0 | 55.0 | 57.0 |
| Short-term debt/International Reserves (%) | 39.7 | 36.4 | 32.8 | 33.2 | 38.4 | 43.1 | 44.4 | 44.5 | 42.3 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 5.1 | 5.0 | 4.9 | 5.0 | 5.1 | 5.2 | 5.3 | 5.0 | 5.3 |
| CPI, % yoy | 6.7 | 4.3 | 7.1 | 7.2 | 7.5 | 7.3 | 5.1 | 4.9 | 4.7 |
| Policy interest rate, % eop | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 |
| Short-term market rate, % eop | 8.15 | 8.07 | 7.50 | 7.25 | 7.25 | 7.25 | 7.25 | 7.25 | 7.25 |
| Long term yield, % eop | 8.35 | 8.10 | 7.75 | 7.90 | 8.10 | 8.20 | 8.25 | 8.40 | 8.50 |
| lc vs USD, eop | 11,855 | 12,185 | 12,116 | 12,265 | 12,414 | 12,500 | 12,500 | 12,500 | 12,500 |

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).We refer to the FasBI rate to better reflect actual money market rates for Indonesia's policy rate.

# Malaysia

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- **Summary view** – Export growth in 2015 could be modest, with manufacturing likely to do better than commodities, where lower prices could have a mixed impact. Rebalancing away from consumption to investments will continue in 2015. Inflation could trend higher on GST, but given limited demand pull pressures, BNM is unlikely to be in a hurry to hike in 2015.

- **Things to watch** – [1] External developments, [2] commodity prices, [3] domestic demand data, [4] measures to channel subsidy savings back to economy [4] inflation impact of policy measures

- **Strategy** – With the abolishment of RON95 and diesel subsidies removing a longstanding fiscal headwind, and lower oil prices reducing inflation risks, long end rates could remain anchored. The MYR sell-off looks overdone near term, though USD-MYR could still rise in 12M alongside a stronger USD backdrop.

## Rebalancing from consumption to investments continues

**Malaysia's export sectors are expected to experience differentiated growth on a desynchronized global outlook:** Among Malaysia's major export partners, the US is expected to see a growth acceleration to 3.2% YoY in 2015 (2014F: 2.2%), while growth prospects for China, Japan and the Euro Area are less bullish. Manufacturing exports may perform better given the strong dependence on US final demand (17.6% of total manufacturing exports). The outlook for commodity exports however, is less optimistic given dependence on the final demand in China and Japan (48% of total commodity exports), both of which are likely to slow. Commodity exports could also be affected by the softer price outlook. A weaker MYR however may cushion growth as 71% of VA accrues to net exporting sectors.

**The impact of softer commodity prices on Malaysia is likely to be mixed:** With Malaysia now a small net importer of crude oil and petroleum products, lower crude prices alone should impute a slight positive impact on the CA surplus. The abolishment of RON95 and diesel subsidies could allow fiscal flexibility to boost domestic demand via increased cash transfers to poor, and/or cutting the Petronas dividend, whilst still meeting the 3% of GDP deficit target in 2015. We would be more concerned about a concurrent sharp fall in prices of CPO and/or LNG prices, which account for 50% and 80% of the trade surplus respectively. LNG price movements have diverged from crude prices since 2011, although with contracts governing prices for 16.1% Malaysia's LNG export volumes are set to expire in 2014/2015, prices could soon follow oil prices downwards. We expect CPO prices to average $830/t in 2015 (2014: $750/t), but an unexpected fall could materially lower nominal GDP growth and consumption, as they hurt a larger proportion of low income rural consumers that have a higher marginal propensity to consume.

**We expect continued rebalancing away from consumption…** Even without a CPO price decline, consumption could face headwinds from the one-off reduction in real incomes from GST implementation, although with prices of some items lower post GST, the post GST consumption drop may be less severe than in Japan, whilst lower income consumers could be helped by a possible expansion of BR1M handouts. Higher debt servicing burdens (>40% of gross income) is likely to weigh on private consumption as well. The DSR may increase through 2015 on expected OPR increases. However, increased deposit rates and low levels of floating debt in the economy will cushion the impact of potential rate increases, in our view.

**… towards investments.** Manufacturing FDI should be supported by lagged implementation of the surge in investment approvals in 2013 and 2014, while the anticipated recovery in the US should help manufacturing exports and promote investments into the sector. A relatively attractive cost structure – with manufacturing wages on par with China and low industrial land/energy prices should help. The drive to increase the wage share of the national income will further facilitate a capital-labour substitution, aided by fiscal incentives. With export oriented sectors having higher capital productivity, a shift towards manufacturing investments bodes well for the sustainability of the investment cycle. Public investments are expected to increase as well. Budget 2015 outlined several public sector investment projects. A projected 3.7% increase in public development spending should lift public investments, largely through land transport infrastructure projects. One risk may come from lower oil and gas capex, which accounted for a third of net increase in capital stock from 2010-2012, though we suspect this may be felt more in 2016 than in 2015. Assuming investments remain strong, this should lift capital goods imports, which along a muted export recovery, should cause CA surplus to narrow to 4.5% of GDP.

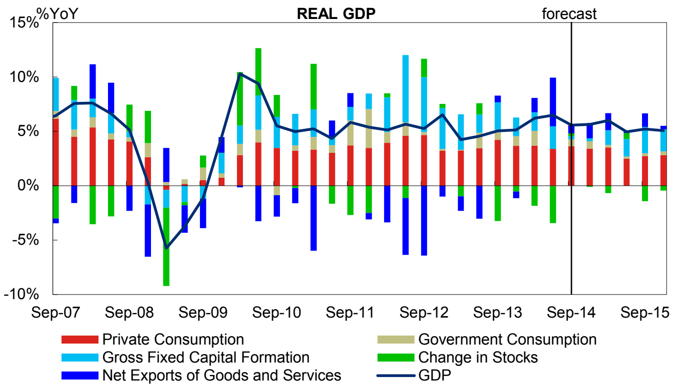
## BNM unlikely to be in hurry to hike

**Headline inflation trend in coming months will reflect the impact of the Oct fuel price hikes, hikes in cigarette prices and the elimination of fuel subsidies for RON95 and diesel, effective 1st Dec, 2014:** The prices of RON95 and diesel will thereafter be set according to a managed float, similar to that of RON97, with average change in monthly cost of product to determine the following month's pump prices. We estimate that the 20 sen/litre cut in RON97 prices to just RM2.55/litre suggests that the market price of RON95 could in fact be slightly lower than the current pump price of RON95 of RM2.30/litre, by around 5 sen/litre. We thus expect the floating of fuel prices, starting 1st Dec, to have a disinflationary impulse. Overall, we expect inflation to rise to around 3% in Nov (largely on higher tobacco prices), before falling to 2.8% in Dec (on expected lower pump prices) averaging 2.9% YoY in 4Q, before moderating to 2.5% in 1Q15 and averaging around 4.5% in 2Q15 and 3Q15 upon GST implementation, subsequently moderating to 4.2% in 4Q15. Our 2014 and 2015 full-year inflation forecast now stand at 3.2% and 3.9%, respectively, moderating to 3.3% in 2016.

**The inflation impact of GST will be cushioned by the list of exempted items:** The inflation impact of GST would be higher, were it not for the additional items exempted from GST, which account for around 12% of the CPI basket (8.2% from fuel), the inflation impact will be lowered by 0.7%-pts, from 1.8% to 1.1%. In all, we now estimate that 61% of the consumption basket should not see a price change upon a switch from SST to GST, with a further 3% of the consumption basket likely to see price declines under GST.

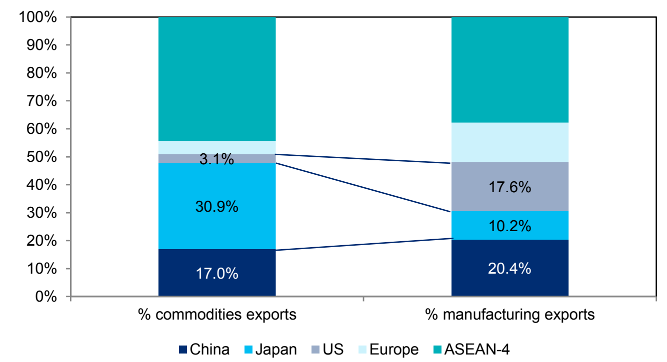
**Earliest window for rate hike opens in 2015:** Demand pull pressures remain muted – core inflation and inflation pervasiveness in Malaysia have moderated recently. Overall, barring positive surprises to private consumption which could raise demand pull pressures, we suspect above average inflation may be a less of a critical factor influencing monetary policy decisions in 2015. We see the window of opportunity for the next rate hike opening in Sep 2015, when BNM has had sufficient data to assess the growth/inflation impact of GST, and after the Fed hikes. Risks remain tilted towards further delays in our view.

**Figure 80. GDP growth forecasts**



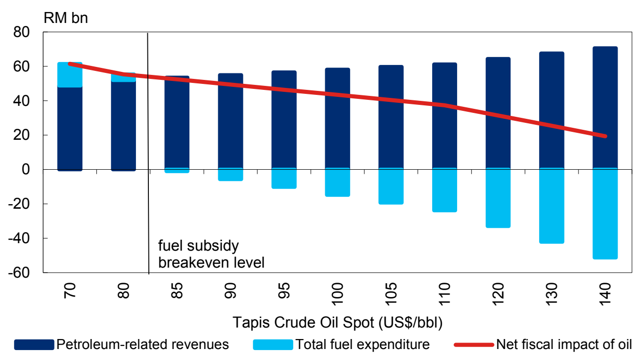

Source: CEIC, Citi Research

**Figure 81. Commodity and manufacturing exports by country [avg. since Dec 2013]**



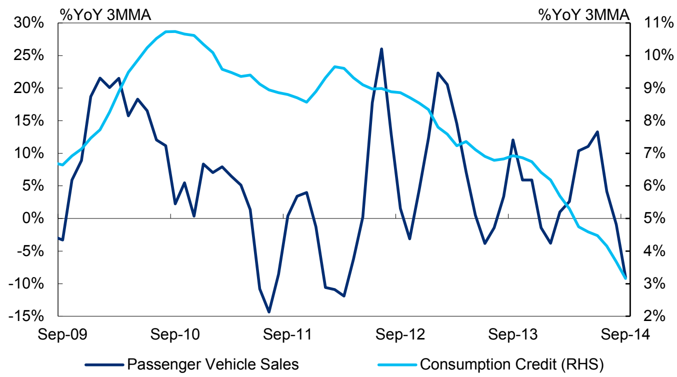

Source: CEIC, Citi Research

**Figure 82. The elimination of fuel subsidies will lead to fiscal savings**



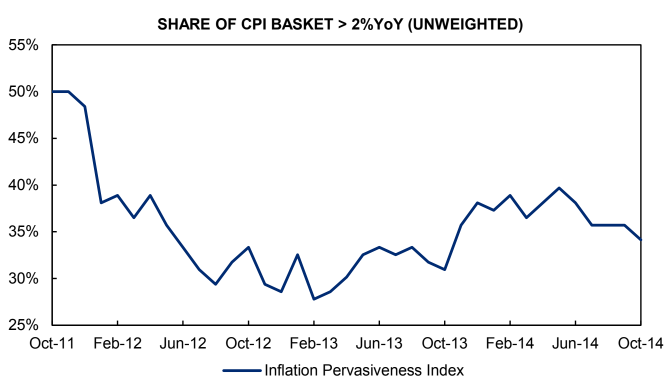

Source: CEIC, Citi Research

**Figure 83. Rebalancing away from consumption**



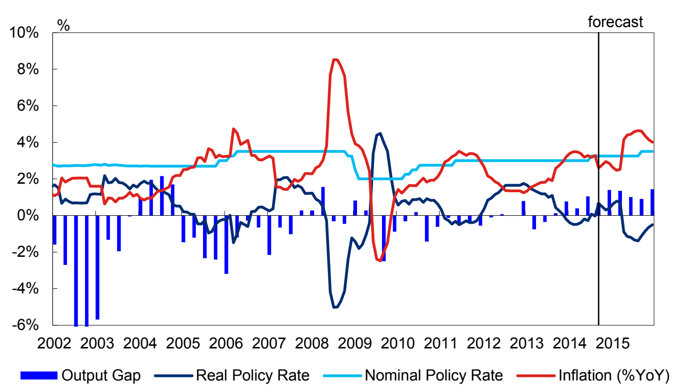

Source: CEIC, Citi Research

**Figure 84. Demand-pull inflation pressures have moderated**




Source: CEIC, Citi Research

**Figure 85. We see the earliest window for a rate hike in Sep 2015**




Source: CEIC, Citi Research

Figure 86. Malaysia Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 231.1 | 202.4 | 247.7 | 289.5 | 305.3 | 313.3 | 321.8 | 330.9 | 353.2 |
| Nominal GDP, local currency bn | 770 | 713 | 797 | 885 | 942 | 987 | 1,055 | 1,121 | 1,191 |
| GDP per capita, US$ | 8,393 | 7,255 | 8,664 | 9,997 | 10,405 | 10,474 | 10,657 | 10,779 | 11,393 |
| Population, mn | 27.5 | 27.9 | 28.6 | 29.0 | 29.3 | 29.9 | 30.2 | 30.7 | 31.0 |
| Unemployment, % of labour force | 3.3 | 3.7 | 3.4 | 3.1 | 3.0 | 3.1 | 2.9 | 2.9 | 3.0 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 4.8 | -1.5 | 7.4 | 5.2 | 5.6 | 4.7 | 6.0 | 5.3 | 5.1 |
| Real investment growth % yoy | 1.8 | -9.4 | 25.3 | 3.0 | 20.3 | 4.9 | -0.7 | 5.3 | 1.7 |
| Real consumption growth % yoy | 8.4 | 1.4 | 6.2 | 8.8 | 7.5 | 7.0 | 6.4 | 4.8 | 5.3 |
| private consumption growth % yoy | 8.7 | 0.6 | 6.9 | 6.9 | 8.2 | 7.2 | 6.8 | 5.5 | 6.3 |
| Real export growth, % yoy | 1.6 | -10.9 | 11.1 | 4.5 | -1.8 | 0.6 | 5.6 | 5.1 | 6.9 |
| Real import growth, % yoy | 2.3 | -12.7 | 15.6 | 6.2 | 2.5 | 2.0 | 3.7 | 4.7 | 6.2 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 4.5 | 1.0 | 2.1 | 3.0 | 1.2 | 3.2 | 2.8 | 4.0 | 3.3 |
| CPI, % avg | 5.4 | 0.6 | 1.7 | 3.2 | 1.6 | 2.1 | 3.2 | 3.9 | 3.3 |
| Nominal wages, % yoy | 4.5 | 2.5 | 8.2 | 3.8 | 6.4 | 7.8 | 6.2 | 5.5 | 5.5 |
| Credit extension to private sector, % yoy | 10.2 | 6.8 | 10.6 | 12.5 | 12.1 | 10.6 | 9.0 | 8.0 | 8.0 |
| Policy interest rate, % eop | 3.25 | 2.00 | 2.75 | 3.00 | 3.00 | 3.00 | 3.25 | 3.50 | 3.50 |
| Short-term market rate, % eop | 3.37 | 2.17 | 2.98 | 3.22 | 3.21 | 3.32 | 3.80 | 3.80 | 3.80 |
| Long term yield, % eop | 3.00 | 3.79 | 3.39 | 3.23 | 3.24 | 3.66 | 3.70 | 4.00 | 4.20 |
| lc/US$, eop | 3.45 | 3.42 | 3.08 | 3.17 | 3.06 | 3.28 | 3.35 | 3.39 | 3.36 |
| lc/US$, avg | 3.33 | 3.52 | 3.22 | 3.06 | 3.09 | 3.15 | 3.28 | 3.39 | 3.37 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 39.4 | 31.4 | 27.1 | 33.5 | 17.6 | 12.7 | 18.3 | 14.9 | 17.7 |
| % of GDP | 17.1 | 15.5 | 10.9 | 11.6 | 5.8 | 4.0 | 5.7 | 4.5 | 5.0 |
| Trade balance | 51.1 | 39.8 | 42.5 | 49.6 | 40.6 | 34.4 | 40.1 | 38.5 | 38.2 |
| Exports | 198.9 | 157.0 | 199.2 | 228.8 | 222.3 | 215.6 | 225.5 | 249.3 | 276.8 |
| Imports | 147.7 | 117.1 | 156.7 | 179.2 | 181.8 | 181.3 | 185.3 | 210.8 | 238.5 |
| Service balance | 0.5 | 1.2 | -0.4 | -2.1 | -5.3 | -5.3 | -5.7 | -6.8 | -6.0 |
| Income balance | -12.2 | -9.6 | -15.0 | -14.0 | -17.7 | -16.4 | -16.1 | -16.9 | -14.6 |
| FDI, net | -7.8 | -6.3 | -4.3 | -3.1 | -7.9 | -1.7 | -3.0 | -1.0 | -1.0 |
| International reserves | 91.5 | 96.7 | 106.5 | 133.6 | 139.7 | 134.9 | 127.0 | 118.0 | 122.0 |
| Total Amortisations | 6.3 | 9.8 | 11.3 | 9.0 | 7.4 | 10.0 | 10.5 | 11.0 | 11.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -4.6 | -6.7 | -5.4 | -4.8 | -4.5 | -3.9 | -3.5 | -3.0 | -2.5 |
| Consolidated gov primary balance | -3.0 | -4.7 | -3.5 | -2.8 | -2.4 | -1.8 | -1.3 | -0.9 | -0.7 |
| Public debt | 39.8 | 50.8 | 51.1 | 51.5 | 53.3 | 54.7 | 52.8 | 51.0 | 50.0 |
| of which Domestic | 37.2 | 48.9 | 49.0 | 49.5 | 51.5 | 53.0 | 51.3 | 50.0 | 49.0 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 66.6 | 68.3 | 72.6 | 81.5 | 82.8 | 97.9 | 97.0 | 96.0 | 95.0 |
| Private | 41.5 | 41.9 | 44.7 | 53.7 | 55.6 | 69.2 | 67.0 | 67.0 | 66.0 |
| Public | 25.2 | 26.3 | 27.9 | 27.8 | 27.1 | 28.7 | 30.0 | 29.0 | 29.0 |
| External debt / GDP | 28.8 | 33.7 | 29.3 | 28.1 | 27.1 | 31.2 | 30.1 | 29.0 | 26.9 |
| External debt / XGS | 29.0 | 36.9 | 31.4 | 30.7 | 31.8 | 38.3 | 36.7 | 33.0 | 29.7 |
| Short-term debt | 22.5 | 22.7 | 25.4 | 32.8 | 30.4 | 39.4 | 42.0 | 42.0 | 41.0 |
| Short-term debt/International Reserves (%) | 24.6 | 23.5 | 23.8 | 24.6 | 21.8 | 29.2 | 33.1 | 35.6 | 33.6 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 6.5 | 5.6 | 5.6 | 6.0 | 5.0 | 5.2 | 5.0 | 4.9 | 4.7 |
| CPI, % yoy | 3.3 | 2.6 | 2.8 | 2.5 | 4.4 | 4.6 | 4.0 | 4.1 | 3.0 |
| Policy interest rate, % eop | 3.00 | 3.25 | 3.25 | 3.25 | 3.25 | 3.50 | 3.50 | 3.50 | 3.50 |
| Short-term market rate, % eop | 3.55 | 3.80 | 3.80 | 3.80 | 3.80 | 3.80 | 3.80 | 3.80 | 3.80 |
| Long term yield, % eop | 3.70 | 3.90 | 3.70 | 3.70 | 3.80 | 4.00 | 4.00 | 4.00 | 4.00 |
| lc vs USD, eop | 3.21 | 3.28 | 3.35 | 3.37 | 3.39 | 3.40 | 3.39 | 3.39 | 3.38 |

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** – Our 2014 GDP forecast of 6.3% and 6.5% in 2015 is intact despite rising macro challenges. After Japan's 3Q14 recession and imminent 2Q15 power crisis, persistent fiscal underspending could be the spoiler. Start of Aquino's legacy spending with roll out of its rehabilitation/reconstruction program.
- **Things to watch** – Power commitments from MERALCO's industrial customers to the Interruptible Load Program as a means of easing the 2Q15 power crisis. Accelerated fiscal spending as 2H14 reconstructions begins in typhoon devastated areas. Upside inflation risk of 2Q power crisis.
- **Strategy** – Recent JPN recession and risks to the bilateral trade surplus and remittance flows might compound weak PHP sentiment and bond market preference in the near-term. Expect weaker PHP at 45.80 over 6-12 mos. Fiscal underspending risk in 2015 could elevate potential for rate cuts.

## Aquino's 'legacy' spending the key spark to growth

**We keep our GDP growth outlook of 6.3% in 2014 and 6.5% in 2015 although mindful of more downside risks to growth:** 2Q15 power crisis and potential for offshore headwinds intensifying would be key events to watch out for. However we believe that fiscal underspending would probably constitute the largest macro risk over the next 6-12 months since domestic demand continues to be the key growth driver. Net exports can provide one-off surprises just like in 3Q14 when 2-digit export gains and benign imports implied a hefty net export gain that mitigated lackluster fiscal spending during the quarter and propelled 3Q GDP to exceed 6%YoY.

**We believe there's subdued risk of fiscal underspending prospects** from 4Q14 with government having approved and started implementation of the Php170.9bn budget for Yolanda's rehabilitation and reconstruction efforts over 2014-16. It consists of 1) Php35.1bn infrastructure budget, 2) Php26.4bn social services program, 3) Php75.7bn resettlement budget, and 4) livelihood projects worth Php33.7bn. Officials claims to have spent Php37.4bn under the recovery program. Average annual fiscal expenditures devoted to the rehab program are Php57bn, largely coming from non-infrastructure components or at least 2% of annual budget.

**Using 2006 I/O table, annual fiscal spending of Php57bn under Yolanda rehab program could increase output by 0.74% assuming no implementation slippage:** On a 3-yr cumulative basis, we can be assured of 2.2% additional growth. We estimate a 1.65x multiplier from potential income of Php94.3bn for annual fiscal spend of Php57bn. Public administration and other government services probably expanded the most (additional Php49bn up 12.8%) as the main beneficiaries of the rehab program. Construction sector chalked up a 2.2% gain mainly coming from planned infra component. Potential gains from higher fiscal spending incurred by other services: transport, storage & communications (0.4%), financial intermediation (0.85%), and real estate, renting & business services (0.38%) exceeded possible manufacturing upside (0.24%). Fiscal spending multiplier effects would be 'internalized', benefiting domestic market-oriented industries.

**Reconstruction/rehabilitation of typhoon-devastated regions kicks off Aquino's 'legacy' fiscal spending:** Other programs/projects under DAP stalled by the High Court's decision, untangling of legal issues governing recently awarded PPP projects to unleash its investment potential, and other FY15 budget priorities implies a hefty spending gain in 2015.

## Risks from Japan's 3Q14 recession

**Using bilateral [Japan (JPN)-Philippines (PH)] trade data and its composition, direct effect of JPN's 3Q14 recession (buying PH goods for its domestic consumption) would be modest compared to indirect effect on global trade and investments which may slow down materially:** Citi economics upgraded its Japan 2015 growth forecast to 1.7% to downplay these downside risks. Raw foodstuffs account for low 5%-7% of exports to JPN. In 2009 GFC, food exports to JPN fell 7.8%YoY while the overall exports to JPN fell by nearly 25%YoY, which suggests the global market risk (indirect effect) has a larger impact than the consumption (direct) effect. Intermediate and capital goods dominate exports and imports from JPN, suggesting re-processing for re-exports. A 1% drop in world export volume index can undermine exports to JPN by 1.5%. Highly 'elastic' export response to the world demand supports the indirect effect. Total 3Q14 exports (JPN and rest of the world) rose 12.9%YoY to ease any downside suspicion.

## Weak PHP's 'real effect'

**Potential export loss from slower world demand can be mitigated by weak PHP:** A 1% drop in REER PH can improve exports to JPN by 1.5% in our estimate. PHP appears to be tracking other EM Asian currencies although at a much slower pace, that's highly correlated with weak JPY (with strong net export similarity index like Korea/Taiwan). Caveat however is that when global trade slows down sharply like what we saw in 2009, falling currencies may cancel out the benefits of uplifting respective bilateral trades. Purchasing power of the remittances would also be uplifted by relatively weak PHP assuming disinflation persists. Real peso value of the remittances rose 3.9%YoY in Sep when PHP fell to 44.08 compared to July-Aug when PHP strengthened to less than 44.

## Any risk to remittances?

An average of 4.5% of total OFW remittances (2009-13) comes from JPN. If we use the 2009 GFC as extreme yardstick of OFW remittance risk, flows from JPN back then still managed to rise by over 30%. Remittances from other economies not going through sharp downturns could be expected to cushion any JPN risk. If JPN's event risk compels us to lower our 2015 remittance assumption by US$1bn (size of JPN remittances), foregone current account surplus would be 0.5% of GDP.

## Market implications of fiscal underspending risk

**Risk to bilateral trade surplus and remittance flows from recent JPN recession risk would sustain weak PHP sentiment and bond market preference in near-term:** Coupled with 'dim light' scenario in 2Q15, the key question is whether legacy fiscal spending and other income catalysts like remittances, private investments in BPO and power with favorable construction effects, would be sufficient to ensure that the economy continues to chug along at over 6%. If legal issues and corruption allegations come in the wake of Aquino's legacy spending that stalls implementation of the rehabilitation/ reconstruction program and revives fiscal underspending risk, this downside risk can only heighten potential for policy rate easing, in our view. Timing for any rate action on the back of increased fiscal underspending risk would be in 2H15 after the one-off power crisis dissipates and resulting upside inflation risk settles down. Severe criticisms against government's slow pace in deploying the budget to rebuild the typhoon devastated areas a year after the catastrophe sustains government 2015 focus. Conscious of Aquino's legacy, we sense a strong fiscal bias would not be derailed in undertaking various projects/programs to recover potential GDP lost to Yolanda's fury.

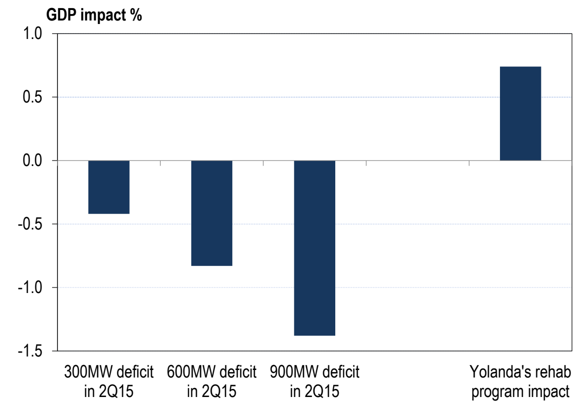
### Figure 87. Potential impact (+0.74%) of Yolanda's reconstruction program

| Production sectors | Assumption on final demand 'triggers' (Php mn) | Effect on Total Output (2006 I/O estimates in Php mn) | Potential increase in Output (%) |
|---|---|---|---|
| Agriculture, Hunting, Forestry, and Fishing | 0 | 1,810 | 0.16 |
| Mining and Quarrying | 0 | 1,016 | 0.91 |
| Manufacturing | 0 | 12,969 | 0.24 |
| Construction | 12,000 | 12,000 | 2.18 |
| Electricity, Gas and Water Supply | 0 | 1,020 | 0.30 |
| Transport, Storage & Communication | 0 | 3,469 | 0.40 |
| Trade and Repair of Motor Vehicles, Motorcycles, and Household Goods | 0 | 3,319 | 0.21 |
| Financial Intermediation | 0 | 4,855 | 0.85 |
| Real Estate, Renting, and Business Activities | 0 | 3,277 | 0.38 |
| Public Administration and Defense; Compulsory Social Security | 45,000 | 49,157 | 12.80 |
| Other Services | 0 | 1,403 | 0.14 |
| TOTAL | 57,000* | 94,293 | 0.74 |

* - annual average of the Yolanda rehab/reconstruction budget of Php170.9bn over 2014-16 period

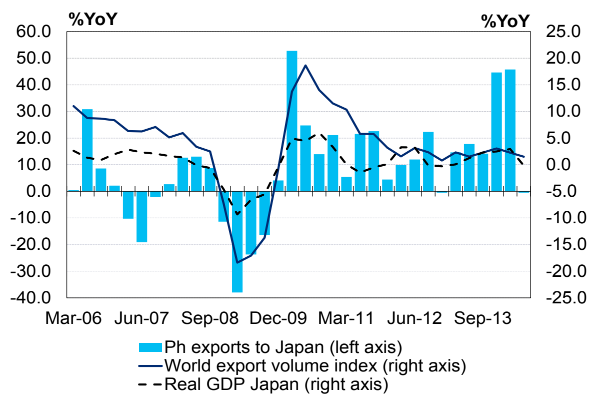
Source: Citi Research

### Figure 88. Fiscal spending needed to mitigate 2Q15 power crisis effects



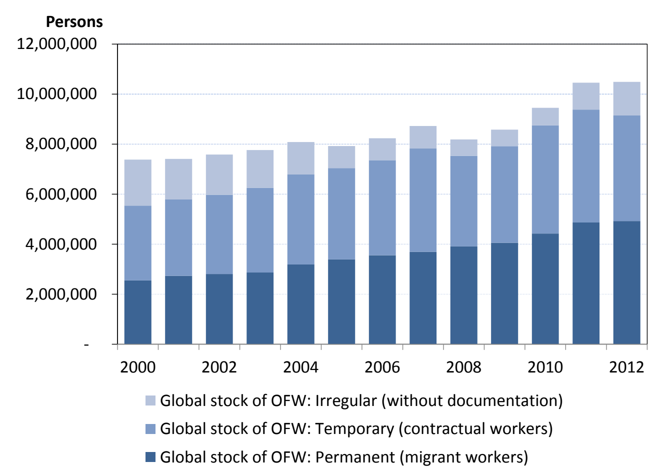

Source: CEIC, Citi Research

### Figure 89. Exports to JPN and external demand determinants



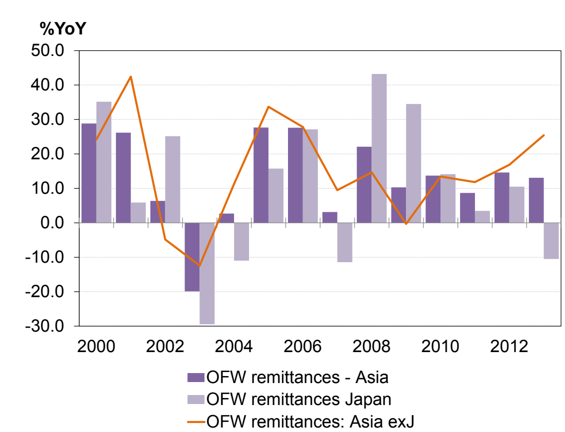

Source: CEIC, Citi Research

### Figure 90. OFW profile in Japan



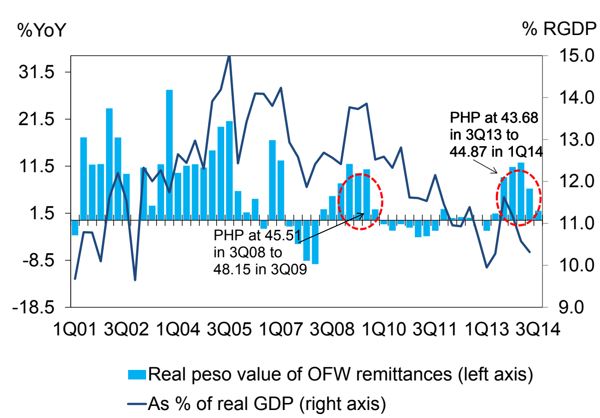

Source: CEIC, Citi Research

### Figure 91. Remittances from Asia exJ continues to be resilient




Source: CEIC, Citi Research

### Figure 92. Weak PHP impact on OFW remittances




Source: CEIC, Citi Research

### Figure 93. Philippines Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 173.4 | 168.6 | 200.0 | 224.1 | 250.6 | 271.9 | 283.5 | 309.4 | 347.1 |
| Nominal GDP, local currency bn | 7,721 | 8,026 | 9,003 | 9,708 | 10,567 | 11,548 | 12,644 | 13,891 | 15,446 |
| GDP per capita, US$ | 1,917 | 1,829 | 2,127 | 2,364 | 2,595 | 2,764 | 2,831 | 3,035 | 3,347 |
| Population, mn | 90.5 | 92.2 | 94.0 | 94.8 | 96.6 | 98.4 | 100.1 | 101.9 | 103.7 |
| Unemployment, % of labour force | 7.4 | 7.5 | 7.3 | 7.0 | 7.0 | 7.1 | 6.8 | 6.5 | 6.0 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 4.2 | 1.1 | 7.6 | 3.7 | 6.8 | 7.2 | 6.3 | 6.5 | 7.3 |
| Real investment growth % yoy | 23.4 | -8.7 | 31.6 | 2.8 | -5.3 | 29.9 | 2.8 | 11.7 | 13.1 |
| Real consumption growth % yoy | 3.3 | 3.3 | 3.4 | 5.1 | 7.7 | 5.9 | 5.9 | 6.2 | 5.9 |
| private consumption growth % yoy | 3.7 | 2.3 | 3.4 | 5.6 | 6.6 | 5.7 | 6.0 | 6.2 | 6.0 |
| Real export growth, % yoy | -2.7 | -7.8 | 21.0 | -2.5 | 8.5 | -1.1 | 7.5 | 4.8 | 5.7 |
| Real import growth, % yoy | 1.6 | -8.1 | 22.5 | -0.6 | 4.9 | 5.4 | 5.0 | 6.7 | 6.2 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 8.0 | 4.3 | 3.6 | 4.2 | 3.0 | 4.1 | 4.1 | 3.3 | 3.7 |
| CPI, % avg | 9.3 | 3.2 | 4.1 | 4.7 | 3.2 | 2.9 | 4.3 | 3.5 | 3.6 |
| Nominal wages, % yoy | 5.5 | 0.0 | 5.8 | 5.4 | 7.0 | 2.2 | 0.0 | 2.5 | 3.0 |
| Credit extension to private sector, % yoy | 12.8 | 4.3 | 13.8 | 16.2 | 14.1 | 17.2 | 13.5 | 15.0 | 17.0 |
| Policy interest rate, % eop | 5.50 | 4.00 | 4.00 | 4.50 | 3.50 | 3.50 | 4.00 | 4.00 | 4.50 |
| 1 mo interbank reference rate, % eop | 5.20 | 4.11 | 0.75 | 1.68 | -1.38 | -0.15 | 0.85 | 1.00 | 2.00 |
| Long term yield, % eop | 6.55 | 6.25 | 4.78 | 4.21 | 3.70 | 2.91 | 3.75 | 4.25 | 5.00 |
| lc/US$, eop | 47.47 | 46.50 | 43.65 | 43.84 | 41.06 | 44.39 | 45.03 | 45.53 | 44.82 |
| lc/US$, avg | 44.48 | 47.56 | 45.06 | 43.29 | 42.22 | 42.46 | 44.62 | 45.53 | 45.13 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 0.1 | 8.4 | 7.2 | 5.6 | 7.0 | 9.4 | 12.3 | 13.4 | 14.7 |
| % of GDP | 0.1 | 5.0 | 3.6 | 2.5 | 2.8 | 3.5 | 4.3 | 4.3 | 4.2 |
| Trade balance | -18.6 | -13.9 | -16.9 | -20.4 | -18.9 | -18.5 | -17.4 | -18.7 | -20.0 |
| Exports | 34.7 | 29.1 | 36.8 | 38.3 | 46.4 | 44.7 | 46.1 | 48.6 | 51.7 |
| Imports | 53.3 | 43.0 | 53.6 | 58.7 | 65.3 | 63.3 | 63.5 | 67.3 | 71.7 |
| Service balance | 2.0 | 4.9 | 5.8 | 6.6 | 6.2 | 6.8 | 6.6 | 7.5 | 8.6 |
| Income balance | 16.8 | 17.4 | 18.3 | 19.5 | 19.7 | 21.1 | 23.1 | 24.6 | 26.1 |
| FDI, net | 0.6 | -0.2 | 1.6 | 0.3 | 1.0 | -0.2 | 2.0 | 3.0 | 2.5 |
| International reserves (ex-gold) | 37.6 | 44.2 | 62.4 | 75.3 | 83.8 | 83.2 | 81.0 | 82.5 | 85.0 |
| Total Amortisations | 7.0 | 5.7 | 8.3 | 6.3 | 2.7 | 9.3 | 9.7 | 10.0 | 10.5 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -0.9 | -3.7 | -3.5 | -2.0 | -2.3 | -1.4 | -1.1 | -1.3 | -1.2 |
| Consolidated gov primary balance | 2.6 | -0.2 | -0.2 | 0.8 | 0.7 | 1.4 | 1.7 | 1.4 | 1.6 |
| Public debt | 54.7 | 54.8 | 52.4 | 51.0 | 51.5 | 49.2 | 46.0 | 45.0 | 44.5 |
| of which Domestic | 31.3 | 30.8 | 30.2 | 29.6 | 32.8 | 32.3 | 31.6 | 31.0 | 30.5 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 54.3 | 54.9 | 60.0 | 60.4 | 60.3 | 58.5 | 58.0 | 58.5 | 58.3 |
| Private | 13.7 | 11.6 | 13.9 | 14.1 | 15.2 | 18.0 | 17.0 | 17.5 | 18.3 |
| Public | 40.6 | 43.2 | 46.2 | 46.4 | 45.2 | 40.5 | 41.0 | 41.0 | 40.0 |
| External debt / GDP | 31.3 | 32.5 | 30.0 | 27.0 | 24.1 | 21.5 | 20.5 | 18.9 | 16.8 |
| External debt / XGS | 113.8 | 126.9 | 110.1 | 105.7 | 90.3 | 87.9 | 82.7 | 78.5 | 73.2 |
| Short-term debt | 7.0 | 4.0 | 6.3 | 7.0 | 8.5 | 11.2 | 10.0 | 10.3 | 10.0 |
| Short-term debt/International Reserves (%) | 18.6 | 9.0 | 10.1 | 9.3 | 10.1 | 13.5 | 12.3 | 12.5 | 11.8 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 6.4 | 6.5 | 6.6 | 6.2 | 5.8 | 6.7 | 7.2 | 7.0 | 7.7 |
| CPI, % yoy | 4.4 | 4.8 | 4.1 | 3.7 | 3.6 | 3.4 | 3.3 | 3.4 | 3.5 |
| Policy interest rate, % eop | 3.50 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.50 | 4.50 |
| Short-term market rate, % eop | 0.79 | 0.98 | 0.85 | 0.70 | 0.80 | 0.85 | 1.00 | 1.30 | 1.50 |
| Long term yield, % eop | 3.50 | 4.00 | 3.75 | 3.65 | 3.85 | 4.00 | 4.25 | 4.50 | 4.75 |
| lc vs USD, eop | 43.63 | 44.97 | 45.03 | 45.31 | 45.59 | 45.68 | 45.53 | 45.38 | 45.24 |

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** – Domestic and external headwinds will likely intensify disinflation in 2015. If growth remains weak, the window of opportunity for policies to turn more growth friendly may open in 2H15, when core inflation falls below 1.5%, interest rates start to rise, and after possible early elections.
- **Things to watch** – [1] External demand developments, [2] house prices and sale volumes, [3] household debt, [4] labor market and core inflation trends and [5] signs of financial stress in the SME sector.
- **Strategy** – Sub 1% headline inflation and a strong USD may pressure the SGD NEER lower vs the band, and MAS may allow the NEER to fall into the lower half of the band as core falls below 1.5% in 2H15. Tightening domestic liquidity will continue to pressure short term rates higher, even before Fed hikes.

## Domestic and external headwinds raise downside risks

**With lackluster demand elsewhere, export prospects will hinge increasingly on a US capex recovery, putting downside risks to our 2015 forecast of 3%:** Compared to earlier in the year, we now expect a more modest acceleration in growth of Singapore's key trading partners. Global growth is now expected to accelerate from 2.7% in 2014 to 3.0% in 2015, or a 0.3%-pt increase, lower than the 0.6%pt increase – from 3% to 3.6% – expected in June, with the US likely to provide the main engine for Singapore's exports. Cyclical demand headwinds aside, manufacturing is facing a permanent downshift in growth rates amidst restructuring pains, notwithstanding ongoing shifts towards higher margin activities. Clusters linked to the global oil supply chain may also be hit by lower oil prices. Since 2012, growth in services exports only offset half of the fall NODX, suggesting limited cushion to overall growth from the structural shift towards services.

**Domestically, construction will be hit by both demand and supply constraints:** On the demand side, growth in private construction contracts awarded have fallen into negative territory for the first time since the GFC in 2Q, led primarily by plunging residential contracts. Supply side constraints have also hurt the construction industry. Not only has construction employment growth slowed in line with tighter foreign worker quotas, but labour productivity have also been *falling* despite government incentives. With supply constraints more binding, the government has been forced to defer the implementation of public sector construction projects. Simulations from a 2007 study by Prof. Tilak Abeysinghe suggest that the 10-15% decline in house prices that we anticipate could shave off 0.4-0.6% off headline GDP growth per annum solely via weaker construction investments.

**Softer private consumption, investments and tighter liquidity may weigh on domestic demand:** Private consumption has slowed since 2012 to the weakest in five years in 2Q14, despite robust wage growth. This partly reflects slowing population growth, but consumption per capita has also slowed significantly in recent quarters, which may be due to tighter access to consumption credit amidst macroprudential measures. The fall in home equity may have exacerbated tighter access to consumption credit, given anecdotal evidence of a proliferation of home equity loans in recent years. With restructuring depressing returns on capital and a shift towards less capital intensive services, prospects for investments or for aggregate productivity improvements remain slim, in our view. Tightening SGD liquidity as deposits shift towards foreign currency, especially offshore RMB could raise interest rates even before Fed hikes and accelerate deleveraging and disinflation.

## Disinflation to deepen, including on core

**Headline disinflation to intensify:** Headline inflation may average just 0.6% in 2015, with core falling below 1.5% in 2H15. Private road transport inflation may impose a drag, as increase in COE supply from November 2014 to January 2015 on increasing vehicle de-registrations, may place a cap on COE premiums even if demand remains firm. The drag from accommodation costs will likely intensify in 2015 as the rising pipeline of private housing completions raises vacancy rates, especially in the context of slower population growth, and places further downward pressure on rentals. With 2Q14 vacancy rates at 7.1% close to 2006/2007 levels and set to rise further, the decline in rentals is likely to accelerate when rising interest rates squeeze landlords' cash flows, likely from 2H15 onwards

**Disinflation is expected to deepen on core as well:** Weak consumer spending amidst deleveraging may force businesses to absorb higher labour costs on margins rather than to pass them onto core CPI, whilst placing a cap on retail rent, acting as another source of upstream cost pressures apart from labour. The weak retail environment has already been reflected in the contraction in tenant traffic and sales of the major retail REITS, though this has yet to translate into rental pressures for REITS, with pressure likely to be more on smaller landlords. The medical subsidies introduced by the government in Sep 2014, though one-off, will also exert disinflationary pressures on core in 1H15. With oil related items around 5% of the CPI basket, oil prices could be another swing factor. Our commodities team expects Brent to average $80/bbl in 2015, close to current levels, which could imply that oil related items may reduce headline inflation by up to 0.5%-pts in 2015.

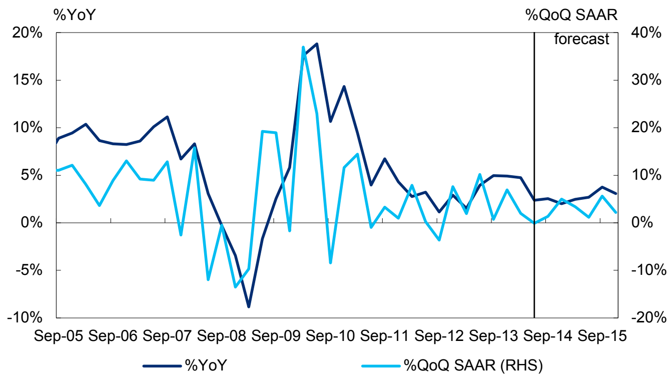
## Tight labour market key constraint in MAS easing

**The MAS is likely to stand pat on upstream cost pressures:** Even if core inflation stays below 2% because of limited pricing power, the continued tightness in the labour market will probably fuel MAS's concern about underlying cost pressures further upstream. Shift to a more dovish policy will hinge on significant downside surprises in growth, core CPI, and – given MAS's emphasis on upstream costs – cracks in the jobs market. Thus far, with the unemployment rate still hovering near 2%, and with nearly 1.4 job vacancies for every unemployed person, there are few signs of job market easing. A window for easing may open up from 2H15, once core falls closer to 1.5% and when Fed hikes tighten monetary conditions, though greater conviction over easing will require cracks in the labour market.

## Elections may determine window for relaxation of policies

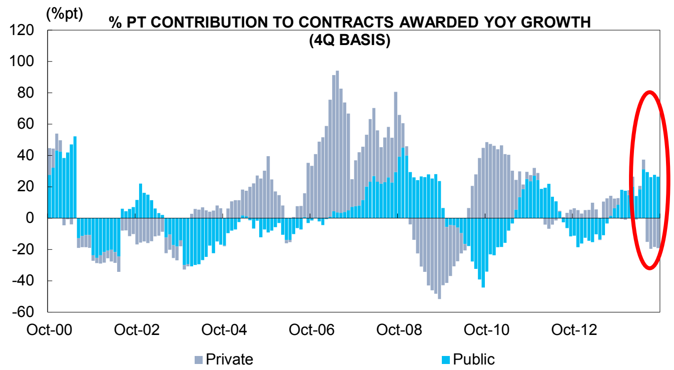
**Early election could effect changes to economic policy direction:** Early elections could be held in 2015, capitalizing on the perceived feel good factor accompanying the 50$^{th}$ anniversary of independence. The PAP's share of the popular vote has been negatively correlated with growth (due to the perception of the PAP as a safe haven) and inflation. The current disinflationary environment could thus theoretically play to the PAP's advantage, with a higher share of the popular vote allowing it fine tune policy towards a more pro-growth direction post-election. Election timing aside, property policies will require another 5-10% fall in prices, if history serves as a guide. If the slow slide in house prices continues this threshold may be hit sometime in 2016.

### Figure 94. We expect GDP at 2.9% in 2014 and 3.0% in 2015



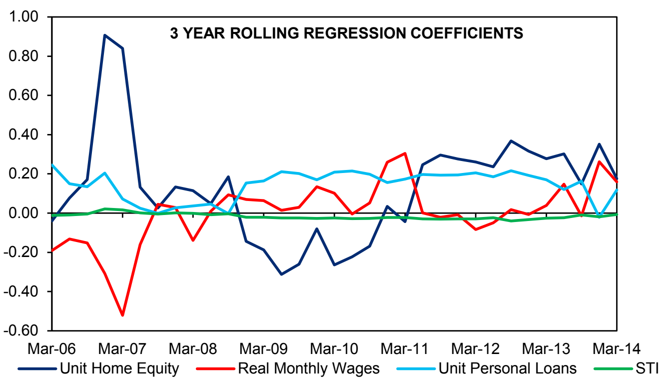

Source: CEIC, Citi Research

### Figure 95. Contracts awarded dragged by private sector since Jun-14



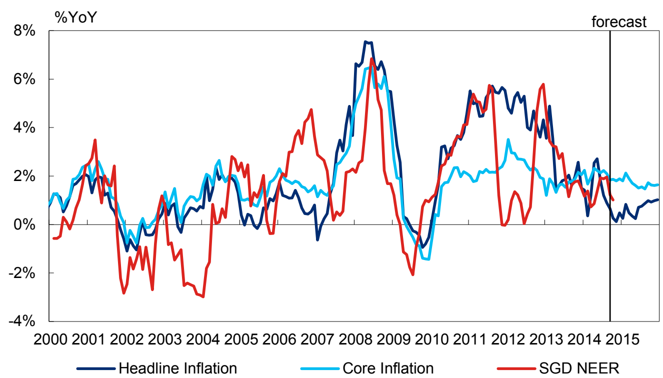

Source: CEIC, Citi Research

### Figure 96. The wealth effect of home equity has turned positive



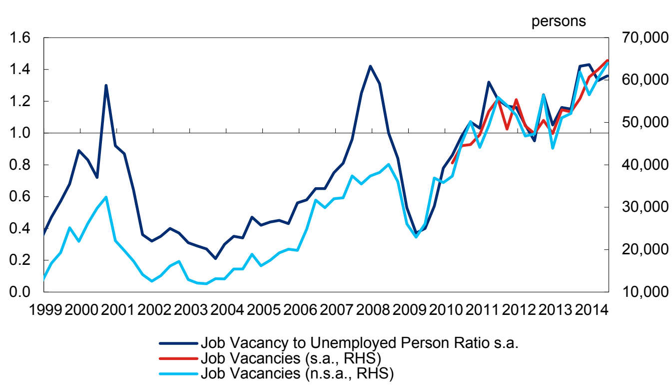

Note: Regression: Private Consumption/person growth = a* (Monthly Wages growth) + b*(Personal Loans/per person growth) + c*(Home Equity/per person growth) + d*(STI)
Source: CEIC, Citi Research

### Figure 97. Disinflation to intensify, including on core




Source: CEIC, Citi Research

### Figure 98. The labour market remains tight




Source: CEIC, Citi Research

### Figure 99. Early elections could herald policy changes

| Polling Date | No. of Seats | Seats Contested | % Seats Contested | GDP (moving average of preceding 4 quarters' YoY growth) | Inflation (12 month moving average of YoY inflation | PAP's share of popular vote | Chg from previous election | STI % chg 1-mth post polling date |
|---|---|---|---|---|---|---|---|---|
| Sep-88 | 81 | 70 | 86.4% | 11.8% | 1.5% | 62.6% | -2.2% | -4.4% |
| Aug-91 | 81 | 40 | 49.4% | 7.6% | 3.7% | 61.0% | -1.6% | -3.3% |
| Jan-97 | 83 | 36 | 43.4% | 7.7% | 1.5% | 65.0% | 4.0% | 3.2% |
| Nov-01 | 84 | 29 | 34.5% | 2.7% | 1.2% | 75.3% | 10.3% | 11.9% |
| May-06 | 84 | 47 | 56.0% | 8.8% | 0.9% | 66.6% | -8.7% | -9.0% |
| May-11 | 87 | 82 | 94.3% | 13.3% | 4.1% | 60.10% | -6.50% | 0.5% |

Source: CEIC, Citi Research

**Figure 100. Singapore Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 192.5 | 193.0 | 236.9 | 274.3 | 287.2 | 298.0 | 301.9 | 294.1 | 302.4 |
| Nominal GDP, local currency mn | 272 | 280 | 322 | 345 | 359 | 373 | 384 | 390 | 404 |
| GDP per capita, US$ | 39,772 | 38,694 | 46,671 | 52,908 | 54,058 | 55,199 | 55,190 | 52,998 | 53,517 |
| Population, mn | 4.8 | 5.0 | 5.1 | 5.2 | 5.3 | 5.4 | 5.5 | 5.6 | 5.7 |
| Unemployment, % of labour force | 2.3 | 3.0 | 2.2 | 2.0 | 1.9 | 1.9 | 2.0 | 2.2 | 2.3 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 1.8 | -0.6 | 15.2 | 6.1 | 2.5 | 3.9 | 2.9 | 3.0 | 3.0 |
| Real investment growth % yoy | 29.6 | -11.3 | 24.4 | 4.3 | 14.9 | -2.2 | -5.7 | 2.2 | 0.9 |
| Real consumption growth % yoy | 4.0 | 0.0 | 6.9 | 3.1 | 3.1 | 4.1 | 1.2 | 1.6 | 1.0 |
| private consumption growth % yoy | 3.5 | -1.1 | 5.9 | 4.3 | 3.9 | 2.6 | 1.5 | 0.5 | -0.1 |
| Real export growth, % yoy | 4.6 | -7.5 | 17.4 | 4.6 | 1.5 | 3.6 | 3.3 | 3.6 | 3.7 |
| Real import growth, % yoy | 10.0 | -10.4 | 16.2 | 3.2 | 3.1 | 3.1 | 2.0 | 2.4 | 2.7 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 5.5 | -0.5 | 4.6 | 5.5 | 4.3 | 1.5 | 0.3 | 1.0 | 1.5 |
| CPI, % avg | 6.6 | 0.6 | 2.8 | 5.2 | 4.6 | 2.4 | 1.1 | 0.6 | 1.4 |
| Nominal wages, % yoy | 5.4 | -2.7 | 5.6 | 6.0 | 2.3 | 4.3 | 3.5 | 3.5 | 3.0 |
| Credit extension to private sector, % yoy | 15.2 | 2.0 | 13.4 | 18.6 | 13.2 | 15.4 | 9.0 | 8.0 | 7.0 |
| Short-term market rate, % eop | 1.00 | 0.69 | 0.44 | 0.38 | 0.38 | 0.40 | 0.42 | 0.60 | 1.10 |
| Long term yield, % eop | 2.05 | 2.66 | 2.71 | 1.63 | 1.30 | 2.56 | 2.30 | 2.90 | 3.10 |
| lc/US$, eop | 1.43 | 1.41 | 1.28 | 1.30 | 1.22 | 1.26 | 1.30 | 1.33 | 1.33 |
| lc/US$, avg | 1.41 | 1.45 | 1.36 | 1.26 | 1.25 | 1.25 | 1.27 | 1.32 | 1.34 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 27.7 | 32.4 | 56.0 | 62.6 | 50.2 | 54.6 | 54.3 | 52.9 | 51.4 |
| % of GDP | 14.4 | 16.8 | 23.6 | 22.8 | 17.5 | 18.3 | 18.0 | 18.0 | 17.0 |
| Trade balance | 41.6 | 47.6 | 62.9 | 69.6 | 63.5 | 67.8 | 65.0 | 65.0 | 68.0 |
| Exports | 352.9 | 287.4 | 370.5 | 432.0 | 434.5 | 437.7 | 440.0 | 445.0 | 453.0 |
| Imports | 311.3 | 239.8 | 307.6 | 362.5 | 371.0 | 369.9 | 375.0 | 380.0 | 385.0 |
| Service balance | -1.5 | -2.3 | -0.4 | 2.8 | 0.9 | 0.8 | 2.0 | 4.0 | 6.0 |
| Income balance | -12.4 | -12.9 | -6.5 | -9.8 | -14.2 | -14.0 | -12.7 | -16.1 | -22.6 |
| FDI, net | 5.4 | -2.4 | 21.7 | 26.9 | 47.7 | 36.8 | 36.5 | 36.0 | 37.0 |
| International reserves | 174.2 | 187.8 | 225.8 | 237.7 | 259.3 | 273.1 | 262.0 | 250.0 | 255.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 0.1 | -0.3 | 0.3 | 1.2 | 1.7 | 1.1 | -0.3 | 0.2 | 1.5 |
| Consolidated gov primary balance | 1.1 | -0.8 | 0.2 | 1.3 | 2.0 | 1.3 | 0.7 | 0.5 | 1.0 |
| Public debt | 93.9 | 104.2 | 99.6 | 102.7 | 107.4 | 104.7 | 110.0 | 110.0 | 110.0 |
| of which Domestic | 93.9 | 104.2 | 99.6 | 102.7 | 107.4 | 104.7 | 110.0 | 110.0 | 110.0 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 2.3 | 2.8 | 1.9 | 2.5 | 2.7 | 3.8 | 3.1 | 3.7 | 3.2 |
| CPI, % yoy | 0.6 | 0.6 | 0.3 | 0.3 | 0.5 | 0.8 | 1.0 | 1.0 | 1.3 |
| Short-term market rate, % eop | 0.40 | 0.40 | 0.42 | 0.45 | 0.47 | 0.50 | 0.60 | 0.65 | 0.75 |
| Long term yield, % eop | 2.75 | 2.90 | 2.30 | 2.60 | 2.67 | 2.75 | 2.90 | 3.00 | 3.10 |
| lc vs USD, eop | 1.25 | 1.28 | 1.30 | 1.31 | 1.32 | 1.33 | 1.33 | 1.33 | 1.34 |

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** – We downgrade 2014 and 2015 growth again by 0.2%p and 0.3%p to 3.4% and 3.5% respectively due to weaker-than-expected recovery pace despite fiscal and monetary boosting measures. Subdued sentiments and shortfall of tax revenue are likely to continue to weigh on economic growth.

- **Things to watch** – Given the downside risks to current recovery pace, fiscal constraint, and very low inflation, the BoK is likely to cut the policy rate by 25bps early next year, mostly in Jan. The BoK may also consider expansion of the Bank Intermediated Lending Support Facilities to support SMEs and local enterprises.

- **Strategy** – We believe KRW to weaken against the USD to 1125 over the 6-12m horizon on the back of concerns about the economy's competitiveness against Japanese exporters and the possibility of an extra rate cut in early 2015 as economic recovery slows further.

## We cut growth forecast for 2014 by 0.2%p to 3.4%

**2H14 growth seems to fall short of expectations:** Unlike the expectations just after the government boosting measures and the BoK's rate cut in Jul and Aug, the economy still seems like to suffer with lack of growth momentum. Particularly, the readings on industrial production on Sep turned out far below the market consensus and retail sales also contracted sharply from previous month, hinting a weaker recovery in 3Q14 than the estimates of the BoK and us. High unemployment (3.5% sa) and job shed (-38K MoM sa) in Oct suggest that there is room for further improvement in labor market. The only data that surprised market was exports in Oct which increased by 2.5%YoY (vs. consensus: 1.4%YoY) and led the record high monthly trade surplus of US$7.38bn.

**Recovery pace in the remainder of this year is also likely to stay below the path we currently speculate:** First of all, it is worth noting that, despite the government's fiscal stimulus and monetary easing, economic sentiments do not show signs of meaningful improvement, especially business sentiment, but deteriorate further. Secondly, the easing regulations on property market and the BoK's rate cuts resulted in an increase in household debt burden. In Oct, household loans from banks excluding mortgage loans assigned to KHFC surged by KRW6.4trn, the highest MoM expansion since Jan 2007, to post KRW507trn. DSR of household inched up to 21.5% from 19.1% a year ago, weighing on consumption recovery.

**Importantly, the government spending in 4Q14 is likely to show smaller contribution to growth than in 3Q14 as shortfall of tax revenue weigh on fiscal spending to postpone to 1H14:** The concerns over shortfall of tax revenue have been overflowing as economic recovery remains weak, particularly after the ferry sinking incident in April; and the National Assembly Budgetary Office (NABO) recently estimated that the government will be short of KRW12.5tn of revenue in this year. In this case, the government spending in 2014 will end up growing just 1.9% from 2013, far below 5.4% of the budget plan. Even if exports and imports are on stable recovery path, these three factors are going to weigh down domestic demand and economic growth. Real GDP in 3Q and 4Q is now expected to grow 0.8%QoQ sa (3.2%YoY) and 0.7%QoQ sa (3.0%YoY) respectively, -0.1%p (0.0%p) and -0.7%p (-0.6%p) from our previous forecast. With this, we cut our 2014 economic growth by 0.2%p to 3.4%.

## Stall growth at 3.5% in 2015, extra rate cut in 1Q15

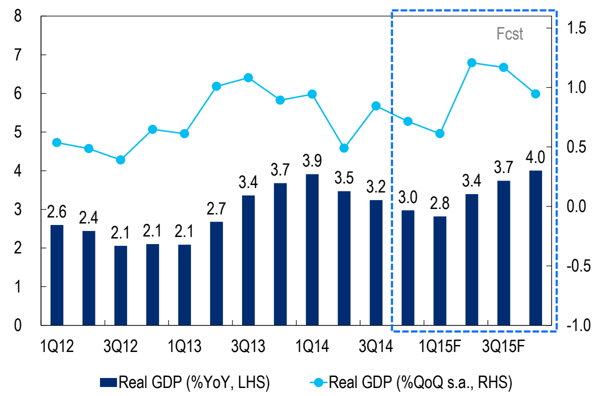
**Economic growth is likely to post 3.5% in 2015, just +0.1%p gain from 2014:** Quarterly GDP growth, in particular, will likely bottom at 2.8%YoY in 1Q15 and rebound to 3.4% in 2Q15 on low base of 2Q14 due to ferry accident of Apr14. First, private consumption growth is likely to be limited with weak household income growth and the continuing higher Cheonse price. We expect job growth in 2015 to slow to 412K YoY from 537K YoY in 2014 with anemic nominal wage growth. On the back of insufficient supply, Cheonse price is expected to continue to rise for a while. The CERIK, a private think tank for construction industry, forecasts 3.5% increase in Cheonse price in 2015. Second, export growth is also likely be limited by further weakening of JPY and sluggish growth in euro area and China. In particular, JPY weakness is concerning since it could deteriorate Korean exporters' price competitiveness against their Japanese counterparts given high export similarity between two countries. Indeed, the real concerning part for the policy makers and industries is that the prolonged and further JPY weakness against KRW could leave Korean exporters to fall into relatively unfavorable operating profits in KRW than those of Japanese counterparties in JPY in the mid to longer horizon.

**2014 and 2015 inflation forecasts are lowered to 1.3% and 1.6%:** The below-consensus readings of recent headline inflation suggest the deflationary pressure from supply side is stronger and likely to continue longer-than-expected. Therefore, we adjust down 4Q14 inflation by 0.3%p to 1.1%YoY and 2014 annual inflation by 0.1%p to 1.3%. We also cut 2015 inflation to 1.6%. Particularly, headline CPI inflation is likely to retreat to 1.0%YoY in Dec and remain at low-1% until end-1H15 on the back of the continued aforementioned deflationary pressures and widened negative output gap due to downward adjustment of economic growth. Negative output gap is expected to persist till 3Q15 and will likely turn slightly in the positive territory in 4Q15. Lastly, if the government fails to implement the tobacco tax hike, not our baseline scenario, headline inflation will fall further to c0.5%YoY in 1H15E.

**We reiterate our call of a rate cut in early 2015:** We believe the BoK will cut its forecasts for 2014-15 growth and inflation in Jan 2015, to take into account the slower-than-expected recovery and downside risks to growth. Given the fiscal constraint noted above and lower inflation path, we think the BoK is going to cut the policy rate by 25bps early next year, mostly in Jan. The bank may also increase the Bank Intermediated Lending Support Facilities to support SMEs and local enterprises. After a cut in 1Q14, the BoK is expected to hold the rate during the rest of 2015 to confirm improving recovery momentum both in economic growth and inflation in 2H15 and may be able to consider the first hike in 1Q16.

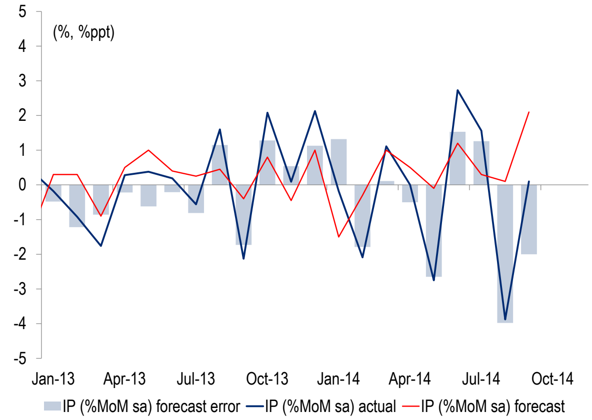
**USDKRW is expected to rise to 1125 in 6-12 month horizon:** In our view, recent weakness in KRW against the dollar has two primary sources. The first is the possibility of an extra policy rate cut in early 2015 as we noted above. The second is concerns on the competitiveness implications of Korean exporters related to the strengthening of KRW against JPY. The two factors appear to have been sufficient for market discounting of the record high trade surplus, and should continue to shape the KRW dynamics in the near term. With USD now stronger and JPY weaker in our forecasts, KRW is likely to depreciate further. Therefore, we downgrade our 6-12m point forecast to 1125. In the long-term, sizeable current account surplus suggest that KRW may get back on the appreciation path as some of the uncertainties around the monetary policies of major central banks dissipate.

Figure 101. We lowered our 2014 and 2015 growth forecast



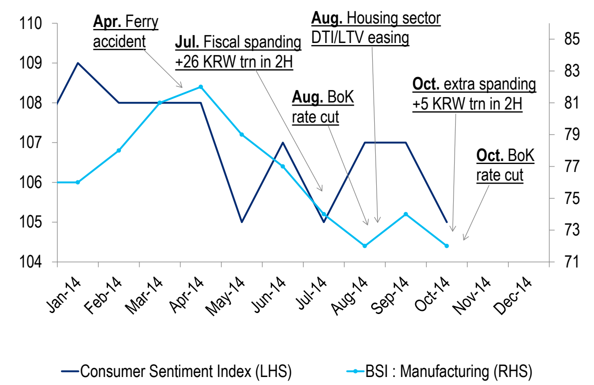

Source: Bank of Korea, CEIC, Citi Research

Figure 102. Disappointing industrial production in Aug and Sep



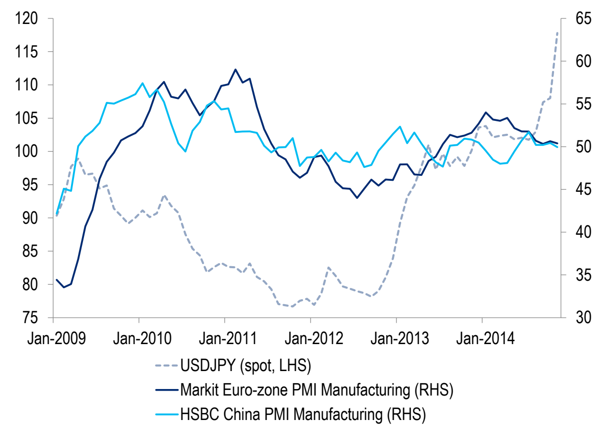

Source: Statistics Korea, Bloomberg, CEIC, Citi Research

Figure 103. Weaker economic sentiment despite stimulus measures



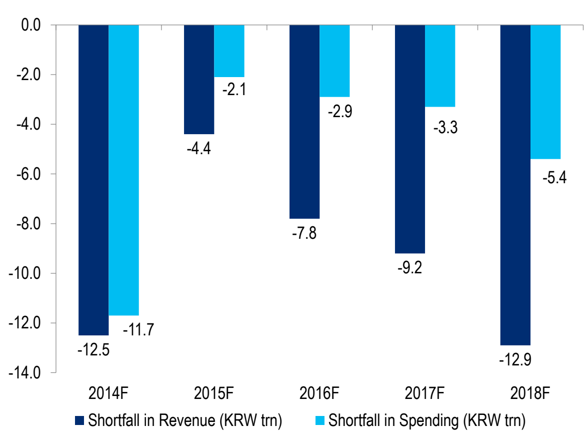

Source: Bank of Korea, CEIC, Citi Research

Figure 104. China Manu PMI, Euro-zone Manu PMI, and USDJPY




Source: KITA, Markit, CEIC, Haver, Citi Research

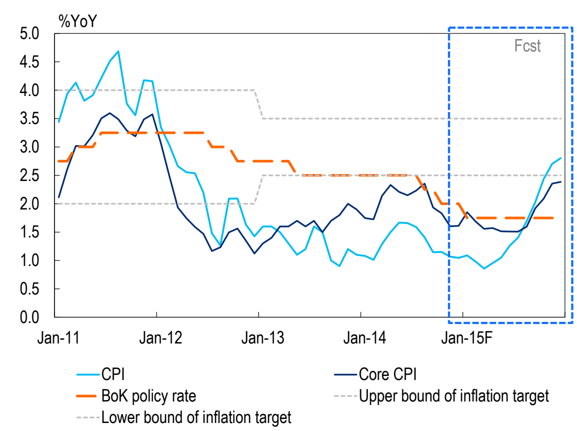
Figure 105. Continued fiscal drag due to lack of tax revenue




Note : Shortfall = NABO's estimate – MoF's estimate

Source: NABO, MoSF, Citi Research, Citi Research

Figure 106. We expect the BoK to cut the policy rate to 1.75% in 1Q15




Source: Bank of Korea, CEIC, Citi Research

**Figure 107. Korea Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 999.7 | 902.6 | 1,094.6 | 1,202.8 | 1,222.5 | 1,304.3 | 1,409.2 | 1,399.1 | 1,483.5 |
| Nominal GDP, local currency bn | 1,104,492 | 1,151,708 | 1,265,308 | 1,332,681 | 1,377,457 | 1,428,295 | 1,489,497 | 1,564,160 | 1,655,590 |
| GDP per capita, US$ | 20,424 | 18,352 | 22,153 | 24,163 | 24,448 | 25,972 | 27,947 | 27,640 | 29,202 |
| Population, mn | 48.9 | 49.2 | 49.4 | 49.8 | 50.0 | 50.2 | 50.4 | 50.6 | 50.8 |
| Unemployment, % of labour force | 3.2 | 3.6 | 3.7 | 3.4 | 3.2 | 3.1 | 3.5 | 3.5 | 3.3 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 2.8 | 0.7 | 6.5 | 3.7 | 2.3 | 3.0 | 3.4 | 3.5 | 3.7 |
| Real investment growth % yoy | -1.0 | -10.1 | 17.8 | 3.5 | -2.3 | 0.0 | 5.0 | 4.3 | 6.1 |
| Real consumption growth % yoy | 2.2 | 1.3 | 4.3 | 2.7 | 2.2 | 2.2 | 2.1 | 3.0 | 3.2 |
| private consumption growth % yoy | 1.4 | 0.2 | 4.4 | 2.9 | 1.9 | 2.0 | 1.9 | 2.9 | 3.3 |
| Real export growth, % yoy | 7.5 | -0.3 | 12.7 | 15.1 | 5.1 | 4.3 | 3.3 | 4.9 | 5.6 |
| Real import growth, % yoy | 3.2 | -6.8 | 17.3 | 14.3 | 2.4 | 1.6 | 2.6 | 6.0 | 6.1 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 4.1 | 2.7 | 3.1 | 4.2 | 1.4 | 1.1 | 1.0 | 2.8 | 2.2 |
| CPI, % avg | 4.7 | 2.8 | 3.0 | 4.0 | 2.2 | 1.3 | 1.3 | 1.6 | 2.6 |
| Nominal wages, % yoy | -4.1 | 2.6 | 6.8 | 1.0 | 5.3 | 3.9 | 4.8 | 4.7 | 4.4 |
| Credit extension to private sector, % yoy | 14.9 | 5.0 | 4.0 | 6.5 | 3.2 | 4.7 | 5.7 | 7.3 | 8.1 |
| Policy interest rate, % eop | 3.00 | 2.00 | 2.50 | 3.25 | 2.75 | 2.50 | 2.00 | 1.75 | 2.25 |
| Short-term market rate, % eop | 4.68 | 2.82 | 2.80 | 3.55 | 2.89 | 2.66 | 2.10 | 1.85 | 2.35 |
| Long term yield, % eop | 4.22 | 5.39 | 4.52 | 3.79 | 3.16 | 3.58 | 2.50 | 2.80 | 3.00 |
| lc/US$, eop | 1,263 | 1,166 | 1,121 | 1,159 | 1,064 | 1,051 | 1,096 | 1,122 | 1,110 |
| lc/US$, avg | 1,102 | 1,275 | 1,156 | 1,108 | 1,127 | 1,095 | 1,057 | 1,118 | 1,116 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 3.2 | 33.6 | 28.9 | 18.7 | 50.8 | 79.9 | 88.0 | 82.5 | 78.2 |
| % of GDP | 0.3 | 3.7 | 2.6 | 1.6 | 4.2 | 6.1 | 6.2 | 5.9 | 5.3 |
| Trade balance | -13.3 | 40.4 | 41.2 | 30.8 | 28.3 | 44.0 | 48.1 | 43.6 | 34.5 |
| Exports | 422.0 | 363.5 | 466.4 | 555.2 | 547.9 | 559.6 | 579.9 | 613.6 | 656.4 |
| Imports | 435.3 | 323.1 | 425.2 | 524.4 | 519.6 | 515.6 | 531.8 | 569.7 | 621.6 |
| Service balance | -5.7 | -6.6 | -8.6 | -5.8 | -5.2 | -7.9 | -9.5 | -10.8 | -10.5 |
| Income balance | 3.7 | 1.6 | -2.1 | 0.3 | 6.6 | 7.2 | 3.6 | 5.8 | 5.6 |
| FDI, net | -16.9 | -14.9 | -22.2 | -16.4 | -18.9 | -13.1 | -8.6 | -4.3 | -3.7 |
| International reserves | 201.1 | 270.0 | 291.5 | 304.2 | 323.2 | 341.7 | 362.5 | 372.3 | 392.3 |
| Total Amortisations | 31.0 | 30.2 | 35.7 | 42.7 | 43.3 | 43.7 | 44.3 | 45.0 | 47.2 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 1.1 | -1.5 | 1.3 | 1.4 | 1.3 | 1.0 | 0.9 | 0.3 | 0.3 |
| Consolidated gov primary balance | 2.4 | -0.2 | 2.6 | 2.7 | 2.6 | 2.1 | 2.0 | 1.3 | 1.3 |
| Public debt | 28.0 | 31.2 | 31.0 | 31.6 | 32.2 | 34.3 | 35.4 | 36.6 | 37.6 |
| of which Domestic | 26.1 | 29.1 | 30.2 | 29.4 | 31.4 | 33.5 | 34.6 | 35.9 | 37.0 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 317.4 | 345.7 | 359.8 | 398.7 | 409.4 | 416.6 | 428.4 | 441.1 | 452.2 |
| Private | 264.9 | 277.9 | 280.0 | 314.7 | 311.2 | 312.3 | 322.5 | 332.4 | 342.9 |
| Public | 52.5 | 67.8 | 79.7 | 84.0 | 98.2 | 104.3 | 105.9 | 108.7 | 109.3 |
| External debt / GDP | 31.7 | 38.3 | 32.9 | 33.1 | 33.5 | 31.9 | 30.4 | 31.5 | 30.5 |
| External debt / XGS | 61.9 | 79.1 | 65.0 | 61.3 | 62.8 | 63.0 | 62.5 | 60.4 | 57.6 |
| Short-term debt | 149.9 | 149.2 | 139.8 | 137.4 | 127.2 | 115.3 | 112.8 | 106.3 | 117.7 |
| Short-term debt/International Reserves (%) | 74.5 | 55.3 | 47.9 | 45.2 | 39.4 | 33.7 | 31.1 | 28.6 | 30.0 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 3.5 | 3.2 | 3.0 | 2.8 | 3.4 | 3.6 | 4.0 | 3.8 | 3.8 |
| CPI, % yoy | 1.7 | 1.1 | 1.0 | 0.9 | 1.3 | 2.0 | 2.8 | 2.7 | 2.8 |
| Policy interest rate, % eop | 2.50 | 2.25 | 2.00 | 1.75 | 1.75 | 1.75 | 1.75 | 2.00 | 2.25 |
| Short-term market rate, % eop | 2.65 | 2.35 | 2.10 | 1.85 | 1.85 | 1.85 | 1.85 | 2.15 | 2.40 |
| Long term yield, % eop | 3.17 | 2.85 | 2.50 | 2.60 | 2.65 | 2.65 | 2.80 | 3.00 | 3.15 |
| lc vs USD, eop | 1,012 | 1,055 | 1,096 | 1,107 | 1,119 | 1,124 | 1,122 | 1,120 | 1,118 |

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** – Steady growth of 3.6%yoy and benign inflation of 1.7%yoy likely in 2015E. We see competition from two fronts: (1) KRW deprecation and (2) China-Korea FTA. Political uncertainties especially in regard to cross-strait relations will be market focus in 2015.
- **Things to watch** – 1) Cross-strait momentum: Taiwanese banks allowed to set up branches in China, RMB swap line, relaxation in RMB conversion quota; 2) export competitveness; 3) politics ahead of 2016's Legislative/Presidential elections; 4) TPP and RECP talks; 5) 4th nuclear plant refrendum; and 6) pension reforms.
- **Strategy** – Policy rate is likely to be stable untill 1Q16, CBC prefers to use NCD for liquidity managment; 10Y government bond yields likely to be on a gradual uptrend. TWD depreciate along with regional currencies admidst USD strength. Our house view expects TAIEX to re-climb to10,000 by mid-2015.

