

Asia Macro and Strategy Outlook

Plausible Macro Surprises to Watch in 2014

- We summarize below what we believe are the more plausible macro surprises worth noting, and where we have a view of the more likely direction of the surprise.
- **China: Growth surprises negatively on inv., but then C/A surprises positively.** Funding conditions will likely remain structurally tighter due to the credit overhang, increased regulation and looming risk of selective defaults, but there is *no financial crisis*. Downside domestic growth risk leads to upside C/A surplus that would support RMB appreciation, but CN credit spreads could remain under pressure on supply.
- **India: INR could be more resilient than expected despite lingering risks.** Despite upside rate risk on a more hawkish *Ujit Patel* report, food-led CPI disinflation could still surprise, the external position is in better shape and RBI has strong incentives to cap INR weakness to mitigate CPI pass-through. Election risks are hard to assess (we have no strong directional view), but we think investment-led growth revival on supply 'de-bottlenecking' provides modest growth upside.
- **Indonesia: Budget deficit on upside risk; C/A risks look even.** Worries over 2014 budget revisions & reliance on debt-related flows to finance CAD is a risk in absence of pre-election subsidy reforms. Nonetheless, we think value on IDR bonds is emerging — it is selling off more than what credit risk premiums would imply.
- **Korea: Domestic demand weaker on prudent policy = bigger C/A.** Chance of a surprise cut/hike in 2014 looks even (our call: no change). Prudent monetary/fiscal & high HH debt put downside surprise risk to domestic growth recovery, and upside surprise risk to C/A. We O/W KRW within Asian FX's.
- **Malaysia & the Philippines: CBs in both could tighten earlier than expected.** The balance of growth vs. inflation risks should lean more on the latter, as also evidenced by growing aggressiveness of both CBs to cap FX volatility. We could see both tightening earlier/more than what market expects to anchor FX stability and inflation expectations. We think MYR & PHP remain vulnerable in the near term without a decisive CB tightening move, which may not emerge until 2Q14.
- **Singapore: Surprise from housing weakness – growth drag + deflation risk.** Downside surprise comes from a weaker property market and household debt issues; property adds to disinflation surprise; we remain underweight SGD.
- **Thailand: Growth slump from protracted political crisis worse than expected.** Economy may be less resilient to protracted political shocks than what it faced during the 2006-coup aftermath: 1) TH's export competitiveness is weakening, 2) exposure to 'sentiment-sensitive' tourism revenues has significantly risen over the years; and 3) household balance sheets are much weaker. BoT will likely keep rates low for much longer as fiscal is paralyzed; overweight duration on THB bonds.

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Citi Key Economic Forecasts

Figure 1. GDP forecasts (growth rate in percent)

	2013E GDP	2014 GDP Forecasts			2015 GDP Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	6.2	6.2	6.2	6.3	6.3	6.3	—
Asian NIEs*	2.8	3.5	3.5	3.5	3.9	3.9	3.7
SEAN-4**	5.1	4.7	5.0	5.1	5.3	5.3	5.4
China	7.7	7.3	7.3	7.5	7.0	7.0	7.4
Hong Kong	3.0	3.4	3.4	3.5	3.8	3.8	3.6
India***	4.8	5.6	5.6	5.4	6.7	6.7	—
Indonesia	5.7	5.3	5.3	5.4	5.5	5.5	5.8
Malaysia	4.5	5.0	5.0	5.1	4.9	4.9	5.0
Mongolia	12.0	11.0	11.0	—	8.0	8.0	—
Philippines	6.9	7.0	7.3	6.3	6.8	6.8	6.2
Singapore	3.7	3.5	3.5	3.8	3.5	4.0	3.9
South Korea	2.8	3.7	3.7	3.5	4.0	3.9	3.7
Sri Lanka	6.8	7.0	7.0	7.1	7.0	7.0	6.7
Taiwan	2.0	3.2	3.2	3.3	3.8	3.8	3.8
Thailand	2.8	1.8	3.1	3.6	3.9	4.3	4.6
Vietnam	5.4	5.7	5.5	5.6	5.9	5.8	5.9

Figure 2. CPI forecasts (growth rate in percent)

	2013E CPI	2014 CPI Forecasts			2015 CPI Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	3.8	4.0	3.9	3.5	4.1	4.1	—
Asian NIEs*	1.7	2.2	2.3	2.3	2.9	2.9	2.6
SEAN-4**	4.6	4.8	4.6	4.5	4.6	4.6	4.2
China	2.6	3.3	3.3	3.1	3.7	3.7	3.3
Hong Kong	4.3	3.6	3.6	3.8	4.0	4.0	3.6
India***	6.5	6.0	5.0	5.9	5.0	5.0	—
Indonesia	7.0	6.4	6.6	6.2	5.7	5.7	5.3
Malaysia	2.1	3.6	3.4	3.1	4.5	4.3	3.4
Mongolia	10.5	13.6	12.0	—	12.0	9.0	—
Philippines	2.9	4.8	3.5	4.0	4.0	3.9	3.9
Singapore	2.4	1.9	2.1	3.0	2.2	2.2	2.8
South Korea	1.3	2.1	2.3	2.1	3.1	3.1	2.6
Sri Lanka	6.9	6.0	6.5	6.7	6.5	6.5	6.9
Taiwan	0.8	1.7	1.7	1.4	2.3	2.3	1.8
Thailand	2.2	2.3	2.2	2.4	2.8	3.1	2.8
Vietnam	6.6	6.9	7.1	7.4	7.2	7.2	7.6

Figure 3. Current account forecasts (percent of GDP)

	2013E CAB	2014 CAB Forecasts			2015 CAB Forecasts		
	Current	Current	Previous	Consensus	Current	Previous	Consensus
Asia-Pacific	2.1	1.9	1.8	0.8	1.4	1.3	—
Asian NIEs*	7.5	6.3	6.4	2.0	5.7	5.8	1.7
SEAN-4**	-0.6	0.4	-0.1	-0.4	-0.1	-0.1	-0.2
China	2.2	2.0	2.0	2.2	1.5	1.5	2.1
Hong Kong	2.8	3.1	3.1	1.5	3.9	3.9	1.8
India***	-2.3	-2.3	-2.4	-2.6	-2.1	-2.4	—
Indonesia	-3.3	-2.9	-2.8	-2.6	-2.4	-2.3	-2.0
Malaysia	3.8	4.4	4.4	3.9	4.0	4.0	4.3
Mongolia	-31.7	-20.5	-21.4	—	-16.2	-17.6	—
Philippines	3.5	3.4	3.2	3.1	2.9	2.9	2.8
Singapore	14.0	13.5	13.5	16.4	13.0	13.0	15.8
South Korea	5.7	4.0	4.1	4.2	3.1	3.2	3.4
Sri Lanka	-4.0	-3.1	-3.1	-4.0	-3.1	-3.6	-3.5
Taiwan	10.9	9.8	9.8	10.3	9.5	9.5	9.7
Thailand	-0.9	2.2	-0.7	-0.1	-1.0	-1.0	0.4
Vietnam	4.9	3.7	3.8	0.0	2.5	2.5	0.0

Note: * Asian NIEs are Hong Kong, Korea, Singapore, and Taiwan. ** SEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asia-Pacific is Asian NIEs + SEAN-4 + China + India + Mongolia + Sri Lanka + Vietnam, GDP-weighted. *** India Fiscal year runs from April-March and inflation forecasts are Wholesale Price Index.

Source: CEIC Data Company Limited, Consensus Economics (January 13, 2014) and Citi Research estimates.

Macro Overview

Plausible Macro Surprises to Watch in 2014

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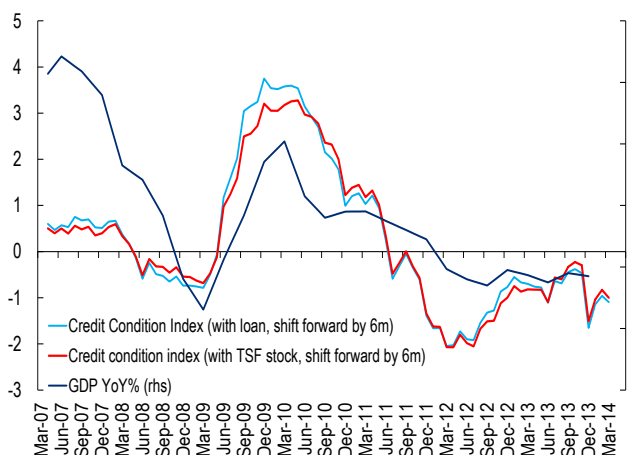
We think the bias of growth risk to watch is a small downside one as domestic funding conditions remain structurally tighter amid greater regulatory oversight/uncertainty (which will also put greater pressure to increase reliance on external funding)

With the plethora of 2014 outlook publications already out (our own: [Asia Macro and Strategy Outlook - Prospects 2014 & Beyond](#)), we believe there are macro events that have asymmetric probability distributions, and where the economic risks could tilt in one direction, influencing both policy and market outcomes. We summarize what we think are the main macro surprises to watch in 2014.

China – Growth surprises negatively on inv.; C/A surprises positively

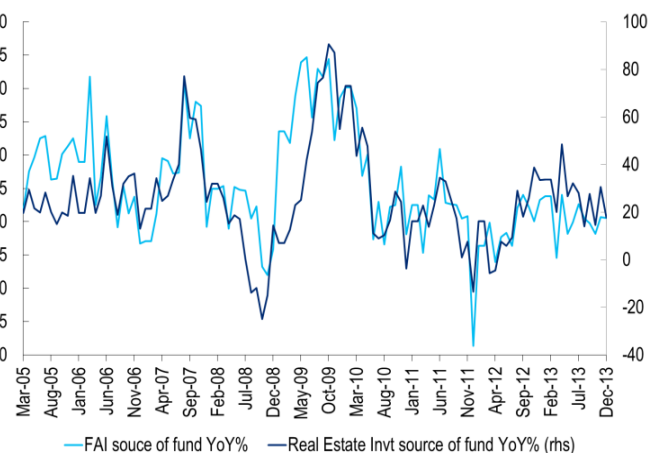
We think the growth risk to watch this year for is a downside one as domestic funding conditions remain structurally tight. While policymakers want to support growth (we think they will target around 7.5% growth this year), and will likely go slow on reforms if necessary to achieve this, even they are conscious of policy constraints that are building as a consequence of the credit overhang. The regulatory environment will likely continue to put greater emphasis on both tightly managing local government debt and increasing regulation of shadow banking, and even accommodating some defaults on off-balance-sheet products (shadow banking is estimated to be 60% of GDP) to reduce moral hazard in an environment where profit margins are continually squeezed from a double whammy of stronger RMB and higher cost of capital. All these factors will likely tighten onshore funding conditions and slow investment, with risks to the downside. However, we do not anticipate a financial crisis as we believe policymakers still have significant policy tools to manage systemic/contagion risks.¹ Chinese firms will likely increasingly rely on external funding to offset domestic funding pressures. After tapping the USD bond market with a record US\$58bn in supply in 2013 (+102% yoy increase), we expect CN issuance will continue to climb in 2014F, reinforcing challenging dynamics to CN-related credit spreads, but financial crisis risks look overblown.

Figure 4. China Credit Conditions indicate slower growth ahead



Source: CEIC, WIND, Citi Research

Figure 5. Secured Funding for FAI has decelerated gradually



Source: CEIC, Citi Research

¹ See [China Macro View - Financial Crisis Not Imminent](#) (24-Jan-2014).

Slower domestic growth risk amid still a relatively decent export performance could lead to a larger than expected current-account surplus. This will likely put more pressure for further RMB appreciation given growing reluctance by the PBoC to further accumulate foreign-currency reserves.

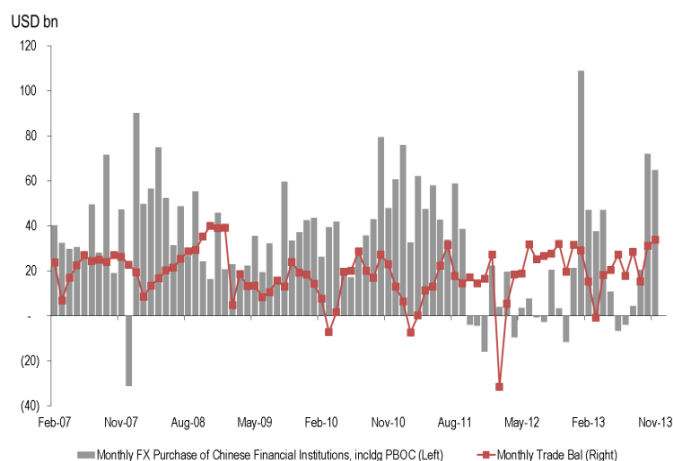
However, the direct corollary of downside risk to investment growth, all else equal, would be some upside surprise to our current-account forecast of 2% of GDP. CN's exports have fared relatively well vis-à-vis other Asian countries, and despite the strong REER appreciation of RMB since 2007, it seems competitiveness has been somewhat maintained vis-à-vis its ability to boost productivity, partly via innovation and mechanization. Thus, our 5.5% YoY nominal export growth assumption in 2014F is relatively conservative (though this figure is partly downwardly biased by the export over-invoicing problem in early 2013). Meanwhile, downside CN growth risk will likely mean industrial commodity prices, which CN influences, will remain relatively benign, safeguarding terms of trade. Import growth could be weaker than we expect if investment growth slows more rapidly than our base case (see Figure 6), which together could lead to a larger than expected trade surplus. Such an outcome would likely compound RMB appreciation pressures, and since PBoC Vice Governor Yi Gang announced that CN no longer benefits from further accumulation of foreign-currency reserves (FX reserves climbed another 15% to US\$3.8trn in 2013), the asymmetric expectation on appreciation will likely persist for most part this year, and could surprise again on the slightly strong side.

Figure 6. China's Real Growth in Fixed Capital Formation vs. Import Growth



Source: CEIC, Citi Research

Figure 7. China – Monthly Net FX Purchases by Financial Institutions (including PBOC) and Monthly Trade Balance



Source: CEIC, Citi Research

India's disinflation led by a correction in food prices could persist and be larger than what people expect – government has strong incentives (and some means) to keep food prices low ahead of elections

India – Disinflation and Investment-Led Growth “Surprise” – INR could remain well supported

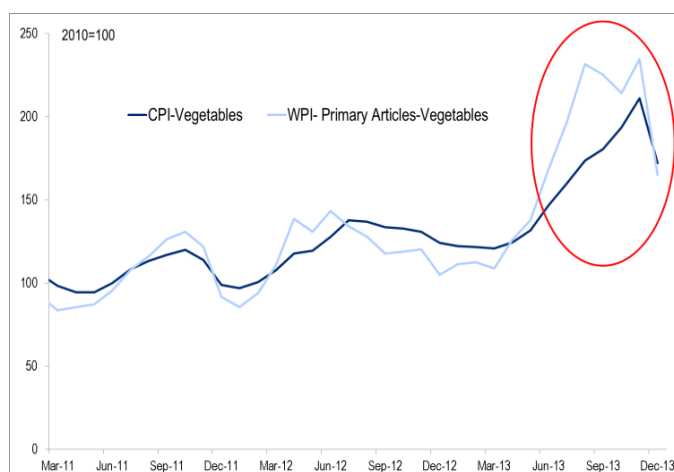
If last year's positive surprise was the faster than expected compression of India's current account, **we think this year's surprise could come from faster than expected disinflation led by food, but this will unlikely help ease the monetary stance, which we expect will stay tight/tighter.**² Since Sep, both WPI and CPI surprised significantly, with an important driver being vegetable prices, up 78% YoY in Jul-Nov 2013, even though India saw good monsoons.³ However, we think severity of the food price shock is unwinding, with vegetable prices falling sharply in Dec (Figure 8). We still see room for food price pressures to ease further:

² We highlighted this theme earlier [India Macroscope - 'Four' Sights for Fourteen \(2014\)](#) (8-Jan-2014).

³ The food price shock was a particularly potent one given that 50% of the CPI basket and 24% of the WPI basket is made up of food.

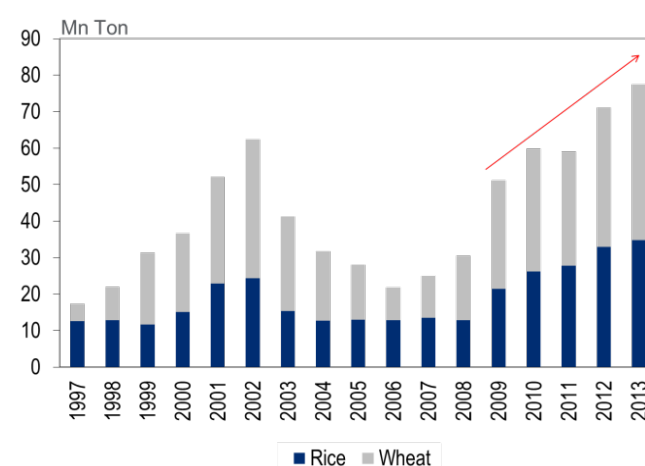
1) the incumbent government has *strong* incentives to design policies to ease food prices – an example of this is the proposal of Congress-ruled states to take fruit and vegetable prices from the Agriculture Produce & Market Committee (APMC) Act and allow direct sale of produce to end users and wholesalers; and, 2) Government also is sitting on record-high food-grain stocks (Figure 9), well above buffer norms, and releasing these food stocks is an obvious relief valve for inflation. Regardless, the *Urjit Patel* (UP) report has put a high bar on its nominal anchor of using CPI, setting an ambitious $4 \pm 2\%$ target in 2yrs time and advocating a positive real rate (with some caveats). Disinflation surprise may not bring much relief to shorter end rates (we expect a 25bp hike with 50bp upside if UP report is fully adopted) but could cap tightening expectations and eventually anchor the longer end of the curve.⁴

Figure 8. India- Vegetable Price: “what comes up must come down”



Source: CEIC, Citi Research

Figure 9. India – Trends in Grain Stocks (Mn T)



Source: FCI

Project approvals are making progress and prospects of a stable government could provide some upside risk to capex cycle

We think INR can remain better supported than what the market expects; eventually, a more hawkish RBI stance should support a flattening bias in the rates curve

Another potential “surprise” is the upside risk to investment-led growth.

Sentiment on India’s growth prospects going into a tumultuous election period, with growing anxiety of a fragmented political landscape, remains fairly weak (*note*: we have no directional view of the nature of the upcoming election, and thus, disregard election-related surprise discussions here). Recent softening of economic activity and a more hawkish RBI stance (post-UJ Report) do not help. But investments could still surprise to the upside in FY15 (Apr ‘14-Mar ‘15) with the Project Monitoring Group already making significant progress in projects worth about 3.8% of GDP (Figure 10), on top of other key projects on the move like the partially JP-funded Delhi-Mumbai Industrial Corridor (DMIC) and integration of the southern grid, which will be key in addressing power supply bottlenecks in the major industrial estates in the South.

We still think INR can remain relatively better-supported than what the market expects, barring a major election/political shock. Even if gold import restrictions are partially relaxed (we doubt significantly so), resolution of key supply bottlenecks could help the trade account by boosting iron ore exports/reducing coal/scrap metal imports. Portfolio equity flows could prove sticky if domestic/global growth rebounds as we expect, and after six consecutive months of FII outflows from INR debt securities (\$13+bn of outflows), less crowded positioning could reduce risk of significant taper-led foreign exit exacerbating INR volatility as it had during the Jun-Sep 2013 sell-off, though the recent US\$3bn net inflows in Jan alone deserve some attention (Figure 11).

⁴ See [India Macro View - Urjit Patel Committee Report – It’s Positive and Bold... but Risky](#) (22-Jan-2014).

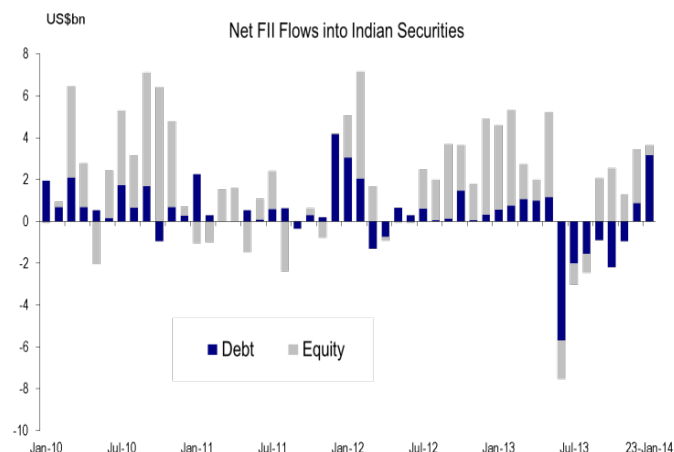
With the RBI now anchoring its monetary policy on CPI inflation, but its pragmatic stance on monetary policy evidenced by its decision to pause in December, we think both RBI's ammunition (US\$289bn including its net short position in the forward book) and incentive to cap INR volatility remain high (to avert exchange rate pass through). However, the room for appreciation remains capped given its precautionary reserve accumulation motives. We envision a relatively tight range for USD-INR (61-63), and thus could be a relative outperformer on a total return basis in EM Asia.

Figure 10. India – Project Monitoring Group's (PMG) Progress so Far

Sector	By Number		By Value (Rs bn)		By Value (US\$bn)	
	Resolved	Remaining	Resolved	Remaining	Resolved	Remaining
Power	86	77	3,612	5,086	58	82
Road Transport and Highways	5	30	65	460	1	7
Petroleum and Natural Gas	8	37	128	3,483	2	56
Steel	4	33	561	3,988	9	64
Railways	4	20	84	367	1	6
Shipping	4	13	58	213	1	3
Chemicals and Fertilizers - Chemicals and Petrochemicals	1	-	50	-	1	-
Chemicals and Fertilizers - Fertilizers	-	3	-	192	-	3
Mines	1	6	70	326	1	5
Civil Aviation	1	-	120	-	2	-
Coal	22	38	110	234	2	4
Commerce and Industry-DIPP	1	11	35	228	1	4
Commerce and Industry - Commerce	-	8	-	523	-	8
Textiles	-	1	-	13	-	0
TOTAL	137	277	4,893	15,112	79	244

Source: http://www.cabsec.nic.in/cci_acceptedprojects.php (as of 24th of Jan)

Figure 11. India – Net FII Flows in India Debt & Equity Securities



Source: CEIC, SEBI, Citi Research

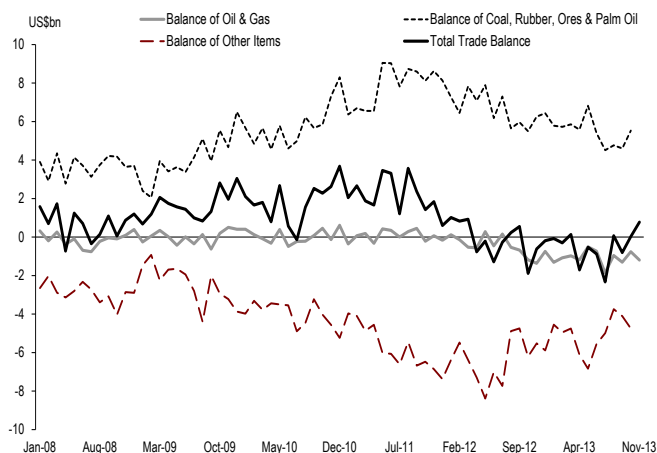
While the worst is over for Indo's CAD (and that is not a surprise anymore), we think the risks to the pace of CAD improvement is fairly even around our 2.8% of GDP forecast in 2014.

Indonesia – Budget deficit revisions; CAD surprise risk looks even

We think it's too premature to get *too excited* about a positive surprise in the current account despite a much better than expected trade balance in Oct-Nov. While it is clear that the worst of the CA deficit in Indonesia is now behind us following a significant 18% IDR vs. USD depreciation and 175bps rate hike since mid-2013 (and that should *not* be a surprise), we think the risks to our 2014 CA deficit forecast of 2.8% of GDP are still fairly even either way. The lack of improvement in the fuel import bill amid inelastic demand and still significant gap between subsidized and market fuel prices (IDR depreciation essentially nullifying much of the subsidy savings from the subsidized fuel price hike in June) remain a pressure point, alongside risk to election-related spending. Linger risks to CN's growth could cap the price rebound we saw in 4Q13 in key commodity prices like coal, palm oil and rubber (all three together account for 30% of ID's exports). Moreover, while the implementing rules for the mineral ore export ban that took effect on 12-Jan are not as punitive as earlier announced, less generous exemptions for some items like nickel and bauxite will also be marginally negative.⁵

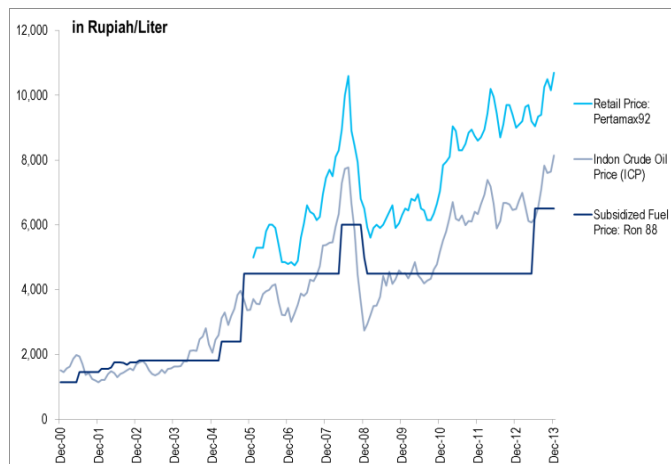
⁵ See [Indonesia Macro Flash - More on the Mineral Export Regulations](#) (16-Jan-2014).

Figure 12. Indonesia – Decomposition of the Trade Balance, in US \$bn



Source: CEIC, Citi Research

Figure 13. Indonesia – Gap between subsidized & market fuel price widens significantly again, largely on IDR depreciation

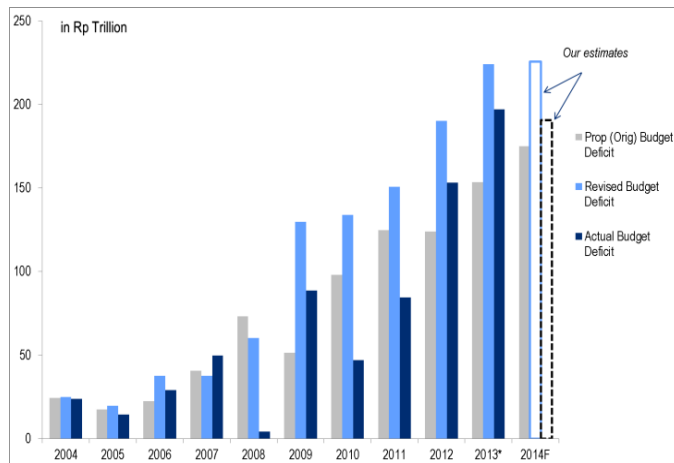


Source: CEIC, Bloomberg, Citi Research

The significant upward revision to 2014 budget deficit & how it is financed will be a key source of (negative) surprise.

We think the more important potential “surprise” to watch will be the upward revised 2014 budget deficit, largely on subsidy overruns, and how this will be financed. ID has a very long track record of undershooting its budget deficit targets, mostly due to under-spending of non-subsidy related items, but deficit targets have been regularly revised up for the most part of the last decade. We think the 2014 budget deficit revision (vs. the original target of 1.7% of GDP) could surprise people to the upside not only because macro assumptions are very outdated (e.g. growth forecast of 6%, USD/IDR at 10,500) but mainly due to the risk that fuel subsidy spending significantly exceeds targets again, and an election year will complicate the ability to take timely corrective action. We expect the budget deficit to eventually be revised up to a similar level (nominally) in 2013 or about 2-2.5% of GDP, and may submit proposed revisions before April parliamentary election, possibly around February.

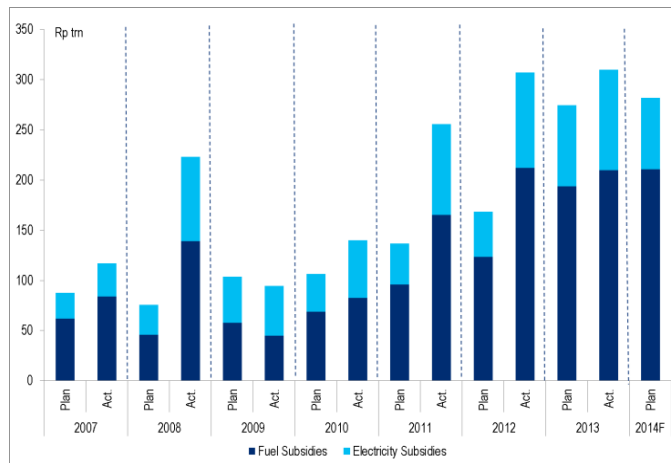
Figure 14. Indonesia – Planned Budget Deficits (Original & Revised) vs. Actual Budget Deficits (In Rp Trillions)



Source: MoF, CEIC, Citi Research

Note: *2013 Actual budget deficit is unaudited.

Figure 15. Indonesia – Energy Subsidies – Planned vs. Actual (in Rp trn)



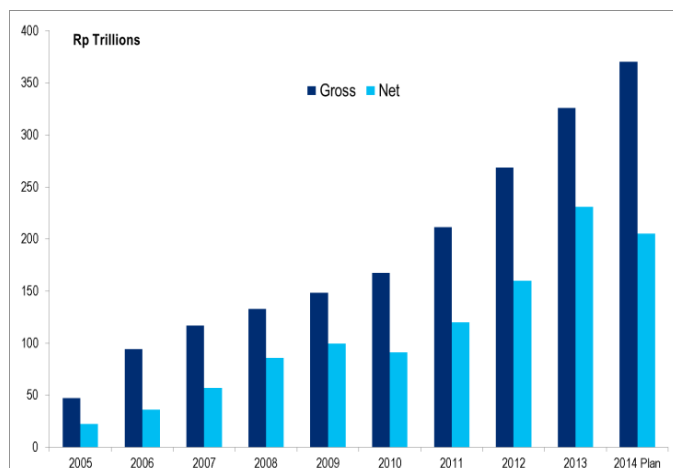
Source: MoF, CEIC, Citi Research

Note: *2013 Actual budget deficit is unaudited.

An increase in gross bond issuance, with upside risk on the budget revisions, will likely keep re-pricing risk on IDR government bonds relatively high

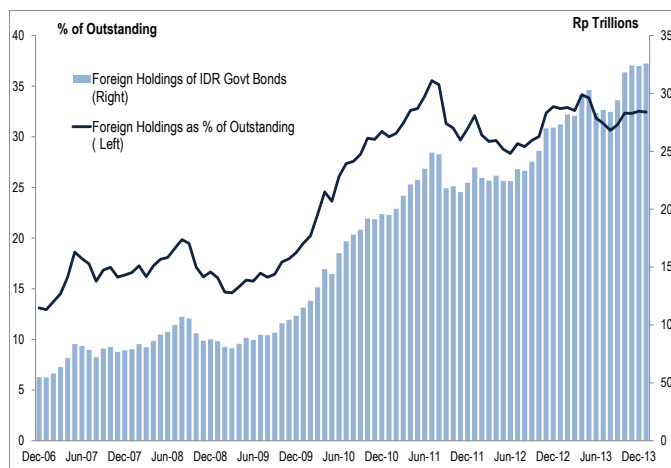
Additional financing from an already largely bond issuance plan this year risks further bond re-pricing. While recent IDR bond sentiment improved following decent demand during early issuances and 10yr Treasuries getting some relief, global risk appetite for EM Bonds has seen renewed weakness following Argentina-related noise, CN worries and QE-exit process advances (our assumption is less inflows into EM bonds than before). The proposed 2014 budget already envisions a 14% yoy *increase* in gross bond issuance to IDR370trn. We take little comfort in the 11% decline in net bond issuance to IDR205trn this year as this seems largely due to sizeable T-bill maturities held by banks (where rollover appetite could diminish given the tightening liquidity – rupiah LTD hitting 94% by late 2013 vs 86% IDR LTD ratio a year earlier -- and rising cost of funding) and ~US\$3bn in FCY bond maturities. We expect net issuance of regular IDR government securities could rise further pending 2014 budget revisions, which may not be fully covered by the estimated Rp29trn over-borrowings from last year.

Figure 16. Indonesia – Gross and Net Government Bond Issuance



Source: CEIC, DMO, MoF, Citi Research

Figure 17. Indonesia – Foreign Holdings of Government Bonds, outstanding Rp trillion and % of Outstanding



Source: DMO, Citi Research

While KR should benefit relatively well from global demand recovery, domestic demand revival may surprise on the weak front due to very conservative cyclical policies, and challenges to pace of household income growth undermining household balance sheets

Korea – More modest domestic growth recovery, though we think BoK will still stand pat

While KR remains one of the countries in the EM (and Asia) that should more visibly benefit from improvement in global growth, thus supporting our 3.7% growth forecast for 2014 (vs. BoK's 3.8% forecast), **there is lingering risk that the outlook for domestic demand recovery following through with external demand recovery could marginally surprise on the weak side:**

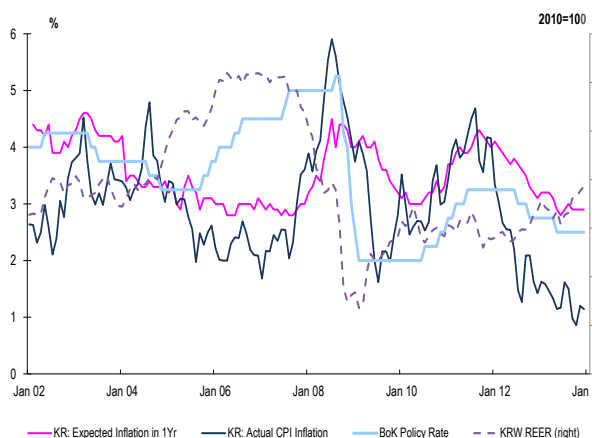
First, monetary policy remains very prudent, even amid benign inflation (gradual KRW REER appreciation further fuel disinflationary forces; see Figure 18). Inflation is likely to head gradually higher (to 2.1% in 2014) on rising industrial product prices, public service tariff hikes, and low base effect in 2013. We sense the hurdle for BoK to cut is higher than what people think assuming the cyclical backdrop improves.

Second, fiscal support looks even weaker. The 2014F spending is targeted to rise by only 1.9% YoY (vs. 7.2%YoY in 2013) to support expanded welfare programs, though offset by budget cut in SOC (infra) spending, with deficit (excluding social security funds) projected to remain unchanged at 1.8% of GDP. Weak revenue collection last year makes it unlikely we will see another supplementary budget, and there is pressure to mobilize more revenues to balance the budget after 2017.

