Global

Economics

24 May 2012 | 176 pages

Emerging Markets Macro and Strategy Outlook

Who can cut rates?

- Against a background of very high risk premia, yields in EM have shifted sharply down since the start of April, and rate cuts are now being priced into a number of markets. The question is: will policymakers actually do what the markets think they'll do, and cut rates?

- There are a number of elements to the argument that EM policymakers will ease policy. Above all is the idea that the Eurozone crisis could produce Lehman-like outcomes for the global economy that would require aggressive loosening by policymakers almost everywhere. And even without considering tail-risks, there are other factors pushing inflation pressures down. The most obvious of these is the downside risk to global growth in the wake of the April data from China; and to a lesser extent, weakening economic surprises from the US. Falling commodity prices also point to lower inflation expectations, and the drop in oil prices is particularly significant, since it was rising oil prices in Q1 that were instrumental in pushing up inflation expectations.

- All this considered, though, we *don't* think it is right to assume that EM rates will be cut dramatically in the next few months. High global risk aversion will keep policy tight in countries with large external financing needs; depreciating currencies should make policymakers cautious about cutting rates if there is a risk of causing unwelcome currency spirals; and policymakers will also be held back by the fact that real interest rates are already quite low in many countries

- We see a picture of almost completely unchanged rates in 2012, with a few exceptions: Brazil, Ukraine, Chile, Czech, Hungary and India. Ukraine's rates should rise as the balance of payments pressure the country is under becomes more evident. As for the rest, we do expect cuts, and in all of those cases – Brazil, Czech, Hungary, India and Chile – our forecasts are more dovish than is priced into the market. So we think there are some mispricings in the market's view of interest rates these days, but they are selective: the idea that EM rates will be slashed across the board is not one we subscribe to.

EM Economics and Strategy

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

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Who can cut rates?

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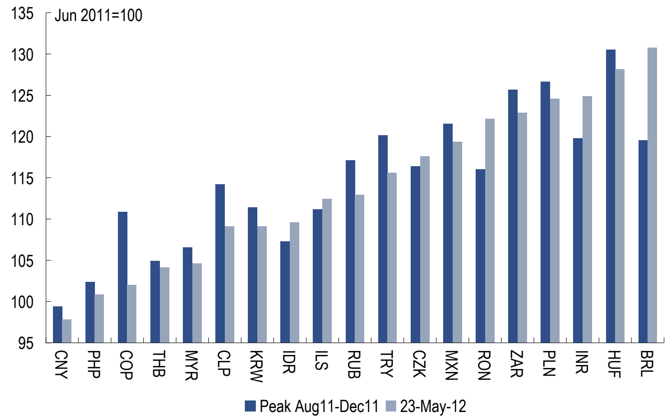
Markets appear to be held hostage to the Greek political process. The uncertainty over the June 17 elections is quite significant, and Citi assumes a high probability of "Grexit" (50-75%), but it is not certain. To incorporate this risk we consider a scenario where Greece is unlikely to produce a government that can fulfill the conditions imposed by the Troika, and as a result muddles through a process that ends in an abandonment of the EMU.

We think that emerging markets are likely to be torn between two forces in a Grexit scenario. On the one hand, it appears to us that while there is a consensus view that Greece's political circumstances are quite dire, many still think that the EU will go out of its way to prevent the country's exit from the euro area. Therefore, if our Grexit scenario materializes, it is our view that volatility will continue as markets gradually reassess that probability. Furthermore, there seems to be a fairly firmly held view that the immediate process after a resolution surrounding Greece would be characterized by a spike in risk aversion –with some fearing a Lehman-like event. Against those bearish forces, our baseline scenario holds that policymakers will respond with a forceful set of policy measures. While many such responses are likely to emerge after the market is subject to greater pressures, EM should take into consideration the strength of the expected response.

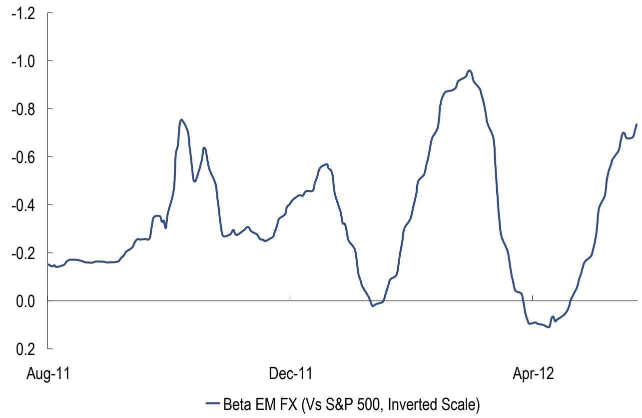
Emerging Markets are already pricing a very negative scenario – though undoubtedly one less dramatic than a Lehman-like event. In fact, in FX, the sell-off since the beginning of March has been so strong that we observe levels close to (in a few cases even higher than) those of November 2011. This, after the extraordinary liquidity injections and guidance on interest rates, is tantamount to either substantially more risk premia or a perception that monetary policy in EM is likely to significantly ease in months to come.

Figure 1. EM: Currencies in May 23 2012 vs. Peak 2011



Source: Bloomberg and Citi Investment Research and Analysis

Figure 2. EM: EM FX becoming increasingly sensitive to external developments



Source: Bloomberg and Citi Investment Research and Analysis

There is mounting evidence that risk premia has taken an important role in EM pricing. The joint movement in EM currencies, with only a relatively secondary role for idiosyncratic factors, is suggestive that risk aversion remains prevalent. Indeed, the first principal component across most of the leading EM currencies explains close to 72% of the total variation in the period March-May 21st, 2012. The fraction of the total variance explained by this component is, however, somewhat lower than that observed in the second half of 2011, when it reached 85%. Furthermore, global indicators of risk aversion, such as VIX show a relatively modest increase in the

March-May '12 period (to 24% as of this writing) compared to the H2-2011 period. A plausible explanation for the strong movement in EMFX is that the market's beta to global risk factors has increased. Our 8-week window estimate of EMFX first principal component beta to SPX has in fact increased significantly. The levels (0.8) are similar to those observed during the H2-2011 selloff, though they are somewhat lower than those observed during the LTRO-2 rally in February.

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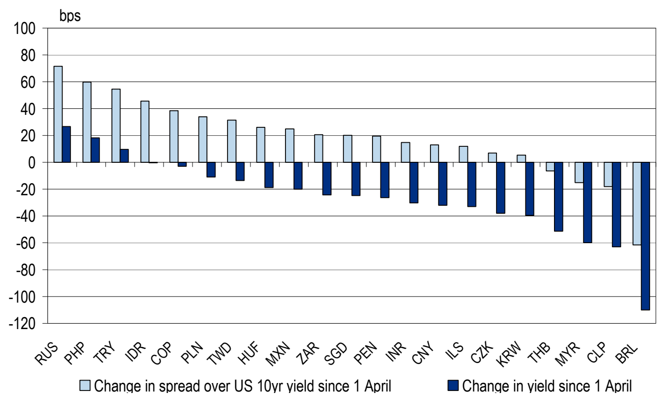
Yields in EM have shifted sharply down since the start of April, and rate cuts are now being priced into a number of markets. Figure 1 illustrates the downward shift in yields. Of the 21 countries included here, all but 3 have seen yields fall since early April; and 4 of them – Brazil, Chile, Malaysia and Thailand - have seen their 10 year yield spread over the US fall too. Figure 2 shows how the market has raised its expectation of rate cuts in a number of countries. The question is: will policymakers actually do what the markets think they'll do, and cut rates?

There are a number of elements to the argument that EM policymakers will ease policy. Above all is the idea that the Eurozone crisis could produce Lehman-like outcomes for the global economy that would require aggressive loosening by policymakers almost everywhere. And even without considering tail-risks, there are other factors pushing inflation pressures down. The most obvious of these is the downside risk to global growth in the wake of the April data from China; and to a lesser extent, weakening economic surprises from the US. Even with a growth rate of 8.1% this year, China will be generating 32% of global GDP growth, and so further downside to Chinese GDP growth – which could easily materialize if Chinese policymakers are too slow to implement further stimulus measures in addition to the RRR cuts so far announced – would have global significance. Falling commodity prices also point to lower inflation expectations, and the drop in oil prices is particularly significant, since it was *rising* oil prices in Q1 that were instrumental in pushing up inflation expectations.

Figure 3. Long term EM yields have shifted sharply down alongside US yields…



Source: Bloomberg and Citi Investment Research and Analysis

Figure 4. …and a number of markets are pricing in rate cuts

6-months implied bps rate change relative to spot

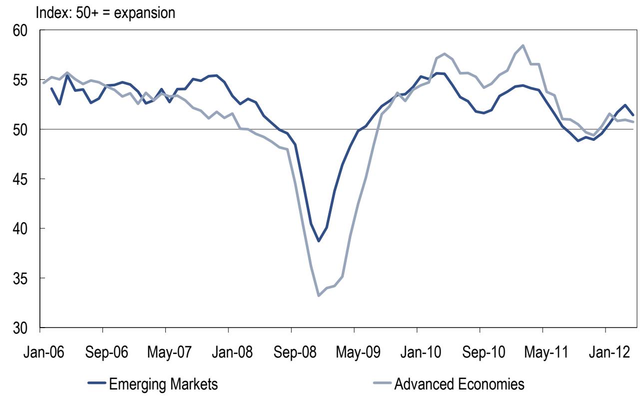
	May-21	Apr-20	Change
India	10	6	4
Mexico	22	19	3
Thailand	-18	-15	-3
Turkey	224	233	-9
Israel	-12	-1	-11
Poland	34	47	-13
Malaysia	0	15	-15
S. Africa	2	23	-21
Czech R	22	46	-24
Korea	-1	24	-25
Hungary	4	32	-28
Brazil	-163	-126	-37
Chile	-30	19	-49

Source: Bloomberg and Citi Investment Research and Analysis

All this considered, though, we don't think it is right to assume that EM rates will be cut dramatically in the next few months. High global risk aversion will keep policy tight in countries with large external financing needs; depreciating currencies should make policymakers cautious about cutting rates if there is a risk of causing unwelcome currency spirals; and policymakers will also be held back by the fact that real interest rates are already quite low in many countries. In what follows, we consider the arguments.

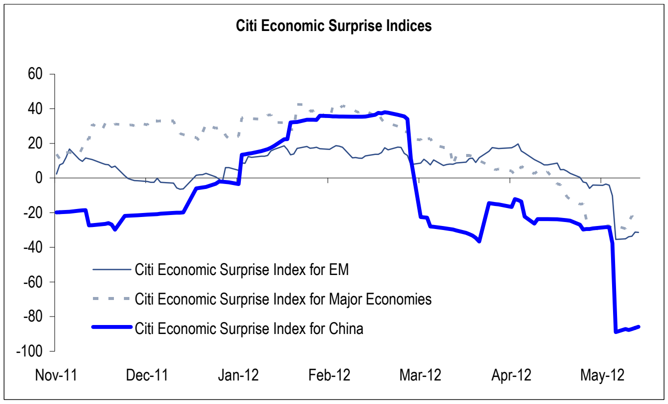
Asia-centred downside growth risks have helped to generate worries about global GDP. Figure 4 shows how economic surprises in EM have been the biggest source of disappointment in the last few weeks. This is led of course by China which makes up 25% of the weight Citi's EM CESI, and whose April data was a big source of shock both to market participants and, we suspect, to the Chinese authorities themselves. Poor Chinese data also reinforces the sense of crisis for the Eurozone: a country that is potentially insolvent could be tipped into actual insolvency if external demand is weak enough. In other words: if creditworthiness is partly explained by how strong a country's export growth is likely to be, then weak Chinese data plays negatively into the market's confidence about Europe.

Figure 5. The superiority of EM PMIs over DM PMIs weakened a little in April…



Source: Haver Analytics and Citi Investment Research and Analysis

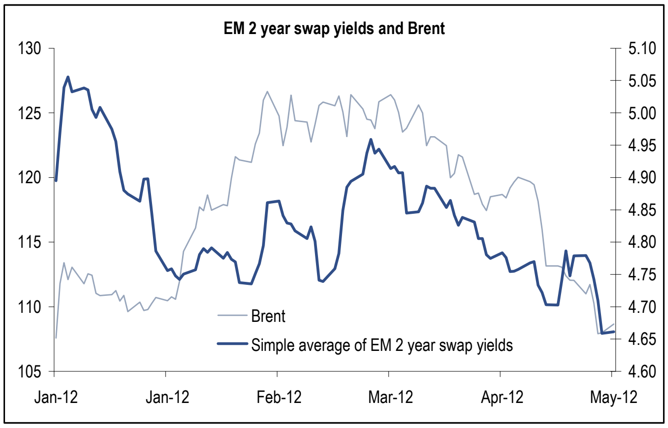
Figure 6. …and EMs – led by China – are the biggest generator of downside surprises to growth these days



Source: Bloomberg and Citi Investment Research and Analysis

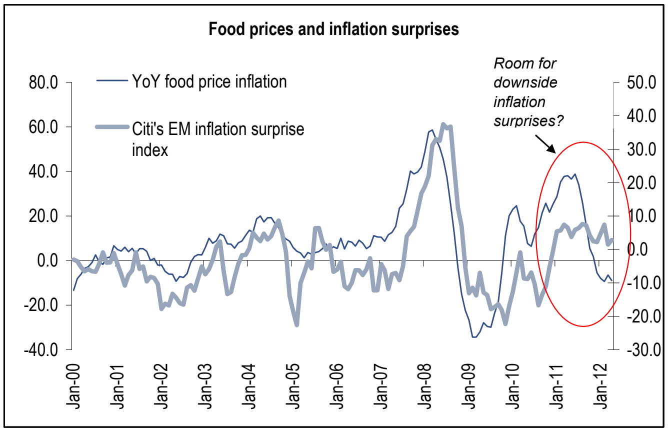
Commodity price declines also help to constitute a case for lower interest rates in EM. Rising oil and food prices during Q1 were, we think, instrumental in driving inflation expectations higher in many emerging economies. Although inflation expectations are not very well measured in most countries, Figure 5 shows how 2 year swap yields seem to have shifted lower in line with falling oil prices since the beginning of March. If falling energy prices generate some disinflationary bias for EM policymakers, this bias is reinforced by recent trends in global food prices. Global food prices (according to the FAO) fell in April, the first monthly fall since the start of 2012. Judging from the rather close relationship between global food price inflation and inflation surprises in EM (Figure 6) there might be some room for downside surprises in EM inflation data over the next few weeks.

Figure 7. EM yields have fallen with the decline in oil prices, whose rise earlier this year was instrumental in pushing up CPI expectations…



Source: Bloomberg, Haver Analytics, and Citi Investment Research and Analysis. The average is made up of Chile, Mexico, Colombia, Korea, Malaysia, Singapore, Philippines, Poland, Israel, South Africa, Turkey, Czech.

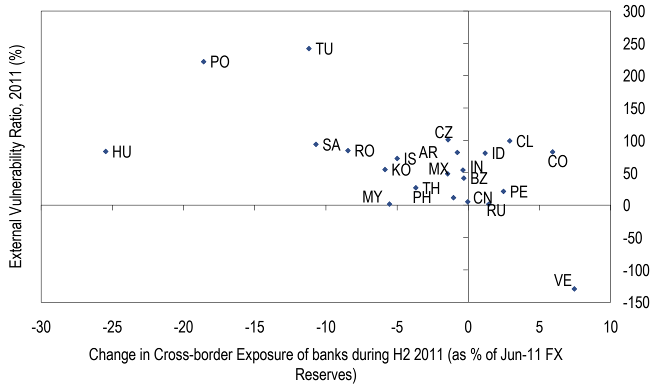
Figure 8. …and the decline in food prices seems to create some room for downside inflation surprises



Source: UN FAO; Citi; Citi Investment Research and Analysis

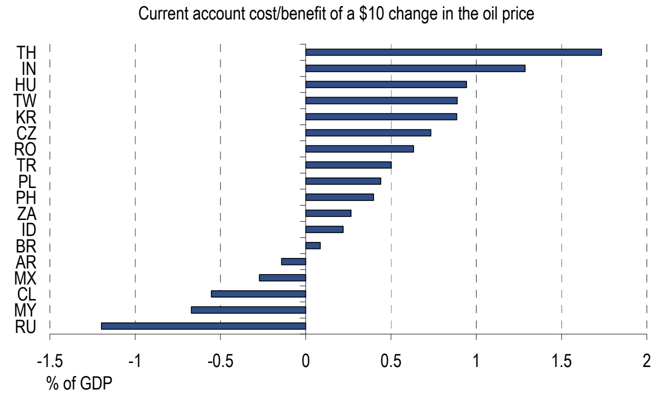
All in all, then, there are some reasonable arguments in favour of looser monetary policy in EM. But the case isn't watertight. The most obvious group of countries for whom looser monetary policy is unachievable is those with large external financing needs, since it is those countries most at risk of seeing capital outflows in the current environment. And since rate cuts would simply accelerate capital outflows, lower rates in these countries – particularly in countries like Poland, Turkey, Hungary, South Africa and Romania – seem difficult to justify. Figure 7 shows the relationship between our indicator of external financing vulnerability and the reduction in gross cross-border exposure of banks reporting to the BIS. The message here – which is quite intuitive – is that riskier countries are more vulnerable to capital outflows, and will therefore be less able to cut rates for fear of creating room for even more capital outflows. Recent policy tightening in Turkey and Poland is, arguably, a partial recognition of this limit to policy flexibility in these countries. This limit may be slightly softened by the benefit that some countries enjoy from lower oil prices. Figure 8 shows that some of the more vulnerable EMs – Turkey, Hungary, India, Romana, Poland, for example – are large-ish net oil importers whose current account balances stand to gain from a sustained decline in energy prices. But this benefit is probably questionable: what these countries gain on the current account from lower oil prices is probably offset by declining capital account.

Figure 9. EMs experience in H2 2011 was that banks took the largest repayments out of the most vulnerable countries…



Source: BIS; Citi Investment Research and Analysis

Figure 10. …and while some of these countries might benefit from lower oil prices, that probably won't be enough to restore confidence



Source: OEF; Citi Investment Research and Analysis

In addition to these vulnerabilities, there are some pure 'Grexit' risks that are focused in Southeastern Europe. Any insolvency for Greek banks would increase the risk that funding that is in place in the subsidiaries of Greek banks abroad would be repatriated. Greek banks are important players in the Balkan banking markets of Bulgaria, Romania, and Serbia, with the key Greek banks representing c 25%, 15%, and 16% of sector assets, respectively. The absolute exposure to Turkey is also worth noting, as the Greek banks would be likely to find it more difficult to fund their subsidiaries in these markets if we see a "Grexit". This in turn could lead to liquidity problems, which if inadequately managed by local and regional authorities, could lead to a loss of confidence and potential bank runs.

Figure 11. The funding gap for Greek banks' subsidiaries in southeastern Europe

EURm	Loans	Deposits	Loans/Deposits	Funding gap
Romania	11,497	4,665	246%	6,832
Bulgaria	8,379	5,230	160%	3,149
Serbia	3,176	2,213	144%	963
Albania	1,061	1,170	91%	-109
Ukraine	956	413	231%	543
Turkey	16,062	12,846	125%	3,216
FYROM	870	986	88%	-116
Total	42,001	27,523	153%	14,478

Source: Citi Investment Research and Analysis

So, any country wanting to cut rates will need to have low financing needs and be far away from Greece. The one exception to this rule is likely to be Hungary, where we expect rate cuts to materialize later this year in the context of progress made in negotiating a new loan facility with the EU and IMF - driven in particular by the inclination of the MPC's external members to loosen monetary policy. Ukraine, by contrast, is a country where we think the overall pressure on the balance of payments is serious enough to warrant a rate hike later this year: as inflation rises from its current low level, the consequent decline in real interest rates would create an unacceptable threat to financial stability.

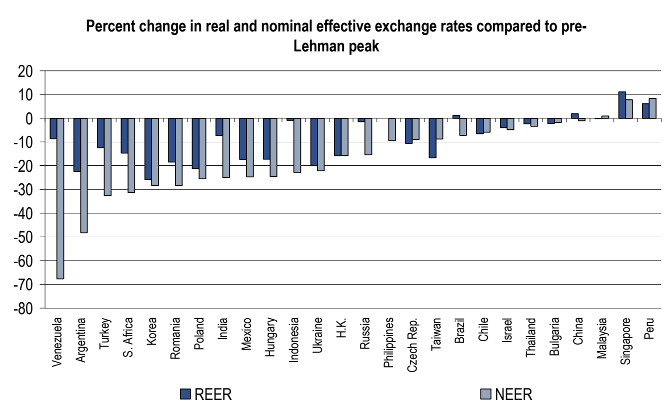
Figure 12. Citi's interest rate forecasts and the risks

	Current Rate (%)	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Cumulative rate moves expected	Risks to forecast in 2012
Thailand	3.00	0.00	0.00	0.00	25.00	25.00	50.00	Hawkish
South Africa	5.50	0.00	0.00	0.00	0.00	50.00	50.00	Dovish
Philippines	4.00	0.00	0.00	0.00	25.00	25.00	50.00	Hawkish
Korea	3.25	0.00	0.00	0.00	25.00	25.00	50.00	Neutral
Indonesia	3.75	0.00	0.00	0.00	25.00	25.00	50.00	Dovish
Ukraine	7.50	0.00	0.00	25.00	0.00	0.00	25.00	Hawkish
China	3.50	0.00	0.00	0.00	25.00	0.00	25.00	Dovish
Israel	2.50	0.00	0.00	0.00	0.00	0.00	0.00	Dovish
Turkey	5.75	0.00	0.00	0.00	0.00	0.00	0.00	Hawkish
Taiwan	1.88	0.00	0.00	0.00	0.00	0.00	0.00	Dovish
Mexico	4.50	0.00	0.00	0.00	0.00	0.00	0.00	Dovish
Malaysia	3.00	0.00	0.00	0.00	0.00	0.00	0.00	Dovish
Colombia	5.25	0.00	0.00	0.00	0.00	0.00	0.00	Dovish
Romania	5.25	0.00	0.00	0.00	-25.00	0.00	-25.00	Hawkish
Chile	5.00	0.00	0.00	-50.00	0.00	25.00	-25.00	Hawkish
Czech	0.75	-25.00	0.00	-25.00	0.00	0.00	-50.00	Hawkish
Poland	4.75	0.00	0.00	0.00	-25.00	-25.00	-50.00	Hawkish
India	8.00	0.00	-25.00	0.00	0.00	-50.00	-75.00	Dovish
Brazil	9.00	-50.00	-75.00	0.00	0.00	50.00	-75.00	Dovish
Russia	8.00	0.00	0.00	0.00	-50.00	-50.00	-100.00	Neutral
Hungary	7.00	0.00	-25.00	-75.00	-25.00	0.00	-125.00	Hawkish

Source: Citi Investment Research and Analysis

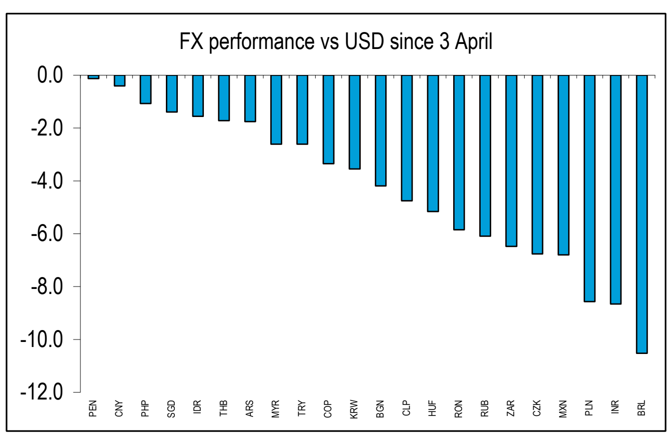
FX markets could be an additional constraint on the ability of central banks to cut rates. As Figure 10 shows, we see a picture of almost completely unchanged rates in 2012 with the exceptions of Brazil, Ukraine, Chile, Czech, Hungary and India. In addition to the factors highlighted above, we think that there are two other factors that help explain our view that EM rates are unlikely to be shifted down across the board. Not only are exchange rates pretty weak in an historical context (Figure 11) but they have depreciated sharply since the start of April. Although we don't expect currency weakness to be an immediate obstacle to easing in Brazil – which is in some ways a special case these days – we do think that currency depreciation is probably adding enough stimulus in most countries to encourage central banks to hold off from cutting rates. Otherwise the risk of over-loosening could become a threat to financial stability.

Figure 13. Not only are EM exchange rates pretty weak compared to pre-Lehman levels…



Source: BIS, Citi Investment Research and Analysis

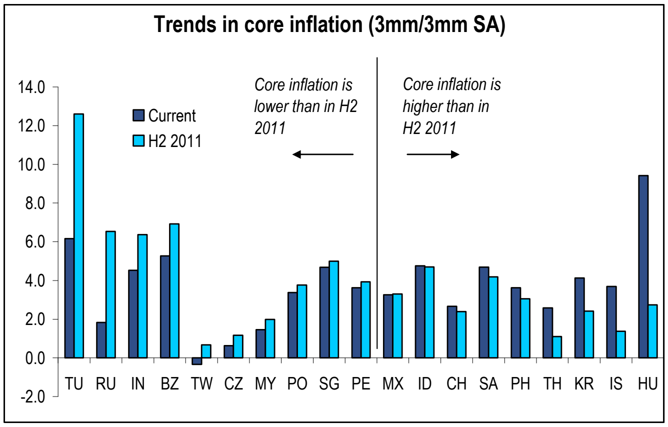
Figure 14. …but EMFX has had a miserable two months, which for the most part can be thought of as adding monetary stimulus to EM



Source: Bloomberg and Citi Investment Research and Analysis

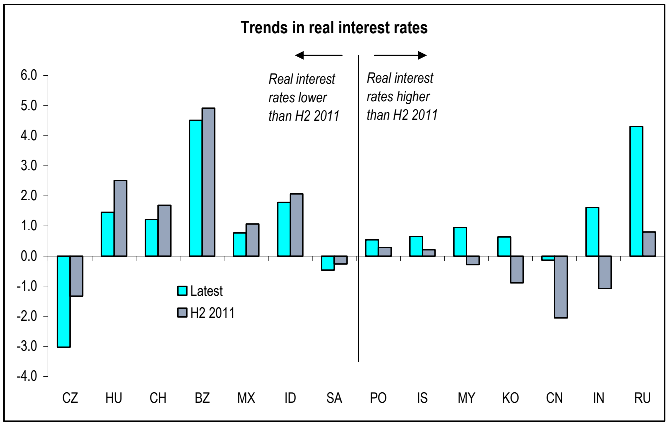
Levels of core inflation and real interest rates also do not point to a story in which EM rates can be cut across the board. Many of the disinflationary pressures that seem to be emerging – falling food prices, falling energy prices – affect the broad CPI, but not core. Of course there's nothing to stop policymakers from cutting rates in response to falling commodity prices alone, particularly if there is a good reason to think that lower commodity prices will begin to have benign effects on wage-setting. But it is worth bearing in mind that core inflation pressures in many EMs are, if anything, arguing against looser policy (Figure 13). And since real interest rates are not universally high in EM, there is no particular reason to think that wholesale monetary easing is about to take hold in EM.

Figure 15. Core inflation trends are pointing down in a number of countries but that's not true across the board…



Source: Haver Analytics and Citi Investment Research and Analysis

Figure 16. …and real interest rates are currently lower than they were in 2011 in a number of countries



Source: Haver Analytics and Citi Investment Research and Analysis

As for the countries where we *do* expect rate cuts, there are a few where we're forecasting lower rates than the market is expecting. In Chile's case, our view that rates can fall by 50 bp is based on an expectation that the Banco de Chile will see sufficient evidence of weaker domestic activity to warrant a move – albeit that the risks to this forecast are to the hawkish side, since the current macro story there remains characterized by a tight labour market and strong wage growth. In Brazil – where we are expecting 125 bp of cuts this year, before they have to be partially reversed in 2013 – our forecast is also pricing in greater cuts than the market. Our expectation of some aggressive easing in Hungary is based on our view that the MPC will move quickly in the wake of any start to loan talks with the EU/IMF. All in all, although there are some receiving opportunities in EM these days, these are selective: the idea that EM rates will be slashed across the board isn't one we subscribe to.

Annual Indicators

Figure 17. Emerging Markets – Economic Forecasts, 2011F-2013F

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F	2011F	2012F	2013F
Asia	**7.2**	**6.8**	**7.3**	**5.7**	**4.1**	**4.0**	**2.3**	**1.5**	**1.2**	**-2.2**	**-2.8**	**-2.1**
China	9.2	8.1	8.5	5.4	3.5	3.5	2.8	2.0	1.5	-1.3	-2.4	-1.5
Hong Kong	5.0	2.6	4.2	5.3	4.0	3.0	5.1	9.4	10.2	3.9	0.8	0.7
India*	6.9	7.0	7.5	9.0	7.0	6.5	-4.0	-4.1	-3.4	-8.4	-8.0	-7.7
Indonesia	6.5	6.2	6.5	5.4	4.4	4.7	0.2	-1.0	-0.9	-1.2	-1.8	-0.7
Korea	3.6	3.4	4.2	4.0	3.0	3.2	2.4	1.1	0.7	1.5	1.4	1.2
Malaysia	5.1	5.0	5.3	3.2	2.3	3.1	11.5	10.5	9.0	-5.0	-5.0	-4.7
Pakistan	2.8	3.1	4.2	10.5	11.0	11.0	-2.8	-3.6	-3.8	-6.5	-6.2	-5.5
Philippines	3.7	4.6	5.0	4.8	3.5	4.0	3.1	3.1	2.4	-2.0	-2.8	-2.0
Singapore	4.9	3.6	5.0	5.2	4.4	3.3	21.9	15.0	13.0	1.5	1.0	1.0
Sri Lanka	8.3	7.4	7.6	6.8	7.5	7.7	-7.9	-7.3	-6.1	-7.0	-6.2	-5.5
Taiwan	4.0	3.3	4.2	1.4	1.9	2.1	8.8	8.7	8.4	-1.9	-1.6	-1.6
Thailand	0.1	4.7	5.0	3.8	2.9	3.3	3.4	-1.3	-0.5	-1.5	-3.8	-2.7
Vietnam	5.9	5.0	5.6	18.6	10.0	7.9	-1.1	-1.2	-3.7	-3.5	-4.5	-4.3
Latin America	**3.9**	**3.6**	**4.1**	**6.8**	**6.0**	**6.3**	**-1.0**	**-1.2**	**-1.5**	**-2.3**	**-2.1**	**-2.3**
Argentina	8.9	3.0	3.0	9.8	9.6	12.2	0.4	0.3	0.2	-1.6	-3.0	-3.0
Brazil	2.7	3.3	4.5	6.6	5.4	5.6	-2.1	-2.1	-2.4	-2.6	-1.9	-2.6
Chile	6.0	4.5	5.0	3.3	3.7	3.2	-1.3	-1.8	-1.9	1.6	0.7	0.6
Colombia	5.9	5.0	4.5	3.4	3.5	3.8	-3.0	-3.1	-2.9	-2.9	-3.0	-2.5
Mexico	3.9	3.9	3.8	3.4	3.9	3.9	-0.8	-1.4	-2.0	-2.5	-2.2	-2.0
Panama	10.6	7.0	7.0	5.9	5.6	3.2	-12.7	-11.8	-10.2	-2.3	-2.7	-1.5
Peru	6.9	5.7	6.5	3.4	3.8	2.9	-1.3	-2.4	-2.8	1.7	1.2	-0.3
Venezuela	4.2	5.0	3.5	27.1	23.8	27.4	9.1	6.9	8.3	-5.0	-5.0	-4.0
Europe	**5.0**	**2.8**	**3.7**	**6.7**	**5.5**	**5.8**	**-0.2**	**0.0**	**-1.3**	**-0.3**	**-1.2**	**-1.1**
Czech Republic	1.7	-0.6	1.3	1.9	3.3	2.7	-2.9	-2.6	-2.6	-3.1	-3.1	-2.8
Hungary	1.7	-0.5	0.9	3.9	5.6	3.9	1.7	1.0	1.0	4.3	-2.8	-2.5
Kazakhstan	7.5	6.2	6.4	8.3	5.2	6.5	7.6	1.9	2.3	5.9	1.7	3.0
Poland	4.3	2.7	2.4	4.3	3.8	2.6	-4.3	-3.9	-4.0	-5.1	-3.1	-2.5
Romania	2.5	1.3	3.0	5.8	2.8	2.7	-4.2	-4.5	-4.7	-4.1	-2.4	-2.2
Russia	4.3	3.5	4.0	8.4	5.1	6.9	5.2	5.3	2.1	2.0	0.3	0.1
Slovakia	3.3	2.2	1.8	3.9	3.7	3.1	0.2	1.3	0.8	-4.8	-4.7	-3.2
Turkey	8.5	2.5	4.3	6.5	9.7	7.0	-10.0	-8.4	-8.0	-1.3	-2.2	-2.5
Ukraine	5.1	3.0	4.5	8.0	3.4	7.3	-5.2	-6.6	-4.3	-3.8	-3.4	-3.5
Africa/Mideast	**6.0**	**4.3**	**5.2**	**5.5**	**6.0**	**6.0**	**11.5**	**12.5**	**13.2**	**2.3**	**4.8**	**3.4**
Bahrain	3.2	3.0	3.9	-0.4	3.0	3.5	11.6	29.2	21.4	-1.2	4.8	5.1
Egypt	1.8	3.0	3.9	10.2	10.0	11.2	-2.3	-2.7	-3.3	-10.1	-9.1	-7.4
Ghana	14.4	7.5	6.5	8.7	10.2	11.6	-8.2	-7.2	-4.5	-5.4	-5.6	-4.7
Iraq	9.4	9.3	11.5	5.6	5.0	6.0	-5.1	32.7	66.7	15.8	16.5	25.2
Israel	4.9	2.7	3.0	3.4	2.6	2.7	0.1	-1.5	-1.0	-2.7	-3.2	-2.7
Jordan	2.6	2.5	3.0	4.4	5.0	5.0	-10.6	-12.4	-11.7	-3.9	-8.0	-9.5
Kenya	4.5	5.0	5.8	14.0	11.9	8.2	-8.2	-7.5	-6.5	-5.5	-5.0	-4.9
Kuwait	4.3	0.2	2.5	4.7	5.0	5.0	47.5	45.6	46.8	17.1	17.1	13.9
Lebanon	6.0	3.5	4.3	5.1	6.0	5.0	-21.3	-22.6	-23.5	-6.8	-8.0	-9.1
Nigeria	7.8	7.4	7.0	10.8	12.4	9.8	6.1	5.5	6.4	-3.1	-2.2	-2.1
Oman	4.9	3.0	4.5	4.0	3.0	3.0	3.4	2.6	21.3	5.4	4.4	3.9
Qatar	18.1	6.0	8.3	3.0	3.0	3.0	38.7	38.2	30.3	8.1	7.1	3.3
Saudi Arabia	6.8	7.1	6.5	5.0	7.0	8.0	26.8	29.2	24.5	13.7	20.5	12.2
South Africa	3.1	2.9	3.8	5.0	6.1	5.4	-3.4	-4.7	-5.6	-5.0	-4.8	-4.2
Tanzania	6.3	6.2	6.8	12.7	15.7	7.4	-8.5	-7.8	-11.2	-7.8	-6.2	-5.8
UAE	5.3	0.5	3.4	0.9	1.1	1.3	15.0	3.5	5.7	NA	NA	NA
Uganda	5.7	4.5	5.5	18.6	16.4	6.0	-11.1	-12.5	-10.7	-7.2	-5.5	-5.2
Zambia	6.6	6.5	6.9	8.7	7.5	8.0	4.2	1.2	-2.5	-3.2	-4.2	-5.2
Total	**6.0**	**5.2**	**5.8**	**6.1**	**4.9**	**5.0**	**2.2**	**2.0**	**1.6**	**-1.5**	**-1.6**	**-1.5**

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

Economic Framework

Figure 18. Citi's Global Economic Forecasts

	GDP Growth (% YoY)			CPI Inflation (% YoY)			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Global	**2.7**	**2.9**	**3.6**	**3.0**	**2.9**	**2.9**	**0.2**	**0.2**	**0.1**	**-4.1**	**-3.3**	**-2.8**
Based on PPP weights	*3.2*	*3.4*	*4.0*	*3.4*	*3.3*	*3.3*	*0.4*	*0.3*	*0.0*	*-3.8*	*-3.1*	*-2.7*
Industrial Countries	**1.2**	**1.1**	**2.2**	**1.9**	**1.5**	**1.5**	**-0.8**	**-0.6**	**-0.5**	**-5.6**	**-4.5**	**-3.8**
United States	2.1	2.1	3.5	1.9	1.7	2.1	-3.3	-3.1	-3.1	-7.8	-5.9	-4.6
Japan	2.6	1.5	1.5	0.4	0.0	0.3	1.5	2.0	2.0	-10.5	-8.1	-7.9
Euro Area	-0.6	-0.7	0.9	2.5	1.8	1.3	-0.1	0.1	0.2	-3.1	-2.9	-2.4
Canada	2.0	2.3	2.8	1.8	1.7	2.0	-1.6	-1.6	-1.9	-1.2	-0.5	-0.1
Australia	2.8	3.5	3.6	1.9	3.4	2.9	-4.0	-5.8	-4.9	-3.0	0.1	0.1
New Zealand	1.8	2.3	3.0	1.6	2.4	2.6	-5.2	-7.6	-6.9	-5.9	-3.1	-0.9
Germany	1.4	1.0	1.2	2.1	2.3	2.2	5.4	4.5	4.6	-0.5	-0.3	-0.2
France	-0.1	-0.1	1.3	2.3	1.0	1.4	-1.9	-1.1	-0.3	-4.4	-4.1	-3.8
Italy	-2.5	-2.0	0.0	3.6	2.0	0.2	-2.3	-1.8	-1.4	-2.9	-2.7	-2.8
Spain	-2.2	-2.6	1.1	2.2	2.3	1.0	-2.1	-1.0	0.8	-6.4	-6.3	-4.7
Greece	-7.4	-10.1	-0.9	1.2	15.3	19.1	-8.4	-4.4	-0.1	-10.7	-5.8	-4.7
Ireland	-0.8	0.4	2.1	0.1	0.2	0.5	3.2	3.6	6.1	-9.3	-9.7	-7.4
Portugal	-4.6	-5.2	-0.6	3.1	2.2	0.7	-4.6	-2.5	-1.6	-5.5	-4.1	-4.1
Netherlands	-1.5	-0.6	1.1	2.8	2.6	1.6	9.8	9.5	8.5	-4.5	-3.5	-2.3
Belgium	0.0	0.1	1.8	2.9	1.7	1.9	-0.2	0.3	1.0	-3.2	-2.9	-1.9
Denmark	0.6	1.2	1.4	2.2	1.7	1.5	5.8	5.5	4.0	-4.0	-2.4	-1.9
Norway	3.0	2.9	2.7	1.3	1.8	2.0	14.3	14.9	15.2	13.6	14.0	15.0
Sweden	0.4	2.0	2.4	1.2	1.6	2.2	7.0	7.3	7.3	-0.4	-0.2	0.5
Switzerland	0.7	0.9	1.5	-1.1	-1.5	-0.9	13.8	14.0	14.2	0.2	-0.2	0.0
United Kingdom	-0.2	0.5	1.3	2.9	1.8	1.6	-1.3	-0.5	0.2	-6.3	-7.7	-7.1

Source: National sources and Citi Investment Research and Analysis

Figure 19. G3 Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of 23 May 2012

	23 May 2012	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13
United States: Federal Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Yr. Treasuries (Period Ave.)	1.77	1.90	2.20	2.50	2.65	2.80	3.05
Euro Area: US$/€	1.27	1.23	1.24	1.25	1.26	1.27	1.28
Euro Repo Rate	1.00	0.50	0.50	0.50	0.50	0.50	0.50
10-Yr. Bunds (Period Average)	1.46	1.40	1.25	1.25	1.35	1.75	2.15
Japan: Yen/US$	79	80	80	80	81	82	83
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Average)	0.87	0.95	1.10	1.20	1.10	1.30	1.30

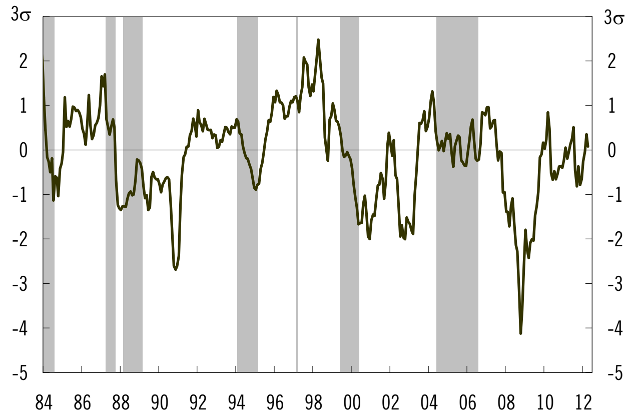
Industrialised Countries 10-Year Yield Spreads (Period Average)

	Spread vs. US$						Spread vs. Germany					
	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	Current	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13
United States	NA	NA	NA	NA	NA	NA	32	51	96	127	132	107
Japan	-91	-96	-111	-132	-157	-152	-59	-45	-15	-5	-25	-45
Euro Area	-32	-51	-96	-127	-132	-107	NA	NA	NA	NA	NA	NA
Canada	14	5	5	30	41	41	46	564	101	157	172	148
Australia	142	127	122	122	147	173	174	177	218	248	279	280
New Zealand	177	172	162	152	178	199	209	223	259	279	310	306
France	102	109	54	13	-2	13	133	160	150	140	130	120
Italy	399	499	504	423	418	393	430	550	600	550	550	500
Spain	436	549	504	423	368	343	467	600	600	550	500	450
Netherlands	16	29	-16	-57	-72	-57	47	80	80	70	60	50
Belgium	163	149	94	53	38	53	194	200	190	180	170	160
Denmark	-43	-55	-101	-132	-137	-112	-12	-4	-5	-5	-5	-5
Norway	25	-16	-56	-82	-82	-52	55	35	40	45	50	55
Sweden	-24	-51	-96	-127	-127	-102	7	0	0	0	5	5
Switzerland	-110	-130	-165	-196	-207	-207	-79	-79	-69	-69	-75	-100
United Kingdom	12	-11	-56	-82	-87	-57	43	40	40	45	45	50

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

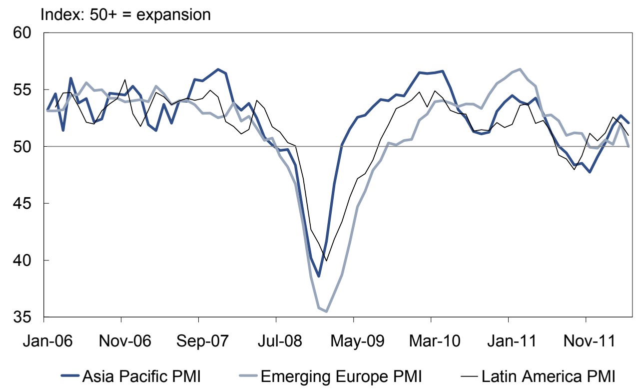
Regional Indicators

Figure 20. US Financial conditions has improved, but still teetering.



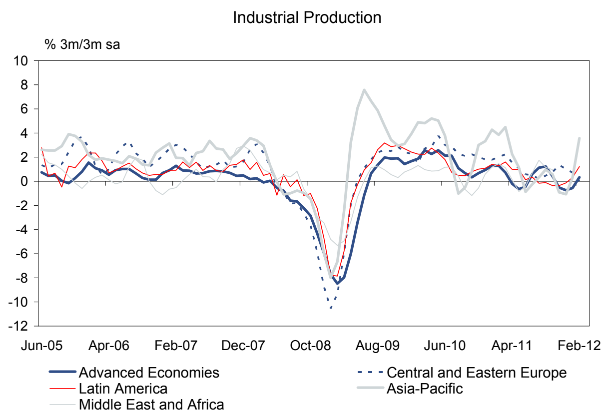
Source: Haver Analytics, Citi Investment Research and Analysis. Note: Shaded sections mark recession periods.

Figure 21. The same is true for the PMIs



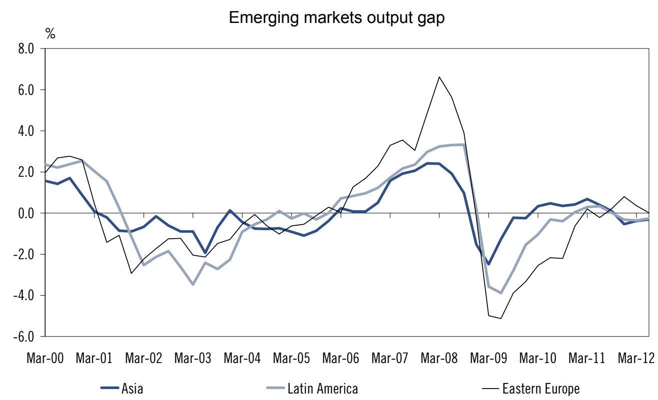
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 22. But EM industrial production is leading advanced economies



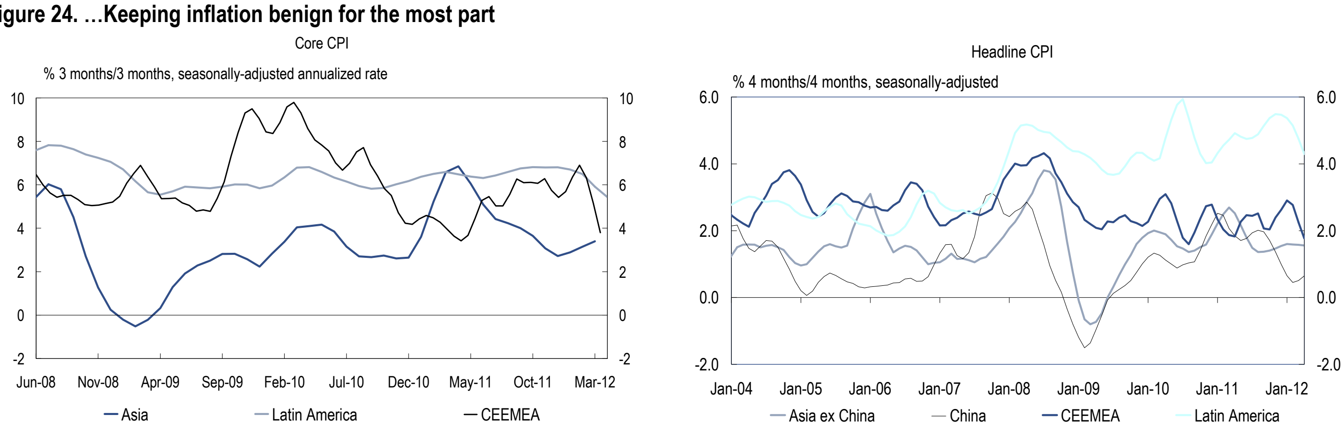
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 23. By our estimation, output gap is near zero or slightly negative this quarter…



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 24. …Keeping inflation benign for the most part



Source: Haver Analytics, Citi Investment Research and Analysis

Source: Haver Analytics, Citi Investment Research and Analysis

Monetary Policy Watch

Figure 25. Asia Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	3.50	Jul-11	+25	Feb-13	+25	3.50
India	Repo Rate	8.00	Apr-12	-50	Sep-12	-25	7.75
Indonesia	FasBI	3.75	Feb-12	-25	Mar-13	+25	3.75
Korea	BOK Policy Rate	3.25	Jun-11	+25	Feb-13	+25	3.25
Malaysia	Overnight Policy Rate	3.00	May-11	+25	2014	-	3.00
Philippines	Overnight Policy Rate	4.00	Mar-12	-25	Mar-13	+25	4.00
Taiwan	Discount Rate	1.875	Jun-11	+12.5	Sep-13	+12.5	1.88
Thailand	Overnight Repo Rate	3.00	Jan-12	-25	Mar-13	+25	3.00

Source: Bloomberg, Citi Investment Research and Analysis

Figure 26. CEEMEA Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Date	Amount (bp)	Forecast
Czech Republic	2 Week Repo Rate	0.75	Jun-11	-25	Jun-12	-25	0.25
Hungary	14-Day Repo Rate	7.00	Dec-11	50	Sep-12	-25	6.00
Israel	Base Rate	2.50	Jan-12	-25	2014	-25	2.50
Poland	7-Day Repo Rate	4.75	May-12	25	Feb-13	-25	4.75
Romania	Refinancing Rate	5.25	Mar-12	-25	1Q13	-25	5.25
Russia	Policy Rate	8.00	Dec-11	-25	1Q13	-25	8.00
S. Africa	Average Repo rate	5.50	Nov-10	-50	1Q13	+50	5.50
Turkey	1-week repo rate	5.75	Aug-11	-50	3Q13	+25	5.75
Ukraine	Discount Rate	7.50	Mar-12	-50	Nov-12	+25	7.75

Source: Bloomberg, Citi Investment Research and Analysis

Figure 27. Latin America Policy Rates and Movement

			Last Move		Likely Next Move		End-2012
		Spot	Date	Amount (bp)	Forecast	Amount (bp)	forecast
Brazil	SELIC	9.00	Apr-12	-75	May-12	-50	7.75
Chile	CAMARA (Overnight)	5.00	Jan-12	-25	Oct-12	-25	4.50
Colombia	Central Bank Repo Rate	5.25	Feb-12	+25	Jul-13	+25	5.25
Mexico	Official Overnight Rate	4.50	Jul-09	-25	Sep-14	+25	4.50
Peru	Reference Rate	4.25	May-11	+25	-	-	4.25

Source: Bloomberg, Citi Investment Research and Analysis

FX Views

Figure 28. Asian Currencies Exchange Rates

	23-May	2Q12 Forecast	2Q12 Forward	2Q12 Returns (%)	4Q12 Forecast	4Q12 Forward	4Q12 Returns (%)	4Q13 Forecast	4Q13 Forward	4Q13 Returns (%)
vs USD										
China yuan	6.33	6.33	6.33	0.0	6.27	6.37	1.6	6.15	6.41	4.1
Hong Kong dollar	7.77	7.76	7.76	0.1	7.75	7.76	0.1	7.75	7.76	0.1
India rupee	56.01	54.40	56.49	3.7	54.49	58.43	6.7	52.51	60.25	12.8
Indonesia rupiah	9359	9327	9450	1.3	9349	9735	4.0	9369	#N/A	#N/A
Korea won	1173	1174	1175	0.1	1156	1183	2.3	1042	1190	12.5
Malaysia ringgit	3.15	3.14	3.15	0.5	3.08	3.18	3.3	2.97	#N/A	#N/A
Philippines peso	43.5	43.1	43.6	1.0	42.5	43.9	3.3	41.7	44.4	6.0
Singapore dollar	1.28	1.27	1.3	0.5	1.25	1.3	2.2	1.21	1.3	5.7
Taiwan dollar	29.5	29.93	29.52	-1.4	29.56	29.33	-0.8	28.43	29.02	2.0
Thailand baht	31.5	31.7	31.58	-0.3	31.1	31.86	2.4	30.0	#N/A	#N/A

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

Figure 29. CEEMEA Currencies Exchange Rates

	23-May	2Q12 Forecast	2Q12 Forward	2Q12 Returns (%)	4Q12 Forecast	4Q12 Forward	4Q12 Returns (%)	4Q13 Forecast	4Q13 Forward	4Q13 Returns (%)
vs EUR										
Czech Republic koruna	25.5	25.5	25.52	0.1	25.3	25.52	0.8	24.4	25.52	4.5
Hungary forint	302	297	305	2.7	290	305	5.0	288	305	5.6
Poland zloty	4.37	4.45	4.37	-1.9	4.40	4.37	-0.8	4.03	4.37	7.7
vs USD										
Israel shekel	3.85	3.87	3.85	-0.4	3.92	3.85	-1.9	3.92	3.85	-1.7
Russia ruble	31.6	31.3	31.7	1.3	31.7	32.7	3.1	32.1	34.1	5.8
Turkey new lira	1.85	1.85	1.87	1.0	1.88	1.94	3.2	1.87	2.05	8.7
S. Africa rand	8.40	8.41	8.44	0.3	8.47	8.66	2.1	8.66	8.96	3.4

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

Figure 30. Latin American Currencies Exchange Rates

	23-May	2Q12 Forecast	2Q12 Forward	2Q12 Returns (%)	4Q12 Forecast	4Q12 Forward	4Q12 Returns (%)	4Q13 Forecast	4Q13 Forward	4Q13 Returns (%)
vs USD										
Brazil reais	2.08	2.02	2.10	3.5	1.98	2.15	8.2	1.87	2.24	16.2
Chile peso	511	510	513	0.6	504	523	3.6	491	536	8.5
Colombia peso	1827	1810	1840	1.6	1813	1880	3.6	1835	1935	5.2
Mexico new peso	14.0	14.0	14.0	0.1	13.7	14.0	1.7	12.6	14.0	9.5

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

Our Forecasts vs. Consensus

Figure 31. Citi vs. Consensus forecasts

	GDP Growth (% YoY)				CPI Growth (% YoY)				Current Account Balance (US$ bil)			
	2012F	Consensus	2013F	Consensus	2012F	Consensus	2013F	Consensus	2012F	Consensus	2013F	Consensus
Asia	**6.8%**	**6.8%**	**7.3%**	**7.2%**	**4.1%**	**4.1%**	**4.0%**	**4.3%**	**221.6**	**288.4**	**196.9**	**306.2**
China	8.1	8.3	8.5	8.5	3.5	3.4	3.5	3.6	167.6	209.2	144.0	216.1
Hong Kong	2.6	2.7	4.2	4.5	4.0	4.3	3.0	3.7	24.3	9.6	28.3	11.7
India	7.0	7.2	7.5	7.7	7.0	7.2	6.5	6.7	-76.9	-70.3	-75.6	-72.3
Indonesia	6.2	6.0	6.5	6.3	4.4	5.3	4.7	5.8	-9.6	-0.8	-9.1	-0.8
Korea	3.4	3.3	4.2	4.0	3.0	2.9	3.2	3.2	12.0	20.4	8.7	20.5
Malaysia	5.0	4.3	5.3	5.0	2.3	2.4	3.1	2.9	31.8	31.3	30.4	35.2
Pakistan	3.1	3.5	4.2	4.3	11.0	10.8	11.0	9.8	-9.0	-5.0	-10.9	-6.3
Philippines	4.6	4.1	5.0	5.0	3.5	3.5	4.0	4.2	7.7	7.2	6.8	8.0
Singapore	3.6	3.1	5.0	4.5	4.4	4.0	3.3	2.9	41.7	49.1	41.2	51.4
Sri Lanka	7.4	6.8	7.6	7.0	7.5	6.5	7.7	7.3	-4.2	-4.0	-4.2	-3.4
Taiwan	3.3	2.9	4.2	4.5	1.9	1.7	2.1	1.9	42.6	40.1	45.2	42.5
Thailand	4.7	5.3	5.0	4.6	2.9	3.4	3.3	3.5	-4.8	5.4	-2.2	9.3
Vietnam	5.0	5.4	5.6	6.5	10.0	10.9	7.9	9.9	-1.7	-3.7	-5.7	-5.8
Latin America	**3.6%**	**3.6%**	**4.1%**	**4.1%**	**6.0%**	**6.2%**	**6.3%**	**6.5%**	**-64.4**	**-71.3**	**-86.6**	**-86.0**
Argentina	3.0	3.3	3.0	3.3	9.6	9.9	12.2	10.1	1.5	1.3	1.1	0.7
Brazil	3.3	3.0	4.5	4.3	5.4	5.1	5.6	5.4	-51.4	-61.1	-65.4	-71.3
Chile	4.5	4.6	5.0	4.9	3.7	3.3	3.2	3.1	-4.6	-6.6	-5.4	-7.5
Colombia	5.0	5.1	4.5	4.8	3.5	3.3	3.8	3.3	-11.2	-10.0	-11.4	-10.7
Mexico	3.9	3.7	3.8	3.5	3.9	3.7	3.9	3.7	-15.6	-11.4	-26.2	-16.1
Panama	7.0	6.8	7.0	6.5	5.6	5.2	3.2	4.5	-4.1	-4.3	-3.9	-4.4
Peru	5.7	5.7	6.5	6.3	3.8	3.1	2.9	2.7	-4.7	-3.6	-6.0	-4.5
Venezuela	5.0	4.3	3.5	2.6	23.8	25.6	27.4	30.3	25.7	24.4	30.6	27.8
Europe	**2.8%**	**3.0%**	**3.7%**	**3.7%**	**5.5%**	**6.2%**	**5.8%**	**5.4%**	**-0.1**	**-8.2**	**-59.6**	**-39.9**
Czech R	-0.6	0.2	1.3	1.9	3.3	3.3	2.7	2.1	-4.9	-5.0	-5.3	-5.1
Hungary	-0.5	-0.4	0.9	1.6	5.6	5.4	3.9	3.3	1.3	2.6	1.4	2.5
Kazakhstan	6.2	6.1	6.4	5.4	5.2	7.1	6.5	6.4	4.0	11.0	5.7	7.0
Poland	2.7	2.8	2.4	3.1	3.8	3.6	2.6	2.7	-18.3	-19.5	-20.8	-20.9
Romania	1.3	1.1	3.0	2.7	2.8	3.1	2.7	3.7	-7.7	-8.0	-8.8	-9.2
Russia	3.5	3.8	4.0	3.8	5.1	6.3	6.9	6.0	102.6	77.2	44.8	53.1
Slovak Rep	2.2	1.1	1.8	2.6	3.7	3.0	3.1	2.8	1.2	-0.6	0.8	-0.9
Turkey	2.5	2.5	4.3	4.7	9.7	9.6	7.0	6.8	-66.4	-56.1	-68.7	-57.6
Ukraine	3.0	2.7	4.5	3.6	3.4	5.5	7.3	8.4	-11.8	-9.8	-8.8	-8.8
Above Total	**5.3%**	**5.3%**	**5.9%**	**5.9%**	**4.8%**	**5.0%**	**4.9%**	**5.0%**	**157.2**	**208.9**	**50.7**	**180.4**

Source: Consensus Economics, Citi Investment Research and Analysis

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China

- **Summary view** — We have downgraded annual GDP growth forecast to 8.1% from 8.4% due to larger-than-expected drag from property investment as well as its spillover effect on consumption. The risk of below 8% growth becomes clear and present if policy easing continues to lag behind.

- **Things to watch** — Further cyclical easing looks inevitable to offset the external headwinds amid the rising chance of Greece's exit from the euro area ("Grexit"), as well as to support domestic economic activities. Joint efforts of monetary, fiscal and industrial policies are needed to stabilize growth before the leadership transition this fall.

- **Strategy** — We expect the oversold H-share market to outperform if the oversold rebound materializes in the near term. We favor those sectors that were sold-off but with solid valuation and earnings support, namely transportation, insurance, consumer discretionary, capital goods, banks, materials, healthcare and property

Time to defend growth

Data for Apr were weak across the board, prompting RRR cut. Imports stagnated, confirming weak domestic demand. Industrial value added grew 9.3% YoY, the lowest since May 2009. Property investment growth plummeted from 19.6% YoY in Mar to 9.2% in Apr, and data on new residential starts and land acquisition predicts further slowdown in the months ahead. Retail sales growth slowed to 14.1% YoY. M2 growth fell from 13.4% YoY in Mar to 12.8% in Apr (relative to PBOC forecast of 14% growth for 2012), and monthly RMB lending fell from 1,011bn to 682bn. Fiscal revenue growth fell to 6.9% YoY (tax revenue 2.6% YoY), from 18.7% in Mar and 25% in 2011. In response, PBOC cut RRR by 50bps effective on May 18, unlocking about Rmb400bn of deposits.

Stabilizing growth becomes a priority. One week after the RRR cut, Premier Wen stressed that stabilizing growth should be on top of the policy agenda. He agreed that the economy is facing further downward pressure, and weak demand and profit margin squeezes are two present challenges. The government will aim to expand domestic demand and stabilize external demand. In our view, this signals that policy is shifting to defend growth. To win the battle, policy fine-tuning would have to be upgraded to more aggressive easing.

More resolute policy easing

New round of measures to promote consumption kicked off. The State Council decided in the middle of the month to allocate Rmb36.3bn to subsidize energy-saving consumption. This is in line with our expectation that successor consumption supporting policies would be targeted, benefiting producers of energy saving and low emission products. Based on our estimation, the policy can potentially leverage sales of more than Rmb300bn, although the net addition to sales would be less since a large part of the new consumption is simply substituting consumption of less energy efficient products. Active spending by the government, either directly or through subsidy, may boost GDP by more than the original expenditure.

We expect the downside risks to trigger further policy easing. The political economics in a year of leadership transition suggest that the authorities would not like to see continued economic slowdown into Q3 right before the National Party Congress. We see the latest RRR cut as the beginning of more resolute policy easing. Further policy easing may include: (i) two additional RRR cuts this year to bring M2 growth to 14%, and loosening of LDR requirement to address the supply side of weak credit growth; (ii) fiscal deficit close to the budgeted level (effectively 2.4% of GDP); pilot tax reform in the services sector is likely to be expanded from Shanghai to Beijing and then to more provinces in the near term (iii) extension of property policy easing from first home purchase to second home purchase, accompanied by adequate funding of social housing programs; (iv) launch of new infrastructure projects under the 12th Five-Year Plan. The government will also encourage private investors to invest in the railway, subway, financial, energy, telecom, education and medical sectors, but progress may not be fast enough to significantly spur short-term growth.

Above 8% growth still achievable

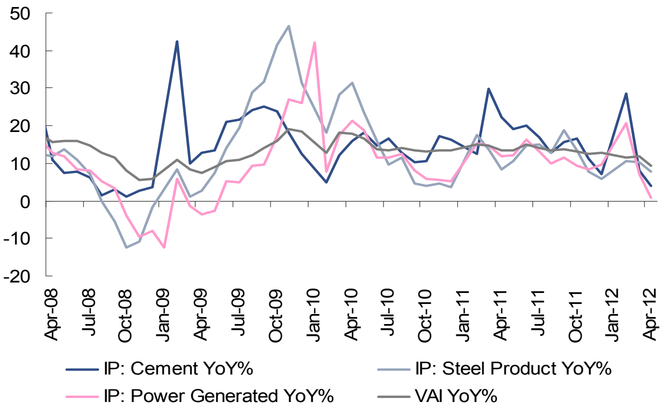
The government is still aiming for above 8% growth this year – There are signs that the government can now tolerate slower growth amid declining potential growth and economic rebalancing agenda. However, we have learned that the government has a working growth target (above 8%) apart from the official growth target (7.5%), and the fiscal and monetary policy mix set at the beginning of the year is supportive of 8-9% growth. There is no convincing evidence indicating a change of the working target.

Annual growth may fall to 8.1% while 2H rebound is likely to be weaker. Based on the recent data and assumption on continued policy easing, we have adjusted our 2012 growth forecast from 8.4% to 8.1%. In particular, total FAI growth is revised down from 18-19% to 16-17%. The slowing investment is expected to have a spillover effect on consumption. We keep the contribution of net export to growth at -0.7ppt, assuming weakening exports (especially due to possible escalation of the European sovereign crisis) are to be offset by slowing domestic demand and imports. We also downgraded Q2 growth from 7.9% to 7.5% YoY.

The buffer zone is shrinking in case of policy missteps. Above 8% growth is still achievable with sustained policy easing. However, as our expected growth is approaching 8%, the risk of below 8% growth becomes clear and present if policy easing continues to lag behind.

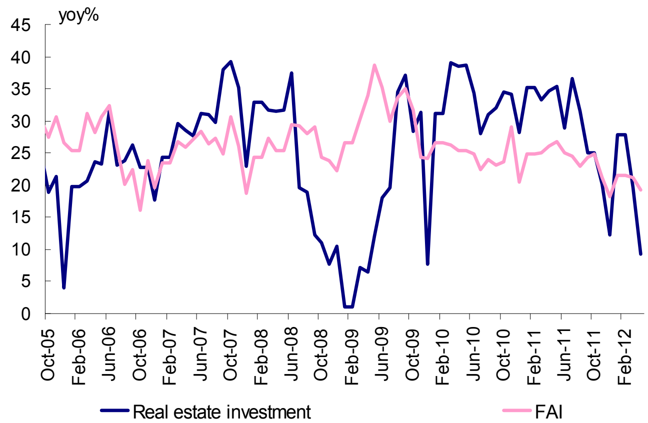
Opportunity and risks. The market opportunity lies in the fact that the Chinese authorities still have the firepower to stabilize growth, while there are uncertainties on how soon the policy action would turn into growth recovery and how much the quality of growth will be sacrificed to defend 8% growth. The H-share market looks oversold on external uncertainties and domestic policy delay. The recent sell-off has erased most of the gains in HSCEI, while the A share market outperformed firmly. We expect the H-share market to outperform if the oversold rebound materializes in the near term. To play the oversold rebound, we favor those sectors that were sold-off but with solid valuation and earnings support. We overweight transportation, insurance, consumer discretionary, capital goods, banks, materials, healthcare and property.

Figure 32. Industrial production growth fell rapidly…



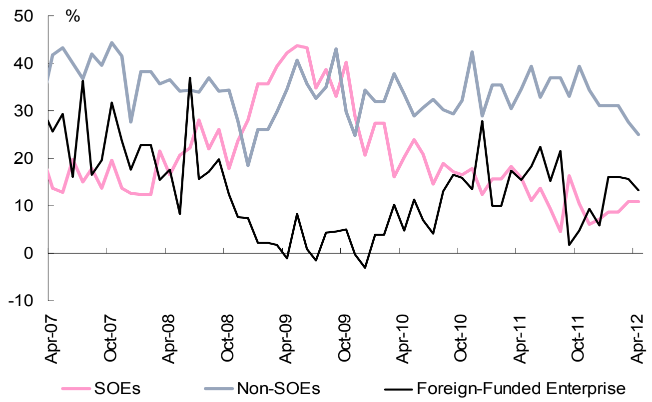
Source: NBS and Citi Investment Research and Analysis

Figure 33. …so it is with investment…



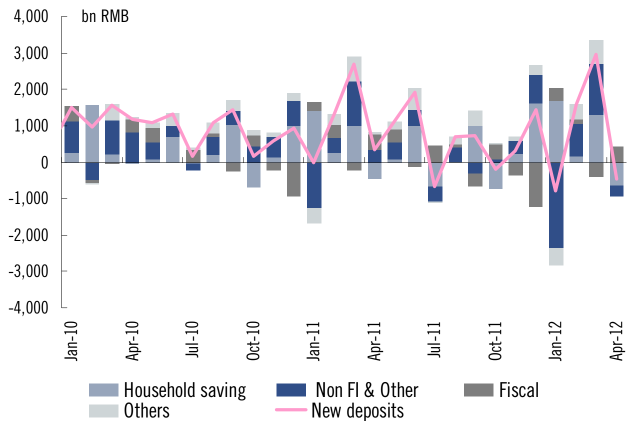
Source: NBS and Citi Investment Research and Analysis

Figure 34. Private investment is slowing down



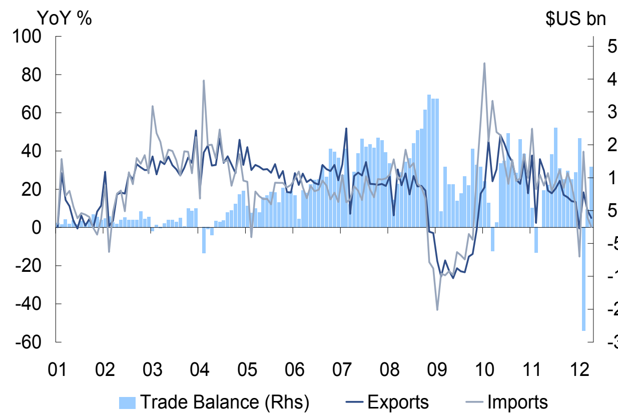
Source: NBS and Citi Investment Research and Analysis

Figure 35. Deposit decline constrained loan extension



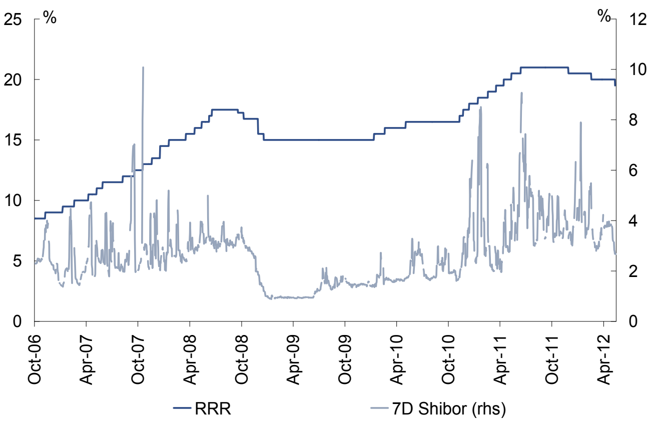
Source: PBOC and Citi Investment Research and Analysis

Figure 36. Both export and import growth were lower than expected



Source: CEIC and Citi Investment Research and Analysis

Figure 37. RRR was cut in May, the third in this easing cycle



Source: CEIC and Citi Investment Research and Analysis

Figure 38. China Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	2283.5	2787.2	3494.5	4544.0	5070.5	5932.5	7295.2	8331.4	9585.1
Nominal GDP, local currency bn	18,713	22,224	26,583	31,490	34,632	40,151	47,156	52,507	59,308
GDP per capita, US$	1,746	2,120	2,645	3,422	3,967	4,428	5,414	6,156	7,054
Population, mn	1,307.6	1,314.5	1,321.3	1,328.0	1,334.7	1,339.7	1,347.4	1,353.4	1,358.8
Unemployment, % of labour force	4.2	4.1	4.0	4.2	4.3	4.1	4.1	4.2	4.1
Economic Activity									
Real GDP, % yoy	11.3	12.7	14.2	9.6	9.2	10.4	9.2	8.1	8.5
Real investment growth % yoy	10.6	13.6	14.7	11.0	19.9	12.2	10.6	8.8	8.7
Real consumption growth % yoy	8.0	9.8	11.0	8.5	9.0	7.9	10.0	9.6	9.4
private consumption growth % yoy	9.4	11.3	11.1	9.2	10.3	8.4	10.3	9.8	9.6
Real export growth, % yoy	—	—	—	—	—	—	—	—	—
Real import growth, % yoy	—	—	—	—	—	—	—	—	—
Prices, Money & Credit									
CPI, % yoy	1.6	2.8	6.5	1.2	1.9	4.6	4.1	4.0	4.0
CPI, % avg	1.8	1.5	4.8	5.9	-0.7	3.3	5.4	3.5	3.5
Nominal wages, % yoy	14.3	14.6	18.5	16.9	11.6	13.3	17.4	11.3	13.0
Credit extension to private sector, % yoy	9.1	14.3	19.3	14.0	33.2	20.3	13.6	14.0	14.0
Policy interest rate, % eop	2.25	2.52	4.14	2.25	2.25	2.75	3.50	3.50	3.75
1 month inter-bank rate, % eop	1.90	2.58	3.61	1.23	1.79	6.17	5.99	4.00	4.25
Long term yield, % eop	2.49	2.62	4.19	1.80	3.06	3.61	3.27	3.17	3.42
lc/US$, eop	8.07	7.81	7.30	6.83	6.83	6.61	6.29	6.27	6.15
lc/US$, avg	8.19	7.97	7.61	6.93	6.83	6.77	6.46	6.30	6.19
Balance of Payments, US$ bn									
Current account	134.1	232.7	354.0	426.1	261.1	305.4	201.1	167.6	144.0
% of GDP	5.9	8.3	10.1	9.4	5.1	5.1	2.8	2.0	1.5
Trade balance	102.0	177.5	262.2	298.1	195.7	181.5	155.1	120.2	98.4
Exports	762.0	969.0	1,220.5	1,430.7	1,201.6	1,577.8	1,898.6	2,022.1	2,287.9
Imports	660.0	791.5	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,902.0	2,189.5
Service balance	-9.4	-8.8	-7.9	-11.8	-29.4	-22.1	-55.4	-60.9	-67.0
Income balance	-16.1	-5.4	7.9	17.7	7.3	30.4	-14.2	-5.0	-5.0
FDI, net	105.9	102.9	143.1	121.7	70.3	124.9	170.5	138.6	138.2
International reserves	818.9	1066.3	1528.2	1946.0	2399.2	2847.3	3181.1	3413.1	3529.7
Total Amortisations	21.93	22.11	25.00	30.00	35.00	34.44	38.25	35.47	39.0
Public Finances, % of GDP									
Consolidated government balance	-1.2	-1.0	0.6	-0.4	-2.2	-2.2	-1.3	-2.4	-1.5
Consolidated gov primary balance	-0.8	-0.5	1.0	0.1	-1.8	-1.7	-0.9	-2.0	-1.1
Public debt	17.4	15.8	19.6	17.0	17.7	16.8	15.3	16.1	15.8
of which Domestic	16.0	14.5	18.6	16.2	16.9	16.2	14.8	15.6	15.3
Foreign Assets & Liabilities, US$ bn									
External debt	296.5	338.6	389.2	390.2	428.6	548.9	695.0	764.5	840.9
Private	263.5	304.2	354.3	356.9	391.8	510.1	657.6	723.4	795.7
Public	33.0	34.4	34.9	33.3	36.9	38.8	37.4	41.1	45.3
External debt / GDP	13.0	12.1	11.1	8.6	8.5	9.3	9.5	9.2	8.8
External debt / XGS	35.4	31.9	29.0	24.7	32.1	31.3	33.0	34.0	33.1
Short-term debt	171.7	199.2	235.7	226.3	259.3	375.7	475.7	523.2	575.5
Short-term debt/International Reserves (%)	21.0	18.7	15.4	11.6	10.8	13.2	15.0	15.3	16.3

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	8.9	8.1	7.5	8.3	8.4	8.6	8.8	8.7
CPI, % yoy	6.1	4.1	3.6	3.3	3.1	4.0	3.6	2.9	3.4
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.50	3.50	3.75	3.75	3.75
1 month inter-bank rate, % eop	5.92	5.99	4.22	4.20	4.10	4.00	4.25	4.25	4.25
Long term yield, % eop	3.82	3.27	3.17	3.17	3.17	3.17	3.42	3.42	3.42
lc vs USD, eop	6.38	6.29	6.30	6.33	6.31	6.27	6.23	6.20	6.17

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and CIRA Estimates
*Note: Public debt is based on official data, not including the local government debt as audited by the National Auditing Office in summer 2011. External debt is based on the residency of the holder of the debt (not by currency denomination).

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Hong Kong

- **Summary view** — We lowered our 2012E GDP forecast to 2.6%yoy (from 3%) on slower-than-expected 1Q GDP (0.4% for both yoy and %qoq sa). Net exports will likely still be the main drag in 2Q, despite some cushioning from local consumption and exports of services (tourism).

- **Things to watch** — Inflation likely moderating with slowing economy (despite higher public rents/transportation/utilities fees); but recent property price rise raises policy risks. Look out for possible policy directives (e.g. CEPA and QDII) from Chinese President Hu Jintao's visit to HK on 1-Jul and after new CE takes office.

- **Strategy** — Risk-off sentiments have captivated the equity markets recently and fund outflows are notable via the HKD retreating toward the mid-trading band; volatility near mid-band expected in the near term. Barring any counterparty risk that may freeze banking funds, our HIBOR forecasts climb only very gradually.

Looming external risks on HK's growth performance

1Q GDP underperformed expectations on net exports drag. HK 1Q GDP only grew a mere 0.4% in both YoY and QoQ sa terms, as the haul by net exports (-1.67ppt of GDP growth) was more severe than thought and erased most of the contributions in other GDP components. Actually both consumption (+3.47ppt) and gross fixed capital formation (GFCF) (+2.28ppt) together provided a larger-than-expected cushion in 1Q. GFCF have been increasing and accelerating in recent quarters, on higher machinery spending and private construction activities — a reflection of property developers building away, after they acquired more land from the Government. The acceleration of infrastructure works (after legal bottlenecks have been removed) and a typical higher public expenditure at the fiscal year end have increased government spending (+0.23ppt) in 1Q.

Moderate 2QF expansion after 1Q GDP trough. The Government takes the view that the GDP fallout will likely be arrested in 1Q, a view that we have reiterated for a while. Although incoming data have shown more mixed performance, they suggest that the external/domestic dichotomy will prevail. Several forward-looking indicators (PMI/loans growth/business confidences/hiring sentiments/property market activities), coupled with smaller negative base effects, do point to some improvements in the 2Q. However, given the fluidity of the Greek situation (Citi now expects a 50-70% chance of Greece leaving the Euro monetary union) and our recent downgrade of China's GDP to 8.1% (from 8.4%), which entails a weaker 2H rebound, we conservatively lower our 2QE GDP growth forecast to 1.9%yoy.

Contagion coming at HK from everywhere. HK, being a small open economy, is highly exposed to external headwinds, in particular in four aspects: (1) trade, (2) asset prices, (3) credit and (4) sentiment. We discuss each one in more details:

(1) We have already noted a visible trade drag due to external demand slowdown since later 2011, which will likely continue, thus taking a toll on the overall economy, as HK exports to China, Euro Zone and US accounts for 92%, 19% and 17.5% of HK's GDP, respectively.

(2) With the resurgence of European woes taken to new heights recently, the Hang Seng Index has dropped 19.4% since the beginning of May. Overall the risk-off environment has led to fund outflows, which can be noted from the HKD retreating from 7.7587/USD on 2 May to 7.7652 as of 22 May. We think gyrations toward the center of the band 7.78 are likely in the near term.

(3) Worries about deleveraging by European/UK banks from HK have re-emerged. Investors were particularly worried about this issue at the end of last year before the launching of LTRO, and later there were signs that some of the credit void left by the retreating European banks were taken up by other Asian banks. However, the ability of Asian banks to continue to take up the slack is diminishing going forward given their high loan-to-deposit ratio (which could worsen when deposit falls with fund outflows), thereby reigniting concerns on possible near term credit tightening in HK.

Before we go on further, we do not expect system-wide panic in HK's credit sector. Our previous research[1] using BIS data has shown that European (ex-UK) banks' foreign claims (both as a share of GDP or domestic credit to private sector) in Asia don't look particularly vulnerable when compared to other EMs; and this is true even for financial centers like HK.

However, for HK, we do expect trade financing and lending to small-medium enterprises would be affected in light of falling trading volumes and tight credit times. The HK Government's Loan Guarantee Scheme for SMEs and exporters (announced in Feb's Budget) would provide some timely help. In terms of funding cost, our base-case scenario remains that HK interest rates will remain very low given global monetary accommodations (with our HIBOR forecasts climb only very gradually across our forecast horizon); needless to say, this base case excludes any unexpected counterparty risk that may freeze banking funds.

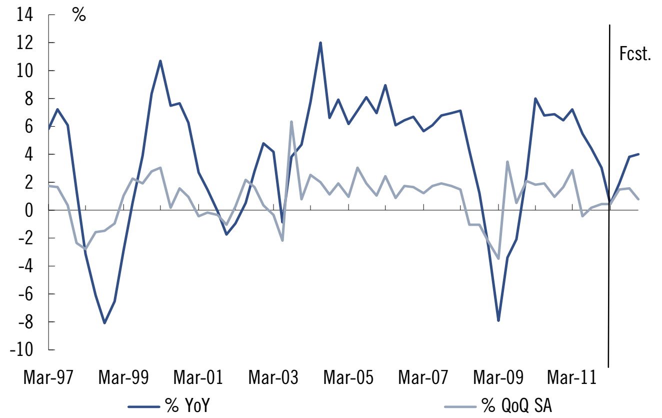
(4) External turmoil inevitably will weigh on consumer and business sentiments. Consumption continued to underpin economic growth in 1Q, and retail sales recovered in March (17.3%yoy) and would likely be relatively resilient in April too. However, anecdotal signs of early May sales in chain stores have suggested May retail sales will turn weak again, reflecting both more conservative local consumption post stock market losses and likely relatively leaner spending by Mainland tourists during the Golden week holiday compared to previous years. As for businesses, prior to the latest worry of Grexit, most firms (including those in trading) were expressing better confidence on 2Q's business situation in the Business Tendency Survey that was released in late April. This confidence may not last given looming external worries. Note that for PMI, although it still posted an expansion reading in April (50.3), a marked contraction in Mainland orders does imply upcoming pressure on growth.

On aforementioned concerns, we have downgraded our 2012E GDP forecast to 2.6%yoy (from 3%). Our forecast is similar to consensus of 2.7%, but still at the higher end of the official forecast range of 1-3%. We continue to expect a rebound in the 2H, after giving some time for European issues to pan out and Chinese policy easing to kick in amidst a less harsh YoY comparison base. We would also look out for possible new policy directives (e.g. CEPA and QDII) from Chinese President Hu Jintao's visit to HK on 1-Jul and after new CE takes office.

Inflation is moderating as pass-though from home rentals has peaked and food prices retreated. Also, YoY readings will likely decline on high base effects amidst a slowing economy. Although our CPI forecast is maintained at 4%yoy for 2012E average, the year-end rate could come near to 3%. However, home prices continue to rise and reach beyond 1997's prices. Property (Centa City) Leading Index also points to further rises beyond 1997's reading in April. HKMA Chief Norman Chan and Government Chief Economist Helen Chan have both recently warned that the Government is on guard and further property cooling measures are possible.

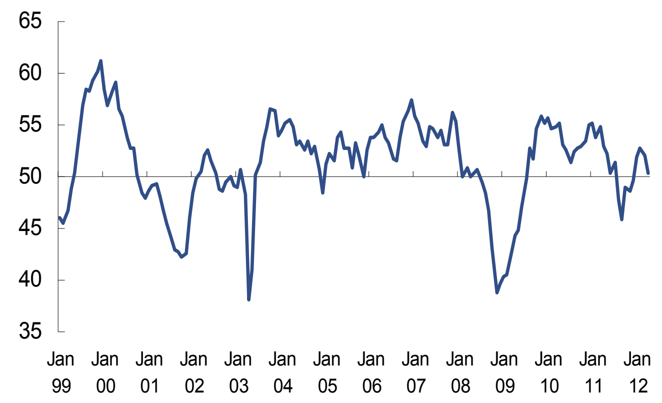
[1] *Asia Macro and Strategy Outlook - Prospects for 2012*, 29 Nov 2011, page 9

Figure 39. 1Q GDP grew a mere 0.4%, but likely mark the YoY trough



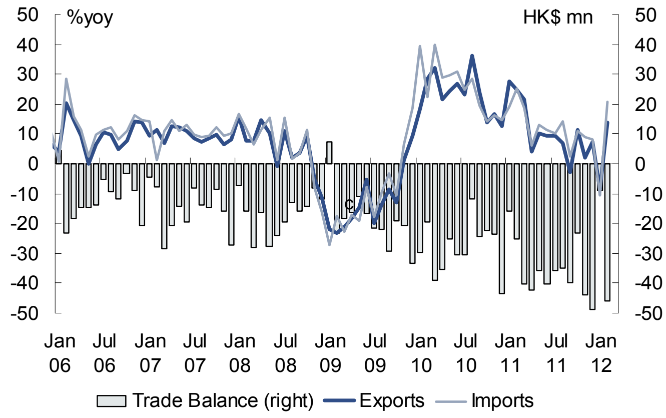
Source: CEIC and CIRA estimates

Figure 40. PMI indicates economic expansion is fragile



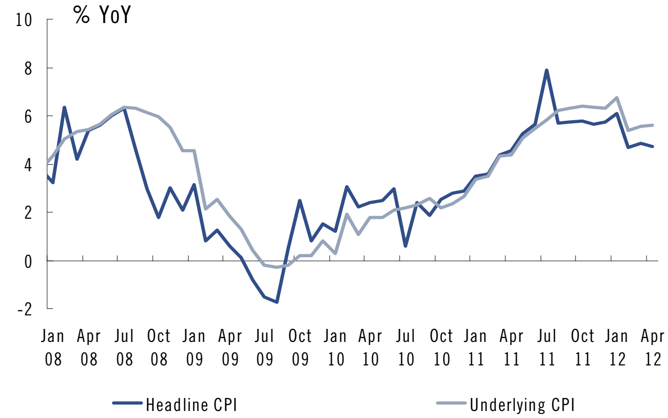
Source: Haver and Markit
Note: A reading above 50 signals expansion and below 50 signals contraction.