## Politics could takeover headlines in 2015

**The 2014 local elections is only the warm up for the blue-green battle.** Recent waves of social movements have led to a general sense of political uncertainty. Regardless of elections outcome, the 2016 Government will be pressured to respond to grass roots demands and established policy positions will need to be adjusted. Promises in political campaigns starting 2H15 likely will drive market's perception on key issues like closer economic cooperation with China and thus affect market's assessment on whether Taiwan could go back to its perceived 4% potential growth in the next two years. With ECFA stalled by politics, market hopes that banks related cross strait liberalization can be implemented separately.

## Export outlook remain challenging despite global recovery

**Global recovery and tech cycle:** We continue to expect Taiwan, being a small export-oriented economy, would benefit from warming global trade, and associated manufacturing volumes would be subsequently added, as orders pick up. For 2H14, we witnessed the benefit to Taiwan from the typical seasonal recovery in tech exports ahead of shopping festivities and well-timed tech product launches. We expect this will be repeated again 2H15E. We will need to monitor two major tech trends in 1H15E to determine whether Taiwan can reposition itself in the tech space: (1) Apple products will face renewed competition from the new android launch in early 2015, and (2) how receptive will the new Windows 9 launch be; both of these are expected to have major implication on Taiwan's semi/PC/notebook components supply chain. Aside from tech, we also see potential for growth in Taiwan's exports of machineries and auto parts due to production expansions by advanced economies and global consumer demand recovery.

**Currency war impact growing:** Competitive depreciation sparked by JPY in the region is likely to take toll on Taiwan's exports given high net export similarity with Korea, as well as with Japan. Our study indicated that in 2013, Taiwanese net exports have a 44.3% overlap with Korea, and a 23.5% overlap with Japan. According to SITC breakdown, overlapping sectors between Japan and Taiwan are "electrical machinery/apparatus/appliances" (~8.7% similar), which includes circuits, panels, semiconductors; "road vehicles" (~3.1% similar); and "metal working machinery" (~2.8% similar). As with Korea, the overlapping sectors are electrical machinery/apparatus/appliances (~16.8% similar), telecom (~7.5% similar), and road vehicles parts (~3.1% similar).

**China-Korea FTA threat in 2H15E:** The recently confirmed FTA between Korea and China (with details expected to be announced in 2H15E) is heightening Taiwan's competiveness concerns. According to MOEA, about 24.7% of Taiwan's exports to China will be affected, of which 2-5.4% will be completely substituted by Korean competitors. In particular, Taiwan's display panel and petroleum industries will likely be the most affected, as their exports to China see a 5% and 6.5% tariff, respectively; and the Korean competition could take away >US$1bn equivalent of business for each of the two industries. Other than these, exports of glass (China imposes tariff of 13.3%), textiles (11.2%), auto parts (10.1%), machine tools (8.9%), polarizers (8%), and steel (5.3%) could also be diverted to Korea. The expected loss in export orders from these eight industries amounts to a 0.5%pt GDP hit, according to MOEA. On top of that, there would be a potential loss in foreign direct investment in the next few years, which is harder to quantify. In the absence of quick actions on TPP/RECP, we worry foreign investments aimed towards the Chinese consumer markets will likely opt for Korea over Taiwan, given FTA tariff reductions usually come with a product origination clause, and the impact would be more visible in 2016.

**We expect the TWD to depreciate in 6-12 months to 31.5/USD.** We see the TWD to depreciate along with regional trends (our house view see the USDCNY going to 6.25, USDJPY to 125 and USDKRW to 1125 in 6-12M) to help maintain export competitiveness.

## Steady economy in 2015E

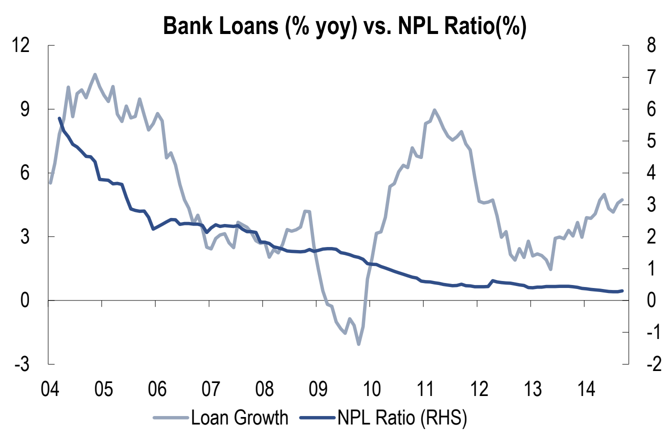
**Real GDP likely to stay at 3.6%yoy in 2015E (same as 2014E):** We are cautiously optimistic about the economy in 2015, but 2014 created a high base and above-mentioned external headwinds and local challenges have led us to expect flat growth. We expect food safety issues, which are expected to weaken 4Q's consumption, will likely wane in 2015E, as previous episodes of food safety typically had only short term impacts on GDP. As China begins to employ conventional rate cut to help cushion the economy, we think negative pass-through to Taiwan is also reduced for both Taiwan's non-tech exports and banking risks. According to CBC, credit to China reached 5.41% of total credit after 85.4%yoy jump to NT$136trn in 2013. This growth likely moderated in 2014 but remain elevated, in our view.

**We expect benign inflation at 1.7%yoy in 2015E (vs. 1.4%yoy in 2014E):** Given moderate growth expectations for 2015E, recent deflation noted in WPI, and likely continued competition in electronics/optical goods and telecom services next year, we believe inflation will be kept in check. We see recent decline in global oil prices to also have a mild disinflationary impact on Taiwan. Our calculations show that historical sensitivity to oil price for Taiwan is low at 2.6%, and this is in line with the low weights of electricity (2.2ppt) and fuel & lubricants (3.5ppt) in the CPI basket.

**Interest rate outlook:** We anticipate policy rates to remain on hold till 1Q16, while long-term bond yields again creep up with Fed rates normalization. We expect the CBC will maintain maximum accommodation to spur economic growth in 2015E. The mark-to-market nature of Taiwanese gov't bond investors will likely track global FI sentiments more closely, suggesting Taiwan's 10Y government bond yields could rise when we come around to US Fed hike talks in 2H15E.

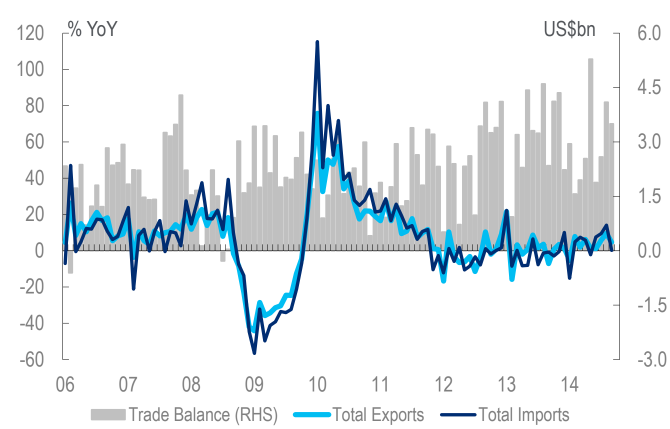
**TAIEX to re-climb to10,000 by mid-2015:** Our equity strategist, Peter Kurz thinks the index will challenge the 10,000 level over the course of the next three quarters given that growth drivers remain intact. Peter recommends a re-weighting back into Tech, reversing the rotation into Financials over the summer, and considers positioning into the large-cap sector Telecom.

**Figure 108. Loan growth still likely on uptrend**



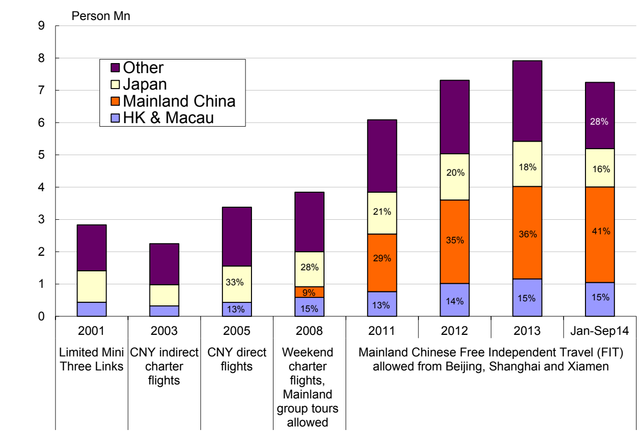

Source: CEIC, Citi Research

**Figure 109. Trade headwinds likely in 1H15E**



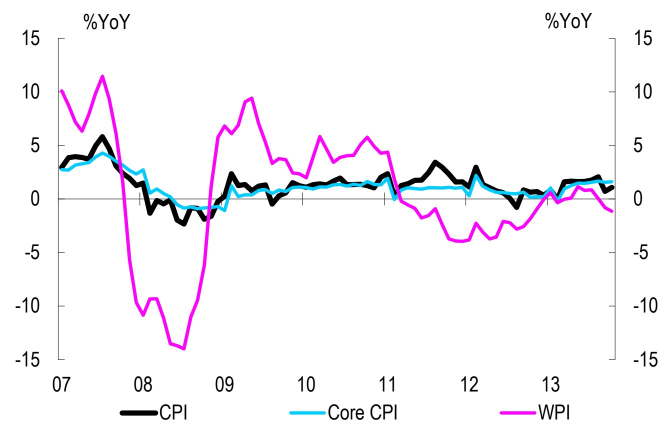

Source: CEIC, Citi Research

**Figure 110. Mainland tourist contribution to consumption is rising**



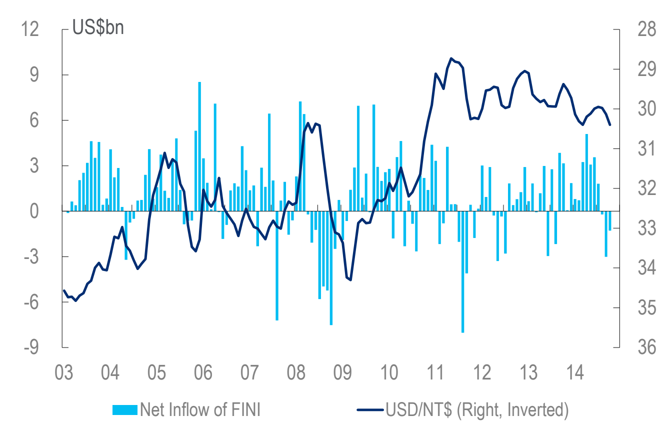

Source: CEIC, Citi Research

**Figure 111. Benign inflation gives room for CBC's accommodation**



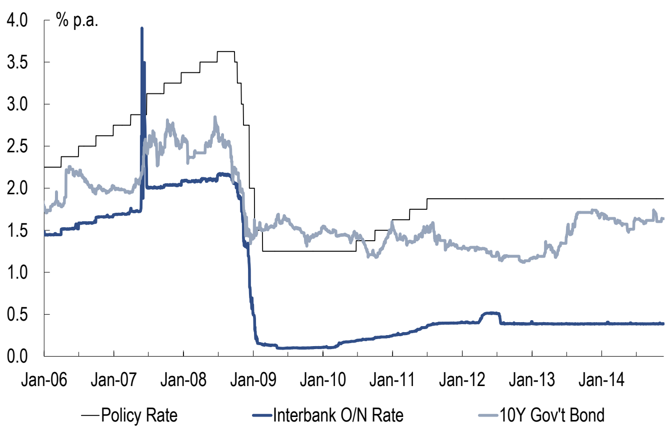

Source: CEIC, Citi Research

**Figure 112. TWD could depreciate with strong USD & mixed FINI flows**




Source: CEIC, Citi Research

**Figure 113. 10Y gvt bonds could edge up with US rate normalization**




Source: Bloomberg, Citi Research

**Figure 114. Taiwan Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 400.2 | 378.0 | 430.3 | 466.5 | 476.3 | 490.6 | 501.1 | 531.4 | 568.1 |
| Nominal GDP, local currency bn | 12,620 | 12,481 | 13,552 | 13,709 | 14,077 | 14,561 | 15,284 | 16,101 | 17,043 |
| GDP per capita, US$ | 17,370 | 16,348 | 18,579 | 20,084 | 20,429 | 20,991 | 21,396 | 22,644 | 24,160 |
| Population, mn | 23.0 | 23.1 | 23.2 | 23.2 | 23.3 | 23.4 | 23.4 | 23.5 | 23.5 |
| Unemployment, % of labour force | 4.1 | 5.8 | 5.2 | 4.4 | 4.2 | 4.2 | 4.0 | 3.9 | 3.9 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 0.7 | -1.8 | 10.8 | 4.2 | 1.5 | 2.1 | 3.6 | 3.6 | 3.8 |
| Real investment growth % yoy | -7.9 | -21.2 | 36.8 | -6.8 | -4.6 | 2.2 | 5.8 | 1.2 | 2.6 |
| Real consumption growth % yoy | -0.6 | 1.3 | 3.3 | 2.9 | 1.5 | 1.6 | 2.2 | 2.7 | 2.6 |
| private consumption growth % yoy | -0.9 | 0.8 | 4.0 | 3.1 | 1.6 | 2.0 | 2.4 | 3.2 | 3.1 |
| Real export growth, % yoy | 0.9 | -8.7 | 25.6 | 4.5 | 0.1 | 3.8 | 4.6 | 5.2 | 5.4 |
| Real import growth, % yoy | -3.7 | -13.1 | 27.7 | -0.5 | -2.2 | 3.9 | 4.0 | 4.0 | 4.3 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 1.3 | -0.2 | 1.2 | 2.0 | 1.6 | 0.3 | 2.1 | 2.8 | 1.9 |
| CPI, % avg | 3.5 | -0.9 | 1.0 | 1.4 | 1.9 | 0.8 | 1.4 | 1.7 | 2.0 |
| Nominal wages, % yoy | -0.1 | -5.0 | 5.3 | 2.6 | 0.1 | 0.2 | 0.5 | 1.0 | 1.8 |
| Credit extension to private sector, % yoy | 2.7 | -0.8 | 6.7 | 5.6 | 4.1 | 5.3 | 6.0 | 7.0 | 8.0 |
| Policy interest rate, % eop | 2.00 | 1.25 | 1.63 | 1.88 | 1.88 | 1.88 | 1.88 | 1.88 | 2.38 |
| Short-term market rate, % eop | 1.07 | 0.27 | 0.49 | 0.79 | 0.76 | 0.64 | 0.84 | 0.98 | 1.22 |
| Long term yield, % eop | 1.44 | 1.47 | 1.47 | 1.27 | 1.15 | 1.69 | 1.67 | 1.79 | 2.01 |
| lc/US$, eop | 32.78 | 32.23 | 29.17 | 30.29 | 29.06 | 29.83 | 30.83 | 31.07 | 29.93 |
| lc/US$, avg | 31.58 | 33.04 | 31.50 | 29.40 | 29.57 | 29.68 | 30.41 | 31.22 | 30.34 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 27.5 | 42.9 | 39.9 | 41.7 | 50.6 | 57.3 | 60.1 | 58.5 | 45.4 |
| % of GDP | 6.9 | 11.4 | 9.3 | 8.9 | 10.6 | 11.7 | 12.0 | 11.0 | 8.0 |
| Trade balance | 15.2 | 29.3 | 23.4 | 26.8 | 30.7 | 35.5 | 38.3 | 41.4 | 45.3 |
| Exports | 255.6 | 203.7 | 274.6 | 308.3 | 301.2 | 305.4 | 315.7 | 329.4 | 345.7 |
| Imports | 240.4 | 174.4 | 251.2 | 281.4 | 270.5 | 269.9 | 277.5 | 288.0 | 300.4 |
| Service balance | 1.8 | 2.0 | 2.5 | 3.9 | 6.3 | 10.4 | 10.7 | 15.0 | 19.5 |
| Income balance | 10.0 | 12.5 | 13.6 | 13.2 | 15.3 | 14.3 | 19.2 | 21.0 | 23.0 |
| FDI, net | -4.9 | -3.1 | -9.1 | -14.7 | -9.9 | -10.7 | -10.7 | -11.0 | -10.0 |
| International reserves | 291.7 | 348.2 | 382.0 | 385.5 | 403.2 | 416.8 | 425.0 | 450.0 | 470.0 |
| Total Amortisations | 2.5 | 3.2 | 6.8 | 3.4 | 2.9 | 3.1 | 3.2 | 3.2 | 3.2 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 0.9 | -2.2 | -1.2 | -0.5 | -1.4 | -1.3 | -1.4 | -1.6 | -1.3 |
| Consolidated gov primary balance | 1.9 | -1.2 | -0.3 | 0.3 | -0.5 | -0.5 | -0.6 | -0.5 | -0.3 |
| Public debt | 34.7 | 38.0 | 38.3 | 40.0 | 41.0 | 39.9 | 39.4 | 38.4 | 38.1 |
| of which Domestic | 34.7 | 38.0 | 38.2 | 40.0 | 41.0 | 39.9 | 39.4 | 38.4 | 38.1 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 90.4 | 82.0 | 101.6 | 122.5 | 130.8 | 170.1 | 190.0 | 210.0 | 230.0 |
| Private | 88.9 | 76.0 | 93.5 | 118.0 | 127.5 | 165.8 | 184.7 | 204.6 | 224.6 |
| Public | 1.5 | 5.9 | 8.0 | 4.5 | 3.3 | 4.3 | 5.3 | 5.4 | 5.4 |
| External debt / GDP | 22.6 | 21.7 | 23.6 | 26.3 | 27.5 | 34.7 | 37.9 | 39.5 | 40.5 |
| External debt / XGS | 30.9 | 34.7 | 32.0 | 34.6 | 37.4 | 47.6 | 51.5 | 52.7 | 53.3 |
| Short-term debt | 78.8 | 68.2 | 83.7 | 107.8 | 116.5 | 155.6 | 180.0 | 200.0 | 220.0 |
| Short-term debt/International Reserves (%) | 27.0 | 19.6 | 21.9 | 28.0 | 28.9 | 37.3 | 42.4 | 44.4 | 46.8 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 3.7 | 3.8 | 3.5 | 3.4 | 3.7 | 3.8 | 3.6 | 3.1 | 3.6 |
| CPI, % yoy | 1.6 | 0.7 | 2.1 | 1.3 | 0.9 | 1.8 | 2.8 | 2.5 | 2.2 |
| Policy interest rate, % eop | 1.88 | 1.88 | 1.88 | 1.88 | 1.88 | 1.88 | 1.88 | 2.00 | 2.13 |
| Short-term market rate, % eop | 0.83 | 0.83 | 0.86 | 0.89 | 0.95 | 1.01 | 1.07 | 1.13 | 1.19 |
| Long term yield, % eop | 1.56 | 1.72 | 1.67 | 1.70 | 1.73 | 1.76 | 1.79 | 1.82 | 1.85 |
| lc vs USD, eop | 29.87 | 30.43 | 30.83 | 31.09 | 31.35 | 31.37 | 31.07 | 30.77 | 30.47 |

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 growth forecasts were lowered to 0.5% in 2014 and 3% in 2015. Despite 3Q14 domestic demand gains, persistent lackluster external demand and public investments slowly shifting gears suggest an unexciting recovery pace. MPC poised to resume rate cuts to support prospects.
- **Things to watch** – (1) Whether a strong governance agenda dampens roll out of the FY15 infrastructure budget; (2) Bilateral trade prospects with Japan and Euro area; (3) Pace of disinflation amid low oil prices and lackluster demand (4) Will mfg slack re-appear if offshore headwinds intensify?; (5) Potential for MPC's rate cuts.
- **Strategy** – Recent domestic demand gains may not withstand lackluster exports. With MPC's dovish bias amid fiscal underspending risk, we expect potential rate cuts of 50bp starting Dec that bodes well for THB weakness at 33 (0-3 months) while arguing strongly for increased bond duration exposure.

## Still missing the spark for growth

**On the back of persistent shallow GDP gains with 3Q14 GDP growth of 0.6%YoY (+1.1%QoQ SA), we downgraded our 2014 GDP forecast to 0.5% (previous: 1%) and 2015 forecast to 3% (previous: 4%):** The macro backdrop hasn't change for the worse with 3Q GDP release, since 3Q domestic demand ex-inv grew 2.1%YoY snapping four straight quarterly declines, or 1.6%QoQ SA. According to NESDB, private investments grew 3.9%YoY to head back to the positive column, while public investments during the quarter dipped 0.8%YoY. Real investments ex-inv grew 2.9%YoY (3.9%QoQ SA) after dropping for four straight quarters signaling 'slack' bottoming out. HH consumption grew 2.2%YoY (1.1%QoQ SA) with durable goods consumption down 16.7%YoY (-1.5%QoQ SA) led by transport equipment (-25.9%YoY). Base effect weighed on tourism expenditures reflected by non-residents consumption down 15.2%YoY (-0.8%QoQ SA).

**We expect softer contribution of net exports at least in the near-term:** Main drag to 3Q GDP came from disappointing merchandise exports that fell 1.4%YoY (-1.6%QoQ SA) after two quarters of growth, coupled with service exports narrowing by 12.4%YoY. Tourist arrivals, a key driver of service exports, improved in 3Q but growth was much lower compared to a year-ago. 3Q merchandise imports fell 1.1%YoY, after two quarters of 2-digit declines, signifying recovering non-oil imports in line with domestic demand.

**Farm output grew 2%YoY (-1.8%QoQ SA) while non-farm output rose 0.5%YoY (1.4%QoQ SA), chiefly driven by services:** Manufacturing output fell 0.7%YoY in 3Q14 registering sustained weakness and reflecting de-stocking, although up 2.5%QoQ SA despite lower exports. Construction output fell 5.8%YoY (-2.7%QoQ SA) while total services output grew 1.3%YoY (0.7%QoQ SA).

**In our revised GDP forecasts, we think domestic demand gains would persist with modest purchasing power lift from low oil prices and hefty FY15 public investments which would be deployed gradually to curb slippage and potential corruption:** With the same less exciting regional growth backdrop, net export gains would ease to extend its lackluster 3Q estimate. Base effect would also contribute to elevating domestic demand by 2.9%YoY in 4Q14 to 3.8%YoY-3.9%YoY later in 2015. We assume modest tourism recovery in 2015 is likely to uplift exports of goods and services by 3.3%YoY in 2015 from -1.1% in 2014. As slack narrows, real investments should make a comeback of ~5% in 2015 following a 2.7% drop in 2014 to enable an investment-to-GDP ratio of 21.4%.

## MPC's dovish tilt

**MPC's recent policy rate (5 Nov) meeting minutes confirmed its dovish bias, largely due to elevated threats of offshore headwinds traced to weaker-than-anticipated growth of key trading partners:** Heightened recession risk in the euro area, recent recession in Japan, moderating growth in China and subdued upside of ASEAN economies could rule out strong export recovery. Prior to the 3Q GDP release, MPC noted a slow recovery in domestic demand and weak exports during the quarter. Against this backdrop, with easing oil/ commodity prices, 'most central banks left policy rates unchanged'. MPC's dovish tilt came from risk of global demand sputtering and not so much from disinflationary forces at work. We don't expect to simulate 4Q08 global trade collapse but persistent trade weakness could easily blot out fledgling domestic demand gains evident in 3Q14 GDP data. MPC also noted easing financial stability risk due to slower pace of HH debt creation, and moderate gains of housing price index amid a 'healthy' corporate balance sheet. Despite increased global and Thai financial market volatility, local market volatility was modest, enabling the domestic financial backdrop to support growth.

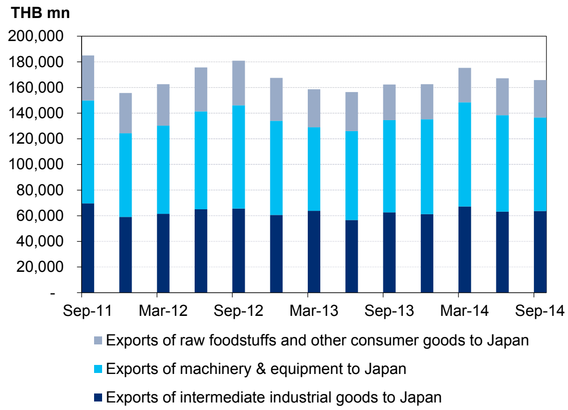
## Real risks from 3Q14 recession in Japan

**Bilateral trade deficit with Japan can either be sustained or reduced. While our Japan economics team expects 2015 growth of 1.7% with postponement of the consumption tax hike, we use Japan's 3Q14 recession to highlight the real risks that cannot be ignored since Japan is a key trading partner and FDI provider:** The bilateral trade deficit with Japan can either be sustained or reduced depending on the 1) impact of Japan's recession risk on global trade that comes back to haunt Thai exports; and 2) how Japanese FDI fares with Japan in recession. Both the world export volume index and FDI approvals from Japan were key determinants in our quarterly regression equation determining exports to Japan. A 1% drop (rise) in the world export volume index and FDI approvals (lagged 1 quarter) could lower (increase) export earnings by 1.3% and 0.03%, respectively. Other variables like Japan's real GDP (direct consumption effect), REER JPY and THB were not statistically significant explanatory variables. With intermediate industrial goods and capital goods mostly machinery and equipment, accounting for nearly 80% of total shipments to Japan that implies products for re-processing and re-exports to the rest of the world, we are not surprised by results showing a strong statistical impact of the global trade indicator rather than real GDP of Japan. Moreover export capacity to Japan is provided by FDI approvals from Japan over time. Perhaps the key uncertainty is whether Japan's FDI, that is also funding this bilateral trade, would wither or remain steady, despite less than ideal global demand. In the 2009 GFC when the global economy was under severe stress, FDI approvals from Japan slumped 44.5%.

## MPC could resume rate cuts on subdued demand risk

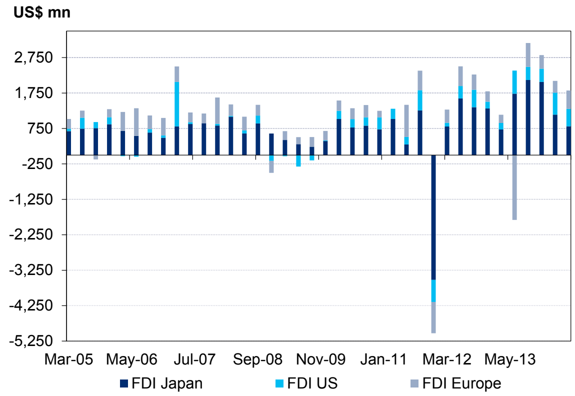
We now expect a 50bp cut consistent with MPC's concerns over strengthening offshore headwinds that could easily overcome fledging domestic demand gains. The need to protect/nurture domestic demand gains, while fending off financial volatility owing to US monetary shifts through greater monetary accommodation, could prompt the MPC to cut its rate by 25bp on 17 Dec. Fiscal expenditures gradually shifting gears amid persistent export weakness would probably lead to another 25bp cut on 11 Mar 2015, bringing the overnight rate down to 1.5%, which will end of this round of accommodation. We assign higher probability to the rate cut event in Dec while giving a 50/50 chance that MPC would undertake another stimulus in 1Q15. Delayed public investments would be key to a Mar rate cut.

Figure 115. Global trade rather than Japan's recession matter more to exports



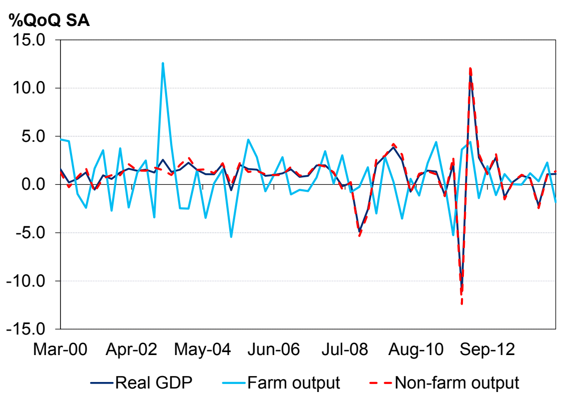

Source: CEIC, Citi Research

Figure 116. Uncertain outlook of Japan's FDI due to recession in Japan?



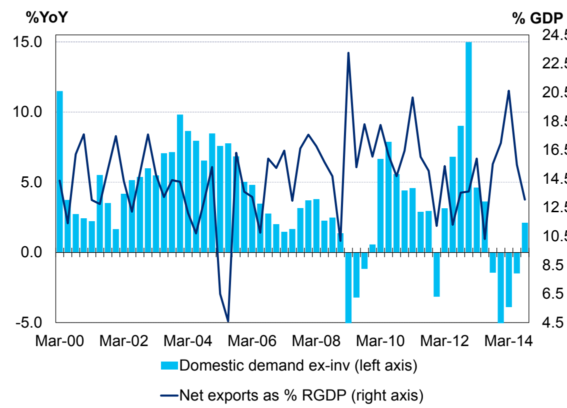

Source: CEIC, Citi Research

Figure 117. Non-farm output grew 1.4%QoQ SA in 3Q14 but can it withstand strong offshore headwinds?



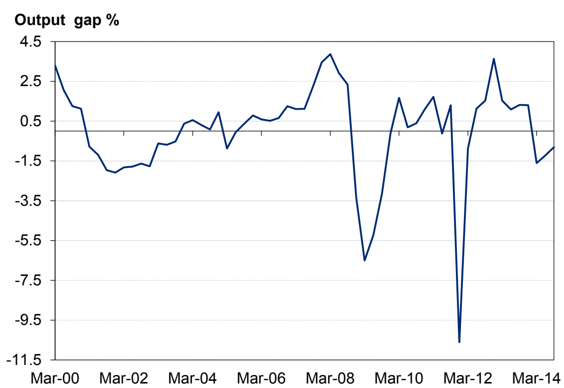

Source: CEIC, Citi Research

Figure 118. Domestic demand recovered in 3Q but net exports falling fast



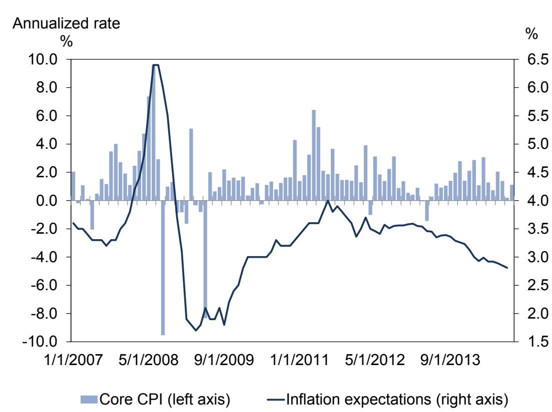

Source: CEIC, Citi Research

Figure 119. Easing 3Q14 output gap consistent with mfg slack bottoming out in July




Source: CEIC, Citi Research

Figure 120. Easing inflation expectations alongside annualized core at slightly >1%




Source: CEIC, Citi Research

**Figure 121. Thailand Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 276.1 | 263.8 | 319.3 | 346.1 | 366.4 | 387.8 | 373.2 | 386.0 | 409.3 |
| Nominal GDP, local currency bn | 9,080 | 9,042 | 10,105 | 10,540 | 11,375 | 11,899 | 12,140 | 12,662 | 13,465 |
| GDP per capita, US$ | 4,355 | 4,153 | 4,998 | 5,401 | 5,685 | 5,987 | 5,732 | 5,900 | 6,224 |
| Population, mn | 63.4 | 63.5 | 63.9 | 64.1 | 64.5 | 64.8 | 65.1 | 65.4 | 65.8 |
| Unemployment, % of labour force | 1.4 | 1.5 | 1.0 | 0.7 | 0.7 | 0.7 | 0.8 | 0.8 | 0.7 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, % yoy | 2.5 | -2.3 | 7.8 | 0.1 | 6.5 | 2.9 | 0.5 | 3.0 | 3.8 |
| Real investment growth % yoy | 8.1 | -25.2 | 28.7 | 0.1 | 16.8 | 2.2 | -9.1 | 3.0 | 8.9 |
| Real consumption growth % yoy | 2.9 | 0.1 | 5.1 | 1.3 | 6.8 | 1.1 | 0.8 | 3.4 | 2.9 |
| private consumption growth % yoy | 2.9 | -1.1 | 4.8 | 1.3 | 6.7 | 0.3 | 0.5 | 3.0 | 2.6 |
| Real export growth, % yoy | 5.1 | -12.5 | 14.7 | 9.5 | 3.1 | 4.2 | -1.1 | 3.3 | 3.9 |
| Real import growth, % yoy | 8.9 | -21.5 | 21.5 | 13.7 | 6.2 | 2.3 | -4.7 | 3.5 | 4.8 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy | 0.4 | 3.5 | 3.1 | 3.5 | 3.6 | 1.7 | 1.0 | 1.5 | 2.5 |
| CPI, % avg | 5.5 | -0.9 | 3.3 | 3.8 | 3.0 | 2.2 | 1.9 | 1.3 | 2.0 |
| Nominal wages, % yoy | 10.5 | -1.9 | 5.8 | 7.2 | 11.9 | 7.9 | 4.0 | 4.0 | 5.0 |
| Credit extension to private sector, % yoy | 6.3 | 2.5 | 18.8 | 18.3 | 14.0 | 10.5 | 8.5 | 10.0 | 11.2 |
| Policy interest rate, % eop | 2.75 | 1.25 | 2.00 | 3.25 | 2.75 | 2.25 | 1.75 | 1.50 | 2.00 |
| Short-term market rate, % eop | 3.07 | 1.28 | 2.03 | 3.26 | 2.79 | 2.31 | 1.90 | 1.70 | 2.25 |
| Long term yield, % eop | 2.84 | 4.37 | 3.74 | 3.28 | 3.55 | 4.07 | 3.15 | 3.20 | 3.75 |
| lc/US$, eop | 34.79 | 33.36 | 30.07 | 31.57 | 30.60 | 32.70 | 33.02 | 33.43 | 32.85 |
| lc/US$, avg | 33.21 | 34.33 | 31.71 | 30.48 | 31.08 | 30.72 | 32.58 | 33.42 | 33.10 |
| **Balance of Payments, US$ bn** | | | | | | | | | |
| Current account | 2.2 | 21.9 | 10.0 | 8.9 | -1.5 | -2.5 | 9.9 | 8.7 | 8.1 |
| % of GDP | 0.8 | 8.3 | 3.1 | 2.6 | -0.4 | -0.6 | 2.6 | 2.2 | 2.0 |
| Trade balance | 17.3 | 32.6 | 29.8 | 17.0 | 6.0 | 6.7 | 20.9 | 19.6 | 18.0 |
| Exports | 175.2 | 150.8 | 191.6 | 219.1 | 225.9 | 225.4 | 224.7 | 232.6 | 244.2 |
| Imports | 157.9 | 118.2 | 161.9 | 202.1 | 219.9 | 218.7 | 203.9 | 213.0 | 226.3 |
| Net service and Transfer accounts | -12.9 | -6.4 | -10.7 | -10.6 | -3.4 | 3.7 | -0.4 | -0.8 | 1.0 |
| Income balance | -2.3 | -4.4 | -9.0 | 2.5 | -4.0 | -12.8 | -10.6 | -10.1 | -10.9 |
| FDI, net | 4.4 | 0.7 | 4.5 | -2.8 | -2.2 | 6.1 | 3.6 | -1.0 | 2.5 |
| International reserves | 111.0 | 138.4 | 172.1 | 175.1 | 181.6 | 167.3 | 160.0 | 165.0 | 170.0 |
| Total Amortisations | 15.4 | 11.3 | 9.4 | 8.8 | 9.5 | 18.0 | 19.0 | 20.0 | 20.5 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -1.0 | -5.7 | 0.0 | -1.0 | -2.2 | -1.8 | -2.7 | -2.2 | -1.8 |
| Consolidated gov primary balance | 0.2 | -4.5 | 1.1 | -1.5 | -1.6 | -1.2 | -1.8 | -1.4 | -0.8 |
| Public debt | 37.3 | 45.2 | 42.6 | 41.7 | 45.4 | 45.9 | 46.5 | 47.5 | 48.3 |
| of which Domestic | 33.0 | 40.9 | 39.0 | 38.4 | 42.3 | 42.7 | 43.2 | 44.2 | 44.8 |
| **Foreign Assets & Liabilities, US$ bn** | | | | | | | | | |
| External debt | 76.1 | 75.3 | 100.6 | 104.3 | 130.7 | 141.9 | 150.0 | 156.8 | 160.0 |
| Private | 72.7 | 69.4 | 87.9 | 88.1 | 104.5 | 116.7 | 120.0 | 125.3 | 127.0 |
| Public | 3.4 | 5.9 | 12.7 | 16.2 | 26.2 | 25.2 | 30.0 | 31.5 | 33.0 |
| External debt / GDP | 27.6 | 28.5 | 31.5 | 30.1 | 35.7 | 36.6 | 40.2 | 40.6 | 39.1 |
| External debt / XGS | 36.5 | 41.6 | 44.5 | 40.0 | 47.5 | 49.9 | 54.6 | 55.0 | 52.6 |
| Short-term debt | 32.5 | 33.3 | 50.7 | 47.3 | 58.2 | 61.9 | 62.0 | 63.5 | 65.8 |
| Short-term debt/International Reserves (%) | 29.3 | 24.0 | 29.4 | 27.0 | 32.0 | 37.0 | 38.8 | 38.5 | 38.7 |

**Quarterly Economic Indicators**

| | 2014 Q2F | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 0.4 | 0.6 | 1.5 | 2.1 | 3.0 | 3.3 | 3.5 | 3.7 | 3.8 |
| CPI, % yoy | 2.4 | 1.8 | 1.0 | 1.0 | 1.2 | 1.4 | 1.5 | 1.9 | 2.1 |
| Policy interest rate, % eop | 2.00 | 2.00 | 1.75 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Short-term market rate, % eop | 2.18 | 2.18 | 1.90 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 | 1.80 |
| Long term yield, % eop | 3.76 | 3.56 | 3.15 | 3.00 | 3.10 | 3.15 | 3.20 | 3.30 | 3.40 |
| lc vs USD, eop | 32.44 | 32.43 | 33.02 | 33.25 | 33.47 | 33.55 | 33.43 | 33.31 | 33.19 |

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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**Oyu Tolgoi remains the top policy priority for the new government:** Under the leadership of the New Prime Minister Ch. Saikanbileg, we maintain an OT2 deal in 1H15 as our base case and expect FDI to trickle in nine months, after the deal is signed. Tavan Tolgoi coal operations need new partner to restart in early 2015 as Erdenes TT still has an outstanding of US$100mn+ debt to pay back to Chalco, amidst a still poor coal price outlook next year. With or without OT and TT resolutions, we believe major FDI investment for 2015E will be railway related. The recent decision to use narrow gauge for southbound rails and broad gauge for northbound rails have finally allowed fund raising and tracks laying for the TT-GHS rail and construction planning for the Bogd Khan and northern route. Minerals/oil explorations restart is also needed.

**Leveraging on immediate/third neighbors and concessional loans:** Agreed bilateral deals with its two neighbors China and Russia will be gradually implemented next year. New PM is seeking US$1bn soft loan from China and working out a ruble swap line with Russian central bank. Free Trade Agreement with Japan will likely start 1Q2015. Various concession loans can be tapped when MIGA documents are signed and/or public debt ceiling is lifted.

**Easing bias to continue:** According to our estimate, BoM's exit of QE thus far has been largely offset by the expansion of the subsidized 8% housing mortgage for UB eligible flats, and recent program expansion to include countryside mortgages would offset those designed PSP cuts in 2015. The approved 2015 fiscal budget deficit is at 1.8% of GDP (satisfying the FSL deficit limit of 2%), but populist measures are highly likely in a pre-election year. We believe risks of higher government debt ceiling (current public debt is at 50% of GDP, above the FSL required 40%) and quasi-sovereign bond supply risks remain for late 2015. With accommodative fiscal and monetary support remaining, the BoP improvements from better copper exports, lower imports & artificial replenishments to FX reserves are insufficient to trump MNT depreciation.

**Figure 122. Mongolia Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 5.6 | 4.6 | 6.2 | 8.8 | 10.3 | 10.3 | 11.5 | 13.6 | 16.7 |
| GDP per capita, US$ | 2,138 | 1,717 | 2,287 | 3,186 | 3,595 | 3,525 | 3,850 | 4,507 | 5,449 |
| Population, mn | 2.6 | 2.7 | 2.7 | 2.8 | 2.9 | 2.9 | 3.0 | 3.0 | 3.1 |
| Real GDP, % yoy | 8.9 | -1.3 | 6.4 | 17.5 | 12.4 | 11.7 | 6.5 | 9.0 | 8.0 |
| CPI, % yoy | 22.1 | 4.2 | 13.0 | 10.2 | 14.0 | 12.5 | 12.5 | 11.7 | 9.3 |
| CPI, % avg | 28.0 | 8.0 | 10.1 | 9.2 | 14.3 | 10.5 | 13.0 | 12.6 | 10.4 |
| Policy interest rate, % eop | 9.75 | 10.00 | 11.00 | 12.25 | 13.25 | 10.50 | 12.75 | 13.50 | 14.00 |
| Long term yield, % eop | 20.58 | 21.67 | 20.07 | 16.61 | 18.11 | 18.48 | 19.90 | 20.90 | 21.40 |
| lc/US$, eop | 1,275 | 1,433 | 1,233 | 1,378 | 1,378 | 1,660 | 1,890 | 1,852 | 1,797 |
| lc/US$, avg | 1,167 | 1,434 | 1,349 | 1,256 | 1,353 | 1,505 | 1,831 | 1,874 | 1,811 |
| Current account (US$ bn) | -0.7 | -0.4 | -0.9 | -3.4 | -3.2 | -3.2 | -1.1 | -1.2 | -2.1 |
| % of GDP | -12.8 | -8.9 | -15.0 | -38.4 | -30.9 | -30.9 | -9.7 | -8.6 | -12.5 |
| Trade balance (US$ bn) | -0.7 | -0.3 | -0.3 | -1.8 | -2.4 | -2.1 | 0.3 | 0.4 | -0.3 |
| Exports (US$ bn) | 2.5 | 1.9 | 2.9 | 4.8 | 4.4 | 4.3 | 5.8 | 6.4 | 6.8 |
| Imports (US$ bn) | 3.2 | 2.1 | 3.2 | 6.6 | 6.7 | 6.4 | 5.4 | 6.0 | 7.2 |
| FDI, net (US$ bn) | 0.8 | 0.6 | 1.6 | 4.6 | 3.9 | -2.1 | 0.9 | 1.4 | 2.3 |
| International reserves (US$ bn) | 0.6 | 1.3 | 2.2 | 2.3 | 3.9 | 2.2 | 2.0 | 3.7 | 4.9 |
| Consolidated government balance (% of GDP) | -4.5 | -5.2 | 0.5 | -6.9 | -9.9 | -7.8 | -7.9 | -6.9 | -6.5 |
| Public debt (% of GDP) | 30.6 | 44.2 | 28.7 | 28.9 | 42.1 | 67.3 | 72.0 | 75.1 | 75.0 |
| External debt (% of GDP) | 38.8 | 65.1 | 95.7 | 109.9 | 149.2 | 184.1 | 178.2 | 156.6 | 130.8 |

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates.
*Note: Consolidated government balance for Mongolia include off budget spending.

## Pakistan

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**On balance, we are bullish on Pakistan's macro outlook for 2015:** The conclusion of the fourth and fifth IMF reviews promised a US$1.1bn disbursement in December. This was made possible with the implementation of energy tariff hikes that could bolster the fiscal outlook in 2015. We expect further progress in the programme which include further cuts in tax loopholes (SROs), implementing the Gas Infrastructure Development Cess (GIDC – a tariff on non-personal gas use), and other measures aimed at strengthening the tax base.

**The recent investment agreement between Pakistan and China, known as the China-Pak Economic Corridor (CPEC) will, if implemented, prove a fillip to the Pakistani economy and substantially alleviate energy pressures, in our view:** The CPEC entails over US$45bn in Chinese investments in Pakistan, mainly in the energy sector. Over six years, the investment averages to around 4-5% of GDP per year, boosting the domestic economy as well as shoring up external balances. The expected increase in electricity generation should also alleviate energy shortages, which has constrained economic growth in recent years.

**Finally, falling oil prices could provide some relief to external balances and inflation:** We calculate that fall in oil prices will reduce the country's trade deficit by US$1.5bn in 2015, roughly balancing the current account. Lower oil prices along with softening food prices will also ease inflationary pressures and potentially allow the State Bank of Pakistan to further cut rates, as in November of 50bp to 9.5%, supporting the economic growth in the medium term.

**This relatively rosy outlook is, of course, dependent on a supportive political environment:** Although the protest movement which led to heightened uncertainty and partial government paralysis in August and September has receded, the threat of social and political instability, especially in an environment of fiscal austerity, is ever present in our view. In addition, this implies a corollary threat of military intervention, as highlighted by events in August.

**Figure 123. Pakistan Economic Indicators**

| | FY09 | FY10 | FY11 | FY12 | FY13 | FY14 | FY15F | FY16F | FY17F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 169.7 | 167.1 | 176.7 | 212.4 | 221.7 | 229.6 | 243.1 | 258.0 | 257.1 |
| GDP per capita, US$ | 1,031 | 994 | 1,029 | 1,211 | 1,239 | 1,258 | 1,305 | 1,357 | 1,326 |
| Population, mn | 164.7 | 168.2 | 171.7 | 175.3 | 178.9 | 182.5 | 186.3 | 190.1 | 194.0 |
| Real GDP, % yoy | 1.7 | 2.8 | 1.6 | 2.7 | 3.5 | 4.4 | 5.4 | 4.5 | 4.3 |
| CPI, % yoy | 21.5 | 11.0 | 11.8 | 13.3 | 11.3 | 5.9 | 8.2 | 8.0 | 7.5 |
| CPI, % avg | 12.0 | 19.6 | 10.1 | 13.7 | 11.0 | 7.4 | 8.6 | 7.5 | 7.5 |
| Policy interest rate, % eop | 12.00 | 14.00 | 12.50 | 14.00 | 12.00 | 9.00 | 10.00 | 10.00 | 10.00 |
| lc/US$, eop | 79.1 | 84.4 | 85.7 | 89.9 | 97.3 | 105.4 | 98.8 | 103.6 | 116.0 |
| lc/US$, avg | 69.9 | 81.5 | 85.2 | 86.4 | 93.3 | 101.4 | 103.2 | 104.5 | 112.5 |
| Current account (US$ bn) | -13.9 | -9.3 | -3.9 | 0.2 | -4.7 | -2.5 | -3.0 | -2.3 | -5.2 |
| % of GDP | -8.2 | -5.5 | -2.2 | 0.1 | -2.1 | -1.1 | -1.2 | -0.9 | -2.0 |
| Trade balance (US$ bn) | -14.8 | -12.5 | -11.5 | -10.4 | -15.7 | -15.4 | -16.5 | -17.3 | -18.7 |
| Exports (US$ bn) | 20.4 | 19.1 | 19.7 | 25.4 | 24.7 | 24.8 | 25.2 | 25.9 | 27.9 |
| Imports (US$ bn) | 35.3 | 31.7 | 31.1 | 35.8 | 40.4 | 40.2 | 41.7 | 43.2 | 46.6 |
| FDI, net (US$ bn) | -5.3 | -3.7 | -2.1 | -1.6 | -0.7 | -1.3 | -1.5 | 2.9 | 4.5 |
| International reserves (US$ bn) | 11.1 | 11.6 | 15.1 | 17.7 | 14.2 | 8.0 | 11.2 | 11.2 | 11.2 |
| Consolidated government balance (% of GDP) | -7.3 | -5.2 | -6.2 | -6.6 | -6.9 | -8.2 | -5.5 | -6.2 | -6.1 |

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates. * Pakistan Fiscal year runs from July-June.

## Sri Lanka

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**Strong growth and policy continuity expected despite election uncertainties:** Snap polls will be held on 8th of January with President Rajapaksa seeking a third term. We think election uncertainties has risen significantly following a few government defections with the opposition rallying behind a unified candidate, former Health Ministera and old-hand at SLPA, Maithripala Sirisena. The opposition is critical of the concentrated powers held by the Rajapakse family, advocating a shift to parliamentary democracy from executive presidency, but has not yet made pronouncements about disagreements with existing economic policies. In fact, Rajapaksa's 2015 budget recently passed the parliament with 72% of the votes. Regardless of the election outcome, we don't anticipate a dramatic change in economic policies, but a change in government could add to investment uncertainty. We think growth will fall short of the 8% target for 2015-16F as investment will likely normalize from unusually strong growth rates in recent years, given that some infra projects are reaching later stages and public investment is constrained by tighter budget. Unusually low inflation this year should reverse next year and along with reviving credit growth, may put our rate cut expectations at risk.

**Current account deficit will likely narrow only gradually:** The consumer-friendly policies amid weak global growth backdrop make us believe that the narrowing of the CAD will be more gradual than what CBSL is envisioning, heading towards 2% of GDP by 2016F. Amid the strong dollar environment, rupee will likely be under some modest depreciation pressure which will be accommodated given low FX reserve coverage ratio.

**Figure 124. Sri Lanka Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 40.7 | 42.1 | 49.6 | 59.2 | 59.4 | 67.2 | 73.7 | 81.9 | 106.3 |
| GDP per capita, US$ | 2,011 | 2,055 | 2,400 | 2,836 | 2,920 | 3,281 | 3,570 | 3,936 | 5,066 |
| Population, mn | 20.2 | 20.5 | 20.7 | 20.9 | 20.3 | 20.5 | 20.6 | 20.8 | 21.0 |
| Real GDP, % yoy | 6.0 | 3.5 | 8.0 | 8.2 | 6.3 | 7.3 | 7.7 | 7.8 | 7.6 |
| CPI, % yoy | 13.9 | 5.0 | 6.8 | 4.9 | 9.2 | 4.7 | 2.7 | 7.0 | 6.3 |
| CPI, % avg | 22.6 | 3.6 | 6.2 | 6.7 | 7.5 | 6.9 | 3.4 | 4.6 | 6.0 |
| Policy interest rate, % eop | 12.00 | 12.00 | 9.75 | 9.00 | 8.50 | 9.50 | 8.00 | 7.50 | 7.50 |
| lc/US$, eop | 113.0 | 114.4 | 110.9 | 113.9 | 127.7 | 130.8 | 131.0 | 129.0 | 129.0 |
| lc/US$, avg | 108.3 | 114.9 | 113.0 | 110.5 | 127.2 | 129.1 | 130.8 | 132.3 | 129.0 |
| Current account (US$ bn) | -3.9 | -0.2 | -1.4 | -4.6 | -4.0 | -2.6 | -2.0 | -2.1 | -2.2 |
| % of GDP | -9.5 | -0.5 | -2.8 | -7.8 | -6.7 | -3.9 | -2.7 | -2.6 | -2.1 |
| Trade balance (US$ bn) | -6.0 | -3.1 | -5.2 | -9.7 | -9.4 | -7.6 | -7.4 | -7.8 | -8.6 |
| Exports (US$ bn) | 8.1 | 7.1 | 8.3 | 10.6 | 9.8 | 10.4 | 11.7 | 12.6 | 13.6 |
| Imports (US$ bn) | 14.1 | 10.2 | 13.5 | 20.3 | 19.2 | 18.0 | 19.0 | 20.4 | 22.1 |
| FDI, net (US$ bn) | 0.7 | 0.4 | 0.4 | 0.9 | 0.9 | 0.9 | 1.1 | 1.0 | 1.0 |
| International reserves (US$ bn) | 1.8 | 5.1 | 6.6 | 6.0 | 6.9 | 7.2 | 8.8 | 10.1 | 11.1 |
| Consolidated government balance (% of GDP) | -7.0 | -9.9 | -8.0 | -6.9 | -6.4 | -5.9 | -5.4 | -5.2 | -4.5 |

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

## Vietnam

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**Continued macro stability and robust FDI trends support gradual economic recovery:** Real GDP is expected to improve to 5.9% and 6.2% in 2015F to 2016F with exports and (foreign) investments boosting industrial sector, and generating some positive spillovers in the domestic economy, including technology upgrade and rise in productivity growth. Moreover, three years of sustained macro stability and deleveraging provide a more conducive environment for a modest rebound in private investment. We expect inflation will continue to remain benign next year, though higher than this year on the back of the "base effect". SBV has room to lower refinancing rate another 50bps, in line with its recent move to lower the

deposit rates. Amid a stronger USD environment putting pressure on regional currencies, and the change in our view towards a more sizeable 2% depreciation of RMB in 2015F, we think SBV will want to maintain its relative competitiveness by accommodating a slightly larger depreciation than we earlier forecasted (~1.5% depreciation). However, market pressure for devaluation will likely be contained amid large CA surplus, net FDI inflows and limited foreign portfolio flows.

**Weak public finances will remain an issue next year:** Weak revenues on the back of lower taxes and oil-related revenues, plus capex spending pressures, will likely keep fiscal deficits high. Public debt will likely remain in an upward trajectory, and test the 65% public debt ceiling soon. However, a rising proportion of debt is now funded domestically, and could mitigate the risks somewhat.

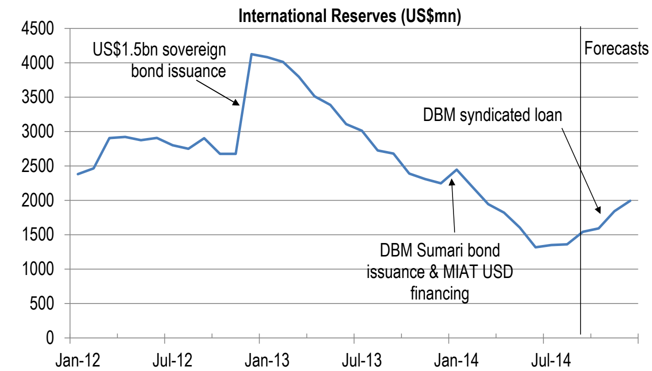
**Expect slow structural reforms in 2015F:** NPL ratio in the banking system according to SBV is 9% while Fitch estimates it to be about 15%. Tighter loan classification and provisioning requirements under Circular 02 and Circular 09 to be fully implemented by April 2015 will provide greater transparency, though continually be a drag to credit. SOE reforms characterized by equitizations are not aggressive enough, given government still holds majority stakes and we see no strong catalyst for significant and transformational improvement in SOE performance next year as long as the growth picture continues to look satisfactory.

**Figure 125. Vietnam Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, US$ bn | 90.3 | 93.1 | 103.5 | 122.8 | 141.4 | 157.2 | 171.0 | 187.0 | 207.1 |
| GDP per capita, US$ | 1,061 | 1,083 | 1,191 | 1,398 | 1,592 | 1,752 | 1,890 | 2,048 | 2,249 |
| Population, mn | 85.1 | 86.0 | 86.9 | 87.8 | 88.8 | 89.7 | 90.5 | 91.3 | 92.1 |
| Real GDP, % yoy | 5.7 | 5.4 | 6.4 | 6.2 | 5.2 | 5.4 | 5.7 | 5.9 | 6.2 |
| CPI, % yoy | 19.9 | 6.5 | 11.8 | 18.1 | 6.8 | 6.0 | 3.2 | 7.6 | 6.5 |
| CPI, % avg | 23.1 | 7.0 | 9.2 | 18.6 | 9.3 | 6.6 | 4.3 | 5.0 | 5.7 |
| Policy interest rate, % eop | 9.50 | 8.00 | 9.00 | 15.00 | 9.00 | 7.00 | 6.50 | 6.50 | 6.50 |
| Long term yield, % eop | 10.00 | 11.68 | 11.49 | 12.55 | 9.75 | 9.29 | 6.00 | 6.50 | 7.00 |
| lc/US$, eop | 17,483 | 18,474 | 19,498 | 21,034 | 20,840 | 21,095 | 21,334 | 21,763 | 21,548 |
| lc/US$, avg | 16,445 | 17,806 | 19,123 | 20,648 | 20,875 | 21,028 | 21,248 | 21,548 | 21,548 |
| Current account (US$ bn) | -10.8 | -6.6 | -4.3 | 0.2 | 9.3 | 9.5 | 8.3 | 7.4 | 6.6 |
| % of GDP | -12.0 | -7.1 | -4.1 | 0.2 | 6.6 | 6.0 | 4.9 | 3.9 | 3.2 |
| Trade balance (US$ bn) | -12.8 | -7.6 | -5.1 | -0.5 | 8.7 | 8.7 | 10.6 | 9.2 | 5.6 |
| Exports (US$ bn) | 62.7 | 57.1 | 72.2 | 96.9 | 114.5 | 132.1 | 148.0 | 165.8 | 185.6 |
| Imports (US$ bn) | 75.5 | 64.7 | 77.4 | 97.4 | 105.8 | 123.4 | 137.3 | 156.6 | 180.1 |
| FDI, net (US$ bn) | 9.3 | 6.9 | 7.1 | 6.6 | 7.2 | 6.9 | 7.0 | 7.2 | 7.4 |
| International reserves (US$ bn) | 23.9 | 16.4 | 12.5 | 13.5 | 25.6 | 25.9 | 37.4 | 47.8 | 57.3 |
| Consolidated government balance (% of GDP) | -2.2 | -7.2 | -3.0 | -3.2 | -4.8 | -5.6 | -6.4 | -6.0 | -5.7 |
| Public debt (% of GDP) | 39.4 | 46.9 | 41.2 | 39.7 | 38.2 | 41.4 | 44.6 | 46.3 | 47.9 |
| External debt (% of GDP) | 33.8 | 39.9 | 41.5 | 41.8 | 41.9 | 41.7 | 41.2 | 41.3 | 40.7 |

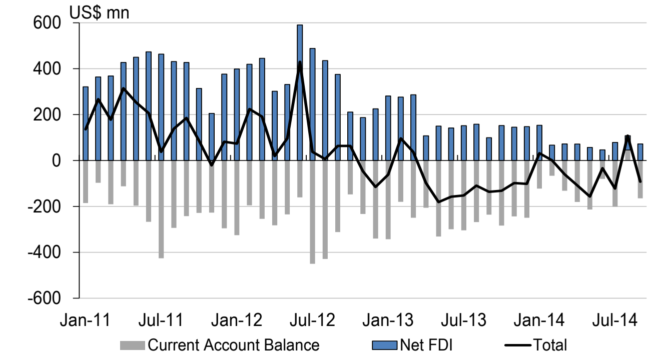
Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and Citi Research estimates

**Figure 126. Mongolia – FX reserves to rise on foreign borrowings**



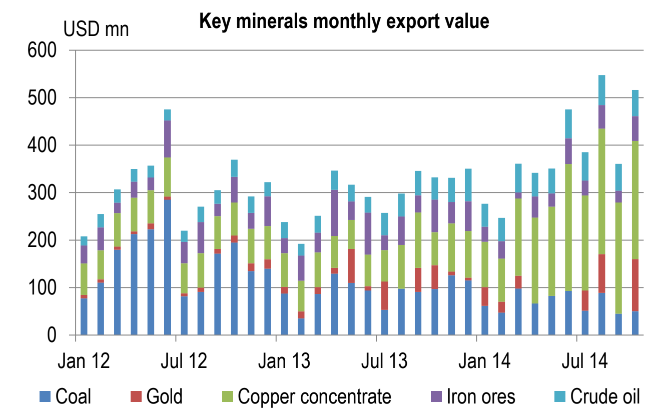

Source: BoM, CEIC and Citi Research

**Figure 127. Net FDI & Current Account improves BOP**



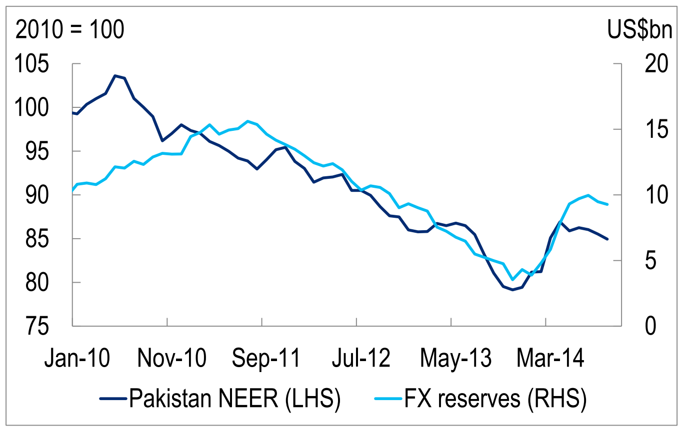

Source: BoM, CEIC and Citi Research

**Figure 128. Copper exports driving CA improvements**



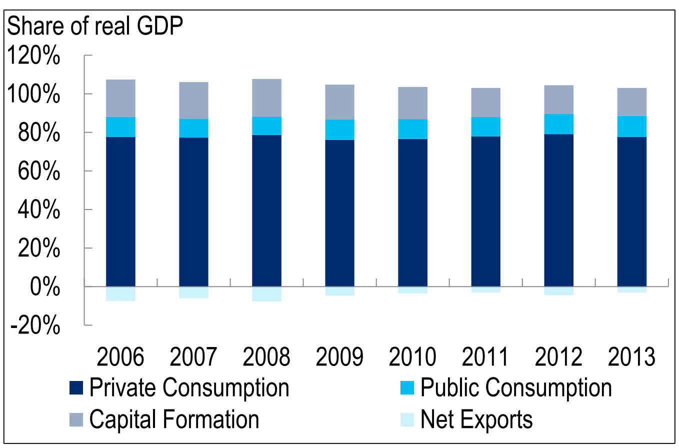

Source: BoM, CEIC and Citi Research

**Figure 129. Pakistan – Reserves rebuilding on back of rupee strength**



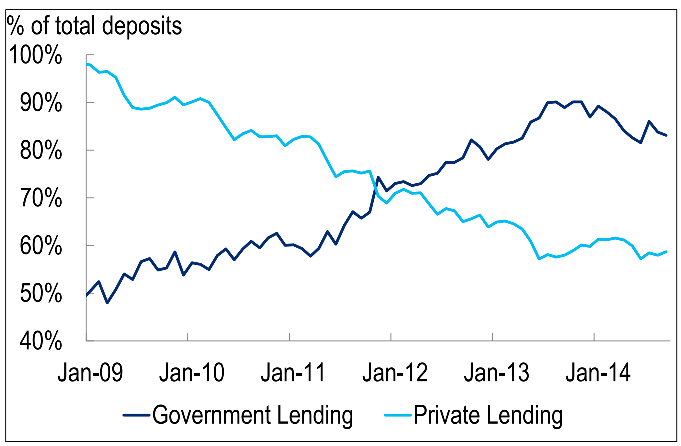

Source: Haver Analytics, Citi Research

**Figure 130. While the private sector drives economic growth**



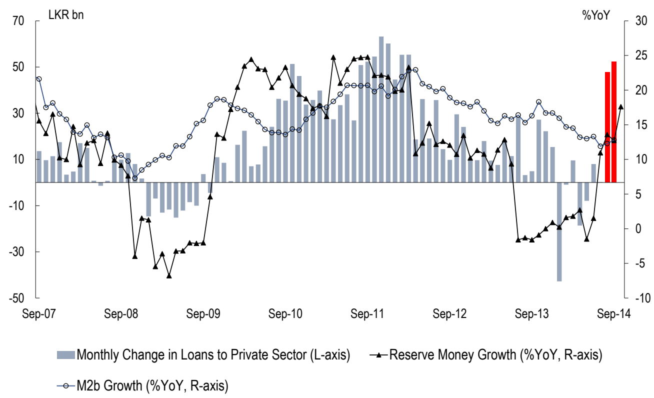

Source: Haver Analytics, Citi Research

**Figure 131. The government has been crowding out private sector credit**



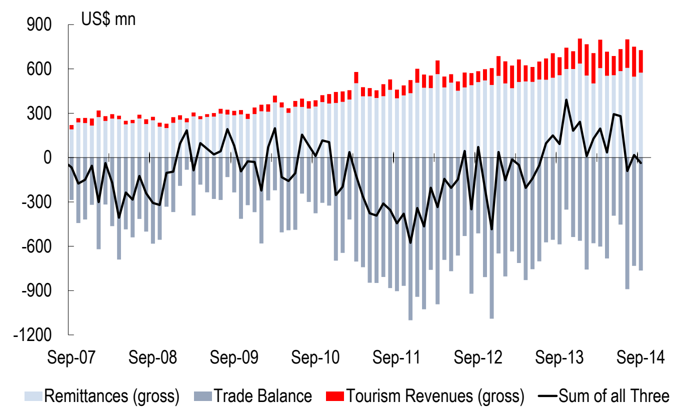

Source: Haver Analytics, Citi Research

**Figure 132. SRI LANKA– Liquidity has eased significantly, providing a more conducive environment for credit revival**



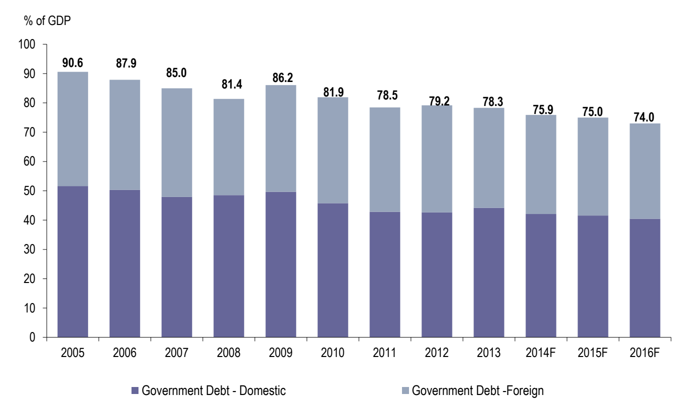

Source: CBSL, CEIC, Citi Research

**Figure 133. Current account deficit will unlikely narrow as quickly as what they forecast**



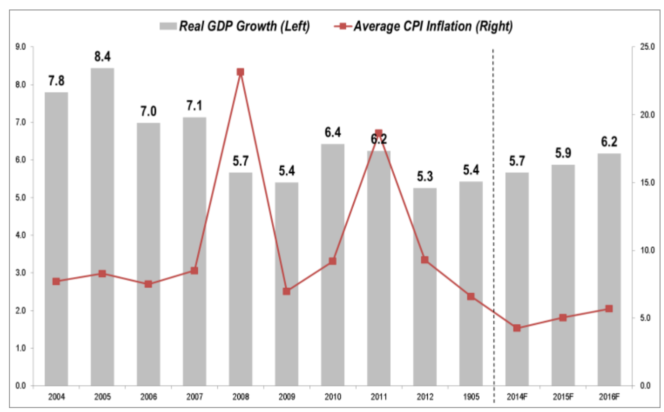

Source: Haver, CEIC, Citi Research

**Figure 134. Very slow approach to public debt reduction will constrain the rating**



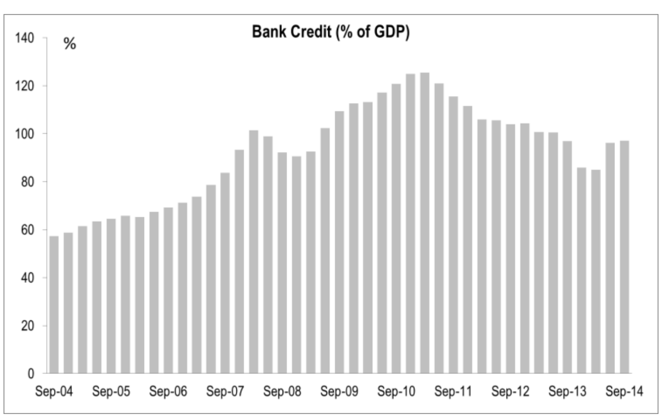

Source: Haver, Citi Research

**Figure 135. VIETNAM – Real GDP growth expected to progressively improve while Inflation looks manageable**



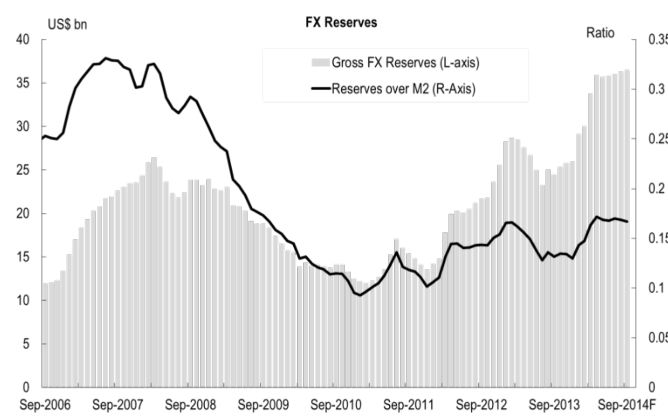

Source: Haver, CEIC, Citi Research

**Figure 136. Deleveraging cycle is now abating though recent credit rebound may not last given weak bank capitalization**




Source: Haver, CEIC, Citi Research

**Figure 137. External liquidity position goes from strength to strength**




Source: CEIC, Citi Research

# CEEMEA

# Czech Republic

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- **Summary view** — We cut both our 2014 and 2015 GDP forecasts by 0.1%pt to 2.3% given a weaker outlook for foreign demand; we expect growth to accelerate to around 3% in 2016. We expect exports to decelerate in 2015 reflecting weaker demand and a higher 2014 base, but we expect growth to resume in 2016 on the back of stronger demand and a supportive currency. Moreover, improved labour market conditions and fiscal easing bode well for growth.

- **Things to watch** — We think the risks to CNB's inflation forecast are skewed to downside, although inflationary factors remain. The CNB will watch closely to see if adjusted core CPI developments show domestic inflationary pressures in 4Q14/1Q15. The impact of the ECB's likely QE on the Czech koruna is uncertain, though if the ECB delivers, it would ease the disinflationary risk to the CNB's forecast.

- **Strategy** — EURCZK is likely to be virtually unchanged on 0-3m basis, but we expect it to be more volatile as the ECB's likely QE edges closer. We keep our outlook for a weaker koruna, though we do not assume a hike in the EURCZK floor. We postponed the CNB's exit from this floor to 4Q16, with the first hike in policy rate in 1Q17. MinFin is likely to continue to curb net issuance which, together with the ECB's QE, are likely to keep Czech 10y yields below 1% in 4Q15-1Q15.

## External factors are worse, domestic developments better

**We cut our 2014 GDP growth forecast by 0.1%pt to 2.3% due to a downward revision to previous dynamics...** Regarding the short-term outlook, October confidence improved to a recent high, which suggests GDP growth of 2.7%YoY in 4Q14; this represents an upside risk to our own forecast of 1.9%YoY. Also the 4Q European Commission business survey on expected manufacturing exports indicates a mild improvement in 4Q14. This suggests no change to the recent solid developments and increased in manufacturing production capacity utilization which should be supportive for investment activity.

**… and we also cut our 2015 GDP forecast by the same extent, also to 2.3% on the back of weaker foreign demand outlook before accelerating to around 3% in 2016.** The outlook for foreign demand is weaker than we previously assumed, with lower German, Euro Area GDP growth and a mild recession in Russia. The CNB *Inflation Report* suggests there would be a negative impact of 0.4%pt in 2015 on Czech GDP growth if there is a one-year 20% drop in Russian imports. While it still does not suggest a contraction in Czech exports, the euro area export market growth (measured by GDP) is likely to decelerate slightly compared to 2014 and Czech global export growth is likely to stagnate. However, we assume the koruna will weaken and this is likely to last longer than we previously thought. That said, Czech exporters are likely to face an unfriendly demand environment, which we, however, assume to be partly offset by greater koruna weakness. Overall, we expect Czech exports to decelerate in 2015 reflecting weaker demand and a higher 2014 base, but it is likely to resume stronger growth in 2016 on stronger demand accompanied by a supportive currency. Though we assume exports will decelerate in 2015, the Czech economy should be supported by an improved labour market in 2014 and fiscal easing in 2015-16.

## Growth and commodities disinflationary, FX inflationary

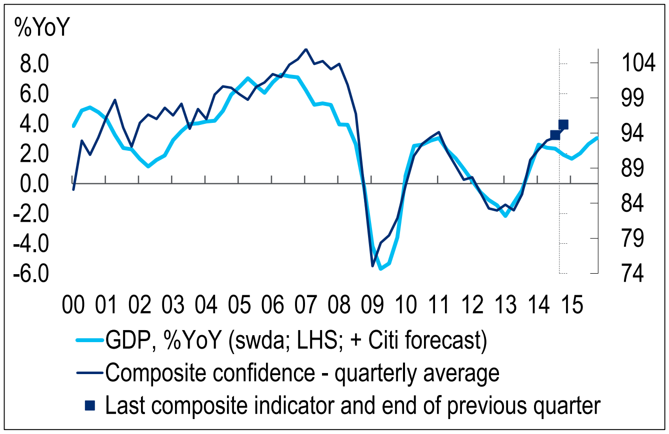
**Risks to inflation forecast are asymmetric, but skewed to downside.** Producer and import prices, together with our currency forecast, still suggest that adjusted core CPI will accelerate further, but food and fuel prices are likely continue to remain disinflationary, though the impact of lower commodity prices is limited by our weaker koruna outlook (driven by parity of EURUSD on 2year horizon). We assume the CNB will not fight the initial disinflationary push from lower commodity prices. However, if inflation continues to undershoot the CNB's target, we believe the CNB will likely remain dovish.