Third, household income growth could stay structurally weaker and uneven than what history would imply, making it more difficult to manage the still highly levered household balance sheet (Figure 19). While export recovery should lead to some income growth, the distribution of wage gains could remain very uneven, with manufacturing offshoring remaining a disinflationary force on lower skilled workers.

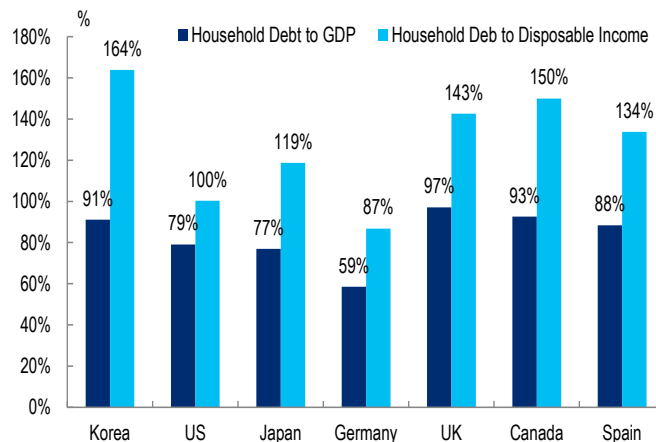
Fourth, we expect mild housing recovery in 2014F with the help of supportive fiscal policies (acquisition tax cut has now been made permanent) plus surging Jeonse-Property Price ratio should induce more housing purchases. However, some surge in housing transactions in 2013 may have been front-loaded when people perceived fiscal support to be temporary (Figure 20), and thus, some payback in 2014 is possible. LT challenges to demographics may cap the extent of housing rebound.

Figure 18. Korea – Inflation, Policy rate and KRW REER



Source: CEIC, BIS, Citi Research

Figure 19. Korea – Household Debt, as % of GDP & % of Disposable Income

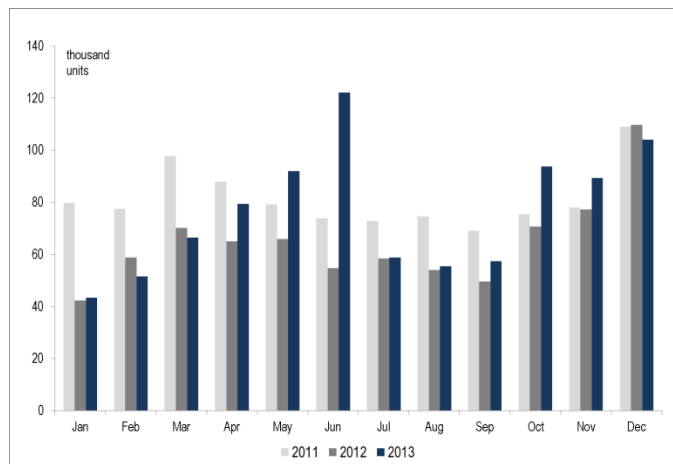


Source: Statistics Korea, Citi Research

Korea's external balance sheet will likely remain very solid, KRW appreciation pressure will continue to mount (we like this currency) and while KR curve can steepen further, it might continue to lag the steepening in the US given drags to domestic recovery

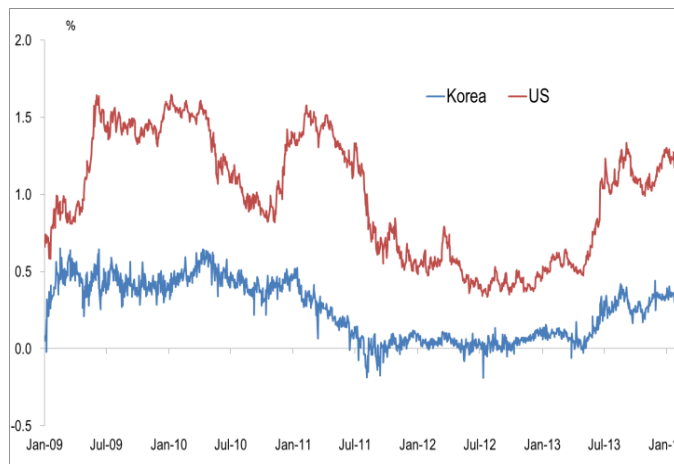
There are **two market implications**: **first**, the C/A surplus may remain wide (we are slightly above consensus at 4.1% of GDP in 2014F vs. 5.6% of GDP in 2013 est), KR credit risk premium will remain low as the external position looks very resilient (KR CDS to outperform in risk-off events), and pressure for KRW appreciation will eventually persist, notwithstanding recent weakening pressure amid passivity of the BoK to depreciation; and **second**, while it may be tempting to pay/put steepener on KR IRS on dips due to the very flat curve given correlation with US rates, we believe there may be structural factors – as described above – that may prevent the KR curve from aggressively steepening from here.

Figure 20. Korea - Housing Transactions in 2012 & 2013



Source: CEIC, Citi Research

Figure 21. Korea vs US- Comparing the 2y5y IRS Spread



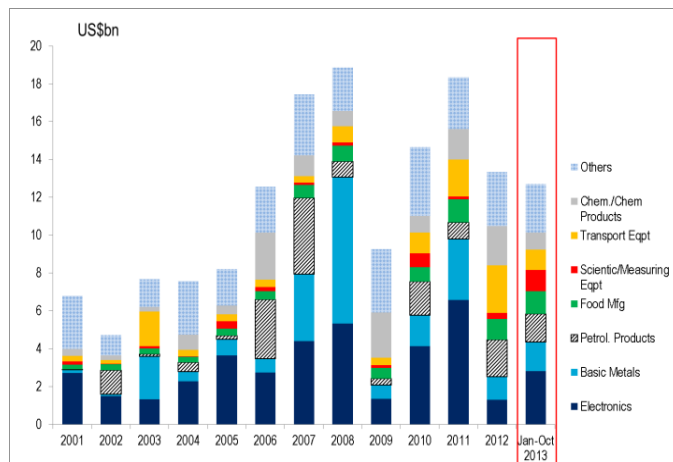
Source: Bloomberg, Citi Research

Malaysia & Philippines – Surprise risk could tilt towards CBs tightening earlier than market expectations

Both the Malaysia and Philippines economies look relatively resilient, the former cushioned by exports and healthy pipeline of investment approvals, though offset by drags from fiscal tightening and household debt, while the latter from resilience of domestic demand and likely manageable damage from typhoon Yolanda.

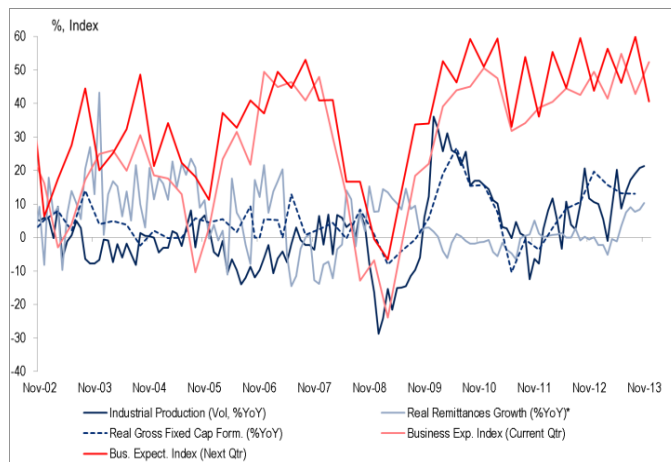
We think balance of risk between growth and inflation will tilt to inflation in both these countries for partially differing reasons. MY's economy looks better positioned to benefit from stronger demand in DM with relatively stronger export momentum in recent months, and upside prospects for future performance amid very sharp increases in investment approvals in the tradable sectors like electronics last year (Figure 22). However, this will likely be partially offset by drags to domestic demand, especially amid ongoing fiscal tightening, knock off impact on investment and headwinds from an already very strong upturn in household debt. PH growth resilience has less to do with the spillover from exports (though its exports are also *rebounding*) but resilience of domestic demand amid low leverage, ample liquidity, buoyant remittances (whose peso value *in real terms* is rising on PHP weakness) supporting household consumption (68% of the country's total output), double digit fixed capital formation and robust manufacturing production activity (Figure 23), with more than half of the manufacturing sectors registering capex utilization rates above 80%. We expect the typhoon impact on the PH economy will be relatively muted to keep full year growth close to 7% in 2013 and 2014F. While ongoing investigations on the misuse of the Presidential Assistant Development Fund (aka "pork barrel") have seen a sharp slowdown on non-interest fiscal spending since Aug, we expect typhoon-related reconstruction efforts will help reverse this in early 2014F.

Figure 22. Malaysia – Manufacturing Sector Investment Approvals



Source: MIDA, Citi Research

Figure 23. Philippines – Resilient Indicators of Economic Activity



Source: CEIC, Citi Research

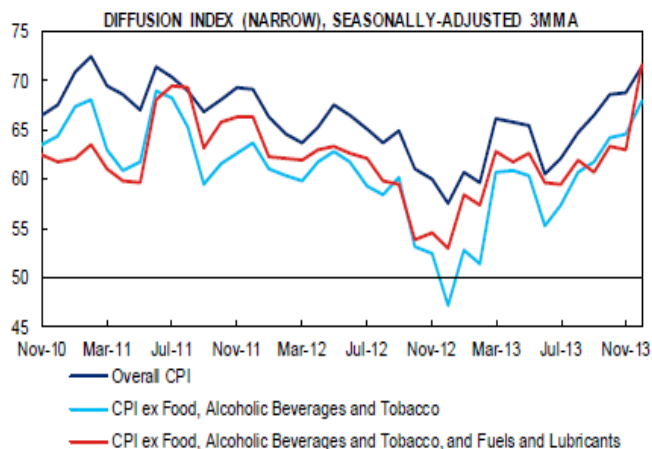
Note: *We adjust remittances in PHP terms, discounted by domestic inflation

Malaysia & Philippine CBs have been more aggressively intervening to cap FX weakness, likely due to growing worries about inflation pressures, the former due to second round impact of fiscally-driven administered price hikes and the latter more due to the lagged impact of an overly accommodative monetary stance and persistent output gap putting upward price pressures.

Central banks in Malaysia and the Philippines may tighten earlier than expected. Central banks of both countries have already been more visibly intervening in the FX market, we think influenced by worries over exacerbating inflation pass through of a weaker exchange rate. We add the following points:

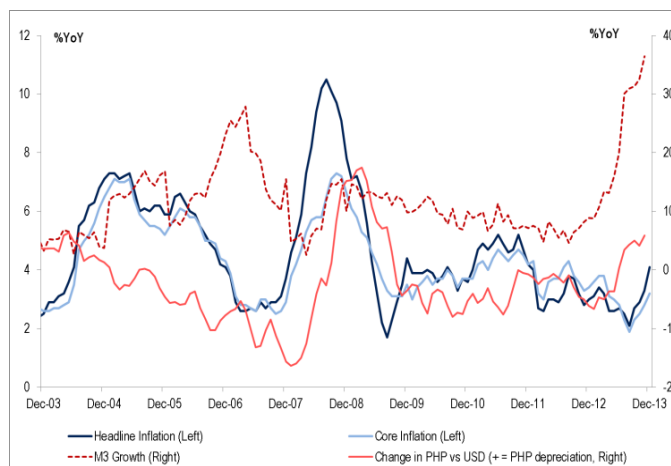
- **Malaysia:** Recent inflation upturn as a result of actual + planned administered price adjustment will be hard for BNM to ignore, especially given signs of second round effects with price pressure spreading beyond food, fuel, tobacco (Figure 24). Worries about financial imbalances will likely make BNM averse to seeing persistently negative real rates. With the 15% electricity hike taking effect this month and our base case for at least two more rounds of fuel price hikes this year, we think inflation will stay in the 3.5% throughout most of 2014, approach 4% by 2Q, prompting 2x25bps hike starting May 2014, more than what is being priced in the MYR rates market (+25bps hike over 12M).
- **Philippines:** We think BSP overdid its rate easing (e.g. SDA rate cut 250bps since mid-2011), on top of restricting SDA access for investment managed accounts (IMA) which fueled an explosion of liquidity growth (M2/M3 growth >30% YoY since July), all against the backdrop of BSP's own admission that PH's output gap is positive. One area where supply constraints vs. robust demand are already evident is in the power sector—the *Malampaya* power plant shutdown contributed to the Dec. inflation surprise, and further pent-up electricity hikes (e.g. Supreme Court 60-day Temporary Restraining Order electricity hike) pose upward price pressures. Despite what would seem to be robust external flows from the CA and net FDI flows, we think the growing pressure for PHP weakness is symptomatic of liquidity leaking out, partly due to very low returns to savings, which in turn threaten to exacerbate imported inflation pressures. We think the surprise risk is for BSP to tighten earlier than expected – it already raised its inflation forecast to 4.5% in 2014F (vs 4±1% inflation target in 2014F) and BSP may need to act earlier than expected to bring inflation towards the 3±1% inflation target in 2015F. We expect some adjustment to the SDA rate or reserve requirements to rein in liquidity growth in 2Q14 before adjusting the O/N reverse repo rate in 3Q14.

Figure 24. Malaysia – Our inflation index has been on an upward trend across a broad MoM price increases



Source: CEIC, Citi Research; Note: We assign values on CPI components based on their MoM changes (increases=100, no change=50, decreases=0), weigh them according to their CPI weights and seasonally adjust the data.

Figure 25. Philippines – Headline and Core Inflation, M3 Growth & Annual change in PHP vs. USD (increase=PHP depreciation)



Source: CEIC, Citi Research

Both MYR and PHP could benefit from a more decisive turn in monetary stance, but MYR could find an anchor earlier than PHP. In our view BNM may act earlier and more credibly to anchor inflation expectations.

Both MYR and PHP could benefit from a more decisive shift in monetary stance, but we think MYR could find an anchor earlier than PHP. On the one hand, PH's economy looks more resilient to a marginal tightening of monetary stance given very low leverage, a more neutral fiscal stance, more room for productivity catch-up via higher investment and less exposure to potentially volatile capital flows. However, BNM may act more credibly/earlier than BSP to anchor inflation expectations (e.g. BNM has kept rates on hold since mid-2011 and fiscal policy is already tightening) and growth beta from net export recovery in MY should be more evident. BSP's relatively more complacent stance is somewhat of a concern. On a rates front, we are more cautious on MY given that foreigners still own 44% of the MGS market and transmission channel of weaker external flows into EM debt could hit MY more than the largely locally owned PH bond market.

Property market is likely to be under pressure amid rising vacancies, stretched household balance sheets and binding impact of macro-prudential tightening.

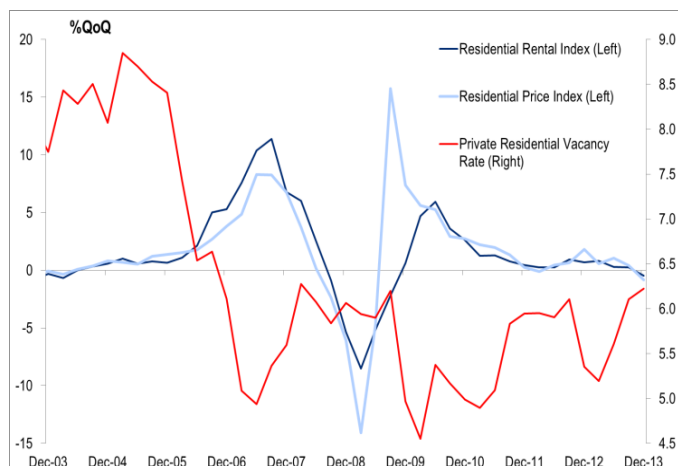
Singapore: Negative Surprise from Property Prices & Household Debt

We see more downside growth surprise this year coming from a sharper than expected decline in property prices and drag from household deleveraging. Eroding cost competitiveness and supply constraints, especially among SMEs, could dampen the historically high lift SG gets from external demand recovery. Meanwhile, rising pipeline of private housing completions starting 2014 (to reach the highest levels since early 2000s) will likely push up vacancy rates, and put downward pressure on rentals & prices which were already evident in 4Q13 (see Figure 26). This is further compounded by already stretched household balance sheets (household debt now over 200% of income as of 2Q12, and we think this probably rose further in 2013 (Figure 27) and the binding impact of macro-prudential property tightening policies, such the Total Debt Servicing Ratio (TDSR) restrictions introduced in June 2013. Our property analyst anticipates a 5% decline in property prices in 2014F and a 10-15% decline over the cycle. This would knock off ~0.5ppts to real GDP growth and be disinflationary on headline CPI even as core will be on a steady uptrend on pent-up cost pressures being partially passed on.

Impact of a weaker property on the economy will likely be larger than before –share of construction investment has been rising and consumption is more vulnerable to rising asset-based lending.

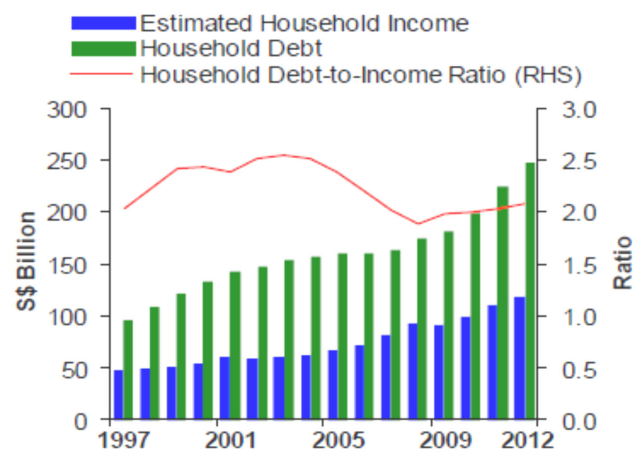
We think the impact of property price decline in SG's economy could be larger than previous history. Not only would it directly impact the construction-related investments which have seen a rising share in GDP in recent years, but financial innovations in recent years allowing home owners to monetize housing equity to obtain personal loans could mean the impact on consumption could be somewhat larger.⁶ Even at historically low rates, new data from the MAS show that as much as 20% of borrowers now have debt service ratios that are 40-60% of their monthly incomes, on top of another 5% of borrowers having debt repayments exceeding 60%, making them very vulnerable to any upward adjustment to mortgage rates, unless sufficiently compensated by income growth. Thus, even if the global backdrop improves and provides some cyclical lift to SG's export sector, we think the hurdle for MAS changing monetary policy -- tightening or loosening -- remains high, and if deflationary forces from economic/ housing drag escalate, the odds of MAS allowing SGD NEER to stay in the mid to even low side of the band will rise. Thus, we remain biased towards underweighting SGD.

Figure 26. Singapore Residential Property– Declining Rentals & Price Indices on a QoQ basis and Steadily Rising Vacancy Rates (%)



Source: CEIC, Citi Research

Figure 27. Singapore – Household Debt and Income, SGD billions and Ratio (%)



Source: MAS's *Financial Stability Review* (Dec 2013) citing MAS estimates and DOS.
Note: Household debt estimates are at Q2, in line with household income estimates.

The current political crisis has no solution in sight – things may need to get worse before political foes come together.

Thailand – Economic Weakness to Persist Longer than Expected

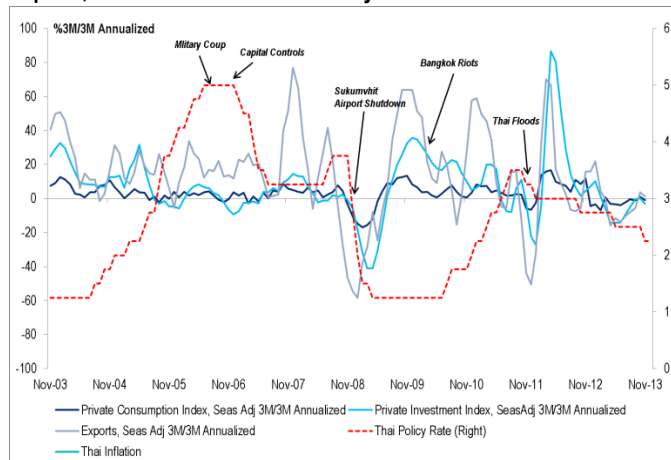
The escalating political crisis will likely lead to more downside surprise to economic growth. The schism between the majority elected government led by PM Yingluck Shinawatra, and the anti-Thaksin opponents continues unabated. We think elections look increasingly likely to be delayed following Constitutional Court's decision to allow delay, but unless the two sides find a compromise that satiate the opposition's "reform before election" call, the electoral process will unlikely be a lasting solution. Their positions remain very wide apart -- opposition wanting to cleanse government of Thaksin's influence and advocating the rule of an unelected "People's Council", while Thaksin and his allies are legitimized by their popular mandate and will unlikely give up control easily. We sense the situation will have to turn for the worse (i.e. more violence, more economic damage) before some compromise or even reluctant intervention by the military ensues.

⁶ We find evidence that asset based lending has been on the rise given the surge in debt levels by age – [Singapore Macro View - Should We Worry About Household Balance Sheets?](#) (7-Nov-2013).

Market may still be underestimating both the downside growth risk and longer term damage of the political stalemate on TH's economy – we think TH is in a somewhat weaker economic position than it was during the 2006 coup due to eroding export competitiveness challenges, the larger role played by tourism revenues and the already very levered household balance sheet.

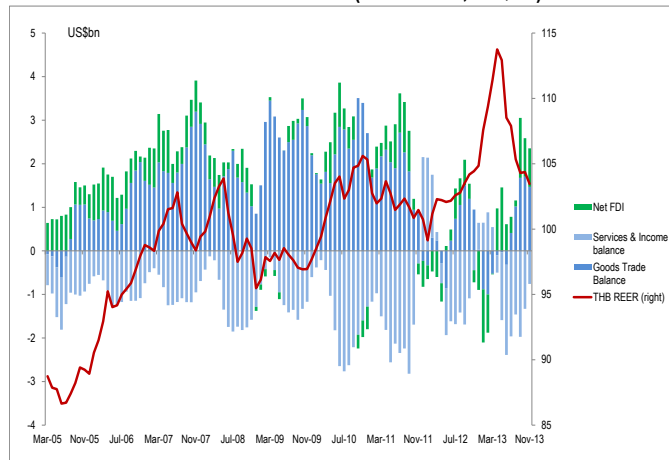
We think the market is underestimating both the downside growth risk and the longer term damage this political stalemate will do to TH's economy. Some people may draw analogies to TH's economic resilience during the run-up and aftermath of the 2006 coup, but we think TH is in a more vulnerable position than before for two reasons: First, both the global growth conditions and export competitiveness issues seem more challenging now, especially as technological innovation has likely undermined TH's structurally challenged electronics sector, and given TH's failure to upgrade its lagging infrastructure to boost productivity vis-a-vis its relatively more appreciated *real effective exchange rates* (Figure 29). Relative to pre-GFC levels, THB outperformed MYR, TWD, INR, IDR & KRW substantially on a REER basis (using BIS data). Second, Thailand's exposure to tourism revenues has also increased significantly over the years to likely ~9%-10% of GDP in 2013 vs 6% of GDP in 2006-07 and thus, protracted political instability could be relatively more damaging than it had been historically. Third, weak consumer confidence is compounded by a significant deterioration in household balance sheets in recent years, which could make the consumption growth even more vulnerable to adverse income shocks than before. Public-led investment was supposed to be the key driver for TH's future growth, but with paralyzed fiscal policy under a possible prolonged caretaker government, this now looks off the table.

Figure 28. Thailand – Private Consumption, Private Investment & Exports, %3M/3M SAAR vs. Thai Policy Rate



Source: CEIC, Citi Research

Figure 29. Thailand - BOT's Broad THB REER Index and evolution of the Current Account & Net FDI flows (in 3 MMMA, US\$bn)



Source: CEIC, Citi Research

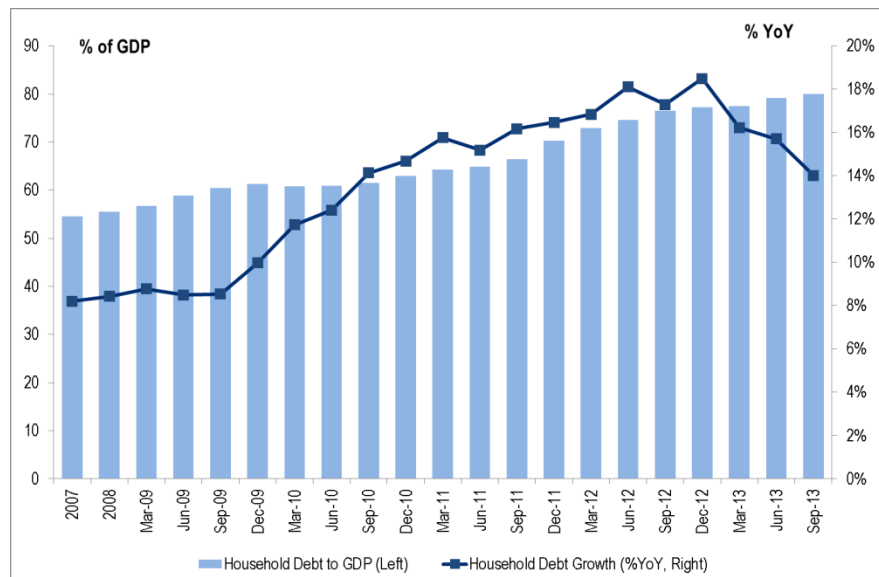
Note: We do a rolling 3Month Average for the BoP components to smooth the data.

Rates will likely stay for longer with possibility of one more cut as inflation risk should be benign, worries over financial imbalances will likely cap downside room for rate cut (though we think shouldn't deter one more cut).

There are three implications: First, we think inflation will not be a serious concern as economic slack widens, and thus, monetary policy will have to be particularly accommodative – we believe hikes are off the table for longer and we still envision one cut (to 2%). Second, while the BoT may be concerned about financial imbalances due to household debt, we think risk that further rate cut exacerbates this may be exaggerated given already weak domestic sentiment and already slowing household debt growth (Figure 30; Note: we think BoT's definition of household debt may be overstated by ~20% as it lumps together consumer & business loans⁷). Nonetheless, concerns over financial imbalances may cap *any downside adjustment to policy rates*. Third, while weaker domestic demand will likely restore current account to a surplus, the stabilizing impact this will have in THB may be quite different from what we saw in previous rounds given that exports could be weaker, and TH's long term growth prospects look more challenged amid uncertain prospects for upgrading infrastructure, and this could impact growth-sensitive capital flows such as net FDI.

⁷ For details, see [Thailand Banks - Household Debt: Not as Bad as Feared](#).

Figure 30. Thailand – Household Debt as seen by BoT



Source: BOT, Citi Research;

Short Term Market Outlook

We continue to favor CNH, KRW, INR — we are somewhat tactically neutral THB at this juncture given heavy short positioning but would eventually move this back to underweight as we expect medium term outlook looks troubled. We are tactically more cautious PHP and MYR as delayed CB action on the monetary front, plus the latter's risk to portfolio outflows in a bear steepening MGS market, could keep both FX under pressure.

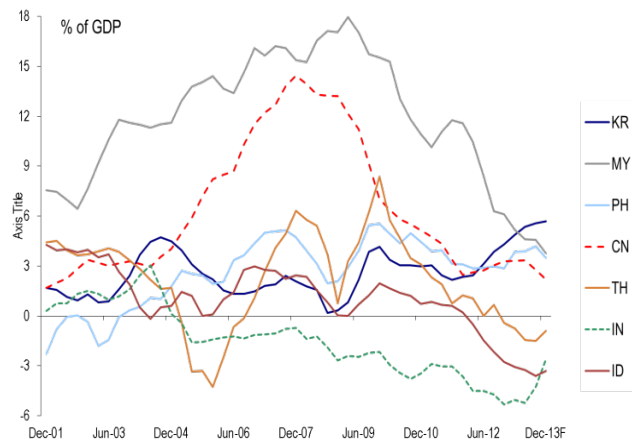
We are overweight duration on THB bonds, we see value emerging in IDR bonds following recent sell-off, we would underweight MGS and remain neutral KRW

ON FX, we think Asia FX will outperform the other EMFX in this de-risking environment, as one main source of EM de-risking, China, *ironically* will be more likely to keep CNY on a stable fixing to anchor sentiment amid still decent C/A surplus and huge FX reserves. Most of Asia should be able to withstand the downside growth risk from CN as long as the intra-CN related trade on supply chain/intermediate goods trade persists. KRW also benefits from the most insulated current account dynamics (Figure 31) and we would fade KRW recent weakness, especially as additional BoJ easing is still sometime away (June-July). We also like INR given a sizeable C/A adjustment and the one of the smallest CN trade exposures in EM. We are somewhat more tactically neutral THB at this juncture given what seems to be already bearish FX positioning—it appears cumulative portfolio equity inflows in TH since May 2009 have been unwound, but we would be biased to underweight THB structurally as we expect longer term direction will still be weakness. We also remain relatively neutral IDR – a bit more cautious on further weakness on spot, but expecting it not to weaken substantially beyond what is already priced in the forwards as BI monetary policy will likely act otherwise and CA appears to be showing more responsiveness to IDR weakness. We are tactically more underweight MYR, PHP, and structurally underweight SGD & TWD. BNM and BSP should eventually tighten monetary policy to anchor inflation expectations and ease FX weakness, but it's not clear to us that is going to happen in a hurry. Thus, we expect their currencies to remain under some pressure despite recent FX intervention, until we see a more hawkish stance evolve going into 2Q14.

On the local rates, we would overweight duration in THB bonds amid paralyzed fiscal policy muting supply pressure and rates on hold for longer with a bias to ease. We also now see value emerging in the sharp IDR bond following the recent sell-off, which we think is selling off beyond what ID credit risk premiums (we think credit fundamentals remain stable) would imply despite lingering IDR FX risks and further BI rate adjustment (Figure 32). We also continue to recommend insulating oneself from less correlated and higher carry frontier markets (which have much less exposure to foreign portfolio flows) and we would underweight MGS given very

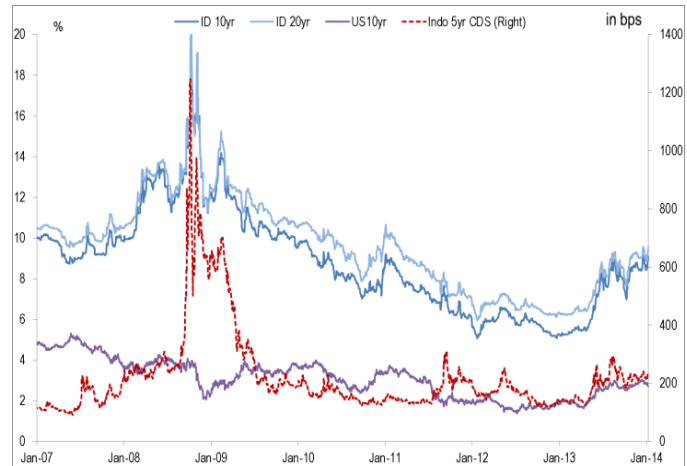
vulnerable investor positioning, while we remain neutral on KR rates as it is more likely to benefit from a retracement in the US yield curve. We are also neutral PHP bonds as ample domestic liquidity and minimal foreign positioning could cap its ability to sharply sell off from here.

Figure 31. Comparing Current Account Dynamics



Source: CEIC, Citi Research

Figure 32. Indonesia – Indo Govt Bond 10yr and 20yr yields vs US 10yr Yields and Indo 5yr CDS spread



Source: Bloomberg, Citi Research

Asian Currencies & Interest Rate Forecasts

Figure 33. Currency Forecasts and Forwards

	Mkt Data			Forecasts								
vs USD	23-Jan	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Euro	1.35	1.35	1.36	1.37	1.40	1.41	1.37	1.39	1.40	1.40	1.40	1.41
Japanese Yen	105	105	104	105	107	115	105	106	107	108	110	111
Chinese Renminbi	6.05	6.10	6.11	6.04	6.00	6.00	6.03	6.02	6.00	6.00	6.00	6.00
Hong Kong Dollar	7.76	7.76	7.76	7.75	7.76	7.75	7.75	7.76	7.76	7.76	7.76	7.75
Indonesian Rupiah	12,168	12,373	13,065	11,900	12,000	11,600	11,916	11,954	11,992	11,937	11,858	11,779
Indian Rupee	61.8	63.1	66.7	60.0	63.0	58.0	60.5	61.6	62.8	62.2	61.2	60.2
Korean Won	1,072	1,079	1,089	1,050	1,030	985	1,047	1,039	1,032	1,023	1,014	1,005
Malaysian Ringgit	3.33	3.35	3.40	3.33	3.15	3.10	3.30	3.23	3.16	3.14	3.13	3.12
Philippine Peso	45.3	45.5	45.7	46.0	44.8	40.8	45.8	45.4	44.9	44.2	43.4	42.6
Singapore Dollar	1.28	1.28	1.28	1.27	1.27	1.24	1.27	1.27	1.27	1.27	1.26	1.25
Sri Lanka Rupee	130.8	131.9	NA	131.0	131.8	125.0	131.0	132.0	133.0	133.4	132.0	132.0
Thai Baht	33.0	33.1	33.5	33.5	32.5	29.9	33.3	33.0	32.6	32.1	31.6	31.1
Taiwan Dollar	30.2	30.1	29.8	30.0	29.5	29.0	29.9	29.7	29.5	29.4	29.3	29.2
Vietnam Dong	21,090	21,575	22,425	21,125	21,160	21,000	21,160	21,160	21,160	21,160	21,357	21,467

*Forecast as of Citi's [Foreign Exchange Forecasts](#) (January 20, 2014)

Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

Figure 34. Interest rate forecasts (% period end)

	23-Jan	ln 3M	ln 6M	ln 12M	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15
US* Fed Fund Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-Year Treasuries	2.86	NA	NA	NA	2.85	3.10	3.20	3.30	3.50	3.50
EU* Repo Rate	0.25	0.25	0.00	0.00	0.25	0.00	0.00	0.00	0.00	0.00
10-Year Bunds	1.76	NA	NA	NA	1.75	1.70	1.70	1.80	1.90	1.90
JP* Call Money	0.07	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Year JGBs	0.69	NA	NA	NA	0.65	0.55	0.70	0.85	0.95	1.05
CN 1-Year Deposit rate	3.00	3.00	3.00	3.25	3.00	3.00	3.00	3.25	3.50	3.75
1-Month Shibor	6.95	5.30	5.30	5.61	5.30	5.30	5.30	5.55	5.80	6.05
Government bond yield (5 -Year)	4.44	3.90	3.90	4.21	3.90	3.90	3.90	4.15	4.40	4.65
HK 3-Month Interbank Rate	0.38	0.43	0.53	0.73	0.40	0.50	0.60	0.70	0.80	1.00
5-Year Exchange Fund Note	1.38	1.55	1.73	2.05	1.50	1.70	1.80	2.00	2.20	2.40
IN Overnight Repo Rate	7.75	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Overnight Reverse Repo Rate	6.75	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
91-Day T Bill	8.69	8.10	8.10	8.10	8.10	8.10	8.10	8.10	8.10	8.10
10-Year Gilt	8.61	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.50
ID BI Policy Rate	7.50	7.75	7.75	7.75	7.75	7.75	7.75	7.75	8.00	8.25
FasBI Rate	5.75	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.25	6.50
O/N Interbank Rate	5.88	6.25	6.25	6.31	6.25	6.25	6.25	6.25	6.50	6.75
10-Year Government Bond	8.61	8.26	8.35	8.56	8.25	8.30	8.50	8.50	8.75	8.75
MY Overnight Policy Rate	3.00	3.00	3.25	3.50	3.00	3.25	3.50	3.50	3.50	3.50
3-Month Interbank Rate	3.29	3.26	3.51	3.70	3.20	3.45	3.70	3.70	3.70	3.70
5-year MGS	3.68	3.73	3.83	4.03	3.70	3.80	3.90	4.00	4.10	4.10
PH O/N Rate	3.50	3.50	3.50	4.00	3.50	3.50	3.75	4.00	4.25	4.50
1-Month Reference Rate	0.54	-0.37	0.38	2.06	-0.50	0.00	1.50	2.00	2.25	2.50
5-Year T Bond	3.44	2.89	3.13	3.56	2.85	3.00	3.50	3.50	3.75	4.00
SG 3-Month Interbank Rate	0.41	0.40	0.40	0.41	0.40	0.40	0.40	0.40	0.45	0.50
10-Year SGS	2.48	2.64	2.79	3.00	2.60	2.75	2.90	3.00	3.00	3.10
KR BOK Policy Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00
91-Day CD	2.65	2.75	2.75	2.79	2.75	2.75	2.75	2.75	2.90	3.10
5-Year Treasury	3.28	3.49	3.61	3.68	3.45	3.60	3.65	3.65	3.75	3.95
SL Reverse Repo Rate	8.00	7.50	7.50	7.50	7.50	7.50	7.50	7.50	8.00	8.00
1-Month T-Bills	8.53	8.00	8.08	8.58	8.00	8.00	8.30	8.50	8.80	9.00
5-Year Government Bond	9.11	9.00	9.13	9.56	9.00	9.00	9.50	9.50	9.75	9.75
TW Overnight Rate	0.39	0.39	0.39	0.42	0.39	0.39	0.40	0.42	0.45	0.48
Re-discount Rate	1.88	1.88	1.88	2.13	1.88	1.88	1.88	1.88	2.00	2.13
10-Year Government Bond	1.65	1.70	1.73	1.88	1.70	1.72	1.77	1.85	1.95	2.05
TH Overnight Repo Rate	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.25	2.50
1-Month interbank Rate	2.31	2.10	2.10	2.15	2.10	2.10	2.10	2.10	2.30	2.60
10-Year Government Bond	3.95	4.09	3.89	3.93	4.15	3.90	3.85	3.90	4.00	4.25
VN Refinance Rate	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
1-Month interbank Rate	5.48	4.13	4.88	6.00	4.00	4.50	6.00	6.00	6.00	6.00
5-Year Treasury	9.29	8.30	8.35	8.97	8.30	8.30	8.50	9.00	8.88	8.75

Note: *Forecast as of [Global Economic Outlook and Strategy](#) (January 22, 2014).