Figure 41. Trade rebounded post CNY, but trend still weak



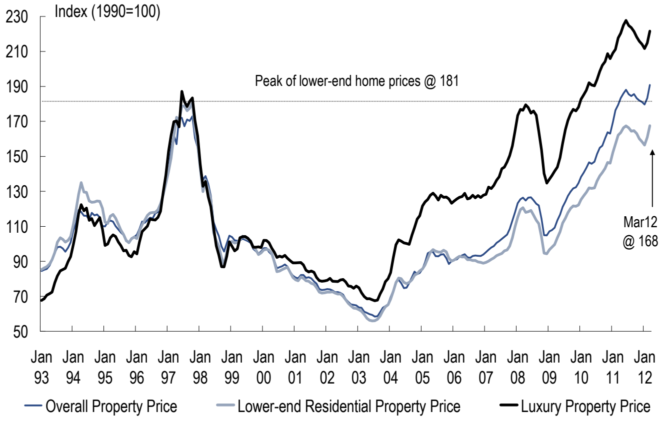
Source: CEIC and CIRA

Figure 42. Inflation have started to trend down



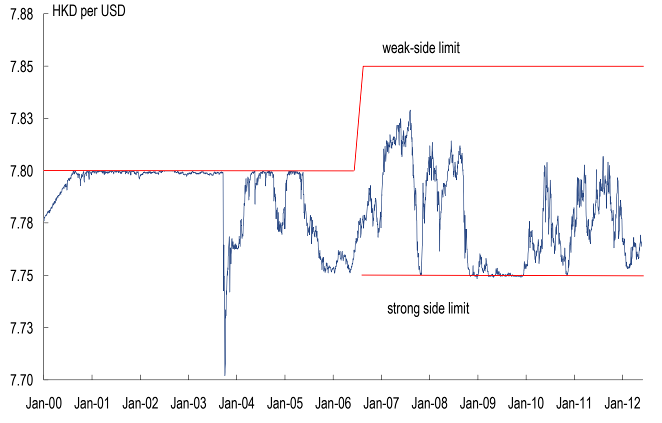
Source: CEIC and CIRA

Figure 43. HK home prices continue to rise despite cooling economy



Source: CEIC and CIRA

Figure 44. HKD retreats with risk appetite faltering



Source: Reuters and CIRA

Figure 45. Hong Kong Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	177.8	189.9	207.1	215.4	209.3	224.2	242.9	259.7	278.4
Nominal GDP, local currency bn	1,383	1,475	1,616	1,677	1,623	1,742	1,891	2,015	2,159
GDP per capita, US$	26,092	27,698	29,889	30,896	30,018	31,915	34,405	36,455	38,764
Population, mn	6.8	6.9	7.0	7.0	7.0	7.1	7.1	7.1	7.2
Unemployment, % of labour force	5.7	4.8	4.1	3.4	5.2	4.4	3.4	3.6	3.7
Economic Activity									
Real GDP, % yoy	7.1	7.0	6.4	2.3	-2.6	7.0	5.0	2.6	4.2
Real investment growth % yoy	-0.8	8.5	8.3	-0.7	0.4	11.5	1.2	-0.5	4.5
Real consumption growth % yoy	2.1	5.2	7.8	2.3	0.9	6.3	7.6	3.7	1.9
private consumption growth % yoy	3.0	5.9	8.5	2.4	0.7	6.7	8.4	3.8	2.0
Real export growth, % yoy	10.6	9.4	8.3	2.5	-10.3	16.7	4.2	0.6	7.0
Real import growth, % yoy	8.0	9.1	9.1	2.3	-9.0	17.3	4.6	1.1	6.1
Prices, Money & Credit									
CPI, % yoy	1.3	2.3	3.8	2.1	1.5	2.9	5.7	2.9	3.0
CPI, % avg	0.9	2.0	2.0	4.3	0.6	2.3	5.3	4.0	3.0
Nominal wages, % yoy	0.8	2.1	2.4	4.0	-1.9	2.4	9.9	5.0	4.0
Credit extension to private sector, % yoy	7.7	2.3	15.2	11.0	-2.1	20.9	12.8	8.0	8.0
Policy interest rate, % eop	—	—	—	—	—	—	—	—	—
1 month inter-bank rate, % eop	4.06	3.88	3.13	0.33	0.13	0.23	0.34	0.47	0.92
Long term yield, % eop	4.11	3.69	3.10	1.19	1.93	1.76	0.96	0.90	1.40
lc/US$, eop	7.75	7.77	7.80	7.75	7.76	7.78	7.77	7.75	7.75
lc/US$, avg	7.78	7.77	7.80	7.79	7.75	7.77	7.78	7.76	7.76
Balance of Payments, US$ bn									
Current account	20.2	22.9	25.5	29.5	18.0	12.4	12.4	24.3	28.3
% of GDP	11.4	12.1	12.3	13.7	8.6	5.5	5.1	9.4	10.2
Trade balance	-10.5	-17.9	-23.5	-25.9	-28.9	-43.1	-54.8	-48.7	-46.3
Exports	289.5	316.8	344.7	363.0	318.7	390.4	429.2	447.5	499.7
Imports	299.9	334.7	368.2	388.9	347.6	433.5	484.0	496.3	546.1
Service balance	29.7	35.7	42.1	45.2	42.5	55.2	65.1	68.0	71.0
Income balance	0.2	3.5	5.7	10.7	5.5	3.6	7.3	8.5	10.0
FDI, net	6.4	0.1	-6.7	9.0	-11.6	-24.3	1.5	-1.0	3.0
International reserves	124.2	133.2	152.6	182.5	255.8	268.7	285.4	310.0	340.0
Total Amortisations	—	—	—	—	—	—	—	—	—
Public Finances, % of GDP									
Consolidated government balance	1.0	3.9	7.5	0.1	1.6	4.2	3.9	0.8	0.7
Consolidated gov primary balance	1.1	4.0	7.5	0.1	1.6	4.3	3.9	0.9	0.8
Public debt	1.7	1.4	1.2	1.0	0.7	0.6	1.1	1.8	2.4
of which Domestic	0.8	0.6	0.4	0.3	0.0	0.1	0.2	0.6	0.5
Foreign Assets & Liabilities, US$ bn									
External debt	—	—	—	—	—	—	—	—	—
Private	—	—	—	—	—	—	—	—	—
Public	—	—	—	—	—	—	—	—	—
External debt / GDP	—	—	—	—	—	—	—	—	—
External debt / XGS	—	—	—	—	—	—	—	—	—
Short-term debt	—	—	—	—	—	—	—	—	—
Short-term debt/International Reserves (%)	—	—	—	—	—	—	—	—	—

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	4.4	3.0	0.4	1.9	3.8	4.0	4.6	4.5	4.5
CPI, % yoy	6.3	6.2	4.9	4.0	3.8	3.2	2.3	2.0	5.1
Policy interest rate, % eop	—	—	—	—	—	—	—	—	—
1 month inter-bank rate, % eop	0.21	0.24	0.30	0.37	0.42	0.47	0.57	0.67	0.82
Long term yield, % eop	0.76	0.96	0.55	0.60	0.80	0.90	1.00	1.10	1.30
lc vs USD, eop	7.79	7.77	7.76	7.76	7.75	7.75	7.76	7.76	7.76

Source: CEIC Data Company Ltd, IFS, Fitch and CIRA Estimates
*Note: Public debt is general government debt.

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India

- **Summary view** — There is near-consensus that the India story has de-rated, with growth at best likely in the 6% to 7% range. Critical variables remain whether recent policy efforts to encourage investment indeed play out and the direction of oil prices.
- **Things to Watch** — The deterioration in the fiscal deficit could has further implications for ratings. Variables to watch include steps to meet the subsidy cap of 2% and pass-through of oil prices.
- **Strategy** — Our FX team believes the recent sell-off in the INR is overdone. They have revised Mar 13 and Mar 14 INR forecasts to Rs54.8/$ and Rs51.5/$ from Rs54/$ and Rs51.1/$, respectively.

Growth – trends appear bleak, but lower oil could help

Consensus de-rating of the India story. During our recent interactions with US investors (see US Marketing Takeaways – De-rating Led by Self Goals), there was near consensus that the India story had de-rated, with growth at best likely in the 6% to 7% range. The unfortunate part is that the problems appear self inflicted, with India now seen to be specializing in scoring 'self goals' — e.g. (1) in-ordinate delays in project approvals and fuel supply issues and (2) controversies surrounding foreign investment — GAAR, telecom, gas pricing. The macro focus has centered on Quadruplet deficits (*current account, fiscal, governance, liquidity — see India Macroscope - Deficits – Not Twins, But Quadruplets*). However, while the bearishness has been more pervasive than in the past, investor positioning looks not as bearish as the view. This is possibly a reflection of the sharp market rebound seen in Jan-Feb, and risks of another bounce given India's high Beta.

Could the vicious cycle turn virtuous? Yes, but dependent on external factors. As mentioned earlier, India needs luck, in terms of lower oil prices and capital flows. A point to note is that our macro forecasts have incorporated crude at US$125/bbl. Thus the ~10$bbl decrease in oil prices would (a) reduce the CAD by 10% and consequently external financing requirements by 10%, (b) lower the subsidy bill, and (c) temper inflation and thus provide the RBI more leeway on rate easing.

Monetary policy decisions get tougher

Both wholesale and retail price trends have edged higher. Despite a relatively strong base effect, the WPI edged up to 7.23%YoY in April vs. 6.89% last month, on the back of a broad-based rise across components. Trends in the new combined CPI have also been alarming, with the April release coming in at 10.4%YoY. Monthly trends have increased ~100 bps since the release of the first print in Jan 2012, which came in at 7.6%. This was followed by an 8.8% and 9.5% rise in Feb and March, with the latest April release coming in at 10.4%.

Price trends could stay firm but oil may help temper inflation. The inflation outlook is determined by (a) the interplay between commodities and (b) Food prices, trending higher. A high base effect should result in WPI remaining benign in the ~7% range in the near-term, although we could see an upward bias in the latter half of the year due to exchange rate pressures and the base effect. Structural factors driving food inflation coupled with likely MSP rises could also keep trends firm. Monsoons are another wild card. One silver lining could be oil prices edging lower.

Our base case remains that of 25bps of further easing. Given the addition of several goal-posts to the inflation outlook, i.e. (a) suppressed inflation, (b) exchange rate pass-through, (c) impact of tax hikes, (d) higher food inflation, and (e) retail/ wage pressure, odds are in line with our and consensus expectations of one more rate cut this year. But where could we be wrong? (a) If the RBI switches back to its focus on non-food manufactured inflation, which is now trending to its long-term target of 4%; (b) If oil prices fall further; (c) If quarterly GDP growth slips to sub 6%, we could see the RBI easing more than expectations.

Fiscal deterioration could prompt further rating action

The sharp deterioration in the fiscal situation, with the combined deficit rising from 4.1% in FY08 to 8-9% levels currently, is worrying. Late last month, S&P lowered its outlook for India from Stable to Negative given the rising fiscal deficit and high debt/GDP ratios are an added risk. While the government achieving its 2% subsidy cap would be a key positive, the current political gridlock and upcoming parliamentary elections in 2014 should result in only modest progress on fiscal reforms. We expect the centre's deficit target of 5.1% to slip to 5.5%. SEB losses are an added risk. This should result in the combined deficit at 8.4-8.8%.

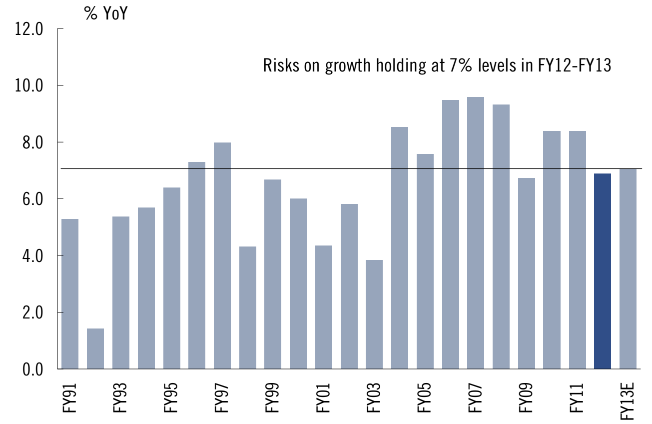
This could have an impact on ratings. While recognizing the captive demand for government bonds, the rise in debt and deficits could have an impact on ratings. More concerning is the growing recognition that the rise in the deficit is structural rather than cyclical. We expect other agencies to follow through S&P's recent outlook revision (from stable to negative). Moreover, a lack of measures on fiscal consolidation could impact the overall rating, which is currently at the lowest rung in the investment grade (Baa3/BBB-). S&P has said that the outlook revision indicates '*a one-in-three likelihood of a downgrade over the next 24 months*.'

External – widening CAD weighs on the currency

Financing pressures remain a worry. With the current account deficit rising eight-fold in absolute terms, from US$9.6bn in FY91 to US$74.3bn in FY12 (~4% of GDP), there is growing worry on financing pressures. Risks on the external account include (i) A high dependency on portfolio flows (ii) Eroding FX reserve cover — import cover has slowed from 14 months in FY08 to 6 months currently (iii) Government policy reversals could deter investors/foreign investment. However, two key rays of light are (1) Easing oil prices (2) Decelerating demand for gold.

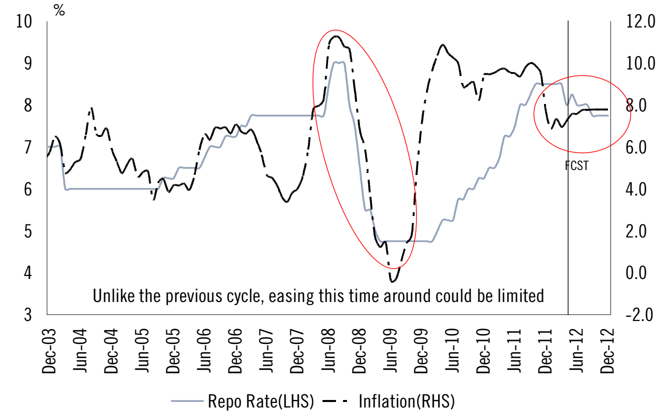
Weak macro fundamentals have weighed on the currency. Weak confidence has already taken a toll on the currency, which is down 20%YoY currently. Our global strategists believe that although the INR has depreciated ahead of forecasts, it is expected to recover some lost ground after the sell-offs, which seem overdone. However, they point out that the INR, which hit a record low against the dollar, has come under pressure for the 'right' reasons. These include high current account and fiscal deficits and a mix of high interest rates with rising inflation but rapidly slowing growth. Our current forecasts have USD/INR at Rs54-55/$ in the next year, unchanged from last month. However, taking into account the spot price, the interpolated Mar 13 and Mar 14 INR numbers stand at Rs54.8/$ and Rs51.5/$ from Rs54/$ and Rs51.1/$, respectively.

Figure 46. Growth has seen a consensus de-rating



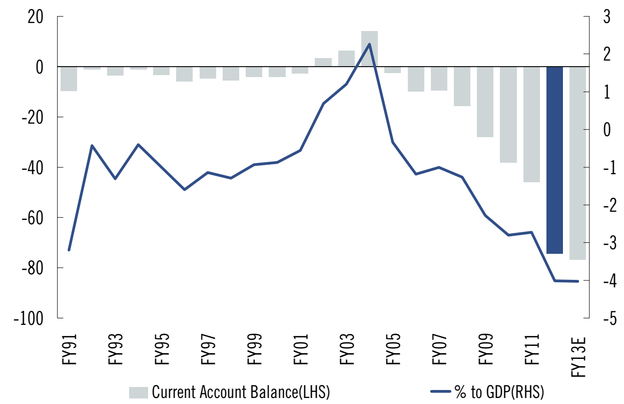
Source: CSO

Figure 47. Inflation trends stay firm though it could prompt more easing



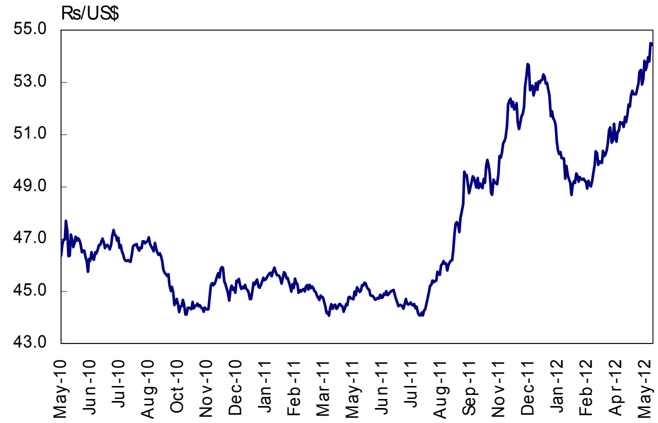
Source: RBI, Office of the Economic Advisor

Figure 48. The CAD is likely to remain sticky at 4% of GDP in FY13



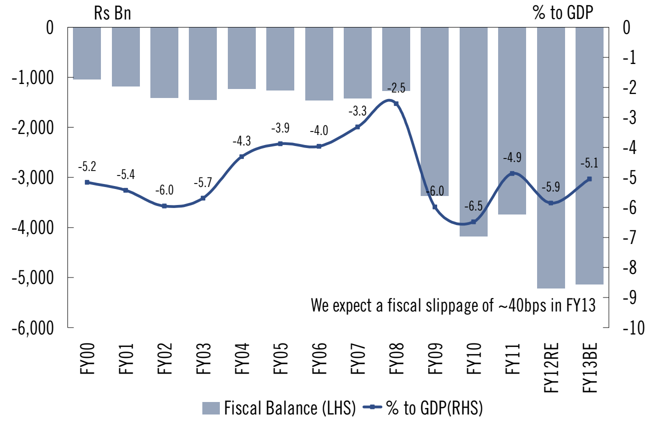
Source: RBI

Figure 49. …this and weak capital flows have weighed on the INR



Source: Office of the Economic Advisor

Figure 50. The government's deficit target of 5.1% is likely to be missed



Source: Ministry of Finance

Figure 51. This could have implications for ratings

	S&P	Moody's	Fitch
LT Foreign Currency	BBB-	Baa3	BBB-
LT Local Currency	BBB-	Baa3	BBB-
Outlook (FC)	Negative	Stable	Stable

Source: Rating Agencies

Figure 52. India Economic Indicators

	FY06	FY07	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F
Summary Data									
Nominal GDP, US$ bn	969.5	1103.3	1400.5	1403.8	1619.0	1683.7	1852.8	1872.4	2214.2
Nominal GDP, local currency bn	42,947	49,871	56,301	64,574	76,741	76,741	89,122	102,044	117,351
GDP per capita, US$	864	970	1,214	1,198	1,382	1,416	73,855	83,314	94,395
Population, mn	1,122.0	1,138.0	1,154.0	1,171.3	1,171.3	1,188.9	1,206.7	1,224.8	1,243.2
Unemployment, % of labour force	—	—	—	—	—	—	—	—	—
Economic Activity									
Real GDP, % yoy	9.5	9.6	9.3	6.7	8.4	8.4	6.9	7.0	7.5
Real investment growth % yoy	13.4	18.1	-5.2	15.6	11.1	5.8	5.8	5.9	6.8
Real consumption growth % yoy	7.9	9.3	7.6	8.1	8.1	6.0	6.0	6.3	6.7
private consumption growth % yoy	8.7	9.2	7.1	7.0	8.1	6.5	6.5	6.5	6.7
Real export growth, % yoy	25.8	20.0	5.9	14.4	-5.5	17.9	14.3	13.5	15.0
Real import growth, % yoy	32.5	21.3	10.2	22.7	-1.8	9.2	17.5	8.3	10.8
Prices, Money & Credit									
WPI, % yoy	6.8	7.7	1.5	10.2	9.0	6.9	6.9	7.4	6.5
WPI, % avg	6.5	4.8	8.0	3.6	8.6	8.8	9.0	7.0	6.5
Nominal wages, % yoy	—	—	—	—	—	—	—	—	—
Credit extension to private sector, % yoy	28.5	23.0	17.8	17.1	21.2	21.2	17.5	17.5	17.5
Policy interest rate, % eop	7.75	7.50	5.00	5.25	5.00	6.75	8.50	7.75	6.00
1 month inter-bank rate, % eop	9.43	8.00	5.68	4.49	7.25	6.50	6.50	6.50	6.50
Long term yield, % eop	7.50	7.90	7.60	7.00	7.83	7.99	8.54	8.25	8.25
lc/US$, eop	44.6	43.6	40.1	50.7	44.9	44.6	50.9	54.8	51.5
lc/US$, avg	44.3	45.2	40.2	46.0	47.4	45.6	48.1	54.5	53.0
Balance of Payments, US$ bn									
Current account	-9.6	-15.7	-27.9	-38.2	-38.4	-44.3	-74.3	-76.9	-75.6
% of GDP	-1.0	-1.4	-2.0	-2.7	-2.4	-2.6	-4.0	-4.1	-3.4
Trade balance	-59.3	-88.5	-125.0	-109.6	-191.1	-98.2	-181.8	-211.9	-212.0
Exports	126.4	162.9	185.3	178.8	178.7	254.4	300.0	351.0	414.2
Imports	185.7	251.4	310.3	288.3	369.7	352.6	481.8	562.9	626.2
Service balance	29.5	38.9	53.9	35.8	35.7	47.7	57.9	69.2	82.9
Income balance	-7.3	-5.1	-7.1	-8.0	-8.0	-14.9	-14.0	-10.0	-11.0
FDI, net	7.7	15.9	19.8	18.0	18.8	7.1	19.0	16.0	20.0
International reserves	191.9	299.1	241.6	252.8	252.8	273.7	267.0	258.7	257.7
Total Amortisations	14.34	5.94	8.34	8.99	13.24	14.35	15.59	15.59	16.0
Public Finances, % of GDP									
Consolidated government balance	-6.5	-5.4	-4.1	-8.4	-9.7	-8.3	-8.4	-8.0	-7.7
Consolidated gov primary balance	0.0	-1.1	3.4	4.7	2.7	2.2	2.2	2.0	1.0
Public debt	83.0	79.3	76.1	76.1	75.0	71.3	68.9	68.8	68.3
of which Domestic	77.4	74.1	71.4	71.5	70.1	66.6	65.9	65.8	65.2
Foreign Assets & Liabilities, US$ bn									
External debt	172.4	224.4	224.5	261.0	261.2	306.4	334.9	349.9	356.6
Private	123.0	166.3	168.6	193.9	194.1	228.3	279.9	292.9	297.6
Public	49.4	58.1	55.9	67.1	67.1	78.2	55.0	57.0	59.0
External debt / GDP	18.1	18.1	18.3	19.2	18.2	18.1	17.6	16.5	15.0
External debt / XGS	133.7	135.1	118.8	143.1	143.4	122.4	111.4	99.5	86.7
Short-term debt	28.1	45.7	43.3	52.3	52.3	65.0	71.5	81.5	80.0
Short-term debt/International Reserves (%)	14.1	14.8	17.2	18.9	21.4	23.7	23.7	27.1	26.5

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1F	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.9	6.1	5.6	6.5	7.0	7.0	7.0	7.0	7.0
WPI, % yoy	10.0	7.7	6.9	7.1	7.1	7.1	7.0	6.5	7.0
Policy interest rate, % eop	8.25	8.50	8.50	8.00	7.75	7.75	7.75	7.25	7.25
1 month inter-bank rate, % eop	8.96	8.50	6.50	8.50	8.50	8.50	8.50	8.50	8.50
Long term yield, % eop	8.43	8.57	8.54	8.25	8.25	8.25	8.25	8.25	8.25
lc vs USD, eop	48.9	53.3	51.2	54.4	54.2	54.5	54.8	54.5	53.5

Source: CEIC Data Company Ltd and CIRA 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).

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Indonesia

- **Summary view** — Stagnant exports have been followed by a slowdown in GDP growth to 6.3% 1Q12, from 6.5% in the previous quarter. Meanwhile with oil prices falling, prospects of a fuel price hike are drifting and the near-term inflation outlook is improving. However, BI does not have much room to turn dovish, in our view.
- **Things to watch** — The current account has deteriorated in 1Q12, at a pace stronger than the growth of FDI. Going forward, lower oil prices will help prevent further swelling of the oil trade deficit but lower non-oil commodity prices (e.g. coal) may put pressure exports, which may have a bigger impact.
- **Strategy** — BI has hinted they will scale down their bond purchases and allow long-term yields to rise. We expect the yield curve to bull steepen, with the 10-year yield heading towards 7.25% by 2Q12. We have also revised our 6-12M IDR forecast weaker to 9,400/$ due to our projection of a higher CA deficit.

Slowdown: spotted

GDP growth slowed in 1Q12 and may slow further in forthcoming quarters. Along with slowing exports, GDP growth has slowed to 6.3% YoY in 1Q12 from 6.5% in the previous quarter. The manufacturing sector was hit, with growth reverting below 7%. We expect the slowdown to continue in coming quarters amid intensifying signs of a global economic slowdown. We are closely monitoring the outlook for household consumption, as consumer confidence has come down and vehicle (esp. motorcycle) sales growth has also been slowing, even before the new regulations on minimum downpayments come into effect in June. However domestic consumption was still resilient in 1Q12, growing 4.9% YoY, and may remain relatively strong in the absence of any sudden spike in fuel prices.

Near-term inflation outlook have become more benign. Oil prices have been falling and if the average price of Indonesia crude stays below $116/bl in May and June, the $120.75/bl 6MMA threshold for raising domestic fuel prices is unlikely to be hit anytime soon. Without a fuel price hike, we think YE12 inflation would be close to 4.8%, from 4.5% as of April. This compares to our previous forecast of 6.9% under a 33% fuel price hike assumption. In spite of this, we are watching the risk of fuel supply scarcity towards year-end stemming from uncoordinated rationing of fuel. Some provincial governments have reportedly taken the initiative to ration subsidized fuel sales despite lack of preparation. Inflation expectations also remain elevated despite ticking down in the latest survey in April.

Government budget: another revision? Despite the pre-conditions to raise fuel prices this year unlikely to be met, we do not see the government budget deficit surpassing the 2.2% GDP target, as reallocations from other spending posts seem to be sufficient to cover the potential subsidy overrun. (We expect the budget deficit realization would be close to 1.8% of GDP). As long as the deficit can be maintained within the budget limit, the government need not put forth another budget revision to parliament. However we do not totally rule out this possibility. In our view, the Ministry of Finance could put forward a second budget revision probably in July or August for the sake of getting political support for the new budget posture and communicating to the financial markets that the budget deficit is still manageable. Multiple budget revisions within a year have been done before during the oil price runs in 2005.

Current account deteriorating faster than expected

Current account deficit nearly doubled from the previous quarter, growing faster than FDI. The deficit reached 1.3% of GDP on an annualized basis in 1Q, whereas in the previous quarter it was still in the region of 0.8%. The trade balance deteriorated markedly. The delay of fuel price hikes and rising oil prices pushed the oil trade deficit wider. Meanwhile the non-oil and gas trade surplus also shrank as non-oil commodity prices softened and import growth was relatively strong, although also slowing. The CA deficit deterioration outpaced the growth in FDI. In 4Q11, net FDI (inflow) was still higher than the CA deficit. But in 1Q12, the CA deficit exceeded net FDI which stood at around US$2.0bn. The same goes for the gross FDI figures (into Indonesia), for which the rate of increase between 4Q11 and 1Q12 was slower relative to the pace of current account deterioration.

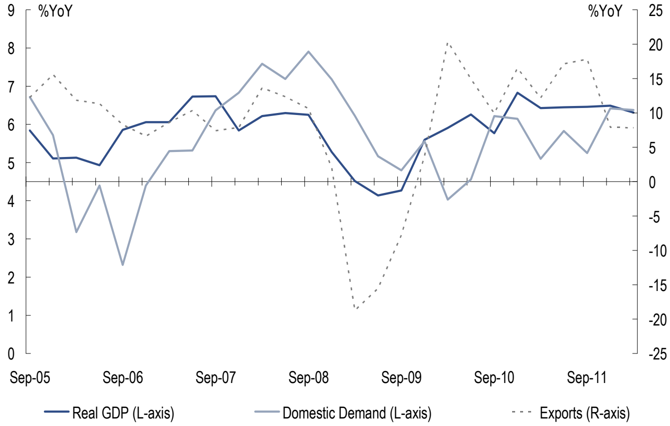
Which one is more important for the trade balance: oil price or coal price decline? Indeed the recent moderation of crude oil prices, if continued, will somewhat limit the swelling of the oil trade deficit. However the impact may not be as strong as had fuel prices been hiked, an event that is usually followed by a noticeable drop in fuel imports. Without a fuel price adjustment, it remains to be seen whether oil consumption and import volumes will ease significantly. And without changes in volumes, any improvement in the oil trade deficit will be to a large extent offset by the lower gas trade surplus (as gas prices are linked to oil prices). What should be monitored more closely, in our view, are coal prices. Indonesia’s coal trade surplus is much higher vs. the oil and gas trade balance combined, thus is more sensitive to movements in prices. Therefore to the extent that China’s slowdown impacts the prices of non-oil commodities such as coal, we think the near-term negative impact to Indonesia’s non-oil commodities trade balance could outweigh any improvement in the oil trade balance. Furthermore there maybe some drag from iron ore exports (3.5% of total exports in 2011) also, as the government has introduced a 20% tax mineral exports. We have revised our FY12 current account deficit forecast to 1.0% of GDP from previously 0.7%.

Policymakers cannot be too dovish

BI is now more cognizant of the need to attract portfolio inflows. Although the inflation outlook is tamer and GDP growth is slowing, BI cannot immediately turn dovish given the growing external imbalance. Following the deterioration of the current account, policymakers have become cognizant of the increased need for portfolio inflows to support the balance of payments. They have raised short-term money market rates beyond the O/N tenor and have also signaled willingness now to let medium- to long-term yields rise, which apparently means its bond-buying operations (which has been perceived to be supporting bond process) will be temporarily scaled-down.

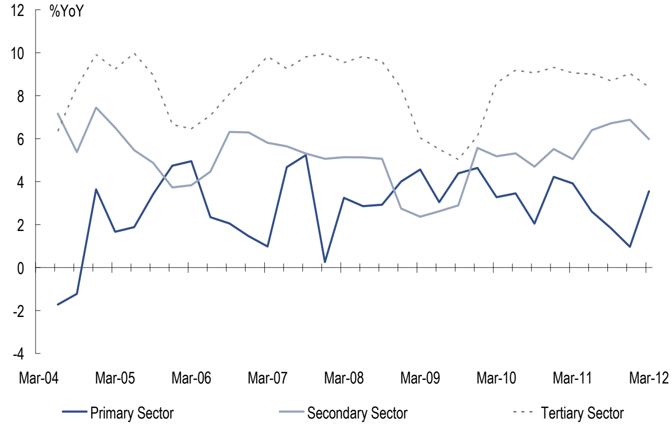
Market implications: With prospects of further CA deficit deterioration still visible and global uncertainties clouding the outlook on portfolio inflows, the exchange rate may see continued upward pressure (Citi YE12 IDR forecast 9,350/US$). And following BI’s change in bond-buying policy, we now see the 10-yr yield rising to 7.25% by 2Q12. Furthermore if the current account deficit continues to outgrow FDI thereby exerting further structural weakness on the IDR, we cannot rule out policymakers considering more meaningful tightening down the road, possibly by using a broader range of policy instruments including the O/N rate. Taking this into account, we have raised our 2013 YE FasBI rate forecast by 50bps to 4.25%.

Figure 53. GDP growth slowed in 1Q but domestic demand still strong



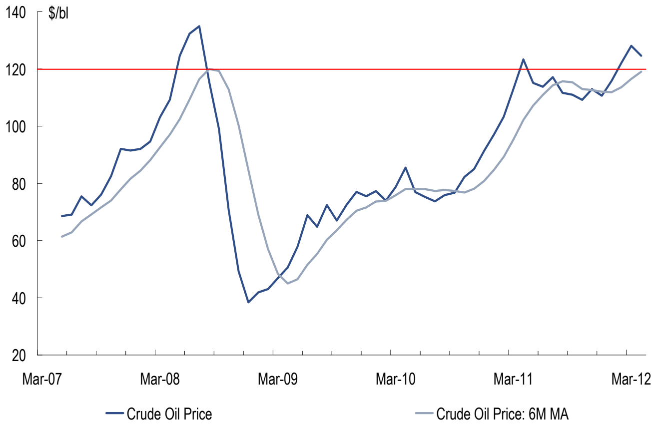
Source: CEIC, CIRA

Figure 54. Secondary sectors seeing cyclical headwinds



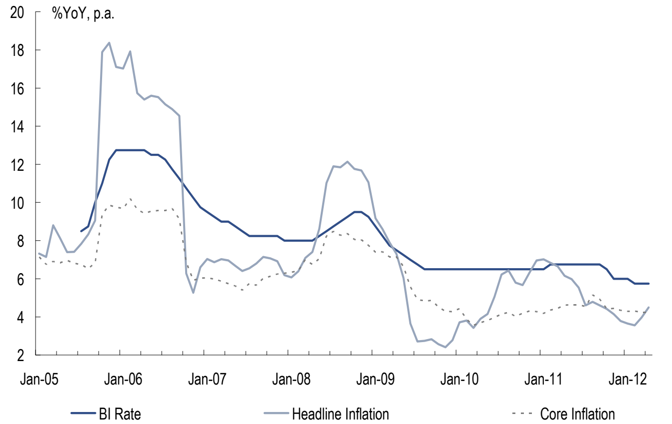
Source: CEIC, CIRA

Figure 55. The fuel price hike threshold may not be hit anytime soon



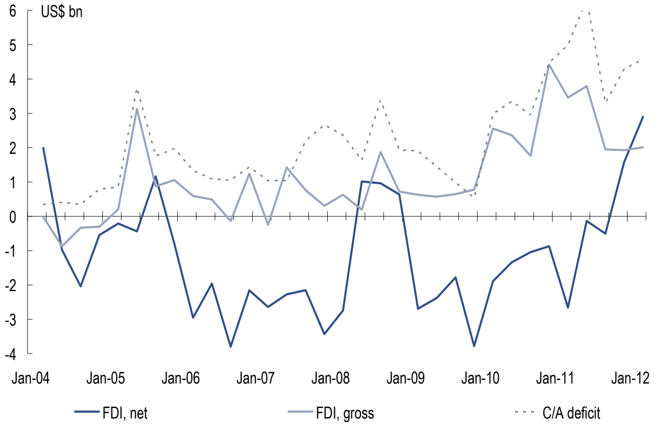
Source: CEIC, CIRA

Figure 56. YE12 CPI inflation may be at 4.8% without fuel hike



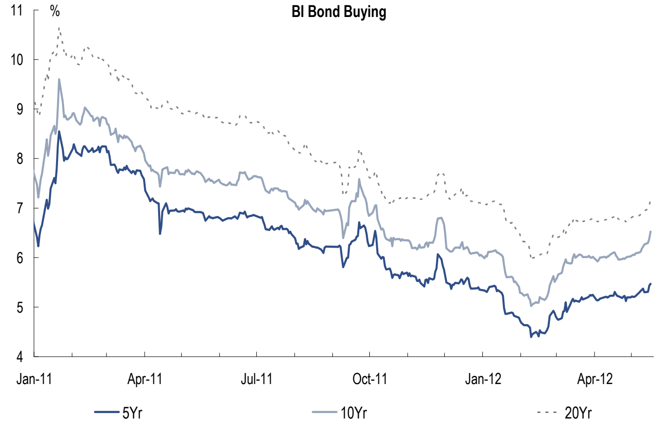
Source: CEIC, CIRA

Figure 57. Rapid current account deficit widening in 1Q12



Source: CEIC, CIRA

Figure 58. BI scaled back its bond buying, letting yields rise



Source: CEIC, CIRA

Figure 59. Indonesia Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	285.7	364.3	432.4	511.3	539.1	707.9	847.1	909.1	1044.6
Nominal GDP, local currency bn	2,774,281	3,339,217	3,950,893	4,948,688	5,606,203	6,436,271	7,427,086	8,440,276	9,800,527
GDP per capita, US$	1,299	1,635	1,916	2,237	2,330	2,979	3,521	3,733	4,306
Population, mn	219.9	222.7	225.6	228.5	231.4	237.6	240.6	243.5	246.6
Unemployment, % of labour force	11.2	10.3	9.1	8.4	7.9	7.1	6.6	6.1	5.9
Economic Activity									
Real GDP, % yoy	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.2	6.5
Real investment growth % yoy	12.4	1.3	1.9	12.4	2.4	11.1	10.6	11.6	11.3
Real consumption growth % yoy	4.3	3.9	4.9	5.9	6.2	4.1	4.5	5.6	5.5
private consumption growth % yoy	4.0	3.2	5.0	5.3	4.9	4.7	4.7	4.8	5.0
Real export growth, % yoy	16.6	9.4	8.5	9.5	-9.7	15.3	13.6	4.6	12.0
Real import growth, % yoy	17.8	8.6	9.1	10.0	-15.0	17.3	13.3	6.7	15.4
Prices, Money & Credit									
CPI, % yoy	17.1	6.6	6.1	11.1	2.8	7.0	3.8	4.8	4.6
CPI, % avg	10.5	13.1	6.7	9.8	4.8	5.1	5.4	4.4	4.7
Nominal wages, % yoy	0.2	15.0	8.2	7.5	6.5	8.3	9.2	10.0	9.0
Credit extension to private sector, % yoy	24.6	14.1	26.4	30.7	10.6	22.8	25.0	23.0	25.0
Policy interest rate, % eop	7.75	4.75	3.00	8.75	6.00	5.50	4.50	3.75	4.25
1 month inter-bank rate, % eop	12.75	9.75	8.00	10.83	6.46	6.35	4.95	3.75	4.30
Long term yield, % eop	13.62	10.18	10.02	11.89	10.06	7.61	6.03	7.00	7.00
lc/US$, eop	9830	9020	9419	10950	9404	9000	9068	9349	9369
lc/US$, avg	9711	9167	9136	9678	10399	9092	8768	9285	9382
Balance of Payments, US$ bn									
Current account	0.3	10.9	10.5	0.1	10.6	5.1	2.1	-9.5	-9.0
% of GDP	0.1	3.0	2.4	0.0	2.0	0.7	0.2	-1.0	-0.9
Trade balance	28.0	39.7	39.6	22.9	30.9	30.6	35.3	23.1	25.9
Exports	87.0	103.5	118.0	139.6	119.6	158.1	201.5	206.4	249.1
Imports	69.5	73.9	85.3	116.7	88.7	127.4	166.1	183.3	223.2
Service balance	-9.1	-9.9	-11.8	-13.0	-9.7	-9.5	-10.6	-11.5	-12.5
Income balance	-12.9	-13.8	-15.5	-15.2	-15.1	-20.3	-25.8	-25.8	-27.0
FDI, net	5.3	2.2	2.3	3.4	2.6	9.8	10.4	11.5	13.0
International reserves	34.7	42.6	56.9	51.6	66.1	96.2	110.1	119.3	128.6
Total Amortisations	22.7	35.4	31.5	40.2	36.7	37.60	38.1	40.3	41.0
Public Finances, % of GDP									
Consolidated government balance	-0.5	-0.9	-1.3	-0.1	-1.6	-0.6	-1.2	-1.8	-0.7
Consolidated gov primary balance	1.8	1.5	0.8	1.7	0.1	1.1	0.1	0.1	0.1
Public debt	47.3	39.0	35.2	33.0	28.0	26.0	25.5	25.0	24.0
of which Domestic	23.1	18.9	17.4	16.4	15.3	14.0	13.5	13.0	12.0
Foreign Assets & Liabilities, US$ bn									
External debt	134.5	132.6	141.2	155.1	172.9	202.4	224.8	260.0	290.0
Private	54.3	56.8	60.6	68.5	73.6	83.8	106.1	126.5	151.5
Public	80.2	75.8	80.6	86.6	99.3	118.6	118.6	133.5	138.5
External debt / GDP	47.1	36.4	32.7	30.2	31.8	28.6	26.5	28.5	27.5
External debt / XGS	138.2	117.3	110.9	101.7	132.7	116.1	100.8	108.9	105.7
Short-term debt	11.0	12.2	12.8	14.6	18.1	25.1	28.7	27.5	27.5
Short-term debt/International Reserves (%)	31.7	28.7	22.4	28.2	27.5	26.1	26.1	23.0	21.4

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.5	6.5	6.3	6.2	6.1	6.0	6.3	6.5	6.7
CPI, % yoy	4.6	3.8	4.0	4.7	4.2	4.8	4.5	5.1	6.0
Policy interest rate, % eop	5.25	4.50	3.75	3.75	3.75	3.75	4.00	4.25	4.25
1 month inter-bank rate, % eop	5.71	4.95	3.98	4.00	4.00	4.00	4.25	4.50	4.50
Long term yield, % eop	6.92	6.03	5.93	7.25	7.10	7.00	7.00	7.00	7.00
lc vs USD, eop	8950	9069	9146	9327	9316	9349	9382	9394	9382

Source: CEIC Data Company Limited and CIRA 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).

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Malaysia

- **Summary view** — GDP growth decelerated to 4.7%YoY in 1Q12. We continue to see a high hurdle for monetary easing in 2012, barring the re-emergence of emergency conditions. Elections are not likely to be delayed beyond early July, after the Felda Global IPO and before Ramadan.

- **Things to watch** — (1) News flow on election timing, (2) Export performance, especially E&E, and spillovers on employment, (3) Implementation of fiscal spending and ETP projects.

- **Strategy** — Heavy foreign positioning keeps risk of a sell-off in MGS and BNM bills high, which could hit the MYR relatively harder in a risk-off environment, and reverse the recent fall in MGS yields.

1Q growth bottom to hinge increasingly on fiscal lift

1Q GDP growth decelerated to 4.7%YoY, 5.5%QoQ SAAR in 1Q12 (4Q: 5.2%YoY, 5.9%QoQ SAAR), as resilience in consumption and fiscal lift to fixed investments offset the continued drag from net exports. We note that the strength of consumption came despite a slowdown in credit sensitive segments of consumption in response to macro-prudential measures targeted at low-income borrowers. Household loan growth has slowed since Dec from 12.9%YoY to 11.9% as of Mar, led by moderating personal loans growth to (Mar: 15.5%YoY, Dec: 20.1%).

Expected growth recovery from 2Q will have to depend less on exports, given external headwinds. While the Composite Leading Index continues to point towards a growth re-acceleration in 2Q, intensifying external headwinds from China, Europe and US, which together constitute about 32% of exports, suggest at best only a patchy recovery in exports from 2Q. Already exports to Europe, and China contributed negatively to growth in 1Q12,, with China seeing a double-digit plunge in imports from Malaysia in Apr. China (13% of exports) remains Malaysia's single largest export market, although only 36.3% of China's imports from Malaysia are for its own domestic demand, of which more than half (20%) is for investment demand. Meanwhile the EU is the fourth-largest export market (10.4% of exports), with about half in cyclically sensitive Machinery and Transport Equipment, including electronics

We do not see significant spillovers from European bank deleveraging from Grexit contagion. While claims by European banks on Malaysia are relatively large as a % of GDP within a regional context, about three quarters of European bank claims are by less vulnerable UK bank. Studies by BNM indicate that out of US$54.3bn of foreign claims of European banks on Malaysia, US$34bn were MYR-denominated (close to two thirds) claims by largely locally incorporated European banks, which cannot easily withdraw from Malaysia.

Growth recovery will hinge increasingly on fiscal lift to domestic demand. As such, our baseline assumption of a GDP growth acceleration from 2Q and full year growth of 5% will hinge more heavily first on pre-election fiscal boost to consumer incomes in 2Q and early 3Q, which could add up to 1.2%-pts to GDP growth this year, and subsequently on ETP related investment spending. On this note, 1Q fiscal data suggests that fiscal firepower is being deployed aggressively. After registering a surplus in Sep, the fiscal position turned into a deficit in Mar that was an 11.3% increase over the deficit in Mar 2011, due to a 19.5%YoY surge in spending ytd despite revenues ytd rising 20.5%YoY.

High hurdle for monetary easing

Inflation to moderate further, though lingering pipeline inflation risks remain. Apr CPI inflation eased to 1.9%YoY, led by lower food prices, though core (ex food and transport) remained stable at 1.8%YoY. While CPI inflation is likely to stay low at near 1.7-2% in the next 3-4 months, few sources of pipeline inflation pressures could build from 2H12: [1] fiscal lift to domestic demand and boost to consumption from the minimum wage have the potential to add to core inflation pressures, and [2] pipeline pressures from commodity prices. CPI inflation could tick up from 2H12, ending the year at 2.7% (assuming a 10sen/litre hike in RON95 prices in Dec).

Notwithstanding a more dovish MPC statement in May, the hurdle for monetary easing is high. The high hurdle for rate cuts will likely stem from BNM's concern over re-igniting household leverage, barring the re-emergence of emergency conditions. These concerns are evident in recent statements from Gov Zeti that BNM wants only "those who have the capacity to take on debt to be able to do so" (in response to pressure to loosen lending guidelines for the auto sector) and that interest rates are "supportive of growth". We also understand that officials see macro-prudential measures to limit household debt as effective only when interest rates are normalized.

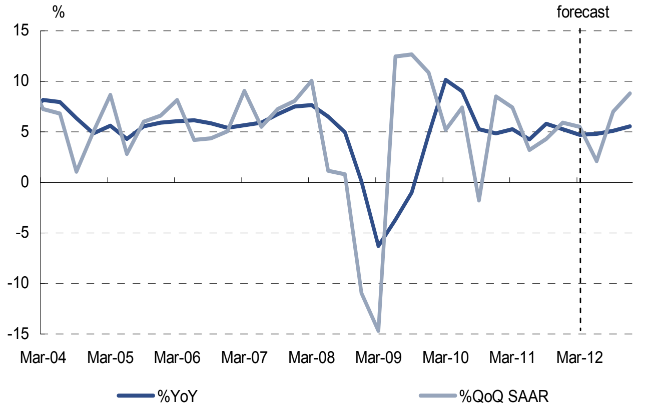
Minimum wage could catalyze a shift towards income-driven consumption. The minimum wage was set at RM900 a month for Peninsular Malaysia and RM800 for Sabah, Sarawak, and the Federal Territory of Labuan for all sectors except the domestic service sector (for example, maids and gardeners). Assuming that the 3.2mn workers earning under RM700/m each see a RM200/m increase in wages, the annual increase in incomes will be around RM7.7bn or 0.9% of GDP (1.9% of PCE), which given the higher marginal propensity to consume of lower-income groups, should facilitate the shift in consumption drivers away from credit, towards incomes. If fully implemented, we estimate sectors accounting for 13-15% of GDP could be affected via profit margins compression, though implementation hurdles may reduce the impact. 18% of the CPI basket may face upward pressure, largely in labor-intensive components such as prepared food. .

Elections still likely sooner rather than later

Elections not likely to be postponed too long despite Bersih 3.0. The minimum wage could deflect some political fallout from the Bersih 3.0 rally. Notwithstanding the negative coverage on the excessive use of force by the police, the government has argued that Bersih was hijacked by the Opposition to provoke the police into overreacting, culminating in recent charges against Anwar under the new Peaceful Assembly Act. Bersih 3.0 may have only solidified the positions of both BN and Opposition supporters, but the impact on fence sitters is likely inconclusive.

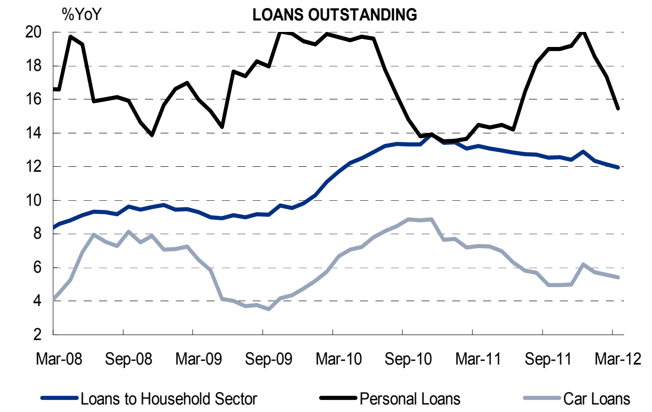
The earliest window for elections could be early July, shortly after the Felda Global IPO on June 28th, which will benefit more than 112,000 rural Felda settlers who will each receive a RM15K windfall in handouts. The next window could be in late Sep/Oct, after the fasting month. Postponing the elections beyond the Budget calendar in Sep/Oct may not necessarily result in a better outcome for PM Najib, as fiscal bullets in the current fiscal year have already been expended, and the pressing need for fiscal consolidation may limit the generosity of the 2013 Budget. Being able to maintain the status quo or regain the two thirds majority would pave the way for critical fiscal reforms on subsidies and GST implementation, though we have reservations about more fundamental changes to affirmative action policies.

Figure 60. 1Q GDP moderated to 4.7%YoY. 5.5%QoQ SAAR



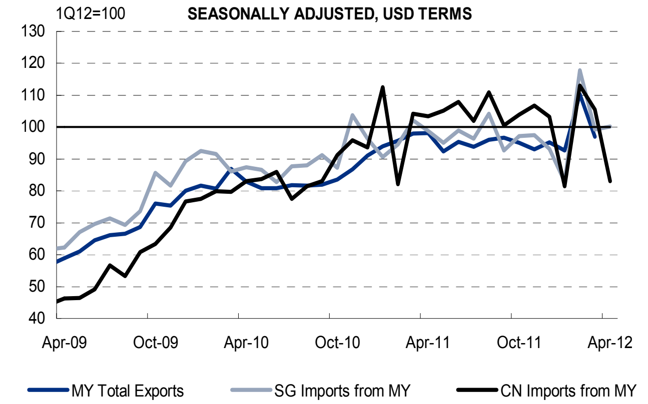
Source: CEIC, CIRA Estimates

Figure 61. Household loans have slowed, led by personal loans



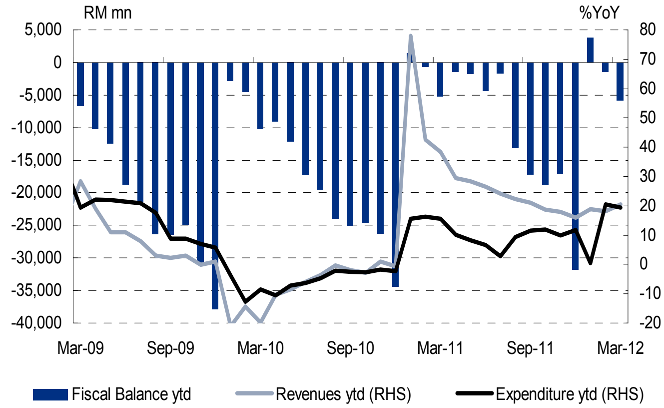
Source: CEIC, CIRA

Figure 62. China's imports from Malaysia plunged in Apr



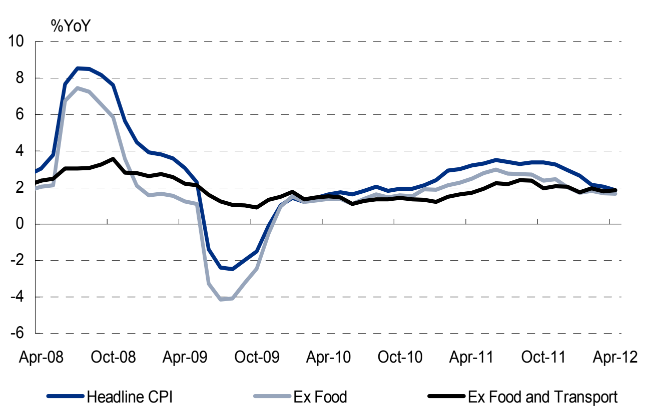
Source: CEIC, CIRA Estimates

Figure 63. 1Q fiscal data suggests some risk of slippage



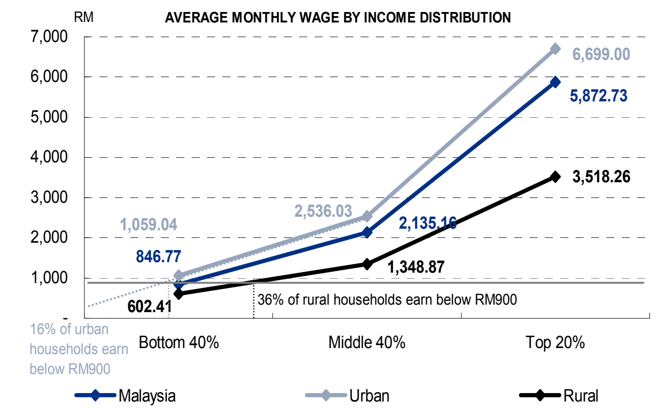
Source: CEIC, CIRA

Figure 64. CPI inflation continued to moderate to 1.9%YoY



Source: CEIC, CIRA Estimates

Figure 65. Minimum wage could affect the poorest 22% of households



Source: EPU, CIRA Estimates

Figure 66. Malaysia Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	138.0	156.6	186.8	222.7	192.9	237.8	278.7	295.6	331.7
Nominal GDP, local currency bn	522	574	642	742	680	766	853	916	995
GDP per capita, US$	5,210	5,837	6,870	8,088	6,916	8,417	9,479	9,852	10,841
Population, mn	26.5	26.8	27.2	27.5	27.9	28.3	29.4	30.0	30.6
Unemployment, % of labour force	3.5	3.3	3.2	3.3	3.7	3.3	3.2	3.0	3.2
Economic Activity									
Real GDP, % yoy	5.3	5.8	6.5	4.8	-1.6	7.2	5.1	5.0	5.3
Real investment growth % yoy	-2.5	11.3	8.4	-2.9	-21.0	-20.0	2.4	9.9	8.1
Real consumption growth % yoy	8.5	6.4	9.7	9.0	1.3	6.2	12.2	9.2	8.1
private consumption growth % yoy	9.1	6.8	10.5	8.7	0.7	6.5	6.9	6.2	5.0
Real export growth, % yoy	8.3	6.6	4.1	1.7	-10.5	9.9	3.7	4.2	4.2
Real import growth, % yoy	8.9	8.1	5.9	2.1	-12.2	15.1	5.4	6.5	4.6
Prices, Money & Credit									
CPI, % yoy	3.2	3.1	2.3	4.5	1.0	2.1	3.0	2.9	3.3
CPI, % avg	3.1	3.6	2.0	5.4	0.6	1.7	3.2	2.3	3.1
Nominal wages, % yoy	3.3	0.9	5.8	7.1	0.6	4.0	5.0	3.0	5.0
Credit extension to private sector, % yoy	9.1	6.8	9.2	10.2	7.0	9.0	10.0	10.0	11.0
Policy interest rate, % eop	3.00	3.50	3.50	3.25	2.00	2.75	3.00	3.00	3.00
1 month inter-bank rate, % eop	3.13	3.62	3.57	3.33	2.11	2.81	3.07	3.20	3.20
Long term yield, % eop	3.73	3.70	3.78	3.00	3.79	3.34	3.23	3.10	3.60
lc/US$, eop	3.78	3.55	3.33	3.55	3.41	3.08	3.18	3.08	2.97
lc/US$, avg	3.79	3.67	3.44	3.33	3.52	3.22	3.06	3.10	3.00
Balance of Payments, US$ bn									
Current account	20.7	26.3	29.8	38.8	31.8	28.2	32.0	31.1	29.8
% of GDP	15.0	16.8	16.0	17.4	16.5	11.8	11.5	10.5	9.0
Trade balance	27.3	30.3	29.8	43.1	33.5	48.7	39.4	49.4	49.6
Exports	141.6	160.8	176.1	199.7	157.3	198.7	227.2	249.4	274.4
Imports	114.3	130.5	146.3	156.5	123.8	150.0	187.8	200.0	224.8
Service balance	-2.5	-2.1	0.8	0.1	1.4	0.3	-2.0	-2.0	-1.5
Income balance	-6.3	-4.9	-4.2	-6.8	-4.3	-8.2	-6.0	-8.0	-9.0
FDI, net	1.0	0.1	-2.7	-7.8	-3.0	1.5	3.0	5.0	7.0
International reserves	70.2	82.5	101.3	91.5	96.7	104.9	135.0	153.0	150.0
Total Amortisations	6.73	6.48	5.56	3.98	10.32	7.82	8.59	9.3	10.0
Public Finances, % of GDP									
Consolidated government balance	-3.6	-3.3	-3.2	-4.8	-7.0	-5.6	-5.0	-5.0	-4.7
Consolidated gov primary balance	-1.4	-1.2	-1.2	-3.1	-5.4	-3.5	-3.2	-3.0	-2.5
Public debt	43.8	42.2	41.7	41.5	53.7	54.6	55.0	55.0	53.0
of which Domestic	38.0	37.8	38.6	38.7	51.7	51.9	52.5	53.0	51.0
Foreign Assets & Liabilities, US$ bn									
External debt	52.3	52.2	56.7	68.2	68.3	72.5	77.0	74.0	80.0
Private	44.4	45.2	50.8	62.3	64.3	67.0	73.0	70.0	76.0
Public	7.9	7.1	5.9	5.9	4.0	5.5	4.0	4.0	4.0
External debt / GDP	37.9	33.4	30.4	30.6	35.4	30.5	27.6	25.0	24.1
External debt / XGS	32.3	28.6	27.5	29.2	37.1	31.2	29.0	25.4	24.9
Short-term debt	12.4	12.1	31.0	29.9	34.7	44.4	62.7	60.0	65.0
Short-term debt/International Reserves (%)	17.7	14.7	30.6	32.7	35.9	42.3	46.4	39.2	43.3

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1F	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.8	5.2	4.4	4.8	5.1	5.5	4.6	4.6	5.0
CPI, % yoy	3.4	3.0	3.0	2.3	2.3	2.3	2.4	2.6	2.7
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
1 month inter-bank rate, % eop	3.10	3.07	3.07	3.07	3.07	3.07	3.07	3.07	3.07
Long term yield, % eop	3.41	3.23	3.28	3.25	3.20	3.10	3.20	3.40	3.50
lc vs USD, eop	3.09	3.16	3.04	3.14	3.12	3.08	3.03	3.00	2.99

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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).

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Pakistan

- **Summary view** — Persistent energy shortages, an uncertain political environment and global challenges will likely keep growth subdued. We expect FY12 and FY13 GDP to come in at 2.8% and 3.1%, respectively.
- **Things to Watch** — On the political front, apart from Pakistan's continually evolving relations with the US, key to watch are upcoming parliamentary elections. The Budget, due in early June, is also key to track. The external sector remains under pressure.
- **Strategy** — The PKR will likely remain under pressure given the dismal outlook for capital flows. We expect policy rates to stay on hold until 2H12, post which rising inflationary risks raise the possibility of monetary tightening.

Growth remains lackluster, politics key to track

Political issues remain at the forefront. On the domestic front, the fracas surrounding the conviction of PM Gilani for refusing to write to Swiss authorities to reopen corruption charges against President Zardari took a fresh turn. The PM was found guilty of contempt by the Supreme Court, but was not sentenced to imprisonment (he faced a 'symbolic' detention for a few minutes). The ruling is positive for the ruling PPP, since Gilani does not need to step down from his post. At this juncture, it appears that the PPP could complete its full term until parliamentary elections are held, possibly in 4Q12. On the global front, US-Pakistan tensions continued at the recent NATO Summit in Chicago. Although Pakistan has agreed in-principle to re-open supply routes to Afghanistan, talks are stuck due to differences over how much the U.S. will pay Pakistan to allow trucks to transit its territory.

Growth trends remain subdued. We retain our GDP forecasts at 2.8% and 3.1% for FY12 and FY13, respectively. Persistent constraints on the energy front, coupled with an uncertain political environment and global challenges, should likely result in growth remaining modest.

External sector likely to remain under pressure

Trends in the external account paint a bleak picture. Slowing export growth coupled with rising imports resulted in the trade deficit widening to US$12.6bn during Jul-April FY12, vs. US$8.5bn during the same period last year. This, coupled with dismal trends in service sector trade, resulted in the current account deficit rising sharply to US$3.4bn vs. US$466mn last year. On the capital account, lackluster FDI and portfolio outflows coupled with IMF loan repayments were key drags. This resulted in an overall deficit to the tune of US$2.5bn vs. a surplus of US$1.2bn during the same period last year.

Reserves drop to US$16.1bn. Continued BoP pressures have resulted in FX reserves moderating from US$17bn at end-Dec11 to US$16.1bn currently. IMF loan repayments scheduled for the end of this month would further deplete reserves. A quick recap — repayments to the tune of US$9bn are to be repaid by FY16

Drawdown to continue in FY12-13. Looking ahead, we maintain our view of the full year trade deficit widening to US$15.8bn in FY12 and US$20bn in FY13. This coupled with a likely moderation in remittances could result in the current account trending towards 2.8% of GDP in FY12 (~US$6bn) and 3.6% in FY13 (~US$9bn). Two positives could be (1) Lower oil prices, which would provide some comfort on the import bill and (2) If Coalition Support Funds from the US and 3G license auction fees are realized, this would reduce the deficit by ~0.5%.On the capital account, IMF loan repayments coupled with lower FDI and portfolio flows, as well as uncertainty surrounding aid flows and loans linked to the IMF deal, suggest a further risk of drawdown to reserves; which we forecast to fall by ~US$4bn by end-FY12 and by a further US$5bn in FY13 (from US$16.1bn currently)

Double-digit inflation could complicate policy decisions

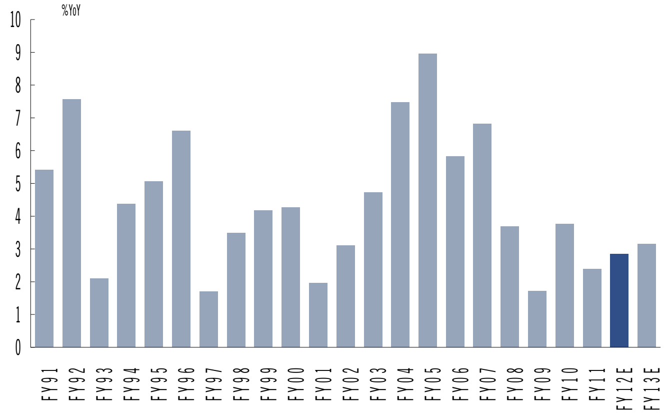
Inflation risks remain, thus complicating policy decisions. Inflation as measured by the CPI edged higher to 11.3%YoY in April from 10.8% the previous month. This was on the back of higher food prices (+10.7% in April from 9.8% last month). Looking ahead, trends are likely to remain in the double-digit range given structurally high food prices, coupled with the severe energy shortage, growing liquidity pressures, and a consistent rise in borrowing requirements. We expect the CPI to average 11% in FY12 and FY13. Mounting price pressures coupled with a difficult growth environment will likely complicate policy decisions. We re-iterate that monetary policy will likely be a tough balancing act given fragile growth trends and rising inflation, but expect rates to be on hold until 2H12.

Fiscal strains persist, FY13 Budget unlikely to bring significant relief

FY12 budget deficit likely to exceed targets, Despite healthy tax revenue collections, higher expenditures (particularly on subsidies) would likely result in government missing its FY12 deficit target of 4.7% of GDP (originally revised from 4%), with the deficit likely to come in at ~6.5% of GDP. Deficit financing remains a challenge given that Coalition Support Funds from the US hang in balance. This coupled with a poor appetite for privatization would likely put the onus on bank borrowing.

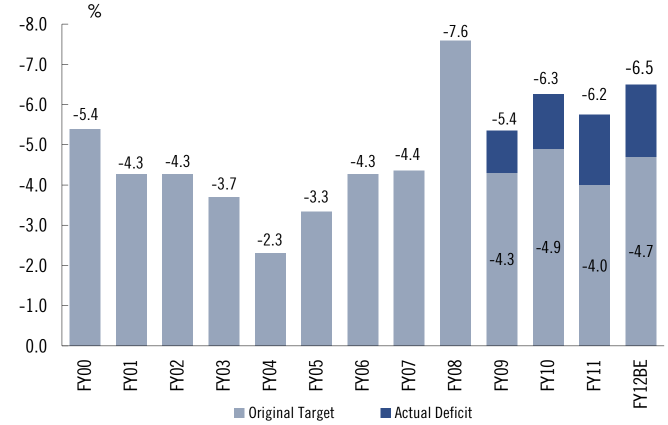
Key to watch is the FY13 Budget, which is due to be announced on June 1st. While the Budget should ideally present a strong plan for fiscal consolidation, this is unlikely. While we could see steps to rationalize the tax structure and reduce tax evasion, measures to cut subsidies are not likely to be drastic. Indeed, upcoming elections could result in more populist steps that would result in continued fiscal strain. A key positive would be measures to enhance capacity in the power sector and implement GST (which has been on the backburner for some time).

Figure 67. FY12 and FY13 growth in would remain lackluster at ~3%



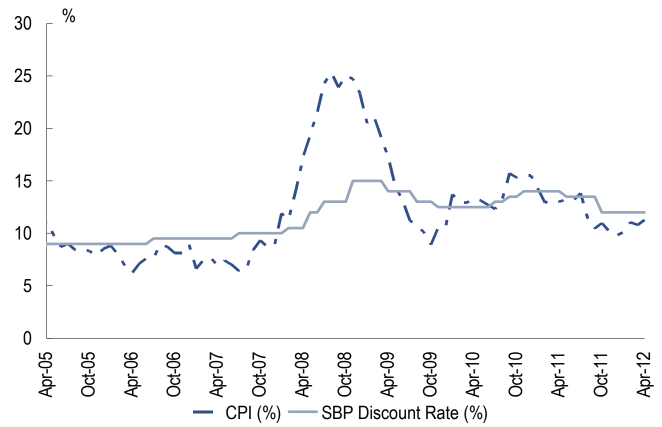
Source: Bureau of Statistics, CIRA

Figure 68. Fiscal slippages priced in for FY12, Budget FY13 to watch



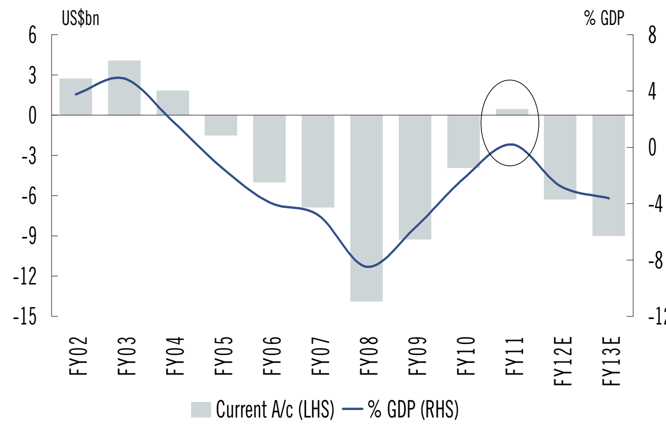
Source: Ministry of Finance, CIRA

Figure 69. Rates still on hold although price pressures could spur hikes



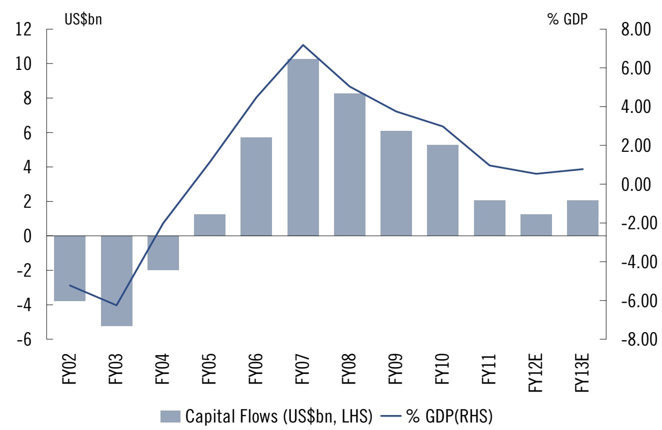
Source: SBP

Figure 70. A rising trade deficit would weigh on the current account



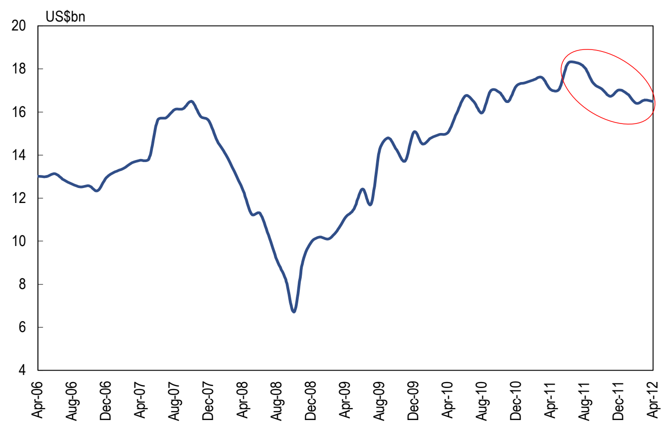
Source: SBP, CIRA

Figure 71. Capital flows remain under strain



Source: SBP, CIRA

Figure 72. Forex Reserves are coming off



Source: SBP

Figure 73. Pakistan Economic Indicators

	FY06	FY07	FY08	FY09	FY10F	FY11	FY12F	FY13F	FY14F
Summary Data									
Nominal GDP, US$ bn	127.4	143.1	163.8	162.1	177.0	211.3	227.9	248.9	291.2
Nominal GDP, local currency bn	7,623	8,673	10,243	12,724	14,837	18,063	20,424	23,276	26,786
GDP per capita, US$	812	896	1,009	990	1,065	1,252	1,331	1,432	1,650
Population, mn	157	160	162	164	166	169	171	174	176
Unemployment, % of labour force	7.7	7.7	6.2	5.2	5.5	5.6	5.2	5.0	5.0
Economic Activity									
Real GDP, % yoy	5.8	6.8	3.7	1.7	3.8	2.4	2.8	3.1	4.2
Real investment growth % yoy	18.4	12.9	6.8	-13.3	-5.1	-0.1	0.7	3.0	3.7
Real consumption growth % yoy	5.6	2.8	2.3	5.0	3.9	7.0	3.4	5.2	5.3
private consumption growth % yoy	1.0	4.7	-2.7	12.2	4.0	7.0	3.0	5.0	5.0
Real export growth, % yoy	9.9	2.3	-5.3	-3.3	15.8	-14.2	33.1	13.0	1.5
Real import growth, % yoy	18.7	-3.5	3.5	-15.1	4.4	6.1	32.7	24.0	1.9
Prices, Money & Credit									
CPI, % yoy	7.7	7.0	21.5	13.3	11.8	13.3	9.5	12.0	10.0
CPI, % avg	7.9	7.8	12.0	22.1	10.1	13.7	10.5	11.0	11.0
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	34.4	17.2	16.0	-0.4	3.7	6.1	5.0	5.0	9.0
Policy interest rate, % eop	9.00	9.50	12.00	14.00	12.50	14.00	12.00	12.50	13.00
1 week inter-bank rate, % eop	7.01	8.87	12.22	12.99	12.00	13.10	12.00	11.00	11.00
Long term yield, % eop	8.50	8.90	11.50	12.40	12.20	13.20	12.00	11.00	11.00
lc/US$, eop	60.2	60.6	67.3	81.0	85.3	86.0	92.5	93.0	91.0
lc/US$, avg	59.9	60.6	62.6	78.5	83.8	85.5	89.6	93.5	92.0
Balance of Payments, US$ bn									
Current account	-5.0	-6.9	-13.9	-9.3	-3.9	0.4	-6.3	-9.0	-10.9
% of GDP	-3.9	-4.8	-8.5	-5.7	-2.2	0.2	-2.8	-3.6	-3.8
Trade balance	-8.4	-9.7	-15.0	-12.6	-11.5	-10.3	-15.9	-20.0	-21.3
Exports	16.6	17.3	20.4	19.1	19.7	25.4	24.9	26.4	30.7
Imports	25.0	27.0	35.4	31.7	31.2	35.7	40.8	46.4	52.0
Service balance	-4.4	-4.2	-6.5	-3.4	-1.7	-2.1	-2.0	-1.5	-1.8
Income balance	-2.7	-3.6	-3.9	-4.4	-3.3	-3.0	-3.0	-3.0	-4.8
FDI, net	3.5	5.0	5.3	3.7	2.1	1.5	0.8	1.0	1.0
International reserves	13.1	15.6	11.3	12.4	16.8	18.2	14.2	9.2	6.0
Total Amortisations	1.0	1.2	1.0	1.1	2.5	1.8	2.0	2.0	2.0
Public Finances, % of GDP									
Consolidated government balance	-4.3	-4.4	-7.6	-5.4	-6.3	-5.7	-6.5	-6.2	-5.5
Consolidated gov primary balance	0.0	-0.9	0.1	-2.5	-0.3	-1.9	-1.6	-2.2	-1.8
Public debt	58.6	56.5	60.7	61.6	62.2	60.9	66.1	67.0	67.2
of which Domestic	30.7	30.1	32.0	30.3	31.4	33.3	35.0	35.7	36.0
Foreign Assets & Liabilities, US$ bn									
External debt	37.2	40.3	46.2	52.3	57.4	61.8	62.0	65.0	64.0
Private	1.0	1.3	1.9	9.8	13.3	6.8	2.5	2.5	2.5
Public	36.2	39.0	44.3	42.6	44.1	55.0	59.5	62.5	61.5
External debt / GDP	29.2	28.2	28.2	32.3	32.4	29.3	27.2	26.1	22.0
External debt / XGS	225	233	226	274	292	243	249	246	209
Short-term debt	0.2	0.1	0.7	0.7	1.0	1.0	1.3	1.7	2.0
Short-term debt/International Reserves (%)	1.3	0.2	6.3	5.2	6.0	5.2	10.0	16.1	22.5

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	—	—	—	—	—	—	—	—	—
CPI, % yoy	10.5	9.7	10.0	9.7	10.0	10.5	11.0	11.0	11.0
Policy interest rate, % eop	13.50	12.00	12.00	12.00	12.00	12.00	12.50	12.50	12.50
1 week inter-bank rate, % eop	13.10	11.63	11.52	11.00	11.00	11.00	11.00	11.00	11.00
Long term yield, % eop	13.20	11.70	11.90	11.90	11.50	11.50	11.50	11.50	11.50
lc vs USD, eop	87.5	89.9	90.6	92.5	93.5	94.0	93.5	93.0	93.5

Source: State Bank of Pakistan, Ministry of Finance, IMF and CIRA 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).

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- **Summary view** — 1Q GDP may post an annualized rate of 9%-10% (up from 3.5% in 4Q11). Domestic demand through consumption and public infrastructure led the way while export recovery eased the trade drag. Risk remains that the 1Q backdrop may stall in a 'Grexit' risk-off environment and slower China prospects.

- **Things to watch** — Electronic export performance in 2Q12. China-Philippine standoff in the Scarborough shoal and its final outcome. Senator-Judges votes on the Chief Justice's impeachment trial to end in May. Whether inflation ticks up in 2Q12 or remains benign. Treasury's decision on how to fund PSALM's requirements.

- **Strategy** — Near-term peso weakness seen due to Grexit environment and China's uncertain prospects but range of 43.50-43.80 would bode well for short USD position. Tapping offshore funding sources via GPN issuance coupled with benign inflation upticks would be conducive to curve flattening pressures in the long end.

Will an upbeat 1Q momentum stall in a 'Grexit' risk-off environment?

Domestic private spending alongside export recovery would result in 1Q GDP growth of at least 4%yoy (or an annualized rate of 9%-10%QoQ SA) up from 3.5% in 4Q11. Domestic demand (ex-inv) will continue to lead the way, with non-durables consumption spending gains in the range of 4.5%yoy-5%yoy. However, durable goods consumption would be a drag as car sales continue to post low-double-digit declines compared to a year-ago. Better purchasing power can be sourced from: 1) Sustained remittance gains (over 5%yoy in 1Q12) amidst disinflation implies modest gains in purchasing power of remittance flows. 2) Lift from livestock (3.2%yoy) and poultry (7.1%yoy) production, although overall farm output grew by a modest 1.1%yoy as rice (-1.1%yoy) and corn (-5.4%yoy) output reported declines. 3) Non-farm sector's recovery led by mfg output up by 4.7%yoy avg following 8.2%yoy in Mar as export-related industries improved on external demand to re-stock. 4) Double-digit growth in primary expenditures, mainly from nearly 50%yoy growth in capital outlays for Jan-Apr and from over 40%yoy growth in maintenance and operating expenditures for the same period. With exports likely registering mild single-digit growth in 1Q12 but still lagging imports, the drag from net imports during the quarter probably eased, allowing more domestic demand gains to drive GDP. Strong electricity kwh sales during the quarter and easing inflation expectations according to BSP's 1Q12 survey bode well for consumer spending and favorable 1Q12 corporate earnings report vouch for GDP growth exceeding 4%yoy.

While upbeat 1Q12 has been accounted for, there's risk the prevailing momentum may not persist in a severe case of risk-off environment underpinned by the 'Grexit' scenario, as well as China's growth uncertainty. Financial markets losing ground would likely drive a weaker peso back to 43, if not more, and elevate inflation expectations. External event risk with potential to abruptly elevate expectations might compel conservative consumption choices. An artificial demand pullback in the near-term may set off an inventory de-stocking response, as well as delays in investment plans. We anticipate the fiscal spending bias to persist in this environment, coupled with an overnight policy rate stance unchanged at a record low of 4%. The accommodative fiscal and monetary bias likely to persist in a 'Grexit' event risk would cushion any downside risk to private spending and export demand. However risk remains that prospects probing 5%yoy by 4Q12 would be difficult to envision in a global setting involving heightened risk aversion, while still missing the upside growth contribution from PPP projects.

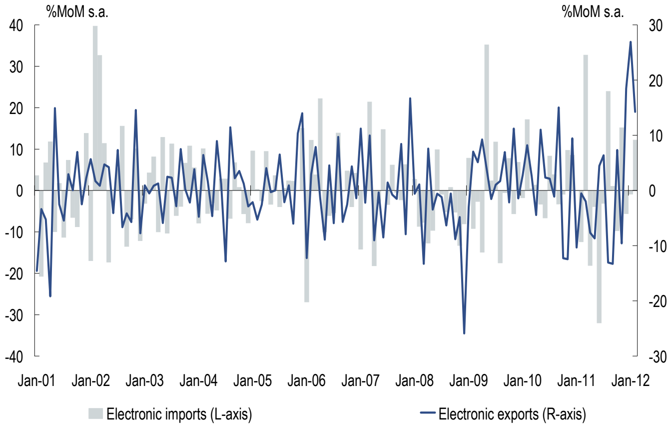
Political events that may have economic repercussions. We refer to the 1) China-Philippine stand-off in the Scarborough shoal and 2) the impeachment trial of Chief Justice (CJ) Renato Corona. A conflict in the contested areas (Spratly islands, Scarborough shoal and Recto bank) would be a disaster to the Philippine navy since it doesn't possess the military hardware for protracted warfare unlike China. Risk of a conflict isn't all political or military since China is among the country's largest trading partners. Earlier there were reports that Philippine bananas and pineapples are now subject to tighter non-tariff standards in China. While we don't expect a collapse is trade with China even with a conflict, the last thing we need is hindered access to China's rich onshore markets at a time when slowdown risk pervades global trading activity. Fiscal bias to spend may shield the local economy and market sentiment from any fallout arising from Corona's impeachment trial. Hopefully the system of checks and balances, i.e. independent judiciary and working relationship between the judiciary and executive branches, key ingredients to sustaining a favorable investment setting, won't be undermined by the outcome of the impeachment trial. This trial appears to be a watershed event resulting from Aquino's strong anti-corruption bias.

Record high budget surplus in Apr. Fiscal tightening is still upon us, with a recorded budget surplus of Php31bn in Apr, the highest surplus recorded ever, up 18.2%yoy from the year-ago surplus of Php28.3bn. While seasonal income tax payments in Apr helped, the fact that the budget surplus was the largest ever strongly suggests the favorable impact of spending during the month was either matched or offset by revenue gains. Total revenues rose 10.8%yoy (cash: 10.6%yoy) while expenditures lagged with growth of 9.1%yoy (cash: 8.7%yoy). The fiscal deficit for Jan-Apr narrowed to Php2.9bn against a 1H12 fiscal deficit target of Php109.3bn. However, the primary fiscal surplus stood at Php9.3bn in Apr, down from Php37.7bn a year-ago, underscoring a more muted fiscal tightening stance. The budget surplus — the highest on record — bode wells for enticing better demand in the long end of the peso bond curve once risk off-sentiment eases or strong USD/Asia stabilizes. The fiscal surplus can be treated as liquidity tightening as well, although it's not as strong or as efficient as the monetary tools. Inflation bottomed out in Mar, with upticks recorded in Apr but the uptrend likely won't be strong enough to prompt a rate hike. A rate neutral stance may persist that won't affect market sentiment. The fiscal surplus however won't deter the government from borrowing on behalf of PSALM, with requirements that may range from Php70bn-Php80bn, likely on the lower end since PSALM's power rate hike petition was granted last month. With risk-off sentiment prevailing as the peso tumbles alongside much of Asian regional currencies and unresolved PSALM borrowings, the budget surplus would still serve as a cushion for bond market sentiment.

Market implications

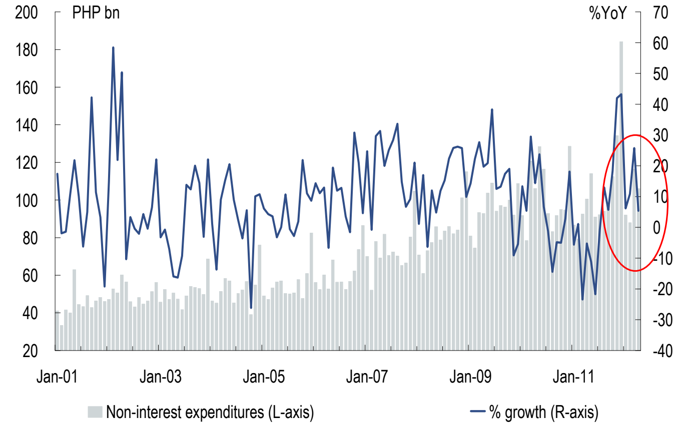
With a change in cash of Php128.5bn in 1Q12 after funding a budget deficit of Php33bn and regular amortization, having a budgetary surplus of Php31bn in Apr serves to reinforce our view that Treasury may have 'overborrowed' in 1Q12. While it's right to expect the government to ease borrowings in 2Q12, the volatile market environment and PSALM's unresolved funding needs may compel Treasury to maintain a 'neutral' stance on the risk of rising local bond yields. Competition from private corporates intending to issue in the bond market would be another factor. Market confidence would be strengthened if Treasury were to tap offshore markets via a global peso note (GPN) to partially replace its local borrowings. Other than establishing benchmark GPN, Treasury can use some of the GPN proceeds to on-lend to PSALM. Otherwise special peso bonds can be issued on behalf of PSALM and evade additional debt supply risk of regular peso bonds.