**Expecting a later exit from EURCZK floor.** However, we still do not expect the EURCZK floor to be hiked, particularly as we are already looking for a weaker koruna. Our forecast that Czech GDP growth will remain above 2% YoY, with a weaker koruna and ECB QE does not suggest the CNB will increase the EURCZK floor. However, in the recent Minutes, the CNB Board welcomed a weaker currency than the 27.4 assumed in CNB's forecast. EURCZK is likely to be virtually unchanged on 0-3m basis, but we expect more volatility with the likely closer ECB QE. We keep our view of a somewhat weaker koruna on a one year horizon reflecting two factors. First, recent domestic data – adjusted core CPI and GDP – have been slightly disinflationary, which will keep open the option of a higher EURCZK floor. Though we do not expect the CNB to raise it, we think lower foreign demand outlook will increase market expectations. Second, regional sentiment will be negatively influenced by a stronger USD, though this is likely to be limited by the ECB's QE. While we still assume the koruna will resume its appreciation on a two year horizon, we believe external factors to remain challenging, particular reflecting a later ECB tightening and relatively modest convergence process ahead. Overall, we believe weaker GDP growth and later ECB's hikes will delay the CNB´s exit from the EURCZK floor. Hence, we postponed the CNB's exit from the EURCZK floor to 4Q16 (from mid-2016 previously) with the first hike in policy rate to 1Q17 (from 3Q17 and three quarters before a likely first ECB's hike). This is three quarters earlier that the CNB assumes.

## 2015 should see limited bond supply and calm politics

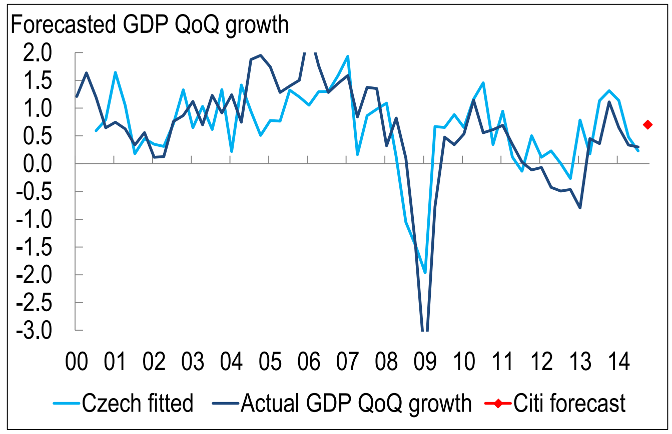
**Fiscal deficit is likely to widen in 2015, but the supply of bonds is likely to remain limited by larger utilisation of cash.** Total general government deficit narrowed to -1% of GDP in 2Q14 from -1.1% a quarter earlier and -2.7% a year previously (the primary measure reached a surplus of 0.3% of GDP vs. -0.8% the prior year). However, the cash measure of the state deficit widened in 3Q14 and the total general government deficit will likely reach around 2% of GDP in 2014. We expect this deficit to widen slightly further in 2015, but it is likely to be narrower in 2016 both due to better economic performance and new tax legislation, which is expected to improve tax collection efficiency (though the impact of the later is still uncertain and socialists will require more spending). The MinFin is likely to continue to curb net issuance as the fiscal deficit is likely to be covered by cash from the Single Treasury Account. Hence, the supply of bonds will be targeted to rollover redemptions of local bonds (around CZK113bn), plus retail (CZK12bn) and local euro denominated bond (CZK8bn). This together with the ECB's QE, are likely to keep Czech 10y yields below 1% in 4Q15-1Q15. While we assume minor tensions within the centre-left government will continue, we do not assume a larger upheaval until spring 2016, when we think the rivalry in the government to increase before the autumn election for 1/3 of the Upper House in autumn 2016 (the general elections are scheduled for autumn 2017).

Figure 138. November confidence data is an upside risk to our GDP forecast …



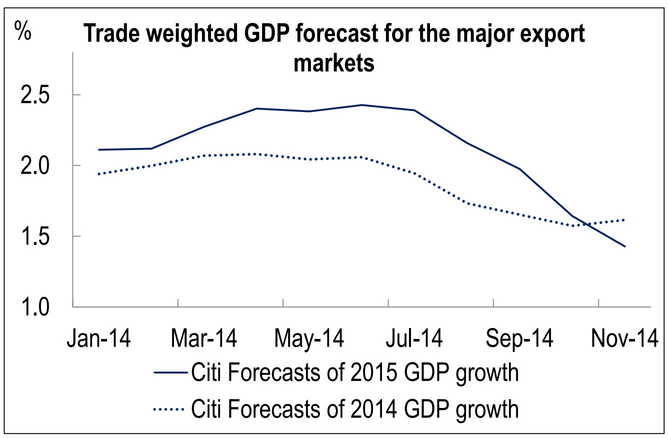

Source: CZSO, Citi Research forecast

Figure 139. … while our momentum guide represents a downside risk to our quarterly GDP growth forecast



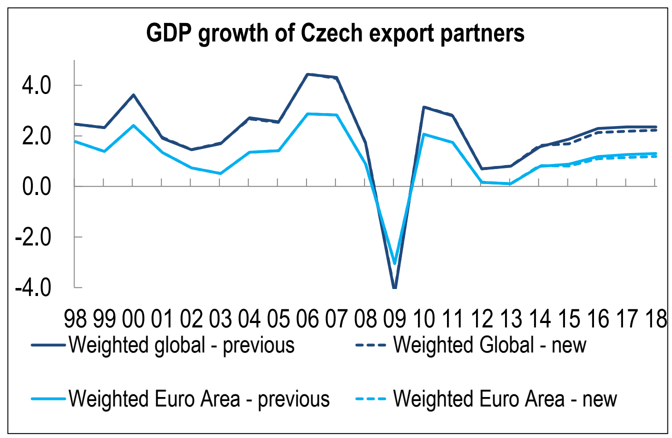

Source: CZSO, Eurostat, Citi Research calculation and forecast

Figure 140. Moreover our foreign demand outlook worsened in 2014 …



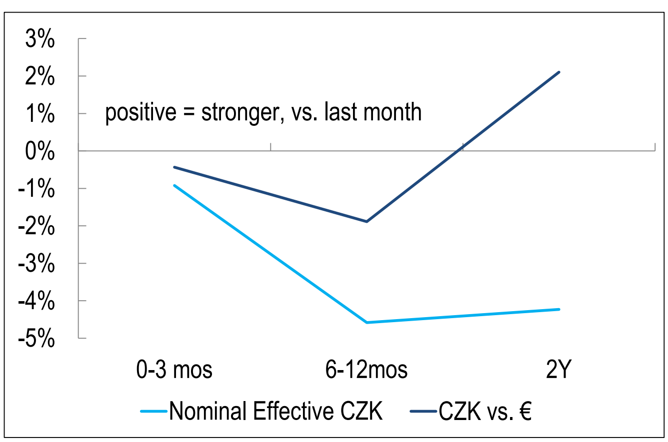

Source: Citi Research calculation and forecast

Figure 141. … though it still remains supportive for export growth …



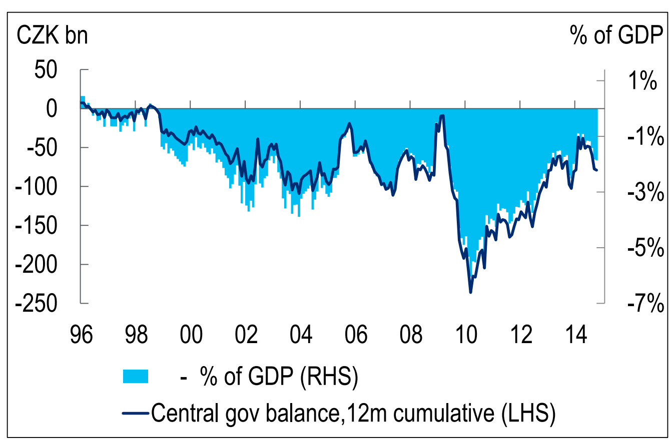

Source: Citi Research calculation and forecast

Figure 142. … particularly if we account for our weaker koruna outlook




Source: CNB, CZSO, Citi Research calculation. Note: positive = stronger, vs. last month

Figure 143. Fiscal deficit worsened in 2H14 and we expect it to persist in 2015, but it will be covered by cash from the STA




Source: Haver Analyitcs, Citi Research calculation

**Figure 144. Czech Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 235 | 206 | 207 | 227 | 207 | 209 | 219 | 216 | 192 |
| Nominal GDP, local currency bn | 4,015 | 3,922 | 3,954 | 4,022 | 4,048 | 4,086 | 4,287 | 4,474 | 4,682 |
| GDP per capita, USD | 22,552 | 19,609 | 19,684 | 21,655 | 19,673 | 19,865 | 20,820 | 20,478 | 18,175 |
| Population, mn | 10.4 | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 | 10.5 |
| Unemployment, % of labour force | 4.4 | 6.7 | 7.3 | 6.7 | 7.0 | 7.0 | 6.1 | 5.7 | 5.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 2.7 | -4.8 | 2.0 | 2.2 | -0.8 | -0.7 | 2.3 | 2.3 | 3.0 |
| Real investment growth % yoy | 1.2 | -18.1 | 4.4 | 1.9 | -3.7 | -5.1 | 4.7 | 4.9 | 8.4 |
| Real consumption growth % yoy | 2.4 | 0.4 | 0.8 | -0.7 | -1.5 | 0.9 | 1.5 | 1.8 | 2.3 |
| private consumption growth % yoy | 2.9 | -0.7 | 1.0 | 0.2 | -1.8 | 0.4 | 1.7 | 2.1 | 2.3 |
| Real export growth, % yoy | 4.2 | -9.8 | 14.8 | 9.3 | 4.1 | 0.3 | 8.4 | 5.0 | 8.6 |
| Real import growth, % yoy | 3.2 | -11.0 | 14.9 | 6.7 | 2.4 | 0.3 | 8.6 | 5.6 | 10.1 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 3.6 | 1.0 | 2.3 | 2.4 | 2.4 | 1.4 | 0.3 | 1.6 | 2.3 |
| CPI, % avg | 6.3 | 1.0 | 1.5 | 1.9 | 3.3 | 1.4 | 0.4 | 1.2 | 2.1 |
| Nominal wages, % yoy | 7.9 | 3.4 | 2.2 | 2.5 | 2.5 | 0.0 | 3.1 | 3.5 | 4.4 |
| Credit extension to private sector, % yoy | 16.1 | 0.8 | 3.0 | 5.5 | 2.6 | 3.7 | 3.2 | 6.5 | 8.0 |
| Policy Interest Rate, % eop | 2.25 | 1.00 | 0.75 | 0.75 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| 3 month inter-bank rate, %, eop | 3.63 | 1.54 | 1.22 | 1.17 | 0.50 | 0.38 | 0.30 | 0.30 | 0.25 |
| Long-term yield, %, eop | 4.15 | 4.01 | 3.86 | 3.69 | 1.90 | 2.30 | 0.74 | 1.40 | 2.10 |
| CZK/US$, eop | 19.2 | 18.4 | 18.7 | 19.8 | 19.0 | 19.9 | 23.0 | 26.0 | 27.0 |
| CZK/US$, avg | 17.0 | 19.0 | 19.1 | 17.7 | 19.5 | 19.6 | 21.1 | 25.1 | 26.8 |
| CZK/EUR, eop | 26.8 | 26.4 | 25.0 | 25.6 | 25.1 | 27.3 | 27.7 | 27.8 | 26.9 |
| CZK/EUR, avg | 25.0 | 26.4 | 25.3 | 24.6 | 25.1 | 26.0 | 27.5 | 27.9 | 27.2 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -4.8 | -4.8 | -7.6 | -6.3 | -2.5 | -2.9 | 0.4 | -1.3 | -2.1 |
| % of GDP | -2.0 | -2.4 | -3.7 | -2.8 | -1.2 | -1.4 | 0.2 | -0.6 | -1.1 |
| Trade balance | 1.7 | 4.6 | 2.8 | 5.3 | 7.6 | 9.6 | 12.1 | 11.4 | 9.2 |
| Exports | 125.1 | 99.1 | 114.0 | 138.5 | 132.7 | 135.6 | 146.3 | 132.6 | 133.0 |
| Imports | 123.4 | 94.6 | 111.2 | 133.2 | 125.1 | 126.0 | 134.2 | 121.2 | 123.8 |
| Service balance | 4.4 | 3.9 | 3.9 | 3.8 | 3.2 | 2.7 | 3.4 | 3.1 | 2.6 |
| Income balance | -10.6 | -13.2 | -14.8 | -15.6 | -13.2 | -16.0 | -16.2 | -15.2 | -13.7 |
| FDI, net | 2.3 | 2.0 | 4.9 | 4.2 | 6.2 | 1.7 | 7.1 | 5.2 | 4.7 |
| International reserves | 36.5 | 39.7 | 40.3 | 37.9 | 42.4 | 53.9 | 54.0 | 47.6 | 45.0 |
| Total amortisations | 4.2 | 6.2 | 5.4 | 8.6 | 5.4 | 7.3 | 7.0 | 5.6 | 5.8 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -2.1 | -5.5 | -4.4 | -2.9 | -4.0 | -1.3 | -1.9 | -2.3 | -2.0 |
| Consolidated gov primary balance | -1.1 | -4.3 | -3.1 | -1.5 | -2.5 | 0.0 | -0.2 | -1.4 | -0.9 |
| Public debt | 28.7 | 34.1 | 38.2 | 41.0 | 45.5 | 45.7 | 43.8 | 42.0 | 41.8 |
| *of which* Domestic | 19.9 | 23.3 | 24.7 | 33.1 | 37.9 | 36.9 | 35.7 | 34.4 | 34.0 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 96.3 | 106.5 | 115.4 | 116.0 | 127.7 | 136.3 | 124.1 | 110.4 | 108.0 |
| Public | 15.3 | 21.0 | 25.2 | 23.8 | 29.5 | 31.4 | 28.5 | 25.2 | 24.7 |
| External debt / GDP | 40.9 | 51.8 | 55.8 | 51.0 | 61.8 | 65.3 | 56.6 | 51.2 | 56.4 |
| External debt / XGS | 65.5 | 89.8 | 85.5 | 71.8 | 82.2 | 86.2 | 72.4 | 70.7 | 69.0 |
| Short-term debt | 38.1 | 37.2 | 39.6 | 43.7 | 44.4 | 49.4 | 44.8 | 39.8 | 39.0 |
| Short-term debt/International reserves (%) | 104.4 | 93.8 | 98.2 | 115.3 | 104.6 | 91.6 | 82.9 | 83.4 | 86.8 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 2.4 | 2.3 | 1.9 | 1.7 | 2.0 | 2.6 | 3.0 | 3.2 | 3.2 |
| CPI, % yoy eop | 0.0 | 0.8 | 0.3 | 0.9 | 1.2 | 1.6 | 1.6 | 2.1 | 2.1 |
| Policy interest rate, %, eop | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| Short-term market rate, % eop | 0.35 | 0.35 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Long-term yield, %, eop | 1.55 | 1.20 | 0.74 | 0.91 | 1.07 | 1.24 | 1.40 | 0.68 | 0.85 |
| CZK/EUR, eop | 27.45 | 27.50 | 27.72 | 27.86 | 28.01 | 28.00 | 27.78 | 27.56 | 27.35 |

Source: National Sources, Citi Research forecasts

# Egypt

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- **Summary view** — The new president will push ahead with three major goals: consolidating his power base prior to the parliamentary elections; improving the security situation; and putting in place policies to kick start the economy.
- **Things to watch** — Gulf support has helped stabilize the exchange rate. But there is still a backlog of foreign exchange shortages and foreign exchange reserves remain low, which may push the Central Bank of Egypt (CBE) to allow a moderate weakening of the EGP at some point in 2015.
- **Strategy** — The government plans to outline a comprehensive plan/vision for the economy at its investor and development conference currently scheduled to be held in Q1 2015. In the meantime, it will seek to further improve short term macroeconomic and political stability.

## Improving security, consolidating political power

**Early 2015 should mark the end of the political roadmap drawn up for Egypt in mid-2013 with the holding of parliamentary elections.** Although these have been subject to various delays we expect them to be held in Q1 2015. Moreover, although the executive will continue to be politically dominant, the formation of a new parliament is important as it demonstrates to the international community that the new president, Abdelfattah el Sisi, can clearly deliver on his promises.

**Meanwhile, he has used the delays to build a wider political power base capable of performing well in parliamentary elections.** Given the weak and fragmented nature of the current political parties in Egypt, no party looks as if it can mount a successful campaign to secure a parliamentary majority. But with new parties being formed by supporters of the president and ex-military figures, coupled with the president's ability to appoint MPs, we believe he should be able to construct a supportive parliamentary alliance.

**With the conclusion of the political roadmap, the president is likely to focus his attention increasingly on restoring the security situation in the country, notably in the Sinai.** This is arguably not only important as part of the country's economic recovery, but a key plank in maintaining popularity. Part of this will be the ongoing clampdown on the Muslim Brotherhood (MB). But pushing the MB underground raises the risk of returning to the low level insurgency of the 1990s. But the clampdown will also be wider, against all forms of dissent, although the president is keen to keep some elements of the Islamist political community on side to preserve his wider political legitimacy.

## Attracting investment and boosting growth

**In addition to the elections, the other focus of Q1 2015 will be the government's planned investor and development conference.** This has also been delayed a number of times, as the government works to develop more specific details of its planned economic reform programme. But it now seems the main focus will be to sell the Egyptian story to investors and outline a range of new reforms and initiatives. These are likely to include large domestic mega projects, such as around the Suez Canal, but also projects based around the theme of growth with social justice, such as the building of low-cost housing or improving health and education facilities in the country. The government will also stress its interest in PPP infrastructure projects.

**In addition, we think there will be three underlying themes to the conference.** The first is how Egypt can reduce its current dependence on Gulf funding. We certainly expect the Gulf to continue to provide high levels of support in the next few years, but it will not be an open ended commitment. Second, can the planned pipeline of reforms and projects significantly boost job creation? And third, given that the army is one of the few institutions in the country which has the logistical capacity to support the ambitious investment agenda, how can investors work with it to achieve the government's goals?

## Short term stability, but an IMF deal is still unlikely

**While the focus on the investor and development conference is the medium term, in the more immediate future the ongoing provision of Gulf support will continue to allow the government to achieve economic stability in 1H 2015**. For the CBE, the immediate focus will be to continue clearing the foreign exchange backlog, rebuilding reserves and providing exchange rate stability, although it may still have to allow a modest weakening of the EGP. But it is not clear to what extent it will be able to ease monetary policy in the near term. Policy was tightened following the decision to reduce the fuel price subsidy in the 2014/15 budget, which has pushed up inflation in 2H 2014 and we expect that it could remain elevated in the 10-13% range until mid-2015.

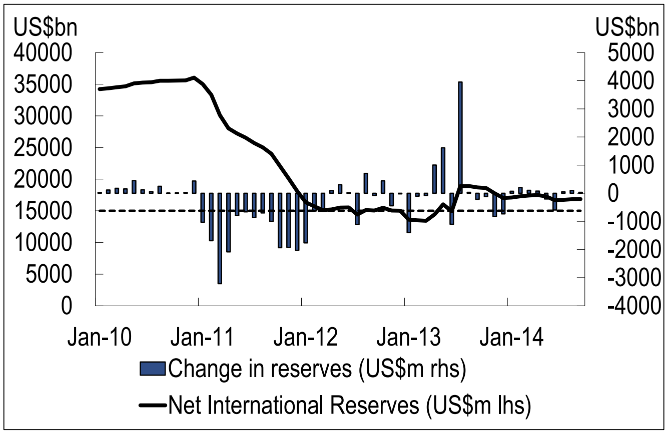
**At this point, the focus will then switch to the 2015/16 budget and the extent to which the government wants to reduce subsidies further**. We expect it to push ahead with this, but perhaps more gradually than in the current fiscal year given the lower international oil price. Instead, there will be an additional focus on driving a slow reduction in the fiscal deficit through further gains in tax revenue as the economy continues to recover.

**This planned programme of fiscal consolidation is also likely to be formalised in home-grown reform programme.** But only when it has been running for some time, do we think that the government will open negotiations with the IMF to possibly agree an externally monitored programme. It may also be that the IMF only provides a stamp of approval to the home grown programme through a Precautionary and Liquidity Line (PLL) as is currently the case with Morocco. In the meantime, the government will continue to use the IMF to help technical aspects of reform such as the introduction of VAT or subsidy reform.

## The need for reality

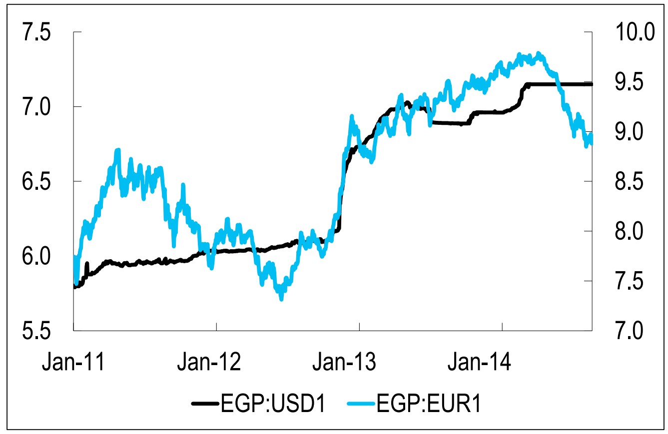
**With the end of the political roadmap drawing near, it is clear that an economic roadmap for Egypt is emerging; in fact it is likely to be formalised during 2015**. But the need for reality must also remain paramount. Even if an ambitious reform agenda along the lines we have outlined is put in place, the reality remains that the state of the economy is still precarious after years of political turmoil and political views remain highly polarised. Moreover, the current fragile stability is still heavily dependent on the current high levels of Gulf support. When set against the background of longer term structural issues, such as a weak civil service, a poor education system, the realities of running the country while boosting growth and job creation is likely to become quickly apparent to the new president in 2015-16, even as political stability improves.

**Figure 145. Reserves have stabilised since late 2013, but remain low**



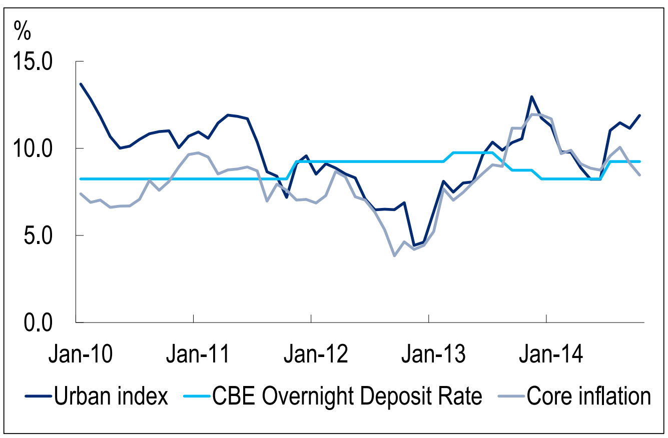

Source: Central Bank of Egypt, Haver Analytics

**Figure 146. EGP – Downward steps against the US dollar**



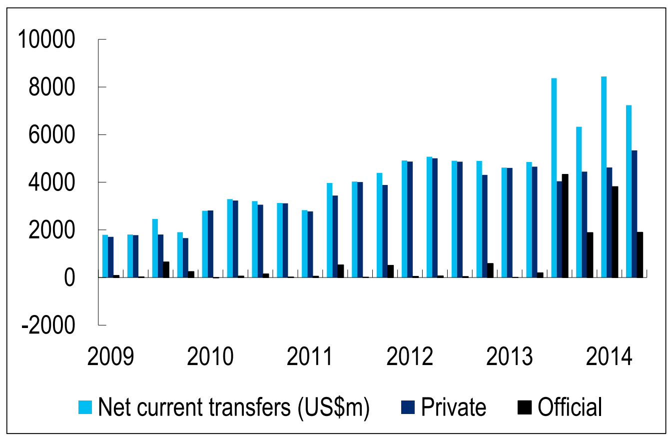

Source: Reuters

**Figure 147. Inflation has picked up following subsidy cuts in July, forcing a response from the CBE**



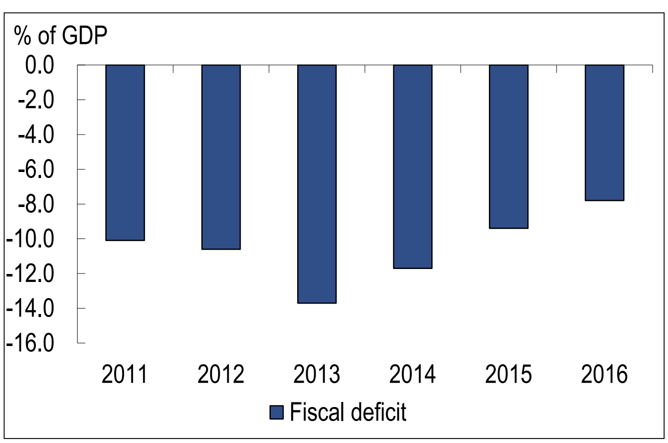

Source: Central Bank of Egypt, Haver Analytics and Citi forecasts for 2H 2013

**Figure 148. Robust transfers have limited the deterioration in the current account and helped support consumption**



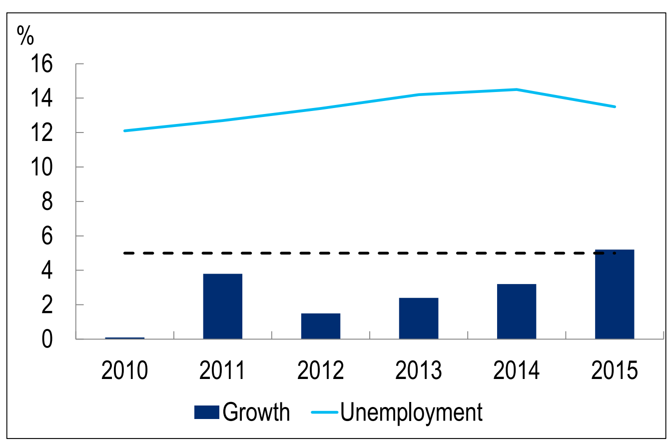

Source: Central Bank of Egypt, Haver Analytics

**Figure 149. Slow fiscal consolidation is likely going forward**




Source: Haver Analytics and Citi forecasts for 2013-2015

**Figure 150. A slow recovery should gain momentum in 2015-16**




Source: Haver Analytics and Citi forecasts for 2013-15

**Figure 151. Egypt Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 165 | 188 | 214 | 231 | 260 | 255 | 279 | 314 | 355 |
| Nominal GDP, local currency bn | 977 | 1,124 | 1,308 | 1,461 | 1,663 | 1,887 | 1,979 | 2,287 | 2,647 |
| GDP per capita, USD | 2,187 | 2,454 | 2,755 | 2,920 | 3,233 | 3,115 | 3,363 | 3,721 | 4,135 |
| Population, mn | 75.4 | 76.6 | 77.8 | 79.1 | 80.4 | 81.7 | 83.1 | 84.4 | 85.8 |
| Unemployment, % of labour force | 8.7 | 9.4 | 9.0 | 12.0 | 12.7 | 13.2 | 14.2 | 14.5 | 13.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 6.0 | 4.6 | 5.5 | 0.1 | 3.8 | 1.5 | 2.4 | 3.2 | 5.2 |
| Real investment growth % yoy | 9.2 | -10.0 | 12.2 | -3.6 | 7.2 | -10.8 | 9.5 | 12.1 | 19.4 |
| Real consumption growth % yoy | 5.4 | 4.7 | 4.9 | 4.3 | 5.3 | 2.1 | 2.9 | 2.4 | 3.0 |
| private consumption growth % yoy | 5.7 | 4.6 | 5.0 | 4.6 | 5.7 | 2.0 | 3.0 | 2.6 | 3.2 |
| Real export growth, % yoy | 14.1 | -18.8 | 8.1 | -12.5 | -5.0 | 1.5 | -2.8 | 5.6 | 6.0 |
| Real import growth, % yoy | 13.7 | -24.0 | 10.5 | -0.9 | 5.4 | -3.9 | 4.8 | 7.2 | 6.7 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 18.4 | 13.2 | 10.6 | 9.5 | 4.7 | 11.7 | 14.4 | 9.5 | 11.2 |
| CPI, % avg | 18.3 | 11.8 | 11.1 | 10.1 | 7.1 | 9.5 | 10.7 | 12.4 | 10.5 |
| Nominal wages, % yoy | - | - | - | - | - | - | - | - | - |
| Credit extension to private sector, % yoy | 12.0 | 3.0 | 6.7 | 6.1 | 7.6 | 6.4 | 6.3 | 7.6 | 9.0 |
| Policy Interest Rate, % eop | 11.50 | 8.25 | 8.25 | 9.25 | 9.25 | 8.25 | 9.25 | 8.50 | 8.50 |
| 1 month inter-bank rate, %, eop | 11.95 | 8.30 | 8.30 | 10.05 | 10.10 | 9.25 | 14.90 | 9.93 | 11.69 |
| Long-term yield, %, eop | 9.00 | 9.00 | 9.00 | 9.50 | 10.00 | 13.50 | 11.00 | 10.00 | 10.50 |
| EGP/US$, eop | 5.50 | 5.48 | 5.81 | 6.03 | 6.36 | 6.95 | 7.15 | 7.35 | 7.60 |
| EGP/US$, avg | 5.44 | 5.55 | 5.63 | 5.94 | 6.07 | 6.87 | 7.08 | 7.28 | 7.46 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -1.3 | -3.2 | -5.6 | -7.9 | -9.5 | -3.5 | -6.0 | -7.2 | -9.8 |
| % of GDP | -0.8 | -1.7 | -2.6 | -3.4 | -3.7 | -1.4 | -2.1 | -2.3 | -2.8 |
| Trade balance | -26.8 | -22.5 | -27.7 | -28.5 | -34.7 | -29.3 | -36.0 | -34.3 | -36.3 |
| Exports | 29.8 | 23.1 | 25.0 | 27.9 | 25.1 | 26.5 | 25.6 | 26.4 | 27.5 |
| Imports | 56.6 | 45.6 | 52.7 | 56.5 | 59.8 | 55.8 | 61.6 | 60.6 | 63.8 |
| Service balance | 15.7 | 11.3 | 9.6 | 5.4 | 5.4 | 1.6 | 1.7 | 1.4 | 1.6 |
| Income balance | - | - | - | - | - | - | - | - | - |
| FDI, net | 7.6 | 6.1 | 5.2 | -1.1 | 5.8 | 3.9 | -0.1 | 3.0 | -2.5 |
| International reserves | 34.2 | 34.2 | 36.0 | 18.1 | 15.0 | 17.1 | 17.9 | 20.4 | 22.9 |
| Total amortisations | 1.8 | 2.4 | 2.0 | 2.2 | 2.3 | 2.5 | 2.8 | 3.1 | 3.4 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -6.4 | -6.6 | -7.7 | -10.1 | -10.6 | -13.7 | -11.7 | -9.4 | -7.8 |
| Consolidated gov primary balance | -1.8 | -2.4 | -2.6 | -4.5 | -4.7 | -6.0 | -2.7 | -0.2 | 1.1 |
| Public debt | 53.5 | 54.0 | 59.8 | 69.0 | 77.7 | 78.6 | 77.0 | 73.2 | 72.7 |
| *of which* Domestic | 53.5 | 54.0 | 59.8 | 69.0 | 77.7 | 78.6 | 77.0 | 73.2 | 72.7 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 32.1 | 33.3 | 35.0 | 33.7 | 38.8 | 45.8 | 38.2 | 35.0 | 32.1 |
| Public | 26.0 | 27.2 | 28.3 | 27.4 | 32.8 | 40.5 | 31.5 | 31.5 | 31.5 |
| External debt / GDP | 19.5 | 17.7 | 16.3 | 14.6 | 14.9 | 18.0 | 13.7 | 11.1 | 9.0 |
| External debt / XGS | 55.6 | 73.0 | 70.9 | 71.1 | 82.4 | 101.7 | 86.1 | 77.8 | 68.2 |
| Short-term debt | 2.8 | 2.6 | 3.1 | 3.0 | 6.7 | 2.8 | 2.8 | 2.8 | 2.8 |
| Short-term debt/International reserves (%) | 8.3 | 7.5 | 8.7 | 16.7 | 44.3 | 16.5 | 15.8 | 13.8 | 12.3 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 1.8 | 3.0 | 3.2 | 3.0 | 3.2 | 3.0 | 3.5 | 4.0 | 5.5 |
| CPI, % yoy eop | 8.2 | 11.2 | 14.4 | 13.2 | 14.0 | 12.1 | 9.5 | 10.6 | 11.5 |
| Policy interest rate, %, eop | 8.25 | 9.25 | 9.25 | 9.25 | 9.25 | 9.00 | 8.50 | 8.00 | 8.25 |
| Short-term market rate, % eop | 9.25 | 9.25 | 14.90 | 13.65 | 14.49 | 12.51 | 9.93 | 11.02 | 11.90 |
| Long-term yield, %, eop | 13.50 | 13.00 | 12.50 | 12.00 | 11.50 | 11.50 | 11.00 | 11.00 | 11.00 |
| EGP/US$, eop | 7.15 | 7.15 | 7.15 | 7.20 | 7.30 | 7.35 | 7.35 | 7.40 | 7.45 |

Source: National Sources, Citi Research forecasts

# GCC

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## Saudi Arabia

**We expect some economic headwinds in 2015 for Saudi Arabia, as lower oil prices put downward pressure on government revenues.** Saudi Arabia has confounded our expectations that it would cut production in order to support the market, and we expect that production will remain close to current levels for the foreseeable future. We believe that Saudi's reluctance to cut makes good economic sense: in the absence of a coordinated move in that direction with other global suppliers, it is not clear that Saudi would achieve much with a cut other than reduced revenues and market share. Lower oil prices are also supportive of global demand and will restrict future uncompetitive supply, helping balance the market outlook.

**We have no concerns that falling oil prices will tip Saudi into anything resembling a fiscal crisis: by our calculations, Saudi can finance the current level of expenditures (in real terms) with US$80 oil from its reserves for the next eight years, without needing to raise any debt at all.** But based on our new oil price forecasts of US$80 per barrel (Brent) next year, rising to US$85 in subsequent years, we expect the Saudi budget to switch sharply into a deficit position of around 3.5% of GDP in 2015, and remain in the 2%-4% range for the foreseeable future absent fiscal reforms. While Saudi has ample fiscal reserves to fund such deficits, as well as plenty of capacity to raise debt, we do expect that the Saudi authorities will seek to put public finances on a sustained footing over the medium term. This implies an accelerated timetable for fiscal consolidation and reform, and early signs of this may appear in 2015.

**The Saudi stock market should be opened to direct foreign investment in H1 of 2015, subject to rules currently being finalized by the country's Capital Markets Authority (CMA).** The rules, a draft of which were published in August, introduce the concept of Qualified Foreign investors, which will restrict entrants to only the largest, most established international investors. Moreover, the CMA has proposed significant limits on foreign ownership that are likely to limit actual access opportunities and could keep the Tadawul out of the MSCI emerging markets index. We expect all these issues to be clarified in the first few months of the year.

## United Arab Emirates

**The UAE economy is also vulnerable to the drop in oil prices witnessed in recent weeks.** Abu Dhabi's fiscal breakeven oil price is around US$76 per barrel, meaning the room for expenditure growth is limited, and expenditure rationalization may be required should the oil price fall further. Indeed, with our updated oil price forecasts, we expect Abu Dhabi to swing into a deficit by 2017 given current revenues and expenditure expectations. While Abu Dhabi, like Saudi, has ample fiscal space to fund deficits in the medium term, we believe that the Abu Dhabi authorities are less likely to do so and will prefer to curtail expenditure. We believe this is in keeping with Abu Dhabi's past track record, and reflects the emirate's conservative approach and lower expenditure pressures. This cautious approach will be evident in 2015 and will set the tenor of the emirate's economic policy for the medium term, we believe.

**Dubai may well be the ultimate regional success story in terms of diversification, but this does not insulate the emirate from the effects of lower oil prices.** Dubai's hub and spoke model, based on financial services, transportation, trade, logistics and tourism, is highly dependent on regional prospects overall, which are in turn sensitive to oil prices. To watch in 2015 will be the real estate market, which has been showing signs of overheating over the past 18 months, and which may receive a knock if regional prospects sour. On the

upside, the recent extension of the P5+1 talks with Iran until mid-2015 keep a deal in play, with potential benefits to Dubai should sanctions be rolled back.

## Kuwait

**Having underachieved on the economic front for the past decade, there are some tentative signs that Kuwait might be starting to turn things around.** The political scene has been relatively stable since mid-2013, with a marked decline in opposition activity. This has created some space for progress on the policy front. The government has introduced a new PPP law, facilitating participation of private sector partners in the implementation of mega-projects, and has also suspended off-set requirements that had previously forced foreign direct investors to invest in a host of auxiliary programs in return for the award of contracts. It is hoped this will reduce some of the barriers to investment in Kuwait by foreign companies.

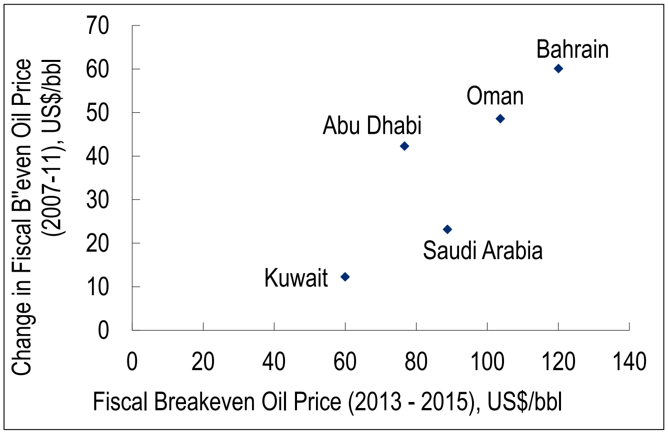
**Project approvals and implementations have also started to rise.** Two bell-weather projects (the US$12bn Clean Fuels Project and the US$8-bn Az Zour North Power plant) are now in full swing and due for completion in 2018. A new 5-year plan is currently before parliament which envisages an annual project spend of over US$40bn between 2015 and 2020. By end-August, Kuwait had awarded US$21bn in projects this year, double the number awarded the year before. And in early November, this number jumped with the award of a US$5bn contract to expand the country's main airport. We believe that further progress on project implementation, even if not the full amount envisaged under the new 5-year plan, would underpin further sustained growth in the corporate and banking sectors over the medium term.

**That said, 2015 will be a critical year in determining whether these early encouraging signs will be sustained.** There are two things to watch: first, despite the apparent progress made over the past year or so as outlined above, we believe that the potential for political dysfunction to interfere with the economic agenda remains significant. This could derail progress. Second, the deteriorating external environment, particularly with respect to falling oil prices, could create significant headwinds for the economy.

## Qatar

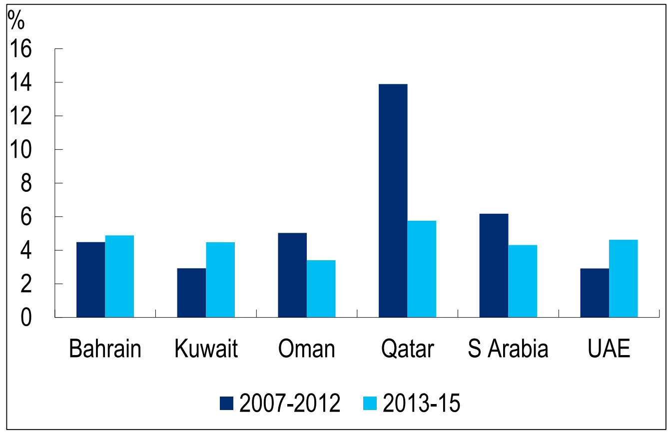
**The recent decision by FIFA to ask Swiss police to investigate alleged bribery in the 2018 and 2022 World cup bids means residual doubt over the event will linger in 2015. A clean bill of health for the Qatar 2022 World Cup proclaimed by the FIFA ethics Chief, Hans-Joachim Eckhart,** was immediately challenged by the body's lead investigator, Michael Garcia, leading to widespread calls for the original investigation to be published in full. Influential football associations in Europe threatened to withdraw from FIFA if their demands for publication were not met, and some of the international body's biggest sponsors also expressed their disquiet. As pressure mounted, FIFA announced that it had asked the Swiss police to conduct an investigation into the bidding process admitting there were 'grounds for suspicion' that bribes had been paid (*The Independent*, 24 November). This investigation, which we expect will progress well into 2015, will mean that uncertainty over the World Cup will remain. One possible consequence is that project implementation ahead of the World Cup will suffer, having negative consequences on non-oil economic growth.

Figure 152. Fiscal breakeven oil prices on the rise



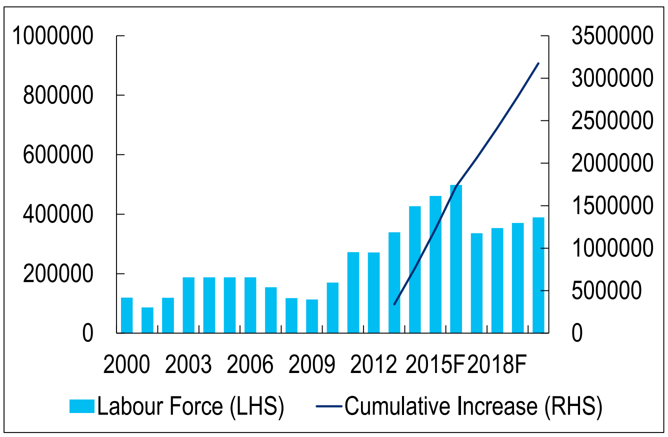

Source: Citi Research estimates

Figure 153. Economic growth will be uneven



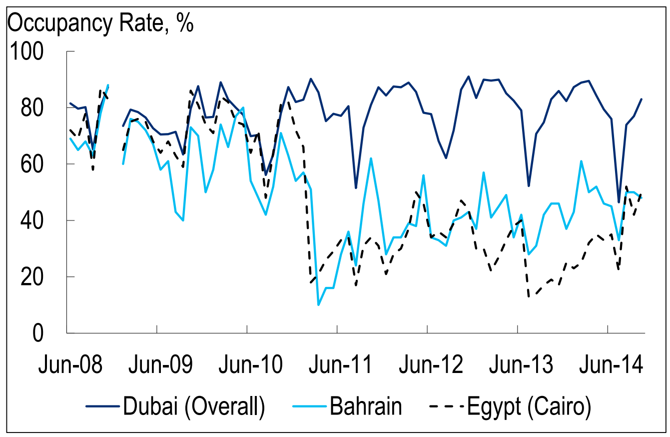

Source: Haver Analytics, Citi Research

Figure 154. 3.3 million entrants in Saudi job market by end of decade



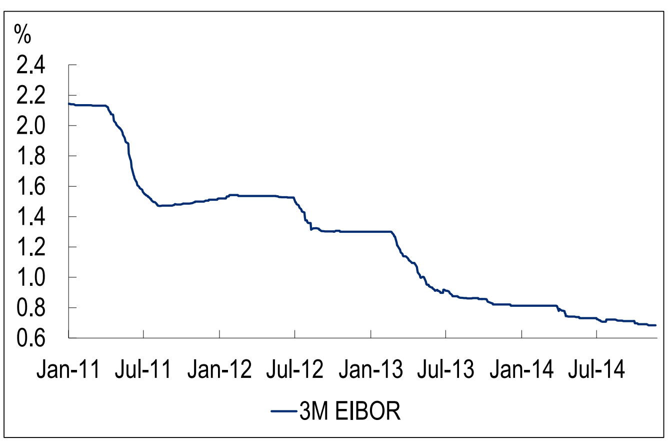

Source: Saudi Central Statistics Office, Citi Research

Figure 155. Dubai hotel occupancy continues to outperform its peers



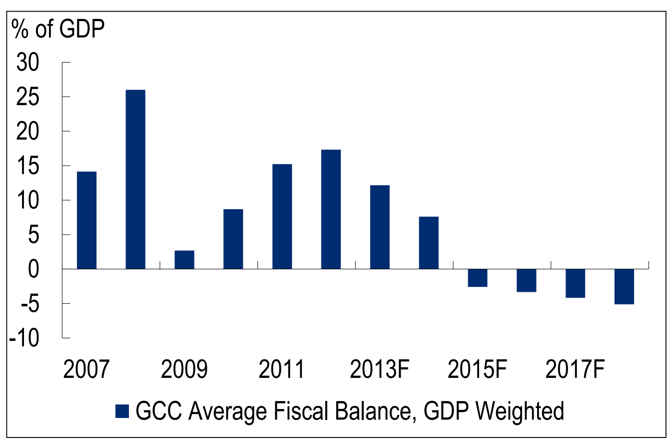

Source: Ernst & Young, Citi Research

Figure 156. EIBOR rates stablise at low levels




Source: Haver Analytics

Figure 157. High government expenditure will drive balances lower




Source: Haver Analytics, Citi Research estimates

**Figure 158. GCC Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **BAHRAIN** | | | | | | | | | |
| Nominal GDP, USD bn | 25.6 | 22.9 | 25.6 | 29.0 | 30.7 | 32.8 | 34.3 | 34.6 | 37.2 |
| GDP per capita, USD | 22,983 | 19,192 | 20,482 | 22,401 | 23,272 | 23,931 | 24,063 | 23,342 | 24,126 |
| Real GDP, yoy avg | 6.2 | 2.5 | 4.3 | 2.1 | 3.4 | 5.5 | 4.8 | 4.4 | 4.4 |
| CPI, % avg | 3.5 | 2.8 | 1.9 | -0.4 | 2.8 | 3.3 | 2.5 | 2.1 | 2.2 |
| BHD/US$, avg | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 | 0.38 |
| Current account, US$bn | 2.1 | 0.4 | 0.6 | 3.0 | 2.0 | 2.2 | 1.8 | -1.7 | -1.5 |
| % of GDP | 8.1 | 1.7 | 2.3 | 10.3 | 6.4 | 6.8 | 5.2 | -5.0 | -4.1 |
| Consolidated gov. balance, % of GDP | 6.4 | -4.3 | -4.8 | -0.3 | -2.0 | -3.3 | -4.1 | -5.9 | -4.5 |
| **KUWAIT** | | | | | | | | | |
| Nominal GDP, USD bn | 136.6 | 105.2 | 114.1 | 146.6 | 168.0 | 174.2 | 171.9 | 156.2 | 165.1 |
| GDP per capita, USD | 50,563 | 36,898 | 38,122 | 46,908 | 52,196 | 52,532 | 50,344 | 44,399 | 45,564 |
| Real GDP, yoy avg | 2.5 | -7.1 | -2.4 | 10.2 | 8.3 | 5.7 | 3.8 | 3.9 | 2.7 |
| CPI, % avg | 10.6 | 4.0 | 4.0 | 4.7 | 2.9 | 2.6 | 3.0 | 3.5 | 3.5 |
| KWD/US$, avg | 0.27 | 0.29 | 0.29 | 0.28 | 0.28 | 0.28 | 0.29 | 0.29 | 0.29 |
| Current account, US$bn | 57.8 | 29.1 | 37.8 | 66.2 | 78.7 | 70.9 | 63.5 | 42.9 | 45.3 |
| % of GDP | 42.3 | 27.6 | 33.2 | 45.2 | 46.9 | 40.7 | 36.9 | 27.4 | 27.5 |
| Consolidated gov. balance, % of GDP | 36.4 | 19.0 | 32.0 | 41.9 | 41.4 | 31.6 | 25.2 | 3.5 | 2.6 |
| **OMAN** | | | | | | | | | |
| Nominal GDP, USD bn | 59.9 | 53.4 | 53.4 | 53.4 | 53.4 | 84.3 | 87.0 | 84.1 | 90.9 |
| GDP per capita, USD | 20,887 | 18,015 | 17,438 | 16,881 | 16,180 | 24,363 | 24,078 | 22,264 | 23,019 |
| Real GDP, yoy avg | 8.2 | 6.1 | 4.8 | 0.9 | 5.8 | 3.4 | 4.1 | 2.7 | 2.3 |
| CPI, % avg | 12.5 | 3.6 | 3.2 | 4.0 | 2.9 | 2.1 | 1.0 | 0.9 | 1.2 |
| OMR/US$, avg | 0.38 | 0.38 | 0.38 | 0.39 | 0.39 | 0.38 | 0.39 | 0.39 | 0.39 |
| Current account, US$bn | 5.0 | -0.5 | 5.0 | 8.9 | 7.8 | 5.1 | 5.6 | -1.5 | -0.4 |
| % of GDP | 8.4 | -0.9 | 9.4 | 16.7 | 14.6 | 6.1 | 6.5 | -1.8 | -0.4 |
| Consolidated gov. balance, % of GDP | 0.3 | -0.1 | 3.1 | -0.4 | -0.3 | 0.8 | -2.7 | -5.4 | -4.6 |
| **QATAR** | | | | | | | | | |
| Nominal GDP, USD bn | 115.3 | 97.8 | 125.1 | 169.8 | 189.9 | 203.2 | 211.0 | 211.6 | 237.4 |
| GDP per capita, USD | 104,982 | 80,294 | 92,546 | 113,128 | 117,172 | 116,084 | 111,578 | 103,608 | 107,642 |
| Real GDP, yoy avg | 17.7 | 12.0 | 16.7 | 13.0 | 6.0 | 6.3 | 5.4 | 5.5 | 5.4 |
| CPI, % avg | 15.2 | -4.9 | -2.4 | 1.9 | 1.9 | 3.1 | 3.0 | 3.5 | 4.5 |
| QAR/US$, avg | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 | 3.64 |
| Current account, US$bn | 26.6 | 6.4 | 24.0 | 52.0 | 62.0 | 62.6 | 62.1 | 49.4 | 56.0 |
| % of GDP | 23.1 | 6.5 | 19.1 | 30.6 | 32.7 | 30.8 | 29.4 | 23.3 | 23.6 |
| Consolidated gov. balance, % of GDP | 9.8 | 13.4 | 2.7 | 7.8 | 11.4 | 15.5 | 9.6 | 3.6 | 1.0 |
| **SAUDI ARABIA** | | | | | | | | | |
| Nominal GDP, USD bn | 519.4 | 429.0 | 526.8 | 669.5 | 733.8 | 748.4 | 750.7 | 707.8 | 759.5 |
| GDP per capita, USD | 20,861 | 16,811 | 20,178 | 25,645 | 27,559 | 27,553 | 27,097 | 25,048 | 26,351 |
| Real GDP, yoy avg | 8.4 | 1.8 | 6.4 | 8.6 | 5.8 | 4.0 | 4.8 | 4.2 | 4.7 |
| CPI, % avg | 9.9 | 5.1 | 5.3 | 3.9 | 2.9 | 3.5 | 2.9 | 3.0 | 3.4 |
| SAR/US$, avg | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 | 3.75 |
| Current account, US$bn | 133.0 | 21.5 | 67.4 | 159.3 | 165.7 | 133.6 | 100.5 | 16.6 | 19.2 |
| % of GDP | 25.6 | 5.0 | 12.8 | 23.8 | 22.6 | 17.9 | 13.4 | 2.3 | 2.5 |
| Consolidated gov. balance, % of GDP | 30.8 | -3.0 | 6.3 | 13.2 | 15.4 | 8.7 | 4.7 | -3.4 | -2.6 |
| **UNITED ARAB EMIRATES** | | | | | | | | | |
| Nominal GDP, USD bn | 315.5 | 253.5 | 286.0 | 347.4 | 372.3 | 402.3 | 431.0 | 461.8 | 496.4 |
| GDP per capita, USD | 66,205 | 51,659 | 56,586 | 66,727 | 68,563 | 70,757 | 72,478 | 74,285 | 76,046 |
| Real GDP, yoy avg | 3.2 | -5.2 | 1.6 | 4.9 | 4.7 | 5.2 | 4.0 | 4.0 | 4.4 |
| CPI, % avg | 12.3 | 1.6 | 0.9 | 0.9 | 0.7 | 1.1 | 2.0 | 2.4 | 2.9 |
| AED/US$, avg | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 | 3.67 |
| Current account, US$bn | 22.7 | 7.9 | 7.4 | 74.3 | 108.8 | 114.1 | 94.9 | 63.0 | 58.6 |
| % of GDP | 7.2 | 3.1 | 2.6 | 21.4 | 29.2 | 28.4 | 22.0 | 13.6 | 11.8 |

Source: National Sources, Citi Research forecasts

# Hungary

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- **Summary view** — Gradual external debt reduction may continue amidst a slowing but stable growth outlook and low inflation. Increased state role in the economy remains a hurdle improve growth prospects and Hungary's credit rating.
- **Things to watch** — Domestic banks' ability to absorb local bond issuance following the FX debt conversion and monetary policy response to a tightening external environment may be the key local stories next year.
- **Strategy** — The external environment, moderation in inflation expectations, the elimination of household balance sheet sensitivity to FX weakness and downside risks to growth bode well for permanently low interest rates.

## Domestic demand helps growth to stabilize around 2%

**Domestic factors of growth will continue to drive the outlook in 2015** as household consumption may accelerate further from close to 2% this year, helped by the 25-30% reduction in FX debt burden, sustained positive real wage growth and gradual labor market improvement. The absorption of EU funds may remain close to record high of 5.5% of GDP this year and next, but may have a negative impact on growth in 2016 as access to EU programs run under the 2007-2013 budget cycle will expire. Manufacturing exports driven by the car industry remain a key engine of growth contributing to Hungary's trade surplus. We expect exports to slow next year as most of the recent new capacity extensions will be utilized and as the German economy loses momentum in 2015.

**Slowing debt deleveraging suggests the economy may grow by around 2% over the medium term.** 2015 may be the last year of private sector credit contraction – primarily driven by a legislative reduction in household mortgage debt – whereas corporate lending may turn positive as we expect further extension of the NBH's Funding for Growth Scheme. Household debt deleveraging may sharply slow after 2015 as the outstanding notional of converted mortgages will be reduced by 25% in average. Low interest rates support a gradual increase in new household lending, albeit household debt-to-GDP is likely to stabilize close to 25% of GDP, given the recent regulatory measures tightening lending conditions and interest rate spreads on retail loans, which may continue to hold back banks' lending activity.

## Fiscal target attainable but may be challenged by the EU

**The structure of the fiscal budget remains a key hurdle** to improve Hungary's long term growth potential, in our view. The centralization rate has remained elevated at 43% of GDP, which is high relative to other CEE countries with similar income levels. Fiscal revenues have shifted towards increased tax burden on large corporates with the exception of the manufacturing sector. Fiscal room provided by the economic upturn has been used to broaden state ownership in the economy, while the structural deficit has widened. Increased regulatory intervention in the economy weakens the business environment and remains one of the key hurdles to improve Hungary's sovereign credit rating.

**Despite the 2.4% of GDP 2015 deficit target, the EC may continue to keep** the risk of reopening the EDP on the table citing the widening structural deficit breaching the 1.7% of GDP medium-term objective defined by the Grow and Stability Pact. In our view the government will take further steps, if needed to avoid the EDP and may set tighter deficit target for 2016 to correct the structural balance.

## Inflation to remain below the NBH's target until 2016

**Headline inflation lagged expectations while core price trends have remained stable since 2Q14.** Non-core items, such as soft food prices and falling energy prices have been the key source of soft inflation surprises, while the tax-filtered core inflation has stabilized around 1.5%YoY. Due to the elimination of the impact of one large utility price cut from Nov-2013 from the annual price index, headline CPI may rebound into positive territory in December and rise above 2% by 4Q15 as the full impact of regulative utility price cuts will be eliminated. Tobacco and alcohol price hikes may also add to CPI in 2015 and the years after. We expect inflation to catch up to the NBH's 3% official target by 1H16.

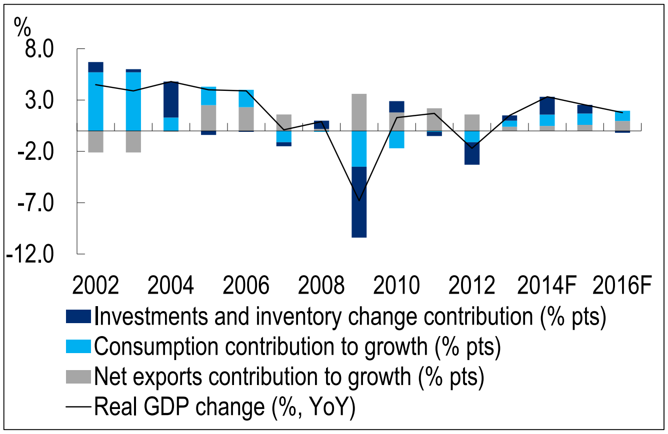
**The NBH may keep its benchmark rate to remain on hold until early 2016.** Although incoming inflation data has undershot the NBH's forecast, in our view further moderation in core inflation measures would be needed to resume rate cuts. Comments from MPC members underlined that the narrowing in the output gap and ongoing consumption recovery may weaken domestic disinflation factors over the medium term target horizon. Nonetheless, a downward shift in the external rates outlook and a collapse in risk premium may encourage the NBH to reassess the rate outlook. Considering the importance of avoiding HUF weakness at year-end in order to keep the public debt ratio on a declining path and uncertainties related to the ECB QE we do not expect any change in the NBH's stance before early 2015.

## External debt reduction and gradually weaker FX

**We expect rates to remain permanently low**, given the downward shift in the external yield environment and the inflation outlook. The domestic interest rate transmission channel may strengthen following the conversion of FX mortgages in Feb-2015: HUF mortgages will be benchmarked to 3-month interbank rates and household FX sensitivity will fall to marginal levels. This suggests that the NBH will keep monetary conditions loose to support growth and may tolerate a weaker FX. Therefore the pace of future rate hikes is likely to be gradual. We expect gradually weaker HUF in 2015 as the erosion of positive HUF real interest rates and rising USD yields putting pressure on EMFX may erode the attractiveness off HUF denominated investments and deliver some outflows by – mainly US based – offshore local bond investors.

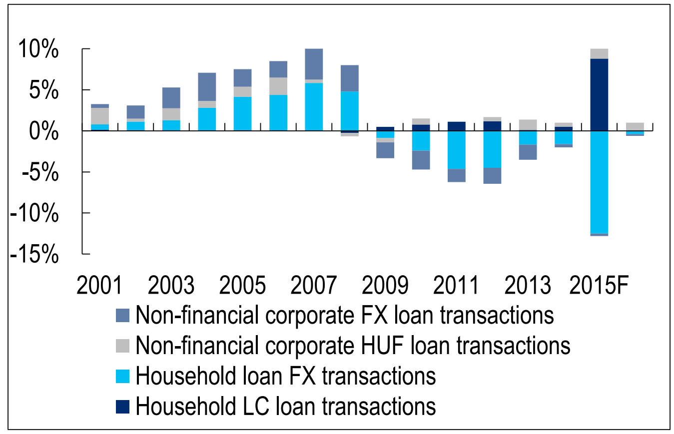
**Hungary's sustained external surplus** and the still significant public debt exposure to FX reduce the risk of a sharp HUF weakness. The drop in global energy prices may slow the erosion in Hungary's current account surplus as domestic demand recovers. We expect the current account surplus to narrow from over 4% of GDP in 2014 to around 3.5% in 2015-2016 while EU transfers registered on the capital account may almost double the external surplus. Inflows from EU transfers provide FX liquidity to replace maturing external government debt with LC funding and help the NBH to cover the FX mortgage conversion without sharp erosion in the FX reserves. External debt reduction reduces Hungary's vulnerability but given the remaining stock, debt reduction is still a long way to go. Any sharp FX weakening may jeopardize debt reduction, as large share of the external debt is FX denominated. Therefore, we believe the NBH is likely to be more responsive in case external stress would put permanent pressure on the HUF.

**Figure 159. Increased contribution by domestic demand to growth…**



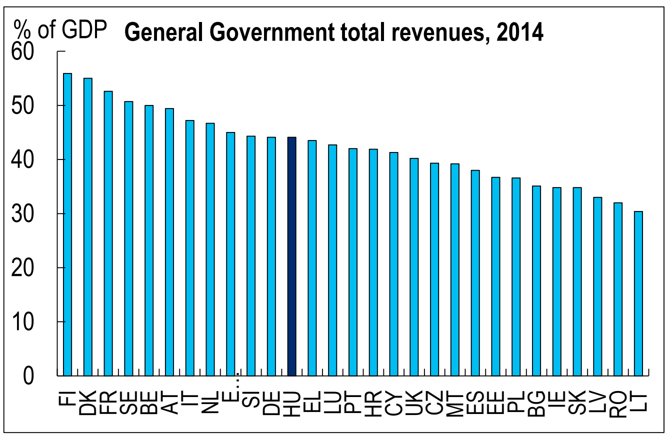

Source: Hungarian CSO, Citi Research estimates

**Figure 160.…as private sector deleveraging slows (flows as % of GDP)**



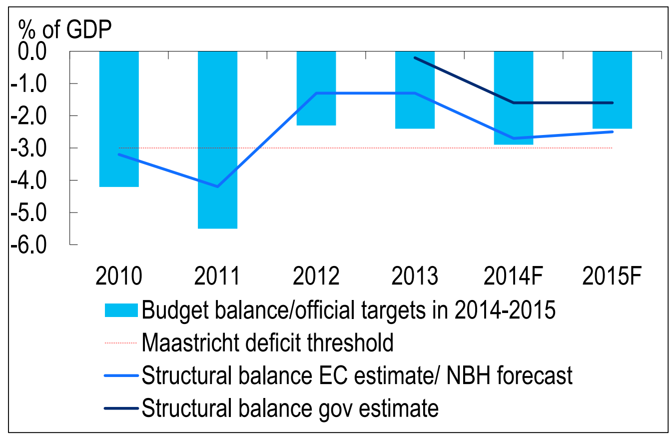

Source: National Bank of Hungary, Citi Research

**Figure 161. Centralization rate remains high relative to income level**



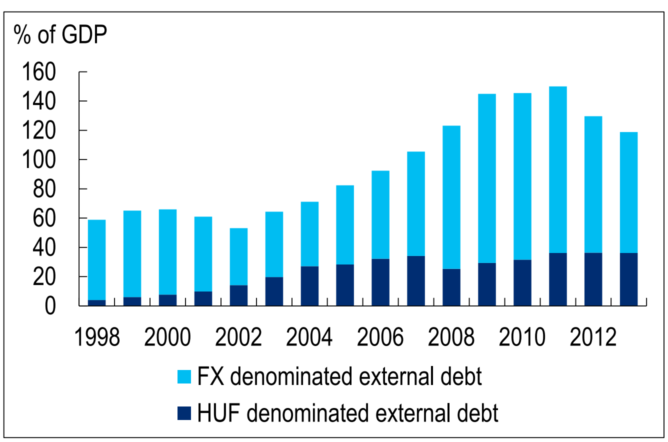

Source: European Commission estimates, Citi Research

**Figure 162. Fiscal correction may be needed to adjust structural deficit**



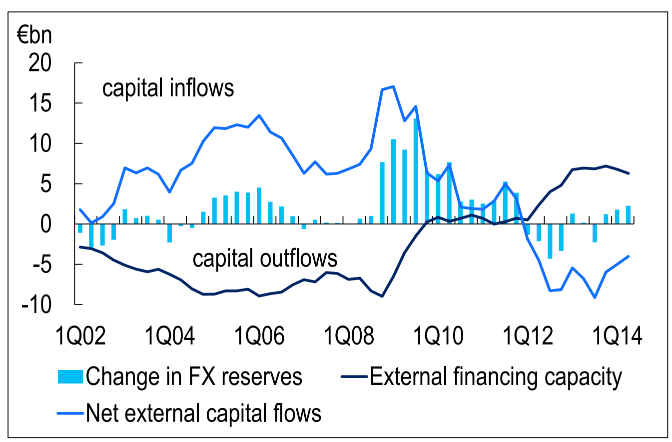

Source: European Commission, National Bank of Hungary, Citi Research

**Figure 163. FX denominated external debt reduction continues…**




Source: National Bank of Hungary, Citi Research

**Figure 164. …without eroding the FX reserves, as FX liquidity need is covered by Hungary's external surplus**




Source: National Bank of Hungary, Citi Research. Note: External financing capacity = CA+ Cap. Acc. + NEO

**Figure 165. Hungary Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 157 | 129 | 130 | 139 | 127 | 133 | 132 | 117 | 110 |
| Nominal GDP, local currency bn | 26,554 | 25,743 | 26,612 | 27,727 | 28,109 | 29,262 | 31,361 | 32,993 | 34,519 |
| GDP per capita, USD | 15,586 | 12,896 | 12,939 | 13,950 | 12,713 | 13,403 | 13,307 | 11,765 | 11,126 |
| Population, mn | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 | 9.9 | 9.9 | 9.9 |
| Unemployment, % of labour force | 8.0 | 10.5 | 10.8 | 10.7 | 10.7 | 9.1 | 7.5 | 6.8 | 6.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 0.9 | -6.8 | 1.1 | 1.6 | -1.7 | 1.1 | 3.3 | 2.5 | 1.8 |
| Real investment growth % yoy | 3.7 | -29.6 | 11.5 | -3.6 | -11.2 | 1.9 | 10.0 | 3.5 | -1.5 |
| Real consumption growth % yoy | -0.2 | -4.5 | -2.5 | 0.3 | -1.5 | 0.5 | 1.6 | 1.8 | 1.6 |
| private consumption growth % yoy | -0.7 | -6.6 | -3.0 | 0.4 | -1.6 | 0.3 | 2.0 | 2.5 | 2.2 |
| Real export growth, % yoy | 5.7 | -10.2 | 11.3 | 8.4 | 1.7 | 5.3 | 6.8 | 6.0 | 6.2 |
| Real import growth, % yoy | 5.5 | -14.8 | 10.9 | 6.4 | -0.1 | 5.3 | 7.1 | 6.1 | 6.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 3.4 | 5.4 | 4.6 | 4.1 | 5.1 | 0.6 | 0.5 | 2.5 | 3.1 |
| CPI, % avg | 6.0 | 4.0 | 4.7 | 3.9 | 5.7 | 1.7 | 0.0 | 1.7 | 2.8 |
| Nominal wages, % yoy | 7.4 | 0.5 | 1.3 | 5.2 | 4.6 | 3.4 | 4.4 | 4.2 | 4.0 |
| Credit extension to private sector, % yoy | 21.7 | -2.7 | 4.1 | -0.5 | -12.5 | -5.7 | 0.3 | -4.8 | 1.2 |
| Policy Interest Rate, % eop | 10.00 | 6.25 | 5.75 | 7.00 | 5.75 | 3.00 | 2.10 | 2.10 | 3.60 |
| 3 month inter-bank rate, %, eop | 10.00 | 6.25 | 5.75 | 7.08 | 5.75 | 3.00 | 2.10 | 2.10 | 3.60 |
| Long-term yield, %, eop | 8.28 | 7.99 | 7.97 | 9.75 | 6.11 | 5.61 | 3.50 | 4.20 | 4.70 |
| HUF/US$, eop | 190 | 189 | 208 | 244 | 221 | 216 | 257 | 296 | 321 |
| HUF/US$, avg | 171 | 201 | 208 | 201 | 225 | 223 | 237 | 283 | 313 |
| HUF/EUR, eop | 266 | 271 | 278 | 315 | 291 | 297 | 310 | 316 | 320 |
| HUF/EUR, avg | 252 | 280 | 275 | 279 | 289 | 297 | 310 | 314 | 319 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -11.2 | -1.1 | 0.4 | 1.0 | 2.4 | 5.5 | 5.6 | 4.4 | 3.7 |
| % of GDP | -7.2 | -0.8 | 0.3 | 0.8 | 1.9 | 4.1 | 4.3 | 3.8 | 3.3 |
| Trade balance | -1.4 | 3.7 | 3.5 | 4.1 | 3.9 | 4.8 | 4.2 | 3.2 | 2.4 |
| Exports | 105.7 | 79.3 | 87.7 | 100.0 | 90.4 | 96.2 | 96.8 | 84.6 | 82.1 |
| Imports | 107.1 | 75.6 | 84.3 | 95.9 | 86.5 | 91.4 | 92.6 | 81.3 | 79.7 |
| Service balance | 1.9 | 1.6 | 3.5 | 4.6 | 4.9 | 5.4 | 5.7 | 5.1 | 4.8 |
| Income balance | -9.9 | -6.0 | -6.1 | -6.8 | -5.4 | -3.9 | -3.4 | -3.0 | -2.7 |
| FDI, net | -3.5 | -0.2 | -1.0 | -1.4 | -2.6 | -0.5 | -1.3 | -0.7 | -1.0 |
| International reserves | 33.2 | 41.1 | 43.1 | 45.4 | 43.5 | 47.0 | 39.4 | 31.7 | 28.6 |
| Total amortisations | 15.2 | 21.9 | 20.5 | 25.8 | 21.6 | 21.5 | 19.3 | 17.6 | 16.7 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -3.7 | -4.7 | -4.6 | 4.3 | -2.0 | -2.2 | -2.8 | -2.4 | -2.1 |
| Consolidated gov primary balance | 0.4 | -0.1 | -0.4 | 8.5 | 2.6 | 2.4 | 0.9 | 1.2 | 1.4 |
| Public debt | 73.4 | 79.7 | 81.2 | 81.8 | 79.7 | 78.8 | 77.5 | 77.2 | 76.3 |
| *of which* Domestic | 38.6 | 38.5 | 41.4 | 40.8 | 43.5 | 44.7 | 48.8 | 50.3 | 50.2 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 172.6 | 196.3 | 185.1 | 172.5 | 164.9 | 164.4 | 147.4 | 134.9 | 127.9 |
| Public | 51.8 | 62.1 | 59.6 | 58.4 | 63.8 | 62.5 | 60.5 | 58.5 | 57.0 |
| External debt / GDP | 110.2 | 151.7 | 142.8 | 123.7 | 130.0 | 123.2 | 111.6 | 115.6 | 116.1 |
| External debt / XGS | 136.7 | 200.7 | 172.7 | 141.1 | 148.3 | 138.7 | 123.4 | 129.2 | 126.8 |
| Short-term debt | 27.5 | 28.0 | 32.9 | 31.7 | 22.8 | 22.9 | 16.4 | 13.5 | 11.6 |
| Short-term debt/International reserves (%) | 82.8 | 68.2 | 76.1 | 69.9 | 52.4 | 48.6 | 41.7 | 42.5 | 40.5 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 3.9 | 3.2 | 2.7 | 2.6 | 2.5 | 2.6 | 2.4 | 2.2 | 1.8 |
| CPI, % yoy eop | -0.3 | -0.5 | 0.5 | 1.2 | 1.7 | 1.8 | 2.5 | 2.7 | 2.8 |
| Policy interest rate, %, eop | 2.30 | 2.10 | 2.10 | 2.10 | 2.10 | 2.10 | 2.10 | 2.35 | 3.10 |
| Short-term market rate, % eop | 2.34 | 2.09 | 2.10 | 2.10 | 2.10 | 2.10 | 2.10 | 2.35 | 3.10 |
| Long-term yield, %, eop | 4.39 | 4.63 | 3.50 | 3.60 | 3.80 | 4.20 | 4.20 | 3.75 | 3.90 |
| HUF/EUR, eop | 310 | 311 | 310 | 312 | 314 | 315 | 316 | 317 | 318 |

Source: National Sources, Citi Research forecasts

# 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 growth in domestic spending.
- **Things to watch** — Israeli price deflation is now a reality, and it is difficult to see why inflation will move back up to the 1-3% target range without further action by the Bank of Israel. We believe this will require a) a further cut in the policy rate to zero, followed by b) aggressive action in the fx market, either by increasing the central bank's dollar-purchases or announcing a 'Minimum Exchange Rate'.
- **Strategy** — The shekel is likely to stay very weak. Not only is the market primed to expect the kind of central bank action outlined above, but there is also evidence that Israeli portfolio managers are less inclined to fx-hedge their purchases of foreign securities.

## Growth prospects turn sour

**The data coming in over the summer shows deterioration in the pace of economic activity.** While the PMI had been rising impressively in Q2, reaching 55.6 in May, it has fallen back below 50 in the subsequent five months. While manufacturing growth returned to positive territory in August and September, the Israeli construction sector is effectively in recession, partly thanks to uncertainty about the prospects for a zero VAT rate on couples' first purchase of newly-built homes: builders are holding off to be sure of what specifications would attract the zero-rating, and buyers are holding off in case the VAT measure is passed. GDP growth fell to 2.2% annualized in Q2, and into negative territory in Q3, thanks to the effects of the conflict in Gaza. Gross fixed capital formation and net exports are creating the biggest drag on economic activity.

## The shekel is part of the problem…

**Israeli gas production set to grow.** Tamar, the smaller of two large gas fields being developed off Israel's northern coast, began production in April 2013. Gas from Tamar (around 300 bcm) substituted some US$2.1bn of energy imports in 2013. A larger field, Leviathan (around 600 bcm), will commence production in 2017 or just after. 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$300bn). 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 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, suggesting that Israel might end up with twice the amount of gas that it has found to date.

**Partly as a result of these developments, the shekel was one of the strongest currencies in the world in 2013 and H1 2014**: the real effective exchange rate appreciated by 10% during this period alone. The appreciation of the shekel might have something to do with the weakening performance of Israeli exports, but the Bank of Israel is unwilling to 'bail out' the corporate sector by artificially depreciating the shekel. However, the shekel's strength is a critical concern for the Bank because it is driving Israeli inflation well below the Bank's 1-3% inflation target. And since cutting the interest rate is no longer much use in creating inflation pressure, the Bank's only remaining tool in the currency.

## …and disinflation looks like it's here to stay

**The exchange rate's impact on CPI is evident from the collapse of tradeables inflation.** Tradeables inflation has been negative every month this year, reaching -1.8% in October. That is dragging down overall CPI, and in turn that is pushing inflation expectations down. Moreover, it is not only the exchange rate that is creating disinflationary pressure in Israel. First, the government's efforts to increase workforce participation among the ultra-Orthodox and Arab Israelis seem likely to increase labour supply, possibly putting downward pressure on wages. Second, in the wake of a recent government commission to increase competition and reduce concentration of ownership in the economy, efforts are being made to increase competition in the retail food sector, in telecoms, TV services and in auto retail. The 'cost of living' remains a major focus in Israeli political debate.