Source: Bloomberg, CEIC Data Company Limited, Reuters, and Citi Research estimates

Country Section

China

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- **Summary view** – 2014 marks the beginning of the seven-year grand reform plan endorsed by the Chinese leadership. The authorities seem unwilling to endure short-term pain or risk triggering a crisis in their efforts to rebalance the economy, with a measured and gradual transition the most likely approach.
- **Things to watch** – Reform initiatives, cost of capital and export growth shall drive the economy in 2014. In order to achieve around 7.5% growth, the Chinese authorities may put growth ahead of reform, curb money market rates after the Chinese New Year, and facilitate two-way volatility in the RMB market.
- **Strategy** – Recent high money market rates could soften after the Chinese New Year due to accommodative policy amid benign CPI inflation. Speculative inflows have pushed the RMB stronger. We expect the government to increase the two-way volatility of the CNYUSD by relaxing control over capital outflows.

2014: Key growth movers

Economy to be refurbished by new reform cycle starting this year. Supported by infrastructure and property investment, China's GDP grew 7.7% in 2013, flat from a year ago but remaining in the downcycle from a peak of 14.2% growth in 2007. The authorities seem unwilling to endure short-term pain or risk triggering a crisis in their efforts to rebalance the economy, with a measured and gradual transition the most likely approach. Beyond reform, China's GDP growth may be under pressure this year due to a surging cost of capital since 2H 2013, which can hardly be offset by better export growth. Recent developments suggest more downside than upside risk to our forecast of 7.3% growth for 2014.

Reform would not only rebuild China's growth outlook but also change market expectations on sustainable growth. We are positive on the direction of the grand reform plan endorsed by the Chinese leadership. However, the government does not seem ready to tolerate sub-7% growth, which may reduce its flexibility in implementing reforms. Any reforms that might prick market bubbles and result in systemic risk in the near-term would likely be postponed. We expect that growth-supportive measures, e.g., one-child policy relaxation and new urbanization plan, would be emphasized over a faster pace of de-leveraging.

Surging cost of capital is result of financial excess and credit dislocation. Bankruptcies and defaults in the real economy and financial markets will be necessary to impose hard budget constraints on local governments and state-owned enterprises, and deliver more accurately priced risk premia. This will likely be a gradual process. Money market rates could come off after the Chinese New Year to avoid damage to economic growth. Recent benign CPI makes accommodative policy possible in the near term.

Export growth could accelerate on better external demand. Unless DM recovery is driven by the tradable sector, our base case scenario is for single-digit export growth this year. Strong RMB and rising labor costs may have eroded competitiveness within the manufacturing sector. Recent rapid RMB appreciation was largely forced by speculative inflows on high onshore money market rates. The government is keen to increase the two-way volatility of CNYUSD, possibly relaxing control over capital outflows and widening the daily trading band.

Investment slowdown is a risk this year

GDP growth continued to be driven by liquidity and investment. China's GDP grew 7.7% in 2013, with 4.2ppts from investment, 3.8ppts from final consumption, and -0.3ppt from net exports. M2 growth exceeded nominal GDP growth by 4.1ppts, roughly in line with 4.0ppts in 2012 but the widest gap since 2003 (excluding the first year after the GFC in 2009). Exit from the financial excess and recently surging cost of capital would weigh on GDP growth this year.

- **FAI may decelerate further.** Fixed asset investment (FAI) excluding investment by farmers grew 19.6% in 2013, but FAI by state-owned or state-controlled firms increased by 16.3% and the private sector (63% of FAI) grew 23.1% in 2013. Infrastructure investment growth fell to 8.7%YoY in Dec, possibly due to the anti-corruption drive, rising cost of capital and local government debt control.
- **Firms may have to rely more on external funding.** Industrial profits rose 13.2%YoY in Jan-Nov, but only 4.4%YoY for core businesses. Out of 41 industrial sectors, 27 were profitable and 12 loss-making.
- **Consumption stabilizes but at the weak end.** Non-luxury goods spending decelerated from 18.1% in 2012 to 14.5% in 2013, more than that of luxury spending, which was down from 17.1% to 16.2%.
- **Wages may continue to rise.** The labor force (aged 16-59) shrank by 2.44mn to 920mn. Monthly wages for farmers working in non-local areas rose 13.9%, a rough indicator of the wage growth of unskilled workers in 2013.

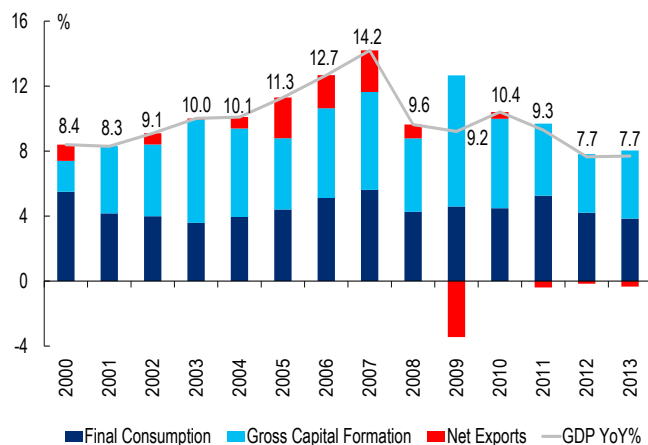
Financial crisis unlikely in the near term

Reform in China will aim at putting market discipline in place in order to improve the efficiency of credit allocation. High cost of capital, if it persists for long, would imply rising refinancing cost and could trigger a wave of defaults and even a financial crisis. Some believe that defaults in the shadow banking sector would lead to a deep adjustment in the Chinese economy and markets. This is a short-term pain scenario to shake out incompetent assets and institutions, but barring policy mistakes politically it's unlikely to happen in the near term. The Chinese authorities seem determined to grow the economy above 7% and avoid any systemic risk that may challenge this target. The remaining question is whether a financial crisis can be postponed or averted.

A set of measures will be taken before a crisis is due. China has had a few experiences of tackling defaults and bankruptcies. Defaults are likely in 2014 but should be isolated. Measures that could be in the manual of the Chinese authorities may include establishing provincial level AMCs, government-led restructuring, securitization, PBOC relending, liquidity injection (e.g., RRR cuts), debt nationalization and so on.

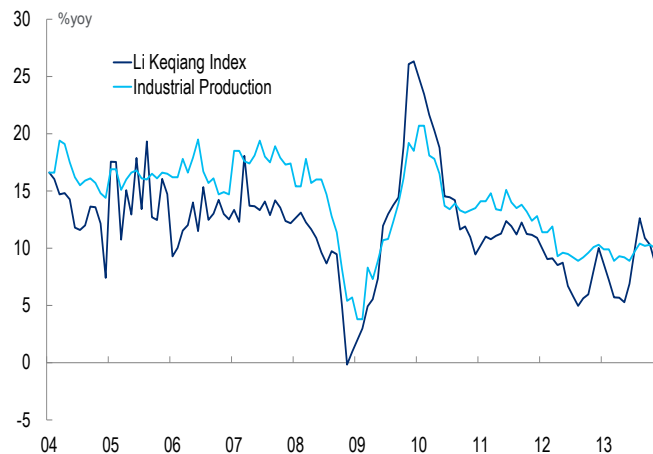
What matters is whether the government is able to reduce the risk of a future systemic crisis while buying time. This is where reform is needed, and marketization is the ultimate goal of reform. In our view, three areas of reforms should be addressed – deleveraging, boosting domestic demand and enhancing productivity.

Figure 35. GDP Growth Breakdown



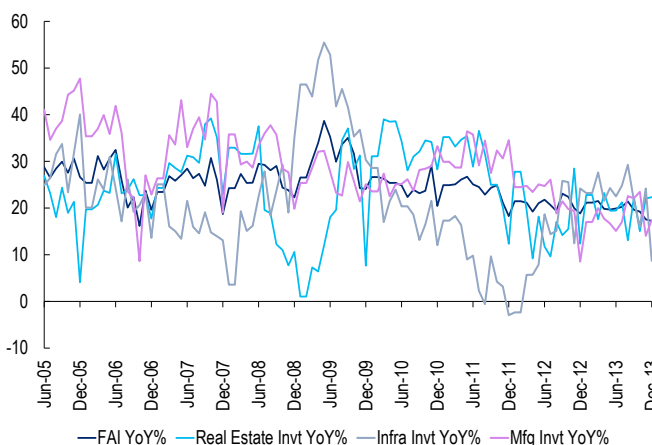
Source: NBS, CEIC and Citi Research

Figure 36. Li Keqiang Index vs. Industrial Production Growth



Source: NBS, CEIC and Citi Research

Figure 37. FAI Growth and Breakdown



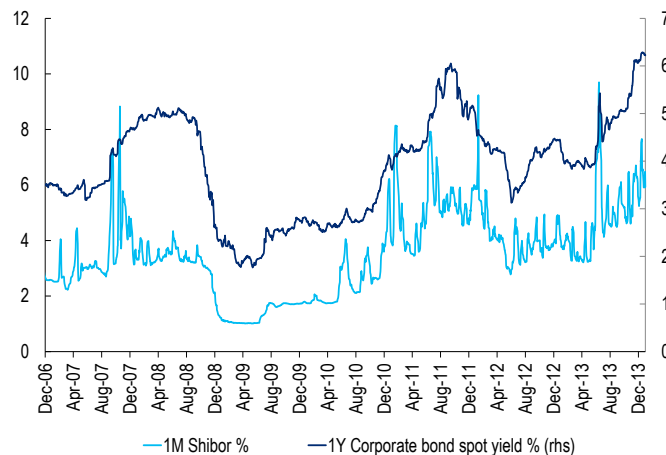
Source: NBS, CEIC and Citi Research

Figure 38. Investment Growth by Ownership



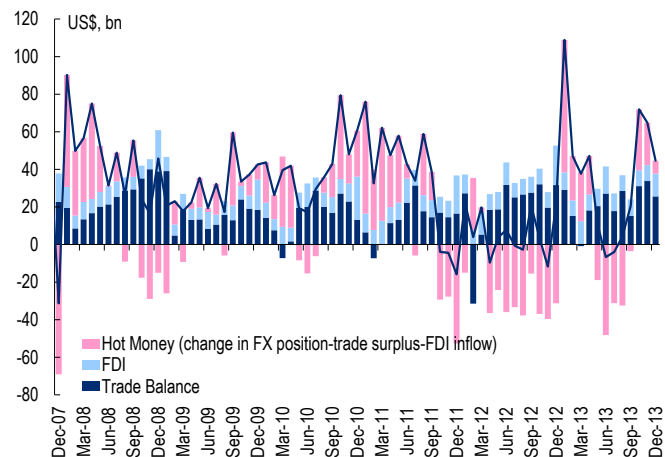
Source: NBS, CEIC and Citi Research

Figure 39. Surging Cost of Capital



Source: WIND and Citi Research

Figure 40. Recent Fast RMB Appreciation From Speculative Inflows



Source: PBOC, CEIC and Citi Research

Figure 41. China Economic Indicators

	2007	2008	2009	2010	2011	2012	2013E	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	3,494.5	4,544.0	5,070.5	5,932.5	7,319.0	8,238.5	9,245.4	10,376.1	11,501.7
Nominal GDP, local currency bn	26,583	31,490	34,632	40,151	47,310	51,894	56,885	62,535	68,780
GDP per capita, US\$	2,645	3,422	3,800	4,424	5,432	6,084	6,794	7,595	8,397
Population, mn	1,321.3	1,328.0	1,334.5	1,340.9	1,347.4	1,354.0	1,360.7	1,366.2	1,369.7
Unemployment, % of labour force	4.0	4.2	4.3	4.1	4.1	4.1	4.1	4.2	4.3
Economic Activity									
Real GDP, % yoy	14.2	9.6	9.2	10.4	9.3	7.7	7.7	7.3	7.0
Real investment growth % yoy	14.4	11.0	19.2	11.9	9.4	8.1	8.9	7.4	6.6
Real consumption growth % yoy	11.0	8.5	9.4	9.2	10.9	8.3	7.8	7.1	7.6
private consumption growth % yoy	11.1	9.2	10.3	8.5	18.2	8.5	8.0	7.3	7.8
Prices, Money & Credit									
CPI, % yoy	6.5	1.2	1.9	4.6	4.1	2.5	2.5	4.0	3.5
CPI, % avg	4.8	5.9	-0.7	3.3	5.4	2.6	2.6	3.3	3.7
Nominal wages, % yoy	18.5	16.9	11.6	13.3	14.4	11.9	9.6	9.9	10.0
Credit extension to private sector, % yoy	19.3	14.0	33.2	20.3	15.1	15.6	14.1	13.6	13.1
Policy interest rate, % eop	4.14	2.25	2.25	2.75	3.50	3.00	3.00	3.25	3.75
1 month inter-bank rate, % eop	3.61	1.23	1.79	6.17	6.00	4.90	5.91	6.29	6.79
Long term yield, % eop	4.19	1.80	3.06	3.61	3.27	3.33	4.49	4.86	5.36
lc/US\$, eop	7.30	6.82	6.83	6.59	6.29	6.23	6.05	6.00	6.00
lc/US\$, avg	7.61	6.95	6.83	6.77	6.46	6.31	6.15	6.01	6.00
Balance of Payments, US\$ bn									
Current account	353.2	420.6	243.3	237.8	136.1	193.1	203.4	207.5	172.5
% of GDP	10.1	9.3	4.8	4.0	1.9	2.3	2.2	2.0	1.5
Trade balance	264.3	298.1	195.7	181.5	154.9	230.3	259.8	283.9	290.4
Exports	1,220.5	1,430.7	1,201.6	1,577.8	1,898.4	2,048.7	2,210.0	2,331.5	2,487.1
Imports	956.1	1,132.6	1,005.9	1,396.2	1,743.5	1,818.4	1,950.3	2,047.7	2,196.7
Service balance	-7.9	-11.8	-29.4	-31.2	-61.6	-89.7	-98.7	-108.6	-119.5
Income balance	8.0	28.6	-8.5	-25.9	-70.3	-42.1	-0.6	-13.6	-23.7
FDI, net	139.1	114.8	87.2	185.7	231.7	191.1	147.1	99.9	47.8
International reserves	1,528.2	1,946.0	2,399.2	2,847.3	3,181.1	3,311.6	3,821.3	4,005.1	4,205.5
Total Amortisations	20.3	23.3	34.2	27.2	33.2	33.0	39.2	41.2	45.3
Public Finances, % of GDP									
Consolidated government balance	0.6	-0.4	-2.2	-2.2	-1.3	-2.0	-2.0	-2.0	-1.5
Consolidated gov primary balance	1.0	0.1	-1.8	-1.7	-0.9	-1.5	-1.5	-1.5	-1.0
Public debt	39.0	37.4	47.8	49.2	44.3	53.5	53.8	53.6	52.3
of which Domestic	38.0	36.6	47.0	48.6	43.7	53.1	53.3	53.2	51.9
Foreign Assets & Liabilities, US\$ bn									
External debt	389.2	390.2	428.6	548.9	695.0	737.0	810.7	891.8	980.9
Private	354.3	356.9	391.8	510.1	657.6	700.4	770.4	847.4	932.2
Public	34.9	33.3	36.9	38.8	37.4	36.6	40.3	44.3	48.7
External debt / GDP	11.1	8.6	8.5	9.3	9.5	8.9	8.8	8.6	8.5
External debt / XGS	29.0	24.7	32.2	31.5	33.4	32.8	33.4	34.9	35.9
Short-term debt	235.7	226.3	259.3	375.7	475.7	504.4	554.8	610.3	671.4
Short-term debt/International Reserves (%)	15.4	11.6	10.8	13.2	15.0	15.2	14.5	15.2	16.0

Quarterly Economic Indicators

	2013 Q2	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	7.5	7.8	7.7	7.6	7.4	7.0	7.2	7.3	7.1
CPI, % yoy	2.7	3.1	2.5	3.3	3.0	3.2	4.0	3.7	3.8
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.75
1 month inter-bank rate, % eop	7.35	5.30	5.91	6.01	6.10	6.19	6.29	6.38	6.48
Long term yield, % eop	3.32	3.90	4.49	4.58	4.68	4.77	4.86	4.96	5.05
lc vs USD, eop	6.14	6.12	6.05	6.03	6.02	6.00	6.00	6.00	6.00

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt includes the debt of central, local govt and Ministry of Railway. Long term yield refers to 5Y Sovereign Bond yield. External debt is based on the residency of the holder of the debt (not by currency denomination).

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Hong Kong

- **Summary view** – Market volatility as US tapering begins, but decent growth in China's economy offers some buffer. Social spending announced in Policy Address means few surprises are likely in upcoming Budget Speech, as Financial Secretary remains worried about the fiscal burden from an aging society.
- **Things to watch** – 1) Liquidity outflows on taper concerns and China's credit tightening; 2) sustainability of trade recovery; 3) property market adjustment; 4) tourist shopping trends (volume vs. value/pax); 5) political debate on electoral reforms; 6) measures to enhance cooperation with Qianhai and Shanghai FTZ.
- **Strategy** – EFN yields likely to trend up along with US tapering. HKD peg likely to remain status quo. Citi's house view is that home prices are likely to drop by 10% in the primary market in 2014E. Our equity strategist's target for HSI for 2014 year-end is 25,000.

Decent 4Q GDP growth; we still expect a dip in 1Q14E

Economic momentum firm at turn of the year. Leading indicator, PMI, signals HK continued to expand for a fourth consecutive month in December, with both output and new orders better than the trends earlier in 2013. Even lagging indicators like labor stats tell a positive story. Employment grew by 17.7K in Oct-Dec13 to a record high of 3.76mn, although some of the additions were temporary jobs during the festive stretch. The labor market is very tight as the unemployment rate has trended down to 3.2%sa as of Dec13.

Trading and logistics activities likely a boost to 4Q GDP. Recovery in advanced economies and a not-as-big-slowdown in China in 4Q have helped improve HK's exports, with growth in the mid-single digits in Oct and Nov (and Nov growth was on the back of a difficult base). 3M/3M seasonally adjusted trends show both exports and re-exports as of Nov improving at 7.7% and 7.9%, respectively – suggesting the logistics sector has also been busy.

Discounts to promote consumption near year end. Retail sales recorded high single digit growth in both value and volume terms as of Nov, partly due to festive demand and to interest in new tech models that came to market. However, competition appears fierce, as the difference between the value and volume retail sales growth was negative 0.6ppt, which is 4.6ppt lower than underlying inflation. The widening of these retailer margin proxies suggests that year-end sales discounts were particularly large to attract both local and tourist customers.

GDP momentum likely to be steady in 4Q13E at 3%YoY or 1.6%qoq sa, with pick-ups in trade momentum, consumption and investment spending (private housing construction and the government's large scale infrastructure works).

We expect 1Q14E to be a quarter of adjustment (dipping to 2.8%YoY GDP growth), as US tapering kicks in. For 2014, we have to gauge if HK's liquidity situation will change as tapering effects kick in and whether China's story remains sound to retain liquidity in HK. The resumption of IPOs by Chinese companies could have a two-sided impact on HK liquidity, depending whether new issues can attract more interest, especially after recent IPO reforms, and given some likely dilutions to existing players.

Government thrust to reduce poverty

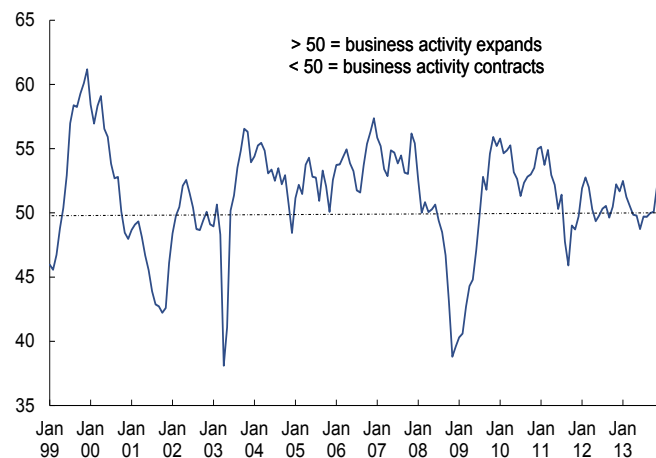
The Second Policy Address (PA) of Chief Executive CY Leung focused on four areas: 1) expanding social welfare, 2) long-term social developments (education and environment), 3) promoting economic growth to finance additional social spending, and 4) an update on land/housing supplies. Post PA HKU pop poll indicates that the public largely endorsed the Government's efforts to reduce poverty, but voices are being raised that the economic measures in the PA offer limited help to the middle class.

Sympathetic to plight of the poor – The social orientation of the PA and its extensive and detailed blueprint for poverty reduction, elderly care, support for the disadvantaged, and nurturing the next generation through education have received positive feedback thus far. In particular, we applaud the bold Low-income Working Family Allowance to assist the working poor, as this new scheme promotes self-reliance with its entitlements being tied to a household's working hours and dependent child(ren). This recurrent scheme would cost around \$3bn annually, but should benefit 200k low-income families, or 710k people.

We think there will be few surprises in the upcoming Budget Speech (26 Feb), where the CE in the press conference has already said there will be no tax hike and this fiscal year government balance will at least be balanced (as opposed to last Budget's expectation of a fiscal deficit). We expect the 2013/14 fiscal budget balance can come in above HK\$20bn due to land sales, stamp duties and investment income from HKMA, and the resulting surplus would at least satisfy the sum needed for the welfare measures announced in this PA for the upcoming year. However, by committing to these new recurrent expenditures on welfare, we may see reductions/discounts in some of the supposed 'one-offs' but are in practice 'regular' handouts/relief subsidies that many take for granted at each Budget Speech. Moving forward, aside from CE Leung's anticipation that stronger economic growth would be sufficient to fund additional recurrent public spending, in our view HK needs to figure out how to make better use of the accumulated large fiscal reserves (HK\$710bn as of Nov13) and look in to the option of mobilizing funds from government bond issuances. We understand that there are concerns on expected fast-rising welfare burdens associated with the aging society, and a large part of the fiscal revenue is dependent on the equity and property market performances, but we still see room for more-efficient use of HK's fiscal reserves or bond proceeds to fund long-term infrastructure development projects for HK.

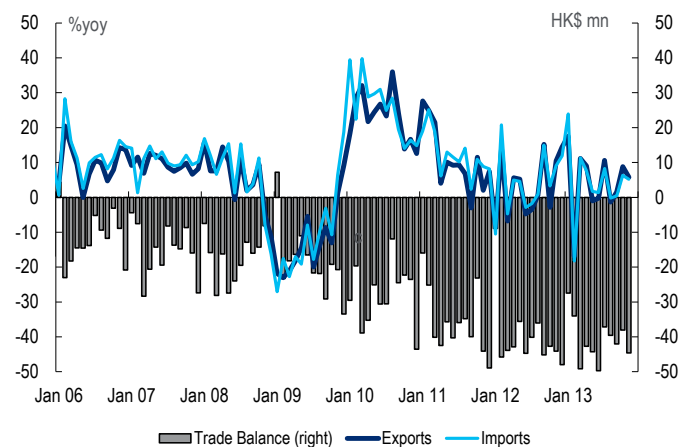
We think the PA is slightly positive for property market sentiment. The PA focused on how to create more land supply in the long term, and all existing prudential measures were kept in place. Near-term supply is unlikely to rise sharply, as the government confirmed private-sector supply at an annual average of 13,600 units in the next five years (versus a previous target of 20k units). Instead, a new housing target is set at 470k units in the next 10 years, with public housing accounting for 60%. The target will be accomplished by increasing the development density ratio by ~20%, as appropriate, creating/enlarging New Development Areas, reclaiming land and redeveloping rundown estates, and exploring the option of developing caverns and underground spaces. See additional comments from our property analyst Ken Yeung [Hong Kong Property - Policy Address Confirms Lower Private Housing Supply](#).

Figure 42. PMI Continues to Point to Expansion Ahead



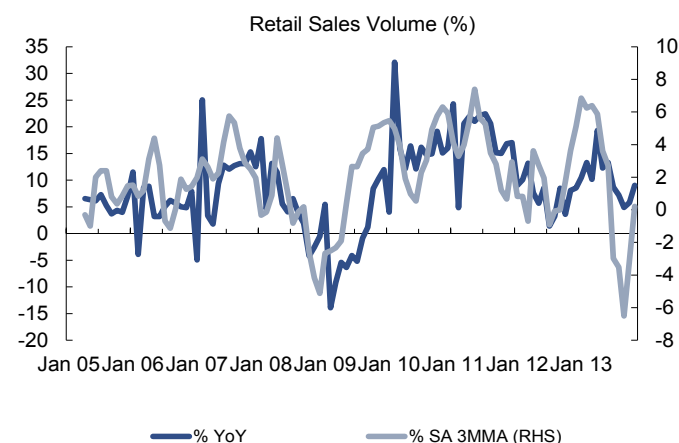
Source: HK C&SD, CEIC and Citi Research

Figure 43. Trade Recovery Proceeding But Likely Bumpy



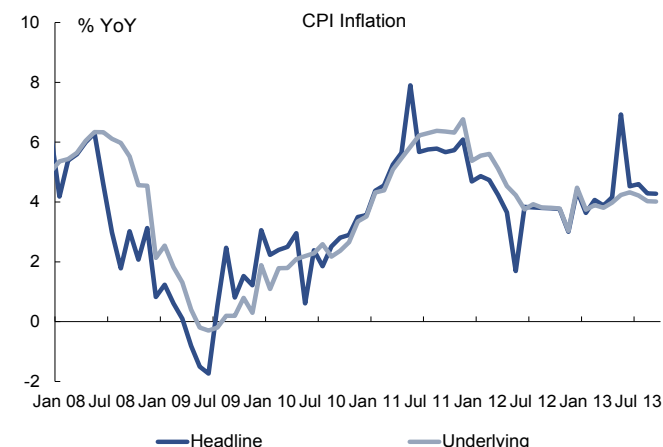
Source: HK C&SD, CEIC and Citi Research

Figure 44. Festive + Tourist Demand Appearing to Lift Retail Sales



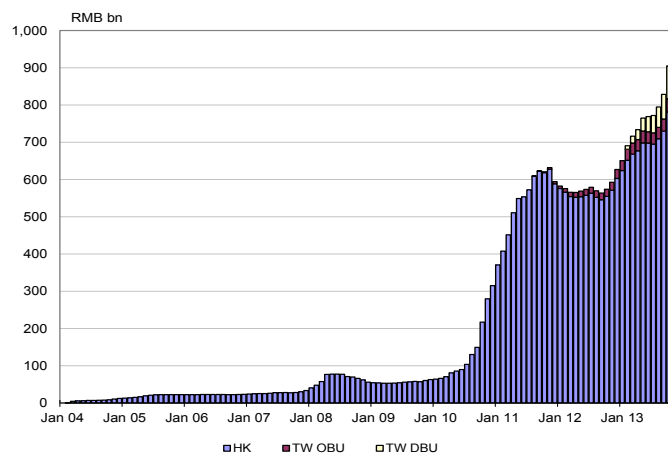
Source: HK C&SD, CEIC and Citi Research

Figure 45. Mild Price Pressure As Private Housing Pass-Through Slows



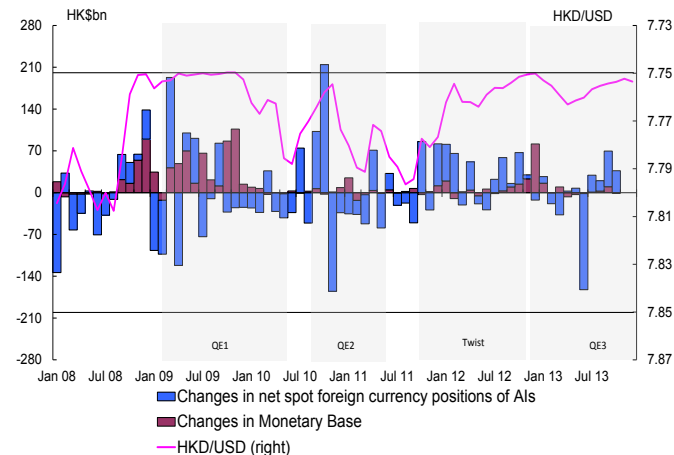
Source: HK C&SD, CEIC and Citi Research

Figure 46. Offshore RMB Deposits Approaching 1trn



Source: HK C&SD, CEIC and Citi Research

Figure 47. Net Inflows Continued in Oct13



Source: HK C&SD, CEIC and Citi Research

Figure 48. Hong Kong Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	211.6	219.3	214.1	228.7	248.7	263.2	278.8	293.8	310.9
Nominal GDP, local currency bn	1,651	1,707	1,659	1,777	1,936	2,042	2,163	2,279	2,410
GDP per capita, US\$	30,495	31,491	30,595	32,432	34,971	36,674	38,814	40,810	43,101
Population, mn	6.9	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.2
Unemployment, % of labour force	4.0	3.5	5.3	4.3	3.4	3.3	3.2	3.2	3.1
Economic Activity									
Real GDP, % yoy	6.5	2.1	-2.5	6.8	4.9	1.5	3.0	3.4	3.8
Real investment growth % yoy	7.9	-0.3	1.0	11.1	2.2	5.2	2.4	3.7	3.3
Real consumption growth % yoy	7.9	1.9	0.5	5.8	7.7	3.0	3.9	2.0	2.2
private consumption growth % yoy	8.6	1.9	0.2	6.1	8.4	3.0	4.1	2.0	2.4
Real export growth, % yoy	8.3	2.5	-10.0	16.8	3.9	1.9	7.0	5.2	6.2
Real import growth, % yoy	9.1	2.2	-9.0	17.4	4.6	2.8	7.2	4.8	5.7
Prices, Money & Credit									
CPI, % yoy	3.8	2.1	1.5	2.9	5.7	3.8	4.1	3.6	3.5
CPI, % avg	2.0	4.3	0.6	2.3	5.3	4.1	4.3	3.6	4.0
Nominal wages, % yoy	2.4	4.0	-1.9	2.4	9.9	4.7	3.5	4.5	4.5
Credit extension to private sector, % yoy	15.2	11.0	-2.1	20.9	12.5	7.0	16.0	11.0	8.0
1 month inter-bank rate, % eop	3.45	0.95	0.14	0.28	0.38	0.40	0.38	0.40	0.85
Long term yield, % eop	3.10	1.19	1.93	1.76	0.96	0.32	1.40	1.90	2.70
lc/US\$, eop	7.80	7.75	7.75	7.77	7.77	7.75	7.75	7.76	7.75
lc/US\$, avg	7.80	7.79	7.75	7.77	7.78	7.76	7.76	7.76	7.75
Balance of Payments, US\$ bn									
Current account	27.6	32.9	21.2	16.1	14.0	4.4	7.7	9.2	12.0
% of GDP	13.0	15.0	9.9	7.0	5.6	1.7	2.8	3.1	3.9
Trade balance	-23.1	-25.8	-28.8	-43.0	-54.9	-61.6	-62.7	-63.9	-64.2
Exports	344.5	362.7	318.5	390.2	428.7	442.8	459.2	482.5	514.7
Imports	367.6	388.6	347.3	433.1	483.6	504.3	521.9	546.4	578.9
Service balance	-4.3	-2.7	3.6	10.2	17.2	24.6	28.7	29.7	30.3
Income balance	6.8	12.9	6.4	4.8	6.8	3.8	7.0	7.0	7.0
FDI, net	-19.0	-8.9	-6.4	-10.5	-8.7	-11.2	-10.0	-11.0	-12.0
International reserves	152.6	182.5	255.7	268.6	285.3	317.2	311.2	335.0	360.0
Public Finances, % of GDP									
Consolidated government balance	7.3	0.1	1.5	4.1	3.8	3.1	1.4	1.3	0.7
Consolidated gov primary balance	7.4	0.1	1.6	4.2	3.8	3.2	1.4	1.4	0.7
Public debt	1.2	1.0	0.7	0.6	0.6	0.5	0.6	1.0	1.4
of which Domestic	0.4	0.2	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	3.2	2.9	3.0	2.8	3.2	3.6	4.0	3.9	3.5
CPI, % yoy	4.2	4.6	4.1	4.0	3.7	3.9	3.6	3.9	3.7
1 month inter-bank rate, % eop	0.21	0.22	0.22	0.25	0.35	0.45	0.55	0.65	0.85
Long term yield, % eop	1.12	1.15	1.39	1.50	1.70	1.80	2.00	2.20	2.40
lc vs USD, eop	7.76	7.76	7.75	7.75	7.76	7.76	7.76	7.76	7.75

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is general government debt.