Figure 74. Electronic exports posted strong monthly gains in Jan-Feb



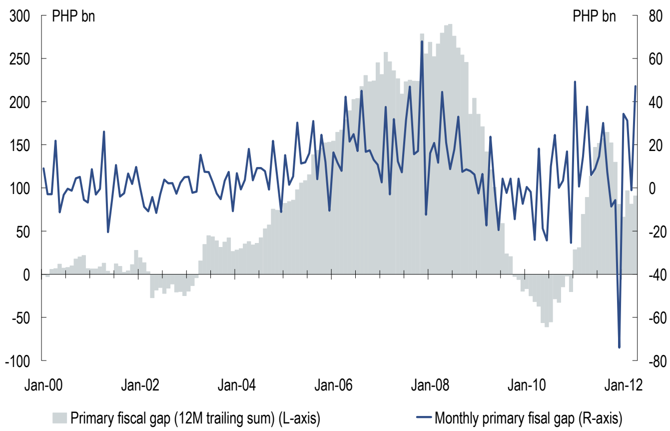
Source: CEIC Data Company Ltd., and CIRA

Figure 75. Primary expenditures for Jan-Apr up 12.1%yoy



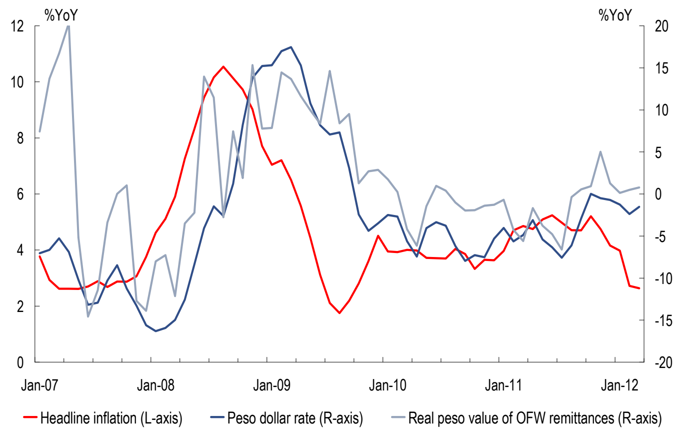
Source: CEIC Data Company Ltd., and CIRA

Figure 76. Fiscal tightening after the primary surplus of Php47bn in Apr



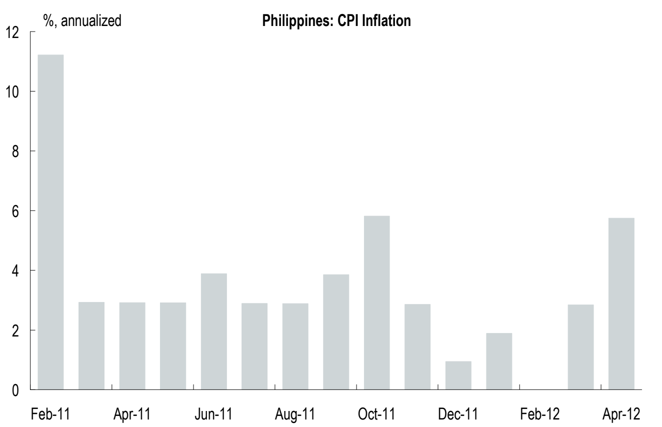
Source: CEIC Data Company Ltd., and CIRA

Figure 77. Real peso value of the remittances up 0.5%yoy in 1Q12



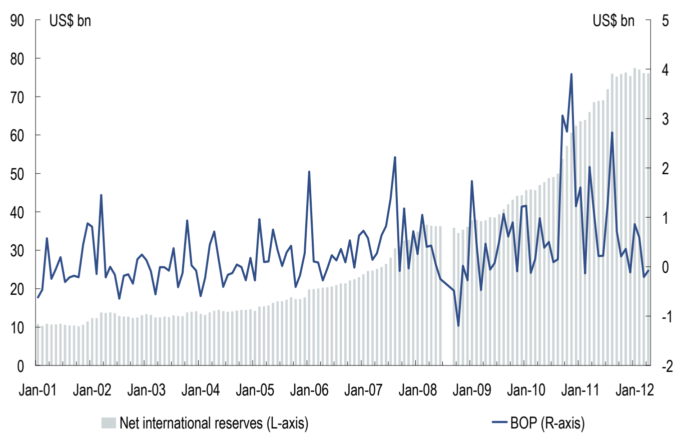
Source: CEIC Data Company Ltd., and CIRA

Figure 78. Annualized inflation rate edged up to 5.7% in Apr



Source: CEIC Data Company Ltd., and CIRA

Figure 79. GIR steady with modest BOP deficits in Mar-Apr



Source: CEIC Data Company Ltd., and CIRA

Figure 80. Philippines Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	103.3	122.3	150.1	173.0	168.3	199.2	224.7	247.3	278.6
Nominal GDP, local currency bn	5,678	6,271	6,893	7,721	8,026	9,003	9,735	10,594	11,674
GDP per capita, US$	1,161	1,352	1,631	1,912	1,823	2,118	2,343	2,468	2,727
Population, mn	84.6	86.3	88.6	90.4	92.2	94.3	95.9	97.8	99.8
Unemployment, % of labour force	8.8	8.0	7.3	7.4	7.5	7.3	7.0	7.0	6.8
Economic Activity									
Real GDP, % yoy	4.8	5.2	6.6	4.2	1.1	7.6	3.7	4.6	5.0
Real investment growth % yoy	3.0	-15.1	-0.5	23.4	-8.7	31.6	11.1	5.4	6.1
Real consumption growth % yoy	4.2	4.9	4.9	3.3	3.3	3.4	5.2	5.5	5.2
private consumption growth % yoy	4.4	4.2	4.6	3.7	2.3	3.4	6.1	5.6	5.5
Real export growth, % yoy	5.0	12.6	6.7	-2.7	-7.8	21.0	-3.8	5.7	4.8
Real import growth, % yoy	3.3	3.5	1.7	1.6	-8.1	22.5	1.9	6.9	5.9
Prices, Money & Credit									
CPI, % yoy	6.7	4.4	3.8	7.7	4.5	3.6	4.2	4.2	4.6
CPI, % avg	7.7	6.3	3.0	8.2	4.2	3.8	4.8	3.5	4.0
Nominal wages, % yoy	9.5	8.7	3.8	6.2	0.0	5.0	6.0	5.0	6.5
Credit extension to private sector, % yoy	-2.2	7.4	4.8	17.5	10.0	10.0	12.1	9.0	11.3
Policy interest rate, % eop	7.50	7.50	5.25	5.50	4.00	4.00	4.50	4.00	4.50
1 month Philippine Reference rate, % eop	7.74	6.40	6.00	5.20	4.11	0.75	1.68	2.50	4.00
Long term yield, % eop	9.57	5.25	5.50	6.53	6.25	4.78	4.21	5.00	5.50
lc/US$, eop	53.1	49.1	41.4	47.5	46.2	43.8	43.9	42.5	41.7
lc/US$, avg	55.0	51.3	45.9	44.6	47.7	45.2	43.3	42.8	41.9
Balance of Payments, US$ bn									
Current account	2.0	5.3	7.1	3.6	9.4	8.9	7.1	7.7	6.8
% of GDP	1.9	4.4	4.7	2.1	5.6	4.5	3.1	3.1	2.4
Trade balance	-7.8	-6.7	-8.4	-12.9	-8.8	-11.0	-15.5	-15.7	-17.7
Exports	40.3	46.5	49.5	48.3	37.6	50.7	47.2	52.0	55.7
Imports	48.0	53.3	57.9	61.1	46.5	61.7	62.7	67.7	73.5
Service balance	-1.3	0.1	2.3	1.2	2.1	2.7	3.6	3.7	3.8
Income balance	-0.3	-1.3	-0.9	0.1	-0.2	0.5	1.3	1.2	1.2
FDI, net	1.7	2.8	-0.6	1.3	1.6	1.2	1.0	1.5	2.0
International reserves (ex-gold)	15.8	19.9	30.1	33.1	38.6	55.1	66.7	72.5	82.1
Total Amortisations	4.91	4.84	4.13	4.14	4.32	7.8	8.0	8.5	8.0
Public Finances, % of GDP									
Consolidated government balance	-2.6	-1.0	-0.2	-0.9	-3.7	-3.5	-2.0	-2.8	-2.0
Consolidated gov primary balance	2.7	3.9	2.6	-0.2	-0.3	-0.2	0.8	0.0	0.6
Public debt	71.4	63.9	55.9	54.7	54.8	52.4	50.0	49.1	48.5
of which Domestic	39.8	35.7	33.1	31.3	30.8	30.2	29.0	30.0	31.0
Foreign Assets & Liabilities, US$ bn									
External debt	54.4	53.9	55.5	54.3	54.9	60.0	63.5	64.8	66.0
Private	17.7	16.5	17.5	13.7	11.6	13.0	14.6	14.2	14.5
Public	36.7	37.4	38.0	40.6	43.2	47.0	48.9	50.6	51.5
External debt / GDP	52.7	44.1	37.0	31.4	32.6	30.1	28.3	26.2	23.7
External debt / XGS	121.5	101.8	93.6	93.7	112.8	93.9	106.7	99.0	94.0
Short-term debt	6.4	5.0	7.1	7.0	4.0	6.1	7.5	9.3	11.5
Short-term debt/International Reserves (%)	40.5	25.2	23.6	21.2	10.4	11.1	11.3	12.8	14.0

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1F	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.6	3.7	4.3	4.6	4.8	4.7	4.9	5.1	4.8
CPI, % yoy	4.8	4.2	2.6	3.0	3.3	3.5	4.0	4.4	4.6
Policy interest rate, % eop	4.50	4.50	4.00	4.00	4.00	4.00	4.25	4.50	4.50
1 month Philippine Reference rate, % eop	2.37	1.68	3.13	3.40	3.45	3.50	4.00	4.25	4.00
Long term yield, % eop	5.08	4.21	4.48	5.00	4.85	5.00	5.25	5.50	5.50
lc vs USD, eop	43.0	43.6	42.9	43.1	42.8	42.5	42.2	41.9	41.8

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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).

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- **Summary view** — Positive growth momentum likely continued into early 2Q, though potential drags to growth in 2H12 remain. Inflation remains a pressing policy concern and the hurdle for easing is high; monetary tightening in Oct is possible if growth surprises positively, alongside non-monetary measures

- **Things to watch** — (1) Leading indicators of manufacturing momentum, (2) Labor market developments, especially on immigration policy, (3) Further property measures for private and HDB markets.

- **Strategy** — Conditional upon further weakening in EUR, we revise up our 3M and 12M and USD-SGD forecast to 1.27 and 1.23, respectively. We would watch for risks of USD interbank funding stresses spilling over the SIBOR in the event of Grexit. Already SOR fixings have started to creep up, reflecting a stronger USD.

Positive growth momentum carried into 2Q12

Final estimates for 1Q GDP was hardly changed from the Advance Estimate at 10% QoQ SAAR, 1.6% YoY. While both Manufacturing and Construction saw upward revisions from the Advance Estimates, Services was however revised *down*, dragged lower by financial services and wholesale and retail trade. On the whole however, all three sectors contributed positively to QoQ SAAR growth momentum. By expenditure, while the increased contribution from final external demand was well flagged, there was also a larger contribution from final domestic demand, largely due to private fixed investments, led by construction (including residential) and transport equipment. Overall, the V-shaped 1Q12 sequential rebound more than erased the cumulative 1% peak-to-trough *slow slide* in GDP levels between 1Q12 and 4Q11, and effectively translated into a widening of the positive output gap.

Data suggests positive growth momentum likely continued into early 2Q. [1] The Composite Leading Indicator (which leads QoQ SAAR GDP growth by one quarter) rose 2.9%QOQ in 1Q (4Q: 1.2%), pointing to a positive QoQ SAAR reading for ex-biomed GDP in 1Q. [2] EDB's survey of business expectations suggests output in the volatile biomedicals sector could see QoQ expansion in 2Q12, allaying concerns that biomed could be a drag on GDP growth. [3] 8.3% YoY and 13.1% MoM SA surge in Apr NODX appears to have bucked the regional trend of weak Apr exports. [4] New private home sales (ex ECs) in April were the strongest in nearly three years, with 2,487 units sold, up 13% from the monthly average of 2200 in 1Q12, and the highest monthly level since 2,772 units were sold in July 2009.

Nonetheless potential drags to growth in 2H12 remain. These may stem from [1] continued drag on exports to Europe, China and truncated re-stocking in tech; [2] Impact on sentiment-sensitive sectors in the domestic economy, such as property sales, stock market volumes, retail sales and tourist arrivals; and [3] financial spillovers in the event of a contagion from “Grexit”, via tightening of non-SGD funding. Our 2012 3.6% GDP growth forecast already incorporates a significant slowing of growth momentum in 2H12 from these factors, but we see two-way risks to these forecasts depending on the evolution of risk factors.

Inflation and property prices still policy concerns

Inflation remains a pressing policy concern. CPI inflation unexpectedly rose to 5.4%YoY in Apr from 5.2%, reflecting perhaps the lagged impact of the unexpected widening of the output gap. In the near term, the persistently elevated above 5% headline CPI prints may potentially have the effect of raising inflation expectations again. Perhaps recognizing the importance of reducing headline inflation to anchor inflation expectations, we would not be surprised to see more aggressive non-monetary measures from the government on the supply side, including slowing the reduction in COE quotas and ramping up of housing supply.

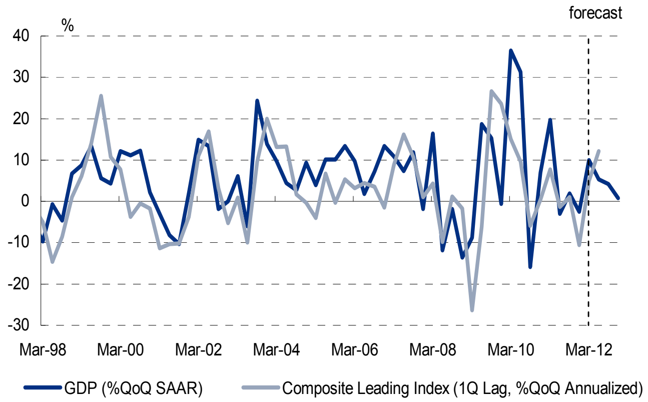
Our 2012 inflation forecast of 4.4% anticipates a moderation in headline CPI to around 3.9% in 2H12, from over 5% in 2Q. Base effects as well as increased supply of COEs and housing should combine to eventually moderate private road transport and housing inflation in 2H12. However core will likely remain elevated as [1] wage pressures from the structurally tight labor market, as well higher rentals, could be passed through into CPI inflation and [2] other pipeline business cost pressures have already brought about a re-acceleration in unit business.

We think the hurdle for easing would be high with inflation in the coming months still likely to be at the upper end of MAS's (higher) implicit inflation tolerance thresholds (likely 2-3%). The risk of policy easing would probably increase in the event of a sharp slowdown — or even negative — quarterly GDP growth momentum, which would result in a sharper narrowing of the output gap that imputes a disinflationary impulse on core inflation. If risk factors do not materialize, however, policymakers may be biased towards further tightening in Oct if growth surprises positively and the positive output gap widens further.

With respect to property policy, policymakers seem to weighing between the disinflationary impact of rising supply in the medium term, and the stimulatory impact from low interest rates and smaller home sizes in the near term**.** With property sales volumes remaining strong in April and May and concern over the proliferation of shoe-box units, the risk of further tightening measures on the demand side remains. Imposing cash down-payments (currently 10%, with the other 10% comprising CPF down-payments) is likely to hit the mass market harder. Alternatively, it is not inconceivable that restrictions be placed on the size of units, which should limit affordability and dampen mass-market demand. Nonetheless, we sense policymakers remain cognizant of the risk of over-tightening in the near term, given the sizeable pipeline incoming supply in the medium term. This may temper the aggressiveness of tightening measures on the demand side.

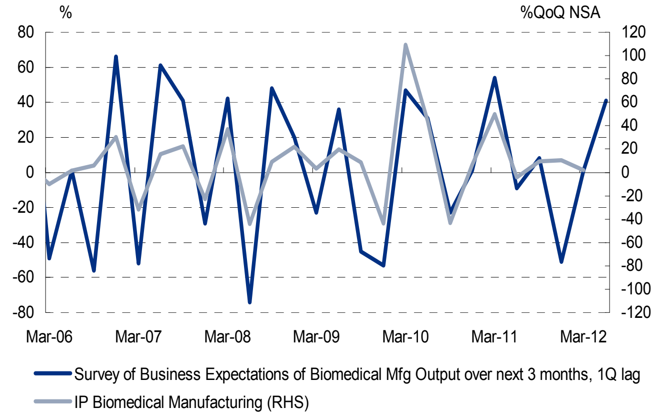
SGD NEER has more than reversed all of its gains since the MAS tightening on Apr 13th, falling slightly below the mid-points of the band. Conditional upon a further expected weakening in EUR to 1.23 and 1.25 on a 3M and 12M horizon, respectively, we revise up our 3M and 12M and USD-SGD forecast to 1.27 (prev: 1.25), and 1.23 (prev: 1.21), respectively. While our previous forecasts had not explicitly factored in further MAS tightening in Oct, weaker economic data may reduce marginally expectations of another tightening and dampen the pace of SGD appreciation. While the Apr slope steepening has started to place some downward pressure on SIBOR, we would be vigilant about the risks of USD interbank funding stresses spilling over the SIBOR in the next few months. Already SOR fixings have started to creep up in recent weeks, reflecting the stronger USD outlook.

Figure 81. Composite Leading Indicator rose 2.9%QoQ



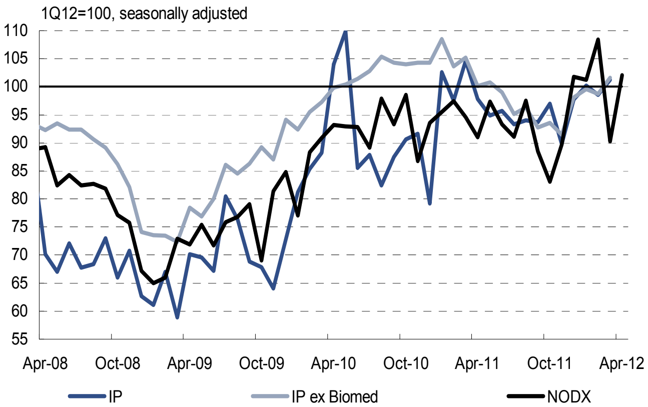
Source: CEIC, CIRA Estimates

Figure 82. Biomed output could see QoQ expansion in 2Q



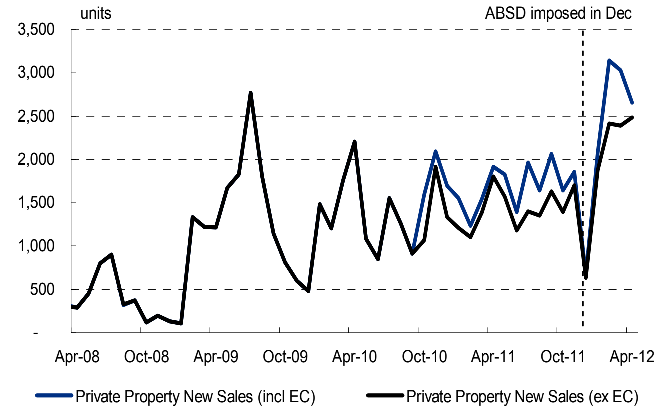
Source: CEIC, CIRA

Figure 83. NODX surged in Apr, bucking regional trends



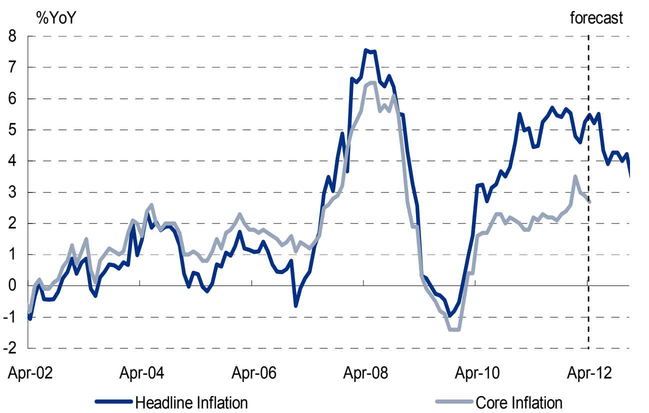
Source: CEIC, CIRA

Figure 84. New private home sales remain strong



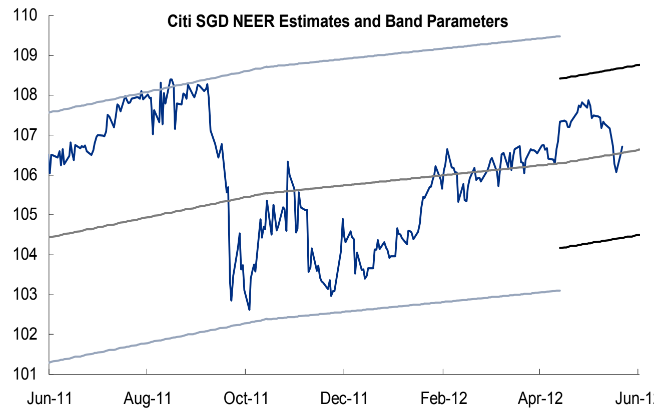
Source: URA, CIRA

Figure 85. Inflation remains a pressing policy concern



Source: CEIC, CIRA Estimates

Figure 86. SGD NEER has reversed its gains since 13-Apr



Source: Reuters, CIRA Estimates

Figure 87. Singapore Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	131.5	153.2	188.8	189.4	183.4	222.7	265.9	286.6	320.5
Nominal GDP, local currency mn	208,764	230,923	267,254	267,952	266,659	303,652	334,433	361,359	391,280
GDP per capita, US$	28,350	31,622	36,384	37,597	37,598	43,867	51,289	54,524	59,952
Population, mn	4.3	4.4	4.6	4.8	5.0	5.1	5.2	5.3	5.3
Unemployment, % of labour force	3.1	2.7	2.1	2.2	3.0	2.2	2.0	2.3	2.0
Economic Activity									
Real GDP, % yoy	6.4	8.8	8.9	1.7	-1.0	14.5	4.9	3.6	5.0
Real investment growth % yoy	-0.4	17.5	16.4	27.4	-20.1	5.8	9.7	12.0	8.7
Real consumption growth % yoy	3.9	5.0	5.9	3.9	0.9	7.4	3.4	2.3	4.4
private consumption growth % yoy	3.6	5.0	6.8	3.3	0.1	6.5	4.1	3.8	4.8
Real export growth, % yoy	12.4	10.9	9.0	4.7	-7.8	19.1	2.6	3.8	5.9
Real import growth, % yoy	11.3	11.3	8.1	9.5	-11.1	16.2	2.4	5.2	6.6
Prices, Money & Credit									
CPI, % yoy	1.3	0.8	3.7	5.5	-0.5	4.6	5.5	6.1	3.3
CPI, % avg	0.5	1.0	2.1	6.6	0.6	2.8	5.2	4.4	3.3
Nominal wages, % yoy	3.5	3.2	6.2	5.4	-2.6	4.0	6.0	4.0	6.0
Credit extension to private sector, % yoy	2.0	4.9	16.9	15.2	2.0	6.0	16.5	8.0	10.0
Policy interest rate, % eop	—	—	—	—	—	—	—	—	—
1 month inter-bank rate, % eop	3.25	3.44	2.00	0.81	0.44	0.27	0.31	0.35	0.50
Long term yield, % eop	3.21	3.05	2.68	2.05	2.66	2.71	1.63	1.88	2.12
lc/US$, eop	1.53	1.45	1.44	1.44	1.41	1.31	1.30	1.25	1.21
lc/US$, avg	1.59	1.51	1.42	1.41	1.45	1.36	1.26	1.26	1.22
Balance of Payments, US$ bn									
Current account	26.7	35.0	47.3	36.2	33.8	49.5	58.4	43.0	41.7
% of GDP	20.3	22.9	25.1	19.1	18.5	22.2	21.9	15.0	13.0
Trade balance	29.6	33.1	36.3	18.3	23.9	40.8	41.5	1.3	10.3
Exports	229.7	271.7	299.1	336.9	269.0	351.4	406.1	445.5	481.1
Imports	200.1	238.6	262.8	318.7	245.0	310.6	364.6	444.2	470.9
Service balance	-0.9	-0.6	7.5	11.0	5.6	7.0	12.0	8.0	12.0
Income balance	-7.4	-5.3	-4.1	1.4	0.7	-4.0	-8.5	-9.0	-9.0
FDI, net	4.2	10.5	4.3	8.8	-3.2	25.0	30.0	10.0	15.0
International reserves	115.7	135.8	162.5	173.6	186.0	230.0	238.0	330.0	200.0
Total Amortisations	—	—	—	—	—	—	—	—	—
Public Finances, % of GDP									
Consolidated government balance	6.4	9.1	11.1	9.0	-1.6	0.5	1.5	1.0	1.0
Consolidated gov primary balance	6.5	9.2	11.1	9.0	-1.6	0.5	1.5	2.0	1.0
Public debt	99.4	99.4	93.0	99.2	106.0	107.0	110.0	115.0	118.0
of which Domestic	99.4	99.4	93.0	99.2	106.0	107.0	110.0	115.0	118.0
Foreign Assets & Liabilities, US$ bn									
External debt	—	—	—	—	—	—	—	—	—
Private	—	—	—	—	—	—	—	—	—
Public	—	—	—	—	—	—	—	—	—
External debt / GDP	—	—	—	—	—	—	—	—	—
External debt / XGS	—	—	—	—	—	—	—	—	—
Short-term debt	—	—	—	—	—	—	—	—	—
Short-term debt/International Reserves (%)	—	—	—	—	—	—	—	—	—

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.0	3.6	1.6	2.9	4.1	5.8	5.9	5.0	5.5
CPI, % yoy	5.5	5.5	5.2	5.2	4.0	3.9	3.4	3.2	3.4
Policy interest rate, % eop	—	—	—	—	—	—	—	—	—
1 month inter-bank rate, % eop	0.24	0.24	0.24	0.20	0.20	0.15	0.15	0.15	0.15
Long term yield, % eop	1.62	1.63	1.66	1.70	1.80	1.88	1.95	2.00	2.12
lc vs USD, eop	1.25	1.30	1.26	1.27	1.26	1.25	1.24	1.23	1.22

Source: CEIC Data Company Limited, IFS, Moody's and CIRA estimates
*Note: Public debt is general government debt.

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- **Summary view** — We lower our 2Q12 economic growth forecast by 0.2%p to 3.0%YoY in light of already released Apr figures pointing to slowing external/domestic demand, and developments in Euro area. With regained focus on economic growth, the BoK will likely hold policy rates at the next MPC meeting.

- **Things to watch** — Recent stumble in Kospi market with revisited risk aversion may depress consumer/business sentiment and job growth. Meanwhile, inflationary pressures seem to be building up from the weak KRW and deferred public tariff hikes.

- **Strategy** — Risk aversion due to Greece exit and uncertainties on global growth are expected to put downward pressure on KRW and heighten volatility of USDKRW. However, as excessive weakening of KRW could add inflationary pressure, FX authority's market intervention could become more active.

We revise down 2012 GDP forecast to 3.4% from 3.7%

Production would further flag amidst external downside risks. Mar industrial production (IP) contracted by 3.1% from Feb, sustaining a year-on-year growth of merely 0.3%. Although sequential correction was anticipated following a rebound to 14.3%YoY, which was mainly due to the timing of Lunar New Year, IP growth slowed faster than expected, particularly on the drag from machinery & equipment, and semiconductors & parts. In tandem with slowing production, the manufacturing sector registered an average operation ratio lower than Feb's by 2.9%p and further shed jobs by 6K MoM and 80K YoY. On a quarterly basis, IP growth notched down to 3.7%YoY in 1Q12 from 5.0% in 4Q11, and declining export growth suggests the downtrend will continue in the following quarter. Apr exports fell 4.8%YoY, led by falling exports of major goods, e.g. wireless communication devices, shipbuilding, semiconductors, and household appliances. We expect exports, to Euro area and China in particular, to remain sluggish, given dissipating external demand with increased odds of Greece exit and China's expected growth dip in 2Q12.

Consumption likely to remain lackluster. Mar service activities and retail sales both decreased from Feb, reflecting waning domestic demand. Service activities growth slowed fast to 1.4%YoY from 5.6% in Feb, led down by financial & insurance and transportation services. Retail sales growth also decelerated to 0.0%YoY from 5.4% a month ago, with sluggish sales of semi-durables and non-durables. Despite sharp moderation in Mar, service activities and retail sales in 1Q12 continued to expand, by 2.4%YoY and 1.9% respectively, held up by relatively stronger growth in Jan-Feb. However, Apr retail sales figures point to slower consumption growth in 2Q12 on YoY terms, with sales at major discount chains and department stores down by 2.4%YoY and 3.4%, respectively. Most of the sales categories, except sporting goods, fell short of last year's sales records. With the recent stumble in the Kospi market, and uncertainties regarding Europe and global growth prospects likely to discourage consumer and business sentiment, as well as employment, we expect private consumption and facilities investment to be less supportive of economic growth in 2Q12 by just expanding 1.3%YoY and 1.9%YoY, slower than 1.6% and 9.1% in 1Q12. Incorporating these assumptions, we have revised down our growth outlook for 2Q12 by 0.2%p to 3.0%YoY and for 2H12 by 0.3%p to 3.9%YoY, lowering annual growth outlook by 0.3%p to 3.4%YoY.

Monetary policy remains intact

Headline inflation further moderates on base effect and government policies. CPI inflation came off for the fourth consecutive month in Apr to 2.5%YoY, down by 0.1%p from Mar. In addition to high base of a year ago, government measures to lower insurance premiums for medicines and to subsidize childcare and free school meals mainly led the moderation. Core CPI inflation also edged down by 0.1%p from previous month to 1.8%YoY. Nonetheless, inflation expectations surveyed by the BoK remained high at 3.8% in Apr.

Inflationary pressures are likely to fade in. Deferred public tariff hikes will likely be carried out in 2Q12 or in early 3Q12. Further postponing will just increase pressure to the government with the presidential election ahead in Dec. The Ministry of Knowledge Economy is currently reviewing KEPCO's proposal of electricity rate hike of 13.1% to compensate for some of their operating loss due to delayed hikes. The market is expecting the MKE to agree on raising the charge by 4-7%, or less, in Jun. With other conditions equal and USDKRW at around 1,170 levels, we estimate the hike would push up headline inflation by 0.5%p.

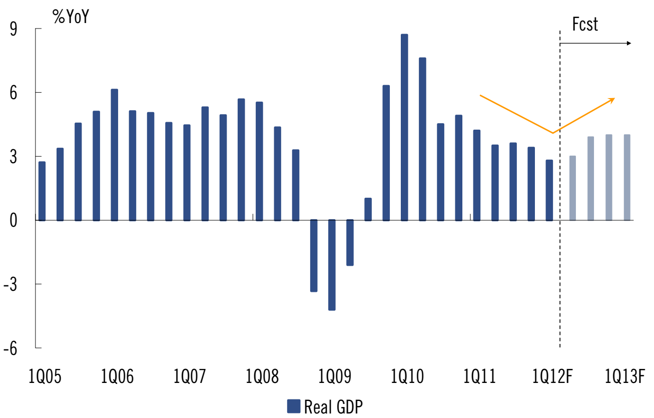
BoK's hawkish stance maintained but growth concern woos back. The BoK left the policy rate on hold at May MPC meeting for the eleventh month. Its concern on domestic economic growth seemed to have loomed over the month along with regained attention on euro sovereign woes due to recent political developments in the area. However, Governor Kim confirmed his hawkish stance on inflation, mentioning that Apr headline inflation would have registered 3.1%YoY if it were not for the impact of change in government policies, and that inflation expectations are still elevated. He reaffirmed the necessity of rate normalization but was cautious about the speed. In light of recent economic data signaling a further growth slowdown and inflationary upsides, BoK will likely be less hawkish but maintain current policy stance since it thinks the current level of policy rate is accommodative.

KRW depreciates with high volatility

Volatility of KRW sparked by risk-off trade. USDKRW surged up to 1,170 levels as of 18 May from 1,130 at the end of Apr as risk aversion rose on the back of the potential Greece exit and Moody's credit rating downgrades of European sovereigns and banks. During 1-18 May, foreigners' net sales in Korean equity markets registered KRW3.2trn, exceeding KRW0.6trn during the month of Apr. In addition, foreign net inflow into the bond market during the same period shrank rapidly to KRW0.1trn from KRW1.5trn in Apr. Volatility of KRW against USD measured by average daily changes during 1-18 May (0.4%) was the highest among seven Asian currencies but not as severe as in Sep 2011 (0.9%) after the downgrade of the US credit rating (see Figure 87).

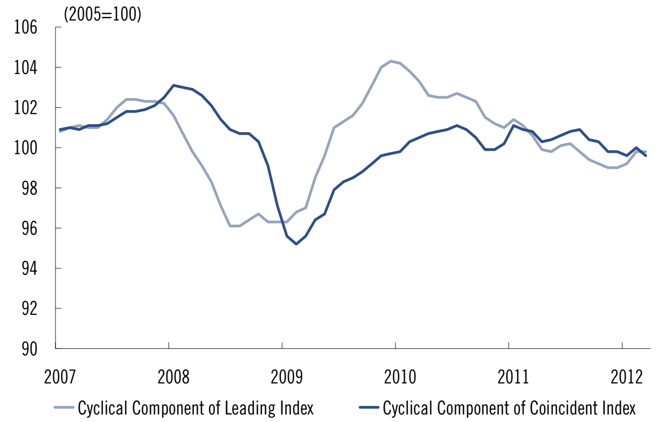
Frequent market interventions are likely to prevent excessively weak KRW. On 15 May, as USDKRW headed up towards 1,160 from the previous closing of 1,149.2, the Minister of Strategy and Finance made a remark that volatility of the currency seems excessive compared to fundamentals. He had also mentioned, only a few days before that current volatility is manageable and is not too high compared to other competitive countries. To reduce the volatility of the market and inflationary pressures from imports, FX market interventions may become more active amidst financial instability emanating from Greece exit issue, as well as related risk aversion.

Figure 88. We lowered our 2012 GDP forecast by 0.3%p to 3.4%YoY



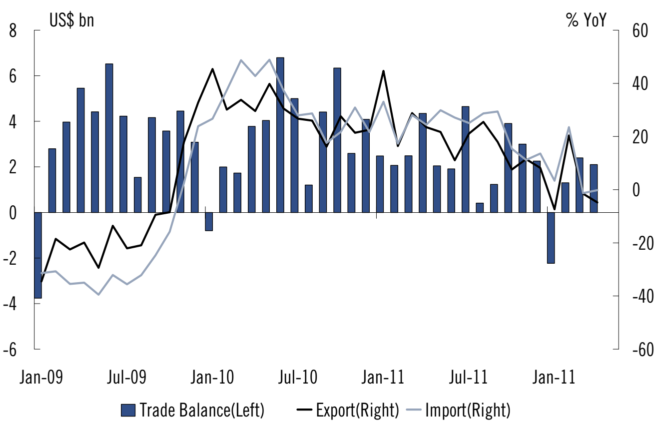
Source: Bank of Korea, CIRA estimates

Figure 89. Cyclical composite index tilted back down



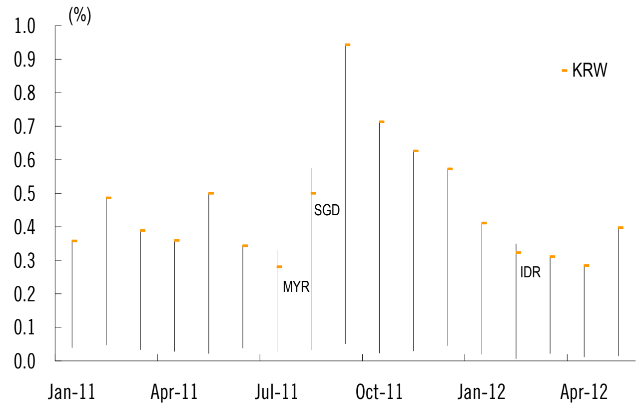
Source: Statistics Korea

Figure 90. Apr exports contracted faster; recovery unlikely before 2H12



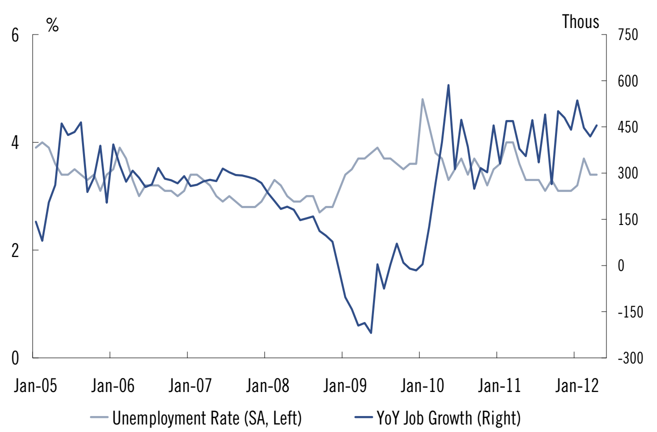
Source: Korea International Trade Association

Figure 91. USD/KRW volatility reduced but still highest among Asian FX



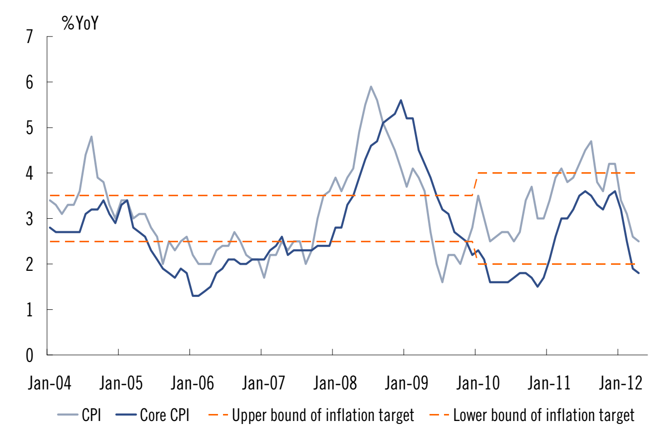
Source: Bank of Korea, CIRA estimates

Figure 92. Job growth set to slow on external downside risks



Source: Statistics Korea

Figure 93. Inflations ease on base effect and government policies



Source: Statistics Korea

Figure 94. Korea Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	845.7	954.0	1048.0	929.1	834.7	1014.9	1116.3	1131.6	1281.1
Nominal GDP, local currency bn	865,241	908,744	975,013	1,026,452	1,065,037	1,173,275	1,237,128	1,310,578	1,403,043
GDP per capita, US$	17,548	19,721	21,564	18,981	16,971	20,541	22,430	22,630	25,510
Population, mn	48.1	48.4	48.6	48.9	49.2	49.4	49.8	50.0	50.2
Unemployment, % of labour force	3.7	3.5	3.2	3.2	3.6	3.7	3.4	3.3	3.2
Economic Activity									
Real GDP, % yoy	4.0	5.2	5.1	2.3	0.3	6.3	3.6	3.4	4.2
Real investment growth % yoy	2.3	4.4	3.5	0.0	-13.5	15.8	1.5	4.4	4.5
Real consumption growth % yoy	4.6	5.1	5.1	2.0	1.2	4.1	2.2	2.0	3.4
private consumption growth % yoy	4.6	4.7	5.1	1.3	0.0	4.4	2.3	1.7	3.6
Real export growth, % yoy	7.8	11.4	12.6	6.6	-1.2	14.7	9.5	4.3	7.6
Real import growth, % yoy	7.6	11.3	11.7	4.4	-8.0	17.3	6.5	3.5	7.4
Prices, Money & Credit									
CPI, % yoy	2.6	2.1	3.6	4.1	2.8	3.0	4.2	3.5	3.0
CPI, % avg	2.8	2.2	2.5	4.7	2.8	3.0	4.0	3.0	3.2
Nominal wages, % yoy	6.6	5.7	0.7	3.1	2.6	6.8	1.0	4.3	5.8
Credit extension to private sector, % yoy	7.4	14.7	12.4	15.0	2.3	3.6	5.1	7.6	12.6
Policy interest rate, % eop	3.75	4.50	5.00	3.00	2.00	2.50	3.25	3.25	4.00
91-Day CD Rate, % eop	4.04	4.76	5.73	4.68	2.82	2.80	3.55	3.54	4.23
Long term yield, % eop	5.36	5.00	5.78	3.77	4.92	4.08	3.46	3.80	4.45
lc/US$, eop	1013	930	938	1258	1168	1148	1152	1156	1042
lc/US$, avg	1023	953	930	1105	1276	1156	1108	1158	1095
Balance of Payments, US$ bn									
Current account	18.6	14.1	21.8	3.2	32.8	29.4	26.5	12.0	8.7
% of GDP	2.2	1.5	2.1	0.3	3.9	2.9	2.4	1.1	0.7
Trade balance	23.2	16.1	14.6	-13.3	40.4	41.2	30.8	14.0	12.2
Exports	284.4	325.5	371.5	422.0	363.5	466.4	555.2	582.7	655.1
Imports	261.2	309.4	356.8	435.3	323.1	425.2	524.4	568.7	642.9
Service balance	-10.0	-13.3	-12.0	-5.7	-6.6	-8.6	-4.4	-4.8	-6.5
Income balance	-4.3	-4.0	-3.4	3.8	1.6	-2.1	-0.1	-0.1	0.6
FDI, net	-0.1	-7.6	-17.9	-16.9	-14.9	-22.2	-15.7	-18.5	-12.5
International reserves	210.4	239.0	262.2	201.2	270.0	291.5	304.2	311.0	319.0
Total Amortisations	20.5	17.7	43.8	42.9	43.6	40.0	42.0	43.0	42.0
Public Finances, % of GDP									
Consolidated government balance	0.4	0.4	3.5	1.2	-1.7	1.4	1.5	1.4	1.2
Consolidated gov primary balance	1.6	1.7	4.9	2.6	-0.2	2.8	2.9	2.7	2.5
Public debt	27.6	30.1	29.7	29.0	32.5	31.9	32.6	32.8	31.7
of which Domestic	26.2	28.9	28.6	28.1	31.4	31.0	31.7	32.0	30.9
Foreign Assets & Liabilities, US$ bn									
External debt	161.4	225.2	333.4	317.4	345.7	359.4	398.4	413.2	426.0
Private	145.9	205.3	279.8	265.0	278.2	314.7	358.0	373.0	384.8
Public	15.5	19.9	53.6	52.4	67.4	44.7	40.4	40.2	41.2
External debt / GDP	19.1	23.6	31.8	34.2	41.4	35.4	35.7	36.5	33.3
External debt / XGS	47.5	57.3	72.1	60.4	80.1	65.5	61.4	60.7	55.7
Short-term debt	65.9	113.8	160.3	149.9	149.2	139.8	136.1	146.6	151.7
Short-term debt/International Reserves (%)	31.3	47.6	61.1	74.5	55.3	48.0	44.7	47.1	47.5

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.6	3.3	2.8	3.0	3.9	4.0	4.0	4.1	4.3
CPI, % yoy	3.8	4.2	2.6	2.7	3.2	3.5	3.4	3.3	3.0
Policy interest rate, % eop	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00
91-Day CD Rate, % eop	3.58	3.55	3.55	3.54	3.54	3.54	3.77	4.00	4.22
Long term yield, % eop	3.66	3.46	3.70	3.35	3.52	3.80	4.05	4.30	4.40
lc vs USD, eop	1119	1147	1126	1174	1170	1156	1142	1117	1080

Source: CEIC Data Company Limited, Moody's and CIRA 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).

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Sri Lanka

- **Summary view** — Recent ‘adjustment’ measures taken by the government, as well as the challenging global environment and continued pressures on the external account, could result in GDP decelerating to ~7% levels in 2012 from 8.3% in 2011.
- **Things to Watch** — The government expects the current account deficit to narrow significantly in 2012, but we think the targets are optimistic. Continued reliance on overseas borrowings also remains a risk. Trends in foreign exchange reserves are key to track.
- **Strategy** — Given mounting price pressure, the CBSL will likely remain cautious, although policy rates could be on hold for now. We expect the LKR to end the year at LKR127/$.

Growth trends to moderate in 2012

GDP could move to the ~7%+ range in 2012. Trends in growth this year are likely to be hurt by recent ‘adjustment’ measures taken by the government (policy rate tightening, fuel price hikes), as well as the challenging global environment and continued pressures on the external account. We expect GDP to average ~7.4% in 2012, slightly above the government’s estimate of 7.2%. At Citi’s recent ADB Investor Conference (*macro meetings organized by Citi in early May on the sidelines of the 44th Annual Asian Development Bank Meetings – see Asia Macro View - Citi’s ADB Investor Conference – Key Takeaways*), a CBSL government official stated that medium-term growth prospects are still in the 8%+ range, citing continued efforts to improve infrastructure. Potential growth areas include agriculture, ICT, apparels and tourism. However, the key is Sri Lanka’s potential to attract FDI — while the government is targeting FDI to double to US$2bn in 2012; we think these estimates are on the optimistic side.

External trends need close monitoring

The current account deficit is targeted to narrow significantly, but estimates appear optimistic. On the external front, authorities expect the current account deficit, which widened to a high of 7.9% of GDP in 2011, to narrow significantly (CBSL’s estimate is 3.8%) in 2012. They factor in the sharp narrowing of the CAD to come from low import growth (0-3%YoY in 2012 from 51% in 2011) and buoyant worker remittances. This estimate appears ambitious — forecasts of the CAD at 6.9% of GDP in 2012 factors in import growth at 25%YoY, and export growth at 17%YoY. However, one saving grace could be lower oil prices

FX reserves have only inched up marginally. CBSL officials believe that policy measures taken in recent months to restore external imbalances are “already working” and that FX stability should come shortly. A quick recap —these measures had included tightening monetary policy, allowing more flexibility in the LKR, imposing credit growth curbs, raising fuel prices, and raising taxes on key import items. At the outset, the government’s adjustment measures are positive, but given optimistic assumptions on the CAD and FDI, we are unlikely to see a dramatic (or immediate) translation onto FX reserves (*although the latest published number is reserves at US$5.5bn in Feb, while the CBSL mentioned that reserves stood at US$5.9bn in April vs. US$5.8bn in December*). While the CBSL believes that the LKR has largely ‘overshot’, we expect the LKR to see marginal stabilization to LKR127/$ by end 2012.

Continued risk of dependence on overseas borrowings. The risk that current account adjustment could be slower than expected could result in Sri Lanka (official and corporate/banks) becoming increasingly reliant on external borrowings to support its BOP. Indeed, the government is likely to float another sovereign bond this year (US$500-1000mn). The Bank of Ceylon has already raised corporate borrowings to the tune of US$500mn. Moreover, the Ports Authority also intends to issue two 10-year bonds worth US$500mn each. This would raise Sri Lanka's already relatively high external debt burden.

Monetary - focus to remain on reserves, credit growth

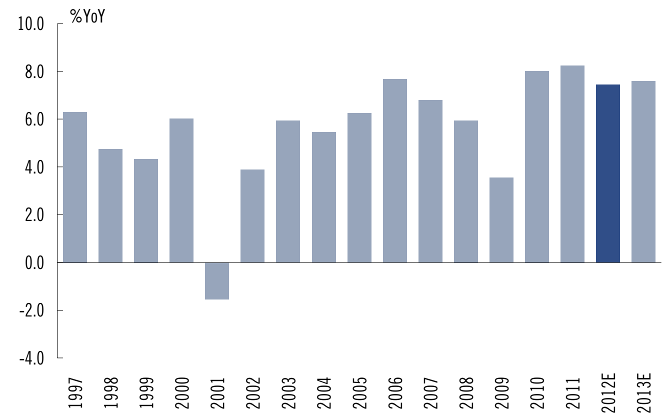
CPI edges higher, but lower oil prices could add some comfort. Inflation as measured by the CPI edged higher to 6.1% in April from 5.5% the previous month (and ~3%+ levels earlier in the year). The steady uptick is a consequence of fuel/electricity price revisions (which have translated into higher transport costs) as well as double-digit price rises in 'clothing and footwear' items. From May, price rises should appear more pronounced as the base effect turns less favorable. We expect the CPI to average 7.5%YoY in 2012 (vs. 6.8% in 2011). However, oil prices moving significantly lower could prove favorable.

Further rate hikes cannot be ruled out. Apart from inflation, we expect the central bank's policy focus to remain on (1) reining in credit growth (*currently up ~35%YoY*) and (2) re-building FX reserves (*which have come off to sub-US$6bn from a peak of US$8.1bn in mid-2011*). While our base case is for rates to remain on hold until 2H12, the official at the ADB conference did state that if the external position fails to stabilize with recent policy steps, it can still adjust policy, citing that the policy (repo) rate and statutory reserve requirement rate (SRR) are still at a low level of 7.5% and 8.0%, respectively. The government could also impose a further ceiling on imports. To this end, variables to monitor include (a) higher oil prices, (b) the success of upcoming corporate bond issuances and (c) credit growth trends.

Fiscal data remains elusive

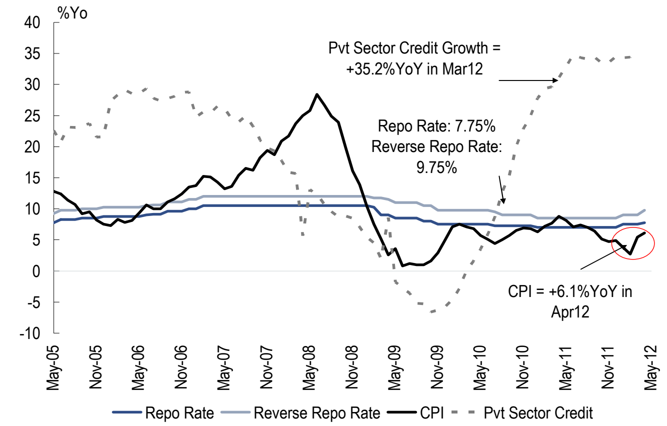
There continues to be a long lag in the release of 2012 public finance data, which makes trends difficult to gauge. A quick recap — the government had targeted the deficit to consolidate to 6.2% of GDP in 2012 (vs. 6.9% in 2011). While lower oil prices could offer some comfort on the subsidy bill, we expect pressure points to emerge due to (1) optimistic revenue assumptions (+20%YoY); (2) the possibility of higher borrowing costs given higher interest rates and (3) public sector wage hikes.

Figure 95. Growth could edge lower to 7%+ range in 2012



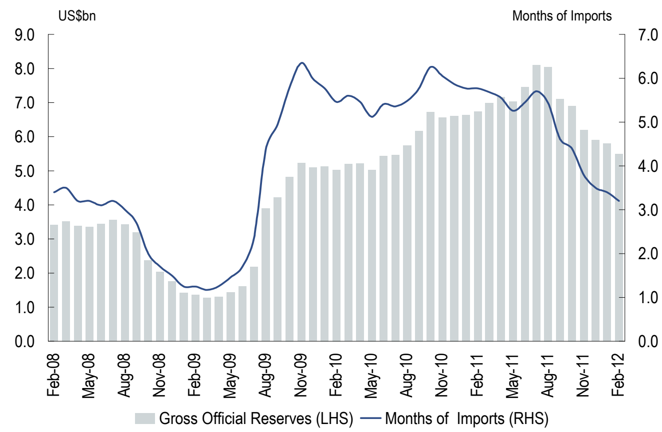
Source: CBSL, CIRA

Figure 96. Mounting price pressures could complicate policy decisions



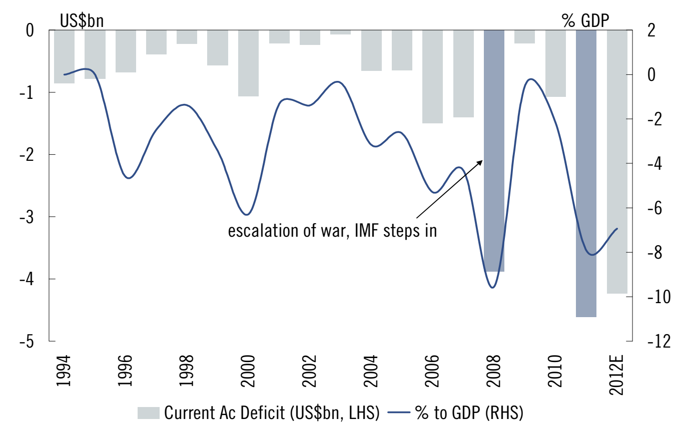
Source: CBSL, CIRA

Figure 97. External liquidity and FX reserves would shape the rate path



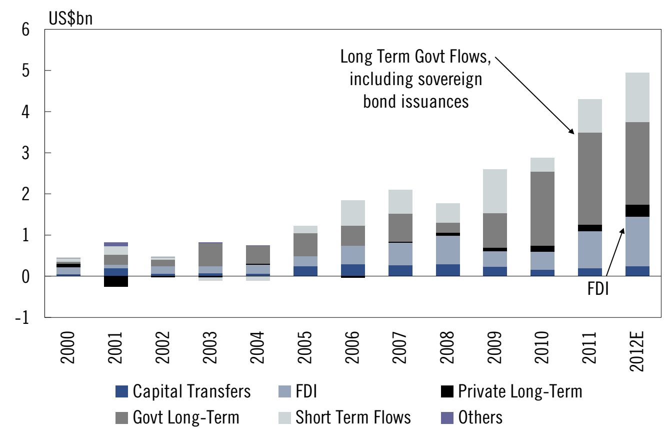
Source: CEIC Data Company

Figure 98. We expect the CAD to narrow in 2012, but not significantly



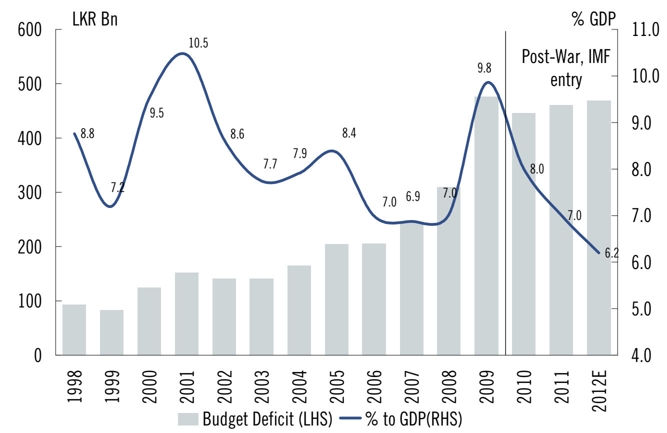
Source: CBSL

Figure 99. Growing reliance on overseas borrowings is key to track



Source: CBSL

Figure 100. The 6.2% fiscal deficit target for 2012 could see slippage



Source: Ministry of Finance

Figure 101. Sri Lanka Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	24.4	28.3	32.4	40.7	42.0	49.6	58.3	68.4	79.2
Nominal GDP, local currency bn	2,453	2,939	3,579	4,410	4,835	5,604	6,445	7,411	8,449
GDP per capita, US$	1,242	1,422	1,609	2,003	2,048	2,387	2,775	2,737	3,184
Population, mn	19.7	19.9	20.1	20.3	20.5	20.8	21.0	21.2	21.5
Unemployment, % of labour force	—	—	—	—	—	—	—	—	—
Economic Activity									
Real GDP, % yoy	6.2	7.7	6.8	5.9	3.5	8.0	8.3	7.4	7.6
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	7.5	13.5	18.8	13.9	5.0	6.9	4.9	9.5	7.0
CPI, % avg	11.0	10.0	15.8	22.5	3.4	6.0	6.8	7.5	7.0
Nominal wages, % yoy	—	—	—	—	—	—	—	—	—
Credit extension to private sector, % yoy	21.5	28.8	19.3	7.0	-5.8	24.9	31.0	20.0	15.0
Policy interest rate, % eop	8.75	10.00	10.50	10.50	7.50	7.25	7.75	8.00	8.00
1 month inter-bank rate, % eop	11.50	15.29	19.46	18.08	9.50	8.40	9.46	11.00	10.00
Long term yield, % eop	10.37	12.96	19.96	19.08	9.33	7.55	7.50	10.50	10.00
lc/US$, eop	102.0	107.8	108.9	111.4	114.3	111.0	113.9	127.0	122.0
lc/US$, avg	100.4	103.9	110.6	108.3	114.9	113.1	110.6	127.5	123.6
Balance of Payments, US$ bn									
Current account	-0.6	-1.5	-1.4	-3.9	-0.2	-1.4	-4.6	-4.2	-4.2
% of GDP	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-7.9	-7.3	-6.1
Trade balance	-2.5	-3.4	-3.7	-6.0	-3.1	-4.8	-9.7	-13.0	-13.3
Exports	6.3	6.9	7.6	8.1	7.1	8.6	10.6	12.4	15.1
Imports	8.9	10.3	11.3	14.1	10.2	13.5	20.3	25.3	28.4
Service balance	0.3	0.3	0.3	0.4	0.4	0.7	1.1	1.7	1.9
Income balance	-0.3	-0.4	-0.4	-1.0	-0.5	-0.6	-0.6	-0.1	-0.1
FDI, net	0.2	0.5	0.5	0.7	0.4	0.4	0.9	1.2	1.0
International reserves	2.5	2.5	3.1	1.8	5.1	6.6	6.0	6.7	7.8
Total Amortisations	0.4	0.8	0.8	1.1	1.3	1.1	1.2	1.4	1.1
Public Finances, % of GDP									
Consolidated government balance*	-8.4	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.5	-6.0
Consolidated gov primary balance*	-3.5	-2.9	-2.6	-3.1	-3.4	-1.7	-1.6	-1.3	-0.5
Public debt	90.6	87.9	85.0	81.4	86.2	81.9	80.0	79.0	78.0
of which Domestic	51.6	50.3	47.9	48.5	49.8	45.8	43.0	40.0	38.0
Foreign Assets & Liabilities, US$ bn									
External debt	13.0	14.0	16.5	17.8	20.9	24.8	28.0	32.0	40.0
Private	3.7	3.7	4.7	5.2	7.1	8.8	9.9	11.9	17.9
Public	9.4	10.2	11.8	12.6	13.8	16.1	18.1	20.1	22.1
External debt / GDP	53.3	49.4	50.9	43.6	49.8	50.1	48.0	55.0	58.0
External debt / XGS	205.1	203.1	215.7	219.1	295.2	287.9	265.2	259.0	265.4
Short-term debt	0.7	0.6	1.1	1.5	3.1	2.6	2.2	2.6	2.7
Short-term debt/International Reserves (%)	27.0	25.1	36.3	83.3	60.8	39.6	36.7	38.3	36.2

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1F	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	8.4	7.3	7.2	7.4	7.6	7.7	7.5	7.6	7.5
CPI, % yoy	6.4	4.9	5.4	8.1	9.4	9.5	8.1	6.9	6.9
Policy interest rate, % eop	7.00	7.00	7.50	7.75	7.75	8.00	8.00	8.00	8.00
1 month inter-bank rate, % eop	8.16	9.46	9.46	11.50	11.50	11.00	10.00	10.00	10.00
Long term yield, % eop	7.31	9.31	11.32	10.50	10.75	10.50	10.00	10.00	10.00
lc vs USD, eop	110.0	113.9	127.8	129.0	127.0	127.0	125.0	124.5	119.0

Source: CEIC Data Company Limited, Central Bank of Sri Lanka, Moody's and CIRA 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).

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Taiwan

- **Summary view** — We revise down 2012 GDP forecast to 3.3% from 3.5%. However, we still believe the economy has bottomed out in 1Q12 and should pick up more growth momentum in 2H12. First CBC rate hike will likely be delayed until 3Q13.
- **Things to watch** — (1) Development in Greek politics and consequent impact on European debt crisis, (2) Tax reform and utility price hike; (3) Slow China growth may persist longer; (4) Retreating energy prices are positive for GDP growth.
- **Strategy** — Yield curve likely remains flat as long rates are well anchored. Risk-off sentiment and net outflow of foreign capital will likely weaken NT$ further. Equities are likely under pressure to go down further before finding some support.

We lower 2012GDP forecast to 3.3% from 3.5%

Outlook for both exports and domestic demand turn more cautious. Deteriorating Greek political uncertainty and slowing China growth are two main external factors that have cast shadows over our 2H12 GDP outlook. In addition, tax reform and utility price hikes are adding headwinds to domestic demand. As a result, we trim export growth forecast this year to 2.6% from 4.0% and private consumption forecast to 2.2% from 2.8%. We still believe 1Q12 to be a cyclical bottom and growth momentum should pick up more strongly in 2H12, despite a less sanguine view than previous thought.

April economic data point to further downside risk. Export declined further to -6.4% yoy in April from -3.2% yoy in March. Export orders also weakened to -3.5% yoy in April from -1.6% yoy in March. Main reasons for slowing exports and orders are weakening China demand and a softening demand from Europe and the US. On average, exports were 0.1% below 1Q12 level, suggesting a flattish export performance in 2Q12 that could drag 2Q12 GDP growth below our 2.3% forecast. We believe US slowdown is temporary, likely reflecting a payback from a weather-boosted 1Q12 growth. However, if downside risks from Europe and China persist longer, we will have to cut our GDP forecast further.

Inflation pressure eases as the government readjusts utility hike policy. The government decided to raise utility prices in three stages instead of initial plan of a one-off adjustment. According to the new plan, utility prices will increase 40% of original plan on June 10, and then another 40% on December 10, with the remaining 20% depending on people's satisfaction in Taipower's reform efforts to improve efficiency and lower costs. Coupled with recent fall in energy prices, CPI inflation will likely stay below 2% this year and we notice that the CBC has stopped pushing overnight interbank rates higher on May 14 after it had aggressively led overnight rates higher in early May. We believe the CBC still has slightly more concerns on rising inflation than downside growth risks. Thus we don't expect a rate cut in June despite the deteriorating growth outlook. However, the CBC will likely not raise policy rates in the short term either. An eventual rate hike will likely be delayed until 3Q13 when growth momentum should be more solid and self-sustainable.

President Ma's inauguration speech outline policy blueprint

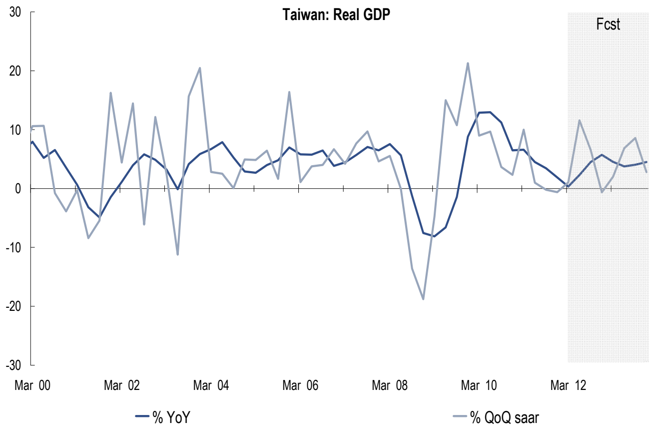
Five pillar to boost competitiveness. President Ma Ying-jeou delivered his second-term inauguration speech on May 20. Compared with the speech four years ago, President Ma has put growth and competitiveness as the top policy priority. Worrying about being marginalized, Ma is determined to push forward FTAs with trading partners (including ECFA with China) and join the Trans-Pacific Partnership (TPP) before 2020. The second pillar is to create more jobs and improve social justice (narrowing income gap). In addition, tax and fiscal reform, aging issues, and reform in judiciary system also fall into this category. The third pillar is to develop an environment that is low on carbon emission but high on green energy dependence. Thus increasing utility costs and energy tax are important goals of the government. The fourth pillar is to build up culture as a source of national strength that could transform into economic output and value. The fifth pillar is to cultivate, recruit, and retain talent. This includes reform in the education system and liberalization in labor markets.

The coming eighth cross-strait meeting will likely conclude the long-awaited investment protection agreement. The eighth cross-strait meeting will likely take place in late June where both representatives from Taipei and Beijing will likely conclude the long over-due investment protection agreement. In addition, both sides will also likely sign an agreement to facilitate the customs process of cross-strait trade. Afterwards we also expect the CBC to sign a currency settlement agreement with the PBoC (not a currency swap agreement) in the summer. We believe the government will quicken the pace of ECFA negotiation such that Taiwan can conclude a free trade agreement with China in both goods and services trade ahead of a potential free trade zone for China, Korea, and Japan. Despite that leadership transition in China possibly slowing down the cross-strait economic ties this year, we believe progress will likely accelerate in 2013. In the meantime, the preparation for a trade & investment framework agreement (TIFA) with the US will also likely occur in 2013 when the government solves the issue of US beef imports that contain ractopamine.

Long rates likely stay low longer

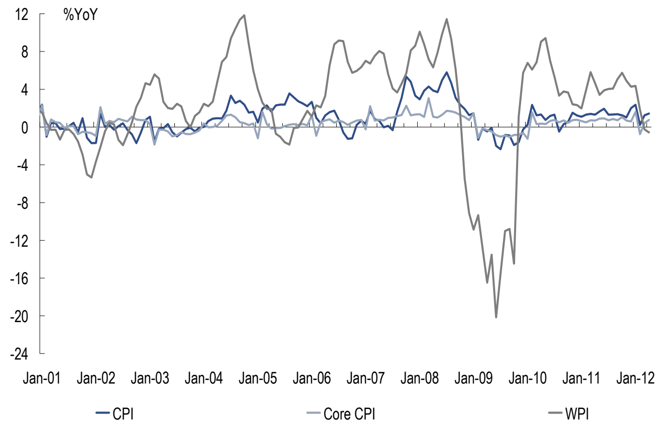
Despite a sharp rise in overnight rates, long-term government bond yields were actually lower in May on lower global rates, causing the yield curve to become flatter. We believe long rates will likely stay well anchored this year and then gradually pick up in 2013. Meanwhile, the recent sharp rebound in global US dollar as investors shunned risky asset has led portfolio investment away from emerging Asia, which also led to a weakening in NT$ exchange rate. Still we believe the cyclical uptrend in both GDP growth and CPI inflation will likely lead to a stronger NT$ in the latter part of 2012. Our equity strategist is bearish on the near-term share price outlook due to the overhang from the capital gain tax and net capital outflow of foreigners. But we are more upbeat on 2H12 as share prices become attractive again and there are likely more positive developments in terms of growth outlook and ample liquidity that comes from further accommodative measures from major central banks.

Figure 102. GDP will likely hit a bottom in 1Q12



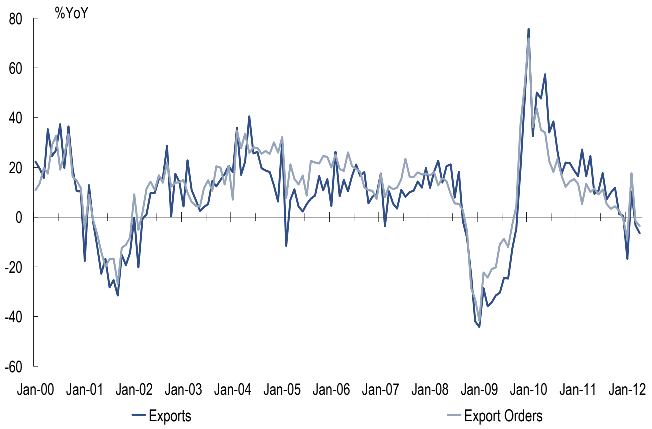
Source: CEIC Data Company Ltd., and CIRA

Figure 103. CPI inflation remained low up to April



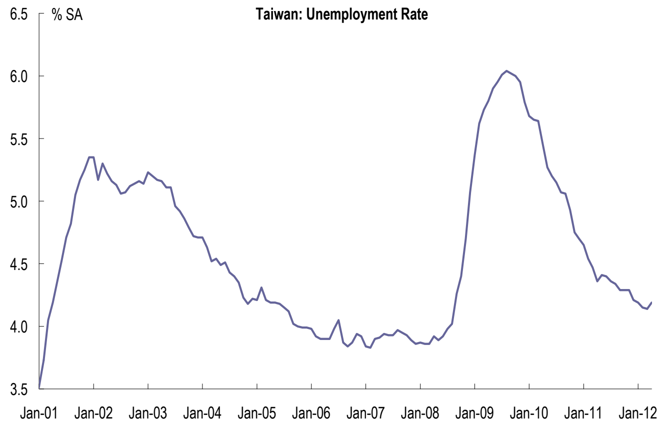
Source: CEIC Data Company Ltd., and CIRA

Figure 104. Exports weakened in April



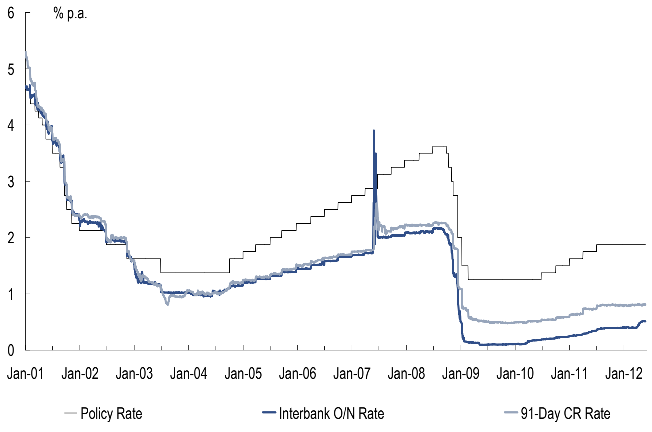
Source: CEIC Data Company Ltd., and CIRA

Figure 105. Job markets continued to improve



Source: CEIC Data Company Ltd., and CIRA

Figure 106. Overnight interbank rates rose sharply in April



Source: Bloomberg

Figure 107. NT$ depreciated on risk-off sentiment & capital outflow

Source: CEIC Data Company Ltd., and CIRA

Figure 108. Taiwan Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	364.8	376.3	393.1	400.2	377.6	430.8	466.8	486.4	534.6
Nominal GDP, local currency bn	11,740	12,243	12,911	12,620	12,481	13,614	13,757	14,475	15,344
GDP per capita, US$	16,051	16,491	17,154	17,399	16,359	18,588	20,139	20,945	22,979
Population, mn	22.7	22.8	22.9	22.9	23.0	23.1	23.1	23.2	23.3
Unemployment, % of labour force	4.1	3.9	3.9	4.1	5.8	5.2	4.4	4.3	4.2
Economic Activity									
Real GDP, % yoy	4.7	5.4	6.0	0.7	-1.8	10.7	4.0	3.3	4.2
Real investment growth % yoy	0.0	0.5	-0.7	-7.9	-21.2	39.5	-7.6	-1.0	4.6
Real consumption growth % yoy	2.4	1.1	2.1	-0.6	1.3	3.1	2.8	1.8	2.6
private consumption growth % yoy	2.9	1.5	2.1	-0.9	0.8	3.7	3.0	2.2	3.3
Real export growth, % yoy	7.8	11.4	9.6	0.9	-8.7	25.6	4.5	2.6	6.2
Real import growth, % yoy	3.2	4.6	3.0	-3.7	-13.1	28.2	-0.6	-0.6	5.1
Prices, Money & Credit									
CPI, % yoy	2.2	0.7	3.3	1.3	-0.2	1.2	2.0	1.5	1.9
CPI, % avg	2.3	0.6	1.8	3.5	-0.9	1.0	1.4	1.9	2.1
Nominal wages, % yoy	1.0	0.8	2.1	0.0	-5.1	5.5	3.0	2.8	3.2
Credit extension to private sector, % yoy	9.7	6.8	4.8	3.9	-1.3	4.4	7.6	5.0	6.0
Policy interest rate, % eop	2.25	2.75	3.38	2.00	1.25	1.63	1.88	1.88	2.13
1 month inter-bank rate, % eop	1.43	1.70	2.06	1.83	0.10	0.24	0.35	0.40	0.60
Long term yield, % eop	1.84	1.99	2.53	1.44	1.47	1.47	1.27	1.40	1.50
lc/US$, eop	32.9	32.6	32.4	32.9	32.0	30.6	30.3	29.6	28.4
lc/US$, avg	32.2	32.5	32.8	31.5	33.1	31.6	29.5	29.8	28.7
Balance of Payments, US$ bn									
Current account	17.6	26.3	35.2	27.5	42.9	39.9	41.3	42.2	45.0
% of GDP	4.8	7.0	8.9	6.9	11.4	9.3	8.8	8.7	8.4
Trade balance	15.8	21.3	27.4	15.2	29.3	23.4	26.8	29.2	33.9
Exports	198.4	224.0	246.7	255.6	203.7	274.6	308.3	323.7	344.6
Imports	182.6	202.7	219.3	240.4	174.4	251.2	281.4	294.5	310.7
Service balance	-6.7	-3.5	-1.6	1.8	2.0	2.5	3.0	3.2	3.5
Income balance	9.0	9.6	10.1	10.0	12.5	13.6	13.0	13.5	14.0
FDI, net	-4.4	0.0	-3.3	-4.9	-3.1	-9.1	-14.5	-12.0	-7.5
International reserves	253.3	266.1	270.3	291.7	348.2	382.0	385.5	429.0	465.0
Total Amortisations	6.4	2.6	2.3	3.8	2.60	4.4	5.2	5.5	5.8
Public Finances, % of GDP									
Consolidated government balance	-0.1	0.1	0.3	-0.5	-3.5	-2.3	-1.9	-1.6	-1.6
Consolidated gov primary balance	1.2	1.4	1.6	0.8	-2.3	-1.1	-2.0	-1.5	-1.3
Public debt	30.2	29.6	28.8	30.0	38.0	38.6	38.9	39.2	39.5
of which Domestic	15.5	18.9	25.6	28.4	32.3	31.8	31.9	32.4	32.6
Foreign Assets & Liabilities, US$ bn									
External debt	86.7	85.8	94.5	90.4	82.0	101.6	124.6	117.3	112.0
Private	72.8	75.2	91.1	88.9	76.0	93.5	116.7	109.5	104.3
Public	13.9	10.6	3.5	1.5	5.9	8.0	7.9	7.8	7.7
External debt / GDP	23.8	22.8	24.0	22.6	21.7	23.6	26.7	24.1	20.9
External debt / XGS	43.7	38.4	38.3	35.5	40.3	37.1	40.6	32.1	27.4
Short-term debt	73.7	74.2	83.3	78.8	68.2	83.7	106.0	110.0	105.0
Short-term debt/International Reserves (%)	29.1	27.9	30.8	27.0	19.6	21.9	27.5	25.6	22.6

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	1.9	0.4	2.3	4.5	5.7	4.5	3.8	4.0
CPI, % yoy	1.4	2.0	1.2	2.0	2.4	2.5	3.2	1.6	1.7
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	1.88	2.00
1 month inter-bank rate, % eop	0.46	0.47	0.42	0.51	0.52	0.55	0.58	0.61	0.64
Long term yield, % eop	1.38	1.29	1.28	1.23	1.24	1.25	1.28	1.30	1.32
lc vs USD, eop	29.7	30.3	29.5	29.9	30.1	29.6	29.1	28.7	28.6

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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).

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Thailand

- **Summary view** — 1Q12 economic rebound after GDP posted 11%QoQ SA growth, leaving no doubt of recovery in place. Investment-driven growth enabled manufacturing to heal faster. Domestic demand should continue to pace growth in a risk-off setting at the cost of a huge fiscal deficit and current account weakness.

- **Things to watch** — Pace of exports in 2Q12 as manufacturing constraints fade. Hawkish talk from BoT officials and potential for rate adjustment. Funding strategy of the government as the budget deficit balloons. Whether core disinflation continues on the back of a correction in the CPI of prepared food.

- **Strategy** — With the GDP rebound and ensuing tightening monetary implications, the Baht has room to retrace better ranges below 31 in a risk-off environment. FDI and other capital flows can support a yawning current account gap, with BoT's FX reserves capable of assuming any funding gap.

Rebound of 1Q GDP bode well for stronger 2H growth

1Q GDP's pace of 11%QoQ SA was sizzling hot despite roughly 55%-60% recovery in mfg capacity during the period. First quarter gain matched the 10.8%QoQ SA contraction in 4Q11. All key sectors of the economy measured by GDP on the expenditures and production side posted upbeat quarter-on-quarter gains. Real investments (ex-inv) posted growth of 13.9%QoQ SA to exceed the 7.4%QoQ SA drop in 4Q11 to lead expenditures. The manufacturing sector, which is not yet fully healed, rose 22.5%QoQ SA to nearly overcome the 23.3%QoQ SA decline on the supply side. Private investments (over 17%QoQ NSA) led the way in investment recovery, which probably suggests increased replacement capex of machinery and equipment damaged by the floods (including expenditures to rehabilitate industrial zones affected by the deluge), as well as stirrings of new industrial capacity being put in place. Consumption posted a hefty jump of 6.5%QoQ SA to eclipse the 3.6%QoQ SA drop in 4Q11. Durable goods consumption led by transport equipment (55.6%QoQ SA) grew 34.5%QoQ SA to overcome the 26.5%QoQ SA contraction in 4Q11. Exports, on the other hand, reported an 11.6%QoQ SA increase in 1Q12 to partially recover lost earnings due to the deluge (-15.5%QoQ SA in 4Q11) and outpace imports, which grew 7.3%QoQ SA. Government consumption expenditures rose by 2.5%QoQ SA, earlier signaled by material increases in the cash budget spending last March. Using the government's SA-GDP components, we estimate domestic demand (ex-inv) grew 7.9%QoQ SA in 1Q12 to account for nearly 85% of GDP's sharp quarterly rise.

While these hefty quarterly gains may slow down over the succeeding quarters, the basis for recovery cannot be doubted. Moreover, stronger YoY growth prospects have been put in place. What's impressive about this rebound is that real investments, and not consumption, led the way. Real investments have enabled manufacturing capacity to normalize quickly, fade supply disruption and enable local consumption and exports to register near-term recovery. The drag from net exports eased with export recovery; net exports accounted for 15% of 1Q12 real GDP, which pales next to its 18%to 20% contribution over the past two years. The 1Q12 net export contribution de-compressed from its 11% share of GDP in 4Q11 as a result of the deluge that disabled manufacturing capacity. Another source of the lift would be the rise in the inventory to GDP ratio to 2.4% in 1Q12 versus -0.6% in 1Q11. Government reported that some manufacturing goods sourced from office equipment, computers and electronic parts, and processed food went up, including the stock of gold and crude oil and refined products.

Upside risk to existing forecasts. Strong QoQ gains often precede an upbeat YoY outcome. Hence we are not surprised by a year-ago comparison that shows 1Q GDP growth of 0.3%yoy. With the strong first quarter momentum led by domestic demand and assuming no severe global downturn, we think 2H12 could show YoY comparisons that exceeding 5%yoy-6%yoy growth. Impact of real wage gains on consumption, inventory buildup as mfg capacity normalizes and reduced drag from net exports would complement an upbeat domestic demand outturn.

Unchanged overnight rates while fiscal spending intensifies. Upbeat quarterly GDP gains would anchor policy rates while shifting policy focus to upside inflation risk. With the output gap less negative, the backdrop of a faster wage cost pass-through beckons unless labor conditions worsen. Only a collapse of oil/food prices by 40% or so would be sufficient to mitigate the 40% wage hike impact likely to be passed on by those who complied with the wage order. Coupled with more fiscal cash transfers and public investments expected in succeeding quarters, MPC would likely be on hold for the rest of the year, although rate hike risk looms. In Feb-Mar cash budget expenditures, particularly subsidies and transfers, accelerated by over 40%. The Bt350bn floodworks and drainage projects serve to strengthen and attract investor sentiment after the flooding.

Political stability for now. Politically, the PM Yingluck Shinawatra has enjoyed some semblance of stability as the package of policies in response to the deluge, e.g. Bt30,000 subsidy per affected household, soft loans, earned support for the government. The Court's approval of the emergency decrees, one of which is the proposed Bt350bn floodworks project over a 3yr-5yr span, was a turning point. In response, exiled ex-PM Thaksin Shinawatra will not insist on his imminent return until appropriate political, economic and political conditions are in place. The ruling Pheu Thai party has not initiated legal/criminal charges against the military generals and Democrat party leaders for their role in the bloody aftermath of the May 2010 dispersal of the pro-Thaksin red shirts. Constitutional amendments that may pave the way for Thaksin's pardon and return have been initiated by the ruling coalition but parliamentary rules and courtesy have been observed in the process. All these bode well for stability, while recovery, rehabilitation from the floods and welfare of those affected continue to be prioritized by all parties.

Market implications

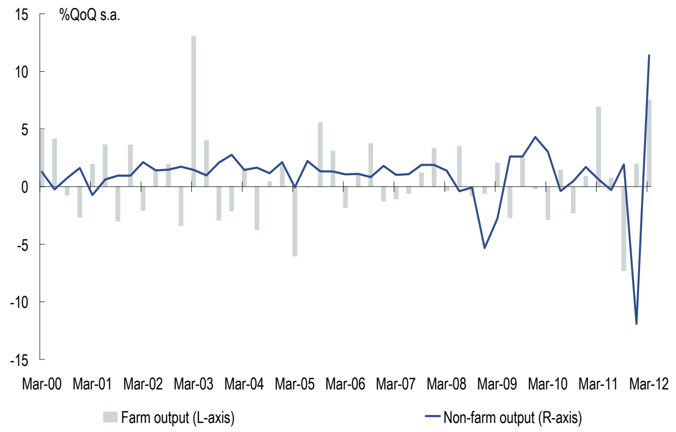
Rate hike risk remains. We think only a severe downturn in global demand that implies lower oil/commodity prices could lead to rate adjustment, which may come as early as 4Q12 because of rapid growth. We forecast the first rate hike in 1Q13. Core disinflation has room to remain benign in succeeding months, hitting core lows of 1.5% likely to result in a 12-month average in the lower half of the BoT's inflation target range. Potential for CPI prepared food to continue to correct lower supports benign core inflation. Core ex-CPI prepared food yields 1% versus Apr core in the range of 2%.

A better Baht outlook, closer to 30.40 towards end-year, bodes well for upbeat GDP prospects and its monetary tightening implications. Near-term, the GDP rebound could curtail Baht weakness. Fiscal and trade/current account positions could move into deficit as growth escalates. With domestic demand likely to lead recovery, both consumption and investments would require more non-oil imports. Our FY12 projection of a current account deficit of 1.5% of GDP however would be supported by FDI, trade credits and portfolio flows. Any funding gap would come from GIR and BoT's forward book, which would allow the Baht to move freely in line with the regional currencies.