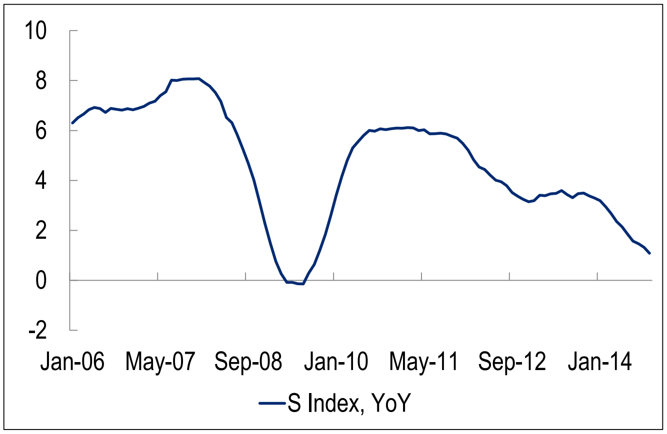
## Time for radical thinking about the exchange rate?

**The central bank is now close to running out of traditional policy tools.** The BOI's policy rate has fallen from 1% at the start of this year, and now having nearly reached the zero lower bound the central bank will be forced to consider alternative ways of delivering monetary stimulus. In our view, that stimulus is most likely to come from the fx market: since Israel's low inflation problem is largely currency-induced, it follows that the solution should be currency-oriented. In that case, it might not be long before the Bank considers something like a 'Minimum Exchange Rate' along the lines pursued by the Czech and Swiss National Banks. An alternative to this would be simply for the Bank to pursue aggressive intervention in the fx market. Either way, the consequence would likely be a weaker nominal exchange rate. The next couple of months' worth of inflation data will be particularly important in shaping the outlook for an unconventional exchange rate policy. The Bank of Israel has expressed uncertainty about the wisdom of a Minimum Exchange Rate, arguing that a) it is practically very tough to establish the right level for the MER, and b) that it only gives a one-off boost to the price-level, rather than a sustained boost to inflation.

## Fiscal and political noise rising

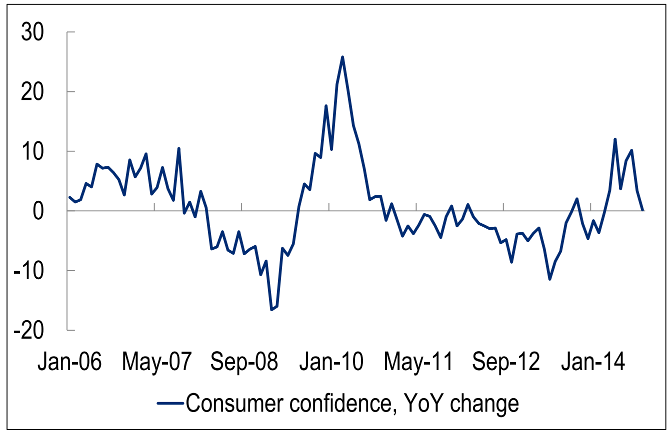
**A dispute over fiscal policy might act as a constraint on the central bank's willingness to loosen monetary policy.** The finance ministry has proposed a temporary departure from Israel's fiscal rules for 2015, ending up with a proposed deficit for next year of 3.4% GDP compared to the original target of 2.5%. While the Bank of Israel sympathises with the need for some leniency on next year's deficit – up to 3% of GDP, partly in acknowledgement of the costs of the 2014 conflict in Gaza – the Bank remains concerned about the consequences of excessively loose fiscal policy. This is relevant to the Bank's decision-making, since the looser fiscal policy is, the less easy it will be to justify extraordinary measures on the monetary side. At the same time, the Bank will also need to consider the impact of tighter monetary policy in the US. If higher US rates and a strong dollar help to suck capital out of Israel and generate a weaker shekel, it might suit the Bank of Israel's effort to find a way to push inflation up.

**Figure 166. Economic activity is stabilizing at a weak level, partly due to what the BOI describes as a 'virtual standstill' in world trade…**



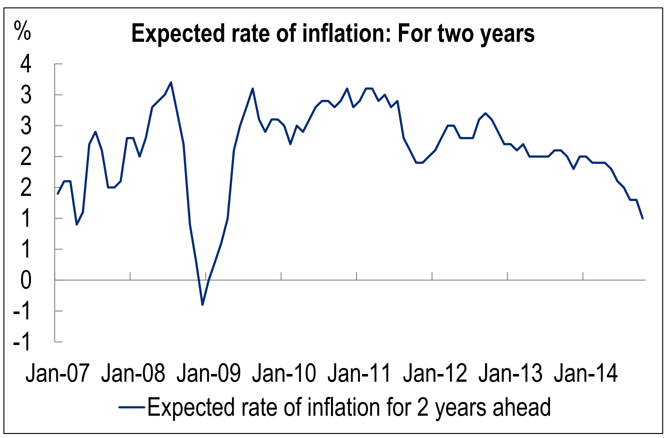

Source: Haver Analytics, Citi Research

**Figure 167. …and consumer confidence is fragile even though household borrowing has been relatively robust**



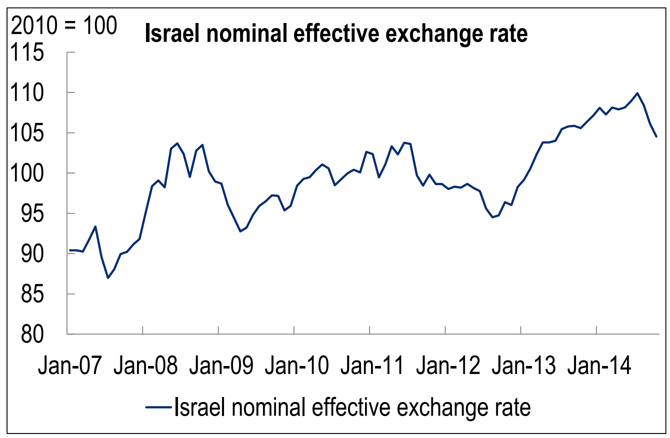

Source: Haver Analytics, Citi Research

**Figure 168. Inflation expectations have fallen sharply…**



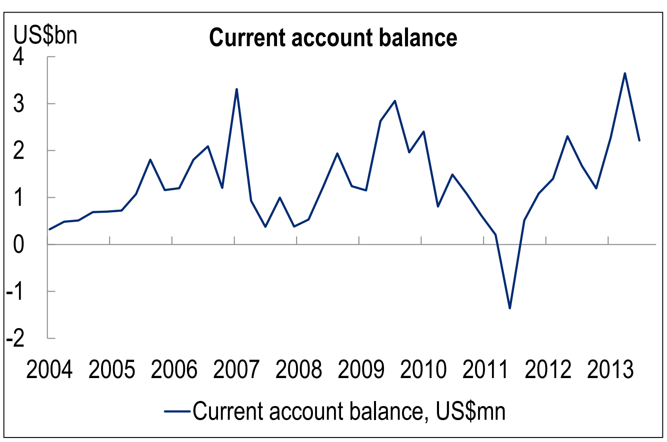

Source: Haver Analytics, Citi Research

**Figure 169. …largely thanks to the appreciation of the shekel…**



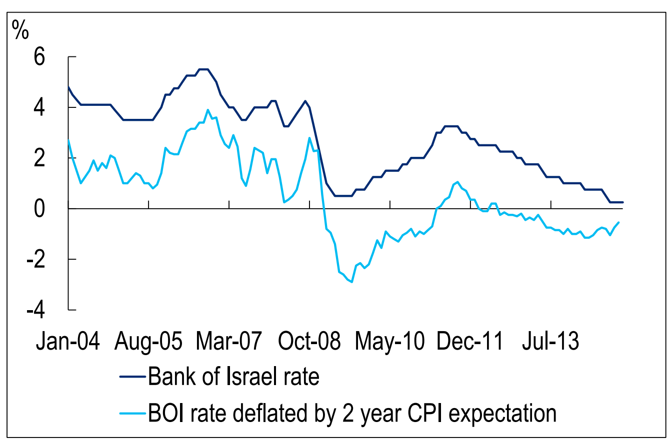

Source: Haver Analytics, Citi Research

**Figure 170. …on the back of a sharply improving current account balance…**




Source: Bloomberg, Citi Research

**Figure 171. …giving room for the BOI to cut rates, and, probably, increase its effort to weaken the shekel**




Source: Bloomberg, Citi Research

**Figure 172. Israel Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 214 | 206 | 233 | 258 | 257 | 291 | 301 | 286 | 291 |
| Nominal GDP, local currency bn | 768 | 812 | 871 | 925 | 992 | 1,049 | 1,079 | 1,106 | 1,134 |
| GDP per capita, USD | 30,101 | 28,383 | 31,440 | 34,263 | 33,648 | 37,573 | 38,440 | 36,086 | 36,251 |
| Population, mn | 7.1 | 7.3 | 7.4 | 7.5 | 7.6 | 7.7 | 7.8 | 7.9 | 8.0 |
| Unemployment, % of labour force | 7.7 | 9.4 | 8.3 | 7.1 | 6.9 | 6.3 | 6.4 | 6.8 | 6.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 4.0 | 1.7 | 5.5 | 4.4 | 3.1 | 3.1 | 2.3 | 2.2 | 2.5 |
| Real investment growth % yoy | 4.8 | -2.6 | 9.9 | 14.7 | 3.1 | 1.1 | 4.5 | 6.5 | 2.5 |
| Real consumption growth % yoy | 1.4 | 2.6 | 4.0 | 3.0 | 3.3 | 3.4 | 2.0 | 2.1 | -1.3 |
| private consumption growth % yoy | 1.3 | 2.4 | 4.4 | 3.1 | 3.0 | 3.4 | 2.1 | 2.4 | -1.6 |
| Real export growth, % yoy | 7.4 | -12.4 | 16.2 | 6.2 | 1.0 | 2.0 | 3.0 | 4.0 | 4.9 |
| Real import growth, % yoy | 2.2 | -12.8 | 14.1 | 11.2 | 3.3 | -1.4 | 1.6 | 3.5 | 3.6 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 3.8 | 3.9 | 2.7 | 2.2 | 1.6 | 1.8 | 0.6 | 0.3 | 1.4 |
| CPI, % avg | 4.6 | 3.3 | 2.7 | 3.5 | 1.7 | 1.5 | 0.5 | 0.3 | 1.0 |
| Nominal wages, % yoy | 3.8 | 0.7 | 3.4 | 3.8 | 2.6 | 2.5 | 5.0 | 5.0 | 5.0 |
| Credit extension to private sector, % yoy | -0.4 | 6.4 | 7.1 | 4.9 | 3.4 | 1.9 | 4.0 | 4.5 | 5.0 |
| Policy Interest Rate, % eop | 2.50 | 1.00 | 2.00 | 2.75 | 2.00 | 1.00 | 0.00 | 0.25 | 0.50 |
| 3 month inter-bank rate, %, eop | 1.90 | 1.31 | 2.06 | 2.74 | 1.75 | 0.99 | 0.25 | 0.25 | 0.50 |
| ILS/US$, eop | 3.78 | 3.79 | 3.52 | 3.81 | 3.73 | 3.47 | 3.76 | 3.90 | 3.88 |
| ILS/US$, avg | 3.58 | 3.93 | 3.73 | 3.58 | 3.85 | 3.61 | 3.59 | 3.87 | 3.90 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 3.2 | 8.0 | 7.9 | 3.9 | 2.1 | 6.9 | 5.9 | 5.2 | 9.5 |
| % of GDP | 1.5 | 3.9 | 3.4 | 1.5 | 0.8 | 2.4 | 2.0 | 1.8 | 3.3 |
| Trade balance | -6.4 | 0.7 | -1.9 | -8.1 | -9.7 | -9.3 | -5.0 | -2.3 | 3.0 |
| Exports | 58.0 | 46.8 | 56.4 | 64.3 | 62.0 | 62.0 | 71.0 | 75.3 | 80.5 |
| Imports | 64.4 | 46.1 | 58.3 | 72.4 | 71.8 | 71.3 | 76.0 | 77.5 | 77.5 |
| Service balance | 5.2 | 5.1 | 6.7 | 6.8 | 10.2 | 13.5 | 9.0 | 12.0 | 11.0 |
| Income balance | -4.0 | -5.1 | -5.2 | -3.6 | -6.5 | -6.3 | -6.1 | -4.5 | -4.5 |
| FDI, net | -3.7 | -2.7 | 3.6 | 0.1 | -4.8 | -7.1 | 4.0 | 6.0 | 7.0 |
| International reserves | 42.5 | 60.6 | 70.9 | 74.9 | 76.0 | 81.8 | 87.0 | 95.0 | 100.0 |
| Total amortisations | 4.1 | 4.7 | 5.2 | 16.2 | 7.8 | 7.3 | 4.2 | 3.0 | 5.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -1.2 | -4.2 | -2.8 | -2.5 | -3.5 | -2.7 | -3.0 | -3.3 | -2.5 |
| Consolidated gov primary balance | 4.0 | 1.0 | 2.3 | 2.5 | 1.4 | 2.1 | 1.6 | 3.0 | 3.0 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 2.8 | 1.9 | 3.0 | 2.8 | 2.4 | 2.0 | 1.6 | 3.0 | 2.8 |
| CPI, % yoy eop | 0.5 | -0.3 | 0.2 | 0.0 | 0.3 | 0.6 | 0.3 | 1.7 | 1.1 |
| Policy interest rate, %, eop | 0.75 | 0.25 | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 |
| Short-term market rate, % eop | 0.65 | 0.21 | 0.20 | 0.05 | 0.05 | 0.05 | 0.25 | 0.25 | 0.25 |
| ILS/US$, eop | 3.43 | 3.68 | 3.76 | 3.81 | 3.87 | 3.90 | 3.90 | 3.90 | 3.90 |

Source: National Sources, Citi Research forecasts

# Kazakhstan

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- **Summary view** — Heightened geopolitical uncertainty in the CIS region, China slowdown and lower oil prices will keep economic activity subdued in 2015. We forecast 2014 and 2015 GDP growth at 4.0% and 4.3% (6.0% in 2013). More activist government policy may provide support to growth.
- **Things to watch** — One recent key macro concern has been the deterioration of the current account position, driven by a steady decline in exports related to sluggish global growth. Citi's forecast for oil prices in 2015 at $80bbl may continue to exert pressures on the current account.
- **Strategy** — The National Bank of Kazakhstan (NBK) devalued the tenge by 20% in Feb by announcing a new central level for the USDKZT of 185 within a 182-188 band. The NBK widened the corridor to 170-188 on 11 September. The NBK has now the resources to support the KZT, but pressures will re-emerge in 2015.

## Growth to remain subdued in 2015

**GDP growth has been on a broad uptrend since 2010.** Kazakhstan recovered strongly from the recession in 2009, posting above 7% GDP growth rates in 2010 and 2011. The pace of economic activity moderated in 2012 in line with more challenging global conditions, with GDP expanding at 5% and picking up pace to 5.9%YoY in 2013.

**We now estimate that 2014 GDP will decelerate to 4.0% on heightened regional uncertainty and a China slowdown.** Events in Ukraine and Russia already act as some headwinds for the economy. Industrial production has started the year on a downbeat note, contracting 0.3%YoY during Jan-Oct. Consumption will remain a key driver in 2014, although the pace of expansion will moderate. A slowdown in China will also bite. As a result, we see 2014 GDP growth weakening to 4.0% from 5.9% 2013.

**Economic performance in 2015 will be additionally challenged by lower oil prices, although a relatively low break-even oil price will ensure macroeconomic stability.** Citi commodity strategists see Brent oil prices moderating to US$80/bbl in 2015 from US$101/bbl, which will provide a new headwind to economic activity. As a result, we forecast that GDP growth will remain subdued by Kazakh standards at 4.3% in 2015 (6.4% average over 2010-2013). At the same time, Kazakhstan has one of the lowest break-even oil prices among oil-exporters at US$65bbl and this should ensure that macroeconomic performance will still be robust even in the face of already materializing sizable decline in oil prices.

**The government also intends to provide countercyclical support to GDP via spending from the National Oil Fund.** In recognition of the intensifying headwinds to growth, the government announced that it will tap the National Oil Fund and spend US$3bn (1.4% of 2014 GDP) annually during 2015-2017 to prop up economic activity. The money will be chiefly invested in infrastructure projects, including building roads and terminals.

**Growth will continue to be supported by consumption, but investment and industrial production should make a stronger contribution in 2015.** The last couple of years were characterized by diverging behavior of retail sales and industrial production. While real retail sales grew at 12.8% during 2013, industrial production increased only 2.3% in the same time period. The rift has deepened in 2014, with retail sales expanding by 12.1% YoY during Jan-Oct and industrial production contracting by 0.3% YoY in the same period. However, the infrastructure spending that the government plans for 2015 will boost real investment spending from an estimated 3.0% in 2014 to 4.0% in 2015.

**While the broader macro-economy has been reasonably solid, the worsening current account position is a key reason for concern.** The current account surplus dipped from 5.5% of GDP in 2011 to only 0.5% in 2013 on slower global growth. The current account surplus improved to US$6.2bn in 1Q and US$0.4bn in 2Q and we estimate that the full-year surplus will amount to 2.3% of GDP. However, much lower oil prices in 2015 will weaken the surplus to 1.8% of GDP in 2015.

**The deterioration of the external position has also led to a decline in reserves.** Gross foreign reserves have followed current account's performance, falling from a high of US$35.0bn in April 2012 to a low of US$23.7bn in October 2013. Foreign reserves have more recently improved, rising to US$28.3bn in October 2014.

## Another devaluation may be in store in 2015

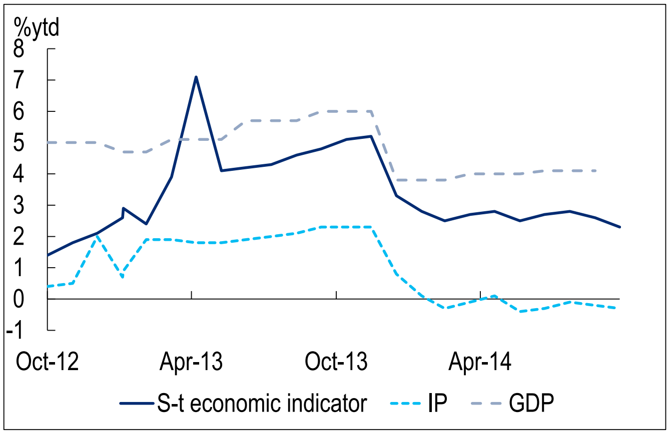
**This led to the National Bank of Kazakhstan (NBK) to devalue the tenge by 20% in early February 2014.** The new central level for the USDKZT is 185, with the tenge being allowed to fluctuate between 182 and 188. The NBK has a history of adjusting the tenge to sizable moves in the RUB (early 2009 a prime example) and the NBK's statement explicitly cites concerns about the RUB and, more generally, about potential loss of competitiveness. Devaluation fears had also been growing in the country with the FX share of deposits rising rapidly from 29.8% in December 2012 to 47.7% in March 2014, although it dropped to 45.6% in September.

**The NBK widened the corridor to 170-182 in September 2014.** The central bank widened the band of the corridor to 170-185 from 182-188 in September, allowing more flexibility for the tenge on the downside.

**However, the move to a free float in Russia has led to the RUBKZT reaching levels well below those at which the tenge was devalued in Feb, inviting fresh concerns that another devaluation may be imminent.** The NBK has argued that it is now comfortable with a range for the RUBKZT at 3.5-4.5, which suggests that another drop of 10% of the KZT against the RUB will lead to the RUBKZT breaking the lower level of that band. From a broader perspective, the KZT REER is still running at levels that suggest that the tenge is now broadly fairly valued. Still, if geopolitical uncertainty intensifies, putting additional pressure on the RUB and forcing the RUBKZT to fall below 3.5, the NBK may have a stronger incentive to consider bringing the tenge more in line with the RUB.

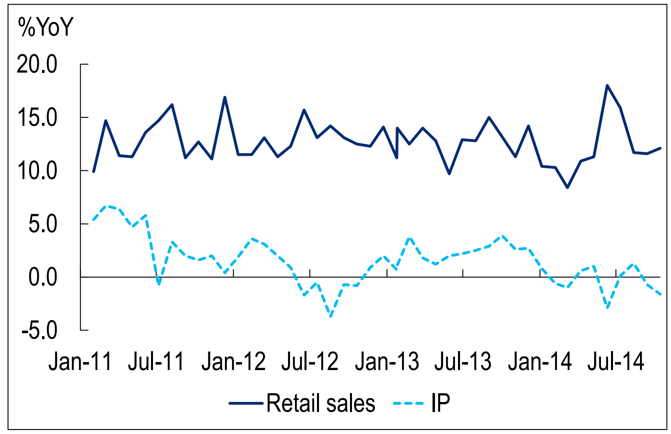
**The social aspects of effecting another devaluation also need to be considered.** The Feb devaluation brought about significant dissatisfaction among the population, although social unrest was minimal. Still, in our view authorities will be very cautious to introduce another devaluation so soon after the last one on order not to run the risk of inviting stronger dissatisfaction among the population. Given the significant devaluation implemented in Feb, we think that a further step down that road will only be taken in the event of oil prices declining to well below US$80 and/or geopolitical tensions significantly intensifying.

Figure 173. Economic activity is seeing headwinds



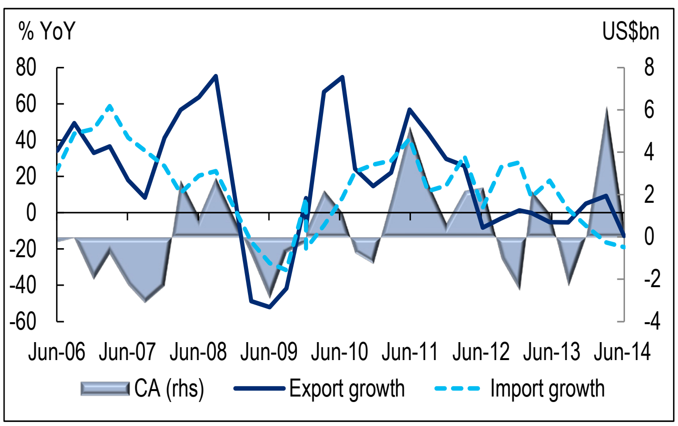

Source: Kazstat, Citi Research

Figure 174. Growth is mainly consumption driven as production struggles



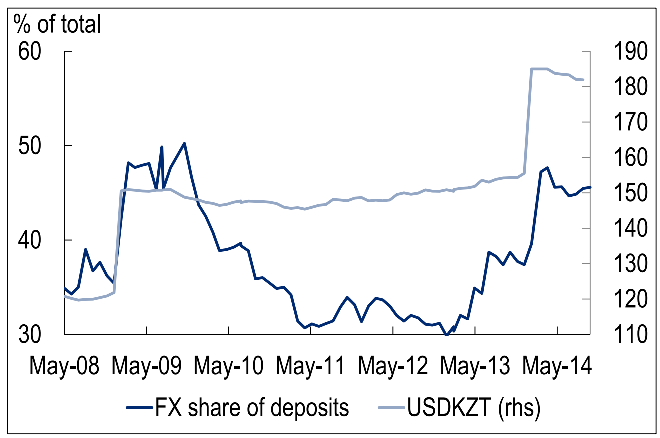

Source: Kazstat, Citi Research

Figure 175. Current account improved in 1H



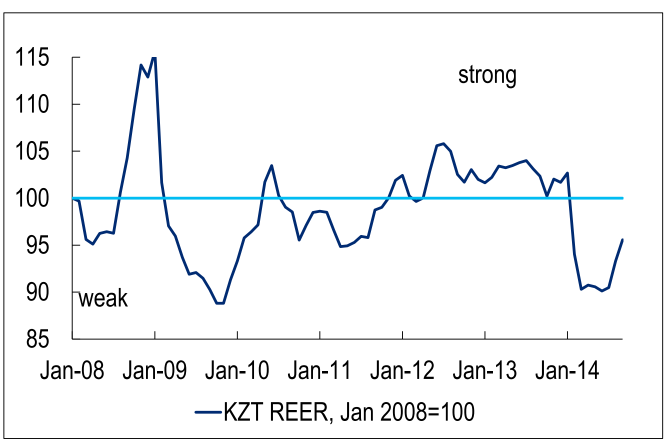

Source: NBK, Citi research

Figure 176. FX share of deposits have started to stabilize after the Feb devaluation



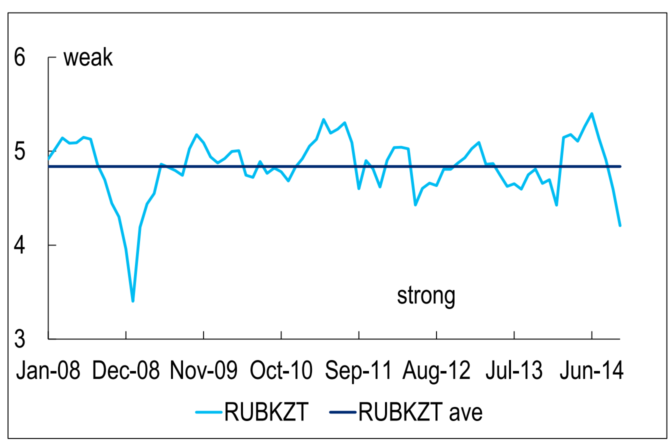

Source: NBK, Citi Research

Figure 177. Tenge is not too strong when judged by the REER…




Source: NBK, Citi Research

Figure 178. …although it has now fallen against the RUB to levels below those at which at which it was devalued in Feb




Source: Bloomberg, Citi Research

**Figure 179. Kazakhstan Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 136 | 111 | 146 | 186 | 202 | 222 | 208 | 223 | 245 |
| Nominal GDP, local currency bn | 16,350 | 16,386 | 21,323 | 27,305 | 30,147 | 33,772 | 37,293 | 41,159 | 45,323 |
| GDP per capita, USD | 8,730 | 7,056 | 9,171 | 11,568 | 12,426 | 13,503 | 12,513 | 13,272 | 14,385 |
| Population, mn | 15.6 | 15.7 | 15.9 | 16.1 | 16.3 | 16.4 | 16.6 | 16.8 | 17.0 |
| Unemployment, % of labour force | 6.6 | 6.6 | 5.8 | 5.4 | 5.3 | 5.2 | 5.2 | 5.2 | 5.2 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 3.6 | 0.8 | 7.3 | 7.5 | 5.0 | 5.9 | 4.0 | 4.3 | 5.0 |
| Real investment growth % yoy | -12.8 | 2.3 | 2.0 | 5.9 | 12.2 | 10.7 | 2.3 | 3.1 | 3.5 |
| Real consumption growth % yoy | 6.0 | 0.7 | 10.0 | 10.9 | 11.4 | 8.2 | 3.7 | 4.3 | 5.7 |
| private consumption growth % yoy | 6.4 | 0.7 | 10.9 | 10.9 | 11.2 | 9.0 | 4.0 | 4.5 | 5.8 |
| Real export growth, % yoy | 0.9 | -11.9 | 3.1 | 0.4 | 4.7 | -0.2 | 2.0 | 2.0 | 3.5 |
| Real import growth, % yoy | -11.5 | -15.7 | 2.9 | 2.8 | 20.9 | 5.2 | 3.0 | 6.0 | 7.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 9.5 | 6.2 | 7.8 | 7.4 | 6.1 | 4.6 | 7.5 | 5.7 | 5.5 |
| CPI, % avg | 17.1 | 7.3 | 7.1 | 8.3 | 5.2 | 5.8 | 6.6 | 6.4 | 5.7 |
| Nominal wages, % yoy | 16.2 | 10.8 | 14.9 | 15.9 | 13.5 | 6.8 | 7.0 | 6.0 | 7.0 |
| Credit extension to private sector, % yoy | 5.2 | 7.3 | 0.3 | 15.8 | 12.1 | 12.8 | 12.0 | 10.0 | 15.0 |
| Policy Interest Rate, % eop | 10.50 | 7.00 | 7.00 | 7.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 |
| 3 month inter-bank rate, %, eop | 12.00 | 4.95 | 2.00 | 2.00 | 3.00 | 6.50 | 8.00 | 7.00 | 6.00 |
| KZT/US$, eop | 121 | 149 | 147 | 148 | 150 | 154 | 185 | 185 | 185 |
| KZT/US$, avg | 120 | 147 | 147 | 147 | 149 | 152 | 179 | 184 | 185 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 6.3 | -4.1 | 1.4 | 10.2 | 1.0 | 1.1 | 4.7 | 4.0 | 5.2 |
| % of GDP | 4.6 | -3.7 | 0.9 | 5.5 | 0.5 | 0.5 | 2.3 | 1.8 | 2.1 |
| Trade balance | 33.6 | 15.0 | 28.5 | 44.8 | 38.1 | 34.8 | 37.9 | 39.3 | 42.3 |
| Exports | 72.0 | 43.9 | 61.4 | 85.2 | 86.9 | 85.6 | 90.7 | 95.3 | 100.0 |
| Imports | 38.4 | 28.9 | 32.9 | 40.3 | 48.8 | 50.8 | 52.8 | 56.0 | 57.7 |
| Service balance | -6.9 | -6.0 | -7.2 | -6.6 | -7.9 | -6.9 | -6.0 | -7.0 | -7.5 |
| Income balance | -19.4 | -12.4 | -19.4 | -27.7 | -28.1 | -25.2 | -26.2 | -27.3 | -28.7 |
| FDI, net | -13.1 | -10.1 | -3.7 | -8.6 | -11.9 | -8.1 | -6.0 | -8.6 | -8.6 |
| International reserves | 19.9 | 22.7 | 27.7 | 28.8 | 27.7 | 24.1 | 29.9 | 34.2 | 38.8 |
| Total amortisations | 34.1 | 39.0 | 25.4 | 29.6 | 31.9 | 31.9 | 10.5 | 11.1 | 5.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -2.0 | -3.1 | -2.6 | -2.1 | -3.0 | -2.0 | -2.4 | -2.2 | -1.9 |
| Consolidated gov primary balance | -8.8 | -9.3 | 3.0 | 6.3 | 4.4 | 4.5 | 3.0 | 2.9 | 2.8 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 3.2 | 3.9 | 5.0 | 5.1 | 5.3 | 4.0 | 3.2 | 4.4 | 4.6 |
| CPI, % yoy eop | 6.8 | 7.5 | 7.5 | 6.4 | 6.3 | 6.0 | 5.7 | 5.9 | 5.7 |
| Policy interest rate, %, eop | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 |
| Short-term market rate, % eop | 6.50 | 6.50 | 8.00 | 8.00 | 7.00 | 7.00 | 7.00 | 6.00 | 6.00 |
| KZT/US$, eop | 184 | 182 | 185 | 185 | 185 | 185 | 185 | 185 | 185 |

Source: National Sources, Citi Research forecasts

# Levant

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**The coming year will be critical in determining whether the threat of jihadi extremism in the Levant will recede, or whether the devastating violence in Syria and Iraq will continue to destablise the region.**

**The confirmation of the Iraqi Defence and Interior ministers is a significant step towards bolstering the government of Prime Minister Haider al-Abadi.** We believe the most urgent task of the new government is to pave the way toward some sort of reconciliation or accommodation between the country's polarized sectarian populations, and in particular to reduce the sense of disenfranchisement and marginalization among the Sunni population that has enabled the rise of extremist insurgency in Sunni-dominated areas. The completion of a broad-based unity government goes a long way to establishing these political pre-conditions, in our view.

**Further evidence of the improving political climate is provided by the Kurdish-Baghdad détente, which bolsters government efforts to oppose ISIS, as well as plans to raise oil exports. In October, the Kurdish leadership announced that it would participate in the new government despite outstanding issues. The following month,** a temporary agreement on the issue of oil exports was signed between Baghdad and Erbil. This deal saw a one-off payment of US$500m to the Kurds, in return for the right to sell 150,000 barrels per day of Kurdish oil under the federal umbrella.

**In our view, the deal is little more than a confidence building measure as it resolves none of the outstanding issues between the two sides.** These include the resumption of regular budget payments to Erbil, the budgetary arrears that Baghdad is running towards Erbil, the question of rights to export, or the recently annexed Kirkuk fields. This was a 'non-deal', in our view – a limited show of goodwill to allow negotiations towards a more substantial deal to continue.

**Despite this, we believe the announcement supports our relatively bullish view on the prospects for a workable deal emerging in the first half of 2015**, maybe even within the context a grand agreement on issues as wide-ranging as the disputed territories, Peshmerga financing, etc.

**Despite each side's seemingly unshakeable public stance on the principles pertaining to oil exports, we believe a number of developments argue for a higher likelihood of compromise.** These include:

– **A change of guard**: PM Al Abadi has the opportunity to rebuild trust between Baghdad and Erbil which was significantly damaged under the leadership of Nouri al Maliki. While Abadi will remain constrained by his Shia constituency, he will have a greater capacity for compromise than his predecessor, in our view.

– **Narrowing of options for Erbil**: while the KRG may still harbour long-term hopes of independence, we believe that international support, particularly by Turkey, of such an eventuality has diminished markedly in recent months. The threat of ISIS has highlighted the importance of maintaining workable relations between Ankara-Baghdad-Tehran, and the emergence of a new leadership in Iraq has rekindled enthusiasm in Ankara for the 'win-win-win' solution: a deal between Erbil and Baghdad that will benefit Turkey. Without a realistic hope of independence, the KRG might be forced to compromise for a workable deal.

– **ISIS crisis**: not only has the ISIS offensive brought Baghdad and Erbil into common cause, it has acted to significantly increase the influence of international players, especially the United States, in Iraqi domestic policy. This influence will likely be brought to bear to ensure Iraq's leadership compromises, in our view.

- **Financial motives**: for Baghdad, the loss of the Kirkuk-Ceyhan pipeline to fighting and the recent fall in oil prices means a looming revenue crisis, while for Erbil the lack of success in getting paid for its exports to date while remaining cut off from the federal budget is hurting domestically.

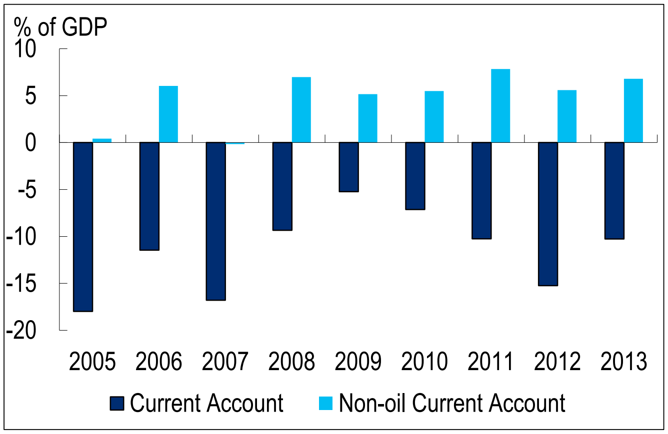
**Militarily, the fight against ISIS appears to be bearing fruit.** US-led airstrikes in Iraq and Syria have been decisive in halting ISIS's advance and have turned the military balance against the extremist group. In the past month, the Syrian Kurdish border-town of Kobani has become the focal point of the conflict, as ISIS has striven and failed to gain control of the strategic border-crossing at great loss of life (481 fighters, according to the Syrian Observatory for Human Rights). Their failure is in large part due to the intensity of US-led aerial bombardment, and the story is repeated numerous times across northern Syria and Iraq. Kurdish and Iraqi security forces have made headway in recapturing strategic towns.

**We believe that while the international will to defeat ISIS in Iraq is strong, this does not translate into a will to eliminate the Jihadi insurgency in the Levant as a whole.** Specifically, US-led airstrikes against Jihadist groups in northern Syria do not appear to have undermined the operational capacity of these groups to attack government forces and areas, as evidenced by the recent successful raid on Idlib by Jabhat al-Nusra (JAN) militants, al Qaeda's official affiliate in the region. In our view, this reflects a key policy dilemma of the US-led coalition: that a comprehensive defeat of Jihadists in the Levant would hand a victory to the Assad regime in Damascus and its allies, including Iran, Russia and Hizbollah. This would be an unacceptable outcome, and hence we do not believe that military action will bring about an end to the Syrian civil war any time soon.

**The prolonging of the conflict in Syria spells risks for neighbouring Lebanon, in our view.** Not only has the Lebanese economy been overwhelmed by the arrival of over 1 million displaced Syrians (20% of the Lebanese population), the Syrian civil war has also threatened to flare up already heightened sectarian tensions within Lebanon. A spate of bombings in Beirut in the summer appears to have subsided, but after the attack and capture of Arsal by JAN militants in August, the northern city of Tripoli has in recent days seen fighting between government troops and forces linked with JAN. The Jihadi group has responded by threatening to execute 30 Lebanese soldiers it has been holding since the fighting in Arsal in the summer, and shelling Hizbollah positions in the Bekaa Valley.

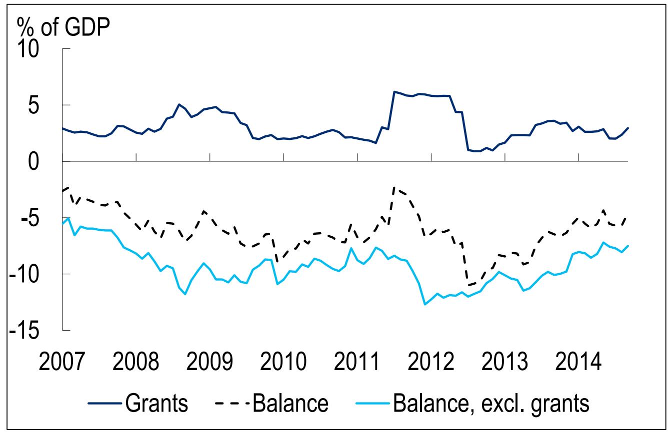
**While the fiscal, economic and political picture looks difficult, our view remains that the slide in country risk does not necessarily signal a slide in Lebanese sovereign risk.** This is because we believe the stability of the sovereign risk profile rests on the robustness of the Lebanese banking sector and its ability to continue funding the government. Banking sector indicators remain robust. Overall deposit growth was 7% yoy in February, with non-resident deposit growth remaining in the double digits (11%). The dollarisation ratio remained stable at under 60%, and the risk premium on Lebanese Lira deposits has likewise hardly moved in recent months. In our view, the banking sector remains sound and liquid and retains significant capacity to continue financing the Lebanese sovereign through the purchase of government securities. This keeps sovereign risk in check, despite an evidently deteriorating country risk profile (see Lebanon Macro View - The gap widens between country and sovereign risk)

**Figure 180. Jordan current account dominated by oil imports …**



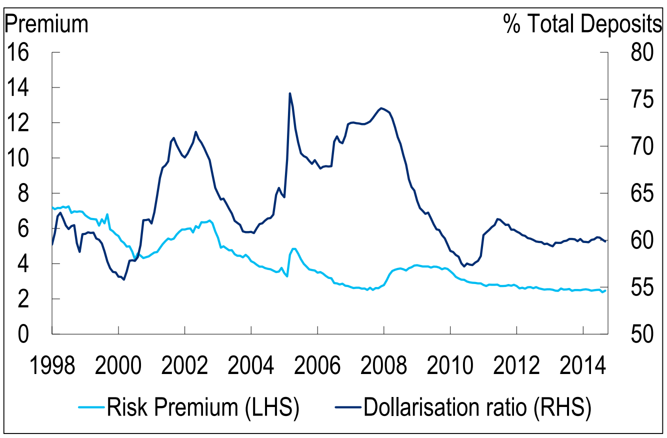

Source: Haver Analytics, Citi Research

**Figure 181. Without grants Jordan's fiscal situation would be worse**



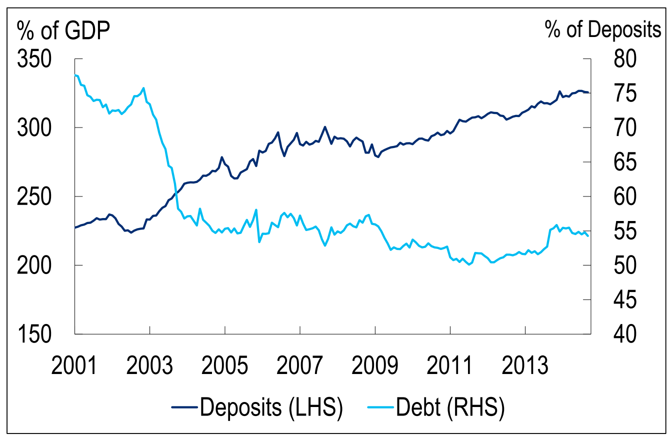

Source: Haver Analytics, Citi Research

**Figure 182. Lebanon dollarization has gone up, but risk premium stable**



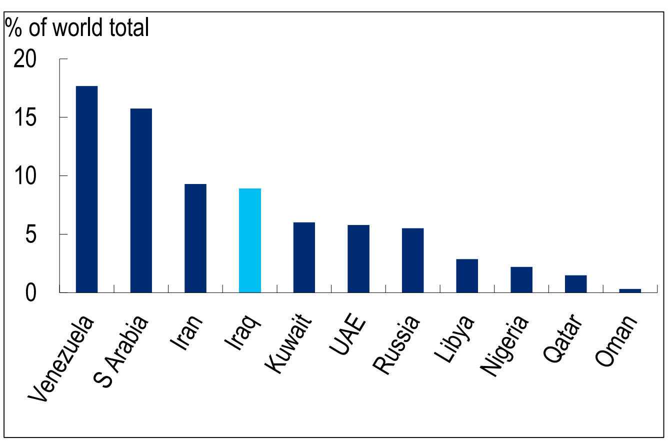

Source: Haver Analytics, Citi Research

**Figure 183. Deposit growth has been slowing, but still plenty of capacity**



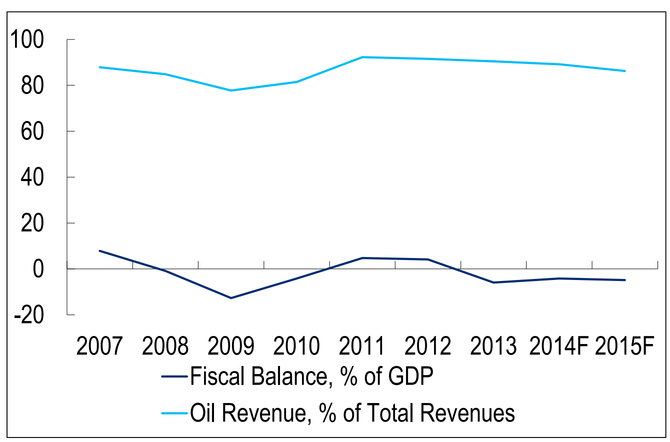

Source: Haver Analytics, Citi Research

**Figure 184. Iraq has world's fourth largest proven oil reserves and …**




Source: BP, Citi Research

**Figure 185. … public finances should strengthen as a result**




Source: Haver Analytics, Citi Research

**Figure 186. Levant Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **IRAQ** | | | | | | | | | |
| Nominal GDP, USD bn | 135.6 | 113.6 | 138.9 | 186.3 | 216.6 | 230.1 | 225.5 | 228.1 | 265.3 |
| GDP per capita, USD | 4,607 | 3,766 | 4,487 | 5,871 | 6,655 | 6,892 | 6,586 | 6,497 | 7,369 |
| Real GDP, yoy avg | 6.6 | 5.8 | 5.5 | 10.2 | 10.3 | 6.8 | 0.1 | 8.9 | 10.4 |
| CPI, % avg | 2.7 | -2.2 | 2.4 | 5.6 | 6.1 | 1.9 | 2.5 | 5.0 | 5.0 |
| IQD/US$, avg | 1,189 | 1,156 | 1,167 | 1,171 | 1,164 | 1,162 | 1,162 | 1,162 | 1,162 |
| Current account, US$bn | 28.4 | -1.3 | 6.3 | 26.2 | 39.6 | 32.4 | 21.0 | 5.8 | 13.8 |
| % of GDP | 20.9 | -1.1 | 4.6 | 14.1 | 18.3 | 14.1 | 9.3 | 2.5 | 5.2 |
| Consolidated gov. balance, % of GDP | -0.9 | -12.7 | -4.2 | 4.7 | 4.1 | -5.9 | -4.2 | -4.8 | -0.9 |
| **JORDAN** | | | | | | | | | |
| Nominal GDP, USD bn | 22.0 | 23.9 | 26.5 | 28.8 | 30.9 | 33.6 | 35.7 | 38.1 | 40.9 |
| GDP per capita, USD | 3,722 | 3,866 | 4,104 | 4,284 | 4,404 | 4,615 | 4,712 | 4,839 | 4,995 |
| Real GDP, yoy avg | 7.2 | 5.5 | 2.3 | 2.6 | 2.7 | 2.8 | 3.6 | 3.8 | 4.3 |
| CPI, % avg | 13.9 | -0.7 | 5.0 | 4.4 | 4.8 | 5.5 | 3.0 | 4.0 | 4.2 |
| JOD/US$, avg | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 | 0.71 |
| Current account, US$bn | -2.1 | -1.2 | -1.9 | -3.0 | -4.7 | -3.5 | -3.3 | -1.0 | -0.8 |
| % of GDP | -9.3 | -5.2 | -7.1 | -10.3 | -15.3 | -10.3 | -9.2 | -2.7 | -2.0 |
| Consolidated gov. balance, % of GDP | -4.4 | -8.9 | -5.6 | -6.8 | -8.3 | -5.5 | -6.4 | -6.8 | -6.8 |
| **LEBANON** | | | | | | | | | |
| Nominal GDP, USD bn | 28.8 | 35.1 | 38.0 | 40.1 | 43.0 | 44.2 | 46.7 | 52.4 | 56.8 |
| GDP per capita, USD | 7,572 | 9,111 | 9,726 | 10,126 | 10,647 | 10,731 | 11,112 | 12,234 | 12,993 |
| Real GDP, yoy avg | 9.1 | 10.3 | 8.0 | 2.0 | 2.5 | 1.7 | 3.6 | 9.8 | 5.8 |
| CPI, % avg | 10.8 | 1.2 | 4.0 | 5.0 | 6.6 | 2.1 | 1.6 | 2.3 | 2.5 |
| LBP/US$, avg | 1,507 | 1,504 | 1,502 | 1,506 | 1,504 | 1,507 | 1,508 | 1,508 | 1,508 |
| Current account, US$bn | -3.2 | -4.4 | -5.1 | -5.1 | -5.5 | -5.8 | -7.0 | -5.0 | -4.8 |
| % of GDP | -11.1 | -12.5 | -13.3 | -12.8 | -12.7 | -13.1 | -14.9 | -9.6 | -8.4 |
| Consolidated gov. balance, % of GDP | -10.1 | -8.4 | -7.6 | -5.8 | -9.1 | -9.5 | -9.5 | -8.9 | -8.6 |

Source: National Sources, Citi Research forecasts

# Nigeria

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- **Summary view** — Political uncertainty and a falling oil price will eventually combine to force a modest naira devaluation in early 2015. While this initially pushes up inflation and slows growth, the adjustment should feed through the economy by late 2015 and into 2016.
- **Things to watch** — The weakening of the oil price has increased pressure on the naira since early October. Although the CBN and policy makers have a number of policy options to limit naira weakness, including tightening monetary policy, there is a limit to reserve burn they can tolerate.
- **Strategy** —The finance minister, Ngozi Okonjo-Iweala, will seek to maintain fiscal discipline despite the approaching elections, while progress with structural reform is likely to stall. All eyes will then focus on the outcome of the elections and the policy choices the new government makes in 2H 2015.

## Strains increasingly show as elections approach

**As 2014 has drawn to a close, Nigeria has increasingly seemed an economy under pressure.** On the political front the rapidly approaching elections have increased political tensions. And the tensions have been increased by the ongoing battle against Boko Haram. Meanwhile, although the economy has been growing robustly according to the GDP data, corporate earnings in the banking and consumer sector have been poor. And to top it off, the naira has come under sustained pressure as the world oil price has weakened significantly. And the problem has been made worse by the relatively uncoordinated approach to this pressure by the ministry of finance and the Central Bank of Nigeria (CBN).

## Naira policy will be under the spotlight

**None of these stresses and strains is likely to ease before the elections or in their immediate aftermath.** In particular, in the next six months, the main focus will be on the naira and the CBN's response to this. On the one hand, there is a very strong argument that the CBN will be very unwilling to allow a major devaluation of the currency prior to the elections given the political fallout this would potentially create. Very few members of Nigeria's political elite see devaluation as a positive factor for Nigeria, especially given fears it will push up inflation. As such, the CBN is unlikely to step aside from defending the naira without a fight.

**However, the real question is whether the CBN avoid it.** This is likely to depend on the extent to which it is prepared to tighten monetary policy in a pre-election period, the rate of reserve burn over the coming months, and whether oil prices keep falling or partially recover in early 2015. But of all these variables, probably the most important is foreign exchange reserves. If reserves fall to around the US$30bn level, the options facing the CBN will quickly become much starker: either it opts to keep spending reserves to support the currency; or it allows a significant devaluation. Or more worryingly, it imposes greater currency and capital controls.

**Even if the CBN can keep the currency relatively stable up to the polls and even if it has run down reserves to achieve this, the naira will remain under pressure unless the oil price recovers significantly**. This means that after the election it is likely to have to re-think its commitment to nominal naira stability. With our forecasts for the oil price being at its weakest in 2Q 2015, we think a devaluation is most likely after the elections, but before the new National Assembly is sitting, or when political opposition is potentially most limited.

## The economic impact of naira devaluation

**Despite the clear political opposition to devaluation in Nigeria, on our oil price forecasts of around US$80-85/b in 2015-16 we still think it will have to happen, even if the scale remains relatively limited**. As such its economic impact will be relatively minor with the naira falling about 10-15%, but likely to stabilize at somewhere between NGN185-195:US$1. But knowing the scale of the devaluation is very hard and in addition to the uncertainty over this, it is also not clear what sort of exchange rate policy that the CBN will adopt after allowing a more major move. While initially it is likely to want a short term period of new stability, with the oil price remaining low it is going to have to think about a more flexible exchange rate policy unless it wants to continue to run a very tight monetary policy which seems unlikely.

**A devaluation of this scale will push up imported inflation**. But if 2009-10 is a guide following a more significant devaluation, this will be relatively modest. And while it will provide a boost to government revenue we expect a modest rise in the fiscal deficit. While it will also push the current account into a deficit in 2015, the future path of this depends heavily on oil production trends. But even with a modest deficit, Nigeria has low debt levels and can easily finance deficits of the forecast magnitude through increased borrowing. But, coupled with the political tensions, this still means that the economy will be under pressure in 1H 2015. But as the impact of the devaluation works its way through the real economy it should start to recover as the year progresses.

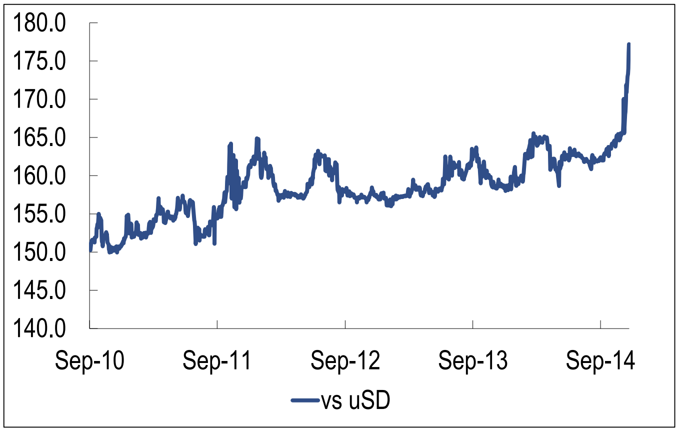
**The speed of the recovery in 2H 2015 will also be exacerbated by the outcome of the elections.** Although there is not really a major difference in the policy agendas of the two main parties, there is an argument that if the incumbent president, Jonathan Goodluck, and the ruling People's Democratic Party (PDP) remain in power, we would expect a relatively robust policy response. After all many of their key policies, notably power sector reform, are largely in place and could be quickly accelerated supporting the economy. Conversely it would take longer for the All Progressives Congress (APC) to put together a government and implement its policies (although once established in power, they may show significant policy dynamism in their early days in office).

## Lower oil prices are a potential spur to reform

**But whoever wins the polls will also face ongoing and major challenges in running Nigeria in an era of lower oil prices**. Even if, as we think, the new Nigerian government can broadly live with the new projected oil prices, both the Federal government and state governors will have to face a new financial reality and curtail the excessive spending of recent years. But most problems in Nigeria are not resolved by money. For example, a long term political solution with Boko Haram is unlikely to be based on money, but a combination of military competence and astute political negotiation.

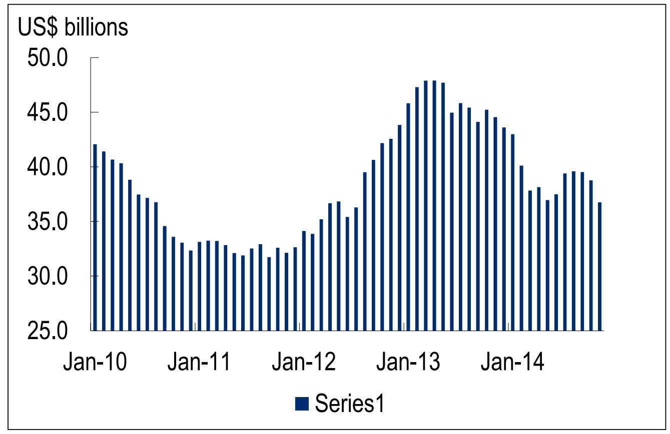
**And while a lower price can promote greater political infighting, it can just as easily be a spur for a greater reform effort**. While a lower oil price affects our naira, fiscal and current account outlook, after the GDP revision the oil sector is now a relatively small sector of the economy, whose main engines are clearly the service and agricultural sectors. Moreover, the future of these sectors is crucially dependent on the implementation of the proposed power sector reform, not the oil price. However, to really fully adjust to a lower oil price and move on, Nigeria will have to allow an exchange rate adjustment and adopt a more flexible regime after this. Battling to defend a nominal peg is arguably the worst possible approach.

**Figure 187. Pressure on the naira has come and gone in 2014, and is currently on as the oil price has weakened**



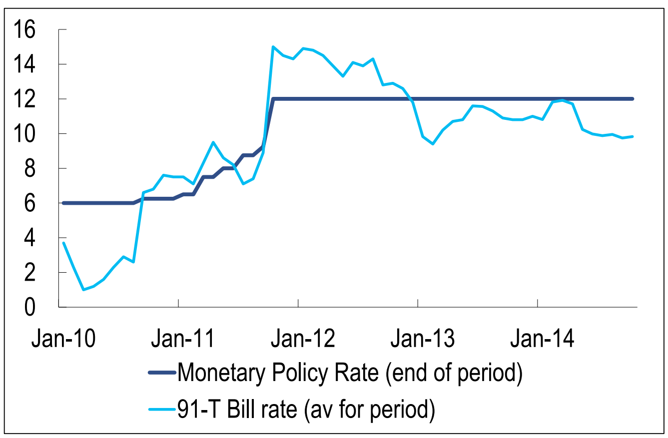

Source: National Bureau of Statistics

**Figure 188. Reserves have also started to come pressure again in late 2014**



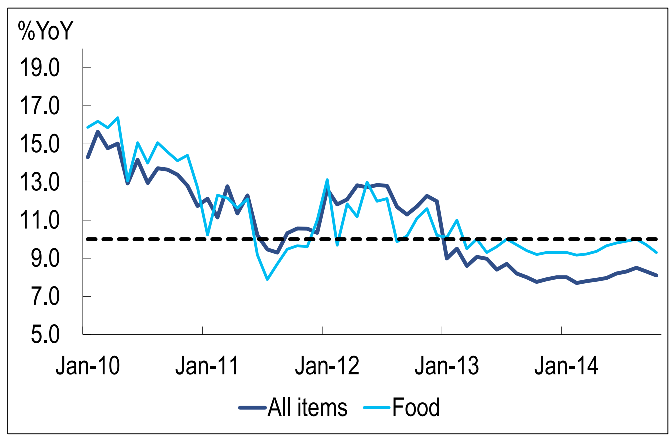

Source: International Energy Agency

**Figure 189. In response, the CBN has had to think about tightening a long unchanged monetary policy**



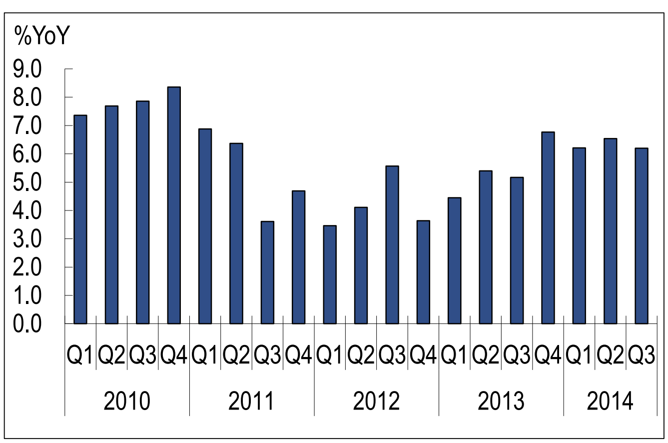

Source: National Bureau of Statistics

**Figure 190. Even though inflation has remained in single digits so far in 2014**



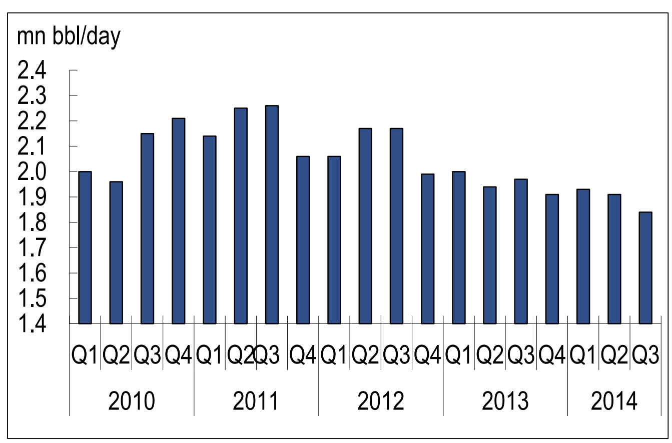

Source: Central Bank of Nigeria

**Figure 191 New growth data shows an economic recovery since 2H 2013, but can it be sustained with the naira under pressure**




Source: Reuters

**Figure 192. At least oil production seems to have stabilized a bit recently**




Source: Haver Analytics and Central Bank of Nigeria

**Figure 193. Nigeria Economic Forecasts**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | - | - | 361 | 404 | 452 | 509 | 566 | 583 | 635 |
| Nominal GDP, local currency bn | - | - | 54,612 | 62,980 | 71,714 | 80,093 | 91,951 | 105,820 | 122,928 |
| GDP per capita, USD | - | - | 2,283 | 2,488 | 2,712 | 2,983 | 3,232 | 3,245 | 3,449 |
| Population, mn | 150.6 | 154.4 | 158.4 | 162.4 | 166.6 | 170.8 | 175.2 | 179.7 | 184.2 |
| Unemployment, % of labour force | - | - | - | - | - | - | - | - | - |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | - | - | - | 5.3 | 4.2 | 5.5 | 6.2 | 4.8 | 6.3 |
| Real investment growth % yoy | - | - | - | - | - | - | - | - | - |
| Real consumption growth % yoy | - | - | - | - | - | - | - | - | - |
| private consumption growth % yoy | - | - | - | - | - | - | - | - | - |
| Real export growth, % yoy | - | - | - | - | - | - | - | - | - |
| Real import growth, % yoy | - | - | - | - | - | - | - | - | - |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 15.1 | 13.9 | 11.7 | 10.3 | 12.0 | 7.9 | 8.0 | 10.7 | 7.8 |
| CPI, % avg | 11.6 | 12.5 | 13.7 | 10.8 | 12.2 | 8.5 | 8.1 | 9.9 | 9.3 |
| Nominal wages, % yoy | - | - | - | - | - | - | - | - | - |
| Credit extension to private sector, % yoy | 59.4 | 26.8 | -3.8 | 44.3 | 6.8 | 9.0 | 10.1 | 15.0 | 11.5 |
| Policy Interest Rate, % eop | 9.75 | 6.00 | 6.25 | 12.00 | 12.00 | 12.00 | 13.00 | 13.50 | 12.00 |
| 91-Day Tbill rate, %, eop | 18.00 | 15.79 | 13.07 | 17.17 | 14.39 | 12.61 | 13.60 | 14.00 | - |
| Long-term yield, %, eop | 12.45 | 8.32 | 7.15 | 16.50 | 11.90 | 11.77 | 12.70 | 15.17 | 13.70 |
| NGN/US$, eop | 138 | 150 | 152 | 162 | 156 | 160 | 168 | 190 | 197 |
| NGN/US$, avg | 119 | 150 | 151 | 156 | 159 | 159 | 164 | 182 | 193 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 29.1 | 14.0 | 14.5 | 12.6 | 18.9 | 20.6 | 13.6 | -5.4 | 4.0 |
| % of GDP | - | - | 4.0 | 3.1 | 4.2 | 4.0 | 2.4 | -0.9 | 0.6 |
| Trade balance | 45.9 | 25.7 | 31.7 | 35.0 | 40.9 | 43.7 | 35.8 | 16.1 | 26.6 |
| Exports | 85.7 | 56.8 | 78.5 | 97.2 | 94.3 | 95.1 | 89.0 | 70.2 | 82.8 |
| Imports | 39.8 | 31.1 | 46.8 | 62.2 | 53.4 | 51.4 | 53.2 | 54.1 | 56.2 |
| Service balance | -22.1 | -16.7 | -18.5 | -21.4 | -21.7 | -20.1 | -21.8 | -20.6 | -21.4 |
| Income balance | -15.1 | -14.6 | -19.7 | -23.0 | -22.3 | -25.2 | -23.4 | -24.1 | -24.5 |
| FDI, net | - | - | - | - | - | - | - | - | - |
| International reserves | 53.0 | 42.4 | 32.3 | 32.9 | 43.8 | 43.6 | 34.9 | 32.4 | 37.6 |
| Total amortisations | 0.6 | 0.5 | 0.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -0.1 | -1.8 | -2.0 | -1.8 | -1.4 | -1.6 | -2.0 | -2.4 | -2.0 |
| Consolidated gov primary balance | - | - | - | - | - | - | - | - | - |
| Public debt | - | - | - | - | - | - | - | - | - |
| *of which* Domestic | 5.5 | 7.1 | 8.2 | 8.4 | 9.2 | 8.8 | 9.0 | 10.0 | 10.2 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 3.7 | 4.6 | 4.6 | 5.7 | 6.5 | 8.8 | 9.2 | 12.3 | 14.1 |
| Public | 3.2 | 3.9 | 4.4 | 5.0 | 6.0 | 7.3 | 7.7 | 10.0 | 11.1 |
| External debt / GDP | - | - | 1.3 | 1.4 | 1.4 | 1.7 | 1.6 | 2.1 | 2.2 |
| External debt / XGS | 4.2 | 7.7 | 5.6 | 5.6 | - | - | - | - | - |
| Short-term debt | - | - | - | - | - | - | - | - | - |
| Short-term debt/International reserves (%) | - | - | - | - | - | - | - | - | - |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 6.5 | 6.2 | 6.0 | 4.5 | 4.0 | 5.0 | 5.5 | 6.0 | 6.3 |
| CPI, % yoy eop | 8.2 | 8.3 | 8.0 | 8.2 | 10.3 | 10.7 | 10.7 | 10.6 | 9.4 |
| Policy interest rate, %, eop | 12.0 | 12.0 | 13.0 | 13.5 | 13.5 | 13.5 | 13.5 | 13.5 | 13.5 |
| Short-term market rate, % eop | 12.1 | 13.4 | 13.6 | 14.0 | 15.0 | 16.0 | 14.0 | 13.0 | 12.0 |
| Long-term yield, %, eop | 12.2 | 11.8 | 12.7 | 13.3 | 13.9 | 14.6 | 15.2 | 14.8 | 14.4 |
| NGN/US$, eop | 163 | 164 | 168 | 168 | 186 | 187 | 190 | 190 | 193 |

Source: National Sources, Citi Research forecasts

# Poland

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- **Summary view** — Economic growth in 2015 is expected to reach 3.4% and thus accelerate slightly as compared to 2014. This coupled with a likely increase in CPI will probably stop the central bank from larger monetary easing.

- **Things to watch** — Uncertain external environment remains the key risk factor for Poland. On the domestic front the approaching parliamentary elections are worth watching although opinion polls suggest little change on the political stage.

- **Strategy** — Asset purchases by the ECB, are likely to support Polish bonds in the coming months, but bond prices will be under pressure in 2H15. Still strong growth and the end of rate cut cycle should support the zloty in 12M horizon.

## Growth set to accelerate

**The Polish economy is entering 2015 in a relatively good shape** as even despite weaker than expected monthly activity in 3Q 2014, growth in Poland appears resilient. The past good results may be partly due to temporary factors, including a build-up in inventories, but the overall performance is better than was expected a few months ago. Growth may slow slightly below 3% in 1Q 2015 due to smaller increase in inventories as well as due to a high statistical base. However, in our scenario GDP growth is to accelerate later in 2015, with economic growth reaching 4%YoY by year-end. The pace of labour market improvement is only gradual but since it is happening in an environment of highly uncertain external outlook, we find it impressive. The jobless rate is currently running at the lowest level in five years (s.a.), though it may be partly attributed to changes in maternity leave system in Poland. The lengthening of leave forced Polish firms to increase employment and therefore contributed to a decline in jobless rate. With this in mind we expect the pace of improvement in the labour market may slow somehow in 2015. All in all however, moderate growth in employment as well as continued healthy growth in lending to households, supported by low commodity prices should fuel further private consumption.

## No room (and no need) for large policy easing

**The central bank is facing difficult choices**. On one hand surprisingly strong growth suggests the economy doesn't need additional stimulus and indeed several MPC members already appear reluctant to cut rates further. On the other hand the prospect of negative CPI until early 2015 means inflation is likely to run well below target for a considerable period of time. Our analysis suggests inflation is depressed largely by factors remaining outside central bank's control, including very good harvests in 2014, Russia's sanctions on Polish food and falling oil prices. This means that base effects may be a powerful force next year, pushing inflation above 1.5%YoY by end-2015. Yet, this would still be below the central bank's 2.5% target. Since the MPC has signaled it is now putting more emphasis on economic growth prospects than on the near term inflation outlook, we believe the robust GDP numbers diminish chances of additional rate cuts. Having said this we now expect the base rate to remain on hold at 2% at least until the end of 2015. Additional rate reductions cannot be entirely ruled out - we attach approximately 40% probability to a scenario of 25bp cut in early 2015 and we believe potentially weaker than expected growth in Germany could be a trigger. Taking into account the subdued inflation outlook in Poland and additional easing in the eurozone in our opinion the first rate increase is unlikely to materialize before 2016.

## EDP to be removed next year?

**We see room for significant positive fiscal surprises in 2015**. The budget performance so far in 2014 has been much better than expected and according to our estimates the central government deficit could undershoot the planned level by around PLN17bn or close to 1% of GDP. This is a result of a significant overshooting of budget revenues and an undershooting of spending. The above, as well as good performance of local governments sector, increases chances the general government deficit in 2014 could fall below 3% of GDP and below 2.5% in 2015. In our view this would allow the European Commission to lift the excessive deficit procedure (EDP) by 2015, a year earlier than the government estimates. This also means that in case of a negative growth surprise the government would have sufficient fiscal space to provide fiscal easing and thus offset unfavourable shocks while still keeping the deficit below 3%. This makes us relatively constructive when it comes to the 2015 and 2016 growth outlook for Poland. Improvement in the fiscal outlook, the relatively low current account deficit and resilient growth increase chances that rating agencies may start to appreciate positive trends. Although Poland's sovereign rating upgrade is not in our scenario already for next year we believe it is likely that in 2015 at least one agency may consider raising the rating outlook to positive from neutral.

## Potential risks

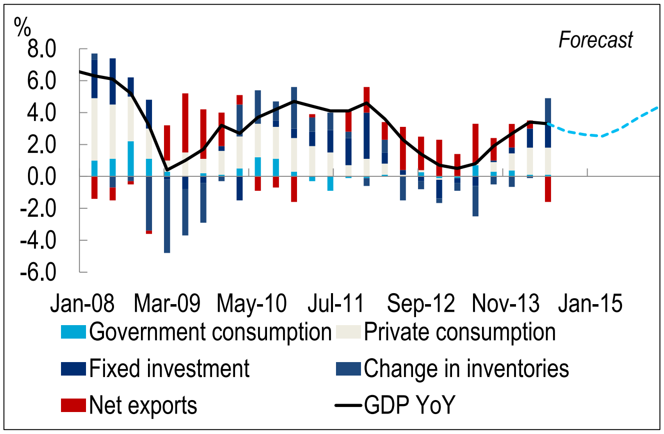
**The biggest risk to this outlook seems to be related to external factors.** Weak growth in Russia and the uncertain geopolitical situation could weigh on business confidence, postponing investment decisions. Far more important is probably uncertainty regarding growth outlook in Germany, Poland's key trading partner. Given the high correlation between business cycles in Poland and Germany, the latter factor has the potential to keep growth muted for extended period of time.

**On the domestic front, parliamentary elections are scheduled for Autumn 2015** and the presidential vote for June 2015. The opinion polls suggest the current PO-PSL coalition has chances of being re-elected but may need to invite an additional party to reach a majority in the new parliament. In any case, given the unpredictability of the political situation in Poland the situation deserves close monitoring.

## Growth will support zloty, but bonds to weaken in 2H15

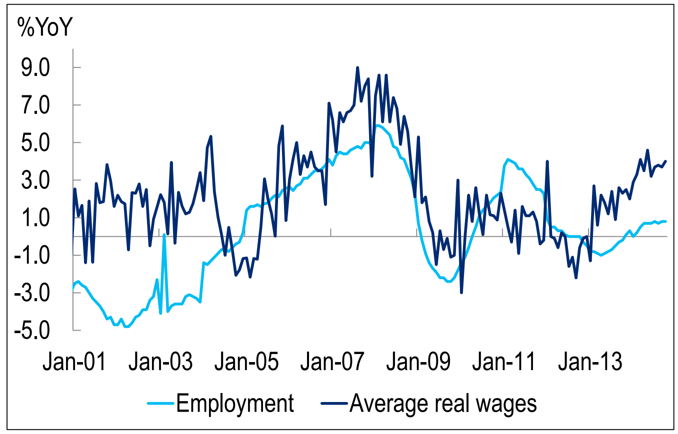
**We expect the zloty will be supported on a twelve month horizon by relatively strong and above-potential GDP growth that is fuelled by domestic demand**. The zloty should also benefit from higher level of interest rates compared to other European economies. In our view the quantitative easing program in the Eurozone and strong domestic fiscal position will likely support Polish government bonds in the next few months. However, the upward move in inflation in 2H15 as well as expected interest rate hikes by the Fed will probably push the yield curve up later during 2015. A potential rise in political risk premium in the election period as well as rising geopolitical risks could work in the same direction.