India

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- **Summary view** – With an improving global backdrop in 2014, we believe that the pillars of India's problems would also become the legs for India's recovery. We maintain our estimates of modest upturn in GDP growth from 4.8% in FY14 to 5.6% in FY15 and believe a pick-up in private sector investments will be key
- **Things to watch** – Four domestic factors to watch out for : (1) sustaining the trends in CAD; (2) easing inflation on food price normalization; (3) investment pick-up on measures to resolve execution bottlenecks; and (4) political development into the May general elections (for details, see [Four "Sights" Into Fourteen](#)).
- **Strategy** – Given an improving outlook on investments and growth, we expect INR to remain range-bound within the 60-63 range. With inflation topping off, bond yields drifted lower from 9% to ~8.5% but, in the light of recommendations made by [Ujit Patel committee](#), yields could head higher.

Expect a modest upturn in GDP growth to 5.6% in FY15

Agri and exports to aid 5%+ growth in 2HFY14: While current trends in industry remain sub-par (core infrastructure output up 0.5%YoY in Oct-Nov, automobile production continues to contract), on the brighter side, export growth and trends in the summer harvest/ winter sowing have been encouraging.

If all goes well, Investments could surprise in FY15: An Investment pick-up could push GDP growth from 4.8% in FY14 to 5.6% in FY15. Key factors that support our view are (1) progress made by the Project Monitoring Group (PMG)- 122 projects or ~3.5% of GDP have been cleared since June; (2) developments on Delhi-Mumbai Industrial Corridor; (3) integration of the southern grid and (4) the project-financing pipeline.

External sector: gold in FY14; coal, iron ore in FY15?

Trends in current account deficit: Hard work on the policy front has brought the current account deficit (CAD) down from a high of US\$88bn or 4.8% of GDP in FY13 to estimated US\$42.5bn or 2.3% of GDP in FY14. While the narrowing of CAD so far has been primarily due to compression in gold/non-essential imports, we expect trends to sustain in FY15 as the resumption of iron ore exports and lower coal/metal scrap imports is likely to keep the trade balance in check.

Capital Flows: boost from FCNR deposits: After getting a one-time boost of US\$34bn thanks to RBI's concessional swap facility for FCNR/Bank Tier 1 capital, there is an uneasy calm on the capital front. With improving trends in portfolio flows, we expect capital flows to touch US\$57bn and a BoP surplus of \$13.7bn in FY14.

Inflation & interest rates: outlook improves

Both WPI and CPI declined by ~130bps in Dec to 6.2% and 9.9%: Inflation data surprised positively in Dec with headline WPI inflation decelerating to 6.2%YoY from 7.5% last month while CPI declined from 11.2% to 9.9%. The drop in inflation was led by vegetables which dropped sequentially by 30%MoM in WPI and 18%MoM in CPI. Core WPI and CPI both edged marginally higher to 2.8% and 8.1% in Dec. We expect headline WPI and CPI inflation to moderate to 6% and 8.3% in FY15 thanks to easing food prices and initiatives to remove perishables from the APMC act.

Urjit Patel Committee Recommendations: the committee has recommended CPI as the nominal anchor with a target set at 4% with a band of +/-2% over a 2-yr time frame, with more clarity on the operating framework. This is positive and bodes well for transparency, accountability and developing a term money market. However, it's risky in the current macro environment, with concerns of possible overkill to meet the 6% target at a time of potential political transition. For more details, please see [Urjit Patel Committee Report - It's Positive and Bold...but Risky.](#)

Monetary policy: pause likely in Jan. Following the surprise decision to leave rates unchanged in Dec, the RBI said that it could act outside policy dates, if (1) food inflation doesn't come down significantly or (2) core inflation doesn't fall in the next round of data releases. While headline CPI and WPI have eased, core WPI/CPI have edged up marginally. As mentioned in our [Macroscope](#), we maintain our call of a 25bps hike in the rest of FY14 and expect rates to remain higher for longer. Going forward, if the recommendations are accepted entirely, there is ~50bps upside risk to our interest-rate trajectory.

Fiscal policy: red line challenging to meet

Fiscal trends: Apr-Nov fiscal deficit at 94% of full year: Fiscal trends remain worrisome with the deficit for April-Nov at Rs 5100bn or 94% of the FY14 budget estimates (BE). While expenditure remains within the budgeted growth rate of 18%, cumulative revenue growth for the period Apr-Nov at 12.5% remains far below the budgeted growth rate of 22%. Given current fiscal trends and the re-iteration to adhere to its 4.8% fiscal deficit target, we estimate that the central government may need to cut plan expenditure by ~Rs700bn to deliver its fiscal deficit targets

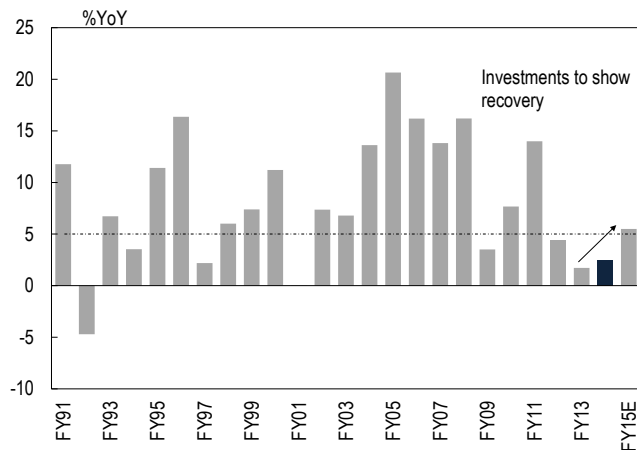
Borrowing program to increase from FY15: In order to stay closer to the fiscal roadmap, as recommended by Kelkar Committee, the government will likely present a fiscal deficit of 4.5% in FY15, which translates to gross borrowing of Rs6,768bn (17% higher than FY14). Note that redemptions are likely to increase at a CAGR of 28% in the next four years and remain elevated thereafter, on account of a rise in fiscal deficit from ~2.5% in FY08 to ~5% after FY09.

Politics: changing dynamics of general elections

State Elections: BJP wins highest number of seats in four states. The recently-held assembly elections in four key states went largely in favor of the main opposition party, the Bhartiya Janta Party (BJP). The BJP formed the government in three of the four states and a new political party, Aam Aadmi Party (AAP), has formed the government in Delhi.

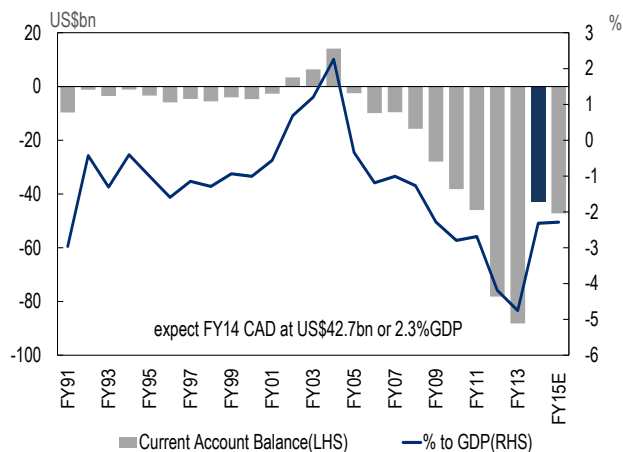
Upcoming general elections: changing arithmetic with the entry of AAP: While the BJP has gained significant ground after it announced Narendra Modi as its prime ministerial candidate, the AAP has simultaneously become a force to reckon with after its success in Delhi just one year after its founding. With the AAP now likely to contest the general election, earlier political arithmetic on likely election outcomes would need to be re-visited as the BJP is no longer the sole claimant of anti-incumbency votes against Congress. The Congress has also shown that it is capable of taking tough decisions – the recent parliament session saw passage of bills like land acquisition, companies bill, FDI in pensions etc. While the markets priority will be a single party-led stable alliance after May elections, the rapidly-evolving political dynamics suggest that such an outcome is far from certain at this point of time.

Figure 49. Trends in investments (%YoY)



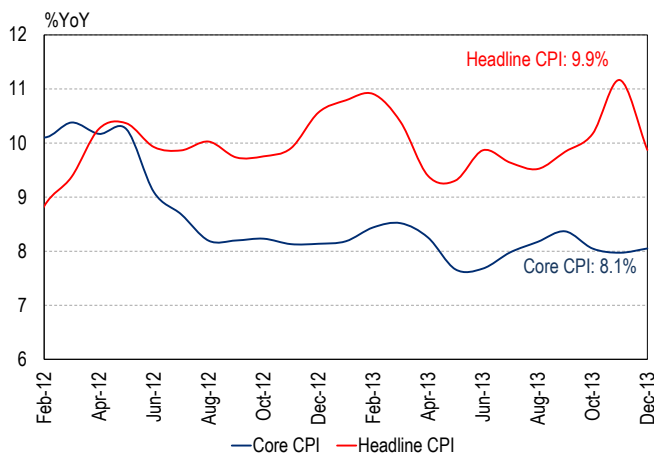
Source: CSO, Citi Research

Figure 50. Trends in current account balance (US\$bn, %GDP)



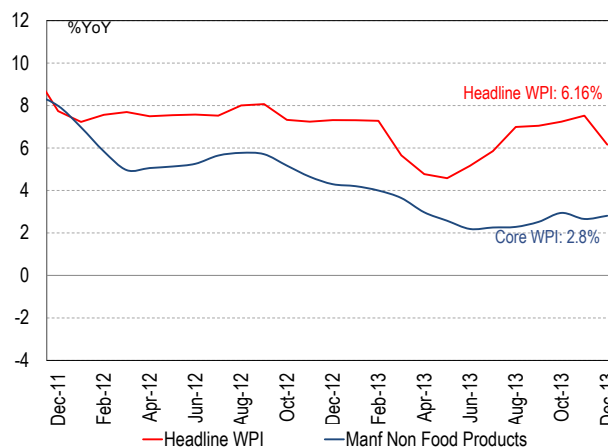
Source: RBI, Citi Research

Figure 51. Trends CPI – headline and core (%YoY)



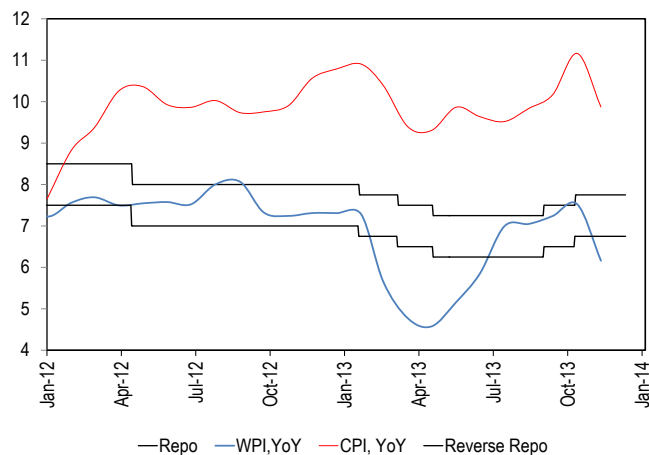
Source: CSO

Figure 52. Trends in WPI – headline and core (%YoY)



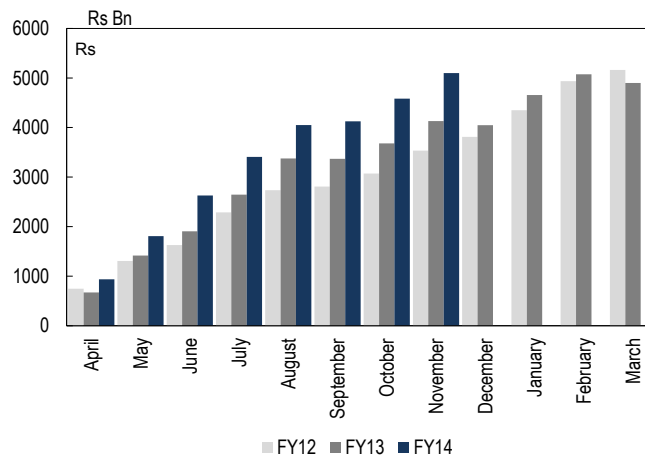
Source: Office of the Economic Advisor

Figure 53. Trends in inflation and policy rates (%)



Source: RBI, CSO, Office of the Economic Advisor

Figure 54. Trends in cumulative fiscal deficit (Rs bn)



Source: CGA

Figure 55. India Economic Indicators

	FY08	FY09	FY10	FY11	FY12F	FY13F	FY14F	FY15F	FY16F
Summary Data									
Nominal GDP, US\$ bn	1,240.6	1,223.9	1,366.6	1,710.2	1,865.9	1,855.7	1,848.3	2,066.5	2,707.9
Nominal GDP, local currency bn	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743	146,767
GDP per capita, US\$	1,090	1,061	1,168	1,442	1,552	1,521	1,493	1,644	2,123
Population, mn	1,138.0	1,154.0	1,170.0	1,186.0	1,202.0	1,220.0	1,238.3	1,256.9	1,275.8
Economic Activity									
Real GDP, % yoy	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6	6.7
Real investment growth % yoy	18.1	-5.2	17.3	15.2	0.5	6.5	1.0	4.5	6.1
Real consumption growth % yoy	9.4	7.7	8.4	8.1	8.1	3.9	4.9	6.4	7.7
private consumption growth % yoy	9.4	7.2	7.4	8.6	8.0	4.0	4.5	6.5	8.0
Real export growth, % yoy	5.9	14.6	-4.7	19.7	15.3	3.0	5.2	11.0	9.0
Real import growth, % yoy	10.2	22.7	-2.1	15.8	21.5	6.8	5.0	9.5	9.3
Prices, Money & Credit									
WPI, % yoy	7.7	1.5	10.6	9.7	7.7	6.0	6.5	6.0	5.0
WPI, % avg	4.8	8.1	3.8	9.6	8.9	7.3	6.5	6.0	5.0
Credit extension to private sector, % yoy	23.0	19.0	16.0	17.0	17.5	17.5	17.5	17.5	17.5
Policy interest rate, % eop	7.75	5.00	5.00	6.75	8.50	7.50	8.00	8.00	8.00
1 month inter-bank rate, % eop	8.00	5.68	4.49	9.54	10.90	8.50	8.50	8.50	8.50
Long term yield, % eop	7.96	7.01	7.83	7.99	8.56	8.00	8.50	8.50	8.50
lc/US\$, eop	39.41	48.62	46.41	44.71	53.02	55.00	61.81	62.21	58.22
lc/US\$, avg	41.18	43.42	48.30	45.68	46.63	53.38	58.57	61.76	59.73
Balance of Payments, US\$ bn									
Current account	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-42.8	-47.2	-57.2
% of GDP	-1.3	-2.3	-2.8	-2.7	-4.2	-4.8	-2.3	-2.3	-2.1
Trade balance	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-158.7	-169.8	-184.9
Exports	166.2	189.0	182.4	250.5	309.8	306.6	323.4	355.8	398.5
Imports	257.6	308.5	300.6	381.1	499.5	502.2	482.1	525.5	583.4
Service balance	38.9	53.9	36.0	48.8	64.1	64.9	72.1	77.8	84.0
Income balance	-5.1	-7.1	-8.0	-17.3	-16.0	-21.5	-24.0	-24.0	-26.0
FDI, net	15.9	22.4	18.0	9.4	22.1	19.8	20.0	18.0	23.0
International reserves	299.1	241.6	252.8	273.7	260.9	264.7	278.4	294.8	315.2
Total Amortisations	14.9	15.6	19.1	18.7	22.8	23.0	18.7	19.9	21.0
Public Finances, % of GDP									
Consolidated government balance	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.9	-6.7	-6.3
Consolidated gov primary balance	-1.1	3.4	4.6	2.7	2.2	--	--	--	--
Public debt	76.1	76.8	75.5	70.1	69.9	70.4	69.3	67.7	65.2
of which Domestic	71.4	72.2	70.6	65.5	65.9	66.0	65.4	63.8	62.1
Foreign Assets & Liabilities, US\$ bn									
External debt	224.4	224.5	260.9	317.9	360.7	400.3	400.3	415.3	430.3
Private	166.3	168.6	193.9	239.8	278.8	318.6	321.9	334.9	347.9
Public	58.1	55.9	67.1	78.1	81.9	81.7	78.4	80.4	82.4
External debt / GDP	18.1	18.3	19.1	18.6	19.3	21.6	21.7	20.1	15.9
External debt / XGS	88.5	77.7	95.2	84.7	80.9	90.5	87.5	79.1	61.0
Short-term debt	45.7	43.3	52.3	65.0	78.2	96.7	94.8	99.8	104.8
Short-term debt/International Reserves (%)	15.3	17.9	20.7	23.7	30.0	36.5	34.0	33.8	33.2

Quarterly Economic Indicators

	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	4.7	5.3	5.0	5.2	5.6	5.8	5.8	6.5
WPI, % yoy	4.8	6.6	7.0	7.0	6.0	6.5	5.5	6.0	5.0
Policy interest rate, % eop	7.25	7.50	7.75	8.00	8.00	8.00	8.00	8.00	8.00
1 month inter-bank rate, % eop	8.05	10.50	9.00	8.10	8.10	8.10	8.10	8.10	8.10
Long term yield, % eop	7.50	8.28	8.80	8.50	8.50	8.50	8.50	8.50	8.50
lc vs USD, eop	59.53	62.59	61.81	60.48	61.61	62.75	62.21	61.23	60.23

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Indonesia

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- **Summary view** – Recent data show growth heading for a soft landing and external accounts improving. BI has been using the exchange rate as a policy instrument and let IDR weaken significantly on a trade-weighted basis. Risks are not gone, but have receded significantly compared to two months ago.
- **Things to watch** – The oil trade deficit remains unrestrained as market prices of fuel has reverted to pre-June '13 levels. We may also see a temporary surge in imports in 1Q amid election campaigns, while exports could see hiccups upon implementation of the raw mineral export ban, which starts this month.
- **Strategy** – We think recent improvements in trade data and the better clarity over policies warrant some short term strengthening against the dollar. However we are less constructive on a 6-12M view, as the CAD, despite improving, has not yet reached sustainable levels. We still see another 25bps policy rate hike in 1Q.

Risks not gone, but subsiding

Recent economic data depict a soft landing amid improvement in external accounts. The current account deficit may have improved faster than expected in 4Q13, as trade data showed two consecutive monthly surpluses in Oct and Nov, possibly followed by benign numbers in Dec as well. Although part of the improvement was linked to recovery in coal and palm oil exports, we have also seen a declining trend in non-oil and gas imports (-13% YoY in Nov). Growth in car and cement sales volumes, a proxy of growth in material-intensive industries which we have been watching, has receded to single-digit levels. And although car sales volume growth is still positive, the value of vehicle imports (excl. dump trucks) has declined YoY, indicating that there has been a decline in the value per unit of vehicles sold.

Better clarity on mineral export regulations, though implementation risks still exist. Regulations detailing the 2009 mining law (which prohibits raw mineral exports) have finally been issued. Ore concentrate exports are allowed to continue for copper, iron, tin, lead, and zinc, and exceptions could be given to export minerals that are below mandatory requirements. However, the above do not apply to nickel and bauxite, and new export tariffs on six minerals have also been introduced. By our estimate this could mean that about half of exports under HS code 26 (ores, slag and ash) may continue. The impact to the CA deficit we therefore expect could be around 0.2-0.3% of GDP, significantly lower than previous guidance from the government, and total ore exports of about 0.5 - 0.6% of GDP.

Exchange rate continues to be used as a policy instrument. In Sep-Dec, the IDR depreciated against the USD and on trade-weighted basis by 5% and 6%, respectively. This happened concurrently with an increase in foreign reserves even after adjusting for BI's short-term dollar borrowing (from onshore banks through their USD term deposit and swap facilities). This marks a break from the past, in our view. Before Aug-13, foreign reserves usually decline during periods of exchange rate pressure, as BI intervenes heavily to minimize the currency depreciation. Nowadays the exchange rate has apparently become a more effective policy instrument to correct the current account deficit. Previously it appeared more like a policy objective, in our view, which was managed so as not to breach certain psychological levels (e.g. 10,000/US\$).

However, a number of risks still lie on the horizon

Oil trade deficit, election campaigns, and export policy implementation hiccups should be closely watched.

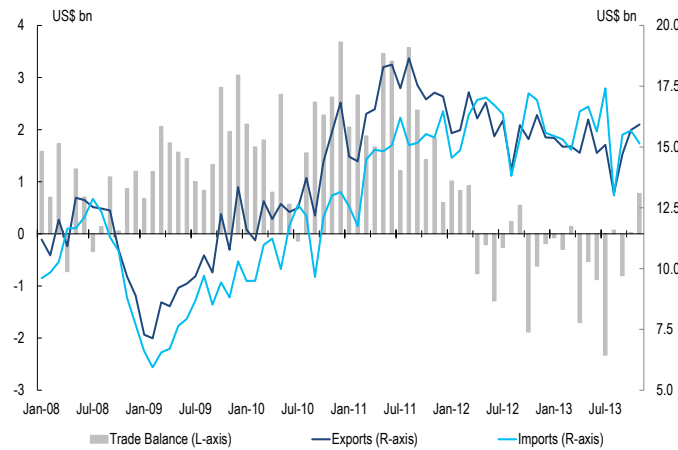
According to the government, consumption of subsidized fuel in 2013 amounted to 46mn kl, i.e. below its target of 48mn kl. However this is no cause for comfort, in our view. Consumption still grew 5% YoY and oil import volumes grew 30% YoY in the Jan-Sep period. Furthermore, with domestic oil lifting still on a secular downtrend, the oil trade deficit has seen no noticeable improvement, not even since the fuel price hike in Jun-13. Second, apart from the oil accounts, we also see risk of raw material imports resurging as the 2014 campaign election period intensifies in 1Q14. (Household consumption saw a temporary spike during the election campaign period in 2009 and we expect it to recur this year). Third, we are also watchful of a reversion of commodity exports, both due to policy glitches in the implementation of the mineral export ban as well as a reversion in the prices of coal or palm oil.

Government budget deficit may also be revised upward, possibly in 1Q. The existing budget deficit target of 1.7% of GDP is based on an exchange rate assumption of Rp10,500/US\$, which seems obsolete. The timing of the mid-year budget revision could be earlier than usual, possibly in 1Q14. From April onwards, members of parliament and political parties will likely be pre-occupied with the general elections. We expect the government will revise the budget deficit target from the current 1.7% of GDP (Rp179tn) towards 2 – 2.5% of GDP. The government still has a cumulative financing balance of around Rp60tn which can partly be tapped. However we expect that it may also have to raise the net bond issuance target vs the current Rp205tn.

Finance ministry again foreshadowing subsidy reform, but may fall short of any drastic measure. Along with the revision of the 2014 budget, the policy on fuel subsidies may come under review. The FinMin is again proposing a floating price mechanism for fuel, although such a mechanism has been annulled before by the constitutional courts. However, we think the possibility of another significant one-off fuel price adjustment is quite low. The current administration tends to accompany fuel prices hikes with compensatory cash subsidies; and parliament is unlikely to approve a cash subsidy program during an election year. (Our baseline for a fuel price hike is after the new administration comes into office, possibly in early 2015). Yet there is possibility that electricity and gas prices be (further) adjusted sometime this year. We slightly raise our YE14 inflation forecast from 4.9% to 5.3% to account for the possibility of such adjustments.

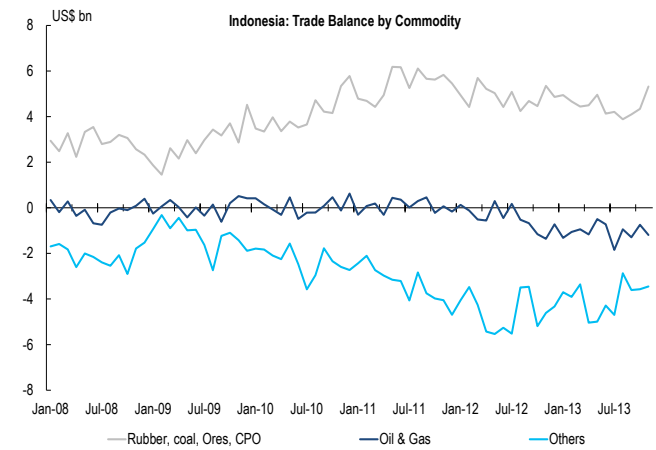
Market and policy implications. Overall, the risks on the external account are subsiding in our view, though they have not gone away. In regard to the IDR, we think recent improvements and better clarity over the mineral export regulations warrant some strengthening against the dollar in the short term. However, we are less constructive on a 6-12M horizon. We do not see massive interest rate hikes from hereon, given that BI has also been allowing exchange rate depreciation as part of its policy mix. However, we maintain our view of another 25bps hike in 1Q. Although we expect the CA deficit to have narrowed to 2.7% of GDP in 4Q13 (i.e. lower than initial expectations of 2.9 -3%), it is still considered high and above sustainable levels.

Figure 56. Trade balance trend improving



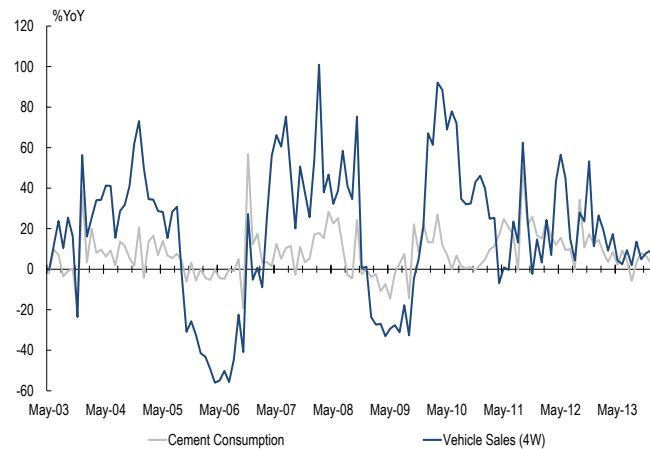
Source: CEIC, Citi Research

Figure 57. Non-oil and gas imports declining, and exports nudged up



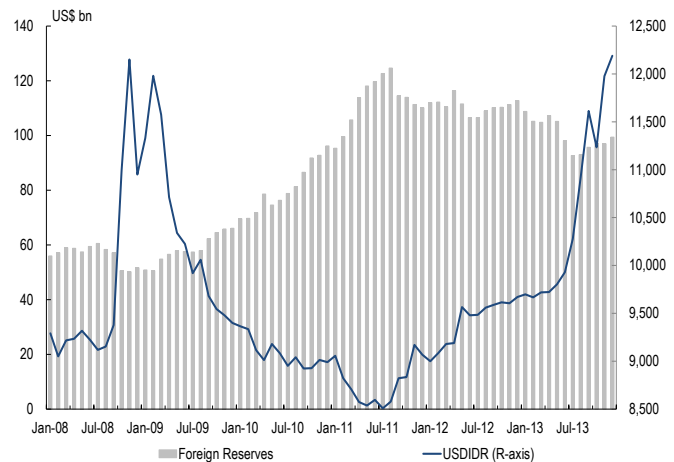
Source: CEIC, Citi Research

Figure 58. Car and construction indicators point to soft landing



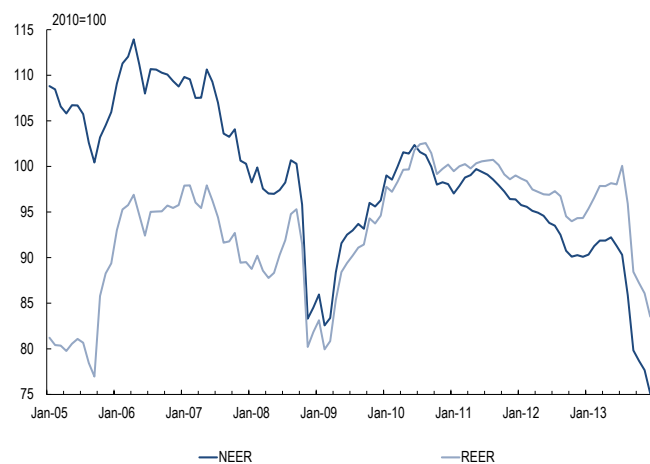
Source: CEIC, Citi Research

Figure 59. IDR depreciation accompanied by rising reserves



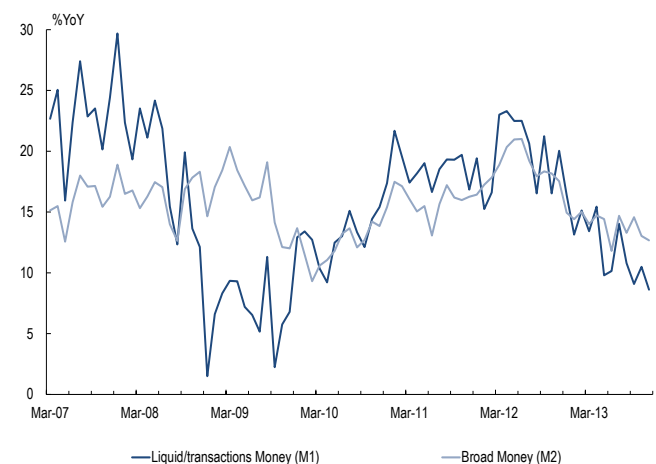
Source: CEIC, Citi Research

Figure 60. IDR has depreciated substantially on trade weighted basis



Source: BIS, CEIC, Citi Research

Figure 61. Monetary indicators point to continued slow-down



Source: CEIC, Citi Research

Figure 62. Indonesia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	432.2	510.7	538.6	709.5	845.8	878.3	879.8	842.8	954.0
Nominal GDP, local currency bn	3,950,893	4,948,688	5,606,203	6,446,852	7,422,781	8,241,864	9,176,153	10,026,877	11,236,737
GDP per capita, US\$	1,915	2,235	2,328	2,986	3,486	3,596	3,556	3,379	3,780
Population, mn	225.6	228.5	231.4	237.6	242.6	244.2	247.4	249.4	252.4
Unemployment, % of labour force	9.1	8.4	7.9	7.1	6.6	6.1	6.3	6.5	6.3
Economic Activity									
Real GDP, % yoy	6.3	6.0	4.6	6.2	6.5	6.2	5.7	5.3	5.5
Real investment growth % yoy	1.9	12.4	2.4	8.8	10.5	16.9	5.0	4.5	6.0
Real consumption growth % yoy	4.9	5.9	6.2	4.1	4.5	4.8	5.0	4.7	4.7
private consumption growth % yoy	5.0	5.3	4.9	4.7	4.7	5.3	5.0	4.6	4.3
Real export growth, % yoy	8.5	9.5	-9.7	15.3	13.6	2.0	3.5	5.5	10.0
Real import growth, % yoy	9.1	10.0	-15.0	17.3	13.3	6.6	0.8	4.0	9.0
Prices, Money & Credit									
CPI, % yoy	5.8	11.1	2.8	7.0	3.8	4.3	8.4	5.3	6.4
CPI, % avg	6.3	9.9	4.8	5.1	5.4	4.3	7.0	6.4	5.7
Nominal wages, % yoy	4.9	7.6	5.3	12.2	3.4	20.4	21.2	17.1	15.0
Credit extension to private sector, % yoy	22.4	30.7	18.0	20.6	25.9	22.3	18.0	16.0	17.0
Policy interest rate, % eop	3.00	8.75	6.00	5.50	4.50	4.00	5.75	6.00	6.50
1 month inter-bank rate, % eop	3.35	9.44	6.39	5.66	4.57	4.24	6.01	6.25	6.90
Long term yield, % eop	10.02	11.92	10.07	7.83	6.05	5.39	8.60	8.80	9.00
lc/US\$, eop	9,393	10,900	9,425	9,010	9,068	9,638	12,170	11,937	11,618
lc/US\$, avg	9,140	9,673	10,376	9,078	8,763	9,361	10,449	11,950	11,738
Balance of Payments, US\$ bn									
Current account	10.5	0.1	10.6	5.1	1.7	-24.4	-29.4	-24.4	-23.1
% of GDP	2.4	0.0	2.0	0.7	0.2	-2.8	-3.3	-2.9	-2.4
Trade balance	32.8	22.9	30.9	30.6	34.8	8.6	4.4	5.9	9.2
Exports	118.0	139.6	119.6	158.1	200.8	188.5	181.5	187.7	209.4
Imports	85.3	116.7	88.7	127.4	166.0	179.9	177.1	181.8	200.3
Service balance	-11.8	-13.0	-9.7	-9.3	-10.6	-10.3	-11.1	-10.5	-10.8
Income balance	-15.5	-15.2	-15.1	-20.8	-26.7	-26.8	-26.7	-24.0	-26.0
FDI, net	2.3	3.4	2.6	11.1	11.5	14.0	15.8	14.0	14.5
International reserves	56.9	51.6	66.1	96.2	110.1	112.8	99.4	104.3	107.8
Total Amortisations	18.8	16.7	20.4	24.0	25.2	29.4	41.0	42.0	42.0
Public Finances, % of GDP									
Consolidated government balance	-1.3	-0.1	-1.6	-0.7	-1.1	-1.9	-2.2	2.2	-1.7
Consolidated gov primary balance	0.8	1.7	0.1	0.6	0.1	-0.6	-0.9	1.0	-0.5
Public debt	34.1	29.3	31.4	26.4	23.6	23.3	25.0	26.0	25.0
of which Domestic	19.7	16.2	19.3	16.7	15.5	16.0	15.6	15.6	16.0
Foreign Assets & Liabilities, US\$ bn									
External debt	141.2	155.1	172.9	202.4	225.4	252.4	265.0	277.0	290.0
Private	60.6	68.5	73.6	83.8	106.7	126.2	126.5	135.0	142.0
Public	80.6	86.6	99.3	118.6	118.6	126.1	138.5	142.0	148.0
External debt / GDP	32.7	30.4	32.1	28.5	26.6	28.7	30.1	32.9	30.4
External debt / XGS	108.2	100.1	130.2	115.8	101.8	119.3	129.0	130.2	123.2
Short-term debt	18.7	20.5	24.0	31.6	36.6	43.4	44.0	46.0	49.0
Short-term debt/International Reserves (%)	32.8	39.7	36.4	32.8	33.2	38.4	44.3	44.1	45.5
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	5.8	5.6	5.4	5.8	5.4	4.6	5.2	4.6	4.9
CPI, % yoy	5.9	8.4	8.4	7.4	7.4	5.3	5.3	5.9	7.0
Policy interest rate, % eop	4.25	5.50	5.75	6.00	6.00	6.00	6.00	6.25	6.50
1 month inter-bank rate, % eop	4.45	5.70	6.01	6.25	6.25	6.25	6.25	6.50	6.75
Long term yield, % eop	7.21	8.54	8.60	8.50	8.40	8.60	8.80	9.00	9.00
lc vs USD, eop	9,925	11,580	12,170	11,916	11,954	11,992	11,937	11,858	11,779

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination). We refer to the FasBI rate to better reflect actual money market rates for Indonesia's policy rate.