Figure 109. GDP rebound in 1Q12 to offset 4Q11 loss

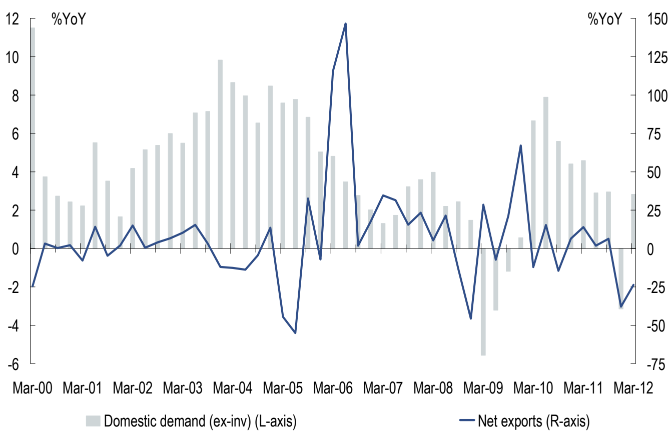
Source: CEIC Data Company Ltd., and CIRA

Figure 110. Both farm and non-farm output rose sharply in 1Q12



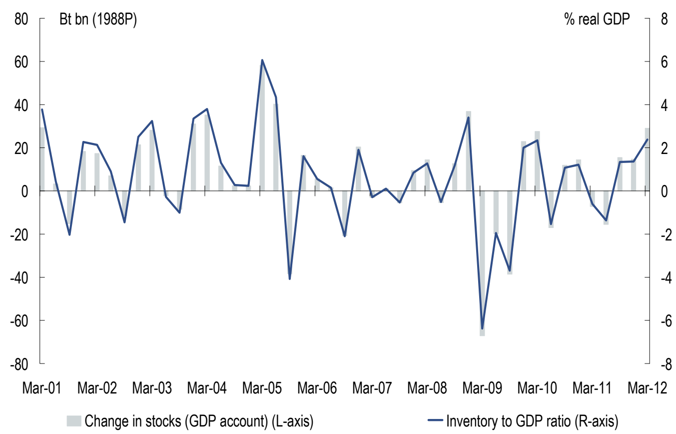
Source: CEIC Data Company Ltd., and CIRA

Figure 111. Domestic demand improved; net exports drag eased



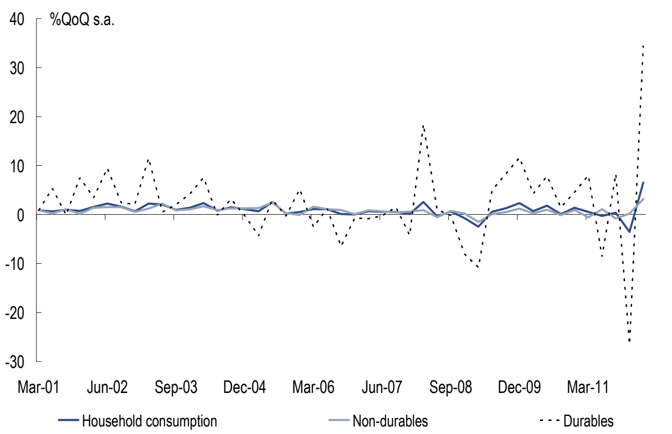
Source: CEIC Data Company Ltd., and CIRA

Figure 112. Inventory re-stocking in 1Q12 with fading mfg constraints



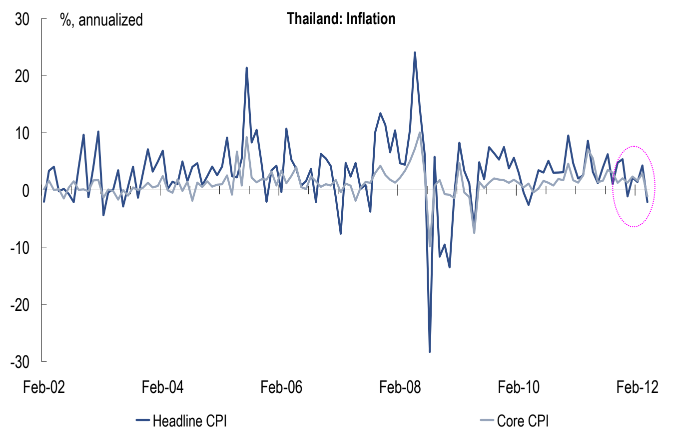
Source: CEIC Data Company Ltd., and CIRA

Figure 113. Durables demand up in 1Q12 to lead consumption



Source: CEIC Data Company Ltd., and CIRA

Figure 114. Benign inflation outlook as core disinflation speed up in Apr



Source: CEIC Data Company Ltd., and CIRA

Figure 115. Thailand Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	176.3	207.1	247.0	272.4	263.8	318.9	345.6	365.6	413.1
Nominal GDP, local currency bn	7,093	7,845	8,525	9,080	9,042	10,105	10,539	11,454	12,481
GDP per capita, US$	2,824	3,295	3,918	4,298	4,153	4,992	5,301	5,711	6,230
Population, mn	62.4	62.8	63.0	63.4	63.5	63.9	64.3	64.6	65.0
Unemployment, % of labour force	1.9	1.5	1.4	1.4	1.3	1.1	1.0	1.2	0.8
Economic Activity									
Real GDP, % yoy	4.6	5.1	5.0	2.5	-2.3	7.8	0.1	4.7	5.0
Real investment growth % yoy	12.8	-3.6	1.0	8.1	-25.2	28.7	0.0	12.8	3.6
Real consumption growth % yoy	5.5	3.0	2.9	2.9	0.1	5.1	1.3	4.5	4.0
private consumption growth % yoy	4.6	3.2	1.8	2.9	-1.1	4.8	1.3	4.0	3.9
Real export growth, % yoy	4.2	9.1	7.8	5.1	-12.5	14.7	9.5	5.5	8.7
Real import growth, % yoy	9.0	3.3	4.4	8.9	-21.5	21.5	13.6	8.2	8.1
Prices, Money & Credit									
CPI, % yoy	5.8	3.5	3.2	0.4	3.5	3.0	3.5	3.3	3.5
CPI, % avg	4.5	4.7	2.2	5.4	-0.9	3.3	3.8	2.9	3.3
Nominal wages, % yoy	6.9	6.2	3.0	10.2	-2.5	3.5	6.0	5.0	5.0
Credit extension to private sector, % yoy	8.0	4.5	4.8	8.8	2.5	9.1	15.0	8.8	10.0
Policy interest rate, % eop	4.00	5.00	3.25	2.75	1.25	2.00	3.25	3.00	4.00
1 month inter-bank rate, % eop	4.30	5.23	3.70	2.85	1.28	2.05	3.25	3.25	4.00
Long term yield, % eop	5.47	5.44	4.94	2.69	4.18	3.79	3.35	4.00	4.50
lc/US$, eop	41.0	36.0	33.7	34.9	33.3	30.1	31.6	31.1	30.0
lc/US$, avg	40.2	37.9	34.5	33.3	34.3	31.7	30.5	31.3	30.2
Balance of Payments, US$ bn									
Current account	-7.6	2.3	15.7	2.2	21.9	13.2	11.9	-4.8	-2.2
% of GDP	-4.3	1.1	6.3	0.8	8.3	4.1	3.4	-1.3	-0.5
Trade balance	3.4	13.7	26.6	17.3	32.6	31.8	23.5	4.3	5.6
Exports	109.4	127.9	151.3	175.2	150.8	193.7	225.4	244.5	279.0
Imports	106.0	114.3	124.6	157.9	118.2	161.9	201.9	240.2	273.4
Net service and Transfer accounts	-11.0	-11.4	-11.0	-15.2	-10.7	-18.6	-11.6	-9.1	-7.8
Income balance	—	—	—	—	—	—	—	—	—
FDI, net	7.6	8.5	8.3	4.4	0.7	5.0	4.0	7.0	5.5
International reserves (ex-gold)	50.7	65.3	85.2	108.7	135.5	167.5	167.4	175.0	190.0
Total Amortisations	8.0	15.4	19.5	12.7	16.1	15.0	16.7	17.3	18.0
Public Finances, % of GDP									
Consolidated government balance	-0.3	-1.1	-0.4	-4.3	-0.3	-2.0	-1.5	-3.8	-2.7
Consolidated gov primary balance	1.0	0.1	0.8	-3.1	0.9	-0.8	0.2	-2.1	-1.3
Public debt	26.2	24.9	24.1	23.5	29.2	29.7	29.7	31.1	30.7
of which Domestic	22.8	22.9	23.0	22.7	28.0	29.3	28.9	30.5	30.0
Foreign Assets & Liabilities, US$ bn									
External debt	59.3	70.0	74.4	76.1	75.3	100.6	97.8	100.1	102.5
Private	44.1	54.6	59.5	61.3	59.9	79.1	74.3	75.1	76.9
Public	15.2	15.4	14.9	14.8	15.4	21.5	23.5	25.0	25.6
External debt / GDP	33.6	33.8	30.1	27.9	28.5	31.5	28.3	27.4	24.8
External debt / XGS	54.2	54.7	49.2	43.4	49.9	51.9	43.4	40.9	36.7
Short-term debt	23.1	27.3	34.0	33.6	33.1	50.6	47.5	49.8	51.1
Short-term debt/International Reserves (%)	45.5	41.7	39.9	30.9	24.5	30.2	28.4	28.5	26.9

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.7	-8.9	0.3	3.8	7.2	8.0	5.3	5.0	4.8
CPI, % yoy	4.0	3.5	3.4	3.0	3.0	3.3	3.4	3.5	3.5
Policy interest rate, % eop	3.50	3.25	3.00	3.00	3.00	3.00	3.25	3.50	3.50
1 month inter-bank rate, % eop	3.55	3.25	3.04	3.25	3.25	3.25	3.50	3.65	3.60
Long term yield, % eop	3.75	3.35	3.82	4.00	3.85	4.00	4.25	4.25	4.45
lc vs USD, eop	30.4	31.2	30.7	31.7	31.7	31.1	30.5	30.2	30.1

Source: CEIC Data Company Limited, IFS, Moody's and CIRA 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).

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Vietnam

- **Summary view** — Growth still remains very weak, prompting the government to announce a new set of fiscal measures via Resolution No. 13, but we think this will not be enough. We expect more aggressive monetary easing will also take place to offset the already sharp deleveraging in the banking sector. Nonetheless, this will still likely not be enough to lift growth beyond our 5% forecast for this year.

- **Things to watch** — Consultative donor group will give their mid-year update in June. There will be talks on liberalizing bank deposit rates in June or July, but we are skeptical it will happen given risks to the banks. We think restoration of macro stability and improvement in external finances amidst what we think is a relatively manageable contingent liability from the banking sector should warrant Vietnam's credit rating outlook to be revised to 'stable' from 'negative" in the coming months. If the trade gap remains modest, this should bolster confidence in the dong and flexibility for the government do to more counter-cyclical easing.

- **Strategy** — While short-tenor VND bond yields have already collapsed 300bps since February, there is still a possibility yields start testing the 8.5% range as we doubt SBV is done with monetary easing and we expect dong stability can hold in the near-term. However, Vietnam external debt (cash bonds and CDS) remain vulnerable to global risk aversion amidst Eurozone crisis fears.

Weak growth prompts more fiscal easing

In mid-April, we downgraded Vietnam's growth to 5% this year and 5.6% next year, and it looks like latest data continues to support this weak outlook. In a speech before the National Assembly, Deputy Prime Minister Nguyen Xuan Phuc noted the sharp rise in inventories in the first four months, weak domestic consumption and business closures rising 9.5% YoY in the first four months of the year, which could lead to further job losses and social stability concerns. Even Vietnam's previously very buoyant exports have lost some momentum, largely on lower oil exports and some softness on traditional exports like textile/garments. However, electronics exports are still booming (up more than 100% YoY in the last 3 months). Retail sales and industrial production data recovered from the previous weak month, but with still tight financial and monetary policies, M2 and credit growth continue to be very weak, up 1.55% and -0.66% as of April ytd, respectively. The weakness in domestic demand with weaker funding conditions can be seen by the sharp slowdown in import growth of key items such as oil imports (-35% YoY) and automobiles (-39.2%).

Government announces a fiscal stimulus package to support business enterprises; fiscal impact looks manageable. On May 10th, the government issued Resolution 13, which is a set of relief package for businesses enterprises to support the industry/manufacturing sector that we estimate accounted for more than a third of the GDP growth slowdown in 1Q 2012 vs. the previous quarter. The fiscal measures include a 6-month deferral of VAT payments incurred in April to June 2012, a 9-month extension on 2011 corporate income tax (CIT) payments for SMEs and "labor intensive companies", selective CIT reduction of 30% and VAT, Personal Income Tax (PIT) and CIT for 2012, and a 50% cut and payment extensions on land leasing fees, among other things. These combined relief measures are estimated to amount to about $1.3bn (1% of GDP) but as some of these measures incorporate deferral and not total cancellation of payments, thus the impact on the budget will probably be much less. Regardless, with slower growth, we expect the budget deficit will widen from around 3.5% of GDP in 2011F (including on-lending, excluding amortizations) to about 4.5% of GDP in 2012F.

Is there fiscal space to do some easing? Given how weak growth has been and strong demand for VND government bonds, we think there is room to do extra fiscal stimulus if well targeted to boost growth. We forecast only a modest rise in general government debt to GDP ratio, partly aided by dong stability and JPY depreciation (24% of Vietnam's government debt is denominated in yen), though still slightly down from the 2010 peak. The key wildcard will be the fiscal cost of recapitalizing the banks amid the previous credit boom. IMF estimates the cost of restructuring Vietnam's banking system is ~5% of GDP, which look relatively manageable.

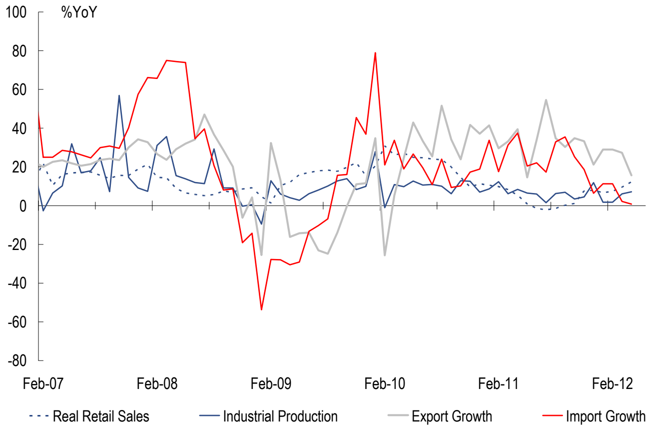
Sharper-than-expected disinflation should facilitate monetary easing

Inflation was again very muted in May after a sharper-than-expected disinflation in previous months. In the last few months, inflation has remained more benign than expected, rising only a modest 0.18% MoM in May vs an even more modest 0.05% MoM in April, largely with the help of very benign food prices (three consecutive months of food deflation), which account for 40% of the CPI basket, as well as weak demand numbing the second round inflation impact of administered price adjustments back in March (fuel hike) alongside decline in commodity prices already filtering into housing/construction materials. Even if we were to get further electricity tariff hike, with food inflation remaining manageable, we expect the base effect to have a significant impact on headline inflation by July to August where headline inflation is forecast to bottom at around ~6.5% range. We have lowered our 2012F and 2013F annual inflation forecasts to 10.0% and 7.9%, respectively, with risks to the downside.

We expect SBV to take further action to ease monetary policy in the next few months, complementing recent fiscal easing measures. In early May, SBV again reiterated its plan for 100bps rate cut in each quarter in the rest of 2012F (we were calling for something more aggressive than that) and another 300bps this year after 200bps cut so far this year, especially as the bank sector is still deleveraging ytd. Nonetheless, Vietnam also announced earlier this month a lending ceiling rate of 15% for prioritized sectors, and there has been earlier talk of liberalizing deposit rates in June/July to improve the ability of banks to mobilize deposits, but we somewhat doubt they can push through with this so soon given the negative impact this would have on the already troubled banking sector. However, while growing margin pressure could help accelerate the bank restructuring process, we still believe the banking system as a whole is deficient of capital, which will likely need some state-funded recapitalization on top of efforts to attract foreign capital via lifting foreign ownership limits further.

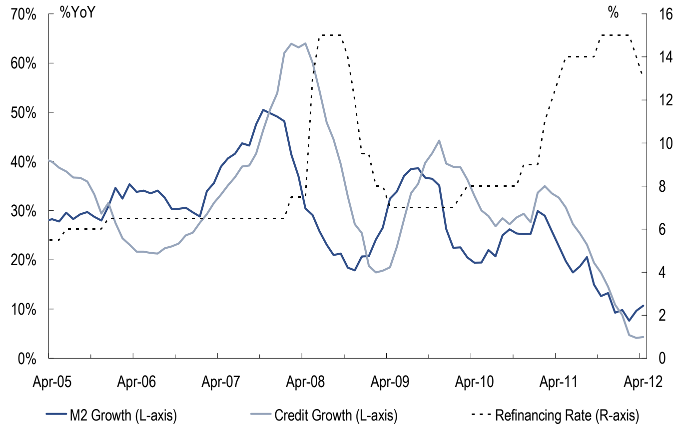
Dollar funding situation in Vietnam still looks fairly stable. Despite the surge in dollar demand globally amidst the escalating Eurozone fears from "Grexit", we are not hearing of dollar funding shortage in Vietnam, with SBV still periodically buying USDs. One supportive factor to insulate Vietnam's external flows is the sharp collapse in the current account and trade deficit. The latest cumulative Jan-April 2012 trade deficit is only $83mn after previous month revisions, an extremely small figure when taking into account that we think long-term capital flows have remained resilient (e.g. "realized" FDI in the first four months of this year of $3.6bn is only down 0.3% YoY) and there are very little offshore portfolio flows.

Figure 116. Vietnam's economic indicators still point to weak momentum



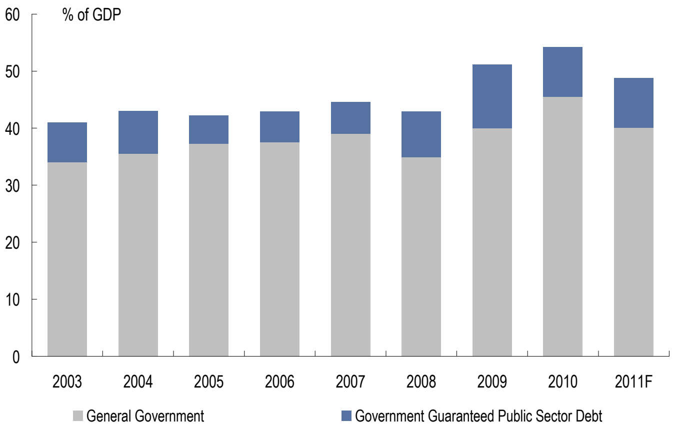
Source: CEIC Data Company Ltd., and CIRA

Figure 117. Vietnam credit and M2 growth versus refinancing rate



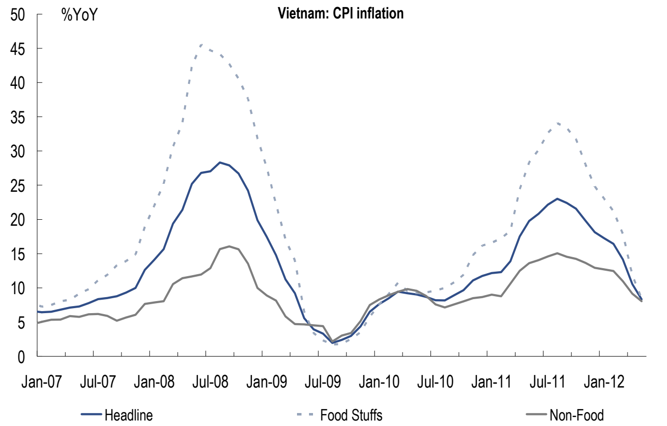
Source: Various news sources, CEIC Data Company Ltd., IMF, and CIRA

Figure 118. Public debt remains elevated but down from the peak



Source: CEIC Data Company Ltd., and CIRA

Figure 119. Steep disinflation persists with the help of benign food prices

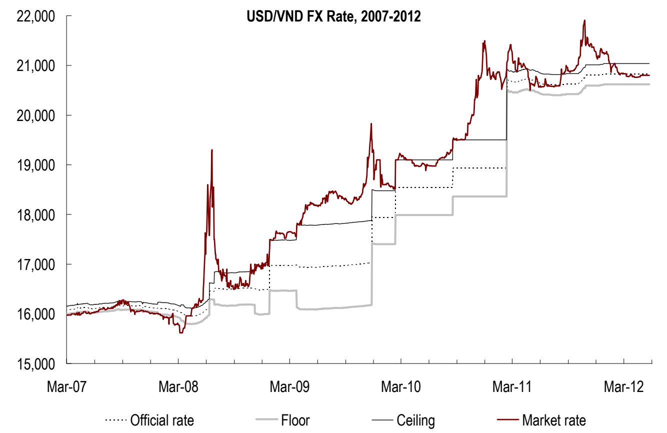


Source: CEIC Data Company Ltd., and CIRA

Figure 120. VND bond yields fell on rate easing outlook and dong liquidity

Source: Bloomberg

Figure 121. VND remained stable and insulated from capital flow volatility



Source: Bloomberg, and CIRA

Figure 122. Vietnam Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data									
Nominal GDP, US$ bn	52.9	60.9	71.2	90.0	91.9	102.4	121.2	138.8	152.2
Nominal GDP, local currency bn	839,211	974,266	1,143,715	1,485,038	1,658,389	1,980,900	2,535,000	2,916,023	3,311,094
GDP per capita, US$	637	724	836	1,044	1,054	1,163	1,361	1,542	1,674
Population, mn	83.1	84.1	85.2	86.2	87.2	88.1	89.0	90.0	90.9
Unemployment, % of labour force	5.3	4.8	4.6	4.7	4.6	4.3	4.6	4.7	4.8
Economic Activity									
Real GDP, % yoy	8.4	8.2	8.5	6.3	5.3	6.8	5.9	5.0	5.6
Real investment growth % yoy	11.2	11.8	26.8	6.3	4.3	10.4	-9.2	4.4	7.8
Real consumption growth % yoy	7.3	8.4	10.6	9.2	3.5	10.2	4.7	6.8	6.4
private consumption growth % yoy	7.3	8.3	10.8	9.3	3.1	10.0	4.4	6.8	6.5
Real export growth, % yoy	20.5	17.6	16.0	15.1	-6.0	—	—	—	—
Real import growth, % yoy	15.9	18.8	28.1	15.4	-6.4	—	—	—	—
Prices, Money & Credit									
CPI, % yoy	8.8	6.6	12.6	19.9	6.5	11.7	18.1	8.3	8.1
CPI, % avg	8.3	7.5	8.5	23.2	7.0	9.2	18.6	10.0	7.9
Nominal wages, % yoy	15.4	18.1	21.4	15.0	12.0	9.6	19.6	14.0	12.0
Credit extension to private sector, % yoy	31.6	25.5	53.9	19.7	37.8	28.0	10.9	10.0	12.0
Policy interest rate, % eop	6.50	6.50	6.50	9.50	8.00	9.00	15.00	10.00	10.00
1 month inter-bank rate, % eop	7.25	8.04	7.55	7.95	10.49	13.17	13.58	10.00	10.00
Long term yield, % eop	8.75	8.29	8.73	10.00	11.68	11.50	12.55	9.00	11.00
lc/US$, eop	15914	16051	16010	17486	18900	20800	21240	21269	21914
lc/US$, avg	15855	16002	16072	16496	18048	19338	20920	21007	21751
Balance of Payments, US$ bn									
Current account	-0.6	-0.2	-7.0	-10.7	-7.2	-3.9	-1.3	-1.7	-5.7
% of GDP	-1.1	-0.3	-9.8	-11.9	-7.8	-3.8	-1.1	-1.2	-3.7
Trade balance	-2.4	-2.8	-10.4	-12.8	-8.3	-5.1	-3.8	-2.6	-7.7
Exports	32.4	39.8	48.6	62.7	57.1	72.2	95.2	114.2	132.5
Imports	34.9	42.6	58.9	75.5	65.4	77.3	99.0	116.8	140.2
Service balance	-0.3	0.0	-0.8	-0.9	-1.2	-2.5	-2.0	-2.5	-1.7
Income balance	-1.2	-1.4	-2.2	-4.4	-3.0	-4.6	-4.5	8.0	8.5
FDI, net	1.9	2.3	6.6	9.3	6.9	7.1	6.9	7.3	7.5
International reserves	9.1	13.4	23.5	23.9	16.4	12.5	18.2	26.5	30.2
Total Amortisations	1.10	1.24	1.35	1.5	1.5	2.0	2.3	2.5	3.0
Public Finances, % of GDP									
Consolidated government balance	-4.5	-1.1	-5.3	-4.7	-8.9	-7.9	-3.5	-4.5	-4.3
Consolidated gov primary balance	-4.1	-0.3	-4.2	-3.7	-7.5	-6.7	-2.2	-3.4	-3.4
Public debt	42.2	42.9	44.6	42.9	51.2	56.7	57.3	57.8	58.3
of which Domestic	10.8	11.1	11.6	12.9	20.0	11.0	11.1	11.2	11.3
Foreign Assets & Liabilities, US$ bn									
External debt	18.7	19.1	23.1	28.4	38.8	44.5	49.6	52.9	54.0
Private	5.4	4.5	3.1	5.7	9.6	10.6	10.9	11.1	11.3
Public	13.3	14.6	20.0	22.7	29.2	33.9	38.7	41.8	42.7
External debt / GDP	35.3	31.4	32.5	31.5	42.2	43.4	40.9	38.1	35.5
External debt / XGS	51.1	42.5	42.3	40.7	61.7	61.9	59.2	54.2	47.4
Short-term debt	2.2	2.6	4.6	6.3	5.8	6.8	5.9	6.0	6.1
Short-term debt/International Reserves (%)	24.0	19.1	19.7	26.2	35.0	54.6	32.3	22.5	20.2

Quarterly Economic Indicators

	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.1	6.1	4.1	4.3	5.6	5.7	5.5	5.6	5.7
CPI, % yoy	22.4	18.1	15.4	8.2	6.9	8.3	7.7	8.0	7.9
Policy interest rate, % eop	14.00	15.00	14.00	12.00	11.00	10.00	10.00	10.00	10.00
1 month inter-bank rate, % eop	13.50	13.60	11.90	7.50	7.00	8.00	9.00	10.00	10.00
Long term yield, % eop	12.40	12.55	11.48	9.50	8.50	9.00	9.50	10.50	11.00
lc vs USD, eop	21000	21240	20850	20850	21059	21269	21482	21697	21914

Source: CEIC Data Company Limited, IFS, IMF, Haver, Moody's and CIRA
*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).

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- **Summary view** — After GDP fell 1%QoQ in 1Q12, we now expect it to fall 0.6% in 2012 and increase 1.4% in 2013. A "Grexit" suggests risks to our forecast and leads to questions about the appropriate policy mix.
- **Things to watch** — The political balance remains fragile and, together with June data, could influence the CNB decision on 28 June: 1Q wages (7 June), 1Q GDP details (8 June), May CPI (11 June).
- **Strategy** — Recent CNB comments and weaker 2013 foreign demand outlook are behind our call for further monetary easing with the policy rate reaching 0.25% by year-end. Weaker koruna, as always, can influence size and timing of easing.

Unexpected 1Q GDP drop and Grexit risks limit recovery

After a stronger-than-expected drop in GDP by 1%QoQ in 1Q12, we now expect it to fall 0.6% in 2012 and grow 1.4% in 2013 (previously -0.4% and 1.6%). We have not fully included the adverse impact of the 1Q outturn (it would otherwise imply 1.3%YoY fall this year) as we expect part of 1Q's fall to be offset in 2Q12 or even revised on 9 June, when details are published, as 1Q12 was distorted by the collection of indirect taxes (large tobacco forward buying in 4Q11) and a drop in volatile sectors (financials, insurance and pension (due to pension reform) and construction). Monthly indicators also worsened, excluding foreign trade, in 1Q12.

The manufacturing PMI dropped to 49.7 in April from 52.1 in March, which is in line with our forecast of an overall weaker performance of Czech industry this year; we expect production to increase by 0-2%YoY in 2012. March industrial output contracted 0.7%YoY due to fewer working days, almost in line with our forecast. It slightly increased by 0.3%MoM swda, which was the first increase after a cumulative drop of 1.6% in Dec11-Feb12. However, industrial production growth eased to 1%YoY in 1Q12 from 3.7% in 4Q11.

While Czech GDP has more or less recovered to its pre-crisis peak of 1Q08, investment activity is 16% lower, slightly worse than the EU average. All other kinds of expenditure are above (exports) or close to pre-crisis levels (consumption). While the recovery in investment activity is stronger compared to regional peers (excluding Poland), it is weaker compared to the EU/EA average. Lackluster investment activity is widespread given the performance gap is in the range of 10-20% across fixed assets. The April business survey suggests reduced production capacity, while higher utilization in manufacturing points to a slightly stronger investment in these assets. On a sectoral basis, the largest gap is in the corporate sector (around 20% compared to 1Q08 in current prices), but the gap is still growing in government. The gap is even larger if we take into account net investment, as the consumption of fixed capital has risen during the crisis (due to previous strong investment) by 10-13% across sectors compared to 2008.

Labor market improved, but likely to worsen

We have recently observed a labor market improvement, but a weaker economic outlook points to its deterioration. We expect a second decline in a row for the sa registered unemployment rate, to 8.6% in April from 8.7% two months ago. However, our forecast suggests it will reach around 9% by end-2012. Our forecast particularly reflects a weaker economic outlook and with GDP growth below 2%YoY growth, we do not expect an improvement until late 2013.

Current account better, financial not so

Overall, the current account has remained a supportive fundamental for the currency keeping the, albeit milder, appreciation trend in place over the medium-term. The March current account surplus improved compared to the previous year. The large trade surplus offsets a lower inflow of EU funds and thus it will continue to keep the current account in surplus, although the dividend outflow has remained quite large. As a result, the annual current account narrowed to 2.1% of GDP in March 2012 from 3.9% a year ago. Excluding the reinvested earnings it reached -0.4% of GDP, while it was 5x larger a year ago. Our forecast envisages a narrowing of the trade surplus ahead, but still supported by weak domestic demand. The dividend outflow is likely to increase reflecting seasonal patterns (likely around CZK80bn in 2Q12, a bit less than in 2Q11). Overall, we expect the current account to be around 2.5% of GDP in 2012 narrowing from 2.8% in 2011. FDI disappointed after strong inflow into equity a month ago and returned to a performance last seen in 2011.

CPI to ease on commodities, but VAT keep it up in 2013

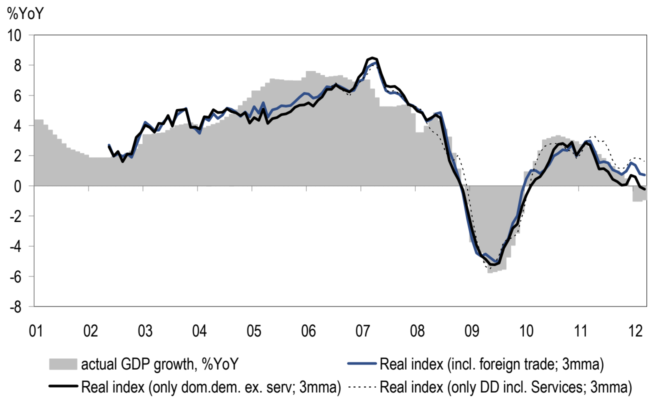
Our inflation forecast is somewhat below CNB forecast in 2012, but higher in 2013 due to different VAT assumption. April CPI growth eased to 3.5%YoY from 3.8% a month earlier, below the CNB forecast of 3.9%. The core adjusted CPI (watched by CNB) eased its contraction to -0.2% in April from -0.3%YoY in March, slightly above the CNB's forecast. While the CNB expect the pace of disinflation to be 3.5%YoY in May/June, we expect 3.2% in May. Though CPI eased a bit below our forecast of 3.6%, it is likely to remain elevated above3%YoY until 4Q12. However, we expect CPI inflation to remain at 2.7%YoY in 2013, when VAT rates will be hiked by another 1 percentage point to 15% and 21% (impact of 0.7%pt). This is actually a disinflationary risk for the CNB until we see a stronger wage growth. CNB's baseline forecast works with lower VAT rates, but the approval of VAT hike in January 2013 is likely later this year, unless there is another round of coalition tensions.

Doubts about appropriate policy mix?

After a recent series of dovish comments, we are now looking for a 25bp cut at the June meeting, and another 25bp in 2H 2012 – a cumulative 50bp cut in the policy rate to leave it at 0.25% by year-end. We previously expected policy rates to be cut once in 4Q12 due to some upside risks, particularly the koruna (koruna at 26 against the EUR could postpone any cut), and uncertainty about 1Q GDP outturn and politics. If there is another wave of political tension, this would likely lead to less severe austerity measures (in our base case, we expect these measures to be slightly milder on lower interest rate expenditures). However, if the government is successful in front-loading the fiscal consolidation, it would suggest additional easing of CNB monetary policy. Additionally, possible contagion from the "Grexit" scenario into the real economy and our outlook on ECB's further easing later support the forecast of CNB's easing. However, there are still upside risks to our view in the form of a weaker koruna and domestic political uncertainty.

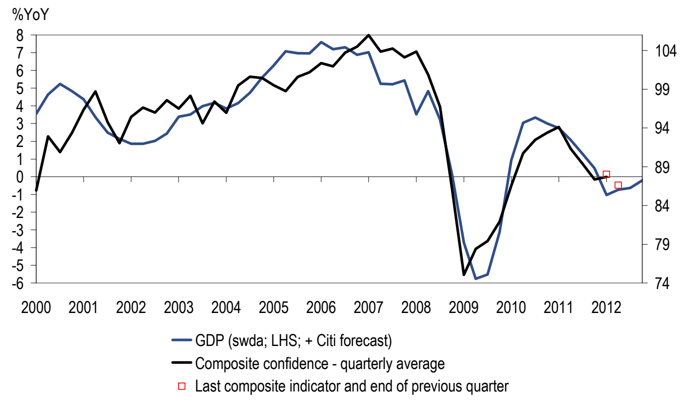
The poor Czech GDP outturn supports doves on the CNB's Bank Board and could also slightly ease the consolidation effort to target a cyclically adjusted fiscal balance instead of an overall fiscal balance that is in our view manageable given the strong issuance of gov't bonds in 1H12. However, we do not expect a strong immediate policy response unless the GDP details are provided and the flash estimate is confirmed or revised.

Figure 123. GDP below our activity indicator, but value added likely less



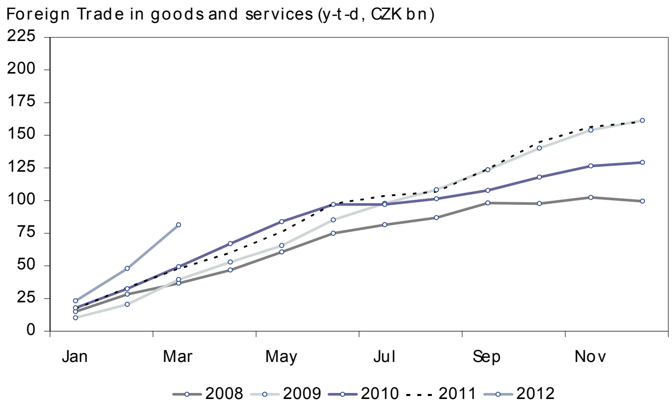
Source: Czech Statistical Office, Haver and CIRA

Figure 124. Confidence data suggest a milder contraction than 1Q GDP



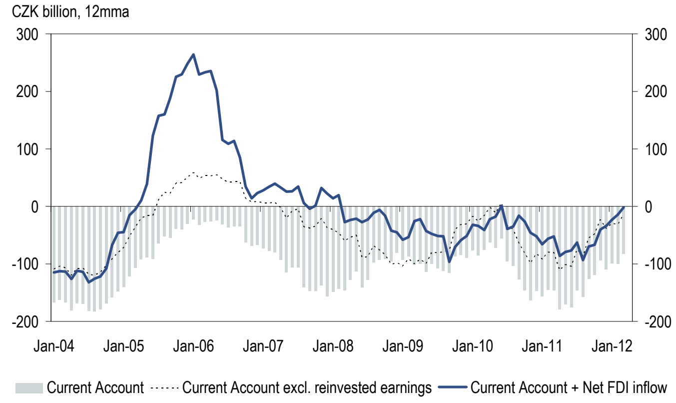
Source: Czech Statistical Office, CIRA

Figure 125. Historical trade surplus has continued to ease …



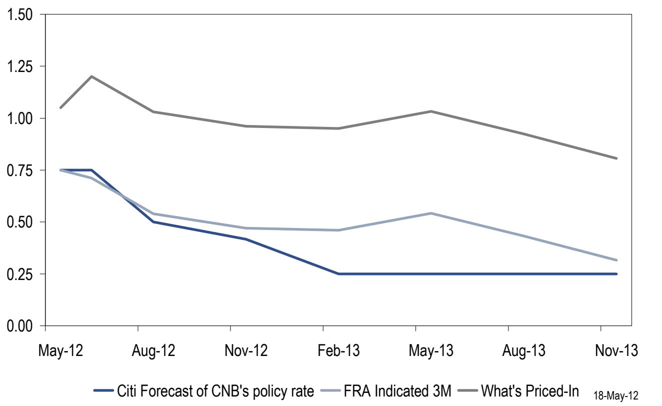
Source: Czech Statistical Office, CIRA

Figure 126. … financing requirement of the current account



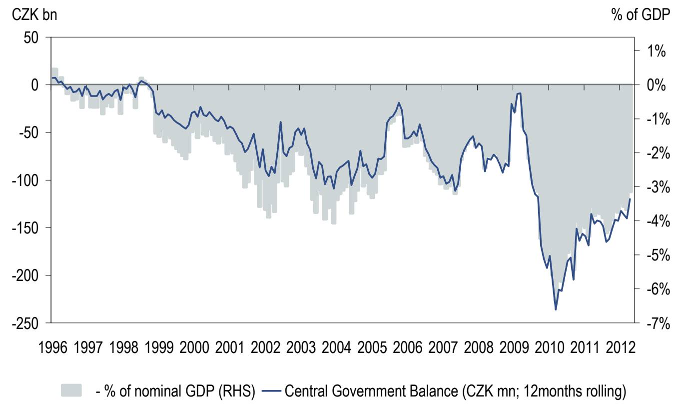
Source: European Commission, Czech Statistical Office, CIRA

Figure 127. Market started to price-in a cut, we two cuts



Source: Reuters, CIRA forecast and calculation.

Figure 128. Fiscal consolidation has so far remained on track



Source: Ministry of Finance, Haver Analytics, CIRA

Figure 129. Czech Republic Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	114.0	130.1	148.4	180.5	225.4	196.2	197.7	215.3	191.5	204.5
Nominal GDP, local currency bn	2,929	3,116	3,353	3,663	3,848	3,739	3,775	3,809	3,828	4,008
GDP per capita, US$	11,167	12,709	14,452	17,484	21,614	18,696	18,795	20,510	18,219	19,429
Population, mn	10.2	10.2	10.3	10.3	10.4	10.5	10.5	10.5	10.5	10.5
Unemployment, % of labour force	9.8	8.9	8.1	6.6	5.4	8.1	9.0	8.5	8.8	8.9
Economic Activity										
Real GDP, % yoy	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.7	-0.6	1.3
Real investment growth % yoy	3.0	6.0	5.8	13.2	4.1	-11.5	0.1	-1.5	-1.0	2.2
Real consumption growth % yoy	1.3	2.7	2.9	3.1	2.3	0.8	0.6	-0.9	-1.1	0.4
private consumption growth % yoy	3.2	3.1	4.4	4.2	2.8	-0.4	0.6	-0.7	-0.8	0.5
Real export growth, % yoy	13.6	11.6	13.8	11.2	4.0	-10.0	16.4	11.1	2.0	3.3
Real import growth, % yoy	10.0	5.9	10.8	12.8	2.7	-11.6	16.0	7.4	-1.5	5.0
Prices, Money & Credit										
CPI, % yoy	2.7	2.2	1.7	5.5	3.6	1.0	2.3	2.4	2.6	2.8
CPI, % avg	2.8	1.8	2.5	2.9	6.3	1.0	1.5	1.9	3.3	2.7
Nominal wages, % yoy	6.3	5.0	6.5	7.2	7.9	3.4	1.9	2.2	3.3	3.2
Credit extension to private sector, % yoy	12.4	20.0	20.5	26.6	16.1	0.8	3.0	5.5	2.9	0.0
Policy interest rate, %, eop	2.50	2.00	2.50	3.50	2.25	1.00	0.75	0.75	0.25	0.50
1 month inter-bank rate, %, eop	2.53	2.05	2.52	3.94	3.21	1.29	0.99	0.94	0.45	0.65
Long-term yield, %, eop	4.80	3.57	3.72	4.72	4.29	4.04	3.95	3.59	3.50	3.30
CZK/US$, eop	22.4	24.6	20.9	18.1	19.3	18.4	18.8	19.9	20.4	19.0
CZK/US$, avg	25.7	24.0	22.6	20.3	17.1	19.1	19.1	17.7	20.0	19.6
CZK/EUR, eop	30.5	29.0	27.5	26.6	26.9	26.5	25.1	25.8	25.3	24.4
CZK/EUR, avg	31.9	29.8	28.3	27.8	25.0	26.5	25.3	24.6	25.3	24.7
Balance of Payments, US$ bn										
Current account	-5.8	-1.2	-3.1	-7.9	-4.8	-4.8	-7.6	-6.3	-4.9	-5.3
% of GDP	-5.0	-0.9	-2.1	-4.4	-2.1	-2.5	-3.8	-2.9	-2.6	-2.6
Trade balance	-0.5	2.1	2.6	2.2	1.7	4.6	2.8	5.3	5.4	5.2
Exports	67.2	71.8	85.6	106.5	125.1	99.1	114.0	138.5	131.2	131.9
Imports	67.8	69.7	83.0	104.3	123.4	94.6	111.2	133.2	125.8	126.7
Service balance	0.6	1.6	2.2	2.9	4.4	3.9	3.9	3.8	3.4	3.7
Income balance	-6.1	-5.3	-7.4	-12.7	-10.6	-13.2	-14.8	-15.6	-14.2	-15.0
FDI, net	3.9	11.6	4.0	9.0	2.3	2.0	4.9	4.2	3.2	6.0
International reserves	27.8	29.1	31.1	34.4	36.5	39.7	40.3	37.9	42.0	44.0
Total amortisations	4.52	5.26	6.00	6.04	7.67	10.06	9.85	12.9	13.7	11.5
Public Finances, % of GDP										
Consolidated government balance	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1	-3.1	-2.8
Consolidated gov primary balance	-1.8	-2.2	-1.3	0.4	-1.2	-4.5	-3.4	-1.4	-1.6	-1.3
Public debt	28.9	28.4	28.3	27.9	28.7	34.4	38.1	41.2	44.1	44.9
of which Domestic	23.8	21.2	21.0	20.3	20.7	24.1	25.2	28.5	30.2	30.6
Foreign Assets & Liabilities, US$ bn										
External debt	45.2	46.5	57.3	76.2	84.2	89.2	94.2	102.8	102.8	108.2
Public	14.5	14.0	18.4	21.4	21.7	25.0	25.3	26.1	30.3	33.2
External debt / GDP	34.5	36.7	35.7	37.6	42.3	43.8	46.8	53.8	54.8	51.4
External debt / XGS	58.8	55.7	57.4	61.5	57.3	75.3	69.8	63.6	66.8	69.6
Short-term debt	15.4	14.6	15.4	22.6	27.1	23.9	23.6	29.5	24.5	26.0
Short-term debt/International reserves, %	55.3	50.1	49.6	65.5	74.2	60.2	58.5	77.9	58.3	59.1

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	2.1	1.3	0.6	-0.9	-0.6	-0.5	-0.2	3.3	7.0	6.9
CPI, % yoy	1.8	1.8	2.4	3.8	3.5	3.3	2.6	2.3	2.8	2.8
Policy interest rate, %, eop	0.75	0.75	0.75	0.75	0.50	0.50	0.25	0.25	0.25	0.25
1 month inter-bank rate, %, eop	0.98	0.96	0.94	0.95	0.70	0.70	0.45	0.40	0.40	0.40
Long-term yield, %, eop	3.75	2.97	3.79	3.48	3.20	3.50	3.50	3.45	3.40	3.35
CZK/US$	16.8	18.4	19.8	18.6	20.4	20.7	20.4	20.1	19.8	19.4
CZK/EUR	24.3	24.7	25.6	24.8	25.5	25.5	25.3	25.1	24.9	24.6

Source: National sources and Citi Investment Research and Analysis

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Egypt

- **Summary view** — The political focus is now firmly on the first round of the presidential elections, which is to be held on May 23/24, and the run-off, if required, scheduled for June 16/17. Progress with economic reform, and notably a deal with the IMF, is now only likely in 2H 2012.

- **Things to watch** — Even when Egypt has elected a new president, it is unlikely that a new constitution will be in place, meaning their exact role will be unclear. How the new president acts in these circumstances will be important to the future of the political transition still underway in the country.

- **Strategy** — Government economic policy will continue to preserve the status quo in 2012, notably a stable exchange rate. But falling foreign exchange reserves continue to highlight that this policy option may well have run its course and harder choices have to be made in late 2012.

The political focus is now on the presidential polls

The main focus of the ongoing political transition in the country is now the battle for the presidency. Assuming there is no last minute postponement, this is scheduled for two rounds in late May and mid June. But, without a new constitution, which may not be completed until September, the job description of the new president remains unclear and this means that the political uncertainty could continue into 2H 2012 as these issues are clarified. However, we still expect the country's first post Mubarak president to be a key player in the political scene, most crucially as an important force for political reconciliation.

But while the headlines may focus on the presidential election, an equally important political battle is underway, largely behind the scenes. With the Freedom and Justice Party (FJP) having won around half of the seats in the new parliament, it must now determine how to use this strong expression of public support. It must also work out exactly what sort of political accommodation it wants with the Supreme Council of the Armed Forces (SCAF). These tensions are already clear from its recent decision to field its own candidates in the presidential polls, when it had earlier insisted it had no intention of doing so. They will also come to fore again when the FJP and the new president will have to agree the process by which a new government, acceptable to all sides, can be formed. This is especially the case as we think it unlikely that a new constitution will be in place for some time after the election, although we still think political compromises are possible.

Funding the current account deficit

2011 current account data shows that the deficit actually fell marginally in 2011 compared to 2010. But there are significant changes in its composition. In particular, falling tourism earnings have been broadly offset by rising remittances. But the main change has come on the financing. The withdrawal of foreign investors from both the T-bill and equity markets has meant that the balance of payments deficit has largely been funded by the draw down of foreign exchange reserves. Inflows from donors have so far been limited, although there have been some, while there was a net outflow of FDI. But with foreign exchange reserves falling to US$15.1bn at the end of March 2012, the ability of the government to continue to follow this policy is now likely to be limited as the year progresses, especially as we do not expect any significant reduction in the current account deficit.

An exchange rate adjustment

The most obvious way to close the current account deficit in the medium term would be via a devaluation of the exchange rate. But there is a concern this would both be inflationary and increase political uncertainty and capital flight. However, with reserves now reaching critical levels, the options are limited, unless the government is prepared to open up negotiations with donors to attract sufficient funding for the current account deficit which may also “crowd in” private sector portfolio flows. Although it is now in negotiations with the IMF, there is unlikely to be a deal until after the presidential polls. But we also think even with donor inflows a devaluation will still be necessary in 2H 2012 or early 2013, unless the government seeks to impose some form of capital controls (or both). However, we still think the government will be reluctant to allow a major one off fall in the Egyptian pound and may seek a stepped devaluation.

Double-digit inflation is likely to return in 2012

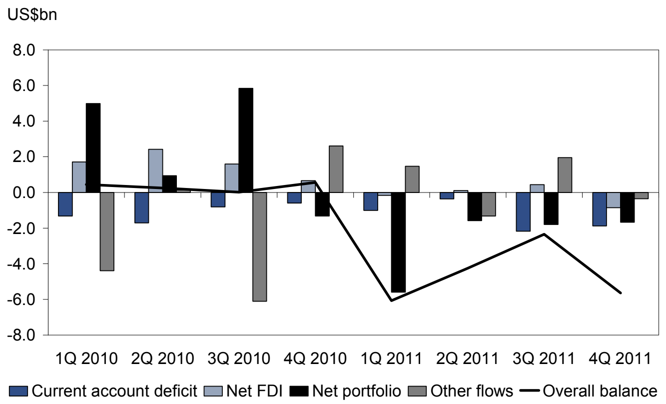
While inflation has remained in single-digits since August 2011, it has been volatile. Moreover, while we expect it to continue to jump around below the 10% YoY level throughout 1H 2012, we still think that the likely devaluation of the currency will mean that the inflation rate picks up in late 2012 and into early 2013, although the increase will be partially limited by the country’s food and fuel subsidies. There is also likely to be an increase in the core inflation rate, which means that the Central Bank of Egypt (CBE) will have to increase interest rates. However, we think the CBE will be reluctant to raise interest rates quickly because of the weak growth environment and given the size of the fiscal deficit.

While the expected fall in the exchange rate is likely to drive a short-term increase in inflation, the real issue is more a medium-term one: **will it help improve the current account balance?** While we think it will help, it will also be needed to be supported by other reform efforts, notably structural reforms to make the economy more competitive. Supporting this reform process and helping to fund the current account deficit, notably through the funding of infrastructural spending, is a key area that donors could support to help offset the economic dislocation caused by the devaluation. But this will require the new government and donors to reach some form of compromise agreement in early 2012, and without this, the adjustment could be much more traumatic.

Where to in 2013?

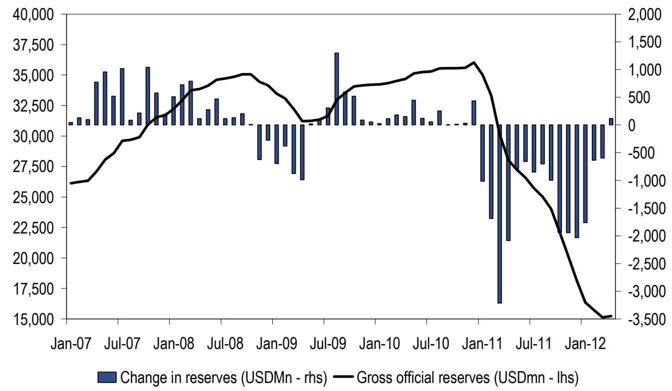
If 2012 proves to be a year of difficult political and economic adjustment then 2013 is potentially the year the government can seek to consolidate the reform process. But in order to more fundamentally restore growth and confidence in the economy, any government will have to quickly formulate a more coherent medium- to long-term policy with the IMF in 2H 2012 to be implemented aggressively in 2013. If this is a more populist economic policy, with no long-term goal to reduce the fiscal deficit, then the medium-term economic outlook in Egypt could prove to be relatively unpromising. However, we expect a more reformist minded government to push ahead with long-overdue reforms. But meeting the main aim of political protestors to date — the need to create jobs and reduce inflation — against the background of the need to reduce the fiscal deficit and devalue the exchange rate, will continue to remain a tricky policy goal for any new government, especially one with only limited political experience and a weak fiscal inheritance, without significant external support.

Figure 130. Funding the balance of payments deficit



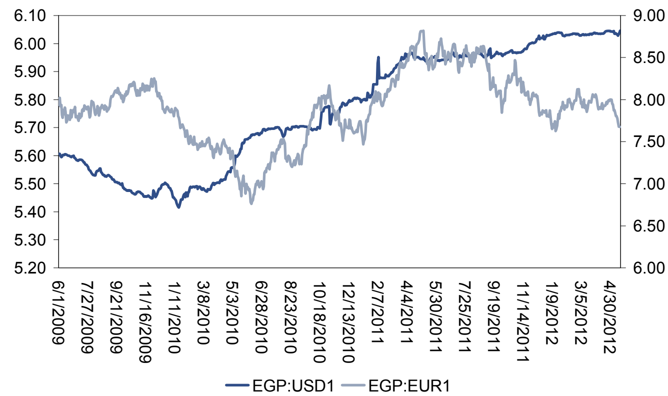
Source: Haver Analytics

Figure 131. The fall in reserves slows in early 2012



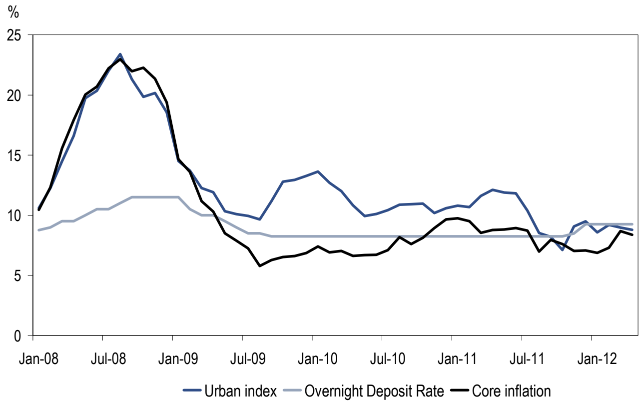
Source: Central Bank of Egypt

Figure 132. A broadly stable EGP:USD despite the pressure



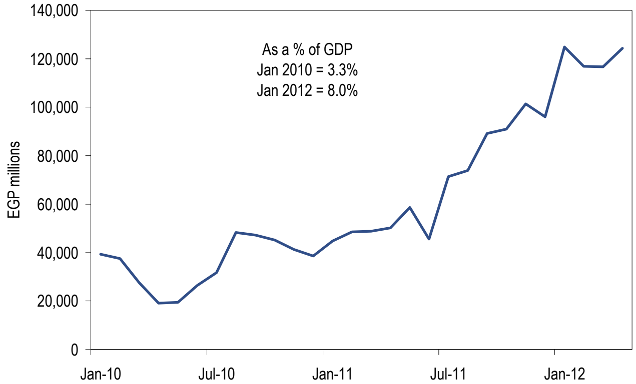
Source: Reuters

Figure 133. Inflationary pressures remain



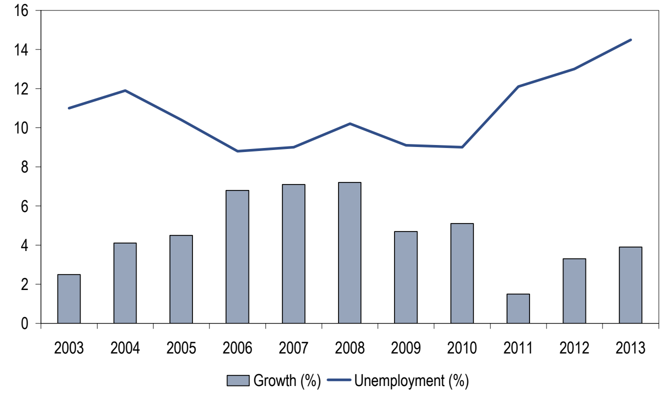
Source: EcoWin

Figure 134. CBE funding of the government deficit rises



Source: Haver Analytics

Figure 135. Growth should recover in 2012-13, but only slowly



Source: Haver Analytics

Figure 136. Egypt Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	78.3	93.2	107.9	132.2	164.8	188.0	214.4	231.1	255.4	269.3
Nominal GDP, local currency bn	485	539	618	745	896	1042	1207	1372	1551	1785
GDP per capita, US$	1,075	1,256	1,427	1,717	2,101	2,352	2,634	2,787	3,024	3,130
Population, mn	73	74	76	77	78	80	81	83	84	86
Unemployment, % of labour force	10.3	11.2	10.6	8.9	8.7	9.4	9.0	12.1	13.0	14.5
Economic Activity										
Real GDP, % yoy	4.1	4.5	6.8	7.1	7.2	4.7	5.1	1.8	3.0	3.9
Real investment growth % yoy	6.3	14.2	13.8	23.7	14.8	-10.2	7.7	-5.6	9.9	3.4
Real consumption growth % yoy	2.1	4.5	5.9	7.6	5.2	5.7	4.2	4.9	2.3	3.9
private consumption growth % yoy	2.1	4.8	6.4	8.8	5.7	5.7	4.1	5.0	0.2	1.5
Real export growth, % yoy	25.3	20.2	21.2	20.2	28.8	-14.5	-3.0	3.7	-3.8	6.3
Real import growth, % yoy	17.2	23.8	21.7	30.5	26.3	-17.9	-3.2	8.1	-2.3	5.5
Prices, Money & Credit										
CPI, % yoy	11.4	3.2	12.3	6.9	18.4	13.2	10.6	9.5	11.5	7.1
CPI, % avg	11.3	4.9	7.6	9.5	18.3	11.8	11.1	10.2	10.0	11.2
Nominal wages, % yoy	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Credit extension to private sector, % yoy	3.6	6.3	10.3	10.0	12.0	3.0	6.7	6.1	4.0	7.5
Policy interest rate, %, eop	10.00	9.50	8.75	8.75	11.50	8.25	8.25	9.25	15.00	11.00
1 month inter-bank rate, %, eop	11.78	9.41	9.00	8.75	11.95	8.30	8.30	10.05	11.95	7.56
Long-term yield, %, eop	NA	9.10	10.75	9.50	9.00	9.00	9.00	9.50	9.00	9.00
EGP/US$, eop	6.22	5.73	5.71	5.53	5.50	5.48	5.80	6.05	6.30	7.00
EGP/US$, avg	6.20	5.78	5.73	5.63	5.43	5.55	5.63	5.94	6.07	6.63
EGP/EUR, eop	8.29	6.75	7.53	8.05	7.53	7.77	7.66	7.91	7.81	8.97
EGP/EUR, avg	7.70	7.19	7.19	7.71	7.99	7.69	7.47	8.26	7.71	8.34
Balance of Payments, US$ bn										
Current account	3.2	2.0	2.5	0.2	-1.3	-3.2	-5.6	-5.4	-6.8	-8.8
% of GDP	4.1	2.2	2.3	0.2	-0.8	-1.7	-2.6	-2.3	-2.7	-3.3
Trade balance	-9.3	-11.3	-12.7	-20.8	-26.8	-22.5	-27.7	-26.1	-26.7	-25.6
Exports	12.3	16.1	20.5	24.5	29.8	23.1	25.0	27.9	28.1	29.7
Imports	21.6	27.4	33.3	45.3	56.6	45.6	52.7	54.0	54.8	55.2
Service balance	8.0	7.6	9.5	12.7	15.7	11.3	9.6	5.4	5.6	0.8
Income balance	-	-	-	-	-	-	-	-	-	-
FDI, net	2.0	5.3	9.9	10.9	7.6	6.1	5.2	-1.1	1.9	2.6
International reserves	15.5	21.9	26.1	31.7	34.2	34.2	36.0	18.1	13.5	9.6
Total amortisations	1.9	2.1	2.5	2.3	2.1	2.1	1.0	1.0	2.3	2.3
Public Finances, % of GDP										
Consolidated government balance	-6.1	-7.0	-7.7	-5.2	-6.4	-6.6	-7.7	-10.1	-9.1	-7.4
Consolidated gov primary balance	-0.4	-1.5	-2.1	0.0	-1.8	-2.4	-2.6	-4.5	-5.0	-3.6
Public debt	60.3	64.8	62.8	64.2	53.5	54.0	59.8	68.9	77.0	75.3
of which Domestic	60.3	64.8	62.8	64.2	53.5	54.0	59.8	68.9	77.0	75.3
Foreign Assets & Liabilities, US$ bn										
External debt	31.1	29.7	29.0	32.8	32.1	33.3	35.0	31.5	44.8	60.1
Public	20.7	19.7	19.0	21.6	26.0	27.2	28.3	27.2	28.2	29.7
External debt / GDP	39.7	31.9	26.8	24.8	19.5	17.7	16.3	13.6	17.6	22.3
External debt / XGS	117.6	92.4	73.9	68.8	55.6	73.0	70.9	66.5	93.1	119.0
Short-term debt	1.7	1.7	1.7	2.2	2.8	2.6	3.1	3.1	3.1	3.1
Short-term debt/International reserves, %	11.1	7.5	6.6	7.0	8.3	7.5	8.7	17.4	23.4	33.0

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	0.4	0.3	1.0	1.5	2.5	3.4	3.7	3.5	3.7	4.2
CPI, % yoy	11.7	8.3	9.4	7.9	9.3	11.3	11.5	13.0	12.9	10.0
Policy interest rate, %, eop	8.25	8.25	9.25	9.25	9.50	15.00	15.00	14.00	13.00	11.00
1 month inter-bank rate, %, eop	9.55	9.70	10.05	11.00	9.74	11.77	11.95	13.41	13.35	10.48
Long-term yield, %, eop	9.25	9.50	9.50	9.50	10.00	10.75	12.00	13.00	13.00	13.00
EGP/US$	5.97	5.97	6.03	6.04	6.05	6.05	6.30	6.50	6.50	6.80

Source: National sources and Citi Investment Research and Analysis

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Gulf Cooperation Countries

Saudi Arabia

April figures show an uptick in Saudi production to 9.8 mbpd, supporting our view that Saudi will pursue a lower oil price through greater production. That said, we note that the uptick does not necessarily indicate higher crude exports considering that domestic demand is on the rise as we enter the summer months. Moreover, Brent oil prices have come off around 10% since early May, mainly on the back of concerns over a re-escalation in the European sovereign debt crisis, which spells downside risks to our oil production forecast of around 9.5mbpd for the year on average. For the time being, we maintain our GDP growth forecast of 7.1% in 2012, project record fiscal revenues. Expenditures will once again overshoot budget (although will remain lower than 2011 levels due to the one-off nature of many such expenditures), but the net result will be a budget surplus of around 16.5% of GDP in 2012, up from just under 14% in 2011. We believe growth in the non-oil economy will remain strong, around 8.5%, on the back of continued high government expenditure and increased domestic demand. We continue to expect progress on passing of the mortgage law in 2012, which we believe will create a significant boost to the local housing sector and domestic demand. Meantime, inflation remains sticky, flat at 5.4% in March, but we continue to expect demand side pressure to pose a significant threat to price stability in the coming months.

Bahrain

A Saudi initiative to transform the GCC from a loose economic federation to a formal union was discussed at the GCC summit in May. Details on what this would entail were not revealed, but the Saudi's have proposed a common security, foreign and economic policy. The proposals have been met with a lukewarm reception by most GCC members other than Bahrain, which we expect will enter into some form of union agreement with Saudi Arabia in the near term. We expect the agreement will be a blueprint that will allow wider membership across the GCC over time. In practice, however, we do not expect a meaningful GCC-wide union in the foreseeable future, and would not expect any shift in domestic policies in any of the GCC states, including Bahrain, even if a union agreement were signed. The GCC itself serves as an example of how lofty ideals of regional integration are rarely implemented in practice. On paper, the GCC has had a customs union in place since 2003, and an Economic Area since 2008, but neither of these actually exists on the ground. One of the main obstacles to this, in our view, has been that greater regional integration necessitates individual states to relinquish sovereignty to regional institutions. The weak institutional framework and the reluctance of regional rulers to relinquish sovereignty is unlikely to change for the foreseeable future, in our view, and thus we believe any agreements signed by would-be union members is unlikely to have much practical impact.

That said, the idea of a formal union with Saudi Arabia has been perceived by the opposition in Bahrain as a signal that the government is digging its heels in further with respect to ongoing confrontations over political reform. Saudi Arabia is the regional Sunni power that, in the eyes of the Bahraini opposition, supported the suppression of protests in March through military intervention. Saudi is seen as hostile by the opposition, and supportive of the hard-line anti-opposition members of the Bahraini ruling family. As such, the proposed union has been strongly opposed by the opposition, and has lead to a marked escalation in anti-government protests in recent weeks.

United Arab Emirates

Lead indicators point to a continued recovery in Dubai's economy, with DP World announcing a 9% increase in volumes at Jebel Ali Port and DHCOG, which owns the Jumeirah Hotel group, announcing strong revenue growth. In a recent Knight Frank report, Dubai premium property prices are showing a strong recovery as well, up 4% in the first quarter of 2012, higher than any of the 22 other global cities surveyed in the report. That said, supply continues to come on line, meaning that prices are likely to remain soft outside the mature premium areas of Dubai. Dubai's debt restructuring efforts continue to progress. Dubai Drydocks has applied for insolvency protection under Dubai Decree 57, having lost a lawsuit the previous month to one of its minority creditors, Monarch Capital. This will be the first test of the insolvency regime since its establishment in 2009. DIC, a private equity arm of Dubai Holding Group, finally reached an agreement with creditors over the restructuring of US$2.5bn in debt. The IMF on May 16, however, expressed caution over what it said was US$30bn of GRE debt falling due in 2012, and more in 2014-2015.

Kuwait

Kuwait's parliament, which is dominated by opposition MPs who won 34 out of the 50 contested seats in parliamentary election in February, will be 'grilling' Finance Minister Al-Shamali over allegations of financial and administrative irregularities in the coming week. The move will be the first such 'grilling' since the new parliament was established, and confirms our view that the opposition victory in February will only exacerbate frictions between the government and the National Assembly, and lead to further legislative gridlock in Kuwait. Mr Al-Shamali is likely to face a vote of no confidence that we believe will most probably force him out of office. Such a vote requires the support of just 25 MPs. In the current environment, we see little chance of progress on the legislative agenda, which bodes poorly for implementation of the economic development plan.

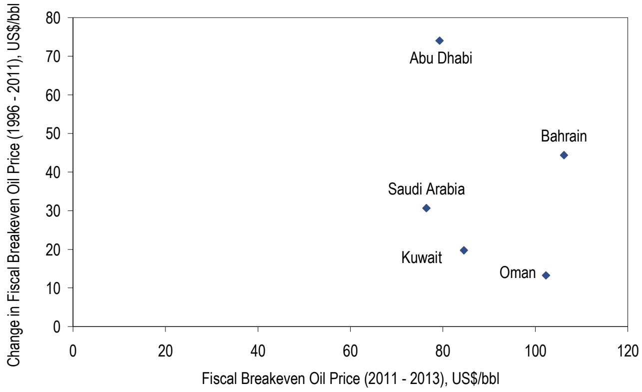
Qatar

The Qatari government has reportedly finalized the draft 2012-2013 budget, and will publish it in late May. We expect that total expenditures will rise sharply compared with last year's budget, but that in practice most of the increase is related to expenditure introduced during the course of last year during the regional unrest. Reuters reports that the Qatari government has appointed banks for a debut Sukuk offering.

Oman

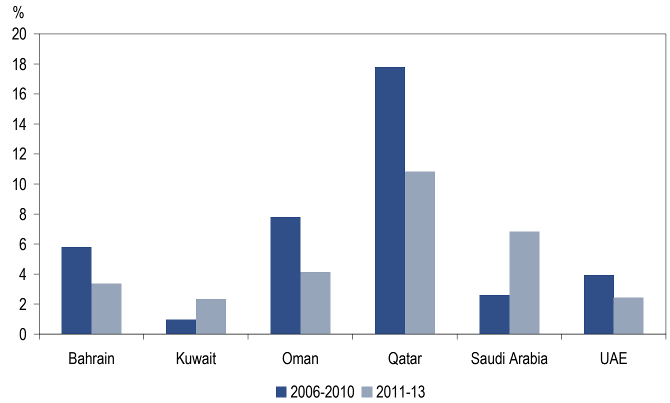
On a one-year rolling basis, latest fiscal data show a marked improvement in Oman's public finances. The budget has gone from a deficit position equivalent to 8.1% of GDP in the 12 months to Q1 2011, to a surplus position of over 10% of GDP for equivalent period in 2012, according to our calculations. However, the turnaround masks growing imbalances in Oman's public finances. The improvement reflects soaring oil production and prices, which have swelled revenues by almost 30% of GDP during this period. At the same time, government expenditure has risen by a massive 20% of GDP, leaving the budget highly exposed to a future fall in the oil price. Indeed, we estimate a fiscal break-even oil price of almost US$110 per barrel in 2012, compared with just over US$90 per barrel last year.

Figure 137. Fiscal breakeven oil prices on the rise



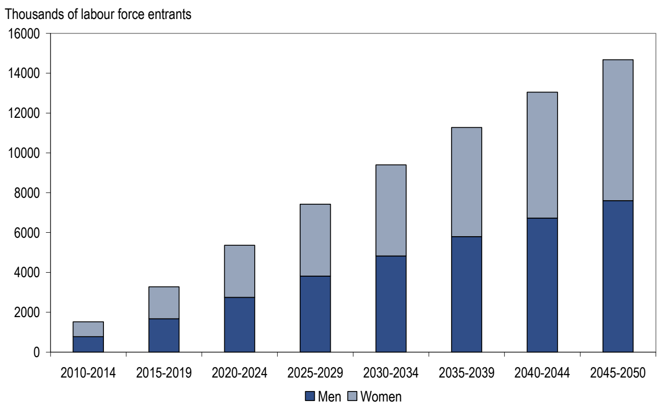
Source: Citi Investment Research and Analysis estimates

Figure 138. Economic growth will be uneven going forward



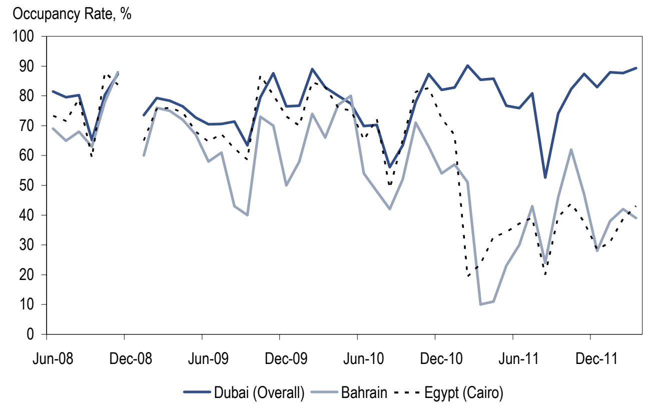
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 139. 3 million entrants in Saudi job market by end of decade



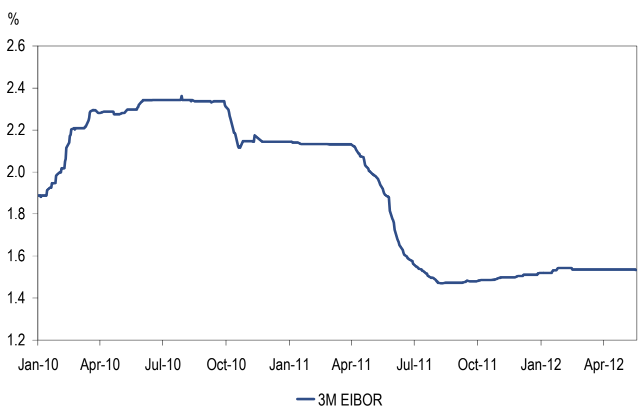
Source: Saudi Central Statistics Office, Citi Investment Research and Analysis

Figure 140. Dubai hotel occupancy continues to outperform its peers



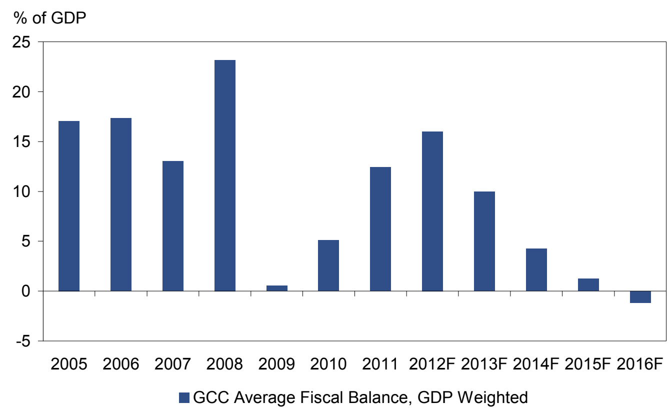
Source: Ernst & Young, Citi Investment Research and Analysis

Figure 141. EIBOR rates appear to have bottomed



Source: Haver Analytics

Figure 142. High government expenditure will drive lower surpluses



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 143. GCC Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
BAHRAIN									
Nominal GDP, US$ bn	13.4	15.8	18.5	22.4	19.6	21.9	25.8	25.4	26.3
GDP per capita, US$	18,511	19,493	19,963	21,329	16,725	17,330	19,813	18,755	24,454
Real GDP, % yoy	7.9	6.7	8.4	6.3	3.1	4.5	3.2	3.0	6.9
CPI, % avg	2.6	2.0	3.3	3.5	2.8	1.9	-0.4	3.0	3.5
BHD/US$, eop	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
BHD/US$, avg	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38
Current account, US$bn	1.4	2.0	2.8	2.1	0.4	0.6	3.0	7.4	-0.4
% of GDP	10.2	12.9	14.9	9.3	1.9	2.7	11.6	29.2	-1.5
Consolidated government balance, % of GDP	7.6	4.7	3.1	7.3	-5.1	-5.6	-1.2	4.8	-4.0
KUWAIT									
Nominal GDP, US$ bn	80.8	101.9	119.2	143.2	106.2	122.8	159.1	178.9	166.2
GDP per capita, US$	35,663	43,471	49,119	57,023	40,832	45,634	57,143	62,080	55,717
Real GDP, % yoy	10.6	5.2	4.4	-1.1	-9.3	5.5	4.3	0.2	2.5
CPI, % avg	4.1	3.1	5.5	10.6	4.0	4.0	4.7	5.0	5.0
KWD/US$, eop	0.29	0.29	0.27	0.28	0.29	0.28	0.28	0.28	0.28
KWD/US$, avg	0.29	0.29	0.28	0.27	0.29	0.29	0.28	0.29	0.29
Current account, US$bn	30.1	45.5	43.0	58.5	25.8	37.5	75.7	81.6	77.8
% of GDP	37.2	44.6	36.0	40.9	24.3	30.6	47.5	45.6	46.8
Consolidated government balance, % of GDP	23.2	18.1	22.2	14.4	13.9	11.0	17.1	17.1	13.9
OMAN									
Nominal GDP, US$ bn	30.9	36.8	41.9	59.9	53.4	57.7	62.6	83.4	87.2
GDP per capita, US$	12,702	14,756	15,259	20,887	18,015	18,833	19,781	25,061	24,798
Real GDP, % yoy	12.2	3.7	10.4	14.0	4.3	6.7	4.9	3.0	4.5
CPI, % avg	1.2	3.0	5.9	12.5	3.6	3.2	4.0	3.0	3.0
OMR/US$, eop	0.39	0.39	0.39	0.39	0.39	0.39	0.39	0.39	0.39
OMR/US$, avg	0.39	0.39	0.38	0.38	0.39	0.39	0.39	0.39	0.39
Current account, US$bn	5.2	5.7	2.5	5.0	-0.6	1.5	2.1	2.2	18.5
% of GDP	16.8	15.4	5.9	8.4	-1.1	2.6	3.4	2.6	21.3
Consolidated government balance, % of GDP	2.5	-0.1	2.7	0.3	-3.8	-0.2	5.4	4.4	3.9
QATAR									
Nominal GDP, US$ bn	44.5	60.5	80.8	110.7	98.3	110.1	167.3	195.3	199.2
GDP per capita, US$	55,930	72,192	86,829	100,831	80,717	81,443	111,486	120,451	113,762
Real GDP, % yoy	7.5	26.2	18.0	17.7	12.0	15.2	18.1	6.0	7.8
CPI, % avg	8.8	11.8	13.6	15.2	-4.9	-2.4	3.0	3.0	3.0
QAR/US$, eop	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.6
QAR/US$, avg	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.64	3.6
Current account, US$bn	7.5	9.5	9.0	15.9	6.7	32.2	64.8	74.6	21.5
% of GDP	16.8	15.6	11.2	14.3	6.8	29.2	38.7	38.2	10.8
Consolidated government balance, % of GDP	9.2	8.5	10.9	10.0	15.2	2.9	8.1	7.1	14.0
SAUDI ARABIA									
Nominal GDP, US$ bn	315.3	356.1	384.6	475.9	376.6	450.8	576.8	626.2	670.8
GDP per capita, US$	13,638	15,028	15,835	19,116	14,758	17,266	21,620	23,009	24,166
Real GDP, % yoy	5.6	3.2	2.0	4.2	0.1	3.4	6.8	7.1	6.1
CPI, % avg	0.6	2.3	4.1	9.9	5.1	5.4	5.0	7.0	8.0
SAR/US$, eop	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.8
SAR/US$, avg	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.8
Current account, US$bn	90.6	99.6	94.3	133.0	21.5	67.4	154.3	183.1	47.6
% of GDP	28.7	28.0	24.5	27.9	5.7	14.9	26.8	29.2	7.1
Consolidated government balance, % of GDP	18.4	21.0	12.2	32.5	-6.1	5.2	13.7	20.5	-6.1
UNITED ARAB EMIRATES									
Nominal GDP, US$ bn	180.6	222.1	258.2	314.8	270.3	297.6	325.2	340.0	329.9
GDP per capita, US$	44,388	52,521	57,526	66,069	55,079	58,882	62,459	62,614	58,022
Real GDP, % yoy	4.9	9.9	3.2	3.3	-1.6	1.4	5.3	0.5	2.3
CPI, % avg	6.2	9.3	11.1	12.3	1.6	0.9	0.9	1.1	2.9
AED/US$, eop	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
AED/US$, avg	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
Current account, US$bn	11.6	15.2	6.0	7.4	3.0	8.2	15.0	3.5	6.4
% of GDP	42.8	57.5	46.5	63.8	42.5	63.6	89.0	55.1	2.0
Consolidated government balance, % of GDP	-	-	-	-	-	-	-	-	-

Source: National sources and Citi Investment Research and Analysis

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Hungary

- **Summary view** — We continue to believe that Hungary will secure an IMF deal, most likely in 4Q12 as funding reserves erode. Due to the slow progress towards starting official loan talks, Hungarian assets are likely to be largely exposed to external shocks.
- **Things to watch** — The EC's assessment of the convergence program, the June 22 ECOFIN decision and progress towards reaching compromise on the Central Bank Bill with the IMF will be key market moving factors in the short term.
- **Strategy** — We expect slow progress towards finalizing an IMF deal and tightening liquidity in the European banking sector to put local assets under pressure before the government compromises with international lenders.

The start of official loan talks is still uncertain

Monetary policy independence is still an obstacle to start official loan negotiations. Following the EC's positive decision to drop infringement on the Central Bank Bill and provide a green light to the start of official loan negotiations as the government implements the agreed legislative changes, Hungary still needs to compromise with the IMF on one monetary policy issue to meet all preconditions. The parliamentary vote on CB bill amendments is scheduled for May 29, which will ensure legal compliance with the EU's preconditions but not address one of the IMF's key concern: the transfer of executive rights from the Board to the MPC, which is a material issue to the IMF because it provides the MPC almost full power in issues like FX reserve management. The government is trying to solve the issue without legislative changes (arguing that the new rights have been transferred back to the NBH's Board by the MPC's internal decision) and there is still an effort to compromise on five party talks involving the EC, the ECB, the IMF, the NBH and the government. The Hungarian government can quickly pass the legislative changes and PM Orban's recent decision to extend the spring parliamentary session until mid-July suggests that there is still room to harmonize the CB bill before the summer recess. The fact that Hungary holds up the start of the negotiations on one minor issue suggests that the government is still gambling, hoping that it can either avoid a deal or — more realistically — loosen conditions as the deepening crises in peripheral Europe may ease international lender's stance towards Hungary.

The deterioration in global risk environment may put increased pressure on the government to move forwards in negotiations. The government does not seem to feel the urge to speed up its negotiating strategy as it has about € 6bn in cash reserves and about €2.5bn in assets remaining from the nationalization of the private pension funds in 2011. These funds can cover funding needs for about 3-4 months even without LC issuance. According to our calculations, if LC auction demand can be sustained by hopes of an IMF agreement in the coming months, funding needs may be covered until 1Q13 without Eurobond issuance. Accessing the Eurobond markets without an IMF deal may be challenging for the government in a global risk-averse environment. Based on the rising FX debt redemptions in 4Q12 and the potential risk of weakening inflows from foreign funds, which have been the marginal buyer year-to-date, to LC currency papers as the European debt crises escalates, we expect increased pressure on the government to move forward in the negotiation process during the coming months. Our base-line scenario is that official negotiations may start in September and conclude in 4Q12.

Fiscal adjustment based heavily on sectoral taxes

While loan negotiations are delayed, the government makes efforts to keep the fiscal deficit below the EU's 3% threshold striving to ease potential disagreements during future negotiations on fiscal loan conditions. Based on the newly announced fiscal measures under the Szell Kalman Plan 2.0, the EC has lowered its deficit forecasts to 2.5% and 2.9% of GDP for 2012 and 2013, respectively. This suggests that the ECOFIN may lift the suspension of Cohesion Funds from 2013 on its June 22 meeting. Although the new measures may be enough to lift the EDP in our view, a significant change in economic policies to turn more growth supportive may be still required by the IMF to approve a loan program. The new fiscal measures are 60% based on sectoral tax revenues, mostly the financial transaction tax and the new telecom tax. Adjustments to the flat tax system in order to lower wage costs in the low income segment, expenditure cuts at state owned transportation companies and at local municipalities and tightening social benefit schemes may be key areas that the IMF will likely require to be addressed in order to improve Hungary's long term growth prospects.

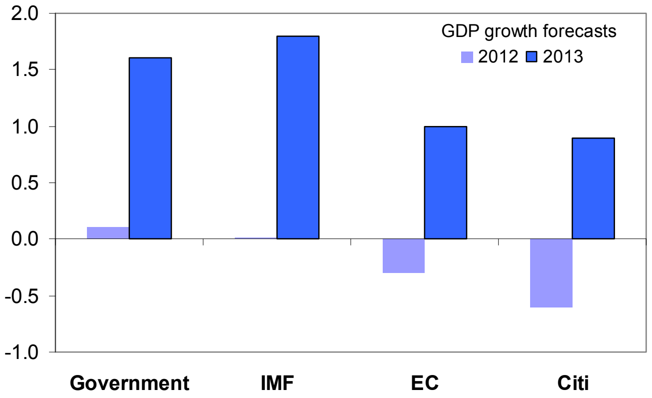
Growth outlook weakens on fiscal measures and deteriorating external demand. GDP growth has surprised to the downside dropping from 1.4%YoY in 4Q11 to -0.7%YoY in 1Q12. The deceleration in industrial exports, weak agriculture crop expectations and fiscal adjustment burdening domestic demand suggest that the economy is likely to slip further into recession in 2Q12. We have lowered our growth forecast to -0.5%YoY for 2012 and to 0.9%YoY for 2013 from -0.1% and 1.4%, respectively.

Dovish MPC on weak growth but stability constrains cuts

The MPC is divided between financial stability risks and weak growth prospects. External MPC members have turned more dovish recently as the growth outlook continues to slide and have signaled that rate cuts may start ahead of signing an IMF deal if there is any progress in official talks. Although tax measures may keep CPI close to 4% in 2013, dovish MPC members focus on tax filtered core inflation measure which is close to the 3% target. Internal MPC members take a more cautious approach as the timing of the IMF agreement remains uncertain and global risk aversion raises amidst European debt woes.

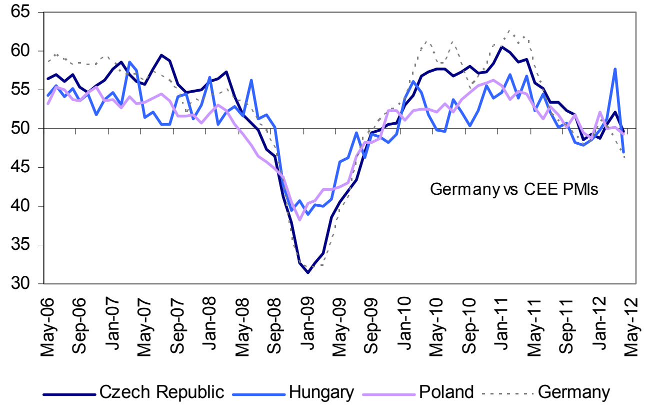
Despite the impacts of the various household FX mortgage loan aid schemes the Hungarian economy remains vulnerable to FX weakening: Household sector FX debt exposure has dropped from 25% of GDP in 3Q11 to 20% of GDP by 1Q12 due to the accelerated debt amortization on the FX mortgage prepayment scheme. The new FX mortgage monthly installment fixation scheme will provide temporary relief (for 5 years) to most the remaining household FX debt expose but FX weakening will still hit households at the end of the scheme. Moreover the corporate sector has still around 19% of GDP FX debt obligation to domestic banks, of which a huge portion is unhedged. Banking sector stability is also highly sensitive to FX weakening due to local banks' reliance on swap markets to provide FX liquidity due to the FX mismatch of their balance sheets. FX pass-though to CPI (~15-20%) is still a concern to monetary policy decision makers as latest CPI data confirm that the impact of currency weakening to CPI has not diminished despite the weak domestic demand. Therefore monetary policy likely continue to focus on risk premiums and the magnitude of future rate cuts will largely depend on global risk factors beside the domestic factors.

Figure 144. Growth outlook deteriorates on fiscal austerity…



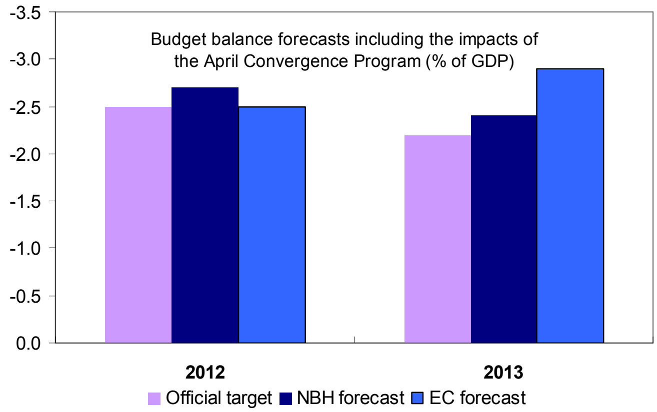
Source: IMF, Ministry of National Economy, EC, CIRA

Figure 145. …and weakening demand for manufacturing exports



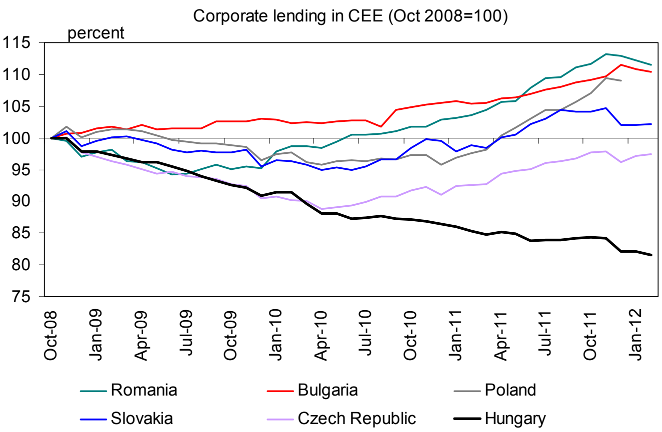
Source: Haver, CIRA

Figure 146. New fiscal measures may keep the deficit below 3%...