**Figure 194. Economic growth is likely to recover after 1Q15 …**



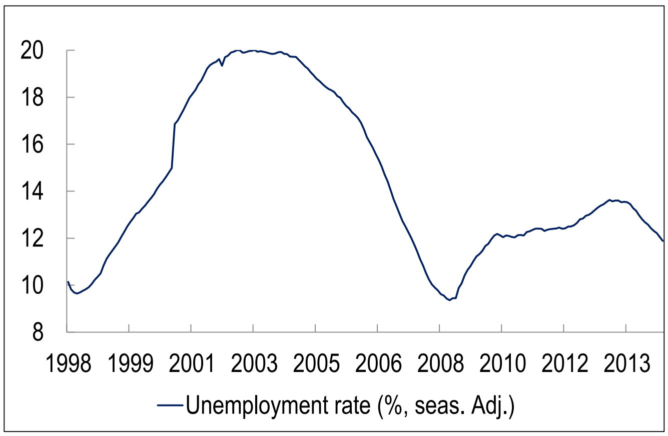

Source: CSO, Citi Research forecasts

**Figure 195. … supported by continued positive labour market data …**



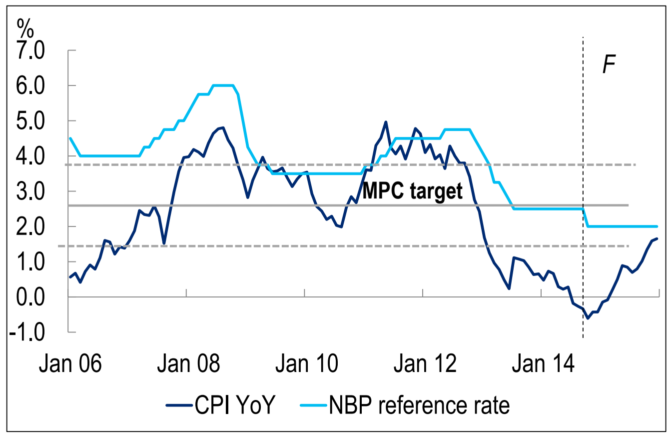

Source: GUS, Citi Research

**Figure 196. … which translates into the lowest jobless rate in 5 years**



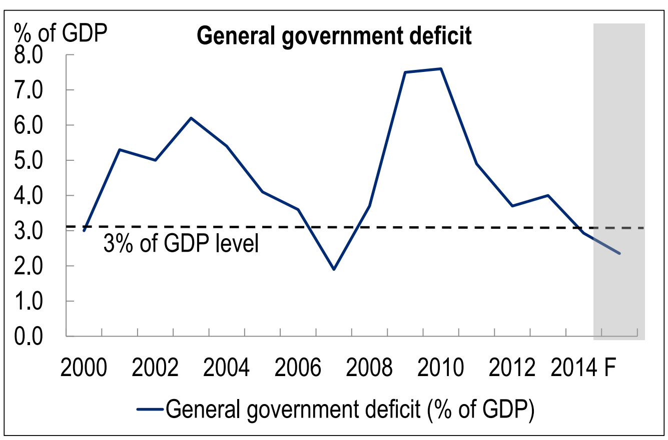

Source: CSO

**Figure 197. Inflation is likely to rise gradually and interest rates expected to stabilize in 2015**



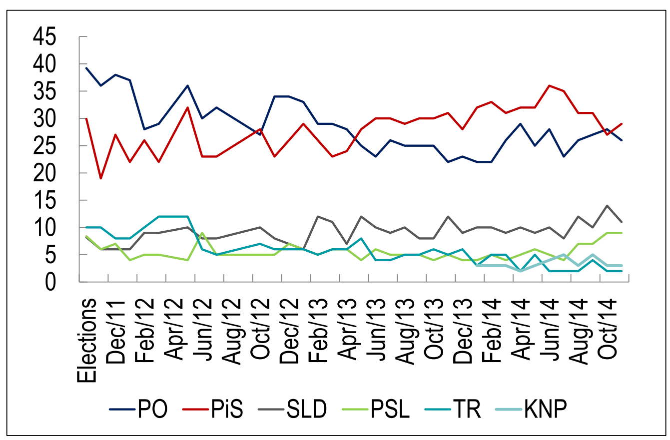

Source: CSO, Citi Research forecasts

**Figure 198. Decline of fiscal deficit will likely allow removal of EDF procedure**




Source: CSO, Ministry of Finance, Citi Research

**Figure 199. Political risk premium will likely increase before parliamentary elections**




Source: TNS, PAP

Figure 200. Poland Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 534 | 434 | 470 | 517 | 496 | 526 | 534 | 472 | 465 |
| Nominal GDP, local currency bn | 1,276 | 1,345 | 1,417 | 1,528 | 1,596 | 1,662 | 1,714 | 1,787 | 1,888 |
| GDP per capita, USD | 13,990 | 11,361 | 12,203 | 13,403 | 12,879 | 13,662 | 13,865 | 12,282 | 12,095 |
| Population, mn | 38.1 | 38.2 | 38.5 | 38.5 | 38.5 | 38.5 | 38.5 | 38.5 | 38.5 |
| Unemployment, % of labour force | 9.5 | 12.1 | 12.4 | 12.5 | 13.4 | 13.4 | 11.7 | 11.3 | 10.9 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 3.9 | 2.6 | 3.7 | 4.8 | 1.8 | 1.7 | 3.3 | 3.4 | 3.6 |
| Real investment growth % yoy | 2.2 | -12.7 | 9.7 | 12.2 | -4.3 | -3.7 | 10.0 | 6.5 | 7.2 |
| Real consumption growth % yoy | 5.9 | 3.5 | 2.8 | 1.7 | 0.7 | 1.3 | 2.1 | 2.4 | 3.2 |
| private consumption growth % yoy | 6.1 | 3.4 | 2.7 | 2.9 | 0.9 | 1.0 | 2.3 | 2.6 | 3.2 |
| Real export growth, % yoy | 7.0 | -6.3 | 12.9 | 7.9 | 4.3 | 5.0 | 3.4 | 3.9 | 6.0 |
| Real import growth, % yoy | 9.4 | -12.4 | 14.0 | 5.5 | -0.6 | 1.8 | 4.4 | 3.8 | 7.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 3.4 | 3.7 | 3.2 | 4.6 | 2.6 | 0.8 | -0.4 | 1.7 | 2.4 |
| CPI, % avg | 4.2 | 3.5 | 2.6 | 4.3 | 3.7 | 0.9 | 0.0 | 0.8 | 2.4 |
| Nominal wages, % yoy | 10.5 | 4.2 | 3.6 | 4.9 | 3.5 | 2.6 | 3.8 | 4.3 | 4.8 |
| Credit extension to private sector, % yoy | 36.4 | 7.0 | 8.5 | 13.9 | 2.4 | 4.5 | 6.5 | 8.0 | 9.0 |
| Policy Interest Rate, % eop | 5.00 | 3.50 | 3.50 | 4.50 | 4.25 | 2.50 | 2.00 | 2.00 | 2.75 |
| 3 month inter-bank rate, %, eop | 5.88 | 4.27 | 3.95 | 4.99 | 4.11 | 2.71 | 2.12 | 2.14 | 3.23 |
| Long-term yield, %, eop | 5.46 | 6.24 | 6.07 | 5.91 | 3.73 | 4.34 | 2.55 | 3.20 | 4.30 |
| PLN/US$, eop | 2.97 | 2.87 | 2.97 | 3.45 | 3.09 | 3.02 | 3.52 | 3.90 | 4.10 |
| PLN/US$, avg | 2.39 | 3.10 | 3.01 | 2.96 | 3.25 | 3.16 | 3.21 | 3.78 | 4.05 |
| PLN/EUR, eop | 4.15 | 4.10 | 3.97 | 4.47 | 4.08 | 4.15 | 4.24 | 4.17 | 4.09 |
| PLN/EUR, avg | 3.52 | 4.32 | 3.99 | 4.12 | 4.18 | 4.20 | 4.19 | 4.20 | 4.12 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -34.9 | -17.3 | -24.1 | -27.1 | -17.6 | -7.0 | -9.5 | -14.9 | -18.3 |
| % of GDP | -6.5 | -4.0 | -5.1 | -5.2 | -3.5 | -1.3 | -1.8 | -3.2 | -3.9 |
| Trade balance | -30.7 | -7.6 | -11.8 | -17.4 | -9.2 | 0.9 | 1.2 | -3.4 | -6.5 |
| Exports | 178.7 | 142.1 | 165.9 | 184.2 | 181.1 | 197.8 | 207.4 | 198.8 | 212.5 |
| Imports | 209.4 | 149.7 | 177.7 | 201.6 | 190.3 | 196.9 | 206.2 | 202.2 | 219.1 |
| Service balance | - | - | - | 7.3 | 8.0 | 10.6 | 8.8 | 7.6 | 7.6 |
| Income balance | -12.8 | -16.6 | -19.1 | -18.0 | -16.1 | -18.0 | -20.2 | -20.1 | -22.3 |
| FDI, net | - | - | - | -13.8 | -6.6 | -3.7 | -10.0 | -10.0 | -11.0 |
| International reserves | 58.9 | 73.4 | 86.3 | 89.7 | 100.3 | 99.3 | 100.1 | 102.9 | 105.8 |
| Total amortisations | 44.0 | 46.9 | 44.1 | 38.3 | 47.5 | 48.7 | 49.2 | 51.0 | 49.6 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | - | - | -7.6 | -4.9 | -3.7 | -4.0 | -2.9 | -2.4 | -2.2 |
| Consolidated gov primary balance | - | - | -5.2 | -2.5 | -1.0 | -1.5 | -0.8 | -0.5 | -0.5 |
| Public debt | 46.9 | 49.8 | 52.8 | 53.4 | 52.7 | 53.1 | 46.9 | 47.5 | 46.9 |
| *of which* Domestic | 34.8 | 36.7 | 38.4 | 36.5 | 35.7 | 37.0 | 29.3 | 29.4 | 28.8 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 245.0 | 280.5 | 318.6 | 323.4 | 366.7 | 382.1 | 380.1 | 360.1 | 370.1 |
| Public | 69.4 | 92.2 | 117.9 | 121.2 | 156.8 | 163.9 | 163.0 | 154.4 | 158.7 |
| External debt / GDP | 45.9 | 64.7 | 67.8 | 62.6 | 73.9 | 72.7 | 71.2 | 76.3 | 79.6 |
| External debt / XGS | - | - | - | 143.7 | 165.0 | 157.4 | 150.5 | 148.8 | 143.0 |
| Short-term debt | 51.3 | 54.3 | 48.4 | 44.8 | 42.4 | 46.3 | 44.3 | 40.3 | 40.3 |
| Short-term debt/International reserves (%) | 87.0 | 73.9 | 56.1 | 50.0 | 42.3 | 46.6 | 44.2 | 39.2 | 38.1 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 3.5 | 3.3 | 3.0 | 2.9 | 3.2 | 3.6 | 4.1 | 4.0 | 3.5 |
| CPI, % yoy eop | 0.3 | -0.3 | -0.4 | 0.2 | 0.8 | 1.0 | 1.7 | 2.1 | 2.6 |
| Policy interest rate, %, eop | 2.50 | 2.50 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Short-term market rate, % eop | 2.68 | 2.28 | 2.12 | 2.19 | 2.19 | 2.13 | 2.14 | 2.16 | 2.46 |
| Long-term yield, %, eop | 3.56 | 3.07 | 2.55 | 2.70 | 2.85 | 3.00 | 3.20 | 3.50 | 3.80 |
| PLN/EUR, eop | 4.16 | 4.18 | 4.24 | 4.22 | 4.21 | 4.19 | 4.17 | 4.15 | 4.13 |

Source: National Sources, Citi Research forecasts

# Romania

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- **Summary view** — It would be premature to argue Romania is on a sustained recovery path until we see signs of a pick-up in investment spending.
- **Things to watch** — Whether the new President will seek to undermine Mr. Ponta's power with a view to creating conditions for a vote of confidence motion and the fate of the IMF-EU supported economic program deserves close monitoring.
- **Strategy** — The possibility of higher political noise and the NBR's accommodative stance cloud the FX outlook, as we question whether the bond market rally has further legs following the marked downward move in yields this year.

## Will investment spending recover at last…

**According to the flash estimate, at 3.2%YoY, Romania's third quarter GDP growth came in considerably stronger than the consensus (1.0%)**. While the detailed data was not released at the time of writing, we believe the stronger-than-expected outturn is probably driven by private consumption and exports. Standing at about 1.9 %QoQ (SWDA), the flash estimate also suggests economic activity in 3Q has gained considerable momentum when compared with 2Q (-0.3%QoQ) and 1Q 2013 (0.5%QoQ).

**Although the stronger-than-expected 3Q GDP reading and the revision of the past data led us to revise our 2014 growth forecast to 2.8% from 2.0%, we believe that it would be premature to argue that the economy is now on a sustained recovery path.** It is true we saw some signs of a pick-up in private consumption this year. However, the failure of investment spending to gain momentum remains an important drag on the recovery, as the deleveraging process has turned out to be particularly painful for Romania, owing to the widespread FX borrowing and the high degree of overheating during the boom period. Looking ahead, we believe private consumption is likely to remain resilient thanks to the combination of low inflation and an accommodative monetary policy stance. This, coupled with recent developments such as tax exemption for reinvested profits and a cut in social security contributions, should finally boost investment, in our view. Against this backdrop, we look for a moderate pick-up in economic activity next year with GDP growth reaching 3.0%.

## …and disinflation in non-food component continue?

**Inflation is expected to be around 1.8%YoY in 2014 thanks to historically low food inflation and the VAT cut for bread.** Regarding next year's inflation, however, we remain more cautious than the NBR, which sees it at 2.2% compared with our forecast of 2.8%. Our view is underpinned by the notion that the sharp decline in inflation this year was driven largely by the above-noted temporary factors without a commensurate improvement in underlying inflation dynamics. Consequently, we think it would be premature to argue that the recent downtrend in the non-food inflation component will be sustained going forward. Moreover, while we recognize the noticeable improvement in forward-looking inflation expectations, we argue this picture can change quite rapidly, since our analysis suggests the causality runs from actual inflation outturns to forward-looking expectations and not the other way around.

## Is there room for further rate cuts in 2015?

**The NBR brought its policy rate down to 2.75% this year from 4% in December 2013.** Given the NBR's inclination to keep money market rates below the policy rate, monetary policy stance in practice has been more accommodative than implied by the policy rate. We have been skeptical about the effectiveness of this approach since our analysis suggests that low interest rates alone may not be sufficient to bolster credit growth. Our empirical analysis suggests that economic activity and the exchange rate play a more important role in affecting RON-denominated lending activity.

**Developments to date beg the following question: will the NBR be able deliver further rate cuts in 2015?** In our view, the NBR is likely to keep rates on hold throughout 2015, as we see the Bank relaxing its policy stance through lowering RRRs. This view is based on our more cautious inflation forecast trajectory, unimpressive capital inflows and the bleak prospects for further VAT cuts in 2015—all of which suggests to us that there isn't much room left for further easing next year.

## Will fiscal discipline and reforms continue without IMF?

**Romania had a small budget surplus (RON 0.4bn) in the first nine months of 2014, compared with a deficit of RON 8.1bn in the same period of 2013.** While revenues during the period under consideration increased by about 5.5%YoY, expenditures were down by about 0.3%YoY. Developments to date suggest to us that this year's budget gap is likely to be narrower than the target (2.2% of GDP). Concerning next year, while there is an indicative deficit target under the umbrella of the IMF program (1.4% of GDP), we are inclined to think that the IMF may be flexible for a wider deficit target.

**In terms of the fate of the EU-IMF arrangement, which is currently frozen, we still think the authorities are likely to take actions to put program back on track.** In any event, it is worth noting that the likelihood of another IMF-EU program once the current one expires in 2015 is very low, in our view. Consequently, the onus will be on the authorities to ensure policy predictability and continue with structural reform measures, while pursuing a prudent fiscal policy.

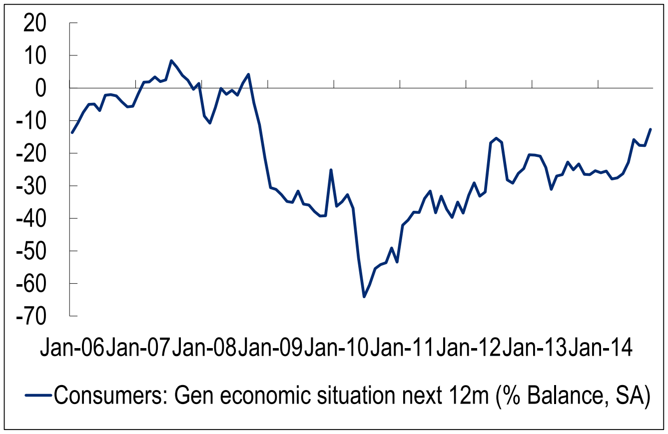
## While external imbalance remains in check…

Romania's current account balance printed a deficit of about €559 million in the first nine months of 2014, which is wider than the deficit seen in the same period of 2013 (€413 million). In line with our expectations of a moderate pick up in domestic demand and private credit growth, we expect the current account gap to widen to around 2.0% of GDP in 2015 from an estimated 1.2% in 2014. On the capital account front, the absence of a meaningful pick up in inflows warrants concern.

## …subdued inflows cloud the FX outlook

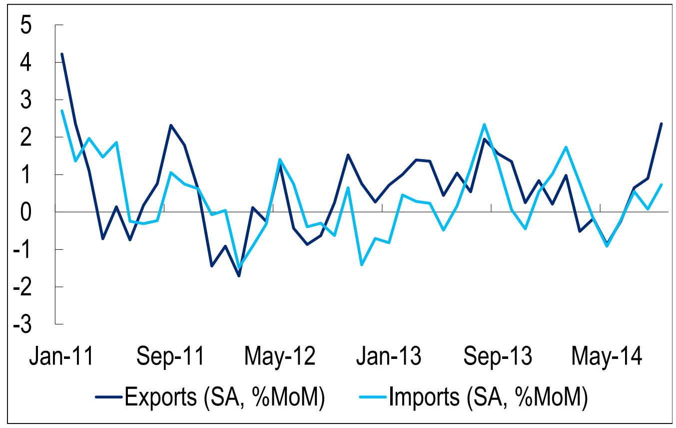
**We observe a moderate deterioration in the leu's relative performance with respect to its regional peers (HUF, PLN, CZK) since end August**. In our view, low yields and weak capital inflows—coupled with the NBR's inclination to keep money market rates below the policy rate and the possibility of higher political noise—cloud the outlook for the leu. Against this backdrop, we expect the EUR/RON to be around 4.45 and 4.50 by the end of 2014 and 2015, respectively.

**Figure 201. Private spending and …**



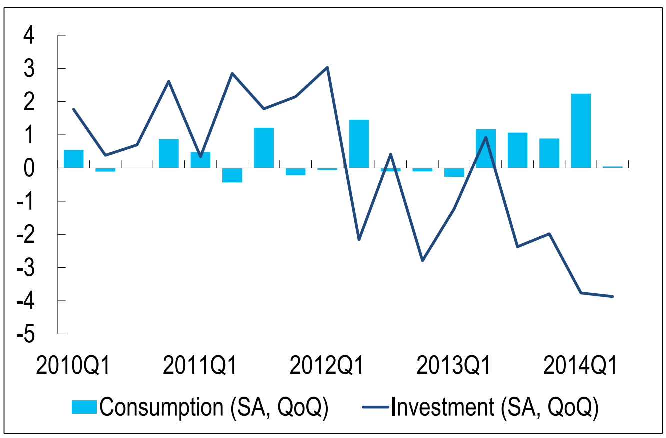

Source: Haver Analytics, Citi Research

**Figure 202. …exports were probably the main drivers behind 3Q GDP…**



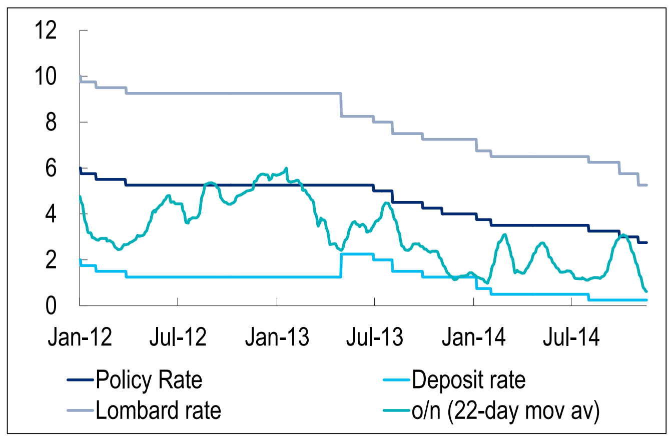

Source: Haver Analytics, Citi Research

**Figure 203. …as we continue to wait for a pick-up in investment.**



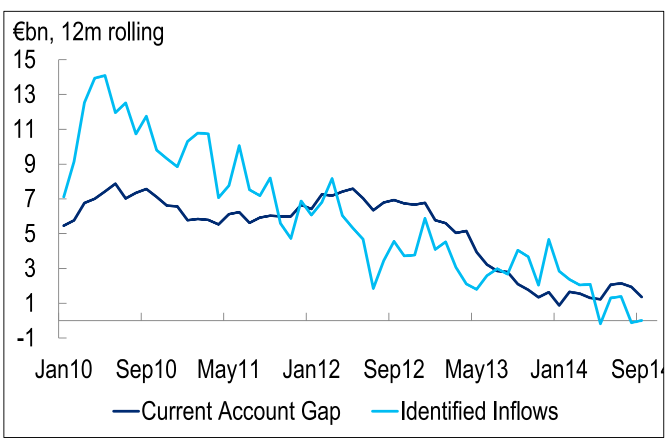

Source: Haver Analytics, Citi Research

**Figure 204. NBR has been keeping rates below the policy rate …**



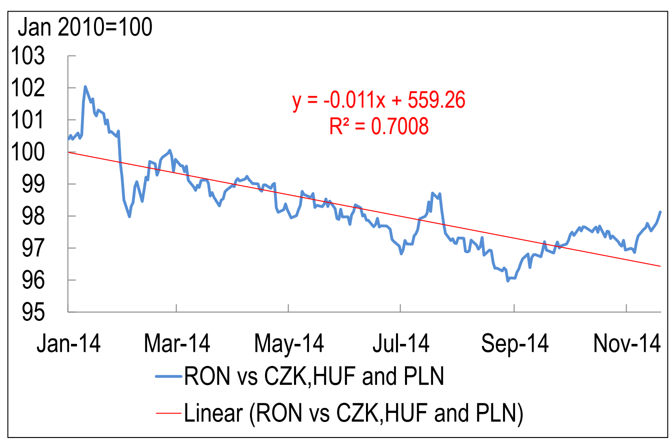

Source: Haver Analytics, Citi Research

**Figure 205. … but subdued capital inflows…**




Source: : Haver Analytics, Citi Research

**Figure 206. …and the possibility of higher political noise could undermine the performance of the leu.**




Source: Haver Analytics, Citi Research. Note: A rise in this index represents a deterioration in the leu' s relative performance vis a vis these currencies

### Figure 207. Romania Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 204 | 165 | 165 | 183 | 169 | 189 | 192 | 177 | 183 |
| Nominal GDP, local currency bn | 515 | 501 | 524 | 557 | 587 | 629 | 654 | 689 | 728 |
| GDP per capita, USD | 9,176 | 7,397 | 7,413 | 8,246 | 7,642 | 8,550 | 8,703 | 8,052 | 8,306 |
| Population, mn | 22.3 | 22.2 | 22.2 | 22.2 | 22.1 | 22.1 | 22.1 | 22.0 | 22.0 |
| Unemployment, % of labour force | 4.0 | 6.3 | 7.6 | 5.4 | 5.1 | 5.3 | 5.5 | 5.5 | 5.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 7.5 | -6.6 | -1.2 | 2.4 | 0.5 | 3.5 | 2.8 | 3.0 | 3.0 |
| Real investment growth % yoy | 3.0 | -34.3 | 8.9 | 12.1 | -0.3 | -8.7 | -2.4 | 3.6 | 1.5 |
| Real consumption growth % yoy | 9.3 | -9.0 | -0.8 | 1.4 | 1.4 | 1.0 | 4.5 | 3.2 | 3.3 |
| private consumption growth % yoy | 9.5 | -10.4 | -0.3 | 1.5 | 1.4 | 1.3 | 5.0 | 3.5 | 3.5 |
| Real export growth, % yoy | 7.6 | -6.3 | 14.2 | 12.0 | -1.8 | 13.1 | 10.0 | 4.0 | 4.6 |
| Real import growth, % yoy | 7.6 | -21.4 | 12.5 | 10.6 | -0.3 | 2.3 | 8.0 | 4.1 | 4.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 6.3 | 4.7 | 8.0 | 3.1 | 5.0 | 1.6 | 1.8 | 2.8 | 2.7 |
| CPI, % avg | 7.9 | 5.6 | 6.1 | 5.8 | 3.3 | 4.0 | 1.2 | 2.2 | 2.6 |
| Nominal wages, % yoy | 23.6 | 8.4 | 2.5 | 4.9 | 5.0 | 5.0 | 5.0 | 4.5 | 4.5 |
| Credit extension to private sector, % yoy | 33.7 | 0.9 | 4.7 | 6.6 | 1.3 | -3.3 | 3.6 | 5.0 | 6.0 |
| Policy Interest Rate, % eop | 10.25 | 8.00 | 6.25 | 6.00 | 5.25 | 4.00 | 2.75 | 2.75 | 4.50 |
| 3 month inter-bank rate, %, eop | 15.46 | 10.65 | 6.17 | 6.05 | 6.05 | 2.44 | 2.25 | 2.55 | 4.30 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| RON/US$, eop | 2.89 | 2.96 | 3.17 | 3.33 | 3.37 | 3.25 | 3.66 | 3.97 | 3.95 |
| RON/US$, avg | 2.50 | 3.04 | 3.17 | 3.04 | 3.46 | 3.33 | 3.41 | 3.89 | 3.99 |
| RON/EUR, eop | 4.03 | 4.24 | 4.24 | 4.32 | 4.45 | 4.46 | 4.45 | 4.50 | 4.40 |
| RON/EUR, avg | 3.68 | 4.24 | 4.21 | 4.24 | 4.46 | 4.42 | 4.44 | 4.48 | 4.44 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -24.1 | -7.6 | -7.7 | -8.6 | -7.8 | -1.6 | -2.3 | -3.5 | -4.0 |
| % of GDP | -11.8 | -4.6 | -4.7 | -4.7 | -4.6 | -0.8 | -1.2 | -2.0 | -2.2 |
| Trade balance | -31.8 | -12.0 | -11.9 | -12.5 | -11.5 | -7.2 | -7.3 | -8.2 | -8.8 |
| Exports | 39.9 | 33.6 | 43.4 | 55.8 | 51.3 | 58.3 | 59.9 | 56.2 | 57.9 |
| Imports | 71.7 | 45.6 | 55.4 | 68.3 | 62.8 | 65.5 | 67.2 | 64.3 | 66.6 |
| Service balance | 4.3 | 1.3 | 2.0 | 2.3 | 3.2 | 6.2 | 7.1 | 5.8 | 6.0 |
| Income balance | -2.2 | -2.2 | -2.0 | -2.3 | -3.0 | -4.1 | -5.6 | -4.8 | -4.9 |
| FDI, net | 13.3 | 4.7 | 3.0 | 2.4 | 3.1 | 3.9 | 2.9 | 4.1 | 4.2 |
| International reserves | 36.5 | 39.4 | 42.3 | 42.4 | 41.8 | 45.5 | 37.4 | 35.3 | 35.3 |
| Total amortisations | 18.1 | 17.7 | 19.7 | 19.6 | 25.0 | 34.0 | 31.0 | 30.0 | 28.9 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -4.8 | -7.3 | -6.4 | -4.3 | -2.2 | -2.5 | -1.7 | -2.0 | -2.5 |
| Consolidated gov primary balance | -3.9 | -5.7 | -4.9 | -2.6 | -0.4 | -0.3 | 0.5 | 0.2 | -0.3 |
| Public debt | 21.3 | 29.4 | 37.1 | 40.1 | 41.0 | 42.5 | 41.9 | 42.4 | 43.1 |
| *of which* Domestic | 12.6 | 15.4 | 19.8 | 21.9 | 18.5 | 18.5 | 19.9 | 19.4 | 20.6 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 105.8 | 113.0 | 122.4 | 137.3 | 128.1 | 127.6 | 122.9 | 109.9 | 109.6 |
| Public | 14.2 | 19.6 | 24.8 | 28.9 | 34.2 | 40.9 | 37.7 | 36.5 | 36.7 |
| External debt / GDP | 51.8 | 68.7 | 74.3 | 75.1 | 75.7 | 67.5 | 64.0 | 62.0 | 60.0 |
| External debt / XGS | 188.0 | 249.1 | 227.4 | 202.2 | 200.2 | 167.7 | 156.4 | 148.9 | 144.1 |
| Short-term debt | 28.5 | 22.5 | 26.2 | 29.5 | 28.0 | 26.3 | 23.1 | 22.6 | 23.4 |
| Short-term debt/International reserves (%) | 78.1 | 57.0 | 61.9 | 69.7 | 66.9 | 57.7 | 61.8 | 64.1 | 66.3 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 0.8 | 3.3 | 2.9 | 2.6 | 3.6 | 2.6 | 3.1 | 3.2 | 3.3 |
| CPI, % yoy eop | 0.7 | 1.5 | 1.8 | 1.7 | 2.2 | 2.6 | 2.8 | 2.7 | 2.5 |
| Policy interest rate, %, eop | 3.50 | 3.00 | 2.75 | 2.75 | 2.75 | 2.75 | 2.75 | 3.25 | 3.50 |
| Short-term market rate, % eop | 2.42 | 3.10 | 2.25 | 2.55 | 2.55 | 2.55 | 2.55 | 3.05 | 3.30 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| RON/EUR, eop | 4.39 | 4.41 | 4.45 | 4.47 | 4.48 | 4.49 | 4.50 | 4.47 | 4.45 |

Source: National Sources, Citi Research forecasts

# Russia

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- **Summary view** — The economy may be near recession with little prospect for a substantial near-term improvement. The impact of sanctions on the economy will become clearer over time, but it will probably be quite difficult to unpack the effect of sanctions from the many other factors that help to explain Russia's slowdown.
- **Things to watch** — Uncertainty will remain elevated during 2015. The possibility that further sanctions could be imposed may impose additional costs to the economy and endanger our -1.0% GDP forecast. The monetary hiking cycle should be over as inflation peaks in 1Q before starting to moderate thereafter.
- **Strategy** — While the current account surplus has been performing better than expected, it will continue to be challenged by large capital account outflows, thus putting pressures on the rouble. The formal adoption of inflation targeting from 2015 may also add to currency volatility.

## Russian economy to stagnate in 2015

**The Russian economy may be near recession with little prospect for substantial near-term improvement.** The impact of sanctions will become clearer over time, but it will probably be quite difficult to unpack the effect of sanctions from the many other factors that help to explain Russia's slowdown, a slowdown which was evident even before the Ukraine crisis intensified in early 2014. Some of these factors include deteriorating terms of trade, weak investment climate, challenging demographics, a currency which still may not be particularly cheap, and the fact that both fiscal and monetary policy have been tightening in recent years. Despite the broader deceleration of the economy, it has so far avoided technical recession, but the sanction-based backdrop may increase the chances of this happening.

**There is still no 'crisis' in the economy, but the effect of sanctions will be to dampen growth prospects in a variety of ways.** The intensification of the tit-for-tat sanctions between Russia and the West in 2014 is likely to make for a challenging backdrop to 2015. Sanctions will affect the Russian economy directly and indirectly. The direct impact comes mostly from the loss of access to international capital markets for significant Russian borrowers, and the ensuing rising cost of capital. But the indirect impact is also likely to be significant, and this has two elements. The first is the likelihood that a sanctions environment will deaden Russia's commitment to structural reforms, rendering the investment climate weaker. The second is the effect that a sanctions environment will have on macro-economic policy, both monetary and fiscal. The bottom line is that Russia's response to sanctions will end up in a tightening of policy, amplifying the consequences of Russian economic isolation.

**The more fraught geopolitical backdrop has already brought about a weaker, albeit better than anticipated, economic performance in 2014.** Preliminary estimates from Rosstat point to economic growth slowing marginally to 0.7%YoY in 3Q14, down from the 0.9 and 0.8% expansion posted in 1Q14 and 2Q14. While on a downtrend, GDP has actually been growing better than anticipated in 2014, although this has been mainly due to dim expectations rather than to solid growth. Still, we see full-year 2014 GDP growth at 0.5%, down from the 1.3% economic performance in 2013.

**We anticipate the economy will stagnate further in 2015 as GDP growth slides to -1.0%.** Heightened geopolitical uncertainty, still rising inflation, weak currency and declining oil prices should continue to weigh on consumer and business

confidence, creating the perfect storm for economic performance to start deteriorating more meaningfully in the coming quarters. We thus forecast -1.0% 2015 GDP growth as sanctions continue to bite and uncertainty lingers on. As a result, this will be the 6th consecutive year of a decelerating GDP performance.

**We see consumption growth transitioning to negative territory for the first time since 2009 on high inflation, weaker currency and more restrictive regulatory behaviour.** While GDP performance has been decelerating since 2010, consumption spending has been the one bright spot in Russian macro in the last couple of years as purchasing power was boosted by solid growth in retail lending. However, this mini consumer boom is now coming to a close as the retail lending market has become saturated and the CBR has tightened regulatory requirements. The sliding currency and high inflation have also eaten away at real purchasing power, leading to more subdued consumer spending. We see these factors combining to further constrain real spending to 0.6% in 2015 from an already low 0.4% in 2014.

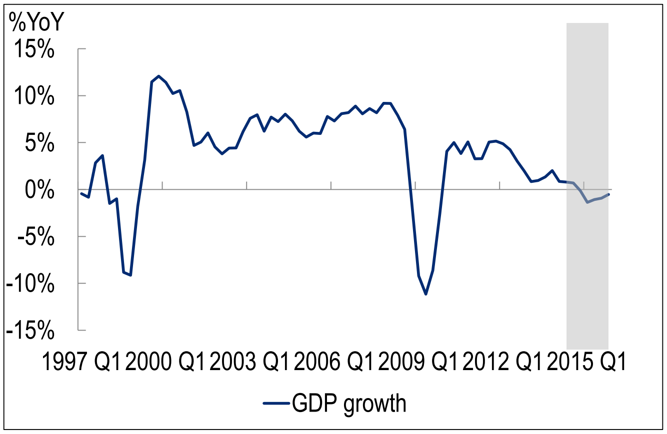
**Investment spending, which is the key avenue via which heightened geopolitical uncertainty weighed on growth performance, will continue to contract in 2015.** Real investment suffered significantly at the start of 2014 as geopolitical uncertainty rose and is on course to contract by 3.5% for the year. We see this behaviour continuing in 2015, although the pace of decline should moderate somewhat to -3.3% as public investment, related for example to the construction of the Power of Siberia pipeline to China, will add a useful fillip to overall investment.

**The only GDP component that will remain robust is net exports.** The current account surplus continues to perform well as the significant RUB weakening is providing a welcome boost to exports while at the same time crimping imports. Even if the current account surplus declined in 3Q14 to US$11.4bn from the US$14.1bn in 2Q, the performance of the current account is on track to meet our own 2014 forecast of US$60.3bn (3.2% of GDP vs the 1.6% of GDP in 2013). The background will remain supportive in 2015 and we see the current account surplus remaining broadly on par at 3.1% of GDP.

**The subdued growth environment may induce more active government policy to help private sector manage the 'crisis'.** We expect the Russian government to provide active support to key enterprises to help navigate the more challenging growth backdrop, including via following on the successful 2009 policy of tapping the National Welfare Fund.

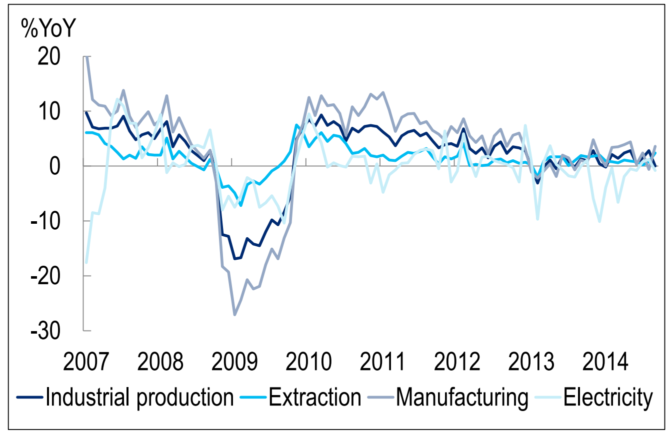
**The CBR has embarked on a new monetary policy paradigm that promises more FX volatility in 2015.** The CBR learned a critical lesson from the 2008-2009 crisis episode, when it stuck to its heavily managed FX policy for too long before allowing the RUB to respond more nimbly to market forces. These hard-learned lessons were applied to the current situation as the regulator has become more agnostic to RUB moves by permitting a gradual currency weakening as a means to letting the economy adjust to unfavorable external shocks. In early November the CBR effectively moved to a free float by eliminating the currency bands around the RUB basket and discontinuing its rule-based interventions in the FX market. The CBR has thus adopted the modus operandi of a traditional emerging markets central bank, which only intervenes at irregular intervals to smooth out excessive RUB volatility. In the current sanction-based environment, we expect that this new monetary policy paradigm will be consistent with larger than normal FX volatility.

Figure 208. Growth is subdued



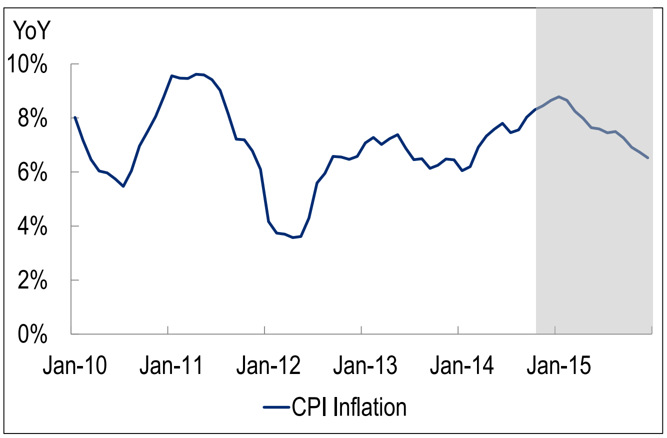

Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 209. Industrial activity is also weak



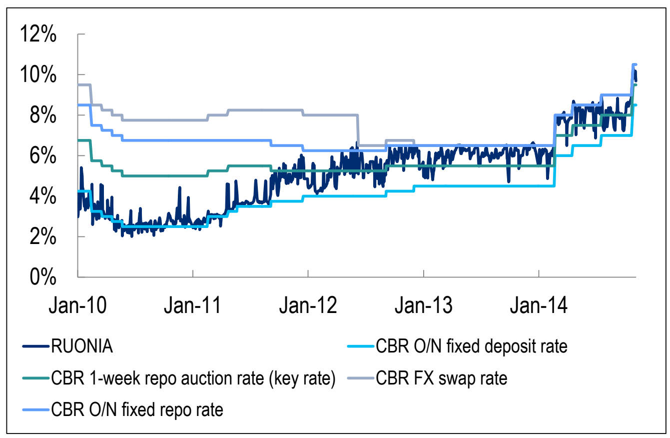

Source: Rosstat, Citi Research

Figure 210. Inflation will remain well above the medium-term target of 4%.



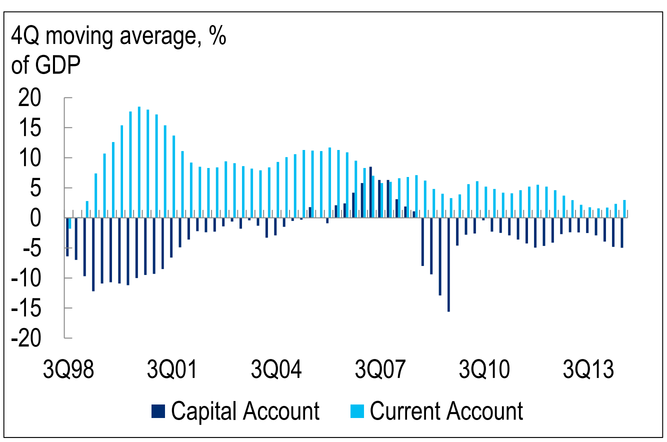

Source: Rosstat, Citi Research (shaded area is Citi forecast)

Figure 211. Rates may see some moderation in 2015, but only if geopolitical backdrop eases



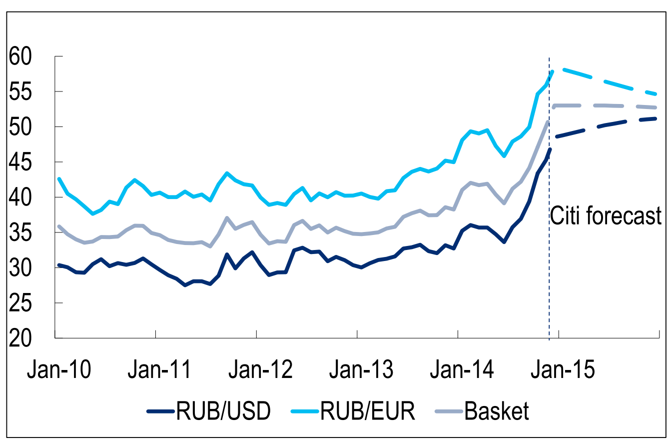

Source: Bloomberg, Citi Research

Figure 212. The gradual disappearance of the current account…




Source: CBR, Citi Research

Figure 213. …poses risks for the ruble




Source: Bloomberg, Citi Research

**Figure 214. Russia Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 1,665 | 1,229 | 1,524 | 1,903 | 2,000 | 2,093 | 1,834 | 1,539 | 1,628 |
| Nominal GDP, local currency bn | 41,277 | 38,807 | 46,309 | 55,967 | 62,218 | 66,755 | 72,130 | 77,567 | 84,299 |
| GDP per capita, USD | 11,585 | 8,554 | 10,611 | 13,267 | 13,969 | 14,656 | 12,877 | 10,831 | 11,489 |
| Population, mn | 143.7 | 143.7 | 143.6 | 143.4 | 143.2 | 142.8 | 142.5 | 142.1 | 141.7 |
| Unemployment, % of labour force | 6.2 | 8.2 | 7.4 | 6.5 | 5.5 | 5.5 | 5.7 | 6.0 | 5.8 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 5.2 | -7.8 | 4.5 | 4.3 | 3.4 | 1.3 | 0.5 | -1.0 | 1.7 |
| Real investment growth % yoy | 10.5 | -41.0 | 28.5 | 21.0 | 1.5 | -6.1 | -4.7 | -5.6 | 2.7 |
| Real consumption growth % yoy | 8.4 | -3.9 | 3.5 | 5.3 | 7.0 | 3.6 | 0.4 | -0.6 | 0.8 |
| private consumption growth % yoy | 10.4 | -5.1 | 5.5 | 6.7 | 7.9 | 4.7 | 0.5 | -0.7 | 1.0 |
| Real export growth, % yoy | 0.6 | -4.7 | 7.0 | 0.3 | 1.4 | 4.2 | 0.0 | 1.0 | 1.0 |
| Real import growth, % yoy | 14.8 | -30.4 | 25.8 | 20.3 | 8.8 | 3.7 | -3.0 | -1.0 | 4.4 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 13.3 | 8.8 | 8.8 | 6.1 | 6.6 | 6.5 | 8.7 | 6.5 | 5.5 |
| CPI, % avg | 14.1 | 11.6 | 6.8 | 8.4 | 5.1 | 6.8 | 7.5 | 7.6 | 5.8 |
| Nominal wages, % yoy | 27.4 | 9.1 | 12.8 | 11.7 | 13.3 | 12.3 | 13.5 | 12.7 | 10.0 |
| Credit extension to private sector, % yoy | 37.2 | 2.6 | 12.9 | 28.1 | 19.4 | 17.2 | 15.0 | 8.0 | 10.0 |
| Policy Interest Rate, % eop | 9.50 | 6.00 | 5.00 | 5.25 | 5.50 | 5.50 | 9.50 | 8.50 | 7.00 |
| 3 month inter-bank rate, %, eop | 21.80 | 7.05 | 4.06 | 7.22 | 7.47 | 7.15 | 9.89 | 8.62 | 7.69 |
| Long-term yield, %, eop | 10.90 | 9.45 | 8.23 | 8.77 | 7.04 | 7.88 | 9.74 | 8.68 | 7.74 |
| RUB/US$, eop | 30.5 | 30.3 | 30.6 | 32.2 | 30.6 | 32.9 | 48.5 | 51.2 | 51.8 |
| RUB/US$, avg | 24.9 | 31.7 | 30.4 | 29.4 | 31.1 | 31.9 | 39.3 | 50.4 | 51.8 |
| RUB/EUR, eop | 42.7 | 43.4 | 40.9 | 41.7 | 40.3 | 45.2 | 58.5 | 54.6 | 51.7 |
| RUB/EUR, avg | 36.6 | 44.2 | 40.3 | 41.0 | 40.0 | 42.3 | 51.3 | 56.0 | 52.7 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 103.9 | 50.4 | 67.5 | 97.3 | 71.3 | 34.1 | 60.3 | 53.3 | 43.5 |
| % of GDP | 6.2 | 4.1 | 4.4 | 5.1 | 3.6 | 1.6 | 3.3 | 3.5 | 2.7 |
| Trade balance | 177.6 | 113.2 | 147.0 | 196.9 | 191.7 | 181.9 | 192.3 | 192.7 | 187.8 |
| Exports | 466.3 | 297.2 | 392.7 | 515.4 | 527.4 | 523.3 | 536.4 | 547.1 | 563.5 |
| Imports | 288.7 | 183.9 | 245.7 | 318.6 | 335.8 | 341.3 | 344.1 | 354.4 | 375.7 |
| Service balance | -20.4 | -17.6 | -26.1 | -33.5 | -46.6 | -58.3 | -54.0 | -59.9 | -64.5 |
| Income balance | -46.5 | -39.7 | -47.1 | -60.4 | -67.7 | -80.2 | -69.0 | -70.5 | -70.9 |
| FDI, net | 19.1 | -6.7 | -9.4 | -11.8 | -18.1 | 12.4 | -5.0 | 0.0 | 5.0 |
| International reserves | 410.7 | 405.8 | 432.9 | 441.2 | 473.1 | 456.4 | 396.7 | 415.1 | 413.6 |
| Total amortisations | 47.2 | 49.9 | 40.8 | 52.0 | 90.5 | 139.1 | 163.1 | 81.4 | 106.4 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 4.1 | -5.9 | -3.9 | 0.8 | -0.1 | -0.5 | 0.0 | -1.0 | -0.6 |
| Consolidated gov primary balance | 4.4 | -5.4 | -3.4 | 1.2 | 0.6 | 1.6 | 1.8 | 0.8 | 1.2 |
| Public debt | 5.2 | 9.5 | 9.3 | 9.4 | 11.4 | 11.2 | 12.0 | 12.7 | 13.5 |
| *of which* Domestic | 3.4 | 4.7 | 5.3 | 6.3 | 5.9 | 4.6 | 7.2 | 10.9 | 9.4 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 480.6 | 467.3 | 488.9 | 538.9 | 636.4 | 728.9 | 655.9 | 694.4 | 718.0 |
| Public | 29.5 | 31.3 | 34.5 | 34.7 | 38.1 | 43.1 | 35.6 | 39.7 | 47.2 |
| External debt / GDP | 28.9 | 38.0 | 32.1 | 28.3 | 31.8 | 34.8 | 35.8 | 45.1 | 44.1 |
| External debt / XGS | 91.8 | 136.3 | 110.7 | 94.0 | 107.9 | 122.8 | 111.2 | 116.5 | 118.0 |
| Short-term debt | 73.6 | 52.7 | 60.2 | 68.2 | 81.5 | 85.3 | 74.5 | 84.2 | 97.6 |
| Short-term debt/International reserves (%) | 17.9 | 13.0 | 13.9 | 15.5 | 17.2 | 18.7 | 18.8 | 20.3 | 23.6 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 0.8 | 0.7 | -0.1 | -1.4 | -1.1 | -0.9 | -0.5 | 1.9 | 1.8 |
| CPI, % yoy eop | 7.8 | 8.0 | 8.7 | 8.2 | 7.6 | 7.3 | 6.5 | 6.5 | 6.1 |
| Policy interest rate, %, eop | 7.50 | 8.00 | 9.50 | 9.50 | 9.50 | 8.50 | 8.50 | 8.50 | 8.00 |
| Short-term market rate, % eop | 9.20 | 9.45 | 9.44 | 8.83 | 8.46 | 8.27 | 8.18 | 7.66 | 7.24 |
| Long-term yield, %, eop | 8.53 | 9.44 | 9.74 | 9.78 | 9.36 | 8.87 | 8.68 | 8.16 | 7.74 |
| RUB/US$, avg | 35.0 | 36.3 | 48.5 | 49.4 | 50.2 | 50.9 | 51.2 | 51.5 | 51.8 |

Source: National Sources, Citi Research forecasts

# Slovakia

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- **Summary view** — We have raised our 2014 GDP growth forecast 0.1%pt to 2.4% on stronger GDP in 3Q14, but we cut our 2015 forecast by 0.1%pt to 2.5%. Overall, we continue to expect domestic demand to support GDP growth in 2015 due to the improving labour market and larger fiscal buffer for 2015. However, risks to our outlook are asymmetric and skewed to downside for 2015.

- **Things to watch** — The main risks are external demand and the large errors in the balance of payments data that probably remained high even after the methodological changes to national accounts. While we do not expect major political changes, the left-wing SMER-SD party is unlikely, in our view, to be able to form another one-party majority government after the March 2016 elections.

- **Strategy** — More cash from the single treasury account, a potential fiscal buffer (after partly escaping the debt-brake triggers) and likely further ECB loosening should bode well for Slovak bonds, though we see some risk to the debt-to-GDP ratio from larger errors in BoP and election cycle will influence the fiscal policy.

## Slower growth, but recovery is set to continue

**We increase our 2014 GDP outlook…** Stronger GDP growth in 3Q14 leads us to raise our 2014 GDP growth forecast to 2.4%YoY from 2.3%,;however, we lower our quarterly growth outlook in 4Q14 to 0.4% from 0.6%. This reflects two factors – stronger dynamics in 3Q14, which we assume to be have been driven by net foreign trade and lower confidence indicators, including expected exports in 4Q14. Hence, if there is some surprise in the composition of GDP, it could be an upside risk to our forecast. Domestic demand continues to be supported by solid employment and wage growth. Employment is still driven by the services sector excluding retail. Moreover, nominal average wage growth accelerated in the private sector to 3.8%YoY in September (driven by manufacturing), though there was milder growth of 2.5%YoY in 3Q14 after 3.3% in 2Q14. However, still around 5%YoY growth of central government wages suggests total average wage growth also exceeded growth in the private sector in 3Q14.

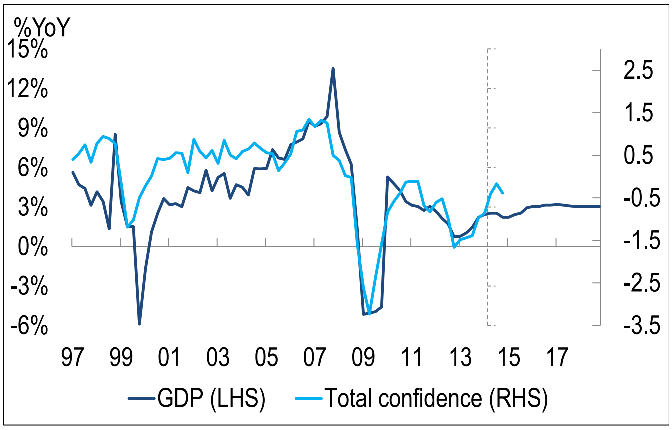
**… but lower our 2015 GDP forecast; the risks to our outlook are asymmetric, but skewed to the downside for 2015.** A stronger base effect from 2014 and unchanged outlook on quarterly GDP dynamics lead us to lower our 2015 GDP growth forecast to 2.5% from 2.6%. However, though the foreign demand outlook demand is somewhat weaker than a few months ago, it still suggests a slight increase in 2015 on a trade-weighted measure of euro area GDP and even more if measured as trade-weighted global GDP growth. Moreover, we assume the euro will weaken substantially with parity reached vs. USD on a 2 year horizon. This should result in a milder, though still supportive, weakening of the currency, against Slovakia's trading partners, of 2% on a one year horizon and more than 4% on a two year horizon. This is supportive for stronger export growth in 2016 after the likely mild deceleration in 2015. However, we continue to expect domestic demand to support GDP growth in 2015 due to an improved labour market in 2014 and larger fiscal buffer for 2015. Weaker external demand is likely to represent a headwind but we still assume it will pick-up in 2015. We continue to see the large errors in the balance of payments as a downside risk to our outlook.

## Fiscal buffer or larger spending ahead of election?

**Revision cuts the debt-to-GDP ratio, but for how long?** The higher level of nominal GDP and other methodological changes brought the government debt ratio below the 55% trigger of the debt-brake rule. This was probably due to two factors. First, though the trade surplus was narrowed on average by 1.5% of GDP in 2011-13, we do not think this is enough to diminish the errors in the balance of payments, which reached in 5.1% of GDP in 2011-13 or 5.7% in July 2014. Hence, we continue to see a risk of eventually lower nominal GDP if Eurostat does not approve the methodological changes made by the Slovak statistical office as they compensated for a narrower trade surplus with unexplained upward benchmark revision elsewhere. If there is a negative impact of around 1.5% of GDP on the level of nominal GDP, it would result into another breach of 55% trigger of the debt-brake rule with 3% freezing of outlays. Second, the Fiscal Council warned that the methodological changes also eliminated the gradual incorporation of hospitals´ liabilities into government debt (0.3% of GDP annually in 2012-2013) which could lead to a larger one-off transfer into government debt later. These two factors risk becoming more material if the government raises the deficit target to 2.5% of GDP (from the 2% currently proposed) – this would raise the debt to GDP ratio to about 54.5% (compared with below 54% if the deficit were to be at 2% of GDP). We also remind that the lower outlook on debt reflects the MinFin's plan to cover its financing needs by the utilization of cash from the Single Treasury Account of 1.2% and 1.6% of GDP in 2015-16 after 2.5% of GDP in 2014. This suggests that the gross borrowing requirements will increase only to €5.1bn in 2015-16 and €6bn in 2017 after €3.7bn in 2014, even though the gross financing need is likely to be €6bn in 2015 and around €6.3bn in 2016-17 after €5.6bn in 2014.

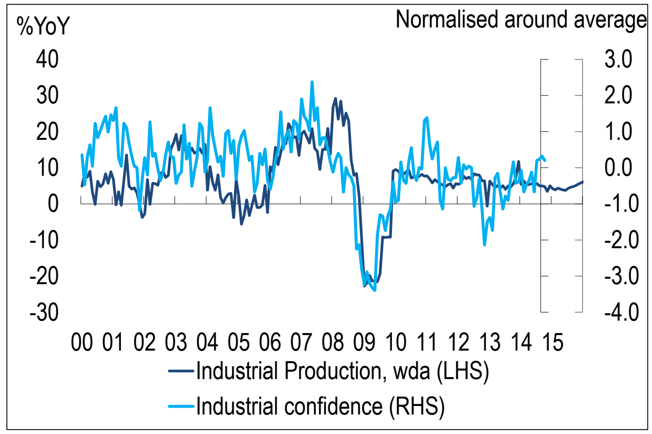
**Will the government keep the fiscal buffer or prefer higher spending in a pre-election year?** The government plans to narrow the general government deficit to 2% of GDP in 2015 from 2.9% in 2014 and a larger narrowing of the structural deficit by 1.2%pt to 0.8% of GDP in 2015 (though it is merely 0.5%pt below the level in 2013). This is based on consolidation measures worth 1.6% of GDP, though some of them do not have a significant impact on growth (for example not lowering VAT from 20%, is worth of 0.4% of GDP). Excluding this, the measures are focused on higher corporate tax (CIT) revenues (0.3% of GDP, longer depreciation of capital), cuts in central government consumption (0.3% of GDP) and cuts in local government investment (0.5% of GDP). We see a risk here as the draft budget assumes a budget surplus of 1% for the rest of the government as the state's deficit is expected to reach 3% and 2% in 2015-16. The Fiscal Council (RZZ) sees the proposal of budgets for 2015-17 as an improvement as it is not based on one-off measures, but RZZ highlighted the risk of smaller dividend revenues. However, as we already mentioned above, we expect the government to spend more of the tax revenues ahead of the general election in March 2016. Hence, the consolidation effort will be milder than the advised 1.2%pt. While this will be probably reflected in a greater consolidation effort in 2016, it will be unlikely to cause much pain for the government as planned consolidation effort for 2016 is currently zero. Hence, the one-party majority government of PM Fico (socialist SMER-SD) is likely to ease the consolidation pain in 2015 ahead of spring election. One test of the election cycle will be the utilization of privatization revenues from the telco company as there are three discussed options: to lower debt, to buy an energy company or to spend (or mix of these three). While SMER-SD is likely to win the election with sufficient majority, we now think SMER will be not able to form another one-party majority government.

**Figure 215. October confidence – though lower - remained supportive for GDP forecast**



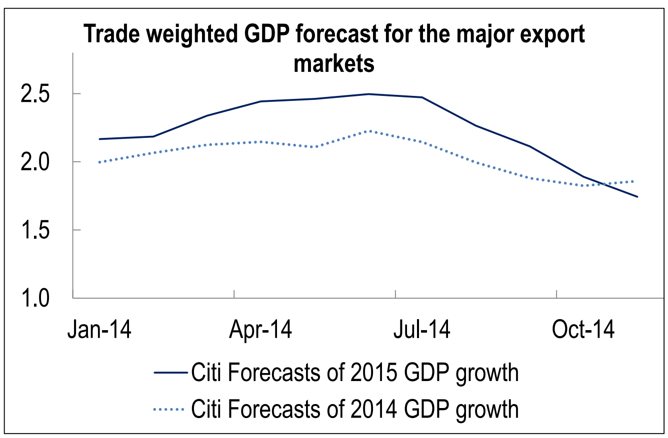

Source: Statistical Office of the Slovak Republic, Citi Research estimates

**Figure 216. Industrial production also remained supportive …**



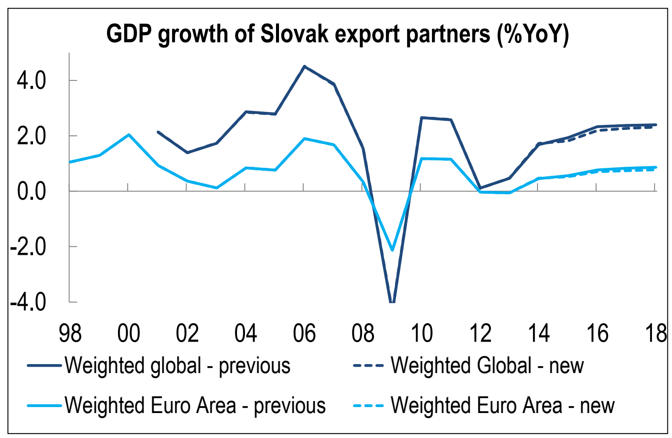

Source: Statistical Office of the Slovak Republic, Citi Research estimates

**Figure 217. … but the outlook on the foreign demand worsened**



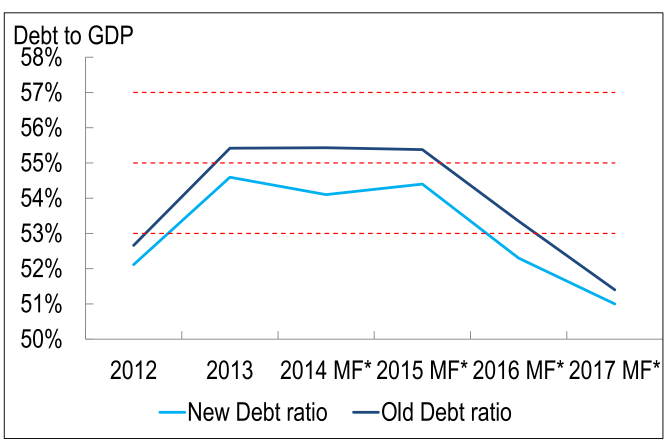

Source: Statistical Office of the Slovak Republic, Haver Analytics, Citi Research

**Figure 218. It still does not, however, suggest a drop in economic activity**



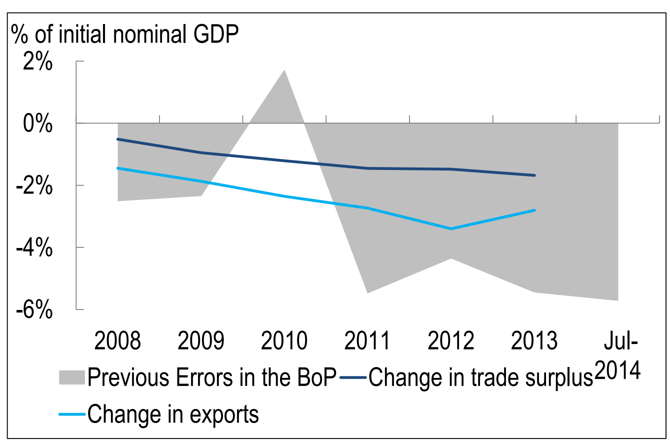

Source: MinFin, Citi Research calculation.

**Figure 219. Revision of national accounts lowered the deb-to-GDP ratio, but …**




Source: MinFin, Citi Research calculation.

**Figure 220. … errors in the Balance of payments probably remained high that create risk of downward revision of nominal GDP in future**




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

### Figure 221. Slovakia Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 95 | 88 | 87 | 96 | 91 | 96 | 100 | 89 | 84 |
| Nominal GDP, local currency bn | 67 | 62 | 66 | 70 | 72 | 74 | 75 | 78 | 82 |
| GDP per capita, USD | 17,493 | 16,156 | 16,087 | 17,654 | 16,781 | 17,587 | 18,314 | 16,340 | 15,453 |
| Population, mn | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 | 5.5 | 5.5 | 5.5 | 5.5 |
| Unemployment, % of labour force | 7.7 | 11.4 | 12.5 | 13.2 | 13.6 | 14.1 | 12.8 | 12.1 | 11.4 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 5.4 | -5.3 | 4.8 | 2.7 | 1.6 | 1.4 | 2.4 | 2.5 | 3.1 |
| Real investment growth % yoy | 5.8 | -29.2 | 18.8 | 7.6 | -14.0 | -0.1 | 9.7 | 4.2 | 4.9 |
| Real consumption growth % yoy | 5.9 | 1.2 | 0.5 | -1.0 | -0.8 | 0.0 | 3.1 | 2.1 | 2.3 |
| private consumption growth % yoy | 6.0 | -0.5 | 0.1 | -0.7 | -0.4 | -0.7 | 2.8 | 2.0 | 2.4 |
| Real export growth, % yoy | 3.0 | -17.0 | 15.7 | 12.0 | 9.3 | 5.2 | 5.5 | 4.9 | 7.3 |
| Real import growth, % yoy | 3.6 | -19.1 | 14.7 | 9.7 | 2.6 | 3.8 | 7.2 | 5.8 | 7.6 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 4.4 | 0.5 | 1.3 | 4.4 | 3.2 | 0.4 | 0.0 | 1.9 | 2.1 |
| CPI, % avg | 4.6 | 1.6 | 1.0 | 3.9 | 3.6 | 1.4 | -0.1 | 1.1 | 2.3 |
| Nominal wages, % yoy | 8.2 | 3.0 | 3.3 | 2.2 | 2.5 | 2.4 | 5.0 | 2.0 | 3.9 |
| Credit extension to private sector, % yoy | 16.3 | 0.9 | 4.8 | 8.6 | 2.8 | 5.6 | 3.0 | 3.9 | 5.3 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | - | - | - | - | - | - | 1.5 | 0.4 | 0.5 |
| % of GDP | - | - | - | - | - | - | 1.5 | 0.5 | 0.5 |
| Trade balance | -1.1 | 1.3 | 1.0 | 1.4 | 4.6 | 5.6 | 5.2 | 3.8 | 3.9 |
| Exports | 72.9 | 55.4 | 64.0 | 79.0 | 79.9 | 85.3 | 87.7 | 80.8 | 79.9 |
| Imports | 74.0 | 54.1 | 63.0 | 77.6 | 75.4 | 79.6 | 82.4 | 77.0 | 76.1 |
| Service balance | - | - | - | - | - | - | -0.1 | 0.0 | -0.1 |
| Income balance | - | - | - | - | - | - | -3.1 | -2.9 | -2.9 |
| FDI, net | - | - | - | - | - | - | 1.0 | 1.5 | 1.8 |
| Total amortisations | 1.7 | 1.8 | 2.1 | 2.1 | 2.2 | 2.6 | 2.6 | 2.6 | 2.8 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -2.3 | -7.9 | -7.5 | -4.1 | -4.2 | -2.6 | -2.9 | -2.8 | -2.1 |
| Consolidated gov primary balance | -0.8 | -6.6 | -6.3 | -3.5 | -3.2 | -1.7 | -2.1 | -1.8 | -1.2 |
| Public debt | 28.8 | 36.7 | 41.6 | 43.5 | 52.1 | 54.6 | 54.5 | 54.3 | 52.1 |
| *of which* Domestic | 19.6 | 21.0 | 25.8 | 30.7 | 49.1 | 93.4 | 58.8 | 65.4 | 67.6 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 52.5 | 65.3 | 65.8 | 68.5 | 70.9 | 82.3 | 83.5 | 85.7 | 89.2 |
| Public | 10.3 | 11.4 | 13.3 | 15.5 | 25.9 | 34.2 | 37.3 | 36.2 | 38.2 |
| External debt / GDP | 55.5 | 74.5 | 75.3 | 71.3 | 77.6 | 85.9 | 83.6 | 96.0 | 105.6 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 27.1 | 37.4 | 36.3 | 36.7 | 28.1 | 25.0 | 23.0 | 24.4 | 24.9 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 2.4 | 2.5 | 2.3 | 2.2 | 2.2 | 2.3 | 2.6 | 2.8 | 3.0 |
| CPI, % yoy eop | -0.1 | -0.1 | 0.3 | 0.8 | 1.3 | 1.6 | 1.9 | 2.1 | 2.0 |
| Short-term market rate, % eop | 0.24 | 0.10 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| Long-term yield, %, eop | 2.05 | 1.49 | 1.15 | 1.50 | 1.50 | 1.75 | 1.69 | 0.80 | 0.90 |

Source: National Sources, Citi Research forecasts

# South Africa

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(On Maternity Leave)

- **Summary view** — The South African economy is currently flirting with stagflation as real GDP growth remains weak and inflation is stuck around the top end of the SARB's target band of 3-6%.
- **Things to watch** — With limited scope to significantly alter fiscal and monetary policy, the main mechanism for adjustment will continue to be the rand. This could remain highly volatile, especially at times of emerging market turmoil.
- **Strategy** — The SARB is committed to policy normalization, or to raising its key Repo rate, but we think its actions will remain very much data-dependent.

## Only a weak recovery in GDP growth in 2015

**With real GDP growth of only 1.4% now expected in 2014, the focus is really on whether there are signs that growth will pick up in 2015**. In some ways the prognosis is poor. The rebalancing of the economy away from consumption as an engine of growth towards production, as seemed to be happening in early 2014, has not gained momentum. Moreover, going into 2015, the combination of still relatively high inflation, tight lending standards, high consumer indebtedness, lackluster consumer confidence and rising electricity tariffs, all point to a sub-par purchasing power environment. Moreover, labour unrest could potentially rear its head again in mid-year when the coal and gold sector start wage negotiations.

**But it is still far from clear that South Africa is caught in a low growth trap.** The first unit of the Medupi power station will be fully operational by Q2 15, and while initially the additional electricity supply will be offset by increased maintenance, its commissioning could mark the beginning of the end of the current electricity constraint. Moreover, wage awards granted in 2014 should also support some consumption, while investment growth, notably in property, should recover having slowed significantly in recent years as monetary policy continues to remain loose.

## Rebalancing is some way off; the ZAR is under pressure

**The clear widening of the current account deficit in 2014 reflects the lack of rebalancing in the economy to date**. We think that this will mean that the 2014 current account deficit remains 'stuck' at 5.3% of GDP, compared to 5.6% in 2013. This is a large deficit given the extent of recent currency weakness. It also means that the government needs to attract around ZAR200bn a year to fund the deficit. And with financial account flows still relatively unpredictable, notably portfolio flows and unrecorded transactions, we continue to expect the ZAR to remain on the back foot weakening to R11.40/USD on a 6-12 month basis.

**But we still think that a slow reduction in the deficit and a rebalancing of the economy is possible in the coming years helped by the weak rand**. This will also partially be helped by a lower global oil price in the coming few years. And despite short term problems such as irrational fears of Ebola contagion, the weaker rand has made South Africa an increasingly attractive tourist destination and will limit import growth and provide a boost to domestic production. Export growth should also benefit from wider African growth and the EU showing signs of a modest recovery. The combination of these trends should ultimately push the current account deficit down towards 4% of GDP by 2016.

## Monetary policy: inflation, growth and normalisation

**We think that inflation recently peaked at 6.6% YoY in June and is set to slowly trend down in 2015**. But the trajectory will prove slow and sticky due to contradictory forces: downward pressures in food and fuel prices being offset by upward pressure from ZAR pass-through in the form of higher core inflation, even if muted versus previous cycles. The lack of a more significant ZAR pass-through to-date is not surprising given the efforts of the listed retail sector to push volumes while absorbing cost push pressures. This is affirmed by both the BER retail survey and financial statements of the listed retail sector. Put together, this allows CPI to remain within the 3-6% target band throughout 2015. But the inflation rate is likely to remain firmly anchored at the top end of the band.

**The fact that inflation remains within the band, but at the top end, coupled with weak GDP growth, left monetary policy walking a tightrope in 2014.** The SARB hiked twice in the year: first by 50bp in January and then by 25bp in July raising the policy rate to 5.75%, with the rationale for the slow moderate hiking being the explicit trade off trade-off between upside inflation risk, and concerns about the growth outlook. What's more, the SARB has moved to smaller incremental hikes of 25bp as a way of signaling that it remains tough on inflation risks, but remains concerned about GDP prospects.

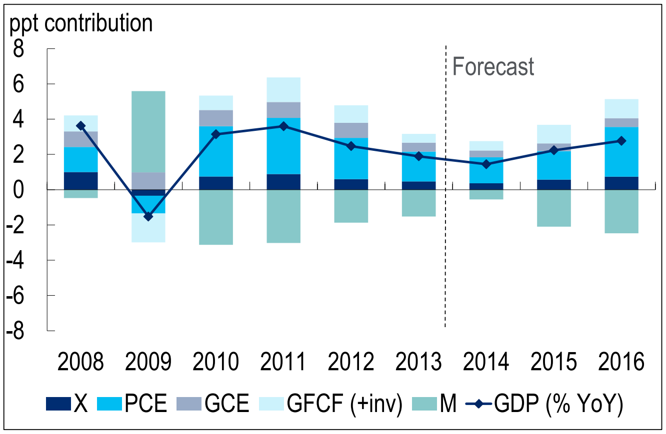
**This essential dilemma will remain in 2015, but with inflation being within the band, even if at the top end, we believe that the SARB will feel less pressure to hike**. But, the SARB is still thinking hard about how to achieve the long term goal of normalizing monetary policy, coupled with the need to attract portfolio inflows to fund the current account, especially at a time when US monetary policy looks set to enter a tightening phase. We think this will eventually push it into further modest rate rises, but probably only in 2016. But we are still not sure how the ZAR will react to changing market expectations of Fed monetary policy. And we expect the SARB to act more aggressively only if it felt that ZAR weakness was substantial enough to push its inflation outlook back above 6.0% for three or more quarters.

## Tough structural policy decisions

**The recent S&P and Fitch sovereign ratings downgrades encapsulate the fine line facing policy makers given the current economic woes in South Africa**. As a result, there was perhaps more than the usual level of interest in the recent October Medium-Term Budget Policy Statement made by the new finance minister, Nhlanhla Nene. In the end he left the deficit reduction path unchanged, but alluded to the need to raise taxes, although he put off any announcement until the February 2015 budget presentation. More worryingly, despite the talk of proposed expenditure restraint, negotiations on public wage rises have only just started and will be a crucial determining factor in this.

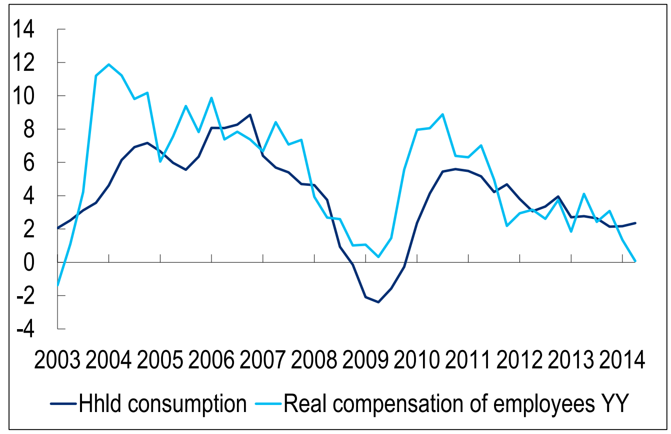
**While Mr Nene explicitly stated that the tax increases outlined in the budget will be based on the current Davis Tax Committee review, our research points to a higher VAT rate as the most obvious tax policy shift**. But we also acknowledge how difficult it will be for National Treasury to find an acceptable compromise that does not impact too negatively on growth. This raises the risk that that tax changes are only formally proposed in the budget speech and actual implementation is pushed back to 2015.