Malaysia

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- **Summary view** – Export demand could drive a 4Q GDP sequential expansion and CA upside surprise, though fiscal consolidation is taking a toll on domestic demand. This should keep the MPC on hold near term, but administered price hikes could fan inflation expectations.
- **Things to watch** – [1] Signs of slowing domestic demand; [2] improvements in external demand, especially to the G3; [3] private investments and FDI; [4] fuel price hikes and impact on inflation; [5] signs of rising inflation expectations; [6] progress on fiscal consolidation; [7] comments from Gov Zeti.
- **Strategy** – Improving CA, fiscal dynamics and rate hikes could help the MYR, though heavy foreign positioning remains a headwind. Our base case remains for BNM to commence rate hikes in 2Q, though risks of a delay to 2H14 remain if fiscal consolidation takes a larger toll on domestic demand than expected.

Fiscal consolidation taking a toll on domestic demand ...

Export demand appears to have remained strong into 4Q13. Average seasonally-adjusted Oct-Nov export levels are now 3.1% higher than the 3Q13 average, with average Oct-Nov Electrical and Electronics (E&E) exports 7.4% above 3Q. This is mirrored in the IP data with average Oct-Nov Manufacturing up 3.7% and E&E Manufacturing IP rising 5.9% over 3Q13 as manufacturers likely continued to replenish stocks of components used to produce exports – average Oct-Nov imports of intermediate goods are 4.6% above 3Q13. With the average Oct-Nov trade surplus of RM9.0bn higher than the 3Q monthly average of RM6.2bn, the 4Q CA surplus could surprise on the upside at 6% of GDP (3Q: 4.0%), which should bring the full year 2013 CA surplus to 3.8% of GDP (2014F: 4.4%).

However fiscal consolidation also gained momentum. The Jan-Nov ytd fiscal deficit has stabilized on slowing expenditure growth and improving revenues, raising the odds of meeting (or beating) the 4% of GDP target for 2013. The Jan-Nov fiscal deficit stands at RM24.0bn or 61% of the downwardly revised target of RM39.2bn, largely reflecting expenditure restraint – expenditure in the first 11 months stands at 83.1% of the revised target of RM259.7bn (below the 84.6% historically in the same period). Extrapolating from historical patterns would yield a deficit of RM36.7bn (3.7% of GDP). In his new year message, PM Najib also announced a freezing of government entertainment budgets and applications for the renovation of government offices, among other measures to cut spending.

The data points to still-slowing domestic demand, especially for investment. Average seasonally-adjusted Oct-Nov imports of capital goods have plunged 8.5% below the 3Q13 average while Oct-Nov imports of consumption goods are down 0.8%. Elsewhere, outstanding consumption credit growth slowed to 6.9%YoY in Oct-Nov (3Q: 7.4%) while passenger vehicle sales have fallen into decline (Oct-Nov: -1.3%YoY, 3Q: +12%).

Overall, 4Q GDP could see stronger sequential expansion. The strong Oct-Nov IP data are likely to support 4Q GDP, with sequential boosts from manufacturing as well as mining – average seasonally-adjusted Oct-Nov Mining IP is 6.8% above the 3Q13 average while average Oct-Nov Electricity IP is up 1.9%. Factoring in some sequential pullback in Dec to limit inventory buildup, 4Q GDP growth could print closer to 4.5%YoY.

...but inflation expectations could be rising

While demand-pull pressure is benign, administered price hikes risk fanning inflation expectations. Headline inflation continued to tick up to 3.2%YoY in Dec (Nov: 2.9%), while core inflation (excluding Food, Alcoholic Beverages and Tobacco, and Transport) ticked up but remained low at 1.5%YoY (Nov: 1.3%). The fuel-price hikes in Sep have proven to be only the first in a slew of administered price adjustments as the government frontloads the pain well in advance of the next elections (due in 2018). At face value, the cumulative impact of CPI of hikes in electricity tariff, school bus fares and highway tolls could be close to 1%pt, although a plethora of exemptions, e.g. low-usage households from electricity tariff hikes, suggest the actual impact will probably be much lower. That said, there is a risk that these hikes may fan inflation expectations. Looking at the most granular CPI data available, for example, our inflation diffusion index suggests that the share of the CPI basket seeing MoM price increases has already been on an upward trend since the middle of the year and the Sep fuel price hikes.

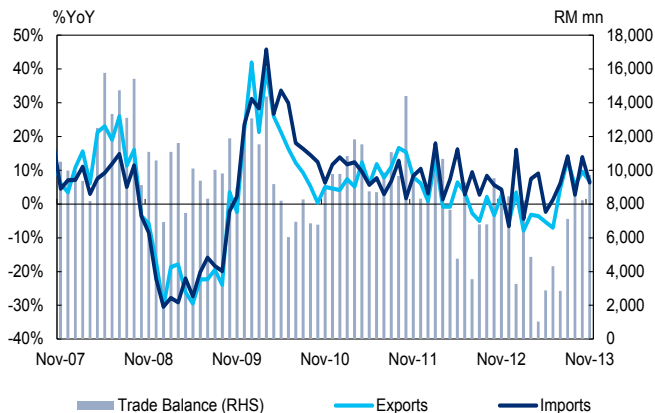
The full implementation of the minimum wage on 1 Jan could also pressure services costs upwards. The government had previously estimated that about 3.2mn workers earning below RM700 a month would benefit from the minimum wage – about a quarter of the labour force of 12.7mn then. Our own estimates suggest at least 32.8% of workers or 4.2mn workers stood to benefit from the minimum wage. While this, together with BR1M handouts, could provide some relief to lower-income households after the recent price adjustments, household debt service burdens and their impact on consumption will have to be watched, especially if rates are hiked as we expect – recent newsflow for example already suggests more households have encountered financial difficulties since the fuel price hike in Sep.

MPC likely to remain on hold near term

Our base case remains for BNM to commence hikes in 2Q14. Slowing domestic demand, especially as fiscal consolidation accelerates, will likely keep the MPC cautious near term despite recent export upside surprises. Fiscal belt-tightening is unlikely to be reversed as long as public unhappiness remains confined to urban, i.e. opposition-leaning, areas like KL, while BR1M handouts should placate 7.9mn persons in households earning under RM4,000/month – while part of cost normalization, the price adjustments also lend evidence of the government's resolve in advancing fiscal reforms which should bolster its credibility with ratings agencies.

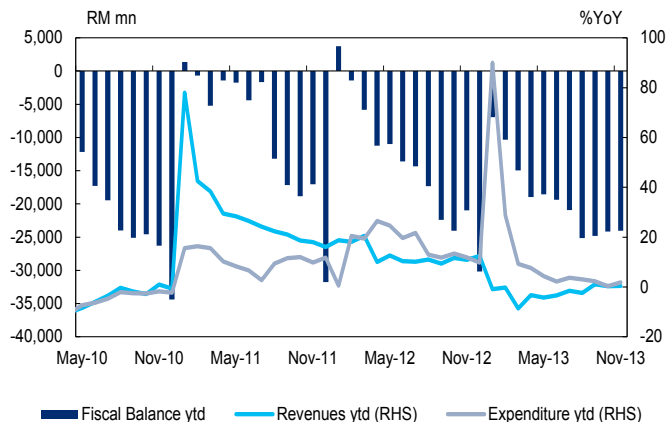
The risk of rising inflation expectations needs to be watched however – Gov Zeti's comments to Bloomberg on 18 Dec stressing that monetary policy will depend on the source of inflation – supply-side driven inflation is likely to be seen as "temporary" and thus tolerated – continue to suggest that BNM would prefer to wait and see more data points before committing to a hike. Our base case remains for BNM to commence hikes in 2Q as headline inflation breaches 3.5% and export improvements bolster the MPC's confidence on the growth outlook, though risks of a delay to 2H14 remain if fiscal consolidation takes a larger toll on domestic demand than expected. We would watch for guidance from BNM – any intention to hike will likely be communicated to the market in advance via either the MPC statement or comments to media. Should a March hike be in the cards, this will likely be hinted at in the Jan MPC statement.

Figure 63. Oct-Nov trade surplus hints at 4Q CA upside surprise



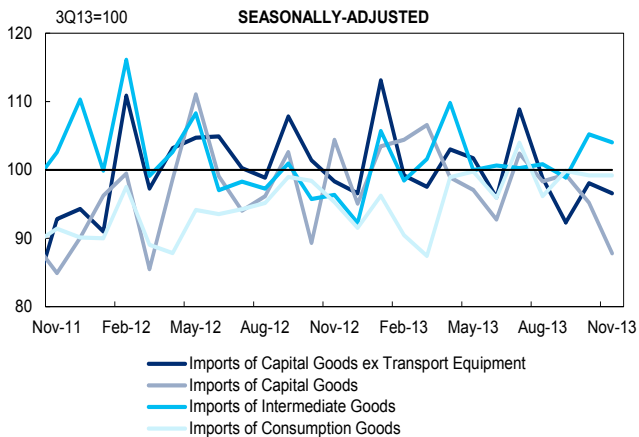
Source: CEIC, Citi Research

Figure 64. Fiscal consolidation has gained momentum



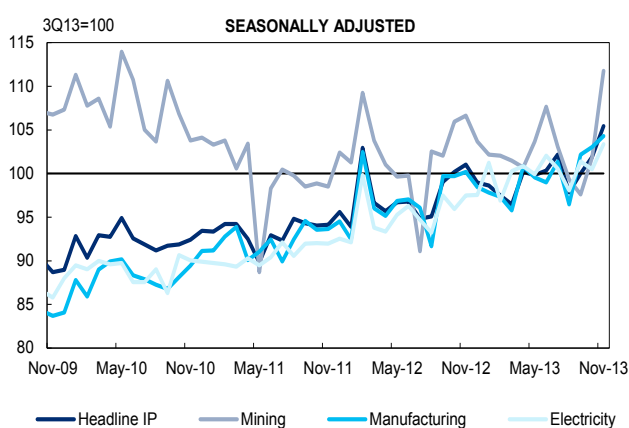
Source: CEIC, Citi Research

Figure 65. Imports point to still slowing domestic demand



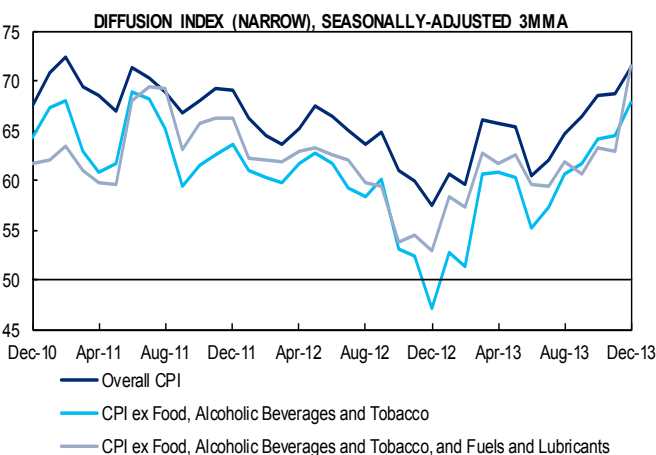
Source: CEIC, Citi Research

Figure 66. The strong Oct-Nov IP data is likely to support 4Q GDP



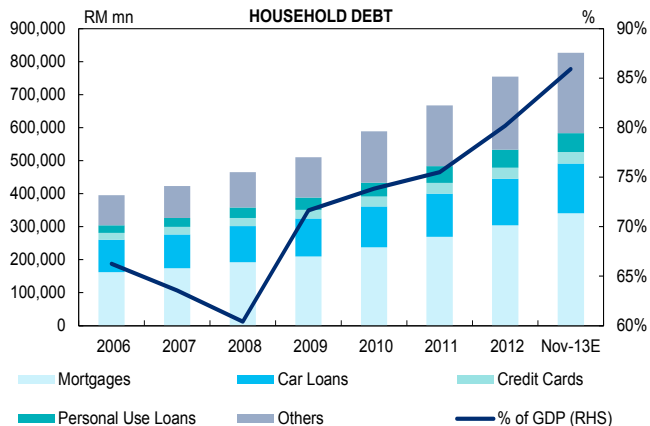
Source: CEIC, Citi Research

Figure 67. Our inflation diffusion index has been on an upward trend



Note: We examine the most granular CPI data assign each category values based on their MoM changes – increases=100, no change=50, and decreases=0. We then weight these by their CPI weights and then seasonally-adjust the diffusion index. Values above 50 thus indicate that the CPI basket is overall seeing MoM increases.
Source: CEIC, Citi Research

Figure 68. We estimate household debt is 85.9% of GDP as of Nov



Source: CEIC, Citi Research Estimates

Figure 69. Malaysia Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	193.7	231.1	202.4	247.7	289.3	305.0	313.2	328.8	357.8
Nominal GDP, local currency bn	665	770	713	797	884	941	986	1,056	1,116
GDP per capita, US\$	7,123	8,393	7,255	8,664	9,987	10,398	10,541	10,782	11,542
Population, mn	27.2	27.5	27.9	28.6	29.0	29.3	29.7	30.5	31.0
Unemployment, % of labour force	3.2	3.3	3.7	3.2	3.1	3.0	2.9	2.9	2.9
Economic Activity									
Real GDP, % yoy	6.3	4.8	-1.5	7.4	5.1	5.6	4.5	5.0	4.9
Real investment growth % yoy	9.1	1.8	-9.4	25.3	2.3	22.3	7.8	3.1	8.0
Real consumption growth % yoy	9.7	8.4	1.4	6.2	8.6	7.1	6.6	5.0	3.4
private consumption growth % yoy	10.4	8.7	0.6	6.9	6.8	7.7	7.4	6.5	4.7
Real export growth, % yoy	3.8	1.6	-10.9	11.1	4.6	-0.1	-0.8	4.4	3.3
Real import growth, % yoy	5.9	2.3	-12.7	15.6	6.1	4.7	1.3	3.8	3.0
Prices, Money & Credit									
CPI, % yoy	2.3	4.5	1.0	2.1	3.0	1.2	3.2	3.5	4.9
CPI, % avg	2.0	5.4	0.6	1.7	3.2	1.6	2.1	3.6	4.5
Nominal wages, % yoy	4.3	4.5	2.5	8.2	3.8	6.4	5.0	5.0	5.0
Credit extension to private sector, % yoy	9.2	10.2	6.8	10.6	12.3	12.1	11.0	11.0	11.0
Policy interest rate, % eop	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.50	3.50
3 month inter-bank rate, % eop	3.61	3.37	2.17	2.98	3.22	3.21	3.32	3.70	3.70
Long term yield, % eop	3.78	3.00	3.79	3.39	3.23	3.24	3.66	4.00	4.00
lc/US\$, eop	3.31	3.45	3.42	3.08	3.17	3.06	3.28	3.14	3.10
lc/US\$, avg	3.44	3.33	3.52	3.22	3.06	3.09	3.15	3.21	3.12
Balance of Payments, US\$ bn									
Current account	29.7	39.4	31.4	27.1	33.5	18.6	11.9	14.5	14.3
% of GDP	15.4	17.1	15.5	10.9	11.6	6.1	3.8	4.4	4.0
Trade balance	38.1	51.1	39.8	42.5	49.6	40.7	32.0	34.0	35.0
Exports	176.5	198.9	157.0	199.2	228.8	227.9	229.0	257.4	265.0
Imports	138.5	147.7	117.1	156.7	179.2	187.2	197.0	223.4	230.0
Service balance	0.4	0.5	1.2	-0.4	-2.1	-4.5	-4.7	-3.8	-3.0
Income balance	-8.7	-12.2	-9.6	-15.0	-14.0	-17.6	-15.4	-15.7	-17.7
FDI, net	-2.7	-7.8	-6.3	-4.3	-3.1	-7.0	-5.0	-3.0	-1.0
International reserves	101.3	91.5	96.7	106.5	133.6	139.7	134.9	135.0	140.0
Total Amortisations	7.8	6.3	9.8	11.3	9.0	7.4	10.0	11.0	12.0
Public Finances, % of GDP									
Consolidated government balance	-3.1	-4.6	-6.7	-5.4	-4.8	-4.5	-4.2	-3.5	-3.0
Consolidated gov primary balance	-1.2	-3.0	-4.7	-3.5	-2.8	-2.4	-1.7	-1.3	-0.9
Public debt	40.1	39.8	50.8	51.1	51.6	53.3	54.8	55.0	55.0
of which Domestic	37.1	37.2	48.9	49.0	49.5	51.5	53.0	53.5	53.5
Foreign Assets & Liabilities, US\$ bn									
External debt	56.2	66.6	68.3	72.6	81.5	82.8	96.0	97.0	96.0
Private	37.8	41.5	41.9	44.7	53.7	55.6	65.0	65.0	64.0
Public	18.4	25.2	26.3	27.9	27.8	27.1	31.0	32.0	32.0
External debt / GDP	29.0	28.8	33.7	29.3	28.2	27.1	30.6	29.5	26.8
External debt / XGS	27.4	29.0	36.9	31.4	30.7	31.1	35.7	32.7	31.4
Short-term debt	16.3	22.5	22.7	25.4	32.8	30.4	40.0	42.0	42.0
Short-term debt/International Reserves (%)	16.1	24.6	23.5	23.8	24.6	21.8	29.7	31.1	30.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.4	5.0	4.5	5.6	4.7	5.5	4.2	4.1	5.3
CPI, % yoy	1.8	2.6	3.2	3.5	4.0	3.5	3.5	3.2	5.0
Policy interest rate, % eop	3.00	3.00	3.00	3.00	3.25	3.50	3.50	3.50	3.50
3 month inter-bank rate, % eop	3.20	3.21	3.32	3.20	3.45	3.70	3.70	3.70	3.70
Long term yield, % eop	3.20	3.52	3.53	3.70	3.80	3.90	4.00	4.10	4.10
lc vs USD, eop	3.16	3.26	3.28	3.30	3.23	3.16	3.14	3.13	3.12

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Wage is based on Citi Research estimates of average manufacturing sector wage. Public debt is general government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Philippines

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- **Summary view** – The impact of Yolanda's fury isn't as bad as anticipated, leading us to upgrade our 4Q13 GDP growth estimate to 5.5% (from 4%). Spending catalysts remain in place that can lead to the resumption of the upbeat backdrop and growth in the 7% range in 2014.
- **Things to watch** – Accelerating primary fiscal expenditures in 1Q14 driven by rehabilitation/reconstruction in the typhoon-devastated areas following tempered pace of spending in 4Q13. Sustained core CPI uptrend. Weak PHP despite diminished trade deficit risk as export gains persist. Rate tightening in 2H14.
- **Strategy** – Recent t-bill auctions fetched sharply higher rates due to higher inflation expectations, more t-bill supply risk in 1Q14 and absence of steep discounts in the offshore PHP NDF rate. By end-Mar we expect PHP to drift to 46 on tapering risk in full bloom amid subdued BSP intervention and growth bias.

Subdued typhoon impact on 4Q13 fundamentals

Upbeat signals from key macro indicators in Nov more than offset the impact of typhoon Yolanda's fury. As such, we upgraded our 4Q13 GDP growth forecast to 5.5%YoY (from 4%), which supports full-year growth of 6.9% in 2013. The strong macro backdrop of quarterly gains in the range of 7% could easily resume in 2014 on the back of 1) rehabilitation/reconstruction program in the Visayas, 2) an infrastructure spending bias remaining intact, likely supported by recent budgetary reforms, 3) real exchange rate weakness that sustains strengthens purchasing power (PP) of remittance recipients, which supports consumption; and 4) renaissance of non-tech mfg exports bode well for industrial employment.

Supply constraints caused by Yolanda failed to suppress strong export growth in Nov. Electronic exports managed to rise 10%YoY. Non-tech exports including some farm products expanded 27.1%YoY to show another month of double-digit export gains. Weak PHP, new 'supply chain' capacity amid firming external demand, supported strong non-tech exports. Coconut exports fell 14.4%YoY although offset by sugar products (27.9 x increase), fruit & vegetables (88.5%) and other agro-based products (42%). Farm production for exports may have lingering supply risk concerns but the worst is probably over. Weak PHP could divert more farm output to export markets. Hefty customs trade exports in Oct-Nov led us to revise upward our 4Q13 real export growth to 13.5%YoY. This eased the drag from the 4Q13 net trade deficit estimate to 2.4% of GDP from 5.7% in 4Q12.

Real peso value of the OFW remittances in our estimate grew by 10.2%YoY in Nov on weak PHP. This material gain in the PP of remittances matched the pick-up seen for much of 2009 when the PHP also slumped against USD due to the global crisis. Inflation rose to 3.3%YoY during the month and could have weakened PP, but this was more than offset by lackluster PHP which fell by an average of 7.6%YoY. For Oct-Nov, the growth in real remittance value (9.3%YoY) bodes well for 4Q13 consumption, and cushions downside risk to 4Q13 consumption caused by Yolanda's fury.

Mfg. production rose by 21.3%YoY in Nov. Mfg index tracked strong sales volume index that grew 38%YoY. Except for the 4.4%YoY drop on food, we failed to detect strong traces or hints of typhoon-driven supply constraints that could curb mfg. Strong manufactured exports uplifted mfg sales volume, which underpinned much of mfg output. Upbeat construction and a de-stocking cycle in the past for some provided additional support for 13 out of 20 industries that reported gains in Nov.

Upside core risk likely to be sticky downwards

Supply constraints caused by typhoon Yolanda were mirrored by lingering food price pressures as 2013 ended. CPI settled at an average of 2.9% in 2013. Broad food CPI jumped 4.8%YoY in Dec, presumably on lingering supply pressures. Higher electricity tariff rate adjustments in Nov on lower power supply caused primarily by Malampaya's year-end maintenance helped push fuel core CPI's up sharply to 3.2%YoY in Dec. We estimate seasonally-adjusted CPI yielded a 10% annualized rate to close 2013. While food price pressures should abate in 1Q14 when local food supply normalizes and food imports come around, higher core is likely to be 'sticky downwards' and remains a policy risk. Core pressures would come from pass-through of higher import costs due to a weak PHP amid a strong demand environment. We pencil in 4Q14 average inflation of 4.5%YoY.

Lower risk of fiscal deficit undershooting this year

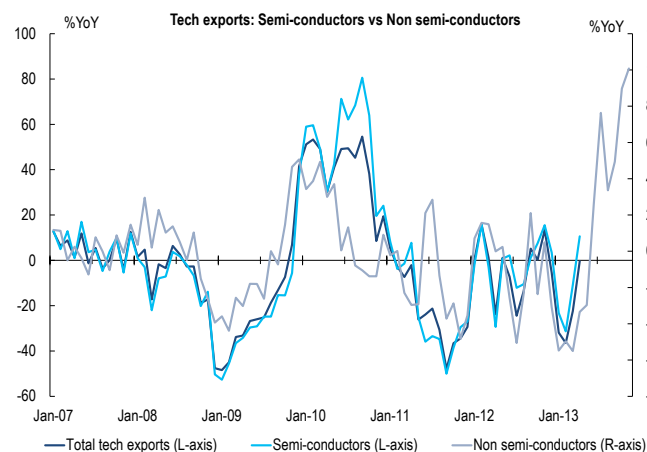
Expected 2013 budget deficit (Php191bn) probably undershot the fiscal deficit target of Php238bn, while the 2014 projected budget gap of Php224bn (-1.8% of GDP) may also fall short of this year's deficit target of Php266bn. While we see strong reasons for government to spend, particularly in this year, it will be hard pressed to match the upbeat revenue gains after stalling in 4Q13, largely due to ongoing investigations on misuse of the presidential assistance development fund (pork barrel) by some prominent politicians and other cases of fiscal corruption involving abuse of discretion. Upside to fiscal spending would be driven by the reconstruction efforts in the Visayas and budgetary reforms that facilitated early release of disbursements this year. The annual budget program approved by Congress would be the document that releases for funds starting 2014, cutting layers of bureaucratic approvals that introduce vulnerability to delays and corruption. Upside to spending may not be a match for a rising tax to GDP ratio, likely to be at a conservative 13.5% this year considering another round of excise tax hikes on cigarettes and liquor under the excise tax reform law.

Government proposed a 2015 budget of Php2.6tn up 15% with a fiscal deficit target of Php285bn (2% of GDP). Driven by goals of 'rapid growth and inclusive development', we anticipate the fiscal cycle to peak next year with the highest fiscal gap target under Aquino as it constitutes his last full fiscal year. Hopefully recent budgetary reforms would enable government to pursue a larger expenditure program with lower risk of 'absorptive capacity'. The 2015 budget proposal may be loaded with a heavier infrastructure budget, with 4% of GDP as target.

Yield curve shifts up as PHP strays in the 46 range

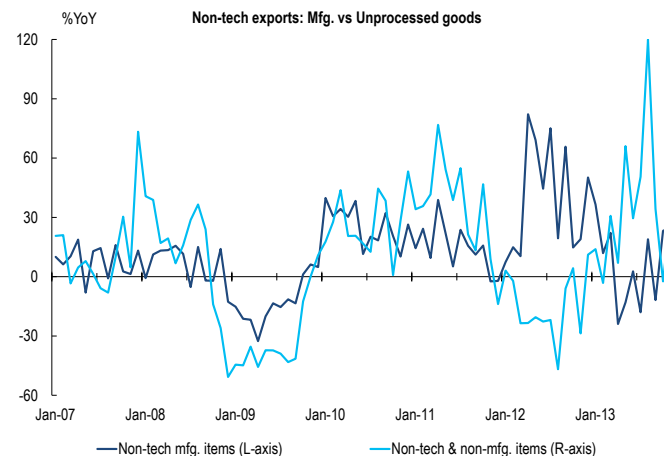
Higher Dec CPI, despite the potential for some correction, suggests a 2014 CPI uptrend is in place and may compel tightening rates starting in 3Q14. A weak PHP outlook amid upbeat domestic demand prospects and abundant liquidity support a rising CPI trajectory. Recent t-bill auctions fetched sharply higher rates due to higher inflation expectations, more t-bill supply risk in 1Q14 and an absence of steep discounts in the offshore PHP NDF rate. End-Mar we expect PHP to drift to 46 on US Fed tapering risk in full bloom amid subdued BSP intervention and growth bias. With the fiscal deficit cycle still to peak, debt supply risk and a higher short-term rate outlook would handicap long bond yields. As local rates rise consistent with normalization of the global monetary and interest rate outlook, PHP's weakness in 2H14 could ease. Strong onshore liquidity, favorable onshore risk sentiment and limited investment outlets would mitigate upward bond-yield pressures.

Figure 70. Electronic exports up in Nov to ease typhoon impact



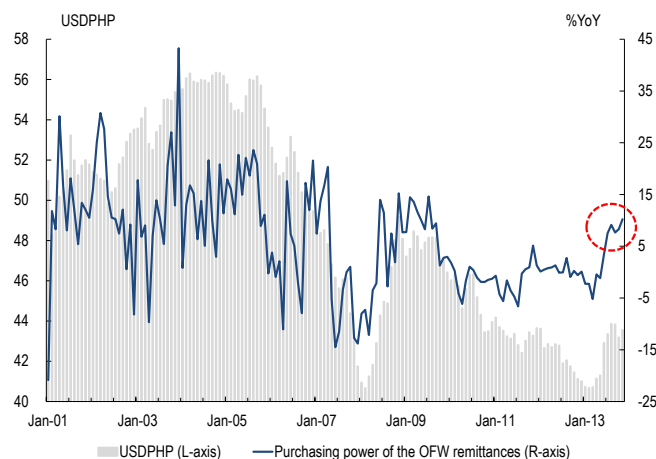
Source: NSCB, CEIC, Citi Research

Figure 71. Strong non-tech exports in Nov fend off typhoon shocks



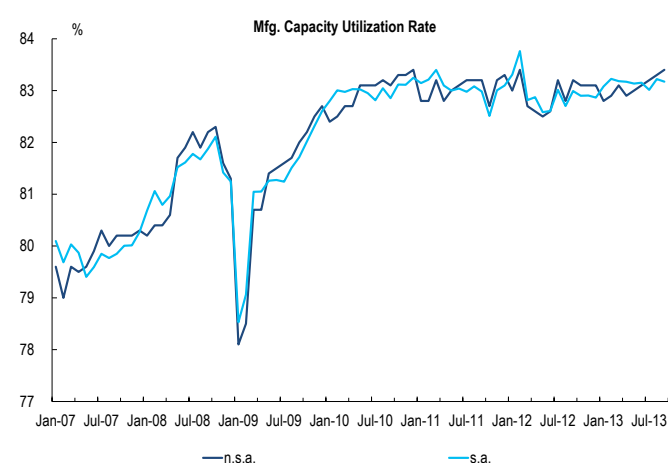
Source: CEIC, Citi Research

Figure 72. Weak PHP in Nov buoy up remittances' purchasing power



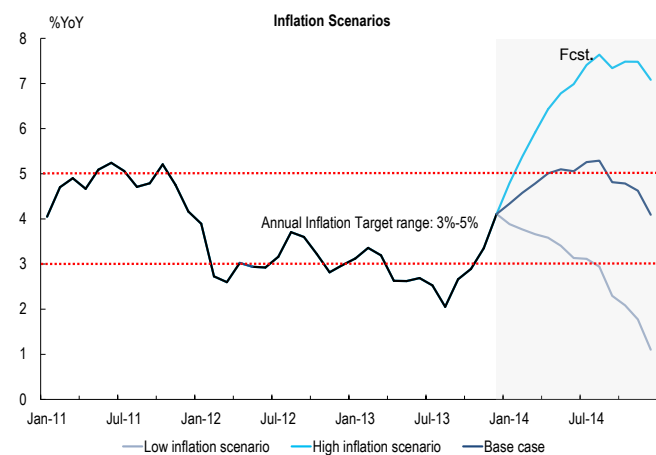
Source: CEIC, Citi Research

Figure 73. Post-Yolanda, utilization rates remain firm at 83.2%



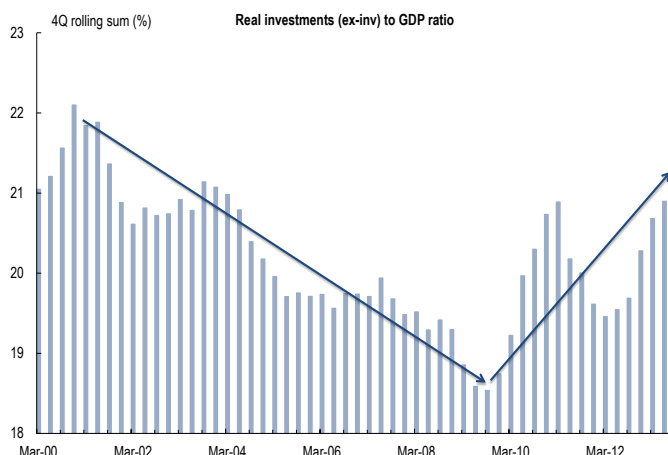
Source: CEIC, Citi Research

Figure 74. Base case inflation scenario could breach upside of 5%



Source: CEIC, Citi Research

Figure 75. Rising contribution of real investments to GDP



Source: CEIC, Citi Research

Figure 76. Philippines Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	150.2	173.4	168.6	200.0	224.1	250.5	272.2	283.0	348.5
Nominal GDP, local currency bn	6,893	7,721	8,026	9,003	9,706	10,565	11,623	13,034	14,409
GDP per capita, US\$	1,693	1,917	1,829	2,127	2,339	2,567	2,739	2,796	3,380
Population, mn	88.7	90.5	92.2	94.0	95.8	97.6	99.4	101.2	103.1
Unemployment, % of labour force	7.3	7.4	7.5	7.3	7.0	7.0	6.5	6.0	5.7
Economic Activity									
Real GDP, % yoy	6.6	4.2	1.1	7.6	3.6	6.8	6.9	7.0	6.8
Real investment growth % yoy	-0.5	23.4	-8.7	31.6	2.0	-3.2	16.9	5.9	9.7
Real consumption growth % yoy	4.9	3.3	3.3	3.4	5.2	7.3	6.2	6.3	6.3
private consumption growth % yoy	4.6	3.7	2.3	3.4	5.7	6.6	5.6	6.0	6.2
Real export growth, % yoy	6.7	-2.7	-7.8	21.0	-2.8	8.9	1.1	7.6	5.2
Real import growth, % yoy	1.7	1.6	-8.1	22.5	-1.0	5.3	3.8	5.8	5.6
Prices, Money & Credit									
CPI, % yoy	3.9	8.0	4.3	3.6	4.2	3.0	4.1	4.5	3.9
CPI, % avg	2.8	9.3	3.2	4.1	4.7	3.2	2.9	4.8	4.0
Nominal wages, % yoy	3.4	5.5	0.0	5.8	5.4	7.0	2.0	5.0	5.0
Credit extension to private sector, % yoy	10.6	12.8	4.3	13.8	16.2	14.1	10.0	13.5	15.0
Policy interest rate, % eop	5.25	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.50
1 month Philippine Reference rate, % eop	6.03	5.20	4.11	0.75	1.68	-1.38	-0.15	2.00	3.00
Long term yield, % eop	5.70	6.55	6.25	4.78	4.21	3.70	2.91	4.00	4.50
lc/US\$, eop	41.23	47.47	46.50	43.65	43.84	41.06	44.39	44.17	40.98
lc/US\$, avg	46.05	44.48	47.56	45.06	43.29	42.22	42.46	45.06	42.18
Balance of Payments, US\$ bn									
Current account	7.1	3.6	9.4	8.9	7.0	7.1	9.5	9.8	10.0
% of GDP	4.7	2.1	5.5	4.5	3.1	2.8	3.5	3.4	2.9
Trade balance	-10.4	-14.4	-9.7	-12.3	-17.0	-15.2	-13.2	-14.4	-15.1
Exports	34.1	35.2	29.8	37.6	38.3	46.3	48.4	51.7	55.5
Imports	44.4	49.5	39.4	49.9	55.2	61.5	61.6	66.0	70.5
Service balance	4.2	2.6	2.9	4.1	5.3	3.9	3.1	3.3	3.4
Income balance	13.3	15.4	16.1	17.2	18.7	18.4	19.6	20.8	21.7
FDI, net	0.6	-1.3	-1.6	-0.7	-1.3	-1.0	2.0	3.0	3.0
International reserves (ex-gold)	33.8	37.6	44.2	62.4	75.3	83.8	83.2	93.5	98.0
Total Amortisations	4.7	7.0	5.7	8.3	6.3	2.7	9.3	9.7	10.0
Public Finances, % of GDP									
Consolidated government balance	-0.2	-0.9	-3.7	-3.5	-2.0	-2.3	-1.7	-1.8	-1.6
Consolidated gov primary balance	3.7	2.6	-0.2	-0.2	0.8	0.7	1.2	1.1	1.1
Public debt	53.9	54.7	54.8	52.4	51.0	51.5	47.0	46.0	45.0
of which Domestic	31.9	31.3	30.8	30.2	29.6	32.8	31.0	30.0	29.5
Foreign Assets & Liabilities, US\$ bn									
External debt	55.5	54.3	54.9	60.0	60.4	60.3	60.0	61.0	63.5
Private	17.5	13.7	11.6	13.9	14.1	15.2	18.0	18.0	18.5
Public	38.0	40.6	43.2	46.2	46.4	45.2	42.0	43.0	45.0
External debt / GDP	36.9	31.3	32.5	30.0	27.0	24.1	22.0	21.6	18.2
External debt / XGS	120.9	117.0	131.8	113.3	107.7	93.0	88.4	84.6	82.6
Short-term debt	7.1	7.0	4.0	6.3	7.0	8.5	10.0	11.1	12.0
Short-term debt/International Reserves (%)	21.0	18.6	9.0	10.1	9.3	10.1	12.0	11.9	12.2
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	7.6	7.0	5.5	6.8	7.3	6.8	7.1	7.3	7.0
CPI, % yoy	2.7	2.7	4.1	4.6	5.1	5.1	4.5	4.3	4.0
Policy interest rate, % eop	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25	4.50
1 month Philippine Reference rate, % eop	0.26	-0.39	-0.15	-0.50	0.00	1.50	2.00	2.25	2.50
Long term yield, % eop	2.80	3.02	2.91	3.50	3.75	4.00	4.00	4.25	4.50
lc vs USD, eop	43.10	43.48	44.39	45.81	45.36	44.90	44.17	43.38	42.59

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is central government debt excludes contingent liabilities, and external debt is based on the residency of the holder of the debt (not by currency denomination).