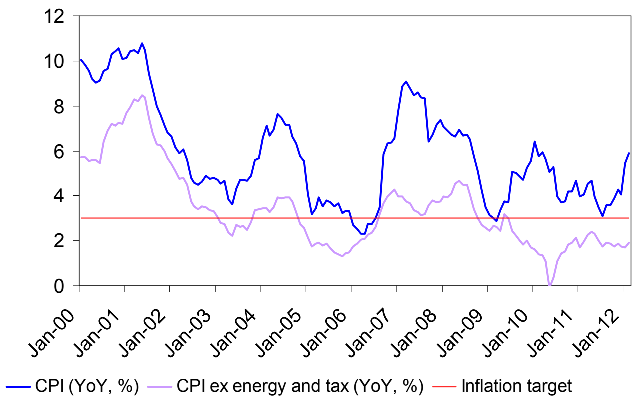
Source: Ministry of National Economy, EC, NBH , CIRA

Figure 147. …but financial transaction tax may accelerate deleveraging



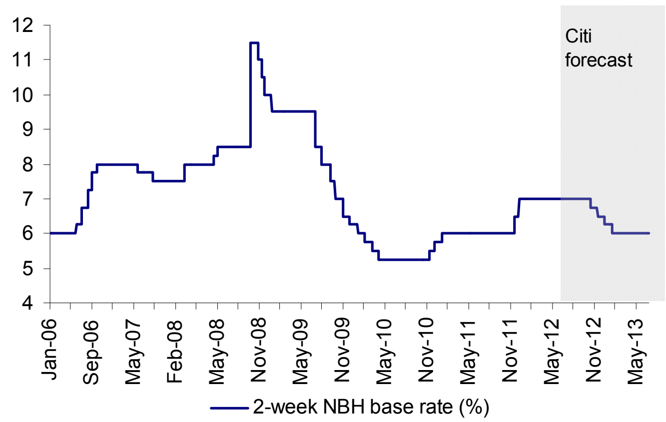
Source: National Bank of Hungary, CIRA

Figure 148. CPI elevated by tax hikes and external price shocks



Source: NBH, CIRA

Figure 149. MPC to cut rates as risk premiums drop on IMF news



Source: NBH, CIRA

Figure 150. Hungary Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	114.6	103.0	123.6	144.8	141.3	136.2	128.2	117.2	123.9	135.0
Nominal GDP, local currency bn	20,665	22,008	23,676	24,992	26,546	25,623	26,748	28,154	28,991	30,364
GDP per capita, US$	11,337	10,215	12,277	14,417	14,096	13,621	12,817	11,771	12,476	13,592
Population, mn	10.1	10.1	10.1	10.0	10.0	10.0	10.0	10.0	9.9	9.9
Unemployment, % of labour force	6.1	7.2	7.5	7.4	7.8	10.0	11.2	11.6	11.8	11.0
Economic Activity										
Real GDP, % yoy	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.7	-0.5	0.9
Real investment growth % yoy	7.2	4.5	-2.7	3.8	2.9	-11.0	-9.7	-5.4	-2.3	0.2
Real consumption growth % yoy	1.7	2.3	2.2	-1.4	-0.2	-4.6	-2.1	-0.1	-2.0	-1.2
private consumption growth % yoy	1.7	2.3	1.7	1.1	-0.7	-6.2	-2.2	0.0	-1.8	-0.8
Real export growth, % yoy	15.0	11.3	19.1	15.0	5.7	-10.2	14.3	8.4	4.2	6.2
Real import growth, % yoy	14.3	6.9	15.1	12.8	5.5	-14.8	12.8	6.3	3.3	5.2
Prices, Money & Credit										
CPI, % yoy	5.5	3.3	6.6	7.4	3.4	5.4	4.6	4.1	5.3	3.7
CPI, % avg	6.8	3.5	4.0	7.9	6.0	4.0	4.7	3.9	5.6	3.9
Nominal wages, % yoy	-	8.8	8.2	8.0	7.4	0.5	1.3	5.2	6.5	4.5
Credit extension to private sector, % yoy	18.6	18.9	16.7	18.8	21.7	-2.7	4.1	-0.5	-11.1	-5.6
Policy interest rate, %, eop	9.50	6.00	8.00	7.50	10.00	6.25	5.75	7.00	6.00	5.75
1 month inter-bank rate, %, eop	9.60	6.04	8.08	7.50	10.00	6.25	5.75	7.08	5.98	5.85
Long-term yield, %, eop	7.05	6.97	6.71	7.08	8.28	7.99	7.97	9.75	8.10	7.98
HUF/US$, eop	180	214	192	173	188	188	209	240	234	224.9
HUF/US$, avg	203	200	210	184	172	202	208	201	232	227.1
HUF/EUR, eop	246	253	252	253	265	271	279	311	290	288.1
HUF/EUR, avg	252	248	264	251	251	281	275	279	294	286.8
Balance of Payments, US$ bn										
Current account	-8.8	-8.2	-8.3	-9.9	-11.4	-0.2	1.6	2.0	1.8	2.5
% of GDP	-8.5	-7.6	-7.1	-7.3	-7.7	-0.1	1.2	1.6	1.4	1.9
Trade balance	-3.9	-3.2	-3.1	-0.9	-1.8	3.3	4.3	5.6	6.3	7.3
Exports	55.4	61.8	73.3	93.0	106.1	80.0	91.5	107.2	104.5	111.9
Imports	59.3	65.0	76.4	93.9	107.9	76.7	87.2	101.5	98.1	104.7
Service balance	0.6	1.5	1.8	1.8	2.2	2.8	3.9	4.5	3.6	4.0
Income balance	-5.4	-6.2	-6.7	-10.1	-11.0	-6.8	-7.1	-8.8	-8.4	-9.2
FDI, net	3.2	5.5	2.9	0.3	3.9	0.1	1.0	-0.2	1.1	1.3
International reserves	15.3	18.3	20.9	23.2	33.2	41.1	43.1	42.7	37.8	39.1
Total amortisations	7.5	8.8	7.7	9.3	15.2	16.1	15.2	14.5	15.5	15.4
Public Finances, % of GDP										
Consolidated government balance	-6.4	-7.9	-9.4	-5.1	-3.7	-4.6	-4.2	4.3	-2.8	-2.5
Consolidated gov primary balance	-2.0	-3.8	-5.4	-0.9	0.5	0.0	0.0	8.5	1.7	1.9
Public debt	59.5	61.6	65.7	66.9	72.3	78.4	80.2	80.8	78.6	77.4
of which Domestic	34.8	33.8	35.9	36.1	37.6	36.9	40.9	39.5	41.2	41.9
Foreign Assets & Liabilities, US$ bn										
External debt	81.1	85.0	114.4	151.7	172.7	194.9	183.7	174.9	166.2	175.6
Public	32.4	31.9	40.7	50.5	55.3	67.4	69.5	311.1	69.3	74.8
External debt / GDP	70.7	82.5	92.6	104.8	122.2	143.0	143.3	149.3	134.1	130.1
External debt / XGS	122.5	113.7	131.5	137.7	136.6	197.7	165.6	135.7	132.9	131.3
Short-term debt	17.0	18.6	21.9	32.0	26.8	27.3	31.3	28.5	28.5	32.0
Short-term debt/International reserves, %	111.3	101.9	105.0	138.1	80.7	66.4	72.5	66.7	75.4	81.8

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	1.5	1.4	1.4	-1.0	-0.9	-1.2	0.6	0.4	0.9	1.1
CPI, % yoy	3.5	3.8	4.0	5.4	5.7	5.7	5.3	4.0	3.9	3.9
Policy interest rate, %, eop	6.00	6.00	7.00	7.00	7.00	6.75	6.00	5.75	5.75	5.75
1 month inter-bank rate, %, eop	6.05	6.05	7.08	7.14	7.10	6.73	5.98	5.85	5.85	5.85
Long-term yield, %, eop	7.31	8.14	9.75	9.06	8.50	8.10	8.10	7.98	7.98	7.98
HUF/US$	183	219	244	221	237	238	234	230	227	226
HUF/EUR	266	293	315	295	297	293	290	287	286	287

Source: National sources and Citi Investment Research and Analysis

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Israel

- **Summary view** — Strong investment spending kept growth relatively robust in Q1, but Israel still faces a fall in growth this year to levels below 3%, largely driven by external shock.
- **Things to watch** — Inflation expectations have declined a bit, and are likely to stay under some downward pressure in particular because of the fall in oil prices — it was the rise in oil prices earlier this year that was instrumental in pushing expectations up in the first place.
- **Strategy** — Weaker growth and lower oil prices have led the market to price in a rate cut as early as this summer, but we think the Bank will remain on hold: fiscal policy implementation is relatively weak, the trade deficit has grown, and the depreciation of the ILS is producing a fair amount of stimulus already.

External shock is clear but domestic signals are mixed

External demand is clearly a drag on Israeli growth. Export performance has been disappointing recently, and YoY export growth has been negative in the past four months. This is mostly due to the weakness of external demand, but Israel's export performance is also being hindered by the fact that the shekel is no longer as competitive as it was during the 2000s when it benefited from the substantial real exchange rate depreciation that occurred between 2001 and 2005. One consequence of this performance is the decline in the current account surplus, which was close to zero in 2011 having enjoyed a string of surpluses between 2004-2010 averaging 2.8% GDP. Although import growth has remained rather high — again, partly thanks to an appreciated real exchange rate, although also due to low unemployment and rapid investment growth — there are other indicators of domestic spending that point to weakness. House price inflation is low; credit markets are relatively weak because banks are under pressure to rebuild their capital bases to meet new regulatory minima; and there is an absence of much wage pressure. Overall, we expect a slowdown in GDP growth to below 3% in 2012, from 4.7% in 2011.

Small current account deficits, and not permanent

The current account is likely to move into deficit. In addition to the exchange rate, another factor supporting import growth has been the rise in energy prices: Israel is a heavy importer of energy, and the rise in raw materials imports last year accounts for half the deterioration in the trade balance. Weak global demand and high-ish energy prices this year should tip the current account into deficit, a deficit that could be magnified by the import requirement associated with the development of Israel's gas resources. In addition, Egypt's suspension of gas exports to Israel is likely to raise the foreign exchange cost of meeting Israel's electricity demand. Israel's gas production will commence close to 2017 and should have substantially beneficial consequences both for the current account of the balance of payments as well as for the public sector's balance sheet. The government estimates that the present value of fiscal revenues generated by Israeli gas production is in the order of US$35bn, or 15% of current GDP. A sovereign wealth fund will be created which, according to the Prime Minister's office, could reach over US$80bn in current dollars by 2040.

Inflation expectations are on a decline

After a sharp rise in inflation expectations, things have improved and are set to get even better. 2-year inflation expectations had risen from 2% in September last year to 2.7% now, but have come under a lot of downward pressure since the start of May. We think this is largely due to the decline in oil prices: there is a strong relationship between Israeli inflation expectations and energy prices. Indeed, the global environment has now pushed Israeli yields down by enough for the market to be pricing in a rate cut as early as this summer, having priced in a hike as recently as a few weeks ago. The question is: will the Bank of Israel validate the market's optimism about a rate cut?

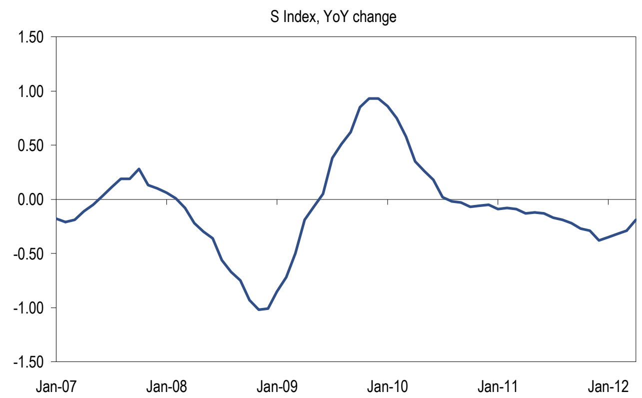
Rate cut risks have risen but we think BOI won't move

The Bank of Israel has displayed willingness in the past to ease monetary policy quickly when global risks rise, and so a rate cut this year can't be ruled out. However, we think there are a number of reasons to stick with our view that a rate cut soon is unlikely, largely because there is already a reasonable amount of policy stimulus in the economy. First, the budget deficit target of 2% will be significantly overshot this year, largely thanks to unfunded spending on childcare, teachers' wages and other measures recommended by the Trajtenberg commission formed in the wake of last summer's social protests. Second, the weakening of the exchange rate — and we think there is more to come — will add to the stimulus. Finally, although real interest rates in Israel are relatively high these days by recent standards — the inflation-adjusted policy rate is around 0.5% — this is probably warranted in the context of a sharp deterioration in Israel's external accounts. All in all, we think that the current policy rate strikes the right balance between accommodation and the avoidance of excessive risk.

Shekel is set for further depreciation

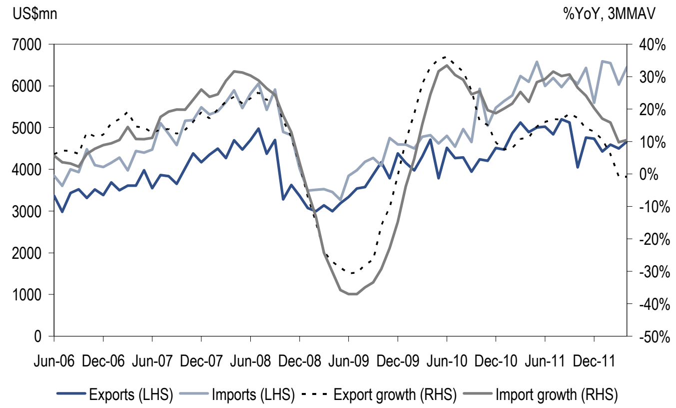
Citi's expectation that the Euro will continue to weaken is likely to put pressure on USDILS, and we expect the exchange rate to hit 3.9 near-term. It is also likely that the trade-weighted shekel will weaken if risk aversion remains alive, as was the case during late 2011. Although the shekel is relatively protected by the fact that foreigners do not own large chunks of the domestic bond market — foreign ownership is around 5-6% — the openness of the Israeli economy by itself is enough, we think, to create downward pressure on the exchange rate that prevents the Bank of Israel from needing to cut rates. Exchange rate pressure would be reinforced, of course, if the market worries again about the risk of an Israeli attack on Iran. A recent absence of that risk has helped Israeli CDS spreads to remain rather stable versus similarly-rated sovereigns. The spread between Israel and South Africa for example has narrowed from around 40 bp in March, when geopolitical fears were at their height, to less than 10 bp now.

Figure 151. Signs of decelerating activity…



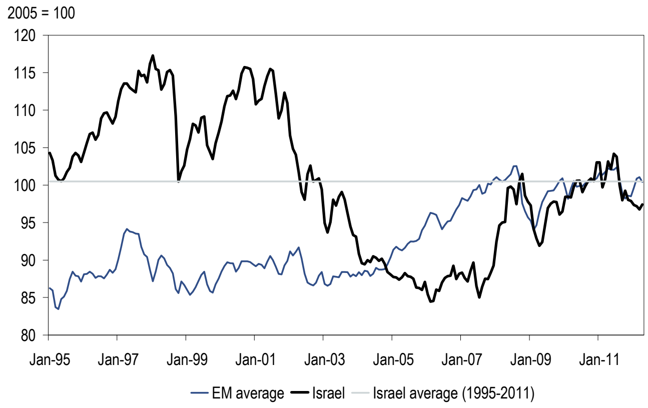
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 152. ...coincides with a deterioration in the current account



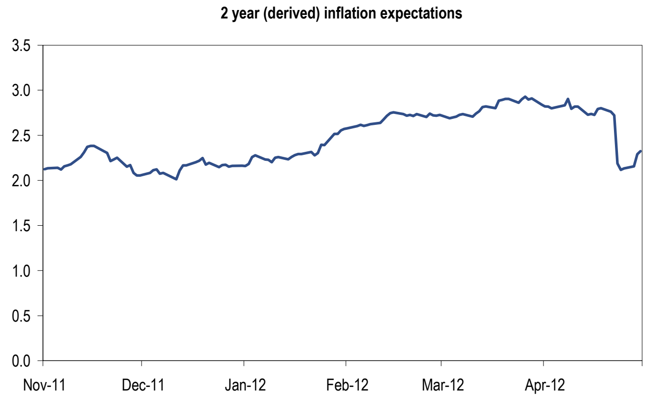
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 153. The shekel is no longer as cheap as it used to be



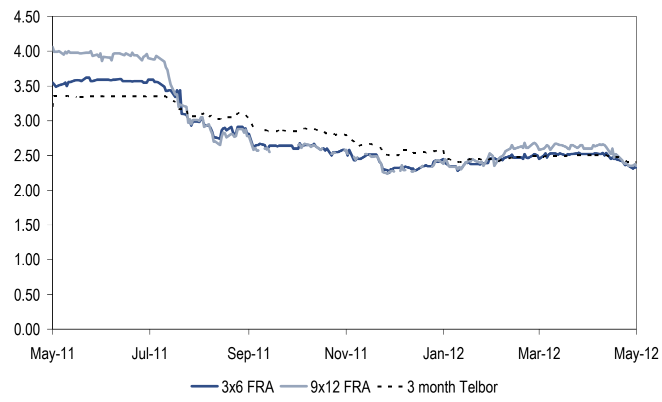
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 154. Inflation expectations have fallen…



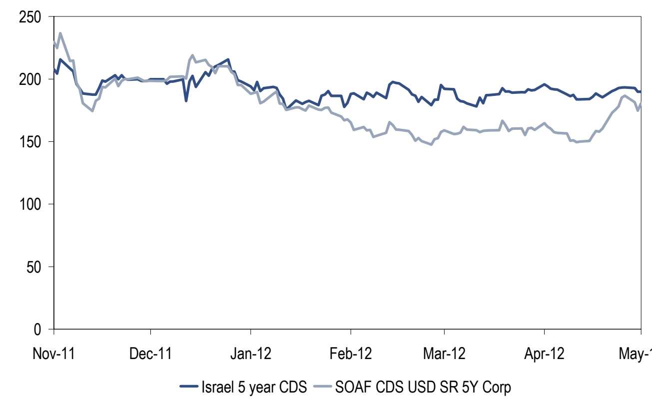
Source: Bloomberg

Figure 155. …and the market has started to price in a rate cut



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 156. Falling regional risks have supported Israel CDS



Source: Markit, Citi Investment Research and Analysis

Figure 157. Israel Economic Indicators

	2004	2005	2006	2007	2008	2009F	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	126.6	134.0	145.5	167.1	201.7	194.8	217.8	242.9	238.6	248.0
Nominal GDP, local currency bn	567	601	648	687	724	766	813	869	919	976
GDP per capita, US$	19,560	20,282	21,533	24,149	28,436	26,692	28,285	27,922	30,208	30,617
Population, mn	6.5	6.6	6.8	6.9	7.1	7.3	7.7	8.7	7.9	8.1
Unemployment, % of labour force	10.4	9.0	8.4	7.3	6.2	7.6	6.5	106.5	6.2	5.7
Economic Activity										
Real GDP, % yoy	4.6	5.1	5.6	5.5	4.2	0.4	5.1	4.9	2.7	3.0
Real investment growth % yoy	-0.2	3.7	13.1	14.4	3.9	-4.3	12.7	17.7	-5.9	-0.6
Real consumption growth % yoy	2.9	2.7	3.8	5.5	2.3	1.6	4.4	3.7	5.0	3.3
private consumption growth % yoy	5.1	3.1	4.2	6.4	2.7	1.5	5.1	3.8	5.4	4.3
Real export growth, % yoy	18.0	4.5	5.2	9.8	6.5	-12.6	14.7	3.9	4.0	2.0
Real import growth, % yoy	11.8	3.9	2.7	11.7	2.5	-13.9	12.5	9.1	8.4	2.9
Prices, Money & Credit										
CPI, % yoy	1.2	2.4	-0.1	3.4	3.8	4.0	2.6	2.2	3.2	2.6
CPI, % avg	-0.4	1.3	2.1	0.5	4.6	3.3	2.7	3.4	2.6	2.7
Nominal wages, % yoy	3.8	7.0	8.2	7.2	7.9	0.9	7.5	7.7	7.0	7.2
Credit extension to private sector, % yoy	3.2	4.2	6.3	7.6	12.2	5.0	6.0	5.9	3.2	2.4
Policy interest rate, %, eop	3.70	4.50	4.50	4.25	2.50	1.00	2.00	2.75	2.50	2.50
1 month inter-bank rate, %, eop	4.06	4.75	5.03	4.50	1.90	1.31	2.06	2.74	2.50	3.00
Long-term yield, %, eop	NA	5.54	5.61	6.17	4.72	5.11	4.75	4.55	5.10	5.75
ILS/US$, eop	4.31	4.60	4.23	3.85	3.80	3.78	3.55	3.82	3.92	3.92
ILS/US$, avg	4.48	4.49	4.46	4.11	3.59	3.93	3.73	3.58	3.85	3.93
Balance of Payments, US$ bn										
Current account	2.2	4.1	7.0	4.6	1.8	7.0	6.3	0.2	-3.5	-2.5
% of GDP	1.7	3.1	4.8	2.7	0.9	3.6	2.9	0.1	-1.5	-1.0
Trade balance	-2.6	-3.5	-3.2	-5.2	-6.7	0.3	-1.9	-9.1	-9.0	-10.0
Exports	36.9	40.4	43.9	50.8	57.7	46.3	56.1	62.8	69.0	75.0
Imports	39.5	43.9	47.2	56.0	64.4	46.0	58.0	71.9	78.0	85.0
Service balance	2.5	3.0	3.6	2.7	4.1	4.3	6.2	7.0	6.0	7.0
Income balance	-4.0	-1.4	-0.8	-0.3	-4.1	-5.1	-6.3	-6.4	-7.5	-7.0
FDI, net	-1.6	1.9	-0.2	0.2	3.7	2.7	-2.8	8.1	0.0	2.0
International reserves	26.6	27.8	29.0	28.4	42.3	60.6	67.6	74.9	72.0	74.0
Total amortisations	4.73	4.72	5.31	5.60	4.66	4.47	5.00	5.00	4.00	3.80
Public Finances, % of GDP										
Consolidated government balance	-3.1	-1.4	-0.4	0.5	-1.2	-4.4	-3.0	-2.7	-3.2	-2.7
Consolidated gov primary balance	3.6	5.1	5.9	6.7	4.9	1.6	3.1	3.3	1.7	2.3
Public debt	96.1	92.0	83.0	76.2	75.5	77.9	79.3	78.5	78.3	77.4
of which Domestic	72.6	68.2	62.3	59.1	60.6	63.5	61.5	61.0	60.9	59.5
Foreign Assets & Liabilities, US$ bn										
External debt	78.5	78.2	87.5	90.8	88.4	93.3	106.0	91.0	93.0	95.0
Public	31.3	31.2	34.9	36.2	28.9	35.0	35.0	36.5	37.0	38.0
External debt / GDP	62.0	58.4	60.1	54.4	43.8	47.9	48.7	37.5	39.0	38.3
External debt / XGS	149.9	136.6	140.5	127.9	108.2	137.7	131.9	101.6	95.9	90.5
Short-term debt	6.1	6.5	7.3	8.0	8.5	9.0	9.0	10.0	12.0	13.0
Short-term debt/International reserves, %	22.8	23.3	25.1	28.2	20.1	14.9	13.3	13.4	16.7	17.6

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.2	4.9	3.8	3.3	2.5	2.7	3.0	2.9	3.1	2.8
CPI, % yoy	4.2	3.0	2.2	1.9	2.2	3.3	3.2	2.9	2.7	2.5
Policy interest rate, %, eop	3.25	3.25	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50
1 month inter-bank rate, %, eop	3.27	3.00	2.74	2.50	2.50	2.50	2.50	2.50	2.50	2.50
Long-term yield, %, eop	4.70	3.80	3.50	3.59	3.70	3.70	3.90	4.00	4.25	4.75
ILS/US$	3.40	3.72	3.81	3.71	3.87	3.91	3.92	3.94	3.94	3.93

Source: National sources and Citi Investment Research and Analysis

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- **Summary view** — Slowdown of 1Q GDP to 5.6%YoY poses risks to our annual growth forecast of slightly above 6% and government support remains important. However the critical oil price for Kazakhstan is US$50-60/bbl. Real credit growth accelerated at the start of 2012 but NPLs still weigh on the banking system.

- **Things to watch** — While NBK does not rule out further rate cuts as inflation remains at record-low levels, CPI started to accelerate on fuel . The effect of a distressed asset fund and "bad banks" are expected in 2H12. There are signs of a recovery in residential property.

- **Strategy** — We expect KZT/USD to fluctuate around 147-119 in 2012 with the tenge likely to be somewhat stronger at the beginning of the year. NBK likely to resist any major appreciation. NBK does not rule out further rate cuts as inflation remains at record-low levels.

Stable amid global headwinds[2]

Slowdown of GDP to 5.6%YoY in 1Q posts risks to our annual growth forecast of slightly above 6%. The main driver remained output of services. The short-term indicator of economic activity calculated by Kazstat and covers about 68% of the economy increased by just 4.4%YoY and industrial production was up 2.7%YoY in in Jan-April. While the main drag seems to come from oil extraction, manufacturing decelerated as well to 5.6%YoY in April from double digits in early 2012. At the same time domestic demand oriented sectors continued to show strong growth. Retail sales growth remained stable at 11-12%YoY supported by 15% growth in real incomes in Jan-April. Budget support remains important. As we expected, the 2012 spending plan was increased to support growth and transfer from the National Oil Fund was increased by KZT180bn to KZT1.38tn annually, which should lead to a reduction in borrowings in subsequent years. This transfer will be used to finance additional expenditures distributed evenly between social and investment-related projects. So far we keep our GDP growth forecast of about 6% in 2012 in the base case (Brent at US$110-120 in 2012) with export volume growth slowing to 2.5-3% (5% in 2011) and internal demand slowing to about 7% (8.5% in 2011), however risks to this forecast seem to concentrate on the downside.

Real credit growth accelerated in the beginning of 2012 but NPLs still weigh on the banking system. After a catch-up in lending in 2H11, credit growth accelerated to 18% and 12-13%YoY for corporates and households in 1Q 2012. Mortgages were up 47% in 2011 and 51%YoY in Jan accompanied by recovery in residential prices. However a high proportion of NPLs and lack of reliable borrowers remain major brakes on the credit recovery, according to polls. In the end of April NBK confirmed creation of Distressed Assets Fund Banks, which is supposed to buy bad loans from commercial banks, issuing bonds to finance its activities. Eligible for purchase will be loans classified as hopeless or group 5 doubtful and granted to companies owned by Kazakh residents that have relevant collateral. While the volume of loans the volume is still to be determined, NBK Governor Marchenko mentioned the scheme should help to clean USD 2bn of bad loans from bank balance sheets, which is less than 10% of the total bad loans in the system. The scheme includes also tax preferences for loan write-off and creation of special SPV companies by commercial banks where part of the bad loans will be transferred. We expect these measure bear fruit only closer year end.

NBK may cut again if inflation remains below 6%...

[2] Kazakhstan Macro View - Stable Amid Global Headwinds (30 Jan 2012)

While NBK does not rule out further rate cuts as inflation remains at record-low levels, CPI started to accelerate on fuel. Consumer inflation stood at 4.8%YoY in April increasing from from 4.6%YoY in March after the hike of electricity tariffs (1.6% of the CPI) and about 5.7% increase in fuel prices (2% of the basket). The NBK cut its refinancing rate by another 50bp to 6.5% effective from April 2. NBK's annual inflation forecast was cut to 5.9-6.0%, which is the lower bound of the target range (Reuters,11 Apr). NBK will consider further rate cuts in June if inflation stays below the target range of 6-8%. Given strong internal demand and lack of competition in some sectors inflationary risks remain significant and likely push inflation higher in 2H, in our view.

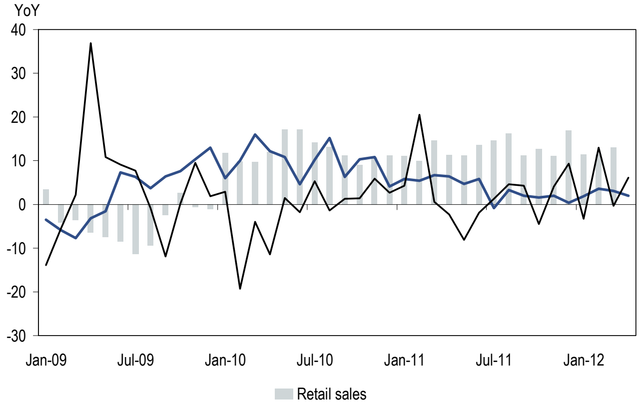
The cut in the refinancing rate will only have a limited effect on the market given over US$10bn of bank claims due to the central bank. Despite short-term spikes in 3Q, when the NBK was selling FX to support the tenge, the short-term money market rate stayed close to 0-2% and remained negative in real terms. The NBK raised reserve requirements in mid-2011 and allowed for somewhat higher effective rates on NBK notes, which went up 20-30bp since mid-2011. In 1Q NBU injected about US$1.4bn (US$1.2bn in Feb and US$0.2bn in March) through FX market. And it absorbed most of this liquidity in Feb and March through deposits (up 35% in Feb to KZT 668bn) and issuance of NBK notes (up by KZT180bn (US$1.2) or 90%YoY in March).

…while limiting FX volatility

High oil prices support strong external position. Following the robust growth in the oil market, Kazakh economy experienced capital inflow of around US$3bn during the first 2 months of the year. Net purchases by non-residents of non-government Eurobonds stood at around US$30mn in January as opposed to the net outflow of US$6mn in 2011. While we expect FDI to remain positive at US$4bn in 2012, we envisage the balance of payments weakening, with the current account surplus falling to US$4bn. We also believe most foreign investors closed their positions in 2Q-3Q11, and therefore the volume of portfolio outflows is limited by the available tenge liquidity. In our view, capital outflows resulting from accumulation of public savings do not represent a threat to the balance of payments. External debt repayments (about US$13bn including US$3.6bn of intercompany debt and about US$3bn of bank external debt) represent about half of the National Bank's reserves in foreign currencies. A negative surprise, however, could come from cash purchases by the Kazakh population.

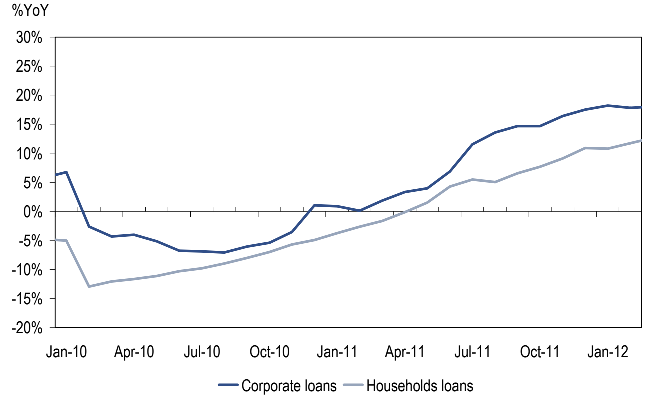
For our base case, we expect the tenge to stay around 147-149 KZT/USD. In its monetary policy guidelines, the NBK said it would start to gradually reduce its operations on the FX market. However it will continue to smooth exchange rate volatility to limit its negative effect on competitiveness. We think the NBK will continue FX market interventions and will limit any major tenge appreciation. At the same time ruble remains key for Kazakh FX policy. Should the ruble devalue for fundamental reasons, NBK likely to follow within weeks, however the volatility probably will be much lower.

Figure 158. Household spending outperform other sectors



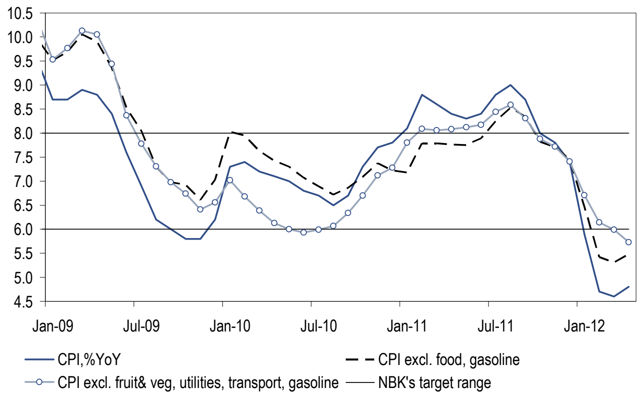
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 159. Credit growth gets stronger



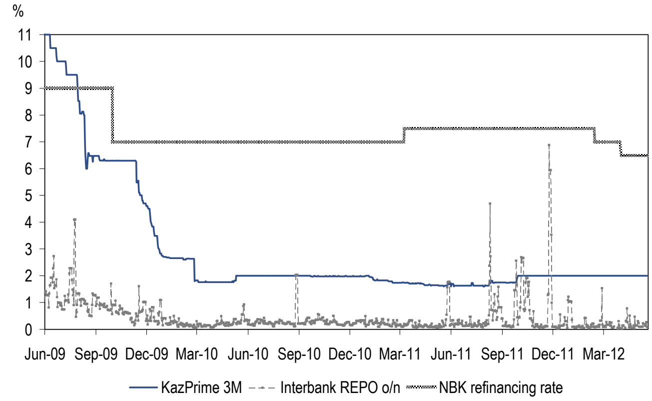
Source: AFN, CIRA estimates

Figure 160. NBK may cut again if inflation remains below 6%...



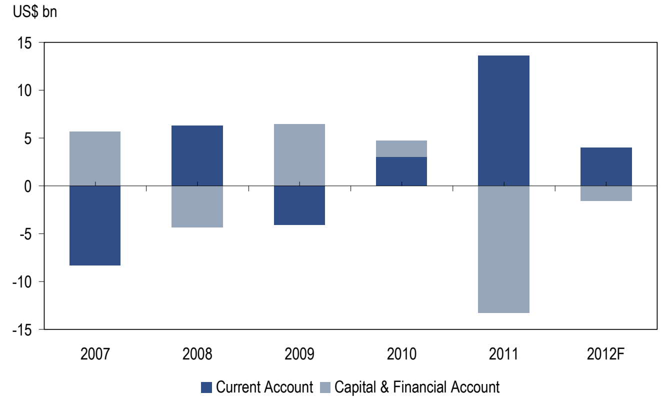
Source: Haver Analytics, Ministry of Finance, CIRA estimates

Figure 161. …but the move is unlikely to affect the market considerably



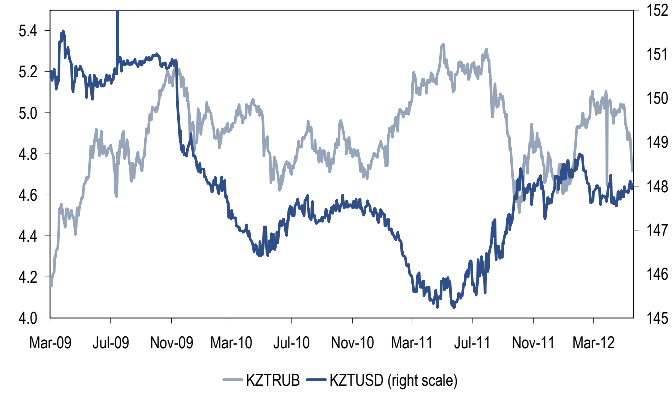
Source: Haver Analytics, NBK, CIRA

Figure 162. CA likely to narrow from extremely high surplus in 2011



Source: Haver Analytics, CIRA estimates

Figure 163. KZT/USD to fluctuate around 147-149 in 2012



Source: Haver Analytics, CIRA

Figure 164. Kazakhstan Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	43.2	57.1	81.0	104.8	133.4	115.3	146.0	186.2	211.7	245.6
Nominal GDP, local currency bn	5,870	7,591	10,214	12,850	16,053	17,008	21,516	27,303	31,360	36,186
GDP per capita, US$	2,867	3,765	5,290	6,775	8,524	7,279	9,218	11,755	13,366	15,502
Population, mn	15.1	15.2	15.3	15.5	15.7	15.8	15.8	15.8	15.8	15.8
Unemployment, % of labour force	8.4	8.1	7.8	7.3	6.6	6.6	5.8	5.5	5.5	5.5
Economic Activity										
Real GDP, % yoy	9.6	9.7	10.7	8.9	3.3	1.2	7.3	7.5	6.2	6.4
Real investment growth % yoy	22.5	28.1	29.7	17.3	1.0	-0.8	3.8	3.6	8.0	8.5
Real consumption growth % yoy	13.3	10.7	11.6	11.4	4.8	0.7	10.0	11.0	7.7	7.2
private consumption growth % yoy	13.8	10.7	11.7	11.8	3.9	0.5	11.0	11.9	8.0	7.5
Real export growth, % yoy	11.2	1.1	6.5	9.0	0.9	-11.6	1.9	3.5	2.5	2.0
Real import growth, % yoy	14.9	12.5	12.2	25.8	-11.3	-16.0	0.9	6.9	6.5	7.0
Prices, Money & Credit										
CPI, % yoy	6.5	7.5	8.4	18.8	9.5	6.2	7.8	7.4	6.4	5.0
CPI, % avg	6.8	7.5	8.6	10.8	17.1	7.3	7.1	8.3	5.2	6.5
Nominal wages, % yoy	21.9	19.7	20.6	28.1	16.2	10.8	14.9	15.9	8.1	7.6
Credit extension to private sector, % yoy	53.7	74.2	80.2	55.2	5.2	7.3	0.3	15.5	10.0	8.0
Policy interest rate, %, eop	-	8.00	9.00	11.00	10.50	7.00	7.00	7.50	7.00	5.50
1 month inter-bank rate, %, eop	-	5.83	6.25	11.50	-	6.50	1.50	1.50	-	-
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
KZT/US$, eop	130.0	134.0	127.4	120.3	120.8	148.4	147.4	148.0	148.7	146.5
KZT/US$, avg	136.0	132.9	126.1	122.6	120.3	147.5	147.4	146.6	148.1	147.4
KZT/EUR, eop	177.1	159.0	167.3	177.2	170.9	212.8	195.2	191.4	188.7	188.4
KZT/EUR, avg	169.0	165.4	158.3	167.8	177.0	205.7	195.7	204.1	192.9	186.5
Balance of Payments, US$ bn										
Current account	0.3	-1.1	-2.0	-8.3	6.3	-4.1	2.4	14.1	4.0	5.7
% of GDP	0.8	-1.8	-2.5	-7.9	4.7	-3.6	1.6	7.6	1.9	2.3
Trade balance	6.8	10.3	14.6	15.1	33.5	15.0	28.7	47.3	32.1	34.5
Exports	20.6	28.3	38.8	48.4	72.0	43.9	61.6	88.5	77.4	79.8
Imports	13.8	18.0	24.1	33.3	38.5	29.0	32.9	41.2	45.3	45.3
Service balance	-3.1	-5.3	-5.9	-8.2	-6.7	-5.8	-7.1	-6.4	-9.3	-9.3
Income balance	-2.9	-5.7	-9.5	-13.1	-19.5	-12.6	-18.7	-26.5	-18.5	-18.5
FDI, net	5.4	2.1	6.7	8.0	13.1	10.1	2.9	8.4	8.9	3.0
International reserves	9.3	7.1	19.1	17.6	19.9	22.7	27.4	27.7	30.1	34.8
Total amortisations	7.2	9.2	8.5	19.7	25.2	16.0	14.0	16.8	11.5	11.7
Public Finances, % of GDP										
Consolidated government balance	-	5.5	7.8	4.5	-9.3	-9.6	2.6	5.9	1.7	3.0
Consolidated gov primary balance	-	5.1	7.5	4.2	-9.7	-10.0	2.1	5.4	1.2	2.4
Public debt	10.0	7.1	5.9	5.3	6.3	9.5	10.3	10.0	11.2	11.0
of which Domestic	3.9	3.9	3.7	4.0	5.1	7.6	7.8	7.6	9.1	9.2
Foreign Assets & Liabilities, US$ bn										
External debt	32.7	43.4	74.0	96.9	107.9	112.9	118.2	134.2	145.7	157.4
Public	2.5	1.6	2.6	1.6	1.7	3.2	4.8	5.1	5.7	6.2
External debt / GDP	75.8	76.0	91.4	92.4	80.9	97.9	81.0	72.1	68.8	64.1
External debt / XGS	144.7	142.3	178.0	186.6	141.3	234.3	179.6	144.3	171.5	182.7
Short-term debt	3.9	8.2	12.7	12.0	10.0	10.3	9.1	9.1	11.1	11.1
Short-term debt/International reserves, %	42.5	115.3	66.2	67.8	50.2	45.2	33.3	33.0	36.9	31.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	7.2	7.5	8.2	5.6	4.6	6.0	4.1	10.1	6.7	4.7
CPI, % yoy	8.2	8.9	7.4	4.5	4.9	4.8	6.4	7.2	6.9	6.4
Policy interest rate, %, eop	7.50	7.50	7.50	7.00	7.00	7.00	7.00	6.75	6.75	6.75
1 month inter-bank rate, %, eop	1.50	1.50	1.50	1.50	2.50	2.50	2.50	2.50	2.50	2.50
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
KZT/US$	145.9	148.2	148.5	148.0	148.5	148.7	148.7	146.0	146.0	146.0

Source: National sources and Citi Investment Research and Analysis

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Levant

Iraq

In May, Exxon Mobil signed a deal with government-owned Iraq Drilling Company to drill 20 wells on its West Qurna phase 1 project. We believe this is clear evidence that the row over KRG contracts that Exxon signed last October have not in any practical manner derailed Exxon's efforts in developing the field. In March, Exxon reached a deal with the government to receive payment for cost recovery in oil, further evidence that relations between the company and Baghdad are on the mend. Exxon had reportedly not been receiving payments until then, a problem which we saw as a more material threat to the companies' commitment in Iraq.

Exxon remain, however, barred from participating in the fourth bidding round for exploration contracts, planned for end-May. They also have been removed from leading the water-reinjection project, a vital piece of infrastructure for boosting production from the South.

We also believe that the threat of expulsion from Iraq remains real if Exxon were visibly to make progress on its Kurdish contracts. Currently, the Iraqi government claims that Exxon has promised to shelve its plans in the North, giving it a face-saving excuse not to banish the company. We believe that in the near term, Exxon can continue with setting up its offices and some of the more low-key operations (such as seismic testing). However, the company will need to drill within the three-year time limit in order to maintain its contract with the KRG, and this may precipitate a stronger reaction from Baghdad. We continue to regard this as an ongoing risk, one we believe is worth monitoring.

Meanwhile, Shell has opened discussions with the Iraqi government over the terms of its contract to develop the Majnoon oil field. The company is reportedly trying to reduce the production target from the currently stipulated 1.8mbpd, although no details have been revealed. Last month, Deputy Prime Minister for Energy Al-Shahristani said that Iraq had reduced its peak production target from 12 million bpd to 10 million bpd starting in 2017. At the same time, he extended the plateau over a longer period of time. He also targeted 5-6 million bpd over the next 3-4 years, with export capacity expanding faster to 6-8 million bpd, especially via new export terminals in the south.

Oil exports thus far in May are running below April's record, but we still expect exports to continue rising. Exports out of the South fell to an average of around 1.9mbpd, implying total exports of around 2.3mbpd thus far in May. The final tally in April was 2.5mbpd. There are several reasons for the drop. The government has variously blamed a technical glitch and the fact that more oil production is being diverted for domestic uses as the summer approaches. There are also indications that the April figures were unsustainably boosted by the sale of Iraqi reserves.

Jordan

The King swore in a new government on May 2, headed by Fayez Tarawneh, a veteran politician and former Royal Court advisor. The new line-up was immediately criticized for being too conservative to lead the reform drive, and has been described by the main opposition group, the Islamic Action Front (IAF), as a setback for reform. Although Mr Tarawneh's predecessor, Awn Khasawneh had angered the opposition over the proposed draft electoral law in April, he was at least seen as a credible partner in reform by the IAF. This was evident in comments by the IAF, who said they met with Mr Khasawneh after his resignation to thank him for his efforts to enact real reform.

Mr Tarawneh's government is in for a bumpy ride, by contrast. Street protests against the government have already taken place, and will likely intensify as key reform legislation, including the controversial electoral law, aim to be passed during the current parliamentary session that terminates end-June.

One key battle that is already taking shape is the state of public finances. Mr Tarawneh, has described these as being in a state of crisis, and has staked the credibility of his government on measures to bring down the deficit and manage the public debt. This, he said, will encourage friendly countries to step up their donations to the kingdom. Among the measures are the curbing of subsidies on basic commodities and electricity, a move that is highly unpopular among the opposition. Most subsidies had been removed over the past decade, but many were re-introduced last March in response to the threat of an escalation in popular protests. Many conservatives in Jordan see this as having been a knee-jerk reaction and argue for their removal once more. We believe this is going to be a major flashpoint, and spells risks to political stability and public finances in the medium term.

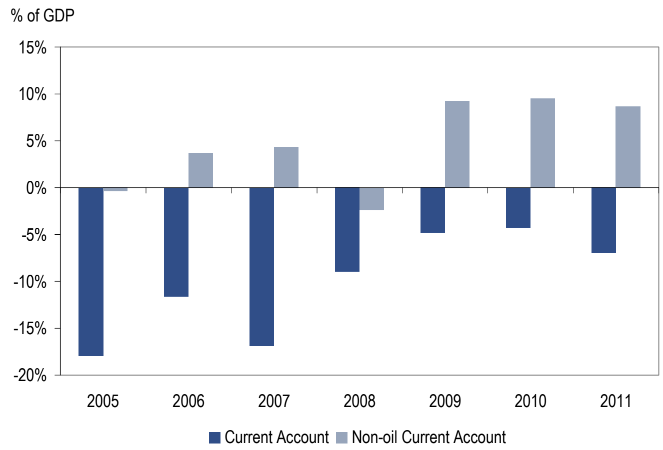
We believe the likelihood of attack of the Egypt-Jordan gas pipeline has diminished as a result of the decision by Egypt to halt exports to Israel (which shares much of the same pipeline infrastructure). This will provide some much-needed respite to Jordan's soaring fuel bill and to Jordan's fiscal and external finances.

Lebanon

Fighting has broken in the northern city of Tripoli between gunmen loyal to the regime of Bashar al Assad and those opposed to it. Tripoli is home to a variety of Muslim sects, including Alawis and Sunni, and has seen occasional outbursts of violence over the past year. However, the latest episode, in which a number of people are thought to have died, was the most serious and required a robust intervention by Lebanon's army to quell. The incident highlights the ongoing risk of serious spillover of sectarian violence from Syria into Lebanon. However, we believe that the risk is greatest among minor competing neighborhood militia and is unlikely to descend into a nation-wide sectarian crisis so long as the will to avoid such a scenario remains at the leadership level of Lebanon's main political and sectarian groupings.

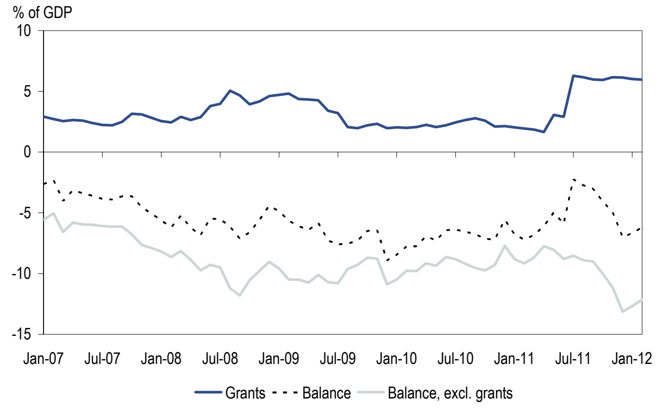
Discussions over a draft electoral law, which is hoped to be the basis for 2013 elections, has become heated, and threatens another political crisis, according to local reports. Frictions in cabinet are also high over the question of public appointments, and the ongoing spending dispute. We believe the current government is likely to continue to lurch from crisis to crisis, reducing its effectiveness and ability to pass meaningful legislation.

Figure 165. Jordan current account dominated by oil imports …



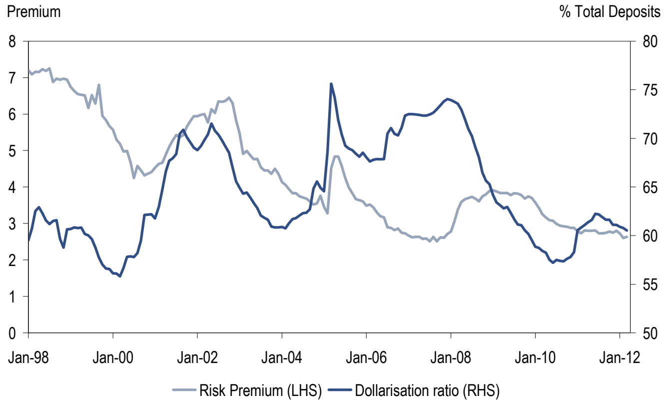
Source: Haver Analytics, USEIA, Citi Investment Research and Analysis

Figure 166. Without grants Jordan's fiscal situation would be worse



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 167. Lebanon dollarization has gone up, but risk premium stable

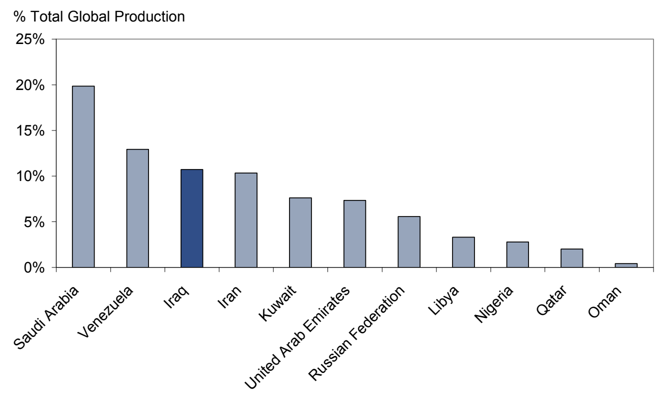


Source: Haver Analytics, Citi Investment Research and Analysis

Figure 168. Deposit growth slows, but still plenty of capacity

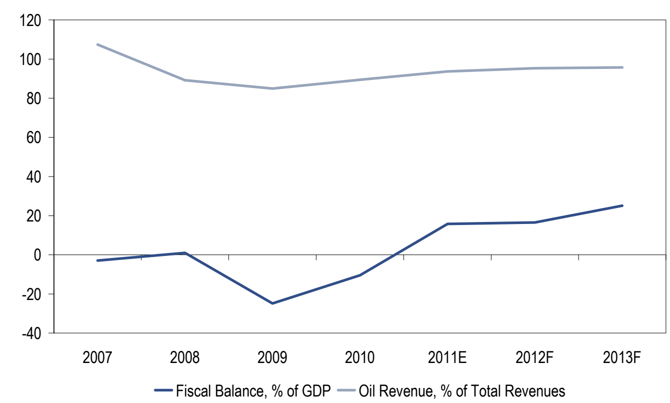
Source: Banque Du Liban, Citi Investment Research and Analysis

Figure 169. Iraq has world's third largest oil reserves and …



Source: BP, Citi Investment Research and Analysis

Figure 170. … public finances to strengthen on greater oil revenues



Source: IMF, Citi Investment Research and Analysis

Figure 171. Levant Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
IRAQ									
Nominal GDP, US$ bn	31.4	45.1	58.8	87.2	66.6	79.4	121.5	148.9	161.2
GDP per capita, US$	1,147	1,602	2,031	2,926	2,168	2,507	3,729	4,443	4,676
Real GDP, % yoy	4.4	10.1	1.4	9.5	4.2	5.9	9.4	9.3	11.5
CPI, % avg	NA	NA	32.6	2.8	-2.8	2.4	5.6	5.0	6.0
IQD/US$, eop	NA	NA	1216	1158	1150	1167	1166	1166	1166
IQD/US$, avg	NA	NA	1223	1188	1152	1164	1168	1168	1168
Current account	-3.3	2.7	15.5	27.1	-12.8	-14.4	-6.2	48.7	107.5
% of GDP	-10.6	5.9	26.4	31.1	-19.2	-18.2	-5.1	32.7	66.7
Consolidated government balance, % of GDP	NA	NA	-2.9	0.9	-24.8	-10.4	15.8	16.5	25.2
JORDAN									
Nominal GDP, US$ bn	12.6	15.0	17.1	22.0	23.9	26.5	28.0	30.0	31.8
GDP per capita, US$	2,288	2,653	2,929	3,656	3,851	4,151	4,255	4,435	4,567
Real GDP, % yoy	8.1	8.1	8.2	7.2	5.5	2.3	2.6	2.5	3.0
CPI, % avg	3.5	6.3	4.7	13.9	-0.7	5.0	4.4	5.0	5.0
JOD/US$, eop	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
JOD/US$, avg	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Current account	-2.3	-1.7	-2.9	-2.1	-1.2	-1.9	-3.0	-3.7	-3.7
% of GDP	-18.0	-11.5	-16.8	-9.3	-5.2	-7.1	-10.6	-12.4	-11.7
Consolidated government balance, % of GDP	-5.4	-4.2	-5.1	-4.4	-8.9	-5.6	-3.9	-8.0	-9.5
LEBANON									
Nominal GDP, US$ bn	21.9	22.4	25.1	30.1	34.7	37.1	40.8	43.9	47.5
GDP per capita, US$	5,823	5,969	6,666	7,899	8,984	9,499	10,318	10,874	11,545
Real GDP, % yoy	1.0	0.6	7.5	9.3	8.5	6.0	6.0	3.5	4.3
CPI, % avg	-0.7	5.6	4.1	10.8	1.2	4.0	5.1	6.0	5.0
LBP/US$, eop	1508	1508	1508	1508	1508	1508	1508	1508	1508
LBP/US$, avg	1508	1508	1508	1508	1508	1508	1508	1508	1508
Current account	-2.2	-1.1	-1.4	-4.1	-6.7	-7.5	-8.7	-9.9	-11.2
% of GDP	-10.3	-5.1	-5.5	-13.8	-19.5	-20.1	-21.3	-22.6	-23.5
Consolidated government balance, % of GDP	-8.5	-13.5	-10.2	-9.7	-8.5	-7.8	-6.8	-8.0	-9.1

Source: National sources and Citi Investment Research and Analysis

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Nigeria

- **Summary view** — Despite the ongoing political uncertainties in the north due to the activities of Boko Haram, we still expect growth to remain robust in 2012-13 driven by strong activity in the south. Although inflation may rise in mid-2012, it should be modest and trend down to low single digits again in 2013.
- **Things to watch** — With high oil prices a key indicator of the government's progress with economic reform and its ability to maintain naira stability will be the formal implementation of the new Sovereign Wealth Fund in the coming months.
- **Strategy** — With Ngozi Okonjo-Iweala as finance minister, alongside incumbent central bank governor, Lamido Sanusi, Nigeria has a respected economic team committed to improving fiscal discipline and driving a return to more orthodox monetary policies and improved fiscal discipline.

A strong economic team creates cautious optimism

The "points victory" in the battle to remove fuel price subsidy in early 2012 does seem to have given some impetus to the economic reform effort. Not only has the debate over the budget, eventually based on a tough benchmark oil price of US$72 per barrel been relatively muted, but there has also been some progress with re-building foreign exchange reserves and we now expect savings into the new Sovereign Wealth Fund (SWF) to start in the coming months. The government also seems to be making some progress with power sector reform, having outlined a timetable for tariff rises, and is in the process of trying to unify the various editions of the Petroleum Industry Bill which have been debated over the last few years. However, we still await concrete progress with all these key reforms.

There are also some tentative signs that President Goodluck Jonathan is also imposing presidential control on the ruling People's Democratic Party (PDP). The most visible sign of this was the appointment of Bamangar Tukur as PDP National Chairman at the March party conference, while the finance minister, Ngozi Okonjo-Iweala, also seems to be adopting a higher profile political role. This should help support the reform effort, although if she were to depart to head up the World Bank, which we think unlikely, it would at least temporarily, increase uncertainty.

Growth looks set to remain robust

Whereas oil production had been on a downward trend from 2006-09, the conclusion of a ceasefire in the Delta region in late 2009 has allowed a steady recovery in output in 2010 and into 2011. The main implication of this on the growth story of recent years, is that whereas negative oil sector growth had been offset by strong non-oil sector, both supported growth in 2010-11 pushing up the overall growth rate. Although growth slowed marginally in 1H 2011 due to the election-related uncertainty, the growth rate quickly picked up again in 2H 2011 and we expect it to remain robust in 2012.

This reflects a number of factors, notably the restart of delayed investment projects. However, with greater fiscal discipline and only a modest further rise in oil production likely in 2012, driven by rising offshore production, we think growth is likely to slow moderately in 2012-13 to around 7%. It is also worth noting, the growth story could be slightly complicated by a proposed revision to GDP data following a rebasing exercise. If a similar change in Ghana in 2010 is a guide, this could increase total GDP in the order of 40%.

Pressure on the naira has eased in early 2012

The naira was under steady pressure in 2H 2011. But even with the political unrest in early 2012, the pressure seems to have eased as the Central Bank of Nigeria (CBN) overall strategy to reduce demand for foreign exchange and rebuild foreign exchange reserves has started to slowly have an impact. This is reflected in the modest rise in total foreign exchange to US$35.5bn at the end of March, their highest level since September 2010.

The most visible element of the policy has been an aggressive hiking of the Monetary Policy Rate (MPR) to 12%. The CBN has also opened up the T-bill market, by removing the one-year lock in for foreign investors. Combined this does seem to have increased the attractiveness of holding naira assets for both local and portfolio investors. In addition, it has also started to place stricter limits on the amount of foreign exchange that various groups can buy at its twice weekly Wholesale Dutch Auction (WDAS). The initial target was the Bureau de Change (BDC) but this now includes other groups, notably oil importers whose demand has risen very sharply in recent years. Finally, the government is also hoping that reduced government spending, notably by state governments in 2012, will also reduce the demand for imports and pressure on the naira.

But the policy is not without risks, and naira stability still depends on the oil price not fall back significantly in 2012. This may work. With confidence in the government rising as it moves ahead with its economic reform program, it should be able to maintain the naira around current levels. But if the oil price were to fall back sharply, then the reality is that it would become increasingly difficult for the CBN to maintain stability, especially if demand for foreign exchange remains high and reserves continue to fall. But we do expect the CBN to try and maintain stability for as long as possible even if the international economic environment deteriorates substantially.

The fiscal deficit and inflation

One reason that the CBN is keen to maintain naira stability is that it should help to reduce inflationary pressures. In fact, the extent to which inflation will pick up in 2012-13 up will depend largely on four factors: the value of the naira, the overall level of food prices, or domestic food production, the government's efforts to bring spending under control and the inflationary impact of the fuel price rises.

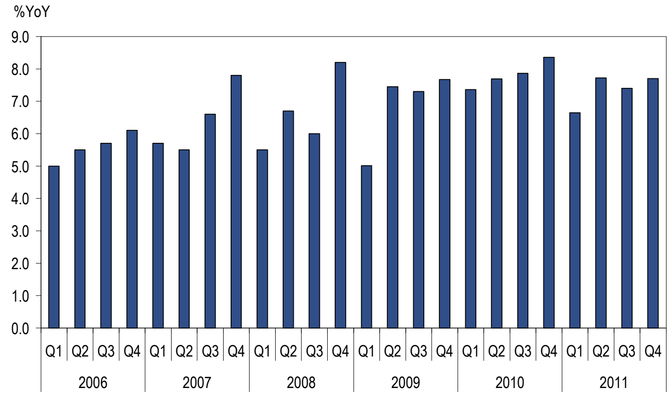
We think that although the federal government's fiscal deficit has been relatively modest as a percentage of GDP in both 2010 and 2011, this partially obscures a steady increase in spending in recent years. This is partially illustrated by the increase in government wages prior to the 2011 polls, but more clearly visible from the lack of savings despite the high oil price. The increase in spending is also particularly noticeable for state governments, which only have a limited capacity to borrow, but have financing spending in recent years by demanding the release of their portion of the savings previously held in the ECA.

Although inflation has trended down in 2011, and even fell into single digits in July and August, it moved back into double digits since. Moreover, we expect it to remain around current levels into early 2012, before picking up modestly in the middle of 2012 to around 13% before easing in 2H 2011 into 2013. While there is an outside chance the CBN will raise the MPR in 1H 2012, to keep it in positive real territory as well as to defend the naira, the more likely outcome is that it will hold it steady, paving the way for modest cuts in early 2013.

Figure 172. Pressure on the naira has eased marginally in early 2012

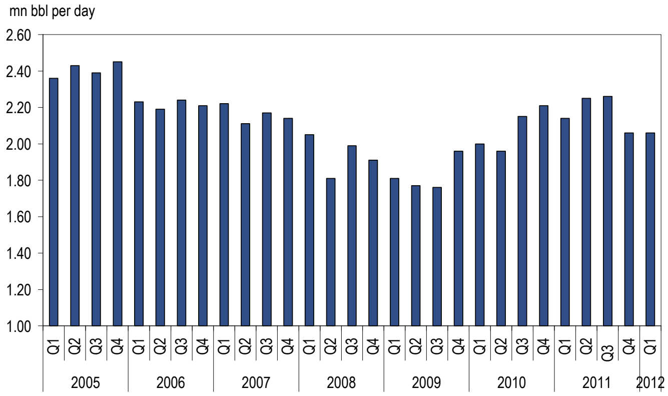
Source: Reuters

Figure 173. Growth has remained robust in 2011



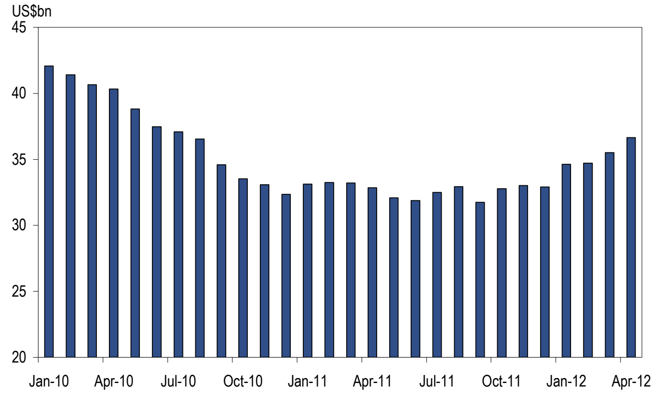
Source: National Bureau of Statistics

Figure 174. Oil production has rebounded steadily in 2011



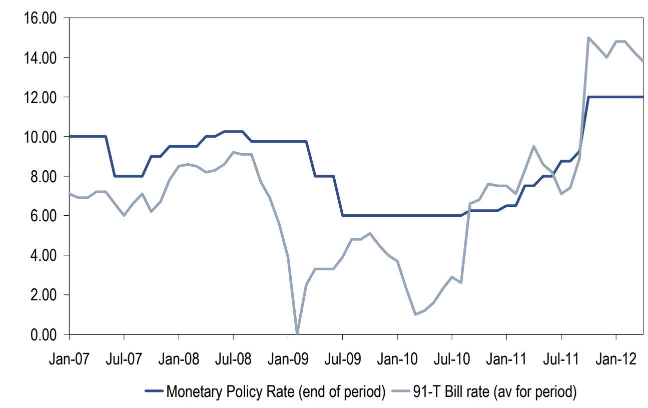
Source: International Energy Agency

Figure 175. Reserves modestly rebound in early 2012



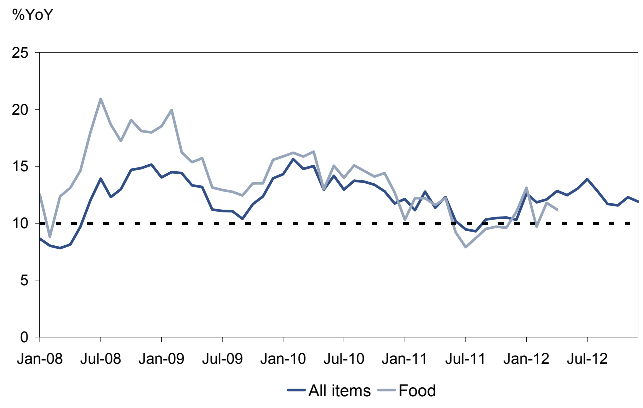
Source: Central Bank of Nigeria

Figure 176. Interest rates have picked up sharply since 2H 2011



Source: Haver Analytics, Central Bank of Nigeria

Figure 177. We only expect a modest pick up in inflation in 2012



Source: National Bureau of Statistics

Figure 178. Nigeria Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	85.9	111.0	144.3	164.2	201.1	189.2	225.3	259.2	302.5	343.5
Nominal GDP, local currency bn	11,411	14,572	18,565	20,657	23,842	28,263	34,035	40,385	48,371	56,538
GDP per capita, US$	622	785	997	1,109	1,329	1,225	1,430	1,613	1,845	2,054
Population, mn	138	141	145	148	151	154	158	161	164	167
Unemployment, % of labour force	-	-	-	-	-	-	-	-	-	-
Economic Activity										
Real GDP, % yoy	9.3	1.0	8.2	4.4	2.3	-8.3	7.8	7.4	7.0	7.2
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	10.0	11.6	8.5	6.6	15.1	13.9	11.7	10.3	11.9	9.9
CPI, % avg	15.0	17.8	8.2	5.4	11.6	12.5	13.7	10.8	12.4	9.8
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	26.6	30.8	27.8	97.1	59.4	26.6	-4.9	15.0	19.0	23.0
Policy interest rate, %, eop	-	13.00	10.00	9.50	9.75	6.00	6.25	12.00	12.00	11.00
1 month inter-bank rate, %, eop	14.41	13.00	12.00	12.50	18.00	15.79	9.00	7.50	-	-
Long-term yield, %, eop	-	-	-	9.3	9.3	11.8	8.5	10.0	9.0	9.3
NGN/US$, eop	133.2	130.4	128.8	117.9	139.7	149.5	152.6	162.3	162.0	168.0
NGN/US$, avg	134.4	132.9	128.5	125.8	119.0	149.8	151.1	155.8	159.9	164.6
NGN/EUR, eop	180.5	154.4	170.0	172.0	195.3	214.0	204.2	210.1	200.9	215.2
NGN/EUR, avg	167.3	165.4	161.5	172.4	175.1	208.9	200.4	216.9	202.2	207.9
Balance of Payments, US$ bn										
Current account	16.8	36.5	36.5	27.6	28.1	22.0	14.2	15.9	16.5	21.9
% of GDP	19.4	32.9	25.1	16.6	13.5	11.6	6.3	6.1	5.5	6.4
Trade balance	19.8	29.2	34.9	37.7	45.9	29.4	33.4	40.8	40.0	45.5
Exports	34.8	55.2	56.9	66.0	85.7	60.0	74.6	92.0	87.0	93.0
Imports	15.0	26.0	22.0	28.3	39.8	30.6	41.2	51.2	47.0	47.5
Service balance	-2.6	-4.8	-11.6	-16.9	-22.1	-15.5	-19.5	-20.5	-21.0	-21.9
Income balance	-2.5	-3.0	-4.6	-11.7	-15.1	-10.1	-16.9	-22.5	-21.6	-21.4
FDI, net	-	-	-	-	-	-	-	-	-	-
International reserves	17.0	28.3	42.3	51.3	53.0	42.4	32.3	32.9	39.9	45.5
Total amortisations	1.2	3.9	6.5	0.9	0.6	0.5	0.5	0.4	0.3	0.3
Public Finances, % of GDP										
Consolidated government balance	-1.5	-1.1	-0.5	-0.6	-0.2	-2.9	-2.4	-3.1	-2.2	-2.1
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-	-
Public debt	-	-	-	-	-	-	-	-	-	-
of which Domestic	12.0	10.7	9.6	10.9	8.7	11.4	13.2	13.4	13.2	13.2
Foreign Assets & Liabilities, US$ bn										
External debt	35.9	20.5	3.5	3.4	3.7	4.6	4.6	5.7	7.1	7.5
Public	33.7	18.4	2.9	3.0	3.2	3.9	4.4	4.6	5.2	5.5
External debt / GDP	41.9	18.4	2.5	2.1	1.8	2.4	2.0	2.2	2.3	2.2
External debt / XGS	97.4	40.8	6.2	5.1	4.4	7.6	6.1	6.2	8.1	8.0
Short-term debt	-	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves, %	-	-	-	-	-	-	-	-	-	-

Source: National sources and Citi Investment Research and Analysis

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Other Africa

Ghana

- Despite the delay in reaching peak production levels, rising production from the Jubilee oil field and strong government spending should continue to help drive strong GDP growth in 2012-13, even if the rate slows from the double digit rate recorded in 2011.

- While there were many forecasts that the start of oil production should have had a positive impact on cedi stability, it has weakened substantially in 2012. In fact, the speed and scale of the depreciation has been surprising and seems to be at least in part driven by rising government spending as Ghana moves towards presidential and parliamentary elections in December 2012. Having failed to significantly reduce the fiscal deficit in 2010-11, we expect it to widen marginally in 2012 driven by both higher capital spending and the ongoing implementation of the single spine salary structure. In addition, the ongoing build-up of debt, domestic and external, will remain a concern and could potentially sow the seeds to a new fiscal crisis in 2013, as occurred in 2000 and 2008.

- We think the weakening of the cedi in early 2012 means that the Bank of Ghana will have to tighten monetary policy. However, despite a 200 basis point rise in the monetary policy rate so far in 2012, the modest pick-up in inflation to date may mean that policy is not tightened further until later in 2012 or early 2013. Meanwhile, we do think that the cedi has overshot and should stabilize in 2H 2012 at around GSH1.80:USD1 as it already looks relatively cheap and as the current pressures on the currency run their natural course.

Kenya

- The decision to delay holding elections until March 2013 has created some uncertainty. But we think that they delay should mean the polls are less rushed and in the end the delay is a positive. However, it does mean that political campaigning will rise steadily in 2H 2012 and act as a drag on investment.

- Although the sharp rise in inflation and shilling weakness in 2011, against the background of the approaching elections has undermined confidence in the economy, we still think that growth in 2012-13 will pick up modestly driven by the private sector boosting trade with the East Africa region, the ongoing recovery in the tourism and the agricultural sectors and strong government spending. The government is also moving ahead with ambitious plans to end the current power constraint on growth.

- The shilling has probably over reacted to the Central Bank of Kenya's (CBK) tightening of monetary policy in late 2011. Although we think inflation will ease in 2012, the overall pressure will be for shilling depreciation given the large current account deficit, slowness in bringing the fiscal deficit under control and a slow easing of monetary policy against the background of rising political tensions.

Tanzania

- The review of Tanzania's constitution is set to gather pace in 2012 with the creation of a Constitutional Review Commission. However, the main focus of the government will be on economic reform, and crucially implementation of policy. The most immediate pressing priorities are resolving the ongoing power sector crisis, which has led to prolonged electricity shutdowns in major urban centers, and sharply rising inflation.

- Growth should continue to be robust in 2012-13, although for it to really pick up strongly the government will have to make real progress in implementing its *Kilimo Kwanza* (Agriculture First) policy. The current account deficit is set to remain substantial despite ongoing increases in gold exports, but with aid and FDI inflows, increasingly into the gas sector, remaining high, the deficit should prove relatively easy to finance compared to Kenya and Uganda.

- As with the other two East African shillings, the Tanzanian shilling came under pressure in 2H 2011 as inflation rose and due to a delayed monetary policy response. Although the shilling will continue to weaken in 2012-13, we expect this to be relatively modest as inflation falls back, monetary policy remains relatively tight while the fiscal deficit is slowly brought back under control.

Uganda

- 2012 is set to be a difficult year for the Uganda economy as growth looks set to slow to its lowest level for over a decade and the fiscal and current accounts remain substantial. Meanwhile, the Bank of Uganda (BoU) has had to tighten monetary policy sharply to stabilize the shilling and in response to the sharp rise in inflation in 2H 2011.

- While the BoU would like to loosen monetary policy more aggressively to support growth, the reality is that although inflation should fall, its fall may be more moderate than in Kenya and the authorities need to continue to attract portfolio inflows to fund the twin deficits. The trick for the central bank will be to ease monetary policy only slowly, balancing the need to maintain inflows and so there is only modest weakening of the Shilling against the US dollar.

- On a positive note, in late 2013 and into 2014, the country should become an oil producer, although the impact on growth and government revenue will, initially, be minimal given that production will initially only be very limited. While the development of the field will push up the current account deficit, it should be largely fully funded through FDI inflows.

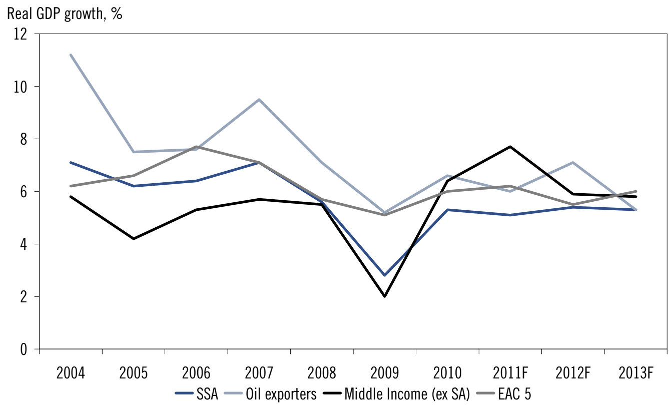
Zambia

- Following his victory in the September 2011 elections, the new president, Michael Sata, of the Patriotic Front, is now set to oversee a gradual rise in government spending over the next few years. This will be funded both domestically and with a debut Eurobond issue, probably in Q3 2012. But while government spending is set to increase, the rise may be slower than budget for as the new government only slowly gets to grips with being in power given the general inexperience of many of the new ministers.

- The wave of FDI into the copper mining sector in 2004-07 will continue to drive a steady increase in copper production in 2012-13, helping underpin growth. But the copper price crash of late 2008 is still fresh in the minds of the government, reinforced by the fall in the price in 2H 2011, and the focus of policy will continue to be economic diversification and the need to create jobs and push ahead with infrastructure development.

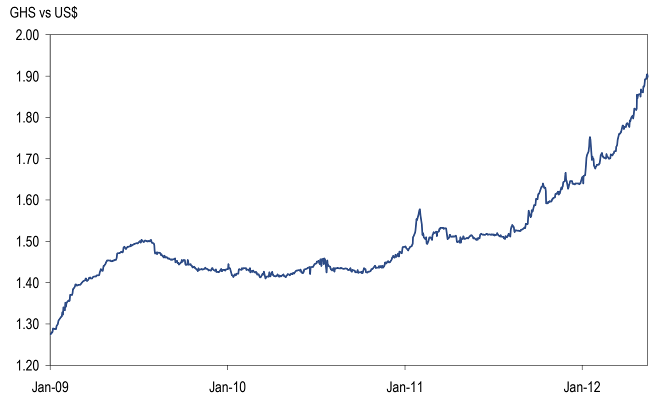
- Strong growth and rising government spending is likely to suck in imports, reducing the current account surpluses of recent years, while the government is also likely to try and keep interest rates low. We think this will eventually feed into a gradual pick-up in inflation and a weakening kwacha in 2012-13.

Figure 179. Growth looks set to pick up in 2011-12



Source: IMF

Figure 180. Two January wobbles in the cedi are a concern

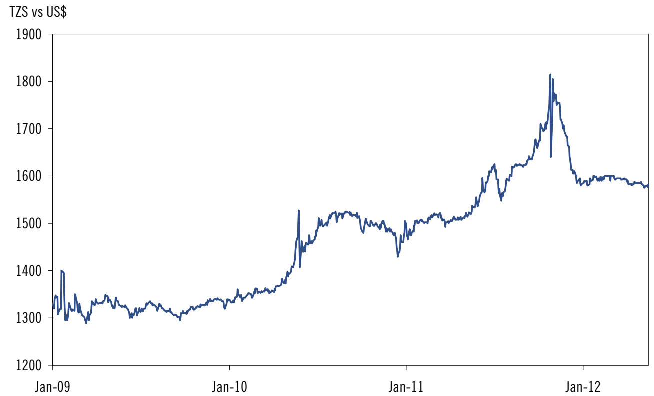


Source: Haver Analytics

Figure 181. The Kenyan shilling has bounced back, but probably too far

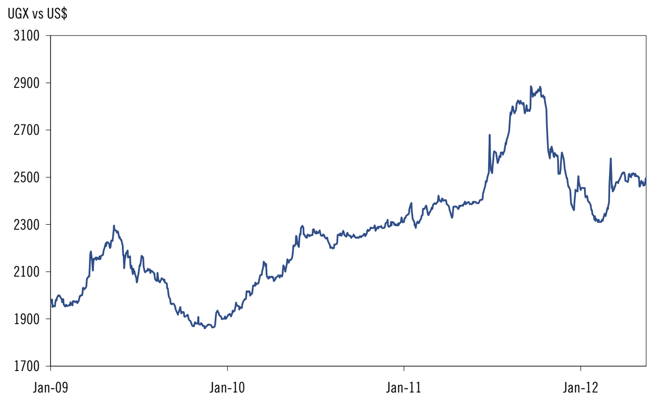
Source: Haver Analytics

Figure 182. Tanzanian shilling weakness in 2011 should slow in 2012



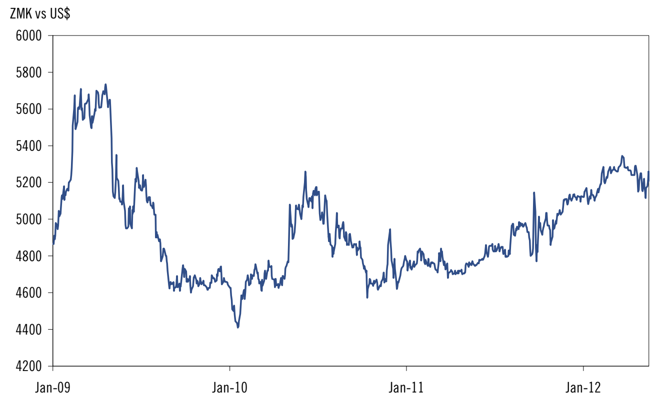
Source: Haver Analytics

Figure 183. Portfolio inflows drive a major Ugandan shilling rebound



Source: Haver Analytics

Figure 184. A roller coaster ride for the kwacha



Source: Haver Analytics

Figure 185. Other Africa Economic Indicators

	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
GHANA									
Nominal GDP, US$ bn	17.4	20.4	24.8	28.5	26.0	32.2	39.2	39.0	46.2
GDP per capita, US$	804	921	1,090	1,226	1,090	1,319	1,570	1,527	1,768
Real GDP, % yoy	6.0	6.1	6.5	8.4	4.0	8.0	14.4	7.5	6.5
CPI, % avg	15.4	11.7	10.8	16.5	19.2	10.7	8.7	10.2	11.6
Policy interest rate, %, eop	15.50	12.50	13.50	17.00	18.00	13.50	12.50	16.00	15.00
GHS/US$, eop	0.91	0.92	0.97	1.27	1.43	1.49	1.64	1.80	1.82
GHS/US$, avg	0.90	0.91	0.96	1.08	1.43	1.43	1.55	1.79	1.81
Current account, US$ bn	-0.8	-1.0	-2.1	-3.5	-1.6	-2.6	-3.2	-2.8	-2.1
% of GDP	-4.4	-5.1	-8.6	-12.4	-6.2	-8.1	-8.2	-7.2	-4.5
International reserves, US$ bn	1.8	2.1	2.8	2.0	3.0	4.7	4.9	5.3	6.0
Consolidated government balance, % of GDP	-3.2	-5.0	-6.1	-11.7	-7.2	-7.5	-5.4	-5.6	-4.7
KENYA									
Nominal GDP, US$ bn	19.4	23.3	28.5	30.5	30.6	32.2	33.7	41.1	43.6
GDP per capita, US$	544	638	760	793	776	794	811	962	994
Real GDP, % yoy	6.0	6.3	7.0	1.5	2.6	5.6	4.5	5.0	5.8
CPI, % avg	9.9	6.0	4.3	15.1	10.6	4.1	14.0	11.9	8.2
Policy interest rate, %, eop	11.07	10.00	8.75	8.50	7.00	6.00	18.00	13.50	11.00
KES/US$, eop	72.4	69.6	63.8	78.2	75.9	80.7	85.1	88.0	93.0
KES/US$, avg	75.3	72.0	64.4	69.2	77.3	79.3	88.9	85.2	91.6
Current account, US$ bn	-0.3	-0.5	-1.1	-2.3	-1.7	-2.1	-2.8	-3.1	-2.8
% of GDP	-1.4	-2.2	-3.7	-7.4	-5.7	-6.5	-8.2	-7.5	-6.5
International reserves, US$ bn	1.8	2.4	3.4	2.9	3.8	4.3	4.3	4.5	4.8
Consolidated government balance, % of GDP	-1.8	-2.5	-3.0	-3.9	-5.5	-6.5	-5.5	-5.0	-4.9
TANZANIA									
Nominal GDP, US$ bn	13.7	14.3	15.2	19.0	21.0	22.6	22.7	27.2	27.3
GDP per capita, US$	353	359	370	450	481	504	491	572	556
Real GDP, % yoy	7.4	7.0	6.9	7.3	6.7	6.9	6.3	6.2	6.8
CPI, % avg	4.4	5.6	6.3	8.4	11.8	6.2	12.7	15.7	7.4
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
TZS/US$, eop	1145	1260	1154	1318	1340	1505	1582	1675	1800
TZS/US$, avg	1121	1247	1148	1199	1323	1443	1586	1610	1719
Current account, US$ bn	-0.7	-1.2	-1.6	-2.3	-2.2	-2.1	-1.9	-2.1	-3.1
% of GDP	-5.1	-8.2	-10.4	-11.9	-10.7	-9.3	-8.5	-7.8	-11.2
International reserves, US$ bn	2.0	2.3	2.9	2.9	3.5	3.9	3.7	3.9	4.3
Consolidated government balance, % of GDP	-2.8	-4.7	-3.7	0.0	-4.8	-7.0	-7.8	-6.2	-5.8
UGANDA									
Nominal GDP, US$ bn	9.2	10.0	11.9	14.4	15.8	17.2	17.2	21.0	21.2
GDP per capita, US$	324	339	393	461	488	514	498	591	576
Real GDP, % yoy	6.3	10.8	8.4	8.8	7.2	5.9	5.7	4.5	5.5
CPI, % avg	8.0	6.6	6.8	7.3	14.2	9.4	18.6	16.4	6.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
UGX/US$, eop	1,812	1,734	1,698	1,943	1,900	2,310	2,480	2,600	2,800
UGX/US$, avg	1,771	1,825	1,711	1,719	2,032	2,182	2,525	2,494	2,692
Current account, US$ bn	-0.1	-0.3	-0.4	-0.4	-1.4	-1.7	-1.9	-2.6	-2.3
% of GDP	-1.4	-3.4	-3.1	-3.1	-8.7	-9.6	-11.1	-12.5	-10.7
International reserves, US$ bn	1.3	1.8	2.6	2.3	3.0	2.7	2.6	3.1	3.0
Consolidated government balance, % of GDP	-0.5	-0.9	-1.3	-3.0	-2.4	-5.0	-7.2	-5.5	-5.2
ZAMBIA									
Nominal GDP, US$ bn	7.2	10.7	11.5	14.6	12.8	16.2	18.4	19.3	20.8
GDP per capita, US$	626	911	957	1,183	1,006	1,237	1,366	1,388	1,454
Real GDP, % yoy	5.3	6.2	6.2	5.7	6.4	7.6	6.6	6.5	
CPI, % avg	18.3	9.0	10.7	12.4	13.4	8.5	8.7	7.5	8.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-
ZMK/US$, eop	3,415	4,428	3,863	4,795	4,641	4,800	5,125	5,400	5,800
ZMK/US$, avg	4,442	3,588	3,996	3,748	5,046	4,801	4,863	5,298	5,633
Current account, US$ bn	-0.6	0.0	-0.8	-1.1	0.5	1.1	0.8	0.2	-0.5
% of GDP	-8.5	-0.4	-6.5	-7.2	4.2	7.1	4.2	1.2	-2.5
International reserves, US$ bn	0.6	0.7	1.1	1.1	1.9	2.1	2.3	2.6	3.2
Consolidated government balance, % of GDP	-2.7	19.8	-1.3	-1.5	-2.6	-3.1	-3.2	-4.2	-5.2

Source: National sources and Citi Investment Research and Analysis

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Poland

- **Summary view** — We expect no further changes to monetary policy parameters this year after a surprising rate hike in May. In our view economic growth will decelerate in the second half of this year. Although inflation could stay elevated almost till the end of this year, the CPI target could be reached in early 2013.
- **Things to watch —** The scale of CPI growth acceleration during EURO 2012 and its persistence could be important for MPC members from the point of view of monetary policy prospects.
- **Strategy** — As a high-beta currency, the zloty can potentially suffer from an increase in risk aversion in the near term. Central bank will continue with verbal interventions if the zloty weakens further, though if the depreciation is too dynamic, the bank could step in to the market. In the longer term, we would expect the zloty to recover.