**Figure 222. GDP growth will only pick up slowly in 2015**



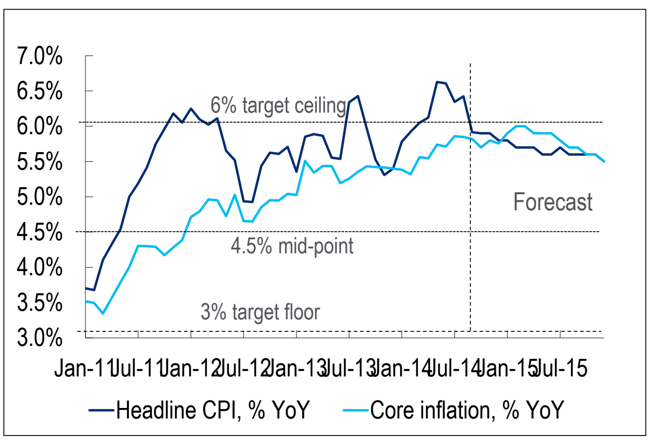

Source: SARB, Citi Research Projections

**Figure 223. Consumption growth is under pressure along with real incomes**



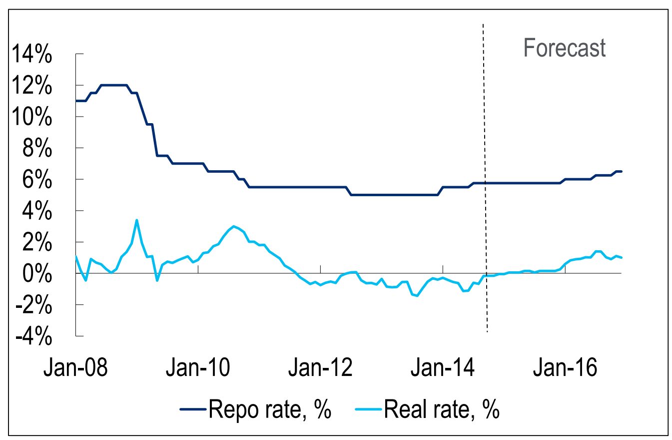

Source: SARB, Citi Research calculations

**Figure 224. Although on a downward trend, the CPI will only ease slowly**



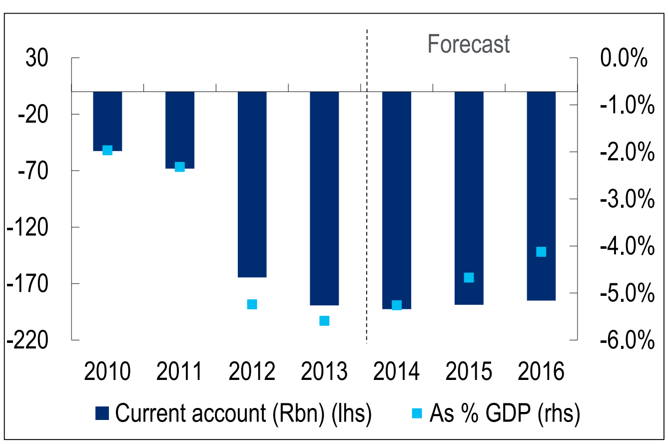

Source: Stats SA, Citi Research projections

**Figure 225. Rand volatility suggests further Repo rates cuts are unlikely**



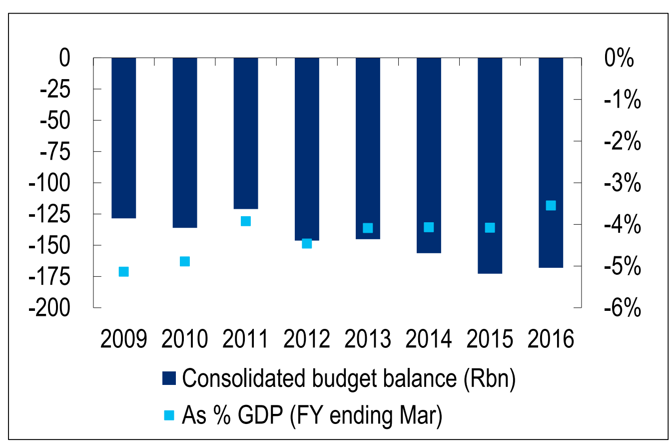

Source: SARB. Stats SA

**Figure 226. Only a very slow narrowing in the current account deficit**




Source: SARB, Citi Research projections

**Figure 227. Fiscal consolidation will likely be slow**




Source: National Treasury, Haver Analytics, Citi Research projections

**Figure 228. South Africa Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 273 | 287 | 366 | 404 | 382 | 351 | 336 | 356 | 391 |
| Nominal GDP, local currency bn | 2,256 | 2,408 | 2,674 | 2,933 | 3,139 | 3,385 | 3,661 | 4,038 | 4,486 |
| GDP per capita, USD | 5,613 | 5,825 | 7,312 | 8,081 | 7,646 | 6,986 | 6,685 | 7,060 | 7,742 |
| Population, mn | 48.7 | 49.3 | 50.0 | 50.0 | 50.0 | 50.2 | 50.3 | 50.4 | 50.5 |
| Unemployment, % of labour force | 22.5 | 23.7 | 24.9 | 24.8 | 24.9 | 24.7 | 25.0 | 24.6 | 24.2 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 3.6 | -1.5 | 3.1 | 3.6 | 2.5 | 1.9 | 1.4 | 2.2 | 2.8 |
| Real investment growth % yoy | 4.4 | -8.6 | 4.3 | 7.0 | 4.9 | 2.4 | 2.6 | 5.0 | 5.0 |
| Real consumption growth % yoy | 2.8 | -0.1 | 4.4 | 4.7 | 3.7 | 2.5 | 2.1 | 2.3 | 2.8 |
| private consumption growth % yoy | 2.2 | -1.6 | 4.4 | 4.9 | 3.5 | 2.6 | 2.2 | 2.4 | 4.2 |
| Real export growth, % yoy | 1.8 | -19.5 | 9.0 | 6.8 | 0.4 | 4.2 | 3.7 | 4.6 | 5.9 |
| Real import growth, % yoy | 1.5 | -17.4 | 11.0 | 10.0 | 6.0 | 4.7 | 1.7 | 6.3 | 7.1 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 9.3 | 6.0 | 3.4 | 6.4 | 5.7 | 5.3 | 5.8 | 5.5 | 5.5 |
| CPI, % avg | 10.0 | 7.2 | 4.1 | 5.0 | 5.7 | 5.8 | 6.1 | 5.6 | 5.2 |
| Nominal wages, % yoy | 12.8 | 11.8 | 13.5 | 7.2 | 7.5 | 8.1 | 8.5 | 8.7 | 9.0 |
| Credit extension to private sector, % yoy | 13.6 | -0.1 | 5.5 | 6.2 | 10.1 | 6.1 | 8.2 | 9.0 | 10.5 |
| Policy Interest Rate, % eop | 11.50 | 7.00 | 5.50 | 5.50 | 5.00 | 5.00 | 5.75 | 5.75 | 6.50 |
| 3 month rate, %, eop | 11.43 | 7.23 | 5.55 | 5.60 | 5.13 | 5.22 | 6.10 | 6.10 | 6.85 |
| Long-term yield, %, eop | 7.33 | 9.05 | 8.14 | 7.93 | 6.39 | 7.91 | 7.90 | 8.00 | 8.20 |
| ZAR/US$, eop | 9.49 | 7.41 | 6.62 | 8.09 | 8.46 | 10.50 | 11.11 | 11.43 | 11.46 |
| ZAR/US$, avg | 8.27 | 8.41 | 7.32 | 7.26 | 8.21 | 9.65 | 10.89 | 11.35 | 11.47 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -19.6 | -11.6 | -7.2 | -9.4 | -20.0 | -19.6 | -17.7 | -16.6 | -16.1 |
| % of GDP | -7.2 | -4.0 | -2.0 | -2.3 | -5.2 | -5.6 | -5.3 | -4.7 | -4.1 |
| Trade balance | -4.3 | 0.3 | 6.8 | 6.5 | -4.8 | -7.6 | -7.8 | -6.4 | -5.2 |
| Exports | 85.3 | 66.4 | 89.8 | 108.8 | 99.2 | 95.1 | 91.7 | 94.1 | 103.4 |
| Imports | 89.6 | 66.1 | 83.0 | 102.3 | 104.0 | 102.7 | 99.4 | 100.5 | 108.6 |
| Service balance | -4.1 | -2.8 | -4.4 | -4.7 | -2.5 | -2.2 | -1.6 | -2.2 | -2.2 |
| Income balance | -8.9 | -6.4 | -7.2 | -9.2 | -8.9 | -6.6 | -5.5 | -5.4 | -6.1 |
| FDI, net | 12.3 | 6.4 | 3.7 | 4.5 | 1.6 | 2.6 | 2.2 | 2.1 | 1.9 |
| International reserves | 30.6 | 35.3 | 38.2 | 42.6 | 44.0 | 44.8 | 46.4 | 47.2 | 47.8 |
| Total amortisations | 2.7 | 2.1 | 1.7 | 2.4 | 7.4 | 4.0 | 5.5 | 2.8 | 4.4 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -1.0 | -5.1 | -4.9 | -3.9 | -4.5 | -4.1 | -4.1 | -4.1 | -3.5 |
| Consolidated gov primary balance | 2.4 | -3.0 | -2.7 | -1.6 | -2.0 | -1.5 | -1.4 | -1.4 | -0.9 |
| Public debt | 27.8 | 31.3 | 35.6 | 39.4 | 42.5 | 46.1 | 49.6 | 50.8 | 50.7 |
| *of which* Domestic | 23.4 | 27.7 | 32.3 | 35.6 | 38.8 | 41.9 | 45.6 | 46.7 | 47.2 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 60.4 | 63.8 | 80.6 | 89.7 | 113.7 | 108.6 | 101.3 | 106.8 | 112.0 |
| Public | 18.1 | 22.6 | 35.8 | 41.5 | 55.9 | 52.8 | 55.7 | 55.7 | 56.7 |
| External debt / GDP | 22.1 | 22.2 | 22.1 | 22.2 | 29.7 | 31.0 | 30.1 | 30.0 | 28.6 |
| External debt / XGS | 61.6 | 81.4 | 77.7 | 72.6 | 99.4 | 99.4 | 95.7 | 98.3 | 93.0 |
| Short-term debt | 25.5 | 21.3 | 21.7 | 20.5 | 27.9 | 27.2 | 28.7 | 29.2 | 30.7 |
| Short-term debt/International reserves (%) | 83.2 | 60.4 | 56.9 | 48.2 | 63.3 | 60.9 | 61.9 | 62.0 | 64.3 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 1.0 | 1.5 | 1.6 | 1.9 | 2.3 | 2.1 | 2.6 | 2.4 | 2.8 |
| CPI, % yoy eop | 6.6 | 5.9 | 5.8 | 5.7 | 5.6 | 5.6 | 5.5 | 5.1 | 5.0 |
| Policy interest rate, %, eop | 5.50 | 6.00 | 5.75 | 5.75 | 5.75 | 5.75 | 5.75 | 6.00 | 6.00 |
| Short-term market rate, % eop | 5.83 | 6.13 | 6.10 | 6.10 | 6.10 | 6.10 | 6.10 | 6.35 | 6.35 |
| Long-term yield, %, eop | 8.17 | 8.13 | 7.90 | 8.00 | 8.05 | 8.00 | 8.00 | 8.10 | 8.20 |
| ZAR/US$, eop | 10.64 | 11.29 | 11.11 | 11.22 | 11.34 | 11.41 | 11.43 | 11.45 | 11.47 |

Source: National Sources, Citi Research forecasts

# Turkey

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- **Summary view** — Developments to date suggest that Turkey needs to revisit its growth strategy and focus on the supply side to avoid sub-par growth.
- **Things to watch** — Political developments ahead of the 2015 general elections, ratings reviews and geopolitical risks require close monitoring.
- **Strategy** — Lower oil prices and the likely temporary decline in inflation next year can create cyclical opportunities. However, a lasting improvement in inflation is unlikely to occur without a more conventional monetary policy.

## Growth is likely to get harder…

**Developments to date corroborate our view that growth will get harder for at least two reasons**. *First*, the country's ability to tap external sources will be adversely affected by the monetary policy normalization process in the US. Given Turkey's excessive reliance on foreign savings to finance its growth, it will be difficult for Turkey to repeat its past performance. *Second*, more stretched corporate and household balance sheets will make it harder for the country to rely on domestic-demand, which has been the main driver in the past, to deliver decent growth rates. In addition to the noted obstacles, our analysis demonstrates that Turkey's prospects of avoiding the middle-income trap without changing its growth strategy and focusing on the supply side look dim (Turkey Macro View - Should we taper our enthusiasm for growth?). In light of the bleak prospects for structural reforms ahead of the 2015 elections, we look for another year of sub-par growth (3.3%) following an estimated 3.1% growth in 2014.

## ...as the CA gap is set to remain too high for comfort

**The current account gap is set to narrow to about 5.5% of GDP in 2014 from around 8% in 2013.** The noted adjustment was underpinned by the combination of the depreciation of the lira, subdued domestic demand and the sharp reversal in net gold exports. While favourable cyclical factors will be fading, we see the current account gap at around 5.0% of GDP in 2015 thanks in part to lower oil prices. Our current account projection and short-term external debt rollovers (by remaining days to maturity) of some US$166bn point to hefty external financing needs amounting to 25% of GDP. This will in turn keep the country vulnerable to sudden shifts in investor sentiment, particularly if one considers Turkey's dependence on portfolio debt flows and short-term bank flows with FDI stuck in the US$8-10 billion per annum pace, or making up a rather meager 15%-20% of the current account deficit.

## Inflation: Enjoy secular tailwinds in 1H 2015 but…

**Our analysis suggests that Turkey's inflation outlook has become more challenging** (Turkey Macro View - Inflation Prospects: Secular headwinds vs. cyclical tailwinds). A battery of statistical tests demonstrate that there has indeed been a structural break in the inflation process, which coincides with the introduction of the CBT's unconventional monetary policy. Nonetheless, we recognize the possibility of cyclical (largely base-effect related) improvements in annual inflation next year. Specifically, assuming a normal harvest year, we believe that year-on-year inflation may fall as low as about 6.0% by the summer of 2015 before creeping up in 2H due to the reversal of favorable base effects and the likely administrative price adjustments, reaching 7% by end of 2015 from an estimated 9.0% in 2014.

## Trade-offs are becoming more acute for the CBT

**At first blush, it is true that the CBT's unconventional monetary policy, which has stimulated much debate, looks rather straight-forward.** In our view, the Bank's opportunistic approach boils down to: (i) tightening its stance and language when the lira comes under pressure and the markets become skittish; and (ii) relaxing its stance—through either providing more liquidity or cutting rates—when the lira and global conditions permit.

**In practice, however, predicting the future course of monetary policy becomes tantamount to forecasting the evolution of the lira and global risk appetite, which are admittedly difficult undertakings**. With this caveat in mind, we believe that the combination of the likely cyclical decline in annual inflation in 1H 2015 and rising concerns about the growth outlook will lead the CBT to relax its stance. Against this backdrop, we expect the CBT to bring its average funding rate (currently at 8.3%) to as low as 7.50% in 1H 2015, provided that the lira depreciation doesn't get out of hand. Nonetheless, we think that the CBT will be forced to reverse its stance in the second half of 2015 with inflation creeping up and the Fed rate hike cycle beginning in 4Q next year.

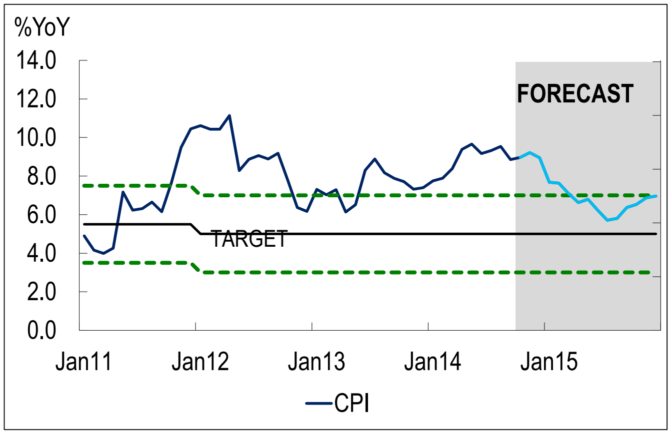
## Fiscal policy may be under pressure to support growth

**Government spending has already started to play a more important role in shaping economic activity in recent years**. For instance, standing at 1.6pp, the contribution of the public sector to GDP growth in 2013 was well above its 2002-12 average of 0.6pp. In our view, such pressures are likely to intensify owing to subdued economic activity, as we approach the 2015 general elections. With this backdrop in mind, we believe that Turkey's fiscal strategy, which is outlined by the 2015-17 Medium Term Program, doesn't go far enough in terms of bolstering national savings and supporting monetary policy to meet the inflation target. More importantly, steady upward revisions in the government's spending projections in recent years and the 2015 general elections lead us to believe that it will be difficult to hold primary expenditures below nominal GDP growth ahead of the upcoming elections. This, coupled with our softer growth projection, leads us to look for a wider overall deficit of around 3.0% of GDP in 2015.

## Turkish Assets: Valuation concerns vs search for yield

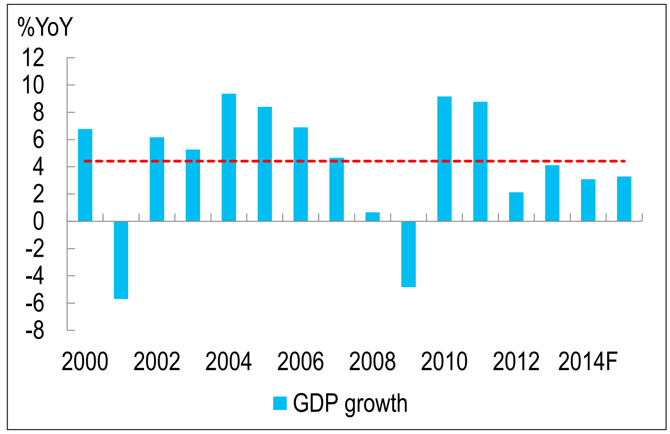
**The country's large external financing needs and the CBT's dovish tendencies make it difficult for us to get excited about the lira outlook.** It is true that the marked decline in oil prices led investors to take a more constructive look at Turkish assets. Nonetheless, our empirical findings suggest that lower oil prices alone shouldn't be taken as a signal for a stronger lira, as the underlying factors behind the decline matter. Concerning the fixed income market outlook, while bonds don't look attractive on valuation grounds, the Treasury's relatively light domestic debt redemption schedule and our inflation forecast trajectory suggest to us that there may be cyclical opportunities. The low likelihood of a durable deceleration in inflation, poor liquidity conditions in the bond market and higher geopolitical risks suggest to us that investors should tread carefully when considering cyclical opportunities in the Turkish fixed income market in 2015.

**Figure 229. Base-effect related improvements in inflation in 1H…**



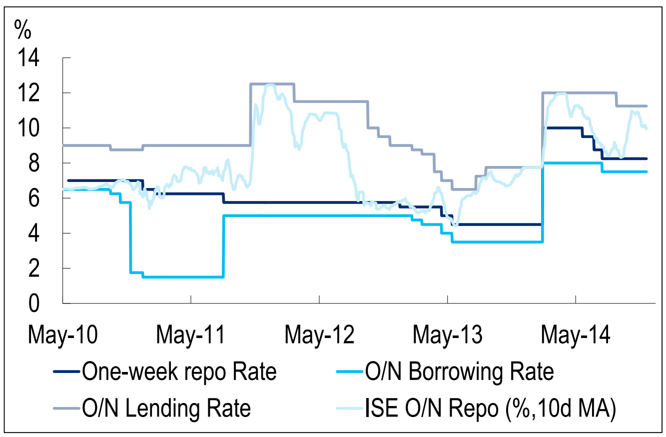

Source: Haver Analytics and Citi Research

**Figure 230. …and the difficult growth outlook…**



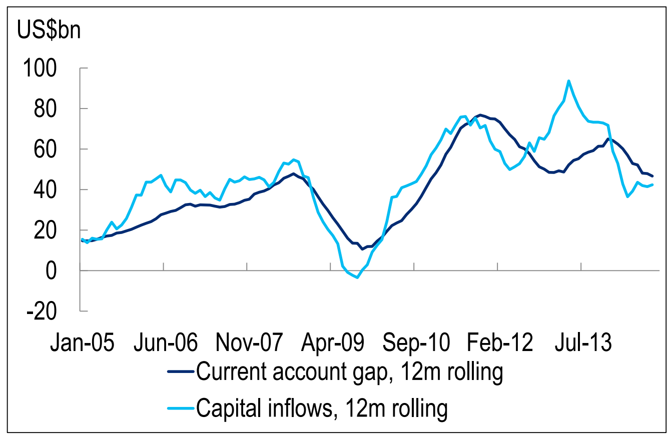

Source: CBT and Citi Research

**Figure 231 …will intensify pressures on the CBT to ease…**




Source: Ministry of Development.

**Figure 232. …but subdued capital inflows…**



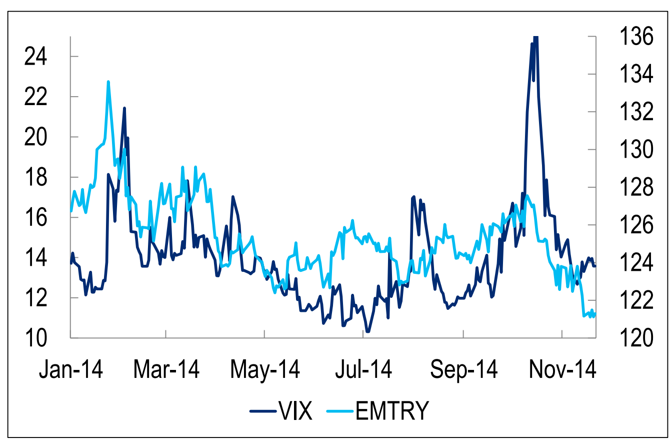

Source: Haver and Citi Research

**Figure 233. …and the country's large external needs…**

| | September 2014 |
|---|---|
| CENTRAL BANK | 1,567 |
| OVERDRAFTS | 0 |
| DEPOSITS WITH CBRT | 1,567 |
| GENERAL GOVERNMENT (**) | 4,923 |
| BANKS | 106,114 |
| CREDITS | 58,651 |
| FX DEPOSITS | 12,587 |
| BANKS ACCOUNTS | 21,998 |
| *Branches and Affiliates Abroad* | *12,229* |
| TRY DEPOSITS | 12,878 |
| *Branches and Affiliates Abroad* | *5,217* |
| OTHER SECTORS | 53,725 |
| TRADE CREDITS | 31,561 |
| DUE TO IMPORTS | 27,252 |
| PRE-EXPORT FINANCING | 4,309 |
| OTHER CREDITS | 22,164 |
| PUBLIC | 217 |
| PRIVATE | 21,947 |
| *Branches and Affiliates Abroad* | *5,955* |
| TOTAL | 166,329 |

Source: CBT and Citi Research. (**) Payments for the government bond issues in the international capital markets (eurobond) maturing within 1 year or less (except the purchases of residents) are included.

**Figure 234. …are likely to leave the lira at the mercy of global markets.**




Source: Bloomberg and Citi Research EMTRY: Higher values represent a weaker lira with respect to EM

**Figure 235. Turkey Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 731 | 615 | 731 | 775 | 789 | 822 | 799 | 787 | 831 |
| Nominal GDP, local currency bn | 951 | 953 | 1,099 | 1,298 | 1,417 | 1,565 | 1,757 | 1,937 | 2,142 |
| GDP per capita, USD | 10,282 | 8,530 | 10,016 | 10,473 | 10,531 | 10,746 | 10,337 | 10,077 | 10,525 |
| Population, mn | 71.1 | 72.1 | 73.0 | 74.0 | 74.9 | 76.5 | 77.3 | 78.2 | 79.0 |
| Unemployment, % of labour force | 10.0 | 13.0 | 11.2 | 9.1 | 8.5 | 9.1 | 9.9 | 10.2 | 10.4 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 0.7 | -4.8 | 9.2 | 8.8 | 2.1 | 4.1 | 3.1 | 3.3 | 3.4 |
| Real investment growth % yoy | -4.8 | -28.6 | 48.4 | 16.8 | -8.5 | 11.3 | -1.4 | 2.0 | 2.4 |
| Real consumption growth % yoy | -0.1 | -1.0 | 6.0 | 7.3 | 0.4 | 5.3 | 1.9 | 3.4 | 3.5 |
| private consumption growth % yoy | -0.3 | -2.3 | 6.7 | 7.7 | -0.5 | 5.1 | 1.3 | 3.2 | 3.5 |
| Real export growth, % yoy | 2.7 | -5.0 | 3.4 | 7.9 | 16.3 | -0.3 | 5.2 | 4.4 | 4.5 |
| Real import growth, % yoy | -4.1 | -14.3 | 20.7 | 10.7 | -0.4 | 9.0 | -2.0 | 3.5 | 4.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 10.1 | 6.5 | 6.4 | 10.4 | 6.2 | 7.4 | 9.0 | 7.0 | 6.7 |
| CPI, % avg | 10.4 | 6.3 | 8.6 | 6.5 | 8.9 | 7.5 | 8.9 | 6.7 | 7.0 |
| Nominal wages, % yoy | 11.6 | 9.9 | 11.8 | 9.7 | 11.5 | 12.4 | 16.0 | 14.0 | 12.5 |
| Credit extension to private sector, % yoy | 22.4 | 13.4 | 40.4 | 32.8 | 19.8 | 33.5 | 15.0 | 15.0 | 15.0 |
| Policy Interest Rate, % eop | 15.00 | 6.50 | 6.50 | 5.75 | 5.55 | 7.10 | 8.30 | 9.00 | 10.00 |
| 3 month inter-bank rate, %, eop | 17.48 | 7.42 | 7.68 | 11.57 | 5.93 | 9.34 | 9.50 | 10.20 | 11.20 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| TRY/US$, eop | 1.54 | 1.50 | 1.54 | 1.89 | 1.78 | 2.15 | 2.26 | 2.53 | 2.60 |
| TRY/US$, avg | 1.31 | 1.55 | 1.51 | 1.68 | 1.80 | 1.91 | 2.20 | 2.46 | 2.58 |
| TRY/EUR, eop | 2.15 | 2.15 | 2.06 | 2.44 | 2.35 | 2.95 | 2.72 | 2.70 | 2.60 |
| TRY/EUR, avg | 1.92 | 2.17 | 2.00 | 2.34 | 2.32 | 2.53 | 2.87 | 2.73 | 2.62 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -40.2 | -9.6 | -42.9 | -72.5 | -45.9 | -61.7 | -44.0 | -40.1 | -45.6 |
| % of GDP | -5.5 | -1.6 | -5.9 | -9.4 | -5.8 | -7.5 | -5.5 | -5.1 | -5.5 |
| Trade balance | -52.9 | -24.8 | -56.3 | -89.1 | -65.3 | -79.9 | -65.8 | -64.5 | -72.9 |
| Exports | 140.9 | 109.7 | 121.0 | 142.4 | 161.9 | 161.8 | 173.9 | 174.1 | 186.8 |
| Imports | 193.8 | 134.5 | 177.3 | 231.5 | 227.2 | 241.7 | 239.7 | 238.6 | 259.6 |
| Service balance | 18.8 | 21.0 | 19.2 | 22.7 | 25.1 | 26.4 | 29.4 | 31.3 | 33.6 |
| Income balance | -8.4 | -8.3 | -7.2 | -7.9 | -7.2 | -9.4 | -8.8 | -8.2 | -7.7 |
| FDI, net | 22.3 | 10.2 | 10.5 | 18.5 | 17.3 | 16.5 | 8.5 | 10.5 | 11.0 |
| International reserves | 71.0 | 70.7 | 80.7 | 78.5 | 99.9 | 109.8 | 114.3 | 118.3 | 122.3 |
| Total amortisations | -34.0 | -43.0 | -41.6 | -39.4 | -46.6 | -49.3 | 35.0 | 40.0 | 40.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -1.8 | -5.5 | -3.6 | -1.3 | -2.0 | -1.2 | -2.0 | -2.9 | -3.0 |
| Consolidated gov primary balance | 3.5 | 0.1 | 0.8 | 1.8 | 1.4 | 0.9 | 0.3 | 0.3 | 0.5 |
| Public debt | 41.2 | 47.7 | 44.4 | 41.2 | 38.8 | 38.7 | 36.2 | 35.7 | 35.2 |
| *of which* Domestic | 28.9 | 34.6 | 32.1 | 28.4 | 27.3 | 25.7 | 25.0 | 24.7 | 24.5 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 281.1 | 269.1 | 292.0 | 304.4 | 337.5 | 482.2 | 506.3 | 536.3 | 566.6 |
| Public | 92.4 | 96.6 | 100.6 | 80.3 | 110.2 | 226.3 | 225.3 | 230.3 | 235.3 |
| External debt / GDP | 38.5 | 43.8 | 39.9 | 39.3 | 42.8 | 58.7 | 63.3 | 68.1 | 68.2 |
| External debt / XGS | 158.1 | 185.0 | 185.7 | 166.3 | 164.6 | 231.5 | 226.4 | 236.5 | 232.8 |
| Short-term debt | 52.5 | 49.0 | 77.3 | 81.9 | 100.8 | 129.4 | 132.4 | 139.4 | 146.7 |
| Short-term debt/International reserves (%) | 74.0 | 69.3 | 95.8 | 104.4 | 100.9 | 117.8 | 115.8 | 117.8 | 119.9 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 2.1 | 2.4 | 3.3 | 2.9 | 3.3 | 3.8 | 4.4 | 3.8 | 3.6 |
| CPI, % yoy eop | 9.2 | 8.9 | 9.0 | 7.1 | 6.2 | 6.4 | 7.0 | 7.1 | 7.0 |
| Policy interest rate, %, eop | 8.82 | 8.72 | 8.30 | 8.00 | 7.50 | 8.50 | 9.00 | 9.50 | 10.00 |
| Short-term market rate, % eop | 9.25 | 10.95 | 9.50 | 9.20 | 8.70 | 9.70 | 10.20 | 10.70 | 11.20 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| TRY/US$, eop | 2.12 | 2.28 | 2.26 | 2.35 | 2.45 | 2.51 | 2.53 | 2.55 | 2.57 |

Source: National Sources, Citi Research forecasts

# Ukraine

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- **Summary view** — Ukraine's classic balance of payment crisis was exacerbated by geopolitical uncertainty, leading to a significant GDP contraction, which we estimate at -6.4% in 2014. We anticipate the economy will continue to shrink in 2015 at -2.4% as uncertainty lingers on.
- **Things to watch** — The IMF Program concluded in April 2014 provided much needed financial resources needed to meet existing obligations, but the deteriorating macroeconomic backdrop will most likely invite a renegotiation of IMF terms in 2015 to include additional financing.
- **Strategy** —USDUAH has since slid by almost 100% relative to the start of 2014. The NBU raised policy rates by 750bp in 2014, with an aim to halting currency-driven inflation, but the fraught political backdrop may continue exert pressures on the currency in 2015.

## Economy to continue shrinking in 2015

**The 27 March 2014 announcement of a new IMF deal provided much needed financial resources to meet upcoming obligations.** The confluence of an unsustainable external position, overvalued exchange rate, and fast declining reserves have kept markets fully aware of the possibility of Ukraine being unable to meet its upcoming external obligations. However, the two-year Stand-By Arrangement announced on 27 March aimed at unlocking US$27bn, including US$17bn from the IMF, has provided requisite financial support to meet obligations.

**However, the recently concluded first review of the IMF Program points to significant difficulties in meeting agreed fiscal targets.** According to an IMF statement released on 29 August, Ukrainian authorities have fulfilled all but one of the end-May performance criteria and all structural benchmarks required to disburse the next US$1.4bn tranche of the two-year US$17bn stand-by agreement. However, the IMF has acknowledged that, mainly due to a shortfall in revenue collections in the East, previously agreed fiscal targets will need to be reviewed to bring the IMF Program in line with realities on the ground. The IMF also acknowledges that the downside risks to the Program remain very high.

**As a result, 2014–2015 fiscal balances were revised.** Most importantly, the revision for this year will be significant, as the headline deficit will widen to 10.1% from the original 8.5% of GDP. 2015 is set to see a small positive change from a deficit of 6.1% of GDP to 5.8% of GDP.

**The government will commit itself to further tightening measures to address fiscal weakness.** These will include deeper reductions in public sector employment, further cuts in capital spending and limitations on planned wage and pension increases.

**The economy is already feeling the strain of tighter policies.** 3Q14 GDP contracted by 5.1%YoY vs 4.6%YoY and 1.3% in 2Q14 and 1Q14. As a result, GDP has fallen by 3.7%YoY during Jan-Sep. The economic pain has been spread across different sectors of the economy, with particularly sharp drops in mining, quarrying and manufacturing. Economic contraction is much deeper in the East, with output falling by an estimated 15-20%YoY and industrial production collapsing by 75.0%YoY and 59.5% in Sep in Lugansk and Donetsk, respectively. We see a deeper fall in 4Q14 at 14.5%, bringing 2014 GDP growth at -6.4%.

**We forecast that the economy will continue to shrink in 2015, albeit at a much more modest pace.** We anticipate that the still fraught geopolitical backdrop will continue to exert pressure on the economy, leading to another year of negative economic growth of 2.4%. Real investment growth should fall for a third consecutive year by 3.5% (vs 6.7% and 7.0% contractions in 2012 and 2014), while real consumption spending will contract by 2.2% vs an estimated 5.3% in 2014 as high inflation and weaker currency eats away at real purchasing power. We see the economy transitioning to a modestly positive GDP growth of 1.6% only in 2016.

**Central bank policy rate hikes are also weighing on growth.** The National Bank of Ukraine (NBU) raised its key policy rate by a cumulative 750bp to 14.5% in 2014. According to the NBU, the hikes were aimed at dealing with higher inflation risks. Inflation has indeed accelerated on weaker currency since the start of the year. CPI inflation rose sharply from 0.5%YoY in Jan to 19.8% in Oct on the back of a currency that has seen a significant depreciation against the US dollar from just 8.25 at the start of the year to 15.60 now. Similarly, producer prices have increased from 1.9%YoY in Jan to 25.9% in Oct.

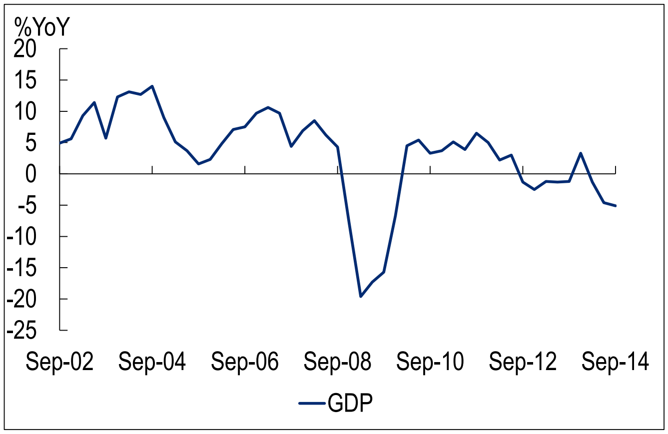
**More broadly, Ukraine faces a classic stagflation scenario against the backdrop of fraught political and geopolitical environment.** The combination of lower growth and rising inflation is pointing to a painful stagflation despite some welcome improvements in the current account and stabilization of local currency withdrawals. Macroeconomic uncertainty is unlikely to dissipate any time soon with the still very tense situation in the Donbass area in Eatern Ukraine.

**Lower growth and IMF conditionalities will impose significant economic pain on the population, manifesting itself in almost 40% decline in incomes.** The forecast 2.4% 2015 GDP contraction would follow on the sharp 6.4% estimated fall in output in 2014 and two consecutive years of almost no growth in 2012 and 2013. This will engender a substantial fall in per-capita incomes from US$3,994 in 2013 to an estimated US$2,449 in 2015–a painful drop of about 40%.

**This suggests that the December IMF review may be difficult to complete, arguing for more revisions in the IMF Program.** While external financing seems secure over the coming months, geopolitical uncertainty and possible domestic unrest over the newly proposed expenditure measures could make it increasingly costly for Kiev to abide by the harsh IMF conditions. The IMF Program is built around the key assumption that the military operations in the East would fade away in the coming months. In the event of this not materializing and the conflict continuing into 2015, which seems increasingly to be the case, the IMF estimates that the external gap will widen by an additional US$19bn by the end of 2015, necessitating a completely revised macroeconomic framework (IMF still assumes positive GDP growth in 2015).

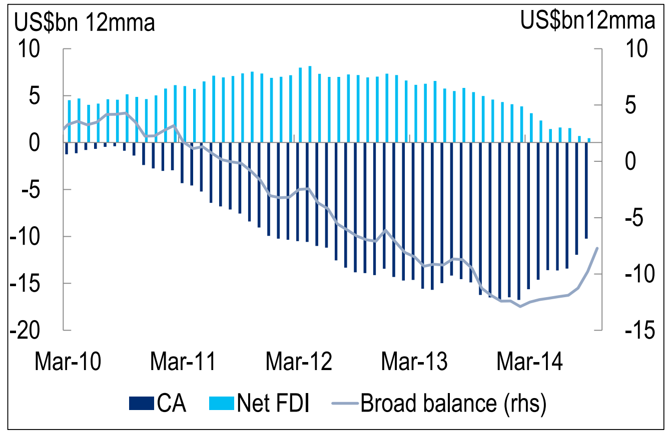
**On the positive side, the current account deficit has improved, but gains in the broad balance have been limited by the collapse of net FDIs related to the very unstable geopolitical environment.** The Jan-Sep 2014 current account deficit amounted to US$3.3bn, which marks a significant improvement on the US$11.5bn current account deficit posted for the same period in 2013. However, the fraught geopolitical backdrop has led to net FDI transitioning from a surplus of US$3.1bn during Jan-Sep 2013 to a deficit of US$0.4bn during Jan-Sep this year. Still, we forecast the current account deficit to improve from 9.1% of GDP in 2013 to and 3.2% of GDP in 2013 and 2.7% of GDP in 2015.

**Figure 236. Economic contraction has deepened…**



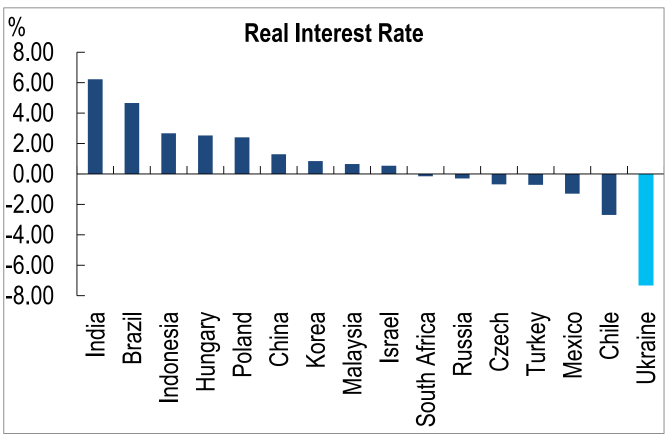

Source: UKR Statistics, Citi Research

**Figure 237. … but the external position has started to improve**



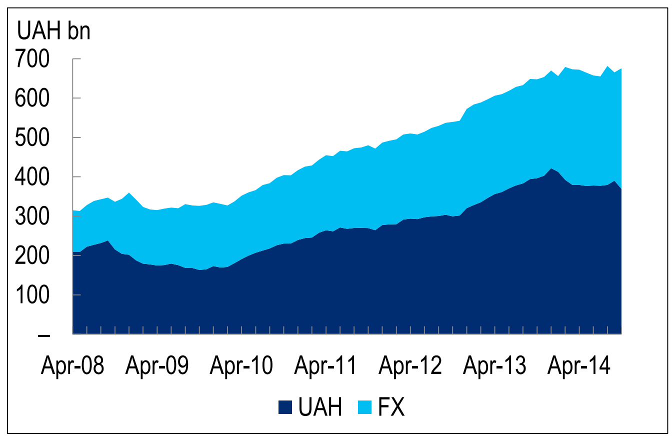

Source: UKR Statistics, Citi Research

**Figure 238. Real interest rates have turned very negative on fast accelerating inflation**



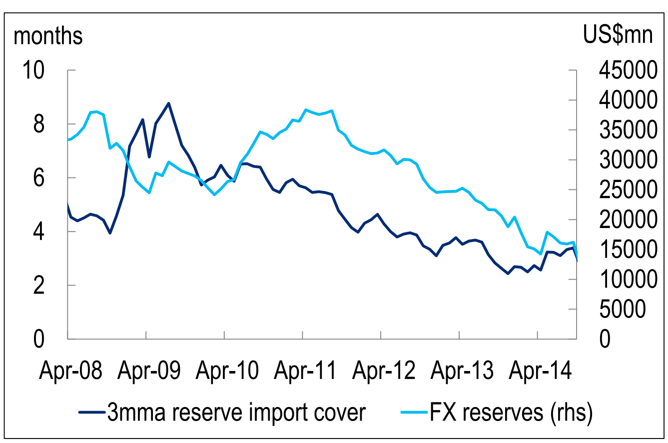

Source: Citi Research

**Figure 239. Deposit withdrawals have resumed**



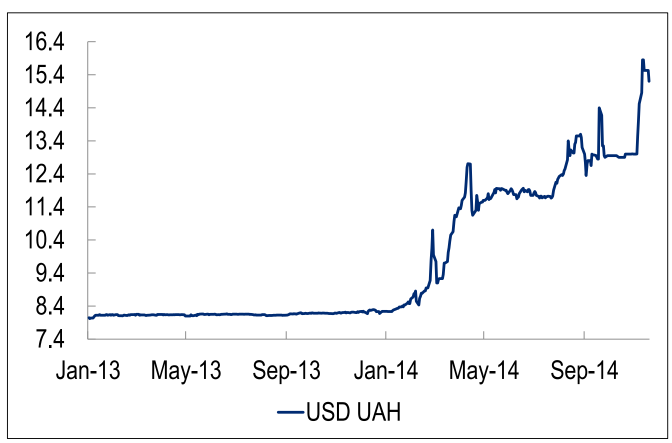

Source: UKR Statistics, Citi Research

**Figure 240. Reserves are hovering about 3 months of imports …**




Source: UKR Statistics, Citi Research

**Figure 241. …while the exchange rate has been weakening**




Source: Haver Analytics

Figure 242. Ukraine Economic Indicators

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 180 | 117 | 136 | 163 | 176 | 181 | 126 | 111 | 131 |
| Nominal GDP, local currency bn | 975 | 921 | 1,077 | 1,291 | 1,402 | 1,449 | 1,495 | 1,666 | 1,835 |
| GDP per capita, USD | 3,871 | 2,533 | 2,955 | 3,561 | 3,854 | 3,994 | 2,777 | 2,466 | 2,917 |
| Population, mn | 46.5 | 46.2 | 46.0 | 45.8 | 45.6 | 45.4 | 45.2 | 45.0 | 44.8 |
| Unemployment, % of labour force | 6.4 | 8.8 | 8.1 | 7.9 | 7.8 | 7.4 | 7.7 | 7.5 | 7.2 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 2.3 | -14.8 | 3.8 | 5.5 | 0.2 | 0.2 | -6.4 | -2.4 | 1.6 |
| Real investment growth % yoy | - | - | - | 12.9 | -4.6 | -17.9 | -16.1 | -6.8 | 5.5 |
| Real consumption growth % yoy | 10.1 | -12.3 | 6.1 | 11.3 | 7.4 | 5.7 | -5.3 | -2.2 | 3.0 |
| private consumption growth % yoy | 12.8 | -14.9 | 6.7 | 15.6 | 8.1 | 7.8 | -6.5 | -3.0 | 3.5 |
| Real export growth, % yoy | 5.7 | -22.0 | 3.1 | 2.7 | -5.6 | -9.3 | -5.0 | -2.0 | 2.0 |
| Real import growth, % yoy | 17.0 | -38.9 | 10.6 | 15.4 | 3.8 | -6.4 | -8.0 | -2.5 | 5.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 22.3 | 12.3 | 9.1 | 4.6 | -0.2 | 0.5 | 23.6 | 8.9 | 7.9 |
| CPI, % avg | 25.2 | 15.9 | 9.4 | 8.0 | 0.6 | -0.3 | 12.1 | 16.2 | 8.4 |
| Nominal wages, % yoy | 33.7 | 5.5 | 17.7 | 17.5 | 14.9 | 8.0 | 9.7 | 8.5 | 5.5 |
| Credit extension to private sector, % yoy | 67.1 | -4.2 | 0.7 | 8.9 | 2.8 | 13.8 | 10.0 | 10.0 | 10.0 |
| Policy Interest Rate, % eop | 12.00 | 10.25 | 7.75 | 7.75 | 7.50 | 6.50 | 14.00 | 12.00 | 10.00 |
| 3 month inter-bank rate, %, eop | 23.58 | 18.00 | 8.25 | 20.83 | 24.00 | 16.00 | 16.50 | 15.60 | 14.50 |
| UAH/US$, eop | 8.05 | 8.05 | 7.97 | 8.01 | 8.05 | 8.24 | 15.50 | 15.00 | 14.00 |
| UAH/US$, avg | 5.16 | 8.06 | 7.97 | 7.99 | 8.08 | 8.15 | 11.91 | 15.02 | 14.04 |
| UAH/EUR, eop | 11.25 | 11.53 | 10.66 | 10.37 | 10.62 | 11.33 | 18.68 | 16.02 | 15.68 |
| UAH/EUR, avg | 7.60 | 11.21 | 10.55 | 11.11 | 10.39 | 10.83 | 15.59 | 16.96 | 15.27 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | -12.8 | -1.7 | -3.0 | -10.2 | -14.3 | -16.5 | -4.0 | -2.9 | -2.7 |
| % of GDP | -7.1 | -1.5 | -2.2 | -6.3 | -8.1 | -9.1 | -3.2 | -2.7 | -2.1 |
| Trade balance | -16.1 | -4.3 | -8.4 | -16.3 | -19.5 | -20.0 | -11.8 | -8.8 | -9.0 |
| Exports | 67.7 | 40.4 | 52.2 | 69.4 | 70.2 | 65.0 | 60.4 | 63.5 | 65.4 |
| Imports | 83.8 | 44.7 | 60.6 | 85.7 | 89.7 | 85.0 | 72.2 | 72.2 | 74.4 |
| Service balance | 1.7 | 2.4 | 4.4 | 6.1 | 5.2 | 4.4 | 6.0 | 5.5 | 6.0 |
| Income balance | -1.5 | -2.4 | -2.0 | -3.8 | -3.0 | -3.0 | -1.5 | -3.0 | -3.0 |
| FDI, net | 9.9 | 4.7 | 5.8 | 7.0 | 7.2 | 4.1 | 0.0 | -3.0 | 5.0 |
| International reserves | 31.5 | 26.4 | 34.6 | 31.8 | 24.5 | 20.4 | 10.4 | 17.5 | 19.8 |
| Total amortisations | 13.9 | 17.9 | 23.5 | 23.6 | 20.1 | 20.5 | 18.0 | 22.1 | 25.0 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -1.2 | -7.3 | -8.8 | -3.9 | -5.6 | -6.6 | -10.0 | -6.0 | -4.0 |
| Consolidated gov primary balance | -0.8 | -6.2 | -7.6 | -2.9 | -4.7 | -5.7 | -8.8 | -4.8 | -2.9 |

Quarterly Economic Indicators

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | -4.6 | -5.9 | -12.8 | -5.1 | -4.2 | -2.6 | 1.8 | -2.1 | -0.2 |
| CPI, % yoy eop | 11.9 | 17.5 | 23.6 | 23.1 | 16.1 | 13.4 | 8.9 | 8.4 | 8.9 |
| Policy interest rate, %, eop | 9.50 | 12.50 | 14.00 | 14.00 | 14.00 | 14.00 | 12.00 | 11.00 | 10.00 |
| Short-term market rate, % eop | 18.00 | 18.00 | 16.50 | 16.50 | 16.25 | 16.00 | 15.60 | 15.50 | 15.25 |
| UAH/US$, eop | 11.75 | 12.95 | 15.50 | 15.00 | 15.00 | 15.00 | 15.00 | 14.00 | 14.00 |

Source: National Sources, Citi Research forecasts

# Other Africa

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## Ghana

- The November budget presentation outlined an aggressive reduction in the 2015 fiscal deficit, but it is based on very optimistic revenue projections, especially as the authorities seems to have now accepted that growth will slow significantly in 2015. While we think the revenue projections will not be met, what is less clear is whether it can serve as a base for a deal with the IMF in early 2015. And reaching a deal is becoming increasingly important as Ghana rapidly approaches a period of intensive cedi bond repayments in 2H 2015 and into 2016.

- With inflation creeping up in 2014, the Bank of Ghana (BoG) has slowly tightened monetary policy in response. The BoG will also have welcomed the recent stability. But we think this is temporary, and the cedi remains under pressure. Moreover, the ability of the BoG to limit cedi depreciation in 2015 will depend on fiscal developments and the funding attached to any IMF deal.

- The government will probably be able to muddle through, especially if a deal can be struck with the IMF and it commits to a programme of fiscal consolidation that runs over the December 2016 elections with only minimal slippage. However, there is also a very real chance that the government could face a wider loss of investor confidence in late 2015 or early 2016. This could potentially lead to a wider economic crisis and a complete loss in confidence in the cedi.

## Kenya

- A steady pick-up in growth towards 6% by 2015 seems underway, but the recovery is clearly being constrained by ongoing political uncertainty, sporadic terrorist incidences, periodic drought and infrastructure bottlenecks.

- The recent GDP revision, plus a proposed revision to the balance of payments statistics, should reduce the twin fiscal and current account deficits and provide a more logical explanation of only gradual Kenyan shilling depreciation in recent years and the ability of the CBK to build foreign exchange reserves. But the government will have to avoid the temptation of using the lower fiscal deficits debt stock as an excuse for not continuing with its programme of gradual mid-election fiscal consolidation.

- Although the Central Bank of Kenya (CBK) will be sorely tempted to cut rates to support the economic pick-up, with inflation remaining either above, or at the top end of its inflation target (5%, +/- 2.5pp), for the rest of 2014 and into early 2015 we think it will act cautiously. Especially as rate cuts could spill over into more substantial KES depreciation than the gradual depreciation the CBK seems comfortable with.

## Tanzania

- Tanzanian politics will be dominated by the battle to succeed current president, Jakaya Kikwete, and adopting a new constitution, although it now seems unlikely that the constitution can be agreed upon and approved prior to the polls scheduled to be held in October 2015. Both issues will detract from the need for economic reform, notably the pressing need to resolve the ongoing power sector crisis, which has negatively impacted growth, pushed up imports and made bringing down the inflation rate a much slower process than elsewhere in East Africa, although it is now firmly in single digits.

- After two years of relative stability, the substantial fiscal and current account deficits have started to translate into more significant shilling weakness in 2014. Whether this picks up pace next year could well depend on the extent of fiscal slippage in the run up to the 2015 elections. But with revenue collection behind targets and arrears a mounting concern, pressure could potentially increase limiting the scope of the Bank of Tanzania (BOT) to loosen monetary policy.

## Uganda

- The Uganda economy is slowly recovering after the sharp slowdown in 2012. The recovery should be helped by the expansionary fiscal budget announced in June 2014 which is based on a sharp rise in infrastructure spending. But external financing could problematic, and coupled with capacity issues the deficit may well prove lower than the 7.6% projected by the government. If external borrowing is problematic, increased domestic borrowing can partially offset, although domestic debt has already risen significantly in recent years.

- In this environment, the Bank of Uganda (BoU) will face a difficult balancing act. While it probably wants to cut the Central Bank Rate (CBR) in 2H 2014 in line with its inflation outlook this may well spill over into potential Ugandan shilling (UGX) weakness given the fiscal stance especially if the government bows to raising recurrent spending in 2015 as the February 2016 elections loom closer. So we expect it will opt for a more cautious approach limiting depreciation.

- At some point in the next five years, Uganda will become an oil producer. But this is still a long term promise, and its impact on growth and government revenue will, initially, be minimal. While the development of the fields will push up the current account deficit, it should be largely funded through FDI.

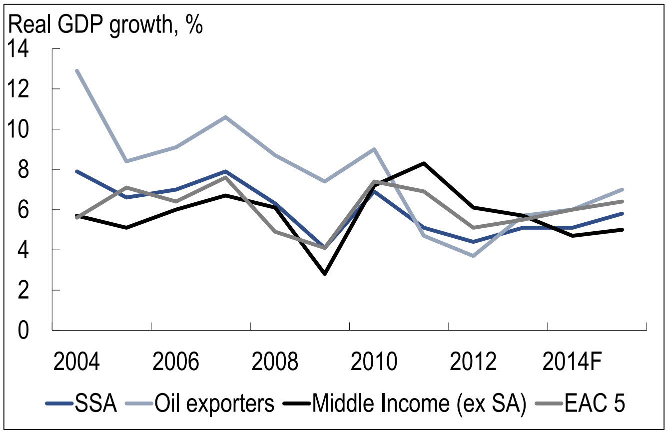
## Zambia

- The death of President Sata on October 29 means that elections will now be held on January 20. These are likely to be closely contested between the three main parties, but orderly as were the elections in 2008 under the same circumstances. But the two main parties are facing significant internal battles over the selection of their presidential candidates, which is creating some further uncertainty.

- While the political uncertainty has led to short term pressure on the kwacha since early October, with the 2015 budget outlining still further fiscal consolidation next year, coupled with the current account now expected to remain in a small surplus and strong FDI inflows, we expect the current bout of kwacha weakness to be relatively limited and further kwacha stability in 2015.

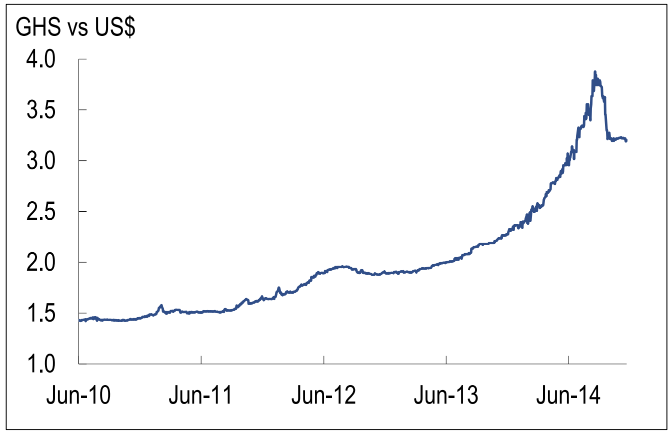
- Kwacha stability would be further boosted if the government can agree a new programme with the IMF in early 2015. These trends should also allow the Bank of Zambia (BoZ) to rebuild foreign exchange reserves which are low by regional standards. Although under the new GDP data growth has slowed significantly in recent years from the peak in 2010, it has still been above 6% in recent years.

Figure 243. Growth should remain robust in 2014-15



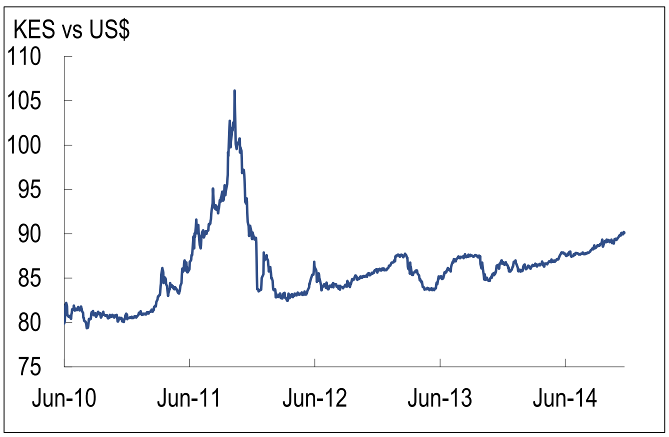

Source: IMF

Figure 244. A temporary cedi stabilization, but for how long?



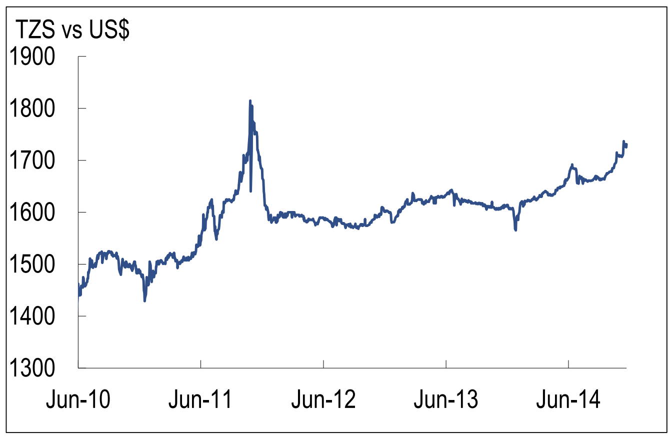

Source: Haver Analytics

Figure 245. A gradual depreciation of the Kenyan shilling in 2014




Source: Haver Analytics

Figure 246. The Tanzanian shilling has eventually started to weaken




Source: Haver Analytics

Figure 247. The Ugandan shilling is now coming under more pressure


Source: Haver Analytics

Figure 248. The Zambian kwacha remains under only moderate pressure


Source: Haver Analytics

**Figure 249. Other Africa Economic Forecasts**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **GHANA** | | | | | | | | | |
| Nominal GDP, USD bn | 28.5 | 26.0 | 32.2 | 39.6 | 41.7 | 45.2 | 39.3 | 37.0 | 38.6 |
| GDP per capita, USD | 1,234 | 1,096 | 1,326 | 1,594 | 1,646 | 1,744 | 1,487 | 1,370 | 1,402 |
| Real GDP, yoy avg | 8.4 | 4.0 | 8.0 | 15.0 | 8.8 | 7.2 | 4.6 | 4.0 | 6.0 |
| CPI, % avg | 16.5 | 19.3 | 10.7 | 8.7 | 9.2 | 11.7 | 15.2 | 13.2 | 8.0 |
| Policy Interest Rate, % eop | 17.0 | 18.0 | 13.5 | 12.5 | 15.0 | 16.0 | 19.0 | 16.0 | 12.0 |
| GHS/US$, avg | 1.07 | 1.43 | 1.43 | 1.55 | 1.85 | 2.06 | 2.90 | 3.67 | 4.08 |
| Current account, US$bn | -3.5 | -1.6 | -2.6 | -2.5 | -4.9 | -5.2 | -3.5 | -2.9 | -3.2 |
| % of GDP | -12.4 | -6.2 | -8.2 | -6.3 | -11.8 | -11.5 | -8.9 | -7.8 | -8.3 |
| Consolidated gov. balance, % of GDP | -8.4 | -7.0 | -9.4 | -5.2 | -12.1 | -10.0 | -9.8 | -7.6 | -6.5 |
| **KENYA** | | | | | | | | | |
| Nominal GDP, USD bn | 35.9 | 37.0 | 40.0 | 42.0 | 50.3 | 55.2 | 51.8 | 59.2 | 66.0 |
| GDP per capita, USD | 926 | 929 | 978 | 999 | 1,165 | 1,245 | 1,138 | 1,266 | 1,376 |
| Real GDP, yoy avg | 0.2 | 3.3 | 8.4 | 6.1 | 4.5 | 5.7 | 5.4 | 6.0 | 6.2 |
| CPI, % avg | 15.1 | 10.6 | 4.3 | 14.0 | 9.4 | 5.7 | 7.3 | 7.3 | 6.6 |
| Policy Interest Rate, % eop | 8.5 | 7.0 | 6.0 | 18.0 | 11.0 | 8.5 | 8.5 | 8.0 | 8.0 |
| KES/US$, avg | 68.8 | 77.3 | 79.2 | 88.4 | 84.5 | 86.1 | 87.8 | 92.6 | 97.7 |
| Current account, US$bn | -1.9 | -1.7 | -2.4 | -3.7 | -4.2 | -4.8 | -3.9 | -4.4 | -5.3 |
| % of GDP | -5.4 | -4.6 | -5.9 | -8.9 | -8.4 | -8.7 | -7.6 | -7.5 | -8.0 |
| Consolidated gov. balance, % of GDP | -3.3 | -4.4 | -4.4 | -4.0 | -5.0 | -5.7 | -6.0 | -5.8 | -5.6 |
| **TANZANIA** | | | | | | | | | |
| Nominal GDP, USD bn | 20.7 | 21.4 | 22.9 | 23.9 | 28.2 | 32.5 | 36.6 | 40.8 | 45.0 |
| GDP per capita, USD | 489 | 490 | 509 | 515 | 590 | 661 | 721 | 781 | 836 |
| Real GDP, yoy avg | 7.4 | 6.0 | 7.0 | 6.4 | 6.9 | 7.0 | 7.1 | 7.2 | 6.4 |
| CPI, % avg | 10.3 | 12.1 | 7.2 | 12.7 | 16.0 | 7.9 | 6.4 | 6.2 | 6.8 |
| TZS/US$, avg | 1,198 | 1,324 | 1,439 | 1,582 | 1,586 | 1,617 | 1,662 | 1,752 | 1,839 |
| Current account, US$bn | -2.1 | -2.1 | -2.1 | -3.5 | -4.5 | -4.7 | -5.1 | -5.3 | -5.4 |
| % of GDP | -10.2 | -9.8 | -9.3 | -14.5 | -16.0 | -14.3 | -13.9 | -12.9 | -12.1 |
| Consolidated gov. balance, % of GDP | -2.6 | -6.0 | -6.5 | -5.0 | -5.7 | -5.9 | -6.2 | -6.5 | -5.5 |
| **UGANDA** | | | | | | | | | |
| Nominal GDP, USD bn | 16.4 | 16.5 | 17.2 | 18.2 | 21.2 | 23.1 | 25.6 | 27.2 | 29.5 |
| GDP per capita, USD | 515 | 503 | 506 | 518 | 584 | 613 | 659 | 678 | 711 |
| Real GDP, yoy avg | 10.4 | 4.1 | 6.2 | 6.4 | 3.6 | 4.7 | 6.1 | 6.5 | 6.9 |
| CPI, % avg | 12.0 | 13.0 | 4.0 | 18.7 | 14.0 | 5.5 | 4.6 | 4.9 | 4.7 |
| UGX/US$, avg | 1,714 | 2,025 | 2,173 | 2,511 | 2,501 | 2,584 | 2,597 | 2,764 | 2,916 |
| Current account, US$bn | -1.2 | -1.1 | -1.7 | -2.1 | -1.6 | -1.9 | -2.5 | -2.7 | -3.2 |
| % of GDP | -7.5 | -6.4 | -9.7 | -11.4 | -7.7 | -8.3 | -9.7 | -10.1 | -11.0 |
| Consolidated gov. balance, % of GDP | -2.7 | -1.6 | -6.6 | -3.9 | -3.8 | -4.5 | -5.3 | -5.6 | -5.3 |
| **ZAMBIA** | | | | | | | | | |
| Nominal GDP, USD bn | 17.9 | 15.3 | 20.3 | 23.7 | 25.0 | 27.1 | 27.1 | 29.5 | 32.6 |
| GDP per capita, USD | 1,438 | 1,195 | 1,533 | 1,740 | 1,774 | 1,861 | 1,803 | 1,903 | 2,036 |
| Real GDP, yoy avg | 7.8 | 9.2 | 10.3 | 6.4 | 6.8 | 6.7 | 6.5 | 6.3 | 6.1 |
| CPI, % avg | 12.4 | 13.4 | 8.5 | 6.4 | 6.6 | 7.0 | 7.8 | 7.5 | 6.8 |
| ZMK/US$, avg | 3,702 | 5,020 | 4,791 | 4,861 | 5,139 | 5,195 | 6 | 6 | 7 |
| Current account, US$bn | -1.0 | 0.6 | 1.2 | 0.7 | 0.8 | 0.2 | 0.4 | 0.5 | 0.3 |
| % of GDP | -5.6 | 3.8 | 5.9 | 3.0 | 3.1 | 0.7 | 1.5 | 1.8 | 1.0 |
| Consolidated gov. balance, % of GDP | -0.8 | -2.5 | -3.0 | -2.2 | -3.9 | -6.7 | -5.3 | -4.4 | -5.2 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GHS/US$, eop | 3.33 | 3.29 | 3.20 | 3.40 | 3.80 | 3.90 | 3.90 | 4.00 | 4.00 |
| KES/US$, eop | 87.65 | 89.25 | 89.50 | 90.00 | 92.00 | 92.00 | 93.50 | 95.00 | 97.00 |
| TZS/US$, eop | 1,658 | 1,677 | 1,720 | 1,750 | 1,750 | 1,750 | 1,785 | 1,810 | 1,840 |
| UGX/US$, eop | 2,600 | 2,645 | 2,740 | 2,740 | 2,740 | 2,800 | 2,825 | 2,900 | 2,925 |
| ZMK/US$, eop | 5,195.00 | 5,195.00 | 6.40 | 6.40 | 6.45 | 6.45 | 6.45 | 6.50 | 6.50 |

Source: National Sources, Citi Research forecasts

# Other Europe

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## Bulgaria

**We believe that the economy faces more headwinds than tailwinds in 2015.** First, we believe political noise will likely remain elevated in the months ahead, undermining consumer sentiment and thus private spending. Second, the recent data and lower EU growth projections suggest to us that exports are likely to lose steam. Third, we expect investment activity, which has been one of the main drivers of growth this year, to soften next year, as EU funded investment will likely decline during the next programming period. Against this backdrop, we believe that risks associated with our 2015 GDP forecast of 2% (revised from 2.5%) are tilted to the downside. Regarding price developments, we expect inflation to pick up in 2015, reaching about 1% from an estimated 0.4% in 2014 on the back of unfavorable base effects. On the external front, we expect to see a deficit of about 0.5% of GDP in 2015, compared with a surplus of about 0.5% of GDP this year owing to slowing export growth. In the fiscal sphere, we look for a moderate widening in the budget deficit to 3.8 % of GDP from an estimated 3.7% in 2014, which opens the possibility of the government facing excessive deficit procedure (EDP).

**Looking ahead, we believe that Bulgaria needs to build a stronger institutional environment to be better positioned to attract investment and to utilize its resources more efficiently.** For example, according to the World Bank's Worldwide Governance Indicators, the country ranks relatively poorly in key areas such as rule of law (51 percentile) and control of corruption (52 percentile)—all of which reiterates the need for bolstering judiciary and anti-corruption regime, among other things. Similarly, we believe the country would benefit from promoting a more business friendly regulatory environment. For example, according to the most recent Ease of Doing Business Report, Bulgaria ranks 49th among 189 countries. The survey results suggest there is ample room for improvement in areas such as "getting electricity", "dealing with construction permits", "paying taxes" and "enforcing contracts", where the country ranks 125, 101, 89 and 75, respectively. The difficult political environment suggests to us progress in these areas will likely be slower-than-desired, which is likely to overshadow the convergence process.

## Croatia

**We believe economic activity will remain below its potential in the coming quarters owing to continued deleveraging and the wide competitiveness gap.** After six years of economic contraction, we look for positive GDP growth of 0.3% in 2015. The envisaged pick-up in economic activity is expected to be driven by net exports. In parallel, we expect inflation to pick up next year, reaching 1.2% from an estimated 0.5% in 2014, as food prices normalize and unfavorable base effects kick in. Concurrently, we expect the current account balance to register another surplus of about 0.8% of GDP next year, which will be a tad narrower than this year's estimated surplus of about 1% of GDP, owing to subdued domestic demand and relatively strong export performance. On the fiscal front, we expect the budget deficit to remain wide at 5.6% of GDP next year from an estimated 5.5% in 2014. The disappointing outcome for this year is largely driven by lower-than-expected VAT revenue collection and flood-related spending. Looking ahead, the accumulation of arrears in the health sector and additional slippages in other sectors—such as education and transport—emerge as the key risks on the fiscal front.

**In our view, the medium term growth outlook will be shaped by efforts to enhance competitiveness, which require steady progress on structural reforms.** According to the most recent WEF Competitiveness Report, Croatia ranks 77 among 144 countries, as the country continues to struggle with wide competitiveness gap in key areas such as labor market efficiency (ranks 106) and goods market efficiency (ranks 105). Regarding the former, effect of taxation on incentives to work (ranks 142nd among 144 countries) remains one of the key challenges. While various structural reforms have been implemented by the government, we think further steps are needed to increase labor market flexibility and improve the business climate to attract sufficient investment with a view to boosting exports and bringing the economy closer to its growth potential.

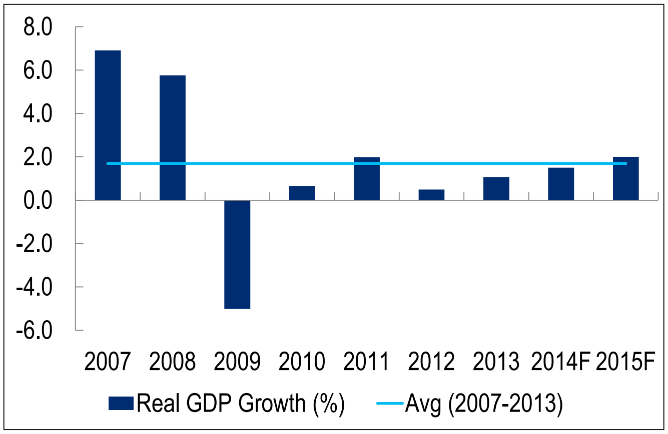
## Serbia

**We expect GDP to contract by 2% in 2014, partly due to the floods in May 2014 and weakening domestic demand, as the prospects for 2015 also look bleak.** Despite the likely positive contribution of net exports to growth next year, GDP is expected to contract by 0.5% in 2015, as the envisaged fiscal retrenchment further depresses domestic demand. Turning to monetary policy, the sharp disinflation, weak domestic demand and relatively stable RSD allowed the NBS to cut the policy rate to 8% in November from 9.5% in 2013. Looking ahead, however, we think that further cuts will be harder to justify since, based on our estimates, inflation will likely rise above the NBS' target of 4% by 2Q 2015 on the back of base effects and the likely administrative price adjustments. On the external front, we expect the current account gap to narrow to about 4.8% of GDP in 2015 from an estimated 5.3% of GDP this year on the back of tighter fiscal stance and softer domestic demand.

**We think that the US$1.3bn 3-year precautionary arrangement with the IMF—if implemented successfully—would play an important role in bolstering investor sentiment and supporting the country's efforts to join the European Union by the end of the decade.** The fiscal consolidation under the new economic program will focus primarily on containing expenditures by scaling down the large public sector wage and pension bills, and reducing budget support to public enterprises. In view of the difficult growth outlook, the potential contractionary impact of the envisaged fiscal consolidation, which will contain a number of politically unpalatable measures, could complicate the implementation of the new arrangement if the program falls short of boosting investor sentiment and capital inflows. Under the umbrella of IMF program, the government aims at narrowing the budget gap to a 4.2% of GDP by 2016 from an estimated 7.8% of GDP in 2014.

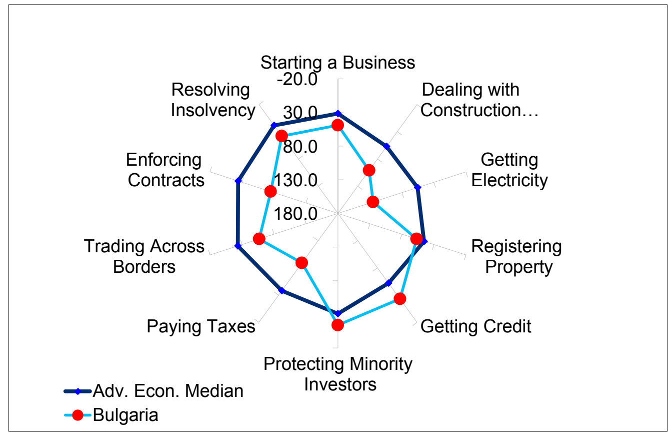
**Despite the recent favorable developments including the new IMF deal, we believe the country needs to address its chronic structural challenges**. In particular, low savings rate (estimated at about 15% of GDP this year) and the wide competitiveness gap—Serbia ranks 94th among 144 countries, according to the WEF competitiveness index—continue to render the country vulnerable to shifts in investor sentiment owing to the wide current account deficit. In this respect, structural reforms to boost productivity and address key weaknesses (such as macroeconomic environment, institutions, goods and labor market efficiency) will likely improve business climate and enhance the resilience of the economy to external shocks, in our view.

**Figure 250. Bulgaria: Risks associated with our 2015 GDP forecast of 2% are tilted to the downside …**



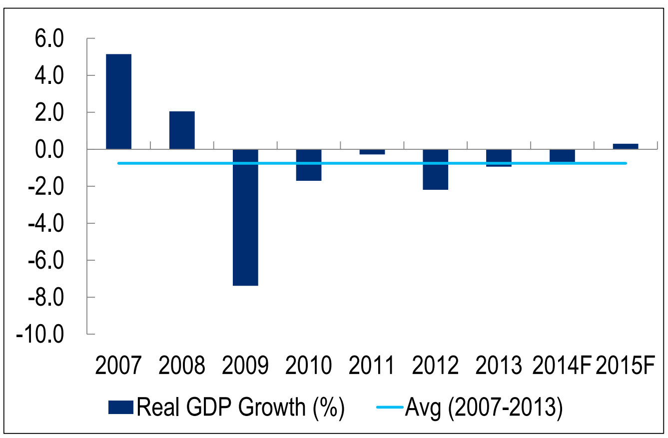

Source: Haver Analytics and Citi Research

**Figure 251. …as we believe that the country could benefit from promoting a more business friendly regulatory environment**



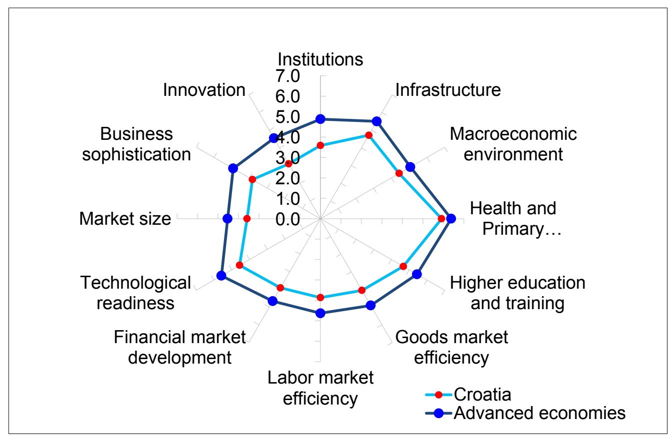

Source: Ease of Doing Business Survey 2015 Report and Citi Research Note: Lower rankings represent a more favorable standing.