Singapore

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- **Summary view** – 4Q GDP could be revised downwards, setting a lower start point for 2014 even as signs of softening in the housing market have emerged. Budget 2014 (to be read on 21 Feb) could announce a mildly expansionary fiscal impulse via a smaller surplus.
- **Things to watch** – [1] Near-term export and production momentum; [2] house price trends, which could trigger policy changes; [3] labour-market and core-inflation trends; [4] signs of stress in the SME sector; [5] Budget 2014 on 21 Feb.
- **Strategy** – While SOR and SIBOR will remain anchored by the Fed, 10Y SGS yields could head towards 3% on Fed tapering. The safe-harbour properties of the SGD and positive slope of the band could be offset by negative carry.

Possible downward revision to 4Q GDP

Exports have yet to see a convincing pick-up. While Dec NODX saw a sequential jump, average seasonally-adjusted 4Q13 NODX levels remain 0.7% below the 3Q13 average. Electronics NODX also remains in the doldrums with average 4Q levels 3.1% below 3Q; 4Q “core” NODX (stripping out lumpy pharma & ship exports) levels are 0.5% below 3Q. Despite the sequential surge in Dec non-oil retained imports of intermediate goods (NORI), 4Q levels also remain 16.8% below 3Q levels, suggesting hesitation among manufacturers in accumulating inventories of parts amid uncertainties on final demand.

Downward revisions to historical NODX data suggest GDP could also be revised down. IE Singapore noted that Sep and Oct trade data have been revised downwards to correct for errors from the multiple-counting of some trade permits. At face value, this suggests a downward revision in 4Q GDP, though as always IP and NODX data can diverge and it is possible that IP measurement is completely insulated from (and thus unaffected by) the trade declaration system – the Dec IP data (to be released on 24 Jan) will reveal whether Manufacturing GDP will see revisions. Downward revisions in Sep and Oct NORX however are likely to hit Transport and Storage Services GDP. Any downward revisions would mean a lower starting point for 2014 GDP, posing downside risks to our growth forecast of 3.5%, especially if external demand does not improve.

Supply-side constraints may also prove to be more binding even if demand improves given the labour market is already straining at full employment. The SME Index study by the Singapore Business Federation and DP Information Group for example revealed that SME hiring expectations had fallen for the next six months, despite higher expectations for turnover and profit growth. Meanwhile the Manpower Inc net employment outlook survey also shows lower hiring intentions for 1Q14 (1Q14: +16, 4Q13: +21).

The latest fall in house prices lends evidence to our view of a 10-15% decline in prices over the course of the cycle on a turn in the demand-supply balance alongside constraints to investment demand from the TDSR framework. The URA private residential property price index fell 0.8%QoQ (3Q: +0.4%) – the first decline since 1Q12 – while the HDB resale price index also saw a second straight quarter of QoQ declines. New home sales also plunged dramatically to just 259 units in Dec (Nov: 1,271) – the lowest since Jan-2009 – as developers held back on launches.

Falling property prices could exacerbate the impact of household debt burdens on consumer spending. As we had argued in our [Singapore Macro View - Should We Worry About Household Balance Sheets?](#), older individuals may have engaged in asset-based (as opposed to income-based) borrowing, pledging their property assets to obtain more leverage. Recent figures from MAS show one in five borrowers have debt service ratios of 40-60%, which suggests that 25-30% of households are above the 40% debt service ratio line. This comes as the Ministry of Law is studying new caps on *overall* unsecured borrowing from licensed moneylenders, as opposed to current caps which do not stop borrowers from taking loans from multiple moneylenders.

Hurdle for MAS easing remains high

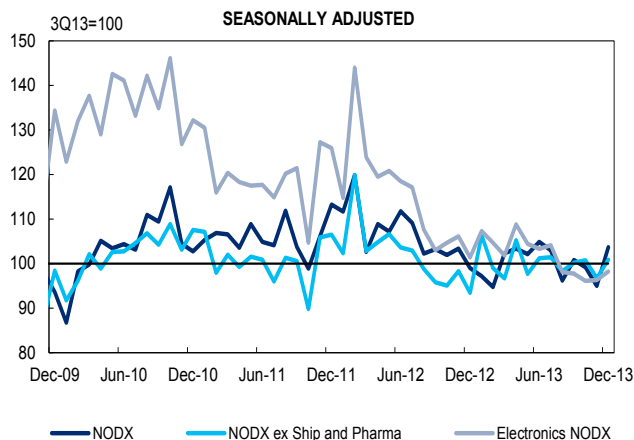
The potential for growth disappointments should reduce pressure to tighten, though core inflation pressures rule out easing. With pent-up labour and other business cost pressures being passed through as the positive output gap gives more pricing power to firms, core inflation is likely to rise to 2-2.5% in 2014. Outside of core however, car prices and imputed rents should be disinflationary, such that headline inflation should remain stable at 2-3% in 2014. Declining property prices and home sales foreshadow lower rentals while private road transport trends will likely be disinflationary at least in the very near term due to base effects and greater COE supply. The latest Singapore Index of Inflation Expectations (SInDEX) already shows one-year inflation expectations eased to 3.72 in 4Q13 (3Q: 3.85). With the rise in core inflation anticipated and still within MAS's tolerance ranges, the hurdle for MAS to hike remains high. Barring an upside surprise in growth that widens the positive output gap beyond MAS expectations – an increasingly unlikely outcome – we think MAS will likely stand pat in Apr.

Budget 2014 to continue restructuring and redistribution

The latest public transport fare review and tiered wage system for cleaners is illustrative of the redistributive shift in policy in the run-up to elections in 2015-16. While the Public Transport Council announced that fares will be raised 3.2% this year effective 6 Apr and another 3.1% next year – both of which will likely each have a MoM inflation impact of less than 0.1%pt due to the small combined weight of bus and train fares of just 2.02% – existing concession schemes will be enhanced, including a new S\$60 monthly unlimited travel concession pass for senior citizens, while two new concession schemes for lower-wage workers and persons with disabilities will also be introduced. Meanwhile a bill has also been introduced in parliament which would require all cleaning companies to pay their workers according to a (yet unspecified) tiered wage system.

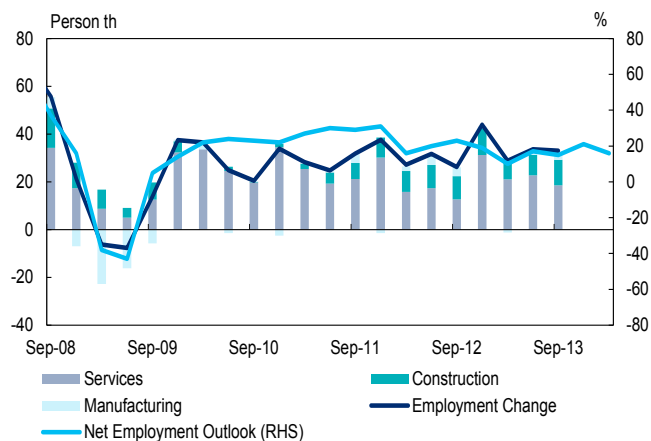
Likewise, we expect Budget 2014 to maintain the themes of restructuring and redistribution. DPM Tharman Shanmugaratnam has already hinted at more measures to help SMEs restructure, including more industry-specific schemes, and health-related measures for seniors. Budget 2014 could announce a mildly expansionary fiscal impulse via a smaller surplus, though the actual surplus will likely be larger than conservative Budget estimates. Enhancement of social safety nets and an adoption of a more progressive tax structure will likely take centre stage, as was the case in Budget 2013. As the current schedule already involves further hikes in FW levies and quota cuts through 2016, further tightening on this front will not be necessary – though we would not be surprised to see further tightening on EP holders.

Figure 77. Exports have yet to see a convincing pick-up



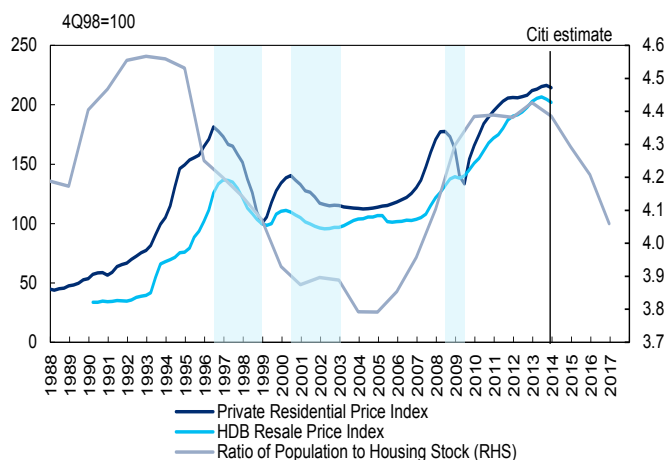
Source: CEIC, Citi Research

Figure 78. Hiring intentions have fallen into 1Q14



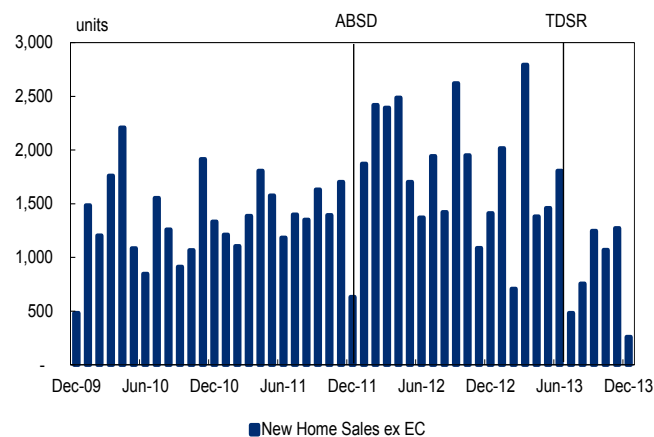
Source: Haver, Manpower Inc, Citi Research

Figure 79. Property prices saw sequential declines in 4Q13



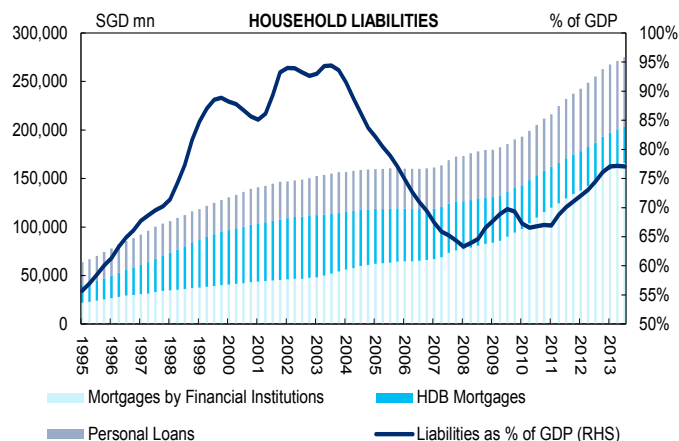
Source: CEIC, Citi Research

Figure 80. New home sales plunged in Dec



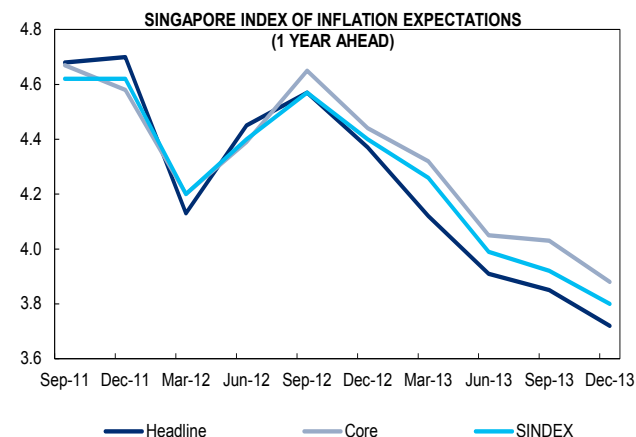
Source: URA, Citi Research

Figure 81. Household debt has risen to 77.1% of GDP as of 3Q13



Source: CEIC, Singapore Department of Statistics, Citi Research

Figure 82. Singapore Index of Inflation Expectations fell in 4Q13



Source: SKBI-Mastercard

Figure 83. Singapore Economic Indicators

	2007	2008	2009	2010	2011	2012	2013E	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	178.2	190.8	189.4	232.2	265.8	276.8	289.4	304.4	327.3
Nominal GDP, local currency mn	268	270	275	316	334	346	362	387	409
GDP per capita, US\$	38,828	39,434	37,970	45,741	51,275	52,099	53,593	55,352	58,431
Population, mn	4.6	4.8	5.0	5.1	5.2	5.3	5.4	5.5	5.6
Unemployment, % of labour force	2.1	2.3	3.0	2.2	2.0	1.9	1.9	1.8	1.8
Economic Activity									
Real GDP, % yoy	9.0	1.7	-0.8	14.8	5.2	1.3	3.7	3.5	3.5
Real investment growth % yoy	16.8	28.5	-21.0	5.4	12.7	26.8	3.0	-5.0	5.9
Real consumption growth % yoy	5.9	3.6	0.5	7.2	3.7	0.9	4.1	3.0	1.9
private consumption growth % yoy	6.7	2.9	-0.5	6.2	4.6	2.2	2.6	2.4	1.3
Real export growth, % yoy	9.0	5.0	-7.6	18.6	3.5	0.3	3.3	3.6	2.9
Real import growth, % yoy	8.1	9.6	-11.2	15.9	3.6	3.2	3.3	2.9	2.9
Prices, Money & Credit									
CPI, % yoy	3.7	5.5	-0.5	4.6	5.5	4.3	1.5	1.6	1.7
CPI, % avg	2.1	6.6	0.6	2.8	5.2	4.6	2.4	1.9	2.2
Nominal wages, % yoy	6.2	5.4	-2.7	5.6	6.0	2.3	4.6	5.0	5.0
Credit extension to private sector, % yoy	16.9	15.2	2.0	13.4	18.6	13.2	12.0	10.0	8.0
3 month inter-bank rate, % eop	2.38	1.00	0.69	0.44	0.38	0.38	0.40	0.40	0.80
Long term yield, % eop	2.68	2.05	2.66	2.71	1.63	1.30	2.56	3.00	3.20
lc/US\$, eop	1.44	1.43	1.41	1.28	1.30	1.22	1.26	1.27	1.24
lc/US\$, avg	1.51	1.41	1.45	1.36	1.26	1.25	1.25	1.27	1.25
Balance of Payments, US\$ bn									
Current account	46.4	28.8	33.5	62.1	65.4	51.5	40.5	41.1	42.5
% of GDP	26.0	15.1	17.7	26.7	24.6	18.6	14.0	13.5	13.0
Trade balance	57.8	42.8	49.3	66.0	72.7	61.0	59.8	62.0	63.0
Exports	312.5	354.5	288.6	371.2	434.4	436.0	443.9	452.0	460.0
Imports	254.7	311.7	239.3	305.2	361.7	375.1	384.1	390.0	397.0
Service balance	-2.7	-1.6	-1.7	2.3	0.7	0.4	1.0	2.0	3.0
Income balance	-8.7	-12.4	-14.1	-6.3	-8.0	-9.9	-20.3	-22.9	-23.5
FDI, net	10.1	5.4	0.9	28.3	29.7	33.6	33.0	32.0	32.0
International reserves	163.0	174.2	187.8	225.8	237.7	259.3	273.1	290.0	300.0
Public Finances, % of GDP									
Consolidated government balance	2.8	0.1	-0.3	0.3	1.2	1.1	0.7	0.5	0.5
Consolidated gov primary balance	2.7	1.1	-0.8	0.2	1.3	1.5	0.4	1.0	1.0
Public debt	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0	120.0
of which Domestic	87.3	94.7	106.1	101.7	106.0	111.4	115.0	118.0	120.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	4.3	5.9	4.4	5.2	1.3	2.8	4.8	2.9	3.2
CPI, % yoy	1.8	1.6	1.5	1.5	2.7	1.8	1.6	1.7	1.4
1 month inter-bank rate, % eop	0.38	0.42	0.40	0.40	0.40	0.40	0.40	0.45	0.50
Long term yield, % eop	2.51	2.35	2.56	2.60	2.75	2.90	3.00	3.00	3.10
lc vs USD, eop	1.27	1.26	1.26	1.27	1.27	1.27	1.27	1.26	1.25

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is general government debt.

South Korea

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- **Summary view** – We expect recoveries of domestic demand, particularly facilities investment, and exports to continue in 1H14, leading 0.8%QoQ growth on average. The housing market is likely to pick up, albeit moderately, alongside a series of government boosting measures, such as a permanent acquisition tax cut.
- **Things to watch** – We expect CPI inflation to trend up, with growing inflationary pressures from public utility charge hikes and a low base of a year ago. The impacts of weakened JPY on exports has not been meaningful but is likely to materialize along with further JPY weakening and KRW strengthening, limiting export growth.
- **Strategy** – The BoK will likely maintain an accommodative stance, keeping the policy rate unchanged this year and providing financial support to SMEs in case of need. Despite uncertainties over the pace of Fed tapering, the still-large current account surplus will likely continue to support the appreciation trend of the KRW.

Signs toward moderate economic recovery

Exports reassure on recovery trend in industrial activities. Industrial production (IP) and shipments dipped in Nov. However, Oct-Nov average IP growth was still up at 1.0%YoY vs 0.0%YoY in 3Q13 and Dec export growth turned out stronger than expected at 7.0%YoY, bringing growth in 4Q13 at 4.7%YoY vs. 2.7% in 3Q13. Despite weak JPY, export rebound has been mainly driven by demand from the US and EU, with shipbuilding, semiconductors, and auto sectors in lead. Equipment investment also fell sequentially in Nov but this followed a large increase in Oct and YoY growth remained positive. Besides increasing domestic machinery orders, further export gains backed by expected global economic recovery and the government's investment boosting measures bode well for equipment investment. BoK's Business Survey Index (BSI) for 2014 also indicates that the share of manufacturing firms that expect facility investment to increase rose from last year.

Consumption growing steadily with some constraints. The pick-up in retail sales continued in Nov albeit at a slower pace than in Oct. Oct-Nov average growth was up at 1.5%YoY vs. 0.7%YoY in 3Q13. This is attributable to resilient job growth and the government's welfare policies alleviating household burdens (e.g. a subsidy for childcare support). In particular, average job growth in 4Q13 rose to 542K YoY from 421K in the previous quarter, mostly in the services sector as well as in age groups of 50 and over, partly reflecting re-employment of retirees. Growing household debt also remains a key constraint to consumption growth. Besides house loans, some retired baby boomers who took out loans to start up their own business are also vulnerable to risks and rate hikes, especially with the number of self-employed workers already falling on YoY terms.

We continue to expect economic growth of 3.7% this year. Exports, facilities investment and private consumption will likely lead further recovery of the economy, while contributions from government spending and construction investment to GDP growth will likely fall. Government's total spending in the finalized 2014 budget was increased only by 1.9% (vs. 7.2% in 2013) on concerns over tax revenue shortfalls, with SoC budget cuts. Budget frontloading in 1H14 could result in a fiscal drag in 2H14, especially in 4Q14, and we expect growth momentum to weaken in the second half, with exports likely to slow on strong a KRW and a weak JPY.

Monetary policy seems to stay accommodative

Inflation still subdued but inflationary pressures are growing. Further declines in agricultural product prices led Dec CPI inflation to edge down to 1.1%YoY from 1.2% in Nov. However, CPI rose 0.1%MoM, with inflationary pressures from livestock products and public utility rate hikes. A recent revision of CPI weights has increased weights of items for which inflation has risen on public utility charge hikes, and the city gas price for residential use, bus fares, and sewage fees were raised this month. We expect annual inflation of 2.1% for this year but an uptrend to continue to near 3%YoY at year-end. Public energy corporations troubled with high debt could raise the price of their services while complying with the government's public institution reform plan. We also expect modest inflationary pressures from the demand side on the back of economic recovery and nominal wage growth.

BoK is unlikely to change the policy rate but make use of credit policy tools.

With its view on domestic economy not much changed from Dec, the MPC at the BoK unanimously decided to keep the policy rate unchanged at 2.5% at the 9 Jan meeting. We expect no change in the policy rate till the end of this year, given headline inflation is unlikely to exceed the upper bound of the BoK's inflation target and moderate economic recovery amid limited fiscal capacity. Instead, to supplement monetary policy, the BoK may use its credit policy tool redefined as 'Intermediated Lending Support Facility (formerly 'Aggregate Credit Ceiling Loans')' to help SMEs with financing difficulties.

Meager total spending growth but more to social welfare

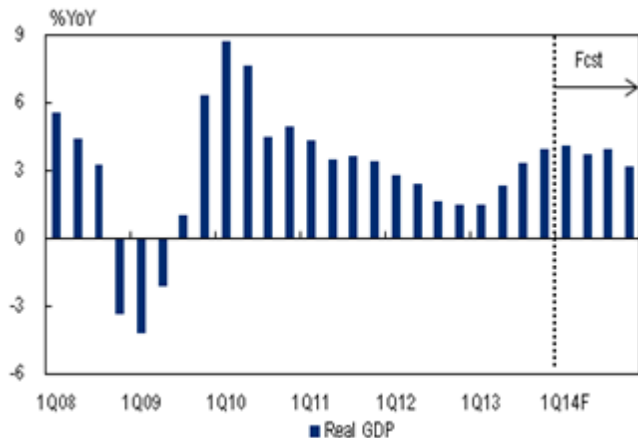
Government chases fiscal soundness and revitalization at the same time. The National Assembly belatedly approved the government's revised 2014 spending bill of KRW355.8trn, cut from KRW357.7trn in the initial plan and less than KRW349.0trn in 2013 budget (incl. supplementary budget). While total spending budget was trimmed from last year to better enable fiscal consolidation, the budget for health, welfare, and employment was increased by KRW7.1trn to KRW106.4trn to alleviate household burdens. The SOC budget was cut to KRW23.7trn from the 2013 budget of KRW25.0trn but was increased from the proposed KRW23.3trn, factoring in job creation and economic revitalization. To firm the economy's recovery momentum, the government will frontload 65% of annual expenditure budget in the first half.

Housing market deregulations to improve sentiment

Housing transactions and prices crawl up but Jeonse price remains high.

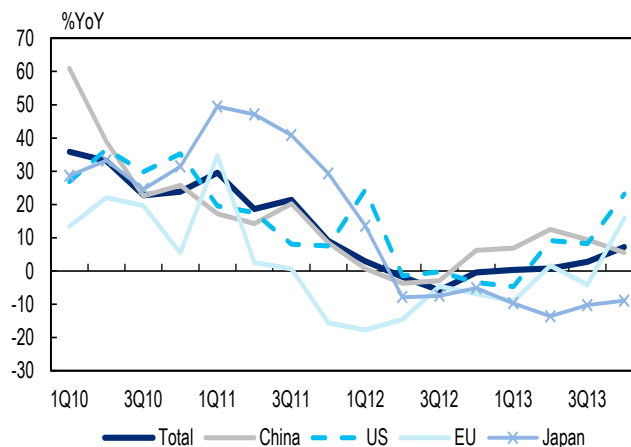
Nationwide housing price and transactions both increased in Dec from Nov amid expectations of market recovery and a rising Jeonse price. The passage of long-delayed housing market deregulations -- such as the abolition of punitive capital gains tax for multiple homeowners, a permanent reduction of property acquisition tax, and permission for vertical extensions in remodeling -- should help sentiment for a while. However, though government measures seem to be effective in stimulating home sale transactions and price, Jeonse/rental transactions and price remain high. According to the Korea Appraisal Board, nationwide apartment prices in the third week of Jan show that sale prices rose for 20 consecutive weeks while the Jeonse price rose for 73 straight weeks at a faster pace than sale price. To induce more renting households to switch over to buy homes and to maintain the recovery trend of the housing market, we think the government will further relax regulations and provide taxation and financial support.

Figure 84. We expect 2014 growth of 3.7% with a fiscal drag likely in 4Q



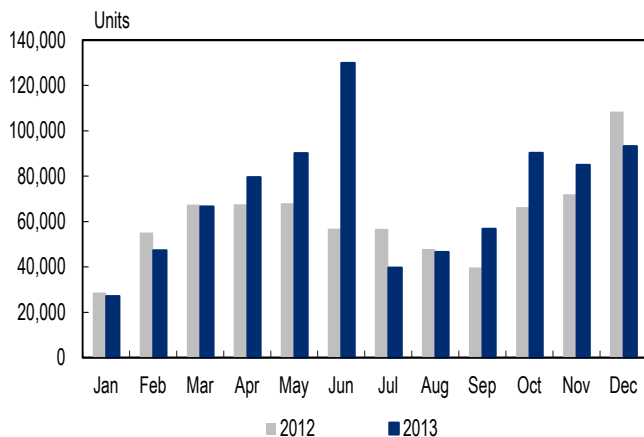
Source: Bank of Korea, Citi Research

Figure 85. Exports further rebounded on demand from the US and EU



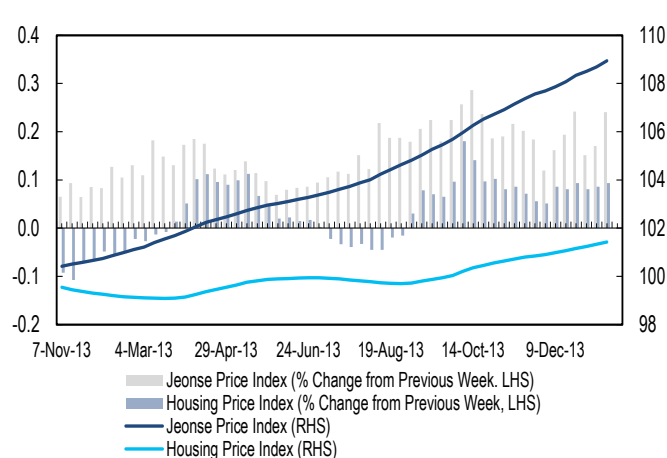
Source: Korea International Trade Association, Citi Research

Figure 86. Government measures have led housing transactions to rise



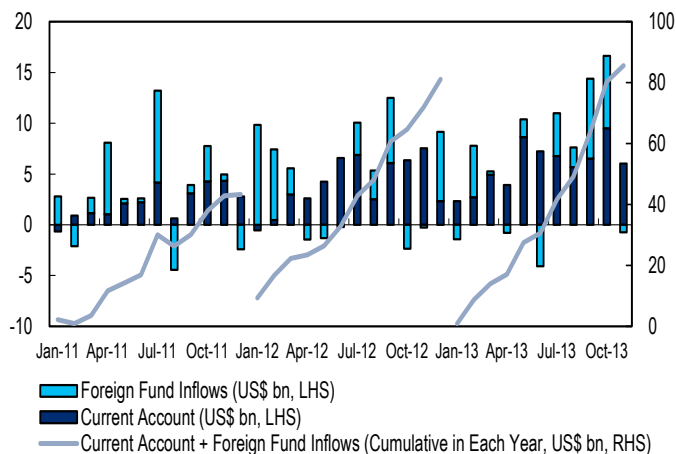
Source: Ministry of Land, Infrastructure and Transport, Citi Research

Figure 87. Jeonse price rise continues to outpace housing price



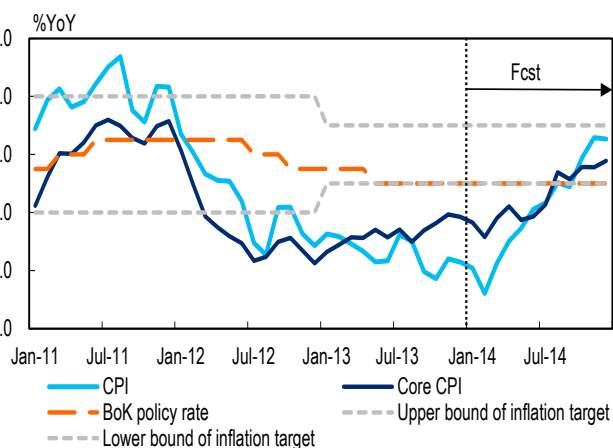
Source: Korea Appraisal Board, Citi Research

Figure 88. CA surplus continued in Dec while foreign funds flowed out



Source: Bank of Korea, Citi Research

Figure 89. Policy rate will likely be held, amid inflation within target



Source: Bank of Korea, Statistics Korea, Citi Research

Figure 90. Korea Economic Indicators

	2007	2008	2009	2010	2011	2012	2013E	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	1,048.0	929.1	834.7	1,014.9	1,115.0	1,129.0	1,208.0	1,355.0	1,498.0
Nominal GDP, local currency bn	975,013	1,026,452	1,065,037	1,173,275	1,235,161	1,272,460	1,322,898	1,402,409	1,498,448
GDP per capita, US\$	21,565	18,981	16,972	20,540	22,399	22,578	24,054	26,872	29,595
Population, mn	48.6	48.9	49.2	49.4	49.8	50.0	50.2	50.4	50.6
Unemployment, % of labour force	3.2	3.2	3.6	3.7	3.4	3.2	3.1	3.1	3.1
Economic Activity									
Real GDP, % yoy	5.1	2.3	0.3	6.3	3.7	2.0	2.8	3.7	4.0
Real investment growth % yoy	3.5	0.0	-13.5	15.8	1.4	-1.8	2.4	3.1	4.8
Real consumption growth % yoy	5.1	2.0	1.2	4.1	2.3	2.2	2.1	2.5	3.2
private consumption growth % yoy	5.1	1.3	0.0	4.4	2.4	1.7	1.9	2.9	3.4
Real export growth, % yoy	12.6	6.6	-1.2	14.7	9.1	4.2	4.5	6.1	8.0
Real import growth, % yoy	11.7	4.4	-8.0	17.3	6.1	2.5	3.5	5.4	7.7
Prices, Money & Credit									
CPI, % yoy	3.6	4.1	2.7	3.1	4.2	1.4	1.1	3.3	2.9
CPI, % avg	2.5	4.7	2.8	3.0	4.0	2.2	1.3	2.1	3.1
Nominal wages, % yoy	5.6	-4.1	2.6	6.8	1.0	5.3	4.3	5.2	4.8
Credit extension to private sector, % yoy	12.4	15.0	2.3	3.6	5.1	1.9	5.3	7.0	8.9
Policy interest rate, % eop	5.00	3.00	2.00	2.50	3.25	2.75	2.50	2.50	3.50
91-Day CD Rate, % eop	5.73	4.68	2.82	2.80	3.55	2.89	2.66	2.75	3.60
Long term yield, % eop	5.78	3.77	4.92	4.08	3.46	2.97	3.23	3.65	4.25
lc/US\$, eop	936	1,263	1,166	1,121	1,159	1,064	1,051	1,023	987
lc/US\$, avg	929	1,102	1,275	1,156	1,108	1,127	1,095	1,035	1,001
Balance of Payments, US\$ bn									
Current account	21.8	3.2	32.8	29.4	26.1	48.1	69.2	54.2	46.8
% of GDP	2.1	0.3	3.9	2.9	2.3	4.3	5.7	4.0	3.1
Trade balance	14.6	-13.3	40.4	41.2	30.8	28.3	44.1	37.6	39.4
Exports	371.5	422.0	363.5	466.4	555.2	547.9	559.6	593.3	642.6
Imports	356.8	435.3	323.1	425.2	524.4	519.6	515.6	555.8	603.2
Service balance	-12.0	-5.7	-6.6	-8.6	-5.8	5.7	9.8	11.0	8.1
Income balance	-3.4	3.7	1.6	-2.1	0.3	2.5	2.9	0.3	-1.0
FDI, net	-17.9	-16.9	-14.9	-22.2	-16.4	-18.9	-12.5	-8.6	-4.3
International reserves	262.2	201.1	270.0	291.5	304.2	323.2	341.7	350.7	364.5
Total Amortisations	43.8	42.9	43.6	40.0	42.0	46.0	47.0	48.2	49.1
Public Finances, % of GDP									
Consolidated government balance	3.5	1.2	-1.7	1.4	1.5	1.5	0.9	1.0	1.6
Consolidated gov primary balance	4.9	2.6	-0.2	2.8	2.9	2.7	2.3	2.4	2.9
Public debt	29.7	29.0	32.5	31.9	32.6	33.4	35.3	33.2	31.3
of which Domestic	28.6	28.1	31.4	31.0	31.8	32.6	34.4	32.3	30.5
Foreign Assets & Liabilities, US\$ bn									
External debt	333.4	317.4	345.7	359.8	398.7	409.4	415.0	424.5	434.5
Private	279.8	265.0	278.3	315.1	358.3	369.2	373.8	382.3	391.3
Public	53.6	52.4	67.4	44.7	40.4	40.2	41.2	42.2	43.2
External debt / GDP	31.8	34.2	41.4	35.5	35.8	36.3	34.4	31.3	29.0
External debt / XGS	75.0	61.9	79.1	65.0	61.3	62.1	61.6	59.2	55.9
Short-term debt	160.3	149.9	149.2	139.8	137.4	127.2	108.5	116.0	124.0
Short-term debt/International Reserves (%)	61.1	74.5	55.3	48.0	45.2	39.4	31.8	33.1	34.0
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.3	3.3	3.9	4.1	3.7	3.9	3.2	3.7	4.0
CPI, % yoy	1.2	1.0	1.1	1.1	2.1	2.4	3.3	3.3	3.3
Policy interest rate, % eop	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00
91-Day CD Rate, % eop	2.69	2.66	2.66	2.66	2.67	2.68	2.75	2.90	3.10
Long term yield, % eop	3.14	3.05	3.23	3.38	3.49	3.55	3.65	3.75	3.95
lc vs USD, eop	1,142	1,075	1,051	1,047	1,039	1,032	1,023	1,014	1,005

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Taiwan

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- **Summary view** – Trade has been recovering gradually since 4Q13, and again picked up pace as early as 2Q. A nascent consumption recovery was witnessed at year-end. Taiwan prepares for TPP and other regional free trade talks. Foreign investors continue to find interest in selected Taiwan equity stories, cushioning the TWD.
- **Things to watch** – 1) Potential luxury tax revisions; 2) Political heat to step up as local elections approaches; 3) Cross-strait momentum: Banks M&A, RMB swap line, ECFA for broader goods; 4) Pension reform; 5) 2014's local elections; 6) Liberalization efforts in FEZ and efforts to kickstart TPP talks mid-year.
- **Strategy** – We have pushed back our policy rate hike forecast to 2015 as benign inflation allows CBC more time to nurture economic recovery. We expect 10Y government bond yields on a gradual uptrend. TWD likely to appreciate mildly on a 6-12M horizon on macro recovery. Citi's TAIEX 2014 year-end target at 8,700.