Surprising rate hike …

In May, the biggest surprise to the market was the decision of the Monetary Policy Council (MPC) to raise the reference rate by 25bps to 4.75%. The Council explained the decision was a response to stubbornly high inflation, near-zero real interest rates and the fact that economic slowdown in Poland proved less severe than feared a few months ago. The MPC stated that it wanted to reduce the risk of second round effects in the face of elevated inflation expectations. With regards to potential future actions, the MPC communiqué was relatively neutral, saying future decisions will be data dependent. The tone of the communiqué and interviews of several MPC members suggest the Council believes one rate hike might be sufficient and the central bank is now likely to choose a wait-and-see approach. We believe the prospect of weaker growth in the coming quarters, as well as a deteriorating labor market situation, do not justify rate hikes. A similar view has been expressed by the IMF staff in its concluding statement after Article IV visit in May.

… despite weak economic prospects …

Despite strong performance of the Polish economy in previous quarters, the coming months will likely bring weakening of economic activity. Although economic growth in 2011 was stronger than expected, most recent data releases on output significantly surprised to the downside. Industrial output decelerated in March to 0.7%YoY, while construction output growth weakened to 3.5%YoY. Weakening of manufacturing output confirmed signals coming from low PMI outcomes in previous months. The PMI for April also surprised to the downside by falling further to 49.2 pts and showing further weakening of domestic and export orders in line with deterioration of economic activity in the euro zone. In our view, this suggests slow industrial output growth in the coming months, with potential negative implications for the labor market. Moreover, we expect significant deceleration of investments growth later this year as the central and local governments are gradually tightening fiscal policy while infrastructure projects are gradually finalized. This will remove one of key factors contributing to dynamic construction output growth in previous months as Poland was preparing for Euro 2012 football championships (to be held in June 2012).

… and prospects of decline of inflation in medium term

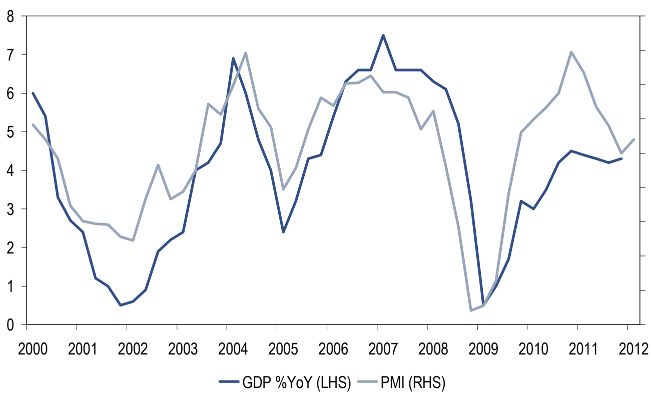
We expect that after a temporary rise above 4% YoY related to Euro 2012 championships, consumer price inflation will fall by the end of this year and it could return to the 2.5% target in early 2013. Inflation increased in April to 4%YoY from 3.9%YoY in March. We expect it will decline again below 4% in May, however data for the next two month June-July will be much more important for the monetary authorities. The CPI for June & July could be inflated by price hikes during the EURO 2012 football championships. Some of the MPC members fear that price rises could turn permanent and might not be fully reversed after the competition. However, in our view any price hikes would be temporary. The labor market remains weak, with only slightly positive employment growth rate, real wage growth remains close to 0%, and demand-side price pressures remain weak. Therefore we do not see material risks of second-round effects in Poland despite high headline inflation and elevated inflation expectations of households. Potential upward pressure on the CPI could come from recent currency depreciation. However, the pass-through of FX changes into prices is likely to be weak due to economic slowdown and increased FX volatility (both factors tend to lower pass-through). We expect inflation to stay above 1.5-3.5% band of acceptable deviations from the inflation target almost until the end of the year and could reach inflation target only in early 2013. Having said this, we expect central bank to keep rates on hold in the coming months and some small interest rate cuts could not be ruled out in early 2013.

Zloty to remain under pressure in the coming weeks

In the short term, the zloty could weaken due to an increase in risk aversion. As a high-beta currency, the zloty can potentially suffer from an increase in risk aversion in the near term. Moreover, although we expect gradual decline of current account deficit to 3.7% GDP at the end of 2012 from 4.3% in March, this is still relatively high level, which could make zloty vulnerable to global sentiment deterioration. Additionally, negative factor for the zloty in the short term is the fact that coverage of the current account deficit by inflows of long-term capital is relatively low and has been decreasing for a few months, which might increase sensitivity of the zloty to changes in risk aversion and mood of portfolio investors.

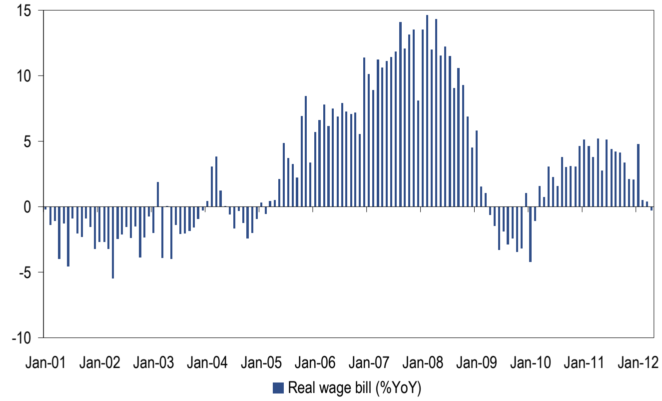
However, in longer term we expect the zloty to strengthen. Poland's foreign trade exposure to Greece and most of other GIPS countries except Italy is very low, while weakening of the Polish economy should be limited by still relatively well-performing Germany and rising share of exports to EM countries. Moreover, zloty depreciation in the near term should partly limit the scale of exports weakening. This should support GDP data in 2H12 and help cut the fiscal deficit this year towards around 3% GDP allowing for withdrawal of excessive deficit procedure by the European Commission in 2013. Some improvement in global sentiment in the longer horizon should allow investors to discount positive fiscal performance in Poland and result in gradual recovery of the zloty. Central bank will continue with verbal interventions if zloty weakens further, though if zloty depreciation is too dynamic and if the zloty weakens more than other CEE currencies the central bank could step in to the market and start selling foreign currencies. Central bank's actions should be rather sporadic as NBP FX reserves are relatively low as compared to other EM countries and will be aimed mainly at discouraging of speculative short-term capital flows.

Figure 186. Low PMI signals economic slowdown



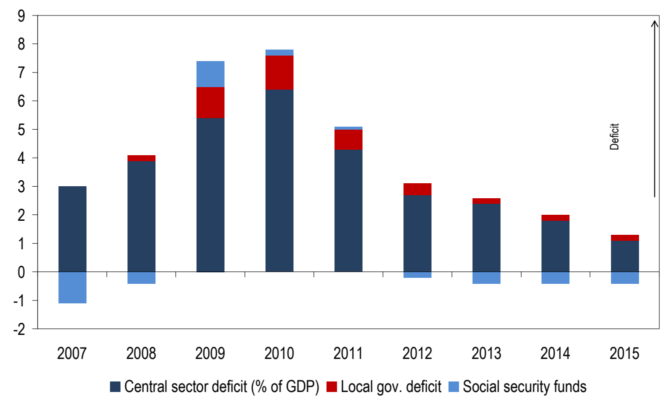
Source: Reuters, GUS.

Figure 187. Labor market slowdown keeps consumption growth low



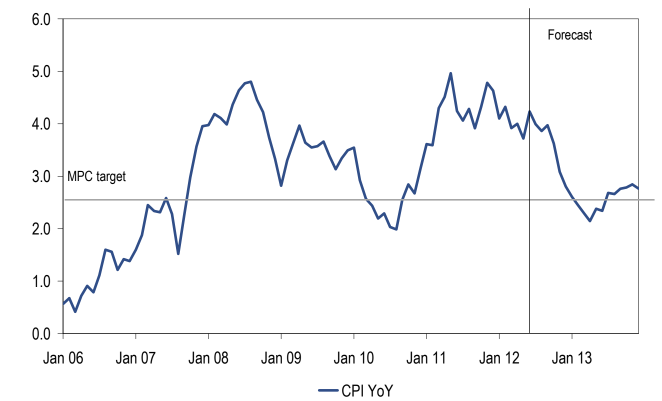
Source: GUS, CIRA.

Figure 188. Fiscal adjustment is likely to weigh on economic growth



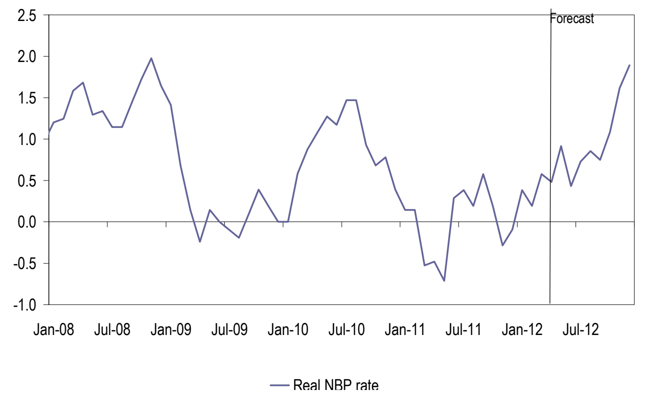
Source: Eurostat, Polish Finance Ministry, CIRA.

Figure 189. Inflation will likely return to the target within next 12 months



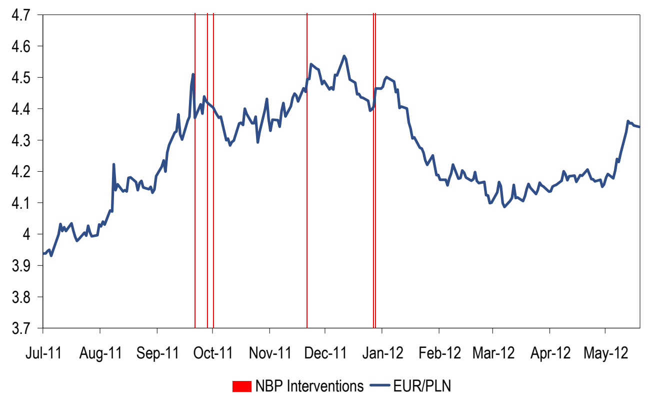
Source: Central Statistical Office, Citi forecasts.

Figure 190. Nominal interest rate could be too high if inflation falls



Source: NBP, GUS, CIRA. Note: Real rate calculated as nominal NBP reference rate less CPI. Nominal rate assumed at 4.75% in the forecast period.

Figure 191. PLN is close to levels that could trigger NBP interventions



Source: Reuters, CIRA.

Figure 192. Poland Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	254	304	342	426	534	434	470	515	470	518
Nominal GDP, local currency bn	925	983	1,060	1,177	1,275	1,344	1,416	1,525	1,625	1,708
GDP per capita, US$	6,644	7,966	8,969	11,185	13,995	11,360	12,306	13,492	12,297	13,609
Population, mn	38.2	38.2	38.1	38.1	38.1	38.2	38.2	38.2	38.2	38.1
Unemployment, % of labour force	19.5	18.2	14.9	11.2	9.5	11.9	12.2	12.5	12.9	11.7
Economic Activity										
Real GDP, % yoy	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3	2.7	2.4
Real investment growth % yoy	6.4	1.4	16.1	24.3	4.0	-11.5	9.3	9.9	2.3	-1.1
Real consumption growth % yoy	4.3	2.7	5.2	4.6	6.1	2.0	3.5	2.0	2.0	2.3
private consumption growth % yoy	4.7	2.1	5.0	4.9	5.7	2.1	3.2	3.1	2.3	2.5
Real export growth, % yoy	14.0	8.0	14.6	9.1	7.1	-6.8	12.1	7.5	4.5	4.5
Real import growth, % yoy	15.2	4.7	17.4	13.7	8.0	-12.4	13.9	5.8	2.9	2.3
Prices, Money & Credit										
CPI, % yoy	4.3	0.5	1.4	3.9	3.4	3.7	3.2	4.6	2.8	2.8
CPI, % avg	3.5	2.1	1.0	2.5	4.2	3.5	2.6	4.3	3.8	2.6
Nominal wages, % yoy	4.2	3.2	5.0	9.1	10.5	4.2	3.6	4.9	4.1	4.8
Credit extension to private sector, % yoy	10.0	9.3	24.0	31.5	36.4	7.0	8.5	13.0	15.0	15.0
Policy interest rate, %, eop	6.50	4.50	4.00	5.00	5.00	3.50	3.50	4.50	4.75	4.25
1 month inter-bank rate, %, eop	6.46	4.40	3.96	5.37	5.41	3.56	3.46	4.77	4.94	4.37
PLN/US$, eop	3.00	3.27	2.91	2.45	3.00	2.86	2.95	3.40	3.55	3.15
PLN/US$, avg	3.65	3.24	3.10	2.76	2.39	3.10	3.01	2.96	3.46	3.30
PLN/EUR, eop	4.08	3.86	3.83	3.58	4.17	4.11	3.96	4.42	4.40	4.03
PLN/EUR, avg	4.54	4.03	3.89	3.78	3.52	4.33	3.99	4.12	4.38	4.17
Balance of Payments, US$ bn										
Current account	-13.3	-7.3	-13.1	-30.5	-35.0	-17.2	-21.9	-22.2	-18.3	-20.8
% of GDP	-5.2	-2.4	-3.8	-7.2	-6.5	-4.0	-4.7	-4.3	-3.9	-4.0
Trade balance	-5.9	-3.1	-7.3	-19.1	-30.7	-7.6	-11.8	-14.2	-11.6	-11.6
Exports	81.9	96.4	117.5	145.3	178.4	142.1	165.9	193.9	184.8	201.2
Imports	87.8	99.5	124.8	164.4	209.1	149.7	177.7	208.1	196.3	212.9
Service balance	0.1	0.7	0.7	0.7	5.0	4.8	3.1	6.1	6.6	6.6
Income balance	-8.4	-6.8	-9.7	-16.4	-12.9	-16.6	-17.0	-20.2	-18.2	-20.7
FDI, net	11.8	6.9	10.7	18.0	10.4	8.5	3.6	9.1	4.2	8.0
International reserves	34.5	38.8	45.1	54.6	57.2	69.7	81.4	86.8	94.0	102.0
Total amortisations	21.3	30.1	23.5	30.2	32.4	32.8	32.1	37.3	37.4	38.9
Public Finances, % of GDP										
Consolidated government balance	-5.4	-4.1	-3.6	-1.9	-3.7	-7.4	-7.9	-5.1	-3.1	-2.5
Consolidated gov primary balance	-2.6	-1.3	-1.0	0.4	-1.5	-4.8	-5.2	-2.3	-0.1	0.5
Public debt	46.7	47.5	47.8	44.8	46.9	49.8	52.8	53.5	51.6	50.2
of which Domestic	34.5	34.5	35.6	34.3	34.8	36.7	38.4	36.5	34.6	34.5
Foreign Assets & Liabilities, US$ bn										
External debt	129.9	132.9	169.8	233.3	244.8	280.2	315.3	321.9	335.9	354.9
Public	57.9	60.8	69.1	86.8	69.4	92.2	116.5	120.2	125.4	132.5
External debt / GDP	51.2	44.1	46.6	48.3	56.8	59.4	66.0	72.2	71.5	68.5
External debt / XGS	136.3	117.9	123.0	140.6	114.4	163.8	158.7	139.4	152.9	148.3
Short-term debt	24.8	27.1	34.6	60.9	65.9	70.0	76.5	72.1	76.1	80.1
Short-term debt/International reserves, %	71.9	69.7	76.7	111.4	115.1	100.4	93.9	83.1	81.0	78.6

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	4.2	4.2	4.4	3.5	3.8	2.1	1.6	1.2	1.3	3.1
CPI, % yoy	4.2	3.9	4.6	3.9	4.2	4.0	2.8	2.3	2.3	2.8
Policy interest rate, %, eop	4.50	4.50	4.50	4.50	4.75	4.75	4.75	4.50	4.25	4.25
1 month inter-bank rate, %, eop	4.34	4.43	4.56	4.52	4.98	4.94	4.94	4.49	4.40	4.42
PLN/US$	2.75	3.29	3.43	3.12	3.56	3.66	3.55	3.44	3.34	3.24
PLN/EUR	4.01	4.36	4.23	4.26	4.47	4.47	4.37	4.27	4.18	4.09

Source: National sources and Citi Investment Research and Analysis

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Romania

- **Summary view** — We expect the NBR to become more cautious and keep rates on hold at 5.25% during the remainder of the year due to the recent leu weakening and political developments.
- **Things to watch** — The upcoming local elections in June and general elections in November, along with the implementation of the IMF-EU supported economic program, deserve close monitoring.
- **Strategy** — While the NBR's more cautious stance should be currency positive, the uncertainties associated with the 2012 election calendar and the euro zone woes render the EUR/RON vulnerable.

Preliminary 1Q GDP data revives recovery concerns

The flash GDP reading for 1Q suggests that the economy contracted by 0.1%QoQ (SWA) after shrinking 0.2%QoQ in 4Q. The disappointing 1Q GDP outturn is likely to revive concerns over the economic recovery, as the focus will turn to the second quarter. Specifically, growth indicators going forward will provide important clues in helping policy makers and the markets to determine whether the observed softening in economic activity in 1Q is largely driven by temporary factors such as harsh winter conditions. While it is too early to make firm conjectures, sentiment indicators point to nascent signs of recovery. Nonetheless, we believe that downside risks to growth remain high given the ongoing Euro zone crisis and the uncertainties associated with the 2012 electoral calendar. Specifically, Romania's 3-month-old center-right government collapsed on 27 April after losing a no confidence vote in Parliament. This was followed by the nomination of Mr. Victor Ponta, leader of the Social Democratic Party, who became the country's new PM after the approval of his cabinet line-up by Parliament on May 7. Developments to date lead us to believe that the new government is likely to be in charge until the elections in November. While the presence of an IMF-EU supported program provides some comfort, the noted political backdrop paints a challenging picture for the much needed recovery.

Favorable food prices drive inflation lower in April

At 1.8% YoY, the inflation outturn in April came in lower than the consensus (2.1%YoY). This outcome was largely driven by favorable food prices, which declined by 0.11%MoM in April, considerably lower than the seasonal average since 2005 (0.42%MoM). Using seasonally-adjusted data, the April print translates into flattish CPI inflation, compared with 0.5%MoM in March and 0.6%MoM in February. In parallel, the evolution of the seasonally adjusted core inflation suggests that underlying inflation dynamics in April remain benign. The improvement in forward-looking inflation expectations provides further comfort about the near-term inflation outlook. Barring surprises, the downward trend in year-on-year inflation should continue next month, in our view. However, a gradual upward trend thereafter is likely with year-end inflation reaching about 3.5% (vs. the NBR's most recent forecast of 3.2%). Looking ahead, we believe that the possibility of additional administrative price adjustments and a reversal in food prices are the key risk factors requiring close monitoring.

May Inflation Report paints a more cautious NBR

In response to the recent political developments and the leu weakening, the NBR kept its policy rate on hold at 5.25% in May. In our view, the May Inflation Report points to a more cautious monetary policy stance going forward, reversing the easing bias in the previous Report and Board Minutes. Specifically, while the NBR kept its year-end inflation at 3.2%, the Bank acknowledged that the balance of risks surrounding the current projection of the inflation rate is more visibly tilted to the upside than anticipated in the February 2012 Inflation Report.

According to the Bank, the ongoing Euro zone crisis, the downward revision of the euro area economic growth outlook in 2012 and the tensions on the international oil market further stand out as the main external risk sources. On the domestic front, the main risks are seen as possible slippages in the implementation of fiscal policy and structural reforms, in the context of the uncertainties generated by the 2012 electoral calendar. The NBR also notes the growth rate of administered prices and that of volatile food prices as additional risks on the domestic front. All in all, the new Inflation Report corroborates our view that the NBR is likely to keep the policy rate constant at 5.25% during the remainder of this year.

IMF agrees to raise 2012 budget gap target to 2.2% of GDP

The IMF and authorities reached an agreement to increase the 2012 budget deficit target to 2.2% of GDP from 1.9%. This revision is based on a weaker growth projection for 2012 (to 1.5%-2.3% from 1.8%-2.3%) and the need to solve a legal issue related with social contributions paid by pensioners as well as to accommodate a partial restoration of the 2010 public sector wage cuts. Notwithstanding this change in the target, the deficit in ESA accrual terms is projected to remain safely below 3% of GDP. Moreover, the most recent IMF mission in May also revealed that the program remains broadly on track. All end-March 2012 quantitative performance criteria in the Stand-By Arrangement with the IMF were observed except the one on central government arrears, which was missed by a small margin.

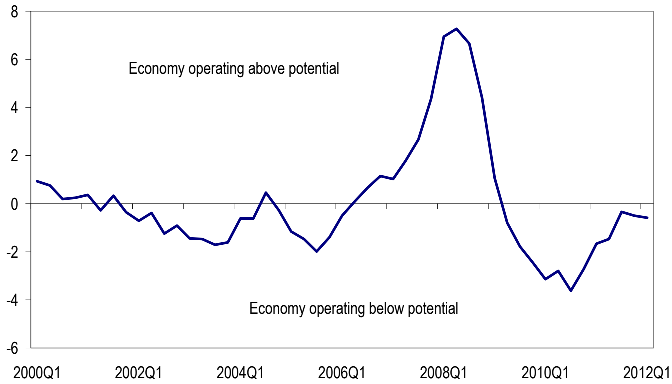
12-month rolling trade gap is stuck at around €10bn

At EUR 1.7bn, the trade gap in 1Q is slightly wider than the deficit seen in the same period of 2011 (EUR 1.5bn). This outcome is largely driven by a moderate pick-up in import growth (1.1%YoY) and a contraction in export growth (-0.4%YoY). Moreover, the seasonally adjusted export and import series suggest that the former may be losing momentum, as the 12-month rolling deficit has been stuck at around EUR 10bn in recent months. Against this backdrop, we look for a moderate widening in the current account gap to 4.5% of GDP this year from 4.2% in 2011.

Low yields and political noise hurt the leu

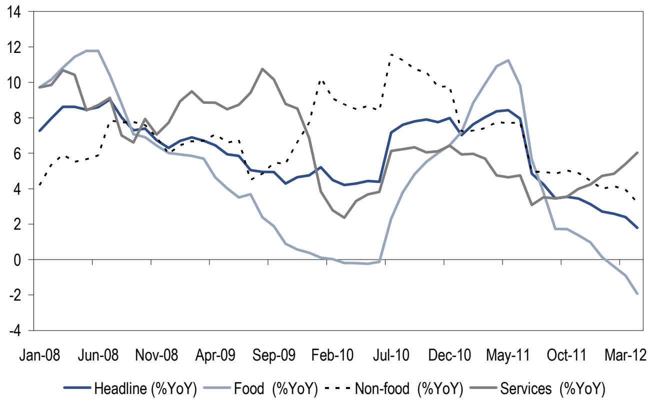
The EUR/RON, which was lagging behind its peers in the region since the beginning of the year, has weakened further following the recent political developments. Following the fall of the government, the EURON moved from 4.3750 to as high as 4.4620 before settling at around 4.44. We think the NBR is likely to tighten RON liquidity to contain depreciation pressures if needed, while the Bank may be somewhat reluctant to sell FX, particularly if there are deviations from the IMF program ahead of the November elections. The noted backdrop, coupled with the Euro zone woes, led us to revise our FX forecast, as we now expect the EUR/RON to be around 4.40 (vs. 4.30 before) by the end of the year.

Figure 193. Economic recovery seems to be losing momentum…



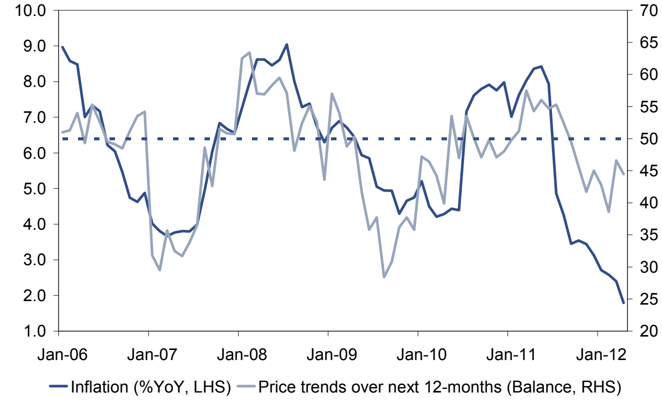
Source: Haver Note: (QoQ, SWA, GDP growth)

Figure 194. …as favorable food prices drive inflation lower…



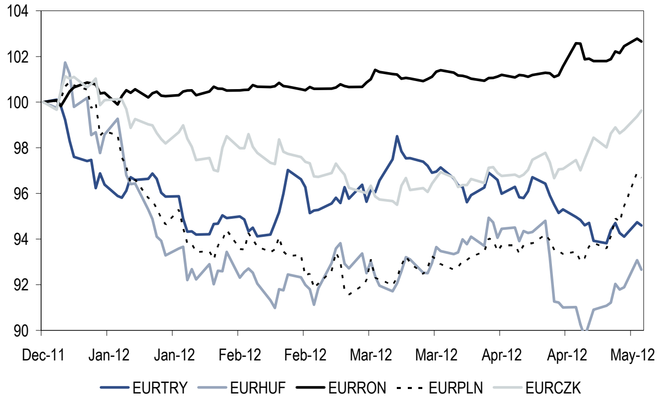
Source: Haver and CIRA

Figure 195. … supporting forward-looking expectations



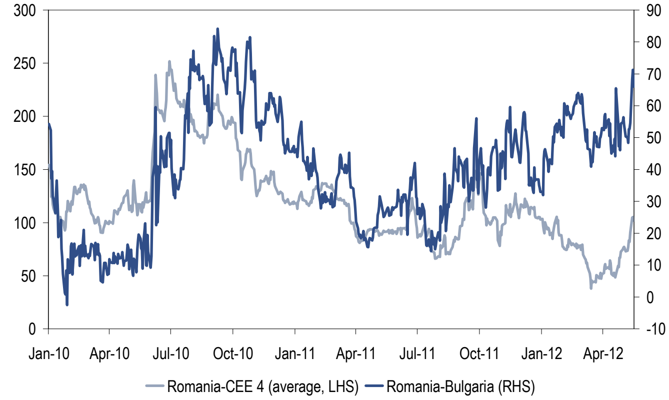
Source: Haver

Figure 196. However, the recent leu depreciation…



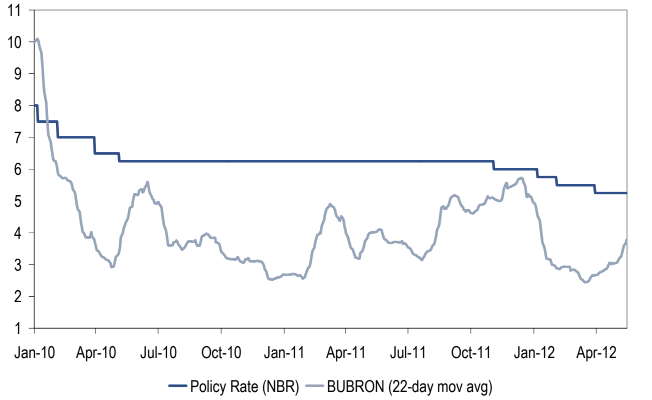
Source: Bloomberg. Note: Dec 30, 2011=100

Figure 197. …and Romania's relative performance in credit markets…



Source: Bloomberg Note: Using 5-year CDS spreads.

Figure 198. …should lead the NBR to become more cautious



Source: Bloomberg.

Figure 199. Romania Economic Forecast

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	75.8	99.2	122.7	170.7	204.4	164.6	164.3	189.9	172.2	186.6
Nominal GDP, local currency bn	247.4	289.0	344.7	416.0	514.7	501.1	522.6	578.6	602.5	637.7
GDP per capita, US$	3,388	4,436	5,496	7,653	9,176	7,397	7,397	8,559	7,777	8,444
Population, mn	22.4	22.4	22.3	22.3	22.3	22.2	22.2	22.2	22.1	22.1
Unemployment, % of labour force	6.8	5.8	5.4	4.3	4.0	6.3	7.6	5.4	5.2	5.2
Economic Activity										
Real GDP, % yoy	8.5	4.1	7.9	6.3	7.4	-6.6	-1.7	2.5	1.3	3.0
Real investment growth % yoy	17.6	4.7	21.7	29.9	12.1	-28.8	0.3	12.5	2.9	3.3
Real consumption growth % yoy	11.7	9.2	10.6	10.5	8.9	-8.9	-0.8	0.8	0.9	2.5
private consumption growth % yoy	15.9	10.0	12.8	11.8	9.0	-10.3	-0.4	1.3	0.9	2.7
Real export growth, % yoy	14.3	7.2	9.8	7.8	7.3	-6.2	15.1	10.5	5.5	4.2
Real import growth, % yoy	22.1	16.0	22.7	27.9	7.1	-21.4	12.7	11.5	3.9	3.2
Prices, Money & Credit										
CPI, % yoy	9.3	8.6	4.9	6.6	6.3	4.7	8.0	3.1	3.5	3.3
CPI, % avg	11.9	9.0	6.6	4.8	7.9	5.6	6.1	5.8	2.8	2.7
Nominal wages, % yoy	22.6	17.0	18.9	22.6	23.6	8.4	2.5	4.9	5.0	5.3
Credit extension to private sector, % yoy	#N/A	45.8	54.5	60.4	33.7	0.9	4.7	6.6	9.4	7.1
Policy interest rate, %, eop	#N/A	7.50	8.75	7.50	10.25	8.00	6.25	6.00	5.25	5.00
1 month inter-bank rate, %, eop	17.38	7.51	8.67	8.24	15.35	10.60	4.05	5.72	5.85	5.60
Long-term yield, %, eop	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
RON/US$, eop	3.27	2.77	2.34	2.53	2.81	2.95	3.21	3.34	3.55	3.36
RON/US$, avg	3.26	2.91	2.81	2.43	2.50	3.04	3.17	3.04	3.50	3.42
RON/EUR, eop	3.87	3.66	3.41	3.54	3.92	4.23	4.29	4.33	4.40	4.30
RON/EUR, avg	4.05	3.62	3.52	3.34	3.68	4.24	4.21	4.24	4.43	4.32
Balance of Payments, US$ bn										
Current account	-6.3	-8.6	-12.8	-22.9	-23.8	-6.8	-7.3	-7.9	-7.7	-8.8
% of GDP	0.0	-8.6	-10.4	-13.4	-11.6	-4.2	-4.5	-4.2	-4.5	-4.7
Trade balance	-6.6	-9.7	-14.8	-24.4	-28.1	-9.6	-10.1	-10.4	-11.7	-10.8
Exports	23.5	27.7	32.5	40.5	49.6	40.5	49.6	62.7	49.9	57.9
Imports	30.2	37.4	47.2	64.9	77.7	50.1	59.7	73.0	61.7	68.7
Service balance	-0.3	-0.4	0.0	0.6	1.0	-0.4	0.5	0.5	0.5	0.6
Income balance	-3.2	-2.9	-4.1	-5.7	-5.4	-2.6	-2.5	-3.3	-3.4	-6.7
FDI, net	6.4	6.5	11.0	9.7	13.7	5.0	3.0	2.7	3.4	4.7
International reserves	14.8	19.8	28.1	37.3	36.5	39.4	42.3	45.8	43.8	50.7
Total amortisations	5.4	6.2	8.6	12.2	18.1	17.7	19.7	18.4	17.9	21.8
Public Finances, % of GDP										
Consolidated government balance	-1.0	-0.8	-1.7	-2.3	-4.8	-7.3	-6.4	-4.1	-2.4	-2.2
Consolidated gov primary balance	0.3	0.3	-0.6	-1.5	-3.9	-5.7	-4.9	-2.4	-0.6	-0.4
Public debt	22.6	20.4	18.4	19.8	21.3	29.6	37.9	38.9	39.2	38.9
of which Domestic	16.1	8.4	7.7	11.7	14.4	17.6	22.5	25.3	24.1	21.7
Foreign Assets & Liabilities, US$ bn										
External debt	28.6	36.4	54.8	84.5	100.1	116.9	123.9	145.2	128.3	130.6
Public	11.9	11.9	13.1	13.9	14.2	19.6	24.8	28.9	26.0	32.0
External debt / GDP	37.8	36.7	44.6	49.5	49.0	71.1	75.4	76.5	74.5	70.0
External debt / XGS	105.4	110.9	138.7	169.3	160.3	232.2	212.2	199.6	214.8	191.3
Short-term debt	4.3	7.4	16.7	28.7	28.5	22.5	26.2	29.8	30.4	34.0
Short-term debt/International reserves, %	28.9	37.3	59.6	77.1	78.1	57.0	61.9	65.1	69.3	67.0

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	1.4	4.4	1.9	0.3	0.4	1.2	2.6	3.3	3.3	3.0
CPI, % yoy	7.9	3.5	3.1	2.4	2.5	3.6	3.5	2.4	2.6	3.2
Policy interest rate, %, eop	6.25	6.25	6.00	5.25	5.25	5.25	5.25	5.00	5.00	5.00
1 month inter-bank rate, %, eop	4.68	6.18	5.72	5.75	5.75	5.75	5.75	5.50	5.50	5.50
Long-term yield, %, eop	na	na	na	na	na	na	na	na	na	na
RON/US$	2.92	3.23	3.34	3.29	3.57	3.61	3.55	3.49	3.44	3.39
RON/EUR	4.24	4.32	4.33	4.39	4.47	4.45	4.40	4.35	4.32	4.30

Source: National sources and Citi Investment Research and Analysis

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Russia

- **Summary view** — Growth accelerated to 4.9%YoY in 1Q12, in line with our expectations. Aggressive pre-election spending supported strong retail sales through wages. We expect consumption to drive 3.5% GDP growth in 2012.
- **Things to watch** — The new government is to be formed in May and is likely to be neutral for the markets. The politically challenging pension reform is scheduled to be discussed in autumn.
- **Strategy** — Ruble is not wholly an oil story, we estimate that global risk aversion matters just as much. From the fundamental point of view, we see basket at 35-36 by the year-end and even weaker if the global growth concerns build up.

Strong growth for now

The Russian economy expanded 4.9%YoY in 1Q12, accelerating marginally from the end of 2011 in line with our expectations. Both the CBR and MoE estimated Russia's GDP growth was above potential (positive output gap) in 1Q2012, likely caused by the aggressive budget spending in the pre-election period and subsequent rise in retail sales. In contrast to 2011 when households spent their savings, this year's consumption seems to be driven mainly by wage growth (see Household consumption strong, but running out of support?). GDP also benefited from investment activity (11.2%YoY in 1Q12). The contribution of net exports most probably remained negative.

We expect strong retail sales of 6-7%YoY to be the main driver of growth in 2012. Strong public spending is unlikely to continue at the pace of pre-election 4Q11 and 1Q12. We estimate the planned increase of budget wages in 3Q12 to add some 2pp to QoQ wage growth. As we approach the year-end, the 2011 high base will counterbalance the positive effect of the budget spending. In our baseline scenario, we expect consumption growth to slow to 5-6% by the year-end, adding 6-7% in 2012 as a whole, and this view is also reflected in the revised MoE forecast for consumption, which was raised by 0.8pp to 6.3%YoY (Russia Macro View: Trip Notes April 23-24). Along with private consumption, GDP will slow down by the year-end and grow by 3.5%YoY in 2012 as a whole.

Budget strong with $110+ oil, but difficulties lie ahead

2012 budget is likely to be balanced. The MoF approved the new tax policy guidelines in end-April. Changes include increasing the gas taxes, fixing the social security contribution rate at 30%, tax incentives for investment in equipment and machinery, and higher excises rates on alcohol and tobacco. Given pressures from the expenditure side, the government likely will seek for new sources of revenues (see Fiscal position: good from afar, but far from good). Meanwhile, the revised 2012 budget allows for a moderate RUB88bn increase in spending and additional RUB898bn revenues generated from the higher assumed oil price ($15 higher) bringing the expected budget deficit down to 0.1%GDP from 1.5%. We estimate each US$10/bbl increase in oil price brings 1% of GDP to the budget. However, non-oil revenues could underperform this year due to lower-than-budgeted GDP growth. We expect 2012 budget to be close to balanced in 2012. According to preliminary Ministry of Finance estimates, the federal budget deficit shrank to RUB60bn in January-April.

Lower budget deficit reduces the need for borrowing, but under either scenario we expect fiscal policy to drain liquidity in 2012. Russia can meet the recently budgeted RUB0.8tn increase in Reserve funds, virtually without further borrowings. It is therefore not surprising the MoF recently announced the next external debt issue will not take place before 2013 (19 April, RIA news). Meanwhile, the foreign debt ceiling was increased by US$8.1bn, but we believe external borrowing is not likely this year. The MoF has also decided to cut domestic borrowing by Rub500bn in 2012 (VoA, 23 April). Nonetheless, the fiscal drag on liquidity will remain RUB0.5-1tn.

If nothing is done, budget spending will continue to increase. Key sources of higher spending are pensions, military and healthcare. In our view, these are of critical importance, but so far, the officials do not have a plan for the pension system reform, and the preliminary discussions will be held in autumn.

Oil is not enough for ruble

CBR Chairman Ignatiev estimates capital outflow to have reached US$42bn in January-April, or some US$10bn in April (Bloomberg, 17 May)**.** This means that the private capital outflow accelerated, since there has been a positive effect on capital account from US$7bn Eurobond placement by the government. We expect capital outflows to reach US$60bn and absorb most of the US$100bn current account surplus in 2012.

We believe ruble is the four-factor four-regime story: oil, oil forecasts, sentiment, rates during risk-on/off, oil up/down. We believe risk attitude matters almost as much as oil for ruble.

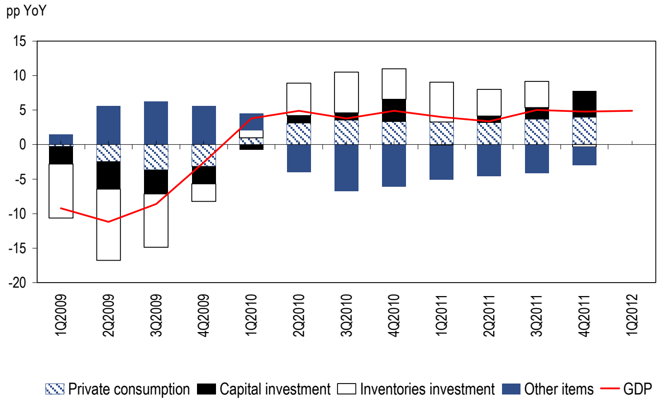
- Oil prices — an average 16% increase in the oil price causes a 1% appreciation of the basket. In the risk-off environment, the ruble is more sensitive to oil.
- Oil price forecasts — become especially significant in a falling oil price environment: a 4% increase in forecasts gives a 1% appreciation of the basket.
- Risk aversion — GRAMI[3] is as important as oil, especially when risk aversion is high. A change of 0.3 points could move the basket by 1%.
- Interest rates — higher rate differentials may either make Russia more attractive, or reflect risk pricing. In our view, 3-month rates are perceived as a risk premium, but ruble gains on higher overnight rates. The sensitivity to rates is low so far, but we expect it to increase as the CBR is adopting inflation targeting.

We also see US stock market's importance, and this suggests that Russia is highly dependent on developed market growth. The US stock market's relative performance seems to strongly influence Russian indicators, and stronger US performance is related to ruble appreciation, probably because US growth adds to market optimism for commodities or, risk-taking by investors.

We see ruble basket at 35-36 by the year-end in our base case of oil averaging $110 in 2012. Foreign borrowings by corporates and tight liquidity should support the ruble, but capital outflows draining current account will be weighing on the ruble throughout the year. We also emphasize the global growth and Euro Area concerns might devaluate ruble through risk-aversion even if oil prices remain favorable.

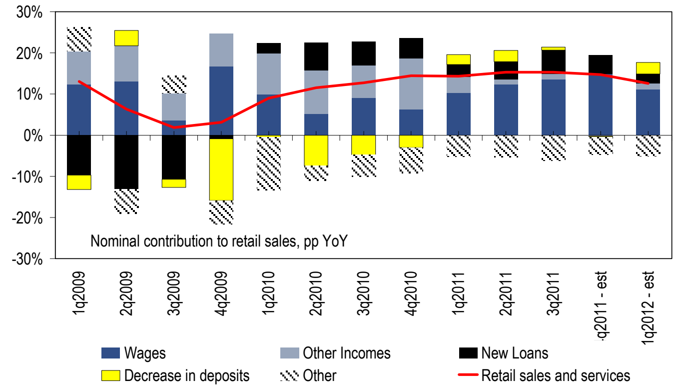
[3] Citi's proprietary Global Macro Risk Aversion Index, BBC: CIGMGRAM Index

Figure 200. GDP accelerated marginally to 4.9% in 1Q12



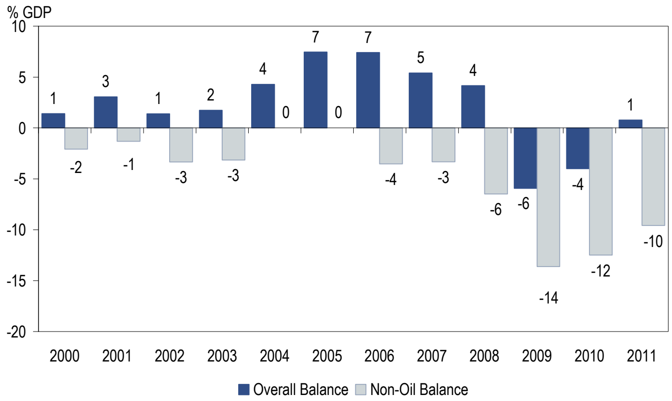
Source: Citi Investment Research and Analysis, Rosstat

Figure 201. Consumption to slow down with less wages growth



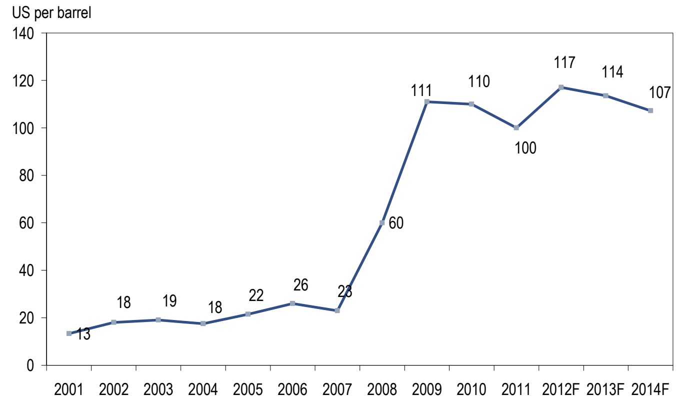
Source: Citi Investment Research and Analysis, Rosstat

Figure 202. Persistent non-oil deficits…



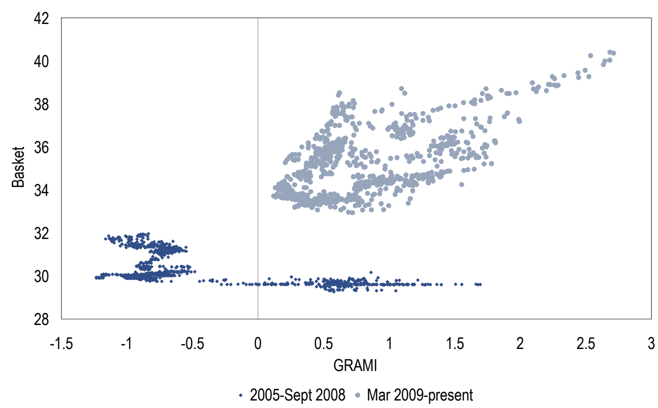
Source: Citi Investment Research and Analysis, MinFin

Figure 203. …are coupled with high break-even oil price



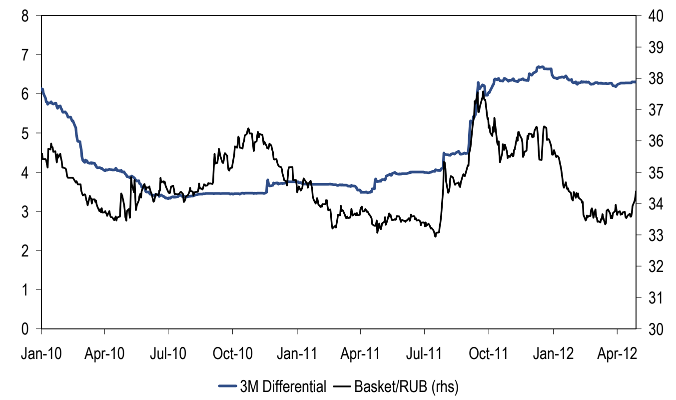
Source: Citi Investment Research and Analysis, MinFin

Figure 204. Risk factors gain in importance for ruble…



Source: Citi Investment Research and Analysis, Bloomberg

Figure 205. …and 3 month interest rates reflect risk premium



Source: Citi Investment Research and Analysis, Bloomberg

Figure 206. Russia Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	591	764	990	1,300	1,661	1,222	1,480	1,885	1,937	2,113
Nominal GDP, local currency bn	17,027	21,610	26,917	33,247	41,277	38,807	45,173	54,586	59,919	67,833
GDP per capita, US$	4,097	5,309	6,898	9,070	11,601	8,542	10,352	13,196	13,572	14,822
Population, mn	144.3	143.8	143.5	143.3	143.2	143.1	143.0	142.8	142.7	142.6
Unemployment, % of labour force	8.2	7.6	7.2	6.1	6.4	8.4	7.5	6.6	7.5	7.5
Economic Activity										
Real GDP, % yoy	7.2	6.4	8.2	8.5	5.2	-7.8	4.3	4.3	3.5	4.0
Real investment growth % yoy	12.6	10.6	18.0	21.0	10.6	-14.4	5.8	8.0	6.7	9.0
Real consumption growth % yoy	8.3	8.1	8.8	10.7	8.4	-3.9	3.3	4.8	5.2	4.4
private consumption growth % yoy	11.8	11.6	11.9	14.2	10.4	-5.1	5.1	6.3	5.9	5.3
Real export growth, % yoy	11.8	6.5	7.3	6.3	0.6	-4.7	7.0	0.4	1.0	2.7
Real import growth, % yoy	23.3	16.6	21.3	26.2	14.8	-30.4	25.8	20.3	4.3	5.8
Prices, Money & Credit										
CPI, % yoy	11.7	10.9	9.0	11.9	13.3	8.8	8.8	6.1	6.9	5.6
CPI, % avg	10.9	12.7	9.7	9.0	14.1	11.6	6.8	8.4	5.1	6.9
Nominal wages, % yoy	24.0	25.2	25.5	26.0	27.4	9.1	13.9	10.6	6.0	6.0
Credit extension to private sector, % yoy		34.6	48.7	49.3	37.2	2.6	12.9	28.0	18.0	20.0
Policy interest rate, %, eop	13.00	12.00	11.00	10.00	13.00	8.75	7.75	8.00	8.00	6.00
1 month inter-bank rate, %, eop	-	6.39	5.71	6.09	20.20	6.32	3.78	6.37	5.50	4.50
Long-term yield, %, eop	-	6.9	6.6	6.6	10.9	9.5	8.2	8.8	8.0	7.5
RUB/US$, eop	27.8	28.8	26.4	24.6	29.4	30.2	30.5	32.2	31.7	32.1
RUB/US$, avg	28.8	28.3	27.2	25.6	24.9	31.8	30.4	29.4	30.9	32.1
RUB/EUR, eop	37.8	34.2	34.6	35.7	41.4	43.4	40.3	41.7	39.3	41.2
RUB/EUR, avg	35.8	35.3	34.1	35.0	36.4	44.2	40.3	40.9	39.1	40.5
Balance of Payments, US$ bn										
Current account	59.5	84.6	94.7	77.8	103.5	48.6	95.3	98.8	102.6	44.8
% of GDP	10.1	11.2	9.9	6.1	6.2	4.0	6.4	5.2	5.3	2.1
Trade balance	85.8	118.4	139.3	130.9	179.7	111.6	151.7	198.2	197.2	140.6
Exports	183.2	243.8	303.6	354.4	471.6	303.4	400.4	522.0	521.1	489.4
Imports	97.4	125.4	164.3	223.5	291.9	191.8	248.7	323.8	323.9	348.8
Service balance	-12.7	-13.8	-13.6	-18.9	-24.3	-19.8	-7.8	-35.9	-36.6	-49.3
Income balance	-12.8	-19.0	-29.4	-30.8	-49.2	-40.3	-48.6	-60.2	-55.0	-44.0
FDI, net	1.7	0.1	6.6	9.2	19.4	-7.2	-9.2	-14.4	-11.9	3.9
International reserves	120.8	175.7	295.3	466.4	410.7	405.8	432.9	441.2	478.3	524.1
Total amortisations	0.4	0.3	0.4	0.4	30.4	117.0	90.0	60.0	50.0	50.0
Public Finances, % of GDP										
Consolidated government balance	4.6	8.1	9.4	6.7	5.3	-5.7	-3.3	2.0	0.3	0.1
Consolidated gov primary balance	5.8	9.0	10.0	7.2	5.6	-5.2	-2.8	2.5	0.9	0.7
Public debt	21.5	13.2	8.3	6.6	5.2	7.3	7.8	8.3	8.5	8.5
of which Domestic	4.4	3.9	3.8	3.8	3.4	4.7	5.4	6.5	6.7	6.6
Foreign Assets & Liabilities, US$ bn										
External debt	196.8	239.9	250.7	361.3	480.0	469.7	489.7	509.7	519.7	529.7
Public	100.8	71.1	44.7	37.4	29.5	31.3	34.5	33.2	35.1	39.1
External debt / GDP	33.3	31.4	25.3	27.8	28.9	38.4	33.1	27.0	26.8	25.1
External debt / XGS	96.6	89.3	74.9	91.8	91.8	136.2	109.9	88.5	89.8	97.5
Short-term debt	26.4	27.1	40.6	72.0	73.0	48.0	53.0	58.0	65.5	73.0
Short-term debt/International reserves, %	21.9	15.4	13.8	15.4	17.8	11.8	12.2	13.1	13.7	13.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	5.0	4.8	4.9	4.8	2.4	2.4	3.9	5.4	5.9
CPI, % yoy	9.4	7.2	6.1	3.7	3.9	6.4	6.9	8.0	7.9	5.8
Policy interest rate, %, eop	8.25	8.25	8.00	8.00	8.00	8.00	8.00	7.50	7.00	6.50
1 month inter-bank rate, %, eop	4.06	5.19	6.64	5.80	4.00	4.10	4.10	4.10	4.10	4.10
Long-term yield, %, eop	8.34	8.84	8.77	8.11	7.50	7.60	7.60	7.60	7.60	7.60
RUB/US$	27.9	32.2	32.2	29.3	31.3	31.4	31.7	32.0	32.1	32.1
RUB/EUR	40.5	43.1	41.7	39.1	39.2	38.7	39.3	39.9	40.4	40.8

Source: National sources and Citi Investment Research and Analysis

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Slovakia

- **Summary view** — We have upgraded our GDP growth forecast to 2.2%YoY for 2012, while we cut it to 1.8% in 2013. The upgrade reflects strong 0.8%QoQ in 1Q12, boosted by autos. We see a downside risk for 2013, reflecting a larger recession in the euro area.
- **Things to watch** — On 6 June, GDP details will be published and we do not expect domestic demand has recovered strongly, given a milder improvement of employment compared to strong GDP growth.
- **Strategy** — "Grexit" scenario could put Slovak assets under pressure, particularly if the government starts to flirt with pro-growth measures at the expense of the consolidation effort. However, government borrowing requirements have already been covered by 88% in May.

1Q activity lead to upward revision to 2012 GDP forecast

Cars boost Slovak GDP in 1Q12. Slovak GDP surged by 0.8%QoQ swda in 1Q12, the same pace as the slightly downwardly revised 4Q11. This was a tick above our forecast of 0.7%QoQ and above the consensus. As a result, GDP growth eased to 3.1%YoY nsa from 3.4% in 4Q11. The GDP performance, mainly driven by the car sector, is in line with our index for real economic activity. We expect private consumption to not fully reflect the strong GDP as employment is up by just 0.6%YoY and 0.2%QoQ. GDP details will be out on 6 June.

Hence, we have upgraded our full-year 2012 GDP growth forecast to 2.2% after 3.3% in 2011, while cut to 1.8% in 2013. March industrial production increased by 3.5%MoM (cumulatively by 8.3% in Dec11-Mar12) and accelerated its growth back to double digits, 11.7%YoY in March, from 2.2% in January Reflecting stronger industrial output, larger trade surplus and better retail sales in 1Q12, we have recently upwardly revised our GDP growth forecast. Our forecast is backed by our index for real economic activity, which improved in 1Q12 from a quarter earlier, pointing to around 3%YoY GDP growth in 1Q12. This is in line with our forecast for growth to ease to 3.2%YoY from 3.4% in 4Q11. After this revision, our forecast for full year 2012 GDP growth is now 2.1% (it was 1.5% initially) after 3.3% in 2011, which is in line with the NBS forecast of 2.1%YoY in 2012 and above the level suggested by the carry-over effect (1.3%YoY). However, our forecast is still accompanied with downside risks given the large export openness of the economy and weaker outlook on the foreign demand under the "Grexit" scenario. Moreover, we have similar doubts as the NBS whether the weak imports suggest a destocking or further lower production activity.

April consumer confidence improves after election

April confidence improved for the fifth month in row in April, reaching a 10-month high, but the structure has changed. The improvement reflects greater confidence among consumers and the construction sector. Stronger consumer confidence probably reflects both the election (left-wing government points to less severe consolidation) and the labor market situation (the unemployment rate fell to 13.3% (sa) in 1Q13 from 13.5% in 4Q11). By contrast, industrial confidence worsened in April, reflecting lower order-books and expected production in the near-term. We expect industrial production growth to stabilize after it has been boosted by the car sector (new production capacities).

Historical trade surplus and openness

The trade surplus reached a new all-time high despite easing export activity. Despite strong industrial production growth in March, export growth eased to 5.3%YoY in March after 8.2% in January. Looking at the time series, there is apparent a lag of export activity behind the industrial activity since 2H10. Despite the deceleration of export activity, the trade surplus kept its momentum and reached €1bn year-to-date, which is the historical trade surplus and which improved by €400mn compared to the previous year performance. The trade surplus in goods reached 4.1% of GDP, while it was 1.4% a year ago, and the openness of the economy (export to GDP) increased to 82% from average 79% in 2011. This increase, however, also reflects a weaker domestic demand recovery. All in all, the large trade surplus narrowed the current account deficit to slightly above 0% of GDP in 1Q12 after being roughly balanced in 2011. We expect the deficit to improve slightly this year, but the improvement of the trade surplus is likely to ease.

Adjustment through the CPI above Maastricht

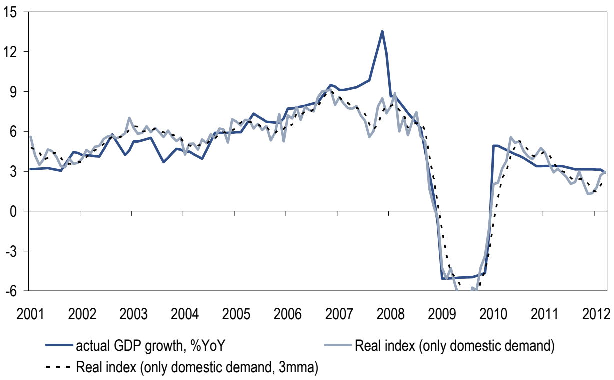
While monthly growth of consumer prices stayed at 0.3%MoM in April, the benign base effect eased the YoY growth to 3.6% in the national methodology. Consumer prices are still driven by seasonally higher clothes prices and by fuel and health prices. By contrast, food prices remain stable. The new left-wing government is unlikely to boost CPI growth with a VAT hike (the last to 20% was done in January 2011). By contrast, we understand the new government will be more prudent in the regulation of utility prices as it was in 2008-2010. Additionally, already before the election the energy regulator URSO announced a 5.2% fall in retail gas price in near-future.

Higher CPI growth points to real appreciation in contrast to a larger fall in the real interest rate. The EU harmonized measure of CPI eased to 3.7%YoY in April from 3.9% a month ago, while a 12-month moving average at 4.2% is more 1.1% points above the Maastricht criterion on the price stability. However, the newest euroarea member state — Estonia — has an even higher 12m average of 4.8%YoY. We expect Slovak HICP growth to ease to 3.7% by year-end and forecast it to average around 3%YoY in 2013. Our mid-term outlook for CPI is close to 3% in 2012-16.

Gov´t will focus consolidation effort into 2013

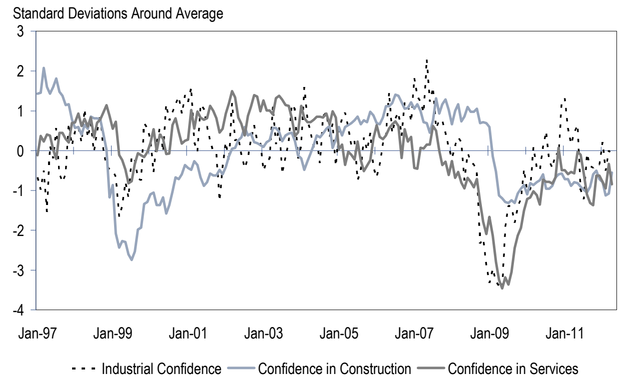
The central government deficit remained at €1.2bn year-to-date in April. This is only slightly above deficit a year ago, while it was almost double in April. The improvement reflects a stabilization of expenditures and improvement in revenue collection. On an annual basis, the deficit narrowed to €3.4bn, or around 4.9% of GDP (4.7% in 2011). We expect the full-year central government deficit to widen slightly and therefore, we expect the general government deficit to remain virtually unchanged around 4.5%-5% of GDP from 4.8% in 2011 (it was actually 4.2% after excluding one-off items). While we made an upward revision of GDP growth, we keep our forecast for a deficit unchanged as we expect the gov´t to finance some pro-growth measures. However, there is not too much room to ease given the possible activation of debt brake procedure. Moreover, there can be a warning from the EC after the middle of the year, if the consolidation effort eases. Reuters cited PM Robert Fico that there will be consolidation of €250-300mn this year, followed by around €1.3bn in 2013 to narrow the deficit below 3% of GDP (15 May). In other news, ARDAL sold €6.7bn of bonds and t-bills that is around 88% of this year borrowing requirement (Reuters, 10 May).

Figure 207. March data improved further to support GDP growth



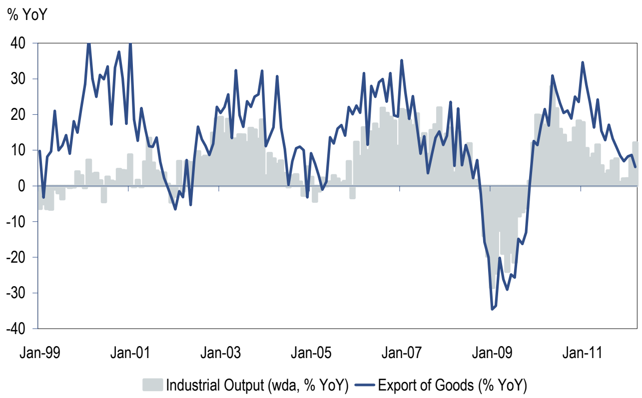
Source: Statistical Office of the Slovak Republic, Haver, CIRA

Figure 208. Business confidence indicators have improved in April



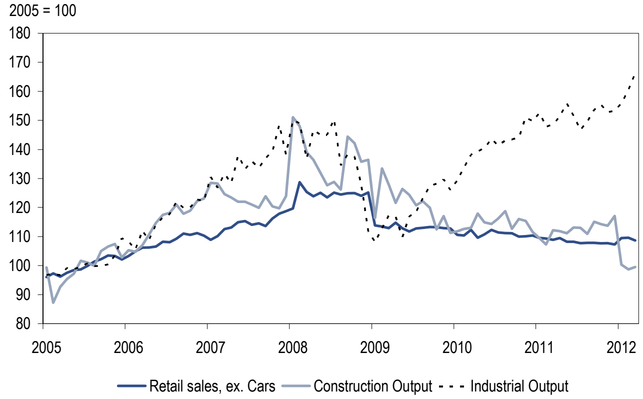
Source: Statistical Office of the Slovak Republic, CIRA

Figure 209. Car production revive the industrial output growth



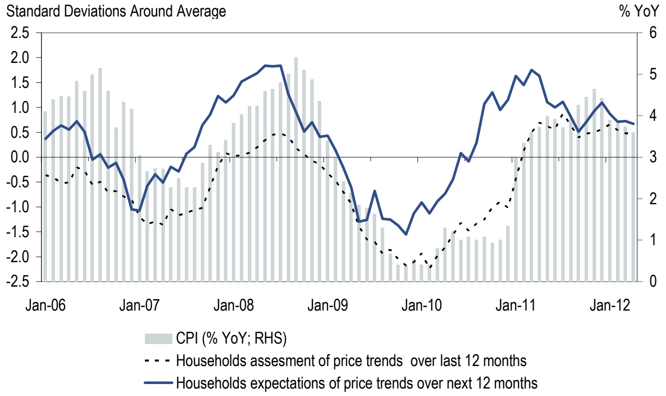
Source: Statistical Office of the Slovak Republic, Haver, CIRA

Figure 210. Industry has continued in outperformance rest of economy



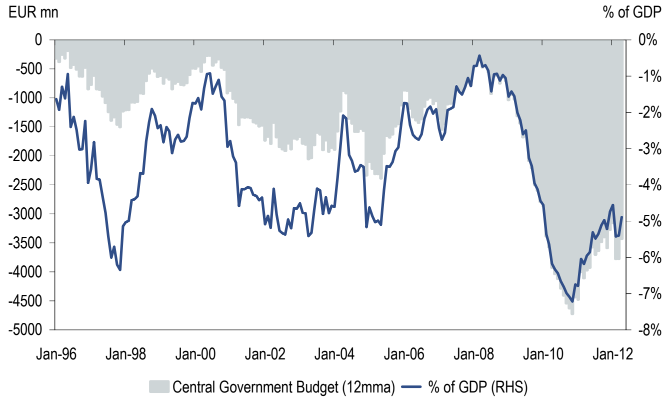
Source: Haver, Eurostat, Statistical Office of the Slovak Republic, CIRA

Figure 211. Households price expectations still far from disinflation



Source: European Commission, Haver Analytics, CIRA calculation

Figure 212. Central gov´t deficit has returned on consolidation path



Source: Haver, Ministry of Finance, Statistical Office of the Slovak Republic, CIRA

Figure 213. Slovakia Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	42.3	47.9	56.2	75.3	94.7	87.6	87.2	96.2	92.0	94.8
Nominal GDP, local currency bn	34	38	45	55	64	63	66	69	73	75
GDP per capita, US$	7,812	8,837	10,371	13,872	17,410	16,076	15,964	17,573	16,784	17,265
Population, mn	5.4	5.4	5.4	5.4	5.4	5.5	5.5	5.5	5.5	5.5
Unemployment, % of labour force	14.3	11.7	10.4	8.4	7.7	11.4	12.5	13.2	13.6	13.5
Economic Activity										
Real GDP, % yoy	5.1	6.7	8.3	10.5	5.8	-4.9	4.2	3.3	2.2	1.8
Real investment growth % yoy	4.8	17.5	9.3	9.1	1.0	-19.7	12.4	5.7	4.9	3.5
Real consumption growth % yoy	2.7	5.8	6.6	5.0	6.1	1.6	-0.3	-1.2	-0.4	0.2
private consumption growth % yoy	4.6	6.5	5.9	6.8	6.1	0.2	-0.7	-0.4	-0.4	0.6
Real export growth, % yoy	7.4	10.0	21.0	14.3	3.1	-15.9	16.5	10.8	6.4	4.5
Real import growth, % yoy	8.3	12.3	17.8	9.2	3.1	-18.1	16.3	4.5	5.1	4.2
Prices, Money & Credit										
CPI, % yoy	6.0	3.7	4.2	3.4	4.4	0.5	1.3	4.4	3.9	3.3
CPI, % avg	7.5	2.7	4.5	2.8	4.6	1.6	1.0	3.9	3.7	3.1
Nominal wages, % yoy	10.1	9.2	8.6	7.5	8.2	3.0	3.3	3.0	3.5	4.0
Credit extension to private sector, % yoy	5.7	27.6	23.7	22.7	17.4	0.8	4.8	8.6	0.5	-0.5
Policy interest rate, %, eop	4.00	3.00	4.75	4.25	2.50	1.00	1.00	1.00	0.50	0.50
1 month inter-bank rate, %, eop	2.08	2.14	2.94	4.08	4.27	0.90	0.57	1.18	0.20	0.40
Long-term yield, %, eop	4.58	3.62	4.15	4.61	4.72	4.12	4.06	5.21	4.20	3.9
€/US$, eop	1.4	1.2	1.3	1.5	1.4	1.4	1.3	1.3	1.2	1.3
€/US$, avg	1.2	1.2	1.3	1.4	1.5	1.4	1.3	1.4	1.3	1.3
Balance of Payments, US$ bn										
Current account	-3.8	-4.7	-5.0	-4.1	-5.9	-2.3	-2.2	0.2	1.2	0.8
% of GDP	-9.0	-9.9	-8.9	-5.4	-6.2	-2.6	-2.5	0.2	1.3	0.8
Trade balance	-2.0	-3.1	-3.2	-1.0	-1.1	1.3	1.0	3.4	3.6	3.0
Exports	36.8	40.9	51.4	64.9	72.9	55.4	64.0	78.5	80.5	82.8
Imports	38.8	44.0	54.6	65.9	74.0	54.1	63.0	75.1	76.9	79.9
Service balance	0.3	0.3	0.8	0.5	-0.7	-1.4	-1.0	-0.6	0.1	0.2
Income balance	-2.2	-2.0	-2.5	-3.2	-2.8	-1.2	-1.7	-2.3	-2.5	-2.7
FDI, net	3.1	2.3	4.2	3.0	4.3	-0.9	0.1	0.0	-0.5	0.5
International reserves	18.9	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total amortisations	1.6	1.6	1.6	1.7	1.7	1.8	2.1	2.1	2.4	2.6
Public Finances, % of GDP										
Consolidated government balance	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.7	-4.8	-4.7	-3.2
Consolidated gov primary balance	-0.2	-1.1	-1.7	-0.4	-0.8	-6.6	-6.3	-3.5	-3.3	-1.8
Public debt	42	34	31	30	28	36	41	43	46	47
of which Domestic	15	9	22	20	19	20	26	31	17	17
Foreign Assets & Liabilities, US$ bn										
External debt	23.4	26.9	32.0	44.1	52.3	43.6	46.0	47.5	57.6	62.1
Public	6.7	5.6	7.7	9.5	10.3	11.4	13.3	15.5	20.2	22.2
External debt / GDP	55.4	56.3	56.9	58.5	55.2	49.8	52.7	49.4	62.6	65.5
External debt / XGS	57.8	59.4	56.3	61.3	64.0	71.0	65.8	55.9	66.1	69.2
Short-term debt	8.5	12.9	11.1	17.4	20.1	8.8	10.3	9.0	13.6	13.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.4	3.2	3.4	3.3	2.8	2.0	1.1	6.9	2.9	2.9
CPI, % yoy	3.9	4.3	4.4	3.7	3.7	3.8	3.8	3.1	3.0	3.1
Policy interest rate, %, eop	1.25	1.50	1.00	1.00	1.00	0.75	0.50	0.50	0.50	0.50
1 month inter-bank rate, %, eop	1.28	1.35	1.14	0.47	0.30	0.25	0.20	0.20	0.30	0.35
Long-term yield, %, eop	4.17	3.84	5.22	5.25	4.50	4.20	4.20	3.55	3.65	3.75

Source: National sources and Citi Investment Research and Analysis

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South Africa

- **Summary view** — Growth is set to remain weak in the forecast period, at around 3% this year and under 4% next. Inflation should only temporarily overshoot the upper end of its target, despite a weaker rand. Monetary policy will remain accommodative for now, and we expect no interest rate hikes until early 2013.
- **Things to watch** — The local economy remains sensitive to the global economic cycle, especially if world industrial output and commodity prices fall. A sudden sharp weakening in the rand is potentially a risk and could complicate monetary policy. Resource nationalism remains a threat amid divisions in the ruling ANC.
- **Strategy** — The weakening of the rand since March highlights its sensitivity to global risk aversion and swings in commodity prices. Bond yields remain at risk of further rises in global risk aversion and eventually, policy normalization. Curve flattening probably will need to wait for genuine economic improvement.

A mixed economic outlook, but growth is clearly subpar

Growth averaged only 3.1% in 2011 and is expected to remain weak in 1H 2012. However, the slowdown is more of a mixed bag than the headline figure may indicate in 2012, with mining weighing on growth, but a mild recovery in manufacturing and still-solid consumer sales helping. In fact, consumer spending has shown surprising resilience, helped by supportive monetary policy. Prices of South African commodity exports have declined of late but the weaker rand is cushioning local producer margins, while giving some boost to competitiveness. Nonetheless, real export performance remains poor and is further undermined by the Euro Zone debt crisis. At the same time, businesses are only gradually resuming hiring and capital spending amid uncertainties about future demand, while the housing sector has yet to turn around.

Despite the upturn in business confidence in early 2012, we think this is only likely to feed through into a rebound in growth in 2H 2012. This should mean that the overall growth rate for the year is marginally below the 2011 outturn. The pick-up should be helped by a greater clarity on the economic situation in the EU, which should support exports and reduce uncertainties that are still weighing on business and consumer confidence. Monetary and fiscal policy is also likely to remain accommodative for a sustained period. That said, one of the traditional drivers of cyclical recoveries — the re-gearing of consumers — is unlikely to happen this time, as household debt already is large and banks are likely to be more cautious than in recent history. Despite efforts at more micro-focused policy interventions, structural obstacles to stronger growth will not dissipate soon and, and coupled with the need to eventually withdraw the policy stimulus, these will limit the extent of the pick-up in growth in 2013.

With weak growth, the current account deficit was moderate in 2011 but is likely to widen over time: we expect a deficit of 4.7% of GDP in 2012. This largely reflects a less favorable terms-of-trade environment, but also that domestic demand (especially investment) will remain relatively weak, preventing an import surge. Businesses also have kept dividend payments low, helping narrow the investment income deficit. In 2013, though, the deficit could move closer to 6% of GDP as import demand accelerates and export performance remains hindered by poor competitiveness. Current account deficit financing typically takes place through portfolio inflows, which came under pressure of late as foreigners sold both SA equities and bonds. Net FDI inflows remain relatively low by global EM standards.

A sustained breach of inflation target is unlikely

We still do not expect a significant and sustained breach of the 3%-6% inflation target, a view confirmed by the March 2012 inflation data, which dropped below 6%. But we still think that inflation is likely to hover around the top end of the target range for most of 2012 and the weakening of the rand in 2H11 should, over time, lead to a rise in core inflation, especially in the consumer goods sector, where prices are still mostly down on a YoY basis. Nonetheless, the renewed widening in the output gap should continue to limit the pricing power of local producers and retailers, while food price inflation is probably close to its peak. Longer term, though, it is going to be difficult for inflation to fall below the 5%-6% range, amid prospective further rand depreciation and sticky wage demands.

Policy on hold for an extended period

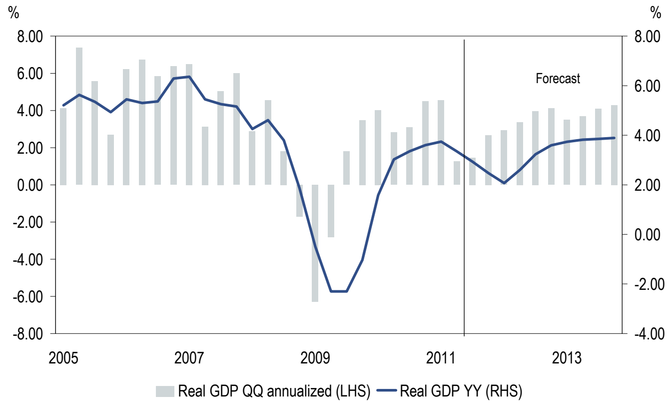
Amid sluggish economic growth, we think a rate hike by the SARB is very unlikely until 1Q 2013. Policy is clearly stimulative, and real rates are near zero or slightly negative when compared to both actual and expected inflation. But the SARB nonetheless feels that low real rates are justified at present given the existence of a rather large output gap, the threat of economic disruption from the EU debt crisis and the absence of demand-driven price pressures. These factors are likely to persist and mean that SARB is unlikely to change tack soon. That said, the SARB also is warning of upside inflation risks from currency volatility, which means in our view that further easing is unlikely unless the global crisis again worsens, and meaningfully. Eventually, a gradual closing of the output gap should prompt repo rate increases, though at a more muted pace than historical norms.

The February 22 budget presentation maintained the recent emphasis of fiscal policy, which we think is unlikely to changed unless the economy falls back into recession. It reaffirmed the government's commitment to support growth with ongoing investment in infrastructure projects, while retaining its commitment to long-term deficit reduction and debt stabilization, with consolidation only expected to begin in earnest when the economy picks up in 2014/15 pushing the deficit back down to levels of around 3.5% of GDP. Other policy concerns are related to "resource nationalism", effectively the push from some factions in the ANC for a nationalization of the mining sector, which may heighten concerns ahead of the late 2012 ANC elective conference. However, there appears to be a strong will among the ANC leadership to rein in the most vocal supporters of such populist policies.

Risk aversion, rand key determinants of bond yields

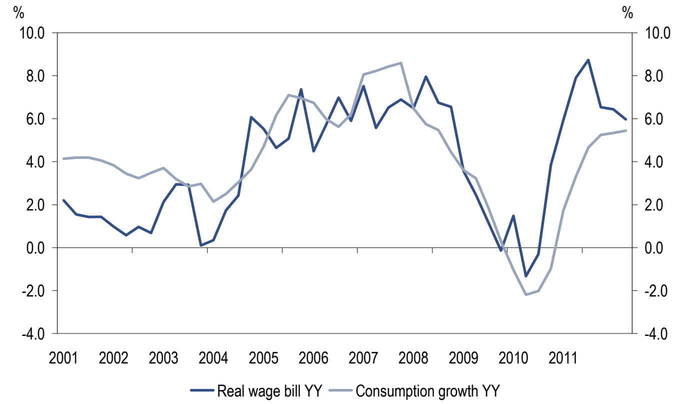
Bond yields have settled in a range that appears justified by current conditions. At around 8.00%, ten-year government yields are relatively low when compared with inflation (and inflation expectations) of around 6%, but this can be explained by the still-large output gap and the loose monetary policy stance. Equally, the yield curve is steep by historical standards but not so when compared to the level of real short-term rates, and an eventual "bear flattening" of the curve probably will await for clearer signs that interest rate hikes are in the pipeline. Swap yields should continue to trade through bond yields of similar maturities amid weak private borrowing demand and elevated public deficits, but recent better fiscal news limit the risk of major bond underperformance. Sovereign and CDS spreads should continue to take their cue from global benchmarks. The rand still looks vulnerable near- to medium-term to global uncertainties and a less favorable commodity price environment, and currency weakness could in turn result in a bond sell-off.

Figure 214. Not another recession, but still a marked slowdown



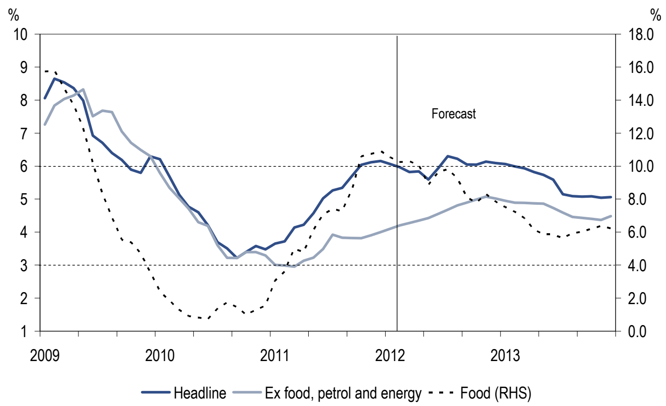
Source: Stats SA

Figure 215. Real wage support to consumption is fading



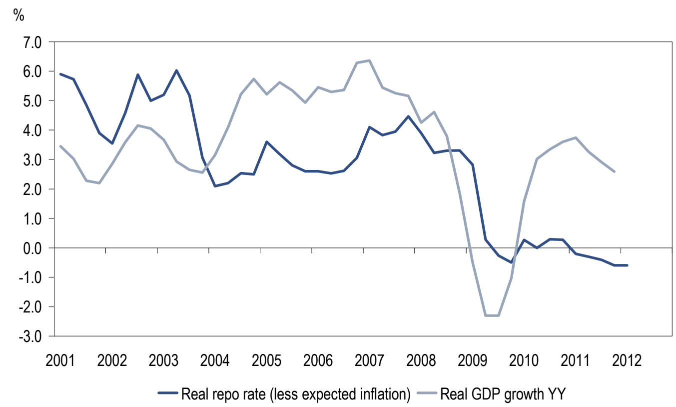
Source: SARB, Stats SA , Citi Investment Research and Analysis calculations

Figure 216. No sustained breach of inflation target in sight



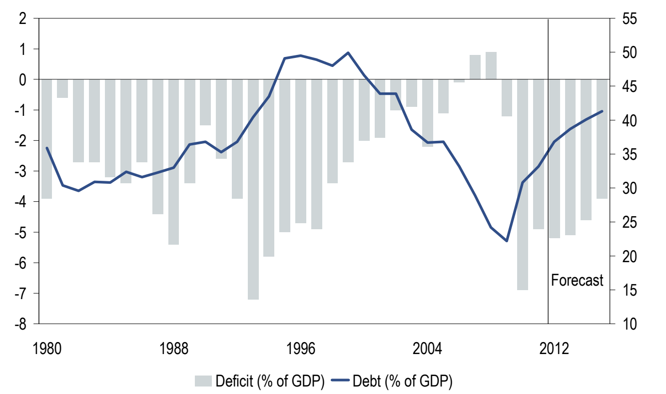
Source: Stats SA and CIRA projections.

Figure 217. Unlike in 2008, loose monetary policy supports activity



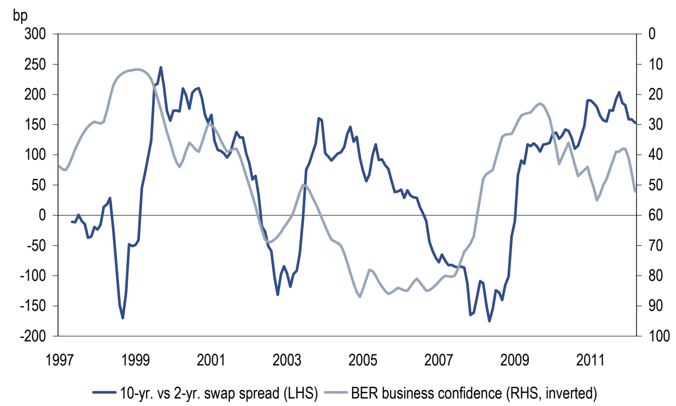
Source: Stats SA, SARB, BER.

Figure 218. Public debt still rising despite deficit reduction plans



Source: National Treasury and CIRA projections.

Figure 219. Flatter yield curve may have to wait for GDP recovery



Source: RMB/BER and Ecowin.

Figure 220. South Africa Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	219.7	246.7	260.9	285.9	274.0	286.1	363.8	401.2	379.9	400.2
Nominal GDP, local currency bn	1,415	1,571	1,767	2,016	2,263	2,398	2,661	2,912	3,135	3,428
GDP per capita, US$	4,736	5,259	5,511	5,993	5,628	5,801	7,278	7,930	7,436	7,740
Population, mn	46.4	46.9	47.3	47.7	48.7	49.3	50.0	50.6	51.1	51.7
Unemployment, % of labour force	25.5	25.0	23.9	23.3	22.9	24.0	25.5	26.0	25.7	25.2
Economic Activity										
Real GDP, % yoy	4.6	5.3	5.6	5.5	3.6	-1.5	2.9	3.1	2.9	3.8
Real investment growth % yoy	12.9	5.7	12.9	12.0	4.5	-8.4	6.0	6.0	3.7	6.2
Real consumption growth % yoy	6.2	5.8	7.5	5.2	2.7	-0.1	4.0	4.7	3.0	3.6
private consumption growth % yoy	6.2	6.1	8.3	5.5	2.2	-1.6	3.7	4.9	2.8	3.3
Real export growth, % yoy	2.8	8.6	7.5	6.6	1.8	-19.5	4.5	5.9	5.3	6.2
Real import growth, % yoy	15.5	10.9	18.3	9.0	1.5	-17.4	9.6	9.1	6.7	7.0
Prices, Money & Credit										
CPI, % yoy	2.2	2.0	4.8	7.6	9.4	6.0	3.4	6.4	6.1	4.9
CPI, % avg	-0.7	2.1	3.2	6.2	10.1	7.2	4.1	5.0	6.1	5.4
Nominal wages, % yoy	0.1	0.1	0.1	0.1	0.1	8.9	7.8	7.2	7.5	8.0
Credit extension to private sector, % yoy	14.6	17.0	25.4	22.0	10.0	4.6	2.0	6.0	8.5	9.5
Policy interest rate, %, eop	7.50	7.00	9.00	11.00	11.50	7.00	5.50	5.50	5.50	6.50
1 month inter-bank rate, %, eop	7.30	6.86	8.98	11.18	11.35	6.94	5.44	5.47	5.60	6.60
Long-term yield, %, eop	8.18	7.48	7.86	8.58	7.33	9.05	8.14	7.93	8.75	8.85
ZAR/US$, eop	5.63	6.34	7.05	6.83	9.25	7.36	6.62	8.07	8.47	8.66
ZAR/US$, avg	6.44	6.37	6.78	7.05	8.26	8.38	7.31	7.26	8.25	8.57
ZAR/EUR, eop	7.66	7.48	9.30	9.99	12.85	10.57	8.88	10.48	10.51	11.09
ZAR/EUR, avg	8.00	7.91	8.52	9.66	12.06	11.64	9.69	10.09	10.44	10.82
Balance of Payments, US$ bn										
Current account	-6.7	-8.6	-13.8	-19.9	-19.6	-11.6	-10.2	-13.6	-17.8	-22.5
% of GDP	-3.0	-3.5	-5.3	-7.0	-7.2	-4.0	-2.8	-3.4	-4.7	-5.6
Trade balance	-0.2	-0.3	-4.3	-5.2	-4.3	0.3	3.7	2.3	-1.3	-3.9
Exports	48.2	56.3	66.1	76.2	85.3	66.4	85.5	102.8	103.1	110.9
Imports	48.4	56.6	70.4	81.4	89.6	66.1	81.8	100.6	104.4	114.8
Service balance	-0.5	-0.8	-2.1	-2.7	-4.1	-2.8	-4.4	-4.7	-3.2	-2.5
Income balance	-4.3	-4.9	-5.1	-9.8	-8.9	-6.4	-7.2	-9.2	-11.0	-13.7
FDI, net	-0.6	5.7	-6.6	1.8	12.5	4.2	4.8	3.4	3.4	3.4
International reserves	13.2	18.6	23.1	29.6	30.6	35.3	38.2	42.6	50.0	52.8
Total amortisations	3.9	2.6	2.0	1.8	2.0	2.5	1.4	2.1	7.3	4.2
Public Finances, % of GDP										
Consolidated government balance	-1.1	-0.1	0.8	1.0	-1.0	-6.9	-5.0	-5.0	-4.8	-4.2
Consolidated gov primary balance	1.4	3.6	4.3	4.4	1.3	-4.7	-2.6	-2.2	-1.8	-1.1
Public debt	35.9	34.7	32.6	28.3	27.2	31.0	35.3	37.7	40.9	42.2
of which Domestic	31.4	30.3	28.1	24.5	22.8	27.4	31.9	33.6	36.7	37.9
Foreign Assets & Liabilities, US$ bn										
External debt	37.1	40.3	51.2	63.0	60.4	63.8	80.6	88.3	85.2	91.8
Public	18.1	18.5	20.7	19.5	18.1	22.6	35.8	51.0	48.0	52.0
External debt / GDP	16.9	16.3	19.6	22.0	22.0	22.3	22.2	22.0	22.4	22.9
External debt / XGS	9.9	9.4	9.7	9.9	7.5	9.7	11.1	75.0	71.0	70.3
Short-term debt	11.2	14.3	20.6	24.0	25.5	21.3	21.7	19.5	19.2	19.8
Short-term debt/International reserves, %	85.1	76.8	89.1	81.2	83.2	60.4	56.9	45.8	38.4	37.5

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.3	3.0	2.9	2.1	2.6	3.2	3.6	3.7	3.8	3.9
CPI, % yoy	5.1	5.7	6.4	6.1	5.9	6.0	6.1	5.9	5.5	5.0
Policy interest rate, %, eop	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	6.00	6.50
1 month inter-bank rate, %, eop	5.50	5.46	5.47	5.49	5.60	5.60	5.60	5.60	6.10	6.60
Long-term yield, %, eop	8.40	8.27	7.93	7.88	8.20	8.48	8.75	8.88	9.00	8.93
ZAR/US$	6.77	8.10	8.09	7.67	8.41	8.46	8.47	8.49	8.53	8.59
ZAR/EUR	9.82	10.84	10.47	10.24	10.51	10.43	10.51	10.58	10.71	10.90

Source: National sources and Citi Investment Research and Analysis

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Turkey

- **Summary view** — Turkey's twin macro challenges of elevated inflation and a wide current account gap continue to overshadow growth prospects and stability.
- **Things to watch** — Developments in the Middle East, the constitutional reform process and the pace of external adjustment deserve close monitoring.
- **Strategy** — The CBT's increased focus on the currency seems to be supporting the lira, which has been performing better than most of its peers since April. Capital account developments to date, however, paint a less comforting picture, raising questions about the lira's performance going forward.