**Figure 252. Croatia: After six years of economic contraction, we look for a positive GDP growth of 0.3% in 2015…**



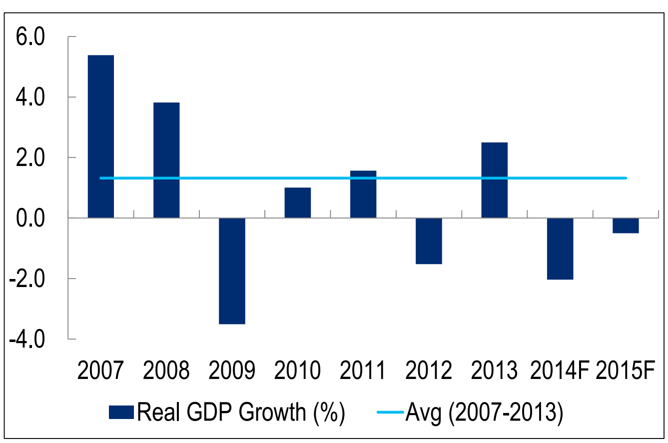

Source: Haver Analytics and Citi Research

**Figure 253. …as the medium term growth outlook will be shaped by efforts to enhance competitiveness.**



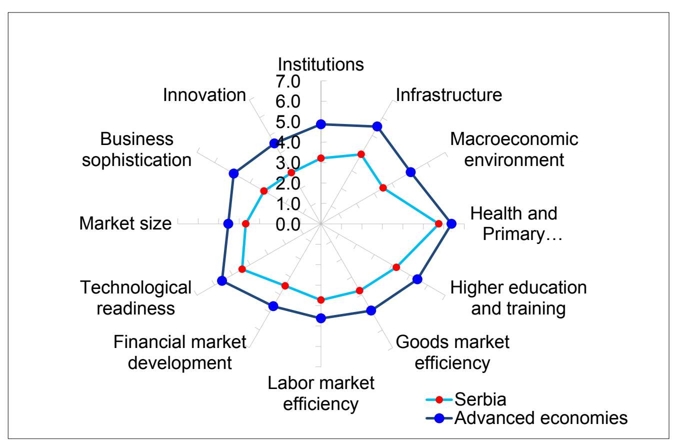

Source: World Economic Forum, The Global Competitiveness Report 2014 - 2015 and Citi Research Note: Higher numbers represent a more favorable standing

**Figure 254. Serbia: GDP is expected to contract by 0.5% in 2015, as the envisaged fiscal consolidation should further hurt domestic demand…**




Source: Haver Analytics and Citi Research

**Figure 255.…as the wide competitiveness gap continues to render the country vulnerable to shifts in investor sentiment**




Source: World Economic Forum, The Global Competitiveness Report 2014 - 2015 and Citi Research Note: Higher numbers represent a more favorable standing

**Figure 256. Other Europe Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **BULGARIA** | | | | | | | | | |
| Nominal GDP, USD bn | 53.6 | 50.3 | 48.8 | 55.8 | 52.6 | 54.5 | 53.6 | 47.3 | 45.0 |
| GDP per capita, USD | 7,047 | 6,646 | 6,500 | 7,617 | 7,225 | 7,532 | 7,448 | 6,600 | 6,306 |
| Real GDP, yoy avg | 6.2 | -5.5 | 0.4 | 1.8 | 0.6 | 1.1 | 1.5 | 2.0 | 2.5 |
| CPI, % avg | 12.3 | 2.8 | 2.4 | 4.2 | 3.0 | 0.9 | -1.2 | 1.4 | 1.3 |
| BGN/US$, avg | 1.33 | 1.40 | 1.47 | 1.40 | 1.52 | 1.47 | 1.50 | 1.76 | 1.93 |
| BGN/EUR, avg | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| Current account, US$bn | -12.0 | -4.3 | -0.7 | 0.0 | -0.6 | 1.1 | 0.3 | -0.2 | -0.7 |
| % of GDP | -22.4 | -8.6 | -1.4 | 0.1 | -1.1 | 2.1 | 0.5 | -0.5 | -1.5 |
| Consolidated gov. balance, % of GDP | 1.7 | -4.3 | -3.1 | -2.0 | -0.8 | -1.5 | -3.7 | -3.8 | -2.0 |
| **CROATIA** | | | | | | | | | |
| Nominal GDP, USD bn | 69.6 | 62.2 | 58.9 | 61.5 | 55.9 | 57.9 | 55.9 | 47.8 | 44.5 |
| GDP per capita, USD | 15,960 | 14,299 | 13,577 | 14,227 | 12,978 | 13,495 | 13,095 | 11,236 | 10,494 |
| Real GDP, yoy avg | 2.1 | -6.9 | -2.3 | -0.2 | -2.2 | -0.9 | -0.7 | 0.3 | 1.3 |
| CPI, % avg | 6.1 | 2.4 | 1.0 | 2.3 | 3.4 | 2.2 | -0.1 | 1.5 | 1.6 |
| Policy Interest Rate, % eop | 9.00 | 9.00 | 9.00 | 7.00 | 7.00 | 7.00 | 7.00 | 7.00 | 7.00 |
| HRK/US$, avg | 4.91 | 5.26 | 5.49 | 5.34 | 5.84 | 5.70 | 5.86 | 6.97 | 7.72 |
| HRK/EUR, avg | 7.23 | 7.34 | 7.29 | 7.43 | 7.51 | 7.58 | 7.63 | 7.75 | 7.85 |
| Current account, US$bn | -6.2 | -3.2 | -0.7 | -0.5 | -0.1 | 0.5 | 0.6 | 0.4 | -0.2 |
| % of GDP | -8.8 | -5.1 | -1.1 | -0.9 | -0.2 | 0.9 | 1.0 | 0.8 | -0.5 |
| Consolidated gov. balance, % of GDP | - | -5.3 | -6.4 | -7.8 | -5.0 | -4.9 | -5.5 | -5.6 | -5.4 |
| **SERBIA** | | | | | | | | | |
| Nominal GDP, USD bn | 49.3 | 42.6 | 39.5 | 46.5 | 40.7 | 42.5 | 40.3 | 33.8 | 31.5 |
| GDP per capita, USD | 6,701 | 5,819 | 5,413 | 6,399 | 5,660 | 5,903 | 5,601 | 4,690 | 4,382 |
| Real GDP, yoy avg | 3.8 | -3.5 | 1.0 | 1.6 | -1.5 | 2.5 | -2.0 | -0.5 | 1.5 |
| CPI, % avg | 12.5 | 8.2 | 6.2 | 11.2 | 7.3 | 7.9 | 2.2 | 3.5 | 4.3 |
| Policy Interest Rate, % eop | 17.75 | 9.50 | 11.50 | 9.75 | 11.25 | 9.50 | 8.00 | 8.00 | 8.00 |
| RSD/US$, avg | 55.2 | 67.4 | 77.5 | 73.2 | 87.8 | 85.1 | 89.9 | 110.6 | 125.3 |
| RSD/EUR, avg | 81.4 | 94.0 | 102.9 | 102.0 | 112.9 | 113.1 | 117.2 | 123.0 | 127.6 |
| Current account, US$bn | -10.5 | -2.9 | -2.8 | -4.0 | -4.4 | -2.1 | -2.1 | -1.6 | -1.4 |
| % of GDP | -21.2 | -6.8 | -7.2 | -8.6 | -10.9 | -4.9 | -5.3 | -4.8 | -4.5 |
| Consolidated gov. balance, % of GDP | -2.0 | -3.9 | -3.9 | -4.4 | -7.2 | -5.7 | -7.8 | -6.0 | -4.5 |

Source: National Sources, Citi Research forecasts

# Latin America

# Argentina

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- **Summary view** — The horizon remains very uncertain in Argentina. Key amongst those sources of uncertainty is whether the government will settle with the holdouts. The widening fiscal deficit in a country in default, a deep recession and accelerating inflation interact with presidential elections in October 2015 and is sure to result in significant volatility. While the market expects an early resolution to the debt default, our baseline scenario assumes that no settlement is reached in 2015. As a result, we forecast (non-official) activity to shrink 2.5% in 2015, on top of the 2.3% contraction this year. We expect (non-official) inflation to rise to 45% in 2015 and new pressures on the USDARS to emerge.

- **Things to watch** — We continue to have a bearish view on the country's credit. We believe that markets underestimate the monetary problems the economy will face next year, the ensuing devaluation expectations and the complex legacy for the new administration expected to takeover in December 2015.

- **Strategy** — We continue to have a bearish view on the country's credit. On the FX, we continue to believe that the current rate of crawl is only sustainable in the short term.

## Prices and activity: up and down

**Activity is falling and is likely to continue doing so.** There are no signs that the economy is close to bottoming. Seasonally-adjusted figures show that the activity contraction has extended into 4Q14, and the recent evolution of external conditions and confidence indicators, plus the increasingly overvalued currency and import restrictions, suggest a reversion to this trend is unlikely. We expect output to fall 2.5% in 2015 in addition to the 2.3% contraction expected for this year.

**External conditions will not come to the rescue.** The prices of Argentina's agricultural exports have decreased roughly 20% in the last few months, when compared to the last harvest season. As a result, we expect agricultural exports to shrink around USD5bn next year. Meanwhile, non-commodity exports should also fall. The outlook for Brazil's growth remains bleak, seriously impacting manufacturing exports. The ARS real overvaluation impacts profitability and the rationing of imports further affect the capacity to sell abroad. The National Statistics Institute (INDEC) reported that during the first three quarters of 2014, industrial exports decreased 13% YoY to USD17.7bn. While lower energy prices may reduce the energy deficit, the improvement (USD 1.5bn) should be dwarfed by the decline in exports.

**Meanwhile, inflation is quite sticky.** Despite the authorities' decision to use the USDARS as a nominal anchor, inflation has not receded, as different estimates show monthly inflation still comfortably above the 2% mark: opposition congressmen reported consumer prices rose 2.3% MoM in October and 41.3% annual inflation. We expect non-official annual inflation to recede slightly in November and December and close 2014 at 39%, but we anticipate that it will accelerate to 45% next year, given the complicated monetary outlook.

## The (unfortunate) absence of fiscal discipline

**The authorities face a difficult tradeoff between political and macroeconomic stability.** In a contractionary environment, higher fiscal spending is likely to emerge as the authorities' choice to control the social situation. However, a growing fiscal deficit, financed with money printing, increases pressures on the external accounts further, aggravating the contractionary and inflationary pressures.

**The data suggests the authorities have chosen to spend their way to December 2015.** The pace of public spending remains high, at least at the national level, while revenues growth is affected by the economic contraction. As a result, the gap between public spending and revenues has widened: in 3Q14 the Federal Government's primary expenditure rose 43.6% YoY, compared to a 30.7% YoY increase in revenues once we adjust for BCRA's accounting profits. During the first semester of 2014, primary spending and revenues (excluding BCRA's accounting profits) had increased 44.3% and 38.4% YoY, respectively.

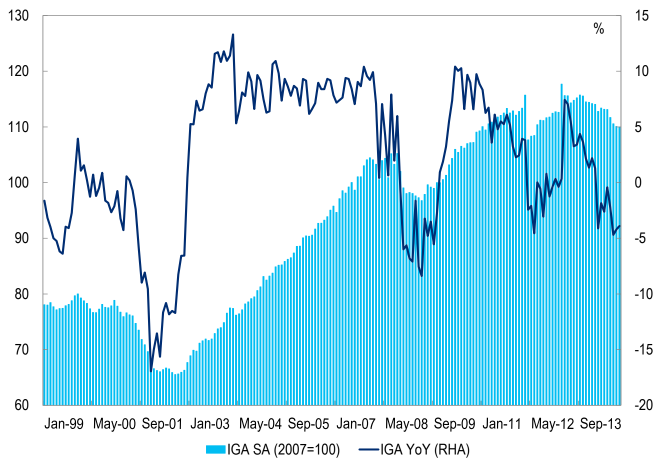
## Monetary policy: one instrument and many objectives

**A challenging central banking year.** The central bank seems determined to attempt to contain expectations and anchor prices via a slow drifting exchange rate. Since reserves run short, import rationing and FX controls will have to be tightened adding to the economic slowdown. Meanwhile, the recession will probably keep the central bank from increasing interest rates, further fueling the demand for dollars. The high debt maturities will impact throughout the year the stock of reserves, further undermining expectations. Finally, the provision of monetary support to the Treasury will maintain a fast pace of money growth. If the authorities decide to contain some of that growth, they will be forced to undertake an unprecedented level of sterilization, adding downward pressure to real private sector credit. .

**Given low net reserves, the choice becomes: faster depreciation of the official FX rate, or sterilizing heavily, or, a combination of both.** If we Assume the authorities keep the current rate of crawl in the official FX market leading the official USDARS to average 9.5 in 2015, and assuming too that official foreign currency purchases stand at USD4bn; in that scenario, for the monetary base to increase 30% in 2015 (a figure consistent with the increase in the USDARS and a similar inflation rate), then the BCRA would need to sterilize ARS285bn (i.e., issue USD31bn of short-term debt domestically). This figure compares to a current stock of BCRA's notes of around ARS245bn and bank deposits for around ARS600bn. And, even if the authorities were able to sterilize this much, this course of action would only imply transferring the monetary difficulties to the next administration. The BCRA's short-term debt would exceed 10% of GDP in a context of very negative real interest rates (around -15% in annual terms). If interest rates become positive, a likely pre-requisite to eliminate FX controls, the quasi-fiscal deficit would increase significantly, adding an additional problem to the monetary program. Furthermore, in 2015 foreign currency public debt obligations stand at USD11bn and, even if the sovereign remains in default, the public sector debt payments would remain above USD9bn. If we add the USD 1.5bn for the City and Province of Buenos Aires, absent any rollover, public debt payments in foreign currency would likely absorb a significant fraction of the net and "super" liquid reserves. With net and liquid reserves close to USD 5-8bn (following our assumption of USD4bn of official FX purchases in markets and modest debt rollover) it is likely that the new authorities at the central bank at the end of 2015 will have to opt for a different FX regime.

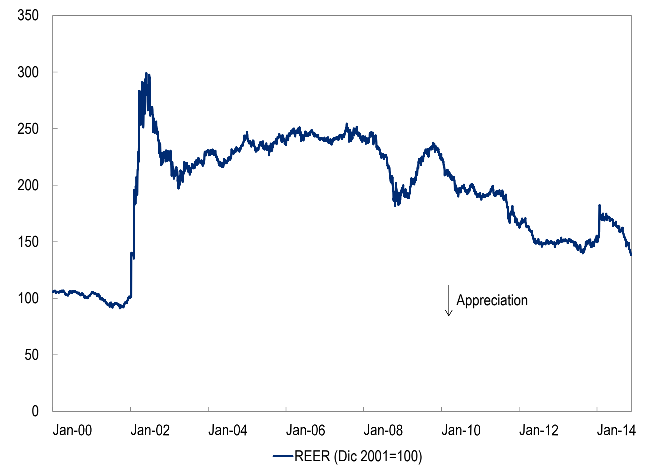
**The lack of consistency of the "30%" scenario described suggests that, sooner or later, the ARS will need to depreciate at a faster pace, and inflation will follow.** The more the problem is delayed, the greater the imbalance becomes and the closer the realignment of the FX looms, adding instability to markets. Thus, we see the official ARS/USD at 13.5 by the end of 2015, and inflation accelerating to 45%.

Figure 257. Activity shrinks…



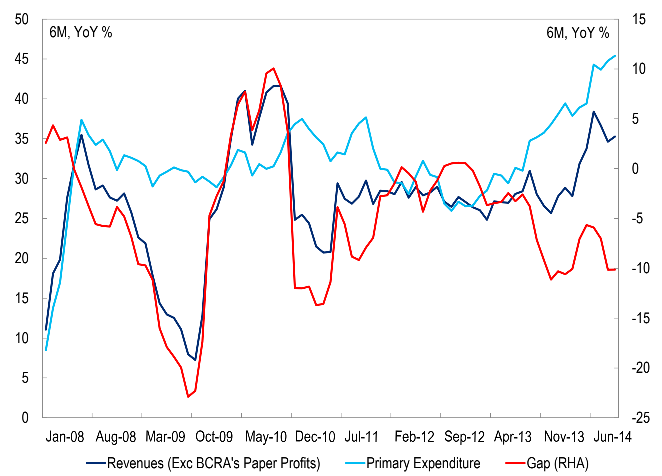

Source: OJF and Citi Research

Figure 258. …and the REER is at its lowest level in more than a decade



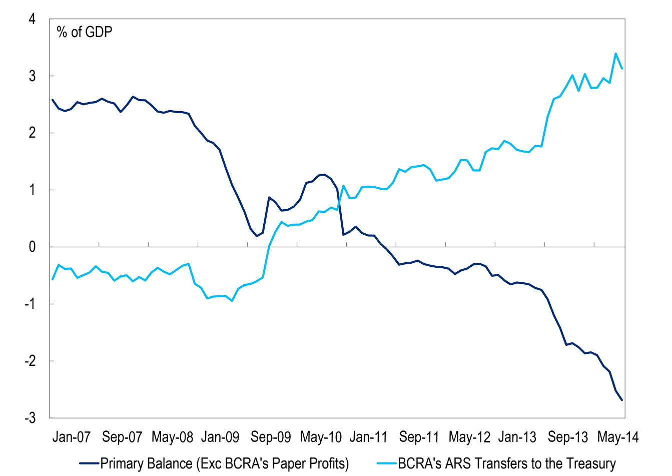

Source: Bloomberg, MyS and Citi Research

Figure 259. The gap between expenditure and revenues growth is rising



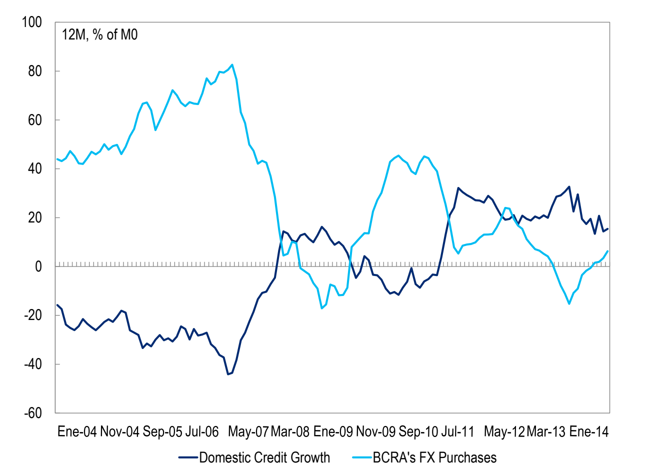

Source: MECON and Citi Research

Figure 260. A widening fiscal deficit fuels money printing



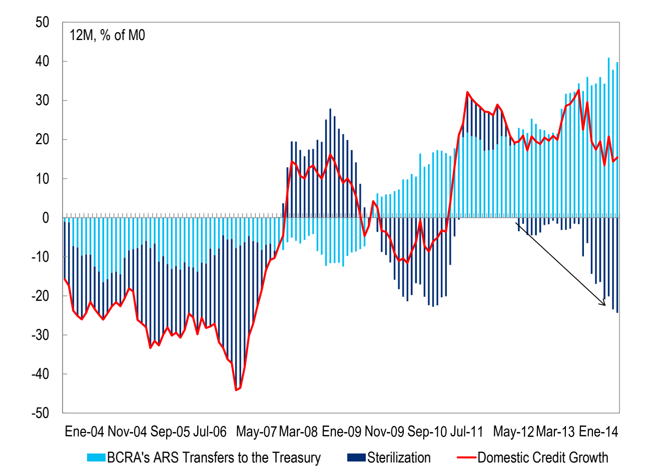

Source: MECON and Citi Research

Figure 261. Keeping domestic credit growth contained is vital to ease the pressure on the FX market…




Source: BCRA and Citi Research

Figure 262. … and maintain domestic credit growth at bay will require increasing sterilization




Source: BCRA and Citi Research

**Figure 263. Argentina Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 409 | 380 | 464 | 560 | 604 | 605 | 511 | 473 | 479 |
| Nominal GDP, local currency bn | 1,284 | 1,412 | 1,810 | 2,303 | 2,745 | 3,346 | 4,240 | 5,287 | 7,507 |
| GDP per capita, USD | 10,281 | 9,470 | 11,456 | 13,684 | 14,628 | 14,515 | 12,140 | 11,137 | 11,166 |
| Population, mn | 39.7 | 40.1 | 40.5 | 40.9 | 41.3 | 41.7 | 42.1 | 42.5 | 42.9 |
| Unemployment, % of labour force | 7.9 | 8.7 | 7.8 | 7.2 | 7.2 | 7.4 | 8.6 | 8.9 | 9.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg (Citi estimates) | 2.3 | -3.9 | 7.5 | 5.0 | -0.1 | 2.9 | -2.3 | -2.5 | 1.0 |
| Real investment growth % yoy | 6.2 | -24.0 | 38.4 | 15.6 | -11.5 | 2.0 | -0.1 | -5.8 | -1.2 |
| Real consumption growth % yoy | 5.5 | 4.1 | 7.2 | 10.5 | 4.5 | 4.5 | -0.5 | -0.2 | 1.3 |
| private consumption growth % yoy | 5.6 | 3.5 | 7.1 | 10.8 | 4.2 | 4.4 | -1.1 | -0.7 | 1.4 |
| Real export growth, % yoy | 0.8 | -8.7 | 14.4 | 4.9 | -5.9 | -4.2 | -5.7 | -2.5 | -0.2 |
| Real import growth, % yoy | 13.5 | -19.3 | 35.0 | 19.8 | -4.7 | 2.1 | -6.2 | -3.4 | -0.6 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy (Citi estimates) | 20.7 | 14.8 | 26.8 | 24.2 | 25.2 | 28.8 | 39.0 | 45.0 | 35.0 |
| CPI, % yoy eop (reported) | 7.2 | 7.7 | 10.9 | 9.5 | 10.8 | 10.9 | 24.2 | 30.1 | 35.0 |
| Nominal wages, % yoy | 22.4 | 20.0 | 21.7 | 27.5 | 27.1 | 25.0 | 31.8 | 32.0 | 38.3 |
| Credit extension to private sector, % yoy | 10.5 | 11.5 | 31.6 | 34.6 | 39.0 | 23.8 | 26.0 | 36.0 | 35.0 |
| Policy Rate (eop) | - | - | - | - | - | - | - | - | - |
| 3 month inter-bank rate, %, eop | 19.75 | 10.00 | 11.25 | 17.19 | 15.44 | 21.63 | 22.00 | 39.00 | 42.00 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| ARS/USD, eop | 3.45 | 3.80 | 3.97 | 4.30 | 4.92 | 6.52 | 8.70 | 13.50 | 17.55 |
| ARS/USD, avg | 3.16 | 3.73 | 3.91 | 4.13 | 4.54 | 5.45 | 8.25 | 11.13 | 15.61 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 6.6 | 10.9 | -1.5 | -3.7 | -1.2 | -4.8 | -5.1 | -6.6 | -5.9 |
| % of GDP | 1.6 | 2.9 | -0.3 | -0.7 | -0.2 | -0.8 | -1.0 | -1.4 | -1.2 |
| Trade balance | 15.4 | 18.5 | 14.0 | 12.9 | 15.2 | 11.1 | 11.0 | 11.2 | 11.9 |
| Exports | 70.0 | 55.7 | 68.2 | 84.1 | 80.2 | 81.7 | 76.3 | 71.0 | 76.6 |
| Imports | 54.6 | 37.1 | 54.2 | 71.1 | 65.1 | 70.5 | 65.3 | 59.8 | 64.7 |
| Service balance | -1.3 | -1.3 | -1.2 | -2.2 | -3.1 | -4.1 | -3.5 | -4.1 | -4.1 |
| Income balance | -7.7 | -9.1 | -13.9 | -13.8 | -12.8 | -11.0 | -12.2 | -13.1 | -13.1 |
| FDI, net | 9.7 | 4.0 | 11.3 | 10.8 | 14.9 | 11.4 | 4.9 | 10.0 | 10.0 |
| International reserves | 46.4 | 48.0 | 52.2 | 46.4 | 43.3 | 30.6 | 26.5 | 17.5 | 20.0 |
| Total amortisations | 4.7 | 11.2 | 10.7 | 12.0 | 9.7 | 9.5 | 8.6 | 8.9 | 10.1 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | 1.1 | -0.5 | 0.2 | -1.2 | -1.9 | -1.8 | -3.7 | -4.7 | -3.7 |
| Consolidated gov primary balance | 2.5 | 1.2 | 1.4 | 0.3 | -0.1 | -0.6 | -2.0 | -3.0 | -2.0 |
| Public debt | 35.7 | 38.7 | 35.4 | 32.0 | 31.6 | 31.6 | 37.9 | 45.6 | 54.0 |
| *of which* Domestic | 19.7 | 22.2 | 20.1 | 18.7 | 19.5 | 19.8 | 24.4 | 29.1 | 34.1 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 125.9 | 116.6 | 130.8 | 142.5 | 143.3 | 141.1 | 127.5 | 132.3 | 150.2 |
| Public | 65.4 | 62.9 | 71.0 | 74.6 | 73.2 | 71.6 | 69.0 | 78.1 | 95.3 |
| External debt / GDP | 30.8 | 30.7 | 28.2 | 25.5 | 23.7 | 23.3 | 25.0 | 27.9 | 31.3 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | - | - | - | - | - | - | - | - | - |
| Short-term debt/International reserves (%) | - | - | - | - | - | - | - | - | - |

| **Quarterly Economic Indicators** | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | -1.7 | -3.0 | -3.9 | -2.9 | -3.9 | -2.2 | -0.9 | -0.1 | 0.8 |
| CPI, % yoy | 39.9 | 41.3 | 39.0 | 36.4 | 39.5 | 41.7 | 45.0 | 42.4 | 39.9 |
| Policy interest rate, %, eop | - | - | - | - | - | - | - | - | - |
| Short-term market rate, % eop | 22.75 | 21.38 | 22.00 | 25.00 | 30.00 | 35.00 | 39.00 | 43.00 | 44.00 |
| Long-term yield, %, eop | - | - | - | - | - | - | - | - | - |
| ARS/USD, eop | 8.13 | 8.43 | 8.70 | 9.71 | 10.84 | 12.10 | 13.50 | 14.42 | 15.39 |

Source: National Sources, Citi Research

# Brazil

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- **Summary view** — Dilma Rousseff's second term has effectively already started and next year promises to be a very difficult one for the Brazilian economy. Besides the challenging domestic and international environment, Rousseff will have to face the political consequences of the corruption scandal in Petrobras. Brazil has been admonished by ratings agencies that a downgrade is possible and, therefore, a gradual fiscal consolidation has become necessary. We forecast a primary surplus of 1.0% of the GDP for 2015, which is not enough to stabilize the public debt/GDP ratio. This improvement in the fiscal numbers will be even more difficult given our downward revision in GDP growth estimates for 2015 (to 0.5% from 1%) and for 2016 (to 1.8% from 2.8%). On the inflation front, our 2015 year-end CPI inflation estimate is still above the upper bound of the inflation target band (at 6.8%), despite our sluggish growth scenario and the expected monetary policy tightening (Selic rate at 12% at 2015 year-end). External conditions (commodity prices and dollar strengthening) have hurt the perspective for the BRL further, limiting improvements in external accounts outlook.

- **Things to watch** — US economic data will continue having relevant impact in domestic forward interest rates and exchange rate. On the domestic front, the announcement of Joaquim Levy as minister of Finance provides us hints about the measures that can be adopted in coming months, exerting important influence over domestic asset prices.

- **Strategy** — We continue assuming that the new economic team/Minister of Finance will not modify meaningfully the conduction of economic policy. Under this crucial domestic assumption amid a global scenario of restricted commodity prices we see further room to depreciate the BRL. Regarding rates, we continue envisaging greater room to increase long term interest rates relative to shorter maturities, supporting further steepening in the yield curve.

## Addressing the macroeconomic imbalances

**Dilma Rousseff won the election with a tiny margin and we do not expect any grace period in the beginning of her second term.** The aftermath of Dilma Rousseff's reelection has been very difficult, with urgent choices to be made on political and economic fronts. Regarding politics, the Petrobras scandal may consume President Rousseff's capital while, additionally, her administration will face a fierce opposition in Congress. The need of fiscal consolidation to keep investment grade status is another though task for the president. The appointment of Joaquim Levy to the Ministry of Finance will buy her some time, given that markets like the former Lula's Secretary of Treasury and CEO of Bradesco Asset Management. But Levy must prove that he has room to maneuver and Rousseff's support to make difficult choices over the next couple of years.

**Fundamentals suggest another disappointing GDP performance in 2015** We are keeping our estimate of a roughly stagnant GDP this year we continue to see macroeconomic fundamentals pointing to a sluggish expansion ahead despite signs of decelerating credit/labor markets and depressed confidence levels in several sectors (industry, services, consumer, etc). In particular, the stronger hikes in monitored prices (see the inflation section) and the concomitant reduction in personal income as well as the likely monetary and fiscal tightening in 2015, should take its toll on domestic demand. Putting it all together, we see 2015 GDP growth at 0.5%, slightly higher than our current forecast for this year at 0.1%.

**We see economic growth accelerating very gradually, suggesting GDP expansion below 2% in 2016.** In addition, the smaller increase in the primary fiscal result in 2016 (to 1.5% from 1.0%) compared to 2015 (to 1.0% from 0% in 2014) points to a less unfavorable fiscal impulse. In this sense, we estimate that GDP growth would accelerate to 1.8% in 2016, embedding quarterly expansions in the range of 0.4% to 0.5% QoQ in the 1H16.

**We now expect Copom to raise Selic rate up to 12.5% in the 1Q15, given the rising risks on inflation outlook.** The change in relative prices during 2015 (monitored prices and adjustment between tradable and non-tradable items) is an important input to determine the extension of Selic rate hikes as well as the fiscal consolidation. Regarding the latter, the appointment of Levy as the new MoF supports Copom in bringing inflation back to the target, given his austerity reputation. In addition, domestic currency depreciation is another factor that must be monitored. In this sense, the declining trend of commodity prices and the degree of intervention in FX markets have crucial roles in envisaging the next steps of monetary policy. Overall, after Selic rate reaching 12.5% at 1Q15, we see Selic rate declining to 12% at 2015 year end and to 11% at 2016 year end.

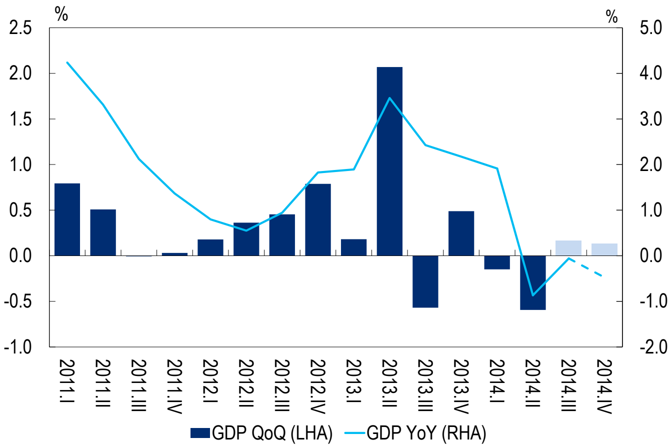
**We see CPI inflation slightly above the target in 2015 because of the necessity of price realignments.** Monitored prices should increase by 8.6% in 2015, if our forecasts of a 20% hike in regulated energy bills and 16% raise in urban buses materialize. Another adjustment already mentioned above is between tradable and non-tradable prices in the event of real exchange rate depreciation. We have USD/BRL at 2.79 at 2015 year-end, which means some pressures on inflation given pass through from FX to prices. We do not expect that the deceleration in non-tradable inflation will offset the higher increases in tradable and monitored prices. Therefore, we see CPI inflation above the upper-limit of the target in 2015.

**We see the government pursuing a tighter fiscal policy next year.** In 2015, one of the challenges Rousseff faces will be to arrest and reverse the recent fiscal deterioration. By end-2014, the primary surplus should reach 0.0% of GDP given that expenditures outpaced revenues in real terms. We believe that if Rousseff is ambitious enough she will tighten the fiscal accounts next year, improving the primary surplus to 1.0% of the GDP in 2015. On the back of such a result, the gross public debt would reach 64.6% of GDP in end-2015 (from 61.1% in end-2014).

**In 2016, fiscal consolidation proceeds, but the primary surplus would still be below 2.5%.** In 2016, expenditures should put less pressure on the budget result. This should help President Rousseff to continue implementing her fiscal consolidation plans and the primary surplus could reach 1.5%. In terms of the dynamics of the debt the primary surplus that stabilizes the long-term debt should be above 2.5% of the GDP. In case, our forecasts prove correct, the base case scenario is that the net debt should reach 39.7% of GDP in end-2015 and 40.5% in end-2016. This implies that the gross debt should reach 65.8% in end-2016.

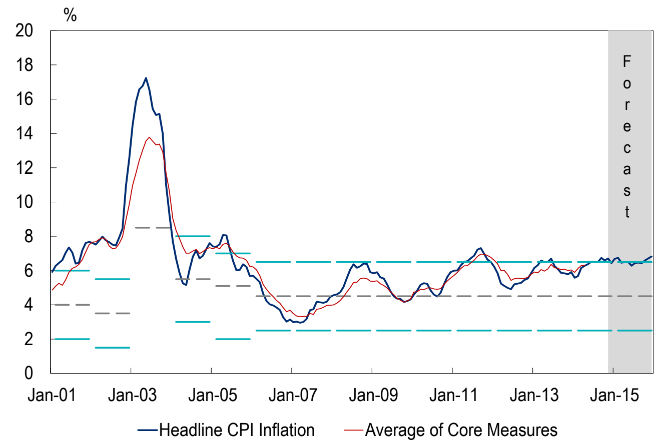
**Global and domestic factors point to further BRL depreciation ahead.** The recent depreciation of BRL to levels above 2.50 (from around USD/BRL 2.25 in August) can be explained by global and domestic factors. Regarding the global drivers, commodity prices declining 6% since August is the most important contributor to depreciating the domestic currency. On the domestic front, the steady deterioration of fiscal fundamentals combined with the absence of signs of a prompt reversal of this trend have been pressuring risk premiums upward, reinforcing the depreciation of BRL. Looking forward, as we do not see meaningful change in either drivers, we see further room for BRL depreciation in the medium/long term. This leads us to forecast USD/BRL at 2.79 and at 2.90 2015 and 2016 year ends.

**Figure 264. We see no meaningful GDP recovery ahead**



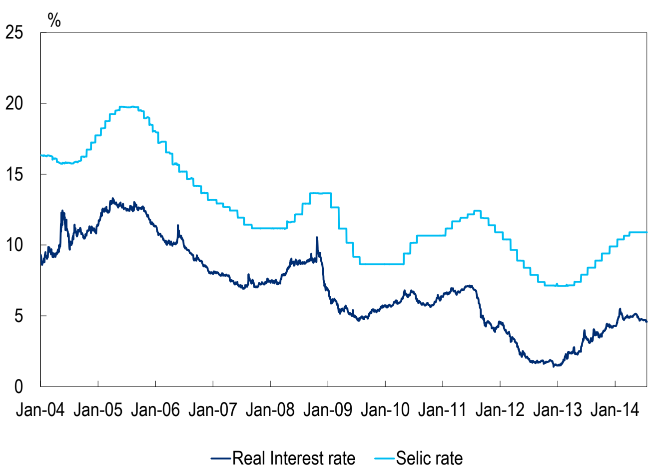

Source: Citi Research and IBGE

**Figure 265. We continue expecting CPI inflation above the target in 2015**



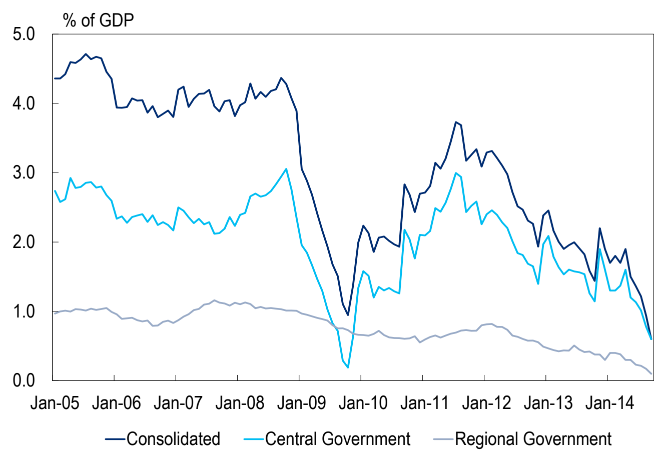

Source: Citi Research, IBGE and BCB

**Figure 266. We expect Copom to hike Selic rate up to 12%**



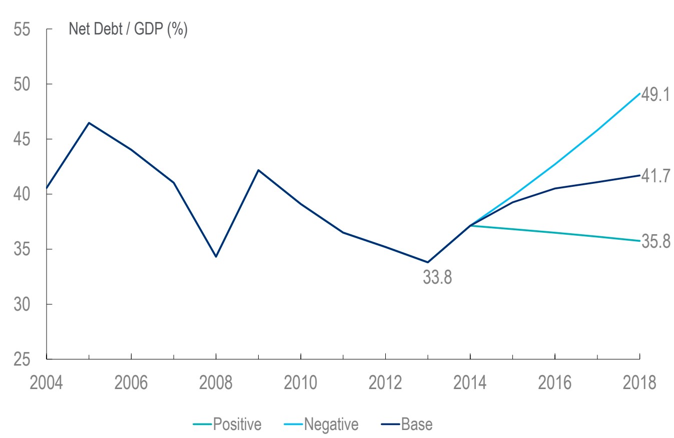

Source: Citi Research and BCB

**Figure 267. We estimate primary fiscal surplus below 2% of GDP in 2015**



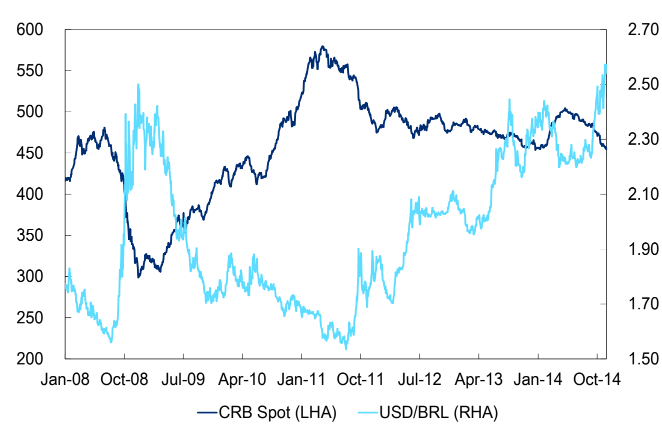

Source: Citi Research and BCB

**Figure 268. nsufficient primary fiscal result will increase public debt/GDP**




Source: Citi Research and BCB

**Figure 269. Lower commodity prices has been pressuring BRL downward**




Source: Citi Research, Bloomberg and BCB

**Figure 270. Brazil Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 1,746 | 1,622 | 2,142 | 2,475 | 2,247 | 2,215 | 2,176 | 2,070 | 2,137 |
| Nominal GDP, local currency bn | 3,032 | 3,239 | 3,770 | 4,143 | 4,392 | 4,815 | 5,118 | 5,473 | 5,908 |
| GDP per capita, USD | 9,114 | 8,379 | 10,955 | 12,536 | 11,278 | 11,019 | 10,729 | 10,120 | 10,353 |
| Population, mn | 191.5 | 193.5 | 195.5 | 197.4 | 199.2 | 201.0 | 202.8 | 204.6 | 206.4 |
| Unemployment, % of labour force | 7.9 | 8.1 | 6.7 | 6.0 | 5.5 | 5.4 | 4.9 | 5.3 | 5.8 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 5.2 | -0.3 | 7.5 | 2.7 | 1.0 | 2.5 | 0.1 | 0.5 | 1.8 |
| Real investment growth % yoy | 16.4 | -16.0 | 33.4 | 4.0 | -7.9 | 7.9 | -6.6 | 1.0 | 3.6 |
| Real consumption growth % yoy | 5.1 | 4.1 | 6.3 | 3.6 | 3.2 | 2.4 | 1.5 | 0.4 | 1.6 |
| private consumption growth % yoy | 5.7 | 4.4 | 6.9 | 4.1 | 3.2 | 2.6 | 1.2 | 0.9 | 2.1 |
| Real export growth, % yoy | 0.5 | -9.1 | 11.5 | 4.5 | 0.5 | 2.5 | 2.3 | 2.4 | 2.4 |
| Real import growth, % yoy | 15.4 | -7.6 | 35.8 | 9.7 | 0.2 | 8.3 | 0.2 | 2.1 | 3.5 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 5.9 | 4.3 | 5.9 | 6.5 | 5.8 | 5.9 | 6.4 | 6.8 | 5.5 |
| Nominal wages, % yoy | 10.4 | 4.8 | 12.7 | 8.9 | 10.7 | 10.8 | 11.3 | 11.7 | 11.0 |
| Credit extension to private sector, % yoy | 30.7 | 15.1 | 20.6 | 18.8 | 16.4 | 14.7 | 11.6 | 13.1 | 13.0 |
| Policy Rate (eop) | 13.75 | 8.75 | 10.75 | 11.00 | 7.25 | 10.00 | 11.75 | 12.00 | 11.00 |
| 3 month inter-bank rate, %, eop | 13.49 | 8.61 | 10.64 | 10.87 | 6.59 | 9.78 | 11.70 | 12.00 | 11.00 |
| Long-term yield, %, eop | 12.27 | 12.25 | 12.24 | 10.66 | 7.96 | 12.00 | 12.27 | 12.77 | 13.27 |
| BRL/USD, eop | 2.31 | 1.74 | 1.66 | 1.86 | 2.05 | 2.36 | 2.65 | 2.79 | 2.90 |
| BRL/USD, avg | 1.84 | 2.00 | 1.76 | 1.67 | 1.95 | 2.16 | 2.40 | 2.74 | 2.87 |
| Balance of Payments, **USD bn** | | | | | | | | | |
| **Current account** | **-28.2** | **-24.3** | **-47.3** | **-52.5** | **-54.2** | **-81.1** | **-86.4** | **-85.3** | **-84.3** |
| % of GDP | -1.6 | -1.5 | -2.2 | -2.1 | -2.4 | -3.7 | -4.0 | -4.1 | -3.9 |
| Trade balance | 24.8 | 25.3 | 20.1 | 29.8 | 19.4 | 2.6 | -0.2 | 2.9 | 8.1 |
| Exports | 197.9 | 153.0 | 201.9 | 256.0 | 242.6 | 242.2 | 234.4 | 249.3 | 266.7 |
| Imports | 173.1 | 127.7 | 181.8 | 226.2 | 223.2 | 239.6 | 234.6 | 246.3 | 258.7 |
| Service balance | -16.7 | -19.2 | -30.8 | -37.9 | -41.0 | -47.2 | -50.9 | -52.7 | -55.1 |
| Income balance | -40.6 | -33.7 | -39.5 | -47.3 | -35.4 | -39.8 | -37.9 | -39.1 | -40.9 |
| FDI, net | 45.1 | 25.9 | 48.5 | 66.7 | 65.3 | 64.0 | 60.3 | 60.0 | 60.0 |
| International reserves | 193.8 | 238.5 | 288.6 | 352.0 | 373.1 | 375.8 | 380.5 | 380.5 | 380.5 |
| Total amortisations | 22.4 | 30.1 | 33.8 | 37.7 | 39.7 | 60.1 | 67.0 | 73.0 | 75.0 |
| Public Finances, **% of GDP** | | | | | | | | | |
| **Consolidated government balance** | -2.0 | -3.3 | -2.6 | -2.6 | -2.5 | -3.3 | -5.5 | -4.7 | -4.4 |
| Consolidated gov primary balance | 3.9 | 2.0 | 2.7 | 3.1 | 2.4 | 1.9 | 0.0 | 1.0 | 1.5 |
| Public debt | 55.9 | 60.9 | 53.4 | 54.2 | 58.8 | 56.7 | 61.1 | 64.6 | 65.3 |
| of which Domestic | 51.2 | 57.5 | 50.5 | 51.5 | 55.9 | 53.6 | 57.7 | 61.2 | 61.9 |
| *Foreign Assets* & **Liabilities, USD bn** | | | | | | | | | |
| **External debt** | 198.3 | 198.2 | 256.8 | 298.2 | 312.9 | 322.8 | 318.6 | 312.0 | 318.0 |
| Public | 84.2 | 93.3 | 103.6 | 102.1 | 113.7 | 119.5 | 116.3 | 113.9 | 116.1 |
| External debt / GDP | 11.4 | 12.2 | 12.0 | 12.1 | 13.9 | 14.6 | 14.6 | 15.1 | 14.9 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 36.4 | 31.0 | 57.3 | 40.1 | 37.2 | 40.0 | 42.0 | 44.0 | 45.0 |
| Short-term debt/International reserves (%) | 18.8 | 13.0 | 19.9 | 11.4 | 10.0 | 10.6 | 11.0 | 11.6 | 11.8 |
| | | | | | | | | | |
| **Quarterly Economic Indicators** | | | | | | | | | |
| | **2014 Q2** | **2014 Q3F** | **2014 Q4F** | **2015 Q1F** | **2015 Q2F** | **2015 Q3F** | **2015 Q4F** | **2016 Q1F** | **2016 Q2F** |
| GDP, % yoy | -0.9 | -0.1 | -0.5 | -0.2 | 0.6 | 0.6 | 0.8 | 1.1 | 1.5 |
| CPI, % yoy | 6.3 | 6.5 | 6.4 | 6.4 | 6.2 | 6.3 | 6.8 | 6.4 | 6.1 |
| Policy interest rate, %, eop | 11.00 | 11.00 | 11.75 | 12.50 | 12.50 | 12.50 | 12.00 | 12.00 | 12.00 |
| Short-term market rate, % eop | 10.80 | 10.82 | 11.70 | 12.48 | 12.50 | 12.50 | 12.00 | 12.00 | 12.00 |
| Long-term yield, %, eop | 12.24 | 11.50 | 12.27 | 12.77 | 12.77 | 12.77 | 12.77 | 13.27 | 13.27 |
| BRL/USD, eop | 2.21 | 2.45 | 2.65 | 2.69 | 2.73 | 2.76 | 2.79 | 2.82 | 2.85 |
| Source: National sources, Citi Research | | | | | | | | | |

Source: National Sources, Citi Research

# CCA

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- **Summary view** — Idiosyncratic factors would prevent low oil prices to translate into an acceleration of GDP growth across the region. Although lower oil prices would not be enough to push up growth, they will most likely suffice to expect lower trade and current account deficits

- **Things to watch** — Costa Rica is expected to propose a change in the sales tax that would transform it into a value-added tax (VAT), but without raising the tax rate. El Salvador will hold congressional and municipal elections in March.

- **Strategy** — The fate of the Dominican Republic's relative value against other credits remains critically dependent on the amount of hard-currency debt supply brought to market over the next year. This would be closely linked to potential changes in Petrocaribe.

## Idiosyncratic Factors Offset Oil Prices

**Idiosyncratic factors prevents low oil prices to translate into an acceleration of GDP growth across the region**. The Caribbean and Central America (CCA) region is a net oil importer, and as such one expects it to benefit from the decline in actual and expected oil prices. We expect regional economies to benefit, but the fall in oil prices is unlikely to trigger a widespread rebound in growth across the region. We expect some idiosyncratic factors to work against growth in some countries.

**Panama and the Dominican Republic continue to be the fastest growing countries in the region, but activity should decelerate in 2015.** Panama begins wrapping up the Panama Canal expansion, which is expected to conclude by late (probably December) 2015. In that vein, construction would begin slowing down to single-digit growth. Moreover, we think it is unlikely that global trade picks up significantly, thereby preventing Panama Canal traffic from helping to accelerate growth. We do expect a rebound in growth in 2016 when the expanded Panama Canal opens to traffic. However, 2015 will probably post the lowest growth since the 2009 global crisis—notwithstanding that it would still be a high rate. In the Dominican Republic, gold exports will not have the favorable base comparison that they had during the past couple of years. In addition, Citi Research's Commodity Price Outlook suggests slightly lower average prices in 2015. This prevents gold exports from pushing up growth significantly. Tourism and construction are expected to perform relatively well, and consequently we would expect the country to experience relatively high growth in 2015, albeit lower than that of 2014.

**Costa Rica and El Salvador will likely post modest growth rates.** In Costa Rica, we expect the full negative effect of Intel's exit of the country to hit in 1H15. We are already witnessing a decline in exports (Zonas Francas) as a result of this exit. The importance of Intel in manufacturing output and in exports has led us to call (for quite some time) for a slowdown in growth in 2015. El Salvador is the only country in this sample of CCA countries in which we expect a higher growth rate in 2015 (when compared to 2014). Despite the expected increase in the growth rate, the level of growth should remain modest and therefore it would be inappropriate to tag this expected performance as "acceleration" in growth. In our view there are still too many political gridlocks preventing the country from reaching agreements to push up private investment in the country. We expect growth in remittances to work in favor of private consumption in 2015, thereby allowing growth to be slightly higher next year.

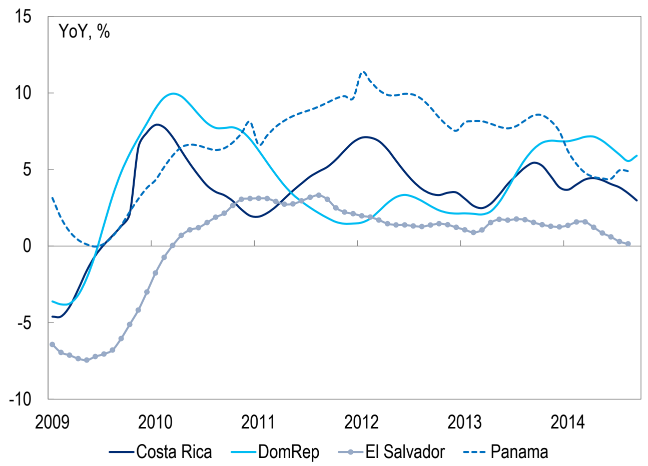
**Although lower oil prices would not be enough to push up growth, they will most likely suffice to expect lower trade and current account deficits.** Big shifts in the current account deficits of this region have traditionally been associated with swings in oil prices. Of course, the notable exception during the past couple of years has been the Dominican Republic, since gold exports have translated into a positive structural change that has pulled down the current account deficit. In Costa Rica, the exit of Intel would prevent a more drastic narrowing in the current account deficit. In Panama, the likely narrowing in the current account deficit during the next couple of years would not only stem from oil prices, but also from the imports of capital goods. As the Panama Canal expansion begins winding down, we expect lower capital goods imports. In El Salvador, higher remittances would also work in favoring of a narrowing in the current account deficit in 2015.

**Lower oil prices could also be regarded as a double-edged sword, as they might trigger changes to the Petrocaribe agreement.** In this sample of 4 countries, only the Dominican Republic and El Salvador are members of Petrocaribe. El Salvador joined Petrocaribe in 2014, and therefore it has not gotten used to the benefits of cheap financing to purchase oil. This situation contrasts with that of the Dominican Republic, which has made Petrocaribe an essential part of its financing strategy during the past few years. In the Dominican Republic, an end to Petrocaribe financing would be considered to be negative for the credit, but the extent of the damage depends on the oil price outlook. The net damage to the Balance of Payments (BoP) from the potential exit from Petrocaribe decreases as we move into a low oil price environment. In the Dominican Republic, not having Petrocaribe under a USD75/bbl environment would be virtually the same in terms of outflows (oil imports minus Petrocaribe financing) as having the membership in an USD100/bbl environment.

**The fiscal stance has weakened in Costa Rica and Panama, while in El Salvador the improvement has been modest.** Costa Rica is by far the country that has the weakest fiscal stance among our sample of CCA countries. The country is expected to propose a change in the sales tax that would transform it into a value-added tax (VAT), but without raising the tax rate. This might give a hand, but is certainly not enough to begin thinking in a turnaround of the story. Our baseline scenario assumes that the fiscal stance would continue to weaken. In El Salvador, there could be additional efforts to reduce the fiscal deficit, but the picture is unlikely to change significantly. In Panama, the deficit has been widening during 2014, but the current administration is expected to be more cautious on the fiscal side, and therefore we expect a narrowing in the deficit in 2015.

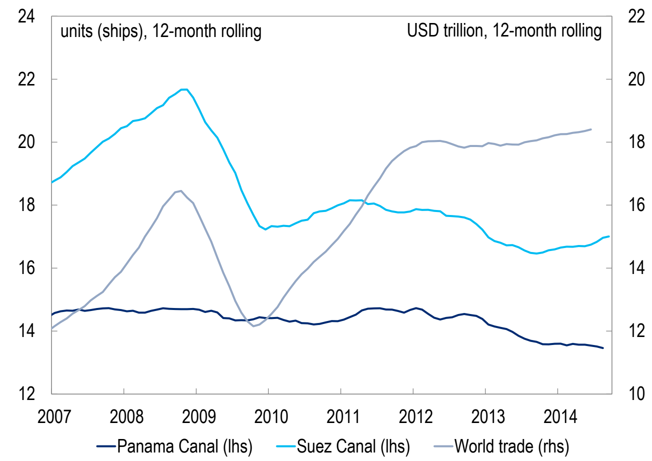
**We expect the fiscal deficit in the Dominican Republic to narrow further in 2015, but to widen in 2016.** The current administration has made a substantial effort to lower the deficit and it will likely continue doing so in 2015. However, in previous comments we have underscored that the most notorious spikes in primary expenditures during past years have taken place during election years. The tighter the election becomes, the higher the incentives for the incumbents to increase – at least temporarily – primary expenditures. The country will hold presidential and congressional elections in 2016. We think the 2016 election could be a little “easier” for the incumbent party than the previous election. This suggests that incentives to increase expenditures could be softer than in 2012. However, it would be untimely to say that the fiscal deficit will not widen in 2016. In fact, our baseline scenario assumes a widening of the deficit in 2016.

**Figure 271. CCA: DomRep and Panama are the fastest growing countries**



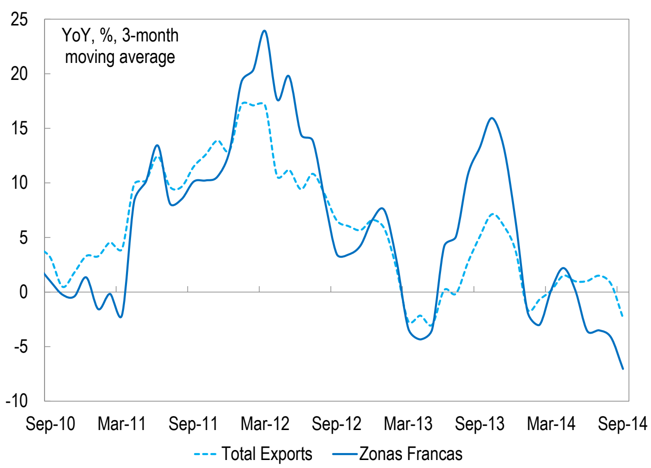

Source: BCCR, BCRD, BCRES, INEC, Haver and Citi Research

**Figure 272. Panama: Traffic in the Canal has slowed down**



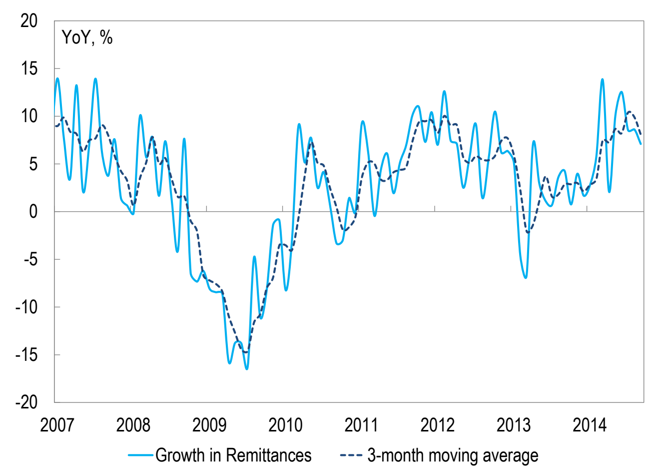

Source: ACP, SCA, IMF, Haver and Citi Research

**Figure 273. Costa Rica: The effects from Intel's exit are evident**



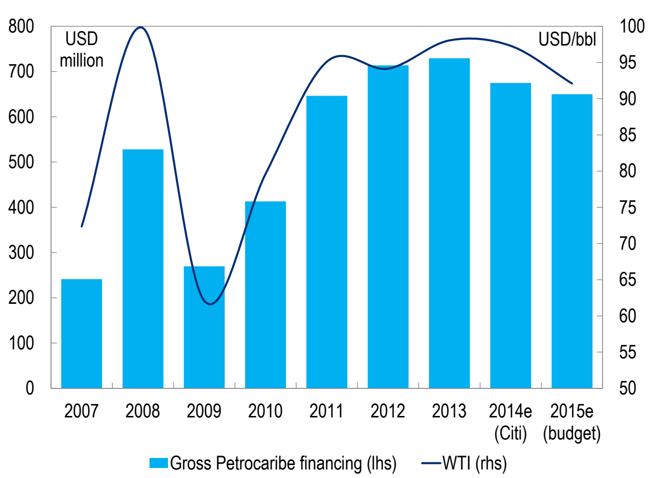

Source: BCCR and Citi Research

**Figure 274. El Salvador: Remittances would support consumption**



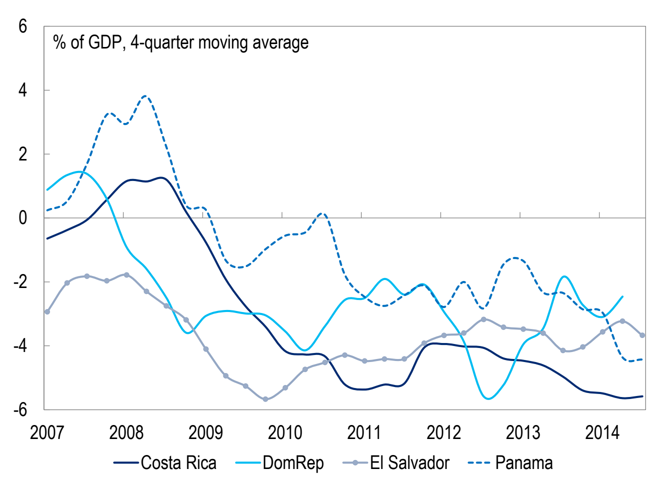

Source: BCRES and Citi Research

**Figure 275. DomRep: Oil prices drive the amount of Petrocaribe financing**




Source: Ministry of Finance (Hacienda), Bloomberg and Citi Research

**Figure 276. CCA: Reducing the fiscal deficit is one of the main challenges**




Source: BCCR, BCRD, BCRES, MEF, INEC, Haver and Citi Research

**Figure 277. CCA Economic Research Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Costa Rica** | | | | | | | | | |
| Nominal GDP, USD bn | 29.8 | 29.4 | 36.3 | 41.2 | 45.4 | 49.6 | 49.6 | 52.4 | 54.7 |
| GDP per capita, USD | 6,583 | 6,359 | 7,955 | 8,964 | 9,654 | 10,557 | 10,329 | 10,909 | 11,164 |
| Real GDP, yoy avg | 2.7 | -1.0 | 5.0 | 4.5 | 5.1 | 3.5 | 3.0 | 2.5 | 3.5 |
| CPI, % avg | 13.4 | 7.8 | 5.7 | 4.9 | 4.5 | 5.2 | 4.5 | 4.8 | 4.6 |
| CRC/US$, avg | 525 | 570 | 521 | 502 | 503 | 501 | 538 | 548 | 568 |
| Real GDP, yoy avg | 560 | 555 | 504 | 506 | 513 | 501 | 535 | 555 | 565 |
| Current account | -2.8 | -0.6 | -1.3 | -2.2 | -2.4 | -2.5 | -2.7 | -2.8 | -2.7 |
| % of GDP | -9.3 | -2.0 | -3.5 | -5.3 | -5.3 | -5.1 | -5.5 | -5.3 | -5.0 |
| Consolidated government balance | 0.5 | -3.9 | -5.3 | -4.2 | -4.5 | -6.1 | -6.7 | -7.3 | -8.0 |
| | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014F** | **2015F** | **2016F** |
| **Dominican Republic** | | | | | | | | | |
| CPI, % yoy eop (reported) | - | - | - | - | - | - | - | - | - |
| GDP per capita, USD | 5,053 | 4,967 | 5,454 | 5,816 | 5,909 | 5,955 | 6,291 | 6,505 | 6,692 |
| Real GDP, yoy avg | 3.1 | 0.9 | 8.3 | 2.9 | 2.7 | 4.6 | 6.8 | 5.0 | 4.5 |
| CPI, % avg | 10.6 | 1.4 | 6.3 | 8.5 | 3.7 | 4.8 | 3.1 | 2.4 | 3.3 |
| Policy Interest Rate, % eop | 9.50 | 4.00 | 5.00 | 6.75 | 5.00 | 6.25 | 6.25 | 6.25 | 6.25 |
| DOP/US$, avg | 34.4 | 35.9 | 36.8 | 38.0 | 39.2 | 41.7 | 43.5 | 45.2 | 47.0 |
| DOP/US$, eop | 35.4 | 36.2 | 37.4 | 38.7 | 40.4 | 42.7 | 44.3 | 46.0 | 47.8 |
| Current account | -4.5 | -2.3 | -4.0 | -4.4 | -4.0 | -2.5 | -2.4 | -2.3 | -2.3 |
| % of GDP | -9.4 | -4.8 | -7.4 | -7.5 | -6.6 | -4.0 | -3.7 | -3.4 | -3.3 |
| Consolidated government balance | -4.3 | -4.8 | -3.7 | -3.8 | -7.9 | -4.1 | -4.0 | -3.6 | -4.5 |
| | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014F** | **2015F** | **2016F** |
| **El Salvador** | | | | | | | | | |
| Nominal GDP, USD bn | 21.4 | 20.7 | 21.4 | 23.1 | 23.8 | 24.3 | 25.1 | 26.0 | 27.2 |
| GDP per capita, USD | 3,485 | 3,343 | 3,443 | 3,696 | 3,780 | 3,835 | 3,916 | 4,066 | 4,245 |
| Real GDP, yoy avg | 1.3 | -3.1 | 1.4 | 2.2 | 1.9 | 1.7 | 2.0 | 2.2 | 2.5 |
| CPI, % avg | 7.3 | 0.5 | 1.2 | 5.1 | 1.8 | 0.8 | 1.3 | 1.6 | 1.9 |
| Policy Interest Rate, % eop | - | - | - | - | - | - | - | - | - |
| SVC/US$, avg | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Current account | -1.5 | -0.3 | -0.5 | -1.1 | -1.3 | -1.6 | -1.5 | -1.5 | -1.6 |
| % of GDP | -7.1 | -1.5 | -2.5 | -4.8 | -5.4 | -6.5 | -6.0 | -5.8 | -6.0 |
| Consolidated government balance | -2.8 | -5.5 | -4.4 | -4.0 | -3.5 | -4.2 | -3.4 | -3.6 | -3.5 |
| | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014F** | **2015F** | **2016F** |
| **Panama** | | | | | | | | | |
| Nominal GDP, USD bn | 24.9 | 25.9 | 28.8 | 33.3 | 38.0 | 42.6 | 46.5 | 49.8 | 54.2 |
| GDP per capita, USD | 7,312 | 7,482 | 8,170 | 9,242 | 10,543 | 11,668 | 12,578 | 13,113 | 14,268 |
| Real GDP, yoy avg | 9.1 | 4.0 | 5.9 | 10.8 | 10.2 | 8.4 | 6.2 | 5.5 | 6.5 |
| CPI, % avg | 8.8 | 2.4 | 3.5 | 5.9 | 5.7 | 4.0 | 2.8 | 1.5 | 2.2 |
| 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 | -2.7 | -0.2 | -2.8 | -5.0 | -3.8 | -4.8 | -4.2 | -4.3 | -3.8 |
| % of GDP | -10.9 | -0.7 | -9.6 | -15.0 | -10.1 | -11.3 | -9.0 | -8.6 | -7.0 |
| Consolidated government balance | 0.4 | -1.0 | -1.9 | -2.2 | -1.5 | -3.0 | -4.5 | -3.5 | -3.0 |

Source: National Sources, Citi Research forecasts

# Chile

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- **Summary view** — Chile is expected to remain growing below it potential rate during most of 2015. The recovery towards potential growth will take some time, as investment is unlikely to return to previous levels soon. Undoubtedly external conditions will not help, but domestic conditions will also take its toll on growth.

- **Things to watch** — The BCCh will release its IPoM in mid-December. If the economy were to move away from the IPoM's baseline scenario, the central bank would begin thinking about adding more monetary stimuli.

- **Strategy** — For now we prefer to keep our view that the policy rate would remain unchanged for quite some time, but we acknowledge that the risks are biased to more monetary easing.

## Below potential growth

**Chile is expected to remain growing below its potential rate during most of 2015.** Real GDP likely increased 1.5% in 2014 and we expect that it would only "rebound"— if such a word is appropriate — to 2.5% in 2015. These growth rates are below 4% — the level we consider to be the country's potential growth rate. Not so long ago, the country's potential growth rate was considered to be around 5% per year. We think that the demise of the commodity's supper cycle and some idiosyncratic factors have pushed down the country's potential growth rate.

**The recovery towards the country's potential growth rate will take some time, as investment is unlikely to return to previous levels soon.** The fall in investment can be attributed to several reasons. The most commonly cited culprits are weak copper price prospects, lower expected growth in China, and the Bachelet's administration tax reform. But the question is whether there could be something that could turnaround the decline in investment. On early 2013, investment was close to 26% of GDP, while currently is below 22% of GDP. The sources of this investment — namely, domestic and external savings — have both contributed to a fall in investment. However, what we find more worrisome is that the decline in domestic savings began even before early 2013. Since early 2011, domestic savings have been falling constantly. Even if the country were to run a higher current account deficit to finance investment, the declining trend in domestic savings would work against the sources to finance new investments.

**A headwind against the recovery is the low level of confidence among locals.** The first clear example is the business confidence index (IMCE). As of October 2014, the IMCE had fallen to levels that are comparable to those of early 2009 — precisely at the worst times of the global crisis. We think that this low level of confidence is a major headwind against the recovery and more specifically for a pickup in investment. In our view, it will take some time before business confidence goes back to more "reasonable" levels.

**It is not a surprise that approval rates have fallen too.** Approval rates for both President Bachelet and her administration began to fall in July — when economic prints began to surprise even more on the downside. The current approval rates are not that different from those of her first term, but it is unlikely that they recover until the economy begins to show more signs of strength. We think that with this approval rates, the current administration's political capital has diminished substantially. This might translate into a delay or a watering down of some reform proposals — particularly the labor reform.

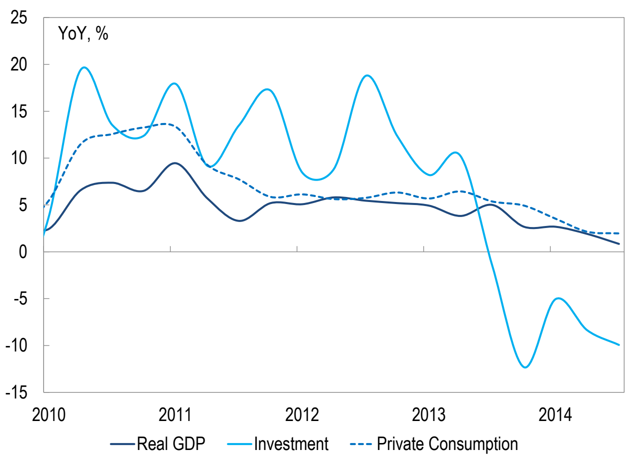
**In the meantime, the BCCh ended its easing cycle, but it is waiting so see if it needs to open the door again.** The Central Bank of Chile (BCCh) has adopted a neutral tone and it seems comfortable with the current level of the policy rate. The full effect of the most recent cuts will take some time to materialize, and therefore the central bank seems in no hurry to cut rates again. However, in our view, the central bank's strategy is lying under the assumption that the economy will begin recovering on early 2015. In our view, available information suggests that slow growth will likely continue throughout 4Q14, thereby jeopardizing a recovery on early 2015.

**The BCCh has yet to set forth its new outlook, which would allow us to have a benchmark to gauge if more easing is likely or not.** The central will release its Monetary Policy Report (IPoM) in mid-December, in which it will likely share its views about the potential timing on the recovery. In our view, if the economy were to shift away from the IPoM's baseline scenario, the central bank would begin thinking about adding more monetary stimuli. For now we prefer to keep our view that the policy rate would remain unchanged for quite some time, but we acknowledge that the risks are biased to more monetary easing.

**The main short-term impediment for additional easing is inflation.** The central bank continued easing even though inflation was running above the target's upper limit. The central bank expects inflation to remain above the target for a while, but to eventually slow down towards the midpoint (3%) of the inflation target. In our view, inflation would come down even though interest rates (both nominal and real) remain at low levels. With the economy growing below its potential, it is unlikely that demand-side inflationary pressures could arise. This would give enough time to wait for "one-off" and "transitory" factors affecting inflation to wear down. In addition, we expect lower oil prices to lend a hand to inflation to begin slowing down.

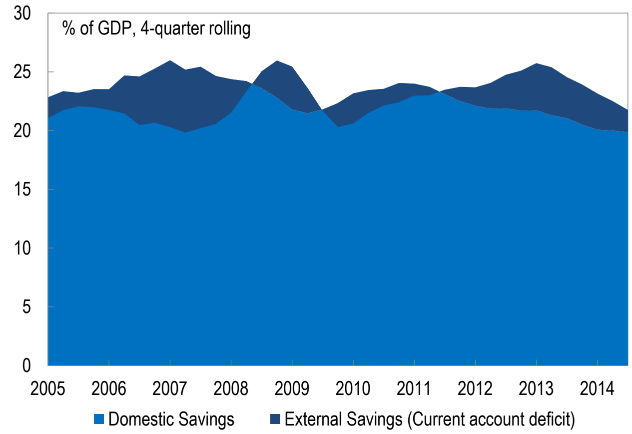
**Finally, we expect the fiscal deficit to continue widening.** It is worth remembering that the 2014 tax reform, and the new revenues associated with it, had the purpose of getting the resources to finance the government's social agenda. In addition, the government is trying to undertake a countercyclical fiscal policy in 2015. The main risk for keeping the deficit in line with the budget is the behavior of economic activity. Growth could fall short of the government's expectations, thereby increasing the risks of witnessing a higher deficit than that of the 2015 budget.

### Figure 278. Investment has pulled down growth



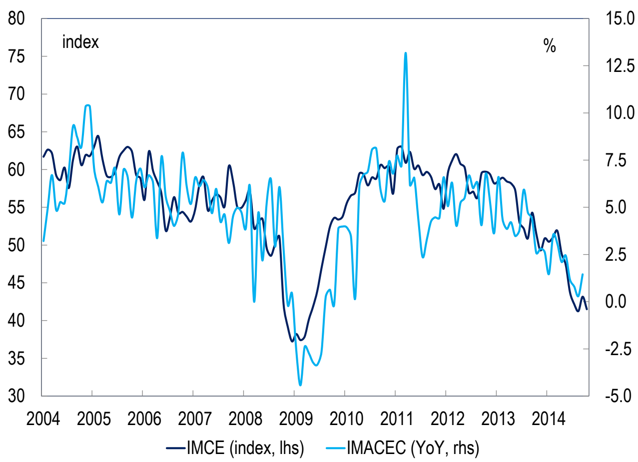

Source: : BCCh, Haver and Citi Research

### Figure 279. Domestic savings (as a % of GDP) have been falling



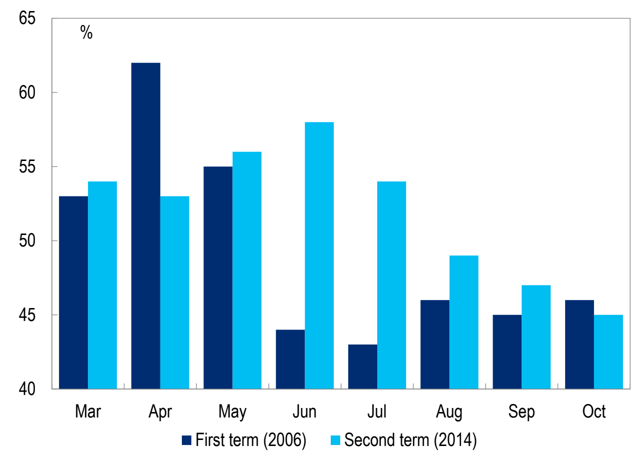

Source: BCCh, Haver and Citi Research

### Figure 280. Confidence is not that different from that of the global crisis



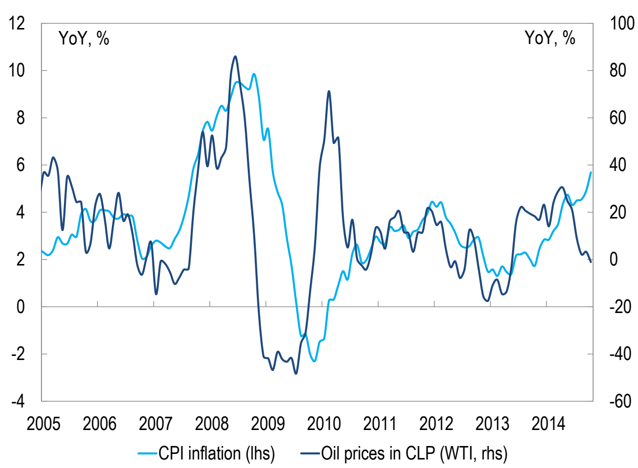

Source: ICARE, Haver and Citi Research

### Figure 281 Bachelet's approval rates are close to those of her first term



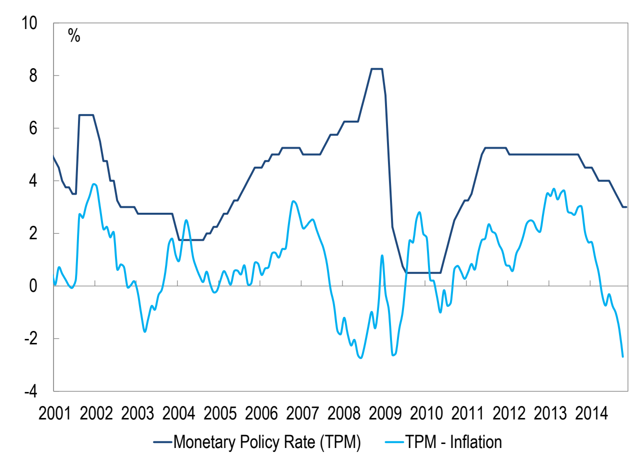

Source: Adimark and Citi Research

### Figure 282. Oil prices could pull down inflation




Source INE, IMF, Haver and Citi Research

### Figure 283. Real interest rates are moving within negative territory




Source: BCCh, INE, Haver and Citi Research

**Figure 284. Chile Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 183 | 173 | 218 | 251 | 267 | 277 | 252 | 246 | 262 |
| Nominal GDP, local currency bn | 94 | 96 | 111 | 121 | 130 | 137 | 144 | 152 | 163 |
| GDP per capita, USD | 10,876 | 10,199 | 12,861 | 14,639 | 15,398 | 15,863 | 14,294 | 13,814 | 14,581 |
| Population, mn | 16.8 | 17.0 | 17.0 | 17.1 | 17.3 | 17.5 | 17.7 | 17.8 | 18.0 |
| Unemployment, % of labour force | 7.8 | 10.8 | 8.2 | 7.1 | 6.4 | 5.9 | 6.5 | 7.2 | 7.6 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 3.3 | -1.0 | 5.8 | 5.8 | 5.4 | 4.1 | 1.5 | 2.5 | 4.0 |
| Real investment growth % yoy | 20.8 | -23.5 | 33.4 | 10.7 | 10.6 | -3.7 | -8.1 | 2.4 | 5.4 |
| Real consumption growth % yoy | 4.4 | 0.8 | 9.8 | 7.8 | 5.6 | 5.4 | 2.5 | 3.7 | 4.6 |
| private consumption growth % yoy | 5.2 | -0.8 | 10.8 | 8.9 | 6.0 | 5.6 | 2.3 | 3.6 | 4.8 |
| Real export growth, % yoy | -0.7 | -4.5 | 2.3 | 5.5 | 1.1 | 4.3 | 1.5 | 2.6 | 3.9 |
| Real import growth, % yoy | 11.2 | -16.2 | 25.9 | 15.6 | 5.0 | 2.2 | -6.3 | 3.3 | 6.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 7.1 | -1.5 | 3.0 | 4.4 | 1.5 | 2.8 | 4.8 | 3.0 | 3.0 |
| Nominal wages, % yoy | 8.5 | 5.8 | 3.5 | 5.8 | 6.3 | 5.8 | 6.4 | 4.9 | 4.5 |
| Credit extension to private sector, % yoy | 18.7 | -1.4 | 7.1 | 16.9 | 12.1 | 9.7 | 7.2 | 6.5 | 6.7 |
| Policy Rate (eop) | 8.25 | 0.50 | 3.25 | 5.25 | 5.00 | 4.50 | 3.00 | 3.00 | 4.00 |
| 3 month inter-bank rate, %, eop | 8.24 | 0.45 | 3.13 | 5.23 | 4.99 | 4.50 | 3.00 | 3.00 | 4.00 |
| Long-term yield, %, eop | 5.93 | 5.38 | 5.81 | 4.92 | 5.45 | 5.10 | 5.00 | 5.00 | 5.00 |
| CLP/USD, eop | 638 | 507 | 468 | 520 | 479 | 525 | 606 | 620 | 615 |
| CLP/USD, avg | 524 | 559 | 510 | 484 | 486 | 496 | 577 | 617 | 619 |
| Balance of Payments, **USD bn** | | | | | | | | | |
| **Current account** | **-5.8** | **3.5** | **3.6** | **-3.1** | **-9.1** | **-9.5** | **-4.9** | **-6.9** | **-7.9** |
| % of GDP | -3.2 | 2.0 | 1.6 | -1.2 | -3.4 | -3.4 | -1.9 | -2.8 | -3.0 |
| Trade balance | 6.1 | 15.4 | 15.7 | 11.0 | 2.5 | 2.1 | 6.4 | 3.3 | 3.0 |
| Exports | 64.5 | 55.5 | 71.1 | 81.4 | 78.0 | 76.7 | 73.4 | 69.3 | 76.1 |
| Imports | 58.4 | 40.1 | 55.4 | 70.4 | 75.5 | 74.6 | 67.1 | 66.0 | 73.0 |
| Service balance | -1.2 | -2.0 | -1.9 | -3.1 | -2.3 | -2.9 | -1.8 | -0.1 | -0.1 |
| Income balance | -13.6 | -11.4 | -14.7 | -13.9 | -11.5 | -11.1 | -11.5 | -12.1 | -12.9 |
| FDI, net | 15.5 | 12.9 | 15.7 | 23.4 | 28.5 | 20.3 | 15.2 | 14.0 | 24.0 |
| International reserves | 23.2 | 25.4 | 27.9 | 42.0 | 41.6 | 41.1 | 37.5 | 40.0 | 40.0 |
| Total amortisations | 14.3 | 16.4 | 12.3 | 12.8 | 22.4 | 22.6 | 22.7 | 23.6 | 24.9 |
| Public Finances, **% of GDP** | | | | | | | | | |
| **Consolidated government balance** | 4.3 | -4.3 | -0.3 | 1.4 | 0.6 | -0.6 | -2.0 | -1.6 | -0.7 |
| Consolidated gov primary balance | 4.8 | -3.8 | 0.2 | 2.0 | 1.2 | 0.0 | -1.4 | -1.0 | -0.1 |
| Public debt | - | - | - | - | - | - | - | - | - |
| of which Domestic | 2.4 | 4.9 | 7.4 | 8.2 | 9.9 | 10.2 | 5.8 | 6.7 | 7.5 |
| *Foreign Assets* & **Liabilities, USD bn** | | | | | | | | | |
| **External debt** | 63.7 | 71.9 | 84.5 | 98.4 | 117.6 | 130.7 | 129.2 | 126.8 | 135.2 |
| Public | 3.3 | 4.0 | 5.6 | 7.1 | 7.9 | 7.5 | 7.3 | 7.4 | 7.9 |
| External debt / GDP | 34.9 | 41.5 | 38.7 | 39.2 | 44.1 | 47.1 | 51.2 | 51.5 | 51.5 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 14.0 | 15.8 | 16.2 | 19.4 | 23.1 | 20.5 | 17.7 | 17.1 | 18.2 |
| Short-term debt/International reserves (%) | 60.6 | 62.4 | 58.3 | 46.3 | 55.4 | 49.9 | 47.1 | 42.8 | 45.5 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | 1.9 | 0.8 | 0.7 | 1.2 | 1.7 | 3.6 | 3.4 | 3.3 | 3.9 |
| CPI, % yoy | 4.3 | 4.9 | 4.8 | 4.0 | 3.6 | 3.1 | 3.0 | 3.0 | 3.1 |
| Policy interest rate, %, eop | 4.00 | 3.25 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.25 | 4.00 |
| Short-term market rate, % eop | 4.00 | 3.25 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.25 | 4.00 |
| Long-term yield, %, eop | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 | 5.00 |
| CLP/USD, eop | 552 | 598 | 606 | 611 | 617 | 620 | 620 | 620 | 620 |
| Source: National sources, Citi Research | | | | | | | | | |

Source: National Sources, Citi Research

# Colombia

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- **Summary view** — Economic activity next year is expected to be mostly driven by domestic sectors such as construction, the financial sector, and retail. That being said, the country is expected to continue suffering from weak external demand, with the prospects for external factors such as oil prices only raising questions about for how long can local activity continue to outperform. These questions are behind our call for GDP growth to be 4.5% next year, a number slightly lower than the 4.8% we expect for this year, and for Banrep remain on hold at 4.5% throughout 2015.