External momentum not as bad as thought

Mild exports recovery started in 4Q. In an unusual MOF historical data revision (due to previously missing data caused by a systems upgrade at customs), 4Q exports data were all revised up (Oct13 reading from -1.5%YoY to +0.7%YoY; Nov's from no change to +3.4 YoY; and Dec's unexpected negative print of -1.9%YoY was revised up to +1.2%YoY). Dec13 export orders also beat expectations at 7.4%YoY (consensus: 2%). These together provide a much needed sign of relief, showing that Taiwan's export trend has been turning around slowly since 4Q.

Dec export orders improvements point to a few trends: (i) recovery in key destinations appears broad-based, from Europe (+11%YoY), Japan (+9.3%YoY), China+HK (+6.9%YoY), US (+6.5%YoY) and ASEAN (+4.8%YoY). China+HK demand could be slightly pushed up in Dec as inventory pre-stocking may have started given the earlier Chinese New Year holiday starting 31-Jan-2014. (ii) confirms that tech exports are finally pushing upwards in Dec. Throughout 4Q13, we had seen dull tech export trends, along with non-tech exports in general. In Dec's export orders we finally saw demand for info/communication products grew 13.5%YoY and electronics rose 14.7%YoY. The better performance of the two major tech categories is crucial for our theme of export revival, but we think a more material recovery will come in 2Q14 and beyond, mainly because 1Q is traditionally the slow season for tech manufacturing and several new tech products are to be launched in 2Q; also, the diffusion index (sentiment surveys) for these subcategories remains in the contraction zone for the next month. The other key tech category of 'precision instruments' will likely to suffer from the end of the Chinese energy-saving home appliance subsidy program, as it created a difficult base which will persist all the way till May14 (the subsidy program expired in Jun13).

In a bid to enhance trade

Taiwan needs structural reforms to promote trade. Longer term, we are worried that beta would be much more moderate than in previous tech cycles, as the Taiwan tech export chain may need more structural adjustments (i.e. to update themselves to produce what the current world really wants in terms of technology, and R&D appears to be a critical factor).

Fast tracking FTA initiatives. The stalling of ECFA for services implementation due to politics could mean delays for the signing of ECFA for goods (although the gov't is still aiming for it to be complete by mid-year). Lately, we have noticed instead a step-up in political will to push for other non-Chinese FTAs. After FTAs with NZ and SG, as well as resuming talks with the US under the Trade and Investment Framework Agreement (TIFA), Taiwan continues to look at potential economic cooperation with India, Philippines and Chile. In his new year speech, President Ma also stressed the need for Taiwan to join two trading blocs, the Regional Comprehensive Economic Partnership (RECP) and Trans-Pacific Partnership (TPP), as soon as possible. The previous goal was to join TPP by 2020, but this goal is now accelerated: the gov't intends to come up with concrete plans for policy changes by the middle of this year in order to join TPP. Liberalization will be the key challenge for Taiwan to join such high-standards free-trade blocs, and this would involve reduced industry protectionism, eliminating tariffs, and harmonizing standards/ trading practices. To join TPP, Taiwan would need to gain consent from all existing 12 TPP members (President Ma was lobbying Canada earlier this month), by "showing its commitment to trade liberalization and to build widespread domestic public support for more open markets".⁸ This will not be an easy task, but policy makers intend to use the Free Economic Zone as a testing site for liberalization, as well as being a driver for Taiwan to re-engineer itself to add more value in its exporting industries and services. In addition, any progress on ECFA would also become an attraction point for other TPP partners who may want to use the ECFA platform through Taiwan. Progress on these fronts would need to be monitored, as it could provide potential upside to medium-long term growth.

The benefits of TPP to Taiwan — According to a recent paper by the Brookings Institution⁹, the rule of origin under TPP will significantly impact Taiwan. On the plus side, new market access from TPP will provide Taiwan the opportunity to develop its own branded goods and services to be sold directly to consumers - thereby fostering innovation. As others in the region enter TPP, regional supply chains would evolve and Taiwan would be able to reinforce its role in the regional supply chain if it also joins TPP. On the other hand, Taiwan's role and competitiveness in the regional supply chain would diminish if it does not join while others in the region join. Also, through structural reforms in the longer run, which may impact certain previously-protected industries, cost could be lowered, and skills and talent could be used more efficiently.

Market outlook

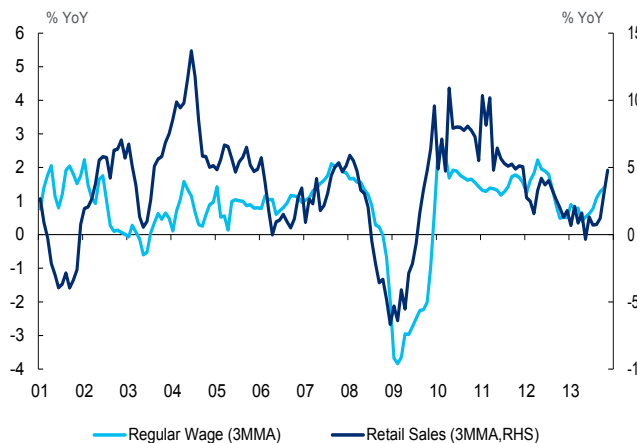
Interest rates — Given weak economic performance and benign inflation, we have pushed back our policy rate hike forecast to 2015. With the Fed tapering beginning in Jan 14, and Taiwanese FI market also being affected by global sentiments, we see 10Y gov't bond yields increasing going forward, but the rate of increase would be slower in Taiwan given the divergence in economic recoveries.

TWD has weakened along with the subdued economy, pressure from the JPY and KRW; and we see it staying at TWD30/USD in the near term. While over 6-12M we expect more economic recovery and possible breakthroughs in FTAs and China relationships, we only factor in a mild appreciation as our house view is that RMB appreciation this year will be much milder.

⁸ American Chamber of Commerce in Taipei, "2013 Taiwan White Paper," Taiwan Business Topics, Vol. 43, Issue 6 (June 2013)

⁹ Richard Bush, Chen-Fu, Cecilia Yen Koo, and Joshua Meltzer "Taiwan and the Trans-Pacific Partnership: Preparing The Way", Center for East Asia Policy Studies The Brookings Institution (Oct 2013)

Figure 91. Consumption picking up more meaningfully at year-end



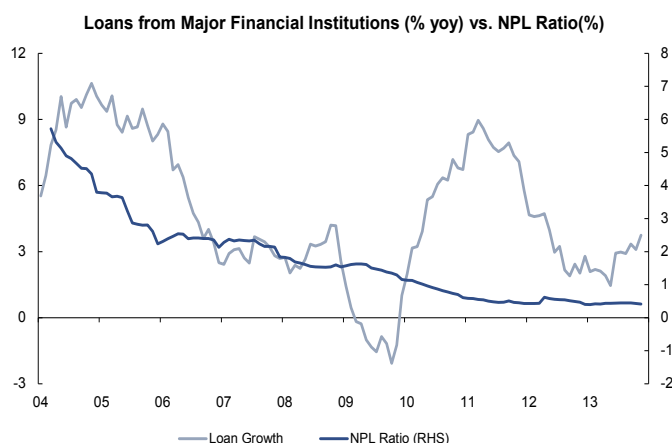
Source: CEIC, Citi Research

Figure 92. Trade on a gradual recovery too



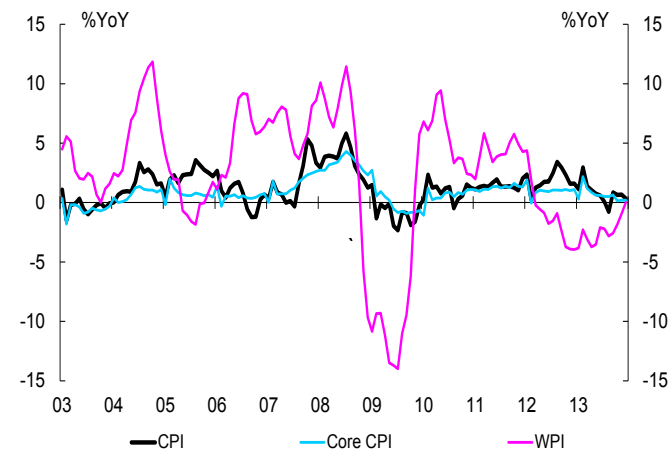
Source: CEIC, Citi Research

Figure 93. Loan growth still rising on OBU lending to China



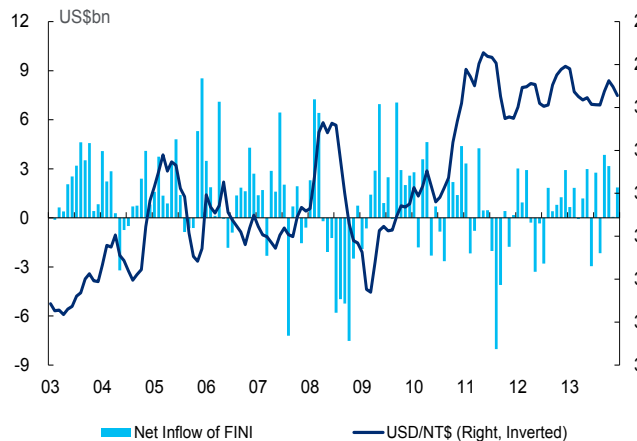
Source: CEIC, Citi Research

Figure 94. WPI recovery likely hint at CPI increase down the road



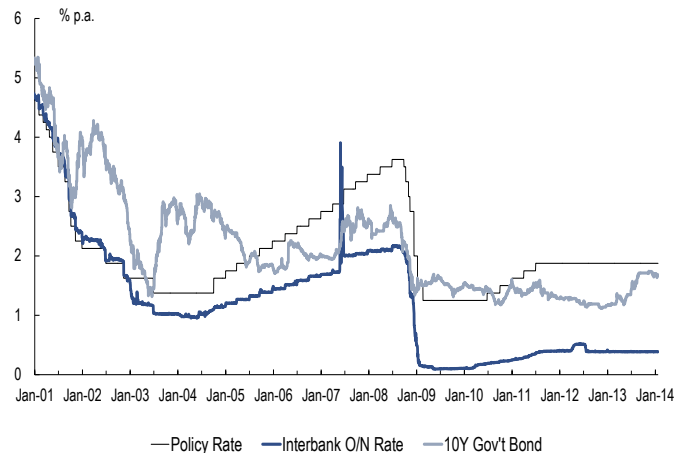
Source: CEIC, Citi Research

Figure 95. Capital inflows offering some support to NTD



Source: CEIC, Citi Research

Figure 96. 10Y gvt bond yields likely on a gradual rise



Source: Bloomberg, CEIC, Citi Research

Figure 97. Taiwan Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	393.0	400.2	378.0	430.3	466.5	476.3	487.4	519.0	554.6
Nominal GDP, local currency bn	12,911	12,620	12,481	13,552	13,709	14,077	14,464	15,175	16,105
GDP per capita, US\$	17,118	17,370	16,348	18,579	20,084	20,429	20,862	22,169	23,643
Population, mn	23.0	23.0	23.1	23.2	23.2	23.3	23.4	23.4	23.5
Unemployment, % of labour force	3.9	4.1	5.8	5.2	4.4	4.2	4.2	4.0	3.9
Economic Activity									
Real GDP, % yoy	6.0	0.7	-1.8	10.8	4.2	1.5	2.0	3.2	3.8
Real investment growth % yoy	-0.7	-7.9	-21.2	36.8	-6.8	-4.6	2.8	5.0	3.2
Real consumption growth % yoy	2.1	-0.6	1.3	3.3	2.9	1.5	1.1	1.5	2.3
private consumption growth % yoy	2.1	-0.9	0.8	4.0	3.1	1.6	1.3	1.7	2.8
Real export growth, % yoy	9.6	0.9	-8.7	25.6	4.5	0.1	3.4	4.6	6.2
Real import growth, % yoy	3.0	-3.7	-13.1	27.7	-0.5	-2.2	3.1	3.6	5.2
Prices, Money & Credit									
CPI, % yoy	3.3	1.3	-0.2	1.2	2.0	1.6	0.3	1.7	3.1
CPI, % avg	1.8	3.5	-0.9	1.0	1.4	1.9	0.8	1.7	2.3
Nominal wages, % yoy	2.1	0.0	-4.9	5.5	2.7	0.3	0.5	1.5	3.0
Credit extension to private sector, % yoy	3.9	2.7	-0.8	6.7	5.6	4.1	5.5	7.0	8.5
Policy interest rate, % eop	3.38	2.00	1.25	1.63	1.88	1.88	1.88	1.88	2.38
1 month inter-bank rate, % eop	2.04	1.02	0.57	0.74	0.87	0.87	0.87	0.93	1.17
Long term yield, % eop	2.53	1.44	1.47	1.47	1.27	1.15	1.68	1.85	2.35
lc/US\$, eop	32.43	32.78	32.23	29.17	30.29	29.06	29.83	29.42	29.02
lc/US\$, avg	32.85	31.58	33.04	31.50	29.40	29.57	29.68	29.65	29.17
Balance of Payments, US\$ bn									
Current account	35.2	27.5	42.9	39.9	41.2	49.9	52.9	50.9	52.7
% of GDP	8.9	6.9	11.4	9.3	8.8	10.5	10.9	9.8	9.5
Trade balance	27.4	15.2	29.3	23.4	26.8	30.7	35.4	41.1	56.0
Exports	246.7	255.6	203.7	274.6	308.3	301.2	305.5	317.7	349.0
Imports	219.3	240.4	174.4	251.2	281.4	270.5	270.1	276.6	293.0
Service balance	-1.6	1.8	2.0	2.5	3.9	6.3	3.1	4.0	-3.5
Income balance	10.1	10.0	12.5	13.6	13.2	15.3	14.0	17.0	19.0
FDI, net	-3.3	-4.9	-3.1	-9.1	-14.7	-9.9	-11.0	-10.0	-9.0
International reserves	270.3	291.7	348.2	382.0	385.5	403.2	416.8	440.0	460.0
Total Amortisations	3.8	8.8	2.5	3.2	6.8	3.4	2.9	3.0	3.0
Public Finances, % of GDP									
Consolidated government balance	0.9	0.9	-2.2	-1.2	-0.6	-1.6	-1.5	-1.4	-1.2
Consolidated gov primary balance	1.9	1.9	-1.2	-0.3	0.4	-0.7	-0.6	-0.6	-0.5
Public debt	33.3	34.7	38.0	38.3	40.0	40.9	41.8	41.0	42.0
of which Domestic	33.3	34.7	38.0	38.2	40.0	40.8	41.8	41.0	36.7
Foreign Assets & Liabilities, US\$ bn									
External debt	94.5	90.4	82.0	101.6	122.5	130.8	150.0	160.0	150.0
Private	91.1	88.9	76.0	93.5	118.0	127.5	146.3	156.0	146.0
Public	3.5	1.5	5.9	8.0	4.5	3.3	3.7	4.0	4.0
External debt / GDP	24.1	22.6	21.7	23.6	26.3	27.5	30.8	30.8	27.0
External debt / XGS	33.4	30.9	34.7	32.1	34.7	37.5	41.2	40.5	34.9
Short-term debt	83.3	78.8	68.2	83.7	107.8	116.5	125.0	130.0	120.0
Short-term debt/International Reserves (%)	30.8	27.0	19.6	21.9	28.0	28.9	30.0	29.5	26.1
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.5	1.6	2.2	2.7	2.9	3.5	3.7	4.1	3.4
CPI, % yoy	0.8	0.8	2.3	2.3	1.3	1.2	1.7	1.2	1.9
Policy interest rate, % eop	1.88	1.88	1.88	1.88	1.88	1.88	1.88	2.00	2.13
1 month inter-bank rate, % eop	0.87	0.87	0.87	0.87	0.87	0.87	0.93	0.99	1.05
Long term yield, % eop	1.41	1.69	1.68	1.70	1.72	1.77	1.85	1.95	2.05
lc vs USD, eop	29.96	29.56	29.83	29.92	29.73	29.54	29.42	29.32	29.22

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

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Thailand

- **Summary view** – We lowered our 2014 GDP growth forecast to 1.8% as the political crisis delays FY14 budget implementation particularly infrastructure projects while having an adverse impact on private spending. Slower growth this year could spell relief for the current account and the fiscal position.
- **Things to watch** – Election outcome on 2 Feb that may lead to relief rallies. Whether the Suthep-led opposition would lift the ‘siege’ of Bangkok. Core uptrend in 2014 coincident with THB weakness amid import cutbacks. Further delays in roll out of FDI approvals lacking strong export recovery and political uncertainty.
- **Strategy** – Absent fiscal stimulus, policy rate easing option would lend more vulnerability to THB from US tapering risk/strong USD. Weak GDP prospects underpin a lackluster portfolio environment that doesn’t favor the THB. Expected current account surplus and compressed fiscal gap would ease THB woes.

Lacking stability, we cut 2014 GDP growth to 1.8%

Persistent political uncertainty that’s likely to stall fiscal spending in 1H14 and further delay private investments led us to downgrade our 2014 GDP forecast to 1.8% (previously 3%). Even with the assumption of 2 Feb elections, the strong likelihood of an opposition boycott and legal charges being readied by the anti-graft body/Constitutional Court against PM Yingluck’s role in the rice pledging scheme and pro-Thaksin former MPs that supported the government-sponsored draft amendments, do not suggest a post-election return to permanent stability. Moreover it remains unclear whether the Bangkok ‘shutdown’ would end with the 2 Feb elections assuming elections do not get postponed—a preference by majority of the Election Commissioners. Whether the required quorum of 375 seats in Parliament would be filled also remains a ‘technical issue’ that implies the possibility of more by-elections, and that it may take time for the new Parliament to function.

Declining trend of public investments since 3Q13 (-16.2%YoY) would probably extend to 2Q14 owing to institutional delays in FY14 budget implementation while the newly elected government/Parliament starts to organize and effectively function. Coupled with the absence of a strong export recovery, private investments could stray into negative territory as well in our forecast. We expect public investments to decline by 13.7%YoY in 1H, which is likely to support a 4.4%YoY fall in real investments (ex-inv). Public protests in Bangkok that escalated at the start of 2014 probably delayed residential construction, including infra spending on new MRT lines. While missing strong durable goods demand, HH consumption should manage to rise by 1%YoY-2%YoY as the base effect eases. Government consumption including limited subsidies/transfers remains in play, although with subdued growth. Domestic demand (ex-inv) in our 1H scenario would post marginal gains of less than 1%.

Silver lining of muted domestic demand spending would be an implied cutback in non-oil imports which would probably elevate the net exports contribution to GDP by over 20%YoY in 1H14. Non-oil imports could shed 8.7%YoY in 1H14 and result in a real import drop of 1.5%YoY during the period. We anticipate imports of capital goods, vehicles & parts and raw materials to lead the import weakness as private spending weakens. Alongside mild export gains, we think net exports would provide the cushion to deter real GDP from sinking into negative territory. Tourism revenues in response to political tensions and the Bangkok ‘shutdown’ won’t be as strong, and that’s unlikely to provide support for total exports and tourism-driven service industries, such as transport.

Expect a current account surplus of 2.1% of GDP in 2014

Underpinned by easing imports, our current account forecast shifted to a surplus of 2% of 2014 GDP from a marginal deficit previously. Non-oil imports on the decline with oil imports bucking weakness would result in total import value staying flat in 2014. Coupled with mild export gains with slightly better momentum in 2H14, this could yield a 2014 trade surplus of US\$16.2bn up from an estimated surplus of US\$6.2bn in 2013. We expect relief from the current account deficit risk amounting to a surplus of roughly 2.1% of 2014 GDP would be a by-product of real economy weakness traced to political uncertainty. Likelihood of a surplus would cushion politically-driven THB pressures.

FY14 budget deficit could narrow to 0.7% of GDP

The political crisis, which could delay FY14 implementation, particularly on the infrastructure side, would probably compress infrastructure spending to roughly 1% of FY14 GDP (vs 2.3% share of FY13 GDP). This resembles the episode of infra spending at 1.2% share of FY10 GDP when political events also affected fiscal disbursements. Infra spending has been on the decline since Aug with double-digit drops in Sep-Nov but with strong base effects. As a result, we expect primary fiscal expenditures to drop 5%YoY in FY14 following a 10.1% growth in FY13. Primary expenditures in Oct-Nov kickstarted FY14 with a 16%YoY decline. Total revenues, on the other hand, dropped 10.6%YoY after a 20%YoY gain in Oct, also on severe base effects. We expect a mild rise of 1.5% for government cash receipts given a weak GDP backdrop. The ensuing primary balance in FY14 would be a surplus of Bt24.3bn following the preceding year's primary deficit of Bt120.6bn. Overall, the FY14 budget deficit could narrow to Bt87bn after an FY13 fiscal deficit of Bt217.5bn. The political crisis and its impact on infra spending and disbursements in general would provide relief to the fiscal gap but constrain growth.

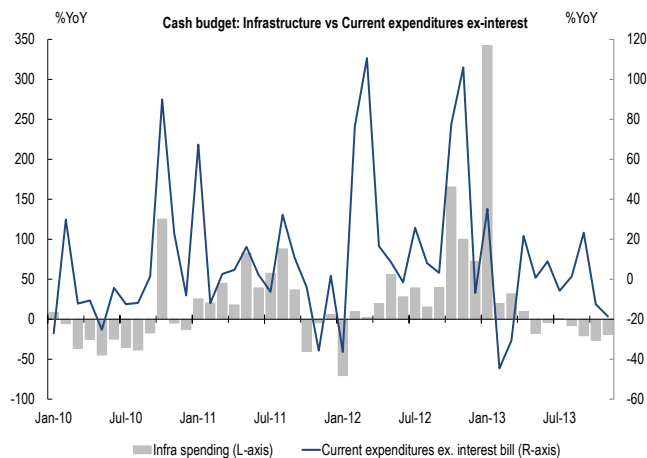
Rising core CPI coincident with weak THB

Core inflation closed 2013 higher at 0.91%YoY coincident with the THB's depreciation of 5.6%YoY in Dec . Core has edged up since Sep, which is roughly the same month in which THB started to wane, in line with Fed tapering risk/strong USD. This correlation of core with THB weakness stood out in 4Q13 since the average dollar import price index of Thai imports has consistently declined YoY (4Q13: -1.6%YoY) while 12-mo. inflation expectations according to BoT's monthly surveys eased since June-July. With the economy in 2014 expected to grow at a pace that's materially less than potential, imported inflation caused by a weak THB would not cause significant upside inflation risk; neither do we anticipate an environment of rapid 'cost pass-through'.

Absent fiscal stimulus, rate easing outlook beckons

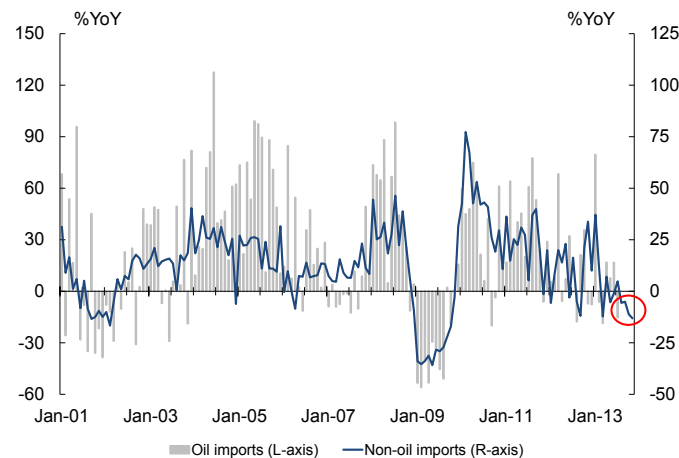
The cost to the economy of the current political crisis could provide a compelling case for policy rate easing. When the political crisis broke in Nov, the MPC manifested its dovish concerns and made a 25bp policy rate cut to 2.25% while allowing THB to weaken. With the Bangkok shutdown and upcoming political challenges that may impact consumer/business sentiment and translate into sustained lackluster spending, there is a strong case for further monetary stimulus. Considering the fiscal paralysis brought about by the crisis as well, sustained low rates following the option to cut would help cushion the expected GDP downturn and accelerate recovery prospects when political stability returns. The tradeoff from a rate cut is a THB vulnerable to weakness as Fed tapering intensifies. The impact of a weak THB on core CPI may prevent a steep rate cut outlook.

Figure 98. Slumping infra spending & current expenditures in Oct-Nov



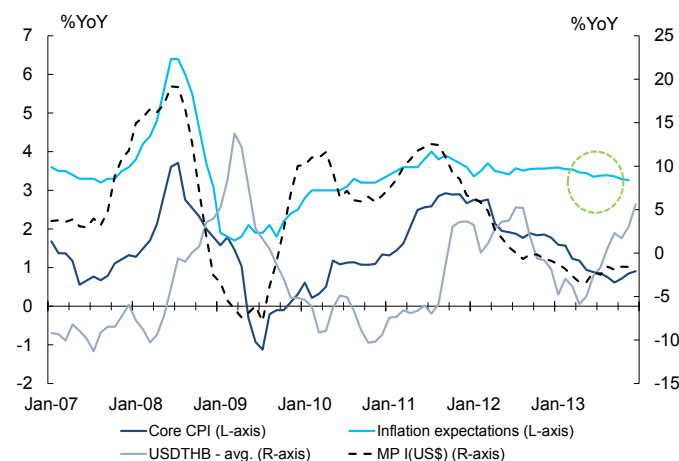
Source: CEIC, Citi Research

Figure 99. Non-oil imports likely to decline as spending sputters



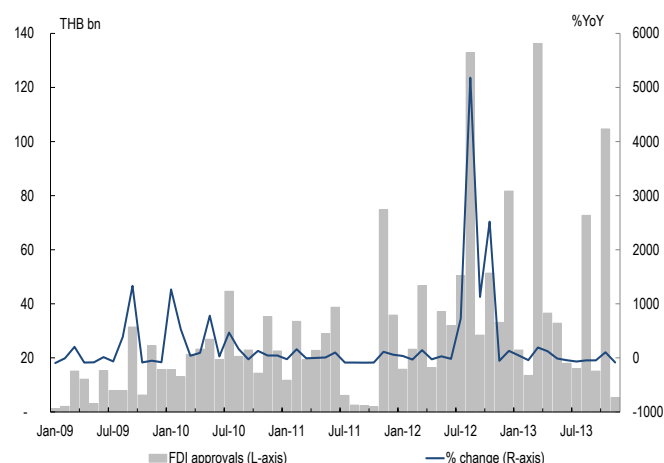
Source: CEIC, Citi Research

Figure 100. Rising core CPI coincident with weaker THB



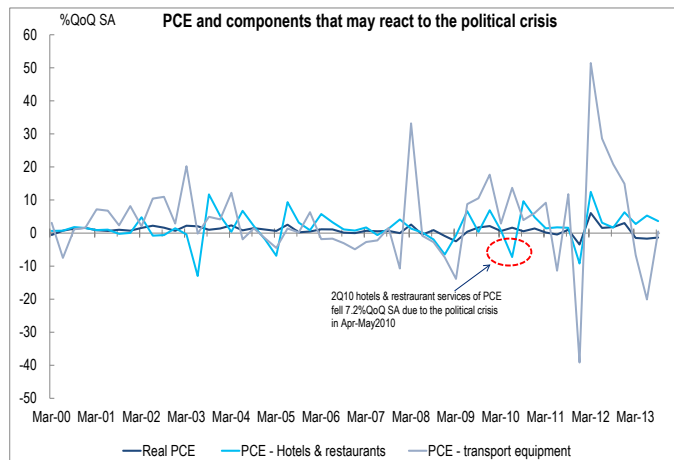
Source: CEIC, Citi Research

Figure 101. Likely delays in rollout of FDI approvals



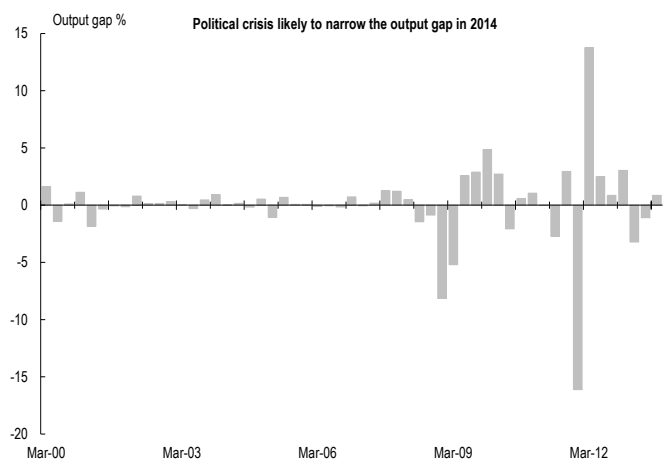
Source: Citi, CEIC Research

Figure 102. Political crisis may drag PCE hotel/restaurant/transport eqp't



Source: CEIC, Citi Research

Figure 103. Less inflation if output gap narrows



Source: CEIC, Citi Research

Figure 104. Thailand Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Summary Data									
Nominal GDP, US\$ bn	265.2	276.1	263.8	319.3	346.1	366.4	387.3	377.3	427.7
Nominal GDP, local currency bn	8,525	9,080	9,042	10,105	10,540	11,375	11,954	12,452	13,297
GDP per capita, US\$	4,207	4,355	4,153	4,998	5,401	5,685	5,979	5,796	6,537
Population, mn	63.0	63.4	63.5	63.9	64.1	64.5	64.8	65.1	65.4
Unemployment, % of labour force	1.4	1.4	1.5	1.0	0.7	0.7	0.9	0.8	0.8
Economic Activity									
Real GDP, % yoy	5.0	2.5	-2.3	7.8	0.1	6.5	2.8	1.8	3.9
Real investment growth % yoy	1.0	8.1	-25.2	28.7	0.1	16.8	0.6	-8.7	5.6
Real consumption growth % yoy	2.9	2.9	0.1	5.1	1.3	6.8	1.7	2.5	3.6
private consumption growth % yoy	1.8	2.9	-1.1	4.8	1.3	6.7	0.9	2.2	3.5
Real export growth, % yoy	7.8	5.1	-12.5	14.7	9.5	3.1	4.3	3.8	5.3
Real import growth, % yoy	4.4	8.9	-21.5	21.5	13.7	6.2	2.6	0.9	5.7
Prices, Money & Credit									
CPI, % yoy	3.1	0.4	3.5	3.1	3.5	3.6	1.7	2.5	2.9
CPI, % avg	2.2	5.5	-0.9	3.3	3.8	3.0	2.2	2.3	2.8
Nominal wages, % yoy	3.0	10.5	-1.9	5.8	7.2	11.9	5.5	4.0	3.5
Credit extension to private sector, % yoy	29.3	6.3	2.5	18.8	18.3	14.0	10.5	11.5	12.5
Policy interest rate, % eop	3.25	2.75	1.25	2.00	3.25	2.75	2.25	2.00	3.00
1 month inter-bank rate, % eop	3.74	3.07	1.28	2.03	3.26	2.79	2.31	2.10	3.10
Long term yield, % eop	5.13	2.84	4.37	3.74	3.28	3.55	4.07	3.90	4.50
lc/US\$, eop	30.05	34.79	33.36	30.07	31.57	30.60	32.70	32.09	30.01
lc/US\$, avg	32.33	33.03	34.33	31.71	30.48	31.08	30.72	32.74	30.80
Balance of Payments, US\$ bn									
Current account	15.7	2.2	21.9	10.0	4.1	-1.5	-3.6	8.3	-4.3
% of GDP	5.9	0.8	8.3	3.1	1.2	-0.4	-0.9	2.2	-1.0
Trade balance	26.6	17.3	32.6	29.8	17.0	6.0	6.2	16.2	2.5
Exports	151.3	175.2	150.8	191.6	219.1	225.9	223.6	233.7	246.5
Imports	124.6	157.9	118.2	161.9	202.1	219.9	217.4	217.4	244.1
Net service and Transfer accounts	-8.0	-12.9	-6.4	-10.7	-10.6	-3.4	-2.5	-0.6	-0.8
Income balance	-3.0	-2.3	-4.4	-9.0	-2.3	-4.0	-7.2	-7.3	-6.0
FDI, net	8.3	4.4	0.7	4.5	5.0	-2.0	-0.7	1.2	1.0
International reserves	87.5	111.0	138.4	172.1	175.1	181.6	167.2	170.0	180.0
Total Amortisations	20.3	15.4	11.3	9.4	8.8	9.5	18.0	19.0	20.0
Public Finances, % of GDP									
Consolidated government balance	-1.6	-1.0	-5.7	0.0	-1.0	-2.1	-1.8	-0.7	-1.8
Consolidated gov primary balance	-0.3	0.2	-4.5	1.1	-1.5	-1.6	-1.2	0.2	-0.7
Public debt	38.3	37.3	45.2	42.6	41.7	45.4	45.9	47.2	48.1
of which Domestic	33.4	33.0	40.9	39.0	38.4	42.3	42.7	43.0	43.3
Foreign Assets & Liabilities, US\$ bn									
External debt	74.4	76.1	75.3	100.6	104.3	130.7	132.3	135.0	140.0
Private	71.6	72.7	69.4	87.9	88.1	104.5	106.7	108.4	112.9
Public	2.8	3.4	5.9	12.7	16.2	26.2	25.6	26.6	27.1
External debt / GDP	28.1	27.6	28.5	31.5	30.1	35.7	34.2	35.8	32.7
External debt / XGS	41.0	36.5	41.6	44.5	40.0	47.5	47.7	46.3	45.4
Short-term debt	33.7	32.5	33.3	50.7	47.3	58.2	60.0	59.8	61.0
Short-term debt/International Reserves (%)	38.6	29.3	24.0	29.4	27.0	32.0	35.9	35.2	33.9
Quarterly Economic Indicators									
	2013 Q2	2013 Q3	2013 Q4F	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F
GDP, % yoy	2.9	2.7	0.5	0.0	1.0	2.8	3.5	3.7	3.8
CPI, % yoy	2.3	1.4	1.7	2.1	2.3	2.4	2.5	2.6	2.7
Policy interest rate, % eop	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.25	2.50
1 month inter-bank rate, % eop	0.00	2.55	2.55	2.10	2.10	2.10	2.10	2.30	2.60
Long term yield, % eop	0.00	3.94	3.94	4.15	3.90	3.85	3.90	4.00	4.25
lc vs USD, eop	31.14	31.24	32.70	33.34	32.96	32.58	32.09	31.58	31.06

Source: CEIC Data Company Ltd, Fitch, IFS, Moody's and Citi Research estimates

*Note: Public debt is central government debt and external debt is based on the residency of the holder of the debt (not by currency denomination).