After a soft patch in 1Q, activity is likely to pick up in 2Q

At 2.4%YoY, industrial production in March came in broadly in line with the consensus, yielding a 2.8%YoY rise in 1Q as a whole. Developments to date lead us to look for flat to slightly positive GDP growth (SA, QoQ) in the first quarter. However, we see signs of a pick-up in 2Q and thereafter. Specifically, the latest April PMI data rose quite sharply to 52.3 up from 49.6 in March, suggesting that manufacturing activity has entered expansionary territory. Moreover, the Real Sector Confidence Index has continued to rise in recent months (latest data is April), and remains comfortably above the 100-mark. Finally, credit growth seems to be picking up as well. Despite the noted favorable backdrop, the risks associated with our 2012 GDP growth forecast of 2.5% are broadly balanced due to the high uncertainty surrounding the eurozone debt crisis.

C/A is narrowing, but pace of adjustment is not dramatic

At US$16.2 billion, the current account deficit in 1Q compares favorably with the deficit seen in the same period of 2011 (US$21.6bn). Standing at US$3.6bn in 1Q, the improvement in the non-energy current account deficit is even more pronounced (US$11.3bn in 1Q 2011). Despite the noted encouraging developments, the seasonally-adjusted current account balance figures in March paint a less favorable picture. Standing at US$5.2bn and US$0.6bn, the overall current account and non-energy current account balances are wider when compared with the previous month (US$4.5bn and US$0.3bn, respectively). While it is too early to form firm conjectures based on only one month, this raises some questions about the pace of the external adjustment going forward, as we expect the current account gap to remain wide at US$ 66 (about 8.5% of GDP) this year.

April inflation renders CBT's year-end forecast unrealistic

At 11.1%YoY, the April inflation reading came in above consensus owing to higher-than-expected clothing prices. Using seasonally-adjusted data, the April inflation reading translates into a rise of around 1.3%MoM, compared with 0.3%MoM in March and 0.60%MoM in February. It is worth noting that seasonally-adjusted core measures in April represent a marked deterioration, reversing the encouraging downward trend observed since the beginning of the year. This, coupled with sticky forward-looking inflation expectations, leads us to remain concerned about Turkey's underlying inflation dynamics. Looking ahead, we expect inflation to decline in May on the back of base effects and then fluctuate at around 10% until October before declining to around 7.5% by the year-end, well above the 5% target and the CBT's forecast of 6.5%.

External financing pressures constrain CBT's flexibility

The April Inflation Report reiterated the CBT's commitment to maintain the interest rate corridor approach, as the Bank continues to adjust the effective funding rate in line with the lira's performance and global economic conditions. Nonetheless, capital account developments have so far been considerably less favorable than was envisaged by the CBT**.** In particular, the marked weakness in identified inflows in relation to the current account deficit levels has caught our attention. Consequently, we believe that the CBT will have limited flexibility (in terms of relaxing its policy stance without hurting the market sentiment) until external financing pressures subside. Looking ahead, we believe that the July Inflation Report will be crucial in shedding more light on the Bank's willingness to tighten to bring inflation closer to the 5% target. A revision of the year-end projection to around 7% or higher is likely to be perceived as throwing in the towel on inflation, which may have adverse consequences for the Bank's inflation fighting credentials and the lira.

CBT's hefty profit transfer puts a smile on April Budget

The budget posted a deficit of TRY 5.0 billion in the first four months of the year, which doesn't compare favorably with the same period of 2011 when the budget printed a deficit of TRY 3.0bn. The noted outcome took place against the backdrop of a hefty profit transfer from the CBT in April (TRY 5.7bn). In real terms, tax revenues declined by 0.6%YoY, while non-interest expenditures rose by 3.1%YoY in the first four months of the year. All in all, while public finances remain favorable, we observe some weakening owing to softer tax revenues, associated with the moderation in economic growth, and a pick up in non-interest spending. Against this backdrop, we project budget deficit to widen to about 2.2% of GDP in 2012 from 1.3% of GDP in 2011, as we continue to question the adequacy of fiscal stance in the context of the wide current account gap.

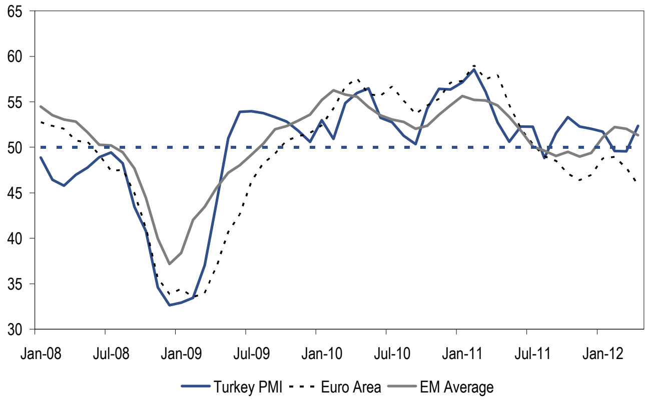
The lira has been holding up well, for now…

Despite the recent weakening of the USDTRY from around 1.75 in end-April to over 1.83 on May 16, the lira's relative performance in the EM space looks favorable. The CBT's recent liquidity policy is keeping the ISE interbank o/n rate at around 10.8%. Standing at around 9% at the time of writing, the lira's interest return (1m-TRY forward implied yield) consistent with standard risk factors is closer to the lower end of our simulation results. Although the CBT's willingness to tighten liquidity to prop up the lira when needed provides some comfort in the near-term, the secular outlook for the currency remains challenging owing to the large external financing needs and the absence of a tighter policy stance, among other things.

…so has been the long end of the curve

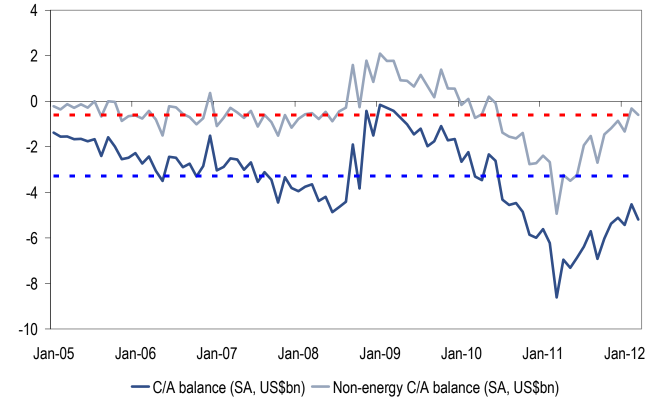
Standing at about 9.4%, the 10-year bond yield has weathered the recent bout of volatility relatively well. In our view, favorable technicals and positioning may lead to further limited decline in the 10-year bond yield as much as 60bp. However, the fact that fundamentals are not supportive of such a move raises the risk of a sharp reversal in the event of an adverse shock, not to mention the uncertainties associated with monetary policy.

Figure 221. We see signs of a pick up in economic activity in 2Q…



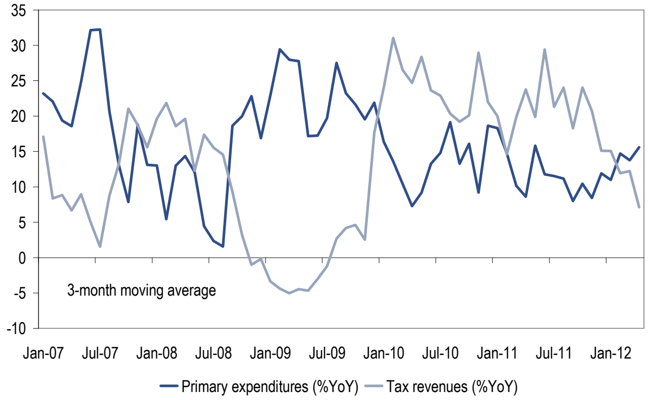
Source: Haver Analytics and CIRA.

Figure 222. …as the external adjustment continues…



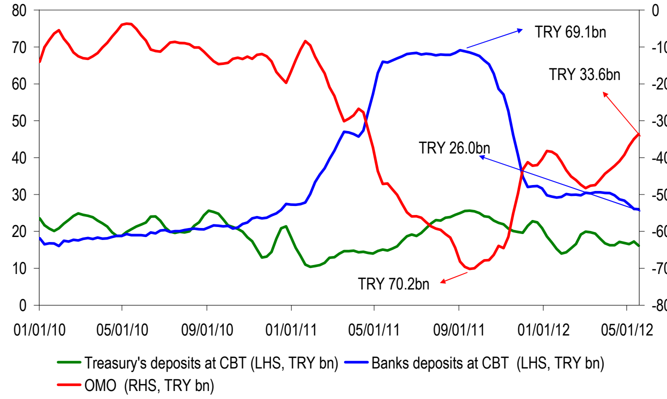
Source: Haver Analytics and CIRA.

Figure 223. Fiscal stance seems to be softening…



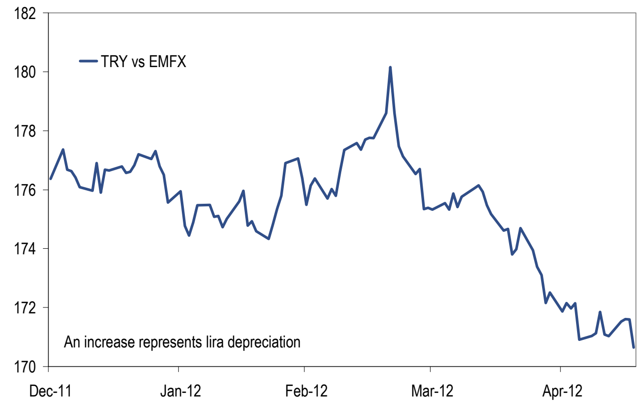
Source: Haver and CIRA

Figure 224. …while the CBT keeps liquidity relatively tight…



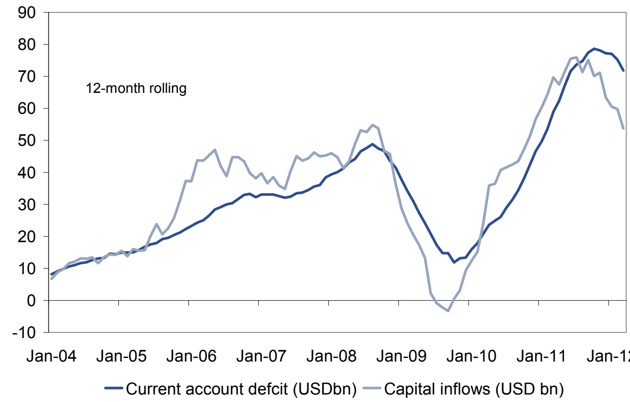
Source: CBT and CIRA

Figure 225. …which seems to be supporting the lira in the near-term…



Source: Bloomberg and CIRA

Figure 226. …but capital account developments call for caution



Source: CBT and CIRA

Figure 227. Turkey Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	392.1	482.8	529.1	646.4	731.0	614.6	731.2	772.8	790.4	861.4
Nominal GDP, local currency bn	559	649	758	843	951	953	1099	1295	1455	1623
GDP per capita, US$	5,789	7,039	7,621	9,201	10,285	8,549	10,058	10,515	10,641	11,475
Population, mn	67.7	68.6	69.4	70.3	71.1	71.9	72.7	73.5	74.3	75.1
Unemployment, % of labour force	10.8	10.6	10.2	10.3	11.0	14.0	12.0	9.8	9.8	10.0
Economic Activity										
Real GDP, % yoy	9.4	8.4	6.9	4.7	0.7	-4.8	9.2	8.5	2.5	4.3
Real investment growth % yoy	17.4	18.4	13.3	5.8	-4.8	-28.6	48.4	17.0	2.3	4.9
Real consumption growth % yoy	10.3	7.2	5.1	5.6	-0.1	-1.0	6.0	7.3	1.3	4.4
private consumption growth % yoy	11.0	7.9	4.6	5.5	-0.3	-2.3	6.7	7.7	1.0	4.5
Real export growth, % yoy	11.2	7.9	6.6	7.3	2.7	-5.0	3.4	6.5	1.8	5.5
Real import growth, % yoy	20.8	12.2	6.9	10.7	-4.1	-14.3	20.7	10.6	-1.4	6.2
Prices, Money & Credit										
CPI, % yoy	9.4	7.7	9.7	8.4	10.1	6.5	6.4	10.4	7.5	6.5
CPI, % avg	8.6	8.2	9.6	8.8	10.4	6.3	8.6	6.5	9.7	7.0
Nominal wages, % yoy	10.2	12.8	11.0	9.5	11.6	9.9	11.8	8.0	10.7	9.0
Credit extension to private sector, % yoy	52.8	67.1	36.1	27.8	22.4	13.4	40.4	31.7	17.0	20.0
Policy interest rate, %, eop	18.00	13.50	17.50	15.75	15.00	6.50	6.50	5.75	5.75	7.25
1 month inter-bank rate, %, eop	20.90	14.82	19.58	17.21	17.16	7.20	6.89	11.54	10.29	9.74
Long-term yield, %, eop	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!	#VALUE!
TRY/US$, eop	1.35	1.35	1.41	1.17	1.54	1.50	1.54	1.89	1.88	1.87
TRY/US$, avg	1.43	1.35	1.44	1.31	1.31	1.55	1.51	1.68	1.84	1.88
TRY/EUR, eop	1.83	1.60	1.87	1.70	2.15	2.15	2.06	2.44	2.33	2.39
TRY/EUR, avg	1.78	1.68	1.81	1.79	1.92	2.17	2.00	2.34	2.33	2.38
Balance of Payments, US$ bn										
Current account	-14.4	-22.3	-32.2	-38.4	-41.5	-13.4	-46.6	-77.2	-66.4	-68.7
% of GDP	-3.7	-4.6	-6.1	-5.9	-5.7	-2.2	-6.4	-10.0	-8.4	-8.0
Trade balance	-22.7	-33.1	-41.1	-46.9	-53.0	-24.9	-56.4	-89.5	-81.3	-85.3
Exports	68.5	78.4	93.6	115.4	140.8	109.6	120.9	143.4	150.6	153.6
Imports	91.3	111.4	134.7	162.2	193.8	134.5	177.3	232.9	231.9	238.8
Service balance	12.8	15.2	13.6	13.3	17.7	17.3	15.5	18.3	20.5	21.8
Income balance	-5.6	-5.8	-6.7	-7.1	-8.4	-8.2	-7.1	-7.8	-7.4	-7.1
FDI, net	2.0	9.0	19.3	19.9	17.0	6.9	7.6	13.4	14.5	14.0
International reserves	36.0	50.5	60.9	73.3	71.0	70.7	80.7	78.3	75.3	77.3
Total amortisations	22.9	28.2	30.3	37.6	41.2	47.5	45.0	37.4	43.8	46.2
Public Finances, % of GDP										
Consolidated government balance	-5.4	-1.5	-0.6	-1.6	-1.8	-5.5	-3.6	-1.3	-2.2	-2.5
Consolidated gov primary balance	4.7	5.5	5.4	4.1	3.5	0.1	0.8	2.0	1.0	1.7
Public debt	56.7	51.1	45.6	39.6	40.0	46.4	43.1	40.1	39.8	38.2
of which Domestic	40.2	37.7	33.2	30.3	28.9	34.6	32.1	30.5	29.8	29.5
Foreign Assets & Liabilities, US$ bn										
External debt	161.0	170.6	208.4	250.4	281.4	269.6	292.3	331.8	364.0	403.9
Public	97.1	85.8	87.3	89.3	92.4	96.8	100.8	117.3	132.3	148.1
External debt / GDP	41.1	35.3	39.4	38.7	38.5	43.9	40.0	42.9	46.1	46.9
External debt / XGS	176.0	162.0	174.9	173.6	159.6	187.8	187.8	181.9	189.4	204.4
Short-term debt	32.2	38.9	42.9	43.2	52.5	49.0	77.5	88.1	100.1	115.1
Short-term debt/International reserves, %	89.4	77.0	70.4	58.9	74.0	69.4	96.0	112.5	132.9	148.9

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	8.4	5.2	2.8	2.5	2.2	2.5	1.6	3.4	5.3
CPI, % yoy	6.2	6.2	10.4	10.4	10.3	9.8	7.5	7.1	7.0	6.7
Policy interest rate, %, eop	6.25	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75	6.50
1 month inter-bank rate, %, eop	8.71	7.66	11.54	10.80	9.97	9.15	10.29	10.06	9.96	9.84
Long-term yield, %, eop	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
TRY/US$	1.62	1.86	1.89	1.78	1.85	1.87	1.88	1.89	1.89	1.88
TRY/EUR	2.35	2.49	2.44	2.38	2.31	2.30	2.33	2.36	2.38	2.39

Source: National sources and Citi Investment Research and Analysis

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Ukraine

- **Summary view** — Major policy moves are unlikely before the October election, making IMF disbursements unlikely. In spite of all vulnerabilities — the size of the external financing requirement and pre-election policy paralysis — there is little evidence of imminent financial stress.

- **Things to watch** — 2012 budget plan became more risky after Rada adopted a US$4.2bn increase in expenditures. The government will need to repay about US$4bn of FX debt in 2012 including US$2bn VTB loan due in June.

- **Strategy** — NBU policy is likely to be more accommodative in the coming months. This should help keep liquidity conditions relatively easy. The hryvnia likely to remain broadly stable in 2Q, but we keep we our year-end forecast at UAH8.5/USD.

Growth loses steam despite strong consumption

While consumer spending grows at double-digits, weak external demand contributes to an overall slowdown. GDP growth in 2011 (5.2%) was driven by strong exports at the beginning of the year and a recovery of domestic demand in 2H. GDP growth fell to 1.8%YoY in 1Q (down 0.3%QoQ in seasonally-adjusted terms) as key export-oriented sectors were negatively affected by the deteriorating global environment and industrial production grew by just 0.7%YoY in Jan-Apr. At the same time a major deceleration in inflation helped to maintain high real income growth and household consumption (15% in Jan-Apr). We expect GDP growth to slow to 3% in 2012 assuming growth of domestic demand of about 4-5% (additional budget spending is supportive for household consumption but is likely to come at the expense of investment spending) and only marginally increasing in exports.

Budget plan became more risky, despite easing financing

2012 budget plan became more risky after Rada adopted increase in both revenues and expenditures by UAH33.4bn (US$4.2bn). Cabinet's forecast of GDP growth (3.9%) and inflation remained unchanged; however revenue forecast was raised to UAH366.2bn assuming increase in tax collection and additional revenues from administrative fees. This allowed increasing planned expenditures to incorporate additional hike of pensions in May, cut in mortgage loan interest and other social expenditures before the parliamentary elections in October. So far the growth in state budget revenue looks less optimistic than the budgeted 20% growth, up by 16%YoY in 1Q with tax revenues up 12%YoY. Meanwhile expenditures were up 16%YoY already Jan-Feb and likely to accelerate further. Taking into account lower-than-expected inflation and most likely slower growth, we think the 2012 budget plan has become more risky. In addition to that, we believe the Naftogaz deficit will likely exceed projected UAH12bn (0.8% GDP).

So far financing for the government seems available on increasingly easy terms… The government plans to borrow about US$4.6bn (UAH37.5bn) in FX, about UAH26bn net in the national currency and to get a privatization revenues of about UAH10bn. In addition to the primary budget gap, in 2012 the government will need to repay about US$4bn of FX debt (including VTB loan maturing in June) and about UAH35bn (US$4.2bn) of local debt. While the NBU's financing of the government has increased in recent months, through direct ownership of government debt on its balance sheet, and by financing the purchase of government debt by state-owned banks, the government has also been able to increase its issuance to commercial banks.

…as the NBU moved to more accommodative policy in view of decelerating inflation, but this could change if FX comes under pressure. Both headline CPI and core inflation continued to slow in March falling to 0.6%YoY and 4.7% respectively. NBU cut the overnight refinancing rates twice in 1Q by 50bp in total and also decreased the share of reserves required to be kept on a special account in the NBU to 60% from 70%. Growth in NBU refinancing operations was accompanied by increase in deposit base and deceleration of credit leading to improving liquidity. The actual pace of inflation during 2012 will obviously depend heavily on the quality of the harvest, but the government's pre-election fiscal expansion is likely to create inflationary pressure. Signs that inflation is accelerating above 7-8% could induce the NBU to tighten policy, not least because higher inflation might threaten the authorities' desire to maintain exchange rate stability.

External account remain main source of vulnerability[4]

While we cut our forecast for the annual current account (CA) deficit to US$12bn, we stress most of the deficit likely to come in 2H. 1Q CA deficit fell to just US$0.3bn in March and deficit for Jan-March stood at US$1.2bn[5]. The financial account remained positive: net capital inflows reached US$640mn in 1Q. Net FDI were up 60%YoY to US$1.4 in 1Q. Most FDI went to the real sector and probably reflects the acceleration of the privatization process. We believe the CA will remain unchanged or widen only marginally in 2Q due to a seasonal fall in energy imports, lower construction imports and a rise in tourism inflows of some US$300-400mn related to Euro 2012 Football Championships. However increasing energy costs and accelerating consumer imports (supported by higher pre-election spending and easing liquidity conditions) could mean a CA deficit of about US$4bn per 2H quarter.

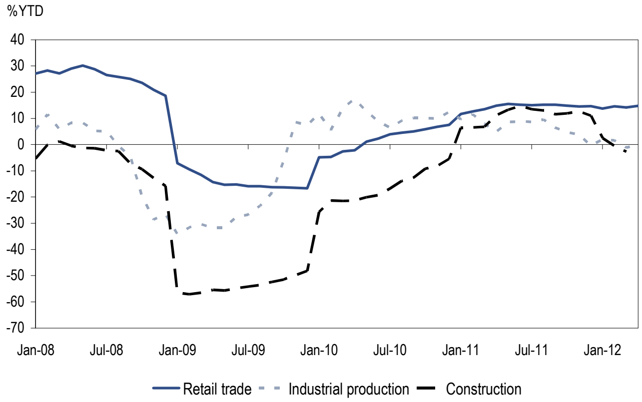
The capital account could also be a source of stress. The NBU's data shows Ukraine has US$57bn worth of external debt coming due in 2012. Our estimate of external financing gap in 2012 is US$10-12bn (excluding the IMF credit) or about 1/3 of the current level of FX reserves. There are two kinds of payments that Ukraine needs to make that have achieved high visibility. The first is the repayment of a US$2bn loan from VTB in June; and the second is repayments to the IMF of some US$3bn during the second half of the year. As for the VTB loan, the Finance Ministry notes there is 'broad agreement' on VTB refinancing of this repayment. Refinancing by the IMF, however, is much less likely.

Hryvnia likely to remain broadly stable in 2Q, but we keep we our year-end forecast at UAH8.5/USD. In spite of all these vulnerabilities — the size of the external financing requirement and pre-election policy paralysis — there is little evidence of imminent financial stress. The National Bank reported that total year-to-date foreign exchange inflows were US$43.2bn compared to total outflows of US$38.6bn. This surplus has helped to finance an increase in official FX reserves so far this year, permitting the NBU to ease monetary conditions. The lack of pressure on the FX market may be partly be helped by an improvement in the private sector's foreign exchange balance sheet. The total unhedged FX debt of the private sector has fallen from US$38bn in Oct 2008 to less than US$14bn now. Rising inflation later this year, however, could be the trigger for more speculative demand for foreign exchange. There appears to be a consensus the exchange rate's current stability will not be sustainable in the latter part of the year and this means the demand for foreign exchange might be triggered sooner (i.e. in the summer) rather than later (i.e. closer to the elections).

[4] Ukraine – Trip notes (27 April)

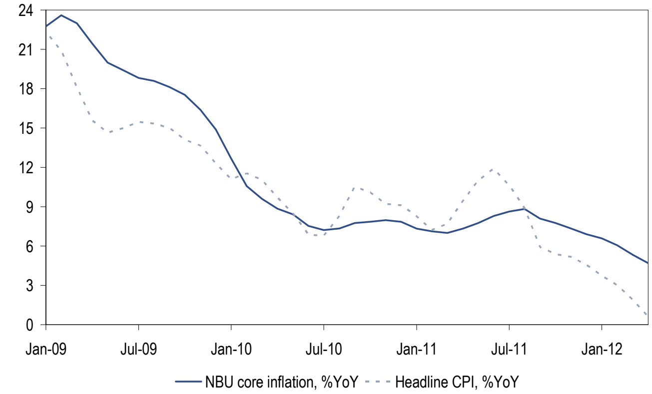
[5] CEEMEA Daily: Ukraine – 1Q BoP Stronger Than Expected (30 April)

Figure 228. As growth loses steam despite strong consumption



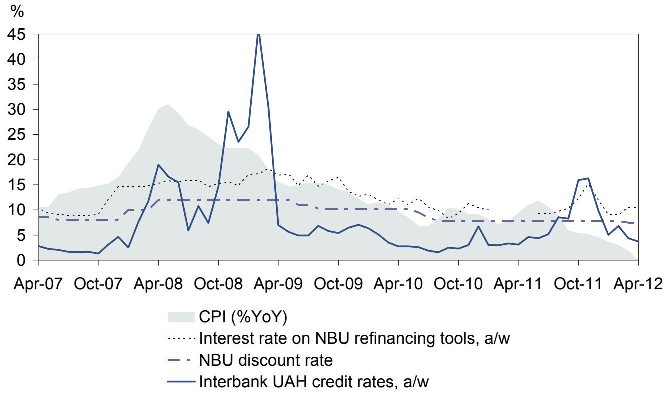
Source: Haver Analytics, Citi Investment Research and Analysis

Figure 229. ….and inflation remains at historic lows…



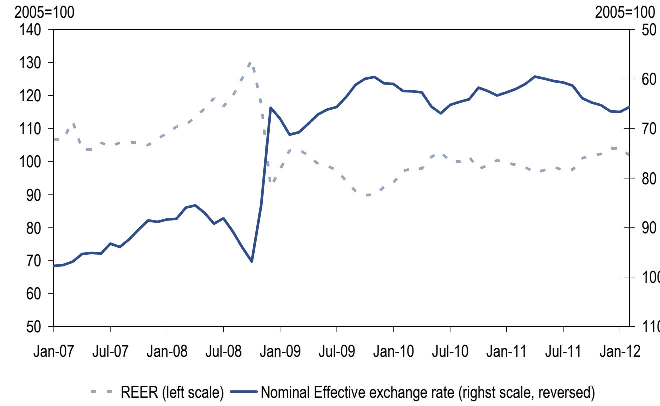
Source: Haver Analytics

Figure 230. …the NBU moves to more accommodative policy



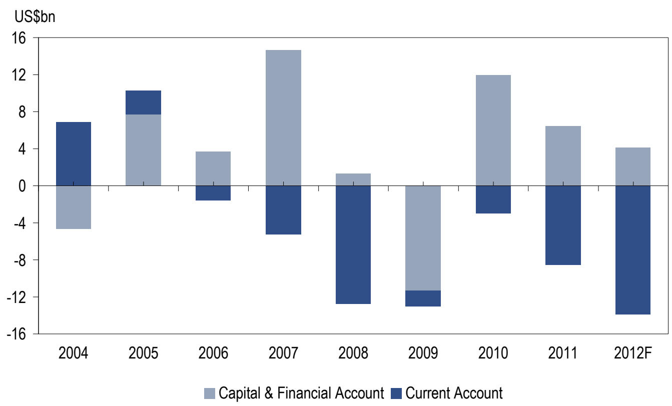
Source: Haver Analytics, CIRA estimates

Figure 231. REER does not appear overvalued…



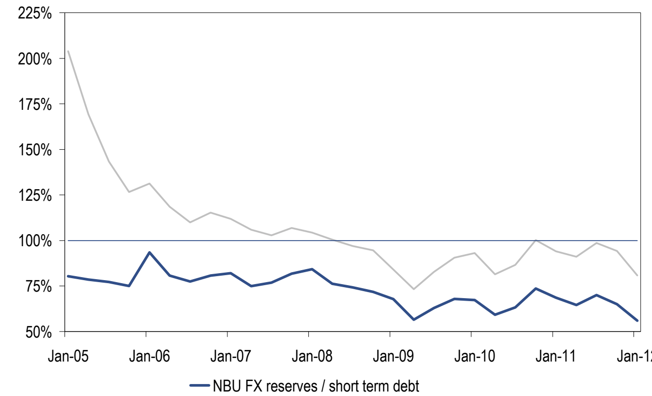
Source: Bloomberg

Figure 232. … but FX risks increase as BoP deteriorates



Source: Haver Analytics, CIRA.

Figure 233. NBU is likely to use any opportunity to accumulate reserves



Source: Haver Analytics, NBU, CIRA estimates.

Figure 234. Ukraine Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, US$ bn	64.9	86.1	107.8	142.7	180.0	117.2	136.4	164.9	180.1	202.9
Nominal GDP, local currency bn	345	441	544	721	948	913	1083	1314	1461	1718
GDP per capita, US$	1,372	1,836	2,313	3,084	3,914	2,566	3,006	3,657	4,020	4,560
Population, mn	47.3	46.9	46.6	46.3	46.0	45.7	45.4	45.1	44.8	44.5
Unemployment, % of labour force	8.6	7.2	6.9	6.4	6.4	8.8	8.1	6.5	5.3	4.4
Economic Activity										
Real GDP, % yoy	12.1	3.0	7.4	7.6	2.3	-14.7	4.2	5.1	3.0	4.5
Real investment growth % yoy	20.4	3.9	20.9	24.4	-1.2	-50.5	4.9	10.4	5.0	5.0
Real consumption growth % yoy	8.7	14.0	12.2	13.1	10.1	-12.3	6.0	11.0	4.0	4.0
private consumption growth % yoy	12.1	19.3	15.4	17.0	12.8	-14.9	7.0	15.0	5.0	5.0
Real export growth, % yoy	21.5	-12.7	-5.8	2.8	5.7	-22.0	4.5	1.8	2.5	3.5
Real import growth, % yoy	15.5	6.7	8.3	23.9	17.0	-38.9	11.1	17.0	5.0	3.0
Prices, Money & Credit										
CPI, % yoy	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	7.5	6.1
CPI, % avg	9.0	13.5	9.1	12.8	25.2	15.9	9.4	8.0	3.4	7.3
Nominal wages, % yoy	27.7	36.5	29.4	29.7	33.7	5.5	17.7	17.5	16.2	15.2
Credit extension to private sector, % yoy	32.2	63.6	69.8	73.7	67.1	-4.2	0.7	12.0	19.0	25.0
Policy interest rate, %, eop	9.00	9.50	8.50	8.00	12.00	10.25	7.75	7.75	7.75	7.25
1 month inter-bank rate, %, eop	-	-	-	8.41	23.78	19.00	10.75	20.25	9.69	9.06
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
UAH/US$, eop	5.31	5.05	5.05	5.05	7.70	7.99	7.96	7.99	8.50	8.60
UAH/US$, avg	5.32	5.12	5.05	5.05	5.27	7.79	7.94	7.97	8.11	8.47
UAH/EUR, eop	7.22	5.97	6.65	7.33	10.86	11.45	10.57	10.30	10.54	11.02
UAH/EUR, avg	6.61	6.38	6.34	6.92	7.70	10.86	10.53	11.09	10.33	10.66
Balance of Payments, US$ bn										
Current account	6.9	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-8.6	-11.8	-8.8
% of GDP	10.6	2.9	-1.5	-3.7	-7.1	-1.5	-2.2	-5.2	-6.6	-4.3
Trade balance	3.7	-1.1	-5.2	-10.6	-16.1	-4.3	-8.4	-13.8	-16.1	-14.6
Exports	33.4	35.0	38.9	49.8	67.7	40.4	52.2	69.4	69.6	72.4
Imports	29.7	36.2	44.1	60.4	83.8	44.7	60.6	83.2	85.7	87.0
Service balance	1.2	1.8	2.1	2.4	1.7	2.4	4.4	4.9	3.5	4.5
Income balance	-0.6	-1.0	-1.7	-0.7	-1.5	-2.4	-2.0	-3.2	-2.2	-2.0
FDI, net	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.5	7.0
International reserves	9.7	19.4	22.4	32.5	31.5	26.4	36.7	30.1	19.8	14.0
Total amortisations	1.5	1.2	14.3	20.4	29.9	39.6	37.7	53.7	56.7	57.0
Public Finances, % of GDP										
Consolidated government balance	-3.1	-1.7	-0.6	-0.8	-1.2	-7.3	-8.8	-3.8	-3.4	-3.5
Consolidated gov primary balance	-2.2	-0.9	0.2	-0.3	-0.7	-6.2	-7.6	-2.9	-2.5	-2.8
Public debt	25.5	16.4	13.2	10.8	14.4	26.7	31.5	29.7	29.9	28.2
of which Domestic	10.0	4.3	3.1	2.5	4.7	10.0	13.1	13.9	14.4	8.2
Foreign Assets & Liabilities, US$ bn										
External debt	30.6	39.6	54.5	80.0	101.7	103.4	117.3	119.3	121.5	123.7
Public	11.7	11.8	11.8	12.3	16.7	24.0	32.5	34.7	36.9	39.1
External debt / GDP	47.2	46.0	50.6	56.0	56.5	88.2	86.0	72.4	67.5	61.0
External debt / XGS	74.2	89.3	108.5	124.9	118.7	256.0	224.8	171.9	174.5	170.9
Short-term debt	10.4	10.9	15.2	20.7	20.3	19.0	23.5	24.9	26.4	23.9
Short-term debt/International reserves, %	107.4	56.4	68.0	63.7	64.4	72.0	64.1	82.8	133.3	171.1

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.9	6.5	4.6	2.0	2.7	3.1	3.5	4.2	4.2	4.1
CPI, % yoy	11.9	5.9	4.6	1.9	1.0	4.3	7.5	8.5	7.6	6.7
Policy interest rate, %, eop	7.75	7.75	7.75	7.50	7.50	7.50	7.75	7.75	7.50	7.25
1 month inter-bank rate, %, eop	6.50	12.60	20.25	9.50	9.38	9.38	9.69	9.69	9.38	9.06
Long-term yield, %, eop	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
UAH/US$	7.97	7.97	7.99	7.99	8.00	8.10	8.50	8.50	8.45	8.50
UAH/EUR	11.50	10.85	10.30	10.60	10.01	9.99	10.54	10.60	10.61	10.78

Source: National sources and Citi Investment Research and Analysis

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Latin America

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Argentina

- **Summary view** — Activity growth continues decelerating, reaffirming our prognosis that "true" real GDP growth for this year will likely stand around 1%, though the National Statistical Institute will likely report 3%. Idle installed capacity, declining investment, weak consumer confidence, credit shortages, and a deteriorated fiscal stance are on the back of our forecasts.

- **Things to watch** — As the peso appreciates in real effective terms, the response of the government is not to devalue the official rate but to intensify exchange and import controls. These controls affect potential GDP growth mainly through investment. Keeping a close eye on fixed capital formation proxies such as construction activity and capital good imports is, therefore, important to infer how long and deep the forthcoming slowdown will be. The information available so far suggests that investment has contracted sharply in the first quarter of this year, but this is only the beginning.

- **Strategy** — Low growth prospects and a growing risk of devaluation reduce appetite for Argentine assets, in particular GDP warrants. In addition to their vulnerability to growth prints, warrants are essentially peso assets regardless of currency denomination.

Growth: From Chinese to Japanese

The economic slowdown is patently obvious. According to our own estimates, seasonally-adjusted real GDP was down 0.5% in March 2012 from September of last year. On an annual basis, real growth was 2.6% y/y in 1Q12 compared to 7.6% in 1Q11.

We do not expect growth to resume anytime soon due to constraints on both demand and supply. On the demand side, private consumption, the main driver of output expansion over much of the past decade, is likely to drop further since, according to UTDT, consumer confidence is down 16% relative to September 2011. Government spending, the second most important driver, is also likely to stagnate as tax collection ceases to grow in real terms and starts to decline. On the supply side, limits to growth are imposed by high existing capacity utilization levels, low investment, and tight import controls.

Investor confidence is equally low. According to OJF, a local consultancy, seasonally-adjusted fixed capital formation dropped by 9.5% in real terms from September 2011 to March 2012. In March alone, it decreased by 5.3% y/y. This is hardly surprising since, to pay dividends, foreign companies have to buy dollars in the blue-chip-swap (BCS) market, which is both expensive (the premium is currently around 30% of the official rate) and risky (due to fears of retaliation by the government via inspections from the National Tax Administration). Moreover, import controls, which affect the supply of intermediate and capital goods, are not likely to be eased in the near term.

All these factors not only confirm our expectation that “true” (i.e., unofficial) growth will only be 1% this year, but actually place a downside risk on the forecast. As a matter of fact, our in-house leading index suggests that negative y/y growth rates are possible in the second half of the current year. Moreover, UTDT’s Leading Index has been posting negative y/y growth rates for the last five months. In the past, prints like these anticipated sharp contractions in output. As for official GDP growth, we also reaffirm our expectation that the government will publish a 3% print, enough to embellish the outlook, but not high enough to trigger a warrant payment in 2013.

Money markets and credit

Thanks to FX controls, the government was able to accumulate AR$23.4 billion worth of foreign reserves since the beginning of the year. Despite this sizable intervention, the monetary base actually fell by AR$0.7 on account of monetary sterilization by BCRA. While seasonal factors and a stagnant economy explain the lower need for nominal balances during the first four months of year, the reduction in real balances points to an increase in money velocity due to higher expectations of inflation and devaluation. For comparison, in the same period of 2011, the monetary base rose by AR$11.3 billion.

The flipside of real money base contraction will be sluggish credit growth. Last year, loans to the private sector increased by a whooping 47% in nominal terms or around 18% in real terms. By contrast, during the first four months of this year, they rose by 5.6% in nominal terms or minus 3% in real terms.

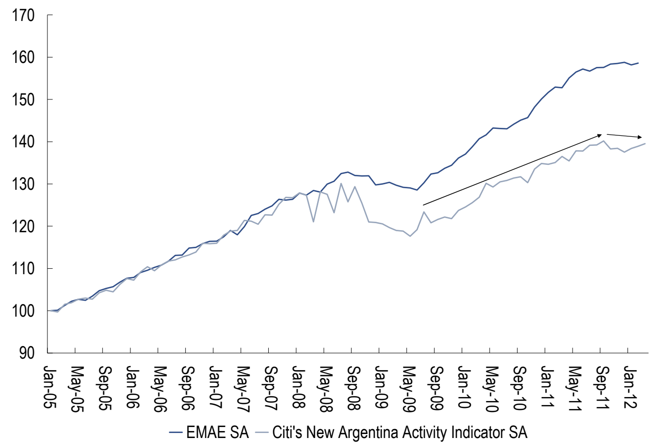
The fiscal stance continues to deteriorate

Late in 2011, President CFK announced the beginning of an era of economic “fine tuning." This was supposed to help curb nominal wage increases and the deterioration in the fiscal accounts in order to ease pressure on the ARS. Yet, this seemingly "orthodox" plan was abandoned before it started, as a sharper than expected slowdown in economic activity in the first quarter of this year changed the government’s priorities. Instead of cutting subsidies by AR$20 billion, or 1.1% of 2011 GDP, as announced, the government reformed the central bank’s organic charter to allow more lending to the Treasury than permitted under the existing legislation.

This year, public spending posted its second highest annual growth rate since 1994. Despite some deceleration in the growth rate of public subsidies to energy, transportation, and other private sector activities, total federal spending grew by 38.8% y/y in 1Q12 causing the overall deficit for the year ending in 1Q12 to rise to 1.8% of GDP, compared to a surplus of 0.2% of GDP in the previous year. This result enhances our view that the fiscal stance will continue to suffer. On the one hand, revenue growth, still high in 1Q12 at 34.4% y/y, will likely fall as the economy slows down further. On the other, expenditure in subsidies will accelerate as the government is unlikely to allow tariffs to increase any time soon. For the year as a whole, we continue to expect the primary balance to be negative 1% of GDP and the overall deficit to reach 3% of GDP.

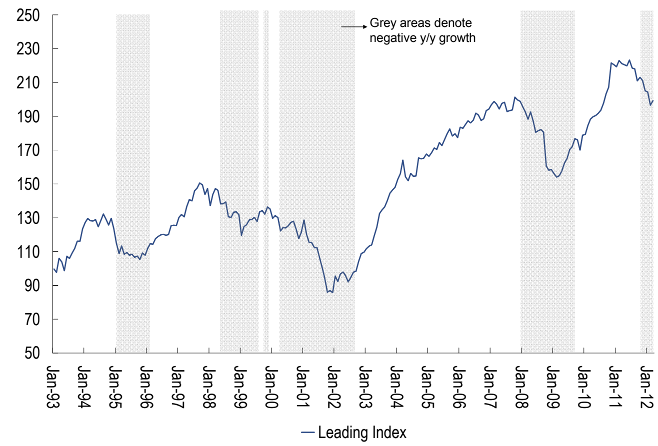
If our prognosis materializes, transitory loans and non-negotiable government bonds will represent almost half of the central bank’s balance sheet by the end of the year. We expect the stocks of transitory loans to increase by AR$52 billion during the current year, taking their share in BCRA assets to 21%, up from 15% on April 23. Additionally, the amount of non-negotiable bonds, which the central bank receives in exchange for the reserves it lends, should rise to 28%, up from 24%.

Figure 235. Due to the controls, real GDP stopped growing since 4Q11



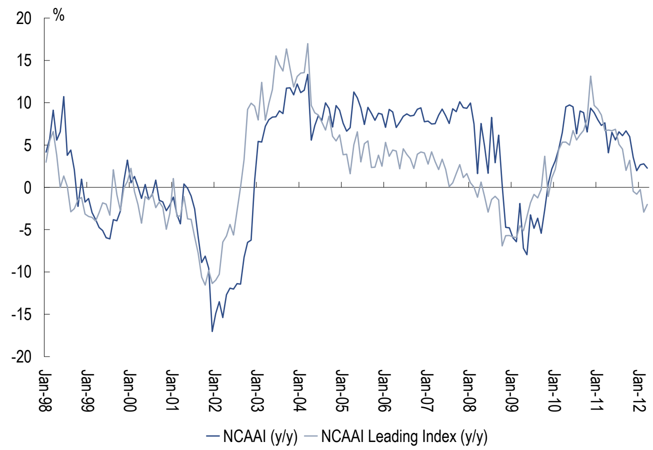
Source: INDEC and Citi Investment Research and Analysis

Figure 236. UTDT's and our in-house leading indices suggest that…



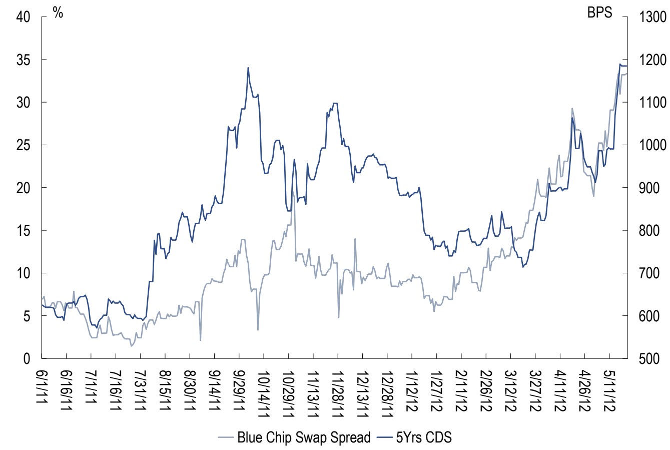
Source: Universidad Torcuato Di Tella and Citi Investment Research and Analysis

Figure 237. …the risk of a hard landing is not negligible



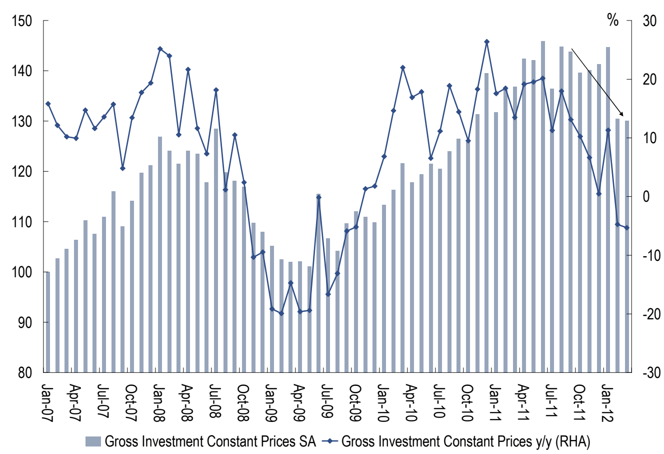
Source: Citi Investment Research and Analysis

Figure 238. Increased risk has been depressing private investment…



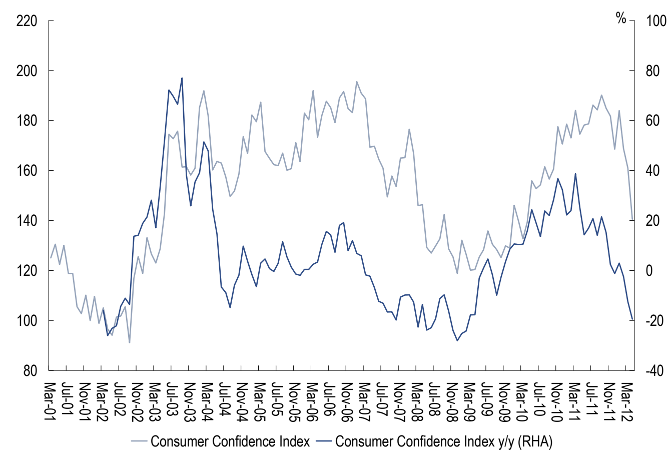
Source: Bloomberg and Citi Investment Research and Analysis

Figure 239. …, that dropped 5.3% y/y in April



Source: Orlando J Ferreres & Asociados and Citi Investment Research and Analysis

Figure 240. Consumer confidence has been plummeting



Source: Universidad Torcuato Di Tella and Citi Investment Research and Analysis

Figure 241. Argentina Economic Indicators

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	151.8	181.5	212.6	260.5	325.1	305.5	367.9	441.9	474.0	466.0
Nominal GDP, local currency bn	447.6	531.9	654.4	808.6	1032.8	1145.5	1442.7	1838.3	2158.6	2539.9
GDP per capita, USD	3971.6	4702.3	5454.3	6618.1	8179.8	7612.0	9078.5	10797.9	11466.9	11167.1
Population, mn	38.2	38.6	39.0	39.4	39.7	40.1	40.5	40.9	41.3	41.7
Unemployment, % of labour force	13.6	11.6	10.2	8.5	7.9	10.1	9.3	8.1	8.1	8.0
Economic Activity										
Citi's Argentina Activity Indicator, % yoy	9.0	9.2	8.5	8.7	6.8	0.9	9.2	8.9	3.0	3.0
Real investment growth % yoy	34.4	22.7	18.2	13.6	9.1	-10.2	21.2	16.6	2.3	4.4
Real consumption growth % yoy	8.3	8.5	7.4	8.8	6.6	1.5	9.1	12.0	3.3	3.8
private consumption growth % yoy	9.5	8.9	7.8	9.0	6.5	0.5	9.0	10.7	2.8	2.8
Real export growth, % yoy	8.1	13.5	7.3	9.1	1.2	-6.4	14.6	4.3	1.9	2.1
Real import growth, % yoy	40.1	20.1	15.4	20.5	14.1	-19.0	34.0	17.8	5.2	6.5
Prices, Money & Credit										
CPI, % yoy (Citi estimates)	8.5	15.4	14.4	20.2	19.2	15.2	25.0	24.2	25.0	35.0
CPI, % avg	10.3	11.9	14.4	16.9	21.9	15.8	21.3	23.4	25.2	30.3
Nominal wages, % yoy	-	-	-	-	-	-	-	-	-	-
Credit extension to private sector, % yoy	7.1	4.9	20.5	29.3	19.0	20.1	38.6	32.6	23.5	27.2
BADLAR Private Banks Rate (eop)	-	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
ARS/USD, eop	2.98	3.03	3.07	3.15	3.45	3.80	3.97	4.30	4.80	6.00
ARS/USD, avg	2.95	2.93	3.08	3.12	3.18	3.74	3.92	4.16	4.55	5.45
Balance of Payments, USD bn										
Current account	12.2	11.7	7.8	7.4	6.7	11.1	2.8	0.0	0.3	-1.5
% of GDP	8.0	6.4	3.7	2.8	2.1	3.6	1.0	0.0	0.1	-0.3
Trade balance	12.2	11.7	12.4	11.3	12.6	16.9	11.6	10.3	10.0	8.1
Exports	34.6	40.4	46.5	56.0	70.0	55.7	68.1	83.1	85.6	90.4
Imports	22.4	28.7	34.2	44.7	57.5	38.8	56.5	72.8	75.6	82.3
Service balance	-1.5	-1.4	-0.5	-0.5	-1.3	-1.2	-1.1	-2.2	-1.8	-2.0
Income balance	8.9	6.6	-6.1	-5.9	-7.6	-9.0	-9.9	-10.8	-10.7	-11.7
FDI, net	4.1	5.3	5.0	6.5	9.7	3.9	7.0	7.2	4.4	4.4
International reserves	19.6	28.1	32.0	46.2	31.7	47.7	51.9	46.4	42.3	40.0
Total amortisations	-	-	-	-	-	-	-	-	-	-
Public Finances, % of GDP										
Consolidated government balance	3.7	2.1	1.8	1.2	1.4	-0.6	0.2	-1.6	-3.0	-2.0
Consolidated gov primary balance	-	-	-	-	-	-	-	-	-	-
Public debt	126.0	84.2	64.2	55.5	44.7	48.0	44.6	40.8	43.0	47.2
of which Domestic	49.7	48.3	37.8	31.7	27.6	30.0	28.0	26.1	27.5	30.1
Foreign Assets & Liabilities, USD bn										
External debt	-	-	-	-	-	-	-	-	-	-
Private	-	112.3	102.9	114.9	114.9	108.1	119.3	98.0	118.6	138.8
Public	115.8	65.2	56.2	62.1	55.5	54.8	61.0	65.3	73.8	79.6
External debt / GDP	112.7	62.5	48.9	44.6	35.7	35.8	32.8	22.4	25.3	30.1
External debt / XGS	430.7	243.5	182.2	156.7	169.1	166.2	142.6	130.0	128.9	115.6
Short-term debt	-	-	-	-	-	-	-	-	-	-
Short-term debt/International reserves (%)	-	-	-	-	-	-	-	-	-	-

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	9.1	9.3	7.3	4.3	2.5	2.5	2.9	3.5	3.5	3.0
CPI, % yoy	9.7	9.9	9.5	9.7	9.6	9.4	9.7	10.0	11.0	12.2
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
BADLAR Private Banks Rate, %, eop	11.43	14.00	17.20	13.00	13.00	13.00	15.00	16.25	17.50	18.75
Long-term yield, %, eop	-	-	-	-	-	-	-	-	-	-
ARS/USD	4.10	4.20	4.30	4.38	4.53	4.67	4.80	5.10	5.40	5.70

Source: National Sources and Citi Investment Research and Analysis

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Brazil

- **Summary view** — We keep our 2012 and 2013 GDP growth forecasts, although setting downward biases in both estimates, on the back of the intensification in global turmoil. The monetary easing cycle should continue in the next Copom meetings, with CPI inflation remaining above the mid point target, but inside the target band. Worsening global conditions motivate us to increase our USD/BRL forecasts, while fiscal policy should continue focusing on the primary fiscal target.
- **Things to watch** — The yield curve should remain sensitive to developments in the international scenario, given the recent deterioration in the global outlook. Activity data and inflation indicators should also be monitored. Overall, we expect activity to show signs of acceleration. Even though the inflation path should become less favorable, it should not represent a big concern for the central bank.
- **Strategy** — Given worsening global conditions, we recognize that the USD/BRL should remain at a higher level than previously estimated. However, assuming a solution for European sovereign debt crises in the near future, it suggests some room for BRL appreciation in the medium/long term. Regarding rates, the complex global scenario should keep some room open for further monetary easing, indicating potential gains in receiving rates in the near term.

Growth acceleration despite higher uncertainty

Activity indicators continue to support our GDP forecasts, although global woes recommend setting downward biases in our 2012 and 2013 estimates. After the release of March's retail sales, we reaffirmed our 1Q12 GDP growth forecast of 0.8% q/q, implying an additional quarterly acceleration in relation to the 0.3% figure printed in 4Q11. For the coming quarters, our BLI and structural models continue to suggest further acceleration, reflecting the expansionary effects of the historically low level of real interest rates. Therefore, we continue to expect 2012 and 2013 GDP growth to reach 3.3% and 4.5%, respectively. Nevertheless, we recognize that the intensification in global turmoil may damage the activity outlook, especially through confidence, trade and credit channels, leading us to set downward biases in both of our annual forecasts.

Monthly inflation will likely moderate, while the downward trend in annual figures should come to a halt. April's higher-than-expected CPI result (0.64% m/m) indicates that the low figure in March (0.20% m/m) was an outlier. However, given that April's upward pressures were partly transitory, we forecast a decline in monthly inflation in the coming months. This would keep the annual inflation rate roughly stable at 5.1%, the lowest level since the peak in September 2011 (7.3%). We keep our CPI inflation forecasts at 5.3% by yearend 2012 and at 5.6% in 2013. However, we acknowledge that risks remain tilted to the upside, especially in 2013. So far, the ongoing domestic currency depreciation has been strong enough to offset the decline in commodity prices, which will likely result in upward CPI pressures ahead, as already indicated by wholesale price behavior. In addition, our scenario still contemplates a narrowing of the output gap in the coming quarters, given that the central bank reaction to the activity slowdown has been fast.

We lowered our Selic rate call to 7.75% in 2012 (from 8.50%), although still expect 200bp in hikes (to 9.75%) throughout 2013. We now expect further cuts in the Selic rate, given that the government changed the saving accounts scheme, withdrawing the 8.50% threshold for the Selic rate. The dovish tone of the central bank and rising concerns regarding the activity recovery also reinforce this view. Our take is that Copom is very sensitive to activity data, which has been surprising to the downside in the case of the industrial sector. In addition, in recent speeches, the central bank governor, Alexandre Tombini, blamed the frequent changes in the communication strategy, toward a more dovish stance, on rising external volatility. In this regard, the worsening of the international outlook reinforces the expectation of lower interest rates this year. As for inflation, the current path and expectations do not look as a restriction for further easing, even after considering currency depreciation. We expect the central bank to cut 50bp in each of the next two meetings, and a final 25bp cut in August 2012.

Worse global conditions require higher USD/BRL

Global turmoil hurts commodity prices and increases risk aversion, both pressuring USD/BRL upward, at least in the near term. The risks associated with the European sovereign debt crisis have intensified lately, damaging the global growth outlook, and consequently, adding pressure on commodity prices. Under this new global environment, the BRL should stabilize at a weaker level, leading to us to revise our 2012 and 2013 year ends estimates to 1.91 and to 1.85, respectively. In terms of external accounts, less favorable global conditions tend to reduce capital inflows, requiring better trade balance/current account results. In this sense, we remain even more optimistic with our above consensus estimates for external accounts performances this year.

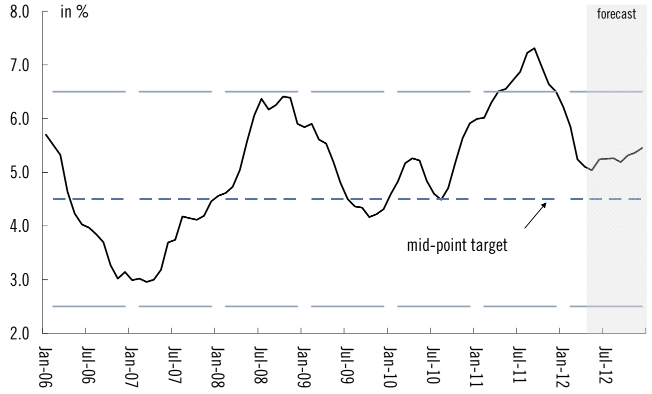
Government signals more stimuli through tax cuts

The government signals new tax cuts, reflecting its concern with the activity outlook, while remaining committed to the fiscal target. In order to boost demand and increase industry competitiveness, the government may announce new tax cuts soon. This should contribute to a deceleration of public revenues during the year, meaning risks to the accomplishment of the primary surplus target of 3.1% of GDP. So far, we continue to expect a primary surplus close to target, given that revenues remain strong helped by one-off revenues. Moreover, public spending growth should accelerate at a moderate pace, as indicated by the freezing of public expenditures set in the 2012 Budget Law, which reinforced the government's commitment with the fiscal target. In March, the 12-month accumulated primary surplus result stood at 3.2% of GDP.

Global woes imply longer monetary easing cycle

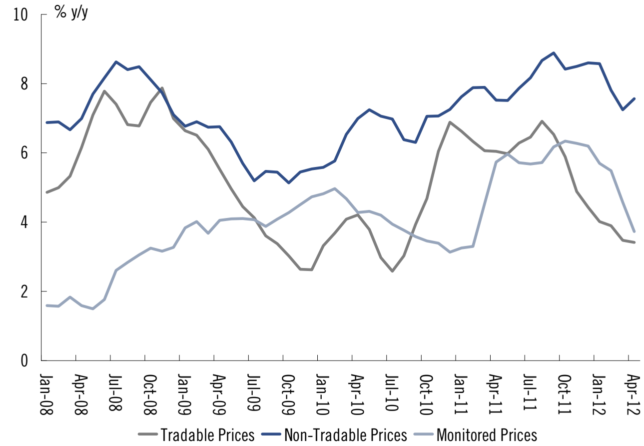
Global woes suggest potential gains in receiving rates in the short end of the yield curve, while expectation of a solution to the European sovereign debt crisis points to BRL appreciation in the medium term. The yield curve is currently pricing in further declines in Selic rate. However, given that global woes should continue in the coming weeks, the central bank should become increasingly comfortable with further monetary policy easing, contributing to further declines in the short end of the yield curve. On the FX front, despite the lack of a favorable scenario in the near term, the possibility of a solution over the medium term suggests BRL should appreciate relative to spot levels in the medium/long term.

Figure 242. Declining trend of annual inflation should come to a halt



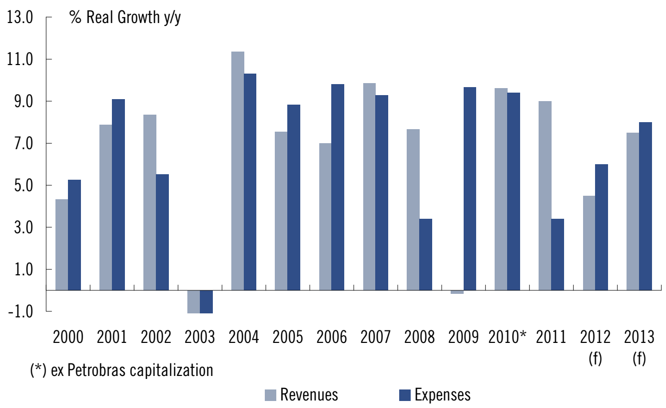
Sources: IBGE and Central Bank of Brazil

Figure 243. Still favorable trend in tradable prices



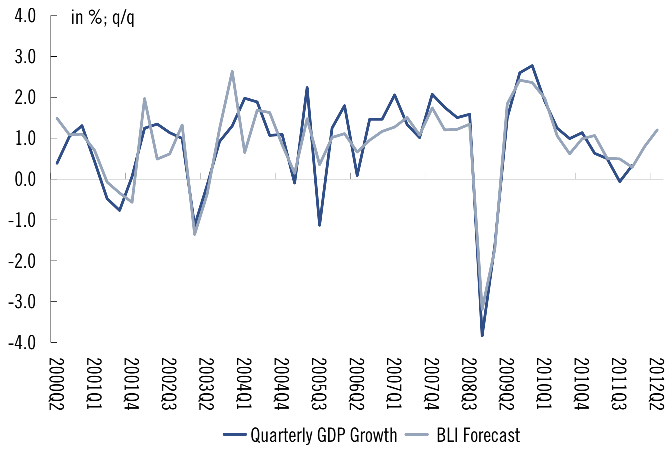
Sources: Citi Investment Research and Analysis and IBGE

Figure 244. Weaker public revenues, amid moderate spending growth



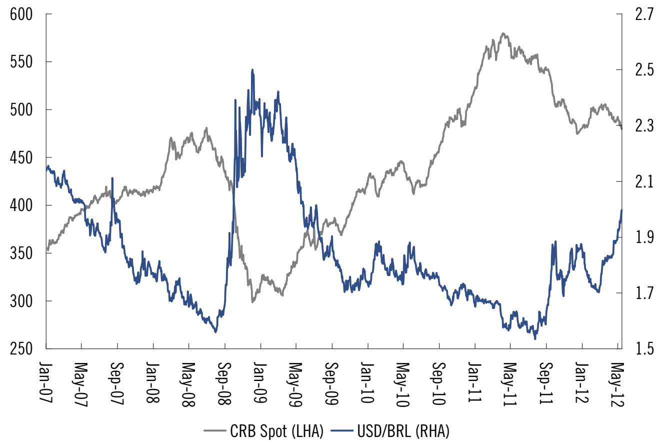
Sources: Citi Investment Research and Analysis and Central Bank of Brazil

Figure 245. GDP growth should continue accelerating



Sources: Citi Investment Research and Analysis and IBGE

Figure 246. Global turmoil hurt commodity pressuring USD/BRL



Sources: Citi Investment Research and Analysis and Bloomberg

Figure 247. Real interest rate has reached levels even lower recently

Sources: Citi Investment Research and Analysis, Central Bank of Brazil, Bloomberg

Figure 248. Brazil Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	663.6	881.7	1096.2	1411.0	1640.6	1540.5	1992.8	2305.2	2423.8	2681.8
Nominal GDP, local currency bn	1941.5	2147.2	2369.5	2661.3	2959.8	3077.3	3504.6	3834.5	4170.9	4604.6
GDP per capita, USD	3716.3	4890.6	6020.9	7668.9	8815.0	8177.0	10446.9	11929.2	12302.3	13437.2
Population, mn	178.6	180.3	182.1	184.0	186.1	188.4	190.8	193.2	197.0	199.6
Unemployment, % of labour force	10.3	9.2	10.0	9.3	7.9	8.1	6.7	6.1	6.3	6.5
Economic Activity										
Real GDP, % yoy	5.7	3.2	4.0	6.1	5.2	-0.3	7.5	2.7	3.3	4.5
Real investment growth % yoy	11.5	-2.4	9.9	16.9	16.4	-16.0	33.4	4.0	3.6	6.4
Real consumption growth % yoy	3.9	3.9	4.5	5.8	5.1	4.1	6.3	3.6	4.0	4.4
private consumption growth % yoy	3.8	4.5	5.2	6.1	5.7	4.4	6.9	4.1	4.2	4.8
Real export growth, % yoy	15.3	9.3	5.0	6.2	0.5	-9.1	11.5	4.5	5.8	6.2
Real import growth, % yoy	13.3	8.5	18.4	19.9	15.4	-7.6	35.8	9.7	8.4	7.0
Prices, Money & Credit										
CPI, % yoy	7.6	5.7	3.1	4.5	5.9	4.3	5.9	6.5	5.3	5.6
CPI, % avg	6.6	6.9	4.2	3.6	5.7	4.9	5.0	6.6	5.4	5.6
Nominal wages, % yoy	5.4	11.3	7.4	7.0	10.4	4.8	12.7	10.4	9.2	9.4
Credit extension to private sector, % yoy	24.4	27.0	23.4	32.6	31.9	12.0	17.0	17.0	17.0	17.0
Policy interest rate, %, eop	17.75	18.00	13.25	11.25	13.75	8.75	10.75	11.00	7.75	9.75
1 month inter-bank rate, %, eop	…	…	…	…	…	…	…	…	…	…
Long-term yield, %, eop	16.83	15.58	12.33	12.95	12.27	12.25	12.24	10.66	10.77	10.77
BRL/USD, eop	2.65	2.34	2.14	1.77	2.34	1.74	1.67	1.88	1.91	1.85
BRL/USD, avg	2.93	2.44	2.18	1.95	1.83	2.00	1.76	1.67	1.92	1.88
Balance of Payments, USD bn										
Current account	11.7	14.0	13.6	1.6	-28.2	-24.3	-47.7	-48.6	-51.4	-65.4
% of GDP	1.8	1.6	1.2	0.1	-1.7	-1.6	-2.4	-2.1	-2.1	-2.4
Trade balance	33.6	44.7	46.5	40.0	24.8	25.3	19.9	29.8	27.0	15.8
Exports	96.5	118.3	137.8	160.6	197.9	153.0	201.6	256.0	251.7	259.7
Imports	62.8	73.6	91.4	120.6	173.1	127.7	181.7	226.3	224.7	243.9
Service balance	-4.7	-8.3	-9.6	-13.2	-16.7	-19.2	-30.8	-37.5	-37.3	-40.2
Income balance	-20.5	-26.0	-27.5	-29.3	-40.6	-33.7	-39.6	-43.8	-44.8	-44.6
FDI, net	18.1	15.1	18.8	34.6	45.1	25.9	48.4	65.1	55.0	55.0
International reserves	52.9	53.8	85.8	180.3	206.8	239.1	288.6	354.1	378.1	378.1
Total amortisations	33.2	32.8	43.0	39.7	22.4	30.1	33.8	29.7	35.7	151.2
Public Finances, % of GDP										
Consolidated government balance	-2.9	-3.6	-3.6	-2.8	-2.0	-3.3	-2.6	-2.6	-1.9	-2.6
Consolidated gov primary balance	4.2	4.4	3.9	4.0	4.2	2.0	2.7	3.1	3.0	2.5
Public debt	65.4	67.4	64.2	61.2	61.3	67.6	62.6	62.6	62.6	63.1
of which Domestic	45.5	56.0	58.0	57.0	56.6	64.1	59.8	57.9	58.2	58.7
Foreign Assets & Liabilities, USD bn										
External debt	201.4	169.5	172.5	193.6	198.3	198.2	255.2	257.6	222.7	228.7
Private	69.1	69.2	83.2	107.6	114.2	100.3	151.9	153.5	119.7	124.2
Public	132.3	100.3	89.2	86.0	84.2	93.3	105.6	108.4	106.2	110.2
External debt / GDP	30.3	19.2	15.7	13.7	12.1	12.9	12.9	11.2	9.1	8.6
External debt / XGS	184.6	126.1	109.6	104.9	86.8	109.7	109.3	87.5	75.9	74.5
Short-term debt	…	18.8	20.3	38.9	36.4	31.0	56.4	60.0	65.0	65.0
Short-term debt/International reserves (%)	…	34.9	23.7	21.6	17.6	13.0	19.6	16.9	17.2	17.2

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.3	2.1	1.4	1.7	2.4	4.0	5.2	5.9	5.4	4.2
CPI, % yoy	6.7	7.3	6.5	5.2	5.2	5.1	5.3	5.7	5.6	5.7
Policy interest rate, %, eop	12.25	12.00	11.00	9.75	8.50	7.75	7.75	7.75	8.25	9.25
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
BRL/USD	1.57	1.67	1.79	1.76	1.99	2.02	1.92	1.91	1.90	1.86

Source: National Sources and Citi Investment Research and Analysis

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Chile

- **Summary view** — We have revised our 2012 GDP growth forecast to 4.5% on the back of better 1Q12 performance, but the bottom line remains that we expect the economy to decelerate in 2012, especially since recent data showed a faster than expected slowdown of domestic demand.
- **Things to watch** — Watch for the evolution of the tax reform debate in Congress, as it promises to be intense. Still, uncertainty over taxes should linger well after the reform's pass through Congress is over, as 2013 is an electoral year.
- **Strategy** — Our call remains for 50bp worth of additional interest rate cuts in 2012. The central bank will keep the cautious stance until it sees further evidence of activity slowing down. The USD/CLP should remain very sensitive to developments on the global front and particularly Chinese activity in the short term.

Government finally releases fiscal reform proposal

Sebastián Piñera finally released his proposal for fiscal reform. The bill relies almost equally on corporate tax increases and closing loopholes to raise revenues, while providing some tax cuts for individuals, reductions in stamp taxes and import tariffs. For more information on the main points of the proposal, please see Emerging Markets Daily - Latin America Edition, May 1, 2012. At the end of the day, the Piñera government is looking to raise around US$1 billion per year (close to 0.3% of 2012 GDP) in additional net revenue, which would be entirely spent on education.

However, criticism did not wait long to surface. For critics, especially those in the opposition, the government's reform proposal fails on three fronts. First and foremost, several members of the Concertación have mentioned that the measure does not raise nearly enough additional revenues, considering the expenditures that would be needed to truly undertake a major overhaul of the education system. Second, the bill fails to address the wide gap between (lower) corporate and (higher) individual income taxes, which is considered the main source of the tax system's regressiveness. The wide gap generates an incentive for rich households, where corporate ownership is concentrated, to keep revenues in companies in order to prevent paying individual income taxes. Finally, since only a small portion of Chilean households actually pay income taxes, cuts in marginal tax rates can be considered contrary to the goal of making the system more equitable.

The fight in Congress will be long and hard, but the debate will likely spillover into next year's presidential campaign. Finance Minister Larraín has said that he hopes the debate to be over shortly before the discussion on the 2013 budget starts in September. However, the important thing to highlight is that the ruling coalition lacks a majority in Congress. In fact, the government was only able to secure the support from the UDI (coalition ally) after it agreed to making changes to fuel taxes. The government has also started lobbying for support from independents. Therefore, the end result and the macroeconomic implications are still unclear. Although Finance Minister Larraín said that the government would not budge from the proposal to take corporate taxes to 20% and no higher than that, talk about additional adjustments will likely intensify in 2013 ahead of the November presidential elections. Therefore, uncertainty over tax reform is still far from over.

Activity fails to slow down, at least markedly

The central bank reported that GDP grew 5.6% y/y in 1Q12. Although the print was higher than the 4.5% registered in 4Q11, it reflects the leap year effect which the central bank estimates at 0.8 percentage points. As a result, the economy grew 1.4% q/q, down from 2% in 4Q11. Interestingly, domestic demand (4.9% y/y) grew below GDP for the first time since the fourth quarter of 2009, reflecting flat government consumption. Nonetheless, exports were an important driver of growth, casting a doubt on whether this will remain the case for the remainder of the year. On the other hand, the government has some room to raise spending to offset worsening external demand without necessarily providing fiscal stimulus.

We have therefore revised our 2012 GDP growth forecast to 4.5%, from 4.2% before. Our forecast incorporates the higher than expected GDP print registered in 1Q12, and we also make a slight adjustment to our quarterly GDP growth path to account for a less aggressive slowdown relative to our previous forecast. But the bottom line remains that we still expect a slower pace of economic activity growth in the next couple of quarters.

Central bank on hold most likely outcome for now

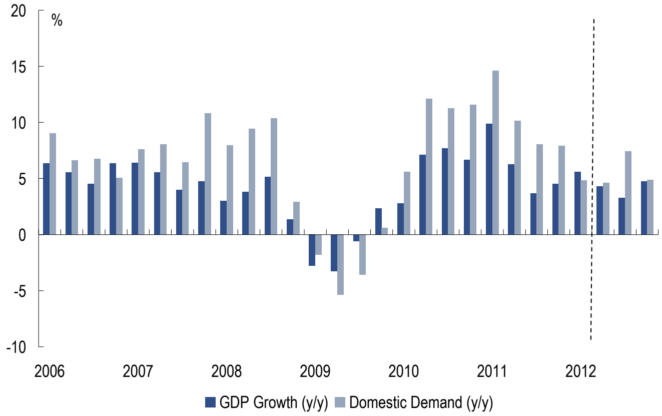
The central bank (BCCh) kept the policy rate unchanged at 5% in May, in line with market expectations. In its communiqué, the BCCh highlighted the recent deterioration in external fundamentals, which has been accompanied by rising tension in global financial markets, volatility and lower commodity prices. Nonetheless, the central bank also underscored that local economic activity was slightly stronger than expected, with the labor market remaining tight and wages rising strongly. Although inflation is less of a concern nowadays — core inflation measures and long term inflation expectations are close to the 3% target — especially given the strong decline in global oil prices.

Our call remains for 50bp worth of additional interest rate cuts this year, but acknowledge that domestic fundamentals have to deteriorate further for these to materialize. As long as the divergence between domestic and global factors continues, the BCCh will opt for keeping the policy rate unchanged. We think this will still be the case for the next couple of months. Before considering cuts, the central bank will have to stop considering hikes as its base case scenario. At the April meeting the BCCh was considering the idea of a 25bp hike. We will have to wait until the minutes of the May meeting (to be released on June 4) to determine whether that is no longer the case. In all likelihood, the central bank's upcoming Monetary Policy Report will show that a more cautious approach to policy decisions will be required, but that interest rate cuts are still not its base case scenario.

FX Outlook

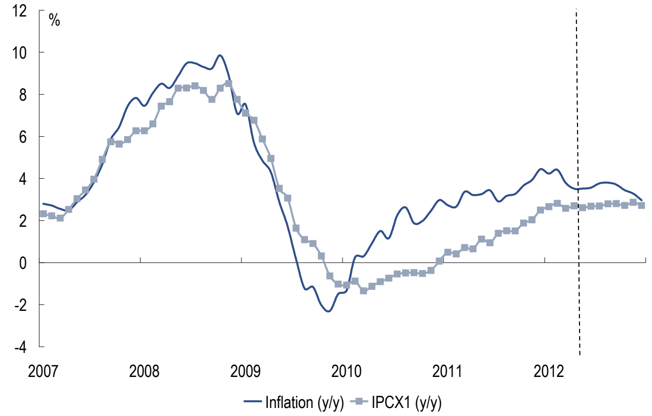
The CLP has suffered from the spike in risk aversion and lower copper prices. The USD/CLP finally broke the 500 barrier after trading in a 480-490 range through March and April. We have adjusted our short term forecast to incorporate financial turmoil but over the medium and long term, expect the USD/CLP to trend back down to the 480-490 level. However, Chinese GDP performance will be a major determinant of the speed at which the peso would strengthen once again. Any news pointing toward a sharper than expected slowdown in China, should keep copper prices and therefore the currency under pressure.

Figure 249. We have revised 2012 growth to 4.5%...



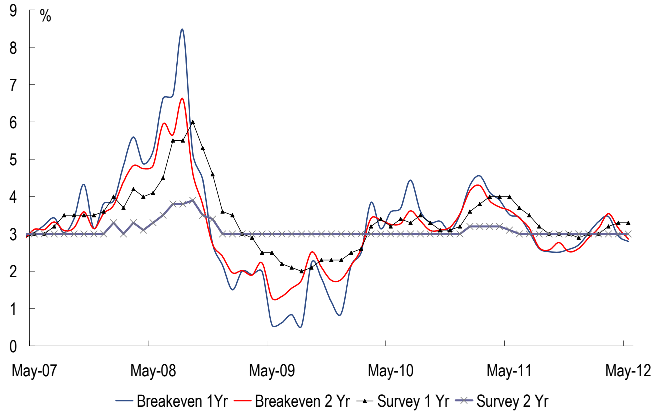
Source: BCCh and Citi Investment Research and Analysis

Figure 250. … but still forecast inflation running at 3% by year end



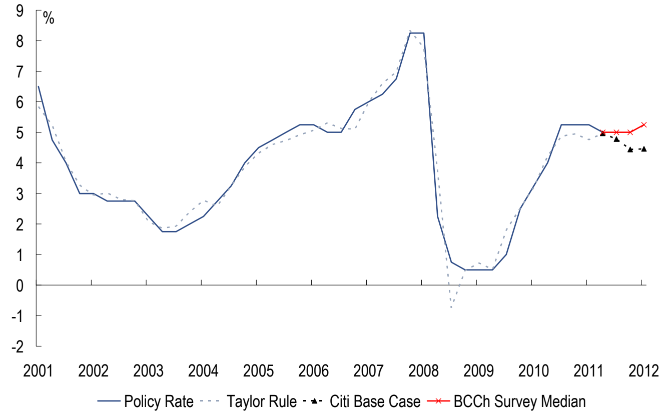
Source: BCCh and Citi Investment Research and Analysis

Figure 251. Market inflation expectations slightly below 3% target



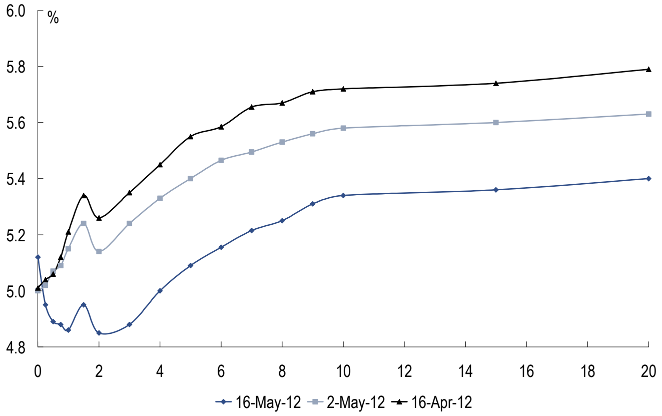
Source: INE and Citi Investment Research and Analysis

Figure 252. We still expect cuts in the policy rate in 2012



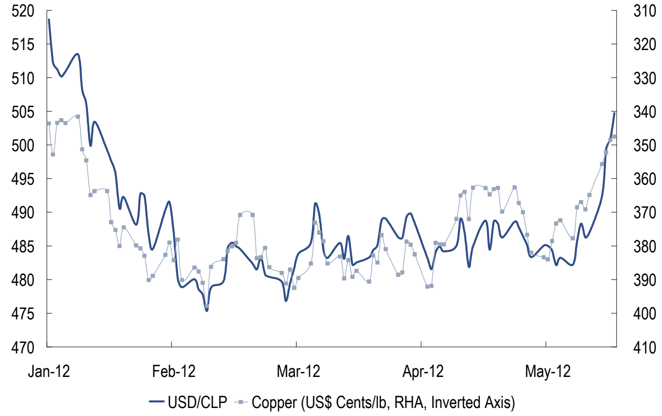
Source:BCCh and Citi Investment Research and Analysis

Figure 253. CAMARA Swap pricing cuts once again



Source: Bloomberg

Figure 254. USD/CLP will likely follow copper prices



Source: Bloomberg

Figure 255. Chile Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	99.4	123.4	154.7	173.3	182.8	173.8	217.1	248.6	256.2	282.1
Nominal GDP, local currency bn	60.5	68.9	82.0	90.4	93.8	96.8	110.4	120.2	128.6	139.0
GDP per capita, USD	6179.3	7588.5	9413.0	10440.7	10903.9	10239.3	12786.3	14500.4	14799.9	15407.3
Population, mn	16.1	16.3	16.4	16.6	16.8	17.0	17.0	17.1	17.3	18.3
Unemployment, % of labour force	9.2	9.1	7.9	7.1	7.8	10.8	8.2	7.1	7.0	7.7
Economic Activity										
Real GDP, % yoy	7.0	6.2	5.7	5.2	3.3	-1.0	6.1	6.0	4.5	5.0
Real investment growth % yoy	8.5	22.8	9.1	6.4	20.8	-23.5	35.6	13.0	6.2	8.9
Real consumption growth % yoy	8.0	8.0	7.5	7.5	4.4	0.8	9.0	7.9	5.1	5.3
private consumption growth % yoy	8.4	8.5	7.8	7.6	5.2	-0.8	10.0	8.6	5.5	5.5
Real export growth, % yoy	14.0	2.8	5.1	7.2	-0.7	-4.5	1.4	4.6	4.6	4.1
Real import growth, % yoy	18.3	17.3	11.4	14.3	11.2	-16.2	27.4	14.4	6.3	7.2
Prices, Money & Credit										
CPI, % yoy	2.4	3.7	2.6	7.8	7.1	-1.5	3.0	4.4	3.0	3.0
CPI, % avg	1.1	3.1	3.4	4.4	8.7	1.5	1.4	3.3	3.7	3.2
Nominal wages, % yoy	3.0	4.7	5.5	7.1	8.5	5.8	3.5	5.8	6.1	4.5
Credit extension to private sector, % yoy	10.6	11.9	11.4	14.7	19.1	-1.4	11.2	18.7	10.8	8.2
Policy interest rate, %, eop	2.25	4.50	5.25	6.00	8.25	0.50	3.25	5.25	4.50	5.00
1 month inter-bank rate, %, eop	2.37	4.53	5.36	5.93	8.24	0.45	3.13	5.23	4.50	5.00
Long-term yield, %, eop	…	…	…	6.25	5.92	5.78	5.11	4.98	4.90	5.90
CLP/USD, eop	589	512	532	505	662	497	468	520	504	490
CLP/USD, avg	611	555	527	523	529	553	509	483	501	493
Balance of Payments, USD bn										
Current account	2.6	1.9	7.1	7.1	-5.8	3.5	3.3	-3.2	-4.6	-5.4
% of GDP	2.6	1.5	4.6	4.1	-3.2	2.0	1.5	-1.3	-1.8	-1.9
Trade balance	10.2	11.3	22.9	24.1	6.1	15.4	15.3	10.8	7.7	6.9
Exports	33.0	42.0	59.4	68.6	64.5	55.5	70.9	81.4	79.6	84.0
Imports	22.9	30.7	36.4	44.4	58.4	40.1	55.6	70.6	71.9	77.1
Service balance	-0.8	-0.8	-0.9	-1.3	-1.2	-2.0	-1.8	-2.4	-1.6	-2.2
Income balance	-7.8	-10.4	-18.4	-18.9	-13.6	-11.4	-14.8	-14.0	-13.6	-13.3
FDI, net	7.2	7.1	7.4	12.6	15.5	12.9	15.4	17.3	18.1	19.5
International reserves	16.0	17.0	19.4	16.9	23.2	25.4	27.9	42.0	42.0	41.9
Total amortisations	8.1	6.1	12.6	9.7	14.3	15.6	11.0	18.7	21.2	21.5
Public Finances, % of GDP										
Consolidated government balance	2.1	4.7	7.9	8.4	4.3	-4.3	-0.3	1.6	0.7	0.6
Consolidated gov primary balance	3.1	5.6	8.5	9.0	4.8	-3.8	0.0	2.0	1.0	0.9
Public debt	11.6	7.9	5.3	4.4	4.3	7.6	10.6	11.1	6.6	5.4
of which Domestic	6.4	4.3	2.4	2.1	2.5	5.3	8.0	8.2	5.2	4.2
Foreign Assets & Liabilities, USD bn										
External debt	43.2	45.6	48.3	53.4	63.7	71.9	84.1	98.6	111.2	121.7
Private	38.1	41.2	43.8	49.4	60.4	67.9	78.5	91.4	107.6	118.5
Public	3	2	2	2	2	2	3	3	2	2
External debt / GDP	43.5	37.0	31.2	30.8	34.9	41.4	38.8	39.7	43.4	43.2
External debt / XGS	130.8	108.7	81.3	77.9	98.8	129.7	118.7	121.1	139.8	145.0
Short-term debt	…	6.8	8.1	9.0	14.0	15.8	16.5	19.4	20.4	22.4
Short-term debt/International reserves (%)	…	39.9	41.7	53.4	60.6	62.4	59.0	46.3	48.5	53.5

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.3	3.7	4.5	5.6	4.3	3.3	4.8	5.6	4.7	4.7
CPI, % yoy	3.4	3.3	4.4	3.8	3.6	3.7	3.0	3.5	3.3	3.1
Policy interest rate, %, eop	5.25	5.25	5.25	5.00	5.00	5.00	4.50	4.50	4.75	5.00
Long-term yield, %, eop	6.03	4.84	4.98	5.20	5.10	5.00	4.90	5.15	5.40	5.65
CLP/USD	467	520	520	488	510	512	504	496	492	491

Source: National Sources and Citi Investment Research and Analysis

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- **Summary view** — Signs of a much expected business cycle deceleration should continue in the following months. Nonetheless, we expect the oil and mining sector, along with fiscal spending aimed at infrastructure, to keep the deceleration at a moderate level. That is why we maintain our GDP growth forecast at 5% for the year as a whole. In addition, the likelihood of further deterioration in the international outlook is once again the main risk factor for growth going forward. When we add stable inflation prints, as has been the case year to date, and the announcement of mandatory increases in consumer loans provisions by the Colombian financial watchdog, our call for Banrep staying on hold for the rest of the year gains significant strength.
- **Things to watch** — Watch for the 1Q12 GDP results which should be released by mid-June. Also, watch for official announcements on the tax reform bill.
- **Strategy** — Local curve behavior should benefit from stable expectations regarding central bank policy rates. Nonetheless, any worse-than-expected evolution of the European outlook should translate into price reductions. Also, if the European situation escalates further, we should expect a convergence of COP depreciation levels to those observed by LatAm peers.