- **Things to watch** — Watch for the peace process' negotiations and the need for a new tax reform bill if government revenues continue to underperform.

- **Strategy** — With the pause by Banrep already priced-in by the market, we believe the steepening or flattening of the local curve will depend on the reaction of the long-end to USDCOP and US Treasuries. On the FX, although the observed speed of the recent COP depreciation was not expected, fundamentals always pointed toward a depreciated currency. Going forward we believe further weakness of COP is justified as long as oil revenues continue to underperform.

## Economic activity and inflation: partly cloudy but no rain

**Next year we expect for domestic drivers to continue to support growth.** In particular, we expect for construction (8.5% YoY), financial services (5% YoY), and retail (4.6% YoY) to be among the top performers in terms of GDP growth. This phenomenon should be a follow up of the good dynamics observed this year for these sectors. Hence, although we continue to expect moderation on growth by forecasting 4.5% GDP growth for next year, we are not considering a change to the sectors that should provide support for this growth in 2015. At the same time, we are considering a mild recovery in oil & mining (3.5% YoY) as we are assuming that some of the temporary issues that led to reductions in oil and coal production will not be present.

**On the activity front, the biggest threat to our call comes from the effect that lower oil revenues could have on economic activity.** Despite the expected recovery in oil production, this will not compensate the observed reduction on oil prices and hence government revenues will be affected. Our base case scenario assumes an average price for the Colombian basket of oil of USD79 per barrel, which implies a reduction of USD3.3bn in exports and USD2.1bn on fiscal revenues. In our view, it is through this reduction in government revenues that economic activity will be affected next year and hence, if oil prices end up falling more than what we are currently considering, the effect on economic activity could be higher.

**At the same time, lower oil prices translate into a weaker COP, which is one of the main forces helping to stabilize the economy.** We believe there is an asymmetry in the FX policy in the country in the sense that policy makers do not suffer from fear of floating when talking about depreciation of the currency and are willing to let the COP weaken as much as necessary, something that does not necessarily happened in the past when the country suffered from COP appreciation and the central bank decided to intervene the market by performing USD outright purchases.

**Hence, and given the already observed COP depreciation against the USD, the question on the pass-through to inflation becomes relevant.** For Colombia, pass-through estimates range between 15-17%: a number relatively low and which over the past few years has remained even lower thanks to the reduction of international prices of raw materials and intermediate goods. We believe this situation partially explains the positive behavior of inflation in Colombia and that it is one of the few countries in the region with inflation contained within its inflation target range as well as anchored inflation expectations.

**Even though our expectation for inflation next year is 3%, the biggest risk to our call lies on the likelihood of a higher-than-expected pass-through.** Although weather related issues were among the main risks for 2015 inflation throughout most of this year, the probability of an El Niño weather phenomenon has fallen sharply and even if it materializes its impact should be weak at this point. Having said that, the fast weakening of the COP, if transmitted at a higher-than-expected rate to consumer prices, could add pressure to inflation next year.

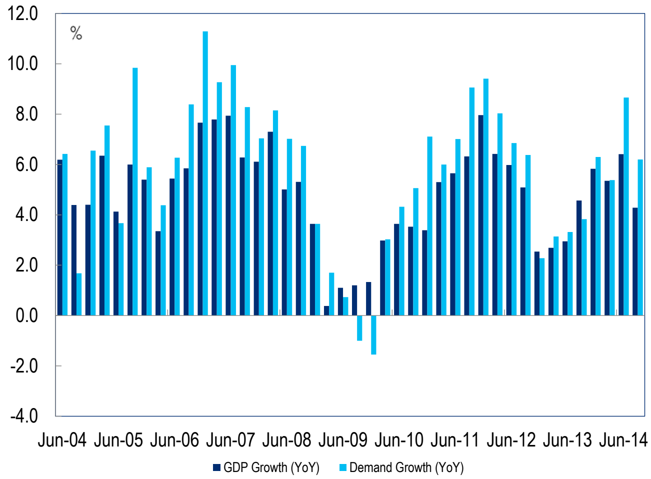
**Under our scenario for activity and inflation for next year, Banrep will not have the need to increase its repo rate further.** With activity growing at what we believe is its potential and inflation expectations under control, Banrep will be able to remain on hold for 2015. Going forward, it is worth to mention that monetary policy will continue being determined by the interaction of both activity and inflation and that the biggest threats to our call comes from weaker-than-expected economic activity from one side and inflation surprises that end up affecting inflation expectations on the other.

**On the fiscal front, the government will likely get a tax reform approved this year; yet, this might not be enough if oil revenues continue falling or if a peace treaty is reached with FARC.** Hence, the government could be in need next year to present a new tax reform which could potentially include a VAT increase given that this is the only main tax which has not been touched by previous reforms. Having said that we believe that, for the government 2015 should not be as complicated as what should happen in the following years given the fact that going forward it will have to face the reality of a permanent reduction of its revenues. The latter will pose the question of adjusting to this reduction by decreasing spending or looking for alternative sources of income by increasing taxes.

**The TES market: between the USDCOP and Treasuries.** Although this year we have observed the local curve has followed movements in the USDCOP more than movements in US treasuries -- a situation which has translated at times into a steepening of the curve when the COP depreciates and a flattening when it appreciates-- we continue to believe the relationship with US treasuries is important as well and next year the local curve should react to it. In our view, with the end of Banrep’s hiking cycle already priced-in by the market, the steepening or flattening of the curve will depend on the reaction of the long-end, which seems to be moving between the behavior of the USDCOP and US Treasuries.

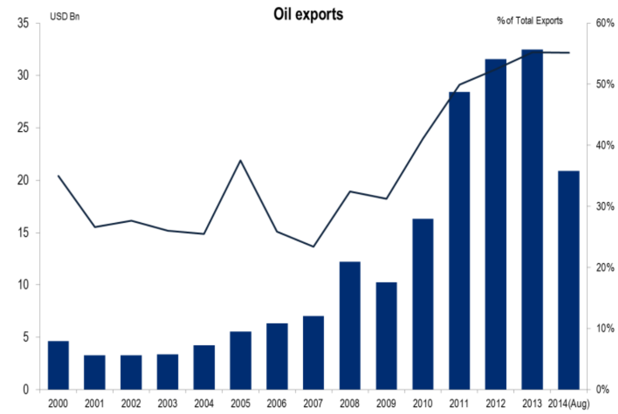
**USDCOP: A weaker COP is here to stay?** On the FX front we continue to expect COP depreciation against the USD. In particular, the recent reduction in oil revenues and its effects in the current account as well as on FDI inflows for next year should act taking the COP to depreciate. Our in-house calculations now show that the USDCOP exchange rate should end 2015 at 2,220.

**Figure 285. Domestic drivers should continue to support growth**



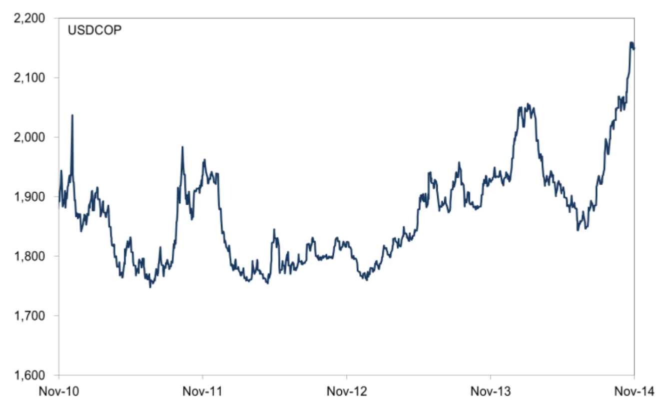

Source: Dane and Citi Research

**Figure 286. With falling oil revenues being the biggest uncertainty**



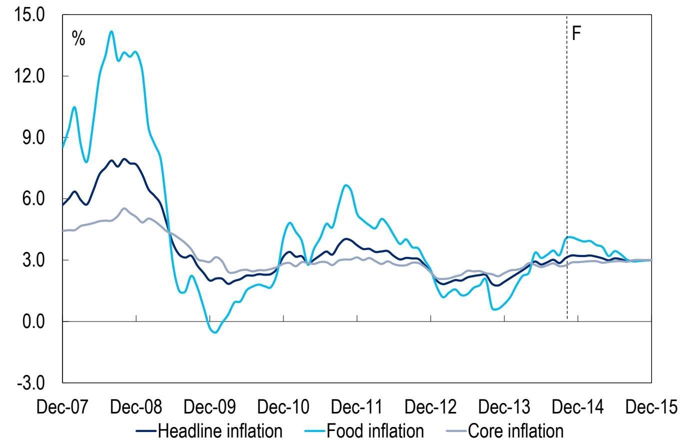

Source: Dane and Citi Research

**Figure 287. Underperformance of oil revenues has affected USDCOP**



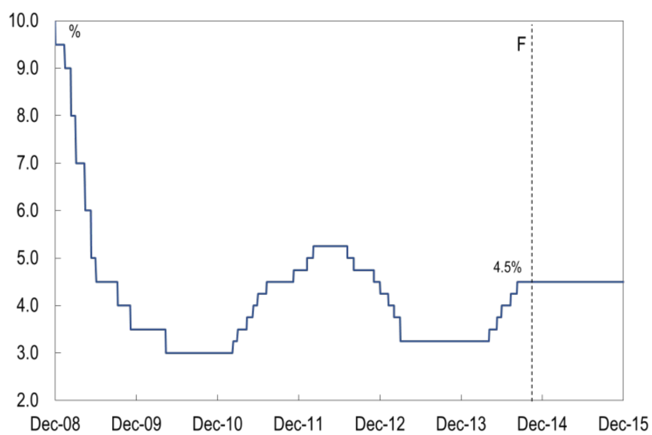

Source: Banrep and Citi Research

**Figure 288. With FX pass-through as the main risk for inflation**



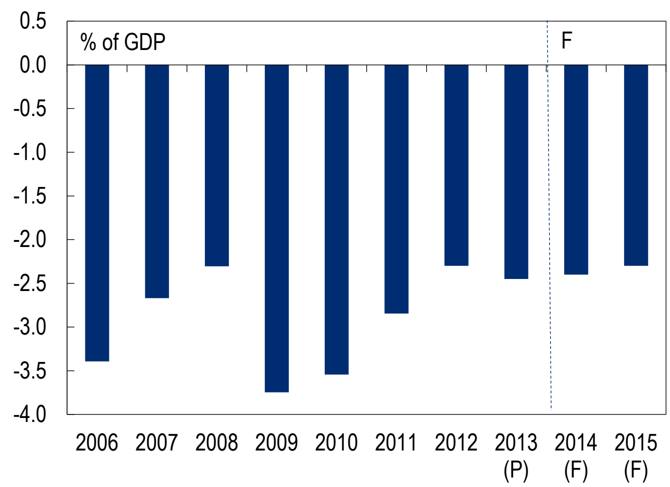

Source: Dane and Citi Research

**Figure 289. We expect for Banrep to remain on hold throughout 2015**




Source: Banrep and Citi Research

**Figure 290. The government could be in need of a new tax reform**




Source: Ministry of Finance and Citi Research

**Figure 291. Colombia Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 242 | 231 | 285 | 334 | 370 | 376 | 382 | 372 | 389 |
| Nominal GDP, local currency bn | 480 | 505 | 544 | 616 | 673 | 732 | 762 | 824 | 890 |
| GDP per capita, USD | 5,447 | 5,136 | 6,262 | 7,269 | 7,954 | 7,985 | 8,030 | 7,725 | 8,008 |
| Population, mn | 44.5 | 45.0 | 45.5 | 46.0 | 46.5 | 47.1 | 47.6 | 48.1 | 48.6 |
| Unemployment, % of labour force | 11.5 | 13.0 | 12.4 | 11.5 | 11.2 | 10.6 | 9.8 | 9.9 | 9.8 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 3.5 | 1.7 | 4.0 | 6.6 | 4.0 | 4.7 | 4.8 | 4.5 | 4.5 |
| Real investment growth % yoy | 9.0 | -3.9 | 7.7 | 18.5 | 4.6 | 5.1 | 12.1 | 5.6 | 3.4 |
| Real consumption growth % yoy | 3.5 | 1.6 | 5.1 | 5.5 | 4.7 | 4.5 | 5.6 | 5.0 | 5.1 |
| private consumption growth % yoy | 3.5 | 0.6 | 5.0 | 6.0 | 4.4 | 4.2 | 5.2 | 4.9 | 5.1 |
| Real export growth, % yoy | 4.5 | -2.8 | 1.3 | 11.8 | 6.1 | 5.4 | -3.5 | 1.0 | 4.3 |
| Real import growth, % yoy | 10.5 | -9.1 | 10.8 | 21.5 | 8.9 | 4.5 | 8.1 | 4.0 | 4.9 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 7.7 | 2.0 | 3.2 | 3.7 | 2.4 | 1.9 | 3.2 | 3.0 | 3.0 |
| Nominal wages, % yoy | 19.1 | 3.0 | 4.1 | 4.2 | 4.3 | 4.4 | 4.5 | 4.6 | 4.7 |
| Credit extension to private sector, % yoy | 14.3 | 6.8 | 9.8 | 18.3 | 10.0 | 13.7 | 14.0 | 15.9 | 14.0 |
| Policy Rate (eop) | 9.50 | 3.50 | 3.00 | 4.75 | 4.25 | 3.25 | 4.50 | 4.50 | 4.00 |
| 3 month inter-bank rate, %, eop | 8.87 | 3.10 | 3.00 | 4.81 | 4.27 | 3.30 | 4.52 | 4.52 | 4.02 |
| Long-term yield, %, eop | 12.76 | 8.47 | 7.70 | 7.60 | 5.86 | 6.75 | 7.32 | 7.32 | 6.40 |
| COP/USD, eop | 2,249 | 2,043 | 1,920 | 1,939 | 1,767 | 1,930 | 2,162 | 2,214 | 2,185 |
| COP/USD, avg | 1,968 | 2,154 | 1,898 | 1,848 | 1,798 | 1,869 | 2,009 | 2,206 | 2,201 |
| Balance of Payments, **USD bn** | | | | | | | | | |
| **Current account** | **-6.9** | **-5.1** | **-8.9** | **-9.9** | **-11.8** | **-12.7** | **-17.3** | **-16.9** | **-17.5** |
| % of GDP | -2.8 | -2.2 | -3.1 | -2.9 | -3.2 | -3.4 | -4.5 | -4.5 | -4.5 |
| Trade balance | 1.0 | 2.5 | 2.3 | 6.1 | 4.7 | 2.8 | -1.7 | -1.3 | -1.7 |
| Exports | 38.5 | 34.0 | 40.8 | 58.3 | 61.4 | 60.0 | 57.1 | 59.3 | 60.8 |
| Imports | 37.6 | 31.5 | 38.5 | 52.2 | 56.7 | 57.2 | 58.9 | 60.6 | 62.5 |
| Service balance | -3.1 | -2.9 | -3.7 | -4.7 | -5.5 | -5.5 | -8.7 | -11.2 | -13.6 |
| Income balance | -10.2 | -9.3 | -12.0 | -16.0 | -15.7 | -14.7 | -11.7 | -9.4 | -7.5 |
| FDI, net | 10.6 | 7.1 | 6.7 | 13.4 | 15.5 | 16.8 | 15.9 | 15.1 | 15.5 |
| International reserves | 24.0 | 25.4 | 28.5 | 32.3 | 37.5 | 43.6 | 47.2 | 47.6 | 50.1 |
| Total amortisations | 5.1 | 5.8 | 6.5 | 6.3 | 12.1 | 6.3 | 7.2 | 8.1 | 8.1 |
| Public Finances, **% of GDP** | | | | | | | | | |
| **Consolidated government balance** | -0.1 | -2.7 | -3.3 | -2.9 | 0.3 | -0.9 | -1.6 | -1.5 | -0.3 |
| Consolidated gov primary balance | - | - | - | - | - | - | - | - | - |
| Public debt | 34.0 | 36.7 | 37.2 | 34.6 | 33.7 | 34.8 | 34.9 | 34.0 | 33.9 |
| of which Domestic | 22.6 | 24.9 | 26.3 | 24.3 | 23.6 | 25.5 | 25.4 | 24.4 | 23.3 |
| *Foreign Assets* & **Liabilities, USD bn** | | | | | | | | | |
| **External debt** | 46.4 | 53.7 | 64.1 | 75.9 | 78.8 | 91.9 | 98.7 | 102.7 | 102.7 |
| Public | 29.4 | 37.1 | 38.9 | 42.8 | 46.1 | 52.1 | 58.6 | 62.6 | 62.6 |
| External debt / GDP | 19.1 | 23.2 | 22.5 | 22.7 | 21.3 | 24.4 | 25.8 | 27.6 | 26.4 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 5.7 | 3.9 | 8.1 | 10.8 | 9.8 | 10.0 | 10.1 | 10.3 | 10.2 |
| Short-term debt/International reserves (%) | 23.5 | 15.6 | 28.3 | 33.4 | 26.2 | 22.8 | 21.4 | 21.6 | 20.3 |
| | | | | | | | | | |
| **Quarterly Economic Indicators** | | | | | | | | | |
| | **2014 Q2** | **2014 Q3F** | **2014 Q4F** | **2015 Q1F** | **2015 Q2F** | **2015 Q3F** | **2015 Q4F** | **2016 Q1F** | **2016 Q2F** |
| GDP, % yoy | 4.3 | 3.9 | 4.5 | 3.5 | 4.6 | 4.9 | 5.1 | 4.6 | 4.6 |
| CPI, % yoy | 2.9 | 2.9 | 3.2 | 3.2 | 2.9 | 3.0 | 3.0 | 3.0 | 3.1 |
| Policy interest rate, %, eop | 4.00 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| Short-term market rate, % eop | 3.53 | 4.52 | 4.52 | 4.52 | 4.52 | 4.52 | 4.52 | 4.52 | 4.52 |
| Long-term yield, %, eop | 6.60 | 7.32 | 7.32 | 7.32 | 7.32 | 7.32 | 7.32 | 7.32 | 7.32 |
| COP/USD, eop | 1,880 | 2,025 | 2,162 | 2,185 | 2,207 | 2,218 | 2,214 | 2,210 | 2,206 |
| Source: National sources, Citi Research | | | | | | | | | |

Source: National Sources, Citi Research

# Mexico

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- **Summary view —** A relatively favorable external position, along with the gradual effect on the demand side of increases in investment stemming from the implementation of structural reforms, suggest an improvement in economic conditions in 2015, notwithstanding "normalization tantrums": we still expect GDP growth to accelerate to 3.9% in 2015 from 2.4% this year.

- **Things to watch —** An ongoing political crisis suggests that addressing institutional issues – the effective application of the rule of law in particular – will be crucial to ensuring a successful implementation of the reforms. Mexico's politicians will have to find time to cooperate on this while competing in the electoral arena, as mid-term elections take place in mid-2015.

- **Strategy —** MXN has been a story of relative strength in LatAm over the past month, hovering around our 0-3m October mid-point of 13.5. Neither political headlines nor faltering oil prices appear to have had much impact. We now expect an USDMXN of 13.6 and 13.4 for the 0-3 and 6-12 months horizons.

## External and macro conditions: better than the average EM

**Mexico´s external conditions in 2015 will be more favorable than for the region as a whole.** Softer demand for commodities on the back of lower growth rates in China, along with tighter financial conditions as the US Fed prepares to normalize, will pose a major challenge for most countries in Latin America. In Mexico though, two distinguishing features mark an important difference: a) Mexico is a manufacturing exporter –commodities account for only 25% of total exports; b) there is a strong correlation with the US business cycle as about 85% of Mexican exports go there. Consequently, external demand should still provide additional momentum to activity during 2015, this being one of the factors behind our expectation of stronger GDP growth (from 2.4% in 2014 to 3.9% in 2015).

**Accordingly, policymakers will not face the dilemma of having to choose between stimulating economic activity or responding to Fed normalization**. Given business-cycle co-movements, Banxico is expected to follow the Fed as normalization proceeds. We think Banxico will start hiking rates in October, 2015. We expect inflation in early 2015 to benefit from a favorable comparison base as well as more moderate increases in local gasoline prices. Our headline inflation forecast stands at 3.3% for 2015 (versus 3.9% in December 2014). FX volatility as normalization approaches will also be a concern, but policymakers may treat this event with "benign neglect". Our USD/MXN forecasts for year-end 2014 and 2015 at 13.6 and 13.3, compared to regional crosses, MXN should outperform.

**Fiscal vulnerability to lower oil prices has declined; emphasis should be on sticking to the fiscal consolidation path.** Congress approved the 2015 budget with an average price for Mexico's oil mix of USD 79 a barrel. The downside risks are covered by actual and "natural" hedges, with put option contracts covering nearly 60% of gross oil exports. Among the natural hedges: (a) local gasoline prices will still be set by the government in 2015, the gap between (slightly higher) local prices and declining foreign prices will increase tax revenues; (b) lower oil prices mean a stronger US economy and thus, more demand for manufacturing exports. All in all, the net impact of lower oil prices for Mexico is still negative, but less than in the past. We expect the government to stick to the approved budget and reduce its deficit to 4% of GDP in 2015 from an estimated of 4.2% this year.

## Structural reforms: crunch time for implementation

**Another important assumption in our outlook for 2015 and beyond is the gradual materialization of structural reforms.** In the economic front, the seven reforms (labor, education, competition, telecom and media, financial, fiscal and energy) could, if properly implemented, radically alter Mexico's economic trajectory.

**For forecasting purposes, the challenge is how to switch from an inertial scenario to one involving structural reforms.** In this respect, we have chosen to stress two reforms –energy and telecomm –as we believe their initial effects on investment could begin to materialize in 2015: a) Investments to enhance Mexico as an energy *consumer* and those related to new participants into the telecom & media sectors are already underway; b) The initial auction of contracts for upstream projects (round 1), or the development of the fiber-optic shared network, are projects whose cycle will take longer to peak. But some initial impacts could be expected by the end of next year – authorities' estimate "round 1" investments will reach USD 8.5 billion per year in 2015-18.

**We are therefore modeling these effects as essentially leading to an investment shock coming from the *demand* side.** We forecast that FDI inflows will grow from USD 21.3 billion this year to USD 26.9 billion and USD 32.6 billion in 2015 and 2016, and we see the share of gross fixed investment in GDP rising gradually to about 25% by 2020, from a recent historical average of 21%.

**Ultimately, the effectiveness of the reforms will involve the extent to which they foster expansion on the supply side of the economy.** In the final analysis, this will determine whether the stimulus sparked by higher investment ratios translates into higher potential growth rates. We think implementation has been adequate, and in the case of the energy reform, it has surprised us positively. However, 2015 could prove crucial in ensuring the reforms start to deliver in terms that the population at large can appreciate.

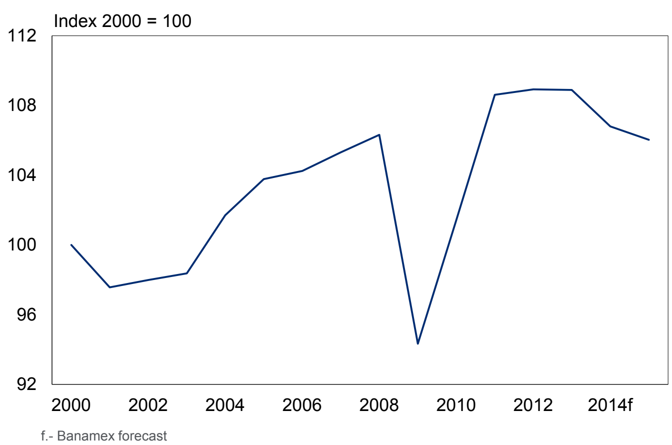
## Politics come back to the fore

**Events at the end of this year stress the relevance of institutional factors in promoting economic development.** The political crisis unleashed by the disappearance of a group of students on orders from the –now incarcerated –mayor of Iguala, in the state of Guerrero, is a reminder that Mexico's modernization cannot rely solely on economic reforms: institutional progress is also crucial.

**The political dilemma in 2015 will be how politicians cooperate to deliver what society demands as mid-term elections loom.** Mexico's institutional problems are essentially a problem of the State as a whole. Thus they require the design of a State policy supported by all political actors and society at large. The challenge is that incentives to cooperate triggered by a sense of crisis coincide with the conflictive stance political parties must adopt as they compete in mid-term elections. Elections of all 500 Federal deputies and local races in 17 out of the 32 federal entities, including 9 governors, are set for June 7, 2015.

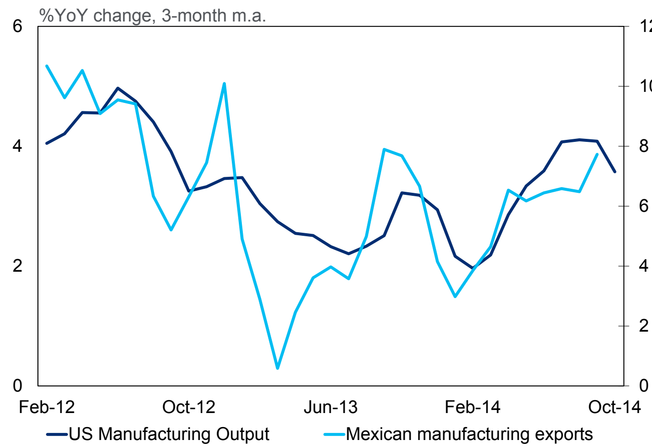
**Thus 2015 is set to be a complex year, but we remain cautiously optimistic**. In spite of a strong macroeconomic stance and ambitious economic reforms, the pending issue is in the institutional side –the rule of law, above all –alongside politics provide for a degree of uncertainty. We believe that institutional checks and balances are the best way of ensuring a successful, transparent execution of the reforms, so crucial for guaranteeing that their benefits are fairly distributed among the population at large.

**Figure 292. Terms of trade likely to rebound in 2015**



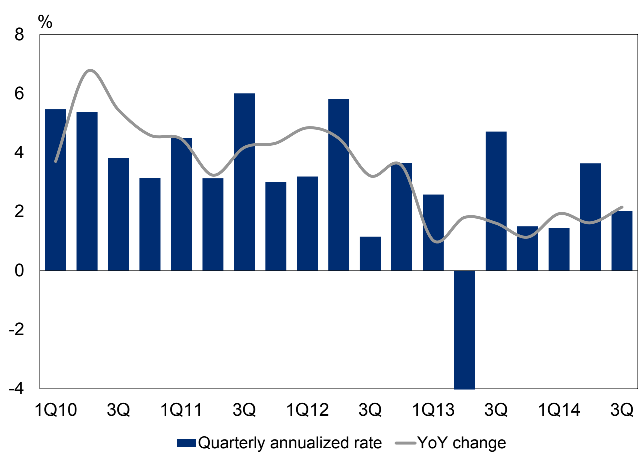

Source: Banamex based on data of Banxico, INEGI and the World Bank

**Figure 293. Manufactured exports respond to the recovery in external demand**



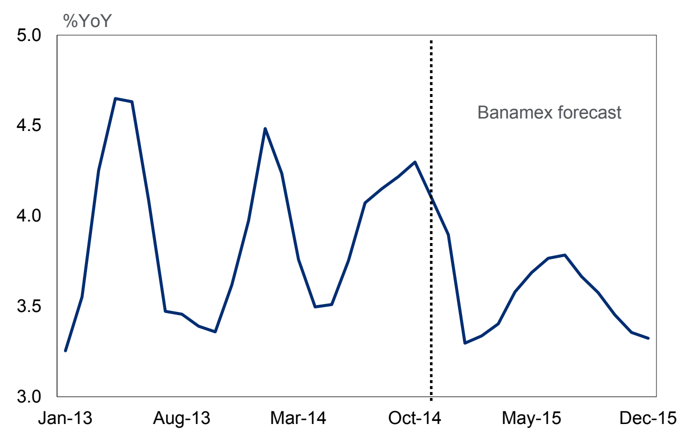

Sources: INEGI and Banamex

**Figure 294. GDP recovery continues, but to a lower pace**




Sources: IMSS and Banamex

**Figure 295. Annual inflation is probably at its peak**




Sources: Ministry of Finance and Banamex

**Figure 296. Selected Announcements of Investment Projects**

| Project | Start Date | USD bn |
|---|---|---|
| **New Mexico City Airport** | Sep-14 | 13 |
| **Fiber-optics shared telecomm network** | Oct-14 | 10 |
| **Gas Pipelines - Los Ramones II** | Jul-14 | 1.2 |
| **Electricity Projects (16) - CFE**<br>(inlcudes: 2 gas pi pelines, natural gas and several generation, transmission and distribution projects) | Aug-14 | 4.9 |

**Figure 297. Better Labor conditions is boosting the sales**

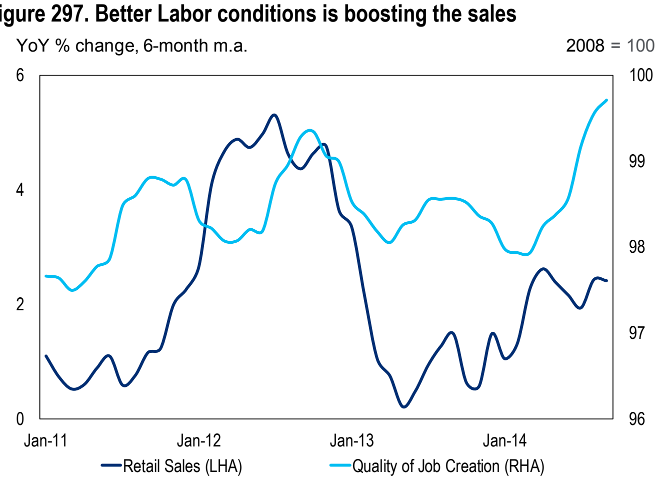


**Figure 298. Mexico Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 1,109 | 897 | 1,052 | 1,171 | 1,186 | 1,261 | 1,295 | 1,391 | 1,550 |
| Nominal GDP, local currency bn | 12,257 | 12,094 | 13,282 | 14,550 | 15,615 | 16,104 | 17,111 | 18,491 | 20,145 |
| GDP per capita, USD | 9,967 | 7,952 | 9,209 | 10,124 | 10,135 | 10,653 | 10,818 | 11,493 | 12,677 |
| Population, mn | 111.3 | 112.9 | 114.3 | 115.7 | 117.1 | 118.4 | 119.7 | 121.0 | 122.3 |
| Unemployment, % of labour force | 4.0 | 5.5 | 5.4 | 5.2 | 5.0 | 5.0 | 4.9 | 4.6 | 4.4 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 1.4 | -4.7 | 5.1 | 4.0 | 4.0 | 1.4 | 2.4 | 3.9 | 4.4 |
| Real investment growth % yoy | 6.2 | -13.3 | 4.5 | 5.4 | 5.5 | -2.4 | 2.7 | 4.9 | 6.0 |
| Real consumption growth % yoy | 2.1 | -5.2 | 5.1 | 4.5 | 4.6 | 2.3 | 2.2 | 3.5 | 4.0 |
| private consumption growth % yoy | 1.9 | -6.5 | 5.7 | 4.8 | 4.9 | 2.5 | 2.2 | 3.8 | 4.3 |
| Real export growth, % yoy | -1.3 | -11.8 | 20.5 | 8.2 | 5.9 | 1.2 | 6.4 | 7.3 | 10.1 |
| Real import growth, % yoy | 4.4 | -17.6 | 20.5 | 8.0 | 5.5 | 1.5 | 4.8 | 8.2 | 9.9 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 6.5 | 3.6 | 4.4 | 3.8 | 3.6 | 4.0 | 3.9 | 3.3 | 3.7 |
| Nominal wages, % yoy | 5.3 | 4.2 | 3.0 | 5.4 | 4.4 | 4.6 | 4.2 | 8.0 | 4.3 |
| Credit extension to private sector, % yoy | 9.6 | 0.5 | 5.7 | 7.4 | 6.8 | 6.3 | 7.3 | 7.9 | 7.4 |
| Policy Rate (eop) | 8.25 | 4.50 | 4.50 | 4.50 | 4.50 | 3.50 | 3.00 | 3.50 | 4.50 |
| 3 month inter-bank rate, %, eop | 8.25 | 4.50 | 4.50 | 4.50 | 4.50 | 3.50 | 3.00 | 3.50 | 4.50 |
| Long-term yield, %, eop | 8.35 | 7.99 | 6.95 | 6.51 | 5.38 | 6.45 | 5.85 | 6.50 | 6.27 |
| MXN/USD, eop | 13.67 | 13.06 | 12.36 | 13.95 | 12.87 | 13.04 | 13.59 | 13.28 | 12.97 |
| MXN/USD, avg | 11.16 | 13.50 | 12.63 | 12.44 | 13.16 | 12.76 | 13.26 | 13.40 | 13.09 |
| Balance of Payments, **USD bn** | | | | | | | | | |
| **Current account** | **-20.2** | **-8.3** | **-3.5** | **-12.3** | **-15.0** | **-26.5** | **-28.3** | **-28.3** | **-36.8** |
| % of GDP | -1.8 | -0.9 | -0.3 | -1.1 | -1.3 | -2.1 | -2.2 | -2.0 | -2.4 |
| Trade balance | -17.3 | -4.7 | -3.0 | -1.4 | 0.0 | -1.2 | -3.7 | -3.1 | -12.1 |
| Exports | 291.3 | 229.7 | 298.5 | 349.4 | 370.8 | 380.0 | 397.4 | 441.7 | 487.2 |
| Imports | 308.6 | 234.4 | 301.5 | 350.8 | 370.8 | 381.2 | 401.1 | 444.8 | 499.2 |
| Service balance | -8.2 | -10.0 | -9.9 | -14.1 | -14.0 | -11.7 | -12.6 | -12.8 | -14.0 |
| Income balance | -20.2 | -15.2 | -12.1 | -19.7 | -23.6 | -35.7 | -35.0 | -36.1 | -36.0 |
| FDI, net | 28.6 | 17.5 | 23.5 | 23.7 | 17.8 | 39.2 | 20.7 | 26.9 | 32.6 |
| International reserves | 85.4 | 90.8 | 113.6 | 142.5 | 163.5 | 176.5 | 195.1 | 208.5 | 222.1 |
| Total amortisations | 46.0 | 79.0 | 57.0 | 47.7 | 52.9 | 50.5 | 43.3 | 39.9 | 38.6 |
| Public Finances, **% of GDP** | | | | | | | | | |
| **Consolidated government balance** | -0.1 | -2.3 | -2.8 | -24.0 | -2.6 | -2.3 | -3.6 | -3.5 | -3.5 |
| Consolidated gov primary balance | 1.8 | -0.1 | -0.9 | -0.6 | -0.6 | -0.4 | -1.5 | -1.4 | -1.4 |
| Public debt | 33.2 | 36.2 | 36.2 | 37.5 | 37.7 | 40.4 | 42.2 | 43.3 | 43.3 |
| of which Domestic | 21.5 | 22.8 | 20.4 | 20.5 | 15.5 | 17.2 | 17.7 | 19.9 | 20.0 |
| *Foreign Assets* & **Liabilities, USD bn** | | | | | | | | | |
| **External debt** | 205.0 | 194.5 | 260.1 | 298.9 | 369.2 | 414.8 | 449.4 | 465.3 | 507.0 |
| Public | 129.3 | 120.9 | 167.1 | 198.9 | 263.6 | 292.8 | 316.9 | 326.1 | 361.8 |
| External debt / GDP | 18.5 | 21.7 | 24.7 | 25.5 | 31.1 | 32.9 | 34.7 | 33.5 | 32.7 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 25.1 | 21.3 | 21.3 | 22.8 | 22.4 | 21.9 | 23.3 | 24.3 | 25.3 |
| Short-term debt/International reserves (%) | 29.4 | 23.5 | 18.8 | 16.0 | 13.7 | 12.4 | 11.9 | 11.7 | 11.4 |
| | | | | | | | | | |
| **Quarterly Economic Indicators** | | | | | | | | | |
| | **2014 Q2** | **2014 Q3F** | **2014 Q4F** | **2015 Q1F** | **2015 Q2F** | **2015 Q3F** | **2015 Q4F** | **2016 Q1F** | **2016 Q2F** |
| GDP, % yoy | 1.6 | 2.2 | 3.6 | 4.2 | 4.0 | 4.4 | 3.2 | 3.7 | 4.9 |
| CPI, % yoy | 3.8 | 4.2 | 3.9 | 3.4 | 3.8 | 3.6 | 3.3 | 3.4 | 3.6 |
| Policy interest rate, %, eop | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.50 | 3.75 | 4.00 |
| Short-term market rate, % eop | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.50 | 3.75 | 4.00 |
| Long-term yield, %, eop | 5.68 | 6.11 | 5.85 | 6.00 | 6.20 | 6.38 | 6.50 | 6.35 | 6.25 |
| MXN/USD, eop | 12.97 | 13.43 | 13.59 | 13.52 | 13.44 | 13.37 | 13.28 | 13.21 | 13.13 |
| Source: National sources, Citi Research | | | | | | | | | |

Source: National Sources, Citi Research

# Peru

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- **Summary view** — Economic activity is expected to perform poorly this year and to post some slightly better numbers on next. We expect growth of 2.5% in 2014 and 3.8% in 2015. With the government announcing a series of measures to boost investment and consumption, and the central bank reducing 50bps its policy rate in the last quarter, the country is following the standard recipe to counteract an adverse economic environment. As we have mentioned before, the analysis of the balance of payments and the trade balance will continue to be the main variables to assess eventual vulnerabilities moving forward.

- **Things to watch** — Inflation and the monthly economic activity will be important to assess the future evolution of monetary policy. At the same time the discussion of possible presidential candidates will begin in the second half of next year.

- **Strategy** — The relatively weak activity growth from 2014 could take the BCRP to further reduce its policy rate going forward as long as inflation permits. The USDPEN should further depreciate on the back of a deterioration in the current account and reductions in FDI.

## Economic activity

**Throughout the year economic activity surprised on the downside on the back of weak external numbers as well as lower-than-expected investment.** This is the main reason why we forecast real GDP to increase 2.5% and 3.8% this and next year, respectively. The contrast of these numbers to the track record of over-performance observed in the Peruvian economy in recent years has raised many questions regarding the level of potential output going forward. With regard to this topic, we believe the average growth level of this decade will be lower to the one the country observed in the previous one, but this situation is more a generalized phenomenon in the region than an idiosyncratic situation for Peru.

**On the back of weak economic performance the government has been making announcements aimed at providing favorable conditions for investing and increasing consumption.** The measures have included the offering of tax stability agreements to investors, improvements in permitting times and procedures, announcements of infrastructure projects, and reduction in taxes aimed at boosting consumption. We believe the government realized that it has to boost domestic sectors in order to withstand the setback originated by weaker external conditions.

**For next year, commodity prices continue to be our main concern for GDP growth.** We acknowledge that the terms of trade have slightly fallen since 2011 does not bode well for the external sector as a main driver of economic growth going forward. Having said that, that new mining projects were originally expected to begin early production by 2015 but now could be doing it in 2016 instead does matter for GDP determination. In addition, and as mentioned by our commodity strategists, growing Chinese macro concerns have impacted the prices for industrial metals, particularly copper, although a mild recovery on copper prices is expected to take place next year, which could help to improve exports.

**Given our view that external factors will likely fail to boost growth in Peru, we believe it is important to look at the health of domestic drivers.** Household consumption has been increasing recently although mildly and we expect these dynamics to continue throughout 2014 as credit conditions remain favorable, even despite the recent increases in non-performing loans. This is why we expect for GDP growth to be 3.8% next year.

## Inflation and monetary policy

**Inflation has been outside the target range for most of the year but we expect it will converge to the upper half of the inflation target range next year.** Understanding that the most important reason for the higher-than-expected prints of inflation this year has to do with foodstuffs, we expect for inflation to end the year at 3.1% and to reach 2.5% in 2015. Risks to our call stem from the transmission of FX depreciation to local prices, which could end up imposing further inflationary pressures.

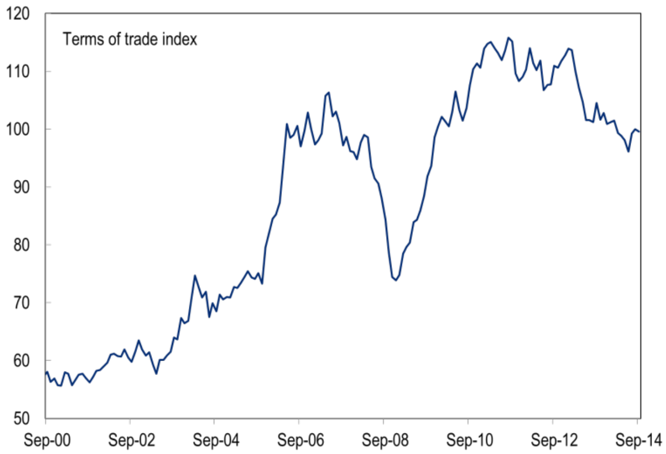
**Monetary policy.** The Central Bank of Peru (BCRP) has been active throughout the year by reducing reserve requirements and by cutting its policy rate by 50bps. The fact the economy has an important level of dollarization has also determined the degree of intervention in the FX market and makes it difficult for BCRP to consider more active policy rate reductions. Having said that, we believe the combination of reserve requirements and interest rates is appropriate for Peru and there is no doubt that the current monetary policy stance is loose. For next year, we are not expecting changes to the policy rate given our base case scenario, but as long as inflation permits and if activity continues to surprise on the downside, the conditions for further reductions of monetary policy could be met.

**Waiting for the effects of fiscal and monetary policy to materialize.** In our view, the reaction of both monetary and fiscal policy amid an environment of weakness in economic activity was the correct one with the government announcing increases in government spending as well as reforms to improve investment, and the central bank reducing its policy rate and reserve requirements. Although the effects of fiscal policy should be felt first to be felt, due to the lag of monetary policy, we are optimistic about the reaction of the Peruvian economy to these measures and hence we expect for GDP growth to recover in 2015 to 3.8%.

## External sector

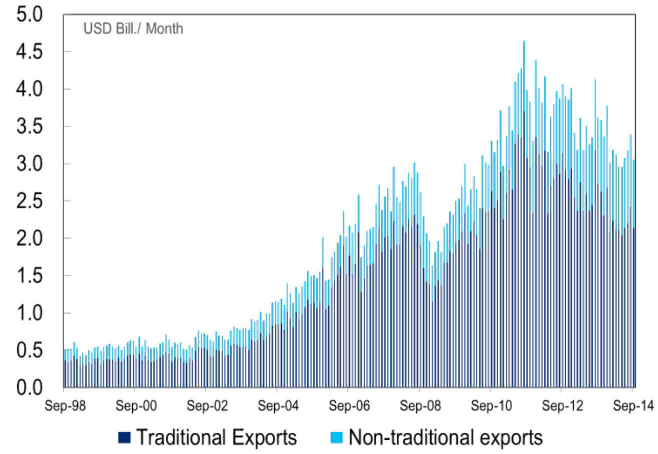
**Balance of payments.** During 2013, the current account deficit stood at 4.8% of GDP, increasing 1.6 percentage points versus the previous year. This increase in the current account deficit was mostly driven by the deterioration of the trade balance, a situation we anticipate to continue this year. This month we have marginally revised our forecasts and we now expect the current account to further deteriorate and post a 5.6% of GDP deficit this year, on the back of stagnant exports and lower commodity prices. For the time being, the current account deficit continued to be financed by foreign direct investment inflows, something that has led to significant increases in international reserves. Nonetheless, we expect a slower reserves accumulation moving forward and the deterioration of the current account and FDI inflows should provide arguments to expect more depreciation of the PEN. For next year we expect the USDPEN to end at 3.1.

Figure 299. Terms of trade dynamics…




Source: Bloomberg and Citi Research

Figure 300. …Could translate into weaker traditional exports…




Source: BCRP and Citi Research

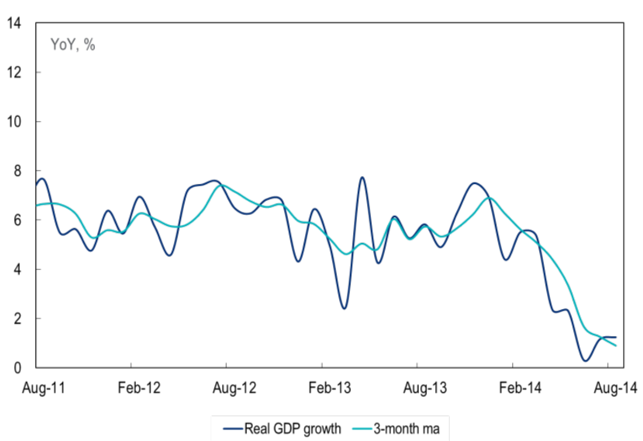
Figure 301. …And a weaker exchange rate


Source: Bloomberg and Citi Research

Figure 302. Inflation dynamics

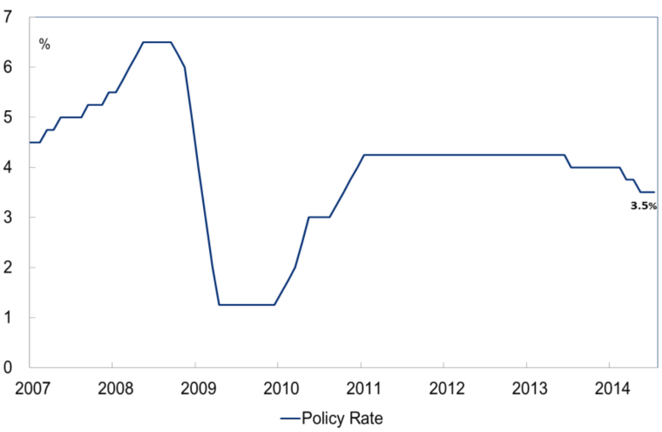

Source: BCRP, Haver and Citi Research

Figure 303. GDP Dynamics




Source: INEI, Haver and Citi Research

Figure 304. The latest BCRP's communiqué came with a dovish tone




Source: BCRP, Haver and Citi Research

**Figure 305. Peru Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 127 | 127 | 153 | 176 | 199 | 208 | 204 | 202 | 213 |
| Nominal GDP, local currency bn | 371 | 382 | 435 | 486 | 526 | 563 | 578 | 615 | 660 |
| GDP per capita, USD | 4,562 | 4,482 | 5,344 | 6,033 | 6,712 | 6,909 | 6,664 | 6,509 | 6,761 |
| Population, mn | 27.8 | 28.3 | 28.7 | 29.2 | 29.7 | 30.1 | 30.6 | 31.0 | 31.5 |
| Unemployment, % of labour force | 8.4 | 8.4 | 7.9 | 7.7 | 6.8 | 5.9 | 6.1 | 6.0 | 6.5 |
| **Economic Activity** | | | | | | | | | |
| Real GDP, yoy avg | 9.1 | 1.0 | 8.5 | 6.5 | 6.0 | 5.8 | 2.5 | 3.8 | 4.6 |
| Real investment growth % yoy | 29.4 | -22.9 | 38.8 | 12.9 | 12.3 | 10.5 | -2.3 | 0.9 | 3.0 |
| Real consumption growth % yoy | 8.6 | 4.1 | 8.2 | 5.8 | 6.4 | 5.5 | 4.7 | 4.4 | 4.4 |
| private consumption growth % yoy | 8.9 | 2.8 | 8.7 | 6.0 | 6.1 | 5.3 | 4.4 | 4.3 | 4.3 |
| Real export growth, % yoy | 7.1 | -0.7 | 1.3 | 6.9 | 3.7 | -0.9 | -1.9 | 1.5 | 3.0 |
| Real import growth, % yoy | 24.1 | -16.7 | 26.1 | 11.6 | 11.3 | 3.6 | -1.1 | 0.3 | 1.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 6.7 | 0.2 | 2.1 | 4.7 | 2.6 | 2.9 | 3.3 | 2.6 | 2.6 |
| Nominal wages, % yoy | 12.8 | 23.1 | -8.8 | 15.1 | 5.4 | 5.0 | 5.0 | 5.0 | 5.1 |
| Credit extension to private sector, % yoy | 14.3 | 10.4 | 20.1 | 14.2 | 13.8 | 12.4 | 13.0 | 13.0 | 12.0 |
| Policy Rate (eop) | 6.50 | 1.25 | 3.00 | 4.25 | 4.25 | 4.00 | 3.50 | 3.50 | 3.50 |
| 3 month inter-bank rate, %, eop | 6.68 | 1.28 | 3.20 | 4.17 | 4.22 | 4.58 | 4.00 | 4.00 | 4.00 |
| Long-term yield, %, eop | 7.69 | 6.31 | 6.34 | 6.16 | 4.24 | 6.16 | 5.30 | 5.70 | 5.70 |
| PEN/USD, eop | 3.13 | 2.89 | 2.81 | 2.70 | 2.55 | 2.80 | 2.95 | 3.05 | 3.10 |
| PEN/USD, avg | 2.92 | 3.01 | 2.82 | 2.75 | 2.64 | 2.70 | 2.84 | 3.05 | 3.10 |
| Balance of Payments, **USD bn** | | | | | | | | | |
| **Current account** | **-5.3** | **-0.6** | **-3.5** | **-3.2** | **-6.3** | **-9.1** | **-11.4** | **-9.6** | **-12.5** |
| % of GDP | -4.2 | -0.5 | -2.3 | -1.8 | -3.2 | -4.4 | -5.6 | -4.8 | -5.9 |
| Trade balance | 2.6 | 6.1 | 7.0 | 9.2 | 5.2 | 0.0 | -2.5 | -0.8 | -3.2 |
| Exports | 31.0 | 27.1 | 35.8 | 46.4 | 46.4 | 42.2 | 37.0 | 38.8 | 38.8 |
| Imports | 28.4 | 21.0 | 28.8 | 37.2 | 41.1 | 42.2 | 39.5 | 39.6 | 42.0 |
| Service balance | -2.1 | -1.2 | -2.4 | -2.2 | -2.4 | -1.8 | -1.8 | -1.8 | -1.9 |
| Income balance | -8.7 | -8.4 | -11.2 | -13.4 | -12.4 | -10.6 | -10.6 | -10.4 | -11.0 |
| FDI, net | 6.9 | 6.4 | 8.5 | 7.7 | 11.9 | 9.3 | 9.9 | 9.0 | 9.8 |
| International reserves | 31.2 | 33.1 | 44.1 | 48.8 | 64.0 | 65.7 | 65.5 | 65.2 | 68.3 |
| Total amortisations | 3.3 | 2.2 | 4.1 | 1.4 | 4.0 | 4.2 | 4.0 | 4.0 | 4.2 |
| Public Finances, **% of GDP** | | | | | | | | | |
| **Consolidated government balance** | 2.3 | -1.6 | -0.3 | 1.8 | 1.9 | 0.6 | 0.5 | -2.7 | -1.7 |
| Consolidated gov primary balance | 3.8 | -0.3 | 0.8 | 2.9 | 3.0 | 1.6 | 1.5 | -1.7 | -0.7 |
| Public debt | 24.1 | 27.2 | 23.5 | 21.8 | 19.9 | 17.4 | 17.4 | 18.0 | 19.7 |
| of which Domestic | 9.0 | 10.9 | 10.5 | 10.3 | 10.3 | 8.9 | 8.9 | 9.3 | 9.3 |
| *Foreign Assets* & **Liabilities, USD bn** | | | | | | | | | |
| **External debt** | 34.0 | 35.5 | 40.6 | 44.0 | 51.9 | 54.3 | 51.9 | 51.6 | 53.8 |
| Public | 19.2 | 20.6 | 19.9 | 20.2 | 19.0 | 17.5 | 17.2 | 17.9 | 18.6 |
| External debt / GDP | 26.8 | 28.0 | 26.4 | 25.0 | 26.1 | 26.1 | 25.4 | 25.6 | 25.3 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 19.5 | 20.1 | 22.9 | 24.2 | 26.5 | 24.0 | 23.7 | 23.8 | 24.9 |
| Short-term debt/International reserves (%) | 62.5 | 60.7 | 52.0 | 49.6 | 41.3 | 36.6 | 36.2 | 36.5 | 36.4 |
| | | | | | | | | | |
| **Quarterly Economic Indicators** | | | | | | | | | |
| | **2014 Q2** | **2014 Q3F** | **2014 Q4F** | **2015 Q1F** | **2015 Q2F** | **2015 Q3F** | **2015 Q4F** | **2016 Q1F** | **2016 Q2F** |
| GDP, % yoy | 1.7 | 1.7 | 1.9 | 3.3 | 3.9 | 4.0 | 4.0 | 4.6 | 4.5 |
| CPI, % yoy | 3.4 | 2.9 | 3.3 | 2.5 | 2.4 | 2.5 | 2.6 | 2.5 | 2.5 |
| Policy interest rate, %, eop | 4.00 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 |
| Short-term market rate, % eop | 4.99 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 |
| Long-term yield, %, eop | 5.70 | 5.30 | 5.30 | 5.70 | 5.70 | 5.70 | 5.70 | 5.70 | 5.70 |
| PEN/USD, eop | 2.80 | 2.89 | 2.95 | 3.00 | 3.00 | 3.00 | 3.05 | 3.05 | 3.10 |
| Source: National sources, Citi Research | | | | | | | | | |

Source: National Sources, Citi Research

# Venezuela

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- **Summary view** — Next year the country will continue facing weakness in economic activity and mounting inflationary pressures due to widespread scarcity of goods and US dollars. We currently expect activity to contract 2.3% and inflation to end at 75% in 2015. Low prices of the Venezuelan basket of oil, if maintained, should have a negative impact in the level of US dollars' availability, which should force the government to announce economic measures such as a devaluation of the official USDVEF 6.3 exchange rate to levels closer to the SICAD I rate of 12. In addition, we expect the government to reduce imports by a further USD4 billion in 2015 — an amount lower than the reductions observed over the previous two years as, in our view, imports below USD40 billion should impose heavy political costs which the government would try to avoid given next year's Congressional elections. At the same time we are assuming that the government will be forced to renegotiate the Petrocaribe arrangement in a similar way to what they did with the Chinese loans. All in all, the high dependency on oil revenues and the sharp decline in them stemming from recent reductions in oil prices, make Venezuela one of the most vulnerable countries in LatAm, and the one who should withstand the most difficult adverse scenario if oil prices continue at current levels.

- **Things to watch** — Watch for ratings agencies Fitch and Moodys which could follow Standard & Poors decision of downgrading the country's rating and putting it in negative watch.

- **Strategy** — Amid an environment where activity is weak, inflation is high, external liquidity is low, and the government has postponed any announcements aimed at improving the situation, the outlook for this credit is negative.

## Economic outlook: weak and vulnerable

**Throughout the year, uncertainty regarding macroeconomic management continues to take its toll on economic performance.** The overall sentiment is that of an economy that is weakening on the back of a reduction in supply due to several bottle necks affecting the production process for local companies. At the same time there are no new investments, either public or private. Hence, we forecast consumption and investment to fall 4% and 6.2%, respectively, this year. This is the reason why we now expect economic activity to fall 4% this year and 2.3% next.

**We now expect annual inflation to reach 64% by yearend and 75% next year, as we do not foresee a reduction on scarcity and we now see evidence of a wage spiral.** Using data from the Ministry of Finance we can now say that most of the growth on fiscal spending has to do with increases in expenditures associated with government payrolls. This fact can be interpreted as evidence of increasing wage's indexation, a factor that leads to higher inflation persistency.

**To an already negative outlook in terms of economic activity, high inflation, and overall low availability of US dollars, it is necessary to add the uncertainty that lower oil prices create for revenues going forward.** In particular we have estimated that for every USD10 drop in the Venezuelan oil price, the country faces a reduction of USD6 billion in revenues. In an environment where US dollar low availability was already in place, the potential effects of a further reduction in the supply of the greenback should add more pressure to the government.

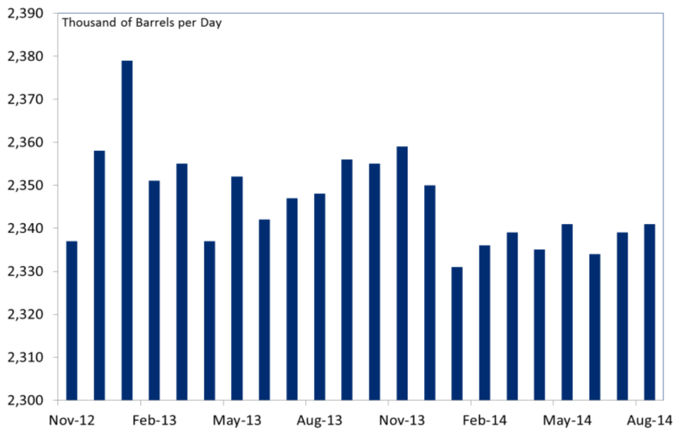
**The government should be forced to announce measures it has postponed until now which include a depreciation of the CENCOEX exchange rate which currently stands at 6.3 to a level closer to the SICAD I rate of 12.** We believe under the current situation the adjustment is inevitable and the 6.3 exchange rate will be eliminated with only the SICAD I and SICAD II rates being left. With this fix, which could be announced before yearend or more likely early in 2015, the government will be able to buy some time specially when thinking about 2015, when elections for the National Assembly are expected to take place. We think that the initial rates that will be in place should be the 12 exchange rate for SICAD I and the 50 exchange rate for the SICAD II, although we do not completely discard the likelihood of an increase of the SICAD I exchange rate to a level of 15 to 17. Having said that, we do not expect for CENCOEX to be eliminated but rather its exchange rate to be adjusted, meaning that the procedures necessary to access the preferential exchange rate will remain.

**At the same time, the government can also announce additional measures aimed at improving its cash flow.** In particular, in a simple cash flow analysis we ran for next year, using an average price of USD79 per barrel for the Venezuelan basket of oil we found that the government has financing needs of USD10.6 billion. We arrived at this conclusion even after considering a USD4 billion reduction in exports, a reduction of almost half in transfers to FONDEN and reductions in financing to Petrocaribe and debt service associated with the Chinese fund. This means that the government will be in need of taking additional measures which could include performing some operations with the gold it currently holds as part of international reserves, it could look at issuing new debt or attempting to perform a debt management operation with debt maturing in 2015, 2016 and 2017, or locally it could increase gasoline prices in order to eliminate a subsidy which costs USD10 billion per year. All of these measures have been in the pipeline of possible adjustments the government could implement and we believe the government will now be forced to decide which of these measures it should take.

**Although it is clear the government still has options, the current negative shock in oil prices is showing an economy that is vulnerable and not well prepared to withstand a structural correction in commodities.** With international reserves slightly below USD20 billion and its cash portion significantly reduced due to the bond payment the sovereign had to do early in October, President Maduro recently announced that it ordered for the latest disbursement of the Chinese fund (USD4 billion) to be added to international reserves bringing the level of international reserves up to USD23.5 billion. However, we do not consider the announcement as increasing the amount of USD available given that the Chinese fund resources are project-based, meaning that they cannot be used for purposes different than the projects for which they are intended.

**In terms of political scenarios for next year our base case scenario is one of a government muddling through until elections.** Under this scenario any announcement by the government will be done in order to buy some time until elections. With approval ratings around 30%, President Maduro cannot make structural changes in economic policy as he is looking at retaining control of the National Assembly, in elections which could be anticipated to June-July once the National Electoral Council members are finally appointed. In order to achieve this goal, the government will be in need of additional resources a situation which happens just at a time when oil revenues have been reduced significantly. In our view, this is the reason behind the recent economic announcements and the ones that will be done early in 2015.

Figure 306. Oil production has been stable

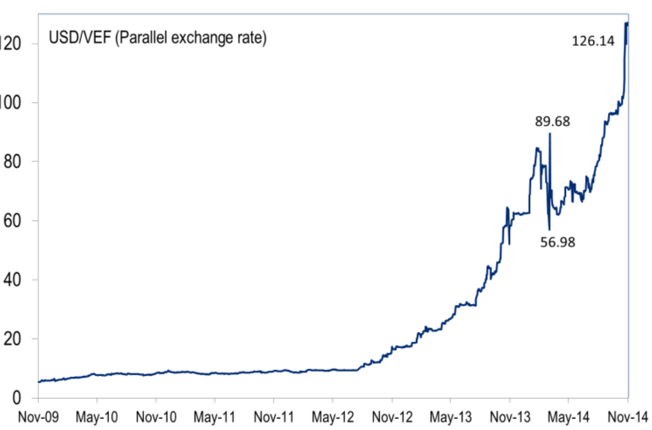



Source: OPEC

Figure 307. Inflation should accelerate despite weak GDP growth

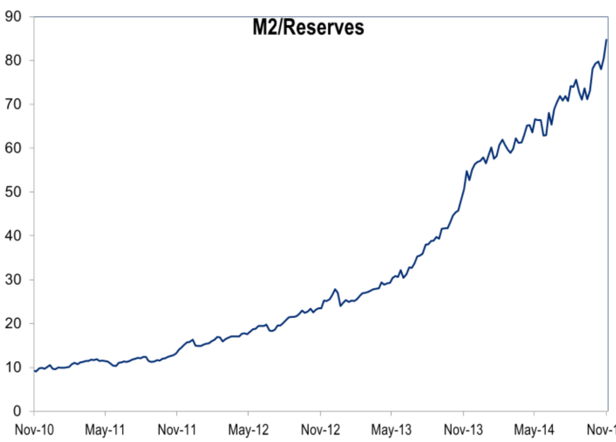

Source: BCV and Citi Research

Figure 308. Pressures on the exchange rate are mounting



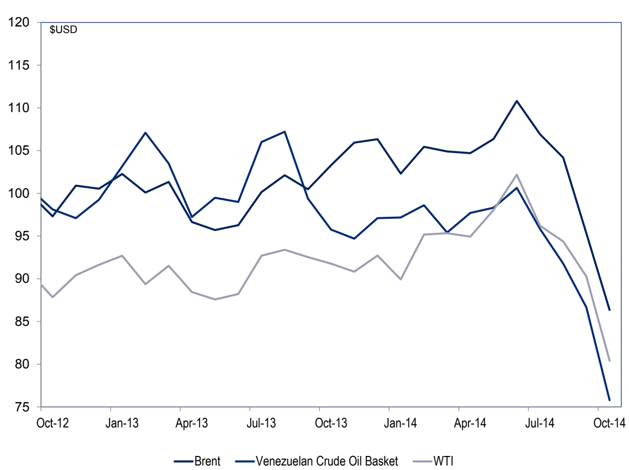

Source: Citi Research

Figure 309 With theoretical FX measures also deteriorating



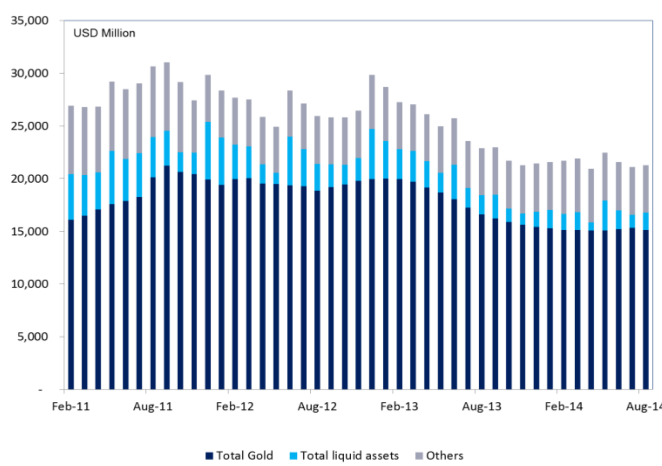

Source: BCV and Citi Research

Figure 310. Venezuelan oil basket prices and WTI prices




Source: BCV and Citi Research

Figure 311. Could total liquid resources continue its downtrend?




Source: BCV and Citi Research

**Figure 312. Venezuela Economic Indicators**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014F | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|
| **Summary Data** | | | | | | | | | |
| Nominal GDP, USD bn | 298 | 284 | 257 | 298 | 361 | 372 | 334 | 293 | 299 |
| Nominal GDP, local currency bn | 678 | 707 | 1,017 | 1,357 | 1,642 | 2,595 | 4,152 | 6,778 | 11,067 |
| GDP per capita, USD | 10,683 | 9,996 | 8,925 | 10,188 | 12,141 | 12,343 | 10,926 | 9,449 | 9,473 |
| Population, mn | 27.9 | 28.4 | 28.8 | 29.3 | 29.7 | 30.2 | 30.6 | 31.0 | 31.5 |
| Unemployment, % of labour force | 6.1 | 6.6 | 6.5 | 6.5 | 5.9 | 5.6 | 7.0 | 8.0 | 8.5 |
| **Economic Activity** | | | | | | | | | |
| Real investment growth % yoy | 2.2 | -19.1 | 1.0 | 15.2 | 24.1 | -14.0 | -6.2 | 0.6 | 1.1 |
| Real consumption growth % yoy | 6.0 | -2.1 | -1.1 | 4.4 | 6.9 | 4.4 | -4.0 | -3.0 | 0.4 |
| private consumption growth % yoy | 6.3 | -2.9 | -1.9 | 4.0 | 7.0 | 4.7 | -5.0 | -4.0 | 0.2 |
| Real export growth, % yoy | -1.0 | -13.7 | -12.9 | 4.7 | 1.6 | -6.2 | -1.0 | -1.0 | 4.6 |
| Real import growth, % yoy | 1.4 | -19.6 | -2.9 | 15.4 | 24.4 | -9.7 | -5.0 | -1.0 | -1.0 |
| **Prices, Money & Credit** | | | | | | | | | |
| CPI, % yoy eop | 31.9 | 26.9 | 27.4 | 29.0 | 19.5 | 52.7 | 64.0 | 75.0 | 85.0 |
| Nominal wages, % yoy | 25.0 | 23.7 | 24.5 | 27.0 | 30.0 | 45.0 | 64.0 | 72.0 | 80.0 |
| Credit extension to private sector, % yoy | 30.6 | 18.0 | 27.6 | 36.8 | 55.3 | 65.8 | 69.0 | 74.0 | 82.0 |
| Policy Rate (eop) | 28.10 | 14.00 | 12.50 | - | - | - | - | - | - |
| 3 month inter-bank rate, %, eop | 28.10 | 11.30 | 12.30 | 14.50 | 14.50 | 14.50 | 18.00 | 18.00 | 18.00 |
| Long-term yield, %, eop | 12.00 | 14.38 | 13.02 | 13.93 | 9.18 | 12.88 | 19.00 | 19.00 | 19.00 |
| VEF/USD, eop | 2.15 | 2.15 | 4.29 | 4.29 | 4.29 | 6.29 | 6.30 | 12.00 | 19.80 |
| VEF/USD, avg | 2.15 | 2.15 | 4.20 | 4.29 | 4.29 | 5.99 | 6.30 | 12.00 | 21.36 |
| **Balance of Payments, USD bn** | | | | | | | | | |
| Current account | 37.4 | 8.6 | 12.1 | 27.3 | 11.0 | 12.2 | 14.9 | 6.9 | 12.4 |
| % of GDP | 12.5 | 3.0 | 4.7 | 9.1 | 3.1 | 3.3 | 4.4 | 2.4 | 4.1 |
| Trade balance | 45.7 | 19.2 | 27.1 | 46.4 | 38.0 | 36.7 | 33.4 | 25.6 | 31.1 |
| Exports | 95.1 | 57.6 | 65.7 | 92.7 | 97.3 | 89.2 | 77.3 | 65.1 | 66.7 |
| Imports | 49.5 | 38.4 | 38.6 | 46.2 | 59.3 | 52.4 | 43.9 | 39.5 | 35.6 |
| Service balance | -8.4 | -7.6 | -9.2 | -10.7 | -16.0 | -13.8 | -7.7 | -7.8 | -7.8 |
| Income balance | 0.7 | -2.7 | -5.3 | -7.9 | -10.0 | -9.8 | -9.8 | -9.8 | -9.8 |
| FDI, net | -0.9 | -4.9 | -1.5 | 5.1 | 0.8 | 2.4 | 0.8 | 0.8 | 0.8 |
| International reserves | 43.1 | 35.8 | 30.3 | 29.9 | 29.9 | 21.5 | 20.0 | 18.5 | 17.0 |
| Total amortisations | 7.5 | 4.3 | 6.9 | 11.0 | 4.1 | 6.8 | 4.5 | 4.6 | 22.6 |
| **Public Finances, % of GDP** | | | | | | | | | |
| Consolidated government balance | -3.5 | -8.7 | -10.4 | -11.6 | -15.0 | -11.9 | -12.3 | -12.6 | -12.7 |
| Consolidated gov primary balance | -2.0 | -7.2 | -8.6 | -9.4 | -12.3 | -9.3 | -9.8 | -10.1 | -10.2 |
| Public debt | 21.6 | 31.3 | 42.0 | 44.2 | 43.4 | 41.5 | 44.3 | 48.7 | 49.7 |
| *of which* Domestic | 4.5 | 7.5 | 8.9 | 11.4 | 14.1 | 12.3 | 10.5 | 8.9 | 7.3 |
| **Foreign Assets & Liabilities, USD bn** | | | | | | | | | |
| External debt | 66.4 | 81.9 | 97.1 | 110.7 | 118.9 | 123.3 | 127.5 | 131.7 | 135.9 |
| Public | 50.9 | 67.4 | 85.3 | 98.0 | 105.8 | 108.8 | 112.8 | 116.8 | 120.8 |
| External debt / GDP | 22.2 | 28.9 | 37.7 | 37.1 | 33.0 | 33.1 | 38.2 | 44.9 | 45.5 |
| External debt / XGS | - | - | - | - | - | - | - | - | - |
| Short-term debt | 19.9 | 17.4 | 16.8 | 16.7 | 21.1 | 21.8 | 19.5 | 17.1 | 19.0 |
| Short-term debt/International reserves (%) | 46.1 | 48.4 | 55.3 | 55.8 | 70.6 | 101.3 | 97.8 | 92.7 | 111.9 |

**Quarterly Economic Indicators**

| | 2014 Q2 | 2014 Q3F | 2014 Q4F | 2015 Q1F | 2015 Q2F | 2015 Q3F | 2015 Q4F | 2016 Q1F | 2016 Q2F |
|---|---|---|---|---|---|---|---|---|---|
| GDP, % yoy | -4.2 | -4.1 | -3.8 | -2.3 | -2.3 | -2.3 | -2.1 | 1.8 | 1.8 |
| CPI, % yoy | 60.5 | 63.6 | 64.0 | 68.8 | 68.6 | 71.6 | 75.0 | 77.5 | 80.0 |
| Policy interest rate, %, eop | - | - | - | - | - | - | - | - | - |
| Short-term market rate, % eop | - | - | - | - | - | - | - | - | - |
| Long-term yield, %, eop | 11.80 | 19.00 | 19.00 | 19.00 | 19.00 | 19.00 | 19.00 | 19.00 | 19.00 |
| VEF/USD, eop | 6.29 | 6.29 | 6.30 | 12.00 | 12.00 | 12.00 | 12.00 | 19.80 | 19.80 |

Source: National Sources, Citi Research forecasts

# Appendix A-1

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