Frontier Asia

Mongolia

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All eyes back on OT negotiations. Hopes are again raised as Erdenes OT director Ganbold was quoted in UB Post that OT negotiations could be concluded by this month (this would allow sufficient time for Rio to complete its financing with the banks consortium before its recently-agreed deadline in March). The restarting of OT phase II is crucial to alleviate Mongolia's fiscal, BOP, and exchange-rate issues. Latest data (Nov) are still rather unattractive with CA deficit at US\$3bn, FDI at US\$2.1bn (ytd), and FX reserves at US\$2.3bn (Dec will be boosted by both the DBM sumari bond and the MIAT financing by US EXIM Bank). Exports in 2013 were down 2.6%YoY (2H improvements were noted with a restart of coal exports to China and the 200mn tonnes of additional OT copper exports in 2H13).

The State Policy on Minerals for 2014-2015 has been approved by parliament.

An clause unfriendly to investors that allows the state to take mineral deposits into state reserves was removed. These are positive steps, along with the repealed New Investment Law, but FDI in mining appears to still be waiting for OT progress.

DBM issued Sumari bond of Y30bn (~US\$290mn) end-Dec13, by making use of the 0.5ppt of GDP gap left under the 2013 FSL public debt of 50% cap. As the parliament rejected the bill to raise 2014's debt ceiling, many would wonder if the 2014 GDP increase would be sufficient to keep debt to GDP ratio $\geq 40\%$. Nonetheless, the Sumari DBM issuance and under-spending of the Chinggis bond so far reduces the government's need for USD bond issuance in 1H14.

The banking sector continues to be a lurking risk, as recently flagged again by Moody's ratings downgrade of Mongolia banks to negative. We have also previously highlighted the central bank's expansionary stance is fueling the domestic economy vigorously. As of 15 Jan, MNT472.6bn worth of mortgages have been refinanced by the 8% subsidized mortgage program. We are not seeing any exit plans being put together to exit such large scale non-conventional monetary easing by BoM. The monetary expansion has already driven up M2 growth to 24.1%YoY and CPI to 12.5% at Dec13. The 2013 NPL ratio has also climbed 1%pt to 5.3%YoY, and we worry this could rise further with the banks' concentrated lending practices.

Sri Lanka

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Current account deficit narrowed more than expected. The "2014 Roadmap" highlights a smaller 2013 CAD forecast (US\$2.6bn, or 3.9% of GDP), from 2012 (6.6% of GDP). Oct-Nov goods trade shows a pronounced YoY export rebound + import compression. While income deficit is reported with a huge lag, other CA components have steadily risen, and the *Roadmap* further reveals strong increase in transport-related services receipts. We lowered our 2013 CAD forecast to 4% of GDP (from 4.6%) but we don't expect CAD to narrow sharply as CBSL envisions in 2014F to 2.1% of GDP (we maintain our 2014 CAD forecast of 3.1% of GDP) as we see rebounding domestic growth could lead imports to pick up.

Capital flows improved - reliance on debt flows still high, but FDI up nicely.

When combined with increased foreign inflows into Treasury securities and other sources of capital inflows, LK's int'l reserves are mildly up in 2013, but reserve coverage on the basis of ST debt (remaining maturity) still look relatively low. However, one encouraging sign is the increase in FDI, which we think climbed 40% YoY on a *net* basis (to US\$1.1-1.2bn), financed at least 40% of the CAD in 2013. On a gross basis, the *Roadmap* has a surprisingly high projection of FDI inflows (~US\$1.5bn in 2013 vs US\$0.9bn in 2012). We think a surge of FDI inflows in Nov-Dec should have coincided with much stronger imports, but this doesn't seem to be the case, based on CBSL's import number/projections.

Inflation remains relatively benign; we expect another 50bp cut. CBSL reverse repo cut to 8% was widely expected. Based on CBSL's more pro-growth bias and dovish tone on inflation, we expect another 50bps cut. After cumulatively cutting rates by 175bps since Apr 2012 plus a 200bps SRR cut in Jul 2013, there are now clearer signs this is feeding through to private sector credit and, given policy lags, needs to be managed in line with LK's lingering external vulnerabilities, plus inflation is very sensitive to food/fuel prices. We expect 2014 inflation (ave) at 6%.

Fiscal consolidation strategy hinges on higher growth, stable FX and lower rates – no revenue reform in sight. LK's lingering source of vulnerability is the lack of concrete measures to put public debt and deficits on a more assured consolidation track, with debt-to-GDP declines painfully slow in the last few years notwithstanding relatively strong growth. While domestic conditions don't look alarming as a source of potential shocks, the external environment remains fraught with risks, and that requires a lower degree of policy complacency.

Vietnam

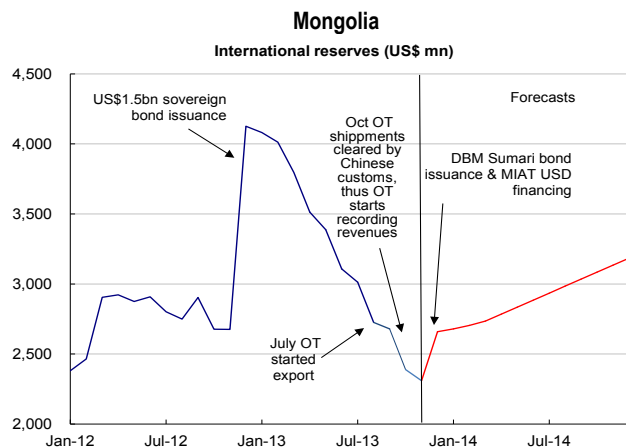
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We upgrade our growth projections following stronger-than-expected economic momentum in 2H13. The higher-than-expected 4Q13 growth (6.1%YoY) lifted 2013 growth to 5.4%, mainly driven by mfg. with the help of improving export demand (esp. tech). We continue to see upside growth risk in 2014-15 on the back of: 1) an export rebound (global GDP growth likely rose to 3.3% this year, from 2.5% in 2013); 2) strong FDI in mfg. (registered FDI reached US\$14bn by YE13, ~70% from mfg.) and its impact in boosting export capacity; 3) easing pressure on bank deleveraging, with some revival in property/construction. Thus, we raise our 2014F GDP forecast to 5.7% (prev. 5.5%), and 2015F to 5.9% (prev. 5.8%).

We now expect SBV to stay on prolonged hold, removing earlier call for a last cut. We slightly revised our 2014F inflation forecast to 6.9% (from 7.1%), and keep our 2015F forecast unchanged (7.2%). With growth looking slightly better and PM Dung reiterating the desire to curb inflation at 7% this year, we think the hurdle for a last SBV cut is higher than we thought earlier. Credit growth last year is also now rebounding marginally (12.5% by YE2013) to reach SBV's target, which also signals less urgency to cut from here. **We also expect the SBV will keep the VND stable and don't anticipate another round of modest devaluation that we saw in June 2013,** given the likely strong external position as the basic balance surplus mounts. SBV reportedly bought \$15bn in reserves in 2013.

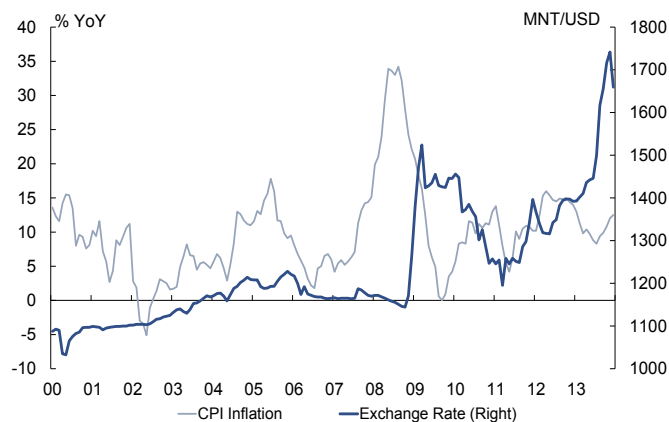
A number of recent reforms to address structural weaknesses in the banking/ SOE sector are underway, but progress still remains slow: 1) In order to speed-up the restructuring/M&A process in the banking system, gov't issued Decree 01 early this month (effective 20 Feb), and raised the 15% limit of foreign (strategic) investors' ownership for VN local banks to 20% (while caps for foreign individual and organization are 5% and 15%, respectively). However, the limit of banks' total foreign ownership remained unchanged (30% of chartered capital), but this can be loosened for weak banks, with the PM's approval. We are doubtful this persistent minority stake cap will have a meaningful impact and slow NPL progress remains a deterrent. 2) SOE restructuring also remained slow in 2013, but there have been some positive steps. Implementation of Decree 61 (issued in Jun 2013) this year will be key in improving transparency, with SOEs being required to disclose their financial information in "a standardized information disclosure system". This will be important, as gov't now plans to reduce its stakes in various listed companies in 2014-15, and raise the 49% cap on foreign ownership of listed companies to 60%. Opening up to foreign capital would be supportive of growth and support a further investment revival amid a dysfunctional banking system.

Figure 105. Mongolia – Reserves likely to improve starting Dec13



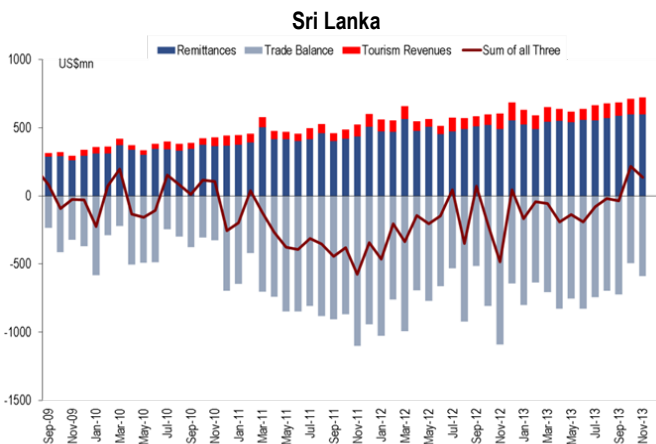
Source: BoM, CEIC and Citi Research

Figure 106. Dec's appreciation driven by proceeds of MIAT financing



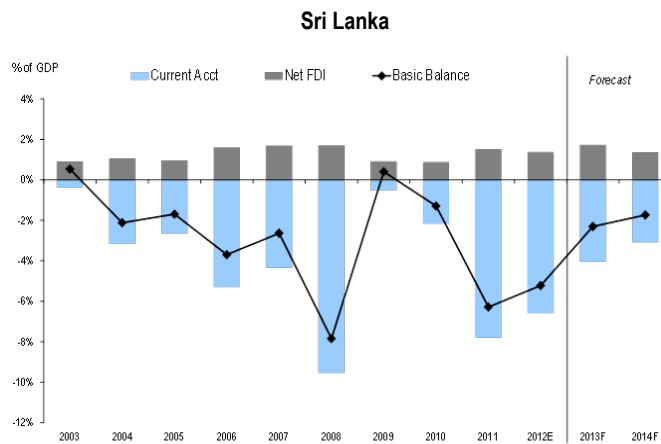
Source: BoM, CEIC and Citi Research

Figure 107. Sri Lanka – If we add the three regularly reported partial components of the current account, it shows an improving trend since mid-2013



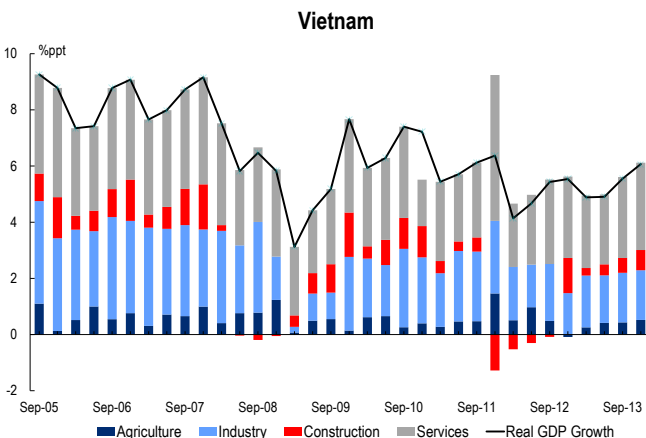
Source: CBSL, CEIC, and Citi Research

Figure 108. Basic balance (CA+ net FDI) deficit improved more dramatically than we thought



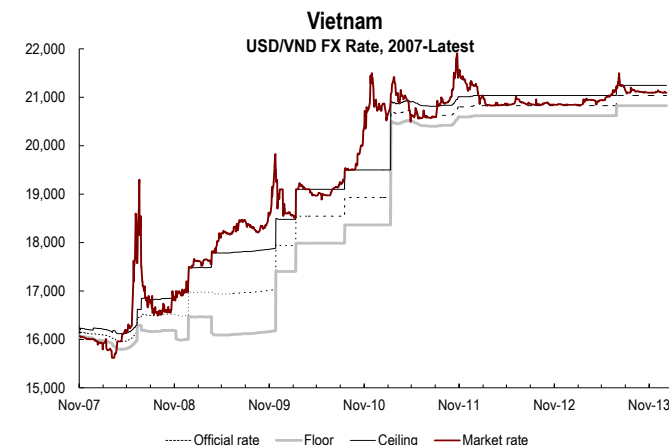
Source: CBSL, CEIC, and Citi Research

Figure 109. Vietnam – Mfg. persisted as the key driver to 2013 growth, followed by the Service sector



Source: CEIC and Citi Research

Figure 110. We no longer expect VND to devalue this year, USDVND likely to hover around the 21,160 range throughout this year



Source: Citi Research

Figure 111. Asia Frontier Economic Indicators

	2007	2008	2009	2010	2011	2012	2013F	2014F	2015F
Mongolia									
Nominal GDP, US\$ bn	4.2	5.6	4.6	6.2	8.8	10.3	10.1	12.7	16.0
GDP per capita, US\$	1,629	2,138	1,717	2,287	3,186	3,595	3,472	4,289	5,346
Population, mn	2.6	2.6	2.7	2.7	2.8	2.9	2.9	3.0	3.0
Real GDP, % yoy	10.2	8.9	-1.3	6.4	17.5	12.4	12.0	11.0	8.0
CPI, % yoy	15.1	22.1	4.2	13.0	10.2	14.0	12.5	13.1	11.5
CPI, % avg	--	28.0	8.0	10.1	9.2	14.3	10.5	13.6	12.0
Policy interest rate, % eop	8.40	9.75	10.00	11.00	12.25	13.25	10.50	11.00	11.50
Long term yield, % eop	21.83	20.58	21.67	20.07	16.61	18.11	15.61	16.81	16.81
lc/US\$, eop	1,172	1,275	1,433	1,233	1,378	1,378	1,660	1,641	1,576
lc/US\$, avg	1,171	1,167	1,434	1,349	1,256	1,353	1,505	1,688	1,600
Current account (US\$ bn)	0.3	-0.7	-0.4	-0.9	-3.4	-2.8	-3.2	-2.6	-2.6
% of GDP	6.3	-12.8	-8.9	-15.0	-38.4	-26.8	-31.7	-20.5	-16.2
Trade balance (US\$ bn)	-0.2	-0.7	-0.3	-0.3	-1.8	-2.4	-2.1	-1.8	-1.6
Exports (US\$ bn)	1.9	2.5	1.9	2.9	4.8	4.4	4.3	5.3	6.3
Imports (US\$ bn)	2.2	3.2	2.1	3.2	6.6	6.7	6.4	7.1	7.9
FDI, net (US\$ bn)	0.4	0.8	0.6	1.6	4.6	3.9	-2.3	3.3	3.0
International reserves (US\$ bn)	0.8	0.6	1.3	2.2	2.3	3.9	2.7	3.3	3.9
Consolidated government balance (% of GDP)	2.6	-4.5	-5.2	0.5	-6.9	-8.3	-8.0	-6.2	-2.9
Public debt (% of GDP)	36.0	30.6	44.2	28.7	28.9	42.1	50.0	57.9	60.0
Sri Lanka									
Nominal GDP, US\$ bn	32.4	40.7	42.1	49.6	59.2	59.4	67.6	73.6	83.8
GDP per capita, US\$	1,615	2,014	2,057	2,400	2,836	2,816	3,169	3,414	3,841
Population, mn	20.0	20.2	20.5	20.7	20.9	21.1	21.3	21.6	21.8
Real GDP, % yoy	6.8	5.9	3.5	8.0	8.2	6.4	6.8	7.0	7.0
CPI, % yoy	18.8	13.9	5.0	6.8	4.9	9.2	4.7	8.0	6.0
CPI, % avg	15.8	22.5	3.6	6.2	6.8	7.5	6.9	6.0	6.5
Policy interest rate, % eop	12.00	12.00	9.75	9.00	8.50	9.50	8.50	7.50	8.00
Long term yield, % eop	19.96	19.20	11.50	9.24	10.00	11.81	9.91	9.50	10.00
lc/US\$, eop	108.7	113.0	114.4	110.9	113.9	127.7	130.8	133.4	132.0
lc/US\$, avg	110.6	108.3	114.9	113.0	110.5	127.2	129.1	132.2	132.0
Current account (US\$ bn)	-1.4	-3.9	-0.2	-1.1	-4.6	-3.9	-2.7	-2.3	-2.6
% of GDP	-4.3	-9.5	-0.5	-2.2	-7.8	-6.6	-4.0	-3.1	-3.1
Trade balance (US\$ bn)	-3.7	-6.0	-3.1	-4.8	-9.7	-9.4	-8.7	-8.8	-9.7
Exports (US\$ bn)	7.6	8.1	7.1	8.6	10.6	9.8	10.5	11.5	12.6
Imports (US\$ bn)	11.3	14.1	10.2	13.5	20.3	19.2	19.2	20.3	22.3
FDI, net (US\$ bn)	0.5	0.7	0.4	0.4	0.9	0.8	1.2	1.1	1.0
International reserves (US\$ bn)	3.1	1.8	5.1	6.6	6.0	6.9	7.1	7.4	8.3
Consolidated government balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.9	-6.7	-6.0	-5.8	-5.6
Public debt (% of GDP)	85.0	81.4	86.1	81.9	78.4	79.1	79.0	77.0	76.0
Vietnam									
Nominal GDP, US\$ bn	77.5	98.3	101.6	112.8	121.7	141.5	156.6	175.9	195.8
GDP per capita, US\$	920	1,154	1,181	1,297	1,385	1,594	1,747	1,944	2,145
Population, mn	84.2	85.1	86.0	86.9	87.8	88.8	89.6	90.5	91.3
Real GDP, % yoy	7.1	5.7	5.4	6.4	6.2	5.2	5.4	5.7	5.9
CPI, % yoy	12.6	19.9	6.5	11.8	18.1	6.8	6.0	8.0	7.3
CPI, % avg	8.3	23.1	7.0	9.2	18.6	9.3	6.6	6.9	7.2
Policy interest rate, % eop	6.50	9.50	8.00	9.00	15.00	9.00	7.00	7.00	7.00
Long term yield, % eop	8.73	10.00	11.68	11.49	12.55	9.75	9.29	9.00	8.50
lc/US\$, eop	16,028	17,483	18,474	19,498	21,034	20,840	21,095	21,160	21,600
lc/US\$, avg	16,081	16,445	17,806	19,123	20,648	20,875	21,028	21,160	21,500
Current account (US\$ bn)	-7.1	-10.8	-6.6	-4.3	0.2	9.1	7.7	6.5	4.9
% of GDP	-9.1	-11.0	-6.5	-3.8	0.2	6.4	4.9	3.7	2.5
Trade balance (US\$ bn)	-10.4	-12.8	-7.6	-5.1	-0.5	9.5	8.9	8.0	6.2
Exports (US\$ bn)	48.6	62.7	57.1	72.2	96.9	114.5	132.8	156.7	180.2
Imports (US\$ bn)	59.0	75.5	64.7	77.4	97.4	105.0	123.9	148.7	174.0
FDI, net (US\$ bn)	6.5	9.3	6.9	7.1	6.5	7.2	7.3	7.6	7.7
International reserves (US\$ bn)	23.5	23.9	16.0	12.1	13.5	25.6	34.8	37.3	42.3
Consolidated government balance (% of GDP)	-5.3	-1.2	-7.2	-3.1	-3.2	-5.2	-5.3	-4.5	-4.0
Public debt (% of GDP)	35.9	34.5	42.8	44.9	43.3	43.0	44.5	44.6	45.0

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

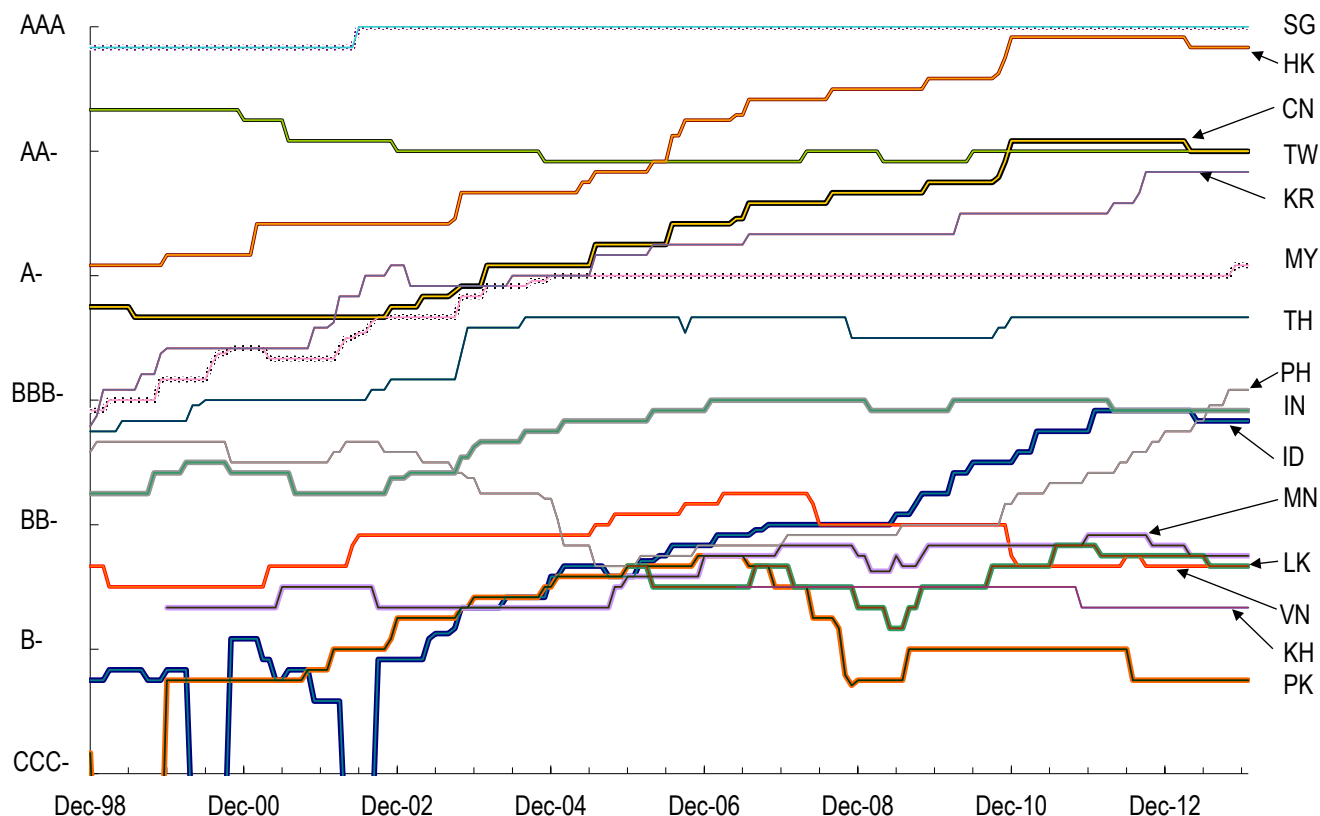
Appendix: Sovereign Risk Ratings Summary

Figure 112. Long-Term Foreign Currency Ratings

	S&P	Moody's	Fitch
AAA/Aaa	Hong Kong (stable) Singapore (stable)	Singapore (stable)	Singapore (stable)
AA+/Aa1	—	Hong Kong (stable)	Hong Kong (stable)
AA/Aa2	—	—	—
AA-/Aa3	China (stable) Taiwan (stable)	China (stable) Korea (stable) Taiwan (stable)	Korea (stable)
A+/A1	Korea (stable)	—	China (stable) Taiwan (stable)
A/A2	—	—	—
A-/A3	Malaysia (stable)	Malaysia (positive)	Malaysia (negative)
BBB+/Baa1	Thailand (stable)	Thailand (stable)	Thailand (stable)
BBB/Baa2	—	—	—
BBB-/Baa3	India (negative) Philippines (stable)	India (stable) Indonesia (stable) Philippines (positive)	India (stable) Indonesia (stable) Philippines (stable)
BB+/Ba1	Indonesia (stable)	—	—
BB/Ba2	—	—	—
BB-/Ba3	Bangladesh (stable) Mongolia (negative) Vietnam (stable)	Bangladesh (stable)	Sri Lanka (stable)
B+/B1	Sri Lanka (stable)	Fiji (stable) Mongolia (stable) Sri Lanka (stable)	Mongolia (negative) Vietnam (positive)
B/B2	Cambodia (stable) Fiji (stable)	Cambodia (stable) Vietnam (stable)	—
B-/B3	Pakistan (stable)	—	—
CCC+/Caa1	—	Pakistan (negative)	—
CCC/Caa2	—	—	—
CC+/Ca1 & Below	—	—	—

Source: S&P, Moody's, Fitch, Bloomberg

Figure 113. Ratings History (Average of S&P and Moody's Ratings), December 1998-January 2014



Source: S&P, Moody's, and Citi Research

Global Assumptions

	2013 Q3E	2013 Q4E	2014 Q1F	2014 Q2F	2014 Q3F	2014 Q4F	2015 Q1F	2015 Q2F	2013E	2014F	2015F	2016F	2017F	2018F
Global Indicators														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	2.5	3.3	3.4	3.6	3.5	3.4
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	2.6	3.0	3.1	3.4	3.5	3.5
Current Account (% of GDP)	—	—	—	—	—	—	—	—	0.7	0.7	0.6	0.3	0.1	0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-3.7	-3.1	-2.7	-2.5	-2.3	-2.2
Industrial Countries*														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	1.2	2.3	2.2	2.3	2.1	1.9
CPI Inflation (average, y/y %)	—	—	—	—	—	—	—	—	1.3	1.6	1.6	1.6	1.6	1.7
Current Account (% of GDP)	—	—	—	—	—	—	—	—	-0.2	0.1	0.2	0.1	0.1	0.2
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-4.8	-3.8	-3.0	-2.8	-2.5	-2.3
United States														
GDP Growth (SAAR %)	4.1	3.5	2.4	3.5	3.2	2.9	3.2	3.1	—	—	—	—	—	—
GDP Growth (y/y %)	2.0	2.8	3.1	3.4	3.1	3.0	3.2	3.1	1.9	3.1	3.1	3.2	2.7	2.2
CPI Inflation (average, y/y %)	1.1	0.9	1.1	1.6	1.6	1.7	1.7	1.7	1.1	1.5	1.7	2.2	2.3	2.2
Current Account (% of GDP)	-2.2	-2.2	-2.0	-1.9	-1.8	-1.8	-1.7	-1.7	-2.3	-1.9	-1.6	-1.8	-1.7	-1.4
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-5.8	-4.6	-3.9	-3.9	-3.8	-3.8
S&P 500 EPS (y/y %)	6.5	7.4	6.1	6.2	6.1	8.5	NA	NA	6.1	6.7	7.2	—	—	—
Business Investment (y/y %)	3.5	2.9	5.5	6.1	6.5	6.1	6.1	5.6	2.8	6.1	5.5	—	—	—
Imports (y/y %)	1.6	3.4	3.5	2.9	3.6	4.2	5.6	6.1	1.6	3.5	6.0	—	—	—
Japan														
GDP Growth (SAAR %)	1.1	3.5	4.7	-4.7	1.7	1.4	0.9	1.6	—	—	—	—	—	—
GDP Growth (y/y %)	2.4	3.1	3.2	1.1	1.2	0.7	-0.2	1.4	1.7	1.6	1.0	1.2	1.2	1.0
CPI Inflation (y/y %)	0.9	1.2	1.3	3.3	2.8	2.8	2.7	0.8	0.3	2.6	1.6	1.6	0.7	1.0
Current Account (% of GDP)	0.1	-0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.7	0.4	0.3	0.8	1.0	1.0
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-9.8	-8.0	-6.2	-5.8	-5.4	-5.0
Euro Area														
GDP Growth (SAAR %)	0.3	1.1	1.2	1.1	1.2	1.2	1.2	1.3	—	—	—	—	—	—
GDP Growth (y/y %)	-0.4	0.5	1.0	1.0	1.2	1.2	1.2	1.2	-0.4	1.1	1.3	1.4	1.5	1.5
CPI Inflation (y/y %)	1.3	0.8	0.8	1.0	0.8	1.1	1.0	0.8	1.4	0.9	0.8	1.2	1.7	1.8
Current Account (% of GDP)	—	—	—	—	—	—	—	—	2.2	2.5	2.6	2.6	2.5	2.3
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-2.9	-2.5	-2.0	-1.6	-1.4	-1.1
Exchange Rates														
US\$ vs. Euro (eop)	1.35	1.37	1.37	1.39	1.40	1.40	1.40	1.41	1.32	1.39	1.41	1.41	1.41	1.41
US\$ vs. JPY (eop)	98	105	105	106	107	108	110	111	98	107	112	115	115	115
JPY vs. Euro (eop)	133	145	145	147	149	152	154	157	130	148	158	162	162	162
Short Interest Rates (eop)**														
United States	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.40	1.50	2.70	3.80
Japan	0.08	0.07	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50
Euro Area	0.50	0.50	0.25	0.00	0.00	0.00	0.00	0.00	0.50	0.06	0.00	0.06	0.50	1.00
10-Yr Yield Forecasts (Period Avg.)														
United States	2.61	3.03	2.85	3.10	3.20	3.30	3.50	3.50	2.35	3.05	3.55	3.85	4.15	4.35
Japan	0.69	0.74	0.65	0.55	0.70	0.85	0.95	1.05	0.71	0.69	0.98	1.25	1.50	1.50
Euro Area***	1.78	1.93	1.75	1.70	1.70	1.80	1.90	1.90	1.60	1.74	1.90	2.15	2.40	2.65
Emerging Markets														
GDP Growth (y/y %)	—	—	—	—	—	—	—	—	4.6	4.8	5.0	5.4	5.5	5.3
CPI Inflation (eop, y/y %)	—	—	—	—	—	—	—	—	4.7	5.1	5.4	5.1	5.1	5.0
Current Account (% of GDP)	—	—	—	—	—	—	—	—	1.9	1.7	1.1	0.5	0.1	-0.1
Fiscal Balance (% of GDP)	—	—	—	—	—	—	—	—	-2.0	-2.1	-2.1	-2.0	-2.1	-2.1
Commodities														
WTI Oil price (US\$/bbl)	108.0	97.6	97.0	89.0	97.0	88.0	91.0	83.0	98.0	92.8	86.3	83.0	78.0	80.0
Copper (Average, USD/MT)	7,096	7,169	6,800	6,700	6,600	6,500	6,500	6,600	7,169	6,650	6,825	7,500	7,800	8,000
Gold (Average, US\$/oz)	1,330	1,274	1,250	1,230	1,260	1,280	1,300	1,340	1,274	1,255	1,350	1,370	1,400	1,420

Note: *It includes: US, Japan, Germany, France, Italy, Spain, Netherlands, Belgium, Finland, Denmark, Norway, Sweden, Switzerland, United Kingdom, Canada, Australia, and New Zealand. **Annual average from 2013 on. ***Ten-year Bond yield. Sources: National authorities and Citi Research.

Recent Publications

Country/Region	Topic	Aurthor	Date
India	Ujjit Patel Committee Report – It's Positive and Bold... but Risky	Rohini Malkani, Anurag Jha	22-Jan-14
Global	Stronger Global Growth	Willem Buiter, Michael Saunders	22-Jan-14
China	Beijing Trip Notes: Reform Hopes	David Lubin, Johanna Chua	16-Jan-14
ASEAN	Chartbook: Banking on G3 Recovery on Domestic Constraints	Wei Zheng Kit, Helmi Arman, Jun Trinidad	9-Jan-14
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Asia-Pacific Economics and Market Analysis

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Notes

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