Macroeconomic outlook: The winter is coming…

Despite economic activity growth remaining on positive ground, deceleration of some indicators has become evident. As shown by the 12-month moving average of both retail sales (RS) and industrial production (IP) growth, the economy reached its peak at some point in 2H11 and since then, started a mild deceleration process. The industrial production print, in particular, evidences that supply is decelerating faster than anticipated. This was confirmed after March's results showed that IP decreased 0.9% year over year and RS expanded 5.1% y/y. Our forecasts indicate that both indicators should continue to decelerate throughout 2012 as a result of an ordinary business cycle process.

Should this economic deceleration be a reason to worry beyond normal? After the weak results displayed in IP and RS, some doubts regarding the speed of the economic deceleration have emerged. In our view, the economy has begun a mild deceleration process which should translate into lower IP and retail sales numbers, moderation of loans, and stabilization of inflation and unemployment. We believe this is the result of business cycle dynamics that are finally catching up with the rest of the region, coupled with last year's CB's interest hikes. Nevertheless, we expect the booming oil and mining sector along with fiscal spending to serve as a buffer for economic activity, helping sustain GDP growth at 5%. Despite this somewhat optimistic scenario, we acknowledge that the external outlook, particularly the European crisis, is once again posing downward risks for our economic outlook. In that sense, if the European financial crisis turns to be worse-than-expected, we could see important increases in risk aversion which should translate into lower commodity prices, currency devaluation, a reduction in capital inflows, and consequently lower GDP growth.

1Q12 GDP results should be positive, despite the deceleration displayed by some sectors. We expect GDP to have expanded 5.0% y/y in the first quarter, mostly driven by strong domestic demand (which we forecast at 7.2%). For the year as a whole, we continue to expect GDP to grow 5%. Said forecast assumes 12.8% growth for investment and a 4.5% growth print for domestic consumption. Exports should expand 8.8% this year while imports should post a 13.6% annual growth rate in real terms under the national accounts' framework.

All quiet on the inflation and monetary policy front

In our view, the main concern in the monetary policy debate lies on the strong growth observed in consumer loans, despite the fact the repo rate has been increased since February of last year. Although for some board members it is clear that monetary policy affects the economy with a lag, for others the fact consumer loans are still growing at a 24-25% annual rate, is a reason for concern. In fact, up to April, consumption loans have only started to show some timid and temporary signs of deceleration and were still growing at a 24% annual pace, a situation that has kept Banrep in an uncomfortable position. Thus, the Ministry of Finance and the financial watchdog (Superintendencia Financiera) decided to step in with additional measures to moderate loan growth by imposing an increase in provisions for consumer loans, for which there is quality deterioration.

Good inflation results, growth moderation in some sectors, new measures to moderate consumer loan growth, and the revival of uncertainty on the external front, should grant policy rate stability. Year to date inflation has been confirming a benign outlook for inflation, which has been already incorporated into inflation expectations. In particular, the market currently expects inflation of 3.3% by yearend. That is why we believe the combination of good inflation prints, activity deceleration, and the fact that the international outlook has once again shifted towards a risk off environment, should provide more than enough reasons for Banrep to stay on hold for the rest of the year.

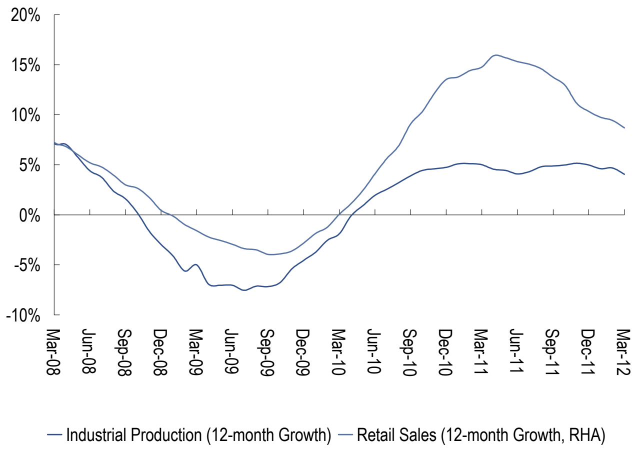
Of tax revenues, tax reform and other demons

June is an important month as the Ministry of Finance has to announce changes to its 2012 and 2013 fiscal plan for which we expect a reduction in 2013 debt issuance. By law, the Ministry of Finance has to present an update of its Medium Term Fiscal Plan by the end of June. We expect this plan to show better-than-expected tax revenues which would help to reduce issuance in 2013. At the same time, the government has begun promoting its tax reform bill after all the noise created when local media published a preliminary and incomplete version of this proposal. In our view, the timing and spirit of this reform is convenient, but several aspects regarding VAT taxes, investment incentives and tax for the middle class should be carefully assessed. We expect the final outcome of this reform to be the elimination of some loopholes in the current tax regime along with an increase of the tax base which should translate into a general increase in tax collections. Unfortunately, for what it is known as of this writing, the reform does not look as a simplification of the already bulky tax code.

Investment Implications

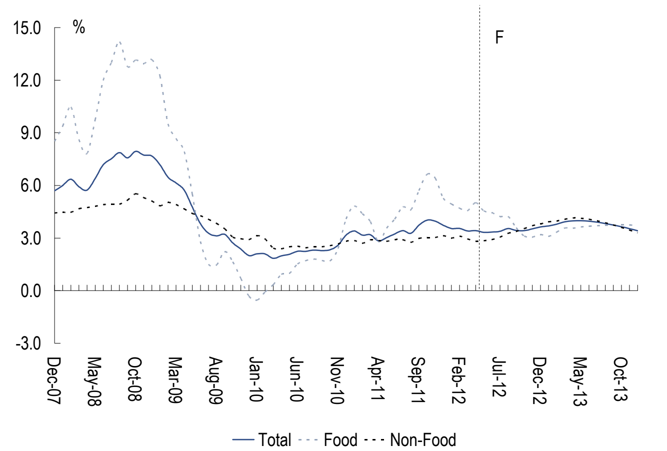
COP depreciation should continue in the short run while the local curve exhibits some steepening. With the increase of risk aversion we have finally seen depreciation of the COP, a trend that should continue as long as uncertainty over Greece and the Euro Zone remains. The COP is finally catching up its LatAm peers after a period in which most of the currencies exhibited depreciation. We expect this trend to continue until markets have a clearer view of the next steps Greece and Euro Area authorities will follow. On the local curve, we expect a steepening of the curve as a consequence of two forces: the traditional steepening stemming from a risk off environment arising from the external outlook coupled with the fact the local market was expecting more hikes from Banrep this year.

Figure 256. Leading indicators signal a deceleration…



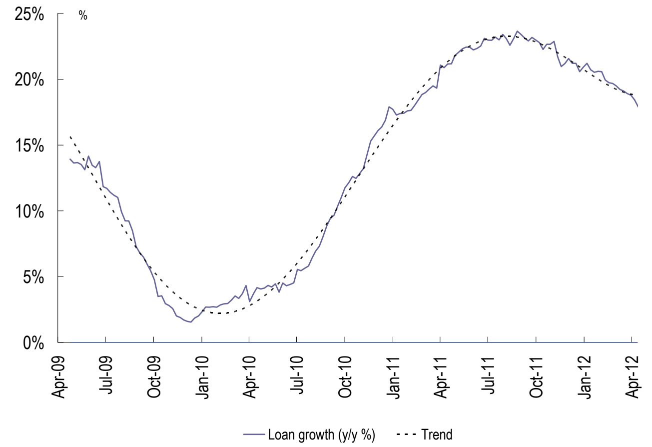
Source: DANE and Citi Investment Research and Analysis

Figure 257. Inflation has posted positive results



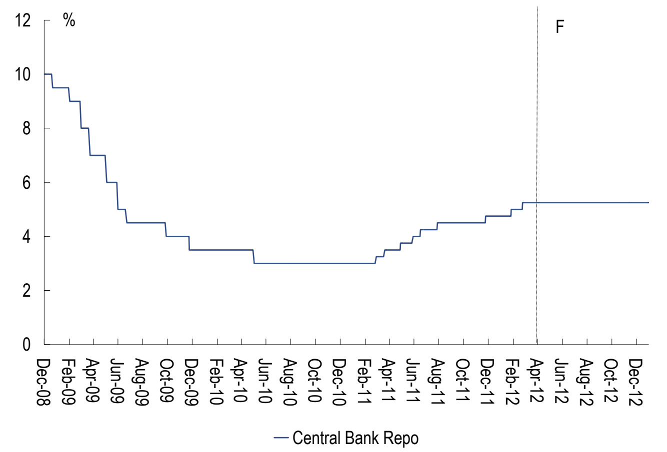
Source: Banrep and Citi Investment Research and Analysis

Figure 258. Loans' growth is decelerating, but still at high rates…



Source: Banrep and Citi Investment Research and Analysis

Figure 259. Nonetheless, it seems that the CB is going to make a pause

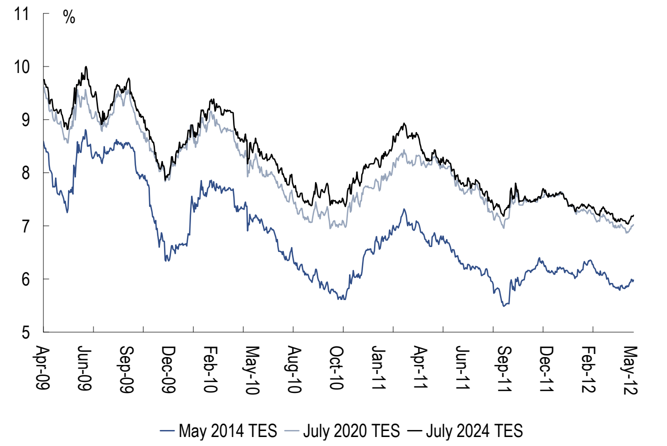


Source: Banrep and Citi Investment Research and Analysis

Figure 260. Additional FX intervention should depend in the COP level

Source: Bloomberg and Citi Investment Research and Analysis

Figure 261. The TES market should be affected by interest rate pauses



Source: Bloomberg and Citi Investment Research and Analysis

Figure 262. Colombia Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	118	147	163	208	243	233	287	328	363	393
Nominal GDP, local currency bn	308	340	384	431	481	509	548	608	655	713
GDP per capita, USD	2778	3420	3744	4726	5458	5176	6300	7133	7809	8335
Population, mn	42.4	42.9	43.4	43.9	44.5	45.0	45.5	46.0	46.5	47.1
Unemployment, % of labour force	15.4	13.9	13.0	11.4	11.6	13.0	12.4	11.5	10.9	10.2
Economic Activity										
Real GDP, % yoy	5.3	4.7	6.7	6.9	3.5	1.7	4.0	5.9	5.0	4.5
Real investment growth % yoy	12.2	12.6	19.2	12.8	9.0	-3.9	7.4	17.2	12.9	4.4
Real consumption growth % yoy	4.3	4.3	6.3	7.0	3.5	1.6	5.1	5.7	4.5	4.6
private consumption growth % yoy	3.9	4.0	6.4	7.3	3.5	0.6	5.0	6.5	5.5	4.7
Real export growth, % yoy	9.8	5.7	8.6	6.9	4.5	-2.8	1.3	11.4	8.8	8.0
Real import growth, % yoy	10.3	11.9	20.0	14.0	10.5	-9.1	10.5	21.5	13.6	7.0
Prices, Money & Credit										
CPI, % yoy	5.5	4.9	4.5	5.7	7.7	2.0	3.2	3.7	3.6	3.4
CPI, % avg	5.9	5.0	4.3	5.5	7.0	4.2	2.3	3.4	3.5	3.8
Nominal wages, % yoy	…	5.3	9.2	5.4	19.1	3.0	4.1	5.2	6.3	7.4
Credit extension to private sector, % yoy	10.6	15.5	43.0	28.8	17.7	2.3	16.8	22.4	18.5	17.0
Policy interest rate, %, eop	6.50	6.00	7.50	9.50	9.50	3.50	3.00	4.75	5.25	5.75
1 month inter-bank rate, %, eop	6.59	5.92	7.50	9.35	8.87	3.10	3.00	4.81	5.32	5.82
Long-term yield, %, eop	…	9.07	9.00	10.27	12.76	8.47	7.70	7.60	7.22	7.72
COP/USD, eop	2390	2284	2239	2015	2234	2046	1990	1943	1813	1835
COP/USD, avg	2615	2319	2362	2076	1981	2183	1911	1854	1803	1816
Balance of Payments, USD bn										
Current account	-0.9	-1.9	-3.0	-6.0	-6.8	-5.0	-8.8	-10.0	-11.2	-11.4
% of GDP	-0.8	-1.3	-1.8	-2.9	-2.8	-2.1	-3.1	-3.0	-3.1	-2.9
Trade balance	1.3	1.6	0.3	-0.6	1.0	2.5	2.2	5.5	4.5	7.0
Exports	17.2	21.7	25.2	30.6	38.5	34.0	40.9	57.7	66.1	75.3
Imports	15.9	20.1	24.9	31.2	37.6	31.5	38.6	52.2	61.6	68.3
Service balance	-1.7	-2.1	-2.1	-2.6	-3.1	-2.8	-3.6	-4.6	-3.5	-3.8
Income balance	-4.3	-5.5	-5.9	-8.0	-10.2	-9.3	-11.9	-15.8	-17.0	-19.6
FDI, net	3.0	10.3	6.7	9.0	10.6	7.1	6.9	13.2	14.2	13.7
International reserves	13.5	14.9	15.4	20.9	24.0	25.4	28.5	32.3	44.1	48.9
Total amortisations	5.6	8.4	8.0	5.7	5.1	5.8	6.5	6.3	7.6	6.8
Public Finances, % of GDP										
Consolidated government balance	-1.0	0.0	0.7	-0.6	-0.1	-2.7	-3.2	-2.9	-3.0	-2.5
Consolidated gov primary balance	…	…	…	…	…	…	…	…	…	…
Public debt	38.9	39.1	37.5	32.9	33.9	36.4	37.0	34.8	36.0	34.7
of which Domestic	21.6	25.1	23.8	21.9	22.6	24.7	26.2	24.3	23.6	22.7
Foreign Assets & Liabilities, USD bn										
External debt	39.5	38.5	40.1	44.6	46.4	53.7	64.1	75.9	73.8	78.3
Private	13.7	14.3	13.8	15.6	16.5	16.3	25.0	32.8	31.0	32.4
Public	25.9	24.2	26.3	28.5	28.8	36.4	38.6	42.4	45.3	46.9
External debt / GDP	33.6	26.3	24.6	21.2	18.7	22.6	22.2	22.9	21.0	20.2
External debt / XGS	202.7	157.8	140.4	130.2	108.7	140.5	141.4	121.1	104.7	97.9
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	5.1	7.5	6.1	5.0	5.4	4.9	4.7	4.2	4.3	4.6
CPI, % yoy	3.2	3.7	3.7	3.4	3.3	3.4	3.6	3.9	4.0	3.7
Policy interest rate, %, eop	4.25	4.50	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.75
1 month inter-bank rate, %, eop	4.19	4.56	4.81	5.25	5.32	5.32	5.32	5.32	5.32	5.82
Long-term yield, %, eop	7.75	7.59	7.60	7.27	7.22	7.22	7.22	7.22	7.22	7.72
COP/USD	1780	1915	1943	1792	1810	1814	1813	1811	1815	1825

Source: National Sources and Citi Investment Research and Analysis

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Mexico

- **Summary view** — In 1Q12 economic data were better than expected, and we think the economy has maintained a good momentum in 2Q12. Thus, we have revised up our GDP growth forecasts for 2012 and 2013 to 3.9% and 3.8%, respectively. We now see Banxico staying on hold at 4.5% until year-end 2013.
- **Things to watch** — The evolution of economic performance in Europe and the United States in coming months should prove crucial for the prospects of economic activity and the USD/MXN during the rest of this year. On the political front, we should see how the polls report movements in electoral preferences, especially after the second of the two mandatory presidential debates to be held on June 10.
- **Strategy** — Local asset performance in the short term is likely to be driven by FX volatility. In the three-month horizon, we now see the USD/MXN significantly higher, at 14.1 vs. our 13.2 forecast a month ago, essentially a reflection of the high-beta of the peso to global risk aversion. In the mid-term, strong fundamentals are likely to prevail and for the end of this year we see the USD/MXN at 13.7 from 12.8 a month ago.

We upgrade our 2012 GDP growth forecast to 3.9%

GDP growth of 4.6% y/y in the first quarter confirms that activity had a good start in 2012. This figure constituted a positive surprise, as we were anticipating annual GDP growth of 4.1% in the first quarter and more importantly still, implies a significant rebound vs. the 3.9% annual GDP growth rate posted in 4Q11. While this result was influenced by a leap-year effect, we think that more fundamental forces were also at play. On the external front, manufacturing exports have been responding to a good performance in the US manufacturing output, including market gains stemming from enhanced competitiveness. In 1Q12, the share of Mexico in total US imports of manufacturing goods reached a record-high of 12.7%, while shipments to non-US destinations rose 19% y/y. Accordingly, while we still predict a deceleration in exports in dollars terms, the resulting average growth rate for 2012 at 9.1% will remain reasonable. In regard to the domestic market, we now see slightly stronger formal job creation at 4.4% on average for 2012 versus 3.9% previously, which in conjunction with bank lending still growing at double-digit rates (10.8% y/y in real terms in March), are behind the recovery of domestic demand.

A milder deceleration in exports, along with a stronger momentum in domestic demand, led us to revise our GDP growth forecast for this year to 3.9% from 3.5% before. For 2013, we also adjusted our GDP growth forecast to 3.8% from 3.6% before. These figures essentially depict an economy keeping a steady growth rate in spite of major global shocks and more importantly still, an improved performance in comparison with the recent past, as between 2000 and 2010 economic growth in Mexico averaged a modest 2.0%. We believe that these rates of growth are sustainable, as neither the external sector nor domestic variables show signs of an economy facing productive capacity restrictions in the near future: (1) we expect this year's current account deficit to average a modest 1.4% of GDP; (2) investment ratios have remained healthy, with our estimate of gross fixed investment to GDP for 2012 (7.1%) above of the 4.0% average for the past 10 years; (3) growth rates of wages are steady, at 4.4% in nominal terms for workers registered in social security.

So long rate cuts, although easing bias remains

Inflation is set to post a temporary rise in coming months, but good results so far this year imply limited inflation risks. Non-core components allowed annual headline inflation to reach its 2012 trough in April at 3.4%, a month later than what we had expected. Thus, annual inflation will probably peak at 4.1% in 3Q12 before falling to about 3.7% by year-end, which we revised from 3.6% a month ago. We see limited risks to this new forecast, but the recent peso depreciation will probably pose a new test on the extent to which pass-through effects have dwindled (our year-end forecast for the USD/MXN increased to 13.7 versus the previous 12.8, although our 3m expectation has risen more substantially, to 14.1 from 13.2 before).

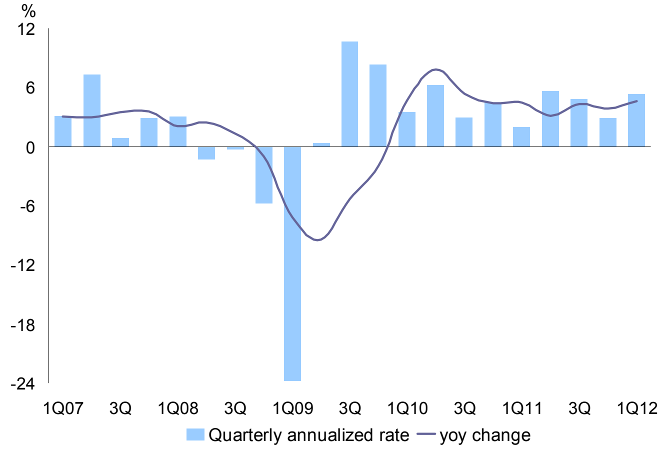
Contrary to our expectation, Banxico's board opted for keeping the overnight rate unchanged at 4.5% in its April 27 meeting. We had based our call of a 50bp cut on our reading of the minutes from Banxico´s March 16 meeting, where a majority within the board had expressed an easing bias, as well as on the market reaction to that possibility. In the end, policymakers considered that the instability of financial markets "made waiting advisable" and with uncertainty increasing since the date of that meeting, we think policymakers´ default option is to remain on hold for longer. We now expect the policy rate to remain at 4.5% until the end of 2013.

However, during that long pause, we see changes in the "policy bias": the current one, which is definitely in the direction of easing, will probably prevail until early 2013. Even though Banxico board remained on hold, the minutes from the April 27 meeting show that the discussion within the board essentially revolves around potential rate cuts. We now believe minutes are only one of several factors to take into account at projecting policy cycles but acknowledge that they are useful at portraying intentionality as well as the kind of conditions which could allow those intentions to come into action. From this point of view, there is no denial that the current "bias" within the board is in the direction of easing. What kind of factors could bring that possibility back on the table? In addition to balances of inflation and activity risks remaining in good shape, our reading of the minutes suggests policymakers would also attach importance to global financial conditions – whose main gauge for policy purposes is the FX market – as well as the monetary stance of Mexico relative to other countries, where potential events such as QE3 figure prominently.

Politics is proving less volatile than markets

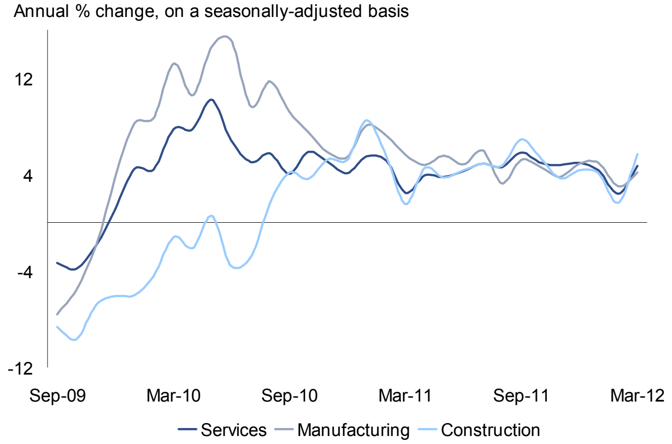
Polls on the July 1 presidential election have been remarkably stable, with Enrique Peña Nieto (EPN) from the PRI enjoying a solid lead. Our tracking of the main pollsters shows EPN with between 44.9% and 49.6% of voter's preferences vs. between 23.1 and 28.0% for Josefina Vazquez Mota from the incumbent PAN and between 22.0% and 26.0% for Andres Manuel López Obrador, from the left-wing PRD. The first of the two mandatory presidential debates on May 6 did not alter preferences substantially and the possibility of major swings in the next few weeks left of campaign is dwindling, particularly with the strict and rigid format of campaigns stemming from the 2009 reform of the electoral law. If this is indeed the case, attention will probably shift to the elections for the federal congress on the same day, as EPN's current lead in the presidential race has led political analysts to ponder the possibility of the PRI achieving legislative majority in both congressional chambers, a situation not seen since 1997.

Figure 263. GDP growth accelerated during 1Q12



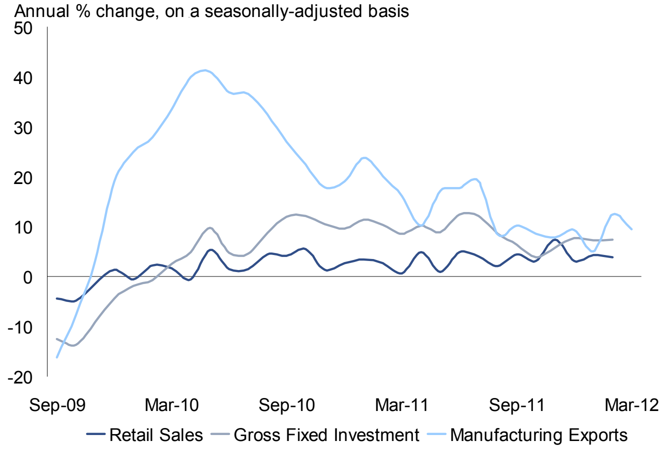
Source: INEGI and Banamex

Figure 264. Across the board the main sectors rebound



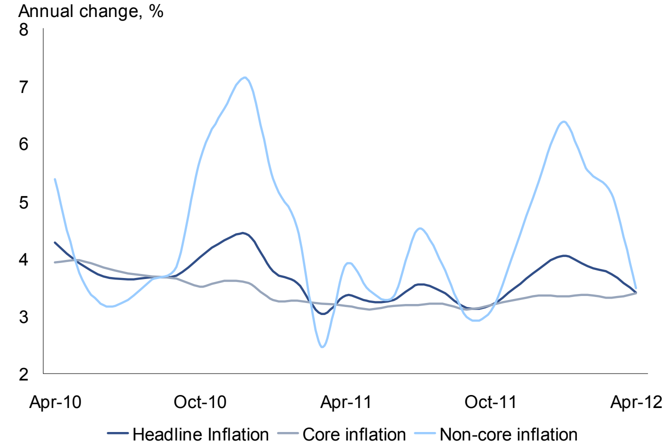
Source: INEGI and Banamex

Figure 265. Investment boost local demand, while exports are slowed



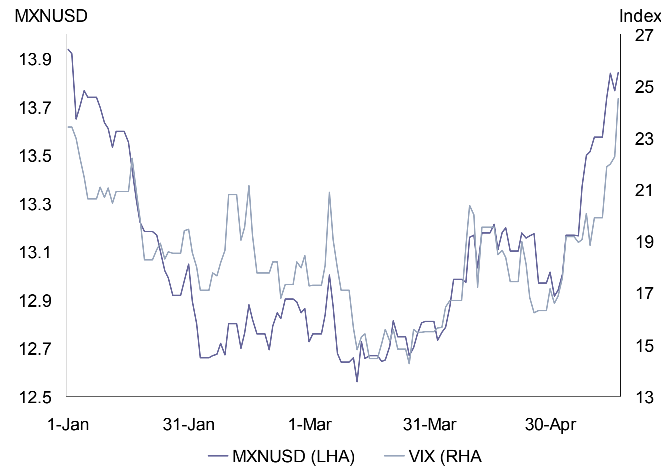
Source: INEGI and Banamex

Figure 266. Inflation continued down, but has probably bottomed



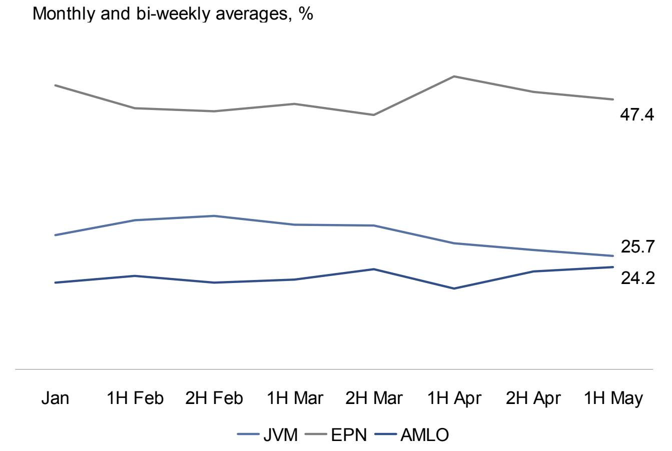
Source: INEGI and Banamex

Figure 267. MXN underperforms on the back of risk aversion rebound



Source: Bloomberg and Banamex

Figure 268. The PRI enjoying a solid lead



Sources: Banamex on polls released by Consulta, Covarrubias, Buendía&Laredo, Reforma, Milenio/GEA-ISA, El Universal, Excelsior/BGC, Ipsos, Parametría, Con Estadística and Votia

Figure 269. Mexico Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	759.6	850.1	951.8	1036.3	1102.7	885.1	1036.9	1155.5	1144.4	1284.3
Nominal GDP, local currency bn	8574.8	9251.7	10379.1	11320.8	12181.3	11923.7	13089.3	14352.9	15608.6	16850.6
GDP per capita, USD	7322.1	8078.9	8922.2	9585.2	10067.1	7978.8	9231.2	10163.2	9946.8	11034.0
Population, mn	103.7	105.2	106.7	108.1	109.5	110.9	112.3	113.7	115.1	116.4
Unemployment, % of labour force	3.9	3.6	3.6	3.7	4.0	5.5	5.4	5.3	5.2	5.3
Economic Activity										
Real GDP, % yoy	4.1	3.2	5.2	3.3	1.2	-6.0	5.5	3.9	3.9	3.8
Real investment growth % yoy	2.6	1.2	7.9	3.3	2.6	-15.6	7.8	4.0	8.8	5.9
Real consumption growth % yoy	4.4	4.5	5.1	3.9	1.6	-5.9	4.8	4.0	3.9	3.6
private consumption growth % yoy	5.6	4.8	5.7	4.0	1.7	-7.3	5.3	4.6	4.2	4.0
Real export growth, % yoy	11.5	6.8	10.9	5.7	0.5	-13.5	21.7	6.7	4.4	6.2
Real import growth, % yoy	10.7	8.5	12.6	7.1	2.6	-18.4	20.5	6.8	7.3	7.0
Prices, Money & Credit										
CPI, % yoy	5.2	3.3	4.1	3.8	6.5	3.6	4.4	3.8	3.7	3.9
CPI, % avg	4.7	4.0	3.6	4.0	5.1	5.3	4.2	3.4	3.9	3.9
Nominal wages, % yoy	6.1	5.8	5.1	5.4	5.3	4.2	3.3	4.5	5.0	4.5
Credit extension to private sector, % yoy	2.6	8.3	11.4	12.0	9.6	0.5	5.6	7.5	7.4	7.1
Policy interest rate, %, eop	8.50	8.22	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.50
1 month inter-bank rate, %, eop	8.50	8.22	7.05	7.50	8.25	4.50	4.50	4.50	4.50	4.50
Long-term yield, %, eop	9.82	8.30	7.46	8.03	8.35	7.99	6.95	6.51	6.48	6.93
MXN/USD, eop	11.15	10.63	10.80	10.90	13.67	13.09	12.34	13.94	13.70	12.60
MXN/USD, avg	11.31	10.85	10.91	10.93	11.21	13.60	12.67	12.48	13.60	13.14
Balance of Payments, USD bn										
Current account	-5.2	-5.9	-4.5	-9.3	-15.7	-5.1	-3.1	-8.7	-15.6	-26.2
% of GDP	-0.7	-0.7	-0.5	-0.9	-1.4	-0.6	-0.3	-0.8	-1.4	-2.0
Trade balance	-8.8	-7.6	-6.1	-10.1	-17.3	-4.7	-3.0	-1.2	-3.6	-10.4
Exports	188.0	214.2	249.9	271.9	291.3	229.7	298.5	349.7	381.3	415.3
Imports	196.8	221.8	256.1	281.9	308.6	234.4	301.5	350.8	384.9	425.7
Service balance	-4.7	-4.7	-5.7	-6.3	-7.4	-8.4	-9.7	-14.3	-18.2	-23.2
Income balance	-10.5	-15.7	-18.6	-19.3	-16.5	-13.6	-11.9	-16.1	-17.6	-18.0
FDI, net	24.8	24.4	20.0	31.3	26.9	16.0	20.2	19.4	20.3	20.4
International reserves	61.5	68.7	67.7	78.0	85.4	90.8	113.6	142.5	163.4	180.3
Total amortisations	36.8	35.5	22.8	26.2	30.1	27.7	32.4	51.5	50.2	52.7
Public Finances, % of GDP										
Consolidated government balance	-0.2	-0.1	0.2	0.0	-0.1	-2.3	-2.7	-2.5	-2.2	-2.0
Consolidated gov primary balance	1.8	2.4	2.6	2.2	1.8	-0.1	-0.9	-0.5	-0.1	0.0
Public debt	38.8	38.3	33.7	33.7	36.5	40.3	38.8	39.6	39.5	38.2
of which Domestic	24.4	25.0	22.8	22.0	24.7	26.6	23.9	23.8	22.8	22.6
Foreign Assets & Liabilities, USD bn										
External debt	166.2	173.1	171.4	196.4	204.8	194.2	246.6	281.1	290.1	299.4
Private	56.5	60.2	67.2	75.4	75.4	73.3	91.5	98.1	98.5	86.3
Public	109.7	112.9	104.2	121.0	129.3	120.9	155.1	183.0	191.6	201.0
External debt / GDP	21.9	20.4	18.0	18.9	18.6	21.9	23.8	24.3	24.5	22.4
External debt / XGS	82.3	75.1	64.4	67.8	66.3	79.3	78.5	77.0	73.1	69.5
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	3.1	4.3	3.9	4.6	4.5	3.3	3.3	2.7	4.1	4.0
CPI, % yoy	3.3	3.1	3.8	3.7	4.1	4.2	3.7	3.9	3.9	4.3
Policy interest rate, %, eop	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.75	5.00	5.00
1 month inter-bank rate, %, eop	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.75	5.00	5.00
Long-term yield, %, eop	6.94	6.61	6.51	6.24	6.20	6.35	6.48	6.62	6.75	6.84
MXN/USD	11.72	13.91	13.94	12.81	14.00	14.00	13.70	13.50	13.20	12.90

Source: National Sources and Citi Investment Research and Analysis

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Panama

- **Summary view** — Confrontation between President Martinelli and Vice President Varela continues to heat up. In the meantime, the ACP is proposing to raise tolls in the Panama Canal and the cabinet approved launching a sovereign wealth fund.

- **Things to watch** — Once again, the main thing to watch is politics. This confrontation could work in favor of Mr. Varela, as he is the strongest name ahead of the 2014 elections. In the case of Mr. Martinelli, we expect this confrontation to pull down his popularity further.

- **Strategy —** We have mixed feelings on Panama. Positive news like the FAP or the raise in tolls arrive at a time in which the political crisis is deepening in the country. .

Politics heat up

Confrontation between President Martinelli and Vice President Varela continues to heat up.[6] President Ricardo Martinelli not only urged Juan Carlos Varela to resign his post as Vice President, but also filed a civil suit against him. Mr. Martinelli argues false corruption accusations. It is worth remembering that President Martinelli's name has been associated to a bribery scheme by an Italian businessman arrested in Rome last month. Mr. Varela suggested that Mr. Martinelli is indeed involved in this bribery scheme.

This confrontation could work in favor of Mr. Varela, as he is the strongest name ahead of the 2014 elections. According to the May poll by Dichter & Neira, Mr. Varela would garner the largest percentage of votes if elections were held today (see graph). It is worth remembering that Ricardo Martinelli became president as a result of an alliance between his own Cambio Democrático (CD) and Mr. Varela's Partido Panameñista (PPA). The original gentlemen's agreement was that Mr. Varela would succeed Mr. Martinelli, as incumbent presidents are prohibited from running for office. Last year, the ruling coalition broke up and therefore Mr. Varela has now become Mr. Martinelli's most important political rival.

In the case of Mr. Martinelli, we expect this confrontation to pull down his popularity further. In a previous comment we said that Mr. Martinelli's popularity would experience a substantial damage as a result of the bribery scandal (see Caribbean and Central America Macro and Strategy Outlook - Politics Are Never Boring, April 20, 2012). According to Dichter & Neira, Mr. Martinelli's approval rate fell to 37% in May from 47% In April. We would not be surprised if after all these political events it goes to the low 30's again. We think that the fall in Mr. Martinelli's popularity has the potential to bury his aspirations to get reelection. Although the constitution prohibits incumbent president from seeking immediate reelection, we have never discarded an eleventh hour change to the constitution that could enable him to run again for office. We now think that the probability of undertaking constitutional changes is substantially lower.

[6] Local newspapers La Prensa and La Estrella de Panama have been covering extensively this confrontation Turing the past few days.

ACP to raise tolls

The Panama Canal Authority (ACP) proposed an increase tolls. On April 20, the ACP announced that its Board of Directors approved a proposal to modify the tolls structure. The changes would increase the number of market segments to eleven from eight currently. The ACP is proposing an increase in tolls in most of the market segments. The ACP will undertake a consultation process and expects the new tolls to become effective on July 1, 2012. There would be another increase on July 1, 2013.

The increase in tolls would lend a hand to the ACP at a time in which traffic is decreasing. According to our own estimations, the average increase would be of 6.5% in both years. In our view, traffic is more related to global growth and therefore tolls would not affect significantly traffic in the waterway. Before the announcement we were not expecting an increase in tolls. According to the Panama Canal Authority (ACP), traffic in the waterway declined 7.6% year over year in April. During February and March, traffic also fell.

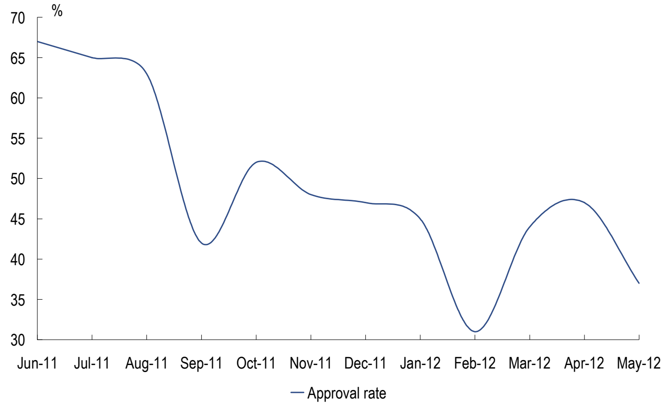
Sovereign wealth fund

The government announced that the cabinet (ministers) approved the creation of a sovereign wealth fund to be named Fondo de Ahorro de Panamá (FAP). The National Assembly (Congress) has the final vote on this proposal. To launch the fund, the FAP will take in the assets from the Fondo Fiduciario para el Desarrollo (about US$1.2 billion). Later on, the excess revenues from the expanded Panama Canal would come into the fund. The government could use the money from the fund in case of national emergency, and only if the costs associated with it are 0.5% of GDP or higher. The government could also use the money in case real GDP growth falls below 2% during three consecutive quarters. The fund will also be used to repurchase sovereign debt, but only after the FAP reaches 5% of GDP. Repurchases could amount to no more than 0.5% of GDP each year. Transfers from the Panama Canal to the Fund would begin on 2015 with approximately US$1.1 billion. The government expects those transfers to reach US$4 billion by 2025. It is worth mentioning that the proposal rules that the sovereign wealth fund's assets cannot fall below 2% of GDP. The creation of a sovereign wealth fund had been widely expected, but its rules were unknown until now.

Investment Implications

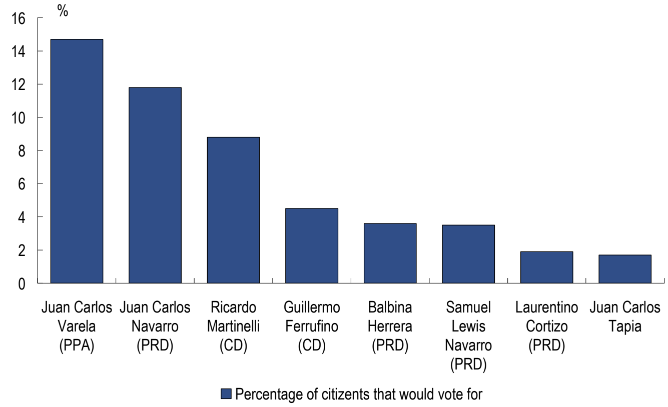
We have mixed feelings on Panama. A deepening of the political crisis in Panama could prevent rating agencies from upgrading further the country. Moreover, it could translate into a gridlock in the remaining of the current administration. On the other hand, we think that the FAP is positive for the country's assets. Besides the macroeconomic benefits of having such a wealth fund, we would expect the potential repurchases of bonds to work in favor of asset prices.

Figure 270. Mr. Martinelli's popularity falls again



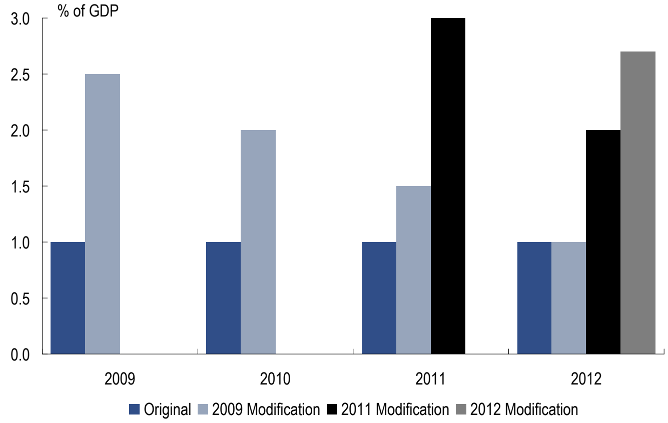
Source: Dichter & Neira and Citi Investment Research and Analysis

Figure 271. Vice president Varela is ahead in polls



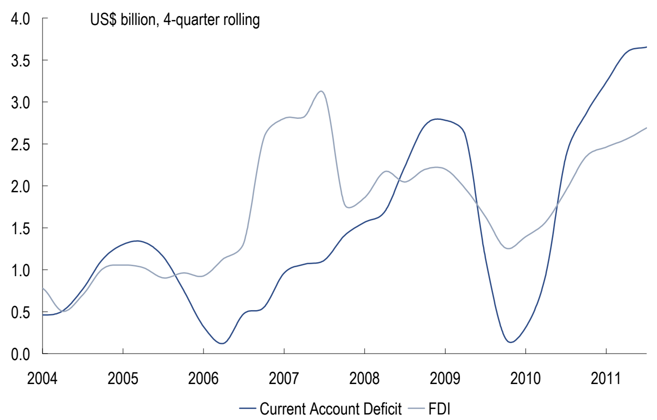
Source: Dichter & Neira and Citi Investment Research and Analysis

Figure 272. The ceiling for the 2012 BFPS deficit is now 2.7% of GDP



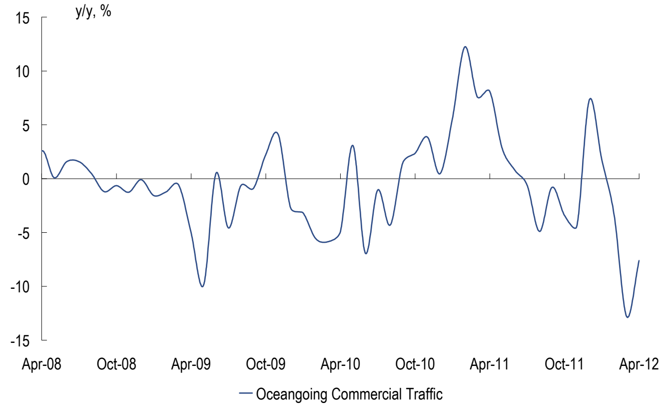
Source: MEF and Citi Investment Research and Analysis

Figure 273. FDI finances bout 70% of the current account deficit



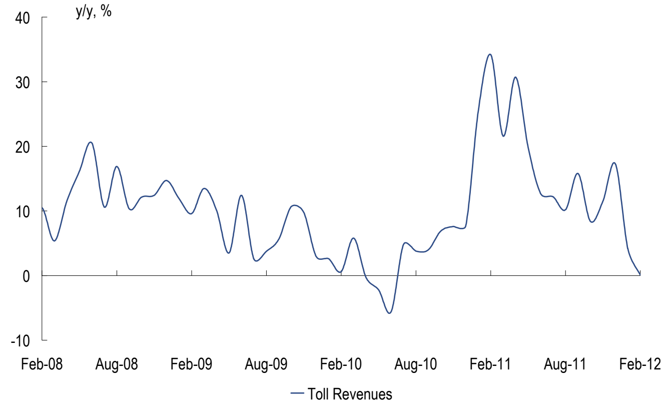
Source: Contraloria, Bloomberg and Citi Investment Research and Analysis

Figure 274. Traffic in the Panama Canal continues to fall



Source: ACP, Contraloria and Citi Investment Research and Analysis

Figure 275. Last year's toll hikes offset falls in traffic



Source: ACP, Contraloria, and Citi Investment Research and Analysis

Figure 276. Panama Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	14.2	15.5	17.1	19.8	23.0	24.2	26.6	30.7	34.7	38.3
Nominal GDP, local currency bn	14.2	15.5	17.1	19.8	23.1	24.2	26.6	30.7	34.7	38.3
GDP per capita, USD	4470.1	4796.5	5218.3	5920.9	6759.2	6973.4	7538.9	8545.1	9483.0	10471.6
Population, mn	3.2	3.2	3.3	3.3	3.4	3.5	3.5	3.6	3.7	3.7
Unemployment, % of labour force	12.4	10.3	9.1	6.8	5.8	6.9	5.5	4.3	3.7	3.7
Economic Activity										
Real GDP, % yoy	7.5	7.2	8.7	12.1	10.1	3.9	7.6	10.6	7.0	7.0
Real investment growth % yoy	9.9	2.8	13.5	33.2	22.0	3.0	8.0	11.0	8.0	8.0
Real consumption growth % yoy	3.9	7.9	4.1	9.7	5.9	-1.5	6.0	8.6	5.7	6.0
private consumption growth % yoy	4.3	8.8	4.4	10.4	5.9	-2.0	6.0	8.8	5.5	6.0
Real export growth, % yoy	18.6	11.3	11.1	15.0	4.4	-3.0	5.1	5.0	5.1	5.1
Real import growth, % yoy	14.4	11.2	7.4	19.3	6.6	-4.0	5.5	8.0	7.0	5.5
Prices, Money & Credit										
CPI, % yoy	1.2	3.4	2.2	6.4	6.8	1.9	4.9	6.3	5.4	5.5
CPI, % avg	0.2	2.8	2.5	4.2	8.8	2.4	3.5	5.9	5.6	3.2
Nominal wages, % yoy	...	...	...	...	...	...	...	...	...	...
Credit extension to private sector, % yoy	...	...	...	...	...	...	...	...	...	...
Policy interest rate, %, eop	...	...	...	...	...	...	...	...	...	...
1 month inter-bank rate, %, eop	...	...	...	...	...	...	...	...	...	...
Long-term yield, %, eop	7.99	7.22	6.39	6.30	7.43	6.23	5.10	5.00	5.50	4.40
lc/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
lc/USD, avg	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Balance of Payments, USD bn										
Current account	-1.1	-0.8	-0.4	-1.4	-2.7	-0.2	-2.9	-3.9	-4.1	-3.9
% of GDP	-7.5	-5.2	-2.2	-7.2	-11.8	-0.7	-10.8	-12.7	-11.8	-10.2
Trade balance	-1.5	-1.3	-1.8	-3.2	-4.5	-2.2	-4.6	-6.0	-6.0	-6.0
Exports	6.1	7.6	8.5	9.3	10.3	12.0	12.7	16.9	18.0	19.0
Imports	7.6	8.9	10.3	12.5	14.9	14.2	17.2	22.9	24.0	25.0
Service balance	1.3	1.4	2.2	2.8	3.2	3.3	3.4	3.8	3.7	3.9
Income balance	-1.0	-1.1	-1.3	-1.3	-1.6	-1.4	-1.9	-1.8	-1.9	-2.0
FDI, net	1.0	0.9	2.5	1.8	2.2	1.3	2.4	2.8	2.8	2.8
International reserves	0.6	1.2	1.3	1.9	1.7	1.4	1.1	1.2	1.3	1.3
Total amortisations	...	...	...	...	...	...	...	...	...	...
Public Finances, % of GDP										
Consolidated government balance	-4.9	-3.2	0.5	3.5	0.4	-1.0	-1.9	-2.3	-2.7	-1.5
Consolidated gov primary balance	-0.6	1.3	4.9	6.9	3.5	1.9	0.8	0.1	-0.3	1.2
Public debt	70.4	66.2	61.0	52.9	45.4	45.6	43.4	43.5	42.5	41.0
of which Domestic	19.4	17.1	15.5	11.1	8.5	3.4	4.4	5.0	5.0	5.0
Foreign Assets & Liabilities, USD bn										
External debt	...	...	...	...	...	...	...	...	...	...
Private	...	...	...	...	...	...	...	...	...	...
Public	7.2	7.6	7.8	8.3	8.5	10.2	10.4	11.8	13.0	13.8
External debt / GDP	...	...	...	...	...	...	...	...	...	...
External debt / XGS	81.4	70.1	62.6	58.0	52.6	58.0	55.3	49.0	51.0	51.4
Short-term debt	...	...	...	...	...	...	...	...	...	...
Short-term debt/International reserves (%)	...	...	...	...	...	...	...	...	...	...

Quarterly Economic Indicators	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	11.4	9.5	9.3	8.5	7.5	7.2	6.6	6.5	7.0	7.5
CPI, % yoy	6.5	6.0	6.3	5.6	5.5	5.6	5.4	5.0	5.0	5.0
Policy interest rate, %, eop	-	-	-	-	-	-	-	-	-	-
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	4.90	4.90	5.00	5.10	5.30	5.50	5.50	5.25	5.25	5.25
PAB/USD	-	-	-	-	-	-	-	-	-	-

Source: National Sources and Citi Investment Research and Analysis

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Peru

- **Summary view** —We have raised our 2012 GDP growth forecast to 5.7% from 5.5% before, after incorporating available information for 1Q12. However, we do not see the economy growing excessively above potential this year. As such, we maintain our 2.8% year-end inflation forecast.
- **Things to watch** — The central bank made a preventive adjustment to reserve requirements due to the acceleration in the de-dollarization of deposits. The central bank will continue monitoring this situation closely.
- **Strategy** — In periods of increased risk aversion, liquidity in Soberanos will likely remain poor, especially now that foreigners own over half of the market.

Inflation remains sticky and growth still close to neutral

Supply shocks keep inflation stubbornly above the central bank's target. In April, inflation came in at 0.53% m/m taking the annual headline figure to 4.1%, above the BCRP's 2% ± 1% target. However, we believe the usual suspects are still the ones behind stubbornly high inflation. For one, food price inflation (representing 37.8% of the CPI) stood at 0.9% thanks to strong pressure on perishable fruits and vegetables. Transportation prices were the other big driver behind April's print, reflecting recent increases in fuel prices. We expect annual inflation to remain close to 4% in May and June due to the low statistical base registered in 2011, but inflation should start to cool afterward as the effect from food price shocks fades away. Overall, we still expect CPI inflation to end 2012 at 2.8% as we see no major output gap imbalances this year.

We have raised our GDP forecast for 2012 to 5.7% from 5.5% before after incorporating information for 1Q12. The INEI published GDP figures for March, which showed that the economy grew by a below consensus 5.6% y/y, despite the fact that construction activity continues growing at double digit rates. Manufacturing was the main culprit, likely reflecting the poor outlook for global growth. As a result, GDP growth stood at 6% y/y in 1Q12. In the months to come, we expect fiscal stimulus to continue countering the effects from an uncertain global outlook and as such, we do not see the output gap entering positive territory.

Reserve requirements are the answer

The central bank made a preventive adjustment to reserve requirements. On April 30, the BCRP announced the first change to reserve requirements since March of 2011. The measure included: 1) raising legal reserve requirements by 50bp; 2) raising marginal requirements in local currency to 30% from 25%; 3) extending the 60% reserve requirement on short-term foreign borrowing to loans with maturities below 3 years (previously it applied to loans with maturities below 2 years) and 4) instituting a 20% reserve requirement on long-term liabilities (excluding mortgage bonds) 2.5 times greater than companies' net capital. According to the BCRP accompanying statement, the measure is intended to control the additional liquidity in PEN resulting from deposit de-dollarization and put a brake on the private sector's rising foreign borrowing. As such, this was a preventive move in nature considering the additional difficulties for monetary management in a dollarized environment.

We do not expect the BCRP to raise interest rates in 2012, but do not rule out additional moves in reserve requirements. For starters, the central bank currently sees the economy growing in line with potential output, while stubbornly high inflation has been mainly the result of shocks to food and fuel prices. Therefore we do not see the central bank in a rush to raise rates from levels that are already considered as neutral by the board. In addition, we believe that raising rates in a context of faster de-dollarization of deposits and stronger foreign borrowing could only make matters worse, as it creates additional incentives to shift deposits to local currency while taking on USD denominated debt, exacerbating the currency mismatches in the private sector's balance sheet. For more information, please see our Peru Macro View - Reserve Requirements Are the Answer.

Despite political turbulence, pilot holds on to control

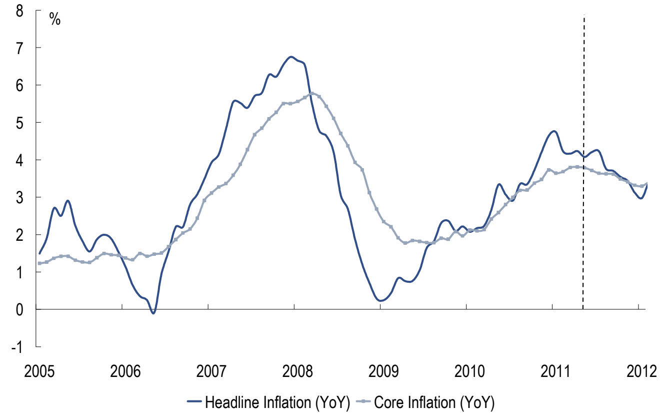
Unsurprisingly, the Humala administration gave the Minas Conga project the green light, although with some modifications. Shortly after the international consultant commission delivered its findings on the project's environmental impact review, President Ollanta Humala delivered a speech in which he supported the project and mining investment. However, he also said that some modifications to the original contract would have to be undertaken. The government will now require the observance of stricter environmental standards, the establishment of a new social development fund and the creation of at least 10,000 jobs in the region of Cajamarca. So far, mining company Yanacocha is still evaluating the new conditions before going ahead. Whether this will affect the outlook for mining investment in Peru, it is still too early to tell.

The cabinet of Prime Minister Valdés has faced substantial pressure in the last couple of weeks. Opposition congressmen called for a non-confidence vote against Defense Minister Alberto Otálora and Interior Minister Daniel Lozada after a failed military operation led to the death of eight police and army members. In a sign of support for Mr. Otálora and Mr. Lozada, Prime Minister Valdés offered his resignation. However, the situation was defused when both Ministers announced their irrevocable decision to step down. In addition, recent media reports suggest that eight congressmen from Gana Perú (President Humala's party) are defecting from the ruling in sign of protest. This should only formalize what has been observed since Mr. Humala took over the presidency, namely that some of the government's original left leaning supporters feel alienated by the Humala administration's moderate stance. We see little implication for economic policy, and if anything this suggests the government will maintain the moderate approach.

In times of turmoil, expect poor liquidity in Soberanos

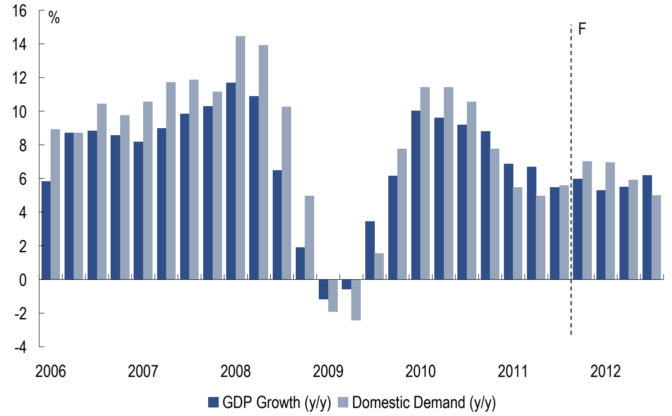
After several months of rallying rates, concerns over the international situation have started to surface. Ever since Ollanta Humala came to the presidency and signaled that he would maintain support for orthodox monetary management, Peruvian assets (bonds, stock and currency) have staged an impressive rally. Foreigners poured heavily into the local sovereign bond market, taking their ownership share above 50% by March 2012, attracted by solid macro fundamentals, a strengthening currency with low volatility and positive carry. With foreigners playing an ever larger part of the Soberano market, liquidity should be very poor, as those who try to get rid of bonds find little demand from locals. This situation could also put pressure on the exchange rate as offshore players try to hedge their exposure to illiquid Peruvian assets. On this front, it is worth highlighting that the central bank holds an impressive war chest of international reserves (US$57 billion) and is willing to use it in case of negative shocks, as it has mentioned in previous episodes of risk aversion.

Figure 277. We expect inflation slowdown to accelerate in 2H12



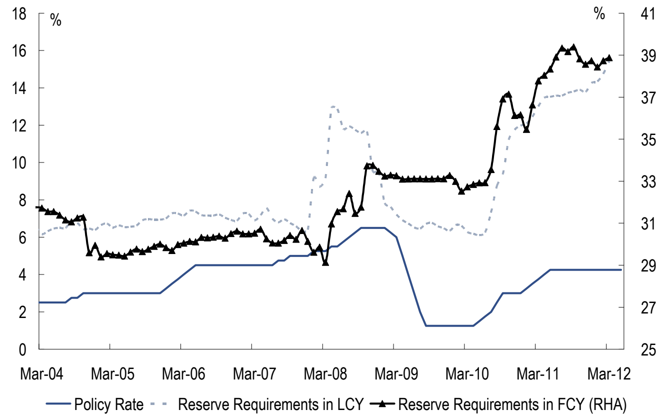
Source: INEI and Citi Investment Research and Analysis

Figure 278. …and GDP growth to remain in neutral terrain at 5.7%



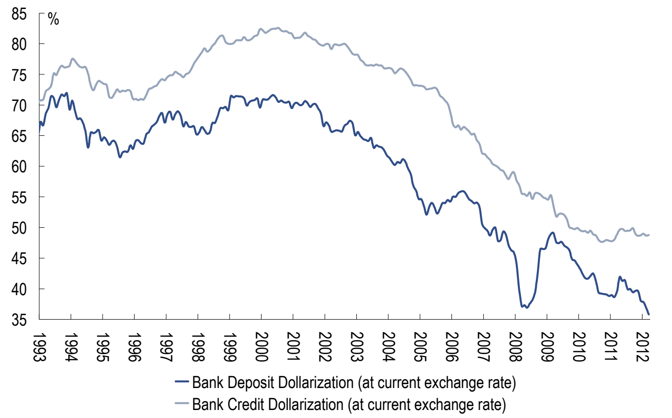
Source: BCRP and Citi Investment Research and Analysis

Figure 279. We see rates on hold, but moves in RR are possible …



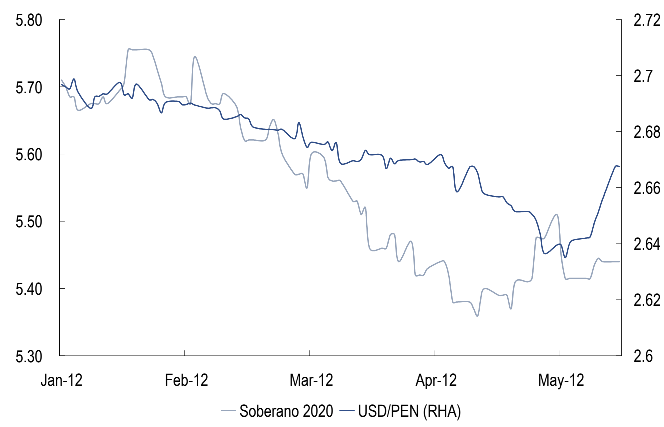
Source: BCRP

Figure 280. … given fast de-dollarization of deposits



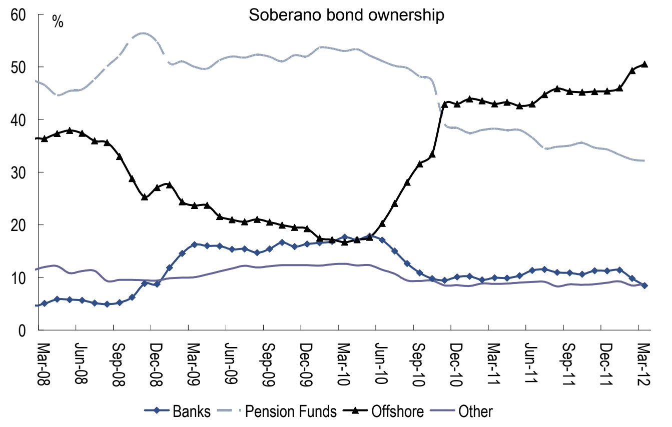
Source: BCRP and Citi Investment Research and Analysis

Figure 281. FX and Soberanos have sold off as of late …



Source: Bloomberg

Figure 282. … which raises the question of what the offshore will do



Source: MEF and Citi Investment Research and Analysis

Figure 283. Peru Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	69.5	79.5	92.1	107.0	127.0	126.7	153.5	176.1	196.7	216.5
Nominal GDP, local currency bn	237.9	261.7	302.3	335.5	371.1	382.3	434.7	486.5	527.2	575.5
GDP per capita, USD	2663.1	2997.1	3415.0	3906.2	4562.5	4482.2	5345.1	6035.4	6634.0	7187.7
Population, mn	26.1	26.5	27.0	27.4	27.8	28.3	28.7	29.2	29.7	30.1
Unemployment, % of labour force	9.4	9.6	8.5	8.4	8.4	8.4	7.9	7.7	7.8	7.8
Economic Activity										
Real GDP, % yoy	5.0	6.8	7.7	8.9	9.8	0.9	8.8	6.9	5.7	6.5
Real investment growth % yoy	4.3	9.2	26.5	25.8	25.8	-20.6	36.9	10.0	6.1	6.8
Real consumption growth % yoy	3.7	5.1	6.6	7.9	8.0	3.9	6.3	6.2	5.3	6.3
private consumption growth % yoy	3.6	4.6	6.4	8.3	8.7	2.4	6.0	6.4	5.3	6.4
Real export growth, % yoy	15.2	15.2	0.8	6.9	8.2	-3.2	1.3	8.8	6.3	7.1
Real import growth, % yoy	9.6	10.9	13.1	21.4	20.1	-18.6	24.0	9.8	5.2	6.6
Prices, Money & Credit										
CPI, % yoy	3.5	1.5	1.1	3.9	6.7	0.2	2.1	4.7	3.0	3.0
CPI, % avg	3.7	1.6	2.0	1.8	5.8	2.9	1.5	3.4	3.8	2.9
Nominal wages, % yoy	…	…	9.2	2.7	14.2	11.5	1.1	15.0	9.0	9.0
Credit extension to private sector, % yoy	8.4	18.7	9.2	23.7	25.5	5.2	22.6	11.8	13.3	13.2
Policy interest rate, %, eop	3.00	3.25	4.50	5.00	6.50	1.25	3.00	4.25	4.25	4.25
1 month inter-bank rate, %, eop	4.69	5.33	5.38	6.29	1.34	3.81	4.15	4.30	4.25	4.25
Long-term yield, %, eop	…	…	…	6.44	7.69	6.31	6.34	6.17	6.20	6.40
PEN/USD, eop	3.30	3.42	3.20	3.00	3.10	2.88	2.81	2.70	2.70	2.65
PEN/USD, avg	3.42	3.30	3.27	3.13	2.96	3.02	2.83	2.75	2.68	2.66
Balance of Payments, USD bn										
Current account	0.0	1.1	2.9	1.5	-5.3	0.2	-2.6	-2.3	-4.7	-6.0
% of GDP	0.0	1.4	3.1	1.4	-4.2	0.2	-1.7	-1.3	-2.4	-2.8
Trade balance	3.0	5.3	9.0	8.5	2.6	6.0	6.8	9.3	6.8	6.8
Exports	12.8	17.4	23.8	28.1	31.0	27.0	35.6	46.3	47.1	50.8
Imports	9.8	12.1	14.8	19.6	28.4	21.0	28.8	37.0	40.3	44.1
Service balance	-0.7	-0.8	-0.7	-1.2	-2.1	-1.1	-2.3	-2.1	-2.5	-2.3
Income balance	-3.7	-5.1	-7.6	-8.4	-8.8	-7.5	-10.1	-12.6	-12.9	-14.6
FDI, net	1.6	2.6	3.5	5.5	6.9	5.6	7.3	7.7	7.3	8.1
International reserves	12.6	14.1	17.3	27.7	31.2	33.1	44.1	48.8	57.3	66.0
Total amortisations	1.3	4.2	1.6	6.8	3.3	2.2	4.1	3.3	3.7	4.4
Public Finances, % of GDP										
Consolidated government balance	-1.2	-0.6	1.7	3.0	2.3	-2.0	-0.6	1.7	1.2	-0.3
Consolidated gov primary balance	0.8	1.3	3.6	4.7	3.8	-0.7	0.6	2.9	2.1	0.6
Public debt	44.4	37.7	33.1	29.8	24.1	27.2	23.5	21.7	17.1	16.0
of which Domestic	9.3	9.7	9.3	11.1	9.0	10.9	9.5	8.8	6.9	6.5
Foreign Assets & Liabilities, USD bn										
External debt	31.2	28.6	28.8	32.0	34.1	35.6	40.5	43.1	48.1	57.4
Private	…	…	…	…	…	…	…	…	…	…
Public	…	…	…	…	…	…	…	…	…	…
External debt / GDP	44.9	36.0	31.3	29.9	26.9	28.1	26.4	24.5	24.4	26.5
External debt / XGS	243.8	164.9	121.0	113.8	109.9	132.1	113.9	93.2	101.9	113.0
Short-term debt	…	22.3	22.0	20.1	19.2	20.6	19.9	20.2	23.1	25.5
Short-term debt/International reserves (%)	…	158.0	127.2	72.5	61.7	62.2	45.1	41.4	40.4	38.7

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	6.9	6.7	5.5	6.0	5.3	5.5	6.2	6.5	6.5	6.3
CPI, % yoy	2.9	3.7	4.7	4.2	4.2	3.5	3.0	2.9	2.4	2.8
Policy interest rate, %, eop	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
1 month inter-bank rate, %, eop	-	-	-	-	-	-	-	-	-	-
Long-term yield, %, eop	6.90	6.45	6.17	5.91	5.90	5.90	6.20	6.40	6.40	6.40
PEN/USD	2.75	2.77	2.70	2.67	2.66	2.70	2.70	2.67	2.65	2.65

Source: National Sources and Citi Investment Research and Analysis

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Venezuela

- **Summary view** — Economic activity continues displaying good results as evidenced by the surprising 5.6% y/y 1Q12 GDP growth print and year to date lower-than-expected inflations prints. In our view, growth prints are supported by heavy fiscal spending which we expect to continue up until 3Q12. Nonetheless, the economy continues to be prone to external shocks given its high dependence on oil revenues. On the other hand, the presidential race and the evolution of Mr. Chávez' health should continue to be the main highlights in the country.

- **Things to watch** — Watch for additional poll results, particularly on the evolution of the undecided electorate which should play an important role for the numbers of both candidates. Also, it is important to keep monitoring any information regarding the health evolution of President Chávez.

- **Strategy** — Political news should continue to be the main driver behind this credit's performance. Nonetheless, with the possibility of a worst-than-expected crisis in Europe along with lower oil prices, bonds with the higher duration should be the ones most affected.

President Chávez about to come out from his labyrinth?

Uncertainty regarding the real health condition of president Chávez continues. As Mr. Chávez's absences from the public arena have intensified recently, there have been some questions regarding his ability to run as a candidate in the October elections. We still believe that at some point before October it will be necessary for Mr. Chávez to announce a political heir, with the most popular name for that post nowadays being that of Foreign Relations Minister Nicolás Maduro. In our view, Mr. Chávez will remain as the most important politician in Venezuela, but in order to guarantee continuity of his policies, at least for the next 6 years, it is more efficient to play the role of backing up a candidate.

Nonetheless, President Chávez continues leading the race for the presidential race according to the polls. The most recent poll made by local political and market research firm Datanálisis, showed that President Chávez has increased his edge (17 percentage points) over opposition candidate Henrique Capriles. In fact, this survey showed that vote intention for Mr. Chávez increased 4 percentage points in May when compared to April's survey. Thus, President Chávez would get 43% of the vote intention while Mr. Capriles would obtain 26% according to the poll. An alternative poll made by Consultores 21 in April showed a technical tie between the two candidates. Nonetheless, the surveys have shown that an important fraction of the electorate continues to be undecided, which could also play a major role in the evolution of the presidential race.

In our view, the fact that president Chávez would support the candidate he chooses is something that has not been incorporated by the polls yet. Although the polls have asked about possible outcomes between different figures close to president Chávez and Mr. Capriles, our view is that once the presence of president Chávez is incorporated, the results would not be as favorable for Mr. Capriles. We expect that due to the treatment for his illness, Mr. Chávez would have to dedicate a good portion of his time to that endeavor, but he still would be able to show support and occasionally appear in campaign events, providing the still to be chosen PSUV candidate with a very strong political ally.

Economic outlook

Although it continues to be a secondary topic these days, economic activity continues to improve. Early indicators of economic activity in 2012 show an economy that has continued improving mostly driven by public sector spending. At the same time, inflation throughout the first quarter of the year has been benign, this despite the *mise en place* of the costs and fair prices law, which puts ceilings on the prices of most goods. This favorable performance on the inflation front led us to reduce our yearend inflation forecast for the national CPI index down to 24.5% from 28% before.

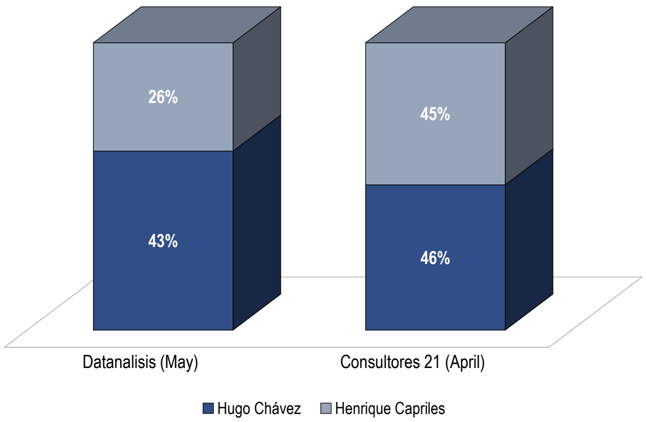
This good economic environment has been reflected in the 1Q12 GDP result, which posted growth of 5.6% year over year. According to announcements made by the Minister of Finance, Jorge Giordani, GDP for 1Q12 expanded 5.6% year over year, a result that beat analysts' expectations at 4.1% and our own in-house forecast. According to the data made public by economic authorities, fiscal spending increased 17% while the construction sector expanded 29.6% year over year. As we have mentioned before, economic activity in Venezuela was set to display good growth prints as a result of fiscal spending. In particular, the government made explicit statements regarding the importance of housing sector investment, which is being conducted through the government program known as *Misión Vivienda Venezuela*. This higher-than-expected result implies that GDP growth could stand at 5% for the year as a whole.

Nonetheless the expansion of GDP could be limited if an external negative shock emerges. It is important to note that Venezuela could be one of the most vulnerable LatAm countries in case an adverse external shock emerges. As shown in the 2008/2009 crises, Venezuelan GDP growth was heavily affected, and it took longer than other LatAm peers to comeback to positive terrain. This situation is the result of the heavy dependence on oil revenue, which given the steady decline in production levels translates into oil prices. If an adverse external scenario in which oil prices dramatically drop materializes, we could see lower oil revenues which would lead to a lower current account surplus, negatively affecting GDP growth, especially next year when the stimulus from the fiscal expansion is expected to fade away. With that in mind, we calculate that the Venezuelan oil basket price that could keep the external accounts balanced next year should be in the US$109-US$117 range.

Investment implications

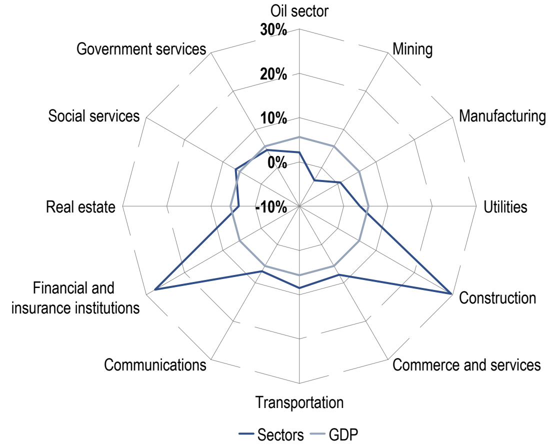
There are two elements that could affect Venezuela credit over the short run: the political race and the evolution of oil prices. In terms of this credit, most of this year's price action associated with Venezuelan debt has had to do with news associated with president Chávez health condition and we believe this should continue to be one of the main factors behind price dynamics going forward. While we think that any development that shows the opposition having a chance of winning this upcoming election should continue creating demand for Venezuelan debt, the evolution of the international outlook, and particularly how it affects oil prices should be an additional factor behind short term price movements of this credit. In that sense, we could see additional falls in Venezuelan bonds prices if the European crisis further deteriorates and oil prices fall.

Figure 284. President Chávez still leads the presidential race



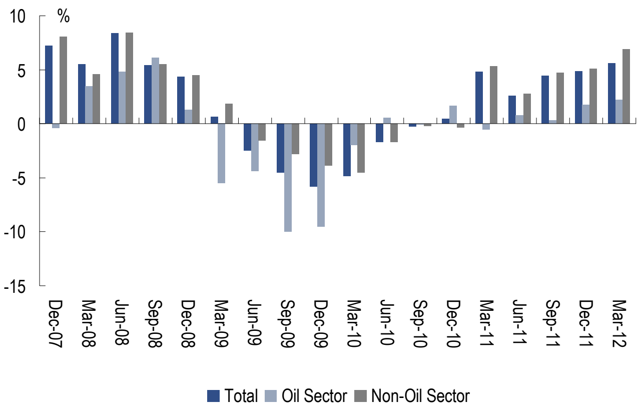
Source: Datanálisis, Consultores 21, Citi Investment Research and Analysis

Figure 285. 1Q12 GDP main driver was the construction sector



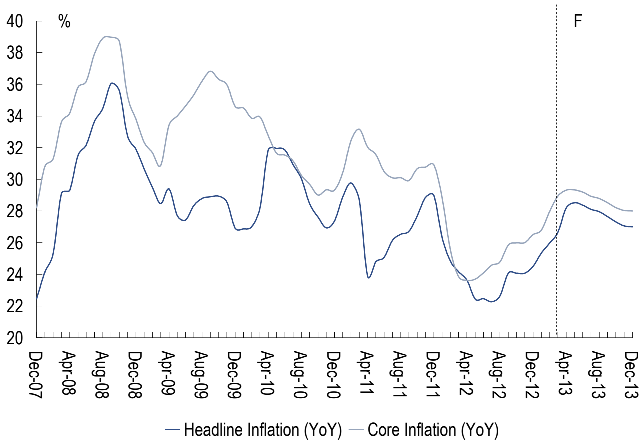
Source: BCV and Citi Investment Research and Analysis.

Figure 286. GDP surprised on the upside



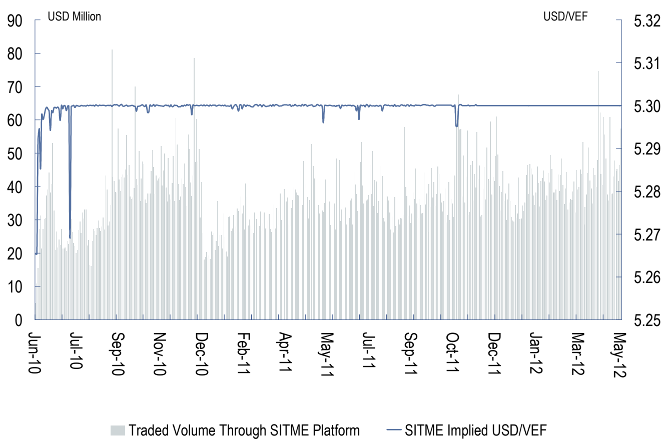
Source: BCV and Citi Investment Research and Analysis

Figure 287. Inflation at bay, despite the law of costs and fair prices



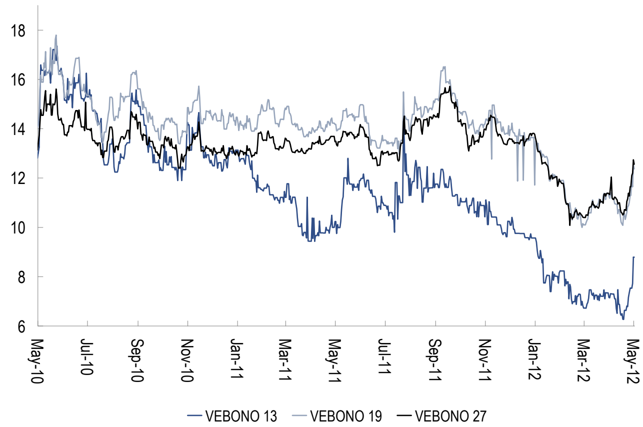
Source: BCV and Citi Investment Research and Analysis

Figure 288. Low USD supply continues.



Source: BCV and Citi Investment Research and Analysis

Figure 289. Political events and oil prices are the main drivers of credit



Source: Bloomberg and Citi Investment Research and Analysis

Figure 290. Venezuela Economic Forecasts

	2004	2005	2006	2007	2008	2009	2010	2011F	2012F	2013F
Summary Data										
Nominal GDP, USD bn	111.2	146.1	187.6	212.7	298.5	283.6	257.3	298.5	374.0	369.2
Nominal GDP, local currency bn	212.7	304.1	393.9	494.8	677.7	707.0	1016.8	1358.1	1825.8	2399.7
GDP per capita, USD	4256.0	5496.5	6939.9	7737.6	10684.9	9992.1	8924.8	10193.0	12585.5	12242.9
Population, mn	26.1	26.6	27.0	27.5	27.9	28.4	28.8	29.3	29.7	30.2
Unemployment, % of labour force	10.9	8.9	8.4	6.2	6.1	6.6	6.5	6.5	6.4	6.6
Economic Activity										
Real GDP, % yoy	18.3	10.3	9.9	8.8	5.3	-3.2	-1.5	4.2	5.0	3.5
Real investment growth % yoy	91.3	30.5	36.3	28.2	2.2	-19.1	1.0	15.2	1.6	3.3
Real consumption growth % yoy	15.2	14.6	14.3	16.3	6.0	-2.1	-1.1	4.4	8.0	1.1
private consumption growth % yoy	15.4	15.7	15.5	16.9	6.3	-2.9	-1.9	4.0	6.4	0.7
Real export growth, % yoy	13.7	3.8	-3.0	-7.6	-1.0	-13.7	-12.9	4.7	6.8	5.2
Real import growth, % yoy	57.7	35.2	34.8	33.0	1.4	-19.6	-2.9	15.4	8.5	-0.9
Prices, Money & Credit										
CPI, % yoy	19.2	14.4	17.0	22.5	31.9	26.9	27.4	29.0	24.5	27.0
CPI, % avg	21.7	16.0	13.7	18.7	31.4	28.6	29.1	27.1	23.8	27.4
Nominal wages, % yoy	22.0	19.1	19.3	20.7	25.0	23.7	24.5	27.0	28.0	29.0
Credit extension to private sector, % yoy	93.7	72.8	81.8	72.5	24.5	12.8	19.7	42.4	30.2	28.6
Policy interest rate, %, eop	7.20	1.88	5.90	18.00	28.10	14.00	12.50	…	…	…
1 month inter-bank rate, %, eop	7.20	1.88	5.90	18.00	28.10	11.30	12.30	14.50	14.50	14.67
Long-term yield, %, eop	…	…	5.41	12.00	12.00	14.38	13.02	13.93	15.50	15.67
VEB/USD, eop	1.92	2.15	2.15	2.15	2.15	2.15	3.80	4.30	4.30	6.50
VEB/USD, avg	1.89	2.11	2.15	2.15	2.15	2.15	3.80	4.30	4.30	6.50
Balance of Payments, USD bn										
Current account	15.5	25.4	26.5	18.1	37.4	8.6	12.1	27.2	25.7	30.6
% of GDP	14.0	17.4	14.1	8.5	12.5	3.0	4.7	9.1	6.9	8.3
Trade balance	22.6	31.7	32.0	23.0	45.7	19.2	27.1	46.2	42.0	47.0
Exports	39.7	55.7	65.6	69.0	95.1	57.6	65.7	92.6	95.7	102.3
Imports	17.0	24.0	33.6	46.0	49.5	38.4	38.6	46.4	53.7	55.3
Service balance	-3.4	-4.0	-4.4	-7.0	-8.4	-7.6	-9.2	-10.5	-7.6	-7.7
Income balance	-3.7	-2.2	-1.0	2.5	0.7	-2.7	-5.3	-8.0	-8.2	-8.2
FDI, net	0.9	1.4	-2.0	1.0	-0.9	-4.9	-1.5	5.1	-3.6	-3.5
International reserves	24.2	30.4	37.4	34.3	43.1	35.8	30.3	29.9	29.1	27.6
Total amortisations	7.6	4.0	7.4	4.0	7.5	3.9	6.1	16.7	11.4	23.2
Public Finances, % of GDP										
Consolidated government balance	2.5	4.1	-1.5	-2.6	-2.6	-5.8	-6.0	-5.0	-5.0	-4.0
Consolidated gov primary balance	6.2	7.1	0.6	-1.0	-1.2	-4.4	-5.5	-3.5	-3.5	-2.5
Public debt	39.3	32.0	23.4	25.6	20.1	29.3	41.2	42.6	35.9	36.0
of which Domestic	14.0	11.1	9.2	7.3	4.5	7.5	8.9	10.3	8.7	7.5
Foreign Assets & Liabilities, USD bn										
External debt	42.3	44.8	41.8	55.9	60.7	73.8	92.8	107.4	112.6	116.8
Private	14.2	14.3	15.2	16.9	14.0	12.2	9.6	11.0	11.2	11.4
Public	28.1	30.5	26.6	38.9	46.7	61.6	83.2	96.4	101.4	105.4
External debt / GDP	38.0	30.7	22.3	26.3	20.3	26.0	36.1	36.0	30.1	31.6
External debt / XGS	106.6	80.4	63.8	80.9	63.8	128.2	141.2	116.0	117.7	114.2
Short-term debt	…	…	…	…	…	…	…	…	…	…
Short-term debt/International reserves (%)	…	…	…	…	…	…	…	…	…	…

Quarterly Economic Indicators

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2F	2012 Q3F	2012 Q4F	2013 Q1F	2013 Q2F	2013 Q3F
GDP, % yoy	2.6	4.4	4.9	5.6	5.2	5.4	4.0	3.4	3.5	3.4
CPI, % yoy	25.1	26.7	29.0	24.2	22.5	24.1	24.5	26.7	28.4	27.7
Policy interest rate, %, eop	…	…	…	…	…	…	…	…	…	…
Short-term Rate (90-day Deposit Rate, eop)	14.68	14.82	14.50	14.50	14.50	14.00	14.50	15.00	14.50	13.90
Long-term yield, %, eop	13.02	15.47	13.93	10.57	11.20	12.16	15.50	16.00	15.50	14.90
VEB/USD	4.30	4.30	4.30	4.30	4.30	4.30	4.30	6.50	6.50	6.50

Source: National Sources and Citi Investment Research and Analysis

Notes

Notes

Notes

Appendix A-1

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